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THE ULTIMATE GUIDE TO

Understanding Credit Scoring

www.datafacts.com

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Close **MORE**. Close **FASTER**. Close **EASIER**

The Basics Of Credit Scoring

Q. What is a Credit Score?
A. It is a score given to an individual to determine their credit worthiness.

Before, we can even begin to explain what a score is, we need to understand WHY we have credit scores in the first place.

Before the 1950's lenders used to physically look over each applicants credit report and credit history to determine whether or not they were going to extend credit. This process was time consuming and resulted in many mistakes.

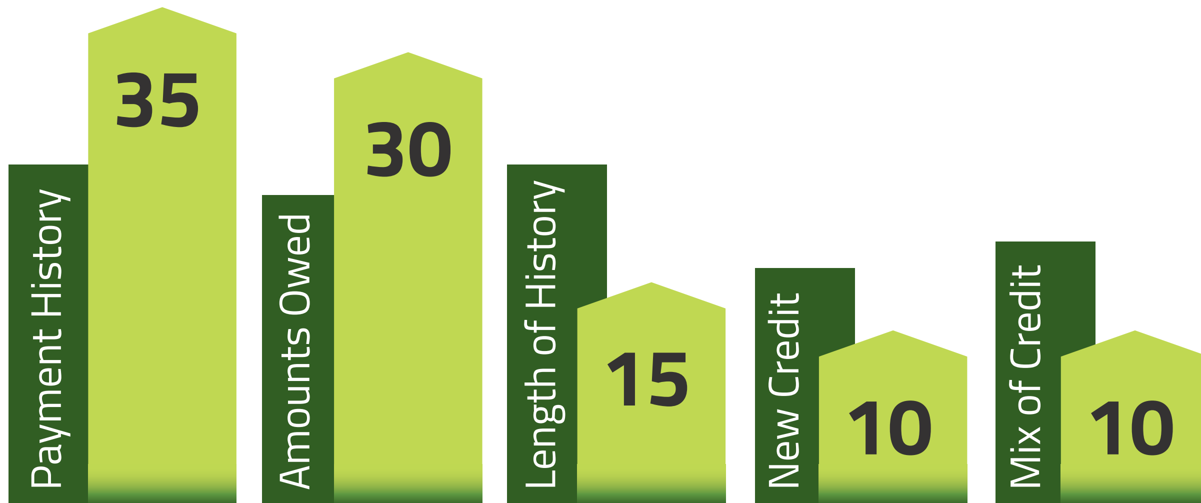
As a result, credit scoring formulas were created to help lenders make better judgments, quicker and easier.

Q: Why is my Credit Score Important?
A: Credit Scores are very powerful predictors of consumers future bill paying performance.

Today scores are requested by Insurance Companies, Cell phone providers, utilities, landlords, and even prospective employers.

It is used in 75% of mortgage lending decisions and by 90% of the largest US lenders.

5 Factors That Make Up A Credit Score



35%: PAYMENT HISTORY

If you pay your bills on time, you gain lots of points on your credit score. If you are late on your payments, then your score drops.The scoring model looks at your delinquencies for Recency, Severity, and Frequency. The more recent a late pay, the more it is affecting your score. The more severe, the more the late affects your score (a 60 date late hurts your score more than a 30 day late, for example). And Frequency. One late will not hurt your score as much as 3 or 4 lates in a short time period. So remember to keep those payments current.

30% AMOUNTS OWED

This includes the amounts owed on your accounts, the number of accounts with balances, and the proportion of credit lines used.

If you run up your credit cards to over 30% of their limit, you can begin to see your credit scores drop, even if you are making your payments on time.

So, keep those balances low.

5 Factors That Make Up A Credit Score
(Continued)

15% LENGTH OF CREDIT HISTORY

The scoring model likes a credit history of 30 years.

It looks at the time since accounts were opened, and the time since there was activity on the account. (Remember an account must have been used in the last 6 months for it to count toward your credit score, inactive accounts are not included).

