



What Is the Cost of Poor Credit?

Diana Elliott, Urban Institute, and Ricki Granetz Lowitz, Working Credit NFP

September 2018

People with poor credit—defined here as a subprime credit score or no credit score at all—have limited options for financial products, are charged the highest rates when they borrow money, and may be limited in where they live or work.¹ This harms their abilities to weather emergencies, save money, start or grow a business, or pursue opportunities like education or homeownership to improve their lives.

The financial cost is high for the 27 percent of Americans in the credit system who have subprime credit. Eighty-six percent of those with subprime credit typically have \$1,360 in delinquent debt that needs to be repaid to achieve prime credit. This may constitute a large portion of their income. When they seek to borrow again, subprime borrowers only qualify for the highest interest-rate loans. Twenty-one percent of subprime borrowers have auto debt, and those with the lowest credit scores will spend nearly \$3,000 more in interest to purchase a \$10,000 used car than someone with prime credit—equivalent to a \$1.40 per hour raise.

Nearly one in five Americans do not even have a credit file, meaning they have no access to safe, affordable credit.² Credit can be invaluable to families who need to smooth expenses until the next paycheck or pay for an emergency expenditure like a medical visit or car repair. Without access to credit—and preferably prime credit—many low-income Americans are stymied on their path to success.

| AMONG THOSE IN THE CREDIT SYSTEM | |
|---|--|
| Average VantageScore | SUBPRIME 532 PRIME 753 |
| Percent with revolving credit | SUBPRIME 28% PRIME 77% |
| Percent with auto loan debt | SUBPRIME 21% PRIME 33% |
| Total interest paid on a \$10,000 used car loan (48-month repayment period) | SUBPRIME 17.548% loan with 500–589 FICO® score = \$3,987 PRIME 4.896% loan with 720–850 FICO® score = \$1,031 |
| Average price of refrigerator | SUBPRIME Rent to own store = \$1,990 PRIME Non-rent to own store = \$678 |
| Total paid for a \$550 car repair over three months | SUBPRIME Payday loan; 391% average APR = \$941.67 PRIME Credit card; 17% average APR = \$565.66 |

Notes: Urban Institute analyses of 2017 data from a major credit bureau, except the following: For total interest paid on \$10,000 car loan: "Loan Savings Calculator," myFICO, accessed August 30, 2018. For rent-to-own prices: Marcelline White and Franz Schneiderman, Rent to Own: Profiting from the Poor (Baltimore: Maryland Consumer Rights Coalition, 2012). For average payday loan APR: Pew Charitable Trusts, "Payday Loan Facts and the CFPB's Impact" (Washington, DC: Pew Charitable Trusts, 2016). For average credit card APR: "Current Credit Card Interest Rates," Bankrate, accessed May 30, 2018.

CREDIT MYTHS



You have to be wealthy to have good credit.

False. Your income has no causal effect on your credit score, nor do factors like race, ethnicity, address, age, education, criminal background, or whether you own a home.³ While low-income and minority communities are disproportionately more likely to have poor or no credit scores, there is no causal relationship.⁴



If you pay all your bills on time, you'll have a good credit score.

False. Even if you pay all your bills on time, you may not have a credit score. Why? The only way to generate a score is to have at least one creditor that reports monthly payment information to the credit bureaus (whether you paid on time, late, or not at all).⁵ Typically, the only businesses that report this way are credit card companies and mainstream lenders.⁶ Without at least one (open and active) credit card or installment loan, your credit report may be “unscored due to insufficient credit history.” Those with no credit scores have limited access to credit and may be offered products with high rates and less desirable terms when they do borrow.



Everyone has a credit score.

False. According to the CFPB, 19 percent of US adults—and 46 percent of those in low-income neighborhoods—have no credit score.⁷ How does this happen? The credit bureaus either lack sufficient information to generate a credit score (remember, you need at least one credit card or one loan to generate a score) or have no record of the person at all.



