

What is a Credit Score and Why Do I Care What It Is?

Your Credit Score is a lot like the score you get on a test. You **get points** for good credit decisions and behavior and you **get points taken away** for bad credit decisions and behavior.

Your credit score (also known as your FICO score) can range from 300-850, and just like your score on a test, the higher your score the better!

Your FICO score is based on a mathematical equation used to evaluate the possible risk associated with lending you money. FICO stands for Fair Isaac Corporation, the company that originally created the formula.

Credit scores give potential lenders a quick way to measure your credit risk. Would you loan money to someone you know is unreliable? If you thought you wouldn't get your money back, you would consider loaning him/her money a risk, right?

Before lenders began using FICO scores to calculate risk, getting a credit decision from a lender was a slow, inconsistent and possibly, biased process. Now that lenders use the FICO score to determine the possible risk of a potential client, there are many benefits.

- **Loans get approved faster.**
Scores are available to lenders online immediately. Credit decisions can be made in minutes and even retail stores. Internet sites and other lenders can make “instant” credit decisions.
- **Credit decisions are fairer.**
The credit scoring process focuses on facts and not on personal bias, gender, race, religion, marital status or nationality.
- **Credit mistakes count for less over time.**
Past credit problems won't haunt you forever. The weight of bad credit decisions in the past fade as time goes by, whereas as good payment patterns and decisions show up on your report.
- **More credit is available.**
Lenders that use credit scoring approve more loans because they have a more precise picture of the risk they are taking when they approve a line of credit for a borrower. Even clients with scores lower than a lender prefers might be approved because some lenders offer a variety of products geared to serve different credit risk levels.

The Benefits of Having a Good Credit Score:

- **BETTER CREDIT RATES:** Car loans, credit cards and other credit products have better rates for a variety of borrowers.
- **RENTING :** Many landlords pull credit reports to see what kind of people they might have as tenants.



- **JOB OPPORTUNITIES:** Many employers use a credit report as information about the type of person they may be hiring.
- **CAR INSURANCE:** Referred rates on car insurance are offered to customers with excellent credit.
- **CELL PHONES:** Many cell phone companies require a credit check prior to opening a new cell phone agreement and before you receive a new phone.
- **MORTGAGES:** When it comes time to buy your first home, your credit score will determine IF you will get a mortgage to purchase that home and at what interest rate!

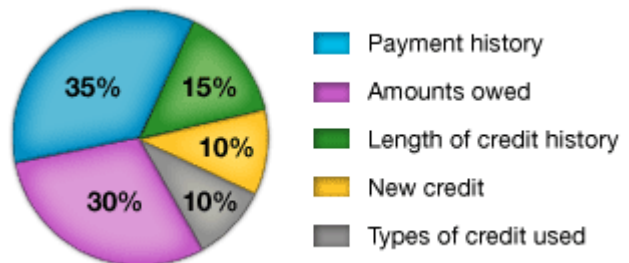
How is My Credit Score Determined?

THE FICO 5

There are five components that make up your credit score. Your payment history and the total amount of your debt are important parts of your score, but not the only factors that go into determining your score.

Breakdown of the five elements that make up your FICO score:

- Payment History 35%
- Debt Amounts 30%
- Length of Credit History 15%
- New Credit 10%
- Credit Type Mix 10%



➤ Payment History

The history of repayment of past debt is the single most important factor in determining a credit score. Past, long-term behavior is used as a forecast of future long-term behavior. A person with a history of late or missed payments is seen as much more risky than a person with little or no history of late or missed payments. Defaulting on a large, installment loan, such as a mortgage loan, will damage a credit score much more severely than defaulting on a smaller, revolving credit line, like a credit card. However, neither is a good option. One of the best ways to protect your credit score is to make consistent, timely payments on all outstanding debts.

If you do have an occasional late payment, it may have an effect on a credit decision. If you have had any late payments recently, a lender might conclude you **are** having some trouble, which means you are a high risk and that extending more credit to you at this time is not a good idea.

If, however, those late payments occurred three years ago, the lender might conclude that you **were** having some trouble a while ago, but your clean payment history since then would indicate that those troubles are behind you.

➤ Debt Amounts

Thirty percent of your credit score is based on the total outstanding debt you carry. Revolving lines of credit are weighted more heavily than installment types of credit. Revolving lines of credit (like credit cards, for instance), allow the borrower to borrow as much or as little as they need up to a pre-determined credit limit. As this debt gets paid down, the debt can then be re-borrowed again and again up to the available limit. Installment credit (such as a car loan), is a set amount, determined at the beginning of the loan and is paid off in installments.

