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# Credit Scoring - What You Need to Know

*Written by*
*Paul Snider, President/CEO of CreditIQ, Inc.*

A few months ago I wrote an article for World Of Special Finance magazine detailing specific information regarding credit scoring and it's effect on consumers. Since that article was published there have been new developments that I feel are pertinent to the finance industry and will have a significant impact on how your customers handle the loan process. I also received so many positive responses to this that I felt compelled to write a follow up article.

Many of the statements appearing here have been taken directly from other publications and websites. I will include a list of all resources used for this article at the end.

*WASHINGTON - The Goliath gatekeeper of credit scores has just yelled uncle. Next month Fair, Isaac, the creator of FICO scores used by numerous lenders, plans to provide consumers with the three-digit grade that plays a giant part in determining who receives loans and how much they pay.*

What a difference a few months make.

In March the San Rafael, Calif.-based company was steadfast against the disclosure of credit scores, a mathematical computation that tells lenders how likely a consumer is to repay a loan or make a payment on time.

In response:

*The Detroit News: Credit scoring remains mystery without specifics for consumers - "'That they did disclose more detail is significant,' said Greg Fisher, a self-styled industry watchdog.... 'But if you can't tell me how many credit cards to have, you can't tell me I have too many or too few. In that case the stuff on their Web site is really useless. And how responsible is it to produce the scores if they can't explain how they work?'"*

Now consumers can find out their score, which in the past was not available. They can also log on to www.fairisaac.com and learn what determines a high or low score by reviewing the factors, which make up credit scoring. Armed with this new and powerful information, consumers will be in a better position to enhance their personal credit scores and in many cases save money because they will be able to negotiate lower interest rates.

As professional finance managers this is very important because during

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About Credit Bureaus
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Your Credit Rights
What Lenders Look For in a Credit Report
Tips for Improving Your Credit File and Score
About Credit Repair Companies
Credit Fraud

Helpful Links

Glossary of Terms
FairIsaac-Understanding Your Credit Score
Credit Monitoring Services
Debt Counselors of America



the credit interview you can explain how the score is developed, factors that will affect the score and why rates are set based on the credit quality of each consumer. By doing this you enhance consumer loyalty in addition to helping credit challenged consumers take action to clean up past problems plus drive home the car of their dreams.

The major factors affecting credit scores are:
1. Payment History 35% of the total score
2. Amounts Owed 30% of the total score
3. How Established is Credit 15% of total score
4. New Credit 10% of the total score
5. Types of Credit 10% of the total score

A score takes into consideration all these categories of information, not just one or two. No one piece of information will determine a score. FICO scores do not consider income or type of credit a person is applying for. Scores consider both positive and negative information and does not consider race, gender, religion or nationality. The score itself represents how likely an individual is to repay a loan or make credit payments on time by using a mathematical equation that evaluates information from a credit report and compares it to the patterns of to thousands of past credit reports. In many cases good credit can be adversely affected by the frequency of late payments or applications made for new credit. The only negative to using past credit reports as models to establish the likelihood a consumer will repay the loan is that the model does not distinguish between late payments. If a consumer had a balance of $50 on a gas card and had a late payment, it is considered equal to a late payment on their mortgage or auto loan. Even though this is factual information, a consumer who lost employment but made their mortgage and auto payments on time is penalized for prioritizing the way they paid their bills during a time of crisis. Despite the fact that lenders will usually accept a letter of explanation, it will still "hurt" the consumer by way of higher interest rates and loan terms.

In addition to credit scores, lenders also use various scoring models such as the ones developed by Equifax and Creative Business Solutions. These scores are different than FICO scores because they are based on historical data derived from actual loan profiles and various static pool information combined with factors such as geographic location, age, occupation and income. Dr. Pat Nanda, one of the countries foremost experts on credit models, has developed numerous programs for lenders with each one being unique and proprietary. This has been a much more effective approach for lenders looking to maximize their profitability while minimizing their risks as each scoring program is catering to that specific lenders needs, unlike a one size fits all solution such as FICO and Beacon scores.

Credit scores were developed 40 years ago to assist lenders in the credit decision process, for most lenders, this has now become a credit decisioning system and in most cases, disqualify an applicant from receiving a loan before a loan officer ever sees the application. This has eliminated the subjectivity from lending practices as denials are based on a number, not the individual. Still not convinced, Fannie Mae, one of the largest mortgage lenders in the US is releasing a new proprietary scoring system this year that does not use FICO or Beacon scores in the decisioning process. Second, credit scores are now being used for reasons other than extending credit. Opening bank accounts, apartment rentals, auto insurance premiums, employment, and utilities are several of those. I have no idea why these companies feel the need to base their decisions and/or rates on someone's credit score.

