The Basics of Credit Scores and Credit Reports

Presented by Graziano Budny Wealth Management Group

As consumers, we know that having a good credit score is important. Whether you are applying for a loan or signing up for a credit card, your credit score plays a major role in determining if you will be approved. Your credit score can also have a significant impact on loan terms and borrowing costs.

What is a credit score?

When you borrow money from a lender or sign a contract pledging to make payments, the other party needs to assess how likely it is that you will fulfill your obligations. Your credit score is a measure of risk that helps lenders quantify this likelihood in real time.

Credit scores also help to make the credit process more efficient. In order to make a decision about whether to lend money, a lender needs to gather a great deal of information. The credit score speeds up this process immensely by giving the lender a quantifiable measure without having to collect all the data. In addition, the efficiency of using credit scores does a lot to increase the amount of credit available, which in turn pushes down the cost of credit to consumers.

Types of credit scores

The FICO® Score, created by the Fair Isaac Corporation, is the most commonly used credit measure. Although in this article we focus on FICO, you should be aware that other scores—for example, VantageScore and PLUS Score—evaluate credit worthiness using their own methodologies.

A consumer's base FICO Score ranges from 300 to 850—the higher the consumer's score, the lower his or her risk to lenders. During the past 25 years, the base FICO Score has undergone many revisions, and the scoring methodology has evolved to account for new data points. Currently, the most widely used measure is the FICO 8 Score. (Fair Isaac has several other scores whose methodology is specific to the type of lending decision being evaluated. For instance, a bank may use a different FICO Score for mortgage lending than it does for making decisions about issuing credit cards.)

How a FICO Score is calculated

When a consumer obtains credit, the lender reports the information to the three major U.S. credit bureaus: Equifax, Experian, and TransUnion. The information then goes into the individual's credit report, which provides the raw data used to calculate the credit score.

The credit report includes the consumer's personal information (e.g., date of birth, social security number), all of his or her account information, information about credit inquiries, and negative information such as bankruptcies and late payments. For calculating an individual's credit score, the FICO formula looks at five primary categories of information:

1. The consumer's total amount of debt
2. The combination of different types of accounts
3. The consumer's history of making payments on time
4. How old the consumer's credit history is

5. The amount of new credit applied or shopped for

Although some categories like payment history and amount of debt are more heavily weighted in determining the FICO Score, the relative importance of a category can be affected by the aggregated information in the consumer's credit report.

Improving and maintaining your credit score

Now that you understand what goes into calculating a credit score and why the score is so important, let's look at some strategies for improving, maintaining, and protecting your score. It all starts with an initial check of your credit report.

Consumers may request their credit report once a year from each credit bureau. There is no cost to request the three reports, and they can be obtained easily online through www.annualcreditreport.com.

Once you receive your reports, check them diligently for accuracy. Cross-reference them with each other to be sure that the information is correct across the three bureaus. If you find inaccurate information—especially incorrect negative information—contact the credit bureaus to dispute the data.

Here are some additional tips for improving your credit score:

- Do your best to keep balances on credit cards low compared with your total available credit line. High balances can hurt your credit score.
- Create a system to ensure that you pay your bills in a timely fashion. Consistently paying bills on time will have a positive effect on your score.
- Do not move debt around to avoid payments. Work on a system to pay down debt rather than move it.
- Use credit cards, but use them properly and pay on time. Lenders want to see a track record that demonstrates your ability to manage debt responsibly.
- If you are looking to obtain a loan, shop around within a *short* period of time. If you spread your search out over a long time frame, lenders may infer that you are shopping for many credit lines rather than for just one loan.
- If you are unable to make payments, contact the lenders to try to come up with a plan. Consider working with a credit counselor to develop a strategy for paying down your debt.

Regular monitoring and diligent checking are key

Considering the importance of credit scores, consumers should make a concerted effort to monitor and protect the information that makes up their scores. Request your credit reports at least annually and diligently check the information for accuracy. Take pride in having a good score and enjoy the benefits that come along with it.

Graziano Budny Wealth Management Group is a financial advisory team located at 304 Inverness Way South, Suite 305, Englewood, CO 80112. They offer securities and advisory services as Investment Adviser Representatives of Commonwealth Financial Network®, Member FINRA/SIPC, a Registered Investment Adviser. They can be reached at 720-583-6363 or at jgraziano@grazianobudny.com, bbudny@grazianobudny.com, or mgraziano@grazianobudny.com.

© 2018 Commonwealth Financial Network®