When the FICO calculation shows borrowers habitually max out their credit cards, it shows that people can't handle credit responsibly. To protect your credit score, you should keep low credit card balances in relation to the credit limit of those cards.

The amount of debt you actually owe in relation to your credit limits is a factor that can help or hurt your score. This is calculated on a per-card basis as well as an overall basis.

Make sure you don't borrow more than 50% of the credit limit on any one card. Ideally, you'd like to stay below 33% of your credit limit. This means it is better to owe a little on several cards than to max out one card all the way up to your credit limit.

➤ **Length of Credit History**

The length of time each credit account has been opened and the length of time since there has been any recent activity on each account is 15% of the credit score. For this reason, a person that is just beginning to use credit cannot have a perfect credit score. The longer a credit history is the better picture a lender has of a person's long-term financial behavior. People just starting out should obtain and use credit responsibly and those with a longer history should keep their oldest accounts open and use them.

People with outstanding credit (scores of 800 or better) hold at least three credit cards with low balances and have had them open for more than seven years. Once you get credit, even if you pay it off completely, don't close the account. Instead, keep it open and use it occasionally to keep it active -- then pay it off each month.

➤ **New Credit**

Opening too many new credit accounts all at once might look to lenders like you are in bad financial shape and in need of significant new credit to stay afloat. Therefore, you should only request and take on new credit when it is needed and/or when it makes good financial sense to do so.

➤ **Credit Type Mix**

Historically, borrowers with a good mix of revolving accounts (like credit cards) and installment products (like car loans and mortgages) represent less risk for lenders. In general, this mix tends to indicate the borrower can handle all kinds of credit.

Knowing the weights given to the FICO 5 can help you focus when you are trying to build or improve your credit score. Basically, to get and keep a good credit score you will need a long

history of credit with no late payments or defaults as well as low balances in relation to your overall credit limits.

Good Credit Decisions

Now take a look at a real-life credit decision. The choices you make will determine how to get what you need and improve your credit score at the same time.

Let's say your only credit account is a credit card from ACME Credit services. You are carrying a \$5,000 balance on this card with an interest rate of 15.9% and a total credit line of \$10,000.

One day, you receive an offer in the mail from Bank Uno Credit Services for a credit card with a fixed interest rate that is half of the card you have from ACME! Sure, you are making your monthly payments to ACME with no problem, but dollar signs start flashing in your head as you think of all the interest you'll be saving by transferring your balance to your shiny new Bank Uno card!

You accept the offer from Bank Uno. Your credit is good, right? With no problems your new card arrives in a week. Then, you transfer your balance over from ACME to Bank Uno.

What you do next will determine what happens to your credit score.

Originally, you had a \$5,000 balance on the ACME card with a \$10,000 limit so you were using 50% of your available credit.

$$5000/10000 = .50 = 50\%$$

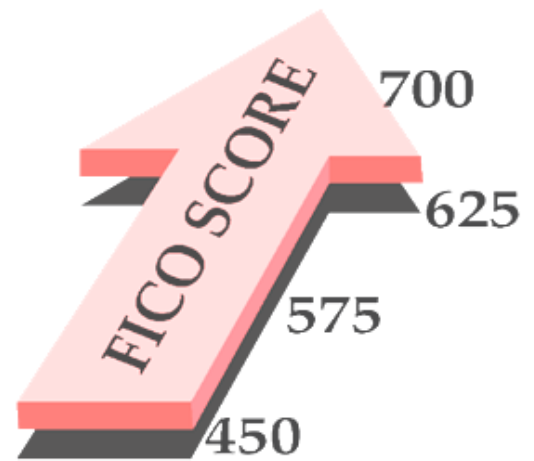
If the new Bank Uno card has a credit limit of \$8,000 you will now be using 62.5% of the credit on your Bank Uno card. Next, you should you close the ACME account because you will be using 62.5% of your total available credit, so your credit score will definitely suffer. Since the new Bank Uno card is brand new, the "Length of Credit History" component of the FICO calculation will suffer and your credit score will drop some more.

If the new Bank Uno card has the same credit limit (\$10,000) as your old ACME card, and you've had the ACME card for a couple of years and a good repayment history with them, then it would be better to keep the ACME card open. Even if you don't use it, you will be using \$5000 out of a total of \$20,000 available credit, which is 25%.

$$5000/20000 = .25 = 25\%.$$

Your debt to available credit ratio just improved from 50% to 25% which is a dramatic improvement so your credit score should improve!

