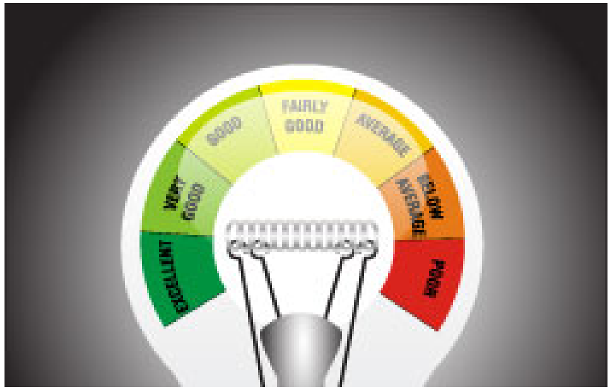
Understanding the basics of credit scores

By Daniel Workman

You likely know your credit score is important when buying a house or applying for a new credit card. But did you know it could affect where you rent or your chances at a job? Do you know exactly what your credit score is -- how it's calculated, who looks at it and what score (if any) is ideal?

If you've ever found yourself nodding along in a conversation about credit scores without quite knowing exactly what's going on, it may be time to get back to basics and learn about the number that affects so many areas of your life.



Credit scores vs. credit reports and ratings
A credit score is a three-digit number from 300 to 900 used to gauge the probability that you will pay your bills on time. Julie Springer, senior vice president at TransUnion, says lenders tend to use credit scores to determine your ability to repay future debt.

Your credit report is a list of accounts you have opened and each

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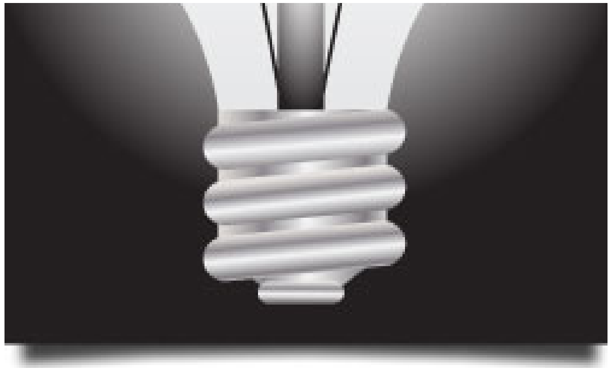
account's payment status. It also shows how much credit you are using.



Your report does not show your credit score but its contents impact your credit score. Your credit score is like a report card mark summarizing how well you manage all outstanding balances on your credit report.

Canada's major credit bureaus, Equifax and TransUnion, provide credit reports for free. You can get your credit score separately, but it will cost you a fee.

Your credit rating (shown on your credit report) is more of a snapshot of the payment status of each account at a particular point in time. A rating is given a letter designating what kind of account it is ("I" for installment loans, "O" for an open line of credit and "R" for revolving credit); and a number (1-9) signifying its payment status.

For example, a credit card account that is in collections or is written off as uncollectible is assigned a rating code of R9; an account that is up-to-date on payments and has never been paid late is assigned an R1 rating.

Who is most likely to look at your score, and why?
Credit scores are well-suited for financing arrangements that involve relatively low dollar amounts and high volumes of users.

Mike Morley, certified public accountant and author of "The Complete Guide to Credit and Credit Repair for Canadians," says banks, credit card issuers and payday loan companies may use credit scores as the sole method of evaluating an application you submit online. In those cases, the system performs an automated credit score check and can complete an approval without human intervention.

"The credit score is a shortcut in the decision-making process, so if you're applying for a $200 loan or a credit card with a relatively low limit, the credit score is adequate," says Morley. "But if you're applying for $400,000 mortgage, banks need to look at a lot more than the credit score."

Searching for the "ideal"
Credit scores do play a role in determining your interest rates -- but each lender has its own policy so there is no way to determine an "ideal" score.

However, Rob McLister, founder of mortgage comparison site RateSpy.com, says consumers should aim for credit scores over 680 to qualify for the best rates. David Trahair, chartered accountant and author of "Crushing Debt," estimates customers of the six big banks who have a credit score from 540 to 720 can expect to pay up to an extra 3 per cent more for a loan than a borrower with a score above 810.

There are no hard and fast rules, though. The credit scores required to qualify for superior interest rates are a moving target. "If a financial institution has a good year, they might drop their credit score thresholds, but after a bad year, they might raise them," says Morley.

And even an outstanding credit score doesn't guarantee the lowest rates. "Lenders often ... determine their risk levels based on their own criteria *plus* the credit score that we deliver," says Paul Le Fevre, Equifax Canada's director of operations.

McLister has seen mortgage applicants with stellar credit scores get declined because they couldn't prove sufficient income, hadn't held their current job long enough, carried excessive debt compared to their income or the desired property didn't meet the financial institution's lending guidelines.

Because lenders determine the factors used to extend credit, they are the best source to ask how much your credit score affects their financing decisions, according to Springer.

Credit scores impact non-credit decisions

The importance of having a healthy credit score extends beyond qualifying for loans or credit cards. Some landlords peruse credit scores before approving tenants, and many insurance companies have incorporated credit scores into their underwriting processes.

"Low scores can result in higher premium rates or even coverage being denied," says Ironshield-certified financial planner Mike Gomes.

Morley says that credit scores can also play a critical role in employment decisions. For instance, banks use scores to screen individuals applying to become tellers. People applying for other types of jobs may be screened similarly. "Company executives who are given big budgets and are in charge of large assets will often have their credit scores and reports checked out," he adds.

Boosting your credit scores

According to Morley, even if you've mismanaged debt in the past, you can improve your credit scores by changing your spending and bill paying behavior. Follow these tips:

1. Review your credit report regularly, ask the credit bureau to fix any errors, and pay attention to who is making inquiries on your file.

2. Pay bills on time, and don't let unpaid balances exceed 25 to 35 percent of your account limit. This ratio -- called your credit utilization ratio -- accounts for 35 per cent of your credit score.

3. Build a pristine payment history for a mix of accounts such as credit cards, cellphone accounts, bank loans and car leases. A long history of paying different types of credit can improve your score by up to 25 per percent.

"One thing people need to realize is that having a zero balance on credit card doesn't necessarily give you the highest credit score," says Morley. "What the banks like to see is you using your card and paying it -- they like to see a revolving amount."

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