 Pretend for a moment that you and your brother are both buying a car. You’re buying from the same dealership and the cars cost exactly the same—except the interest rate on your brother’s loan is more than yours.

The reason comes down to two words—credit score.

Since your brother has a lower credit score, he has to pay a higher interest rate to get the loan. He’ll also have a higher monthly payment and end up paying a lot more for the car over the life of the loan.

But credit scores don’t just affect loans—they can also impact whether you can buy a cell phone, rent an apartment, get utilities without a deposit, and even get some jobs. So, you need to understand how credit scoring works.

A credit score is a “snapshot” of your credit worthiness at one point in time. Each time someone requests your score, the credit rater goes through three steps:

1. Collecting information from the three major credit reporting bureaus—Experian, TransUnion, and Equifax
2. Comparing your credit history to the credit history of consumers with similar profiles
3. Adding or subtracting points from your score for each item that makes you more or less likely to repay a debt

Most people don’t realize that they usually have three scores at any one time — one for each credit bureau — and those scores can vary a lot, because some creditors do not report to all three agencies.

Don’t Be Fooled!

Many websites and TV ads promise a “free” credit report but there are strings attached—often, agreeing to a subscription for a credit monitoring service.

The Fair Credit Reporting Act guarantees you one free report a year from each of the three major credit bureaus and www.annualcreditreport.com is the ONLY website authorized to provide it.

However, you will have to pay a small fee if you want to see your FICO score—no one provides that for free.
Figuring Your FICO

While there are competitors, the FICO score is the most common credit score by far. Similar to the SAT, it ranges from 300 to 850. The chart below shows the five categories of information it draws on and their importance to the score of a typical borrower.

1. Payment History—Do you pay on time? Do you have any negative public records such as bankruptcy and legal actions for nonpayment of debt? The older the negative items are the better.

2. Amounts Owed—How many accounts do you have and how much do you owe? FICO also looks at how close you are to maxing out your accounts.

3. Length of Credit History—How long have you had a credit record? Longer is better.

4. New Credit—How many and what types of credit accounts have you recently opened or applied for? Too many of either in a short period makes credit companies worry you’re having money issues.

5. Types of Credit Used—How many of each type of credit account do you have? Types include major credit cards, store cards, installment loans, school loans, and mortgages. There’s no magic number to strive for, but credit agencies like loans backed by collateral, such as car loans and mortgages, better than “spending” accounts like credit cards and store cards.

Did You Know?

A credit utilization ratio tells FICO how “maxed out” you are. Here’s how it works:

Balance Amount $ / Credit Limit $ X 100 = Credit Utilization Ratio

The lower the number, the better. FICO says to aim for less than 50 percent but other experts recommend 30 percent or less—but above 0 percent.

Three Surprising Moves that Can Sabotage Your Credit Score

Ironically, what seems like a smart move can actually work against you in the world of credit scoring. While how much it will hurt depends on your credit situation, here are three common mistakes to avoid:

1. Transferring a Balance to a New Card. If you’re transferring more than half the credit limit of the new card, they’ll ding you for a high credit utilization ratio (see box above). Of course, simply getting a new card may hurt your score—especially if you’ve applied for several recently.

2. Closing Credit Accounts. It’s true—closing credit accounts usually damages your credit score. That’s because reducing the total credit available to you increases your overall credit utilization ratio. And you’re double dinged if you have a balance on the closed card, because that balance still counts but any available credit you had doesn’t.

Also, if you’re shortening your credit track record by closing an account you’ve had for a long time—another ding. Finally, remember that closed accounts still stay on your credit history for seven to 10 years.

3. NOT Using Credit. Avoiding credit entirely is not good either. In fact, if you have no recent credit history, you may not even have a score. In that case, lenders usually assume you’re high risk.

If you have credit but never use it, you’re not hurting your score but you’re not helping it either. After all, making timely payments shows you can manage debt responsibly and actually raises your score.

Your credit score will have a big influence on your life, so be sure to manage credit wisely!