Understanding Your **CREDIT SCORE** & How to Improve It

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by Jimmy Hurd

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Introduction

A good credit score is important for anyone to have. Building a solid credit history and maintaining a high credit score can have a dramatic impact on your quality of life. Good credit enables you to have access to money that can be used to purchase a house, fund education, start a business or pay for necessities that are out of reach with your current cash on hand. When using credit, a high credit score will result in smaller expenses for interest.

This report gives you some key basics about credit. It will help you gain a better understanding of credit and how to improve it. Regardless of your current credit score, it can always be improved.

The following questions will be addressed in this report:

What is credit?
What are the different types of credit?
What is a credit bureau?
What is a credit report?
What is a credit score?
What is FICO?
Why is having a good credit score beneficial?
How can I improve my credit score?

What is credit?

Let's start at the beginning with the first question. What is credit? Credit is borrowed money that you use to make purchases of goods and services. A provider of the credit grants you that credit. You agree to pay back the amount you used plus finance charges. Your agreement includes paying within a particular time.

What are the different types of credit?

There are four basic types of credit.

1. Revolving credit. Revolving credit begins with the grantor giving you a maximum credit limit. You are able to make charges up to that limit. Each month, you carry a balance and make a payment. The balance that is carried over is referred to as the "revolving" debt. Most credit cards (Mastercard, Visa, Discover) are this form of debt.

2. Charge cards. Charge cards are used to make purchases like credit cards. The difference, however, is that with a charge card the balance must be paid every month. American Express is the only issuer of a true charge card in the United States.

3. Service credit. Service providers all make credit arrangements for services. These include services such as phone service, electricity and gym memberships. The services are provided with the agreement that you will pay for them each month.

4. Installment credit. With installment credit, a creditor loans you a specific amount of money. You agree to repay that amount plus interest. The payments are made in regular installments over a specific period of time. Car loans and home mortgages are examples of this type of credit.

What is a credit bureau?

A credit bureau is a company that collects and maintains individual credit information and sells it to lenders, creditors, and consumers in the form of a credit report. While there are dozens of credit bureaus across the U.S., most consumers are familiar with the big three: Equifax, Experian, and TransUnion.

What is a credit report?

The credit bureaus have information related to you and your credit history. This information is compiled in a credit report. Credit reports have four sections.

1. Personal data
2. Credit history
3. Inquiries
4. Public records

The personal data section includes your name, address (current and former addresses), employers and date of birth.

The credit history section includes accounts you have opened, your repayment history, the amount of credit you have and are using.

Inquiries are records of your applications for new credit. The two types of inquires, soft pulls and hard pulls, will be discussed later in this report.

The public records section includes bankruptcies, tax liens, foreclosures and repossessions.

What is a credit score?

A credit score is a number that reflects the likelihood that you will pay when credit is extended to you. These scores are generated by the credit bureaus. The specific aspects of the FICO credit score will be discussed later.

Your credit score is a unique three digit number ranging from 300 – 850. Credit scores range between poor and exceptional. Below is a numerical breakdown of the score ranges.

300 – 570 Poor
580 – 669 Average
670 – 739 Good
740 – 799 Very Good
800 – 850 Exceptional

Credit scores are based on the information found in your credit report. Your credit score changes depending as the information in the report changes. There are five key elements that contribute to your credit score. These are listed below. A brief explanation follows the list.

Payment history (35%)
Amounts owed (30%)
Length of credit history (15%)
Credit mix (10%)
New credit/inquiries (10%)

<u>1. Payment history (35%)</u>

Payment history describes your practice of paying back what you owe and paying on time. It is best described in terms of derogatory information, whether it is present or lacking. Items such as bankruptcies, liens, judgments, settlements, charge offs, repossessions, foreclosures, and late payments can cause a credit score to drop.

2. Amounts owed (30%)

This is also referred to as the debt burden. There are several measurements that are considered in this area. First is the debt to limit ratio. This number is expressed as a percentage of the amount that you owe on a particular account to your credit limit. For example, let's say you have a credit card that has a $1,000 limit. You owe a balance of $300 on this card. Your debt to limit ratio is 30%. A lower percentage will increase your credit score. Another measure is the number of accounts that you have that still have balances. Having a high number of accounts and a low number of accounts with balances will increase your score. Another measurement is the amount you owe across different types of accounts. The final measurement of this account is the amount that you have paid down on installment loans.

