Fair Isaac's Credit Scoring Change Will Affect MILLIONS. Some Good, Some Bad!

They call it the authorized user trick; or at least I did. I have been forecasting for quite some time that Fair Isaac would eventually fix their software and eliminate the loophole that allows someone to quickly increase their credit score by having someone with a seasoned credit card add that person to their credit card as an authorized user.

Here's how it works: The credit score is similar to a camera whereby it takes a snapshot of the information contained within the credit bureaus database, analyzes the information, and then assigns a score to it that tries to predict the likelihood of whether or not that person will pay 90 days late or more on that account over the next two years.

Not all credit scoring software is the same, just like all software products on the market are not the same. F air Isaac is the Microsoft of credit score providers.   Their credit scoring software called "Classic FICO", is the standard in the mortgage industry and used to determine whether or not loans get approved or not. With a range of 300 to 850, this three digit number has statistically proven in the past whether or not somebody would pay 90 days late or more over the next 24 months with almost pinpoint accuracy, for example; in the past a person with a 500 credit score has shown a tendency to pay 90 days late or more within a two-year period one out of eight times that person in that score range was given a loan. In contrast, a person with over an 800 credit score has shown the tendency to pay 90 days late or more within a two-year period only one out of 1292 times. This allows the banks to forecast how much it will cost them to give a loan to a person based on the applicant's credit score. When the Banks are armed with the statistical knowledge of whether a loan will go into default based on a particular credit score, the banks can then crunch numbers even further and determine how much it cost them to chase the defaulted borrower to collect the money. This is exactly why loan rates vary by credit score range. To explain this even further and put things in context, if you were a landlord that rented a cottage to people during the weekend, and one out of eight people that you rented to drove their motorcycle through the house after running over a skunk, chances are you would charge enough to cover the cost of getting new carpet every eight times you rented the cottage. But if that same skunk run scenario only happened once every 25 years, chances are the rental rate would not increase much; if at all. Whether you're buying new carpet or chasing down delinquent loans, being able to segregate and predict this cost is an invaluable tool when determining what price to charge for a product or service whose cost is directly linked to whether or not an event takes place. That event in the mortgage world is defaulting 90 days late or more in the first 24 months.

The system is not perfect though: Authorized user accounts and the way they are handled by Fair Isaac's Classic FICO Score, has allowed people to increase their credit scores up to 100 points in less than 30 days. This was made possible due to a design flaw in Fair Isaac's software. When Fair Isaac designed the credit score, they did this by analyzing one million credit reports over a two-year period. At the end of two years they looked and took note of the ones that had a 90 day or more delinquency occur during that two years. They then separated these people from the others that did not have a 90 day or more delinquency on the credit report and then proceeded to identify things they all had in common on their credit reports and use those characteristics in the future to predict whether or not somebody was going to join the 90 day group of people or the people that were not 90 days delinquent or more based on the

characteristics they identified in each group. While not a perfect system, it is a very good predictor of whether a person will default by 90 days or more over the next 24 months.

But just like any system there are weak spots and ways to skew those numbers to one's benefit. When fair Isaac designed the scoring software, one of the things they did not look at or analyze in any way was the ownership of the account being reported on the credit report. Add to this the fact that the credit score does not have a memory and you now have two of the three elements needed for the perfect storm. This third element was whether or not a creditor reports the ownership type of a person that is not primarily responsible on the credit card but allowed to use it " the Authorized User" and the perfect storm occurs when the authorized user is reported to the credit bureaus by the bank. The effect this has on the score depends on three variables: The amount of time the credit card has been open, the credit limit of that credit card, and how much money the primary cardholder owes on the credit card in relation to the credit limit. The older the credit card is, the more of a positive effect it has on the credit score, the higher the limits coupled with a low debt ratio, the more the positive effect it has on the credit score.

When the Bank reports the account on the authorized user's credit report, they report the exact same information as they report to the primary cardholder's credit report. Given the fact the credit score has no memory, it has no way of determining that the account was not there yesterday and proceeds to calculate a score based on an extremely long credit history with a very low debt ratio as in our ideal example. Somebody with a limited credit history and a high debt ratio will benefit because when an authorized user account is added to their credit report, this can increase the average age of the credit file on their credit report dramatically, which is 15% of the credit score, and also reduce their debt ratio if this credit card being added has a low debt ratio, which amounts to 30% of the factors used to determine the credit score. Add on a perfect payment history reported on that card, and you just affected 35% of what determines the credit score, which is "payment history".

