

# Credit Scoring and Wealth

## *-The Game of Credit*

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A good credit score increases cash flow  
- it's an important part of building long term wealth.



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## – The Game of Credit

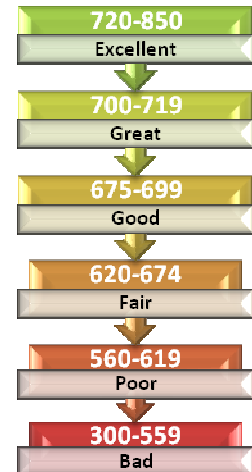
### The Problem –

In most games, it is wise to understand the rules before you begin to play.

- *What if you weren't aware that you were playing a game?*
- *What if you had no choice whether to play or not? – Everyone plays!*
- *What if this game has an important impact on your financial future?*
- *What if you could see how you're doing today?*
- *What if you could learn how to better play to win tomorrow?*

You are in fact playing a game whether you are aware of it or not. In the game of credit your credit score will range from 300 to 850 [see Figure 1] - the higher the better.

Figure 1  
Credit Scores



### What is a Credit Score?

A credit score is a numerical representation of your creditworthiness and, more importantly, of the likelihood that you will become 90 days or more delinquent on any particular debt. The most widely used credit score is the FICO® score, which was developed by Fair Isaac and Company, Inc. in the 1960s.

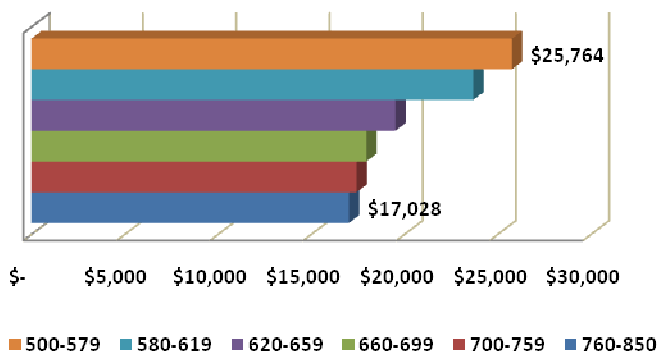
In the game of credit most of us are unaware that we are playing a game, much less that there are specific rules that dictate scoring. The game of credit is not a team sport, it is played individually. Each individual has his own credit score. Married couples will use the low score for their team.

Your credit score tells lenders what they most want to know – “What is the likelihood that you will be over 90 days late on money we lend you?” Play the game well and lenders are more likely to

offer you their lowest possible interest rates. [see Figure 2]<sup>1</sup>

Figure 2  
Annual Interest Cost – By Credit Score

**\$260,000 - 30 Year Fixed Mortgage**



Have all your debt paid off? You are still in the game and you could be playing at a real disadvantage. Banks and mortgage lenders aren't the only ones determining what you'll pay for products and services based on your credit scores. Sellers of life insurance, homeowners insurance, auto insurance, cell phones, and utilities, in addition to employers, are all more likely to rely on your credit score to predict how

<sup>1</sup> myfico.com

you may perform in your obligations to them.

Recent studies show that over 80% of Americans have one or more errors on their credit report, that 40% of Americans are paying a higher mortgage payment due to lower credit scores, and that 25% of Americans have credit report problems that would prevent them from securing a loan or new employment.<sup>2</sup> Lower credit scores often lead to higher interest rates, and higher interest rates result in a greater cost of debt – decreasing your ability to save.