3. Length of credit history (15%)

This refers to the amount of time accounts have been in your credit report. The older a credit history is the better impact it will have on a credit score. Two key factors are measured in this area: the average age of the accounts on a report and the age of the oldest account.

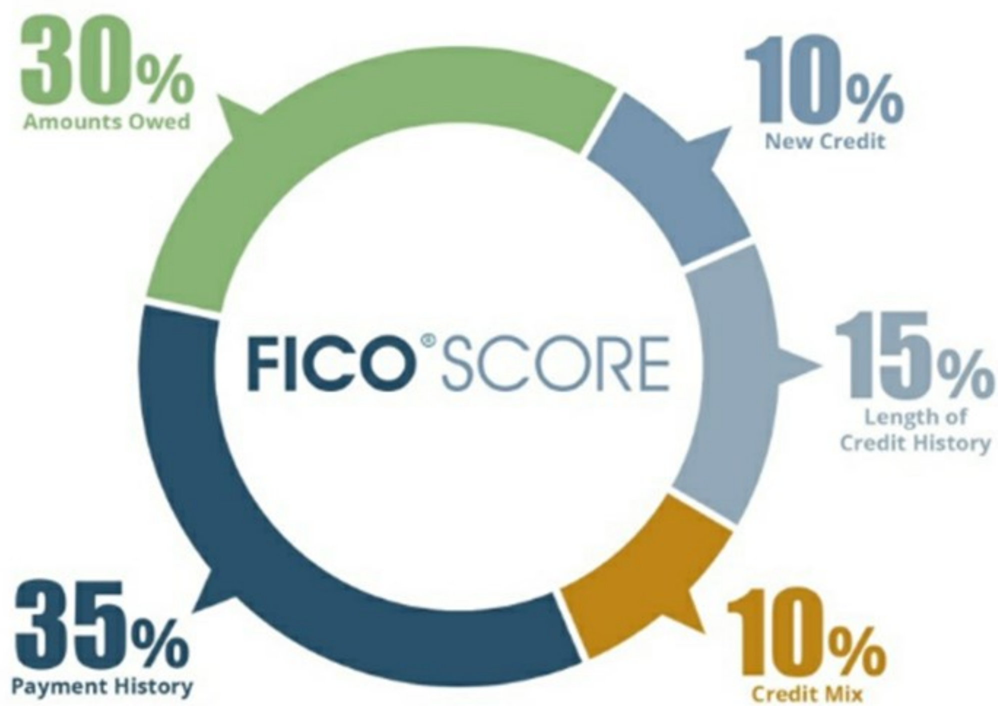
4. Credit mix (10%)

Your credit mix refers to the different types of credit you have, such as credit cards car loans and mortgages. The more diverse the mix of credit the better.

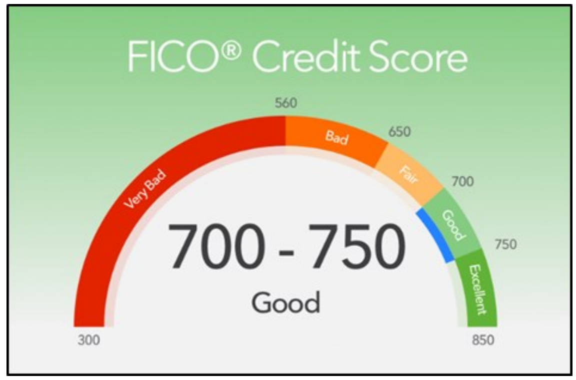
5. New credit inquiries (10%)

In this category, recent searches for credit are referred to as “hard inquiries” or “hard pulls.” These occur when a person applies for a credit card or loan. Having too many of these can lower a credit score. Having a number of inquiries within a short period of time (14 -45 days) made by someone shopping for a mortgage or auto loan will not significantly decrease a credit score.

“Soft pulls” or “soft inquiries” do not have any impact on your credit score. Soft pulls include credit inquiries that you make, yourself. The pulling of credit reports by a potential employer or companies initiating pre-screened offers of credit or insurance are also considered soft pulls.



What is FICO?



A FICO credit score is a credit score developed in 1989 by the Fair Isaac Corporation (FICO). FICO was founded by Bill Fair and Earl Isaac in 1956. It is an analytics company based in San Jose, California. The company specializes in "predictive analytics" which involves analyzing information for the purpose of making predictions.

