

Money for Life

May 2009

Credit scores are a bit of a mystery to the average consumer. That's understandable, because standardized credit scores didn't even exist when many of us were growing up!

In previous generations, lenders would gather information about a loan applicant and apply their own particular criteria to their lending decision. Criteria would vary from one lender to the next, and the lender's "gut feeling" might even be one of the factors involved in some lending decisions.

As credit came to play a larger role in society, with more people using credit and using it more frequently, lenders began looking for "systems" or "formulas" that would help them objectively assess the likelihood that a potential borrower could be relied on to repay a debt. In time, many lenders came to rely on a scoring system developed by Fair Isaac Corporation. The "FICO" score was the first widely-used credit scoring system, although other scoring systems have also been developed.

While most lenders still consider other factors as well, the importance of the credit score has dramatically increased in recent decades. Credit scores may also be used elsewhere, including insurance coverage or premium decisions. Therefore, it is extremely helpful for consumers to understand the factors behind their credit scores. This is particularly true during the current credit crunch, since reduced credit limits and closed accounts can lower your score (see page 2: Current Issues).

Basics. Credit scores typically range from 300-900. Not all scoring systems use identical scoring ranges – for example, the highest FICO scores are in the mid-800s. Five general factors play into the calculation of your

credit score (see page 2: Factors). As those factors change, then your credit score may change. In addition, the score is always based on the information contained in a particular credit report, so a consumer typically could have three slightly different credit scores at the same time, depending on which credit bureau's report was being used (Equifax, Experian or TransUnion).

Obtaining Your Score. Law now gives consumers the right to free credit *reports* annually. This change in law was made to enable consumers to better protect themselves from identity theft. Since knowing your credit score isn't essential to that protection, the law does not include the right to check your credit score for free. As a result, consumers pay a modest fee when requesting their own credit score. Keep in mind, though, that you don't *need* to see your credit score every year – you actually don't *ever* need to see it.

There are situations, however, when it is helpful to see your credit score. If you know you will be seeking a major loan in the next 6 months or so, checking your score may be wise; it will be accompanied by comments on what factors are reducing your score. By obtaining that information 6 months before applying for a loan, you may be able to make changes which will improve your score in time to improve your loan outcome.

The easiest, least-expensive way to see your credit score is to request it at the same time you get your free copy of your credit report, by calling 877-322-8228 or going to www.annualcreditreport.com.

Factors. Although no credit scoring company will give out its exact formula, they do share the five general factors that influence credit scores, and their weight in the scoring formula:

- **Payment History (35%).** This includes the frequency and severity of late payments or failed payments, as well as adverse public records (e.g. collections, court judgments, bankruptcy). Problems within the most recent 12 months weigh heavily in your score; as more time elapses, they have a reduced impact. Even 1-2 years of good credit history can greatly overshadow problems in your past.
- **Amounts owed (30%).** This factor includes the total amount you owe on loans, credit cards, medical bills, etc., as well as the percentage of your available credit you are already using. For example, if you have credit cards or lines of credit that would allow you to borrow \$20,000, but your current debt on those lines is \$3,000, then you are using 15% of your available credit (3,000 divided by 20,000). Fifteen percent is a good ratio. Anything over 50% will have a significant negative effect, so it is best to stay *well-below* 50%. Half of all Americans have ratios below 30%.
- **Length of Credit History (15%).** How long have you had accounts open with your creditors? Longer is better, so if possible, avoid closing your long-standing accounts.
- **Types of Accounts (10%).** What different types of credit have you used – mortgages, installment loans, credit cards, retail accounts, etc. Your score will generally be higher if you have used several types, as long as you have used them wisely.

- **New accounts (10%).** In moderation, new accounts can increase your score. Large numbers of inquiries, however, can hurt your score [*it appears that you are desperately seeking a loan somewhere*]. You should not be penalized for shopping around for a good loan, however; a cluster of several similar inquiries within a few weeks will usually count as just one. Also note that checking your own credit report or score is not counted as an inquiry.

Current Issues. In the current economic climate, lenders are reevaluating the lending risks they have been taking; as a result some are closing accounts or reducing borrowing limits on accounts. This action by lenders may cause a consumer's credit score to go down, even if they have made no credit mistakes. This can occur if one of the oldest accounts on a consumer's credit report is closed, OR if the change causes a problematic increase in the percentage of available credit already in use.

Smart Steps. One of the best things a consumer can do is to work on paying down debt. That's a smart move any time, but especially so if your total available credit has been (or might be) reduced.

Another key step is to check your credit report regularly (once a year); if you find any errors or omissions, follow the credit bureau's process for correcting errors or disputing information. For example, if you had a court judgment against you a few years ago and you paid it off last year, your credit report should show that it has been paid. If not, you should seek to correct the omission.

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