Testimony
regarding
"Helping Consumers Obtain the Credit They Deserve"

Subcommittee on Financial Institutions and Consumer Credit
May 12, 2005

by
Margot Saunders
National Consumer Law Center
on behalf of its
Low Income Clients
and
Consumer Federation of America
National Association of Consumer Advocates
U.S. Public Interest Research Group

Margot Saunders
Managing Attorney
National Consumer Law Center
1001 Connecticut Ave, NW
Washington, D.C. 20036
(202) 452-6252
margot@nclcdc.org
www.consumerlaw.org

Testimony
regarding
"Helping Consumers Obtain the Credit They Deserve"

Subcommittee on Financial Institutions and Consumer Credit
May 12, 2005

Mr. Chairman, Ms. Maloney, thank you for asking me to testify today. My testimony, provided on behalf of the low income clients of the **National Consumer Law Center,**[1] as well as the **Consumer Federation of America,**[2] **the National Association of Consumer Advocates**[3] and the **U.S. Public Interest Research Group**[4] addresses the issue of how to expand the items of information used to determine eligibility and price for credit for new entrants into the credit marketplace.

We commend the Committee for considering the important issues related to the use of alternative credit data on consumers with no credit histories or with inadequate credit information in their credit files. You have asked me to address the question of whether the reporting of alternative credit data could expand credit opportunities. The answer to this question is unquestionably "Yes" – the reporting of alternative credit data holds the potential to help consumers considerably. If the new data and scoring systems are built and used appropriately, the potential benefits to consumers are significant. However, because of the way that credit data and scores are being used in the marketplace, if these systems are built incorrectly, or used

---

[1] The **National Consumer Law Center, Inc**. (NCLC) is a non-profit organization specializing in low-income consumer issues, with an emphasis on consumer credit and access to affordable utilities issues. On a daily basis, NCLC provides legal and technical consulting and assistance on consumer law issues to legal services, government, and private attorneys representing low-income consumers across the country. As a result of our daily contact with these advocates, we have seen numerous examples of invasions of privacy, embarrassment, loss of credit opportunity, employment and other harms that have hurt individual consumers as the result of violations of the Fair Credit Reporting Act. It is from this vantage point – many years of dealing with the abusive transactions thrust upon the less sophisticated and less powerful in our communities – that we supply these comments. NCLC publishes a series of sixteen practice treatises and annual supplements on consumer laws, including *Fair Credit Reporting* (5th ed. 2002 and Cumulative Supplement 2004) and *Access to Utility Service* (3rd ed. 2004) as well as bimonthly newsletters on a range of topics related to consumer credit issues and low-income consumers and a quarterly energy and utility newsletter.

[2]The **Consumer Federation of America** is a nonprofit association of over 280 pro-consumer groups, with a combined membership of 50 million people. CFA was founded in 1968 to advance consumers' interests through advocacy and education.

[3]The **National Association of Consumer Advocates** is a non-profit corporation whose members are private and public sector attorneys, legal services attorneys, law professors, and law students, whose primary focus involves the protection and representation of consumers. NACA's mission is to promote justice for all consumers.

[4]The **U.S. Public Interest Research Group** is the national lobbying office for state PIRGs, which are non-profit, non-partisan consumer advocacy groups with half a million citizen members around the country.

inappropriately, the danger to these consumers could be devastating. This danger is compounded by the fact that many Americans do not have any understanding of how credit scores are developed and used.[5] The goal of this testimony today is to outline some of the issues surrounding the creation and use of the new data gathering, to add the voice of consumers to the development and potential regulation of these new credit data systems.

The prism through which we analyze alternative data systems is the fact that credit data and scores are used to analyze much more than a consumer's worthiness for credit. Today, it is typical for credit scores to be used to affect –

- The **cost of the credit**. In the increasingly risk based method of setting rates and terms for credit, a credit score can often mean the difference between an affordable loan or one that is predatory – and destined to fail.
- **Eligibility for and price for insurance**. Credit based information is used to generate *insurance scores*.
- Both initial **employment and job retention**. In some situations, workers are simply deemed ineligible for employment if they do not have adequate credit scores. In others, credit information and scores are checked on an ongoing basis by employers, and workers can be fired for negative information on their credit report, or even low credit scores.

In addition, in some areas of the nation, policy makers have contemplated allowing credit data to be used to determine initial **eligibility for and the price charged for essential utility service**.

