Credit Scoring

MISSISSIPPI STATE UNIVERSITY™ EXTENSION

Have you ever wondered how a lender decides whether to grant you credit? Credit scores are one tool used by lenders to evaluate your ability to repay loans. Since they are used so widely today, it is a good idea to learn as much as possible about credit scoring and how your behavior can affect your credit score.

Information about you and your credit experiences, such as payment history, number and type of credit accounts you have, collection actions, outstanding debt, and age of your accounts is gathered from your credit application and credit report. Using a complex statistical program, this information is compared to the credit performance of consumers with similar profiles. The credit scoring system awards points for each factor that helps predict likelihood of repaying debt. The total number of points—your credit score—helps predict creditworthiness.

Advantages of Credit Scoring

Credit scores provide lenders a fast, objective measure of your credit risk to help the credit granting process. Benefits to consumers include:

- **Faster loan approval.** Scoring allows lenders to make credit decisions almost instantaneously.
- **Fairer credit decisions.** Scoring focuses on facts, rather than personal feelings. Gender, race, religion, nationality, marital status, and similar factors are omitted from the process.
- **Credit "mistakes" don't haunt forever.** Past credit problems fade as time passes and good payment patterns emerge.
- **More credit available.** Scoring allows lenders to offer credit products geared to different risk levels.
- **Credit rates reduced.** Scoring allows lenders to reduce credit losses, lowering credit rates overall.

What's In a Name?

Credit bureau scores are often called **"FICO"** scores, because most credit bureau scores are produced by software produced by Fair Isaac Corporation. However, each credit-reporting agency may call its scores by a different brand name.

Your score may be different at each credit-reporting agency because each agency bases its scores on only the information in its own files. Scores for certain loans may vary, as well (for example, an auto industry option).

What Does a Credit Score Consider?

Five main categories of information are generally evaluated to determine your credit score. They include:

1. **Payment history—approximately 35 percent.** A lender's first concern is whether you have paid your credit accounts on time. This category looks at:

- Payment information on many types of accounts including credit cards, retail accounts, installment loans, finance company accounts, and mortgage loans.
- Public record and collection items. Reports of events such as bankruptcies, foreclosures, suits, wage attachments, liens, and judgments are considered quite serious.
- Details on missed or late payments, public record, and collection items. The scoring process considers how late payments were, how much was owed, how many are on your record, and how recently they occurred.
- On time payments. A good track record of paying your bills on time will increase your credit score.

2. **Amounts Owed—Approximately 30 percent.** Owing a lot of money on many accounts can indicate that you are overextended, and are more likely to become delinquent in your payments. This category considers:

- Total amount owed on all accounts.
- Total amount owed on differed types of accounts.
- Balance on certain types of accounts. Having a low balance with no delinquencies may show responsible credit management. In contrast, closing unused accounts with zero balances will not generally raise your score.
- How many accounts have balances.
- Portion of total credit line used on credit cards and other "revolving credit" accounts. Persons close to "maxing out" their accounts may have difficulty making payments.
- Portion of installment loans still owed, compared to original loan amounts. Paying down installment accounts is considered a good indication that the individual will be able to manage and repay.

3. **Length of credit history—approximately 15 percent.** A longer credit history will generally increase your score. This section looks at:

- How long your accounts have been established. It considers the age of your oldest account and the average age of all your accounts.
- How long specific accounts have been established.
- Length of time since certain accounts were used.

4. **New credit—approximately 10 percent.** Research suggests that opening several accounts in a short period of time represents greater risk. This category examines:

- How many new accounts do you have and what type are they? What portion of your accounts is new?
- How long has it been since you opened a new account?
- How many recent requests for credit have you made? This is determined by inquiries by the credit reporting agencies?
- Length of time since credit inquiries were made by lenders.
- Improvement in credit history, following past credit problems. Improving payment history after a period of late payment behavior will help to raise your score over time.

5. **Types of credit use—approximately 10 percent.** Do you have a "healthy" credit mix? This category considers your mix or credit cards, retail accounts, installment loans, finance company accounts, and mortgage loans. This factor becomes important if your credit score does not have a lot of other information on which to base your score.

