Understanding Your Credit Score

Article 5 of 9 - In the last article, we began our discussion of what a credit report is. Here, we continue the discussion focusing on the Credit Score and what it represents.

What does your score mean?

The Credit Score rating system is meant to present a snapshot of the risk you currently represent to a lender. Several parameters in your credit file, including length of credit history, number of open accounts, loans, mortgages, public records, and others are formulated to produce a three-digit score between about 300 and 950.

There are other scores used by lenders and insurance companies (some of which are developed by FICO) such as Application and Behavior scores. These other scores take other information into account. Usually a lender will use a combination of your credit score with other factors when determining your risk level. Lenders all have the same objective - to determine the borrower's potential risk. Regardless of whether the score was generated by FICO or a system based on FICO parameters, all scores yield an industry standard three-digit score. This three digit number places the borrower in one of three main categories (we named the third one ourselves.)

Prime, sub-prime, and "Risky"

Prime If your credit score is above 680, you are considered a "prime borrower" and will have no problem getting a good interest rate on your home loan, car loan, or credit card.

Sub-Prime If your credit score is below 680, you are "sub prime", and will likely pay a much higher interest rate on your loan.

Risky Below 560 is the "Risky" score. At least that is how most lenders and credit issuers perceive it. You can still get a credit card but you will likely be hit with a security deposit or high acquisition fee. In addition to that, your interest rate will likely be 22% to 23%. You will have difficulty acquiring home loans and the majority of new car loans if you rank at this score.

Below 560 is no place to be. You will pay much, much more in higher interest and unnecessary fees. You may even pay more for your insurance rates. A very low score can even prevent you from getting a job with some companies.

How are credit scores calculated?

The methods of calculating your FICO may differ slightly depending on the credit bureau. When obtaining your score from one of the Credit Bureaus, it is important to understand that your score does not come directly from FICO. It is adapted to each bureau and is given its own name: Equifax uses "Beacon", Trans Union uses "Empirica", and Experian uses "Experian/Fair Isaac." These scores are also referred to as your "Bureau Scores."

Since your score is derived from your bureau data, it will change every time your reports change. However your score is calculated, it will always take into consideration many categories of information. No one piece of information or factor determines your score. As the information in your credit report changes, the importance of one or several factors may change in your FICO score. Lenders look at many things when making a credit decision, including your income and the kind of credit you are applying for. However, your FICO score does not reflect these facts as it only evaluates the information retained by the credit reporting agency.

What factors affect your credit score?

There are five factors which are used in credit scoring calculations that determine your overall credit score.

1. **Previous Credit Performance (Payment History)-- 35%** A lender wants to know what your payment history is like. Have you paid everything on time, are you late on anything now, and so on. Your payment history is just one piece of information used in calculating your score, although it can be very important.

2. **Current Level of Indebtedness (Amount Owed)-- 30%** How much is too much? The question most lenders ask themselves is, can the borrower pay me and still afford to pay his other bills? Ironically, having available credit can sometimes *help* your ratio of debt to available credit. This may be as important as your previous credit history.

3. **Amount of Time Credit Has Been In Use (Length of Credit)-- 15%** Generally speaking, the longer the credit history

the better your score. However, this factor only makes up 15% of your total score so even young people, students or others with short histories can still score high overall as long as the other factors are good. If you are new to credit than there is little you can do to improve this part of your score. Open an account and be patient.

4. **Pursuit of New Credit --10%** Credit is much more popular today. Just look at the number of credit card offers you get via the Internet and in the mail. Consumers can now shop for credit and find the best terms to meet their needs. Each time someone runs a credit check on you, it creates an inquiry. Fair Isaac has changed some of its calculations to account for these new trends. Specifically, they treat a group of inquiries - which probably represents a search for the best rate on a single loan - as though it was a single inquiry (note: this only applies to auto or mortgage loan inquiries.) For example, auto loan inquires that are within 14 days of each other only count as one inquiry.

5. **Types of Credit Experience -- 10%** Different types of credit, installment loans, retail accounts, credit cards, and mortgage. This score is not normally a key factor in determining your score but having a mixture of different types can help a close score. It's not a good idea to try and open different types of accounts just to try and make this factor better because it will likely reduce your score in other areas. You should never open accounts you don't intend to use.
What type of accounts you have, and how many, can make a big difference. The optimal ratio of installment versus revolving accounts depends on your profile and differs from person to person. One factor that seems to have significant influence is your percent of open installment loans. Too many can lower this portion of your score.

Improving your credit score

Now that you know how your score is calculated, you can begin making changes to your current financial planning. The best things you can do are simple.

- Pay your bills on time. Sounds simple, but this is the biggest thing you can do to keep your score high. Delinquent payments and collections have a major negative impact on a score.

- Keep your balances low on unsecured revolving debt like credit cards. High outstanding balances can affect a score.

- The amount of your unused credit is an important factor in calculating your score. You should only apply for credit that you need.

- Make sure the information in your credit report is correct. If its not, dispute it with the credit agencies and/or with the creditor directly.

- Removing negative items on your credit reports has the biggest impact on your FICO score. Generally, negative items stay on your reports for seven years but you can hire a professional credit report repair service such as Lexington Law Firm to do it for you.

In the next article, we will move on to discuss how to remove bad credit from a credit report.