Understanding & Improving Your Credit Score

When you apply for credit, whether it's a credit card, car loan, or a mortgage, lenders want to know whether you are likely to repay your loan and make the payments on time. To determine if you are a good credit risk, lenders examine your credit score whenever you apply for credit. Your credit score is an important factor in determining whether creditors will approve your credit application and, if you are approved, the cost of your loan. Other factors that can affect your credit application include your income and employment history.

Your credit score is calculated based on information in your credit report, which is a profile of how you manage your credit (loan) accounts. Your credit report details how many credit accounts you have, how much you owe, the amount of your credit limits (primarily applies to credit cards), when you opened the credit account, your repayment history (including late payments), and certain public records (for example, a bankruptcy filing or a tax lien). Each of the three national credit bureaus (Experian, Equifax, and TransUnion) maintains a credit report about you.

Your credit report is updated once a month by each of your creditors (for example, your credit card issuer, car loan lender, or mortgage lender), who provide information to the three credit bureaus about your loans. Your report is also updated regularly based on any new negative information obtained from public records that indicate an increased credit risk (for example, a bankruptcy, lien, or judgment). Consumers with a high credit score are likely to pay back their loans in full and on time, whereas consumers with low scores are likely to carry a high risk of default.

The information your creditors provide to the credit bureaus affects your credit score. For example, if a creditor reports that you made a late payment, it's likely that your credit score will drop.

Most credit scoring models consider the following factors when calculating your score:

PAYMENT HISTORY

- The number of late accounts
- The number of accounts paid on time
- Negative public records (for example, bankruptcy, judgments, suits, liens, and wage attachments)
- The amount past due on delinquent accounts or collection items

AMOUNTS OWED

- For credit cards and other revolving credit with credit limits, the percent of your credit limit that you currently are using. For example, if your credit card has a credit limit of $10,000, and your current balance is $1,000, your credit usage rate (often called your credit utilization rate) is 10 percent.
- The amount owed on all accounts, as well as on different types of accounts
- The number of accounts with balances
- The amount still owed on installment loans relative to the amount originally borrowed. For example, if you took out a car loan for $25,000, but currently only owe $2,000, the small remaining balance relative to the large amount originally borrowed will help raise your credit score.

TYPES OF CREDIT USED

- The mixture of revolving credit (for example, credit card or a home equity line of credit) and installment loans (for example, auto loan or mortgage).

A history of borrowing using different types of credit (for example, credit card, home mortgage, and car loan) increases your score.

LENGTH OF CREDIT HISTORY

- The average time since the accounts were opened
- The length of time since the accounts were opened, by account type
- How long since there was account activity

NEW CREDIT

- The number of recently opened accounts and inquiries by creditors
- The length of time since the last credit inquiry
- Re-establishment of a positive credit history following past payment problems
- The length of time since a new account was opened

In calculating your credit score, most credit scoring models assign a higher weight to your payment history and amounts owed than to the other factors. These two factors will, therefore, have a greater effect on your score than the other factors. But it is important to try to do well on all of the factors so you can maximize your score.

Here are some important tips to increase your credit score:

- At least once a year, review your credit reports from each of the three credit bureaus (Experian, Equifax, and TransUnion) for inaccuracies and file a dispute immediately if you find an error. You are entitled to obtain a free credit report once a year from each of the three bureaus. To obtain a free copy of your credit report, go to www.annualcreditreport.com or call 877-FACT-ACT (877-322-8228). It is important to note that your credit report does not contain your credit score. When you obtain your free credit report from each of the bureaus, you will be offered the option to purchase your credit score. However, you are not obligated to purchase your credit score to receive your free credit report.

- Pay your bills on time. Late payments can hurt your score significantly. If you have missed payments, get current and stay current. The more you pay your bills on time, the better your score.
- Keep credit card balances low relative to credit limits (30 percent or lower is recommended). “Maxing out” your credit cards means you have a very high utilization rate, which significantly lowers your credit score.
- Pay off debt rather than move it around.
- Open new credit accounts only as needed; new accounts decrease the average age of your total accounts. Having accounts that have been opened a long time increases your credit score.
- Avoid closing credit card accounts because this also decreases the average age of your accounts.
- Apply for installment loans (mortgages, car loans, etc.) within a 30-day period because most credit scoring models will count multiple inquiries within a short period of time as only one inquiry.

Your credit score is presented as a number that can fall within a range — usually from 300 to 850. However, some credit scoring products use different ranges —

such as 501 to 990. If you obtain multiple credit scores and the same range was not used, you cannot directly compare the scores. For example, a credit score of 720 within the 300 to 850 range is not the same as a credit score of 720 using the 501 to 990 range.

Maintaining a high credit score is important because this is one of the factors that determine whether you will be approved for credit and the cost of your loan. Applicants with high credit scores typically are offered lower interest rates and better terms and conditions than applicants with lower scores. A low credit score reduces the chances that your loan application will be approved. And if it is approved, you will likely pay a higher interest rate for the loan than a borrower with a higher credit score.

If you apply for credit and are denied, you have the right to obtain a free copy of the credit report the creditor used when denying your application. You should obtain a copy of the credit report to make sure that it is accurate. If you find inaccuracies, you should file a dispute with that credit bureau. Here are the phone numbers and websites of the three major credit bureaus:

Experian
1-888-397-3742
www.experian.com

TransUnion
1-800-916-8800
www.transunion.com

Equifax
1-800-685-1111
www.equifax.com

FOR MORE INFORMATION

The Federal Reserve Bank of Philadelphia has other brochures on credit topics.

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Ten Independence Mall, Philadelphia, PA 19106

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