MODULE 6
Understanding Credit Scoring

INSTRUCTOR GUIDE
# CreditSmart® Module 6: Understanding Credit Scoring

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Welcome to Freddie Mac’s CreditSmart® Initiative

This consumer financial education and outreach initiative is designed to help consumers build and maintain better credit, make sound financial decisions, and understand the steps to successful long-term homeownership.

In this guide, you’ll find everything you need to lead participants through real-life scenarios, group discussions and activities that will encourage them to apply these lessons to their daily lives.

By sharing the CreditSmart resources with others, you’ll help them increase their financial understanding, gain life-long money management skills, and show them how to avoid costly mistakes.

Program Structure

The CreditSmart Curriculum includes 12 complete financial education modules that can be completed in two ways – self-paced online or in a classroom setting.

<table>
<thead>
<tr>
<th>Module</th>
<th>Title</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Your Credit and Why It Is Important</td>
</tr>
<tr>
<td>2</td>
<td>Managing Your Money</td>
</tr>
<tr>
<td>3</td>
<td>Goal Setting</td>
</tr>
<tr>
<td>4</td>
<td>Banking Services: An Important Step</td>
</tr>
<tr>
<td>5</td>
<td>Establishing and Maintaining Credit</td>
</tr>
<tr>
<td>6</td>
<td>Understanding Credit Scoring</td>
</tr>
<tr>
<td>7</td>
<td>Thinking Like a Lender</td>
</tr>
<tr>
<td>8</td>
<td>Avoiding Credit Traps</td>
</tr>
<tr>
<td>9</td>
<td>Restoring Your Credit</td>
</tr>
<tr>
<td>10</td>
<td>Planning For Your Future</td>
</tr>
<tr>
<td>11</td>
<td>Becoming a Homeowner</td>
</tr>
<tr>
<td>12</td>
<td>Preserving Homeownership: Protecting Your Home Investment</td>
</tr>
</tbody>
</table>
Welcome to Freddie Mac’s CreditSmart® Initiative, Continued

Using the Instructor Guides

The Instructor Guides can be used alone or as an adjunct to the Web-Based Training (WBT) program. Even if participants choose not to experience the program online, gaining familiarity with the WBT will help you present the material more effectively. The most up-to-date content can always be found online at www.freddiemac.com/creditsmart/consumer_training.html.

Each of the twelve CreditSmart modules has its own Instructor Guide which follows the organization of the Web-Based Training (WBT) available online, and includes much of the same content. Each Instructor Guide includes:

- A glossary of all the relevant terms introduced in the module
- A module introduction which includes
  - An overview
  - Learning objectives
  - Sample discussion questions to start the lesson
  - “The Basics” – a list of bullet points outlining the key concepts of the lesson
- A module summary of all the key concepts in the lesson
- Activities, knowledge checks, and discussion questions where applicable
Lesson Concepts and Icons

Each module topic will present several key concepts. These concepts are introduced to your participants in a variety of ways described in the table below.

<table>
<thead>
<tr>
<th>Activity</th>
<th>An activity usually involves class participation, whether it is a game, exercise, or worksheet completion. Typically after an activity you will have the opportunity to lead a discussion.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Discussion</td>
<td>Discussions allow you to introduce key concepts while involving your participants in the conversation and making the information relevant to them. Sample questions are included in each lesson to help you guide the discussion.</td>
</tr>
<tr>
<td>Knowledge Check</td>
<td>There are short knowledge checks throughout each topic designed to start discussions or quickly test participants’ knowledge of certain concepts.</td>
</tr>
</tbody>
</table>

How to Access the WBT

The CreditSmart Web-Based Training (WBT) is available free of charge in both English and Spanish and can be accessed online at [www.freddiemac.com/creditsmart/consumer_training.html](http://www.freddiemac.com/creditsmart/consumer_training.html).
Tips for Instructors

The following tips and suggestions will help to ensure the successful delivery of the CreditSmart curriculum.

