International Science Journal of Management, Economics & Finance
2023; 2(2): 10-16
https://isg-journal.com/isjmef/
doi: 10.46299/j.isjmef.20230202.02
ISSN: 2720-6394

INTERNATIONAL SCIENCE GROUP

What to Know Before Taking Out a Payday Loan to Improve Your Credit Score

Karina Sytnychenko
Faculty of Economics, Taras Shevchenko National University, Kyiv, Ukraine
ORCID 0000-0002-3988-972X

To cite this article:
Sytnychenko Karina. What to Know Before Taking Out a Payday Loan to Improve Your Credit Score. International Science Journal of Management, Economics & Finance. Vol. 2, No. 2, 2023, pp. 10-16. doi: 10.46299/j.isjmef.20230202.02.
Received: 02 23, 2023; **Accepted:** 02 28, 2023; **Published:** 04 01, 2023

Abstract: Loans are a fundamental and integral part of people's lives. People of all ages are interested in them to be able to fulfill their desires. A banking establishment, like any other financial institution, requires its clients to pay their debt obligations on time and in full. But they all use credit scores to assess a client's creditworthiness and, in turn, to mitigate their own risks. Likewise, individuals themselves should be aware of how their credit rating is formed in order to make sound financial decisions in the future. The results of the study show that scientists, researchers, and online resources do not have a single approach to the factors that affect credit scores, but the general direction of consideration of a person is very similar. In this article, two of the most popular rating systems in the United States, such as FICO and VantageScore, were reviewed. They have many similarities but also many differences that affect the formation of a credit score improvement strategy. In turn, a low credit score reduces the quality of life and financial inclusion, so its improvement is an important and urgent issue that is addressed in this article.
Keywords: Credit Score, Credit Ratings, Payday loans, Improvement of the Credit Score.

1. Introduction

Borrowers must meet a multitude of criteria set by banks. Their analysis is a difficult procedure involving several variables. Banks utilize information from a borrower's loan history, including a specific tool known as an individual (personal) credit rating, to evaluate a potential borrower. Both borrowers and lenders have access to this information.

People's preferences towards credit alter with age. For younger individuals, building a strong credit history is crucial, so they can someday purchase the home of their dreams [1]. For elderly people, paying off all debts is even more imperative, so they can age in peace. As a result, many are concerned about how to raise their credit score in order to qualify as the bank's ideal borrower and obtain the loan they require. This article, therefore, examines the potential for borrowing money, the variables that affect credit scores, and steps that may be taken to improve them. The study is built on the writings and works of researchers and experts from throughout the world.

The structure of the text is as follows. An outline of the study's object and subject is provided in Section 2. The goal of the research is described in Section 3. An overview of the pertinent literature on the subject is presented in Section 4. The research methods are illustrated in Section 5. All of the study's major findings are presented and reviewed in Section 6. Further research opportunities are covered in Section 7, and the paper's conclusions are outlined in Section 8.

2. Object and subject of research

The object of research is the formation of a credit rating of each individual at the microeconomic level. The subject of the study are the factors influencing credit scoring as well as measures and mechanisms to improve the reliability and financial inclusion of the borrower. Because loan scoring has an impact on both the quantity and the quality of financial inclusion or whether individuals can easily and affordably access money, the two are closely intertwined.

3. Target of research

The purpose of the study is to investigate, characterize and systematize the factors that affect a person's credit rating in order to find the best methods of improving the credit rating. Achieving the set goal is possible due to the correct setting of a number of tasks, namely:

- To analyze the general features of the credit-scoring mechanism,
- To segment consumers' rating brackets,
- To determine the reasons behind low credit score,
- To evaluate the consequences of the low credit rating,
- To formulate steps for achieving higher credit score and financial inclusion.

