Understanding Your Credit Score

Your credit score is a number generated by a mathematical algorithm -- a formula -- based on all the account information in your credit report. The resulting number is a highly accurate prediction of how likely you are to pay your bills. Credit scores are used extensively, and if you’ve gotten a mortgage, a car loan, a credit card or even auto insurance, the rate you received was directly related to your credit score. The higher the number, the better you look to lenders. People with the highest scores get the lowest interest rates.

DETERMINING CREDIT RISK
Credit scoring takes into account various “predictors” of future financial behavior. Consider the following very simplified examples: Sue has been paying her bills on time for the past 25 years, hasn’t taken on any new debt recently, and has no collection items or judgments or bankruptcies. She is likely a low credit risk and probably has a high credit score. In contrast, Roger got his first credit card two years ago and has had four late payments during that time. His balance on the card is currently at the credit limit, and he has applied for new credit four times in the last six months. Based on these facts, he will have a lower score, and is considered a higher risk for default.

The credit scoring system generally used by lenders in the United States is the FICO credit scoring system. This statistical system gives different weight to various components of the credit report. Recent payment history, for example, carries much more weight than an application for credit at a store.

WHY LENDERS USE CREDIT SCORES
Before credit scores, lenders physically looked over each applicant’s credit report to determine whether to grant credit. A lender might have denied credit based on a subjective judgment that a consumer already held too much debt or had too many recent late payments. Not only was this time-consuming, but human judgment also was prone to mistakes and bias. Lenders used personal opinions to make a decision about an applicant that may have had little bearing on the applicant’s actual ability to repay the loan.

Today, credit scores help lenders assess risk more fairly because they are consistent and objective. Consumers also benefit from this method. No matter who you are as a person, your credit score reflects only your likelihood to repay debt responsibly based on your past credit history and current credit status.

UNDERSTANDING CREDIT SCORES
Credit score factors are the elements from your credit report that shape your credit scores. For example, your total debt, types of accounts, number of late payments and age of accounts affect credit scores. Understanding the credit score factors is the key to improving your credit scores. The factors tell you what you must address in your credit history to become more creditworthy over time.

Finally, credit scores can and do change. Often, a negative item on a credit report can result in a quick and sudden decrease in the score. However, improving a credit score usually takes time and patience – there is no “quick fix” for damaged credit.

Information provided by Greenpath Financial Wellness, an official corporate partner of Space Age Federal Credit Union. For more information or other related articles, please visit www.greenpath.com.