Workshop Preparation Tips

- Select handouts and exercises for each topic in advance to help enhance your presentation and discussion with participants.
- Determine if you will need other instructional materials such as overhead transparencies, slides, flip charts, handouts, and videos.
- Arrive at the workshop location early to set up.
- Decide how the room should be set up (e.g., classroom style, lecture).
- Make sure that all of the necessary equipment, such as a computer and projector is available and working.
- Provide a sign-in sheet and allow space (e.g., side table, counter, etc.) for handouts and resource materials.
- Set up refreshments, if provided.
- Provide adequate signs directing participants to the workshop location.
- Greet and welcome participants individually as they arrive.
- Begin the workshop promptly.
- Distribute and collect evaluation forms before the end of each workshop.
- Confirm that all participants have signed the sign-in sheet to ensure credit for attending the workshop.

Before the Workshop Begins

- Welcome participants and introduce yourself.
- Review logistics (session length, restroom location, breaks, etc.).
- Provide a brief history of the CreditSmart curriculum, which you can find at http://www.freddiemac.com/creditsmart.
- Provide an overview of workshop materials.
**Tips for Instructors, Continued**

**Adult Learning Tips**

- Adults learn in different ways; therefore, you will want to use different techniques, vary your presentation style, and be sensitive to how your students are responding.

- Relate the content to what your students already know. Doing so will make your workshop more effective and will help to ensure participants retain more information.

- Be sensitive to those with special needs and/or learning disabilities.

- Use ice breakers, activities, exercises, and/or videos to break up the flow of your presentation.

- Supply handouts and local and/or national articles that highlight the topic being presented.

- Poll the audience to gauge participants’ level of knowledge of the topic being presented.

- Research available community credit counseling resources in advance to ensure that consumers have access to appropriate referrals, as necessary.

**Instructor Training**

Freddie Mac provides CreditSmart instructor training for anyone who is interested in teaching the CreditSmart curriculum. Select one of the options below:

- Contact Freddie Mac by emailing: creditsmart_training@freddiemac.com.

- Attend a CreditSmart Train-the-Trainer workshop hosted by Freddie Mac. This instructor training series includes a comprehensive review of the CreditSmart curriculum, plus instruction on best practices in conducting effective classroom training. Visit www.freddiemac.com/creditsmart for more information.
Introduction to Module 6: Understanding Credit Scoring

Module Overview

This module will help participants understand the process of credit scoring and the various scoring factors. It will describe credit scoring from a borrower’s perspective and illustrate how their behavior as a consumer affects their credit scores. It will also provide participants with some tips on how to potentially improve their credit score over time.

Learning Objectives

After completing this lesson, participants should be able to:

- Define credit score
- Explain how credit scores are determined
- Use tips and techniques to improve their credit score over time

Module Topics:

- What Is Credit Scoring
- Factors That Influence Credit Scores
- How to Obtain Your Credit Score
- How to Improve Your Credit Score

Some of these topics include activities to help simulate real-world scenarios with your participants.

Glossary

A Glossary is included in Appendix A of this guide, and contains definitions and descriptions of terms and phrases related to this module. A Glossary is also included in the Participant Presentation. Encourage your participants to use the Glossary during and after the class to become more familiar with the terminology.
Topic 1: What is Credit Scoring?

Overview
This topic defines credit score, and discusses its purpose and how it is determined.

Time
12 minutes

What is Credit Scoring?

The Basics

- A credit score is a numerical rating used by lenders in the loan approval decision process.

- Credit scoring uses statistical models to evaluate credit risk by comparing credit information about a consumer to the credit performance of others with similar credit reports.

- Credit bureaus keep track of everyone’s credit history information – things like how many credit cards you have and how much you owe; whether you pay your bills on time; where you work and for how long.

- Credit scores may also be used to determine the interest rate you get on a loan.

- By using credit scores, lenders and creditors treat each person objectively because the same standards apply to everyone.

- Credit scores do not include race, religion, national origin, gender or marital status as factors.

Start the Discussion
To start the discussion with your participants, ask some open-ended questions or invite them to discuss what they currently know about credit scores. Here are some examples to get you started:

- What is considered a good credit score (i.e., 450, 600, 720)?
- Name some ways that you could improve your credit score?

Continued on next page
What is Credit Scoring?

Credit scoring uses statistical models to evaluate your credit risk by comparing credit information about you to the credit performance of others with similar credit reports.

The models have been developed based on millions of credit report files and are considered to be excellent predictors of the likelihood that an individual will repay a loan.

