Overview of Credit Scoring

Overview of Credit Scoring

This session will focus on providing you with both information about this topic as well as new ideas and activities for making this topic engaging.

Specifically, as a result of this session, you will be able to:

- Define credit scoring.
- Explain the rationale for credit scoring.
- Describe the reasons credit scoring is so confusing for most people.
- Explain the composition of the FICO score.
- Describe consumer actions that make credit scores go up and down.
- List the steps for improving credit scores.

Is “credit scoring” an important topic to address in financial education for AFI Participants? YES NO

What are some reasons for or against including this topic your financial education program?

____

____

____

____

- ❑ As people to talk at their tables the reasons they think people are confused about credit scoring.
- ❑ Go through presentation.
- ❑ Provide each person with a stack of cards and tally sheet.
- ❑ Have them in pairs, read through the cards one at time and record what is happening with their credit score.
- ❑ Ask people to share what they learned in large group following the simulation.

Credit Scores

Table Talk

With other members of your table, list the reasons credit scoring is so confusing for people in general.

What is a credit score?

What are credit scores supposed to predict?

In most credit scoring models, a high number or credit score represents a low estimated risk to lenders. In other words, people with higher credit scores are supposed to be less likely to miss a loan payment than people with lower credit scores. Based on a scale that runs from 300 to 850, if an individual has a FICO score of 600 or below, he/she has a 50 percent chance of being seriously delinquent during the next two years. By contrast, individuals with a FICO score greater than 701 have a less than five percent chance of being seriously delinquent.[1] According to Fair Isaac Corporation, the median credit score in the U.S. has been 723.

The companies that produce credit scores use different credit scoring models. As a result, an individual may have different credit scores from different credit score producers. That same individual may also have multiple scores from the same credit score producer. For example, FICO scores are based on information provided by the three main credit reporting agencies, and different information from these agencies can result in different FICO scores. The information provided by each of the credit reporting agencies is likely to be different because not all creditors report to all three credit reporting agencies and the agencies do not share information. Therefore, entire credit accounts may be missing from one credit report but present on the other two, for example.

In general, if lenders are looking at all three FICO scores (a credit score derived from each of the three credit reporting agencies), they will consider the middle score. But lenders may be looking at a completely different credit score or set of scores than the individual because there are so many.

In addition to the credit scores people generally know about, the credit scoring industry has specific products to serve defined market segments. For example FICO and Equifax have developed a FICO Mortgage Industry Score that is supposed to be a 25 percent improvement on assessing mortgage repayment risk. There is also a FICO Expansion Score, which is designed to predict credit risk for people that do not have enough credit history from which to generate a traditional credit score.

What are credit scores used by lenders?

[1] Avery, Robert B, Calem, Paul S. and Canner, Glenn B. of the Board's Division of Research and Statistics. *Credit Report Accuracy and Access to Credit.* Summer 2004. Federal Reserve Bulletin.

Who Makes Credit Scores

Fair Isaac Corporation is widely regarded as the dominant business in the credit scoring industry. In general, an individual has three FICO scores based on the information provided by each of the three major credit reporting agencies—Equifax, Experian and TransUnion. Each score is based on one of the credit history files the credit reporting agency maintains.

In addition to a FICO score based on the data from the three credit reporting agencies, each of the agencies also offers its own credit scores. These are generally based on different ranges than the FICO score and can be purchased directly from the reporting agencies. For example, **Experian sells the PLUS credit score** and **TransUnion sells the True Credit score**. Neither the PLUS score nor the True Credit scores are connected in anyway with Fair Isaac Corporation.

In 2006, the three major credit reporting agencies through a joint venture developed a new credit score to compete with FICO called the **VantageScore.** Currently, it is unclear whether lenders will abandon the long used FICO score in favor of this new model. The differences between FICO and VantageScore are discussed further below.

Why Credit Scores Matter

Who uses credit scores?