Although this practice has been going on for quite some time, a few companies came out of the woodwork with a marketable service that catered to consumers that would benefit from the perfect storm. These companies would recruit people from all over the country that had older credit cards with low debt ratios and offer them $100-$300 for each person they added to their credit card as an authorized user. They would then go and market to consumers with limited credit histories and/or high revolving debt ratios and offer to have them added as an authorized user on a seasoned trade line for around $1500 per credit card and pocket the difference. As this practice became more popular, it wasn't long before the over exposure of this loophole shed light on the flaws of fair Isaac software. Under pressure from lenders that used Fair Isaac's software, Fair Isaac made the decision to invest the money and correct this loophole in the software for good. The correction to their software is fairly simple: When Fair Isaac takes that snapshot of somebody's credit file, they are going to look at one extra field that they previously had not looked at when generating the score. That field is the one that says who is responsible for that account. If the scoring software sees that the person is the primary on the account, then it will score the report just like it had done before and no change to the credit score will take place between the old and the new scoring model. This will also hold true if it says that the account is a joint account. But if they see that the responsibility on that account is as an authorized user designation, they will completely ignore that entire account when calculating the credit score. It doesn't matter if the authorized user was added five years ago or yesterday, they will instantly lose the benefits created, if any, from that account being shown on their credit report. You are going to see many people's credit scores drop dramatically the second this new software is implemented. On the flip side you will see some people benefiting because authorized user accounts are not always a good thing to

the person that is the authorized user. Whenever the primary account holder is maxed out on their credit card, so is the authorized user. Whenever the primary account holder had the account for a short amount of time, the authorized user's average age of the credit file is reduced also. And last but not least, when the primary pays late, the authorized user is late. For those people that are authorized users on accounts with these characteristics just mentioned, they will receive a credit score boost once the new scoring criteria is implemented.

Patch one hole, another will follow: There are however shrewd companies already working on the next best solution to the authorized user loophole. One company for example will give a credit card to anybody without even checking their credit. This company offers a credit card that can only be used to purchase their e-book products. Anybody can get a $5,000 credit limit with this company for around a $200 fee. The part that caught my attention was the obvious success potential and chances of this actually lasting when I realized that the cost of goods sold for an e-book was almost nothing. I also quickly determined that no matter if the credit limit is $ 5,000 or $500,000, not many people want to spend more than even $100 on e-books, zero for me. I would also assume that the best thing this company would want is that everybody maxes out the $5,000 and not pay so they could actually attempt to collect even a small portion of these accounts. Given the fact that the monies collected are basically 100% profit, these companies won't even lose any sleep if their default rates went through the roof. This business model is legitimate in the sense that unlike the authorized user loophole, these accounts are opening on the date the person gets the account, they also satisfy the criteria of being a legitimate product being sold in commerce coupled with the extension of credit associated with the marketing and sale of that product. It doesn't take a brain surgeon to see the purpose behind such an offering; but then again, in our society, "if the glove doesn't fit you must acquit!" These types of product offerings are going to increase now that the authorized users reign as king of the credit score loopholes has come to an end.

Even though you can still benefit the credit score today by having someone add you as an authorized user to a seasoned account, many lenders have started denying loan applications if there is an authorized user account on their credit report due to the fact that the credit score may not be an accurate predictor of risk. The primary person on the account does not get hurt by this because there is no way to know whether that person added anybody as an authorized user by looking at the credit report of the primary and therefore that person is not affected in any way now, or in the future when the software is changed. Due to the fact that the scoring model is changing in a few months coupled with the fact that lenders are denying applications in some instances if an authorized user account is present, I would advise that people refrain from getting added as an authorized user immediately since the benefit will soon be gone and taking advantage of that benefit before it leaves may leave a person with no loan at all due to rejection from the lender.   Whether or not the current exploited practice of adding people as an authorized user will amount to mortgage fraud remains to be seen. I would be willing to bet that nobody will be convicted of mortgage fraud when a friend or a family member adds that person to a credit card in order to boost their credit score, but once you take it a step further and hire a company offering the service of adding trade lines, and you then pay for that service and get added to a complete stranger's credit card that you don't have access too, it becomes much harder to defend the position that mortgage fraud is not present.

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