Economic Trends Commentary

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// Our goal with this commentary is to put common credit score myths to rest, and to shed some light on what the insights and research from Equifax proves to be true.

Busting Credit Score Myths

Ah, the credit score. Is there a number that better captures the zeitgeist of our information age?

When considering a loan, underwriters have historically thought about the "three C's" – Character (Is the individual willing to pay back the loan?), Capacity (Is the individual able to pay back the loan?), and Collateral (What does the individual offer as security against the loan?).[1] For many years, this idea of character was highly subjective, begetting images of dressing in an expensive suit to meet with an officer at the local bank branch hoping to pass muster and secure the needed loan. From the lender's perspective, it was a judgment call, and therefore risky.

Ever since Equifax provided records to Fair Isaac & Co (now known as FICO®) to help create one of the first general purpose credit scores in 1989, credit scores have become a standard tool used by lenders when making a loan.[2] This was vitally important because it took the formerly subjective process of determining character and turned it into a highly objective one. The lender no longer felt a need to know an applicant or judge their willingness to repay. This greatly widened opportunities for both borrowers to gain access to credit and lenders to secure more loans.

At first, scores – and the factors used to create them – were not well known or understood. Over the past decade or so, more and more information has become available about how scores are calculated, what they are based on, and what consumers can do to improve their score. Yet, despite these efforts, credit scores are still largely considered to be a "black box."

Perhaps the most insidious misunderstanding around credit scores is the notion that having a low, or subprime score, somehow makes the individual with that score a "subprime person." Contrary to the messaging used by some marketers to sell their service, a credit score is not a judgment of one's character or worth. Rather, a credit score considers an individual's current debt obligations and past history on credit accounts, and then assigns a score that represents how likely that individual is to make good on his or her debt in the near future. This process takes into account how other individuals in similar circumstances have performed on their debt obligations in the past.

[1]Although depending on the lender, there could be as many as six "C's." In addition to the three traits listed in the main text, lenders sometimes consider: (4) Conditions – Is there something now known that could adversely affect the borrower's ability to pay, such as pending sale of a property? (5) Cash or Capital - does the borrower have enough liquid financial assets on hand to pay if a period of adversity arises? And (6) Common Sense - does the borrower demonstrate an ability to make wise decisions?

[2]Prior to 1989, credit scores were custom models built from credit bureau extracts and created to the individual lending institution's requirements. Not all lenders used them. The advent of generic credit scoring models broadly standardized decision making and also enabled the securitization of card receivables, which provided more funding opportunities for banks and other credit card issuers.

Myth 1 - There is only one score

While the most commonly used credit scores were created some 25 years ago, there are a plethora of scores in use today that correspond to the same consumer at any point in time. To start, there are three major consumer credit bureaus in the United States and even when the same score model type is used there will be variation in a given consumer's score depending on the bureau where it originated. This variation arises because there are differences in the information reported to and collected by these companies and in the scoring algorithms used by each.

Over the years, credit score providers have developed and marketed several general purpose scores based on different proprietary statistical models. For example, VantageScore® has developed three different versions of the same score since 2006, and all three versions of the score are in wide use by lenders. Competing with VantageScore® are scores developed by FICO®, as well as scores created by each of the three consumer credit bureaus, among others. Why are there so many scores? Like most areas of commerce, competition begets innovation. Lenders are looking for effective, accurate information at a reasonable price, and competition fosters both a drive to improve quality and lower prices to win that business.

While general purpose scores work across a variety of industries, scores can also be designed for a particular industry or risk, for instance auto lending, or for a particular purpose, such as predicting likelihood of bankruptcy. These specialized scores use additional attributes that are germane to that particular risk, and are tuned to provide greater accuracy than the general scores. When lenders feel they have the best information available, they are more willing to lend, which means more consumers get the credit they need at a price that is agreeable to all parties.

