

# **UNDERSTANDING**

# **CREDIT SCORES**

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Factual Data

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## CREDIT BUREAU SCORE QUESTIONS AND ANSWERS

*Credit Bureau Scores are one of the many elements that are reshaping today's mortgage industry. Credit scoring has been around since the 1950's, and Credit Bureau Scores – scores based solely on credit bureau data – became widely available in the 1980's. Today, Credit Bureau Scores are used extensively in such industries as bankcard and auto lending. The following are answers to frequently asked questions by those new to credit scoring in mortgage lending.*

### **Q: What is a Credit Bureau Score, and how is it calculated?**

Credit bureau scoring is a statistical means of assessing how likely a borrower is to pay back a loan. A Credit Bureau Score is based on the data available in the borrower's credit report. The score measures the relative degree of risk a potential borrower represents to the lender or investor. It is not a measure of a borrower's income, assets, or bank account, although those and other factors are still considered by lenders and investors, independent of the score.

Fair, Isaac Credit Bureau Scores range from approximately 375 to 900 points, and are available through the three national credit data repositories (Equifax, Trans Union, and Experian). All of these three models are often referred to as "FICO" scores. The scoring programs reside at these credit bureaus and are called:

**BEACON**

**EMPIRICA**

**The Experian/Fair, Isaac Model**

**at Equifax (formerly CBI)**

**at Trans Union**

**at Experian (formerly TRW)**

This score is calculated at the repository, and is based solely on the data within that repository's individual credit file. Fair, Isaac is not able to access a borrower's credit bureau data, make corrections to credit bureau data, or calculate a score.

A Fair, Isaac Credit Bureau Score, sometimes referred to as a FICO score, is calculated by a system of scorecards. In developing these scorecards, Fair, Isaac uses actual credit data on millions of consumers, and applies complex mathematical methods to perform extensive research into credit patterns that forecast credit performance. Through this process, Fair, Isaac identifies distinctive credit patterns. Each pattern corresponds to a likelihood that a consumer will make his or her loan payments as agreed in the future. The score is based on all the credit-related data in the credit bureau report – not just negative data such as missed mortgage payments or bankruptcies.

The types of credit information used in the credit bureau scorecards are typically the same items an underwriter would use to make a credit decision. These can include:

- **Payment history**
  - Public record and collection items
  - Severity, recency and frequency of delinquencies noted in trade line section
  
- **Outstanding debt**
  - Number of balances recently reported
  - Average Balance across all trade lines
  - Relationship between total balances and total credit limits on revolving trade lines
  
- **Credit history**
  - Age of oldest trade line
  - Number of new trade lines
  
- **Pursuit of new credit**
  - Number of inquiries and new account openings in the last year.
  - Amount of time since most recent inquiry
  
- **Types of credit in use**
  - Number of trade lines reported for each type:
    - Bankcard
    - Travel and entertainment cards
    - Department store cards
    - Personal finance company references
    - Installment loans
    - Other

Fair, Isaac observes a very large number of credit report histories of mortgage borrowers to determine which credit report items or combination of items are the most predictive of future risk; this data indicates the amount each item contributes to an accurate assessment of credit risk.

Fair, Isaac Credit Bureau Scores do not use race, color, religion, national origin, sex, marital status, or age as predictive characteristics. Occupation and length of time in present house are also not used in the Credit Bureau Scores, Also, any information that is not present in a repository credit file is not used in creating a Credit Bureau Score.

## **Q: Why did this credit file receive the score that it did?**

To understand why a credit report scored the way it did, look at the four reason codes given with each score. These are the top reasons, in order of severity, why it did not score higher, although other factors probably contributed. Mortgage brokers and lenders should receive these reasons along with the score when the score is obtained through a mortgage credit reporting company. A complete list of these score factor reasons accompanies this document.

These reason codes are either a number or letter followed by a brief description. For example a credit report with a score of 563 may have the following factors:

- 02 – Delinquency on accounts
- 01 – Amount owed on accounts is too high
- 09 – Too many accounts opened in last 12 months
- 19 – Too few accounts currently paid as agreed.