If an individual needs to borrow money, his credit score will likely determine whether he is approved for the credit and the rate he will pay to borrow the money. As such, a credit score provides access to credit and sets the price of the credit in tandem with the prime rate, which is based on the fed funds rate.

The following example, based on the calculator on the myfico.com website, shows the impact different credit score ranges can have on the cost of funds to a consumer. The table below is based on a $100,000 fixed, 30-year loan.

Credit Score Range	APR	Monthly Payment	Amount of Interest Paid over the Life of the Loan
720-850	5.299%	$555	$ 99,887
700-719	5.424%	$563	$102,691
675-699	5.962%	$597	$114,959
620-674	7.112%	$673	$142,223
560-619	Generally not eligible for credit or a loan		
500-559			

An individual with a credit score of 670 would pay 42 percent more interest than an individual with a 735 credit score, for example.

While the lending industry has historically been the biggest user of credit scoring, other industries have also started using credit scores as a short cut to making risk assessments and decisions. For example, insurance agencies have other scoring models to assess customer risk, but also use credit scores to help paint the full risk assessment picture of a potential customer. In general, lower credit scores result in higher rates for coverage or even possibly denial of coverage.

Like insurers and creditors, property owners are increasingly using credit scores to assess quickly the risks of renting to a particular individual or family. Bankruptcy (as reported on credit reports) used to be seen as the primary credit-related barrier to renting a place to live. Now, credit scores can also factor into the decision.

Finally, utility companies that require consumer deposits are using credit scores to help determine deposit levels for consumers. The lower the credit score, the higher the deposit because of the perceived risk that the individual with lower credit scores is likely to be late or even miss payments.

What is Included in Credit Scores

The simple answer to what is in a credit score is "it depends on the credit score." Each business that generates a credit score uses its own set of information, and one business may have information than another does not have. This is why it is so important for AFI project staff to obtain credit scores from the same agency if they are planning to use the scores to assess changes in their participants' economic circumstances.

In general, most credit scoring models take into account an individual's:

- Credit repayment history
- Balances on credit
- Rate at which they are using credit versus the amount of credit they have available to them
- Depth of credit history
- Length of credit history

However, different models assign different weights to certain types of information. This section compares FICO scores to VantageScore.

FICO

FICO scores are currently the most widely used by lenders. FICO scores range from 300 to 850 with the higher scores seen as more positive. The scores use five data categories to generate an individual's scores. The five categories include: [2]

- **Payment history**, which shows an individual's track record paying back their debt. This data category accounts for 35 percent of the FICO score and is based on the following questions:
    - Has the individual paid their obligations on time?
    - How often does the individual pay late?
    - How late is the individual?
    - How much has the individual been delinquent with in the past?

  Late payments especially habitual late payments indicate a higher level of risk in the scoring model.

- **Amounts owed**, which includes the debt an individual currently owes and how much available credit the individual is using (also called the credit utilization rate). This data category accounts for 30 percent of the FICO score and is based on the following questions:
    - On all of an individual's credit sources, how much debt is she carrying?
    - What is the individual's credit utilization rate? How much credit is an individual using in relation to her credit limit?

  High credit utilization rates are associated with higher levels of risk for lenders because they mean the individual has tapped all or a greater percentage of his available credit.

[2] Giuffrida, Inger. 2008. Financial Health Increases Your Wealth. Developed for Citizen Potawatomi Nation.

- **Length of credit history**, which is the length of time for which an individual has had credit. This data category accounts for 15 percent of the FICO score and is based on the question:
  - How long has an individual had credit?

  The longer the credit history, the more information the model has from which to derive a score.

