



## The ABCs of Credit Scoring

Credit scoring is a method of assessing the likelihood that credit users will pay back the money loaned to them. Lenders use these scores to help them make lending decisions. However, it is often only one factor in the lender's decision to extend credit. Credit scoring provides a uniform system for analyzing and evaluating creditworthiness.

### **What is a FICO Score?**

FICO is a credit score developed by Fair Isaac & Company. Your FICO score is based only on information in your credit report. It does not take into account your income, assets or length of time on the job. (Lenders will generally evaluate these factors in addition to the FICO score.)

FICO scores range from 375 to 900 points. Someone with a higher score is viewed as a better risk than someone with a lower score. Each of the three credit bureaus will provide the lender with a credit score. The lender generally takes the middle score for their use in evaluating risk.

### **Benefits of Credit Scoring**

The use of credit scores speeds loan approvals, since it is more efficient and less expensive than other methods of analyzing a borrower's creditworthiness. The FICO score provides lenders a quick objective method for assessing your credit risk. Fair Isaac has developed a system that identifies credit patterns that relate to the likelihood that a borrower represents a good credit risk and will make their loan payments as agreed.

### **Credit Scores Analyze a Borrower's Credit History Taking into Account Various Factors**

Although we have a general idea of how credit scores are developed, the scoring companies do not release the formula for determining a score. The five main categories of information

that FICO scores evaluate are outlined below. No one factor will determine your score. The importance of a factor varies depending on the other information in your credit report. The levels of importance listed are based on the population in general and will vary with each individual depending on other aspects of the credit report.

### **1) Payment History**

*(35% of your score is based on this category)*  
Paying your credit accounts on time is the most important factor in your credit score. Your score takes into account your payment history on credit cards and retail accounts, installment loans (e.g. car loans), finance company accounts and mortgage loans. How recent and/or how frequent late payments are is what is most damaging to your credit score.

### **2) Amounts Owed**

*(30% of your score is based on this category)*  
It is better to have lower balances (as a percentage of the maximum balance) on several cards than to have a few cards that are maxed out. If too many of your credit accounts have high balances, that can indicate a higher risk of not paying your bills on time. The score considers the overall amount that you owe, as well as the amount you owe on different types of accounts, such as credit cards and installment loans. It is not necessarily a good idea to close accounts.

### **3) Length of Credit History**

*(15% of your score is based on this category)*  
A longer credit history can increase your score. The score takes into account the age of your oldest account and the average age of all your accounts. The longer that your accounts have been open, the better for your score. It is not a good idea to close longtime accounts and open new accounts. (Although it might be a great financial decision to transfer your credit

balances to a new card with a low introductory interest rate, doing so will lower your credit score. So if you are interested in keeping your credit score strong for a home purchase, delay the balance transferring strategy.)

#### 4) New Credit

*(10% of your score is based on this category)*

Opening a number of credit accounts in a short period of time indicates a greater credit risk, especially for someone who does not have an established credit history.

#### 5) Types of Credit in Use

*(10% of your score is based on this category)*

The score takes into account the types of credit you have: credit cards, retail accounts, installment loans, finance company accounts and mortgage loans. Type of credit is not necessarily a major factor in determining your score. You don't need to have accounts in each category.

#### **Ways to Raise Your Credit Score**

A credit score is just a snapshot of your credit risk at that point in time. Your credit score is not static and will change over time due to the factors listed above. Therefore your credit score can go up or down depending on how you continue to manage your credit from this point forward. Your most recent credit decisions will have the most impact on your score. In other words, your credit history in the last year is weighed more heavily than information from three years ago.

The following are actions you can take to improve your credit score:

- Pay your bills on time.
- Bring your past due accounts current.
- Keep your revolving credit balances low.
- If you have just recently established credit, don't open a number of new accounts. (This will lower your average account age.)
- Managing your credit responsibly is key in raising your score. Having credit cards and installment loans and paying them on time will improve your score. (Don't open new accounts just to change your credit mix.)
- If you are shopping for a home loan or car loan, do so within a two-week period of time. The score will count all the credit inquiries for a particular type of loan within that period as one inquiry.
- Reestablish your credit history if you have had credit problems. Opening new accounts responsibly and making your payments on time will help to raise your score over time.

#### **What about Inquiries?**

An inquiry is a request to check your credit report for the purposes of extending you credit. Too many inquiries can lower your score. A lender is concerned if you have applied for too much credit and your existing credit cards have maximum balances. However, multiple mortgage loan or car loan inquiries within a 14-day period are counted as one inquiry. FICO scores only consider inquiries from the past 12 months.

An inquiry from a consumer requesting his/her own credit report is not counted negatively since it does not indicate that you are looking to take on more credit.

#### **What Does Your Score Mean?**

When the lender receives your FICO score, they also are given up to four score reason codes, which explain the main reasons your score was not higher.

According to Fair Isaac, the top 10 most commonly given reasons (score reason codes) for low scores are:

- Serious delinquency
- Serious delinquency, and public record or collection filed
- Derogatory public record or collection filed
- Time since delinquency is too recent or unknown
- Level of delinquency on account
- Number of accounts with delinquency
- Amount owed on accounts
- Ratio of balances to credit limits on revolving accounts is too high
- Length of time accounts have been established
- Too many accounts with balances