Understanding Your Credit Score

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FEFE Training Conference, June 17, 2008
A Good Credit Score is More Important Now Than Ever Before

- Lenders are backing away from higher-risk applicants
  - Mortgage loans:
    - Purchase money loans
    - Refinancings => homes are no longer an ATM for owners
  - Home equity lines
    => lesson: open one while you can, don’t wait until you are in trouble
  - Auto loans
  - Credit Cards
A Good Credit Score is More Important Now Than Ever Before

- Lenders are backing away from higher-risk applicants

- Risk-based pricing means a low credit score will cost you money – possibly big money
Example of How Much a Low Score Can Cost You

Product: 30-year, fixed rate mortgage, $300,000 loan

<table>
<thead>
<tr>
<th>FICO Score</th>
<th>Interest Rate</th>
<th>Monthly Payment</th>
</tr>
</thead>
<tbody>
<tr>
<td>760</td>
<td>5.9%</td>
<td>$1,787</td>
</tr>
<tr>
<td>650</td>
<td>7.2%</td>
<td>$2,047</td>
</tr>
<tr>
<td>590</td>
<td>9.3%</td>
<td>$2,500</td>
</tr>
</tbody>
</table>

Source: Fair Isaac Co: www.myfico.com
A Good Credit Score is More Important Now Than Ever Before

- Lenders are backing away from higher-risk applicants
- Risk-based pricing means a low credit score will cost you money – possibly big money

- Credit scores have become an important screening tool for many firms other than lenders
  - Insurance (auto; homeowners; life)
  - Apartment rentals
  - Cell phone service providers
  - Utilities (electric, gas, water, cable)
  - Employers
What is Credit Scoring? Why Did It Become So Important?

• The Five “C”s of consumer lending
  – Character (Willing to repay? Past track record?)
  – Capacity (Income? Amount of debt already owed?)
  – Capital (Savings? Other financial assets?)
  – Collateral (Downpayment, or asset to pledge against loan?)
  – Conditions (How will economic climate influence repay risk?)

• Until the mid-1960s, most consumer loans were based on personal judgment of a loan officer
By the 1960s, the lending industry needed a way to automate the knowledge stored inside a loan officer’s head.

- Speed up the processing of applications, and lower the cost

- Have consistent, company-wide standards for accepting risk
  - Example: accept loans with probability of default of 5% or less

- Estimate losses for a portfolio of new loans, to establish proper reserves to cover losses and to better manage company-wide risk
Statistical credit scoring automated an evaluation of the Five “Cs”
# A Simple Scoring Model for a New Loan Application

<table>
<thead>
<tr>
<th>Characteristic</th>
<th>Value</th>
<th>Assigned Points</th>
</tr>
</thead>
<tbody>
<tr>
<td>Type of Housing</td>
<td>Rent</td>
<td>0</td>
</tr>
<tr>
<td></td>
<td>Lives with parents</td>
<td>15</td>
</tr>
<tr>
<td></td>
<td>Owns</td>
<td>38</td>
</tr>
<tr>
<td>Household Income</td>
<td>Less than $25,000</td>
<td>7</td>
</tr>
<tr>
<td></td>
<td>&gt;$25K but, &lt; $50K</td>
<td>35</td>
</tr>
<tr>
<td></td>
<td>&gt; $50,000</td>
<td>61</td>
</tr>
<tr>
<td># of accounts 60 days past due</td>
<td>0</td>
<td>120</td>
</tr>
<tr>
<td></td>
<td>1</td>
<td>34</td>
</tr>
<tr>
<td></td>
<td>2</td>
<td>13</td>
</tr>
<tr>
<td></td>
<td>3 or more</td>
<td>0</td>
</tr>
<tr>
<td>Number of bankcards</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td></td>
<td>1 - 2</td>
<td>37</td>
</tr>
<tr>
<td></td>
<td>3 or more</td>
<td>20</td>
</tr>
<tr>
<td>Minimum possible score = 7</td>
<td>Maximum score = 256</td>
<td></td>
</tr>
</tbody>
</table>
Emergence of Credit Scores as a Commercial Product

- During the 1970s and 1980s, most large national lenders invested in developing proprietary, custom application scoring models
  - Example: the Sears, Roebuck model used only data from Sears own customers, as provided on the credit card application.

