

# **Understanding Your Credit Score: What You Don't Know Can Hurt You!**

**By Timothy Brown  
Academy Residential Mortgage**

## **What is Credit Scoring?**

Ever wonder why you can go online and be approved for a credit card within 60 seconds? Or get pre-qualified for a car loan without anyone even asking you how much money you make?

The answer is credit scoring. Credit scoring is a statistical method for determining a person's risk of default on a mortgage, consumer loan or credit card. Your credit score is a number generated by a mathematical algorithm based on information in your credit report, compared to information on tens of millions of other people. The resulting number is an accurate prediction of how likely you are to pay your bills.

When applying for a mortgage, a person will receive three credit scores, one from each of the three credit reporting agencies: TransUnion, Experian and Equifax. Scores range from 350 to 850 with higher scores reflecting a better credit risk. When getting a mortgage, most lenders use the middle score of the three when considering someone for a loan

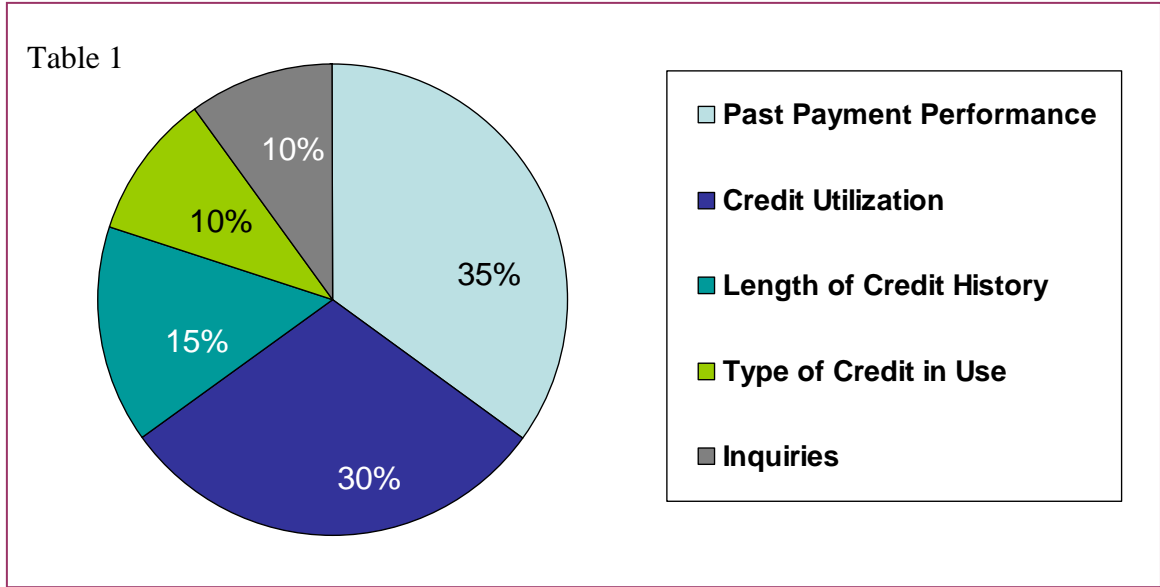
## **Why are Credit Scores So Important?**

Simply put, people with higher credit scores get better interest rates and access to special programs others do not. The difference could mean tens of thousands of dollars in interest savings over the life of the loan. Poor credit may even prevent a person from getting a loan all together. Lenders place a great deal of emphasis on the credit score because they view it as a very objective way to determine the creditworthiness of a prospective borrower.

## **What Factors Are Used to Calculate a Credit Score?**

As shown in Table 1 on the following page, past payment performance and current use of credit are the primary determinants of a borrower's credit score. It is logical that a person's track record in paying their debts on time would be the greatest predictor of future credit worthiness.

Length of credit history is also important and is one reason why younger borrowers tend to have lower credit scores than their parents. The type of debt a borrower has will also affect their credit score. Typically, mortgages are the most favorable type of credit because of the underlying secured asset, while unsecured credit such as credit cards are deemed to be higher risk and thus may adversely affect the borrower's score.



**What are the Keys to Improving Your Credit Score?**

The obvious answers are to pay your bills on time and minimize your use of credit. If you have an outstanding balance that is past due, pay it off immediately. It is also important to check your credit report for errors or inaccuracies that may be impacting your score. A single late payment that is erroneously recorded in your credit history may affect your score by up to 100 points! Remember that inaccuracies must be reported to all three credit agencies to ensure that your credit is fully repaired. Table 2 has the contact numbers for the three agencies.

Table 2

Experian	1-888-397-3742	<a href="http://www.experian.com">www.experian.com</a>
Equifax	1-800-525-6285	<a href="http://www.equifax.com">www.equifax.com</a>
TransUnion	1-800-916-8800	<a href="http://www.transunion.com">www.transunion.com</a>

Other keys for improving your credit score are not so obvious. Here are a few tips for maximizing your credit score:

- Pay down your credit card balances to less than 50% of the total available credit.**  
 The single biggest impact on credit scores other than a poor payment history is excessive use of credit card debt. Many consumers use one credit card to accumulate frequent flyer miles and thus put most of their charges on one card creating a very high credit balance on the particular card. Unfortunately, if this card is being charged close to the limit every month, it will have an adverse affect on your credit score. This is because credit agencies look at the ratio of credit card balances to total available credit for each credit card. If one card is close to the limit, this will be viewed as a potential risk and will lower your score. This is true even if the card is paid off every month! To optimize your score, try to

keep usage (and balances) to below 50% on every card instead of utilizing just one card. Spread charges on to more than one card to ensure that each balance is below 50%.

- **Avoid carrying more than four or five credit cards.** Use of more than five cards could indicate an excessive use of credit which will hurt your score. Many consumers may actually have more credit cards open than they know about. In some cases, consumers get credit cards to take advantage of discounts at department or home improvement stores. Many times they forget to close these accounts which then remain active on the consumer's credit report for years after they were initially open.
- **Be careful which credit cards you cancel.** Typically, if you are going to reduce the number of credit cards you carry, it is best to keep the cards you have had the longest. Remember the longer the credit history, the better the credit score. Canceling "older" credit cards could actually hurt your score by taking away the card that has the most credit history. Try canceling recently opened cards especially department store credit cards which typically are deemed "higher risk" cards than traditional credit cards.
- **Consider a home equity loan to consolidate debt.** This strategy will benefit you in two ways. First a home equity loan will likely have a lower interest rate than the credit card debt that is being consolidated so the monthly payment will go down. Second, the equity line is deemed to be "lower risk" debt than the credit card debt it is replacing which will improve the borrower's credit score.

Whether we like it or not, credit scores will be used for just about every significant financial transaction. Getting a car loan, financing braces for your child or purchasing an appliance with 0% financing all are impacted by your credit score. The key is to become proactive and know your credit score before deciding to buy that home or purchase a car. Consumers can go to the three credit bureaus' web sites shown in Table 2 and get their scores themselves. Another suggestion would be to get pre-qualified for a mortgage well in advance of the eventual home purchase so you have time to correct discrepancies or pay down credit card balances in time to improve your score and get a better interest rate on your mortgage. The bottom line is knowledge of your own credit score and the steps you can take to improve it have the potential to save you thousands of dollars over your lifetime. What you don't know about your credit score may hurt you...in the pocket!

Author Timothy Brown is a loan consultant with Century Home Mortgage in Marietta, GA.