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8 Myths About Credit Scores

By Doug Leeson, Principal

MYTH #1

Checking my credit score hurts my credit score

Many consumers are confused about the difference between a hard inquiry, in which a financial firm is considering making a loan to you, and a soft inquiry in which, say, an employer is conducting a background check or a utility company is setting up a new account for you. If you're trying to refinance your mortgage or sign up for a store credit card—that is, if credit might be extended—those hard inquiries could each drop your score by a few points. True, there are gray areas that could contribute to the confusion. For example, some home-rental applications are hard inquiries, others are not. You can usually open a bank account with no impact, but signing up for overdraft protection might mean a hard query.

Still, there is no confusion when it comes to seeking information about your own score. That is always a soft inquiry and won't cost you points. In fact, doing a self-check on your score can empower you to take charge of your credit reputation. Both of the leading scoring models, FICO and VantageScore, are available free. Most mortgage lenders use FICO scores, which everyone can get through Discover's Credit Scorecard. Similarly, Mint can provide your VantageScore 3.0., which is relied on especially by the credit-card and auto sectors.

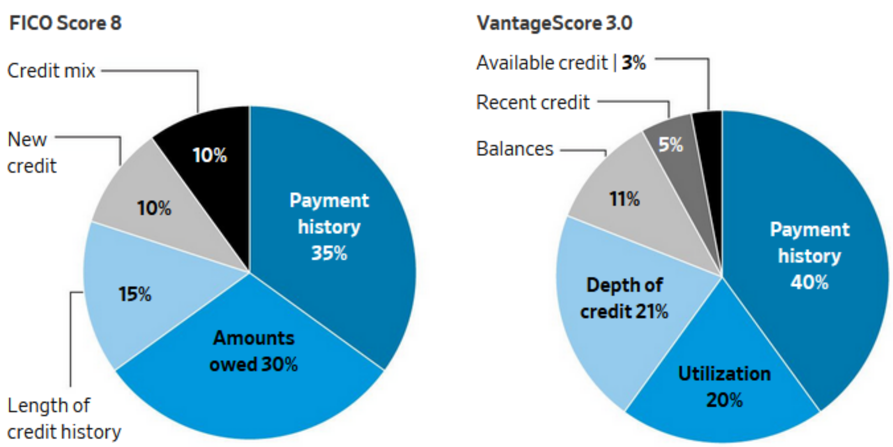
Merely knowing your score can improve it, according to a paper published in July 2019 by the National Bureau of Economic Research. Over 400,000 student-loan borrowers were sent a quarterly email reminder about the availability of their FICO scores. On average, their scores increased about eight points over a year compared with borrowers who weren't getting the alerts. They were also 4% less likely to miss a monthly payment.

MYTH #2

If I pay my bills on time, that's all I need to worry about

For many consumers, the assumption is that on-time bill payment is all that matters when it comes to a good credit score. But that assumption forgets about the importance of credit utilization, which is the percentage of debt you owe compared with the total available credit that's been granted to you. Utilization is one of the most important components of your score. If your credit cards are maxed out, your score won't look good even if you're paying promptly. A rule of thumb is to use less than 30% of your available credit each month and ideally less than 10%.

What Makes Up Your Credit Score



Sources: Fair Isaac Corp., VantageScore Solutions

Another key strategy to consider is calling your card issuer to ask for a higher credit limit. If successful (and 85% of the time it is, according to CreditCards.com, a credit-card comparison site), the request would instantly lower your credit utilization.

MYTH #3

Carrying a balance helps boost my credit score

One persistent misconception is that to build a strong credit score people should demonstrate activity by keeping a charge on their credit cards at all times; that is, they should carry debt over from month to month.

In fact, 22% of consumers who said they had carried a balance did so mistakenly believing that it would help their credit score, according to a 2018 survey by CreditCards.com. But they are wrong: Keeping a balance on your cards doesn't help and could set back your financial goals, which are better served by consistently paying off credit-card debt in full.

MYTH #4

Closing an old credit card with a high interest rate will help my score

Sometimes the first credit cards we get—when our credit profiles aren't well established—have higher interest rates than the more competitive cards we can qualify for as our credit usage matures. And people, especially those with low scores, often assume that shedding some credit cards will help boost a credit score. So they close the cards with the higher interest rate and keep the ones with the lower rates.

