

A CONCISE GUIDE TO CREDIT SCORES

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720/449.0200

Definition: Credit scores are available through the three major national credit repositories, Experian, Equifax, and Trans Union. They are often referred to as FICO scores. Credit scores are the result of extensive research in which credit data on millions of consumers was obtained and compared with the incidence of serious delinquency over a period of time. The results show a strong statistical correlation between the scores and the probability of default. Out of 1000 borrowers with scores below 600, 125 can be expected to default. This compares with only 8 of 1000 borrowers who have scores above 700. In general, credit scores are spread across the sample universe as follows:

Lowest 20%	Below 620
Second 20%	620-690
Third 20%	690-745
Fourth 20%	745-780
Top 20%	Above 780

Please note that these scores relate to probabilities of default within a large sample and say little about whether or not a given individual or borrowing unit will actually default.

The good news is that these credit scores remove subjectivity from the credit analysis process. This is also bad news since evaluation is more rigid than in the past.

Factors That Make up Credit Scores

Payment History (35%)

- Number and length of delinquencies.
- Public Records such as IRS liens, bankruptcies and judgments.
- Comparison between number of delinquent accounts and those accounts paid as agreed.

How Much Credit (30%)

- Amount owed on all accounts (even if paid monthly).
- Percentage of credit used to credit available.
- Amount of money owed on installment debt compared to original amount borrowed.

How Long Established (15%)

- Considers both the age on oldest accounts and average age of all accounts.
- How long has it been since certain accounts have been used.

Is New Debt being acquired (10%)

- Number of New Accounts.
- Number of Inquiries.
- Time Elapsed Between Inquiries.

What is the Mix of Credit (10%)

- Installment debt vs. revolving debt vs. mortgage debt.
- This is very difficult to quantify.

Improving Credit Scores

Since the formula is complex, it is difficult to quantify the effect of any strategy used to improve scores. Some attempts to raise your score may even backfire.

Payment History (35%)

- Most difficult to improve. Unless errors are present there is no quick fix.
- Get current and stay current.
- Maintain prompt payment record. Over time effect of delinquencies diminishes.
- Paying a debt or collection does not remove it from your credit score. Paying off an old collection may actually lower your score.

Amount of Credit (30%)

- Pay down debt. Moving it around won't work or changing its form seldom works.
- Closing unused credit cards as a short-term strategy seldom works.
- Opening a bunch of new credit lines that you don't need could backfire and lower your score.

How Credit Has Been Established (15%)

- No quick fix.
- Don't close a bunch of old accounts and establish a bunch of new one.

Taking on New Debt (10%)

- Do your rate shopping within a short period of time. Contrary to popular belief, a number of inquiries over a short-period of time has no serious negative effect. The program is set to recognize the difference between rate shopping and applying for a large amount of new credit.
- Requesting your own credit report will not lower your score.

A Healthy Credit Mix

- Apply for and open new accounts only as needed.
- Have credit cards and manage them responsibly and your score will be higher than borrowers with no cards.

Short-Term Credit Repair

We have emphasized the point that quick fixes are usually ineffective at increasing credit scores. The exception is when there are mistakes on the report. Example: A mortgage has been transferred and the borrower received inadequate notice. Payments were made to the old lender but lost in the shuffle. The credit score shows a mortgage with a 60-day delinquency. The borrower can correct this by getting documentation from the lender stating that the 60 day delinquency is in error. After that, the best way to have this reflected in the credit score is to contact an agency such as *Factual Data Information Services* (1.800.766.5600). They will contact the repositories reporting incorrect information and obtain a corrected report and revised score within 3-5 business days. Their charge is \$30 per borrower per bureau, thus correcting three bureaus on a joint account is \$180. If time is not an issue, you can do this yourself by sending documentation to the bureaus directly; however, if a mortgage loan is pending it may be worth the charge to pay the agency. While there is never a guarantee as to how a score will be changed by the correction, instances like the example above have resulted in a 70-90 point improvement. This may mean the difference between an A loan and a B paper loan or 1-2% improvement in the interest rate.

Contacting the Bureaus

If you have a client anticipating a major transaction in the future, it is best to get a reading on credit scores as soon as possible to allow time to improve the score. The major credit bureaus are as follows:

Equifax 1.800.685.1111
Experian 1.888.397.3742
Transunion 1.800.888.4213

Comparing your Report to the Averages

Number of Obligations; The average consumer has 11 obligations on record. Seven are likely to be credit cards and the remaining four installment debt, car loans, mortgages etc.

Payment Performance; Almost 60% of consumers have never had a late payment of any kind reported and 80% have never had an obligation 60 days late or more. Less than 10% have ever had a loan or account closed due to default.

Credit Utilization; About 48% of credit card accounts have less than \$1,000. Only 10% carry \$10,000 or more. Excluding mortgages, 54% of consumers have less than \$5,000 of debt.

Available Credit; The average consumer has access to \$12,190 in credit and use less than 30% of their credit limit. Only 12% use 80% or more of their limit.

Length of Credit History; The average consumer's oldest account is 13 years old. Only 1 in 5 have a history of less than 2 years.

Inquiries; The average consumer has had only 1 inquiry during the past year. Fewer than 7% have more than 4 inquiries.