The World of Credit Scores

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March 30, 2017

Credit scores influence the terms and conditions of a consumer's ability to borrow from lending organizations, retail stores and even landlords. A low credit score makes borrowing more expensive, and a high credit score generally makes obtaining loans (credit) easier. When a consumer applies for credit, whether for a credit card, auto loan or mortgage, lenders want to evaluate the repayment risk they are taking on by lending money to that consumer. When lenders order a consumer's credit report, they can purchase a credit evaluation score based on the information in the report. A credit score helps lenders evaluate a credit report; it summarizes the consumer's likelihood to repay a loan, based on a snapshot of a credit report at a single point in time. It helps the lenders, effectively distinguish high-risk credit borrowers from low-risk borrowers.

The most widely used credit scores are FICO Scores, created by the Fair Isaac Corporation. FICO Scores are used in 90% of lending decisions, and almost 100% of lending decisions for highly standardized loans like mortgages. FICO owns the algorithms that compute credit scores using the information that the three credit bureaus, TransUnion, Equifax and Experian, collect on individual. Credit scores are based on the individual's history of borrowing, repayment, amount of borrowing etc... Base FICO Scores have a 300-850 range. The higher the score, the lower the risk. While many lenders use FICO Scores to help them make lending decisions, each lender will also add its own strategy to the evaluation process, including the risk it finds acceptable for a specific product. There is no single cutoff score used by lenders.

There are different FICO Scores for each of the three credit bureaus. Each score is based on the information that particular credit bureau keeps on an individual. This information may vary slightly among the three agencies, creating three different credit scores. Discrepancies in the reported individual consumer histories among the three agencies create variations in the FICO Scores so it is important for the borrowing consumer to periodically evaluate the accuracy of each of the consumer credit agencies. If the credit information is equivalent across all three agencies, the FICO Scores should be relatively close.

There are 6 different kinds of FICO credit scores, depending upon what kind of credit you are applying for: generic, mortgage, auto, bankcard, installment loan, and personal finance. Each score is based upon a different FICO algorithm. Thus, the score you get when applying for a car will probably NOT be the same score you get when applying for a mortgage.

Just as Microsoft has different versions of Windows, there are updated versions of each FICO algorithm. Since FICO Scores were introduced to lenders 26 years ago, lender credit requirements, data reporting practices, consumer demand for credit and consumer use have all evolved. Thus, FICO has redeveloped its scoring algorithms to keep up with behavioral trends of consumers and changing credit landscape. The result is that there are multiple FICO Score versions available in addition to the most widely used version, FICO Score 8. There is a more updated version 9, but it has not been widely adopted. There are three important updates in the new FICO Score 9 version:

- Third-party collections that have been paid off no longer have a negative impact.
- Medical collections are treated differently than other types of debt. Unpaid medical collections will have less of a negative impact on FICO Score 9.
- Rental history, when reported, factors into the score. This may be especially beneficial for people with limited credit history.

One thing to keep in mind is that the algorithm used to score information for mortgage lending is from an earlier version than Score 8. The reason is that Fannie Mae and Freddie Mac who are compelled by law to provide liquidity to the mortgage market under all economic conditions, and thus basically control all mortgage procedures in the US, have all their modeling based on an earlier version of the score. As a result, mortgages underwritten and structured to be sold through the Fannie Mae and Freddie Mac system, (the majority of mortgages) are fairly standardized in their request for detailed information about the borrowers.

How a Credit Score is Determined

For a FICO Score to be determined there must be enough of a certain type of information and enough recent information for the algorithm to be used. Generally, that means that the borrower needs to be living, have at least one account that has been open for a minimum of six months, and at least one account (not in default) that has reported an account history to the credit bureau within the last six months. These can be the same account. However, if a consumer has several accounts that are open but not in use, the second criterion may not apply. This tends to happen more frequently with older people or retirees.

The FICO Score considers both positive and negative information in a consumer's credit report. Late payments will lower FICO Scores but establishing or re-establishing a good track record of making payments on time will raise the score. Negative information, like short sales, foreclosures, and bankruptcies will stay on a credit report for 7-10 years.

FICO Scores are calculated from many different pieces of data. These data are grouped into five categories, and the percentages reflect how important each category is in determining your score.

- Payment History (35% weighted in a FICO Score): The first thing any lender wants to know is whether you have paid past credit accounts on time. As the percentage shows, this is one of the most important factors in determining a FICO Score.

- Amounts Owed (30%): Debt utilization is also a very important part of a borrower's score. Having credit accounts and owing money on them does not necessarily indicate a high-risk borrower with a low score.
- Length of Credit History (15%): A longer credit history will increase a credit score. However, even people who do not have a long history could have high scores based on how the rest of the credit history looks.
- Credit Mix in Use (10%): Basically, how diverse is the credit mix.
- New Credit (10%): Research shows that opening several credit accounts in a short period of time represents a greater risk, especially for people who do not have a long credit history.

Things that are not in a FICO Score:

- Your race, ethnicity, religion, origin, sex and marital status
- Your age
- Your salary, occupation, title, employer, or employment history
- Where you live.
- Whether or not you are participating in credit counseling
- Any interest rate being charged on a particular credit card or other account.
- Certain types of inquiries. Scores do not count "consumer-initiated" inquires, i.e. requests you have made for your credit report to check it. Requests coming from employers are not counted either.

Credit Inquiries

When applying for credit, the borrower authorizes the lender to request a copy of the borrower's credit report from the credit bureau. These credit inquiries themselves are also listed on a credit report. Generally, the only inquiries that impact a FICO Score are those that result from applications for new credit. A large number of inquiries can also mean greater risk.

However, not all credit inquiries are treated the same. Research has shown that FICO Scores are more predictive when they treat loans that commonly involve interest rate-shopping, such as mortgage, auto, and student loans, in a different way. For these types of loans, any inquiries within 30 days are treated as one inquiry rather than multiple requests. So, if you find a loan within 30 days, the inquiries should not affect your credit score.

Recent Change in Credit Reporting

As part of its National Consumer Assistance Plan (the result of a settlement brokered with 31 state attorneys general back in 2015), the nation's three credit reporting agencies will remove and exclude certain negative information from credit reports beginning July 1 Tax liens and civil debts, both new and existing, will no longer be reported on credit reports if the negative information does not include a customer's name, address and social security number or date of birth. These changes

are not meant to reduce the negative impact of failing to make tax payments but are putting the burden of proof on the people and companies submitting negative information.

Removing this information from credit reports will lead to a change in some people's credit scores. FICO projects that approximately 11 million people, or about 6% of the total U.S. population, will experience a score improvement of less than 20 points and that 700,000 will experience a rise of about 40 points. Lenders however, will still be able to check public records on their own to find this information.

Summary

Generally, common traits among consumers with high FICO Scores are that they consistently pay bills on time, keep balances low on credit cards and other revolving debt, and apply for and open new credit accounts only as needed. While FICO Scores are used by 90% of top lenders, they are not the lenders' sole determination of credit. Each lender uses a variance of the score, or their own "magic sauce," to evaluate lending risk to a particular consumer. Other evaluation information in addition to the FICO Scores may change a consumer's ability to obtain a loan. Thus, it is good to check and know your credit information, but realize that most of the credit scores you receive are not the same number as the actual FICO Score, which will be determined when you apply for a loan. In other words, it is important to understand that not every credit score offered for sale online is a FICO Score.

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