Credit Myths that Lead to Disaster

The media and the credit reporting companies have done an excellent job promoting the notion of having a good credit score, almost too good a job because people seem to think that their credit score is the most important aspect of their financial life. Getting out of debt is secondary. Saving for retirement is secondary.

It is almost as if when you have that perfect credit score of 720 or higher, then your life will suddenly become perfect. The advertising is working because even though everyone in the U.S. can order their credit report for free, every year millions of people are going to services that cost them $36 a year to get their “free” report.

People are obsessed with getting and keeping an excellent credit score. We hear these statements regularly on our financial helpline:

A caller who cannot pay their monthly bills because their debt payments are so high says, “I can’t go to credit counseling because I heard it will damage my credit score.”

A caller who is not saving in their 401(k) and missing out on the company match says, “I don’t want to pay off my credit cards. I am keeping a balance to help my credit score.”

This makes no financial sense. People are not going to seek help getting out of debt – lowering the interest rate and possibly the balance owed – because it will hurt their credit score? How is this helpful? If people do not get their debt under control, they may *never* retire. We’ll have a nation of people working into their 80’s with no savings but they can all come together and brag about their credit scores.

Do not even get me started with the notion that carrying a balance on a credit card will somehow help the score. First, it is wrong and secondly, people are harming themselves financially – thinking that paying high interest on credit cards instead of paying them off is a good financial strategy.

Do not get me wrong, having a good credit score has value; it can save on the cost of borrowing money so it is helpful to have the best score possible.   Just make sure you are basing your credit strategy on sound information – not common myths that get you nowhere.

Let us examine some of the biggest credit myths that can lead to disaster:

Assuming if you pay your bills on time, you do not have to do anything else.

Paying your bills on time accounts for about 35% of your credit score but there is another 65% which includes amount owed (30%), length of credit history (15%), new credit (10%) and type of credit (10%). Consider all the other factors.

Also remember that there may be errors on your credit report so if you do not check it, you will never know, and your score will be affected. According to Deborah McNaughton, author of The Get Out of Debt Kit, 80% of credit reports have errors (as cited by Bankrate.com). Many of the erroneous reports had missing information that may boost a score, such as missing a revolving account in good standing, or miscellaneous incorrect information such as an incorrect birthday.

Check your credit report. You can receive a free report from each of the three credit reporting agencies once a year at www.annualcreditreport.com. Credit reports are unique to Social Security numbers, so if you are married, you may want to stagger your requests with your spouse every six months. You can also request your actual score for a onetime fee (which is less than $15 through most credit bureaus). Most credit monitoring services will provide your score for free when you sign up for their service.

Assuming when you divorce, your accounts automatically divorce you. They do not. If you have a joint account and one of the parties on the account is late, you are both late. With some types of loans, such as a mortgage or a car loan, the lender may not accept a letter asking you to be removed from the account after a divorce even if that property is going to your ex-spouse. They will need to qualify for the loan on their own before you will be removed from the account. Take this into consideration because if they do not refinance, and then have late payments, you may find yourself with some credit issues. When possible, close all joint accounts and refinance any debt separately. If it is not possible, maintain some type of control, whether it is an escrow account or at least access to information to make sure the accounts are paid in a timely manner. Do not assume. Also see the last point about closing accounts.

Avoiding consumer credit counseling because it will hurt your credit score. For someone with serious debt, working with a not-for-profit credit counseling agency to develop a debt reduction plan and get out of debt permanently should take priority over credit scores. Credit counselors will work with your creditors to try and reduce your monthly payments or settle your debt altogether. Debt settlement does not affect scores as badly as you would think. In fact, many people do not realize that late payments affect scores more than a debt settlement. Here is an example of how a debt settlement can affect credit scores, and how that compares to late payments.

A late payment hurts your score more than a debt settlement if your score is in the 680 range; it only significantly pulls it down if you are in the 780 range. Let us be honest here, people ready for credit counseling probably do not have the highest scores anyways, and the bottom line is credit scores are fluid – they can be rebuilt. According to Credit.com, a debt write off can stay on your credit report from seven to ten years, but as the information ages, so does its negative impact.

Making late payments aren't that big a deal. According to FICO, a 30-day late payment can affect your score by as much as 110 points. Late payments can have a huge impact on your credit score causing it to drop like a stone. This is one disaster that is relatively easy to avoid. Simply set up all your accounts with an automated minimum payment schedule from your checking account. This way you will never miss a payment. You can always pay additional amounts through online banking. Set yourself up for success with this one because it can be an easy one to miss and makes a significant impact.

Closing accounts to clean up your credit. Closing an account may be a good idea if you only opened the account to get a discount on merchandise or have too many credit cards which is causing confusion, but it won't clean up your credit or help your score. In fact, it can hurt your score when the account you close has a long credit history – especially a good one. Your credit history accounts for 15% of your score, so in making decisions which cards to keep and which ones to close, keep in mind how long you've had the account open and close the most recent ones first.

Are credit scores important? Yes, but they are not the "be all and end all." Now that we have dispelled some of the biggest myths, consider what the "be all and end all" is for you. What are your biggest financial challenges and concerns? Our latest research shows that less than 18% of employees feel they are on track for retirement. Are you part of the 82% that is not? Do you have a personal net worth statement and is it going in the right direction? The point is when you focus on the important financial issues, you have a chance to meet your financial goals. Clean up your credit if you have to and do your best to keep a good credit score, but let's not go overboard and lose sight of everything for just one number.

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