

CHAPTER 5

Where Do Credit Reports And Scores Come From & How Many Do I Really Have?

Now that you know the costs and casualties of low credit scores and poor credit, let's talk about where credit scores come from, and cover some basic questions about credit reports and scores.

Although credit scoring has been around since the 1950s, it wasn't until the 1980s that it hit mainstream in the United States. Before that, lenders would use human judgment and personal opinion when evaluating a credit report to make a decision on an applicant's ability to repay debt. Not only was this a very slow process, it was unreliable because of human error. Fewer loans were made and it was much more difficult to qualify for financing than it is today.

The History Of The Credit Report

Where did those reports come from that lenders based their judgments on? It all started in 1898 with two brothers who owned a grocery store in Chattanooga, Tennessee. Cator and Guy Woolford assembled credit records of local residents and created what they called, The Merchant Guide, which they sold to retailers for \$25 per year. Retailers used the information as an indicator of consumer creditworthiness. Sounds to me like the making of the first credit report!

The Merchant Guide was so successful that the Woolfords set out to make credit reporting their career. Eventually their company, originally called Retail Credit, became Equifax, one of the nation's three major credit reporting agencies.

As with any successful business idea, you can imagine that hundreds of entrepreneurs followed in the footsteps of Retail Credit hoping to profit on the great idea of selling credit reports to lenders and banking institutions. However, only three credit reporting agencies have truly prevailed: The Big Three. Equifax, Experian, and TransUnion (also known as “The Credit Bureaus.”)

The Credit Bureaus — Who Exactly Are The Big Three?

Mistakenly referred to as the “Government,” the “IRS,” the “devil,” and many other names that would not be appropriate to list in this book, I have found that one of the biggest consumer misconceptions in credit is who the three credit bureaus really are.

The word “bureau” in the Encyclopedia refers to “public office, government agency, news bureau.” No wonder there’s so much confusion.

The credit bureaus are NOT government agencies. They do not work for banks or creditors, and they are not paid to make your life miserable—it just feels that way. They are three companies that saw a vision of huge profits to be made by collecting data about YOU from your creditors and reselling that data to prospective lenders, employers, insurance companies, utility companies, and, most recently, to YOU, the consumer.

Today, all credit reports have one thing in common: The Big Three. All credit report vendors get their data from these three credit reporting agencies. So I think it’s extremely important that you familiarize yourself with who they are, and where they came from. I think you will be quite amused. I know I was.

What Is Equifax?

As mentioned above, Equifax was originally founded as the Retail Credit Company in 1898 by Cator and Guy Woolford.

After their initial success selling credit information to local retailers, the company continued to expand with 300 branch offices and nearly 1,400 satellite offices. In the mid-1960s Retail Credit took the first steps toward automation. They took 3” x 5” index cards bearing information on thousands of consumers and converted it into an electronic database, which proved to be the company’s greatest asset.

In 1979, they changed their name to Equifax, Inc. and strengthened their reporting operations by buying up smaller companies. Today the company, headquartered in Atlanta, Georgia, employs approximately 6,900 people in 14 countries throughout North America, Latin America and Europe. They currently maintain data on more than 300 million consumers and 100 million businesses worldwide.

What Is Experian?

If you come from my generation or before, then you probably recognize the name TRW. In order to understand the relationship of TRW and Experian, I'll have to go back a little in history.

Thompson Ramo Wooldridge Inc. (TRW), was founded in 1901 as the Cleveland Cap Screw Co. It began by making cap screws, bolts, and studs, but soon its main product was welded valves for cars made by automotive pioneer Alexander Winton.

In the mid-1960s, TRW launched its Information Services division and started compiling a consumer database. Like Equifax, the company grew by purchasing smaller businesses and continued to expand. By the mid-1980s, the company had a firm position as the largest credit reporting agency in the United States with credit histories on file of approximately 90 million Americans.

However, in the early 1990s, an article in *The Wall Street Journal* accused TRW of sloppy procedures and inadequate response to consumer complaints. These accusations resulted in a multitude of lawsuits, most of which were remedied; however, at that point TRW decided to sell off the Information Services division, and the first buyer in line was a company called Experian, founded in 1980 by a man named John Pace in Nottingham, England.

Prior to 1996, when Experian acquired its U.S. credit reporting business from TRW, Experian's business was in marketing solutions, decision analytics and interactive services, collecting information on people, businesses, motor vehicles, insurance, and lifestyle data.