The ultimate output of these statistical models is your credit score.

### Term | Definition
--- | ---
Credit Risk | Credit risk is the term within the credit industry to refer to the level of risk or likelihood of an individual borrower's future or potential default.
Credit Reports | A credit report provides a history of your use of credit. Specifically, it's a file maintained by a credit reporting agency that contains information about a person, such as where the individual works and lives; information reported to the credit reporting agency by creditors regarding money borrowed and payments made; and public record information, such as whether the person has filed for bankruptcy.
Credit Score | A credit score is a numerical value determined by a statistical model based upon past credit behaviors, which predicts the likelihood of future loan default.
Topic 1: What is Credit Scoring?, Continued

Credit Scores

The Basics

- Credit scores are used – along with your credit report and other information from your loan or credit application – to determine your eligibility for a loan.
- Credit scores speed up the loan approval process.
- Just as with your credit and credit behavior, credit scores change over time.
- Your credit score can impact your ability to get a credit card, purchase a home, borrow money, and whether or not you can get service from utility companies.

Instructor note:
Define the following terms:

<table>
<thead>
<tr>
<th>Term</th>
<th>Definition</th>
</tr>
</thead>
<tbody>
<tr>
<td>Loan</td>
<td>Money you borrow from a financial institution with a written promise to pay it back later. With a loan, financial institutions will charge you fees and interest to borrow the money.</td>
</tr>
</tbody>
</table>
### Topic 1: What is Credit Scoring?, Continued

<table>
<thead>
<tr>
<th>Term</th>
<th>Definition</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Interest Rate</strong></td>
<td>Interest rates are commonly thought of as the cost of borrowing money. The interest rate is expressed as a percentage. The amount of interest that is paid each year is determined by multiplying the amount of the loan by the percentage.</td>
</tr>
<tr>
<td><strong>Lenders</strong></td>
<td>Lender is the term used for the person or entity that is providing credit or a loan to a borrower at specific terms and conditions. The term lender can generally be used interchangeably with the term creditor.</td>
</tr>
<tr>
<td><strong>Creditors</strong></td>
<td>Creditor is the term used for the person or entity that is providing credit or a loan to a borrower at specific terms and conditions. The term creditor can generally be used interchangeably with the term lender.</td>
</tr>
</tbody>
</table>
Topic 2: Factors That Influence Credit Scores

Overview

This topic discusses the five primary factors used to determine credit scores.

Factors That Influence Credit Scores

The Basics

- Credit scores are based on information contained in your credit report.
- There are five primary factors used to determine credit scores.
- Income level is not a factor in calculating a credit score.

Factors That Influence Credit Scores

Your credit score is based on information contained in your credit report. There are five primary factors used to determine your score:

- Your payment history
- The amount of debt you owe
- How long you have been using credit
- How often you’ve applied for new credit and taken on new debt
- The types of credit you currently use, such as credit cards, retail accounts, installment loans, finance company accounts, and mortgages

It’s important to note that your income level is not a factor considered in calculating your credit score. Someone with a high level of income, for example, may have a low credit score, while someone with a low level of income might have a high credit score. It all depends on the past use of credit and the factors described above.

Continued on next page
**Topic 2: Factors That Influence Credit Scores, Continued**

**Factors That Influence Credit Scores**

<table>
<thead>
<tr>
<th>Term</th>
<th>Definition</th>
</tr>
</thead>
<tbody>
<tr>
<td>Debt</td>
<td>What is owed to a person or institution for obtaining merchandise or services without immediately paying for them. Usually, a debt is acquired through a loan or the use of credit.</td>
</tr>
<tr>
<td>Mortgages</td>
<td>A mortgage is a document that is signed by a borrower when a home loan is obtained and gives the lender the right to take possession of the property if the borrower fails to make loan payments.</td>
</tr>
</tbody>
</table>

**Instructor note:**

Define the following terms:

- **Debt**
- **Mortgages**

**Instructor note:**

Ask participants to turn to page 6 of the Participant Presentation and discuss the following five primary factors used to determine credit scores:

- Your payment history
- The amount of debt you owe
- How long you have been using credit
- How often you’ve applied for new credit and taken on new debt
- The types of credit you currently use, such as credit cards, retail accounts, installment loans, finance company accounts, and mortgages

It is important to note that your income level is not a factor considered in calculating your credit score.
### Activity

**Instructor note:**

Ask participants to turn to page 7 of the Participant Presentation. Have them read each action in the left column and decide whether it will have an impact on a credit score. Once they are finished, review their answers and discuss each action using the explanations provided. See the instructor’s copy below.

