FICO Scores

In the good old days, when bankers loaned money right of their and their depositor's pockets, they were not about to loan money to someone who could not pay it back. They relied on the four Cs. (1) Character. (2) Cash flow. (3) Financial Condition. (4) Collateral. These are certainly still important, especially character (When you have integrity, nothing else matters. When you don't have integrity, nothing else matters), but they are subjective.

Objective criteria were required. (1) Since the financial crisis of 2008/9, regulators are looking more closely than ever over the banker's shoulders. (2) There is now often little interpersonal relationship between borrower and lender. (3) Loans are often packaged and sold to a third party, so objective data is critical.

Standardization is essential to progress. In predemocratic times, an inch was the width of the monarch's thumb, a foot was the length of their foot, and a yard was a man's belt or girdle. Compare this to the meter, a universal measure, 1/10,000,000th of the earth's meridian from the North Pole to the equator, running through Paris, France.[1]

In the late 50s, Fair and Isaac (thus FICO) developed an objective system to determine a borrower's creditworthiness. The 5 components are:

1) Payment history. 35%

Most important. Past behavior is the best indicator of future behavior. If you pay your bills and loans in full, and on time, you have little to worry about.

2) Credit Utilization. 30%

People who are habitually close to their credit limit have problems managing debt.

3) Length of credit history. 15%

The longer the track record, the more information to judge.

4) New credit. 10%

If you apply for multiple lines of credit over a short period, it could indicate you are in trouble. Open new credit accounts only when needed.

5) Credit mix. 10%

Borrowers with a mix of revolving credit (such as credit card) and installment debt (such as mortgage and car loans), represent less risk, because they have shown they can service their debt. Compare this to people with no credit cards, who tend to be a higher risk.

The basic goal of FICO scores is to determine the likelihood that a person leant money will pay it back, that they are responsible. Although there are subtleties, it amounts to:

If you keep debt under control,

And pay your bills in full and on time, you will be fine.

I have not owed anyone a penny for 20 years. I have no anticipation of a need to borrow money, and I will never—ever—co-sign a note for anyone, so FICO scores are a non-issue for me.

Since the beginning of my financial writing, it has been my advice that the only things you should ever borrow for are your home and your education. Most people are not in a financial position to purchase a home until 2 to 5 years after they finish their education or training.

So for many people, their first borrowing will be to finance their education. About two-thirds of college graduates have student loans, and more than 80% of medical students graduate with student debt. My realization is that you must maximize your FICO score before you take on student loans. For practical purposes, this means you must start to generate a credit history before you enter college.

Anyone who drives a vehicle needs a credit card for emergencies. Your children can mow lawns, babysit (boys can babysit) or do anything else to earn a buck before getting a high school job at age 16. I suggest you get a credit card, and set up a checking account, in the child's name, with them paying the bills, in their mid-teens, age 13 to 15. This will help teach responsible money management skills, and as it pertains to this discussion, establish a 5 or 7 or even 10-year credit history before they need to take out a student loan. A 1% difference in interest rate over many years is a lot of money.

Disclosure

Dr. Doroghazi is not a registered financial advisor under federal law or any state law. The advice provided is of a general nature, and should not be interpreted as personalized or individualized to your specific portfolio.

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