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YOUR CREDIT SCORE-THE FUTURE IS NOW

In my seminars, I ask who has seen the movie “Minority Report” with Tom Cruise. For those of you who have not seen that movie, it is a science fiction movie about the future. In this future, there are psychics who see murders before they occur. Tom Cruise plays the law enforcement officer who arrests and imprisons the murderers before they commit the crime.

This, of course, is a sci-fi movie. But, in the real world, we have something very similar as it relates to credit. Based on a person’s credit score, lenders and others look into the future, predict whether or not a person will pay a loan back and if the score is poor won’t loan the money- to use my movie example, effectively arresting the murderer before he commits the crime.

WHAT IS A CREDIT SCORE?

A credit score is a rating system based on several individual credit factors that lenders and others use to help them make lending and other decisions. The most commonly used scoring system, FICO, is a proprietary product developed by the Fair Isaac Company. Three different credit bureaus, Experian, Equifax and TransUnion all have FICO scores that can be slightly different. Scores range from a low of 300 to a high of 850. A person can buy a representative credit score from myfico.com for \$16. Alternately, a person can get a free annual credit report from annualcreditreport.com. The free credit reports will have a person’s credit history but not a score.

WHY IS A CREDIT SCORE IMPORTANT?

Credit scores are used by lenders to help judge a person’s risk of default on a loan. With a high number the lender is more likely to make the loan and with a low number it is almost impossible to get a loan. Credit scores are also used to determine interest rates on loans. A higher score can mean a lower rate for home loans, car loans, home equity loans and credit card loans. Insurance companies use credit scores to help them determine if they will insure someone. Landlords, utility companies and others that give service to a person also use credit scores to help them with their decisions. Finally, potential employers can ask a job applicant if they can request a credit report. If the applicant says yes and the credit report score is bad, the applicant is unlikely to be hired. If the applicant does not agree to let the employer get a credit report, the employer wonders why and generally would not hire the applicant.

WHAT GOES INTO A CREDIT SCORE?

The biggest part of a person’s credit score, about 35% of the weighting, comes from the person’s payment history (Fried, Carla, “Win at the Credit Scoring Game,” Money Magazine, September 2009). Lenders, including stores can report delinquent payments of over 30 days to credit bureaus. Payments that are 30 days late or more, lower a person’s score. In fact one late payment can take 100 points off a high credit score. Payments that

are 90 days late or more are especially damaging to a score. If payments are brought current it helps repair the score but late payments, especially 90 days and more can affect the score for years. The next biggest part of a person's credit score, about 30% of the weighting, comes from how much a person owes on credit relative to the credit available. In other words if a person has a credit card with a \$10,000 limit and there is \$10,000 used, there is no available credit which would lower the score. Alternately, if that person was using \$1000 of the credit card then they have \$9000 available to use, a 10% utilization rate, (\$1000 used/ \$10,000 limit) which gives that person a higher score. Usage of 20% or less is the best for the credit score. The idea is that if a person hasn't used all the available credit, then that person has available room to borrow to make payments if he gets in trouble making him a lower risk of default. Therefore it can actually hurt a person's credit score to cancel a card with an available balance because that increases his utilization ratio. The other main factors in the credit score are the length of a person's credit history, whether or not a person has recently taken on credit, and the current mix of credit a person has. Again, the largest factor is a person's payment history on their loans and bills. Pay bills on time. Incidentally, credit that is signed by another person affects that person's score too. If a person cosigns on a loan with another person and the loan isn't paid on time, both credit scores are adversely affected.

WHAT IS A GOOD CREDIT SCORE?

According to Credit.com from Money Magazine, the top 6% have a credit score of 800 or above. Another 27% have a score between 750 and 800. Another 18% are between 700 and 750. Another 15% are between 650 and 700. That means that about two thirds of all people, (66%) have a score above 650. Another 25% have a score between 550 and 650 and the rest, about 9% are below 550. It used to be that a 620-650 score might qualify a person for a loan, but in talking to a local loan officer I have learned that for most home and car loans banks now require a score in the 680-720 range. This effectively means that whereas two thirds of all applicants that applied would have qualified for a loan, that currently it is more like only half of all applicants that apply qualify.

WHAT CAN A PERSON DO TO IMPROVE HIS CREDIT SCORE?

The most important thing a person can do is to begin making all his payments on time. This is the largest and most important component. It is that simple. Secondly, it is also important to keep the credit utilization rate on outstanding credit as low as possible and preferably under 20%. If a person does these two things, most of the rest will most likely take care of itself.

MAKE THE CREDIT SCORE SAY SOMETHING POSITIVE

In my student seminars, I tell them a person's credit score says a lot about a person's reliability, character and integrity. Don't let your credit score make you a Tom Cruise "Minority Report" arrest casualty. Make that credit score tell a good story not a negative one.

(Remember every investor's situation is unique, and it is important to review your specific situation with a financial professional.)

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