<table>
<thead>
<tr>
<th>Action</th>
<th>Impact or No Impact</th>
<th>Explanation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Paying late</td>
<td>Impact</td>
<td>Thirty-five percent of your credit score is your payment history. Consistently being late on your credit card payments will hurt your credit score. Pay your credit card bills on time to preserve your credit score.</td>
</tr>
<tr>
<td>Bank overdrafts</td>
<td>No impact</td>
<td>Overdrafting your bank account can get expensive, especially if you have several overdraft transactions, but those overdrafts won’t hurt your credit score as long as you settle them before they go to collections. If your account remains overdrafted and your bank ends up sending your account to a collection agency, your credit score will take a hit.</td>
</tr>
<tr>
<td>Income</td>
<td>No impact</td>
<td>While information about your employer may be listed on your credit report, your income is not. Having a high or low salary won’t directly impact your credit score. For example, a high salary won’t boost your credit score nor will a low salary drag your score down. But, your salary might influence how you pay your bills and that is included in your credit score.</td>
</tr>
<tr>
<td>Not paying at all</td>
<td>Impact</td>
<td>Completely ignoring your credit card bill is much worse than paying late. Each month you miss a credit card payment, you’re one month closer to having the account charged off.</td>
</tr>
<tr>
<td>Having an account charged off</td>
<td>Impact</td>
<td>When creditors think you’re not going to pay your credit card bills at all, they charge off your account. This account status is one of the worst things for your credit score.</td>
</tr>
</tbody>
</table>

*Continued on next page*
### Topic 2: Factors That Influence Credit Scores, Continued

<table>
<thead>
<tr>
<th>Action</th>
<th>Impact or No Impact</th>
<th>Explanation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Having an account sent to collections</td>
<td>Impact</td>
<td>Creditors often use third-party debt collectors to try to collect payment from you. Creditors might send your account to collections before or after charging it off. A collection status shows that the creditor gave up trying to get payment from you and hired someone else to do it.</td>
</tr>
<tr>
<td>Insurance payments</td>
<td>No impact</td>
<td>Insurance companies check your credit score to decide whether to insure you and to calculate your insurance premium. Even though they use your credit score to make decisions about you, they don’t report your timely or untimely payments to the credit bureaus. Insurance payments won’t affect your credit score.</td>
</tr>
<tr>
<td>Child support and alimony</td>
<td>No impact</td>
<td>Child support and alimony payments won’t affect your credit score unless you fall behind on your payments and a collection agency has to get involved. In that case, your credit score could drop significantly.</td>
</tr>
<tr>
<td>Utility and cell phone payments</td>
<td>No impact</td>
<td>Like insurance companies, many utility service and cell phone providers check your credit score before giving you service. But neither of these businesses provides your payment information to credit bureaus. Your credit score isn’t helped by timely payments on your utility or cell phone bills. However, if your account becomes past due, it may be passed on to a collection agency who would list the account on your credit report leading to a drop in your credit score.</td>
</tr>
<tr>
<td>Defaulting on a loan</td>
<td>Impact</td>
<td>Loan defaults are similar to credit card charge-offs. A default shows that you have not fulfilled your end of the loan contract.</td>
</tr>
<tr>
<td>Filing bankruptcy</td>
<td>Impact</td>
<td>Bankruptcy will devastate your credit score. It’s a good idea to seek alternatives, like consumer credit counseling, before filing bankruptcy.</td>
</tr>
</tbody>
</table>

*Continued on next page*
### Topic 2: Factors That Influence Credit Scores, Continued