These score factor explanations can be relayed back to the borrower to explain how they can increase their score over time. Score factors are less meaningful for higher scoring credit records as they merely point to the reasons why the file did not score even higher.

## **Q: How can a borrower increase his or her Fair, Isaac Credit Bureau score?**

Over time a borrower can improve the information in his or her credit report by paying credit obligations on time and using credit wisely. As derogatory data in the credit report gets older, it affects the score less. A missed payment from four years ago will not count as much as a missed payment from six months ago.

A credit score, like a credit report can be thought of as a snapshot of an individual's changing credit record. Scores from different repositories will be different because of the different data available in the consumers file at each repository. If a request is made that another report be obtained to get an updated score, then the score is likely to change for many reasons; however, it is not possible to limit how that score will change. The credit items on the report are updated often, so new items are likely to have been added since the previous report was generated. In addition, existing items will have aged. Repeatedly requesting a borrower's credit report may substantially increase the number on the repository report, which may affect the score adversely.

## **Q: What if a score is affected by derogatory credit information that the borrowers believes is not his or hers?**

Consumers who want to address what they believe is erroneous information on a mortgage report should contact the credit reporting agency which developed the report. The Fair Credit Reporting Act (FCRA) allows the credit reporting agency a "reasonable period of time", generally not to exceed 30 days, to reinvestigate consumer disputed items. A significant number of credit grantors use an automated system for investigating disputes and respond to the dispute within a few days. Most credit reporting agencies make a special effort to quickly resolve disputed information affecting a mortgage decision.

Consumers wishing to dispute items on their credit files with the credit repository can do so through the following numbers:

- Equifax – (800) 685-5000
- Experian (formerly TRW) – (800) 875-7463
- Trans Union – (800) 916-8800

The credit score is generated using the credit information at one of the three national credit repositories. Therefore, changes made solely to the mortgage credit report and not to the credit repository information will not affect the score.

It is the policy of many lenders and investors, including Freddie Mac and Fannie Mae, that if gross inaccuracies appear on the credit file, erroneous information can be documented and the score disregarded. The applicant is not required to go through the procedure of changing the information at the credit repository for the purpose of altering the credit score in these cases.

### **Q: If the derogatory information is removed, how much will the score increase?**

Because the score uses all the credit-related data on the credit bureau report and takes into account compensating factors, removing or changing one specific derogatory item will not guarantee an increase in the Credit Bureau Score. In some cases a change in the credit bureau report would have little or no effect on the score. And because there are multiple scorecards using complex mathematical formulae at each of the repositories, it is not possible to estimate how much the score will change if specific derogatory information is removed from the single repository report.

Again, it should be stressed that erroneous derogatory information on a credit file can be documented to compensate against a low score. The lender can weigh all factors and documentation provided by the borrower and may choose to disregard the score. It is not required by most lenders and investors that an applicant go through the procedure of changing information at a credit repository for the purpose of altering a credit score when erroneous information is present.

### **Q: What would happen to the score if an applicant were to pay-off his or her balances and/or close some accounts?**

It is not possible to ensure that scores would increase in this case. Such actions may upset the mix of available credit, and actually decrease the score. It is important to remember that the point of the scoring is not to calculate an up-to-date debt ratio – *the debt ratio is still considered by the lender independent of the score*. Therefore, it is not critical that balances be completely up to date for the purposes of scoring. The score reflects data available on the credit report to assess the consumer's current payment patterns as well as payment history.

### **Q: What if an applicant is scoring too low because of inquiries to the credit bureau?**

The number of inquiries may or may not be a factor in the score, and when it is a factor, it is typically not a strong one. However, if a borrower is very close to the score threshold, and can



loan approval is relative to each lender's individual business strategy. Because there is no point of reference for a borrower to understand their individual score, it should not be passed on to them.

