Improving Sales by Understanding FICO Scores

Now more than ever, getting customers approved for loans is a challenge for manufactured and modular home sales professionals. Having a thorough understanding of FICO credit scores is key to helping customers qualify for the best loan. The following is a primer on the credit scoring process.

Overview

FICO credit scores are all about percentages and odds. Lenders use credit scores as a rank-ordering tool to determine how likely it is a consumer will default on a loan. The higher the score the less likely they will default and vice versa. However, the credit score cannot predict whether or not an individual borrower will default; just which group of borrowers they fall into. In every group of borrowers, a certain percentage of consumers will default.

Lending is similar to gambling-- lenders play the odds that the majority of people will pay, just as casinos play the odds that the majority of customers will lose. If a lender makes mortgage loans only to consumers that have a FICO of 800 or above, then statistically only one loan in 1,292 will default in the first year--nice odds! When the consumer's score is 700-719, then one loan in 123 will default. When the consumer's score is 600 or below then statistically one loan in every EIGHT will default.

The odds of a consumer defaulting on a loan are greatest in the first year. The risk drops by a fourth during the second year, then a sixteenth for each year until the loan is five years old, when the risk on the loan being in default will be about half of what it was during the first year.

Believe it or not, 60-65% of consumers have credit reports with no reported delinquencies. Plus, the groups of FICO scores consumers fall into are all equal--there are no more consumers with perfect credit than there are with severely damaged credit.

Consumers break down into the following groups:

FICO Below 620: 20%
FICO 620-690: 20%
FICO 690-745: 20%
FICO 745-780: 20%
FICO Above 780: 20%

How a FICO Score is Calculated

There are many customers that have had next to no credit and the FICO comes up high, and, conversely, there have been consumers that have stable job history, stable residency, pay their bills on time and they score lower than anticipated. The FICO score is determined by these five categories:

1. Payment History
2. Outstanding Debt
3. Credit History
4. Inquiries and New Account Openings
5. Credit Mix

Payment History is 35% of the Score

No surprise--past delinquencies, charge-offs and defaults are the strongest indicators of risk. Delinquencies are evaluated in terms of severity, recency, and frequency. Defaulting on a mortgage is the most severe delinquency after tax liens. Next comes secured loans, such as cars or student loans, then credit cards, and so on.

Outstanding Debt is 30% of the Score

Again this should not be a surprise--debt-to-income ratios are one of the key indicators on a consumer's application. If it takes a majority of the stated income to pay the current balances listed on the credit report, getting a good score will be difficult. The FICO score looks at the number of balances recently reported, the average balance across all trade lines, and the relationship between total balances and total credit limits on revolving trade lines. There is categorization in the scoring: the amount owed on all accounts is taken into consideration as well as the amount

owed on different types of accounts, such as credit cards versus installment loans. If all the accounts have balances, it may drive the score down. A large number of balances and/or a large number of credit cards can indicate over-extension. Also, how much is still owed on installment loans is compared with original loan amounts.

Credit History is 15%

In general, a longer credit history will increase a FICO score. Opening several new credit accounts in a short period of time, such as six to twelve months, drives the score down. The credit score considers both the age of the oldest account and an average age of all the accounts. However, even people who have not been using credit long may get high scores depending on how the rest of the credit report looks--those FICO scores are the most puzzling. Other factors can outweigh the length of credit history, such as when the total outstanding balances are low, the credit limits are not highly accessed, and, as always, if there are no delinquencies.

Inquiries and New Account Openings Account for 10%

This portion of the FICO score looks at the number of inquiries made in the last 6-12 months, the time elapsed since last inquiry, and if several credit accounts have been opened in a short period of time. These factors all represent greater risk of defaulting on a new loan, especially for people who do not have a long-established credit history. Inquiries include requests for additional credit on existing accounts and opening checking accounts. This portion of the score also takes into account how many new accounts by type of account, and how long it has been since a new account was opened. In addition, it takes into account how long it has been since the last credit inquiry, and whether there is good recent credit history following past payment problems. Of particular note in this part of the score: auto and mortgage related inquiries over a 14-day period will be treated as a single inquiry, and auto and mortgage related inquiries within 30 days prior to the time of scoring are ignored.

Types of Credit Used Equals 10% of the Score

Different types of credit accounts and how many of each type establish this portion of the FICO score. There is even a differentiation between credit cards (e.g. bank cards, travel and entertainment cards, department store cards, personal finance company references, and installment loans). It is not necessary to have one of each and it is not a good idea for a consumer to open credit accounts that they do not intend to use. One of the balancing acts of good credit is too many or no bank cards--both lower the credit score. Personal finance company trade lines are seen as an indication of the inability to obtain credit from less expensive sources. The lowest score in this portion of the FICO would be a consumer with no bank cards and several finance company loans.

How Your Customers Can Raise Their FICO Score

Now that we know how a FICO score is calculated, here is how to help your customers improve their score. These are not instant fixes, but hopefully it will help you make the sale six months down the road, because you will be the one that took the time to sit down with them, explain their score and how they can improve it.

--Pay bills on time.
--If there are missed payments, get current and stay current.
--Collections, even if paid, stay on the report for 7 years.
--If their debt-to-income ratio is high, have them contact a credit counselor.
--Pay down balances on credit cards and other revolving debt.
--Pay off debt rather than moving it around.
--Don't close unused credit cards as a short term strategy to raise a score--that ten year old Visa card with a zero balance card contributes to lowering the percentage of outstanding credit and to stability as a long term account.
--Don't open a number of new cards just to increase available credit--this increases recent inquires and will drive down a score.
--If the credit history is short term, such as only a months, don't open any new accounts prior to reapplying for the mortgage.

For more information on helping consumers understand their credit, download the Fannie Mae publication *Knowing and Understanding Your Credit* by clicking here.

This article was based on a presentation by Kim Davidson of Fannie Mae at the 2002 Housing Now Conference. Material reprinted with permission by the Rocky Mountain Home Association.