In the case of credit, the FICO score is used to predict how likely a person is to pay their bills on time and to determine if a person can manage a higher line of credit. The FICO credit score is the most popular scoring system for credit.

To create credit scores, FICO uses information provided by one of the three major credit reporting agencies — Equifax, Experian or TransUnion. FICO itself is not a credit reporting agency. The credit bureaus create a credit score based on the FICO model. FICO creates FICO Score algorithms which are used to generate FICO Scores and provides them to the credit bureaus.

Though a FICO credit score is the most widely used among lenders. 90% of top lenders use FICO scores. There are other scores lenders can choose from, such as the VantageScore, which is becoming more widely used. VantageScore Solutions was created in 2006 as a joint venture of the three major consumer credit bureaus: Equifax, Experian and TransUnion. There are four VantageScore models, and the latest, VantageScore 4.0, uses a range of 300 to 850. In 2013, lenders purchased more than 10 billion FICO scores and about 30 million American consumers accessed their scores themselves.

You have credit scores for each of the three main credit bureaus: Experian, Equifax, and TransUnion. Current scores from each of the three bureaus may differ slightly because the scores are based on the information in the credit report from one particular bureau. To state it another way, your scores may differ because the information from the bureaus used to generate the score may differ.

Why is having a good credit score beneficial?

Having a good credit score has a number of benefits. Overall, having a good credit score saves you money. It also gives you better buying power and provides greater opportunities. Seven specific benefits are discussed below.

1. <u>New Credit/More Credit</u>

Having a good credit score puts you in a position to get new credit. You will be approved for credit cards. You will be approved for loans. You will be approved for mortgages. Once you have credit (be it through a credit card or loan) you will be approved for higher credit limits and larger loans if your credit is good and your credit score is high.

2. <u>Better Interest Rates</u>

A good credit score will enable you to receive better interest rates from lenders. Lenders are willing to offer a better rate because your good credit score suggests that they have a high probability of receiving all of their payments. High interests rates are designed to offset the possible losses of a person not paying or paying late. With a good credit score you may be able to negotiate for a better rate once a loan is issued.

3. Approval for Rental Houses and Apartments

Many landlords use credit scores as a basis for evaluating future tenants. A low credit score can lower the possibility of being accepted as a new renter. This is especially true if the low score was impacted by a previous eviction or an outstanding rental balance. A high credit score will give a new landlord confidence that you will pay your rent on time.

4. No Security Deposits

Utility companies and cell phone companies typically require new customers to pay a security deposit. The security deposit is typically waived for customers with good credit. Again, the security deposit is protection for the companies against those who are a higher risk for not paying their bills. Also, with cell phone companies, it is often the case that if you have a high credit score you will pay less for a telephone.

5. Lower car insurance rates

Another benefit of having a high credit score is that you will receive better car insurance rates. Insurance companies observe that people with higher credit scores file fewer claims. The lower cost of the insurance premium is a reward for that behavior.

6. Smoother entry into new employment

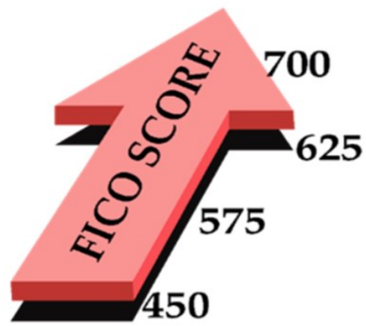
More and more employers are using credit reports as a part of the hiring process. Employers sometimes check credit to get insight into a potential hire, including signs of financial distress. They don't get your credit score, but instead see a modified version of your credit report. Lots of late payments may indicate a lack of personal organization and responsibility. Any evidence of mishandling your personal finances may give an employer the impression that you are a poor fit for handling company money or consumer information.

7. Good Feelings

This intangible benefit is a reality. You simply feel better when you have a high credit score. You feel empowered. You feel more freedom. You feel more satisfied with a job well done in managing your money.

How can I increase my credit score?

Regardless of what your current credit score is, it can be improved. In summary, you can increase your credit score by removing derogatory information and by taking actions to build credit.

