

# Credit Scoring

## Guide to How Your Credit Scoring Works



By

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# Credit Scoring - Special Report

## INTRODUCTION

Once upon a time, people traded to get what they wanted. They would trade goods for services or other goods. As time marched on, they learned to use a different type of bartering system—one that relied on currency.

Money was used to pay wages for work done and to buy food, build homes, and purchase land. When times were hard and money was in short supply, businesses would let people that they knew use credit to buy items they needed until they could get the money.

Businesses began using ledger books to keep track of who owed what. People with more money found it advantageous to lend that money to those who didn't have enough. They could get a return on their investment by charging interest on the borrowed money. Unfortunately the rich got richer and the poor stayed that way, but that is another story.

The world revolves on credit. We buy things on time and pay them back with interest. That's what we do with our homes, our cars, our clothes, our furnishings, and most other things we choose to buy.

But, the exciting world of credit didn't tell us that we would need to save in order to pay for all of the things we bought. People default on loans, miss payments, flip debt from one credit card to the other, or borrow against what we have to pay for it. In order to navigate the world of credit successfully, you have to be responsible with money or you will end up with endless debts.

In this report we will discuss several issues relating to credit. After reading it you will understand:

- Credit Scoring
- How credit scoring can be helpful
- Credit Myths
- Credit Reports
- Credit Reporting Agencies
- How Credit Reports Affect Loans
- How to Improve your Credit Score

Credit scores have been a mystery for so long. Now it's time to find out just what you need to know to protect your credit.

## **WHAT IS YOUR CREDIT SCORE?**

Many people can only guess what their credit score actually is. At one time, no one was allowed to know because it was used by banks and other lenders to determine your eligibility to receive money or products from them. Now, all you have to do is request a copy of your credit report to find out that magic number.

### What is a Credit Score?

A credit score is a three digit number that wields a lot of power in the world of credit dealings. A more common name for a credit score is a FICO score. It was given this name after the firm that came up with the modern credit scoring model, Fair Isaac and Company. Suffice it to say, the way that the score is calculated is a complex algorithm that all but the most learned mathematician wouldn't understand.

There are other scoring methods, but FICO is the most popular. Businesses may employ their own methods to come up with a determination for lending eligibility. With other methods, information such as your gross income is used as a part of the credit score equation.

Let's consider the FICO system for a while. The scoring numbers range from 300 to 900. As you would imagine the higher number is better than the lower one. A credit score is a compilation of a number of things. The main part of the equation is your credit history.

Every time that you open an account at a store, apply for a credit card, make a payment, make a purchase, or close an account these actions become a part of your credit history. It creates a trail that shows lenders how you handle the responsibility of credit.

Lenders can take the time to pull your credit report and read it, but in the interest of time, being able to access a single three digit number is easier. This number scoring system has led to shorter turnaround time on loan requests for homes, cars, and cash. People can access a bank or other lender's website and put in a few bits of information.

In twenty-four hours or less, they can receive an answer to their loan request. The credit score lets lenders say "yea" or "nay" to your request. The amount you can actually receive will be based on what category your credit score falls into. In our instant society, this is one more way to make people happy.

## How Credit Scores Work

A credit score is calculated from various pieces of information gathered from your credit report. We are still working with the FICO system here. According to their calculations and based on a total of 100 percent, this is how a score breaks down.

- **10 percent** – types of credit you currently have
- **10 percent** – number of inquiries on your credit report
- **15 percent** – length of credit history
- **30 percent** – amount of outstanding debt
- **35 percent** – credit payment history

Let's look at each one separately.

1. **Types of credit you currently have.** This includes all of your credit whether they are plastic cards or a line of credit at the bank. Loans for homes and cars are also factored into this ten percent. Some say that you should have a combination of credit types instead of just credit cards or just loans, but there is no concrete evidence that one way is better than another.
2. **The number of inquiries on your credit report.** An inquiry is a request from someone to receive a copy of your credit report. The number of inquiries on your credit report doesn't include what they call "soft inquiries" which are requests that come from you, an employer, or those companies that send you pre-approval credit card letters in the mail. Too many inquiries in a short period of time can send up a red flag to lenders. They will wonder why the desperate need for credit all of the sudden. The average person may have ten or fewer inquiries on their credit report.

3. **Length of credit history.** The longer you have had a credit relationship with a lender the better it is for you. For a credit report to be created for you, you must have had credit of some sort for at least six months. Short-term credit histories don't give an accurate picture of how your credit has changed over time—whether good or bad.
  
