

CBC CREDIT SERVICES OF DAYTON, INC.

A Division of  COMPANIES



Understanding Credit Scores



Scores are part of the lending decision

Credit scores have been widely used in consumer lending for more than 10 years. Typically, lenders making almost any kind of credit decision will look at a variety of types of information, including one or more credit scores. While there are many kinds of credit scores, the most frequently used are credit bureau risk scores developed by Fair, Isaac and Company, Inc.. These are commonly known as FICO® scores, although they have different names at each of the national credit reporting agencies. Equifax's score is known as 'Beacon', Trans Union's Score is known as "Empirica", and Experian's score is known as "Fair Isaac". Scores are used by lenders to make billions of credit decisions each year, including more than 75 percent of mortgage loan originations. The score from each credit reporting agency considers only the data in a specific credit report at that agency. This is why you may have a different score from each of the credit reporting agencies. A score is a number that tells a lender how likely an individual is to repay a loan, or make credit payments on time. When a lender requests a credit report and score from a credit reporting agency, the score is calculated by a "scorecard" or scoring model at the time your credit report is pulled. The score is not part of the credit file.

A score takes into consideration 5 separate categories of information, not just one or two.

The importance of any factor depends on the overall information in a credit report. For some people, a given factor may be more important than for someone else with a different credit history. As the information in a credit report changes, so does the importance given any one factor in determining the score. Therefore, it's impossible to say exactly how important any single factor is in determining a score — even the levels of importance will be slightly different for different credit profiles. What's important is the *mix* of information, which varies from person to person, and for any one person over time.

- **A score only looks at information in a specific credit report.** Lenders look at many things when making a credit decision, including income and the kind of credit applied for. However, the FICO score does not reflect these facts, as it only evaluates the credit report at the credit reporting agency.
- **A score considers both positive and negative information in the credit report.** Late payments will lower the score, but having a good record of making payments on time will raise the score.
- **A score does not consider a person's ethnic group, religion, gender, marital status and nationality.** These are, in fact, prohibited from use in scoring by US law.

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The Five Things That Count



Understanding Credit Scores



Factor Number 1 - Payment History

APPROXIMATELY 35% OF A SCORE IS BASED ON THIS CATEGORY

The first thing any lender would want to know is whether a person has paid past credit accounts on time. This is also one of the most important factors in a credit score. However, late payments are not an automatic "score-killer." An overall good credit picture can outweigh one or two instances of, say, late credit card payments. By the same token, having *no* late payments in your credit report doesn't mean you will get a "perfect score." Some 60-65% of credit reports show no late payments at all.

The score takes into account:

- **Payment information on many types of accounts.** These will include credit cards (such as Visa, MasterCard, etc.), retail accounts (such as department store credit cards), installment loans (such as car loans), finance company accounts and mortgage loans.
- **Public record events such as bankruptcies, judgments, suits, liens, wage attachments and collection items.** These are considered quite serious, although older items will count less than more recent ones.
- **Details on late or missed payments specifically, how late they were, how much was owed, how recently they occurred and how many there are.** A 30-day late payment is not as risky as a 90-day late payment. But how recent and frequency count too. A 30-day late payment made just a month ago will count more than a 90-day late payment from five years ago. Remember that closing an account on which there was a previously missed payment does not make the late payment disappear from the credit report.
- **How many accounts show no late payments.** A good track record on most credit accounts will increase a credit score.

Factor #2 - Amounts Owed

APPROXIMATELY 30% OF A SCORE IS BASED ON THIS CATEGORY

Having credit accounts and owing money on them does not mean a person is a high-risk borrower with a low score. However, owing a great deal of money on many accounts can indicate that a person is overextended, and is more likely to make some payments late or not at all. Part of the science of scoring is determining how much credit is *too* much.

