

# Credit Scoring and Its Role In Lending A Guide for the Mortgage Professional

## How To Improve an Applicant's Credit Score

There is no magic to improving an applicant's credit score. Credit scores automatically improve, as an applicant's overall credit picture gets better. Obviously this is not a fast fix, however there are a few things to remember:

- **Do** encourage the applicant to pay down revolving credit card debt to below 30% of the available maximum balance.
- **Do Not** tell the applicant to close accounts unless the reason code indicates that there are too many revolving accounts and all of their accounts have little or no balances.
- **Do Not** tell an applicant to consolidate debt onto one or two cards and close other cards, or lower their existing credit limit as their outstanding balance declines. That advice may artificially skew the appearance of an applicant's credit utilization.
- **Do** review the credit information in an applicant's file with each repository for accuracy, whether good or bad. Entries that have "maxed out" balances even with no lates represent higher risk.
- **Do Not** send your applicants to credit repair companies. Provide this assistance as a benefit for working with you for their real estate financing.
- If there are significant inaccuracies or outdated information on your applicant's credit report that can be documented, provide documentation to your underwriter, so the score can be ignored and the credit package underwritten manually per FNMA and FHLMC underwriting criteria. If your lender is unwilling to do that, find another lender.

If there are any inaccuracies or outdated information, write the repository reporting the misinformation. Send a letter regarding the dispute (with all available documentation attached) in overnight mail with return receipt requested. The Fair Credit Reporting Act gives the repository five days to notify the reporting creditor of a dispute and request an investigation. Within 30 days, the reporting creditor must report back to the repository regarding whether the disputed entry should be modified, deleted or remain unchanged. If there is no response regarding the dispute, the repository must remove the item from the applicant's file, but if, for example, 10 days later the reporting creditor reports back that

the entry is correct, it will be added back into the applicant's credit file. If there is any change to the applicant's file, the repository must notify the consumer within 5 days of the change. After receiving notification of a modification to an applicant's file, the broker may run a new report (not a reissue) and receive a new score. Be sure if any modifications are made to the date of satisfaction or payment of collection accounts, charge off accounts, or accounts included in bankruptcy that the date reads the date of discharge **NOT** the current date.

**When your applicant can't wait 35-40 days** for a modification, a broker can now utilize the **Bureau Direct Method for Rapid Re-Scoring a File**. Contact your credit report provider to find out if they offer this service for your applicant, and at what cost. To utilize the Bureau Direct Method of Rapid Re-Scoring a File, the broker will need to provide to the credit report provider the following information concerning the inaccurately reported information in the applicant's credit files:

- A legal document such as a release of judgment or lien, bankruptcy discharge with the schedule of accounts discharged or a divorce decree property settlement;
- A letter from the reporting creditor identifying the applicant, the account number for the entry in dispute and specifically what the information should read to be accurate.

Once the credit report provider verbally validates the accuracy of the document being provided them, the information is passed on to the credit report provider's contacts at the three repositories. The repository contact also verbally validates the information and then electronically modifies the raw data stored in the applicant's repository file to read correctly. The repository then confirms with the credit report provider that the correction(s) have been made and a new credit report can be run. **The broker runs a new report and the applicant has an updated report and updated credit scores in approximately five (5) business days.**

Credit scores can increase dramatically if the to read modified entry is the only negative entry information is the only negative information showing on the report and it falls under the first reason code shown with the applicant's credit score. Conversely, there may be little change in the credit score if the modified entry is only one of many negative entries and the others remain on the report.

Remember, collection accounts and charge offs will not necessarily disappear from a credit file after seven years, if unpaid those accounts could be sold to collection possibly resetting the clock. Judgments & bankruptcies stay in credit files up to 10 years and **unpaid tax liens stay in a credit file forever**, and just because a n account is paid to zero it will continue to appear in the file for the seven years before being purged – it was late. The only way to eliminate the impact of an inaccuracy on a score is to have the inaccuracy modified at the repository level. Until the issue is modified at the repository, the applicant's score will be negatively impacted. Information in a credit file changes daily. Don't assume a report is wrong just because the subsequent score for an applicant comes in lower than expected. Consumers must pay their accounts on time, use credit

conservatively (keep balances below 30% of available credit), apply for new credit very sparingly, and refrain from "credit surfing." With no recent "lates," no additional increases to account balances or brand new accounts opened, the applicant's score should go up.

