

The Facts on Credit Scoring - Part 1

By Ginny Ferguson, CMC

National Association of Mortgage Brokers

Credit Scoring Committee Chair

Over the next few weeks we will feature a series on credit scoring. Part I gives an overview of the credit scoring process.

About credit scores

Credit bureau scores are often called "FICO scores" because most credit bureau scores used in the United States are produced from software developed by Fair, Isaac and Company (FICO). FICO scores are provided to lenders by the three major credit reporting agencies: Equifax, Experian and TransUnion. Credit scores provide the best guide to future risk based solely on credit report data. The higher the score, the lower the indicated risk. But no score says whether a specific individual will be a "good" or "bad" customer.

While many lenders use credit scores to help them make lending decisions, each lender has its own strategy, including the level of risk it finds acceptable for a given credit product. There is no single "cutoff score" used by all lenders and there are many additional factors that lenders use to determine your actual interest rates.

It is important to note that credit scoring is **NOT** underwriting a loan application; it is one variable that is looked at in underwriting a loan application.

How credit scoring works

Credit scoring is calculated by a mathematical equation that evaluates many types of information that are in a consumer's credit file at that specific repository/bureau. By comparing this information to the patterns in hundreds of thousands of past credit reports, the score identifies the lender's level of future credit risk. In order for a credit score to be calculated on a consumer's credit file, the file must contain at least one account, which has been open for six months or longer. In addition, the file must contain at least one account that has been updated in the past six months. This ensures that there is enough information -- and enough recent information -- in the credit file on which to base a score.

What a credit score considers

Listed below are the five main categories of information that credit scores evaluate, along with their approximate level of importance.

1. Payment history -- 35% of the score's weight
2. Amounts owed -- 30% of the score's weight
3. Length of credit history -- 15% of the score's weight
4. New credit inquiries -- 10% of the score's weight
5. Types of credit used -- 10% of the score's weight

What a credit score ignores

Credit scores consider a wide range of information on the consumer's credit report. However, they do not consider:

- A consumer's race, color, religion, national origin, sex and marital status.
US law prohibits credit scoring from considering these facts, as well as any receipt of public assistance, or the exercise of any consumer right under the Consumer Credit Protection Act.
- A consumer's age.
Other types of scores may consider age, but FICO scores don't.
- A consumer's salary, occupation, title, employer, date employed or employment history.
Lenders may consider this information, however, as may other types of scores.
- Where a consumer lives.
- Any interest rate being charged on a particular credit card or other account.
- Any items reported as child/family support obligations or rental agreements.
- Certain types of inquiries* (requests for a consumer's credit report).

- Any information not found in the consumer's credit report.
- Any information that is not proven to be predictive of future credit performance.

*The score does not count "consumer-initiated" inquiries -- requests the consumer has made for his/her credit report, in order to check it. It also does not count "promotional inquiries" -- requests made by lenders in order to make a consumer a "pre-approved" credit offer, or "administrative inquiries" -- requests made by lenders to review a consumer's account with them. Requests that are marked as coming from employers are not counted either.

Points to consider when reviewing credit scores

- A score takes into consideration all five categories of information, not just one or two.
- No one piece of information or factor alone will determine the score.
- The importance of any factor depends on the overall information in the credit report.
- A consumer's credit score only looks at information in his/her credit report.
- The consumer's score considers both positive and negative information in his/her credit report. Late payments will lower the score, but establishing or re-establishing a good track record of making payments on time will raise the score.

For some people, a given factor may be more important than for someone else with a different credit history. In addition, as the information in the credit report changes, so does the importance of any factor in determining the score. Thus, it's impossible to say exactly how important any single factor is in determining the score -- even the levels of importance shown here are for the general population, and will be different for different credit profiles. What's important is the mix of information, which varies from person to person, and for any one person over time.

Also, lenders look at many things when making a credit decision including a consumer's income, how long he/she has worked at his/her present job, and the kind of credit the consumer is requesting.