## The Question –

**How do you play the game of credit to increase the likelihood of the highest possible credit scores to reduce your overall total cost of borrowing?**

*CONSIDERATION – You don't really have a credit score sitting out there with your name on it. Your score is actually created in the moment it is requested by a creditor. For this reason your score will actually vary based on the time it is requested and by whom.*

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**While the actual formulas for credit scoring are closely guarded, pressure from Congress forced a release of the 22 criteria for credit scoring to the public. The key to playing the credit scoring game lies in the five key categories that make up the majority of your personal credit score.**

## The Facts –

You can learn to play the game of credit better if you understand the criteria for how you are being scored. Remember, anyone offering you credit of any kind has a primary concern that they'll receive their money back as promised. Your score tells them how much risk you represent. Before we look at how you are scored, let's take a look at what doesn't affect your credit scores. [see Figure 3]

*TIP – Points awarded in the game of credit are hard to gain and easy to lose.*

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When thinking about your credit score, consider that there are actually four types of credit scoring: consumer, auto, renter, and FICO®. We'll be focusing on your FICO® score, as it is used for mortgage and larger credit lending and tends to be the most accurate and difficult score to manage. Manage your credit to the FICO® level and the other three types of credit scores will benefit as well.

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<sup>2</sup> myfico.com

Figure 3  
What Doesn't Affect Your Credit Score



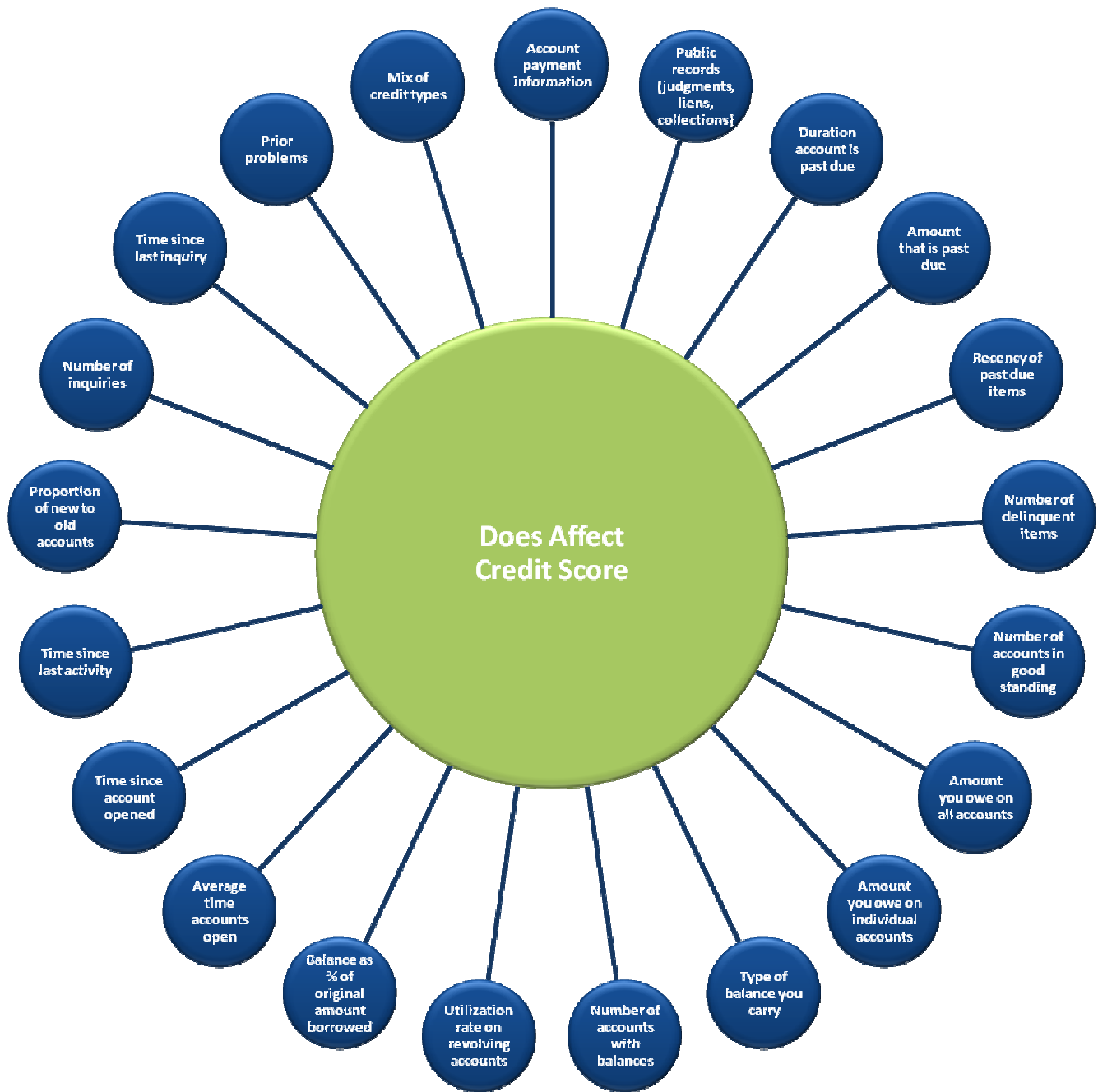
*TIP – Knowing what doesn't affect your credit score helps you focus on what does.*

