

# STUDENT LOAN BUYING GUIDE

## The top 4 things you should know about FICO

BY TAMERA BRIONES

**W**hen a student applies for a private loan, it's the lender's job to determine the risk associated with that borrower. That risk ultimately determines the rate and fee the borrower will pay. Creditworthiness is of great importance, and the primary predictive tool used to assess whether a borrower will repay the lender is a credit score.

There are three major credit bureaus in the U.S who calculate and report credit scores based on the information reported to them by myriads of creditors. So it's actually possible for a consumer to have three different scores. Some lenders pull information from one credit bureau while other lenders may pull from all three.

The most commonly used credit score in the U.S. is a 'FICO score.' FICO is an acronym for its creator, Fair Isaac Corporation. Here are the top four things you need to know about FICO.

### A FICO score can dramatically affect a loan's total cost

**A \$10,000 loan with no fees and a 15-year repayment term.  
Prime rate @ 8.25%**

FICO Score	Interest Rate Formula	Interest Rate	Monthly Payment	Total Cost of Loan
723	Prime - 0.25	8.00%	\$95.57	\$17,201.74
619	Prime + 3.5%	11.75%	\$118.41	\$21,314.36

#### 1. What's a FICO score?

Ranging from 300 to 850, FICO reports the likelihood of a borrower repaying a loan as agreed. The higher the FICO score, the less the risk to a lender. As can be seen from the national FICO distribution graph, the median U.S. FICO score is 723 (see chart below).

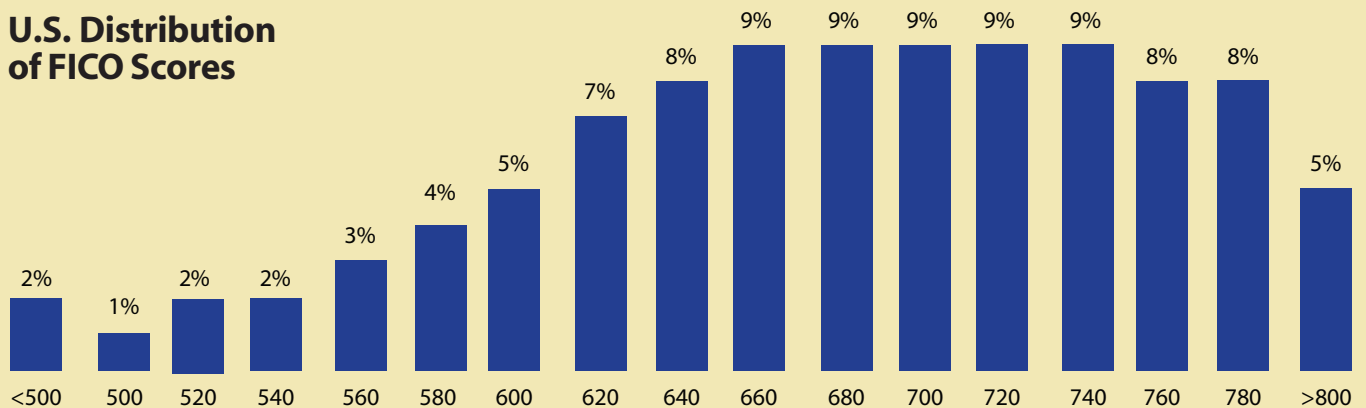
the loan terms he or she will be offered. The higher a student's score, the better the interest rate. And a few points can make a big difference over the life of the loan.

Take the example of a \$10,000 loan with no fees and a 15-year repayment term. Over its life, a borrower with a score of 723 will pay several thousand dollars less than a student with a FICO score of 619 (see chart above).

#### 2. Why a FICO score matters

Private loans are credit-based, which means a student's FICO score affects

### U.S. Distribution of FICO Scores



### 3. FICO score components

A FICO score is built from five components. Not all components are of equal importance.

#### ■ **Payment history, 35%**

Past and current delinquencies are measured, as well as other derogatory payment behavior. Of importance is how recent is the latest delinquency, collection or public record. Also, how severe was the worst delinquency? And how many credit obligations have been delinquent?