Given the current and potential uses of credit data to affect the fundamental economic issues in a household, it is critical that the *new* data collection not exacerbate the situation. There is already a serious polarization of credit opportunities between those with high credit scores and those with low or not credit scores – higher income and more sophisticated consumers routinely are able to access the better sources of credit and obtain lower cost credit options. Subprime credit, which is more expensive (sometimes only by a few percentage points in the cost of credit, yet too often by multiples of the cost), should always be seen as a temporary stop on the road to more affordable and more suitable credit. The new credit data systems under consideration in today's hearing should be developed based on the goal of establishing *low cost* and *affordable* credit opportunities. These new systems must be built with the *consumers' interest as paramount.* For this to occur, the new systems must expand access to affordable credit, while not harming consumers in other areas, such as access to and retention of employment, insurance and utility service.

---

[5]Consumer Federation of America and Fair Isaac Corporation, *Many Americans Misunderstand Credit Scores According to New National Survey*, March 15, 2005; Consumer Federation of America, *Consumers Lack Essential Knowledge, And Strongly Support New Protections, On Credit Reporting and Credit Scores,* July 28, 2003.

The balance of this testimony will explore the important cautions that we recommend be considered in the development of these new credit information systems. To ensure that consumers are truly protected in the development of the new credit data systems, the following issues must be addressed:

1. **Ensure that the Information is Relevant to Determining Likelihood of Payment.** The information relied upon in the new credit data system must be truly relevant to the assessment of a consumer's willingness and ability to repay. As many consumers who have thin credit files are also low income, their decisions on which bills to pay are often driven by different factors than those with higher incomes. These factors must be considered when evaluating whether to include a particular source of information in the new credit data base.
2. **Ensure that the Information is Accurate.** A primary problem with using some sources of alternative credit data is that the recipients of the consumers' payments may not have ready access to information about consumers' payment patterns on a reliable, consistent basis.
3. **Ensure that the New Credit Data is Used for Appropriate Purposes Only.** Creditors have openly touted the new credit systems as sources for new customers. However, public policy is only served if –
    a. The new systems are used by both prime as well as subprime creditors;
    b. The new systems result in *lower* cost credit products for consumers; and
    c. Non-credit uses of the information (such as for new employment or job retention, access or price for utility service, or access or price for insurance) are *strictly limited* until the accuracy and reliability of the scoring systems have been adequately tested and assured.

4. **Ensure that the New Credit Systems are Not Discriminatory.** Credit scores have long been considered to have a disproportionate impact on minorities. Compliance with the letter and the spirit of the Equal Credit Opportunity Act in the development and use of these systems is essential to avoid exacerbating an already problematic situation with the traditional credit scoring model.

Additionally, the evolution of these systems provides an opportunity to advance good public policy through credit scoring by providing more weight to some payments than others. Currently at least one of the credit systems has a model for considering payments to some providers as more important than others.[6] Under this model, for example, the timely payment of a child support payment will provide more positive points to the credit score than the timely payment of a parking ticket.

---

[6]For a detailed analysis of this and related issues, *see* Karen Gross, *Commentary: Give Credit Where Credit Is Due – The Use of Credit Scoring*, Consumer Finance Law, (Winter 2004); *For Student Loan Borrowers, Good Credit Where It's Due,* http://chronicle.com Section: The Chronicle Review, Volume 51, Issue 15, Page B16.

1. Ensure that the Information is Relevant to Determining Liklihood of Timely Payment

There is a serious problem with many of the proposed new items to be evaluated in the new credit scoring system when it is used for low income households. In a low income household, decisions on whether to make payments on time are often based on much more complex criteria than simply the consumer's willingness to pay a particular bill. In various articles discussing the benefits of new credit information data bases and scoring methods, many types of alternative sources of regular payment information are lumped together as being potentially relevant to the determination of a consumer's likelihood of regular credit payments. Examples routinely included are rent, utility payments, wireless payments, remittances to one's home country, repayments of loans from payday lenders, payments to rent to own dealers, and the like.

It is essential that these new scoring systems use payment histories which have characteristics substantially similar to the credit for which the systems will be used. Specifically, the motivating factors for both types of payments (the one being used to measure a consumer's likelihood of repayment and the one for which the measure is being evaluated) must be similar. The problem is that for many low income people, utility payments and some forms of credit, such as payday loans and rent to own transactions, have inherent features which are significantly different than traditional monthly credit payments.