- Advantage:
  - Predicts default risk with greater accuracy and consistency than individual loan officers

- Disadvantage:
  - Expensive to develop
  - Need large numbers of accounts to properly develop the statistical models => only the very large lenders found this worthwhile
Emergence of the FICO Score

• 1980s: A new idea is born: build a model that only uses credit report data
  – Model could be built on millions of consumers, so long as each one had a credit report
  – Developers found it could predict default risk very accurately, using only credit report data
  – Any lender could purchase a score on a borrower and use it to make credit decisions

• 1986: Fair, Isaac Corp introduces the first FICO score
  – The FICO score is a “generic bureau score”. Translation: It uses only information in a credit report – nothing more
Details of the FICO Score

• The FICO Score is one of many types of credit scores, but is the most widely used
  – Leading competitor: Vantage Score, introduced in 2004 as a joint venture by the three major credit bureaus

• Components of the FICO score:
  – Account information
  – Inquiries
  – Collections activity
  – Public records related to debt or non-payment

• Not included: age, address, income, gender or employment information

• Classic FICO score product: scale 300 – 850, where higher number indicates lower risk
Underlying Data from Credit Report

• Account information
  – Industry/account type
  – Date reported
  – Date account opened (month and year)
  – Highest balance or account limit
  – Current balance
  – Current payment status
  – Delinquency history (up to 7 years)

• Inquiries
  – Date (day, month, year)
  – Industry and company

• Public record items (credit-related)
• Collection items
A Peek Inside the “Black Box” of the FICO Score

• FICO scores have only been available for the public to view since 2002

• Since then, they have developed a very informative website that explains credit scores and offers credit advice
  – www.myfico.com
Categories of predictive characteristics, Classic FICO Score

- Payment History, 35%
- Credit Mix, 10%
- Pursuit of New Credit, 10%
- Credit History Length, 15%
- Outstanding Debt, 30%
Payment History (35%)

Key Factors:
• How recent is the most recent delinquency, collection or public record item?
• How severe was the worst delinquency – 30 days, 90 days?
• How many credit obligations have been delinquent?
Outstanding Debt (30%)

Key Factors:
- How much does the consumer owe creditors?
- What percentage of available credit card limits is the consumer using?
- What percentage is outstanding on open installment loans?
Credit history length (15%)

Key Factors:

• How long have accounts been established – average number of months accounts have been open

• New accounts – number of months since most recent account opening
Pursuit of new credit (10%)

Key Factors:

- Inquiries: number of recent inquiries (12 months)
- New accounts – number of trade lines opened in last year
Inquiries
Which inquiries affect scores?

• Only consumer-initiated inquiries posted in last 12 months are considered by the score

• Model incorporates De-duplication logic to account for mortgage and auto rate shopping

• Scores do not consider the following:
  – Inquiries by insurance companies
  – Promotional inquiries
  – Account review inquiries
  – Consumer disclosure inquiries
  – Employment inquiries
Credit mix (10%)

Key Factors:

- What is the mix of credit product types?
- Installment credit – percent of trade lines that are installment loans
Credit Utilization: Tread Carefully in Offering Advice

• Utilization:  \[
\frac{\text{Sum of all credit card balances}}{\text{Sum of credit limits}}
\]

• Example:
  – Consumer owns 2 Visa cards, each with $10,000 credit line
  – Has a balance of $5,000 on one card, $0 on the second card
  – Utilization rate = \( \frac{5,000}{20,000} = 25\% \)

• Generally, model associates higher utilization with higher risk (powerful predictor)

• But, this is a factor that is tricky for the consumer to try and manipulate
Perils of Over-managing your Utilization Rate

- Opening new credit card accounts does boost available credit, and therefore lowers the utilization rate, and raises your credit score. . . But,

- New account openings in a short period (past 12 months) lowers your credit score

- Closing unused accounts may not be a good idea because it lowers available credit, and therefore lowers the utilization rate and your credit score . . But,

- Having multiple accounts with balances also lowers your credit score
So, What is the Best Advice Regarding Utilization Rates?

- Don’t max out your available credit
- Don’t open multiple accounts to boost your score
- Don’t close old credit card accounts
- ALWAYS pay your accounts on time
Do’s and Don’ts In Managing Your Credit Score

• **DO:**
  – Order credit report and search for errors
  – Pay all bills on time (credit and utilities and all other accounts)
  – Be patient if you do slip and have a late payment
    • All negative items roll off credit report after 7 years
    • Importance in credit score can decline after as little as 2 years
  – Maintain a healthy mix of credit (blend of credit cards, installment loans, mortgage loans)
Do’s and Don’ts In Managing Your Credit Score

• DON’T

  – Max out your available credit
  – Open multiple accounts in short period just to establish a credit history or boost available credit
  – Close old credit card accounts
  – Dally when shopping for credit
    • Shop when you need it, but don’t apply multiple times over an extended period (more than 30 days)
Questions?