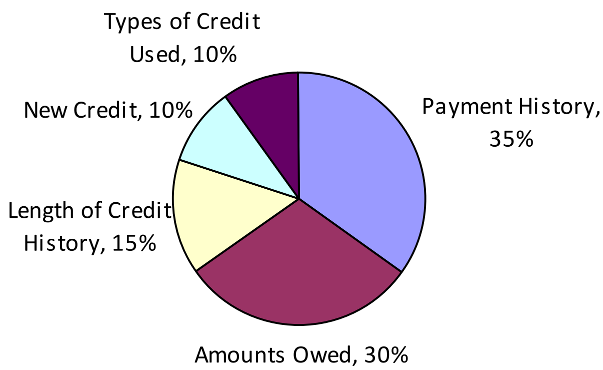
- **New credit**, which is used to determine whether an individual has recently opened credit to catch up or cover budget shortfalls. This data category accounts for 10 percent of the score and is based on the following questions:
  - Has the individual opened any new credit lines recently?
  - What kind and for how much?
  - Has the individual been trying to get more credit (as indicated by inquiries)?

  Attempts to open large numbers of new accounts may signal that a person is becoming over-extended.

- **Types of credit used**, which shows whether an individual can handle diverse types of credit successfully. This data category accounts for 10 percent of the score and answers the following questions:
  - How many credit or department store charge cards does the individual have?
  - How many auto loans?
  - Does he have any mortgages or student loans?
  - Can he manage multiple types of credit?

The chart below shows the weight given to each of these factors in the determining the overall FICO score.

Factors Determining FICO Scores



Source: www.myFICO.com

VantageScore

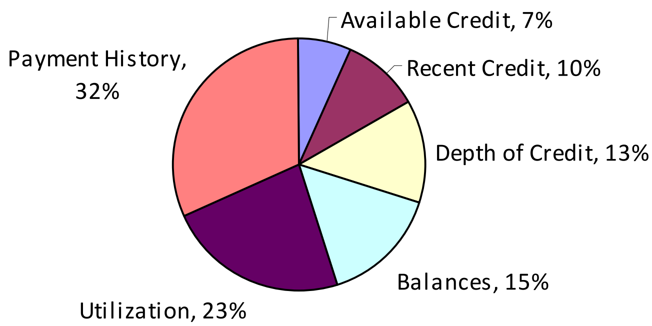
Developed as a joint venture among the three major credit reporting agencies, VantageScore was launched in 2006. Rather than the 300-850 credit score range used by FICO, the VantageScore range is 501-990. Ranges within the VantageScore range are also assigned a letter grade A through F.

The VantageScore is based on six data categories:

- **Payment History:** Repayment behavior.
- **Utilization:** Percentage of credit amount used and owed on accounts.
- **Balances:** Amount of recently reported balances (current and delinquent).
- **Depth of Credit:** Length of credit history and types of credit.
- **Recent Credit:** Number of recently opened credit accounts and credit inquiries.
- **Available Credit:** Amount of credit available.

The chart below shows the weight given to each of these factors in the determining the score. At this point, it is unclear how widely used the VantageScore will become.

Factors Determining VantageScore Scores



Source: http://www.vantagescore.com/about/vantagescore_model

What is Not Included in Credit Scores
While there are many pieces of data and information about an individual that go into calculating his/her credit score, there are some things that cannot be included. The Equal Credit Opportunity Act prohibits the following items from being used in determining an individual's credit score:

- Race
- Color
- Religion
- National Origin
- Sex
- Marital status[3]
- Receipt of public assistance
- Whether the individual has "exercised any consumer right under the Consumer Credit Protection Act"

In addition, FICO specifically does not include an individual's age, salary, occupation, title or employer, employment history, and place of residence. FICO also does not consider interest rates being charged on credit accounts, child or family support obligations or rental agreements, or whether the individual is participating in credit counseling.

FICO also does not count certain inquiries against a person's credit, including:

[3] Consumer Federation of American and Fair Isaac Corporation. *Your Credit Scores.* Federal Citizen Information Center. http://www.pueblo.gsa.gov/cic_text/money/creditscores/your.htm

* Inquiries made by the consumer to check her credit report
* Inquiries made by lenders and other businesses to make offers such pre-approved credit offices
* Inquiries that are considered administrative.[4]

In general, FICO does not use any information that is not found on a credit report produced by one of the three major credit bureaus. Other credit scoring models may consider some of these factors even though Fair Isaac Corporation does not.

