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COVER STORY

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Can You Underwrite The Risk Without A Score Card?

Okay, so you decide that the time is right to purchase that new Mercedes you've always dreamed of. Your friend down the street has one and he got a great deal on the interest rate for his car loan. You decide to go to the same dealer that your friend went to. The dealer sends you to the same lending institution for your loan. However, you discover that the interest rate they're offering you is considerably higher than you friend's. Why? Same car. Same dealer. Same lending institution. Well, the chances are good to excellent that the problem is with your credit score. However, there are steps you can take to raise your credit score, if you know what you're doing.

We've all read about the controversies over insurance scoring, a practice where an insurance company sets the premium for your automobile insurance based, at least in part, on your credit history. Consumer activists believe the practice is discriminatory, benefiting those who are more affluent while hurting the poor or those who have not yet built up a credit history — i.e. the younger population. Insurers, on the other hand, argue that scoring is a legitimate and necessary part of rate-setting. In addition, they say that other factors come into play when charging premiums — claims history, driving records, where the car will be kept, etc. Because of these issues, various state insurance departments have been considering legislation that would more clearly define what role insurance scoring should play in the rate-setting process and whether that role should be limited.

[See a descriptive chart showing current state legislation at NAMIC Online <http//:www.namic.org/scorecard/03InsScoring.asp> *—ed.]*

Credit scoring is similar to insurance scoring, except that a person's credit history is used by a lending institution to determine whether a person should be given a loan for a car, a house or be allowed a new credit card and, if so, what interest rates should be charged. There are three credit bureaus used by lenders to obtain credit scores — Equifax, Trans Union and Experian. These three credit bureaus use credit scores provided by FICO (Fair Isaac Corporation). FICO has its own procedure for determining these scores. But more of that later.

The problem is that many people are not even aware of these credit scores or, if they are, have no idea how to manage them and have not been really given the information they need to do so. *[See news story on this subject on page 35 of this issue —ed.]*

At least, that is the opinion of Stephen Snyder, a self-schooled expert on the subject of credit scores and president of an organization called Increase Your Credit Score.com. Snyder says that his passion for understanding the credit scoring process began with his own personal bankruptcy and his struggle to regain credit worthiness. He has spent the last ten years offering his advice on how to "manage" credit scores in seminars around the country.

"Like an athlete's 40-yard dash time at the NFL scouting combine determines his prospect rank, or how the SAT exam for college entrants has an impact on potential college options, your FICO credit score is a critical indicator of your credit worthiness that almost all lenders use," says Snyder. "The higher your FICO credit score, the more attractive you are to lenders. A high score can lower your interest payments, help you qualify for home or auto loans, and effectively increase your cash flow. A low FICO credit score can kill your wallet and squash dreams of a new home or car almost instantly. Until two years ago, the three major credit bureaus did not disclose FICO credit scores to the individuals they had graded. Using algorithms generated by FICO, the credit bureaus let prospective lenders get a peak under consumers' covers, so to speak, without telling the consumers what they were seeing. Now that the three credit bureaus have made the scores available, consumers can help themselves save money by increasing their credit scores," Snyder says.

So, how does FICO determine credit scores? Actually, according to FICO, the scores are calculated from a lot of different credit data in a particular credit report. This data are grouped into five categories and the percentages accompanying them demonstrate their importance to credit scoring. Payment history comes in as the most important at 35 percent. Amounts owed comes in second at 30 percent. Then there is length of credit history coming in at 15 percent and new credit and types of credit used, each coming in at 10 percent.

However, FICO says that these percentages are based on the importance of the five categories for the general population. For particular groups — for example, people who have not been using credit long — the importance of these categories may be somewhat different.

FICO breaks down these categories further. For example payment history would include: account payment information on specific types of accounts (credit cards, retail accounts, installment loans, finance company accounts, mortgage, etc.); presence of adverse public records (bankruptcy, judgments, suits, liens, wage attachments, etc.), collection items, and/or delinquency (past due items); severity of delinquency (how long past due); number of past due items on file; and the number of accounts paid as agreed. A similar breakdown is used for each of the other general categories.