<table>
<thead>
<tr>
<th>Action</th>
<th>Impact or No Impact</th>
<th>Explanation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Rent payments</td>
<td>No impact</td>
<td>Paying your rent on time won’t help your credit score. In fact, the FICO score would ignore the rental trade line even if it appeared on your credit report. On the other hand, falling behind on your rent could lead to an eviction which would hurt your credit score and your ability to rent or get credit cards and loans in the future.</td>
</tr>
<tr>
<td>Checking your own credit</td>
<td>No impact</td>
<td>You can check your credit report as many times as you’d like and your credit score won’t drop a single point as long as you check it through a reputable source, like AnnualCreditReport.com, the credit bureaus, FICO, or a legitimate third-party. Having a lender check your credit score for you would appear as a hard inquiry which would hurt your credit score the same way a new application for credit would.</td>
</tr>
<tr>
<td>Having your home foreclosed</td>
<td>Impact</td>
<td>Getting behind on your mortgage payments will lead your lender to foreclose on your home. In turn, the late payments will hurt your credit score and make it harder to get approved for future mortgage loans.</td>
</tr>
<tr>
<td>Your interest rate</td>
<td>No impact</td>
<td>Having high interest rates on your credit cards and loans won’t hurt your credit score. Neither will low interest rates improve your credit score. But, there could be a correlation between credit scores and interest rates since lenders typically give the best rates to borrowers with the best credit scores. Your credit score influences your interest rate and not the other way around.</td>
</tr>
<tr>
<td>Credit counseling</td>
<td>No impact</td>
<td>One of the myths about credit counseling is that it’s just as bad for your credit as Chapter 13 bankruptcy. That’s not true. Though credit counseling may be reflected on your credit report, it won’t hurt your credit score. If a credit counselor is managing your credit card payments, you must make sure your creditor is getting your payments on time. Late payments hurt your credit score even if they’re coming from a credit counselor.</td>
</tr>
</tbody>
</table>
### Topic 2: Factors That Influence Credit Scores, Continued

<table>
<thead>
<tr>
<th>Action</th>
<th>Impact or No Impact</th>
<th>Explanation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Closing old credit cards</td>
<td>Impact</td>
<td>Fifteen percent of your credit score is the length of your credit history - longer credit histories are better. Closing old credit cards, especially your oldest card, makes your credit history seem shorter than it really is.</td>
</tr>
<tr>
<td>Closing credit cards that still have balances</td>
<td>Impact</td>
<td>When you close a credit card that still has a balance, your credit limit drops to $0 while your balance remains. This makes it look like you've maxed out your credit card, causing your score to drop.</td>
</tr>
<tr>
<td>Having only credit cards or only loans</td>
<td>Impact</td>
<td>Mix of credit is 10% of your credit score. When you have only one type of credit account, either loans or credit cards, your credit score could be affected. This factor mostly comes into play when you don't have much other credit information in your credit history.</td>
</tr>
<tr>
<td>Your age</td>
<td>No impact</td>
<td>Your age isn’t included in the credit scoring calculation, but there could be a relationship between your age and your credit score. If you’re young, chances are you don’t have much experience with credit, which could limit your credit score. Someone older with more credit history has time for early credit mistakes to drop off their credit report, so they could have a higher credit score.</td>
</tr>
</tbody>
</table>

Source: 10 Things that Don’t Affect Your Credit Score, 15 Things That Hurt Your Credit Score, LaToya Arby, About.Com
Topic 3: How to Obtain Your Credit Score

Overview
This topic discusses how to obtain your credit score.

Time
10

How to Obtain Your Credit Score

<table>
<thead>
<tr>
<th>The Basics</th>
</tr>
</thead>
<tbody>
<tr>
<td>- The most commonly used credit score is known as a FICO® score.</td>
</tr>
<tr>
<td>- FICO scores are ranked on a scale of approximately 300-900 points.</td>
</tr>
<tr>
<td>- Here’s how credit scores might be grouped:</td>
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<td></td>
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<tr>
<td></td>
</tr>
<tr>
<td>- Generally, the higher the score, the lower the predicted risk to the lender.</td>
</tr>
<tr>
<td>- You can obtain a copy of your credit score online for a small fee at <a href="http://www.myfico.com">www.myfico.com</a></td>
</tr>
<tr>
<td>- When applying for a loan, ask your lender or creditor to explain what your credit score means in relation to the final credit decision.</td>
</tr>
<tr>
<td>- Never assume that your score is good or impaired until it has been fully explained to you by a credit industry professional.</td>
</tr>
</tbody>
</table>

Continued on next page
How to Obtain Your Credit Score (continued)

The most commonly used credit score today is known as a FICO® score. Developed by Fair Isaac Corporation, FICO scores are ranked on a scale of approximately 300 to 850 points. Generally, the higher the score, the lower the predicted risk to the lender.

