How lenders make — and monitor — credit decisions

Reports on Credit — Issue 6

You fill out a credit application. Later — sometimes seconds, sometimes a week or two — you get your answer, "yes" or "no."

This issue of Reports on Credit answers these important questions:

- How do lenders decide whether to grant you credit?
- What are credit scores?
- What is account monitoring?
- What are inquiries?

How do lenders decide whether to grant you credit?

When lenders review credit applications and credit reports, the number one thing they look for is financial risk. If they lend you money, extend you credit, or give you goods and services, will you pay them back?

Lenders may consider your income, how long you've lived at your current address, how long you've worked for the same employer, what kind of assets you have and the balances in your bank accounts. Often, though, your credit history has the most impact on their decision.

- **Rule 1: Establish a credit report.**
  You need a credit history to get new credit. Your credit report acts as your financial references.
- **Rule 2: Always pay as agreed.**
  Late payments, also called delinquencies, negatively affect your ability to get credit. Late payments in the past indicate a stronger likelihood that you will make late payments again or be unable to pay your debts in the future.
- **Rule 3: Get a credit card and keep your balances low.**
  Car loans and mortgages are important, but your revolving credit says more about how you manage debt. When you keep your balances low compared with your credit limits, it shows lenders that you aren't tempted to charge more than you can pay.
- **Rule 4: Use caution when closing accounts.**
  Closing an account isn't always a good thing. It can result in the loss of long, positive history, and it can increase your balance-to-limit ratio, also known as your utilization rate, making you appear to be an increased credit risk.
- **Rule 5: Apply for credit judiciously.**
  Don't apply for multiple accounts within a short period of time. Recent inquiries tell lenders that you may have taken on new debt, and too many inquiries within a short period of time can be a sign of financial distress.

- **Rule 6: Time is the key.**
  It takes time to build a credit history and for changes to be updated.
- **Rule 7: Demonstrate stability.**
  Your credit history isn't the only thing lenders look at. Having stable employment, living at the same address and building other assets over time are all ways you can demonstrate that you are financially sound.
- **Rule 8: Have a plan.**
  Be accountable for your decisions and know how you are going to repay your debts.

What are credit scores?

Some lenders make hundreds — even thousands — of credit granting decisions every day. To help make those decisions, they use a decision-making tool called a credit score.

Essentially, a credit score is a statistical summary of the information in a credit report at the moment it is reviewed. It's often calculated while your credit report is delivered electronically from the credit reporting company to your creditor. It's not part of your credit history, and it doesn't appear on your personal credit report.

There are many sources of credit scores. Specialized divisions of some credit reporting companies and many other independent companies develop credit scores for credit grantors. Some credit grantors develop their own credit scores.

Different scoring systems measure various types of risk, such as bankruptcy, profitability or collectability. In addition, there are scoring systems for different types of lenders or lending, such as auto loans, mortgages, banks and credit unions.

Even if there were only one type of credit score, not all credit grantors would use it in the same way. Any given risk score could:

- Result in the extension of credit by one lender and a denial by another.
- Meet a particular lender's test at one time and fail sometime later as the lender changes its risk criteria.
- Affect the kind of credit — or the rate — offered to a consumer by a particular lender.

That's because different credit grantors view the same credit score differently. It all depends on their experiences with other consumers scoring in the same range, their marketing plans, their business niches and many other factors.

If your application is declined based on a credit score, don't focus on the number, because the numbers vary depending on the scoring system used. Instead, concentrate on the factors that most affected the score. You can improve your creditworthiness and your credit scores for any lender by using those factors to change your credit over time.

To better understand how lenders will view your risk level, you can purchase a credit score report that identifies what in your personal credit history most affects your creditworthiness. Educational credit scores are available from many sources, including www.experian.com, www.experian.com/consumer-products/vantage-score and www.experian.com/consumer-products/credit-score.

What is account monitoring?

Once lenders say "yes," they might review your credit report regularly as they continue to manage their financial risk. This automated process, called account monitoring, scans credit reports for certain risk characteristics as defined by the lender.

Some lenders review their accounts frequently. Others review accounts once a year, and some don't review at all. It's often easy to see how this benefits you. For instance, you might receive a notice that your credit limit has been increased — without having to ask.

Account monitoring also lets lenders reduce losses by decreasing a person's credit limit or charging a higher interest rate when the person shows signs of increasing default risk. This helps them minimize their losses, so they don't have to pass the cost of others' bad debts on to you in the form of higher fees and interest rates.

What are inquiries?

An inquiry is a record that someone — you or a busines — asked to review your credit report. At Experian, inquiries remain on a credit report for two years.

Potential lenders wont see inquiries made for the purposes of employment, automated account monitoring, preapproved credit offers or requesting your own report. These inquiries appear only on your personal credit report and don't affect lending decisions or credit scores.

Inquiries resulting from your application for credit will be shown to lenders, so they can affect credit scores. This is important because such inquiries indicate that you've applied for new credit, which could result in additional debt that does not yet appear as an account entry in your credit report. Therefore, potential lenders may view multiple recent inquiries as a sign that you're beginning to overextend yourself.

Both types of inquiries appear on your personal Experian credit report.

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