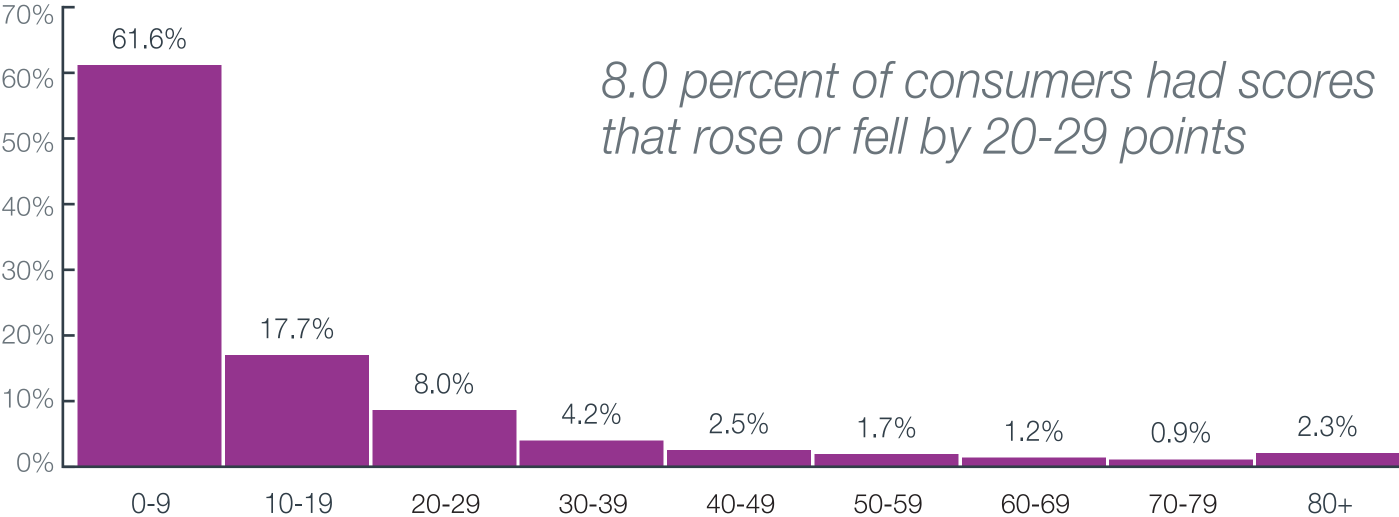
While there are many scores, they typically use the same indicators when evaluating the likely credit risk of an individual. These indicators include; the amount borrowed, the length of time the consumer has had a credit file, the use of open credit, how much the consumer spends in comparison to their limit, the types of credit lines the consumer has open, whether or not there are public records of bankruptcy or judgments, and the repayment history for the individual's accounts. Therefore, good credit habits will generally be reflected positively in scores across the board, while the opposite can be true for missed payments and defaults.

Myth 2 – Credit scores are forever

As Figure 1 shows, there is considerable movement in scores from one quarter to the next. In evaluating 228.5 million recent consumer credit records, we found that 20.7 percent of consumers saw a 20 point or more swing (up or down) in their Equifax Risk Score in a 3-month period. Figures 2 and 3 show the movement in credit scores in more detail for the same 3-month period and for the 12-month window from March 2013 to March 2014, Regardless of the starting score, consumers are more likely to have their score stay within the same score range or move up than they are to have their score move down during this recent window. This is likely a reflection of the improving economy as we will see later on in the commentary.

// A credit score is a point-in-time summary of the current credit situation of an individual and is subject to considerable fluctuation over time as behaviors and situations change.

Figure 1: Distribution of Absolute Change in Consumer Credit Scores Over 3-Month Period



Source: Equifax; Includes all consumers with a valid score in December 2013 and March 2014 (228.5 million). Note - absolute value measures the positive and negative change and considers them equally, thus |20-29| means 8 percent of consumers had scores that rose or fell by 20-29 points.

Myth 2 – Credit scores are forever *Continued*

Figure 2: Migration of Credit Scores Over Three Months

		Equifax Risk Score℠ Band March 2014								
		< 500	500-549	550-599	600-649	650-699	700-749	750-799	800-850	Total
Equifax Risk Score℠ Band December 2013	< 500	67%	27%	5%	1%	<1%	<1%	<1%	<1%	100%
	500-549	12%	59%	26%	3%	<1%	<1%	<1%	<1%	100%
	550-599	4%	9%	67%	19%	1%	<1%	<1%	<1%	100%
	600-649	1%	2%	9%	70%	18%	1%	<1%	<1%	100%
	650-699	<1%	<1%	2%	9%	74%	14%	1%	<1%	100%
	700-749	<1%	<1%	<1%	1%	8%	78%	12%	<1%	100%
	750-799	<1%	<1%	<1%	<1%	1%	6%	81%	12%	100%
	800-850	<1%	<1%	<1%	<1%	<1%	1%	7%	92%	100%

Source: Equifax; Includes all consumers with a valid score in both time periods (228.5 million).