4. Literature analysis

Many scientists and researchers around the world are engaged in the issues of credit rating formation and their analysis, including Hongchang Wang, Chunxiao Li, Bin Gu, Wei Min (Does AI-based Credit Scoring Improve Financial Inclusion? Evidence from Online Payday Lending, 2019), Tsung-Hsien Li, Jan Sun (The Payday Loan Puzzle: A Credit Scoring Explanation, 2022), Prashant Ubarhande, Arti Chandani (Elements of Credit Rating: A Hybrid Review and Future Research Agenda, 2021), Sunitha. G, Dr.V. Venu Madhav (An Empirical Study On Impact Of Credit Rating On Credit Risk Of Banks: A Literature Review, 2021), Jae Min Lee, Narang Park, Wookjae Heo (Importance of Subjective Financial Knowledge and Perceived Credit Score in Payday Loan Use, 2019) and others as well as a number of international agencies with an online presence.

Based on the results of the literature review, it can be concluded that due to the limited amount of literature, the lack of attention to this topic, as well as the insufficient coverage for the general public, which negatively affects financial inclusion, additional study of credit ratings and their formation is required.

5. Research methods

The theoretical, methodological, and practical principles of credit rating development are developed in this article using the following methodological framework, which is also used to define the effects of a poor credit rating and pinpoint solutions for raising it.

- the dialectical method of cognition (as the theoretical underpinning for the impact of many elements on the creation and evaluation of an individual's loan score)
- systemic analysis (the investigation of the elements used in loan evaluation by creditors and banks, as well as how it is formed and used, in order to pinpoint the key trends and variables influencing them);
- comparison analysis (comparing the characteristics of low and high credit ratings, as well as contrasting how they affect financial inclusion);
- logical and abstract analysis (to formulate theoretical generalizations and formulate the conclusions of the study).

6. Research results

Credit scoring, which is used to assess borrowers' creditworthiness for mortgages, vehicle leases, school loans, consumer loans, etc., is the foundation of the lending sector. Due to its effect on both the quantity and the quality of financial inclusion, credit scoring is strongly tied to financial inclusion. In turn, the term financial inclusion can be defined as whether or not individuals can easily and affordably access money [2].

The key to increasing financial inclusion is to raise credit rating. The two methodologies that are often used in credit scoring are rule-based decision-making and statistical model-based decision-making process. The first method is based on the individual characteristics of borrowers and professional expertise, whereas the second method is founded on quantitative methods [2,3].

Lenders take into account many factors in addition to how good an individual's credit history is. They consider one's work, employment history, source of income, and willingness to offer collateral or a guarantor. As a result, consumers with bad credit may occasionally be able to obtain a loan. Conversely, borrowers with high ratings may occasionally receive an unexpected denial.

Based on a person's credit history, the credit rating is automatically determined and updated. Several things are taken into consideration. Here are a few examples:

– Delinquencies. The number, amount, length, and duration of both previous and present infractions are taken into consideration. Even if the infraction occurred years ago, it might result in a lower score.

– The number of payments paid once the delinquencies have been resolved. The higher income an individual has, the better, as it demonstrates that one has overcome momentary financial challenges and can now reliably and on time satisfy their monetary responsibilities.

– The number of latest loan applications. The more entries one submits, the lower one's rating will be. The reason for it would be the obvious likelihood that an individual may be incurring severe living expenses and therefore appealing to several lenders to offset them. This is evidence for the lenders that the debt will not be repaid, and it lowers the credit score.

– Preferred sources of credit. One may choose either financial institutions or less reliable microfinance organizations. Handling microcredit entails increased risks.

– The number of ongoing debts and those that are paid off in full. The likelihood that one will not be able to fulfill the current financial obligations at once increases with the number of active loans one currently has. On the other hand, it's a positive indicator if previously taken sizable debts have been smoothly repaid within the allocated period [4].

There are many agencies that provide credit evaluation, resulting in assigning a number of points to an individual as a signal of the risk that person entails when applying for a payday loan. Every country has national standards, but the most famous are the credit-scoring systems in the US: FICO and VantageScore.

