Myvesta℠

The Financial Health Center℠

Credit Scoring: How it Works and How You Can Improve Your Score

What Is Credit Scoring?

If you have tried to get credit, a loan or a mortgage, you may have had your credit information graded for risk potential. This is called "credit scoring" or "risk scoring." Credit scoring is one factor that lenders or creditors consider to determine if they should give you a loan, a mortgage or extend you credit. According to research, the better a borrower's score, the more likely he is willing and able to repay a loan.

Our mission at Myvesta is to help people improve the quality of their lives by eliminating financial stress through education and services.
Visit our Web site at Myvesta.org or call 1-800-680-3328 or 301-762-5270. We're here to help.

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The "score" is a number grade included in to your credit history at a particular point in time. Lenders use credit scoring to speed up the loan review process and to reduce the cost of examining your credit information. Credit scoring also gives lenders an unbiased method of evaluating your credit history.

Credit scoring occurs at many levels. Each credit reporting agency has a credit scoring model based on that particular reporting agency's data on the borrower. Although the reporting agencies have different names for the credit scoring products they offer, most use a Fair Isaac Company (FICO) model. The scores are scaled consistently so that scores at all three reporting agencies should be similar.

In addition to credit reporting agency scores, there are numerous other company scoring models, such as "application scores," which lenders calculate themselves. Custom scoring models are developed from a business's own data on its customers, such as information from credit application forms and credit reports. This article will concentrate on the FICO scoring model as it is the most commonly used.

A FICO score is based on the information in your credit report located at that particular credit reporting agency.

How Do I Get My Credit Score?

While credit scores have been kept a secret for many years, the good news is that now consumers can review their own credit scores. All three major credit bureaus have announced plans to reveal consumer's credit scores to them, and in the meantime you can purchase a credit score when you buy your credit report through certain companies. For example, you can obtain a copy of your credit score when you order your credit report online at Myvesta.org. Don't forget, though; your credit score may vary somewhat depending on which company compiles the score. And also remember that it can change over time.

How Does Credit Scoring Work?

Credit scoring places a value on the types of accounts you hold as well as your payment history. The formula that determines your score is not disclosed. However, a consumer can determine what information is important in scoring models by knowing what information is put into a FICO score and knowing the four "reason codes" that accompany your score.

Information in a FICO Score

A FICO score is based on the information in your credit report located at that particular credit reporting agency. It is not based on your assets or income, although lenders consider these factors separately. FICO grades your risk by looking at your entire credit picture:

Your Payment History

FICO considers whether you have accounts in collection; whether you have any delinquencies and how frequent and recent they are; and whether you make your payments on time. How much impact each item has on your score depends on what other information is in the report. The FICO model looks at credit patterns, not isolated credit mistakes. For instance, one late payment may not affect your score significantly if the rest of your history is good. In addition, FICO gives you points for maintaining a good payment relationship.

Banks, department stores, employers or landlords make "inquiries" on your credit report every time you apply for credit or a loan at that institution.

The Amount of Outstanding Debt

FICO considers the number of balances recently reported, the average balance across all trade lines, and the relationship between the total balance and total credit limit. FICO considers your current level of borrowing and whether you are close to or over your limit. Carrying too much available credit can be held against you even if you do not have balances on those cards.

Your Credit History

FICO looks at how long you have had your accounts, the total number of "inquiries" and new accounts opened, the number of inquiries and new accounts opened in the last year, and the amount of time since the most recent inquiry. Banks, department stores, employers or landlords make "inquiries" on your credit report every time you apply for credit or a loan with them. The FICO scoring model takes inquiries into account because statistics show that people who are anticipating financial troubles try to increase the number of credit lines they have available. The FICO model takes into account certain lender practices that normally would negatively affect your credit report. For instance, if you were interested in buying a car and the dealer agreed to finance you, the dealer may run credit inquiries on various lenders, which would then show up as numerous inquiries on your credit report. Beginning the first quarter of 1998, FICO models treat all inquiries occurring within a 14-day period as one inquiry. In addition, all models will ignore all auto- and mortgage-related inquires that occur within a 30-day period before calculating your score.

The Types of Credit You Use

FICO looks at the diversity of credit you use, whether you use bankcard, travel and entertainment cards, department store cards, personal finance company references and/or installment loans.