4. **Amount of outstanding debt.** Have you maxed out those credit cards? Experts suggest that we only use about twenty-five percent of our available credit. This gives us a cushion and available funds if we are every in dire need. Using up to the limit could signal some sort of financial trouble in the works. With several lines of credit at their limit, you will need a significant amount of money just to meet the minimum required payments each month. Unfortunately, many consumers do keep their credit cards at or near their limits.
  
5. **Payment history.** It is better to pay bills on time. When you don't that gets recorded on your credit report. Payments that run thirty, sixty, ninety, or more days overdue are worrisome for credit lenders. They won't take a chance on you if you haven't demonstrated the ability to repay on time. But, everyone has rough patches that they go through. It could be that you lost a job. It is always best to contact the creditor for ways to manage during difficult times so your payment history won't reflect overdue amounts.

Ready to improve your Credit Score in as little as 60 days? For the best, most hands-on information, get a copy of the Credit Secrets Bible here:

<http://www.ourfamilybudget.com/creditbible.html>

It could save you thousands of dollars in interest to be able to get a lower rate.

## How Credit Scores are Helpful

Credit reports and scores are not the enemy. In fact, the use of the credit scoring model is helpful to most borrowers. A credit score is a number. The number is one of many on the scale between 300 and 900. Where that number falls on the scale helps determine your fate as far as qualifying for more credit. In that regard credit scores are offer a helping hand.

Loans are approved faster using a credit score as opposed to a credit report. Lenders have already determined how they will lend their money based on the scale. A number of 675 may be accepted but with a slightly higher interest rate. A number of 450 will be rejected outright.

Instead of wading through mountains of paperwork on your part and the lenders, that number expedites the process. If you call the company and they won't instantly qualify you, you don't have to worry about filling out any other paperwork.

It takes time to read the report and it contains personal information. Part of the reason for credit scoring is so that credit decisions are made on a fairer basis. There is no discrimination in a number. People can't be denied credit on the basis of sex, race, religion, or nationality. All a lender will see is the number.

A credit report shows your entire credit history from Day One. A lender can see the years that you missed payments and had other debt issues. Credit scores change all the time to reflect the most recent payment information. The number will be kinder to you than the report with creditors.

Credit scoring has opened up the world of credit. Where lenders used to offer a few loans to affluent borrowers who could pay them back easily, there are not loans for all borrowers along the credit scoring scale. Lenders are making loans available to higher risk borrowers as well. They may not offer as many of these loans as they do to the lower risk category but they are willing to work with a wider spectrum of borrowers.

With the establishment of instant credit systems, the cost of going through the loan process is less than before. People can fill out an online application for a loan that will be processed a lot quicker than a paper one. Credit approval hotlines can access your credit score and return an answer in minutes. The savings are passed on to the customers through less costly loans.

Credit scores have their upside and downside. The good news is that which side you fall on can be largely controlled by you, the consumer. Credit scores don't change overnight but they do change and we want it to be for the better.

## Credit Myths

Somewhere along the line, people developed ideas about credit scores and credit reports. Maybe it was due to the fact that no one knew their credit score. For all we knew, the lender could be flipping a coin behind closed doors to make their decision. Here are a few of those credit score falsehoods that have gotten passed around over the years. In addition to the false statement, there will be a true statement that follows.

**False: A credit score is the only determining factor when applying for credit.** This is not true or we'd all have been in serious trouble at one time or another. A credit score helps for quick credit responses so that a borrower avoids paperwork. It also works for borrowers with so-so scores because many lenders are willing to work with you. They are people too and know that a number doesn't provide the entire picture. A loan application lists information like income, employment history, credit history, and other items. This information may convince a lender that, despite the lower than average credit score, that the borrower is a worthy risk.

**False: Credit scores are discriminatory and biased.** The Equal Credit Opportunity Act was put in place so that lenders could not potentially discriminate against borrowers. A credit score doesn't reflect anything that would suggest race, gender, age, or religious beliefs. In fact, it is fairer than the system was before the scoring model was instituted. When you access an automated loan service, they pull your score. If your score is 450 you will be denied. Anyone who has a score of 450 will be denied. That score suggests that your repayment of loans is less than favorable—nothing more.

**False: A credit score drops when you apply for credit.** I can't tell you how many times I have heard this one. Every time a lender puts in a request for your credit report it creates an entry called an "inquiry" on your credit report. A person is allowed to have a certain number of inquiries on their report. One inquiry may affect your credit report by twenty points but it won't be a lot. Credit inquiries are routinely erased every two years or sooner.

