



Minnesota Home Buyer Assistance Program, LLC.

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How Credit Scores Work, How a Score is Calculated

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

Lenders can use one of many different credit-scoring models to determine if you are creditworthy. Different models can produce different scores. However, lenders use some scoring models more than others. The FICO score is one such popular scoring method.

Its 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 first credit score as well as the FICO score.

Fair Isaac reports that the American public's credit scores break out along these lines:

Credit score	Percentage
499 and below	2 percent
500-549	5 percent
550-599	8 percent
600-649	12 percent
650-699	15 percent
700-749	18 percent
750-799	27 percent
800 and above	13 percent

Currently, each of the three major credit bureaus uses their own version of the FICO scoring method -- Equifax has the BEACON score, Experian has the Experian/Fair Isaac Risk Model and TransUnion has the EMPIRICA score. The three versions can come up with varying scores because they use different algorithms. (Variance can also occur because of differences in data contained in different credit reports.)

That could change, depending on whether a new credit-scoring model catches on. It's called the [VantageScore](#). Equifax, Experian and TransUnion collaborated on its development and will all use the same algorithm to compute the score. Consumers can order their VantageScores online at Experian's [Web site](#) for \$6. Its scoring range runs from 501 to 990 with a corresponding letter grade from A to F. So, a score of 501 to 600 would receive an F, while a score of 901 to 990 would receive an A. Just like in school, A is the best grade you can get.

What's the big deal?

No matter which scoring model lenders use, it pays to have a great credit score. Your credit score affects whether you get credit or not, and how high your interest rate will be. A better score can lower your interest rate.

The difference in the interest rates offered to a person with a score of 520 and a person with a 720 score is 4.36 percentage points, according to [Fair Isaac's Web site](#). On a \$100,000, 30-year mortgage, that difference would cost more than \$110,325 extra in interest charges, according to Bankrate.com's [mortgage calculator](#). The difference in the monthly payment alone would be about \$307.

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 product development and marketing 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 everyone is entitled to a [free copy of their credit report](#) every 12 months from each of the three major credit bureaus -- Equifax, Experian and TransUnion. The program rolled out across the nation one geographical region at a time with all consumers eligible on Sept. 1, 2005.

Key factors of your score

Just what goes into the score? Everything in your credit report, with different kinds of information carrying differing weights, says Fair Isaac Corp. Public Affairs Manager Craig Watts. The FICO-scoring model looks at more than 20 factors in five categories. (The VantageScore relies on slightly different factors. The Bankrate feature "[New Vantage credit score now online](#)" compares the FICO score with VantageScore.)

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

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."

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