Credit Score Basics

Definition of a Credit Score

A credit score is a number lenders use to help them decide: "If I give this person a loan or credit card, how likely is it I will get paid back on time?" Because of this, credit scores are often known as risk scores because they help lenders predict the risk that you will not repay the debt. Scores are generated by statistical models using elements from your credit report, and sometimes from other sources, such as your credit application. Credit scores are fluid numbers that change as the elements in your credit report change.

Many things happen that cause your credit score to fluctuate. However, scores are not stored as part of your credit history. You are scored at the time a lender requests your credit report and then included with the report. Thus, scores may vary from lender to lender or from loan to loan.

How your score is calculated

Credit scoring models are often derived from a large sample size - often over a million people. Common variables are identified from the credit profiles of consumers and then designers structure statistical models that assign weights to each variable. Your credit score is generated from all this combined set of variables from your past credit history. From this, lenders feel they will be able to effectively predict future credit behavior.

What could not affect your credit score?

As mentioned earlier, credit score information varies depending on the score being used. That being said, credit scores are only affected by elements in your credit report. Delinquent payments, total debt, and number of accounts will affect your credit score. However, things that will not affect your credit score include, but are not limited to:

- Race, religion, ethnicity, gender, or marital status. U.S. law prohibits credit scoring from considering these facts.
- As under the Consumer Credit Protection Act, scoring considers only credit-related information. Factors like gender, race, nationality, and marital status are not included. In fact, the Equal Credit Opportunity Act (ECOA) prohibits lenders from considering this type of information when issuing credit. Because the credit score is mathematically calculated, it treats all borrowers the same. Your age, salary, occupation, title, employer, date employed or employment history will not hurt you. Only your credit history - such as timely payments and how much you owe - affects your score. Regardless of income, if you manage your debt responsibly, you can have a high score.
- "Consumer disclosure inquiry" requests you made for your credit report in order to check it.
- "Promotional inquiry" requests made by lenders in order to make a "pre-approved" credit offer - or "account review inquiry" requests made by lenders to review your account with them.
- Finally, inquiries for employment purposes are not counted.

What could affect your credit score?

- Living location.
- Interest rates being charged on all accounts.
- All child/family support obligations or rental agreements.
- Certain types of inquiries (requests for your credit report). Every time you apply for credit, you're giving lenders permission to see your credit report. And other creditors with a qualified purpose - such as sending you a pre-approved credit card offer - can check your report without your per mission. So shouldn't you see what they're seeing?

The most significant impact on your score is whether you have paid past accounts in a timely manner (on or before the date the payment was due). It's always smart to take control of your credit. Check your credit report on a regular basis. If done consistently, you can understand what steps need to be taken to improve your credit and be prepared for negotiations with lenders. Remember that a poor credit report will not haunt you forever. Since it's a mathematical calculation, it changes as new information is added to your credit history. Keep in mind that scores change gradually as you change the way you handle credit. Lenders request a new current score when you submit a credit application, so they have the most recent information available. By taking the time to improve your score, you might qualify for more favorable interest rates and other credit terms.

When and how to get your report

Review your credit report from the three major U.S. credit reporting agencies, Equifax (1-800-685-1111 or www.equifax.com), Experian (1-888-397-3742 or www.experian.com), and TransUnion (1-800-916-8800 or www.transunion.com) before making large purchases, but even if you don't plan to make those large purchases, you should review your credit at least once a year. Naturally, credit agencies charge a small fee for reports. However, you are entitled to a free credit report from each of the three major credit agencies if (1) you believe you may be a victim of identity theft, (2) have been denied credit in the past 60 days, (3) receive welfare benefits, or (4) if you are unemployed. Additionally, if you are a resident of Colorado, Georgia, Maryland, Massachusetts, New Jersey, or Vermont, you are entitled to a free annual credit report.

How to fix report errors

Finding an error in your credit report can be frustrating but they can happen. Clerical errors and mis-reading can occur. When a credit report contains errors, it is often because the report is incomplete, or contains information about someone else. In this case, your first recourse of action should be filling out a dispute form provided by any of the aforementioned credit reporting agencies. You can get your credit report from many sources, but only the credit agencies can actually correct the data on your report. The credit-reporting agency is required to investigate the situation and will reply to you within 30 days. Contact the three major credit agencies directly. If you are in the process of applying for a loan, immediately notify your lender of any incorrect information in your report. Your lender will need to reorder your credit report and score once any changes have been made to your information at the credit-reporting agency.

Human error aside, keep in mind that incorrect data could also be an indication that you have been the victim of fraud or identity theft (for example, someone has applied for credit in your name or used your credit without your permission). Needless to say, catching these mistakes and being proactive in this time is critical. Fix the data on your report immediately!

Inquiries

By applying for a loan, you are authorizing your lender to obtain record of your credit report. This is how inquiries appear on your credit report. The inquiries section contains a list of everyone who accessed your credit report within the last two years.

Credit reports list "voluntary" inquiries (your own requests for credit), and "involuntary" inquiries, such as when lenders order your report to offer you a pre-approved credit offer through the mail. Self-inquiries and involuntary inquiries are not factored into your credit score, as long as you order your credit report directly from the credit reporting agencies, or through an organization authorized to provide credit reports.

In the instance of applying for new credit, your score probably won't drop much. If you apply for several credit cards within a short period of time, multiple requests for your credit report, inquiries will appear on your report. Your score may drop if you open numerous accounts from different types of lenders within a short period of time, however most credit scores are not affected by rate shopping, when multiple inquiries from different lenders are made within a short period of time.

While you don't want to have too many accounts open, it's good to have more than one, so that you're not using too much of one account's available credit limit. Your FICO score will reflect your combination of credit cards, retail accounts, installment loans, finance company accounts and mortgage loans, etc. While a healthy mix will improve your score, it's not necessary to have one of each, and it's not a good idea to open accounts you don't intend to use. Owing a lot of money on numerous accounts suggests to lenders that you may be overextended and more likely to make late payments - or make no payments at all. In general, a more seasoned credit history will increase your credit score. Lenders want to see that you can responsibly manage your credit accounts over time. As you can see, there is a fine line. Determining what is right for you and your situation is key.

Public record and collection items

Credit reporting agencies also collect public record information from state and county courts, and information on debts from collection agencies. Public record information consists of bankruptcies, foreclosures, suits, wage attachments, liens, and judgments. Bankruptcy information stays on your report for 10 years.

Credit Scores should not be the end-all and be-all

Lenders use a number of facts to make credit decisions, including your credit score. Lenders look at information such as the amount of debt you can reasonably handle given your income, your employment history, and your credit history. Based on their analysis of this information under specific underwriting policies, lenders may extend or decline credit to you regardless of your score.

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