**False: A bad credit score will never change.** It may seem that way, but this is not true. Most bad entries on a credit report will disappear after seven years. Bankruptcies are subject to a ten year minimum. Even before those items are erased, a lender may use your recent payment history as the basis for extending you credit. Like I said, credit scores do change over time. Work to improve the score so that it changes in your favor.

### What Doesn't Factor into your Credit Score

Don't labor under the false assumption that your credit score includes information that will bias a lender against you. The score is a reflection of many different things, none of which the lender sees unless they request a copy of your credit report. The number of your score is truly faceless.

A credit score doesn't consider personal information. Your marital status, gender, nationality, and race are not considered. People are not grouped according to income levels. Poorer borrowers are not distinguished from other borrowers in the pool of applicants. It is illegal to extend or deny credit based on these factors.

A credit score doesn't reflect the age of the borrower. Will younger borrowers be denied in favor of older, more established people? No. If the older person has a limited credit history, their score will reflect that. If the younger person has many good entries in their credit history, the score they receive will reflect that.

The credit score is not based on how much money you make. You can have an excellent credit score of 800 and only make \$20,000 a year. A lender may deny you on the basis of not enough money to adequately repay the loan. A lender can look deeper into a borrower's other information when deciding how much credit to offer, but the score is not the source of this information.

Custody agreements, alimony payments, and government assistance are not factored into a credit score. These situations cannot be used to lower a person's score. The borrower may list alimony or child support payments on their loan application as income to be considered for repayment, but that is the borrower's choice.

All sorts of inquiries are made for your credit report. Those people that send pre-approval notices in the mail have asked for your score so that they can determine if they want to send you a mailing. You make requests for credit reports to check for errors. Credit agencies request a credit report for reasons of settling disputes. These inquiries are flagged differently so that they don't show up on the credit report and become a part of the percentage of the score that is dedicated to inquiries.

Information that is not on the credit report is not considered for the credit score. The neighborhood that you live in is not a factor. How many children you have is not a factor. Extraneous information does not play a part in the makeup of your score.

## CREDIT REPORTS

Your credit score is derived from the information found on your credit report. We broke down the percentages in an earlier section of the report. Each piece feeds into the calculation that determines the three digit number.

Credit reports weren't always so nice. In the early days of credit reporting agencies, they used to report only the bad credit items. The good was totally ignored. They included testimonials from people you knew who may or may not feel favorably towards you. These reports included employment, insurance, and driving record information. All it added up to was a lot of biased loans.

Credit reports today report different information. Some of the information is for identification purposes but the majority of what is recorded there is for the purposes of satisfying the needs of the credit score equation. The format may differ from credit reporting agency to credit reporting agency but the information is fairly consistent.

### Credit Reporting Agencies

As we said before, FICO is the most widely used credit scoring model used today. There are three credit reporting agencies that have come up with scores based on the FICO system. Because creditors report to any one of the agencies, the information in a person's credit report can differ from agency to agency. Each lender may choose one of the three agencies to request your credit report from.

**Equifax** – This is one of the three main credit reporting bureaus. Creditors report their information about customer accounts to one of the three agencies. Equifax's FICO score is called the BEACON Score. To request a credit report from Equifax, go to [www.equifax.com](http://www.equifax.com).

**TransUnion** – This is another of the Big Three reporting agencies. Their FICO scoring system is called EMPIRICA. To request a copy of your credit report from them, you can contact them by phone at (800) 916-8800 or log on to their website at [www.transunion.com](http://www.transunion.com).

**Experian** – The last of the three, a creditor may use their credit report to get a FICO score for you. Their scoring system is called Experian/Fair Isaac Risk Model. The toll-free number for contacting them is (888) 397-3742. Their website is [www.experian.com](http://www.experian.com).

Since these agencies differ in their information, it is a good idea to request free credit reports from all three. Compare the information for accuracy and contact each one individually if there is a problem with their information.

### What's Included in a Credit Report

The information that comprises your credit report includes:

1. **Credit history** – This section includes all of the credit accounts you have ever opened. Mortgages and car loans are included. Accounts that have since closed are also included in the report. On time as well as late payments for the time period since the account was opened are also listed.
2. **Personal information** – This information is provided for identification purposes. It includes your name, telephone number, address, social security number, birth date, and current employer.
3. **Inquiries** – Remember that the inquiries included are those requested by lenders who you have given permission to access the report. Even if you don't get the credit or use that particular lender, their inquiry will still be registered on your credit report.