When a consumer is declined credit due to a low score, the score factor codes should be communicated to the consumer. Providing the score alone as the reason for declination does not provide the consumer with actionable information that can be used to increase their score over time, and is not in compliance with Regulation B of the ECOA.

Fair, Isaac also has information available for consumers to understand more about the credit scoring process. Copies can be obtained by faxing us the completed order form on the last page of this document.

## **Q: Why can't some files receive credit bureau scores?**

In order to receive a Fair, Isaac score, a credit bureau file must contain at least one account that is older than six months, and at least one account that has been reported to the credit bureau within the past six months. Both conditions can be met by the same account, and a bureau file containing just one account can get a Fair, Isaac score. In addition to these credit conditions, the bureau file must not contain any indication that the consumer may be deceased.

If you are requesting a credit score on one or more credit repository files used to create a merged report or RMCR, and a score is not returned, you must verify that the credit conditions (e.g. at least one account that has been reported in the last six months and open longer than six months) have been met on the file generated by the scoring credit repository. Your mortgage credit reporting company, or the repository in question, will be able to help you with this verification.

## **Q: What does a score mean?**

A Fair, Isaac Credit Bureau Score is a means of rank-ordering potential borrowers based on the likelihood that they will pay their credit obligations as agreed. A higher score indicates better credit quality. If all other things are equal, borrowers with a score of 660, for example, are less likely to default on a loan than borrowers with a score of 650.

The Fair, Isaac Credit Bureau Score models at each credit repository are of similar design and the scores are scaled to indicate a similar level of risk across all three bureaus. In other words, a score of 680 at one bureau will represent the same relative risk as a score of 680 from another bureau. This risk is defined in terms of the number of accounts that remain in good standing compared to those that default.

## **Credit score ranges for new mortgage borrowers from a national sample**

<b>Score Range</b>	<b>Number of good loans for each bad loan showing serious delinquency or Foreclosure (# of goods to one bad).</b>
Below 600	8 to 1
700-719	123 to 1
Above 800	1,292 to 1

While Credit Bureau Scores will consistently rank-order potential borrowers based on risk, the number of good loans to bad loans denoted by a score is likely to fluctuate due to changes in the economy, regional differences, changes in product offerings or other reasons. A lender using credit scores will compare the performance of their loans by score over time to determine the relationship of score and performance for their own market environment.

### **Q: Doesn't using the score mean fewer people will get mortgage loans?**

No, in fact the opposite may be true. Credit Bureau Scoring is just one of several ways that lenders and the secondary market decide whether to lend someone money, and under what terms. Lenders or investors set the underwriting guidelines. The investor typically sets score cut-offs such that they offer mortgage loans to the same number of borrowers irrespective of the use of scoring.

The lender uses the Credit Bureau Score to determine if the borrower exceeds the acceptable level of risk for the product being offered. If the score on a borrower's credit report is too low for a given product, that does not mean the score is too low for other products. In the past we have seen that once lenders are able to accurately identify the credit risk of all applicants, they can create products designed and priced for various segments, ultimately extending credit to more people.

### **Q: If Credit Bureau Scores from more than one bureau are obtained on a mortgage credit report, which score should I use?**

Each credit file at each repository is capable of being scored. If a mortgage credit report is created using files from all three repositories for a borrower, it is conceivable to have three separate credit scores. Freddie Mac has recommended that a lender rely on the middle score when working with three scores or the lowest score when using two scores. Some lenders or investors may require a credit score from a specific credit repository based on the perceived strength a repository may have in a geographic region.

Borrowers and co-borrowers will also have separate scores. When considering which score will be the basis of a credit decision, Fair, Isaac suggests that a lender rely on the same logic used currently to determine which of the two credit files is used. A typical and conservative approach is to use the lower of the two so that both the borrower and co-borrower meet minimum credit criteria.