We completely agree that the payment of a *monthly rent obligation* is an excellent source of information on which to base an evaluation of a consumer's willingness to repay other credit, especially a home mortgage obligation. The rent payment is in exchange for essentially the same product – a home to live in. The payment is generally at the same intervals – monthly. The consequences of not paying are similar – *loss* of the home and a forced move.

Similarly, the regular payment of a wireless telephone bill is certainly relevant to a consideration of whether the consumer is a good candidate for another type of information exchange service – such as local or long distance telephone, or perhaps even internet access.

Current Utility Protections for the Poor Facilitate Negative Payment Histories. Utility payment information – especially for fuels such as gas, electricity or oil that are used to heat homes during the cold months – is entirely inappropriate to use as the basis for any other credit considerations. This is because factors the low income families use to decide whether to pay for utility service are very different than for other credit.

Many of the programs devised to protect low income households from shut off of essential utility service do not punish for late payments. Indeed, in some of these programs, additional benefits are triggered only after payment delinquencies. As a result, the utility payment histories for low income households will quite often have little relevance to the issue of whether the consumer would make timely payments if they were able.

As the result of the huge spread between low income consumers' ability to pay utility bills and the size of these bills, especially during the high cost months of winter, a number of statutory and regulatory protections have been developed to assist these neediest customers through the winter months. Since utility services are a necessity, required in most American climates to keep warm and stay alive, a household's utility bill depends primarily on the type of home, type of heat, and number of people in the household. The expenditure is non-discretionary, and the ability of the customer to pay the utility bill on a timely basis is not a factor. The bills are charged for the service, and consumers do their best to pay, regardless of ability.

This lack of nexus between the bills and ability to pay is exactly the reason that there are special rules for paying utility bills – which attempt to protect both the consumers and the utility providers from the failure of the utility system to consider ability to pay in the establishing the charges for service. As a result, many of the programs developed to assist low income households with utility bills give priority to households in crisis. Oftentimes payment assistance is only triggered by utility payment delinquencies:

- Requirements for Emergency Heating Assistance May Result in a Poor Payment History: The Low Income Home Energy Assistance Program, LIHEAP, the federal assistance program to help the most vulnerable households afford their heating and cooling bills requires states to set aside a reasonable amount of their LIHEAP block grants for crisis assistance.[7] For the majority of states in FY 2005, *LIHEAP crisis benefits require a disconnection notice or actual disconnection*.[8] The crisis benefits are either supplemental energy assistance payments or expedited LIHEAP assistance payments, depending on the state and the nature of the crisis.
- Winter Moratoria/Extreme Temperature Shut-Off Protections: Because loss of heating in the winter can be lethal for the elderly, the young and the sick, many of the cold weather states have imposed shut-off moratoria for energy utilities. While the utilities cannot disconnect households in these states, the households are still responsible for paying their bills. Recent arrearage and disconnection data from those states that collect this information indicate that more households are falling behind on their utility bills and are eventually disconnected at the end of the moratoria.[9] Numerous advocates report

---

[7] 42 U.S.C.sect. 8623(c).

[8] NCAT LIHEAP Clearinghouse, "Crisis Definition – FY 2005." The LIHEAP statute defines energy crisis as "weather-related and supply shortage emergencies and other household energy-related emergencies." (42 U.S.C. sect. 8622(3)).

[9] As of December 15, 2004 in Pennsylvania, 4,496 households remained without electric service and 10,509 who heat with natural gas were without service. Correspondence with Mitch Miller, PA PUC staff Dec.3, 2004. In Rhode Island, there were nearly 3,000 service terminations in September, more than any other September on record, and 20% more than in September 2003. Meanwhile, there were only 1,800 service restorations, down 9% from last September. The gap between shutoffs and restorations in September '04 was 1,171, higher than any other September on record and 131% higher than the gap in September 2003. The total gap for 2004, a proxy for unrestored accounts

increased disconnections every spring at the end of the shut off periods. Energy bills have been increasing at the same time federal energy assistance has decreased.[10] There is a growing energy affordability gap and a substantial number of low-income households who must sacrifice other basic necessities in order to pay the utility bills.[11]

The factors that motivate consumers to make timely or non-timely utility payments are different than those to determine timely payments underwritten credit. Low income utility consumers are sent signals which allow them to *not* pay without negative consequences. To allow other negative consequences to result – by using utility bills in a new credit score to establish eligibility for low cost credit, is not helpful and undermines the relevance of the data for the new scoring systems.

