Transcript

What Really Goes Into A Credit Score?

As long as human beings have been lending things to other human beings, there's always been the question of how likely is that person that I'm lending that thing to going to give it back? So there's always been this question of credit-worthiness. Is this person a good credit risk? If I lend them money, how likely are they going to be to pay me back? Now people have always found ways to come up with a solution here. How much money do they have, what kind of an income do they have? But in 1956, two gentlemen said, "Hey, I think we can apply the ideas of mathematics, the ideas of statistics, to actually become a little more scientific about how credit-worthy someone is." And so these two gentlemen started what is known as the Fair Isaac Corporation. And when I first heard the name, I assumed it was started by a particularly fair Isaac, or at least someone who, an Isaac who thought that he was fair, so much so that he named it Fair Isaac. But it's actually named after the two founders: Bill Fair and Earl Isaac. So actually the first one was Fair comma Isaac and Corporation, then changed to Fair Isaac Corporation, and now it's often known as FICO®.

And what they came up with – Bill Fair was an engineer, Earl Isaac was a mathematician – is an algorithm for computing how credit-worthy someone is. So they came up with an algorithm. And the algorithm has changed since 1956 because clearly technology has changed, and our understanding of statistics and even the world itself that we're trying to understand has changed. But they started focusing on the problem of, given some inputs, can I give a score that can give you a sense of someone's credit-worthiness? So they would take inputs like total debt, and actually not just total debt but available debt, total debt to how much credit someone could get access to. Things like payment history; so have they paid all their debts on time? And other things, like length of credit history and the types of credit. And other things, like how many people are inquiring about this person's credit and things like that. And then they came up with a score. And today, the modern FICO® score, and the FICO® really is, I would say, the dominant type of credit score.

There are other types of algorithms that people use, but FICO® is still the predominant one. It will give you a score that is between 300 and 850. So 300 at the low end, 850 at the high end. And the general view is – and I actually talked to some folks at some banks to get their sense of things –

that anything above, anything between 780 and 850 is excellent. You have excellent credit. You are amongst the best credit risks. You are viewed to be very likely to pay off whatever loan you are about to get. Anything between 720 and 780 is considered still above average, it's still considered very good. And anything between 650 and 720 is considered kind of middle or average or just okay. And anything less than 650 is not so good, often referred to as subprime.

Prime would be an excellent credit risk or a good credit risk or an okay credit risk. Subprime means okay, this person's a little bit riskier to lend money to. So this is not so good. Now, the question is, who actually collects all of this information in order to apply the FICO® algorithm? And this is where credit bureaus come into the picture. So FICO® is, and it's a large, multibillion dollar company now that does many, many, many things, but it's most famous for devising the FICO® algorithm. But the way that the credit scores tend to be calculated is by the credit bureaus.

So the credit bureaus are the folks that will actually collect the data – your total debt, payment history, and other things – apply the FICO® algorithm, and then give you your actual credit score. And the three major credit bureaus are TransUnion, Experian, and Equifax. So if you were about to lend someone money, you could go to one of these credit bureaus, and you could do an inquiry into their credit score. And actually, you yourself, as an individual, can go and inquire about your credit score with each of these bureaus. And they offer different types of algorithms, but the FICO® one is the most used one.

So you could get a FICO® score from each of these credit unions. And the score might be a little bit different, because they all might have slightly different data here. But the way that it would generally work is if you were to go to your bank and ask for a mortgage or go to a credit card company and ask for a credit card, or get a car loan, that entity – so let's say that this is the bank right over here, that might be interested in lending you money – they are going to go to one of these credit bureaus and say, "Hey, give me this person's credit score." And so that credit bureau's going to look at all the data that it has on that person, put it into the FICO® algorithm if the bank wants the FICO® credit score, and give a score right over here. And if you have excellent credit then you might get a low interest rate, or you might definitely get the loan.

If you have a good credit score, you'll get the loan but it will be a slightly higher interest rate. But if you have really bad credit, you're probably not going to get the loan at all. Now the last question you're probably asking is,

"Well, how do these credit bureaus get the information? How do they know how much total debt I have, and my payment history, and the lengths and types of credit that I have, and the number of inquiries that come in?" Well, in exchange for lenders being allowed to make these inquiries, they usually then pay the credit bureaus to get the information, they also agree to share this information.

So later on – let’s say this bank does give you the loan – they will tell the credit bureaus. They agree to tell the credit bureaus that they gave you that loan. And they will also tell the credit bureau about your payment history. If you pay them all on time, the credit bureaus will know about that and they’ll be able to input it into your FICO® score. But if you don’t pay it on time, they will also know about that, and that will affect your FICO® score.