So if you have a credit card that you have had for years, use it every now and then to keep that credit history calculated into your credit score.

10% NEW CREDIT

Are you taking on new debt?

The model looks at the number of recently opened accounts, the proportion of accounts that are recently opened, and the number of recent inquiries.

If you open too many accounts in too short of a time period, this may decrease your credit score.

10% MIX OF CREDIT

The model likes a mix of different types of credit accounts such as Credit Cards, Retail Accounts, Installment loans, and mortgage.

REMEMBER: A FICO® Score takes into consideration all these categories of information, not just one or two. No one piece of information or factor alone will determine your score.

How Rate Shopping Affects Credit Scoring

Because a mortgage is a major purchase, the bureaus allow a window of time for borrowers to "rate shop" and have their credit pulled multiple times without it affecting their credit score.

Looking for a mortgage or an auto loan may cause multiple lenders to request your credit report, even though you are only looking for one loan.

To compensate for this, the score ignores all mortgage and auto inquiries made in the 30 days prior to scoring. So if you find a loan within 30 days, the inquiries won't affect your score while you're rate shopping.

In addition, the score looks on your credit report for auto or mortgage inquiries older than 30 days. If it finds some, it counts all those inquiries that fall in a typical shopping period as just one inquiry when determining your score.

For FICO® scores calculated from older versions of the scoring formula, this shopping period is any 14 day span. For FICO® scores calculated from the newest versions of the scoring formula, this shopping period is any 45 day span. Each lender chooses which version of the FICO® scoring formula it wants the credit reporting agency to use to calculate your FICO® score.

That being said, I would always go with 14 days as you don't know which scoring formula your particular lender is using.

How Late Payments Affect Credit Scoring

Whatever you do... pay your bills on time. 35% of your credit score is made up of payment history. This is the single most important way to help ensure a higher credit score.

SO HOW BAD DO LATE PAYMENTS HURT?

Experian's National Score Index study showed that the average credit score for U.S. consumers with no late auto payments is nearly 100 points higher than those who have at least one late payment. The national average credit score for consumers with no late auto payments is 703, while the average score for consumers with at least one late payment is 605.

Source: **www.experian.com**

COLLECTIONS

Dealing with old collections as a means to raise someone's credit score can actually have a negative impact on a person's credit score. This is because it will bring the "DLA" current, and the impact of that collection will be felt all over again.

Every month that passes after an account goes into collection is creating new history and that collection is moving further away from the present.

If you have a collection that is 12 months old, that account is not affecting your score nearly as much as it was 11 months ago. When you pay it off, the new DLA is this month bringing your score down. This is one of the biggest mistakes people make.They want to buy a house, they try to clean up their credit by paying off some collections, and when they come into their lender their scores are 100 points lower!!

Therefore, the proper time to deal with collections is as at closing, if possible.

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Common Credit Myths:

True, False or Maybe?

STATEMENT #1

Negative Information On My Credit Report Will Eventually Fall Off.

TRUE

1. Late payments: 7 years
2. Bankruptcies: 7 years for completed Chapter 13 and 10 years for Chapter 7
3. Foreclosures: 7 years
4. Collections: Generally, about 7 years, depending on the age of the debt being collected.
5. Public Record: Generally 7 years, although unpaid tax liens can remain indefinitely.

STATEMENT #2

Enrolling In A Debt Counseling Service Will Not Help Me Increase My Score

TRUE

The actions you take based on the recommendations of a credit counselor may sometimes affect your score. For example, choosing to make PARTIAL payments or agreeing to SETTLE FOR LESS than the full amount on accounts may be regarded negatively by the FICO® scoring model. Additionally, any LATE payments occurring either before or after you began the plan may also be regarded negatively.

Common Credit Myths:

True, False or Maybe?

STATEMENT #3

It Is Good To Close As Many Accounts As Possible To Get Your Score Higher

FALSE

Your FICO® score takes into consideration something called a "credit utilization ratio". This ratio basically looks at your total used credit in relation to your total available credit; the higher this ratio is, the more it can negatively affect your FICO® score. So, by closing an old or unused card, you are essentially wiping away some of your available credit and there by increasing your credit utilization ratio.