Figure 3: Migration of Credit Scores Over One Year

		Equifax Risk Score℠ Band March 2014								
		< 500	500-549	550-599	600-649	650-699	700-749	750-799	800-850	Total
Equifax Risk Score℠ Band December 2013	< 500	40%	37%	18%	5%	1%	<1%	<1%	<1%	100%
	500-549	15%	35%	38%	10%	2%	<1%	<1%	<1%	100%
	550-599	8%	11%	44%	32%	5%	1%	<1%	<1%	100%
	600-649	4%	5%	12%	47%	28%	4%	<1%	<1%	100%
	650-699	1%	2%	4%	12%	52%	25%	3%	<1%	100%
	700-749	<1%	<1%	1%	3%	12%	57%	25%	2%	100%
	750-799	<1%	<1%	<1%	<1%	1%	10%	66%	22%	100%
	800-850	<1%	<1%	<1%	<1%	<1%	1%	14%	84%	100%

Source: Equifax; Includes all consumers with a valid score in both time periods (221.5 million).

Because of the tendency for scores to increase over time during the evaluation period, a large proportion of consumers with very low credit scores move out of their initial score "band" into a higher one over time. For example, over the 3-month observation window, 33 percent of consumers who started out in the "< 500" band and 28 percent in the "500-549" band moved to a higher score range, but viewed over a year, more than 60 percent in the lowest band and 50 percent of consumers in the "500-549" band moved higher. Naturally, over a longer period more people can be negatively affected too, but the shares of those that moved up during the evaluation period are more than twice the shares of those that moved down, excluding the highest range.

Myth 3 – If I were a rich man or woman…

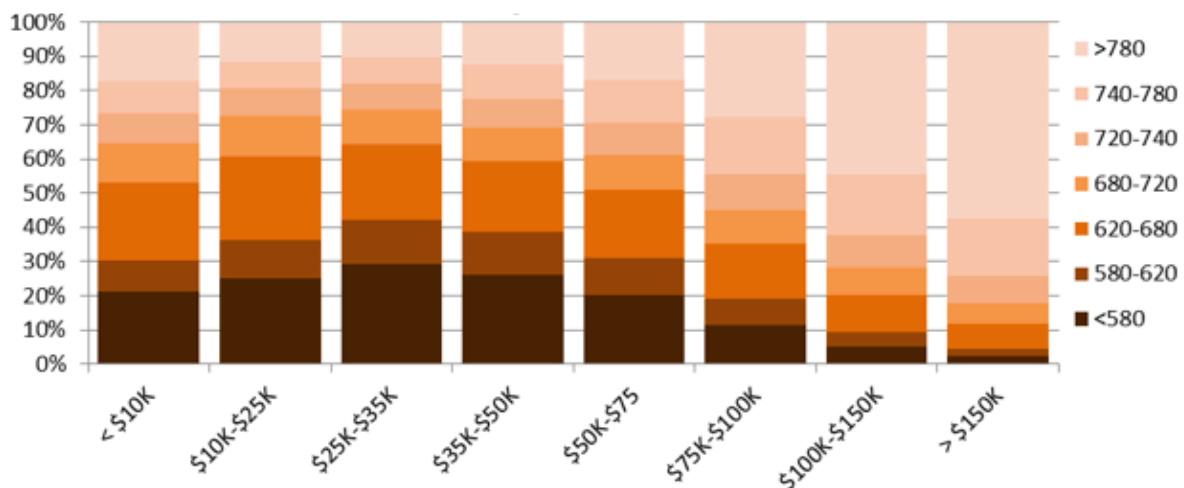
We have been asked many times over the years, "What is the relationship between income and credit scores?" Before we get to that, however, we feel it necessary to underscore that just as credit scores are subject to change, so are incomes and financial circumstances. A person might get a raise, a pay cut, change jobs, lose a job, go on disability, retire, or withdraw from the labor force for a variety of other reasons. According to data from The Work Number®, a solution offered through Workforce Solutions, Equifax, and the largest collection of payroll records contributed directly from employers, current annual job turnover is 43 percent. Meaning, more than four out of every ten jobs at US firms turned over in 2013 with employees separating from their employers.[3]

[3]For more information on job turnover see http://www.talx.com/benchmarks/turnover/index.asp

[4]There is no absolute definition of these various breakpoints. Scores above 720 are generally considered to be "prime" or "super prime" and scores below 620 are generally considered to be "subprime". These specific breakpoints will vary depending on the industry and lender.

