Credit Scores

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WHAT'S COVERED

In this lesson, you will learn how credit scores are developed, calculated, and used. You will also examine how your technology skills can be used in a manner that could lead to increased productivity. Specifically, this lesson will cover:

WATCH

How much do you know about borrowing on credit and credit scores? Several college students were asked that same question. Check out their answers in the following video. Then move on to section 1.

1. The Purpose of Credit Scores

Within the financial world, **credit scores** are used as a way to predict which people are likely to manage their debt wisely in the future. The most widely used credit score was created by Fair Isaac Corporation, referred to as a FICO® score. Each of the major credit bureaus uses a FICO score although each may use a different title (for example, Equifax calls its score a BEACON® Score). FICO scores can range from a low of 300 to a high of 850. Having a higher score means that you have a lower credit risk and are therefore more likely to be approved for a loan.

TERM TO KNOW

Credit Score

A tally that summarizes a person's credit risk.

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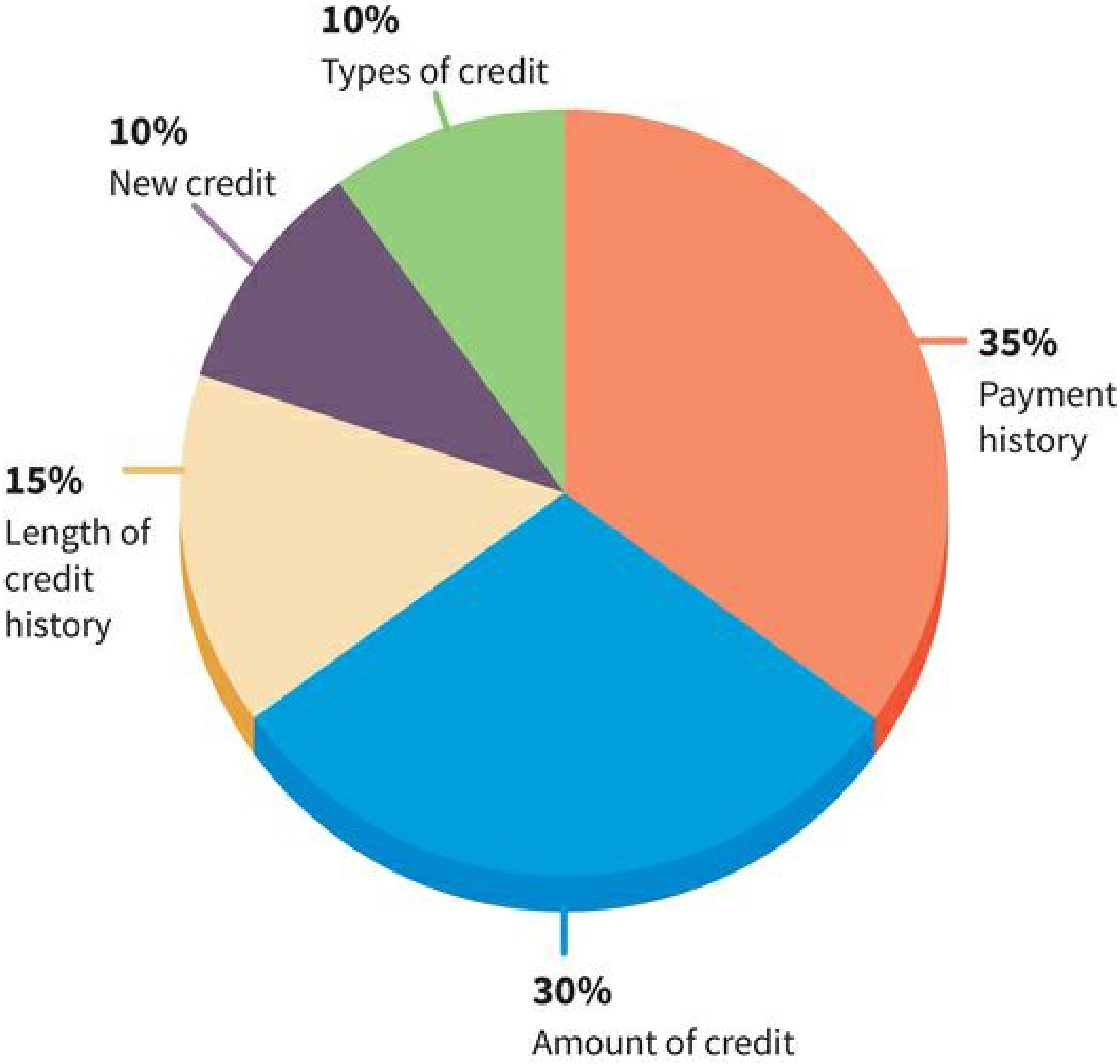
2. How FICO Scores Are Calculated

