ASPECTS

CONSUMER CREDIT SCORES

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RELEVANCE OF CREDIT SCORES

Consider a hypothetical situation:

Person A lives in a rented accommodation and wants to upgrade into a larger owned home. He applies for a home loan at his primary bank, his application is approved and he is satisfied with the repayment terms. He purchases the house and relocates, excited about his life ahead.

Person B, earns a similar income as Person A, and also wants to own a home. However, his application for a home loan is turned down by several banks and finance companies. They inform him that he has a "low credit score" and a "damaged credit file". Surprised and disappointed, he obtains a copy of his credit file from a leading credit bureau, and starts to investigate what a "low credit score" is and how he ended up with one[1].

CREDIT FILES & SCORES

Lenders viz. banks and non bank finance companies, that provide loans and financing to consumers for various purposes e.g. home loans, education loans, credit cards, car loans, retail loans etc. report specifics of their loan accounts including borrower profiles, loan terms, repayment histories and several other attributes, on a periodic basis, to independent companies called credit bureaus.

The bureaus in turn compile all of this information from all of the lenders who report it, and create a Credit File for every individual[2].

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[1] Illustrative situation to discuss certain concepts. Does not relate a known, specific real world example.

[2] People who are less than 18 years of age, those with no history of credit usage or those who are new to a country and with certain specific attributes may not have a credit file at any of the bureaus. They are commonly referred to as "No Hits".

RELEVANCE OF CREDIT SCORES

They also compute a normalised composite score from this information and this score is called a Credit Score or a FICO Score. A credit score is thus, a numerical score assigned to every individual depending on his or her borrowing history, repayment record and usage of credit, amongst other factors[3].

In India, Credit Scores usually range from 300 - 900, and predict the likelihood of a scored consumer not meeting his credit obligations per agreed terms. Low scores imply a higher likelihood of not paying on time and higher scores predict a higher likelihood of timely payments.

The key underlying drivers of great scores are responsible borrowing habits and a pristine repayment track record. On the other hand, borrowing excessively beyond one's means and/or not making timely repayments are likely to lead to a low score and a weak credit profile. Higher is the degree of derogatory behaviour i.e. late payments or overdue amounts, higher is the hit to one's credit score.

A high credit score may enable several options for obtaining credit on favourable terms, while a low score may lead to loan applicants being turned down or credit being offered on unfavourable terms[4].

Now when any individual applies for a new loan, or when a lender is evaluating additional credit or other credit actions (i.e. offering a higher credit line on an existing credit card), the lender is likely to request the credit file and credit score of the applicant under consideration from the credit bureau. The bureau provides this data for a small fee, and it is usually an important part of the credit evaluation process which determines whether a new loan or additional credit will be approved and on what terms.

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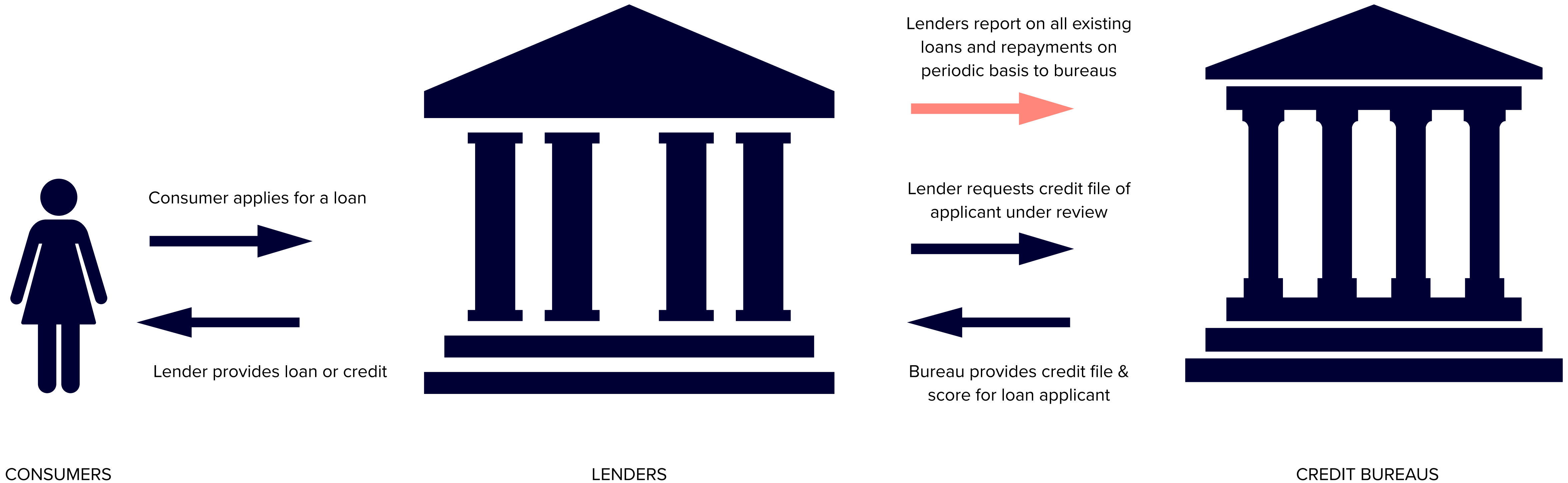
[3] Computation of credit scores involve complex models with many variables and associated data over long timeframes.