Whether we look at income, as in Figure 4, or wealth, as in Figure 5, two points stand out. First, having low income or wealth does not ensure a low score. Conversely, having high income or wealth does not guarantee a high credit score. In fact, over 35 percent of individuals with payroll incomes below $10,000/year have Equifax Risk Scores in the high prime range of 720 and above[4], while 5 percent of individuals with incomes above $150,000 have a score in the subprime range of 620 and below. Similarly, examining household financial assets using the IXI™ Network wealth database from Equifax, 15 percent of households with less than $5,000 in liquid financial wealth have an average Equifax Risk Score in the high prime range. On the other end of the wealth scale, households with average financial assets of more than $1 million still sometimes find themselves with average Equifax Risk Scores of 620 and below.

Figure 4: Equifax Risk ScoreSM Distributed by Payroll Income



Source: Workforce Solutions, Equifax. Based on 37.3 million consumers for whom both valid Equifax Risk Scores and payroll incomes were available in April 2014.

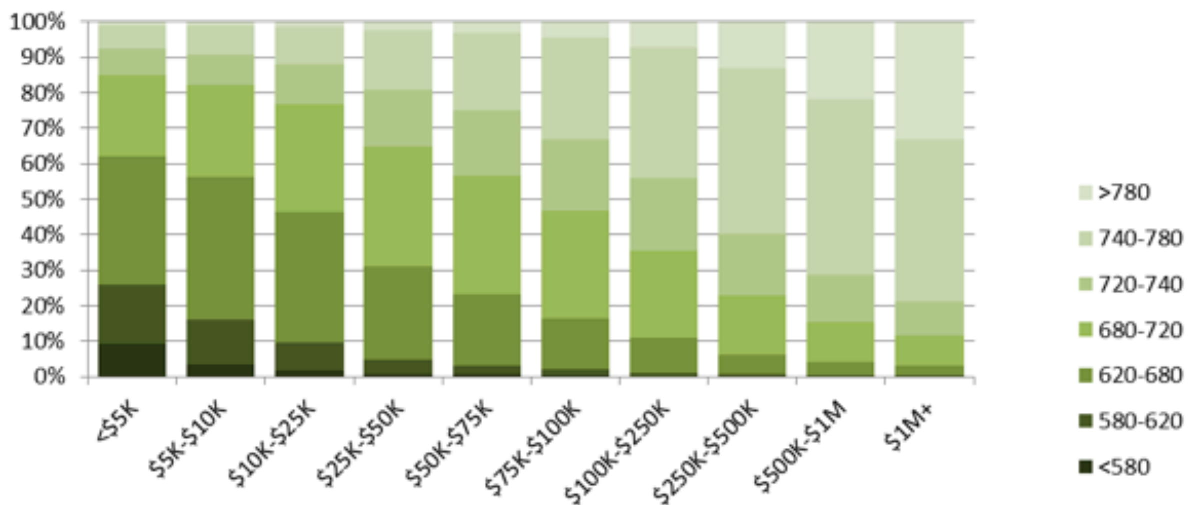
Myth 3 – If I were a rich man or rich woman… *Continued*

Those with modest incomes, up to $35,000/year are most likely to have very low credit scores, but, surprisingly, those with incomes between $50,000 and $75,000 have nearly identical proportions in every credit score band as those with incomes below $10,000. Lastly, at least 10 percent of every income range has achieved Equifax Risk Scores in the high prime range of 780 and above. While greater income and wealth usually brings more financial security, it doesn't necessarily equate to a good credit score.

// More importantly, having lower financial means doesn't imply bad credit.

While age is not a factor in credit scoring models, there are some general trends seen for different age groups. Middle-aged individuals frequently have higher credit scores. This may reflect their experience in managing credit, the likelihood of having a mortgage trade line, and the accumulation of wealth, which can make a difference when there are unexpected expenses. Younger individuals are less likely to have mortgage trades reporting and are more likely to have student loan debt. Credit scores tend to trend downward again as individuals use credit less, as they pay off mortgages and other debts. This decrease in average scores for older individuals is reflective of less recent credit history.