Although the FICO score formula is a corporate secret, we do know how scores are generally calculated. As shown in the pie chart below, your credit score is built using five inputs: payment history, amount of credit, length of credit history, new credit, and types of credit. The first three inputs are the most important in determining your credit score.

DID YOU KNOW

Be assured that there are some things that have no impact on your credit score. These include your age, race, sex, marital status, religion, medical history, criminal history, occupation, and nationality.



Inputs Influencing a FICO Score

2a. Payment History

The first input – payment history – makes up the largest portion (35%) of your FICO score.

- Essentially, lenders are looking for individuals who make on-time payments on credit cards, department store credit cards, retail accounts, mortgage loans, and installment loans for things such as cars, boats, and motorcycles.
- The credit rating agencies rely on lenders to report late payments.
- Credit rating agencies also search public records for delinquent payments that might not be reported, such as being late with utility bills and having a lien placed against a home or a car.

2b. Amount of Credit

The amount of credit someone currently has accounts for approximately 30% of a person's FICO score. This gets a little tricky, but in general, a high **credit limit** – the maximum amount you may borrow – is a good sign.

This can turn negative if you have used a large percentage of your available credit limit. To maximize a FICO score, it is best to use some, but not all, of your credit.

HINT

Consumers who have no outstanding balances sometimes have a lower score than those who have a small revolving balance in comparison to their overall credit limit.

TERM TO KNOW

Credit Limit
The maximum amount you may borrow.

2c. Length of Credit History

Your length of credit history is the third input of a FICO score (15%). The longer you have had an account, the better your score. This is the reason some consumer advocates recommend keeping a credit card active even if you rarely use the card.

2d. New Credit

Applying for new credit or just receiving new credit can decrease your FICO score in the short run.

- Although this accounts for only 10% of your overall score, once your credit record is established, you should apply for additional credit prudently and only when you really need the credit.
- The reason this is a negative input is that other lenders may become worried that your overall ability to make payments across all of your credit lines will fall when new lines of credit are established.
- For example, if you are shopping for a car and you allow the dealerships to run a credit report on you every time you test-drive a vehicle, your score will drop each time there is an inquiry. The good news is that similar inquiries that occur within a 14-day window will generally only count as one inquiry when calculating your overall credit score.

2e. Types of Credit

Types of credit make up the remaining 10% of a FICO score. To have the highest credit score possible, you need a mix of credit types. **Revolving credit** includes credit cards (think Visa®, MasterCard®, and Discover®). **Installment credit** includes student loans, mortgages, personal loans, and car loans. The big difference between the two types of credit is that the monthly payment on a revolving line of credit can vary, whereas installment loan payments tend to be fixed.

TERMS TO KNOW

Revolving Credit
A loan that may be accessed, repaid, and used again indefinitely.

Installment Credit
A type of loan in which a borrower makes a series of payments, typically equal in amount, to the lender over a predetermined period of time.

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3. How to Establish a Credit Score

You need two items to have a credit score:

1. **You must first have a credit report on file with one of the major credit bureaus.** If you're in college right now and have a student loan, you probably already have a credit report and a credit score. You should check your report immediately. You can do this for free once per year by visiting www.annualcreditreport.com. If you find that you don't have a credit report, you might want to apply for a credit card. You don't have to use the credit card often or load up on debt. Just having a credit card for a period of time will lead to establishing a FICO score, which might come in handy later in your financial journey (assuming you manage your credit wisely).
2. **You must have a record of recent credit use.** This means that you should have at least one open line of credit that has been in existence for 6 months.

It is important to remember that just having a credit card is generally not enough to prompt the development of a high credit score. Basically, you must do something with the line of credit to provide the credit bureau with information about your credit use and debt-management skills. This happens when you make a purchase.

