What is a Credit Rating?

Most of us have heard of it and know that it exist but precious little know exactly what it is and how it affects you. In this document we will explore what credit ratings are and how they affect your everyday lives. Your credit rating will affect almost all activities you do that revolve around financing or loans. In its simplest form your credit rating is an estimate based on your history of using credit how likely you are to repay any money that you borrow. If you are in US, your credit score is represented by your FICO score. TransUnion, Experian and Equifax are the three companies which use this credit rating system in the US.

Let's first define what the FICO credit score is. The FICO score was developed by the Fair, Isaac & Co in 1956 and has been widely used fairly unchanged until today. The system assigns a score ranging from 850 (the best) to 300 (the worst). For the most part scores that are below 600 are considered poor or "sub-prime". Individuals who have scored below 600 will have difficulty getting loans or any other financing options approved with normal rates. Most of the time their lower credit score will mean that they will need to pay higher rates than normal. Someone's credit history is evaluated by the credit reporting agencies based on data that is provided to them by finance entities.

The credit score results are based on 5 basic components which account for specific percentages to weight up the overall score. Fair, Isaac & Co however doesn't disclose any other detail except for the percentage weights. They report that 35% of the score is based on the record of how "on-time" you are with your bills. The next important component which is weighed at 30% is how much debt you have versus you income. Specifically they are looking at your repayment schedule versus your income levels. The type of debt that you hold also matters; this is weighed at 10%. Another 10% is determined by your spending habits with your credit card. Another 10% is how well you manage your existing card. Are you the sort that opens and closes accounts frequently?

There are also other factors that will affect your credit score. This will include things like tax liens, defaults or any court judgment regarding nonpayment of debt. Bankruptcy and foreclosure also make a difference as it can black-list you from getting any loans for a certain number of years. With bankruptcies the FICO system will actually place you on a separate category which will make it evident to any lender that you have had past bankruptcies.

Here's the thing that most people don't know. Your FICO score is active and changes all the time. It can be changed by your lender/borrower and can even be changed by you. A finance paper by a renowned university stated that up to 60% of credit reports have some sort of error in them. It is up to you as the subject of the credit report to make the amendments as necessary. All individuals have the right to access a free copy of their credit report from each of the credit reporting agencies each year. Errors in your credit report can negatively impact your score and end up costing you money from a more expensive loan or even cause your financing needs to be rejected.

Source: CreditRelease.com