Impact of Credit Scores On Your Life

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CREDIT UNION

All of our lives changed for better or worse when Bill Fair and Earl Isaac, an engineer and mathematician, got together and formed Fair, Isaac and Company (FICO). They developed a very sophisticated piece of modeling software that was designed to simplify the evaluation of credit reports. In concept, the FICO credit scoring system is simple: a wide variety of information contained in your credit report is compared to data of everyone else. The results of these tests are converted into a points system to form a three digit "credit score". In reality, the system is not so simple. The mathematical algorithms are incredibly complex and exactly how it works is proprietary.

Simple or complex, and secret or not, it quickly caught on because it is fast, inexpensive, and did a pretty good job of predicting whether people were going to pay their debts on time or not. All three of the major credit reporting agencies, Equifax, Experian, and Trans Union, use it to calculate scores. In turn, most lenders soon subscribed to the software and begin relying on the credit score to make their credit decisions. These days, most of the credit decisions rely less on the detailed credit report and more on the FICO credit score.

Most people know it's important to have a good score to qualify for a mortgage, car loan, or credit card. But do you know how many other ways credit scores affect your life? Here are some examples:

Higher Loan Costs
A lower credit score could easily make you pay 1% more on your mortgage costing you an average of $1,500 per year, 3% more on a car loan costing you an average of $500 per year, and 9% on a credit card costing you an average of $300 per year.

Higher Insurance Premiums
Like financial institutions, insurance companies are in the business of calculating risk. According to the Insurance Information Institute, a trade association for insurers, people with low credit scores have 40% more claims than those with high credit scores. Lower credit scores predict slower premium payment which costs them investment income and added paperwork. The end result is 20% to 40% higher rates.

Housing
Prospective landlords often do a credit check. You could miss out on that perfect rental to someone with a higher credit score and never find out the real reason.

Employment
More and more employers require a credit check for new employees. Again, there's a perceived link between personal responsibility and a person's credit score. Unfortunately, for people who are unemployed, this can easily become a catch-22. If their credit score dips because of financial straits caused by unemployment, they may have increased trouble finding a new job.

Cell Phones and Utilities
It is common practice to check your credit score for these services. If your score is too low, you could be denied, require to pay high deposits, or get a co-signer.

Clearly, a credit score will impact your life opportunities and your financial health, so knowledge is key. What a good score is depends on whose reading the FICO. Each lender has an internal business process that defines what good and bad is. The FICO System does not label a score good or bad. A very general rule of thumb is over 720 is good, under 620 is bad. About 50% of Americans' credit scores are above 720 and 20% are under 620.

Know your credit score and regularly review your credit report. It has been estimated that 80% of all credit reports contain errors. There are steps you can take to recover and improve your score.

Learn what's in your score, what's not in your score, how credit scoring helps you, and how to improve by visiting www.myfico.com. Be a good consumer and don't have your financial life reduced to a three digit number you don't understand.