Since its creation in 1989, the FICO rating system has been utilized to evaluate a consumer's creditworthiness. In 2006, three major national credit bureaus—Equifax, Experian, and TransUnion—created VantageScore as a substitute. FICO and VantageScore both use a scale from 300 to 850. However, they place different weights on the variables that affect the scores differently (Figure 1) [5,6].

Comparison	FICO	VantageScore
Number of Factors Constituting the Score	5 (Payment History, Amounts Owed, Length of Credit History, New Credit, Credit Mix)	6 (Payment History, Depth of Credit, Utilization, Balances, Recent Credit, Available Credit)
Length of Credit History	At least 6 months with at least one active account	1 month in the past two years
Late Payment Penalties	Lower penalties	Higher penalties
Collections Penalties	Accounts with a zero balance or those with paid-off balances are not taken into consideration	Once all collection accounts have been settled, it ignores them all
Hard Inquiry Grace Period	Grace period of 45 days	Grace period of 14 days
Multiple Bureaus, Multiple Scores	The score may be different from one lender to another	The credit score is generally consistent across lenders

Figure 1. Comparison of the factors influencing FICO and VantageScore credit ratings.
Build and adapted from [5,6,7].

The points assigned to a credit rating range from 300 to 850. The credit history is considered better with the rising of the numeral value of the rating. With a rating of 800+ points, any bank would give you better credit conditions. If the rating is close to zero, getting a new loan is quite tough.

According to the online outlet Fit My Money, the following is a list of FICO credit score categories and ranges:

- Excellent scores range from 750 to 850.
- Decent scores are between 700 and 749.
- Fair range is between 650 and 700.
- A score below 650 is considered undesirable [8].

In contrast, VantageScore has a similar breakdown for excellent, decent, and fair scores, however, breaks down the lower bracket into low and the lowest ranges with 500-600 and less than 499 points, respectively [9].

It takes time and some factors to build up a bad credit score. There are a few influences that contribute to one’s poor score, namely:

- Late bill payments. Payments that are past due or that are past due remain on your loan history, which is undesirable. Therefore, it is crucial to pay off any bills or obligations on or ahead of time.
- The sum due. Individual credit use and balance are critical factors. A figure of 30% of the overall credit limit is considered desirable. A few actions to reduce how much credit one uses will have a significant impact on the credit score.
- The frequency of loan applications. As the credit score may change if there are many loan inquiries, it is of utmost importance to decrease the number of loan applications as much as possible [8].

Despite the fact that a variety of data points are gathered to create a person's credit score, consumers might not fully comprehend how the rating is created and how it impacts their financial opportunities and decisions. Therefore, another important aspect to consider is the number of drawbacks that a low credit rating poses on the individual’s financial inclusion [9] (Figure 2).