The Facts on Credit Scoring - Part 2

This is the second in a multi-part series on credit scoring. There are five categories of credit scoring:

1. Payment history
2. Amounts owed
3. Length of credit history
4. New credit inquiries
5. Types of credit used

This week, we'll look more closely at the first three categories, payment history, amounts owed, and length of credit history.

Payment history

Payment history accounts for approximately 35% of the weight of the score.

The first thing any lender would want to know is whether the consumer has paid past credit accounts on time. This is also one of the most important factors in a credit score. However, late payments are not an automatic "score-killer." An overall good credit picture can outweigh one or two instances of, say, late credit card payments. By the same token, having no late payments in the credit report doesn't mean the consumer will get a "perfect score." Some 60%-65% of credit reports show no late payments at all -- the payment history is just one piece of information used in calculating the score.

This score takes into account:

- **Payment information on many types of accounts.**
These will include credit cards (such as Visa, MasterCard, American Express and Discover), retail accounts (credit from stores where the consumer does business, such as department store credit cards), installment loans (loans where the consumer makes regular payments, such as car loans), finance company accounts and mortgage loans.
- **Public record and collection items --reports of events such as a bankruptcy, foreclosures, suits, wage attachments, liens and judgments.**
These are considered quite serious, although older items and items with small amounts will count less than more recent items or those with larger amounts.
Never payoff an old collection, judgement, tax lien, etc. till the close of escrow, doing so will turn the delinquency into a current event and the consumer's score will go down.
- **Details on late or missed payments ("delinquencies") and public record and collection items -- specifically, how late they were, how much was owed, how recently they occurred and how many there are.**
A 60-day late payment is not as risky as a 90-day late payment, in and of itself. But recency and frequency count too. A 60-day late payment made just a month ago will count more than a 90-day late payment from five years ago. Note that closing an account on which the consumer had previously missed a payment or satisfying a judgment or collection item does not make the late payment or item disappear from the credit report.
- **How many accounts show no late payments?**
A good track record on most of the consumer's credit accounts will increase the credit score.

Payment history tips

It's important to note that raising a consumer's score is a bit like losing weight: It takes time and there is no quick fix. In fact, quick-fix efforts can backfire. The best advice is to manage credit responsibly over time.

- **Pay bills on time.**
Delinquent payments and collections can have a major negative impact on the score.

- **If the consumer has missed payments, he/she must get current and stay current.**
The longer the consumer pays his/her bills on time, the better their score.
- **Be aware that paying off a collection account will not remove it from the credit report.**
It will stay on the report for seven years.
- **If a consumer is having trouble making ends meet, he/she should contact their creditors or see a legitimate credit counselor.**
This won't improve the score immediately, but if he/she can begin to manage their credit and pay on time, their score will get better over time. The notation, "account managed by Consumer Credit Counseling" is no longer treated, by the scoring model, like a Chapter 13.

Amounts owed

Amounts owed accounts for approximately 30% of the weight of the score.

Having credit accounts and owing money on them does not mean the consumer is a high-risk borrower with a low score. However, owing a great deal of money on many accounts can indicate that a person is overextended, and is more likely to make some payments late or not at all. Part of the science of scoring is determining how much is too much for a given credit profile.

This score takes into account:

- **The amount owed on all accounts.**
Note that even if the consumer pays off his/her credit cards in full every month, their credit report may show a balance on those cards. The total balance on the last statement is generally the amount that will show in their credit report.
- **The amount owed on all accounts, and on different types of accounts.**
In addition to the overall amount the consumer owes, the score considers the amount he/she may owe on specific types of accounts, such as credit cards and installment loans.
- **Whether the consumer is showing a balance on certain types of accounts.**
In some cases, having a very small balance without missing a payment shows that the consumer has managed credit responsibly, and may be slightly better than no balance at all. On the other hand, closing unused credit accounts that show zero balances and that are in good standing will not generally raise your score. In fact it could lower the score.
- **How many accounts have balances.**
A large number can indicate higher risk of over-extension.
- **How much of the total credit line is being used on credit cards and other "revolving credit" accounts.**
Someone closer to being "maxed out" on many credit cards may have trouble making payments in the future.
- **How much of installment loan accounts is still owed, compared with the original loan amounts.**
For example, if the consumer borrowed \$10,000 to buy a car and he/she has paid back \$2,000, he/she still owes (with interest) more than 80% of the original loan. Paying down installment loans is a good sign that the consumer is able and willing to manage and repay debt.