[4] Most lenders would view a high FICO score favourably, however a great score may not necessarily guarantee approval for a specific loan.

RELEVANCE OF CREDIT SCORES

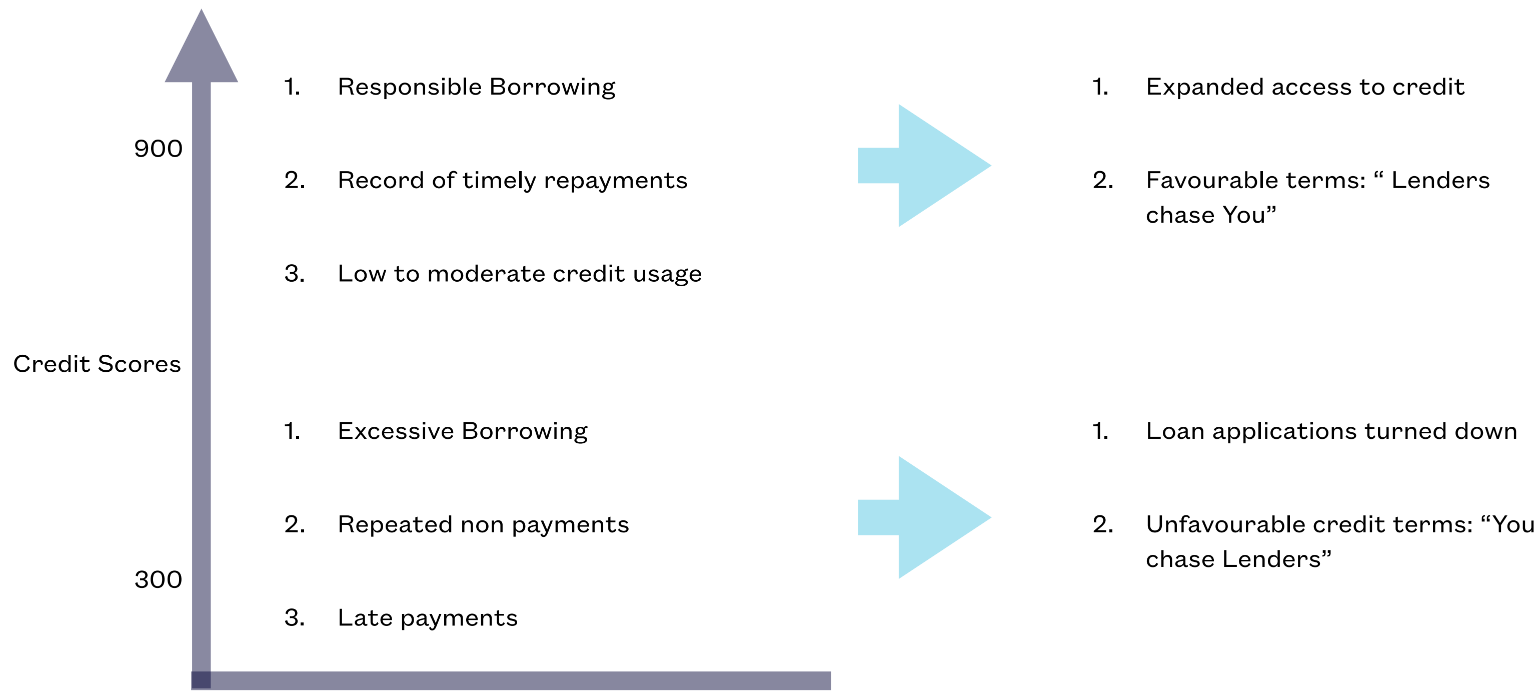
Loan Applications: Consumers, Lenders & Credit Bureaus



From a consumer's standpoint, the power to build and maintain a strong credit profile rests largely with oneself, via responsible credit usage and disciplined repayment habits.