### **What Is Credit Scoring?**

Credit scoring is a quick, accurate and consistent scientific method of **assessing credit risk**. The scores are based on data about an applicant's credit history and payment patterns stored in a credit bureau's file on that applicant. Statistical models that assign points to factors indicative of repayment calculate credit scores. These models are imbedded in software that resides in credit bureaus or lender databases. A score is based on data rather than human assessment and judgment. This is what makes credit scoring an objective risk assessment tool, as opposed to a subjective one (e.g., the underwriter's opinion). Until the utilization of credit scoring in lending, an underwriter's subjective interpretation of information was the only form of risk evaluation available to the real estate finance industry. Since no one has a crystal ball, underwriters obtained application information and credit reports on applicants to try to get an idea of the likelihood of repayment. However, even the best underwriter cannot match the scoring model's statistical ability to weigh and measure hundreds of factors and to come up with a number indicating relative risk in a matter of seconds. The resulting score is a "snapshot." **It sums up what the applicant's past payment performance and current usage say about the perspective applicant's level of credit risk.** Because the score is a composite of all of the applicant's credit information, no single factor – like a bankruptcy, inquiry or late payment – will be the sole cause of an unacceptable score.

### **How Are Scoring Models Developed?**

Large amounts of credit data was analyzed to find out which variables correlate most reliably with subsequent credit related performance. To develop scoring models, analysts collect two categories of data:

First is the credit bureau information about the applicant at the time he or she applied for credit. The second category consists of actual subsequent performance records of the same individuals. Predictive factors are identified and weights are assigned to each. The result of the data analysis is a "scoring model." Models are reanalyzed and modified approximately every 18 months at each repository as social and economic factors change.

### **What Repayment Odds Are Indicated By The Scores?**

When an applicant's information is run through the computerized scoring model at the credit bureau, a number or score is returned. A score may range from 300-850, each score along the range is indicative of a different set of odds for satisfactory repayment of the credit obligation.

<b>Odds</b>	<b>Good Payers to Bad Payer</b>
Below 600	8 to 1
620-659	26 to 1

660-679	38 to 1
680-699	55 to 1
700-719	123 to 1
720-759	323 to 1
760-799	597 to 1
Above 800	1292 to 1

### **What Data Does a Bureau Credit Scoring Model Analyze?**

Scoring models DO NOT consider: race, gender, religion, marital status, income, nationality, address, employment, position or title, length of employment, sexual preference, or interest rate being charged on a particular credit card.

Scoring models DO analyze: all the credit information stored in a bureau's credit file on an applicant at the time of the request.

#### **1- Past Payment Performance (35% of the score's weight)**

- a) The fewer late payments, judgements, liens or collections the better. Zero "derogatory entries" usually indicate lower risk.
- b) Recent late payments are more indicative of future default than those that occurred more than 24 months ago. A 30-day late today will have greater negative impact on the score than a bankruptcy 5 years ago with clean credit since.

#### **2- Credit Utilization (30% of the scores weight)**

- a) Low Balances on several cards is better than high balances on a few cards. Balances should be kept at 30% or less of the potential available credit limit on a card.
- b) Too many credit cards can be detrimental, but unless the first or second reason code states too many credit cards, **DO NOT TELL A CONSUMER TO CLOSE ACCOUNTS UNTIL YOU'VE ANALYZED HIS OR HER ENTIRE CREDIT PROFILE.** You could be giving them the worst possible advice and the score could go DOWN.