There are three different credit bureaus that factor into the creation of your credit score: Equifax, Experian, and TransUnion. Each bureau has its own credit score and credit scoring model that they apply to you. The middle score of the three bureaus will most often be used by the creditor for qualifying their risk (meaning your rate). [see Figure 4]

Figure 4  
National Credit Bureaus

Equifax	Experian	TransUnion
<ul style="list-style-type: none"> <li>• (800) 685-1111</li> <li>• www.equifax.com</li> </ul>	<ul style="list-style-type: none"> <li>• (888) 397-3742</li> <li>• www.experian.com</li> </ul>	<ul style="list-style-type: none"> <li>• (800) 888-4213</li> <li>• www.transunion.com</li> </ul>

Figure 5  
What Does Affect Your Credit Score



*TIP – While there are 22 criteria that determine a credit score, and the formulas for this are a secret, understanding the 5 'key' criteria can help you win the game of credit.*

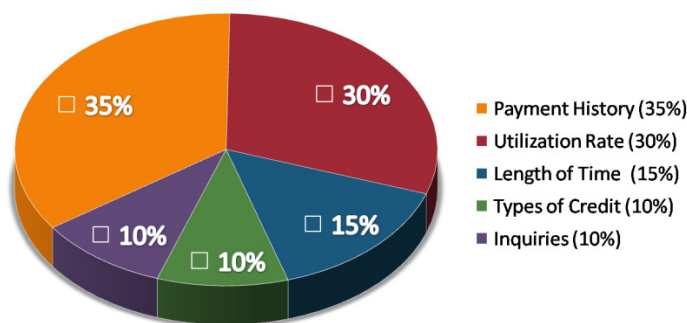
## The Five Key Criteria Categories –

The FICO® score funnels into five categories that make it easier to understand our strategy for playing the credit scoring game. Let's first look at what each category measures and some of the primary ways you earn or lose points for your individual score. Then we'll consider a strategy for what an ideal player in the game of credit might consider based on the current rules. [see Figure 6]

**I - Payment History – 35% of your score** - is the history of your payments weighted to the most recent activity. You lose more points for recent negative payment activity than older negative payment activity and any new negative activity results in the biggest loss of points. Over time, late payments have a lesser and lesser impact on your credit score as creditors want to know what's happening for you now. To earn points pay each bill within 30 days of the due date.

**II - Utilization Rate – 30% of your score** – is the percentage of available credit that you use on any given account based on your high credit limit for that account. You tend to earn points when you utilize less than 30% of your high credit limit on revolving credit and begin to lose points as you exceed 30% of your high credit limit.