4. **Dispute statements** – When you dispute something that is recorded on your credit report, you are allowed to make a statement that will be added to your credit report. This occurs when the dispute is found by the credit company to be unfounded. A statement expresses your point of view on the situation in 100 words or less.
  
5. **Public records** – Bankruptcies, judgments, repossessions, and liens are listed in this section.

### What do These Reports Indicate?

Credit reports can indicate a number of things. The biggest thing that lenders look at is the missed payments. Payment cycles allow for a grace period. If a payment is made during the grace period it is not counted against you as a late payment.

Late payments mean that the payment was made after the grace period. Many lenders will let payments go as many as 120 days past due before reporting the delinquency to an outside agency. Any payments that are frequently overdue send up a warning flag to creditors. If the payments are a part of the recent credit history of the individual it is even more of a concern as the person is applying for new credit.

Open credit accounts are also a thing to watch out for. You would think that it would be good to have accounts that had not been charged off or closed by the lender for late payments. Too many new open accounts signal that the borrower is creating a potentially poor financial situation. They may be desperate for credit because of low cash flow. In that case, how will they make payments on all of these open accounts? Adding another account would not be too high a risk for a creditor.

Inquiries are an indicator of poor financial judgment. A certain number of inquiries are okay. We may be working with lenders for a home loan or shopping for a new car. Too many inquiries in a short span of time can also mean desperation on the part of the borrower. A lender will likely ask about that especially if the person already has several open accounts.

Debt to income ratio is an important factor in determining a borrower's ability to repay a loan. If you have incurred debt that is more than twenty percent of your annual income, you could be headed for trouble. This ratio includes home, car, credit card, and other types of loans.

What it doesn't include is the monthly bills that will need to be met as well as paying down loan debt. Lenders know that in a pinch, the first thing that is left unpaid is the loans in favor of utilities and food. They will be reluctant to loan you money if you already have too much debt.

Credit cards that are paid on time are good. Credit cards that are paid but maxed out are not so good. Lenders will wonder what the reason is behind the limit staying so high. They will also see that as you make payments, new charges bring the card back up to its limit. There is no cushion if all the credit is used up. This says to the lender that there is no money to repay their loan.

## Shortcomings of Credit Reports

While credit reports do help to create our credit score, they can also hurt us. Information that is reported to credit repositories like Experian, Equifax, and TransUnion are taken at face value. This information is not checked for errors.

If the information is reported with mistakes, those mistakes will remain on your credit report until you discover them. It is human error, but it can cost you points on your credit score and therefore ruin your chances of getting a home loan. It is important to check for these human errors and contact the reporting agency to dispute the information as soon as you notice it.

## Credit Reports and Scores Affect Loans and Interest Rates

A credit report is used to determine our credit score. Our credit score in turn is used to determine our eligibility for loans. A lender may outright deny your application for credit based on your credit score. This happens to hundreds of people who have scores that rank on the lower end of the scale.

But, let's say that you do get approved for a home mortgage loan or a car loan. The actual price of the house or car may be the same as it is for a person whose score is on the higher end of the scoring scale. The difference comes in when the interest rate is introduced. That is the rate of return the lender gets for extending you credit.

The borrower on the higher end gets offered an interest rate of 2.9 percent for their car loan and it is financed for five years or sixty months. The other borrower who has the lower score gets an interest rate of 10 percent on their loan and it is financed for the same amount of time. That second person is paying 7.1 percent more in interest than the other borrower for the same car. The lender will make a lot more money off of him just because his credit score was lower.

Borrowing money means higher interest rates for those with low credit scores. Lenders don't use scores alone but if your credit report rightly reflects a poor payment history on several lines of credit, it will be hard for a lender to give you a loan with confidence let alone a lower interest rate.

## CONCLUSION

What have we learned here? Credit scores work in our favor. They don't discriminate in unethical ways. What they do is give a partial picture of how we pay off our debts and manage our money.

What about low scores? We pay higher interest rates and get turned down more often for loans. The low score indicates that something is wrong with our credit report.

The good news is that it is all in our hands. Barring mistakes created from human error, a history of missed payments or poor credit choices won't haunt you forever. A score can change with a little financial discipline from us going forward.

Are you ready to raise your credit score by up to 249 points in as little as 60 days?

Grab a copy of the Credit Secret Bible at

<http://www.ourfamilybudget.com/creditbible.html>

