

CREDIT REPAIR— *NOT a Good Fix*

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With many borrowers seeing their credit scores getting hammered by late mortgage payments and foreclosures, it might seem a good time for credit-repair companies. This article explains why that is not a good fix for struggling consumers.

Consumers across the country from every walk of life have felt the pain of the recent economic downturn. Not only are house prices rapidly falling, another wave of resets on adjustable-rate mortgages (ARMs)—anticipated for 2008's third quarter—promises to send even more homeowners spiraling into foreclosure. ■

Many borrowers who rode in on the origination superhighway several years ago are now facing a harsh reality. Subprime loan resets have decimated the financial lives of countless borrowers and created a huge mess for the servicers holding these defaulted loans in their portfolios. ■

With financial institutions tightening lending standards as a result of higher delinquency rates, credit reports are receiving more scrutiny than ever before. As many borrowers struggle to stay afloat financially, companies that advertise the ability to improve credit profiles are tempting these same borrowers with offers that seem too good to be true. Indeed, credit-repair firms are now capitalizing on the abundance of troubled credit profiles in the marketplace. ■

Lenders are struggling with two major issues at the

moment: scrutinizing the credit quality of new borrowers in an attempt to avoid the problems that led to the current financial crisis, and working their way through a wave of workouts with existing borrowers in an attempt to avoid foreclosures.

In order to make the best lending decisions possible, lenders must have a way to more accurately gauge a borrower's creditworthiness and identify whether a borrower's credit score has been manipulated to make it higher than it should be.

Credit repair nation

The Fair Credit Reporting Act (FCRA) (Public Law No. 91-508) was enacted in 1970 to promote accuracy, fairness and the privacy of personal credit-history information assembled by credit-reporting agencies (CRAs). Credit repair first emerged in the late 1970s when the big automated networks such as Visa, MasterCard, Diner's Club and the like first came on the scene. At that time, credit was viewed as a privilege for a select group, and banks only offered this service to borrowers with very solid credit. As it became more popularized, credit was made available to the masses.

In the late 1980s, credit received a big boost when consumers were introduced to the concept of the tri-merge credit report. To produce these reports, all three credit repositories—Experian, Costa Mesa, California; Equifax Inc., Atlanta; and TransUnion LLC, Chicago—provide a credit score. Around this time, credit technology also was gaining ground, and as this occurred, credit became more widely available with instantly accessible credit records.

The advent of widely available credit raised the collective consciousness of consumers, who gradually began to realize that credit records were lifelong attachments that would be instrumental in enabling (or prohibiting) many things in life, such as auto loans or home loans, and even securing employment. The credit record became the *de facto* way for potential employers and lenders to profile people on a variety of fronts.

Alternately, there was a great deal of variability involved in deciding who would be awarded credit and who wouldn't, as credit profiling was initially performed with no standardized rules.

As a result of this inherently arbitrary credit-assessment system, regulations soon emerged. Comprehensive amendments to the FCRA were made in the Consumer Credit Reporting Reform Act of 1996 (P.L. 104-208). These amendments contained a number of changes to the FCRA designed to improve the accuracy of and access to credit reports.

Mortgage lenders now use a credit score as the primary qualifier for residential mortgage loans. Many borrowers are eager to improve their credit scores because higher scores generally translate into lower interest rates and thus lower mortgage payments for loan applicants.

Many popular organizations that advertise "credit repair" or "credit restoration" services prey upon borrowers' financial ignorance of the credit-scoring process. Credit-repair companies frequently utilize the same channels that consumers could access themselves for free and still require the typical 45 to 90 days to pro-

duce results. Yet many of these for-profit organizations charge significant fees (often more than \$500). I have found that credit-repair companies can end up creating a false and misleading picture of the applicant's creditworthiness due to the tactics they employ.

For example, a primary strategy is to send a letter to each creditor reporting derogatory information on the consumer. The letter argues that the derogatory information is incorrect or that the account in question does not belong to the applicant. The Fair Credit Reporting Act requires that the creditor respond in writing within 30 days of the dispute. If it doesn't, the applicant's claim is accepted, and the derogatory tradeline is removed.

