Credit Scoring

What is credit scoring?

Credit scoring is a system used to predict the relative likelihood that an individual will repay a credit obligation, such as a mortgage loan or credit card. The creditor may examine your past credit history to evaluate how promptly you pay your bills and look at other factors as well, such as the amount of your income, whether you own a home, and how many years you have worked at your job. A credit scoring system awards points for each factor that the creditor considers important. Creditors generally offer credit to those consumers awarded the most points because those points help predict who is most likely to pay back the debt.

Why is credit scoring used?

In smaller communities, shopkeepers, bankers, and others who extend credit often knew by word of mouth who paid their debts and who did not. As some creditors became larger and as the number of their consumer credit applications grew, these creditors needed to establish more systematic and efficient methods for evaluating which consumers were good credit risk. Credit scoring is one such technique.

While smaller creditors still may rely on informal credit evaluations, many large companies now use formal credit scoring systems. While no system is perfect, credit scoring systems can be at least as accurate as informal methods for granting credit - and often are more so because they treat all applications objectively.

How is a credit scoring system developed?

Most credit scoring systems are unique because they are based on a creditor's individual experiences with customers. To develop a system, a creditor will select a random sample of its customers and analyze it statistically to identify which characteristics of those customers could be used to demonstrate creditworthiness. Then, again using statistical methods, a creditor will weigh each of these factors based on how well each predicts who would be a good credit risk.

What is a credit score based on?

- Information in a credit report
- Past payment behavior - current and historical delinquencies as well as their severity and prevalence.
- Level of indebtedness - outstanding debt balances, both in terms of $ and %
- Length of credit history
- Pursuit of new credit
- Types of credit available - generally less important than some of the other categories.

What is a credit score NOT based on?

- Factors prohibited under the Equal Credit Opportunity Act (ECOA)
- Race
- Age
- Gender
- Color
- Religion
- National Origin
- Marital Status
- Also excluded - income, employment, where you live

What are the most common credit scoring models?

Two most common models--

MDS bankruptcy score

scores range from about the 0 to 1300
higher scores = higher risk of default

FICO score

scores range from about the 300s to the 900s
higher scores = lower risk of default

Where do lenders obtain FICO scores?

Each of the three major credit bureau can produce a FICO score based on credit information in its files. Each bureau markets FICO scores under its own trade name:

- Equifax: Beacon score
- Trans Union: Empirica score
- Experian (formerly TRW): Experian/FICO score

Are credit scores predictive of credit risk?

Yes - - for all loans and all borrowers, an individual with a credit score below 620 is 2.7 times more likely to default on his/her mortgage loan than someone with a credit score between 660 and 699

Are low-income households more likely to have low credit scores?

- No - - A low-income buyer is as likely to have a high credit score as a high income home buyer.
- An individual's management of credit, as measured by a credit score, has little correlation with that individual’s income.

What's the relationship between down payment and credit risk?

- Looking at down payment as the primary risk factor overstates the real credit risk of many home buyers.
- Those who make only a 5% down payment but have a high credit score (say, over 740) are LESS likely to default than those who put 30% down but have a credit score under 620.

Does a lender have to show an applicant his/her credit score?

NO - - There is no legal requirement for the lender to reveal a credit score to an applicant. But if the application is denied, the lender must reveal the reason(s) for that denial.

What if the credit report contains errors?

- Individuals should contact the credit repository to report errors.
- Under the Fair Credit Reporting Act, 30-day resolution is now required.
- Lesson: Always obtain credit reports from at least two repositories prior to applying for a mortgage loan to confirm that data is correct.

How can I raise my score?

- While you can improve your future score, it is unlikely that any single action you take will have a large impact on your score immediately. That's because your score reflects your credit patterns over time. With this in mind, there are things you can do now that will improve your score in the future. These include: pay your bills on time. Delinquent payments and collections can have a major negative impact on your score. As they get older and you pay all other obligations on time, the delinquent information will have less impact.
- Pay down your balances. High outstanding debt can affect your score.
- Apply for new credit sparingly. "Shopping" for credit can have an adverse affect on your score. But it's important to remember that there is no single action that will raise everyone's score. Each time a credit score is calculated, specific reasons are delivered to the lender along with the score. If you've been given a score, you can ask your lender for these reasons (also known as "score factors") that came back with your score. These factors represent the four major reasons, in order of importance, why your score was not higher. Anything that you can do to address these reasons (paying off outstanding accounts to address "number of accounts with balances," for example) will most likely result in an improvement to your score. Support good credit habits...
- Pay bills on time
- Use revolving debt responsibly.
- Avoid large and quick build-up of new credit when you're preparing to buy a home.

What are 'score factor' codes?

- Code explanations that show which factors had the greatest impact on the final credit score.
- Up to four explanations codes are provided with each score.
- Example Code 01- Amount owed on accounts is too high (Equifax, TransUnion)