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The basics of risk scoring

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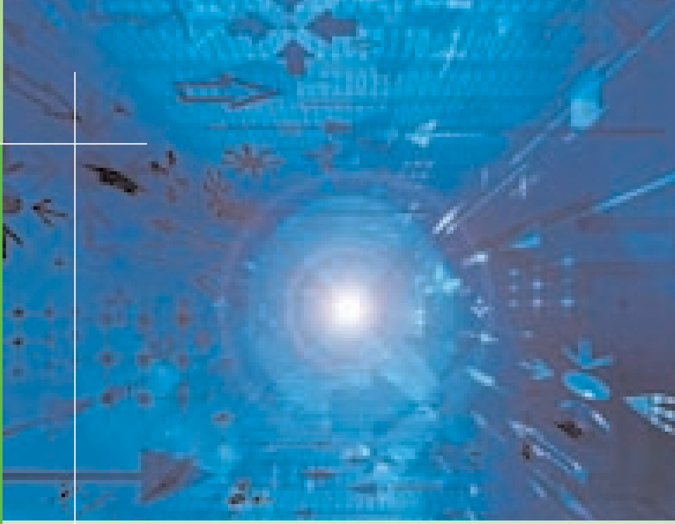

The basics of risk scoring

Companies frequently use automated risk scores to help them make sound decisions rapidly. Risk scores often seem mysterious and secretive. They aren’t.

In the not so distant past, companies relied on experience, intuition and, sometimes, personal bias to make business decisions. Today, some companies use risk scoring to help them analyze information so they can make more objective, consistent decisions — and make them more fairly and quickly.

What is a risk score?

Risk scoring systems utilize formulas to analyze the information in a credit report and sometimes other information you share during the application process. A number, called a risk score, represents the results of that analysis.

Is a risk score part of the credit report?

A risk score is not part of the credit report. Instead, it represents an analysis of the information in the report and perhaps from other sources. Some smaller companies do not use risk scores at all but continue to rely on a manual credit history review.

Experian® may apply one or more risk score models as a separate service when a credit report is sent to a lender or other business. The business may apply risk score models after receiving a credit report, or risk score models may be applied by a third party on behalf of the lender.

Are there different kinds of risk scores?

There is no one risk score associated with your credit report.

A number of companies produce risk score programs, which are called models. Experian has a business, separate from its credit reporting business, that develops risk score models. Some businesses, including lenders and insurance companies, also develop risk score models based on experience with their own customers.

Many businesses use a generic risk model, which is designed to predict the financial risk a consumer will bring to the company. Generic models may be used by many different companies and indicate general financial risk. However, scoring models also may be designed to predict risk for specific types of business decisions.

A credit risk score always is based only on the information in a credit report. The same information, though, is looked at and weighed differently depending on the use. For example, one credit risk score model may be developed by looking at the repayment characteristics of consumers with retail debt over time. Another credit risk score model may look at repayment characteristics as they relate specifically to auto loans. There are also credit risk scores used to help predict the risk of bankruptcy or the likelihood a person will make an insurance claim.

Other scoring models are designed to use additional information. That information may be provided by consumers on their applications or may come from a business's actual experience with the consumer. For instance, mortgage risk scores may incorporate income and employment history from an application, or insurance risk scores may include previous claims records.

How does risk scoring work?

Risk scores don't tell users with absolute certainty that a consumer will or will not behave in a certain way. Rather, a score, within a range of scores for a particular model, reflects how hundreds of thousands of others with very similar credit histories performed over time. No one has a perfect risk score because there is always some risk, even if it is small.

Neither credit reports nor credit reporting agencies "rate" your credit. Businesses must decide what the factual information in a credit history means to them. They use risk scoring systems to help them with that decision.

Not long ago, companies used simple work sheets to review credit reports and application information. By studying repayment patterns, they were able to identify elements in credit histories and sometimes other application information that signaled greater risk.

Today, computerized risk scoring models, also called automated risk scoring models, look at the same information but do so in a much more sophisticated manner. Automated models go beyond simply counting elements in a credit report. They also look at complex relationships among all of the information incorporated into the model.

For example, using a paper-and-pencil formula, a company may have denied a credit application because of a late payment, regardless of other information in the applicant's credit history. Automated risk score models not only consider the number of late payments, but also balance the negative information against all other positive details used in the calculation.

Risk scores also help users make good decisions even though credit histories can be very different. For instance, risk can be assessed on a very short credit history with only one or two accounts or on a credit history with many accounts that have been open for a long time. The issues that indicate risk for a new credit user are not necessarily the same as those for an experienced credit user with a long history. Risk score models balance such differences.

What is a good risk score?

There is no one "good" or "bad" risk score because there are many different risk score models with many different ranges. Companies also consider risk scores differently depending on the amount of risk they will accept and their pricing options.

Each model has its own unique range of scores. In some models, a higher score represents lower risk. In other models, a low score represents low risk. Even companies that use the same risk score model may have different lending criteria, so a "good" score for one company may not be for another.

Is the number important?

While a risk score may be an important part of the lending process, the number by itself is not helpful in understanding a lender's decision.

However, the risk factors that most influenced the risk score at the time it was calculated are very helpful. The risk factor statements describe

what must change in a credit history to influence the characteristics that indicate higher risk to businesses.

Because risk factors describe what is negatively affecting the score — even if the score is very good — they always sound bad. However, models always generate factors, so the better the score, the less significant the factors become.

Businesses provide these statements if they take adverse action based on information in a credit report, even if the businesses do not use automated risk scoring systems to analyze the report.

When a consumer calls Experian with just a number, he or she is referred back to the business to obtain the risk factor statements. Experian doesn't know what a number means because it doesn't know what risk scoring model was used, what scale the business applied or how the business interpreted the score.

■ How do I get a better score?

Because it is not part of the credit report, a risk score cannot be disputed. Instead, you must address information from the credit report or other sources that affected the score. That information is identified by the risk factor statements, which are generated along with the score at the time it is calculated.

The risk factor statements are the keys to improving risk scores. The risk factor statements explain what to address from the credit history or other application information to meet the business's criteria. Addressing the factors should improve a person's overall risk level over time.

Time is also very important. Usually, making a single change to a person's credit history does not instantly result in a dramatic improvement. Addressing the risk factors is the first step. Those changes typically result in slight improvements that become more significant as good credit management is consistently shown over time.

For instance, paying a past-due debt will not typically result immediately in a huge improvement and may negatively impact the score temporarily. Keeping the payments current over time will demonstrate good credit management. That will result in better risk scores, no matter what risk scoring model is used.

How do I see my risk scores?

Risk scores are available for a service fee from a number of sources. Experian offers risk score services that include a score, an explanation of what most affected it, education about how to improve the score — and therefore your creditworthiness — and a simulator that enables you to see how certain actions could influence the score. You can find them online at **www.experian.com**.