While doing this is not illegal, it is ethically questionable. The credit-repair providers know that if just one creditor fails to respond for any reason, the tradeline will be removed and the credit score will likely improve.

Another common tactic in the credit-repair arsenal is encouraging consumers to apply for what is known as an Employer Identification Number (EIN) from the Internal Revenue Service (IRS), and to use this number in place of the consumer's Social Security number (SSN) when applying for credit. This is, in fact, a fraudulent practice that could send the consumer to jail under federal law.

Seemingly benign credit-counseling services also do not provide consumers with a permanent solution to credit woes. These organizations establish relationships with creditors, such as major credit-card companies, to settle balances for financially strapped consumers for cents on each dollar owed. Creditors tend to accept these reduced settlements, fearing that borrowers will instead enter bankruptcy and pay nothing. These transactions are listed as "settled" tradelines on credit reports, and give borrowers a black mark that hurts their credit scores—and they do nothing to curtail similar behavior in the future.

Credit-repair and counseling firms can end up harming mortgage lenders and the very consumers they promise to help. Borrowers get a quick fix, but learn nothing to help them manage their credit profile in the future. Lenders end up calculating risk based on an artificially high score for a borrower, and may well end up holding a bad loan.

According to Steve Bucci, president of Houston-based Money Management International Financial Education Foundation, a nonprofit organization focused on educating consumers about sound personal finance skills by offering educational material to teachers, the term "credit repair" is misleading. "Credit-repair organizations do not actually repair credit; they cover a consumer's bad credit much like a bad paint job on a car. It only lasts for a little while," Bucci says.

"Companies that make money on credit repair focus on the number of a credit score and making you look really good," adds Bucci. "Understanding how credit works and how people use it is a crucial step in being an informed consumer. Being successful in the American financial system today requires that a person have decent credit. Consumers need to understand all the parts comprising a healthy credit profile."

Bad credit? No problem.

Credit repair is the symptom of a much larger financial gap in our nation's consumer knowledge baseline. Poor credit behavior begins with the lack of financial education children receive in their formative years at home. There are no finance courses offered in most schools to educate children and prepare them

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for future investments. Without that basic foundation, many consumers are set adrift to navigate financial waters filled with complex credit terms on credit cards, auto loans and mortgages, with no real understanding of how to properly set the sails.

“Credit repair is a symptom of some of the basic problems in the credit industry,” says Leilani Allen, president of Mundelein, Illinois-based Summer Point Consulting. “One of the main reasons these credit-repair companies exist is a lack of consumer education and awareness. We do not educate children to be financially savvy in this country. We turn people loose in the world with no fundamental understanding of financial instruments—a world where the credit industry is constantly soliciting consumers to go into debt. This combination of ignorance and aggressive marketing creates a negative outcome for the consumer,” she says.

Taking a holistic view of the credit crisis afflicting the nation currently, it is easy to see how consumers got caught in the maelstrom of questionable credit-repair practices. As long as there are consumers making bad financial decisions, companies are going to be around offering them a quick fix. As a result of the lack of basic financial skills and understanding, many consumers fall prey to what I view as the fraudulent practices of these firms.

“It is not bad conduct that causes people to declare bankruptcy—the leading cause [is] medical bills. Most people are not trying to scam the system; they just got in over their heads. This gives credit-repair companies the perfect opportunity to come in and say, ‘We know you are not a bad person; let us help you,’” Allen says.

A market ripe for rip-offs

Today, a lack of financial knowledge paired with rising minimum credit scores for loan qualification creates a situation ripe for credit-repair fraud schemes. Not so long ago, a credit score of 680 to 720 was considered phenomenal. Today, borrowers need a score of 720 to 750 in order to qualify for the best rates from many lenders.

Fair Isaac Corporation, Minneapolis, creator of the FICO® score, is launching a new scoring model entitled FICO o8 that it says will better predict the likelihood of a borrower defaulting on a loan. Foiling yet another credit-repair strategy, FICO o8 will also disregard authorized user records when calculating scores. Fair Isaac made this decision based on the fact that credit-repair companies often charge consumers to be listed as an authorized user on a stranger’s credit card.