Figure 6  
The Five Key Credit Scoring Criteria



**TIP – Charge Cards with no limit (like certain American Express accounts) are calculated using the highest balance you have achieved as the high credit limit. Consider concentrating all necessary expenses in a given month on this particular account to increase your highest balance and lower your utilization rate to under 30%.**

**III - Length of Time – 15% of your score** – is the length of time your account is open. You have an overall age of all your accounts that goes up or down over time. Any time you open a new account it reduces the average age for all accounts, which temporarily reduces your overall score as you build a history of making payments on the new account. Closing an older account could negatively impact your credit for the same reason. As a rule of thumb, new accounts tend to cost you points for the first 12 months, are neutral for the next 12 months, and gain you points after 24 months of on time payments.

**IV - Types of Credit – 10% of your score** – is the varying types of credit you have open. Some games require more players than others and in the credit game you want to have at least one major installment (mortgage), one other installment loan (auto), and three revolving accounts (credit cards) to have a chance at the highest credit scores.

***TIP – ATM debit cards, such as those offered by Visa® and MasterCard®, do not count toward your three revolving credit accounts.***

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Too few accounts, or none that are currently active, and you'll likely see a lower score. Gain points by having a good mix of credit types that show you continue to have an ability and willingness to manage your borrowing.

***TIP – There is one type of credit that always hurts your credit score - no payment or deferred payment finance accounts. These open ended accounts may have no payment for 90 days or more, but they cost you valuable points in the game of credit scoring; they can appear as late, even though you aren't required to make a payment. Don't use them whenever possible.***

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**V - Inquiries – 10% of your score** – are generally shown in two categories; soft and hard. The first, a soft inquiry, is when you request a copy of your own credit report (or an employer requests a copy of your credit report) – it has no direct impact on your credit score. The second, a hard inquiry, is when a lender requests a copy of your credit report – it has a varying degree of impact on your credit score. If multiple lenders request a copy of your credit report for a single new account all those hard inquiries are counted as one (1) hard inquiry on your credit report. While inquiries stay on your report for two (2) years, they only potentially reduce your score for the first twelve (12) months.

***TIP – There is a difference in staying power when it comes to the long term impact of your credit score. While a bankruptcy will stay on your credit report for 10 years, debts, collections, and judgments that are paid off will remain for seven years, and inquiries will remain for only two years.***

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Now that you have a feel for the five key criteria, let's create a simple strategy for how you might consider playing the credit game. We'll call this a first 80% approach. If you want to go deep consider the resources at the end of this paper for more information and tweak the last 20% based on your individual situation. The following simple strategy can equip you to better play the credit scoring game immediately, while you continue to master it over time as time and experience allow.

## The Quick Strategy for a Better Credit Score -

Focus on the Five Key Criteria – (Match This Profile). Potential impact is 50 – 200 points.

**I – Payment History** – make all payments within 30 days of the due date. If you had late payments in the past, keep making your payments current now and the older late payments will have less and less of an impact.

**II – Utilization Rate** – keep all balances under 30% of their high credit limit. If you have credit cards that you pay in full monthly, but you exceed the 30% high credit limit, consider increasing your credit limits to lower your utilization rates.

**III – Length of History** – keep all accounts open and active for as long as possible. If you have older credit cards or installment loans, they are more valuable to you, but they must have been used at least once in the last 12 months to count towards your overall average length of history.

**IV – Types of Credit** – keep at least five active accounts at all times. If you have no need for credit, consider using credit cards for convenience and pay them off monthly. Your ideal credit mix is at least three revolving accounts (credit cards), and two installment accounts secured by real property (mortgages, autos).

**V – Inquiries** – keep your private information private. If you have anyone wanting to request a copy of your credit report other than a potential employer, it can potentially have a negative impact for 12 months. Multiple inquiries for one new account, such as a mortgage or an auto loan, will only count as one inquiry as long as the inquiries occur within a 30-45 day window of one another. Give out your personal information carefully and only when you anticipate a borrowing transaction.

### The Ideal Couple – 5 Simple Steps

**35%**  
**Payment History** – make all payments within 30 days of the due date.

**30%**  
**Utilization Rate** – keep all balances under 30% of their high credit limit.

**15%**  
**Length of History** – keep all accounts open and active for as long as possible.

**10%** –  
**Types of Credit** – keep at least five active accounts at all times.

**10%** –  
**Inquiries** – keep your private information private.

Your first Credit Report Review – (Remove all errors). Potential impact is 20 – 100 points.