<u>Payments to Payday Lenders and Other Abusive Creditors Is *Not* Relevant to Other Credit Decisions.</u> The essential characteristics of payday loan transactions (as well as some other very high cost lenders such as rent to own dealers and title pawn lenders) are so different than more traditional forms of credit, that the payment – or non-payment – of these liabilities is simply not relevant to whether a consumer will pay a credit card bill or a traditional car loan. For example, when a consumer decides whether to make a repayment of payday loan, the factors in that decision include 1) a relatively large sum of money due in one lump sum (the entire principal of the payday loan is generally repayable within a two week period); 2) the consumer may believe that the failure to make the payment could have dire consequences as many payday lenders will threaten criminal prosecution for the failure to honor a check; 3) yet the payment of the loan in one lump sum may result in the consumer having no funds to pay for essentials, such as food or rent. In fact, it is important to note that payday loan consumers are *encouraged* by the lenders *not* to repay payday loans but instead to roll them over, time and again.[12]

These characteristics of payday loans are very different from standard forms of credit. Traditional credit generally has a series of regular payments, which are determined to be affordable by the creditor through underwriting. Traditional credit generally has some grace period in which the consumer can make payments. The non-payment of traditional credit does not trigger the fear of criminal sanctions.

Rent to own transactions (RTO) are similarly starkly different from traditional credit. Although in rent to own transactions, the payments are generally regular, and sometimes

---

from January 2004 – September 2004 was 7,520, higher than any other September on record. Analysis of John Howat, NCLC Oct. 15, 2004.

[10] Olivia Wein, "The Continued Surge in Residential Energy Costs Outpace the Spending Power of LIHEAP," NCLC Energy & Utility Update, Fall 2004.

[11] See e.g., NEADA, *National Energy Assistance* (April 2004).

[12] Creola Johnson, Payday Loans: Shrewd Business or Predatory Lending?, 87 Minn. L. Rev. 1 (Nov. 2002). Indeed, some payday lenders give their customers coupons to encourage non-payment.

affordable (however, merchants in these transactions do not do any underwriting either), the transactions are designed to fail. Despite the fact the most RTO customers enter into the transaction with the intent to purchase the items, the huge majority of these transactions do not result in ownership.[13] Indeed the merchants' incentives are to ensure that the consumers pay for as long as possible on the contract yet not complete the contract to achieve ownership – because that ensures the continued payment stream.

The bottom line here is that some alternative forms of credit may be relevant for consideration on a credit report – because the incentives and potential consequences are similar. However, other forms of credit, like utility bills, payday loans and rent to own transactions are so inherently different from traditional credit, that including information about the payment – or non-payment – of these loans is irrelevant and not predictive of the consumer's willingness to make regular payments on extensions of credit that has been underwritten to determine affordability.

2. Ensure that the Information is Accurate.

The whole system of credit reports and credit scores relies on the accuracy of the information provided by the furnisher. Furnishers of information in the traditional credit reporting system have *some* incentive to provide accurate information because they rely on that very information in making their own credit decisions. However, even in the traditional credit system, the incentives for accuracy are seriously deficient, and as a result, credit reports are full of inaccuracies.[14]

However, there are virtually no incentives for the reporting – much less the *accurate and complete* reporting – of data related to non-traditional sources. Most non-traditional sources of credit do not use the credit reporting system, so they do not have the selfish incentive to promote the reliability upon which they are dependent. Moreover, as is more fully discussed below, it would be bad public policy to promote the development of an alternative credit reporting system for the purpose of providing more information to these high cost creditors. As the system remains voluntary with the creditors, there is no requirement for reporting – and no penalty for not reporting – credit information.

The distinction between accuracy and completeness remains. Unlike the requirement of

---

[13] Federal Trade Commission, Bureau of Economics Staff Report, Survey of Rent-to-Own Customers, Executive Summary.

