Credit score basics

Tips for unlocking your credit potential

In the not so distant past, businesses relied on experience, intuition and sometimes personal bias to make lending decisions. Today, most companies use credit scoring to help them analyze information so they can make more objective, consistent decisions — and make them more fairly and more quickly.

What is a credit score?

Credit scoring is a tool lenders use to analyze the information in a credit report to help them make lending decisions. Scoring models, or computerized formulas, are developed by studying how millions of consumers actually performed in repaying debt over time. These credit scoring models are used to compare the information in your credit report with this proven track record to determine the relative risk that you may become delinquent on account payments or default on a loan. A number, called a credit score, represents the results of that analysis.

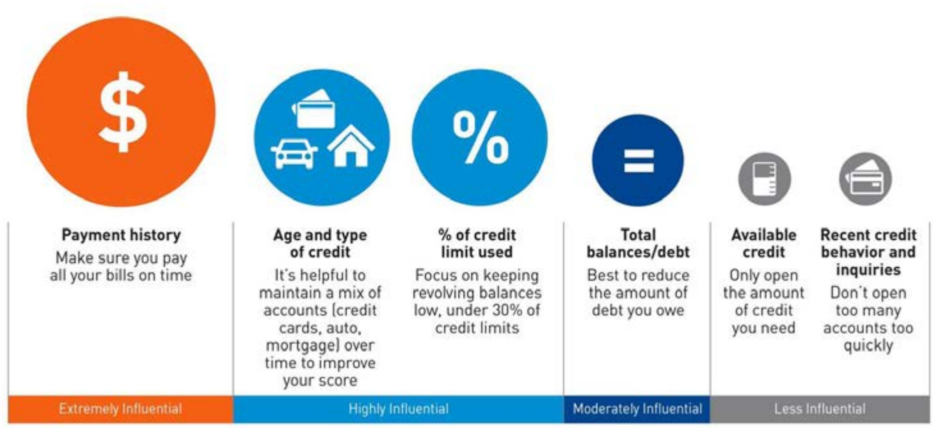
How does credit scoring work?

A credit report does not advise a lender to approve or decline an application. The lender must make that decision.

For many years, lenders used simple, paper work sheets to manually review credit reports and application information. By studying repayment patterns, they were able to identify elements in credit histories, and sometimes other application information, that signaled lending risk. Using a paper-and-pencil formula, a company might have denied your application because of a single late payment, regardless of other information in your credit history.

Today, computerized credit scoring looks at the same information but does so in a much more sophisticated manner.

Credit scores not only consider the number of late payments, but also balance negative information against all other positive details in your credit history. So your application still may be approved despite a single late payment.



Credit scores also help businesses make good decisions for people with very different credit histories. For example, issues that indicate risk for a new credit user are not necessarily the same as those for an experienced credit user with years of credit history. Credit scoring recognizes and accounts for such differences, enabling risk to be assessed accurately for every type of credit user.

Are there different kinds of credit scores?

There are many different credit score models produced by a number of different companies.

Experian's Decision Analytics business, separate from its credit reporting business, develops credit scores for lenders and other companies. There are other companies that specialize in creating credit scores as well. Additionally, some businesses, including lenders and insurance companies, develop their own credit scores based on their experience with customers.

Generic credit scores indicate general financial risk and may be used by many different companies. Custom scores are developed to predict risk for specific types of lending or for individual businesses. For example, one credit score model may evaluate the repayment risk for retail debt. Another model may be specifically for auto loan repayment. There even are credit scores used to help predict bankruptcy risk or the likelihood a person will make an insurance claim.

Usually, though, if one type of credit score indicates a person is low risk, other scores also will predict low risk because the same credit history information is used to make the calculations.

A pure credit score is based solely on the information from a credit report. Other scores are designed to use additional information. That information may be provided by consumers on their applications or may come from a business's actual experience with the consumer. For instance, mortgage risk scores may incorporate income and employment history from an application, or insurance risk scores may include previous claims records.

Is the number important?

The answer, of course, is "yes." The score is important, but the number is meaningful only in the context of that particular score range and that particular business transaction.

Each business selects the scoring service it will use based on its particular needs and risk tolerance. Businesses establish their own policies for deciding if a particular score will result in approving or declining an application or, in some cases, if different prices or fees will apply based on the risk the score represents.

Outside of a specific transaction, though, a credit score is just a random number. Without additional information to explain what it means, the score is useless as a tool to improve your creditworthiness. With a credit report to put it in context, any score is a valuable educational tool.