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Negative Information

Negative information in your credit report that could impact the FICO score includes bankruptcies, delinquencies or late payments on accounts, collections, too many credit lines charged to the max, too little credit history (less than five credit lines in the past two years) and too many credit report inquiries.

Information FICO Does Not Consider

FICO does not consider your race, color, religion, national origin, sex, sexual orientation, marital status or age.

A typical scoring model may also consider your job or profession for stability, and how long you've lived at your address.

How much weight each of these factors has on your score is not disclosed to you because lenders say it causes more confusion than insight into the credit scoring process. Everything in credit scoring is relative — one negative item can have a small or large impact on your score depending on your credit history.

Credit scoring requires that you have at least one account that is older than six months and has been reported to the credit reporting agency in the last six months.

If you have a long and seasoned history of credit and many established accounts, one late payment would have a small impact on your score. However, if you have a short credit history, one late payment would impact your credit history much more.

If you have no established credit, you will have no score. Credit scoring requires that you have at least one account that is older than six months and has been reported to the credit reporting agency in the last six months.

Your score should be affected less if you have late payments on minor credit lines versus major ones. For example, if you are delinquent on a gas or department store account, and not on a mortgage or auto loan, your score should not be affected as much as it would if you are delinquent on an auto loan. Your credit score should be stronger with credit cards than mortgages since statistics show that credit cards are more indicative of paying on a loan than a mortgage is (most people will pay on their mortgage no matter what, and let credit card payments slide). Paying on a secured card should affect your score more than payments on department store cards.

The Reason Codes

Lenders are not required to tell you your credit score, but if your score is low and you are turned down for a loan, the lender must give you the reasons for your low score. Your score is accompanied by "reason codes" that explain why your score wasn't higher, listed in order of impact on the score. These codes are essential in helping you improve your score later in time. The following list of all possible reason codes show how many aspects of your credit report are used in a FICO score.

Your reason codes would be taken from this list:

- Amount owed on accounts is too high
- Delinquency on accounts
- Too few bank revolving accounts
- Too many bank or national revolving accounts
- Too many accounts with balances
- Consumer finance accounts
- Account payment history is too new to rate
- Too many inquiries in last 12 months
- Too many accounts opened in last 12 months
- Proportion of balances to credit limits is too high

- Amount owed on revolving accounts is too high
- Length of revolving credit history is too short
- Time since delinquent is too recent or unknown
- Length of credit history is too short
- Lack of recent bank revolving account information
- No recent non-mortgage balance information
- Number of accounts with delinquency
- Too few accounts currently paid as agreed
- Time since derogatory public record or collection
- Amount past due on accounts
- Serious delinquency, derogatory public record or collection
- Too many bank or national revolving accounts with balances
- No recent revolving balances
- Proportion of loan balances to loan amounts is too high
- Lack of recent installment loan information
- Date of last inquiry too recent
- Time since last account opening is too short
- Number of revolving accounts
- Number of bank revolving or revolving accounts
- Number of established accounts
- No recent bankcard balances
- Too few accounts with recent payment information.

What Is a Good Credit Score?

What actual number is a good score depends on the scoring model, the type of loan and the lender's acceptable risk level and credit policies. For most models, the higher the score, the better. If the score on a borrower's credit report is too low for one product, it may be acceptable for other products. Likewise, if one lender turns down a request for credit, it does not mean that another one will. For instance, an automobile dealer may accept a lower score than a creditor who offers an unsecured line of credit.

FICO scores range from 375 to 900 points. With mortgage lenders, there is a pattern for acceptable FICO scores. Generally a score of 700 to 900 is considered excellent, and very basic underwriting or information beyond the score will be necessary to get a loan with the most favorable terms. If a borrower gets this score, he or she can get a loan for a mortgage in significantly less time. A score above 500 is still acceptable, but will probably cause lenders to look more closely at the borrower's file to determine potential risks. Lenders may require supplemental credit documentation and letters of explanation before an underwriting decision is made. If a borrower has a score between these numbers, a mortgage decision will take approximately the same amount of processing time as it took before mortgage companies starting using FICO scoring.