You can obtain a copy of your FICO credit score online for a small fee at www.myfico.com. This website also provides additional information on credit scoring, factors, and credit tips.

When applying for a loan, ask your lender or creditor to explain what your credit score means in relation to the final credit decision. Because scoring systems and numerical ratings vary, never assume that your score is good or impaired until it has been fully explained to you by a credit industry professional.
How to Improve Your Credit Score

Overview
This topic discusses how to improve your credit score.

Time
10 minutes

How to Improve Your Credit Score

The Basics

- Always make sure that the information in your credit report is correct and manage your credit responsibly over time.
- Credit scores reflect your long-term pattern of credit usage and repayment history.
- Credit scores automatically improve as your overall credit picture gets better.
- There is no quick fix method to improving your credit score.
- Consistently pay your bills on time.
- Keep credit card balances 70% or less of your spending limit.
Knowledge Check

Instructor note:
Now that participants have learned more about credit scoring, ask them to turn to page 11 of the Participant Presentation to identify which factors are used to determine a credit score.

Knowledge Check

Of the factors listed below, which are used to determine your credit score?
(Select all that apply.)

- Payment history
- Income
- Amount of debt
- Types of credit in use
- Pursuit of new credit
- Credit history (how long you've been using credit)
Module Conclusion

Module 6 Summary

Summarize this module by reviewing the key points below with your participants.

Key points from Module 6: Understanding Credit Scoring:

Congratulations! You have completed the Understanding Credit Scoring module of the CreditSmart Online Training Program.

This module presented you with information regarding how your credit score is determined and provided tips on how you can potentially improve your credit score over time.
## Appendix A: Module 6: Understanding Credit Scoring Glossary

<table>
<thead>
<tr>
<th>Term</th>
<th>Definition</th>
</tr>
</thead>
<tbody>
<tr>
<td>Creditor</td>
<td>Creditor is the term used for the person or entity that is providing credit or a loan to a borrower at specific terms and conditions. The term creditor can generally be used interchangeably with the term lender.</td>
</tr>
<tr>
<td>Credit Report</td>
<td>A credit report provides a history of your use of credit. Specifically, it’s a file maintained by a credit reporting agency that contains information about a person, such as where the individual works and lives; information reported to the credit reporting agency by creditors regarding money borrowed and payments made; and public record information, such as whether the person has filed for bankruptcy.</td>
</tr>
<tr>
<td>Credit Risk</td>
<td>Credit risk is the term within the credit industry to refer to the level of risk or likelihood of an individual borrower’s future or potential default.</td>
</tr>
<tr>
<td>Credit Score</td>
<td>A credit score is a numerical value determined by a statistical model based upon past credit behaviors, which predicts the likelihood of future loan default.</td>
</tr>
<tr>
<td>Debts</td>
<td>What is owed to a person or institution for obtaining merchandise or services without immediately paying for them. Usually, a debt is acquired through a loan or the use of credit.</td>
</tr>
<tr>
<td>Interest Rates</td>
<td>Interest rates are commonly thought of as the cost of borrowing money. The interest rate is expressed as a percentage. The amount of interest that is paid each year is determined by multiplying the amount of the loan by the percentage.</td>
</tr>
<tr>
<td>Lender</td>
<td>Lender is the term used for the person or entity that is providing credit or a loan to a borrower at specific terms and conditions. The term lender can generally be used interchangeably with the term creditor.</td>
</tr>
<tr>
<td>Loan</td>
<td>Money you borrow from a financial institution with a written promise to pay it back later. With a loan, financial institutions will charge you fees and interest to borrow the money.</td>
</tr>
<tr>
<td>Mortgage</td>
<td>A mortgage is a document that is signed by a borrower when a home loan is obtained and gives the lender the right to take possession of the property if the borrower fails to make loan payments.</td>
</tr>
</tbody>
</table>