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A secret three-digit number determines how you'll be treated by banks, lenders and even employers. But what if your number is wrong?

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What's Your Credit Score?

● THERE'S A THREE-digit number that determines a big part of your life, yet chances are you don't know it. Rest assured, though, that your bank does, and perhaps your landlord, employer and insurer, too. And they're using your three-digit credit score to decide whether to approve you for a loan, raise the rate on your mortgage, and perhaps even charge you more for home insurance.

Is this a problem? Not according to the financial institutions that calculate the credit scores. But the mechanics of credit scoring are shrouded in secrecy and most observers agree that errors are widespread. "The credit sys-

tem comes down to this simple number," says Sue Lott, a lawyer who recently studied the credit scoring system for the Public Interest Advocacy Centre (PIAC) in Ottawa. "If you're going to pass or fail according to this number, you hope it's fair and accurate, but it's not always."

Credit scores are essentially an attempt to put a precise number on the likelihood of

you repaying a loan. Instead of being labeled an "excellent," "fair" or "bad" credit risk, you're tagged as an 820, a 710 or even—horror!—a 550. No human judgment is involved. Rather, a computer program uses statistical techniques to examine your credit history and estimate your creditworthiness.

While that sounds very scientific, any credit score is only as good as the data fed into the program. In Canada, the scores are typically based upon data amassed by three major credit reporting agencies: Equifax, TransUnion and Northern Credit Bureaus (NCB). These companies collect information from banks, credit grantors, collection agencies and public records. They monitor the number of credit accounts you have, their balances, your payment history, any recent bankruptcies and the like. The bureaus sell this information to businesses, which use it to assess your creditworthiness.

Equifax and TransUnion also use the information in your credit file to assign you a credit score between 300 and 900. (NCB does not currently provide credit scores.) In general, if your score is above the mid-700s you're an excellent candidate for a loan or credit account. A score lower than 600 may result in your being

denied credit; at the very least, you'll pay a higher interest rate. Mike Morley, a Toronto consultant who specializes in mortgages and credit risk, says that if you're between 701 and 750, you'll likely pay one-quarter to half a percentage point more than someone with a score above 750. Over the term of a mortgage, that translates into a difference of thousands of dollars in interest.

The idea of credit scoring is to give lenders a quick and easy way of assessing the risk they're taking by lending you money. In theory, it should also serve the public as well, by speeding up the application process and allowing responsible borrowers to get the best rates. Unfortunately, credit scoring is rife with problems. Here are the three biggest ones:

YOUR CREDIT SCORE IS A BLACK BOX. The formula used to generate credit scores may as well be Colonel Sanders' secret recipe. Equifax's scores are calculated using soft- ➤



me, they always tried to play down the heightened paranoia about credit scores. Well, one way to do that is to be more upfront about what's in them."

YOUR CREDIT SCORE MAY NOT BE ACCURATE. It's easy to find people with horror stories about errors in their file, though credit bureaus argue strenuously that they devote enormous resources to quality control. "It's our bread and butter," says Odette Auger, vice-president of operations for Equifax Canada. "The files have to be accurate, because our customers would not want to buy them if they were not." Richard Huot, president of NCB, says his company is similarly diligent. "We have programmers who work full-time to make sure the information given to us is accurate."

You would think that companies that profess such devotion to accuracy would happily submit to scrutiny, but you would be wrong. The amazing fact is that they can volunteer no data to prove their claims—they've never had their files scrutinized by an impartial outsider to find out how common errors might be.

Whenever consumer advocacy groups attempt their own surveys, the number of errors is shocking. In Lott's survey of more than 3,000 Canadian adults, only 17% had checked their credit files in the last three years—but, of those, 18% found an error and 10% of them felt they had been denied a financial service because of the error. Extrapolating those numbers,

ware developed by Fair Isaac Corporation (FICO), a Minneapolis company that pioneered the concept of credit scores. Trans-Union generates its own scores, as do some banks, but in all cases the formulas are kept under wraps. "It's a secretive system,"

says Lott, the consumer advocate. "The banks have argued in front of the Privacy Commissioner that it's proprietary information that should be allowed to remain secret, and that's been upheld."

You can learn what factors contribute to your score (see *How to improve your credit score* on page 58), but it's impossible to know exactly what effect your actions will have on the final number. Indeed, consumers can harm their scores by doing things that seem eminently sensible. For example, carrying a small balance on a credit card may give you a higher score than if you always have a zero balance (or have no credit card and pay cash), because it demonstrates a tendency to make regular debt payments. Choosing to rent a home or owning one outright rather than carrying a mortgage can also lower your score for the same reason. Closing old, unused accounts after you acquire new ones can harm your score, too, because it appears to shorten your credit history.

Lott wonders how consumers can feel confident about their credit scores when they're expressly prevented from knowing how they're calculated. "If the credit bureaus are defending the scores because of their greater objectivity, then what's so difficult about being open about what constitutes it? In their interviews with

A good credit score can give you prompt access to loans. But a low credit score can cost you thousands of dollars in extra interest charges and higher insurance fees

the report suggests more than three-quarters of a million Canadians have had services withheld as a direct result of inaccurate credit reporting. Morley's assessment is even more grim. Based on his 30 years of experience, he estimates 40% of credit reports are inaccurate.