- Unsecured debt is money borrowed to purchase goods and services that are generally consumed quickly, such as using your credit card to buy groceries.

  HINT

  In 99% of all cases, you should pay off all unsecured debt on a monthly basis.

- This compares to secured debt that is used to buy things like cars and homes.
- These secured assets can be taken back by a lender if the debt is not repaid. Items purchased with unsecured debt typically cannot be repossessed.

TERMS TO KNOW

Unsecured Debt
Money borrowed to purchase goods and services that are generally consumed quickly, such as using your credit card to buy groceries.

Secured Debt
Money borrowed to buy things like cars and homes. These secured assets can be taken back by a lender if the debt is not repaid.

Repossess
When assets that were used to secure a loan are taken by the lender because the loan was unpaid.

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4. Building a Favorable Credit Score

Before reviewing strategies designed to help you build a favorable credit score, it's important to understand why a credit report and credit score are so important in the 21st century.

- Lenders, insurance companies, employers, and landlords all use credit reports and scores to determine how you manage money.

  HINT

Insurance companies set rates you pay for life, auto, and homeowner's policies based in part on your credit score.

- Your money-management skills are a predictor of your overall pattern of responsibility.

If you already have a credit report, there are a few things you can do to make sure that your score is high. FICO scores range from 300 to 850, with high scores representing people with the lowest risk of failing to make a loan payment. Although there are no hard and fast rules, you can use the following guidelines to determine the quality of your credit history:

- 300–550: A score this low is really bad, which will usually lead to rejections for new credit.
- 550–620: This range is considered subprime, which indicates a high-risk borrower. A score in this range means the lender will charge high interest and high annual fees, and limit the amount of credit issued.
- 620–680: This range represents the minimum score needed to be accepted for most loans.
- 680–740: This range represents what lenders consider to be individuals with good credit. The terms and conditions of a loan will be relatively favorable.
- 740–850: A score this high is considered excellent. These borrowers have stellar previous payment histories and always receive the best borrowing terms.

DID YOU KNOW

Several companies, such as Credit Karma and Mint.com, offer credit score tools and credit scores for free. Your technology skills will allow you to take advantage of these tools. You may find using them can lead to increased productivity which is something we all want.

5. How Credit Scores Are Used and Updated

Okay, so now you know the importance of having a credit report and a high credit score. It's worth mentioning again that a credit report summarizes your credit risk in the marketplace. Nearly every lender and merchant that extends credit uses a credit score to determine:

- If they will issue you credit.
- How much credit they will grant you.
- What interest rate they will charge you on the money borrowed.

The lower your score, the less likely that you will be offered credit. For those who do receive an offer of credit, a higher credit score will result in a larger credit line and a lower interest rate. A credit line refers to the maximum amount that can be borrowed. For example, a credit card issuer will indicate the maximum amount that can be borrowed at any time, say $5,000. Once this credit line or limit has been reached, the card will be denied by a merchant.

SUMMARY

Building a favorable credit score is important for securing your financial future. In this lesson, you learned the **purpose of credit scores** from the perspective of a lender and a borrower. You saw**how credit scores are used and updated**. You also reviewed the five factors that go into**calculating a FICO score**:

1. **Payment History**. Have you been paying your bills on time?
2. **Amount of Credit**. What are your credit lines?
3. **Length of Credit History**. How long have you held credit?
4. **New Credit**. Do you have any new accounts on file? How many?
5. **Types of Credit**. Do you have installment or revolving credit?

You need two essential items to **establish a credit score**. First, you must have a credit report on file with one of the major credit bureaus. Second, you must have a record of credit recently used. Maintaining low debt balances and good credit will take you one step closer toward reaching your financial goals.

You can utilize your technology skills to take advantage of digital tools available to you that can impact your credit score. An improved credit score can lead to increased productivity which is always a good thing.

TERMS TO KNOW

Credit Limit
The maximum amount you may borrow.

Credit Score
A tally that summarizes a person's credit risk.

Installment Credit
A type of loan in which a borrower makes a series of payments, typically equal in amount, to the lender over a predetermined period of time.

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When assets that were used to secure a loan are taken by the lender because the loan was unpaid.

Revolving Credit
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