[14] Consumer Federation of America and National Credit Reporting Association, *Credit Score Accuracy and Implications for Consumers* at 24 (Dec. 17, 2002), available at http://www.consumerfed.org/121702CFA_NCRA_Credit_Score_Report_Final.pdf; U.S. Public Interest Research Group, *Mistakes Do Happen: Credit Report Errors Mean Consumers Lose* (1998), available at http://uspirg.org/uspirg.asp?id2=5970&id3=USPIRG&; Consumer Reports, *Credit Reports: How Do Potential Lenders See You?,* at 52-53 (July 2000).

reasonable procedures to assure maximum possible accuracy that the FCRA places on consumer reporting agencies, the FCRA does not directly specify a standard of accuracy for those who furnish information to consumer reporting agencies. Furnishers are required to report accurate information, but there is no specific requirement that the information be complete.[15] As a result, furnishers could fail to report relevant information that would radically change the credit analysis of a consumer's report, so long as the information that it did report was technically accurate. This situation is only slightly ameliorated by the recent changes in made to the FCRA by the FACT Act.[16]

The FCRA also provides only limited remedies for consumers against furnishers who provide inaccuarate and incomplete information. Under the current law, the consumer must dispute the inaccurate or incomplete information, await the results of an investigation by the credit reporting agencies and the furnishers and hope that the investigation results in such information being removed or modified.[17]

The flaws in the current credit reporting system will only be compounded if appropriate safeguards are not in place to ensure the information furnished by traditional and nontraditional sources of credit transactions are reported accurately and completely.

3. Ensure that the New Credit Data is Used for Appropriate Purposes Only.

In evaluating the issues surrounding the new credit data and scoring systems, it is necessary to keep in mind that the driving force behind their development is *not* to provide consumers with less expensive credit. Instead, the inducement for these new systems is a new source of customers, along with a reduction of risk for those customers, for the credit industry.[18] An incidental benefit *may be* the opening of new, lower cost, credit opportunities for consumers. However, as that benefit is not the goal, that benefit cannot be assured, and policy makers[19] should closely supervise the development of these systems to evaluate and address at least the following three concerns:

a. The new systems must be useful to – and thus used by – the least cost creditors, as well as those who traditionally market to consumers considered to be higher credit risks. If only

[15] 15 U.S.C. § 1681s-2(a).

[16] Pub. L. No. 108-159 (Dec. 4, 2003), amending the Fair Credit Reporting Act, 15 U.S.C. § 1681 *et. seq*

[17] 15 U.S.C. § 1681s-2(b).

[18] *See*, W.A. Lee, *New Tools to Find Nontraditional Customers,* American Banker, August 6, 2004, at 5: "With the consumer credit market continuing to get healthier, card issuers are looking to stretch their risk parameters to find new prospects, according to the companies helping them."

[19] Presumably the policy maker for whom it makes the most sense to intervene and evaluate the development of these new data systems is the Federal Trade Commission.

subprime creditors use the new credit evaluations, then it is virtually certain that these consumers will continue to be segregated into higher cost credit. As the basic premise behind the development of these new evaluation systems is that the current system of credit scoring does not adequately assess the risk of lending to consumers with thin or no credit files, an assumption inherent in this development is that some proportion of these consumers have very low risk.

If risk based pricing is to be fair to the universe of consumers, those consumers who are actually riskier borrowers should be charged higher prices for their credit than those consumers who are truly lower risk. A fairer and more thorough evaluation of consumers who have been considered risky borrowers simply because not enough information was known about them will necessarily result in the identification of some of them as very good candidates for low risk – and thus "low cost" – credit. The lowest cost credit is generally provided by "prime lenders." The new systems must be useful to and accepted by these prime lenders, to enhance the potential for the lowest cost credit to be offered to this new pool of potential customers.

b. The credit products offered to the newly identified group of low risk consumers must in fact have lower costs than the credit products currently available to them. The news articles about the new credit scoring products have generally indicated that the credit industry sees these new scores as facilitating new credit to new customers, rather than lower cost credit.[20] These consumers are typically borrowing from the highest cost creditors – payday lenders, rent to own dealers, etc.(indeed those creditors are the proposed sources of the information to be used in the new scoring system). It will not be difficult for the mainstream traditional credit industry to offer lower cost, fairer, terms of credit to this class of consumers. However, in exchange for the gathering of information about these consumers – and the inherent loss of privacy – there should be an implicit promise that lower cost credit will be made available for some substantial percentage of this group of consumers.

