What is a Credit Score?

Description

Have you ever noticed how easy and convenient it is for certain people to access credit? Sometimes, it seems like they can acquire credit cards, loans, and lines of credit simply by thinking about them. But there's also another group of people who struggle incessantly to secure financing for even a paltry sum of money, almost like their mere presence repels it.

So why are there such stark differences between consumers in their ability to obtain credit? One highly probable reason for the disparity may be rooted in the credit score.

What is a credit score — and why is it important?

A credit score is a financial metric that measures how creditworthy you are. In other words, it reflects how risky it is to lend money to you.

Your credit score conveys crucial information to lenders about your ability to handle credit responsibly. If a lender extends a loan to you, what's the likelihood of you missing payments and defaulting on it? This is the primary question lenders ask themselves when determining whether to approve you for a loan — and your credit score plays a pivotal role in helping them arrive at their decision. If they deem you a high-risk borrower, they won't hesitate to reject your application.

Depending on how your credit score ranks, it could have either fortunate or dire implications on your ability to secure financing, be it a credit card, personal loan, or mortgage. For this reason, it's wise to get acquainted with how a credit score functions and the factors that affect it.

Credit score rankings and what they mean

Credit scores range from 300 to 900. If you score high, lenders will be eager to offer you a wide array of financing options at low interest rates. Conversely, if you fall on the low end of this range, they'll be less willing to grant you credit for fear you'll fail to repay the loaned funds.

Here is a general guide for how credit scores are ranked:

- Excellent (scores 760+)
- Very good (scores 725 -759)
- Good (scores 660 – 724)
- Poor (scores 560 -659)
- Very poor (scores 300 – 559)

Traditional lenders like banks and credit unions prefer to lend to borrowers with a credit score of at least 660. If your score falls below this threshold, you'll face difficulty qualifying for standard credit products. You'll have to find sources of financing in the alternative lending market, which exists to serve borrowers with bad credit. However, this class of lenders typically charges exorbitant interest rates.

Who assigns credit scores?

Credit scores are determined and compiled by the two main credit bureaus in Canada: Equifax and TransUnion. The two agencies employ complex scoring models that assign credit scores based on a multitude of financial data collected from consumers. Suppose you're carrying a past due balance on your credit card account. In that case, you can be sure this detail has been captured, documented, and incorporated into these fancy algorithms. Don't think you've gone unnoticed!

What factors determine your credit score?

There isn't one specific formula used to calculate your credit score, as each credit bureau employs multiple scoring models. However, the following five factors and their weightings are a good guideline:

1. Payment history: ~35%

Your payment history contains details about repayments you've made on credit extended to you. It shows whether you have a habit of making timely or late payments or missing payments entirely. Not surprisingly, consistently paying your creditors on time will boost your credit score.

2. Credit utilization ~30%

Credit utilization measures how much debt you owe relative to your available credit. Typically presented as a percentage, a high credit utilization ratio indicates that you consistently carry a large balance on your credit accounts. A low credit utilization ratio suggests you use your available credit sparingly and pay off your balance quickly. Strive to keep your credit utilization ratio at 35% or lower – anything higher will impair your credit score.

3. Length of credit history ~15%

This criterion examines how long you've used and maintained credit accounts. Credit scoring models assess the age of your oldest account and the average age of your accounts in aggregate. The longer your credit history, the better, as it signifies you have extensive experience managing credit.

4. Public records ~10%

This section notes whether you've been through bankruptcy or had outstanding debts transferred to collection agencies. The presence of such details will adversely affect your credit score.

5. Credit inquiries ~10%

Whenever a lender pulls your credit report to assess the risk of loaning funds to you, credit bureaus record the request as an inquiry, which results in a temporary dip in your credit score.

How to find out your credit score

You can request access to your credit score by contacting Equifax or TransUnion. Your bank and certain financial services organization that have partnerships with the credit bureaus may also provide it to you free of charge.

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