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Understanding Credit Scores

A credit score is a number which summarizes a consumer's credit history. The purpose of the score is to help lenders evaluate whether the consumer is a risky borrower. Many auto and home insurance companies also use special credit scores to decide whether to issue a policy and for how much.

Here's how credit scoring works in helping decide who gets credit — and why.

WHAT IS CREDIT SCORING?

Information about consumers and their credit experiences, such as bill-paying histories, numbers and types of accounts, collection actions, outstanding debt, and the age of accounts, is collected from a consumer's credit application and credit report. Using a statistical program, scoring developers compare this information to the credit performance of consumers with similar profiles. A credit scoring system awards points for each factor that helps predict who is most likely to repay a debt. A total number of points — a credit score — helps predict how creditworthy a consumer is, that is, how likely it is that a consumer will repay a loan and make the payments when due.

A consumer's credit score may differ depending on which credit reporting agency (Equifax, Experian, or TransUnion) is making the report. The most popular type of credit score, called a FICO score, is usually between 300 and 850. A higher number is considered a better score. Anything over about 750 is considered to be a very good score by most lenders.

HOW ARE CREDIT SCORES CALCULATED?

Each credit reporting agency and credit scoring company has a slightly different way of calculating credit scores. The biggest credit scoring company, FICO, has disclosed the factors it considers in generating credit scores (see page 2 for various factors).

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- Payment history (about 35% of the score). Late payments, accounts referred to collections, or bankruptcies will lower a score.
- Amounts owed on credit accounts compared to available credit (about 30% of the score). High balances in comparison to credit limits may indicate that the consumer is over-extended.
- Length of credit history (about 15% of the score). In general, a longer credit history increases the score. A too-short credit history may have an effect on a score, but that can be offset by other factors, such as timely payments and low balances.
- New credit (about 10% of the score). Scores get more points if the consumer has an established credit history and doesn't have too many new accounts. Opening several accounts in a short period of time can indicate greater risk. Scoring models measure this factor by looking at "inquiries" on the credit report, that is, when a creditor or other user obtains a credit report. Inquiries can negatively affect a score, but not all inquiries are counted. Inquiries by creditors who are monitoring an account or looking at credit reports to make "prescreened" credit offers are not counted. Credit inquiries made by consumers of their own credit records aren't included either
- Types of credit (about 10% of the score). FICO scoring systems look for a mix of different types of credit. However, this factor is usually not important if there is sufficient other information upon which to base a credit score.

More information is available at www.myfico.com.

WHAT CAN CONSUMERS DO TO IMPROVE CREDIT SCORES?

Credit scoring models are complex and often vary among creditors and for different types of credit. Only the creditor can explain what might improve a score under the particular model used to evaluate a credit application.

To improve a credit score under most models, it is best to concentrate on paying bills on time, paying down outstanding balances, and not taking on new debt. It's likely to take some time to improve a score significantly. Errors involving negative information should be disputed. (See Consumer Facts for Older Americans, "Disputing Errors in a Credit Report.")

Scoring models may be based on more than just information in a credit report. For example, some models designed for home mortgage lending consider information from a credit application, as well as information about jobs or occupations, length of employment, and homeownership.

HOW RELIABLE IS THE CREDIT SCORING SYSTEM?

Credit scoring is only as good as the information in the credit report — garbage in, garbage out — and credit reports are notorious for containing errors. Credit scoring programs often cannot generate a score if the consumer has no recent activity on an account, usually within the last six months. This can be a problem for consumers who have paid off all their loans and do not use credit cards. Lack of a score can mean denial of credit, or auto or homeowner's insurance.

A more fundamental problem is whether credit scores take too much of a broad-brush approach, failing to distinguish between consumers who are simply unlucky (e.g., victim of a job loss or medical bills from illness) and those who are truly irresponsible. Finally, there are serious concerns that credit scoring disproportionately hurts certain minority groups.

WHAT HAPPENS IF A CONSUMER IS DENIED CREDIT OR IS REQUIRED TO PAY A HIGHER PRICE?

If a consumer is denied credit, the Equal Credit Opportunity Act requires that the creditor give a notice that tells the consumer the specific reasons that the application was rejected or the fact that the consumer has the right to learn these reasons. Indefinite and vague reasons for denial are illegal. Acceptable reasons include: "Your income was too low" or "You haven't been employed long enough." Unacceptable reasons include: "You didn't meet our minimum standards" or "You didn't receive enough points on our credit scoring system."

Sometimes consumers are denied credit or charged a higher price because of a credit score or information from a credit report. In those cases, the Fair Credit Reporting Act requires the creditor to give out the name, address and phone number of the credit reporting agency that supplied the information. This notice should also include a copy of the credit score used by the creditor, along with information to explain the score.

Consumers should contact the credit reporting agency listed in the notice in order to obtain a copy of their credit report and to see what it said. This information is free if requested within 60 days of the credit denial. (See Consumer Facts for Older Americans, What You Should Know About Your Credit Report). The credit reporting agency can tell consumers what is in their reports, but only the creditor can tell them why an application was denied. The consumer should ask what characteristics or factors were used by the creditor, and the best ways to improve the application.

If the consumer is denied credit or charged a higher price because of inaccuracies in the credit report, it is important to dispute the inaccurate information. (See Consumer Facts for Older Americans, “Disputing Errors in a Credit Report”.)

HOW TO OBTAIN CREDIT SCORES

Under federal law, the Big Three credit reporting agencies (Equifax, Experian and TransUnion) are required to provide consumers with a credit score upon request. The credit score is not free, nor is it likely to be the same score that creditors use. The credit reporting agencies usually sell an in-house “educational” score or a “VantageScore,” which are not the same as FICO scores. In one out of five times, these educational scores are significantly and meaningfully different than FICO scores. About 90% of the credit scores used by creditors are FICO scores.

When a consumer requests his/her credit score, the credit reporting agency must provide:

- The consumer’s current credit score or most recent score that was calculated by the credit reporting agency relating to the extension of credit.
- A statement indicating that the information and credit scoring model may be different than the credit score used by the lender.
- The range of credit scores of the model used to generate the credit score.
- The key factors that adversely affected the consumer’s credit score, listed in order of impact. The credit reporting agency cannot list more than four (4) key factors, unless one of the factors is the number of inquiries, in which case that factor must be included.

- The date on which the credit score was created.
- The name of the provider of the credit score or the credit file used to generate the credit score.

The consumer is entitled to a free credit score in some instances. Mortgage lenders who use credit scores must provide, free of charge, the consumer's credit score and associated key factors. Consumers who are denied credit or required to pay a higher price should also receive a copy of the credit score used by the creditor in the notice required by federal law.

ADDITIONAL RESOURCES

Consumer Financial Protection Bureau (CFPB)

The CFPB's mission is to make markets for consumer financial products and services work for Americans. To file a complaint or to get free information on consumer issues, visit www.consumerfinance.gov or call toll-free, (855) 411-CFPB (2372); TTY: (855) 729-CFPB (2372).

Books and Websites

National Consumer Law Center, *Fair Credit Reporting* (8th ed. 2013).

National Consumer Law Center, *Guide to Surviving Debt* (2016 ed.).

Call 617-542-9595 or visit www.nclc.org for more information about NCLC publications.

Consumer Federation of America (202) 387-6121 www.consumerfed.org	**Consumers Union** www.consumersunion.org	**U.S. PIRG** (202) 546-9707 www.uspirg.org

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