#### **3 - Credit History (15% of the Credit Score Weight)**

- a) The longer accounts have been opened with no lates, the lower the risk indication.
- b) Opening new accounts and closing seasoned accounts will negatively impact an applicant's score - applicants should avoid "credit surfing".
- c) Established credit history is relative to past payment performance and to what percentage of available credit is being used.
- d) A brief credit history does not automatically indicate a higher credit risk, as applicants with limited credit history can score high as long as they are not heavy users of credit and their payments have been paid on time. Generally automated underwriting systems look for at least two active accounts in good standing to have been open for at least six months.

#### **4- Types of Credit In Use (10% of credit scoring weight)**

- a) Finance company lines will score lower than bank lines and department store lines, and can drive a score down if the only type of credit in the file.

- b) 90-days or six months same as cash or deferred payment lines are generally extended by finance companies, causing this to be a weaker indicator of risk at best.

#### **5- Inquiries - New Applications for Credit** -(10% of the credit scoring weight)

- a) Looking for new credit can mean higher risk if several credit cards are applied for in a short period of time and/or other existing accounts are "maxed out."
- b) Multiple inquiries, regardless of the number, for mortgages or autos within a 14-day period of time are only counted as one inquiry in calculating the score.
- c) Any mortgage or auto inquiry made about an applicant's credit file within the 30 days preceding the lender's inquiry will be shown on the credit report, but will not adversely impact the applicant's credit score.
- d) Promotional or employer inquiries do not adversely impact an applicant's score. (This should be the only type of credit wholesalers should be running on a broker for establishing a straight broker relationship.)
- e) Only inquiries authorized by the applicant for the granting of credit can impact an applicant's score.

**Remember:** Credit information about past payment performance, credit utilization and credit history carries the most weight in a credit score. Credit scores automatically improve, as a consumer's overall credit picture gets better.

#### **How Does Credit Scoring Help Lenders?**

Credit scoring allows lenders to base decisions on relevant credit performance data.

- a) To give objective consistent assessments so the applicant is offered the loan product(s) he or she is most likely to be qualified for.
- b) Credit scoring's objective criteria and ease of automation helps lenders remove the potential for bias and comply with fair lending laws.
- c) As competition for profitability increases today, applicants with lower indicated degrees of credit risk can be offered more favorable terms in order to capture a larger market share.
- d) Scoring gives lenders a reliable method of controlling delinquencies and charge-offs.
- e) Scoring speeds up the decision-making process and allows more time for a lender's underwriter to focus on the complex credit decisions.
- f) Lenders typically loosen certain underwriting criteria and accept more loan applications without taking on a larger pool of poor performing loans.

Reported credit information modification(s) and re-scoring need not take 90 days and can dramatically improve buyer's chances of qualifying for the maximum purchase price with the least amount of required down payment.

#### **How Credit Scoring Helps Consumers**

Credit Scoring is not a crystal ball, but it helps lenders make more informed decisions and offers real benefits to consumers.

1. Credit scoring evaluates all applicants by the same criteria. Opinions do not enter the scoring equation. Empirically derived facts replace myths and personal prejudices about what constitutes a good future customer.
2. Changes in a consumer's credit performance will change a credit score. The key is that as individual credit patterns change, scores are likely to change. While the "scoring scale" remains constant, a consumer's place on that scale may change.
3. Scoring speeds up credit decisions. Scores help lenders make decisions more rapidly and often with less documentation.
4. Scoring helps make more credit available. By helping lenders control losses and costs, scoring helps make more capital available to consumers. Historically, the less information lenders have available to distinguish between credit risks, the more conservative their lending policies tend to be. That means less credit is available to all consumers, low risk as well as high risk, and that the cost of that credit is more expensive.

Credit scoring gives lenders an important piece of information that allows lenders to lend to MORE consumers.

**Thank You!**

NAMB thanks Fair Isaac for its help in modifying scoring models to better serve the mortgage applicant, and for its assistance and permission to use its information for this project. You may choose to visit: [www.MyFICO.com](http://www.MyFICO.com) for further information regarding credit scores.