RELEVANCE OF CREDIT SCORES

Schematic: Credit Score Drivers and Outcomes



CREDIT BUREAUS

Worldwide there are three main consumer credit bureaus, Experian, Equifax and TransUnion and all three are present in India. CRIF High Mark, a prominent European bureau is the fourth consumer bureau operating in India. In addition to being repositories and suppliers of credit and loan information, bureaus also provide sophisticated risk and information management services on consumers and companies to lenders and other third parties.

RELEVANCE OF CREDIT SCORES

TransUnion was the first credit bureau to set shop in India in partnership with CIBIL (Credit Information Bureau India Limited) in the year 2000 and it commenced credit bureau services in 2004. The company carries information on more than 100 crore consumers and companies and more than 5000 lenders and other companies are its members. TU provides the CIBIL consumer credit score.

Experian Credit Information Company of India, started operations in 2010. It has a database of 43 crore records with 5000+ members. The third major credit bureau, Equifax, was registered in India as Equifax Credit Information Services Pvt. Ltd. in 2010 as a joint venture between Equifax Inc. USA and seven Indian banks and NBFC's[5].

Financial institutions accredited by the RBI, can become members with one or more credit bureaus per a fee schedule and commit to providing credit information to the bureaus on an ongoing basis, and obtaining credit data as may be relevant to their business strategies.

Consumers can obtain their credit reports and credit scores from any of the 3 bureaus and can also dispute any information on their credit file which they think is incorrect.

[5] Source: Web portals of credit bureaus.

RELEVANCE OF CREDIT SCORES

A WIN WIN SYSTEM

Evidently, there are 3 main entities in most borrowing and loan transactions. Borrowers or consumers, lenders and credit bureaus. The systemic and widespread use of credit scores and bureau information in assessing credit worthiness and evaluating credit applications has positives for all three.

Consumers can develop strong credit profiles and strengthen and maintain them via conscious self driven choices on credit usage and repayment. By demonstrating responsible credit behaviour they are rewarded by the opportunity to access credit at favourable terms, which may then be deployed towards value and utility enhancing actions e.g. pursuing education enabled by education loans or purchasing a home by taking a home loan etc., and doing so while keeping the financial cost low.

Lenders utilising bureau data, have access to a uniform set of inputs developed on comprehensive historical information across all past loans which they can include in their loan evaluation and strategic decisions in a consistent and transparent manner. They are able to evaluate applicants on demonstrated past behaviours, expand access and provide credit to worthy applicants, while reducing credit and fraud losses.

Credit bureaus, as the independent central repository and processing hub of credit and loan data, benefit by having more lenders and hence more consumers as part of the system since it improves the relevance, depth and accuracy of their information and analytical models, while reducing cost.

RELEVANCE OF CREDIT SCORES

Increasing reliance on credit files and scores for decisioning does involve risks which need to be carefully evaluated and managed. Consumer privacy, country specific regulations, strategic and operational blindspots are perhaps the salient ones.

Finally, while many of us borrow with a plan and intend to repay the monies we borrow, there can always be surprises in one's life which can impact cash flows and the ability to spend and to repay. Consequently, it is perhaps prudent to be financially literate, stay aware of one's credit profile and score and nurture it with responsible credit usage and habits.

APPENDIX

Disclosures

1. Consumer Credit Files and Scores are primarily utilised for evaluating the credit worthiness of applicants for loans and other credit products and for other strategic and operational decisions at financial companies, and are discussed above as such.

2. Newsletter is shared with prospects and clients for informational reasons. We are not compensated by any third party for doing so.

3. Data from the Internet are not additionally verified.

Sources

1. www.transunioncibil.com
2. www.equifax.co.in
3. www.experian.in
4. www.crifhighmark.com
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7. Cover Image: www.googleimages.com

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