



credit cards

What is a credit score?

By Bankrate.com

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Ever wonder why you can go online and be approved for credit within 60 seconds? Or get pre-qualified for a car without anyone even asking you how much money you make? Or why you get one interest rate on loans, while your neighbor gets another?

The answer is credit scoring.

Your credit score is a number generated by a mathematical algorithm -- a formula -- based on information in your credit report, compared to information on tens of millions of other people. The resulting number is a highly accurate prediction of how likely you are to pay your bills.

If it sounds arcane and unimportant, you couldn't be more wrong. Credit scores are used extensively, and if you've gotten a mortgage, a car loan, a credit card or auto insurance, the rate you received was directly related to your credit score. The higher the number, the better you look to lenders. People with the highest scores get the lowest interest rates.

Scoring categories

The scale runs from 300 to 850. The vast majority of people will have scores between 600 and 800. A score of 720 or higher will get you the most favorable interest rates on a mortgage, according to data from Fair Isaac Corp., a California-based company that developed the credit score. (Its own score is called the FICO score.)

American public's credit scores break out along these lines:

Credit score	Percentage
499 and below	1 percent
500-549	5 percent

550-599	7 percent
600-649	11 percent
650-699	16 percent
700-749	20 percent
749-799	29 percent
800 and above	11 percent

What's the big deal?

Your credit score will determine if you get credit at all, and the interest rate on that credit, says Ed Ojdana, president of Experian Consumer Direct, part of Experian, the largest of the three major credit-reporting agencies. "The better the score, the lower the interest rate and that can save you a ton of money."

The difference in the interest rates offered to a person with a score of 520 and a person with a 720 score is 3.45 percentage points, according to [Fair Isaac's Web site](#). On a \$100,000, 30-year mortgage, that difference would cost more than \$85,000 extra in interest charges, according to Bankrate.com's [mortgage calculator](#). The difference in the monthly payment alone would be about \$235.

Powerful little number

If you rented an apartment, got braces, bought cell phone service, applied for a job that involved handling a lot of money, or needed to get utilities connected, there's a good chance your score was pulled.

If you have an existing credit card, the issuer is likely to look at your credit score to decide whether to increase your credit line -- or charge you a higher interest rate, according to a credit scoring study by the Consumer Federation of America and the National Credit Reporting Association.

Buying a car? Most car dealers want to know your credit score when you walk in the door, says Bob Kurilko, vice president of marketing and industry communications for [Edmunds.com](#), an online consumer resource for automotive issues. "They want to know how they can put a loan together for you."

The score has made it easier for many people to get credit, Kurilko says.

Before, it was up to individual lending institutions to come up with their own criteria, he says. "They would hedge their risk and tend to go conservatively. It's opened up lending to a lot more people."

Consumers' rights

Until recently, many Americans didn't even know this number existed because it was a closely guarded secret in the lending industry. In fact, lenders were prohibited from telling borrowers their credit score. The line of reasoning: The number was the result of analyzing complex financial data that the layperson would have difficulty understanding. Plus, if people knew their score (according to the industry mindset at the time), they might be able to change their behavior to manipulate the score and throw off the whole model, rendering it useless.

All that changed a few years ago, when consumers began finding out about the score and demanding to see it. In an unprecedented move in 2000, online lender E-Loan offered to give consumers their scores for free, with

information explaining how the score is calculated and how they might improve it. Fair Isaac responded by cutting E-Loan off from its source of credit reports, effectively crippling its ability to lend money. E-Loan stopped giving away credit scores.

Public outcry on the possibility of people being denied credit based on bad information in credit reports led to several pieces of legislation -- and a much more open attitude about credit scores.

Fast forward to current day: Not only can consumers buy their score online from any number of sources, but they are now entitled to one free credit report per year from each of the three credit reporting agencies. To find out how to order your free credit report, read "Checking your credit report."

Just what goes into the score? Everything in your credit report, with different kinds of information carrying differing weights, says Fair Isaac consumer affairs manager Craig Watts.

5 factors of credit score

1. How you pay your bills (35 percent of the score)
2. Amount of money you owe and the amount of available credit (30 percent)
3. Length of credit history (15 percent)
4. Mix of credit (10 percent)
5. New credit applications (10 percent)

1. How you pay your bills (35 percent of the score)

The most important factor is how you've paid your bills in the past, placing the most emphasis on recent activity. Paying all your bills on time is good. Paying them late on a consistent basis is bad. Having accounts that were sent to collections is worse. Declaring bankruptcy is worst.

2. Amount of money you owe and the amount of available credit (30 percent)

The second most important area is your outstanding debt -- how much money you owe on credit cards, car loans, mortgages, home equity lines, etc. Also considered is the total amount of credit you have available. If you have 10 credit cards that each have \$10,000 credit limits, that's \$100,000 of available credit. Statistically, people who have a lot of credit available tend to use it, which makes them a less attractive credit risk.

"Carrying a lot of debt doesn't necessarily mean you'll have a lower score," Watts says. "It doesn't hurt as much as carrying close to the maximum. People who consistently max out their balances are perceived as riskier. People who never use their credit don't have a track history. People with the highest scores use credit sparingly and keep their balances low."

3. Length of credit history (15 percent)

The third factor is the length of your credit history. The longer you've had credit -- particularly if it's with the same credit issuers -- the more points you get.

4. Mix of credit (10 percent)

The best scores will have a mix of both revolving credit, such as credit cards, and installment credit, such as mortgages and car loans. "Statistically, consumers with a richer variety of experiences are better credit risks," Watts says. "They know how to handle money."

5. New credit applications (10 percent)

The final category is your interest in new credit -- how many credit applications you're filling out. The model compensates for people who are rate shopping for the best mortgage or car loan rates. The only time shopping really hurts your score, Watts says, is when you have previous recent credit stumbles, such as late payments or bills sent to collections.

"Then, looking for new credit will be seen as an alarm because statistically, before people declare bankruptcy and default on everything, they look for a life preserver," Watts says. Also, if you have a very young credit file, an inquiry can count for more than if you've had credit for a long time.

What doesn't count in a score

The scoring model doesn't look at:

- age
- race
- job or length of employment at your job
- income
- education
- marital status
- whether or not you've been turned down for credit
- length of time at your current address
- whether you own a home or rent

A lender may consider all those factors when deciding whether to approve a loan application, but they aren't part of how a FICO score is calculated, Watts says.

Credit scores are not perfect

The major drawback to credit scoring is that it relies on information in your credit report, which is quite likely to contain errors. That's why it's critical that you check your credit reports annually, or at the very least three to six months before planning to buy a house or a car. That will give you sufficient time to correct any errors before a lender pulls your score.

Watts says that the need for accuracy in credit files is one reason why it's good for consumers to learn about credit scores.

"There's a hope that as consumers know about credit reports and scores, they'll do more to correct errors and provide more oversight," he says. "If consumers can police the accuracy of their own reports, everybody gains."

Want to get an approximation of your score? Bankrate and FICO have teamed up to create the free [FICO Score Estimator](#).

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