STATEMENT #4

Will My Fico Score Drop If I Apply For "New" Credit?

MAYBE

It depends on the inquiry type. Most credit scores are not affectedby multiple inquiries from auto, mortgageor student loan lenders within a short period of time. Typically, these are treated as a single inquiry and will have little impact on the credit score. However, if you apply for several credit cards within a short period of time, multiple inquiries will appear on your report. Looking for newcredit can equate with higherrisk which could drop a score.

Common Credit Myths:
True, False or Maybe?

STATEMENT #5

A Poor Score Will Haunt Me Forever!

FALSE

A score is a "snapshot" of your risk at a particular point in time. It changes as new information is added to your bank and credit bureau files. Scores change gradually as you change the way you handle credit. For example, past credit problems impact your score less as time passes. Therefore by taking the time to improve your score, you can qualify for lower interest rates.

Types Of Credit Scoring: FICO

HOW FICO® SCORES WORK

FICO® Scores are the best-known and most widely used credit scores. Most credit scores used in the US and Canada are produced from software developed by FICO®. FICO® Scores are provided to lenders by the three major credit reporting agencies: Equifax, Experian and TransUnion.

When lenders order a credit report, they can also buy a FICO® Score that is based on the information in the report. That FICO® Score is calculated by a mathematical equation that evaluates many types of information from your credit report at that agency. By comparing this information to the patterns in hundreds of thousands of past credit reports, the FICO® Score estimates your level of future credit risk.

In order for a FICO® Score to be calculated on your credit report, the report must contain enough information—and enough recent information—on which to base a score. Generally, that means you must have at least one account that has been open for six months or longer, and at least one account that has been reported to the credit reporting agency within the last six months.

FICO® Scores provide a reliable guide to future risk based solely on credit report data. FICO® Scores have a 300–850 score range. The higher the score, the lower the risk. But no score says whether a specific individual will be a "good" or "bad" customer. And while many lenders use FICO® 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.

Source: **www.myfico.com**

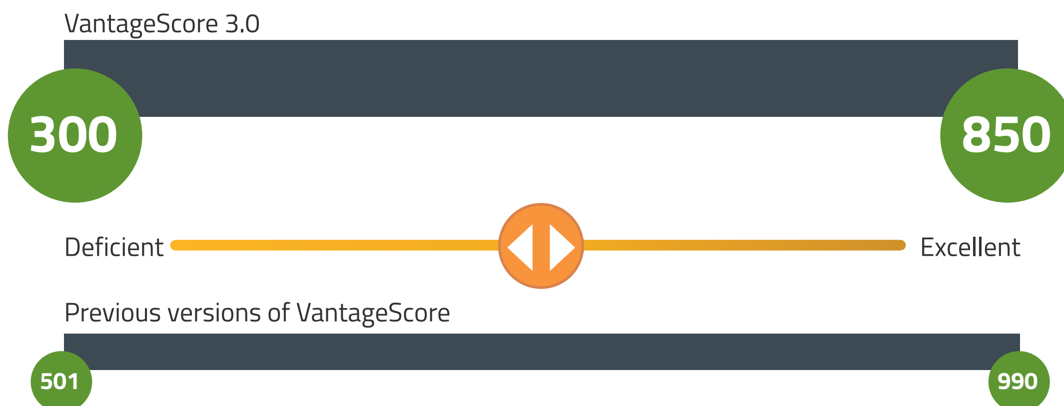
Types Of Credit Scoring: Vantage

HOW VANTAGE SCORES WORK

FICO's only direct competition, but it hasn't picked up much steam and is currently only being used in less than 10% of lending evaluations.

The Vantage score is a generic credit score formula that was created by all 3 credit reporting agencies as an easier way for consumers to better understand their credit score, and to try to evaluate certain consumers better than the fico scoring model.