Here are a few more that I think you will find interesting:

· Discriminatory factors, such as age, occupation, education level, and area of residence, are used to calculate credit scores.

· The manufacturers of credit scoring software are immune from government regulations, because government agencies do not know how credit scores are calculated.

· The scores can change from day to day for no apparent reason, making the difference between acceptance and denial. Are credit scores a valuable tool? Absolutely. In the real world, the bottom line is that credit scoring can be a good thing and is clearly needed in our financial society, however, credit scoring was designed for "risk assessment", but in practicality has become a "speed & weed" tool with "zero tolerance".

According to Fair Isaac's, you are under no legal obligation to share a consumers credit score with them. I do believe, however, that taking the time to explain a credit score, the impact it has, and the effect it has on a credit decision will provide you with a more comfortable consumer who has now begun the "trust building" process with someone who is willing to help them reestablish their credit.

I would like to close this article with an excerpt from the San Francisco Chronicle, regarding credit bureau companies and their previous actions. I will let you decide whether these companies voluntarily decided to provide credit-scoring information to consumers.

*San Francisco Chronicle - April 6, 2000. A major credit reporting agency has forced Internet lender E-Loan to stop giving consumers a peek at one of the most jealously guarded secrets in financial services -- their individual credit scores. Equifax, one of the nation's three big credit bureaus, cut off E-Loan's access to the data Monday, six weeks after the Dublin mortgage provider began letting its customers pull up their own credit scores online. The incident marks the latest episode in the credit-reporting industry's long-standing battle to keep sensitive credit information out of the hands of consumers. ``They have consistently fought federal efforts to require disclosure of credit scores,'' said Consumers Union senior attorney Gail Hillebrand.*

*Credit scores are numerical ratings that calculate the likelihood a borrower will repay a loan based on the consumer's past financial record. Designed by Fair, Isaac, the San Rafael financial software company, they are the most important tool lenders use when deciding whether to offer a customer credit.*

*Until E-Loan put the scores online, consumers generally could learn their ratings only under special circumstances, such as when they got turned down for loans. ``This was the first time consumers had ever been granted ready access to their own credit scores,'' said E-Loan Vice President Sharon Ruwart. E-Loan said 20,000 customers opened accounts after it made the data available.*

*Fair, Isaac and the credit bureaus protect credit scores like the family jewels. Equifax apparently regarded E-Loan's distribution of the data as a slap in the face.*

*After failing to persuade E-Loan to stop posting credit scores, Equifax turned on Credit InfoNet, the vendor that sells Equifax data to E-Loan, demanding that the company stop giving credit scores to E-Loan, said Tom Midkiff, Credit InfoNet's chief executive.*

*When the Credit InfoNet didn't immediately comply, Equifax shut off the flow of all data to the company Sunday, leaving the vendor unable to serve any of its 700 customers for parts of two days. Equifax restored service when Credit InfoNet agreed to stop giving E-Loan credit scores. ``They strong-armed me to cut off credit scores to E-Loan,'' Midkiff complained.*

*Equifax, based in Georgia, did not return calls seeking comment. E-Loan resumed distributing credit scores yesterday using another credit bureau, but that service could be suspended, too. E-Loan declined to identify the bureau, but industry sources said it was Trans Union. Meanwhile, E-Loan contends that Fair, Isaac pressured Equifax and was the real agent behind the data cutoff.*

*For its part, the San Rafael company admits it pressed the credit bureau to act, noting that its contracts with Equifax, Trans Union and Experian, the third credit bureau, specifically bar them from supplying consumers their credit scores under most circumstances. ``We have consistently encouraged the credit reporting agencies to enforce the contracts,'' said Craig Watts, Fair, Isaac's consumer affairs manager.*

*Fair, Isaac said it doesn't want consumers to see their credit scores because it fears they will misinterpret the numbers. ``Consumers need additional information and counsel from a lender to truly understand their credit situation,'' said Watts.*

*The credit industry also worries that consumers will take shortcuts to jack up their credit scores, just the way some students cram for college entrance exams. That could cheapen the value of the data. Consumer advocates counter that the credit industry simply doesn't want consumers to cast a critical eye on how a number that could seal their financial fate is determined. "They just don't want the scores demystified,'' said Hillebrand of Consumers Union.*

Sources:
www.sfgate.com
www.creditscoring.com
www.about.com
www.moneycentral.com