Amounts owed tips

- **Keep balances low on credit cards and other "revolving credit."**
High outstanding debt can negatively affect a score. Maintain balances owed to at or below 30% of the available credit limit.
- **Pay off debt rather than moving it around.**
The most effective way to improve the score in this area is by paying down the revolving credit. In fact, owing the same amount but consolidating the amount onto fewer open accounts may lower the score.

- Don't advise a consumer to close unused credit cards as a short-term strategy to raise the consumer's score.
- **Don't open a number of new credit cards that the consumer doesn't need, just to increase his/her available credit.**
This approach could backfire and actually lower the score.

Length of credit history

Length of credit history accounts for approximately 15% of the weight of the score.

In general, a longer credit history will increase the score. However, even people who have not been using credit long may get high scores, depending on how the rest of their credit report looks.

This score takes into account:

- **How long the credit accounts have been established, in general.**
The score considers both the age of the oldest account and an average age of all the accounts.
- How long specific credit accounts have been established.
- How long it has been since the consumer used certain accounts.

Length of credit history tip

- **If the consumer has been managing credit for a short time, he/she shouldn't open a lot of new accounts too rapidly.**
New accounts will lower the average account age, which will have a larger effect on the score if the consumer doesn't have a lot of other credit information. Also, rapid account buildup can look risky if the consumer is a new credit user.

The Facts on Credit Scoring - Part 3

This is the third in a multi-part series on credit scoring. There are five categories of credit scoring:

1. Payment history
2. Amounts owed
3. Length of credit history
4. New credit inquiries
5. Types of credit used

This week, we'll look more closely at the last two categories, new credit inquiries and types of credit used.

New credit inquiries

New credit inquiries account for approximately 10% of the weight of the score.

People tend to have more credit today and to shop for credit -- via the Internet and other channels -- more frequently than ever. Credit scores reflect this fact. However, research shows that opening several credit accounts in a short period of time does represent greater risk -- especially for people who do not have a long-established credit history. This also extends to requests for credit, as indicated by certain "inquiries" to the credit reporting agencies, resulting from requests by the consumer for new credit. An inquiry is a request by a lender to get a copy of an applicant's credit report. Credit scores do a good job of distinguishing between a search for many new credit accounts and rate shopping, which is generally not associated with higher risk.

This score takes into account:

- **How many new accounts a consumer has.**
The score looks at how many new accounts there are by type of account (for example, how many newly opened credit cards the consumer has). It also may look at how many of the accounts are new accounts.
- **How long it has been since the consumer opened a new account.**
Again, the score looks at this by type of account.
- **How many recent requests for credit has the consumer made, as indicated by inquiries to the credit reporting agencies.**
Inquiries remain on the credit report for two years, although credit scores only consider inquiries from the last 12 months. Note that if a consumer orders his/her credit report from a credit reporting agency -- such as to check it for accuracy, which is a good idea -- the score does not count this, as it is not an indication that the consumer is seeking new credit. Also, the score does not count requests a lender has made for a consumer's credit report or score in order to make the consumer a "pre-approved" credit offer, or to review the consumer's account with them, even though he/she may see these inquiries on the credit report.
- Length of time since credit report inquiries were made by lenders.
- **Whether the consumer has a good recent credit history, following past payment problems.**
Re-establishing credit and making payments on time after a period of late payment behavior will help to raise a score over time.

