

UNDERSTANDING YOUR CREDIT SCORE

A guide to helping you
understand your credit score



LexingtonLaw

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Understanding your credit score

Fair Isaac Corporation, based in Minneapolis, Minnesota, was founded in 1956 by Bill Fair and Earl Isaac. They pioneered the field of credit scoring for financial companies. Over the years they have expanded their enterprise to cover decision systems, analytics, and consulting. Every credit reporting agency, and most lenders, calculate your credit score based on software from FICO®, a division of Fair Isaac, or based on in-house software modeled after the FICO® rating system.

What does your credit 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 300 and 850. 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 "sub prime", 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 fees. In addition to that, your interest rate may likely be between 15 and 23%. With this score, you can forget about most home loans and the majority of new car loans. Below 560 is no place to be. You may pay much, much more in higher interest and unnecessary fees. You may even pay more for your insurance rates. A very low score may even prevent you from getting a job with many companies.



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How much does a low credit score cost you?

Credit Cards: Most, if not all, prime credit cards are entirely out of reach to consumers with bad credit. 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 security 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 \$2,000 and \$5,000 more just for having bad credit. This added interest shows up every month in a higher payment.

\$20,000 car loan paid over 5 years

CREDIT STATUS	RATE	PAYMENT	BAD CREDIT COST
Excellent	7.5%	\$400.75	\$0.00
Mildly Damaged	10.5%	\$420.87	\$1,207.20
Damaged	15%	\$475.78	\$4,501.80

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 \$90,000 and \$250,000 more in interest if you are buying the home with bad credit.

\$200,000 mortgage paid over 30 years

CREDIT STATUS	RATE	PAYMENT	BAD CREDIT COST
Excellent	6%	\$1,200.00	\$0.00
Mildly Damaged	8%	\$1,467.00	\$96,120.00
Damaged	11%	\$1,904.00	\$253,440.00



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As you can see, a low score can cost you hundreds of dollars per month. Which 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 credit score 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 single 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 credit score. Lenders look at many things when making a credit decision, including your income and the kind of credit you are applying for. However, your credit 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 5 factors which are used in credit scoring calculations that determine your overall credit score

1 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, and so on. Your payment history is just one piece of information used in calculating your score, although it can be 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.



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- **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 effect 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.

2 **Current level of indebtedness** (amount owed) **30%**

How much is too much? Can the borrower pay me and still afford to pay their other bills? 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 payments. 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 a higher risk of over-extension. This is weighted in your credit score but most lenders use their own discretion as they have access to your income amount. For the most part, it is good not to have too many credit card accounts. For most consumers, three credit card accounts should be the maximum.



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- **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 \$1,000 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 credit score will factor your overall ratio of debt to your overall limits.

Example

OVERALL RATIO			
ACCOUNT	AMOUNT OWED	LIMIT/LOAN ACCOUNT	PERCENTAGE
Visa	\$500	\$1,000	50%
MasterCard	\$50	\$1,000	5%
Car loan	\$11,000	\$25,000	44%
Home loan	\$95,000	\$145,000	65%
TOTAL	\$106,550	\$172,000	61%

3 Amount of time credit has been in use (length of credit) **15%**

Generally speaking, the longer the credit history the better the 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 well. 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.



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4 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 inquiries that were within 30 days of each other count as one inquiry.

As a reasonable measure you should avoid unnecessary inquiries. The system is designed to take into account rate shopping but things like applying for credit card offers will add inquiries to your file. High overall as long as the other factors show well. If you are new to credit then there is little you can do to improve this part of your score. Open an account and be patient.

5 Types of credit experience 10%

A healthy mix of different types of credit include installment loans and revolving loans. Installment loans allow you to repay the loan over a specific period of time with set monthly payments (home mortgages, auto loans, and personal loans). A revolving loan allows you to repay the loan without a specific set of payments and the loan remains fully open as long as you have not reached the limit of the line of credit (retail accounts, credit cards, and home equity lines).

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.

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. One factor that seems to have significant influence is your percent of open installment loans. Too many can lower this portion of your score.



