Credit Scoring: White Paper

The recent upheaval in the credit markets has made credit scores even more important than they have ever been.

Let's start with a little bit of history. When I started in the mortgage industry, we didn't have credit scoring. Although credit scoring had been around for around 30 years and was used in credit card and automobile lending, it wasn't used for mortgage lending. We still had credit reports, but rather than an underwriter looking at a credit score, they looked at the whole credit history. If there was anything derogatory on the credit report, it was required to be explained in writing to the underwriter. In some ways this was good as a borrower could explain a one time occurrence to the underwriter's satisfaction. With credit scoring, you either met the minimum required score, or did not. An explanation did not matter.

Credit scoring was invented by Fair Issac, Inc. The purpose of credit scoring was to have a model that was useful in predicting the likelihood of a borrower continuing to pay on time. The higher a credit score, the less likely that the borrower would become delinquent. The lower the score the greater the probability repayment problems would occur. A credit score is a snapshot of your credit history at one point in time. It sums up what your past credit performance says about your likely future credit performance. As such, scores are forecasts, not grades. They don't say how well you have done at managing your credit so far; they assess how likely you are to manage your credit in the future. Scores are not static. The score changes as new information is added to or deleted from the individual's credit file at the repository.

So, with the invention of credit scoring for the mortgage industry, credit explanations were no longer useful as the model was designed for future prediction, not an underwriter's decision based on reviewing the facts and explanations from a credit report.

How do different credit scores perform?

Score Range	Ratio of performing loans to loans showing serious delinquency
Below 600	8 to 1
700.719	123 to 1
Above 800	1,292 to 1

Delinquency rates by FICO score (the percentage in that group that will default on a loan, file bankruptcy, or fall 90 days past due on at least 1 credit account in the next 2 years.) [Source myfico.com]

Up to 499	87%
500.549	71%
550.599	51%
600.649	31%
650.699	15%
700.749	5%

750.799	2%
800+	1%

As you can see, there is more risk to the lender for writing a loan to someone with a lower credit score.

How did Fair Issac invent the credit scoring model? They looked at millions of credit reports that were delinquent, and then they looked at what those borrower's credit reports looked like in the 24 months before they became delinquent. By doing statistical analysis, they invented a model that essentially says, "if a borrower's credit looks like x, then the likelihood of delinquency in the future is x."

FNMA (Fannie Mae) and FHLMC (Freddie Mac) began using credit scoring in their systems in 1995. Over time, the mortgage industry began to use credit scoring as a way to do "risk based pricing". Risk based pricing gives people with excellent credit scores better rates, and borrowers with lower credit scores higher rates. With credit scoring, and the borrowers with less likelihood of going delinquent, get rewarded with better rates, as the risk is lower.

Since the mortgage credit meltdown of August 2007, credit scores have become even more important. What has changed? Risk based pricing has become even more prevalent. Some products are not even available to borrowers with lower credit scores, and lower credit scores are charged even higher rates. During the credit boom between 2000 and 2007, the cost of higher risks was not passed onto the consumers due to a high level of competition from investors for mortgage product. It was perceived that there was not additional risk because there were very low levels of losses to investors. During this time, home prices were rising so rapidly, that even if a borrower was beginning to have troubles with their mortgage payments, they were "saved" by the appreciating real estate asset. They could sell their property (or refinance their property to a lower rate) and therefore the end investor of the loan was insulated from any losses. Beginning in 2006 home values stopped rising, and the credit problems began and delinquency and foreclosure rates rose much higher than the mortgage models predicted.

Effective with loans that are purchased by FNMA and FHLMC as of 3/1/2008, they will be charging higher fees for loans with lower credit scores. If the loan to value (LTV) is greater than 70% the additional fees will be as follows:

Below 620	2.00 points
620.639	1.75 points
640.659	1.25 points
660.679	0.75 points

As you can see, the costs of lower credit scores are getting higher and higher. Over the past several years the cost of additional risk had been minimal if at all. Since the credit crisis has started, the cost of risk has increased, and will likely remain high for quite some time.