But the truth is that closing an older credit card won't help your score—and it might actually hurt you.

FICO and VantageScore differ on how they factor for a closed credit-card account. FICO ignores the closed account status and continues averaging its age with your active accounts. But your VantageScore will fall because the closed account essentially disappears from their calculation, shortening the overall longevity of your remaining accounts and erasing your good payment record from the closed account.

Regardless of scoring model, a better move, according to Ms. Marineau of Credit Karma, is to pay off any higher-interest credit cards and then keep them open—either with an occasional charge you promptly repay in full, or by putting a small monthly subscription, such as Netflix, onto it, and auto-paying it so that you don't have to think about it. That way, it helps with longevity but can no longer hurt you.

MYTH #5

Opening a new retail credit card is a good for your score

Retailers constantly tempt us to open a new store card by offering a purchase discount or a promotional 0% interest period. And some consumers believe that doing so can help their credit if they pay off the balance within the promotional period. But every time we open a new credit card—or take out a loan or qualify for a mortgage, for that matter—the overall average age of our credit takes a hit, and the hard inquiry subtracts more points from our credit score.

An exception might be for a young person just starting out. If they've made it through school without student loans and have been reliant on debit cards, they've essentially been invisible to the credit industry. So getting that first credit card is important to building a thicker credit file, and retail cards are often among the easiest to qualify for. For those people, the myth may be accurate after all.

MYTH #6

It hurts my credit score to comparison shop for a mortgage, auto or student loan

People looking for a lender sometimes opt for the first deal or interest rate they are offered, fearing that the credit queries from too many lenders will lower their scores. But, the reality is that the scoring models assume you're going through a shopping process. If they see different lenders pulling your credit score around the same time, they bundle multiple requests as a single query.

But you have to do that shopping fairly quickly. I learned that lesson when I recently bought a home. I had checked with two different lenders over the summer, which meant two hard inquiries that cost me points. When I spotted the credit-score damage from both prequalification applications I stopped shopping around because I wanted to keep my score high enough to get the best interest rate.

VantageScore's shopping period is 14 days. FICO has various scoring models that lenders might look at, with shopping periods ranging from 14 to 45 days during which multiple inquiries count as one.

MYTH #7

Selecting ‘credit’ while using your debit card for a purchase is good for your score

When you choose to make a credit-type purchase with your debit card, your credit score doesn’t benefit—or suffer—from any of those transactions. Still, a survey of 1,051 adults by Credit Card Insider found that 42% of respondents thought using their debit card or selecting the credit option on a debit-card purchase would help their score.

Your bank typically won’t report any debit-card activity to the credit-reporting companies. The main difference is that choosing the credit option on your debit-card purchase means the funds could take up to three days to post, whereas the debit option means immediate withdrawal.

MYTH #8

Credit reports are accurate

Most consumers are unaware of what’s being said about them between their lenders and the credit-reporting companies. And too many people wrongly assume that what ends up on their credit report—and the resulting credit score—must be correct.

The Federal Trade Commission says 21% of consumers studied in 2012 found errors that resulted in modifications by the credit-reporting firms. In 5% of the total number of consumers studied, the error was so serious as to affect the terms of any credit they might be granted.

Errors come from many sources. Sometimes, it’s a mixed file in which activity from someone with your same name has been conflated with yours. Your ex-spouse’s debts could still be showing up in your file. It could be a clerical error because your handwriting was misread. Sometimes, a creditor mistakenly reports a late payment. In some more serious cases, it’s identity theft or fraud, which might show up on your report as a credit card or other account you never applied for.

The best way to deal with mistakes is to catch them early by regularly looking at your credit report. You are entitled to a free copy of your credit report annually from each of the credit-reporting companies (TransUnion, Experian and Equifax). You can request them at AnnualCreditReport.com or by calling 1-877-322-8228. Experts suggest you stagger the requests every four months between the three companies in order to keep an eye on your credit record all year long.

Sources: Wall Street Journal, October 21, 2019. National Bureau of Economic Research, Working Paper #26110, July 2019.