It has a score range from 300-990 and offers a letter grade to go along with each numerical score. It is based on 6 different pieces of information, slightly different than FICO and Authorized-user credit cards are not included in the VantageScore.



Consumers can also purchase a copy of their vantage score. By purchasing this type of credit score, a consumer can have a score that would vary greatly from say a FICO Mortgage score because the numerical range is significantly different. You could have a 700 Vantage score—which sounds good to a consumer, but is considered a non prime score when compared to a FICO score.

Types Of Credit Scoring: Industry Option Scores

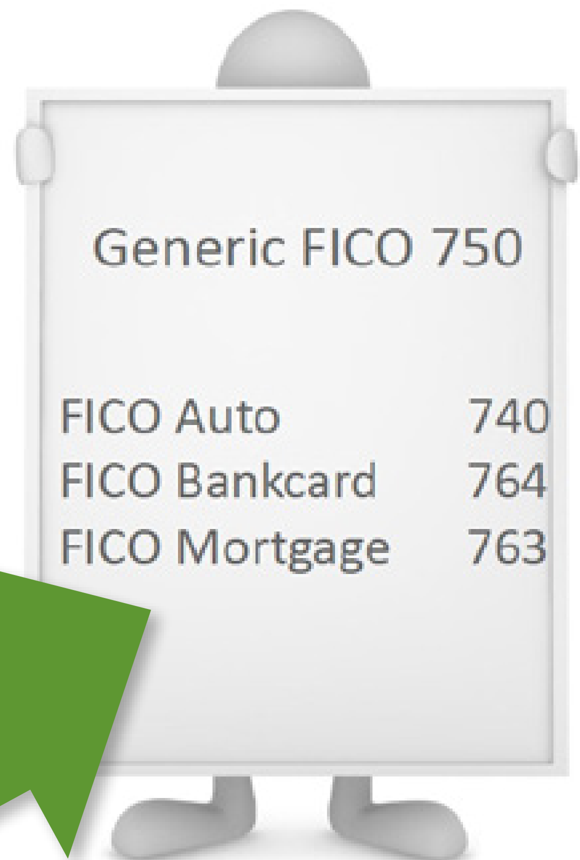
HOW FICO® INDUSTRY OPTION SCORES WORK

These scores use the standard FICO score as a foundation and then adjusts that score up or downbased on the consumer's credit risk for a specific type of loan.

The industry option FICO scores are not currently available for retail sale to consumers.However, with the new Risk Based Pricing Rules and the implementation of the Fair Access to Credit Scores Act this past July 2011 that requires adverse action letters sent to every consumer denied, now consumers will be able to see these actual scores that were used when they applied for credit.

Here are some sample questions an Industry Option score may focus on more heavily when adjusting the custom score.

So, for example, if my FICO score is 750 but I've managed my previous mortgage loans very responsibly it is likely that my mortgage score will be slightly higher. This is because I actually pose less risk to mortgage lenders because I've exhibited that I can manage mortgage debt based on previous experience



An example of what the different FICO scores may look like. As you can see the scores are quite similar, but they won't be **EXACTLY** the same, based on the slightly different industry specific components used in calculating each one.

A Discussion About Scorecards

Designers of the credit scoring model reviewed a set of consumers - over a million - who opened loans at the same time, and determined who paid their loan and who did not.

The credit profiles of the consumers who defaulted on the loans were examined to identify common variables they exhibited at the time they applied for the loan. The designers then built statistical models that assigned weights to each variable, and these variables are combined to create a credit score. Loan Model builders strive to identify the best set of variables from a consumer's / past credit history that most effectively predicts future credit behavior.

In determining credit scores, consumers are placed in a risk category that compares you to a large number of consumers with similar credit histories. This allows lenders to compare "apples to apples," ensuring that your credit behavior is judged in a context that is relevant and fair.

For example, consumers with brief credit histories and only a few accounts are not compared to consumers with long-established credit histories. Rather, these consumers will be compared to other consumers who also have brief credit histories.