How Consumer Actions Impact Credit Scores

Credit scores are not static. They change regularly because consumer actions change regularly, and these changes result in updates to the credit score.

There are many consumer actions that impact credit scores. As outlined above, increasing credit utilization rates and not paying bills as agreed can cause credit scores to drop.

Closing credit accounts can also cause scores to drop for two reasons. First, if participants close their oldest accounts that have been inactive (e.g., a credit card opened at 18 years of age, but not used much in the last ten year), this causes a shortening of the length of credit history, which may cause a drop in credit scores. Second, closing accounts that have unused balances can cause the overall credit utilization rate to increase.

When consumers generate inquiries to their credit reports because they are shopping for credit, this may cause a drop in the credit score. However, if someone is rate shopping for particular kind of credit—looking for a car loan or shopping for a mortgage—all inquiries generated by the consumer within a 30-day period in a particular credit category are counted as one inquiry and will not adversely affect credit scores. This is a change in credit scoring models brought about by innovations in financial services that made rate shopping easy for consumers.[5] Inquiries generated by the consumer for credit cards, department store cards, and other forms of revolving credit will likely negatively impact the credit scores for each occurrence.

[4] www.myfico.com
[5] www.myfico.com

The Role of Credit Reports in Credit Scoring

For FICO and VantageScore credit scores, the information used to develop the credit score comes from the credit reports. In fact, FICO specifically states that all of the information it uses to derive consumer credit scores comes from the credit reports generated by Equifax, TransUnion, or Experian.

Therefore, one of the most important issues for addressing credit scores is ensuring the credit reports from which they are generated are in fact accurate. It is estimated that 79 percent of all credit reports may contain some kind of error and that 25 percent contain errors that actually result in a denial of credit.[6]

Getting and reviewing all three credit reports with AFI participants is the first step in improving credit scores for AFI participants. This is covered in detail in the next section.

Strategies for Helping Participants Improve Their Credit Scores[7]

Because so many decisions are based on credit scores, AFI participants will want to know what they can do to improve their own scores. Unfortunately, there are no easy answers or quick fixes in most circumstances when it comes to improving credit scores.

The first step involves getting information. Participants should get their credit reports from all three credit reporting agencies and review them for accuracy. Participants should be encouraged to get their annual free credit reports (one from each of three major credit reporting agencies—Equifax, TransUnion and Experian—as established by the Fair and Accurate Credit Transactions Act. There are three options for doing this:

Option 1 www.annualcreditreport.com
Instruct participants to go to this site or go through www.ftc.gov to get to the correct website for the free annual reports. There are many sites that claim to be the site for "the annual credit report." These other sites always end up charging the individual.

Option 2 Call 1-877-322-8228

Option 3 Write to:
Annual Credit Report Request Service
P.O. Box 105281
Atlanta, GA 30348-5281

---

[6] Avery, Robert B, Calem, Paul S. and Canner, Glenn B. of the Board's Division of Research and Statistics. *Credit Report Accuracy and Access to Credit.* Summer 2004. Federal Reserve Bulletin.
[7]Giuffrida, Inger. 2008. Financial Health Increases Your Wealth. Developed for Citizen Potawatomi Nation.

If an error is found, participants should submit letters of dispute to correct these errors directly to the credit reporting agencies. Each credit reporting agency has an online process for submitting letters of dispute. Encourage participants to print off copies of anything they submit electronically for their records. They can also call each credit reporting agency or write to them directly using the information that follows.

Equifax PO Box 740241 Atlanta, GA 30374-0241 1-800-685-1111 www.equifax.com	**TransUnion** PO Box 1000 Chester, PA 19022 1-800-916-8800 www.transunion.com	**Experian** PO Box 2002 Allen, TX 75013 1-888-397-3742 www.experian.com

Second, AFI participants should be encouraged to get their FICO scores. This is available at www.myfico.com. Consumers can get their Equifax FICO score or TransUnion FICO score for $15.95 each. The Experian FICO score is no longer sold directly to consumers. The VantageScore is available at www.vantagescore.com for $5.95. Credit scores can also be ordered directly from credit bureaus. Those sold directly from the credit bureaus may not be FICO scores. For more information on ordering credit scores, see appendix to this paper.

