How credit scores work, how a score is calculated

Ever wonder why you can go online and be approved for credit within 60 seconds? Or get pre-qualified for a car without anyone even asking you how much money you make? Or why you get one interest rate on loans, while your neighbor gets another?

The answer is credit scoring.

Your credit score is a number generated by a mathematical algorithm -- a formula -- based on information in your credit report, compared to information on tens of millions of other people. The resulting number is a highly accurate prediction of how likely you are to pay your bills.

If it sounds arcane and unimportant, you couldn't be more wrong. Credit scores are used extensively, and if you've gotten a mortgage, a car loan, a credit card or auto insurance, the rate you received was directly related to your credit score. The higher the number, the better you look to lenders. People with the highest scores get the lowest interest rates.

Scoring categories

Lenders can use one of many different credit-scoring models to determine if you are creditworthy. Different models can produce different scores. However, lenders use some scoring models more than others. The FICO score is one such popular scoring method.

Its scale runs from 300 to 850. The vast majority of people will have scores between 600 and 800. A score of 720 or higher will get you the most favorable interest rates on a mortgage, according to data from Fair Isaac Corp., a California-based company that developed the first credit score as well as the FICO score.

Fair Isaac reports that the American public's credit scores break out along these lines:

Credit score	Percentage
499 and below	2 percent
500-549	5 percent
550-599	8 percent
600-649	12 percent
650-699	15 percent
700-749	18 percent
750-799	27 percent
800 and above	13 percent

Currently, each of the three major credit bureaus uses their own version of the FICO scoring method -- Equifax has the BEACON score, Experian has the Experian/Fair Isaac Risk Model and TransUnion has the EMPIRICA score. The three versions can come up with varying scores because they use different algorithms. (Variance can also occur because of differences in data contained in different credit reports.)

What's the big deal?

No matter which scoring model lenders use, it pays to have a great credit score. Your credit score affects whether you get credit or not, and how high your interest rate will be. A better score can lower your interest rate.

Powerful little number

If you rented an apartment, got braces, bought cell phone service, applied for a job that involved handling a lot of money, or needed to get utilities connected, there's a good chance your score was pulled.

Key factors of your score

1. How you pay your bills (35 percent of the score)
The most important factor is how you've paid your bills in the past, placing the most emphasis on recent activity. Paying all your bills on time is good. Paying them late on a consistent basis is bad. Having accounts that were sent to collections is worse. Declaring bankruptcy is worst.

2. Amount of money you owe and the amount of available credit (30 percent)
The second most important area is your outstanding debt -- how much money you owe on credit cards, car loans, mortgages, home equity lines, etc. Also considered is the total amount of credit you have available. If you have 10 credit cards that each have $10,000 credit limits, that's $100,000 of available credit. Statistically, people who have a lot of credit available tend to use it, which makes them a less attractive credit risk.

3. Length of credit history (15 percent)
The third factor is the length of your credit history. The longer you've had credit -- particularly if it's with the same credit issuers -- the more points you get.

4. Mix of credit (10 percent)
The best scores will have a mix of both revolving credit, such as credit cards, and installment credit, such as mortgages and car loans.

5. New credit applications (10 percent)
The final category is your interest in new credit -- how many credit applications you're filling out. The model compensates for people who are rate shopping for the best mortgage or car loan rates.

What doesn't count in a score

The scoring model doesn't look at:

- age
- race
- sex
- job or length of employment at your job
- income
- education
- marital status
- whether you've been turned down for credit
- length of time at your current address
- whether you own a home or rent
- information not contained in your credit report

Credit scores are not perfect

The major drawback to credit scoring is that it relies on information in your credit report, which is quite likely to contain errors. That's why it's critical that you check your credit reports annually, or at the very least three to six months before planning to buy a house or a car. That will give you sufficient time to correct any errors before a lender pulls your score.