So, if credit scores are much more important than ever, we need to learn more about what actions we take effect our credit scores and what we can do about it.

Mortgage Credit scores range from a theoretical low of 350 to a high of 850. The highest score we have ever seen is 840. The average in the United States is 678. The area with the highest average credit score is the New England area with an average credit score of 702.

National Fico Scores as a percentage of the population as of 2007 (sc: myfico.com):

Up to 499	2%
500.549	5%
550.599	8%
600.649	12%
650.699	15%
700.749	18%
750.799	27%
800+	13%

A credit score, like a credit report is best thought of as a snap shot of an individual's changing credit record. The credit score can change depending on the information that is currently on the report. If there is some incorrect information on a credit report that is "fixed", the score might not go up due to other new information that is now reported. So, it is not possible to completely control how a credit score will change. Items on a credit report are constantly updated, so new items or updated balances can be reported often.

What is included in your score?

35% of your score is from your Payment History. The fewer the late payments, judgments, liens or collections the better off your score will be. Recent derogatory items are more indicative of default than those that occurred more than 24 months ago. The severity of a delinquency (i.e. how far past due) the more it will impact the credit score. Late payments within the past 24 months are the number one thing that affects your credit score negatively.

30% of your score is from the Amounts Owed. Low balances on several credit cards are better than high balances on a few cards. Balances on your cards should be kept to less than 30% of the total credit limit. Keep balances as close to zero as possible for an optimal score. Too few or too many credit cards can be detrimental. But, do NOT close any of your accounts without first discussing your complete credit profile with a trusted mortgage professional. If you close accounts, your credit score could go down! If you use your card every month, and then pay the card in full every month (many borrowers do this to earn airline miles or cash rewards), then your balance that shows on your statement is what is used to calculate your credit score. There are three things you can do about this:

1) You can call to increase your credit line available (so that the balance reported is less than 30% of the credit limit).

2) You can stop using your credit cards for several months before you are going to apply for mortgage credit and only use your Debit Card.
3) You can pay down or off your credit card balance approximately 1 week before your credit card statement is going to be produced (and therefore reported to the credit bureaus). A lower balance means a lower percentage of credit used to credit limit.

One company that we recurrently have trouble with regarding credit scoring for our clients is Capital One. Rather than reporting the Maximum Credit limit that Capital One has approved for a client, they only report the maximum credit that the borrower has ever used in one reporting period (or in some cases they report the limit as $0). Capital One doesn't (at the time of the writing) report its customers' credit limits because "we have always considered that a proprietary, competitive part of our business." But, that policy can hurt your credit score. Remember, the lower your utilization ratio, the better your score. In the absence of a credit limit, the FICO system substitutes the highest reported balance from that creditor. Let's say that your credit limit is $10,000, but you have never used more that $1,000 and you typically pay your mortgage in full every month. Then, you charge $750. It looks like you have used 75% of your available credit to the credit scoring model, even though your actual credit limit is much higher. This shouldn't be an issue for most borrowers, but I feel that you should know about it. You can solve this problem by stopping the use of your Capital One credit card a few months before you apply for credit so that the balance is zero for the reporting period.

15% of your score is from the Length of your Credit History. The longer credit accounts have been opened, the lower the risk indications are about you. Opening new accounts and closing your old "seasoned" accounts will negatively impact your score. You should avoid "credit surfing", and consolidating multiple cards into one new card with a temporary lower interest rate. You should keep your credit accounts open and active. Dormant cards do not help nor hurt your credit history. If you want them to help your credit history, you should use them every 3 months, and then pay them in full. If you have not used a card for more than 6 months, it becomes dormant for the purposes of credit scoring. There are only three good reasons to close credit accounts:

1) If one of the top two reason codes for your credit score says "Too Many Credit Accounts" you should consider closing some of your accounts. You should first consider closing any Finance Company accounts. If you are going to close some bank cards, it is best to consider closing the ones that have been open for the least amount of time.
2) If you are divorced, you should close accounts that are in both borrowers' names that cannot be switched to only one of the two borrowers.
3) Identity Theft. If you are in the unfortunate situation of being involved in an identity theft situation, you need to close your accounts. However, you can have new accounts opened by the same company. And, you can request that they give the new account the same old opening date as your original credit. That way it will not be reported as new credit, but will be reported with the same history as the old debt.