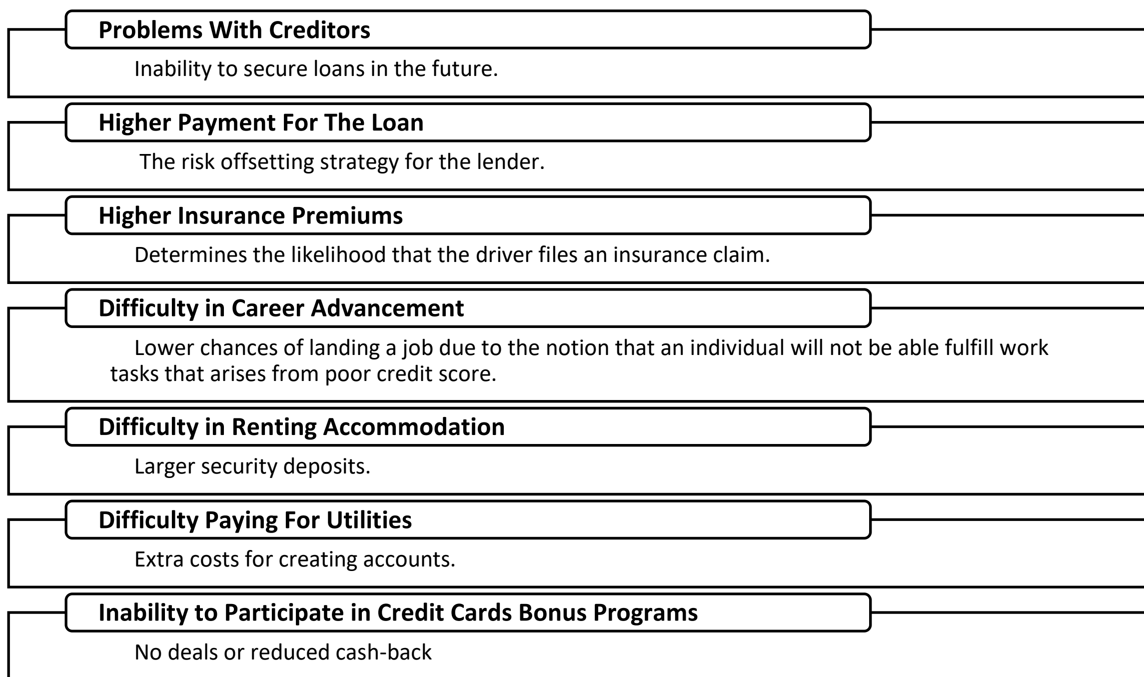

Figure 2. Problems from having a low credit score and their implications.
Adapted from [8,10].

Those with low credit scores should put more time and effort into raising their scores since they may have more trouble getting access to their loan information and using traditional financial services [11]. Discussions regarding payday loan use assign the societal cost to consumers alone (e.g., individuals' irresponsibility) since they do not take into account the current credit market practices and features that affect consumer transactions [12]. Taking this into account, there is an urgent need to determine ways to improve the credit score and, consequently, the financial inclusion of common people.

It's challenging to offer general guidance because every borrower has unique circumstances. Yet, the key action that everyone can do is the following:

– Clear up all past-due accounts. Pay off any delinquencies one has as quickly as possible, no matter how minor.

– As banks don't usually transfer the money right away, make monthly loan installments on time or, better yet, a little early.

– Limit the amount of opened loans. It's best to keep it to two or fewer. If one has more, it is advisable to use the refinancing option.

– Unused cards or accounts should be closed.

– Whenever possible, refrain from taking a payday loan from microfinance organizations [13,14].

7. Prospects for further research development

As a credit score contains establishing data about its subject (sufficient for unambiguous identification), information about the bona fides of its debtor obligations (payer obligations) of all kinds: loans received, taxes, and other system payments, settlements with suppliers, court decisions, etc., as well as information about its potential solvency: the availability of property, cash, securities, and other valuables and assets, it is necessary further to investigate the aspects of privacy and information management.

Also, considering the importance of loan scores in general as well as the great value of factors influencing them, a prospective research question may be whether they should be considered an

important element of the modern civilized market of financial services and whether assigning personal credit ratings to individuals is the right measure to improve the functioning of this market.

8. Conclusions

After conducting the research and analysis based on the tasks set regarding the formation of the credit score of each entity at the individual level and the factors affecting credit rating, as well as measures and mechanisms to improve the reliability and financial accessibility of the borrower, it is possible to make the following most important conclusions:

- Credit-scoring mechanism varies according to the institution that's undertaking it, as well as dependent on the nation. In the United States, the two most important scoring systems are FICO and VantageScore. Although they have a similar approach, they vary in their methodology and considerations regarding negative loan practices done by individuals.
- The score starts from 300 and goes up to 850. Overall, any score above 700 is considered good enough for a normal or special loan. FICO and VantageScore have different brackets for the lower scores. VantageScore divides poor score into bad (500-600) and very bad (less than 499).
- Low scores may generally stem from late bill payments, large sums due, using many loans, or frequent loan applications.
- The consequences of a low credit rating are vast and are not limited to Problems With Creditors, Higher Payment For The Loan, Higher Insurance Premiums, Difficulty in Career Advancement, Difficulty in Renting Accommodation, Difficulty Paying For Utilities, Inability to Participate in Credit Cards Bonus Programs, and so on.
- The steps for achieving higher credit scores and financial inclusion are easily attainable and require clearing up all past-due accounts, making monthly loan installments on time, limiting the amount of opened loans, closing unused accounts, and not dealing with microfinance organizations.

