**The Financial Significance of Credit Scoring**

**What is a Credit Score? And How Does Having a “Good” Credit Score Benefit You?**

The total ***reported*** credit experience of a person (the positive and the negative) is numerically scored by credit bureaus and submitted to potential creditors or other authorized persons, by authorized request. The score is determined according to a formula (originally developed by FICO – Fair Isaac & Company – in 1989 and is accepted industry-wide) that is intended to statistically reflect the level of risk a lender might take on when giving credit to a person. The score is based on a person’s previous and current handling of credit, using several credit factors.

**Credit scoring factors (points are increased or reduced based on reported information):**

* 35% of a score depends on “Payment History,” or how credit has been ***handled* *over time***
* 30% depends on the person’s ***total available*** “Amount of Credit” and how it is handled
* 15% depends on the “Length of Credit History,” or ***how long a person has held credit***
* 10% depends on ***how much*** “New Credit” ***a person* *seeks and holds***
* 10% depends on the “Credit Mix,” or ***various types of loans or credit*** a person holds

The score is expressed in a three-digit number and acts as a gauge for lenders to use when evaluating how a person handles their existing credit, and how ready they are to take on new credit. Besides being used to determine whether a person will be approved for credit, it also often determines how much interest that person will be charged. While scores can fluctuate depending on the ups and downs of a person’s financial life, it is commonly agreed that the higher and more stable a person’s credit score is over time, the better their chance for borrowing and accessing available credit at or near a prime interest rate.

**Credit scores are generally determined to be “very poor” – to “fair” – to “excellent:” (The scale below can differ slightly according to the entity evaluating your credit.)**

* Very poor: 300 to 499
* Poor: 500 to 600
* Fair: 601 to 660
* Good: 661 to 780
* Excellent: 781 to 850

A long and exemplary credit history (not overusing available credit over time; no delinquencies, collections, or bankruptcies; limited new credit) gets the most points. Too much new credit can be a flag, indicating that a person is not able to control spending impulses and is statistically likely to extend their credit beyond their ability to repay (which results in points being taken away). Also, if the total dollar amount of credit a person owes is a high proportion of the person’s total available credit they are considered a potential credit risk and get points reduced.

**Credit scores are of significant importance to a person’s financial well-being**

The average credit score in the U.S. is 716, according to data provided by FICO (August 2021). While a high percentage of scores (23.3%) are now in the 800 - 850 range, 24.7% of all scores still fall below 600; 21.7% are at 600 - 699; and 39.5% (the largest group) are at 700 - 799.

Having a low score doesn’t mean a person will be denied credit, but that person is likely to pay more interest for the credit they do receive. Additionally, many service providers (including utilities, insurance companies, landlords, rental companies, and medical facilities) often use credit reports to determine whether they will offer their services to a person, or to determine how much interest or security costs they will charge on their products or services. A low credit score can demand a large down payment, higher interest rates charged, and/or a co-signer requirement.

People with low credit scores are also often required to pay more for a home mortgage loan. Using myFico.com mortgage rate data from July 2022 (on a 30-year fixed $200,000 mortgage), here is how a person’s credit score would affect their, 1) interest rate, 2) monthly payment, and 3) the total cost of loan. A total cost swing of over $73,000 occurs from lowest to highest scores.

|  |  |  |  |
| --- | --- | --- | --- |
| Credit Score | Interest Rate | Monthly Payment | Total Cost of Loan |
| 760-850 | 5.13% | $1,090 | $192,341 |
| 700-759 | 5.35% | $1,117 | $202,237 |
| 680-699 | 5.53% | $1,139 | $210,210 |
| 660-679 | 5.75% | $1,167 | $219,944 |
| 640-659 | 6.18% | $1,222 | $239,810 |
| 620-639 | 6.72% | $1,293 | $265,604 |

According to the data, having a better credit score could potentially save a person over $200 every month in mortgage costs, which can add up to a lot of money over the life of a 30-year mortgage (over $73,000 dollars in interest). As previously mentioned, a credit score also impacts how much extra a person pays for credit cards, auto loans, insurance rates, and much more which, when added to high housing costs, dramatically compounds the amount of extra money people with low scores pay out over a lifetime compared to people with higher scores.

