Credit Scores

Federal Trade Commission | consumer.ftc.gov

Ever wonder how a lender decides whether to grant you credit? For years, creditors have been using credit scoring systems to determine if you'd be a good risk for credit cards, auto loans, and mortgages. These days, other types of businesses — including auto and homeowners insurance companies and phone companies — are using credit scores to decide whether to issue you a policy or provide you with a service and on what terms. A higher credit score is taken to mean you are less of a risk, which, in turn, means you are more likely to get credit or insurance — or pay less for it.

The Federal Trade Commission (FTC), the nation's consumer protection agency, wants you to know how credit scoring works.

What is credit scoring?

Credit scoring is a system creditors use to help determine whether to give you credit. It also may be used to help decide the terms you are offered or the rate you will pay for the loan.

Information about you and your credit experiences, like your bill-paying history, the number and type of accounts you have, whether you pay your bills by the date they're due, collection actions, outstanding debt, and the age of your accounts, is collected from your credit report. Using a statistical program, creditors compare this information to the loan repayment history of consumers with similar profiles. For example, 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 you are: how likely it is that you will repay a loan and make the payments when they're due.

Some insurance companies also use credit report information, along with other factors, to help predict your likelihood of filing an insurance claim and the amount of the claim. They may consider this information when they decide whether to grant you insurance and the amount of the premium they charge. The credit scores insurance companies use sometimes are called "insurance scores" or "credit-based insurance scores."

Credit scores and credit reports

Your credit report is a key part of many credit scoring systems. That's why it is critical to make sure your credit report is accurate. Federal law gives you the right to get a free copy of your credit reports from each of the three national credit reporting companies once every 12 months.

The Fair Credit Reporting Act (FCRA) also gives you the right to get your credit score from the national credit reporting companies. They are allowed to charge a reasonable fee for the score. When you buy your score, you often get information on how you can improve it.

To order your free annual credit report from one or all of the national credit reporting companies, and to purchase your credit score, visit **www.annualcreditreport.com**, call toll-free 877-322-8228, or complete the Annual Credit Report Request Form and mail it to:

Annual Credit Report Request Service
P. O. Box 105281
Atlanta, GA 30348-5281

For more information, see *Free Credit Reports* at **consumer.ftc.gov**.

How is a credit scoring system developed?

To develop a credit scoring system or model, a creditor or insurance company selects a random sample of customers and analyzes it statistically to identify characteristics that relate to risk. Each of the characteristics then is assigned a weight based on how strong a predictor it is of who would be a good risk. Each company may use its own scoring model, different scoring models for different types of credit or insurance, or a generic model developed by a scoring company.

Under the Equal Credit Opportunity Act (ECOA), a creditor's scoring system may not use certain characteristics — for example, race, sex, marital status, national origin, or religion — as factors. The law allows creditors to use age, but any credit scoring system that includes age must give equal treatment to applicants who are elderly.

What can you do to improve your score?

Credit scoring systems are complex and vary among creditors or insurance companies and for different types of credit or insurance. If one factor changes, your score may change — but improvement generally depends on how that factor relates to others the system considers. Only the business using the system knows what might improve your score under the particular model they use to evaluate your application.

Nevertheless, scoring models usually consider the following types of information in your credit report to help compute your credit score:

- **Have you paid your bills on time?** You can count on payment history to be a significant factor. If your credit report indicates that you have paid bills late, had an account referred to collections, or declared bankruptcy, it is likely to affect your score negatively.
- **Are you maxed out?** Many scoring systems evaluate the amount of debt you have compared to your credit limits. If the amount you owe is close to your credit limit, it's likely to have a negative effect on your score.
- **How long have you had credit?** Generally, scoring systems consider your credit track record. An insufficient credit history may affect your score negatively, but factors like timely payments and low balances can offset that.
- **Have you applied for new credit lately?** Many scoring systems consider whether you have applied for credit recently by looking at "inquiries" on your credit report. If you have applied for too many new accounts recently, it could have a negative effect on your score. Every inquiry isn't counted: for example, inquiries by creditors who are monitoring your account or looking at credit reports to make "prescreened" credit offers are not considered liabilities.
- **How many credit accounts do you have and what kinds of accounts are they?** Although it is generally considered a plus to have established credit accounts, too many credit card accounts may have a negative effect on your score. In addition, many scoring systems consider the type of credit accounts you have. For example, under some scoring models, loans from finance companies may have a negative effect on your credit score.

Scoring models may be based on more than the information in your credit report. When you are applying for a mortgage loan, for example, the system may consider the amount of your down payment, your total debt, and your income, among other things.

Improving your score significantly is likely to take some time, but it can be done. To improve your credit score under most systems, focus on paying your bills in a timely way, paying down any outstanding balances, and staying away from new debt.

Are credit scoring systems reliable?

Credit scoring systems enable creditors or insurance companies to evaluate millions of applicants consistently on many different characteristics. To be statistically valid, these systems must be based on a big enough sample. They generally vary among businesses that use them.

Properly designed, credit scoring systems generally enable faster, more accurate, and more impartial decisions than individual people can make. And some creditors design their systems so that some applicants — those with scores not high enough to pass easily or low enough to fail absolutely — are referred to a credit manager who decides whether the company or lender will extend credit. Referrals can result in discussion and negotiation between the credit manager and the would-be borrower.

What if I am denied credit or insurance, or don't get the terms I want?

If you are denied credit, the ECOA requires that the creditor give you a notice with the specific reasons your application was rejected or the news that you have the right to learn the reasons if you ask within 60 days. Ask the creditor to be specific: Indefinite and vague reasons for denial are illegal. Acceptable reasons might be "your income was 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 you can be denied credit or insurance — or offered less favorable terms — because of information in your credit report. In that case, the FCRA requires the creditor or insurance company to give you a notice that includes, among other things, the name, address, and phone number of the credit reporting company that supplied the information. If a credit score was a factor in the decision to deny you credit or to offer you terms less favorable than most other customers receive, the notice also will include that credit score. If you receive one of these notices, you are entitled to a free copy of your credit report. Contact the company to find out what your report said. The credit reporting company can tell you what's in your report, but only the creditor or insurance company can tell you why your application was denied.

If a creditor or insurance company says you were denied credit or insurance because you are too near your credit limits on your credit cards, you may want to reapply after paying down your balances. Because credit scores are based on credit report information, a score often changes when the information in the credit report changes.

If you've been denied credit or insurance or didn't get the rate or terms you want, ask questions:

- Ask the creditor or insurance company if a credit scoring system was used. If it was, ask what characteristics or factors were used in the system, and how you can improve your application.
- If you receive a notice explaining that you are being offered less favorable credit terms than those offered to most other consumers, ask the creditor or insurance company why you aren't getting its best offer.
- If you are denied credit or not offered the best rate available because of inaccuracies in your credit report, be sure to dispute the inaccurate information with the credit reporting company. To learn more about this right, see *Disputing Errors on Credit Reports* at **consumer.ftc.gov**.

For More Information

The FTC works to prevent fraudulent, deceptive and unfair business practices in the marketplace and to provide information to help consumers spot, stop and avoid them. To file a complaint or get free information on consumer issues, visit **ftc.gov** or call toll-free, 1-877-FTC-HELP (1-877-382-4357); TTY: 1-866-653-4261.

Watch a video, *How to File a Complaint*, at **consumer.ftc.gov/media** to learn more. The FTC enters consumer complaints into the Consumer Sentinel Network, a secure online database and investigative tool used by hundreds of civil and criminal law enforcement agencies in the U.S. and abroad.

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