To build credit, you have to go into debt.

False. You do not have to go into debt to build credit; you can build and sustain a prime credit score by opening one credit card, using it every month to pay for a small expense, and paying your bill in full every month. A credit card, if paid in full every month, is the equivalent of a 0 percent interest loan.



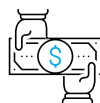
Don't seek out credit; inquiries can ruin your credit score.

False. While an inquiry can lower your score, it typically lowers it by 5–10 points for just two to three months. And if you “rate shop” for certain products like a mortgage, car loan, or student loan, all inquiries made within a 45-day period count as just one inquiry.⁸ What really lowers your score (by 100 points or more) is a delinquency—a payment 30 or more days late on a credit card or installment loan.⁹



Having a lot of credit cards is bad for your score.

False. The scoring system does not look at how many cards you have, but how you use your cards. To build a strong score, you must pay at least the “minimum balance due” on time, and you must keep the balance on each of your credit cards below 30 percent of the credit limit at all times. If you go above 30 percent on even one of your cards, it signals to the scoring system that you may be in financial trouble, which can lower your score by 20–50 points.¹⁰



Rent, payday, and auto-title loans, if managed well, can help you build a credit score.

False. Most payday and auto title loans are “single repayment” loans, which are typically not reported to mainstream consumer credit bureaus.¹¹ Rent payments aren't reported either. So, the most ubiquitous payments and products in low-income communities do not help consumers build credit.¹²

³ Original analyses use the VantageScore® credit score, which ranges from 300 to 850; scores below 600 are subprime; those above 600 are prime. FICO® scores are used in some examples and are comparable; 73 to 80 percent of consumers were in the same credit category, regardless of scoring method. See Consumer Financial Protection Bureau, *Analysis of Differences between Consumer- and Creditor-Purchased Credit Scores* (Washington, DC: Consumer Financial Protection Bureau, 2012). Credit reports are pulled by 47 percent of employers before hiring and by most landlords before renting an apartment. See Society for Human Resource Management, *Background Checking—The Use of Credit Background Checks in Hiring Decisions* (Alexandria, VA: Society for Human Resource Management, 2012).

⁴ About 19.3 percent of US adults are either credit invisible or have unscorable credit records. See Kenneth P. Brevoort, Phillip Grimm, and Michelle Kambara, *Data Point: Credit Invisibles* (Washington, DC: Consumer Financial Protection Bureau, 2015).

⁵ “What’s Not in My FICO Scores?” myFICO, accessed August 30, 2018.

⁶ Caroline Ratcliffe and Steven Brown, “Credit Scores Perpetuate Racial Disparities, Even in America’s Most Prosperous Cities,” *Urban Wire* (blog), November 20, 2017; National Consumer Law Center, “Past Imperfect: How Credit Scores and Other Analytics ‘Bake In’ and Perpetuate Past Discrimination” (Boston: National Consumer Law Center).

⁷ Sarah Chenven, “The Power of Credit Building: Credit Building Strategies for Funders” (Evanston, IL: Asset Funders Network, n.d.).

⁸ “Your Credit History,” *Consumer.gov*, accessed August 30, 2018.

⁹ Brevoort, Grimm, and Kambara, *Data Point: Credit Invisibles*.

¹⁰ “What Are Inquiries and How Do They Affect My FICO Score?” myFICO, accessed August 30, 2018.

¹¹ Equifax Experts, “Can One Late Payment Affect My Credit Score?” Equifax Finance Blog, February 7, 2014.

¹² “How Do Credit ‘Missteps’ Affect FICO Scores?” myFICO, accessed August 30, 2018.

¹³ Experian Team, “Payday Loan Relief and Debt Consolidation,” Ask Experian (blog), September 20, 2016.

¹⁴ Noah Sawyer and Kenneth Temkin, *Analysis of Alternative Financial Service Providers* (Washington, DC: Urban Institute, 2004).