With heightened scrutiny of credit, potential borrowers are desperate for ways to raise their scores. But consumers and law-enforcement agencies are increasingly becoming leery of credit-repair schemes.

Complaints to the Better Business Bureau (BBB) about credit-repair companies are rising. According to a February 2008 release from the BBB, complaints have risen for three straight years to more than 1,400 in 2006—a 38 percent increase from 2004. More than 400 of these complaints were not resolved, because BBB was unable to track down the company, or the company refused to take steps to resolve the issue.

In February, Florida Attorney General Bill McCollum filed two separate lawsuits—one against Laura L. Hess, a Broward County attorney, and another against John J. Hacker and Christa L. Caparella. The first case against Hess states that she allegedly signed up thousands of credit-card debtors for debt-management services

through her law firm. The suit alleges Hess told consumers that once the creditors received notice from her law firm disputing the debts, the consumers no longer needed to pay off the debt. The lawsuit alleges that Hess’ deception led to lawsuits and other undesirable actions against several debtors.

“Consumers who are trying to reduce or eliminate debt are working toward an admirable goal, and it is unconscionable to take advantage of these efforts,” says McCollum.

“Florida citizens should always be wary of companies or individuals who are making unreasonable promises or demands, either to restore credit or reduce debt,” he adds.

The lawsuit filed against Hacker and Caparella suggests the couple promised consumers they could reduce their debt by 50 percent and demanded fees that were greater than the legal limits for debt negotiators. The lawsuit alleges that Hacker and Caparella instructed consumers to cease paying their creditors and send that money instead to the couple.

Rather than sending dispute letters to creditors, which is standard protocol for credit repair, the lawsuit alleges the couple simply took the money without any resulting action. Additionally, the couple ignored customer-refund requests and also debited customer accounts without permission when the business ran short of funding, according to the lawsuit.

Credit proofreading

In stark contrast to the credit-repair approach, the process of credit proofreading strengthens credit profiles by building more credit-conscious consumers and transforming mortgage professionals into viable credit educators.

Credit proofreading is the automated examination of credit-file data, supplied by the three major credit repositories, to detect whether a credit score has been incorrectly evaluated due to errors within the credit file. It looks for two types of errors: data errors (incorrect data used to calculate the score) and usage errors (poor credit-management behaviors). The mortgage originator produces a corrected credit profile and a recalculated credit score by using channels not accessible to the consumer.

Performed by a trained mortgage professional, the purpose of credit proofreading is to help applicants qualify for the interest rates they truly deserve and to help originators more effectively evaluate borrowers’ ability to pay their loans. The process also helps a consumer learn effective credit-management behaviors, and can help create a more capable borrower. Most important, lenders can view borrowers who have undergone the credit-proofreading process as more reliable (presenting less risk of default) than before, because these borrowers are more educated and credit-conscious through participating in the process.

Findings from a new study

A recent study conducted by Cogent Road Inc. discovered that out of 96,352 mortgage applications, 41 percent contained data errors or other issues negatively impacting the applicant’s credit score. Out of 333,721 credit files, 67 percent contained examples in which consumers used available credit in ways that harmed their score, even while maintaining a solid payment history.

The following examples highlight errors typically found in credit reports due to credit-data errors and usage errors.

■ **Data error:** A consumer is in good standing with his creditor by making timely, regular payments on his credit

card with a balance of \$1,000 and a credit limit of \$10,000. One of the credit bureaus mistakenly lists the tradeline with a credit limit of \$1,000, making it appear that the consumer had maxed out his credit card.

■ **Data error:** When a consumer's mortgage originator/servicer went out of business in early 2008 due to the subprime mortgage collapse, another mortgage company acquired her loan. Her credit reports incorrectly list open tradelines for two \$200,000 mortgage loans instead of a zero balance transfer for the original company and a \$200,000 loan for the current loan holder.

■ **Credit-usage error:** A consumer receives a low-interest credit-card offer. The user then immediately transfers a majority of his or her high-interest credit-card debt to the new card. Maxing out the new low-interest credit card may hurt the consumer's overall credit score, even though it improved his or her monthly cash flow.