To keep your credit score high and to improve it, avoid doing anything that will increase your debt percentage. Even though the amount of debt you owe is the same, using 25% of your available debt always looks better than using 50% of it! Don't try too hard to lower your debt



percentage either. Remember, applying for and getting new debt will lower your credit score, at least for a period of time. If it looks like you are accumulating more available credit than you need, that too will lower your score.

Your time would be much better spent trying to pay down your balance to improve your debt percentage instead.

Bad Credit Decisions Can Cost You

While making sound financial decisions will improve your credit score, bad decisions and irresponsible use of credit, can really cost you where it hurts the most: your wallet.

Earlier we mentioned you would get better rates on loans of all types if your credit is good. The opposite holds true, as well. Having a bad credit score will cost you because banks and financial institutions will charge you interest on a loan more than another customer that has better credit.

The higher your interest rate, the more expensive your loan!

Below is an example of a “FICO Score to Interest Rate” table that might be used to make loan decisions on an auto loan of \$25,000 to be paid off in 36 months (three years).

FICO score	APR [?]	Monthly payment
720-850	7.126%	\$773
690-719	8.032%	\$784
660-689	9.785%	\$804
620-659	11.745%	\$827
590-619	15.171%	\$869
500-589	15.999%	\$879



Notice, the higher the credit score the customer has the lower the interest rate the bank will charge for the same loan.

FICO 720-850 is the absolute **lowest risk** to the lender.

The further down the FICO scale a customer’s score falls, the **higher risk** that person is so the banks will try to offset the higher risk by charging a higher rate.

There’s more, over the life of the loan, the customer with the lower credit score will pay considerably more interest for the same loan as the customer with the higher credit score:

FICO Score	Interest Rate	Monthly Payment	Total Interest Paid
720-850	7.126%	\$ 773	\$ 2,843
690-719	8.032%	\$ 784	\$ 3,215
660-689	9.785%	\$ 804	\$ 3,951
620-659	11.745%	\$ 827	\$ 4,786
590-619	15.171%	\$ 869	\$ 6,272
500-589	15.999%	\$ 879	\$ 6,640

A great credit score customer pays \$773 per month and a total of \$2,843 in interest over the three years of the loan.

The worst credit score customer with the same loan pays **\$106 more** per month and **\$ 3,797 more** in interest for the exact same thing. Ouch!

Getting Hired!

Many companies use credit reports as criteria when making employment decisions. They seem to feel a credit score is a more reliable and more unbiased look at a potential employee, rather than checking the person's references.

A good credit score can be an indicator of responsible behavior, showing that this person can be trusted around money and other sensitive information.

A bad credit score can signal a potential for irresponsible behavior and an overall untrustworthiness. Fair or not -- bad things do happen to good people -- more and more companies pull credit on potential employees.



The candidate's credit score can be more of a factor when making an employment decision in certain types of jobs. Jobs that require financial responsibility, senior management, accounting, payroll, or any other position where the employee needs to be trusted with sensitive and confidential information, are likely to use credit scores as heavily weighted criteria.

The type of information found on a credit report can also sway a decision one way or another. Sixty-four percent of firms using credit reports in employment decisions say **judgments** such as lawsuits were very likely to influence an employment decision. Forty-nine percent said the **number of debts in collection** could weigh negatively against a prospective employee. Eighteen percent said a **high debt-to-income ratio** would be a red flag and 11% said a **foreclosure** on the report would end an employee's chances.

There is some good news about credit reports and potential employers. An employer won't usually bother pulling a credit report until the potential employee has impressed them enough to be seriously considered for the position.

A proactive way to handle some bad news on your credit report would be to offer it up in the interview. Explain what the blemishes are and why they are there. The employer will most likely appreciate the honesty and you get the chance to explain in advance instead of letting the employer find the information and form his own conclusions.



Tips for Building & Improving your Credit Score

Things that have a **good effect** on your credit score:

- **Paying your bills on time and in full**
- **Using 33% of your available credit or less**
- **Steady employment History**

Things that have an **adverse effect** on your credit score:

- **Late or missed payments**
- **Using 80% or more of your available credit**
- **Gaps in your employment history**
- **Too many new accounts**
- **Accounts with credit limits more than you need**

Here are some helpful pieces of advice you can use to **create and improve your score**:

- ✓ **Pay your bills on time and in full.**
- ✓ **If you have a late payment, get current and stay current.**
- ✓ **Pay down your credit cards to improve your debt percentage.**
- ✓ **Keep balances low on credit cards.**
- ✓ **Don't open new accounts just to improve your percentages.**
- ✓ **Don't open a lot of new accounts all at once.**
- ✓ **Don't close old accounts; use them and pay them off monthly.**
- ✓ **Be responsible with credit!**



Grow Your Credit Score!