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Making S.M.A.R.T. Financial Decisions

Credit Scores

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A credit score is a number used to predict whether a consumer will pay back a loan. Different credit reporting agencies use different formulas to calculate credit scores. In fact, each credit reporting agency may calculate different credit scores for different purposes. While credit scores from different agencies vary somewhat, they tend to be very similar. If you've got a good credit score with one credit reporting agency, you probably have a good score with the others. And if your credit score is bad with one agency, it's almost certainly bad with the others. The most widely used credit scores are called FICO scores. The three largest credit reporting agencies-- Equifax, Experian, and TransUnion-- each calculate their own FICO score. Each company also calculates its own proprietary credit scores. The lowest possible FICO score is 300-- the highest is 850. Higher scores are better. 50% of people have scores below 712, and 50% have scores above 712. FICO scores between 300 and 619 are considered bad credit. 25% of people have bad credit scores. Scores of 620 to 660 are fair credit. Scores of 661 to 720 are good credit. Scores above 721 are excellent credit, although sometimes for the best terms on a mortgage or a loan, you need a score above 760.

Before discussing how credit scores are calculated, and what you can do to improve yours, let's talk for a moment about why your credit score is important. Not surprisingly, your credit score is a big part of whether or not you're able to borrow money. Whether you're applying for a car loan, a mortgage, a credit card-- the likelihood of approval depends upon your credit score. And maybe more important, the terms of the loan you get depend upon your credit score.

If you've got good or excellent credit, you're going to get a lower interest rate on your mortgage or car loan. On a mortgage, a lower interest rate could save you thousands of dollars. But it isn't only the lenders who pay attention to credit ratings. Landlords check credit scores before renting apartments. Insurance companies charge higher rates to people with bad credit scores. Utility companies, cell phone companies, any company that's considering selling you services that you're going to use before you pay, will check your credit score. If your score is low, your utility company may require a deposit before giving you service. Finally, nearly half of employers check credit scores when hiring. This is especially true for retail positions. In many, many ways, a low credit score makes your life more difficult and more expensive.

Credit scores are calculated from the following types of information in your credit report. First, about 35% of your FICO score is based on your payment history. This is the most important component in determining your FICO score. If you've been more than 30 days late paying credit card companies, or loans, or other creditors, that hurts your credit score. Being late on more accounts, for larger accounts, and for more days will all hurt your credit score. The more loans and credit accounts you've always paid on time, the higher your credit score. Late payments would generally stay on your credit report for seven years. Bankruptcies can stay on your report for up to 10 years. You can get incorrect information removed from your credit report. However, if you were actually more than 30 days late paying a loan or creditor, you won't be able to have that removed. But as long as you build up more years of paying on time, your credit score will improve.

About 30% of your FICO score is based upon how high your total credit limits are, and how much you owe compared to your total credit limits. If your credit card balance is close to the limit, that's going to hurt your score. For example, if you have a total credit card limit on all your credit cards of $10,000, and you currently owe $9,900 on those cards, it's going to hurt your credit score. If you have a total credit limit of $10,000 and you owe $1,000, that's going to be a lot better. The more that you owe compared to your credit limit, the lower your score will be.

About 15% of your FICO score is based upon the length of your credit history. The longer you've had a good credit history, the higher your score. You can, however, have a good credit score even with a short credit history.

About 10% of your FICO score is based on whether you've recently applied for, or have gotten, new credit accounts. If you've recently applied, or gotten several new credit cards or loans, that will lower your score because the rating agency is concerned that financial problems are causing you to apply for a lot of new credit. Multiple credit score inquiries will lower your credit rating. So if you're shopping for a mortgage or an auto loan, you should try to get all your quotes during a one to two week period. The FICO scoring model will treat these as a single inquiry about your credit rating.

About 10% of your FICO score is based on other factors, such as whether you appear to have a typical mix of credit cards and other loans, like mortgages and auto loans. That's generally considered to be the least influential part of the FICO score. Some things that credit scores are not allowed to consider are race, color, religion, national origin, sex, marital status or whether you've received public assistance. Another factor that's not considered in computing your credit score is your income. Even people with low incomes can have high credit scores. Of course, always paying all of your debts on time is harder when you have a low income, but the benefits of a high credit score can be substantial. Usually you have to pay to see your credit score. Fair Isaac Corporation, which developed the FICO score, will sell you your score for $14.95 at myfico.com. You can get free credit scores from websites such as CreditKarma.com. Free credit scores won't usually be your actual FICO score, but they'll be close enough to it, and will give you an indication of your credit rating.

While you may be curious about your FICO score, knowing exactly what it is far less important than regularly checking your credit report to make sure it has no errors. You can get three free copies of your credit report each year, one from each of the three large credit reporting agencies. We'll talk in another video about credit reports. Most likely, you have a bad credit rating if you are currently late on a credit card payment, medical bill, or loan payment-- if in the last six months, you've been more than 60 days late on a credit card payment, medical bill, or loan payment; if all your credit cards are maxed out or nearly maxed out; if you've declared bankruptcy in the last three years.

So how can you improve your credit score? Well, pay your bills on time. Keep balances low on your credit cards. Pay off debt, rather than moving it between credit cards. Apply for new credit accounts only when you need them. If you've missed payments, get current and stay current. The longer you've been paying on time, the better your score. Check your credit report regularly for accuracy. Contact the creditor and the credit reporting agency to get errors corrected. Your credit score is a big factor in determining whether or not you get a loan, but other things matter as well. Lenders will, or at least should, look at your ability to repay the loan. Especially for a large loan, such as mortgages, lenders will consider your income and your other required debt payments. Lenders prefer applicants who earn more, have lived in the same home or apartment for more than a short time, have held their job for awhile, and have a job which seems secure.

Your credit score depends upon your credit history. If you're married, and you and your spouse apply jointly for a credit card or car loan, the payment history on that card or loan affects your credit score. If the car or loan is only in your spouse's name, and you did not co-sign on the debt, the payment history affects only your spouse. It doesn't help you build credit, and it doesn't hurt your credit. However, depending upon the nature of the debt and the state you live in, you may be responsible for the debt even though you didn't sign on it.