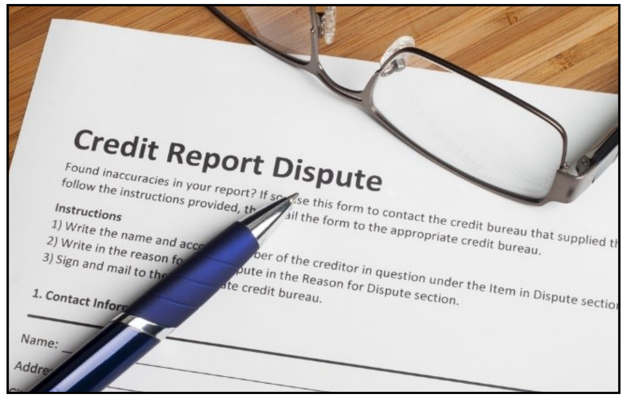


1. Removing derogatory information

First, certain information that lowers a credit score will be removed from your credit report as time passes. The rules for the reporting of debts can be found in the Fair Credit Reporting Act. The act states that most negative items must be removed from your credit report seven years from the first date of delinquency. Some exceptions to the seven-year rule include: 1) Chapter 7 bankruptcy filings (10 years) 2) Judgments (seven years or until the state statute of limitations expires, whichever is longer) 3) Money owed to or guaranteed by the government. (Unpaid taxes or student loans stay on your report indefinitely or until seven years from the date paid.)

Positive information remains on your report for an average of 10 years from the day its corresponding account is closed. This information applies to loans like mortgages and car loans, and the types of agreements that have fixed terms on the number of years for repayment. For revolving accounts, such as credit cards, your positive history will stay on your report for as long as the account is active.

Second, you can contact the credit bureaus and request to remove information you believe to be inaccurate. You can contact a credit bureau in writing to point out the inaccurate information. The credit bureau must investigate the items you question within 30 days. They also must send all relevant data to the organization that provided the information. After the information provider gets notice of a dispute from the credit reporting company, it must investigate, review the relevant information, and report the results back to the credit reporting company. If the investigation reveals that the disputed information is inaccurate, the information provider has to notify the nationwide credit reporting companies so they can correct it in your file. When the investigation is complete, the credit reporting company must give you the results in writing and a free copy of your report if the dispute leads to a change.



You can also contact an information provider to dispute an item. If a provider reports information to a credit bureau, it must include a notice of your dispute. If the information is not accurate, the provider may not report it again.

<u>2. Taking action to build better credit</u>

There are a number of action steps you can take to improve your credit score. It takes about six months of credit activity to establish a FICO score. Your credit score will improve over time with a few positive strategies.

First, pay your bills on time. Your payment history is the most influential factor that impacts your score. So, pay your bills and pay them on time. Make sure you have a system that communicates to you when your payments are due. Many times you may miss a payment because you simply didn't remember when it was due. A good way to do this is to set up automatic payments. Credit card companies, utilities and cell phone companies all have automatic payment systems.

Second, use credit cards strategically. To optimize your credit score you should have between 2-4 bank credit cards. People who don't have a major credit card are considered a bigger credit risk than people with 14 credit cards. Having a credit card gives you an opportunity to demonstrate your ability to pay on time.

With your credit cards, be sure that you keep your balance to a minimum. Remember, the debt to credit ratio is a factor the credit bureaus use to determine your credit score. Having a large credit limit and a low balance is a plus.

Having one or two retail cards (from Home Depot, Target, Kohls or similar retailers) will help to diversity your credit mix. If you have them, be sure that you use them and pay off the balances. Try not to have balances on all of your cards at the same time. Use them so the store will not drop the account due to inactivity. You don't want the store to close an inactive card.

Third, pay down your debt. Here, it is important to understand the impact of paying on two different types of accounts. Revolving accounts have balances that may vary from month to month. Credit card accounts are the key example. You want to pay down your revolving accounts as much as possible.

Installment accounts have payments that are constant such as an auto loan or a mortgage. These involve paying a fixed amount over a predetermined period of time. Paying these balances down will not improve your credit score significantly. With these accounts you want to make consistent payments for the full course of the loan.

Finally, you may choose to use a credit repair company to assist you in reviewing your credit reports, drafting dispute letters and advising you on credit building strategies. Credit repair companies are skilled at reviewing reports and targeting the areas that will result in the fastest increases of your score.

Summary and Conclusion

Understanding credit is a key area for financial success. This report has addressed some of the basic questions about credit. It has given some insights that can help you to take action to improve your credit score.

My hope is that you will continue to learn more and take the proper steps that will lead you to achieving your financial goals.

- Jimmy Hurd