References:

1) White, J. (2022, December 5). *Why is it important to establish credit when young?* Experian. Retrieved February 21, 2023, from https://www.experian.com/blogs/ask-experian/why-it-is-important-to-establish-credit-when-you-are-young/

2) Hongchang, W., Chunxiao, L., Bin, G., & Wei, M. (2019). Does AI-based Credit Scoring Improve Financial Inclusion? Evidence from Online Payday Lending. Retrieved February 21, 2023, from https://web.archive.org/web/20210815030403id_/https:/aisel.aisnet.org/cgi/viewcontent.cgi?article=1569&context=icis2019

3) Authors Maria Fernandez Vidal Senior Financial Sector Specialist Fernando Barbon, Maria Fernandez Vidal Senior Financial Sector Specialist, & Barbon, F. (n.d.). *Credit scoring in financial inclusion*. CGAP. Retrieved February 21, 2023, from https://www.cgap.org/research/publication/credit-scoring-in-financial-inclusion

4) Fontinelle, A. (2023, February 20). *The 5 biggest factors that affect your credit*. Investopedia. Retrieved February 21, 2023, from https://www.investopedia.com/articles/pf/10/credit-score-factors.asp

5) Shift Processing. (2021, August 2). *Credit score*. Shift Credit Card Processing. Retrieved February 21, 2023, from https://shiftprocessing.com/credit-score/#:~:text=Any%20score%20of%20670%20or,percent%20from%20the%20year%20before

6) *About VantageScore*. VantageScore. (2022, August 2). Retrieved February 21, 2023, from https://vantagescore.com/company/about-vantagescore/

7) Opperman, M. (2022, March 25). *Types of credit scores: VantageScore vs. FICO score vs. Credit Score*. Credit.org. Retrieved February 21, 2023, from https://credit.org/blog/fico-scores-vs-vantagescores-know-the-differences/

8) Man, A. (2023, February 17). *What is the lowest credit score in 2023?* Fit My Money. Retrieved February 21, 2023, from https://fitmymoney.com/what-is-the-lowest-credit-score/

9) Gravier, E. (2021, August 6). *Here's everything you need to know about your VantageScore credit score, plus how to check it*. CNBC. Retrieved February 21, 2023, from https://www.cnbc.com/select/what-is-vantagescore/

10) Kurt, D. (2022, July 13). *The side effects of bad credit*. Investopedia. Retrieved February 21, 2023, from https://www.investopedia.com/the-side-effects-of-bad-credit-4769783#:~:text=A%20poor%20credit%20history%20can,you%20in%20a%20job%20hunt.

11) Buckland, Jerry, and Xiao-Yuan Dong. (2008). Banking on the Margin in Canada. Economic Development Quarterly 22: 252–63.

12) Lee, J. M., Park, N., & Heo, W. (2019). Importance of subjective financial knowledge and perceived credit score in payday loan use. International Journal of Financial Studies, 7(3), 53. https://doi.org/10.3390/ijfs7030053

13) Flannery, M. J., & Samolyk, K. (2005). Payday lending: Do the costs justify the price? *SSRN Electronic Journal*. https://doi.org/10.2139/ssrn.771624

14) *Tips on how to improve credit score*. Equifax. (n.d.). Retrieved February 21, 2023, from https://www.equifax.com/personal/education/credit/score/how-to-improve-credit-score/