New credit inquiries tips

- **Advise consumers to do any rate shopping for a given loan within a focused period of time.**
Credit scores distinguish between a search for a single loan and a search for many new credit lines, in part by the length of time over which inquiries occur.
- **Re-establish credit history if there have been problems.**
Opening new accounts responsibly and paying them off on time will raise the score in the long term.

- **Recognize that it's OK to for a consumer to request and check his/her own credit report.**
This won't affect the score, as long as the consumer orders his/her credit report directly from the credit report agency or through an organization authorized to provide credit reports to consumers.

Types of credit used

Types of credit used accounts for approximately 10% of the weight of the score.

The score will consider the mix of credit cards, retail accounts, installment loans, and finance company accounts and mortgage loans. It is not necessary to have one of each, and it is not a good idea to open credit accounts not intended to be used. The credit mix usually won't be a key factor in determining the score -- but it will be more important if the credit report does not have a lot of other information on which to base a score.

This score takes into account:

- **What kinds of credit accounts the consumer has, and how many of each.**
The score also looks at the total number of accounts the consumer has. For different credit profiles, how many is too many will vary.

Types of credit used tips

- **Advise consumers to apply for and open new credit accounts only as needed.**
Don't open accounts just to have a better credit mix -- it probably won't raise the score.
- **Have credit cards -- but manage them responsibly.**
In general, having credit cards and installment loans (and paying timely payments) will raise the score. Someone with no credit cards, for example, tends to be a higher risk than someone who has managed credit cards responsibly.
- **Recognize that closing an account doesn't make it go away.**
A closed account will still show up on the credit report, and may be considered by the score.

The Facts on Credit Scoring - Part 4

This is the fourth in a multi-part series on credit scoring. This week we'll discover what factors Fair, Issac considers when calculating the credit score at one of the major credit reporting agencies, based on the five categories listed below:

1. Payment history
2. Amounts owed
3. Length of credit history
4. New credit inquiries
5. Types of credit used

List of credit score factors

Past payment history

- Account payment information on specific types of accounts (credit cards, retail accounts, installment loans, finance company accounts, mortgage, etc.)
- Presence of adverse public records (bankruptcy, judgements, suits, liens, wage attachments, etc.), collection items, and/or delinquency (past due items)
- Severity of delinquency (how long past due)
- Amount past due on delinquent accounts or collection items
- Time since (recency of) past due items (delinquency), adverse public records (if any), or collection items (if any)
- Number of past due items on file
- Number of accounts paid as agreed

Amount of credit owing

- Amount owing on accounts
- Amount owing on specific types of accounts
- Lack of a specific type of balance, in some cases
- Number of accounts with balances
- Proportion of credit lines used (proportion of balances to total credit limits on certain types of revolving accounts)
- Proportion of installment loan amounts still owing (proportion of balance to original loan amount on certain types of installment loans)

Length of time credit established

- Time since accounts opened
- Time since accounts opened, by specific type of account
- Time since account activity

Search for and acquisition of new credit

- Number of recently opened accounts, and proportion of accounts that are recently opened, by type of account
- Number of recent credit inquiries
- Time since recent account opening(s), by type of account
- Time since credit inquiry(s)
- Re-establishment of positive credit history following past payment problems

Types of credit established

- Number of (presence, prevalence, and recent information on) various types of accounts (credit cards, retail accounts, installment loans, mortgage, consumer finance accounts, etc.)

Interpreting the credit score

When a broker receives a credit bureau risk score, up to four "score reason codes" are also delivered. These explain the top reasons why the score was not higher. If the request for credit needs to be declined, and the credit score is part of the reason, these score reasons can help the broker tell the consumer why their score wasn't higher. If the reason for a low score is not obvious to the broker, the reason codes are the broker's road map to why.

These score reasons are more useful than the score itself in helping the broker and the consumer determine whether the credit report might contain errors, and how the consumer might improve his/her score over time. However, if the report indicates a high score (for example, in the mid-700s or higher) some of the reasons codes may not be very helpful. They may be marginal factors related to the last three categories described previously (length of credit history, new credit and types of credit in use).

