**Understanding Your Credit Score (FICO)**

Fair, Isaac and Co. is the San Rafael, California Company founded in 1956 by Bill Fair and Earl Isaac. They pioneered the field of credit scoring for financial companies. They have expanded their enterprise to cover decision systems, analytics and consulting. Every credit agency, and most lenders, calculate your credit score using software from FICO (Beacon) or in house software based on the FICO rating system.

What does your score mean?
This rating system is meant to develop a snapshot of the risk you currently represent to a lender. Several parameters in your credit file, including length of credit history, number of open accounts, loans, mortgages, public records, and others are formulated to produce a three-digit score between about 300 and 950. There are other scores used by lenders and insurance companies (some of which are developed by FICO) such as Application and Behavior scores.  These other scores take other information into account.  Usually a lender will use a combination of your credit score with other factors when determining your risk. They all have the same objective, to determine the borrower’s potential risk. Regardless of whether the score was generated by FICO or a system based on FICO parameters, they all yield an industry standard three-digit score. This score places the borrower in one of three main categories (we named the third one ourselves.)

Prime, sub-prime, and shafted
**Prime** If your credit score is above 680, you are considered a "prime borrower" and will have no problem getting a good interest rate on your home loan, car loan, or credit card.

**Sub-prime** If your credit score is below 680, you are "subprime", and will likely pay a much higher interest rate on your loan.

**Shafted** below 560 is the shafted score. At least that is how most lenders and credit issuers perceive it. You can still get a credit card but you will likely be hit with a security deposit or high acquisition fee. In addition to that your interest rate will likely be 22 to 23%. You can forget about most home loans and the majority of new car loans at this score. Below 560 is no place to be. You will pay much, much more in higher interest and unnecessary fees. You may even pay more for your insurance rates. A very low score can even prevent you from getting a job with many companies.

How much does a low score cost you?
**Credit Cards** Most if not all prime credit cards are entirely out of reach to consumers with bad credit. And the few credit cards that are available to them (known as “sub-prime” cards) typically require exorbitant setup fees or recurring monthly fees, offer very low credit lines, often require cash deposits, and in most cases do not even report your positive credit activity to the credit bureaus.

**Automobile Financing** If you are making payments on a car, you are probably paying between $5,000 and $9,000 more just for having bad credit. This added interest shows up every month in a higher payment. Take a look.

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| --- |
| *$20,000 car paid over 5 years:* |
| CREDIT STATUS | RATE | PAYMENT | COST OF BAD CREDIT |
| PrimeSub-PrimeShafted | 10%14%20% | $424.94$465.37$529.88  | **$0.00$4,722.54$8,593.30** |

**Home Mortgage** Bad credit in auto financing can really hurt, but it is nothing compared to the cost of bad credit when a home is involved. A typical home can cost between $50,000 and $130,000 more in interest if you are buying the home with bad credit.

|  |
| --- |
| *$100,000 home paid over 30 years:* |
| CREDIT STATUS | RATE | PAYMENT | COST OF BAD CREDIT |
| PrimeSub-PrimeShafted | 7%9%12% | $655.30$804.62$1,028.61  | **$0.00$50,155.24$130,791.63** |

As you can see, a low score can cost you hundreds of dollars per month. This is why it is so important to obtain and maintain as high a score as possible.

How are credit scores calculated?
The methods of calculating your FICO may differ slightly depending on the credit bureau. When obtaining your score from one of the Credit Bureaus it is important to understand that your score does not come directly from FICO. It is adapted to each bureau and is given its own name: Equifax uses “Beacon”, Trans Union uses “Empirica”, and Experian uses “Experian/Fair Isaac.” These scores are also referred to as your “Bureau Scores.”

Since your score is derived from your bureau data, it will change every time your reports change. However your score is calculated, it will always take into consideration many categories of information. No one piece of information or factor determines your score. As the information in your credit report changes, the importance of one or several factors may change in your FICO

score. Lenders look at many things when making a credit decision, including your income and the kind of credit you are applying for. However, you’re FICO score does not reflect these facts as it only evaluates the information retained by the credit reporting agency.

What factors affect your credit score?
There are five factors which are used in credit scoring calculations that determine your overall credit score.



**Previous Credit Performance (Payment History) 35%** A lender wants to know what your payment history is like. Have you paid everything on time, are you late on anything now, etc. Your payment history is just one piece of information used in calculating your score, although it can be the very important.

* Payment history on your accounts. These include credit cards, retail accounts (department store credit cards), installment loans, finance company accounts and mortgage loans.
* Collection items and Public records. This includes judgments, bankruptcies, suits, liens, collection items and wage attachments. Most of these are considered quite serious, although older items count less than recent ones.
* It’s all in the details. This includes specific details on late and missed payments. Negative information/late pays are determined using three factors.
	+ Recency - How long ago was the last delinquency?
	How old is the late pay? A 30-day late payment made just a month ago will affect your score much more than a 90-day late payment from five years ago.
	+ Severity - What level of delinquency was reached?
	How late was the payment made? 30 days, 60 days, 90 days or worst of all, is the payment still outstanding.
* Prevalence - How many credit obligations have been delinquent?
The amount of negative items as compared to your total amount of available credit. For instance, 5 accounts showing 3 late payments is much worse than 10

accounts showing 4 late payments. One of the biggest sub factors is how many accounts show no late payments. A good track record on most of your credit accounts will increase your overall FICO score substantially.