**Scenarios Describing Ways Scored Levels of Credit May Affect a Person’s Financial Life**

**Excellent Credit:**

Congratulations! If your **credit score is above 750, you are considered to be a “prime” consumer and will most likely receive the best interest rates available.** You’ll experience perks like easier approval processes when applying for credit and low interest rates. **According to FICO, statistics reflect one reason for that treatment is that only “1% of consumers with a**[**credit score of 800+**](https://www.self.inc/learn/perfect-credit-score)**are likely to become seriously delinquent in the future.”**

**Good Credit:**

A [**good credit score**](https://www.self.inc/learn/good-credit-score) **(a score in the range of 670 – 749)** will still get you a pat on the back for good behavior. It conveys to lenders that **you’re a good investment and carry little risk when it comes to paying back a loan.** While your credit history may not be perfect, you heed your financial obligations and **are still a low-risk investment**. **Generally, you’ll have little trouble finding a loan when you need it, but you may still not be as eligible to receive lenders’ lowest interest rates as someone is who has an excellent score –** costing you money over time**.**

See FICO page: [How to Improve Your FICO Score | myFICO | myFICO](https://www.myfico.com/credit-education/improve-your-credit-score)

**Fair Credit:**

No one is perfect - and neither is your credit if it is rated as “fair” **(a score of 580 to 669).** **While a “fair” score isn’t necessarily a negative thing, it is below the national average and may (with some lenders) qualify you to be classified as a “subprime” borrower.** Toward the lower end of this range, it’s likely that you’ll be turned down for many credit cards and loans. At the top of this range - while you may not be turned down - you will find it more difficult to get credit without agreeing to pay higher interest rates. One reason for that particular situation is that **according to FICO, “28% of consumers with a credit score of 580 to 669 are statistically more likely than consumers with higher scores to become seriously delinquent in the future,”** which makes you (on paper) an only “provisionally fair” risk for lenders.

**Poor Credit:**

In general, people with “[**poor” credit**](https://www.self.inc/learn/bad-credit-score) **(scores in the 350 to 579 range),** compared to people with higher scores, will face many more difficulties borrowing money (and will often be rejected for credit). If applying for credit cards, they **will be required to** use only debit-type credit cards or pay high fees, make higher deposits on some financed purchases, pay extra fees on established credit, and secure co-signers for loans. While no one should expect their credit score to be high from the start, credit scores this low often signify that items such as delinquencies, collections, judgments, and/or bankruptcies, both past and recent, are to be found on related credit reports.

**No Credit**: **(26 million Americans have no credit history or no credit score)**

In the American financial realm, “good” credit scores have become an essential for people who want to acquire affordable credit and services. A confusing notion for many people is that, in the U.S., a credit score actually depends on a person having to establish and use credit, and it builds up over time: instead of U.S. citizens being born with credit scores. This fact often presents a problem for immigrants, students, individuals who have not used credit in the past or, at the very least, haven’t used credit in the United States.

As of 2022, according to the Consumer Financial Protection Bureau (CFPB), 26 million Americans are “credit invisible” (no files) and 19 million more who have unscorable credit files. This means that 45 million people, 18% of the population, is essentially shut out of the mainstream economy. Immigrants to the U.S. often have a hard time proving that they had good credit in their country of origin. However, it is possible for anyone in the U.S. to utilize effective ways to establish credit – including credit builder loans, secured credit cards and loans, and having regular payments on rent, utilities, cell phones, etc., reported over a fixed period.

It should be common knowledge that all credit is not alike. For instance, retail store revolving charge accounts (which often charge higher than standard interest rates) are weighted differently than other credit cards by credit bureaus due to their restrictions. If consumers are diligent, credit scores can be changed in a positive way in a matter of months, as 1) new, healthy financial activity is reported to bureaus, 2) corrections of wrongly reported information are made, and 3) old accounts that were in arrears are timed off reports. Scores may differ somewhat from bureau to bureau, so it is important that consumers annually request credit reports from all three bureaus (especially if an improved score is a goal). The important thing is for one to stay **proactive** when it comes to accessing and handling credit, credit reports, and scores – it could save thousands to hundreds of thousands of dollars in interest charges and fees over a lifetime.