These categories are called 'score cards'. The premise for separating consumers out this way is to optimize the model's performance for all different consumer credit file types. If the credit scoring model just had one scorecard then it would likely do well for one group of consumers and perform substandard for all others. That's not a good credit scoring system. The better the developer is at defining a unique population, the more accurately predictive the credit score becomes. Currently the FICO scoring system has 10 scorecards and 12 (for FICO 08).

Components Of A Scorecard

THE FOLLOWING THREE COMPONENTS ALL RESIDE WITHIN THE SCORECARDS.

#1 Characteristics: A characteristic is simply a question the model asks your credit report. Each scorecard has a different set of characteristics, but many of the same characteristics reside across multiple scorecards. The model developer will not disclose all of their characteristics but we do know some of them and we do know that there are thousands of possible characteristics to choose from when building a scoring model.

#2 Variables: – If the characteristic is best described as a "question" then the variable is best described as "the answer."

#3 Weights: This is where your final score is going to start coming together. The weight is the point value given to your variable. You can either receive points for your variables, or you can lose points. The point values will be different in different scorecards. (so, in this example, 2 inquiries will effect some scorecards more negatively than others. On some scorecards, you may actually gain points for only 2 inquiries).

Examples Of Components 1

Characteristic
How many inquiries had you had in the last 6 months?

Variable
I have had 2 inquiries in the past 6 months

Weight
2 inquiries = Set number of points

Examples Of Components 2

Characteristic
What is your revolving utilization?

Variable
My revolving utilization is 60%

Weight
60% utilization = set number of points

Examples Of Components 3

Characteristic
How old is your oldest account?

Variable
My oldest account is 18 years old

Weight
18 years of credit history=set number of points

REMINDER - The components affect a consumer differently, depending on the score card on which they live.

Credit Scorecard Hopping

Certain changes to your credit report can cause you to ‘move’ scorecards. This is called a scorecard hop. Sometimes this move helps your credit score, and sometimes it causes your score to decrease. Remember, it’s all about being compared to the other people on that scorecard, and how they manage their credit.

Sometimes the reasons for a scorecard hop are very subtle. Other reasons for a scorecard hop are: This list is not exhaustive, since all the scorecards are not divulged.

Here are a few examples of reasons to scorecard hop:

1. Filing Bankruptcy
2. Having a collection hit a clean report
3. One of your credit card reaching a certain age

How Delinquencies Affect The Credit Score

FICO, recently shed light on how much impact mortgage delinquencies, short sales and foreclosures have on consumer credit scores and how long it may take a credit score to recover.

As the most widely used credit standard in the financial industry and as well as a heavily guarded secret, this release of information from the study was a great insight. The study focused on 3 credit profiles whose credit characteristics, such as utilization, delinquency, history, and age of file, were typical of the 3 score points considered.

The next chart shows FICO's findings on the impact to credit scores following delinquencies:

	Consumer A	Consumer B	Consumer C
Starting FICO Score	620	720	780
FICO score after these events			
30 days late on Mortgage	600-620	630-650	670-690
90 days late on Mortgage	600-620	610-630	650-670
Short Sale/Deed-in Lieu/Settlement (No deficiency balance)	610-620	605-625	655-675
Short Sale (with deficiency balance)	575-595	570-590	620-640
Foreclosure	575-595	570-590	620-640
Bankruptcy	530-550	525-545	525-545

**Estimates assume all else held consistent over time (e.g. no new account openings, no new delinquencies, similar outstanding debt).*

As you can see Consumer A has a beginning FICO score of 620 while Consumer C has a beginning score of 780. If consumer A is 30 days late on their mortgage, their score may not be affected at all, However consumer C's 30 day mortgage late has a significant impact. They could lose almost 100 points.

Continued on Next Page

How Delinquencies Affect The Credit Score

When consumer A has a bankruptcy, their score drops a little over 100 points to a 530, while Consumer C's score drops over 240 points to a 540.