The company, currently employing more than 4,500 people in North America, maintains credit information on approximately 215 million consumers and more than 15 million businesses in the United States. The firm provides address information for more than 20 billion promotional mail

pieces sent out to more than 100 million households annually.

What Is TransUnion?

TransUnion was formed in 1968 to be the parent holding company for the Union Tank Car Company, a railcar leasing operation.

They entered into the credit reporting business in 1969, when they acquired the Credit Bureau of Cook County (CBCC), which manually maintained 3.6 million card files in 400 seven-drawer cabinets.

In the early 1970s, TransUnion—creating the tape-to-disc transfer which drastically cut the time and cost to update consumer files—became the first company in the credit reporting industry to revolutionize the transfer of consumer data between the creditors and the credit bureaus.

Throughout the 1970s and 1980s, they continued to expand their facilities and capabilities through investments in technology and strategic growth initiatives and acquisitions. In 1988 they achieved full coverage in the United States, maintaining and updating information on virtually every market-active consumer in the country.

Today, TransUnion reaches businesses and consumers in 25 countries on 5 continents, and they maintain credit histories on an estimated 500 million consumers around the globe.

The History Of The Credit Score — Who Is Fair Isaac & Co. (FICO)?

In 1956, an engineer named Bill Fair and a mathematician named Earl Isaac saw a great opportunity to fill the need in the credit reporting industry for an objective scoring system that would analyze all of the data about consumers quickly and with greater accuracy than human judgment and personal opinion. So with an investment of \$400 each, they started on a plan to create the first credit scoring system. Their company was called Fair Isaac & Co. (FICO).

Between 1956 and 1980, Fair Isaac & Co. implemented its scoring software into the European Banking System. After much success in Europe, the credit scoring system hit mainstream in the United States in 1989, debuting at Equifax.

In 1991, TransUnion and Experian came on board. These three major credit reporting agencies, Experian, Equifax, and TransUnion worked with Fair Isaac & Co. to implement an objective scoring system that would analyze all available data on any given individual, and then compare it against the national average of consumer spending habits. A 3-digit scoring system was developed to rate individuals with scores between 300 and 850 that would quantify his or her ability to pay back money borrowed on a loan.

FACT

It's important to understand that Fair Isaac & Co. itself does not store data on consumers and they cannot change your credit scores or keep a record of them. They simply provide the analytical tools and solutions to determine credit scores.

Today, credit scores generated using the Fair Isaac & Co. FICO scoring software are the most used credit bureau scores in the world, with more than 100 billion scores sold to date.

How Many Scores Do You Have & Which Ones Count?

You have one score.

You have one plus score.

You have one true FICO score.

All scores are FICO scores.

Only the scores from the three credit bureaus matter.

Etc. Etc. Etc.

Do any of these sound familiar?

Many consumers believe that there is only one credit score. This is not true. Every individual has three credit scores that are used by both lending and non-lending industries. These scores are generated from the data stored at the three credit bureaus: Equifax, Experian, and TransUnion.

Where it gets confusing is that there are hundreds of versions of these three credit scores generated from this data and sold to consumers and lend-

ers by hundreds of different credit score vendors. As I will discuss in more detail below, every credit score vendor uses the same data from each credit bureau, however, they all use different software to calculate those scores.

When it comes to applying for a loan, consumers have no idea of which scores will be used. This makes it crucial for consumers to consistently check and manage the data that is being reported about them to each individual credit bureau.

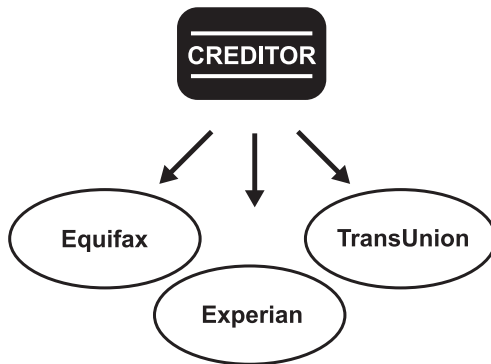
The Credit Distribution Tree

Understanding the different aspects of the credit scoring process can be difficult to get your head around. The following charts use a graphic presentation to illustrate how credit gets distributed. These credit distribution trees should help you understand how there can be so many versions of your three credit scores and reports.