If the credit industry continues to use the assumptions inherent in risk based pricing to justify charging higher interest rates and fees for extensions of credit which are considered risky, then equivalent savings in credit costs must be provided to consumers who are less risky.

c. Non-credit uses of the information (such as for new employment or job retention, access or price for utility service, or access or price for insurance) must be *strictly limited* until the accuracy and reliability of the scoring systems have been adequately assured. One of the most contentious issues currently in the world of credit scoring is the use of credit reports and credit scores for non-credit purposes, such as for insurance and employment hiring and retention purposes.

[20] *See, e.g.* Broderick Perkins, *Non Traditional Credit Borrowers Score Again*, Realty Times, April 26, 2005: "Fair Isaac's FICO 'Expansion' credit risk score is likewise designed specifically to help lenders extend credit to consumers in what is largely considered a 'under served' market of 'cash-basis' borrowers."

A particularly controversial issue is the use of credit scores by automobile and home insurers to determine whether to insure a consumer and at what price. The credit scores used by insurers, or "insurance scores," are specially developed for insurers and not the same as generic credit scores, but they nonetheless are based solely on credit history. Consumers can obtain one version of their insurance scores from ChoicePoint for $12.95.[21] The practice has become widespread, with one survey showing that ninety-two percent of auto insurers surveyed use insurance scores.[22] As a result, a consumer with a poor credit history may be charged forty to seventy-five percent more in premiums for automobile insurance.[23]

The practice of using insurance scores has been criticized as fundamentally unfair and is particularly burdensome to low-income consumers least able to afford high insurance rates. In addition, the use of insurance scores probably disproportionately burdens racial minorities, given that they have lower credit scores as a group. Several states have passed legislation regulating the practice,[24] and legislation has been proposed in many other states.[25] Insurance companies defend their actions by noting the high correlation between credit scores and loss experience.[26] A number of class actions have been filed challenging the practice.[27] Insurance regulators in both Texas and California have taken enforcement actions against insurance companies over this practice.[28]

---

[21] See ChoicePoint's consumer website at www.choicetrust.com.

[22] Brian Grow & Pallavi Gogoi, Insurance: A New Way to Squeeze the Weak?, Business Week, Jan. 28, 2002, at 92 (citing study by Conning & Co.).

[23] Pamela Yip, One Number, Many Uses, Dallas Morning News, Apr. 8, 2002, at 1D.

[24] A summary of some of the state insurance laws governing use of credit information is included in National Consumer Law Center, Fair Credit Reporting, Appx. B.3 (5th ed. 2002 and Supp.).

[25] Pamela Yip, One Number, Many Uses, Dallas Morning News, Apr. 8, 2002, at 1D.

[26] *Id.*

[27] DeHoyos v. Allstate Corp, 345 F.3d 290 (5th Cir. 2003) (holding that a challenge to credit scoring under the FHA and federal Civil Rights Acts was not preempted by the McCarran-Ferguson Act), cert. denied, 124 S.Ct. 2074, 158 L. Ed. 2d 621 (2004); Owens v. Nationwide Mutual Ins. Co., 2003 WL 22364319 (N.D. Tex. Oct. 1, 2003) (class action alleging that use of credit scores for homeowners insurance violates section 3604 of the FHA and the federal Civil Rights Acts); Nat'l Fair Hous. Alliance v. Prudential Insurance Co., 208 F. Supp. 2d 46 (D.D.C. 2002) (class action alleging that the use of credit scores to determine eligibility for homeowners insurance has a disparate impact on minorities in violation of the FHA); Wells v. Shelter Gen. Ins. Co., 217 F. Supp. 2d 744 (S.D. Miss. 2002) (class action challenging use of credit scores under Mississippi insurance law). Cf. Ashby v. Farmers Group, Inc., 261 F. Supp.2d 1213 (D. Or. 2003) (dismissal of claim under Fair Credit Reporting Act against insurance management services company that used credit scores in ratesetting).