You will also notice, if a person has a short sale on their home, their credit score is affected just the same as someone who has a deed of lieu or settlement and a short sale with a deficiency balance (which many of them have) actually affects a person's credit score just the same a foreclosure.This is important insight because at one time not too many years ago, we were thought to believe short sales.

The next chart shows the estimated time it will take for your FICO score to fully recover:

Now lets take a look at a table that an estimated timeline for how long it will take for the credit scores to recover to pre-delinquent status:

In general, the higher the credit score, the longer it takes for the credit score to fully recover (As you can see a short sale even without a deficiency balance will take the same amount of time as a foreclosure for the score to recover.)

	Consumer A	Consumer B	Consumer C
Starting FICO Score	620	720	780
FICO score after these events			
30 days late on Mortgage	9 months	2.5 years	3 years
90 days late on Mortgage	9 months	3 years	7 years
Short Sale/Deed-in Lieu/Settlement (No deficiency balance)	3 years	7 years	7 years
Short Sale (with deficiency balance)	3 years	7 years	7 years
Foreclosure	3 years	7 years	7 years
Bankruptcy	5 years	7-10 years	7-10 years

**Estimates assume all else held consistent over time (e.g. no new account openings, no new delinquencies, similar outstanding debt).*

FICO 9.0

Great New Features, but Currently Not Available For Mortgage Lending

FICO, the nation's most popular credit-scoring system, released the news about its latest credit scoring model, FICO® 9.0. While the media was all a-buzz with the potential "improvements" associated with the expected changes to the new scoring model, it is important to note that this will take time for mortgage consumers to experience its impact.

FICO® stated the expected changes will likely go into effect this fall, however, as noted in numerous articles, it takes time for lenders to incorporate new score models into their underwriting. However, many of the comments seen over the past few days have shown a belief this time will be different, and mortgage consumers will experience these changes immediately.

The mortgage lending market changes only as quickly as Fannie Mae/Freddie Mac and HUD allow underwriting changes, and that has historically been very slow. Since these agencies dictate which credit score models are accepted, it could realistically be years before they are implemented. The current score models required by Fannie/Freddie/HUD are: Equifax Beacon® 5.0; Experian®/Fair Isaac Risk Model V2SM; and TransUnion FICO® Risk Score, Classic 04.

Each of these score models have been replaced by two to three generations of credit scores by both FICO® and the credit score model owned by the three national credit bureaus, VantageScore. The current models required for mortgage lending are based on consumer spending habits from the 2004 – 2005 pre-financial crisis era, which has very distinct differences from the post-financial crisis consumer spending patterns of today.

So what are the upcoming FICO® 9.0 changes?

Reducing the toll that overdue medical bills can take on credit scores, as well as removing other past penalties from consumers who have paid off debts that had been assigned to collection agencies. A consumer whose only major delinquency comes from an unpaid medical bill could see their credit score rise by 25 points due to the changes.

FICO 9.0

Great New Features, but Currently Not Available For Mortgage Lending

The changes come after a recent Consumer Financial Protection Bureau study, which found that both paid and unpaid medical debts were unfairly penalizing consumers' credit ratings. An estimated 64 million Americans have a medical collection item on their credit reports!

These are long past due, much needed, changes to the FICO® scoring model. These enhancements will more accurately score consumers on their credit worthiness, but unfortunately this will take time to be fully implemented into the mortgage industry underwriting guidelines.

NCRA released a whitepaper on this issue and they believe, "that the changes in FICO® 9.0 represent significant improvements and recommends they be implemented as soon as possible. As a supporter of the Medical Debt Responsibility Act since its initial drafting in the 110th Congressional Session six years ago, NCRA welcomes the improvements FICO® 9.0 has made regarding medical collections. Another longtime NCRA issue, allowing rental payments to be factored into credit decisions, will also be addressed in FICO® 9.0. Both changes make the latest FICO® score similar to the VantageScore treatment of collections and rental payments, so this is not a radical change and needs to be embraced as soon as possible by all sectors of the lending community. As soon as these changes are approved for underwriting your NCRA member consumer reporting agency will be able to provide access to them."

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