The Data

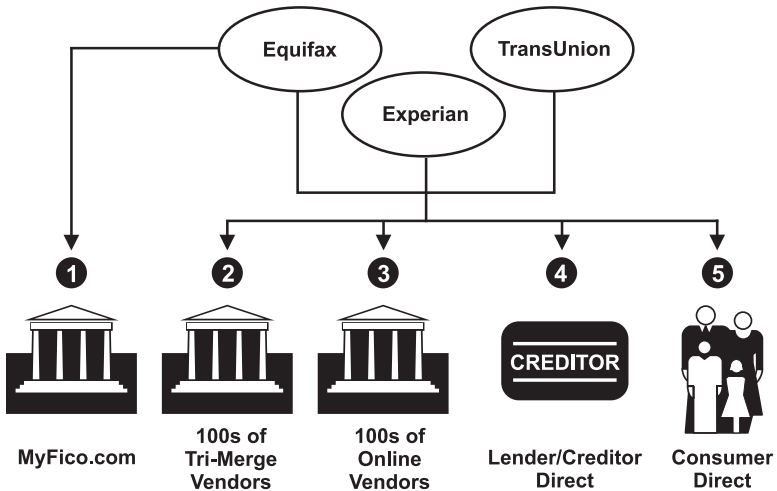
The process starts with a transfer of data from the creditors to the credit bureaus regarding your payment history. This transfer of information is implemented through a tape-to-disc transfer and occurs as follows:

- On open installment and revolving accounts, every 30, 60 or 90 days, depending on the individual creditor's reporting procedures.
- On negative payment history as it relates to collections, charge-offs, and public records, usually within 60-90 days of occurrence.



The Credit Bureaus

- They store your data individually, and do not share that data.
- They update your file whenever the creditor reports. Many creditors do not report to all three credit bureaus, so the information being stored will vary.
- They do not store your credit score. The information in your credit report changes often. Your scores are calculated each time your credit report is pulled.
- They sell your data to Businesses and Consumers in the following ways:



Summary:

1. Equifax sends data to MyFico.com, which I will talk about later in this Chapter.
2. All three credit bureaus sell data to 100s of Tri-Merge Vendors. Tri-Merge Vendors are companies who sell credit reports and credit scores to Businesses (i.e. mortgage companies, auto lenders, insurance companies, banks.) Tri-Merge Vendors would include Land-safe, Kroll Data, and Info 1 as examples.
3. All three credit bureaus also sell data to 100s of Online Vendors.

Online Vendors are companies who sell credit reports and credit scores to consumers directly.

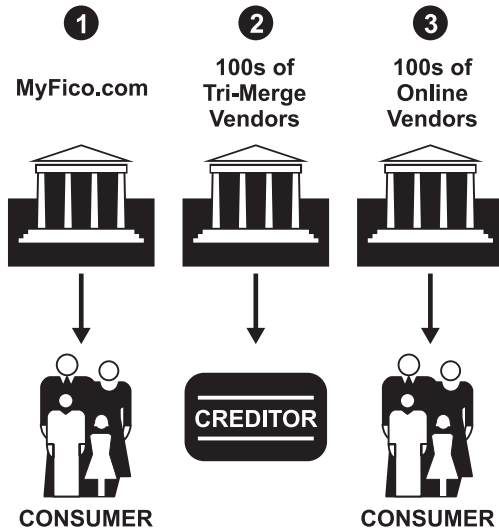
4. All three credit bureaus also sell credit reports and credit scores to businesses direct who use those reports to make lending decisions (i.e. mortgage lenders, auto lenders and banks.)
5. Finally, all three credit bureaus sell credit reports and/or scores to consumers directly.

FACT

The three credit bureaus are the only companies who store your data. In all instances above, the data is fed real-time at the time your credit report is pulled.

Third-Party Vendors

MyFico.com, Tri-Merge Vendors, and Online Vendors are considered Third-Party Vendors because once they receive your credit information from the three credit bureaus they then sell your credit reports and scores as follows:



Summary:

1. MyFico.com sells credit reports and scores to millions of consumers directly.
2. Tri-Merge Vendors sell credit reports and scores to hundreds of thousands of businesses directly that use those credit reports and scores to making lending and non-lending financial decisions about millions of consumers.
3. Online Vendors sell credit reports and scores to millions of consumers directly.

What's The Difference?

As the charts show, there are four channels by which businesses and consumers can access credit scores. They are:

- MyFico.com (AKA: True Fico Score)
- The Credit Bureau Score (AKA: Equifax, Experian and Trans-Union)
- Online Score
- Tri-Merge Score (AKA: Lender Score)

Let's talk about the differences.

The True Fico Score

Credit scores are almost always referred to as FICO scores. This creates some confusion because most people do NOT actually get a true FICO score; rather, they get a score generated from a modified version of the true FICO model.