**Current Level of Indebtedness (Amount Owed) 30%** How much is too much? Can the borrower pay me and still afford to pay his other bills? Not necessarily. Having available credit can actually help your ratio of debt to available credit. These are the types of questions that most borrowers want to know and the answers are almost as important as your previous credit history.

* Total amount owed on all open accounts. Paying off your credit cards in full every month, does not mean that they won’t show a balance on your report. Your total balance on your last statement is generally the amount that will show in your credit report.
* Specific types of accounts, such as credit cards and installment loans are scored differently and in conjunction with the overall amount owed on all open accounts. This also factors into your balance on each specific type of account. For instance; you have a credit card with a very small balance and no late pays. Even though the balance is low, this still looks very good as it shows that you are able to manage your credit responsibly
* How many accounts do you have open and how many have balances? A large number of open accounts, even with small balances, can indicate higher risk of over-extension. This is weighted in your FICO score but most lenders leave it to their discretion as they have access to your income amount. For the most part though it is good not to have too many credit card accounts, three maximum.
* How much of the total credit that is available to you are you using? In other words, are you close to maxing out? For example, if you have a credit card with an available credit line of $1000 dollars and you have a current balance of $850.00 or more, then you are nearly “maxed out.” Several credit cards or other debts with balances approaching the credit limit will affect your score negatively. Even if you have made your payments responsibly. Your FICO score will factor your overall ratio of debt to your overall limits.

**Amount of Time Credit Has Been in Use (Length of Credit) 15%** Generally speaking, the longer the credit history the better your score. However, this factor only makes up 15% of your total score so even young people, students or others with short histories can still score high overall as long as the other factors show good. If you are new to credit than there is little you can do to improve this part of your score. Open an account and be patient.

* How long your credit accounts have been open or the number of months you have been in the credit bureau’s file.
* The age of your oldest account and the average age of all your accounts are taken into consideration
* How long it has been since you used certain accounts as well as the mix of older and new trade lines

**Pursuit of New Credit (10%)** Credit is much more popular today. Just look at the number of credit card offers you get via the Internet and in the mail. Consumers can now shop for credit and find the best terms to meet their needs. Each time someone runs a credit check on you, it creates an inquiry.

Fair Isaac has changed some of its calculations to account for these new trends. Specifically, they treat a group of inquiries — which probably represents a search for the best rate on a single loan — as though it was a single inquiry (note: this only applies to auto or mortgage loan inquiries.) For example, auto loan inquires that are within 14 days of each other only count as one inquiry.

Your score takes into account:

* How many new credit obligations have recently been assumed? Opening several credit card accounts at the same time can look bad. What FICO looks for is “To what extent is this consumer trying to open new credit accounts?”
* How recent were these efforts? How long it has been since you opened a new account. Primary consideration is given to the following:
	+ Number of inquiries in last six months
	+ Number of trade lines opened in last year
	+ Number of months since most recent inquiry
* There are no good inquiries. Inquiries or typically seen as a request for credit and thus are factored as if you are searching for credit. Every time you fill out one of those credit card applications to get a free hat, you are also getting a free inquiry. Every time you fill out an online application for a credit card, or other type of loan, you are getting an inquiry.
* Too many inquiries look bad. While there are no good inquires there are neutral inquiries. These inquiries are most often known as:
	+ **Consumer initiated.** A request for your credit report shows as a consumer inquiry. When you run a credit check on yourself. (provided that you don’t call your mortgage broker buddy to pull your report)
	+ **Pre-Approval.** If a potential lender has viewed your credit reports to determine whether they want to offer you a loan, these are not factored into your score. However, once you fill out a credit application, your full report will be reviewed and a “bad” inquiry will appear on your reports.
	+ **Periodic Review.** Many lenders will periodically review the credit reports of their current customers to see if there have been any major changes to their credit reports. If the lender discovers that your credit score is now too low for their standards, they may close your account. These inquiries created as a result of the periodic reviews are not supposed to be factored into your credit score

How inquiries are computed is somewhat complex. As a reasonable measure you should avoid unnecessary inquiries. The system is designed to take into account rate shopping but things like applying to credit card offers will add inquires to your file.

**Types of Credit Experience (10%)** A healthy mix of different types of credit, installment loans, retail accounts, credit cards, and mortgage. This score is not normally a key factor in determining your score but it can help a close score. It’s not a good idea to try and open different types of accounts just to try and make this factor better. It will likely reduce your score in other areas. You should never open accounts you don’t intend to use anyway.

What type of accounts you have, and how many, can make a big difference. The optimal ratio of installment versus revolving accounts depends on your profile and differs from person to person. If you are denied credit, you will receive four reason codes which indicate why you were denied.

All three credit agencies do not always have the exact same information therefore your three scores will differ slightly. As a general rule though, if you fail to qualify at one agency you are likely to still be denied if one of the other bureaus is checked. Most mortgage loans companies will run all three credit agencies and take the lowest score.