Common score reasons

Here are the top 10 most frequently given score reasons. These reasons can be used in counseling the consumer.

1. Serious delinquency.
2. Serious delinquency and public record or collection filed.
3. Derogatory public record or collection filed.
4. Time since delinquency is too recent or unknown.
5. Level of delinquency on accounts.
6. Number of accounts with delinquency.
7. Amount owed on accounts.
8. Proportion of balances to credit limits on revolving accounts is too high.
9. Length of time accounts have been established.
10. Too many accounts with balances.

The Facts on Credit Scoring - Part 5

This is the fifth in a multi-part series on credit scoring. This week we'll discuss how to correct errors found in a consumer's credit file.

How to correct errors in a consumer's credit file

Changes to correct credit must be made at the repository in order for the information to affect the score. The consumer must write a letter of dispute regarding the erroneous information reported by a specific repository to the repository referencing the tradeline, account numbers, what is incorrect. Send the letter overnight mail, with a return receipt requested.

Under The Fair Credit Reporting Act effective October 1, 1997, a credit repository has 5 days from the receipt of a written investigation request to contact the appropriate credit grantor about investigating the complaint(s). The consumer should receive a reply back within 30 days of the original repository notification.

Within 5 business days after the completion of the investigation, the repository must send a written report to the borrower with its findings (and a copy of the revised report if there was any change). The findings will state one of the following:

- there is an error and the credit report is corrected.
- there is no error, so the report stands.
- the credit grantor(s) did not respond in the allotted time, so the disputed item(s) is dropped from the report.

If credit errors are detected, below is the contact information for the three repositories:

Equifax Information Service

Attn: Disputes
P.O. Box 740256
Atlanta, GA. 30339
(800) 270-3435
www.equifax.com

Experian (formerly TRW)

Attn: NCAC
P.O. Box 2106
Allen, TX. 75002
(888) 567-8688
www.Experian.com

TransUnion Corporation

Attn: Disputes
(800) 888-4213
P.O. Box 390
Springfield, PA 19064-0390
www.transunion.com

How to utilize the Bureau Direct method for rapid rescoring of a credit file

The Bureau Direct method is a newly-released process from each of the three repositories that allows mortgage brokers -- with proof and the affiliated credit reporting company's validation -- to have significant errors found on a consumer's credit report changed.

The change occurs typically within 1 - 5 business days at the repository level, after the broker's credit report company receives the appropriate information. The broker will receive a confirmation that the necessary changes have been made and a new report rescoring the consumer's credit information can be requested.

This service is provided by the affiliates of the repositories to try to enable a rapid rescoring of data for consumers applying for home loans.

Your credit reporting company may or may not participate in this new process, if not, have them find out how they may provide this service to you the broker, for a fee, so that you might better assist your consumers with their loan process. If not, you might call other reporting companies in your area until you locate one who is participating.

Generally, the reporting company will need to know what the error is, why it is an error, and proof of what the correction is that should be made. For example:

- Copies of bankruptcy papers, copies of lien releases, paid receipts, copies of HUD-1s with a copy of the payoff demand, letters from the particular tradeline on tradeline letterhead specifically stating the how the information they have reported is to be changed. **Arbitrary dosen't work here, specific information is needed.**
- Be sure to note on collection accounts or bankruptcy corrections, that the last date of activity column shows the date the collection was paid off or the bankruptcy was discharged with "0" balances. Anything else will drive the scores down not up.

The broker's credit reporting company verifies the information, then has their contact at the repository re-verify the information. The contact then physically changes the raw data at the repository via computer, installs a buffer against future tape update changes and confirms the change is in place.

The broker can now run a new credit report and you will have new scores, assuming there are no other changes in data. When significant errors are removed scores have been increasing on an average of 50 points. and in some cases over 100 points.

The cost runs anywhere from \$75.00 to approximately \$300.00, depending on how many errors need correcting and whether the report is joint or individual.