10% of your score is from the Type of Credit in Use. Finance Company accounts will score lower than accounts secured through banks or department stores. The reasoning is that it appears that you do not qualify for a better type of credit, and these accounts have higher rates of default. Offers like "90 days same as cash" and deferred payments are generally funded by finance companies. What are some of the typical finance company accounts? Citi Financial, Wells Fargo Financial, Household, Beneficial. Really, it is everything that is not VISA, MasterCard, American Express or Discover. But, remember that a 15 year history of an open and active card has much more affect on your credit score than the drag from having credit from a finance company.

10% of your score is from New Credit. Looking for new credit can indicate higher risk. New credit negatively affects a credit score for the first 6 months. New credit has a higher rate of default and therefore is higher risk. However, inquiries are not the most predictive variable. That is why they only affect 10% of the credit score. Multiple mortgage or auto inquiries, regardless of the number within 45 days, only have the impact of a single inquiry. This is a commonly misunderstood part of credit scoring. I regularly have new customers tell me that they do not want their credit report run when they contact me for pre-approval or mortgage advice. Their reasoning is that they do not want their credit score to go down. It is important that they know that multiple mortgage inquiries within 45 days are considered the same a one inquiry. Inquiries show on your credit report for 2 years. They affect the credit score (but remember it is very minimally) for 1 year, and a tri-merge credit report only shows inquiries from the past 90 days. In my conversations with the credit bureaus, the highest amount of credit score change that they have ever seen for inquiries is 17 points. And more often it is 3-10 points. What you shouldn't do is open a new credit account at a retail store just because they are offering you 10% off of your purchase that day. Remember, keep your old accounts open and active, and don't open up new credit.

As you can see, the first three factors contribute to 80% of the credit score (payment history, utilization percentage, and length of credit history). Negative information (late payments or other derogatory items) in the past 24 months have the highest impact on credit scores over every ever possibility.

<u>What is NOT included in your Credit Score:</u>

U.S. law is very specific about what cannot go into a credit score without being in direct violation with federal law. Information regarding race, religion, gender, marital status, the borrower's address, and wages earned, height, weight, or birthplace may not be included. There has been a lot of concern regarding discrimination of minorities by the credit scoring system. However, it is important to remember that what information is used in calculating an individual's score, and recognize that only the information stored in the credit repository report is considered in the score. By reducing judgment reviews, scoring promotes fair lending. Credit usage is the key factor. In other words, at a given score, minority and non-minority applicants are equally likely to pay as agreed. Scoring provides an objective evaluation of the borrowers' credit history. Scoring is inherently unbiased. It only considers the borrower's prior credit habits to access risk.

What if your credit report has errors on it?

Now that we know more about credit scoring, and what affects credit scores, what happens if there are errors on your credit report, and how do you find out about errors? Mistakes happen. It has been said that there is at least one error on 50% of the credit reports. There is no one to take responsibility for double-checking the information except you. That is why it is important to know what is filed in your credit history. How do you get a copy of your report?

First, there is a law that allows you to obtain a free copy of your credit report from each of the credit repositories once per 12 months. The place to do this is www.annualcreditreport.com or by calling 877-322-8228. To get a free copy of your credit report, you must provide your name, date of birth, Social Security number and your current and previous address.

There are many other places that claim to offer free credit reports. If you google "free credit report" you will get something like 16 million matches along with a blizzard of advertisements. Most of these commonly offer a free credit report as long as you sign up for a credit-monitoring service for around $10 per month or $80 per year. Some of these sites have scant information about who owns them, making it risky to give out personal information. The three credit reporting agencies warn against providing personal information to third parties that promise to get free reports on their behalf.