■ **Credit-usage error:** After purchasing \$350 worth of clothing at a retail store, the consumer is offered an instant 15 percent discount if he or she will put the purchase on a brand-new store credit card. Because these cards typically have low credit balances, the purchase reflects a high percentage of the available credit. Although the consumer made a seemingly sound decision resulting in an immediate savings of \$52 at the time of purchase, the long-term effect of this decision may yield a lower credit score.

Data errors may occur in any of the data elements creditors report to the credit bureaus, including credit limit, credit balance, payment amount, current status and payment history. Should any of these data be entered incorrectly due to human or computer error, inaccurate scores may result. Data errors uncovered during the proofreading process can usually be permanently resolved within 72 hours.

Usage errors, on the other hand, require the involvement of the consumer, because seemingly sound financial behaviors can unknowingly harm credit scores. Credit proofreading can identify credit-usage errors and suggest both short-term strategies—such as opening a new credit line or paying off an existing credit-card balance—and long-term strategies—such as establishing a history of regular payments—to alleviate them.

Applicants going through this process become conscious of how these behaviors affect the score, and can then make more appropriate choices in the future. The result typically is a more educated and creditworthy borrower.

In the real world

Originators such as Oak Mountain Mortgage LLC, Birmingham, Alabama, have been strengthening their clients' credit profiles by using a credit-proofreading tool that eliminates potentially harmful data errors. When these errors are removed, the credit report becomes a true reflection of the borrower's risk level.

"We're at a 95 percent success rate on rescoring consumers to lendable status," says Bryan Welch, marketing director for Oak

Mountain Mortgage. "The lending environment has changed so dramatically over the last year; we have reverted to underwriting guidelines from the mid-1990s."

During a time when the lending environment is dramatically changing, mortgage professionals can better understand the credit scores of their borrowers by using credit-proofreading tools.

"A 580 credit score one year ago with bank statements as income documentation would get a consumer 100 percent financing. Now 100 percent financing is all but gone," says Welch.

"A 620 score is considered to be a lower-end score with most FICO-based lenders. Today, a consumer needs to be above 720 to avoid a negative adjustment to their rate because of a score falling in a less-than-premium category. We recommend that borrowers have a good mix of credit with installment, revolving and mortgage accounts to get the greatest possible score. We educate our borrowers on a case-by-case basis, and we pull their credit and see what they need to work on," Welch says.

"If people really believe that they can address a symptom without addressing the underlying cause, they need to think again," says Bucci.

Addressing the cause, not the symptoms

Credit-repair services focus solely on making questionable credit scores look good—and they do whatever is legally within their means to raise scores as high as possible. The result is a higher credit score that misrepresents the borrower's true creditworthiness to unsuspecting lenders. Moreover, applicants, in the process, have not learned about the consequences of poor credit behavior and may continue unsound financial activities.

Credit proofreading focuses on establishing a clearer picture of borrowers' ability to pay off their loans by analyzing the underlying credit data used to calculate the credit score and identifying both credit data and usage errors.

These errors can be corrected to produce an educated applicant who more consciously exhibits good credit behavior. Further, if the result is a higher credit score, it is one that more accurately reflects the applicant's true and accurate borrowing risk. Lenders benefit because they now have a greater chance of making loans with these applicants because they can price a loan to them more competitively.

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"It is important for consumers to understand the U.S. credit system and define achievable financial goals. If we foster a culture of responsibility that extols the virtue of savings as opposed to spending, the economy would begin to improve. Understanding, in terms of [setting] financial goals and plans, is so important to a healthy credit profile," Bucci adds.

Incorrect credit information is never a good thing. No matter how this misinformation is entering the system, it is in everybody's best interest to clean it up. The only good thing that might come out of this current crisis would be getting people to confront this issue of responsible and informed credit usage.

Credit is the lifeblood of a capitalist system, and when the system is flawed, everyone suffers. Through education and financial awareness, consumers and lenders begin to benefit from a better pool of credit-conscious borrowers. **MB**

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