But FICO points out that the importance of any factor depends on the overall information in a person's credit report. For some people, a given factor may be more important than for someone else with a different credit history. In addition, as the information in a person's credit report changes, so does the importance of any factor in determining a person's score. Thus, it's impossible to say exactly how important any single factor is in determining a person's score. Moreover, FICO emphasizes that a person's score considers both positive and negative information in the credit report. Late payments will lower the score, but establishing or re-establishing a good track record of making payments on time will raise a person's score.

The credit scores determined by FICO are purchased by the credit bureaus, who then use additional information (i.e. person's income, length of time at a job or the kind of credit being requested) to interpret the FICO scores, so that each credit bureau may have a slightly different score. A lending institution may subscribe to one bureau, two or all three.

Lending institutions find these credit bureaus necessary in order to gauge a particular risk. Without subscribing to at least one, a lender would have to find some other way of determining a person's credit worthiness. That would be more time consuming and more costly. Getting back to that Mercedes, a person with a credit score of 640 (the highest score is 800) might be approved for the loan, but would have to pay an interest rate of, say, 11.7 percent, while a person with a credit score of 700 might get a much lower interest rate.

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"Once a person understands how FICO works, it can be extremely beneficial," says Snyder. "Back in 1993, when I was forced to file for bankruptcy, FICO played a large part in my recovery. After I realized how to play the game, within months, my credit scores with the various credit bureaus were above 700."

Snyder says that consumers should be very careful in choosing a lender when borrowing money for any reason. For example, he says that most banks work with all three credit bureaus, but many credit unions do not because they find it too costly. "I prefer to work with a lender that works with all three bureaus it gives a better picture of the range of your credit scores."

Moreover, Snyder maintains that once a consumer obtains his or her credit scores from one or more of the credit bureaus, that person should look carefully for errors. "If there is an error, and it produces a negative result, then the consumer has two options," says Snyder. "One is to try to have the error corrected on his or her own. This can be very time consuming and complex, even though all the credit Bureaus now offer their own consumer hotlines to give assistance. The better way is to seek the advice of an attorney who understands FICO and who is better able to substantiate the fact that an error exists."

Snyder says that consumers have to realize that there is "a whole new world out there, and it's all about credit scores." One thing consumers should be careful about is giving permission for credit inquiries, according to Snyder. "Let's say you're at a department store and you're making a purchase. The clerk asks you if you'd like to apply for a credit card for that particular store. You agree and the clerk asks for your Social Security number to run a credit check. That credit inquiry will go on your FICO record and too many inquiries will lower your credit score. Only apply for credit when you really need it. However, pre-approved offers such as with credit cards, do not fall under the category of credit inquiries."

We all know that it's best to pay our bills on time, but Snyder says that's not enough. "Pay your bills at least a week early because it takes time for those payments to be posted. If you pay 'on time,' they may be posted late and that will affect your credit score," he says.

In addition, Snyder advises thinking twice about closing existing accounts. "FICO takes into consideration the length of time you have had credit with a particular account. Some mortgage brokers will advise you to close existing accounts so that it will be easier to obtain a mortgage. But that just lowers your credit score. And, if you have a credit card with a limit of $5,000 and you owe $4,800, raise your limit to $10,000 so it doesn't appear that you are maxing out on the account."

On the subject of insurance scoring, Snyder says that he can understand and empathize with both sides of the controversy. "I can see the insurers' point of view. It has been proven statistically that people with good credit ratings make better risks," he says. "Insurers are in the business of gauging risks and this is a valuable tool. On the other hand, I can understand the consumer's view as well. The consumer will say, 'I have a good driving record, no tickets or accidents, and I have always paid my premiums on time. Why do I have to pay more because I was late on my Macy's card payment?' It's not fair, but that's the way things are. I think the insurance industry has got to do a better job in educating the public about the correlation between good credit and good risks."

And, basically, that's Snyder's view of the entire credit scoring situation. "Like it or not, what we are seeing is the evolution of a new industry. It may need to be streamlined a bit, but it's not going to go away. Some people — people who learn how to manage their credit scores — will benefit. Others will not," he says.