Here's How to Understand Your Credit Score

By Rita Williams

Credit scores can seem pretty daunting. Financial institutions use your credit score to gauge your degree of creditworthiness. It affects whether they are willing to grant you a loan for a car or a mortgage to buy a house. It can affect the interest rate you receive, especially for mortgages. Credit scores are also increasingly used by landlords and employers to indicate reliability.

The scores may seem like a gulf standing between you and things you need and want, like a car, a home, or even a job.

Fear not. It's important to know how credit scores are determined. It's even more important to know how to manage your credit score sensibly. There are ways to make sure it keeps on the right track, and ways improve it if you need to.

The Credit Score: What It Is

First things first. You know what it's used for, but what *is* a credit score?

The score itself is a number between 300 and 850. The exact figure you receive is determined by looking at your credit history.

Most credit scores are generated from a company called FICO. FICO was created by a company called Fair Isaac. While Fair Isaac has never set forth exactly how it determines credit scores, it has publicly released the categories it uses and the percentage of total score each contributes, however.

The largest category is payment history, which makes up 35% of your total score. It means exactly what it says: whether you paid your bills and other obligations on time.

The second largest category is total amount owed. It constitutes 30% of the total score. This category takes into account your utilization ratio: how much credit you are using out of the credit you have available. Lenders are highly interested in the utilization figure. People who max out every available credit card, for example, have a very high utilization ratio. Experience shows that they start missing payments and go into default more often.

The third category is length of credit history. It contributes 15% of the total score. It's determined by examining the average age of the credit you have and when you last used credit.

The fourth category is new credit, which makes up 10% of a credit score. It looks at how often you've opened new accounts.

The fifth and final category is types of credit used. It makes up 10% of the total credit score. It examines the mix of credit: student loans, vehicle loans, mortgages, and credit cards.

Managing Your Credit Score

Lenders consider 740 and above an excellent credit score. If you want a car loan or mortgage, you are very likely to receive it as long as you're employed and have this score.

On the other hand, a score of 650 or below is considered poor. If you apply for a loan and have a score that falls between 300 and 650, the application may be denied.

Here's the good news: armed with the knowledge of what categories FICO looks at, you can manage your credit score.

Be sure to pay bills on time. If you have a habit of missing, it can negatively affect your score. However, it also starts rising when you start making payments on time.

It can help you to manage the utilization ratio. If you have credit cards, for example, keep a small balance on just one. It shows that you have credit, but a low utilization ratio. If you don't have credit cards, it might be to your benefit to open one. Lenders like you to have some track record in managing credit.

Opening up many lines of credit or many credit cards in a short time span can send your score down. In the eyes of lenders, it looks like you really need credit, which they tend not to like.

They look favorably on different types of credit in the mix, because it indicates you are responsible.

A credit score is nothing to fear, after all is said and done. It's a set of categories to be managed prudently.