You can use the www.annualcreditreport.com system to obtain a free credit report every 4 months. Since you can get one from each credit bureau per year, if you calendar every 4 months to ask for one from a different agency, you can get one 3 times per year for free.

What are some things to do or not do to raise credit scores:

1) Past due accounts effect scores tremendously. Paying them off will have an immediate and positive impact.
2) Don't consolidate. Be very careful about consolidating debt and closing credit cards accounts. It is better to have five credit cards with $5,000 limits and four with balances of $1,000, than to consolidate all that into a single card with a $5,000 limit and a $4,000 balance. When the borrowers are using 16% of the available credit, the system sees them as self-disciplined and low-risk. But when they are using 80% of the available credit, they've changed their picture entirely.
3) Don't pay off old collection accounts or charge-offs. By paying off these old accounts, the date last active changes from say, six years ago, to the current month, and it now will stay on your record for another 7 years. To add insult to injury, credit scores are weighted by how recent the derogatory accounts are. A one-month old "paid collection" account does far more damage to a credit score than a six year old "Charge Off". While it may seem ironic that making good on one's obligations can hurt a consumer's credit, it does. So, what should you do? If you have the cash available to pay off the old accounts, you should call the creditor reporting the collection account. It is important that you insist (but be very nice) on speaking with a credit manager that has the authority to negotiate settlements. Speaking with a low level bill collector will get you nowhere. Once

this individual is found, you should offer a settlement of 70% or so (be flexible) of the outstanding balance. This offer must be on the condition that the status of the account be reported as simply "Paid", not "Paid Collection" or not "Paid was 60", etc., and the date last active remain unchanged. Make sure that you receive this agreement in writing prior to making any payment. Once you have made the payment, you lose all of your leverage. Alternatively, you can request that the account be completely removed from your credit report entirely. This is possible, as the creditor reporting the information has the authority for what they report to the bureaus.

It is important to note that the older the account is, the easier it is to negotiate such a settlement. If a settlement cannot be reached, typically the best approach is to wait until the close of escrow to pay off the account. At least this way, the file is underwritten with the older derogatory information affecting the credit score. If you do not have a pressing need, you should just let the old accounts fade off the credit report with time.

If your credit score is high enough to obtain the rate and terms you are after, leave well enough alone. Don't' let your ego get in the way of how the system works. If it's not broken, don't fix it.

Universal Default:

You probably know that your credit-card company is apt to raise your interest rate if you miss a payment or are late. But, did you know that your rate may go up for credit mistakes made elsewhere? Missed or late payments on other credit cards, your mortgage or your car loan alter your credit score, giving an opening for any bank and card issuer to raise rates on consumers who are in good standing, but who somehow have damaged their overall credit. This is called "Universal Default." A survey by Consumer Action, a non-profit consumer-advocacy group, found that 44% of credit-card companies had a universal default policy. The bottom line, be aware that even "fixed" credit card rates can change unexpectedly. This is particularly important when clients move balances to zero or low rate cards. If there is universal default, the rate could rise as high as 29.24%.

What are some of the other credit myths:

1) Myth: My bad credit will haunt me forever. Fact: By law, negative information can only stay on your credit report for seven years (bankruptcies for 10 years). Also, the past 24 months are the most sensitive for credit scores – older negative information will hurt your score less than more recent information.
2) Myth: My score will drop if I apply for new credit (inquiries). Fact: Inquiries are a minimal part of your score calculation. Also, multiple inquiries from mortgage or auto lenders within a short period of time (usually 45 days) are typically treated as a single inquiry. This can be verified at the following website: http://www.myfico.com/CreditEducation/CreditInquiries.aspx Soft inquiries do not affect credit scores. They occur when borrowers request to view their own credit histories, or when a credit card company views consumer profiles to make a promotional offer, or when one of your existing credit accounts checks into your

current credit history (this is done recurrently on existing credit cards and home equity lines of credit).