Figure 5: Average Household Equifax Risk ScoreSM Distribution by Household Financial Wealth



Source: Equifax (WealthComplete®). Household wealth based on holdings in bank deposits, brokerage accounts, annuities, mutual funds and IRAs. Does not include 401(k) accounts. Average household wealth calculated from microneighborhoods, which contain about 7-12 households, and are compared to average credit scores for residents in the same area - for this reason there is some score compression in the lowest and highest bins. Data from June 2013.

Myth 4 – Good intentions are good enough

Without question, it is important to use credit wisely. The total amount of debt obligations should fit into a person's budget so that the monthly payments are manageable given current cash flow, savings, and other expected living costs like rent, utilities and food. But what happens to your planning and budgeting when your life takes an unexpected turn or two at the most inconvenient moments?

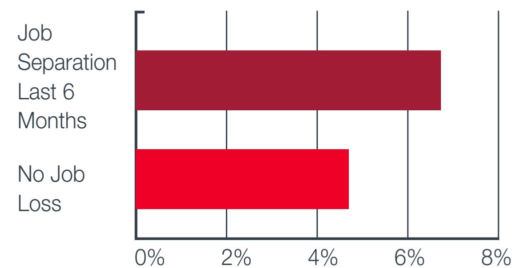
For some, it starts small. First the dog gets sick and the vet bill is put on a credit card to be paid off over the following months. Then the water heater breaks and needs to be replaced, followed quickly by the car blowing a tire. Eventually, these little events add up to more than the budget can handle and the person falls behind on one or more payments.

For others, it's a sudden shock to the system. A major illness or a death in the family, a divorce in the works, or, as was quite common during the Great Recession, a job lost with no replacement in sight. While it is intuitive that losing a job can cause financial hardship, Figure 6 quantifies it in greater detail. Again, using data from The Work Number® database from Workforce Solutions, Equifax, individuals who are separated from their jobs[5] are 48 percent more likely to become 60-days or more delinquent on at least one credit line in the three months following the event than their colleagues who do not suffer a job separation.

During the evaluation period, the effect of a job loss on a person's ability to weather life's turbulence was generally greater for those who previously had higher incomes or who were more successful in managing their credit when employed. In absolute terms, those with high incomes had lower delinquency rates on auto, mortgage and credit card accounts when employed. However, when a job loss occurred they saw the largest percentage increase in delinquency [See Figure 7].

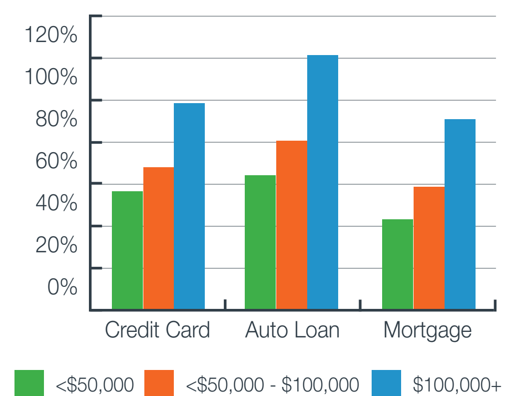
[5]A separation need not be involuntary. Also included in this sample are individuals who retired, left the workforce for various reasons, or who took a different job not part of the Workforce Solutions Network.

Figure 6: 60-day-plus Delinquency Rate for Individuals by Job Separation Status



Source: Workforce Solutions, Equifax; Job status measured July-Sept 2012 and delinquency status measured as any incidence of 60-day or worse delinquency over the following 12 months (through September 2013) Considers mortgage, auto and credit card accounts only.

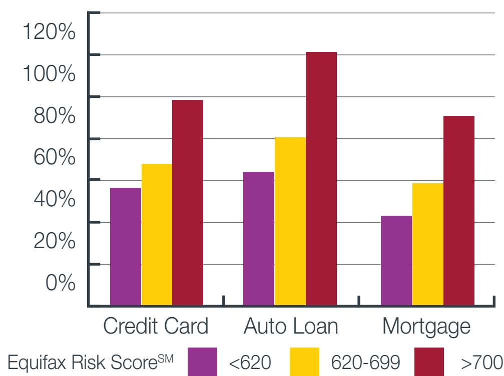
Figure 7: Relative Increase in 60+ DPD Rate Post Job Loss by Individual Payroll Income



Source: Workforce Solutions, Equifax; compares job loss delinquency rate to that of workers who did not suffer a job separation. Income observed Sept 2012 and performance followed for 6 months.