Interpreting Your Score

Most credit scores range from 300 to 850; however, the Vantage Score brand uses a different scale. The higher the score, the lower the predicted list for lenders. Approximate distribution of score ranges is as follows*:

300–499—6.3 percent
500–549—8.7 percent
550–599—9.9 percent
600–649—9.8 percent
650–699—12.1 percent
700–749—15.5 percent
750–799—19.6 percent
above 750—18.1 percent

*Score distribution source 9-19-2011: www.fico.com.

Lenders receive up to four "score reason codes" with each credit score. These reasons explain why your score was not higher. The reasons can be more helpful to consumers than the actual score. They can show consumers the areas where their score may be improved over time. The most frequently given score reasons are:

- Serious delinquency
- Serious delinquency, and public record or collection filed
- Derogatory public record or collection filed
- Time since delinquency is too recent or unknown
- Level of delinquency on accounts
- Number of accounts with delinquency
- Amount owed on accounts
- Length of time accounts have been established
- Too many accounts with balances.

Improving Your Score

To improve your credit score, concentrate on:

- Paying your bills on time
- Paying down outstanding balances
- Keeping balances low on credit cards and other revolving credit products
- Applying for and opening new accounts only as needed.

How Do Credit Scores Impact Interest Rates?

Lenders use credit scores as a component in determining the interest rate they will charge for a loan. However, the actual interest rate for which you qualify will depend on several additional factors including income, down payment, debt-to-income ratios, additional credit-related evaluations, and other lender specific criteria.

The following table shows examples of the impact of FICO scores on average annual percentage rate (APR) for several credit options in November 2011.

Examples of FICO Scores on APR

Home Mortgage – 30-Year Fixed						
FICO Score	620-639	640-659	660-679	680-699	700-759	760-850
APR	5.251	4.70	4.278	4.065	3.889	3.668
Home Mortgage – 15-Year						
FICO Score	500-559	560-639	640-659	660-679	680-719	
APR	12.430	11.180	9.680	8.905	8.405	
48-Month New Auto Loan						
FICO Score	500-589	590-619	620-659	660-689	690-719	720-850
APR	20.000	19.225	11.639	7.888	5.784	4.414

Note: These rates represent averages by credit score ranges. Each lender determines its own credit score ranges for the interest rate terms it offers.

Source: http://www.myfico.com/helpcenter/autos on November 11, 2011.

What If I Am Denied Credit Because of Information on My Credit Report or My Credit Score?

In 2011, new federal rules began requiring lenders to provide information to consumers about how their credit score may affect interest or other credit terms when they are not the best terms available. For example, if you do not qualify for the lowest interest rate available, the lender must tell you your credit score, how it compares to others, why you did not get the lowest rate, and where the score was obtained. Before 2011, consumers had to pay a fee to learn their credit score.

You will then want to get a copy of your credit report from the credit bureau that supplied information for the score, and review it to make sure there are no errors. If you feel that the credit bureau report on which your score is based has errors, you can dispute the information.

The Fair and Accurate Credit Transactions Act of 2003 entitles you to get one free copy of your credit report from each of the three main credit bureaus per year (one every 12 months) through the Internet at www.annualcreditreport.com, by phone at (877) 322-8228, or by mailing a request to: Annual Credit Report Request Service, P.O. Box 105281, Atlanta, GA 30348-5281. You are entitled to receive a free copy of your credit score if you request it within 60 days of being turned down for credit. The credit-reporting agency can tell you what's in your report; however, only the creditor can tell you why your application was denied.

When you get a credit report online, you will be invited to receive a credit score for a fee. If you order a credit report directly from a credit bureau and do not go through the Annual Credit Report Service required by federal law, you will also have to pay a fee.

If you have been denied credit, or did not get the interest rate or credit terms that you want, ask if a credit scoring system was used. If so, ask which factors were used in that system and the best way to improve your application. If you were granted credit, ask if you are getting the best terms available, and if not, why. If inaccuracies in your credit report were the causes of higher rates, take action to dispute the inaccurate information in your credit report.

For More Information

Federal Trade Commission (2007). Washington D. C. Need Credit or Insurance? Your Credit Score Helps Determine What You'll Pay. http://www.ftc.gov/bcp/edu/pubs/consumer/credit/cre24.shtm

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Mississippi State University Extension Service (2010). Credit: American Dream or Nightmare, publication #2399. http://msucares.com/pubs/publications/p2399.pdf

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