## **Q: Are there other types of Credit Bureau Scores that can be used in the mortgage industry?**

Yes. In a recent industry letter, Freddie Mac made reference to two types of credit scores that correlated strongly with mortgage performance. These were the “bureau scores” created by Fair, Isaac as well as the “bankruptcy scores” created by CCN-MDS. Both of these types of scores are available through the three national credit repositories. Fannie Mae issued a similar industry letter, which only referenced Fair, Isaac Credit Bureau Scores. Fair, Isaac is not able to comment on the specific details of the CCN-MDS bankruptcy scores; therefore, this material refers only to the Fair, Isaac Credit Bureau Scores.

You may have heard of other types of bureau scores developed by Fair, Isaac. While Freddie Mac’s industry letter addressed the general Credit Bureau Scores (e.g., BEACON, EMPIRICA, Experian/Fair, Isaac Model), some of your lenders may be using the following:

**UniQuote** – This is a mortgage-specific score available through Trans Union. UniQuote offers additional predictive power over EMPIRICA when used for the mortgage industry. UniQuote relies solely on single repository information from Trans Union and is scaled to match EMPIRICA so that the risk of mortgage default at any given score range is the same. It was developed to replace EMPIRICA in strategies that use one or more of the Fair, Isaac credit bureau scores. One feature attractive to lenders is that all mortgage related inquiries incurred 45 days prior to scoring are ignored. This score has also been validated for use on Home Equity loans.

**CreditQuote** – Like UniQuote, this is a mortgage-specific score. It differs from UniQuote in that it is derived from credit data that has gone through an automated merged process. CreditQuote is available through some mortgage credit reporting agencies. This score is scaled differently from the repository scores, with a range of 100 to 400 points.

**Industry Options** – These are variations of the standard Credit Bureau Scores. They consist of additional scorecards that adjust the standard bureau score to reflect industry-specific risk. These industry options are available to lenders in the Auto, Bankcard, Installment, and Personal Finance industries. There is no industry option available for the mortgage industry.

## **Q: How can I learn more about Credit Bureau Scores and Credit scoring?**

Fair, Isaac has created a video training kit, “Credit Bureau Scores in Mortgage Lending.” This training package was developed specifically to educate mortgage professionals on the fundamentals of credit bureau scoring. It includes a 45-minute video and facilitator teaching guide to help lead discussions and training exercises on the use of credit bureau scores.

In addition Fair, Isaac offers quarterly workshops for new users of Credit Bureau Scores. These comprehensive two-day seminars are designed for new score users who seek education regarding credit bureau score development, strategies, and implementation, as well as the regulation of credit reporting practices. These seminars are designed to cover the use of credit bureau scores across a wide spectrum of lending industries including the mortgage industry.

# How Credit Use Effects Score

## Payment History:

➔ **35% of Score**

**30 – Day late in last 12 months can lower score 70 – 100 points**

## Credit Utilization:

➔ **30% of Score**

**Lower balances on more credit cards is better than high balances on a few  
– Optimum 30 – 35% of Credit Limit**

## Credit History:

➔ **15% of Score**

## Type of Credit Used:

➔ **10% of Score**

## Inquires:

➔ **10% of Score**

**Same industry inquiries within 14 – days count as 1**

**Promotional inquiries don't affect score**

## 5 Areas of Credit Scoring

### **Payment History:** **35%**

- Public record and collection items
- Severity, recentness and frequency of delinquencies noted in trade line section.

### **Outstanding Debt:** **30 – 35%**

Number of balances recently reported. Average balance across all trade lines. Relationship between total balances and total credit limits on revolving trade lines.

### **Credit History:** **10 – 15%**

Age of oldest trade line.

### **Inquiries and New Account Openings:** **10%**

Number of inquiries and new account openings in the last year. Amount of time since most recent inquiry.

### **Types of Credit in Use:** **10%**

Number of trade lines reported for each type:

- ◆ Bankcard
- ◆ Travel and Entertainment
- ◆ Department Store Cards
- ◆ Personal Finance Company References
- ◆ Installment Loans
- ◆ Other