*FICO Fact: Timely payments are essential for a good FICO score.*

#### ■ **Amounts owed, 30%**

Outstanding debt is evaluated. How much is owed to creditors? What percentage of available credit is in use? What percentage of open installment loans is unpaid?

*FICO Fact: Keeping credit balances below 50 percent of the total available credit improves a FICO score.*

#### ■ **Length of credit history, 15%**

How long have accounts been established? How recently were new accounts opened?

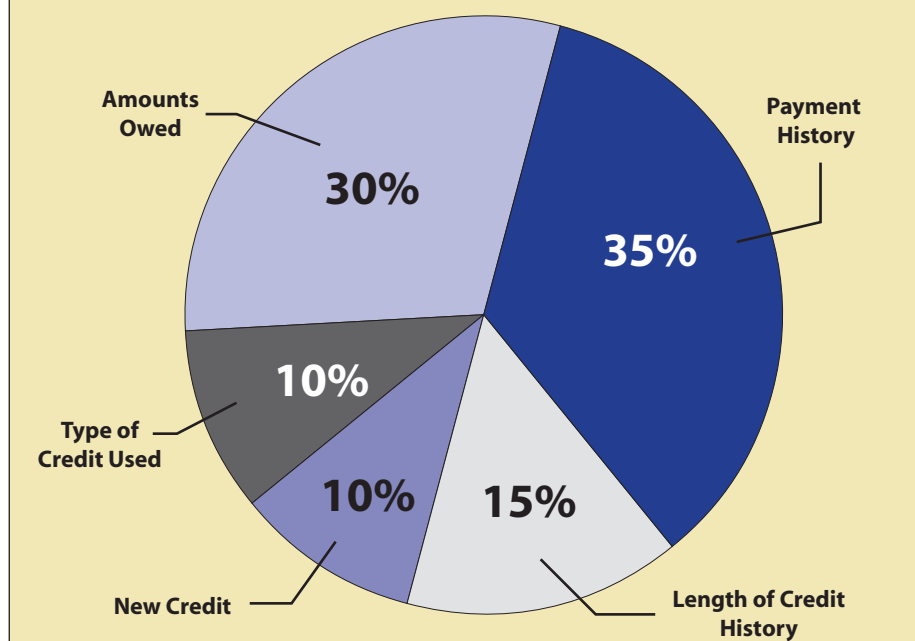
*FICO Fact: The longer a person has credit, the more it helps their FICO score.*

#### ■ **New credit, 10%**

To what extent is a person seeking and acquiring new credit? How many inquiries and how many new accounts were opened in the past 12 months? In any 45-day period, multiple mortgage or auto inquiries are treated as a single inquiry. Customer-initiated inquiries (such as checking your own credit score) are excluded.

*FICO Fact: Private student loans do not enjoy the protection of a 45-day "shopping window." To keep the inquiry count low, shop for the best rates before applying for a private loan.*

### A FICO Score is built from five components, some more important than others.



#### ■ **Types of credit used, 10%**

This category measures the mix of credit product types, such as the number of revolving credit lines and the percent of installment trade lines.

*FICO Fact: Installment loans, such as mortgages and car loans, are viewed more favorably than revolving debt such as credit cards.*

Age, race, religion, marital status, occupation, salary, child/family support obligations and participation in credit counseling are not part of a FICO score.

### 4. How to improve a FICO score

Improving a FICO score takes time and patience. Together, payment history and amounts owed comprise 65 percent of the total score. So the two most important factors that help a credit score are paying bills on time and lowering outstanding balances.

Of the two, consistent, on-time

payments, is the critical element in achieving and maintaining a good credit score. As credit bureaus track an accumulation of on-time payments, a credit score will gradually improve over the course of 18-24 months.

The only quick fix that will dramatically improve a credit score is to pay down the amounts owed. If it's not possible to pay off a balance completely, then reduce revolving debt, such as credit card balances—as opposed to focusing on installment loan balances.

In a society fueled by consumer credit, a good understanding of credit scores is the first step in achieving financial literacy. ■



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