A credit score can be a significant factor in the loan process or just one piece of the puzzle, depending on the lender and the type of loan. For instance, a credit score may play a larger role for consumers seeking home equity loans, as the credit score dictates the pricing for the loan. On the other hand, a traditional first mortgage may not put as much emphasis on the credit score.

What Your Credit Score Tells Lenders

FICO Score: 700 and up

A score of 700 and above is generally considered excellent.

Most lenders give you an A rating.

You will have access to the best interest rates because you have probably not been late with any of your loan payments.

60 percent of the U.S population has a score of 700 or above.

Average delinquency rate = 8 percent.

FICO Score: 600 to 699

A score in the range of 600 to 699 typically means you have good credit.

Most lenders would say you have a B rating, which means that you may have been a few days late with a payment or have a slim credit history. You may still have access to good interest rates, but might not qualify for the very lowest rates.

27 percent of the U.S. population has a score between 600 and 699.

Average delinquency rate = 20 percent.

FICO Score: 500 to 599

A score in the range of 500 to 599 tells creditors that you may have paid unsecured debts more than 60 days late or been late with your mortgage payments. One or more of your accounts may be in collections.

Most lenders would give you a C rating, which means you will probably have to pay at least two percentage points or more than people with excellent credit.

12 percent of the U.S. population has a score between 500 and 599.

Average delinquency rate = 60 percent.

FICO Score: 499 & below

A score of 499 and below tells creditors that you may have liens against your property, a lender may have sued you for missed payments and/or your property has been foreclosed.

You may still be eligible for a loan, but your interest rate could be three points or more higher than people with excellent credit.

1 percent of the U.S. population has a score of 499 or below.

Average delinquency rate = 87 percent.

How Can I Improve My Credit Score?

Your credit score is constantly changing as your credit report information is always changing. Every time you try to get a loan or mortgage, the lender computes a new credit score. Taking steps to improve your credit report may not significantly or immediately impact your credit score since the scoring models study patterns of credit behavior over time.

Keep in mind that as negative information ages, it has less importance.

Here are some general tips on how to improve your credit history which, over time, will improve your FICO score. Keep in mind that as negative information ages, it has less importance. It usually takes one full year of good credit behavior to see a significant change in your credit score. This means you should exhibit a full year of responsible payment behavior in your credit report — specifically, conservative use of credit, paying on time and not requesting too much credit during a short period of time.

Correct Errors:

You should get a copy of your credit report and make sure all information in it is complete and correct. Keep in mind that any corrections you make to your report takes 30 days to take effect. Again, remember that removing or changing one incorrect derogatory item from your credit report will not guarantee an increase in the score. In addition, many lenders will not count errors on your report if you document those errors for the lender. Consumers can obtain a consolidated credit report from the Myvesta.org Web site.

Inquiries:

Keep inquiries to a minimum. Don't "credit surf," or move balances from card to card to take advantage of promotional low interest rates. Many inquiries make it appear that you are shopping for credit, which indicates that you anticipate the need for many lines of credit. The more seasoned and longer your credit history, the better.

Close Unneeded Accounts:

The less available credit you have, the less risk you will pose to a potential creditor or lender. Keep around two to four credit cards for the best score. Close all unused or unnecessary accounts.

Just cutting up your card and tossing it in the trash does not close your credit card account.

Just cutting up your card and tossing it in the trash does not close your credit card account. The safest way to close a credit card account is by sending a certified letter, return receipt requested, to the customer service department of the card issuer.

Ask the card issuer to close your account and to report your account to credit reporting agencies as "closed by consumer." In approximately 10 days, the card issuer should send you a letter confirming that your account is "closed by the consumer." If you don't receive the confirmation letter, follow up by calling the card issuer to make sure it closed your card and is reporting it properly to the credit reporting agencies. You may even want to get another copy of your credit report to make sure it is reported correctly.

Pay Off Credit Cards:

This shows that you use credit wisely and aren't spreading yourself thin. Keep your credit limits and outstanding balances down. Conservative use of credit is important — keep balances at below 50 percent of the available credit for credit cards.

Pay Credit Obligations on Time:

The longer history you have of responsibly using credit and paying on time, the better your score.

Satisfy Any Public Records, such as tax liens or judgments.

If you receive a bad score, request a copy of the four reason codes and do what you can to address them all.

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