The score takes into account:

- **The amount owed on all accounts.** Even if one pays off their credit cards in full every month, the credit report may show a balance on those cards.
- **The amount owed on all accounts, and on different types of accounts.** In addition to the overall amount you owe, the score considers the amount owed on specific types of accounts, such as credit cards and installment loans.
- **Whether a balance shows on certain types of accounts.** In some cases, having a very small balance without missing a payment shows that someone may have managed credit responsibly, and may be slightly better than no balance at all. On the other hand, closing unused credit accounts that show zero balances and that are in good standing will not generally raise the score.
- **How many accounts have balances.** A large number can indicate higher risk of over-extension.
- **How much of the total credit line is being used on credit cards and other "revolving credit" accounts.** Someone closer to "maxing out" on many credit cards may have trouble making payments in the future.
- **How much of installment loan accounts is still owed, compared with the original loan amounts.** For example, if you borrowed \$10,000 to buy a car and you have paid back \$2,000, you owe (with interest) more than 80% of the original loan. Paying down installment loans is a good sign that a person is able and willing to manage and repay debt.

Ways to Boost Credit Scores

The holiday shopping season brings many chances to save 10% or more on purchases by opening credit-card accounts offered by retailers. But consumers looking to buy a car or house this winter might want to think twice before signing up.

The reason: Opening several credit lines in quick succession can lower one's credit scores, the

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all-important numbers used by everyone from car dealers to mortgage lenders to decide how likely you are to repay your debts.

Lower scores mean you may be charged higher interest rates on mortgages, credit cards and other kinds of borrowing. They can also affect consumers in less obvious ways. Many auto insurers, for example, use credit scores to set premium prices, and a growing number of employers factor them into hiring decisions.

Each credit-using consumer has three standard credit scores, as a person's creditworthiness is tallied separately by three major credit-reporting agencies. The scores—known as FICO scores, for Fair Isaac Corp., the company that pioneered credit scoring in the late 1950s—range from 300 to 850. The current national median is 723.

In Full and On Time

While the math behind FICO scores is hopelessly complex, there are several key principles that consumers can follow to raise them.

The most important way to improve credit scores is also the least surprising: Pay bills in full and on time. In fact, your history of making payments accounts for 35% of the FICO score.

Missing credit-card payments or submitting the minimum due each month will immediately lower scores, as will any debt collections or bankruptcy filings that show up on your credit report. The only good news here is that credit scores reflect fairly recent activity, so major negatives like collections will eventually age their way off credit reports after several years.

The second priority for people looking to boost their score is to maintain a low "credit utilization" level. This refers to the percentage of available credit being used on each card.

Put simply, maxing out credit cards will tank your credit scores. Even using 50% or more of a limit can cause problems. If a consumer has four credit cards with a \$1,000 credit line each, for example, it's

not wise to carry a balance of more than \$500 per card. It's better to carry smaller balances on several cards than to pile everything onto one card.

The credit-utilization level falls under a complex category known as "amounts owed," which makes up 30% of the FICO score.

The third-most-important strategy, which makes up 15% of the FICO score, is to build up a lengthy credit history. This means it's usually better not to close out all those old cards—unless new ones are replacing them—because keeping them open builds history. Moreover, keeping otherwise dormant accounts active will help lower the balance-to-limit ratio, since limits are factored into the credit-utilization formula.

Diversify Debt

The final 20% is equally divided between two categories: new accounts and diversification.

Unlike keeping old accounts open, taking out new lines of credit raises red flags because it makes the consumer look riskier. This is why it's best to avoid all those retail cards during the holidays—unless, of course, a temporary decline in credit score is no big deal.

Diversification means consumers get credit for having a variety of loans, so it's better to have an assortment, including installment plans like auto loans or mortgages, rather than just simply credit cards.

Another important consideration for consumers is the accuracy of their credit reports. Since credit scores are based on credit reports, it's vital to make sure the information in your reports is free of errors and fraud. Federal law gives consumers the right to get a free report from each of the major credit bureaus once per year. See www.annualcreditreport.com.

Mortgage applicants in a hurry to raise their scores should ask their lender about "rapid rescoring," a fairly inexpensive process that can erase errors and bump up scores in a matter of days.

By Christopher Conkey