There are only two places to get true FICO scores: from MyFico.com, the consumer division of Fair Isaac & Co., the creator of the credit scoring software; and from Equifax. Even though all three credit bureaus license the software from Fair Isaac & Co., only Equifax has stayed 100% true to the FICO model.

Why would you want a true FICO score? As many as 90% of U.S. lenders use the FICO model to make lending decisions. Thus this score is

the most realistic one that can be purchased directly.

If that's the case, why wouldn't you *always* purchase a true FICO score? Credit reports and scores purchased from MyFico.com are more expensive than most online consumer credit report vendors.

When is it a good idea to purchase a true FICO score? Before applying for a loan. This is the best way to know what lenders will base their terms on. FICO scores are generally the best indicator of credit worthiness and a good overall indicator of where your credit (mortgage, credit card, auto, etc.) stands.

Does it hurt your credit scores to pull a true FICO score? No.

The Credit Bureau Score

You already know that the credit bureaus use software created by Fair Isaac & Co. to calculate credit scores. Although Equifax uses the exact FICO model, the other two credit bureaus have made minor modifications to the software to be unique and to do what they believe gives them a competitive edge. They do so by selling different formatted credit reports, and by calling their credit reports and credit scores different names.

- Experian sells the "PLUS Score."
- TransUnion sells the "TrueCredit" score.
- Equifax sells the "Score Power" score.

What is the benefit of purchasing a credit bureau score? It's a preference. Some people feel more comfortable going directly to the source of the data.

Why wouldn't you always purchase a credit bureau score? Because to get the full picture, you would have to purchase a credit report and score from each credit bureau individually (three transactions vs. one). Each credit bureau will offer to sell you all three credit scores to try to keep all of your business; however, if you order all three credit scores from one credit bureau, you must realize that those scores are being calculated using that credit bureau's version of the FICO model. So the Equifax score that you receive from Experian will not be the real Equifax score.

When would you want to purchase a credit bureau score? If you are not comfortable purchasing from an unknown online company. Again, it's a matter of preference.

Does it hurt your credit scores to pull a credit bureau score? No.

The Online Score

There are hundreds if not thousands of online companies that offer credit reports to consumers. They offer multiple ways to get your reports. You can get all three reports and one credit score, all three reports and three credit scores, or one report and one credit score. In all cases, the data is taken from all three credit bureaus, and the scores are calculated by applying very general criteria that is not specific to any one use. As a result, the scores generated by these online companies are usually unrealistic when it comes to lending and are therefore not a good source for you to make a determination about how a particular type of lender would view you. Hopefully this will change.

Why would you want online scores? For credit maintenance and credit watch purposes, they are more affordable.

Why wouldn't you always purchase online scores? Because the scores generated by these companies are not realistic to the lending industry. Also, the information offered on these reports is incomplete. You don't get the full picture.

When would you want to purchase online scores? If a consumer signs up for an annual program that generates an updated report every 30 days, it provides an opportunity to monitor credit scores at a reasonable cost. Annual programs also monitor credit reports for identity theft.

Does it hurt your credit scores to pull an online report? No.

The Lender Score (aka: Tri-Merge)

When you apply for a home or auto loan or any type of revolving credit, the scores pulled by lenders are not the same scores that you receive from the credit bureaus directly or from online companies.

Most lenders purchase their credit reports and scores from a third-party

vendor. There are literally hundreds of companies that offer this service to mortgage companies, auto lenders, and banks. Some commonly known companies that generate tri-merge reports are Landsafe, Info1, and Kroll Factual Data, to name a few. This is how it works:

Let's say a consumer goes to ABC Mortgage Company to apply for a home loan. ABC Mortgage Company asks the potential borrower to fill out an application that authorizes them to pull credit reports and credit scores. ABC Mortgage Company uses Landsafe as its credit report vendor. The loan originator at ABC Mortgage goes online and accesses the ABC Mortgage account with Landsafe. The borrower's credit application is then entered into the system. From there, Landsafe's automated system contacts the three credit bureaus who, in turn, respond with a data feed. Once the data on the borrower is fed back into Landsafe's system, Landsafe generates a credit score for each credit bureau.

So, as you can see, all lenders calculate credit scores using the *same data* from the three credit bureaus, but all lenders DO NOT use the *same software* to evaluate that data.

Lenders calculate scores based on criteria considered to be the most pertinent for evaluating creditworthiness as it relates to their unique programs.