Remember, over 80% of all credit reports have one or more errors on them. These errors could be costing you valuable points. When you do your first review of your credit report make sure all personal information, names, addresses, employment history, open and closed accounts, high credit limits, payment history, duplicate information or accounts, etc., are correct. If you see any errors contact Equifax, Experian, or TransUnion and begin the dispute process. Each of these bureaus has specific details for how to dispute or correct an error through their websites. Once you get all errors corrected, keep a copy of any correspondence and review your old report against a new one to make sure old errors don't creep back on your report.

Your Credit Review Plan – (Annual Review). The most important inquiry on your report is the one that doesn't show up; it is the one you make for yourself. Tie an annual date, like April 15<sup>th</sup>, to requesting your own credit report. Services like [www.annualcreditreport.com](http://www.annualcreditreport.com) can be invaluable as you'll want to monitor changes. Once you know your score and start to play the game you'll be more aware and sensitive to sudden changes that might help you catch identity theft or other errors that could create real financial problems for you later. More importantly, you'll keep your high score high and continue to win the credit scoring game.

**Additional Tips** – You may want to consider taking a quarterly approach to monitoring your credit. For example, in January go to [www.annualcreditreport.com](http://www.annualcreditreport.com) and request a copy of your Experian credit report. In May, request a copy of your TransUnion credit report. In September, request a copy of your Equifax credit report. Then start the process all over again in January. This method of monitoring your credit report is a proactive approach and will provide you with the confidence that comes from knowing your credit profile is as accurate and up-to-date as possible, as well as allow you to catch any issues or errors at the time they show up.

Be wary of services such as [www.freecreditreport.com](http://www.freecreditreport.com), that purport to offer you a free copy of your credit report. They DO NOT, in fact, offer you a free copy of your credit report. These sites typically require you to enter a credit card number and subscribe to a monthly credit monitoring service that can range from \$12.95 to \$25.95 per month to obtain the “free” report.

**Closing Thoughts** – New changes for FICO '08 are being rolled out in response to the credit crisis around mortgage and other lending changes. The goal is to create greater distinctions around real credit risk candidates. The main impact from the adjustments to the current scoring model should actually make it easier for good to excellent current borrowers to maintain or improve their score, and more difficult for fair to bad borrowers. Some older loop holes, like “piggybacking” on someone else's good credit history, will be eliminated. Correct any errors, and make adjustments based on the Five Key Criteria, and the FICO '08 changes could give you an added lift toward a 720 or higher score.

## Additional Resources -

Equifax – 800-685-1111 – [www.equifax.com](http://www.equifax.com)

Experian – 888-397-3742 – [www.experian.com](http://www.experian.com)

TransUnion – 800-888-4213 – [www.transunion.com](http://www.transunion.com)

Annual Credit Report – [www.annualcreditreport.com](http://www.annualcreditreport.com) – This is the only federally sanctioned website and offers you one free copy of your credit report per year for each of the three credit bureaus.

Fico Score – [www.myfico.com](http://www.myfico.com) – provides you a FICO® score that the lender would see and provides additional resources for managing credit scores, identity theft, etc.

## Final Tips –

Have a plan to protect your credit.

- Use technology to automate bill payment – one late payment creates a potentially difficult journey to regain lost points.
- Consider a service that monitors your credit, notifying you of changes that are reducing your credit score (or monitor yourself using the strategy in Additional Tips).
- Review your credit card bills and statements for changes each month when you pay them.
- Order a full credit score at least twice a year to check your progress.
- Avoid cosigning on loans whenever possible.
- Keep your accounts active and use them at least once a year.
- Establish credit separately. Each spouse should maintain their own accounts.
- In the event of divorce separate all accounts.