Thirdly, participants should be assisted in setting up systems to pay all bills on time. Paying all bills as agreed will have the biggest impact their credit score since 35 percent of the FICO score is comprised of their bill paying track record. This is more important than dealing with an account in collections from the perspective of credit scores. Getting current if payments have been missed and staying current with accounts is a key to improving and maintaining higher credit scores.

The fourth step is for participants to focus on is paying down debt balances. This has to do with getting the amount of total outstanding debt lower and getting the credit utilization rate into a range that does not negatively impact the credit score. Historically, consumers were told to keep their credit utilization rates in the 50 percent range. Most experts now agree that 30 percent is likely to be the rate to target to prevent negative impacts on credit scores.

This issue has been complicated during the economic crisis. FICO estimated that at least 30 million Americans had their credit limits arbitrarily reduced during the second half of 2008.[8] The decrease in credit limits for consumers is a result of financial institutions' desire to limit their risk during this economic recession. In many cases, credit utilization rates literally changed overnight for customers even though there was no change in their behaviors.

Following is an example based on a hypothetical consumer, David. As shown in the table below, David's credit utilization rate increased from 22 percent to 53 percent as a result of the

[8] Leondis, Alexis. July 5, 2009. *FICO Scored Show Flaws as U.S. Banks Cut Credit Lines*. Bloomberg.com.

adjustment to credit limits, even though there was no change in his behavior. The increase in credit utilization could ultimately lead to a decline in David's credit score and an increase in the cost of any credit he seeks in the future.

David's Credit Utilization Rate *Before* Adjustment to Credit Limits			
Credit	**Balance**	**Limit**	**Utilization Rate**
VISA Card	$5,425	$25,000	22%
Discover Card	$4,026	$15,000	27%
Target Card	$ 527	$5,000	11%
Total	**$9,978**	**$45,000**	**22%**
David's Credit Utilization Rate *After* Adjustment to Credit Limits			
Credit	**Balance**	**Limit**	**Utilization Rate**
VISA Card	$5,425	$10,000	54%
Discover Card	$4,026	$7,000	58%
Target Card	$ 527	$2,000	26%
Total	**$9,978**	**$19,000**	**53%**

For credit scoring purposes only, consumers should pay down debts where the credit utilization rate is highest first even if the interest rate on that debt is not the highest among the debts owed. This goes against conventional advice given to customers about paying down debt. Some financial advisors recommend paying down the debt with the highest interest rate first. This, obviously, saves the consumer money. If the consumer is not likely to need to use his credit score within the next one to two years, getting rid of the most costly debt still makes the most sense.

Generally, it is advisable for consumers to keep credit accounts open even if they do not use them or carry balances on them. This impacts both length of credit history and credit utilization rate. **Before dispensing this advice to participants, however, AFI staff need be sure they understand and convey the risks of having unused available credit.** For participants who have had a very challenging time with credit, it may be better for them to take a hit on their credit score as opposed to having the opportunity to easily accumulate another mountain of debt.

For the same reasons, participants should generally be advised against opening credit cards just to increase their available credit. In the end, this strategy could create more problems for participants and cause their credit scores to decline.

Achieving the Vision Questions for Reflection and Action

How does this section of information on *credit scoring* help you build next level financial education for your clients? Specifically, how does it help you help them to potentially:

- **Achieve or retain economic security**

Building the Bridge

In the first financial education training of trainers, you learned about building the bridge for clients with financial education. How does this section of information help you build a **financial education bridge** for your clients? Specifically, how does it help you:

- **Choose topics**
- **Develop an approach**
- **Provide support**
- **Create an environment that helps clients succeed**