Lender scores are not sold to consumers directly. Sometimes your lender can give you a copy of the report that the lending company pulled, but it all depends on the company's agreement with the tri-merge company the lender works with. It doesn't hurt to ask. Just remember that reading a tri-merge report is much different than reading an individual report.

Does it hurt your credit scores when a lender pulls it? Yes. We will talk about how much it hurts your scores in Chapter 11.

What Is A MedFICO Score?

A company named Healthcare Analytics is designing a credit scoring system for hospitals to determine whether patients are capable of paying medical bills. Development of this program is supported jointly by Fair Isaac & Co. and Tenet Healthcare Corp., a leader in the healthcare industry.

The idea behind MedFICO is to pull the credit reports after treatment, not before, so that hospitals can determine whether or not they should write

off unpaid bills as uncollectible, bad debt. Why? Because hospitals are better able to balance expenses against revenue and invest in new ventures if they can more accurately gauge whether or not bills will be paid. The problem is that there is no guarantee. With legislation so far behind, it could be years before a new model contains regulations that force compliance with the FCRA.

Should you be worried? As an expert, I say yes, and here's why: Rumors are swirling that amendments to the Fair Credit Reporting Act are currently under consideration. As we know, the existing legislation currently has many flaws, so how do they expect to regulate and monitor newcomers to the system? And we're not talking about a voluntary credit check (as would be the case for a new car or for a house). We're talking about an emergency, one that catches you completely by surprise—a life-threatening emergency. This development is extremely disconcerting and it elevates the importance of credit monitoring to a critical level.

What Is An Insurance Score?

Some auto insurance companies rely on an Insurance Score. The Insurance Score is very similar to the traditional FICO score. The good news: If you have a high FICO score, you will also have a high insurance score.

What Is Vantage Score?

This is a newly developed program that is backed by the three credit bureaus: Equifax, Experian, and TransUnion. They jointly created Vantage Score in order to have their own scoring software program so they wouldn't have to subscribe to Fair Isaac & Co. (FICO), which owns the scoring software that all credit report vendors use.

To avoid copyright infringement, and to differentiate Vantage from FICO's existing scoring system (which has fallen under a lot of criticism in the media), the three credit bureaus sought to create a completely different product. Vantage uses a numeric scale of 501-990, and also a parallel alphabetic scale that classifies consumers into fixed A, B, C, D, and F grades.

But the Vantage system does not appear to be catching on as a mainstream product. The United States and several other countries have spent billions of dollars implementing the FICO system into business and commerce. It would

be an enormous undertaking and an extraordinary expense to change the way lenders score us. Every lender, creditor and mortgage company would have to implement brand new systems and procedures. In my opinion, it's not going to happen any time in the near future. It's just too big of an undertaking.

And by the way, consumers are just now starting to understand the FICO system. Can you imagine having to start all over again?

What Is Beacon And NextGen?

Beacon and NextGen are not scores. They are versions of the FICO software. Just like when you purchase an update for your computer software.

Beacon (aka: Classic FICO) is the original version of the FICO software, and NextGen 2.0 is the most recent version of the FICO software. The significant differences in my opinion are as follows:

- For the lender, the new model (NextGen 2.0) has 80 predictive variables, more than twice the number in the original Beacon model. This may be good for lenders, however, again—for consumers—doubling the variables only makes the reality of consumers meeting the high standards of the credit scoring system even more difficult.
- For consumers, the most significant change is the increase in the de-duplication period for auto and mortgage inquiries from 14 days to 45 days. De-duplication is the window of time in which consumers can have their credit pulled by as many auto and mortgage lenders as they want and it will only be counted as one hard inquiry. An important point to remember here is that not all credit report vendors have updated their software to the NextGen 2.0 model. I always advise my clients to ask the lender which version of the software they are using to pull their credit. This way they will know whether or not they are going to be hit with a hard inquiry. I talk about this in more detail in Chapter 11.

THE REAL DEAL

The credit scoring system has a generations-long history. From very humble, pre-technology beginnings early developers sought to help quantify the

risk of loaning an individual money. Today, these systems are still widely used on a grand and global scale. This stringing along of seemingly arcane practices makes much of the credit scoring system seem unnecessarily complicated, and not the least bit intuitive.

Thus you need to understand the background that put the systems into place. It is important for you to understand how it all comes together, and how all of these big businesses compile the decision-making information that has master power over your financial future.

Understanding how the credit scoring industry compiles your information will give you a better understanding of how information gets processed, as well as how mistakes happen. The ultimate goal is that this important information will help you be a wiser, better-educated consumer who will know where to go for information and help when there's a problem.