The credit bureaus, of course, dispute these numbers. "No, there are not thousands and thousands of errors. It's minimal," says Auger. Yet she admits that Equifax gets about a million consumer inquiries a year. Even if only one in a hundred is the result of a genuine error, that would amount to 10,000 problems annually.

Auger insists most errors, such as listing an out-of-date employer, don't affect your credit score. Credit bureaus also say people don't realize it takes time for files to be updated after they pay off an account. But Morley thinks those are lame excuses. "Getting your initial wrong, or your previous employer wrong, or listing a spouse who's really an ex-spouse—if it's my credit report, those are big errors. But they're asking, 'What's the big deal?'"

And it's not just wrong initials and ex-spouses. When MoneySense.ca invited readers to share their experiences, we turned up several stories from people whose files contained major errors. Most came from men who shared the same names as their ►

How to improve your credit score



our credit score is probably somewhere between the mid-600s and the mid-800s; the median score in Canada is around 750.

Your score moves slightly with every change to your credit file, but because the scoring systems are a secret, no one can say that doing X will raise your score by Y points. However, you can apply these tips to keep your number as high as possible:

● **PAY YOUR ACCOUNTS ON TIME.** Your history of on-time payments makes up about 35% of your score. Even one or two payments past 30 days will affect your score.

● **KEEP YOUR BALANCES RELATIVELY LOW.** About 30% of the score is related to how much you currently owe. If all your cards are maxed out, you're not a great

candidate for more debt.

● **DEMONSTRATE A CREDIT HISTORY.** The length of time you've been managing credit makes up 15% of your score. So think twice before closing your oldest accounts—doing so will reduce the apparent length of your credit history and thus your credit score.

● **DON'T APPLY FOR ACCOUNTS YOU DON'T INTEND TO USE.** About 10% of your score is based on the number of accounts you've applied for. Another 10% is based on your mix of account types (credit cards, installment loans, lines of credit). Opening too many accounts in a short time can be a red flag, so signing up for a credit card at the mall just to get a free T-shirt is definitely a bad idea.

fathers. In one case, a student was denied a loan because his file included his father's corporate Visa account with a balance of some \$50,000. Auger admits this can also happen with twins who have the same surname, birth date and address.

Who is responsible for correcting these errors? You are. Credit bureaus like to point out that people can order their credit file for free, and that they will investigate any claims of inaccuracy. Yet this is time-consuming and stressful, especially since credit bureaus are notorious for their indifference to the public. After all, the bureaus don't need to care what you think of them, because you're not their customer. "Unless you're correcting personal information like name, address and phone number, you're wasting your time talking to the credit reporting agency," says Morley. He says you should go directly to the financial institution that supplied the misinformation, and then ask them to contact the bureau.

That's why placing the onus on the consumer to correct errors isn't just arrogant, it's ineffective. "The

problem is that the consumer doesn't have that much control over the inaccuracy," Lott says. "They don't control this huge movement of personal information from place to place. So the responsibility has to be greater on all the players in the credit reporting system to try to reduce inaccuracy."

Lott would like regulators to force credit bureaus to make credit scores available free to consumers—Equifax and TransUnion now charge you to see your score. The government could also require bureaus to submit to annual audits: an independent party would pull a random sample of files, check them for accuracy and publish accuracy scores. Finally, Morley thinks the feds should appoint an ombudsman to resolve disputes between bureaus and consumers.

SCORES ARE USED FOR REASONS OTHER THAN GRANTING CREDIT. Credit scores are now being used in many situations for which they were never designed. Landlords may check your score to measure your reliability as a tenant. If you're applying for a job where you'll be handling money, your potential employer may look at your score to determine your trustworthiness. And insurance companies are increasingly factoring in your credit scores when setting your premiums for property insurance.

The Economical Insurance Group, which has over a million policyholders in Canada, openly states on its website that it uses "insurance scores" to adjust premiums, and a low score can result in a surcharge of up to 60%. (Insurance scores are not exactly the same as credit scores, but are derived from similar information in your credit file.) Economical says that most of its policyholders get discounts because of their insurance scores, but the Insurance Brokers Association of British Columbia reported in April 2005 that U.S. agents are seeing the opposite trend: "They have seen rates double or triple since insurance credit scoring went into effect. Insurers talk of discounts but in reality, base rates are increased substantially and then discounts are applied if the insured is eligible." James Daw, a certified financial planner and columnist with the *Toronto Star*, calls insurance scoring an "occult practice" and would like to see provincial governments nip it in the bud.

That's an excellent idea. Given the importance of credit in our daily lives, government needs to impose controls. It could insist that scoring systems be fully transparent, that independent audits be done to ensure the quality of credit bureau files, and that the use of credit scores to set insurance premiums be banned. Until such reforms are imposed, Canadians have a score to settle. ■

FOR MORE INFORMATION

You can get your credit report for free by mail, but your credit score is only available online. Equifax charges \$23.95 (visit www.equifax.ca and click on Score Power) while TransUnion charges \$22.90 (available at www.transunion.ca).

The Financial Consumer Agency of Canada has an excellent booklet called "Understanding Your Credit Report and Credit Score." It's available at www.fcac-acfc.gc.ca.

The Public Interest Advocacy Centre's paper on credit reporting is available at www.piac.ca.

Mike Morley's book, *The Complete Guide to Credit and Credit Repair for Canadians* (Nixon-Carre, 2005), has a chapter devoted to credit scores and advice on how to improve them.