Myth 4 – Good intentions are good enough *Continued*

Figure 8: Relative Increase in 60+ DPD Rate Post Job Loss by Credit Score Band

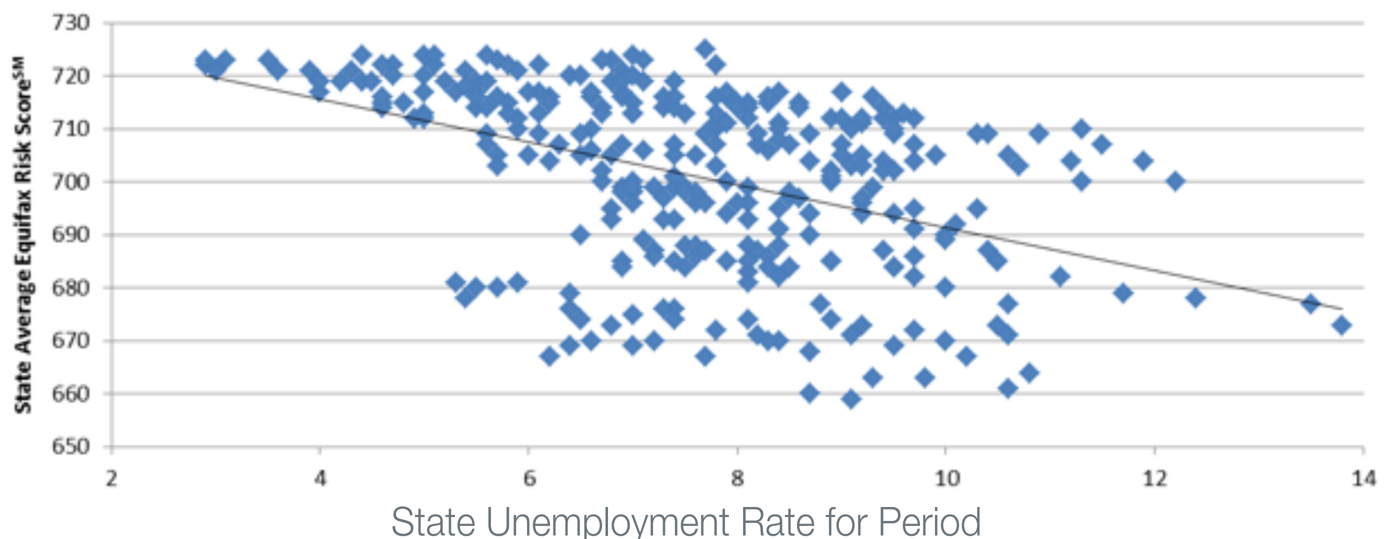


Source: Workforce Solutions, Equifax; compares job loss delinquency rate to that of workers who did not suffer a job separation. Equifax Risk Score measured Sept 2012 and performance measured for following 6 months.

Similarly, during the same period, those with lower credit scores had generally higher levels of delinquency (presumably a contributing factor for the low scores) while employed, but when job loss occurred, the hit to their credit performance was relatively less than for those with higher scores prior to their job loss [See Figure 8].

Clearly, financial stress is a significant driver of bad credit outcomes at the individual level. What happens when the entire nation is under financial stress? If a rising tide floats all boats, does a lowering tide maroon them as well? There is evidence that it does. Figure 9, suggests the relationship between unemployment and average Equifax Credit Score at the state level. Each point represents data collected every 6 months beginning in December of 2010. While there is considerable variation, the trend is clear: higher unemployment leads to lower average credit scores.

Figure 9: State Average Credit Score by Unemployment Rate



Source: Equifax (CreditMix™) and U.S. Bureau of Labor Statistics; data span December 2010 - June 2013 in 6-month intervals.

Parting Thoughts

In this commentary, we've addressed four common myths regarding credit scores and demonstrated that there is more than one credit score; that scores are not permanent; that it isn't how much a person makes that determines their score; and that despite good habits and detailed planning, bad things happen.

Much like cold remedies, the old advice is the best advice. Think carefully before borrowing money. Take on only as much debt as you can comfortably afford. Save as much as possible. Regularly examine your credit report for inaccuracies and fraudulent activity. While you may not be able to stop the rain that life brings, by taking these steps, you can make sure that you're carrying a big umbrella.

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