3) Myth: It doesn't matter how high my credit card balances are, as long as I make my payments on time. Fact: Maxed-out credit cards are viewed as a negative item. Try to keep your balances at or below 30% of your available credit. Maxed-out credit cards look risky to lenders because it appears that the borrower is incurring debt at a faster rate than they can pay it off.
4) Myth: Closing out old accounts that I no longer use will increase my credit score. Fact: Closing accounts actually can hurt borrower's credit scores. It is often thought that if someone has many open lines of credit, it is better to close some of those accounts. But, there are two reasons why closing accounts can lower a credit score. First, closing accounts will reduce borrower's amount of available credit, therefore increasing the utilized percentage. Second, credit scores take into consideration the length of time that a borrower has had credit. Closing accounts cam make their credit history appear shorter than it really is. Your score is based on both positive and negative credit. Those old accounts show a nice long payment history that adds positively to your credit score. Keep them open and use them every 6 months or so just to keep them active.
5) Myth: It's a good idea to open up an account if I'm offered a discount at the store or a 0% interest for a few years. Fact: Opening up a new account through a finance company has a negative impact on your score. It also is reported as new credit. On top of this, it will likely be reported as a maxed-out revolving account – another negative factor!
6) Myth: Married couples have merged credit scores. Fact: Married couples have separate credit files and therefore have separate credit scores. When applying for a mortgage, a couple can apply as a borrower and a co-borrower with separate credit information. Their credit scores cannot be merged to get a better average score. If a couple have joint accounts, then the information will appear on both of their credit files. If one spouse has a poor credit score, then removing that spouse from the loan application is recommended.
7) Myth: If I co-sign for a loan, it won't affect my credit. Fact: By co-signing for a loan, you are signing on as a responsible party. If there is anything on that account that is negative, it will negatively impact your score. Even it is paid on time, it could lower your score due to being "new credit" or having a high usage percentage.
8) Myth: Lenders will judge me on my credit score alone. Fact: While a credit score is very important, lenders also look at other factors including total debt ratios, income, employment history and your loan to value percentage.
9) Myth: A higher salary means a higher score. Fact: Borrower's salaries play no role in determining credit scores. Although a borrower may have a high salary, they may also have a lot of debt.
10) Myth: If I dispute my information with one bureau, they will send the updated information to the other two. Fact: The bureaus do not share information, so it's up to you to contact all three bureaus. Don't forget to keep copies of all records and correspondence!

What are the best things you can do for your credit history and credit scores?

1) Make your payment on time
2) Don't max out your credit cards (keep them below 30% of the limit)
3) Don't close old credit cards
4) Don't open any new finance company accounts (i.e. department store credit)
5) Resist the temptation to open new credit accounts no matter how attractive the incentives are (do you really need that free baseball cap?)
6) Continue to use credit cards prudently, even if you have had problems in the past
7) Move high balance cards with balances greater than 30% of the overall limit to other cards, so that all cards are with balances less than 30% of the available limit.

Other questions:

1) Does everyone have a credit score? If a borrower has no credit or very limited established credit, he or she will probably not have a credit score.
2) Can an applicant have an acceptable score if they had a bankruptcy or foreclosure? If the bankruptcy or foreclosure is recent, it will probably have a major negative impact on the credit score – as it should have. However, if the bankruptcy or foreclosure occurred some time ago and the applicant has exhibited prudent and timely use of credit since, the score may well be within the acceptable range.
3) Are Credit Score and FICO the same? FICO is the scoring system used by Experian. The two other credit repositories, Trans Union and Equifax, have their own scoring systems, Empirica and Beacon respectively. All three scoring systems score similarly; thus, a 700 is equally good whether it is a FICO, Empirica or Beacon score. The term FICO score is the generic term for credit score. Lender's traditionally get all three credit scores, and use the middle of the three scores.