You'd Better Pay Attention to FICO

In the U.S., consumers and borrowers are advised to know and understand—especially if they are looking for a new loan— one all-important number: their FICO score. Also known as a credit score, lenders of all types use this three-digit number to approve or deny loans, or to set interest rates or other loan terms. If you have ever applied for a credit card, a car loan, or a mortgage, you have basically been at the mercy of your FICO score.

This past month, the creators of the FICO score unveiled a new way of calculating the number. The new scores, named FICO 10 and FICO 10T, will have significant ramifications—both positive and negative—for millions of borrowers.

How FICO Scores Are Calculated

The Fair Isaac Corporation was started in the 50s by Stanford friends Bill Fair and Earl Isaac. For its first three decades, it quietly worked in the background to help lenders assess the creditworthiness of their customers. Then in 1989 it introduced the now ubiquitous FICO score. It was designed to tell lenders, in one succinct number, how likely borrowers were to pay back a loan based on their credit history. It also helped lenders decide what interest rate to charge. To calculate a FICO score, Fair Isaac uses the information in a consumer's credit report that is maintained by the three credit bureaus, Experian, TransUnion, and Equifax.

FICO scores have a typical range of 300 to 850 and have an inverse relationship to credit risk: the lower the number, the higher the risk to lenders. Fair Isaac categorizes the different range of scores in the following manner:

FICO Score Ranges	Rating	Description
< 580	Poor	Well below the average score of U.S. consumers and demonstrates to lenders that the borrower may be a risk.
580 - 669	Fair	Below the average score of U.S. consumers, though many lenders will approve loans with this score.
670 - 739	Good	Near or slightly above the average of U.S. consumers and most lenders consider this a good score.
740 - 799	Very Good	Above the average of U.S. consumers and demonstrates to lenders that the borrower is very dependable.
800 +	Exceptional	Well above the average score of U.S. consumers and clearly demonstrates to lenders that the borrower is an exceptionally low risk.

source: Fair Isaac Corporation

While Fair Isaac does not provide the exact formula they use to calculate FICO scores, they have disclosed the different components that go into the calculation:

Payment History (35% of the score)

Whether your credit payments have been made on time is the most important factor in determining your credit score. For this category FICO looks at accounts like credit cards, retail accounts, and mortgage loans and considers how late the payments were, how much was owed, how recently the late payments were made, and how many late payments there have been.

Amounts Owed (30% of the score)

The amount of money you owe on all your accounts is also a very important factor in determining your FICO score. Your credit utilization ratio—that is, the percentage of your total available credit that you are using—is critical. The more of your overall available credit you use, the more overextended you might be in your borrowing. One minor tip here: don't close credit card accounts that you don't use; hide away the card, but keep the account open, as this helps in lowering your credit utilization ratio.

Length of Credit History (15% of the score)

A longer credit history has a positive effect on FICO scores. This is another reason to keep accounts open—even those that you don't use.

New Credit (10% of the score)

Opening new accounts in a short amount of time is detrimental to FICO scores.

Credit Mix (10% of the score)

FICO scores also consider the mix of credit cards, retail accounts, installment loans, and mortgage loans in your credit history. According to the myfico website, "Having credit cards and installment loans with a good credit history will raise FICO Scores. People with no credit cards tend to be viewed as a higher risk than people who have managed credit cards responsibly."

What Is Changing

In late January, Fair Isaac announced that it is tweaking its formula to calculate FICO scores. While the new formula will not change the main components of the score that we mentioned above, it will take into account some more specific behaviors that it didn't before.

The first change comes in response to a new phenomenon in consumer credit. Though the U.S. has been on an 11-year rebound from the depths of the Global Financial Crisis of 2008-09, with growing wages and declining unemployment, one slightly sordid statistic that has gone along with this economic boom has been the growth in personal loans.

These unsecured, uncollateralized loans usually come with sky-high interest rates, but consumers seem to be willing to take those on in exchange for avoiding the scrutiny that can come with a mortgage refinance or home equity line of credit. Since 2012, the amount of personal loan debt outstanding in America has roughly tripled to a current level of around $160 billion.

According to the Wall Street Journal, who broke the news on the changes being made in response to these trends, "FICO for the first time will place more weight on personal loans in a way that penalizes some borrowers. For example, consumers who transfer credit-card debt to a personal loan but continue to rack up credit-card balances will likely experience a bigger drop in their credit scores."

Additionally, the new FICO scores will look differently at the credit utilization ratio. Instead of looking statically at just one month of your credit balances, it will look dynamically at a trend of at least the past two years. This could have a substantial effect on some people. We remember being given advice that, before applying for our first mortgage, we should pay off our credit cards or get the balances as low as possible about a month or two before submitting an application. Well, that strategy won't work as well now.

Fair Isaac estimates that most consumers, about 110 million, will see minor changes to their credit score. But about 40 million people who already have good scores (above 680) are expected to gain about 20 points, while another 40 million with low scores (below 600) can expect to see a drop. Two of the credit bureaus—TransUnion and Experian—are expected to offer the updated scores by the end of the year, while Equifax will start offering it this summer.

Conclusion

We should all know our FICO scores and understand the different factors that have an impact. That way, we can be more proactive in setting up our financial life to increase our credit scores. After all, in this credit-driven society that we all live in, we are at the mercy of this all-important three-digit number.

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