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Cracking the code

If you are denied credit, you will receive up to four reason codes which indicate why you were denied. These codes appear in order of importance.

The chart below is a typical readout your lender might view. This particular readout presents information from all three credit agencies. In the example below, the individual failed to qualify for each credit agency with the listed reasons in descending order.

***** BORROWER: SMITH, JOE M. *****

TU Score: [00623]

Reason1=[022] Reason2=[016]

Reason3=[028] Reason4=[004]

Experian Score: [00629]

Reason1=[022] Reason2=[016]

Reason3=[028] Reason4=[032]

Equifax Score: [00617]

Reason1=[022] Reason2=[032]

Reason3=[024] Reason4=[004]



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CREDIT BUREAU RISK SCORE REASONS	EQUIFAX	TRANS UNION	EXPERIAN
Amount owed on accounts is too high	1	1	1
Level of delinquency on accounts	2	2	2
Too few bank revolving accounts	3	N/A	3
Too many bank or national revolving accounts	4	N/A	4
Too many accounts with balances	5	5	5
Too many consumer finance company accounts	6	6	6
Account payment history is too new to rate	7	7	7
Too many recent inquiries last 12 months	8	8	8
Too many accounts recently opened	9	9	9
Proportion of balances to credit limits is too high on bank revolving or other revolving accounts	10	10	10
Amount owed on revolving accounts is too high	11	11	11
Length of time revolving accounts have been established	12	12	12
Time since delinquency is too recent or unknown	13	13	13
Length of time accounts have been established	14	14	14
Lack of recent bank revolving information	15	15	15
Lack of recent revolving account information	16	16	16
No recent non-mortgage balance information	17	17	17
Number of accounts with delinquency	18	18	18
Date of last inquiry too recent	N/A	19	N/A
Too few accounts currently paid as agreed	19	27	19
Length of time since derogatory public record or collection is too short	20	20	20
Amount past due on accounts	21	21	21
Serious delinquency, derogatory public record or collection filed	22	22	22
Number of bank or national revolving accounts with balances	23	N/A	23
No recent revolving balances	24	24	24
Number of revolving accounts	26	N/A	26
Number of established accounts	28	28	28
No recent bankcard balances	N/A	29	29
Time since most recent account opening too short	30	30	30
Too few accounts with recent payment information	31	N/A	31
Lack of recent installment loan information	32	4	32
Proportion of loan balances to loan amounts is too high	33	3	33
Amount owed on delinquent accounts	34	31	34
Serious delinquency and public record or collection filed	38	38	38
Serious delinquency	39	39	39
Derogatory public record or collection filed	40	40	40

Please note: these codes change often and may not represent the current codes.

What factors affect your credit score?

The three credit agencies do not always have the exact same information. Therefore your three scores will differ slightly. As a general rule, if you fail to qualify at one agency you are also likely to be denied if one of the other bureaus is checked. Most loan companies will run reports from all three credit agencies and take the lowest score.



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Improving your credit score

Now that you know how your score is calculated, you can begin making changes to your current financial planning. The best things you can do truly are simple.

- **Pay your bills on time.** Sounds simple, but this is the best thing you can do to keep your score high. Delinquent payments and collections have a severe impact on a score.
- **Keep your balances low on unsecured revolving debt like credit cards.** High outstanding balances may affect a score negatively.
- **Only apply for credit that you need.** The amount of your unused credit is an important factor in calculating your score.
- **Make sure the information in your credit report is correct.** If it's not, dispute it with the credit agencies and/or with the creditor directly.
- **Removing negative items on your credit report has the biggest impact on your credit score.** Generally, negative items stay on your credit report for seven years. Hiring a professional firm like Lexington Law to remove negative items on your credit report can be one of the first steps to a higher credit score. Lexington Law is the leader in credit report repair and has helped thousands of clients quickly and legally clean up their credit reports.

Sign up today! \$99/sign up \$39/month

Call today: 1-800-280-9121 or visit www.lexingtonlaw.com