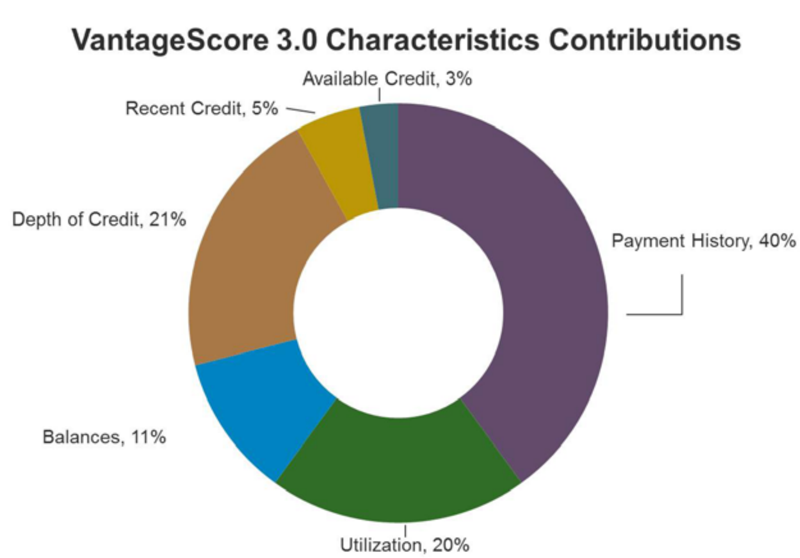
What is a good credit score?

There is no one "good" or "bad" credit score. Every credit scoring model has its own unique range of scores. Generally, a higher score represents lower risk. However, in some models, a low score represents low risk, so a low score could be better. Even companies that use the same credit score model may have different lending criteria, so a "good" score for one company may not represent a "good" score for another.

How can I change my credit use to get a better score?

A credit score represents the information in your credit report. In order to improve your credit scores, you must address the information from your credit report that most affected the scores. That information is identified by risk factor statements, which are generated along with the score at the time it is calculated. The statements often are included in a declination letter sent by the lender when your application is declined. Addressing the factors should improve your creditworthiness over time and consequently result in better credit scores.

For instance, paying a past-due debt generally will not immediately result in a huge improvement. However, keeping the payments current after paying the past-due debt will demonstrate good credit management, resulting in better credit scores over time.



When you purchase a credit score and report from Experian, it provides not only a credit score, but also a thorough explanation of both the negative and the positive factors affecting the score. You also receive educational information about how to improve the score and a simulator that enables you to see how certain actions could influence the score. Because of the information it includes, a credit score report can be a very good tool to help you improve your creditworthiness and, therefore, all credit scores.

Is a credit score part of a credit report?

A credit score is not part of a credit report. Credit reporting companies often are erroneously referred to as "credit rating agencies." In fact, neither credit reports nor credit reporting companies "rate" your credit. Credit scoring is a separate process from credit reporting.

A simple way to think of a credit score is to compare it with the grade on a school paper. The grade represents an analysis by the teacher of the information in the paper in much the same way that a credit score represents an analysis of the information in the credit report.

A credit score is calculated only when a credit report is requested. The lender selects which score is applied. The score represents the information in the credit report at that moment.

How do I get a credit score?

Credit score reports are available for a fee from a number of sources, including Experian. Any score you receive through a consumer score disclosure service will explain what that number means in terms of general credit risk and will describe the factors from your credit report that most influenced the score.

While the numbers you receive can vary greatly, the risk level they represent will be relatively consistent no matter which score was used or what number it produced.

You can obtain your Experian credit score online at www.experian.com or at www.annualcreditreport.com. You also can purchase a score and learn much more about credit scores at www.nationalscoreindex.com.

10 tips for managing your credit report to improve your scores

1. **Establish a credit report:** Creditors need financial references, and that is what your credit report provides. The report's content is used to calculate your credit scores.
2. **Always pay on time as agreed:** Late payments will negatively impact your ability to get credit and are the first signs of impending credit problems.
3. **Have a mix of credit, but obtain and use a credit card:** You decide how to use the card and repay the balance, which tells more about how you make credit decisions than other types of loans, such as auto loans or mortgages.
4. **Use caution when deciding to close accounts:** Closing accounts reduces your available credit. That can increase your total balance-to-limit ratio, which is a sign of risk and can negatively impact credit scores.
5. **Apply for credit judiciously:** Recent inquiries indicate you may have taken on new debt that isn't yet shown as an account on your credit report. Many inquiries in a short time might suggest you are trying to take on large amounts of debt. Both issues signify risk.
6. **Time is the key:** It takes some time for your credit report to be updated, so balances can't be reduced overnight. Additionally, credit scores not only look at whether your bills are paid, but also at how long they have been current and how far in the past negative information appears. It takes time for scores to improve after you have taken control of your credit.
7. **Demonstrate stability:** Lenders may look beyond your financial transactions and ask how long you have had your job, how long you have lived in the same location and whether you have built other assets over time.
8. **Have a plan:** Know how you are going to repay the debt when you use your credit card or get a loan, and stick to that plan.
9. **Put credit to work for you:** Use credit as a tool to take advantage of low interest rates, convenient shopping, rewards programs and financial management. When you are in control, credit works for you.
10. **Share your knowledge:** Share what you've learned about credit with your friends and family so that they can avoid pitfalls and mistakes you might have made.

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