[28] Press Release, Tex. Dept. of Ins., State of Tex., Farmers Insurance Reach Agreement (Nov. 30, 2003) (resulting in a $100 million settlement, including $30 million in refunds for improper use of credit scores. Settlement does not prohibit use of credit scoring in insurance, and requires only disclosures acceptable to the Attorney General); R.J. Lehman, Allstate Settles California Insurance-Scoring Dispute for $3 Million, Bestwire,

A study conducted by the Missouri Department of Insurance found a stunning correlation between insurance scores and race as well as income, age, marital status, and educational attainment.[29] Using credit score data aggregated at the ZIP code level collected from the highest volume insurers in Missouri, the study found the following:[30]

- Insurance scores were significantly worse for residents of high-minority zip codes. The average consumer in an "all minority" neighborhood had a credit score that fell into the 18.4th percentile, while the average consumer in a "no minority" neighborhood had a credit score that fell into the 57.3th percentile--a difference of 38.9 percentile points.
- Insurance scores were significantly worse for residents of low-income zip codes. The average consumer in the poorest neighborhood had a credit score 12.8 percentile points lower than residents in the wealthiest communities.
- The correlation between race (high-minority neighborhoods) and credit scores remained even after eliminating other variables, such as income, education, marital status, and unemployment. Residency in a minority concentration neighborhood proved to be the single most reliable predictor of credit scores.
- The gap in credit scores was also expressed on a more individualized basis. The average gap between the percentage of minorities with poor scores and non-minorities with poor scores was 28.9 points. The gap between lower-income and higher-income households was 29.2 percentage point.

The author and researcher of the Missouri study concluded that "the evidence appears to be credible, substantial, and compelling that credit scores have a significant disproportionate impact on minorities and on the poor."[31]

A study conducted by the Texas Department of Insurance resulted in similar findings.[32] Instead of using geographic neighborhood as a proxy for race, the Texas study was able to determine the actual race of policyholders by using motor vehicle records for approximately 2 million consumers. The Texas study found dramatic disparities by race, finding that African American and Hispanic consumers constituted over 60% of the consumers having the worst

---

March 5, 2004 (Allstate allegedly violated California law prohibiting use of credit information in underwriting or ratesetting for auto insurance; settlement prohibits use of credit scores and imposes a $3 million fine.)

[29]Brent Kabler, Mo. Dept. of Ins., Insurance-Based Credit Scores: Impact on Minority and Low Income Populations in Missouri (Jan. 2004).

[30]*Id.*

[31]*Id.*

[32]Texas Department of Insurance, Report to the 79th Legislature - Use of Credit Information by Insurers in Texas, December 30, 2004.

credit scores, but less than 10% of the consumers having the best scores.[33] Thus, African Americans and Hispanics were over-represented in the worse credit score categories and under-represented in the better credit score categories. The Texas study concluded there was a consistent pattern of differences in credit scores among the different racial and ethnic groups, with whites and Asians faring better than African Americans and Hispanics.

Given the considerable issues with the use of traditional credit scores in insurance, it is imperative that these problems not be compounded by the use of these new credit scoring models for insurance – or for employment – purposes until their accuracy, relevance, and predicative value for these purposes have been thoroughly proven.

4. Ensure that the New Credit Systems are Not Discriminatory.

As long as there have been credit scores, there have been concerns that scoring systems contain biases which disproportionately impact protected groups.[34] These concerns are heightened by numerous studies showing that, as a group, certain racial and ethnic groups have lower credit scores than whites. As the new credit scoring systems are developed, every effort should be made to ensure that the potential discriminatory problems inherent in their older, more traditional counterparts, are not replicated in these programs. For one thing, the federal government should conduct an ongoing review of all credit scores for legitimacy, accuracy and disparate impact. Astonishingly, this kind of review does not currently occur.

A 1996 Freddie Mac study found that African-Americans are three times as likely to have FICO scores below 620 as whites. The same study showed that Hispanics are twice as likely as whites to have FICO scores under 620.[35] Fair Isaac's own analysis showed that consumers living in minority neighborhoods had lower overall credit scores.[36]

A Federal Reserve Board study of over 300,000 credit history files found that fewer than 40% of consumers who lived in high minority neighborhoods had credit scores over 701, while nearly 70% of consumers who lived in mostly white neighborhoods had scores over 701.[37] A

---

[33] *Id.*

[34] Fed. Reserve Bank of Boston, *Perspectives on Credit Scoring and Fair Lending: A Five-Part Article Series (*pt. 1), Communities & Banking, Spring 2000, at 2.

[35] See Freddie Mac, Automated Underwriting: Making Mortgage Lending Simpler and Fairer for America's Families (Sept. 1996), available at www.freddiemac.com/corporate/reports/moseley/mosehome.htm.

[36] Fair, Isaac & Co., The Effectiveness of Scoring on Low-to-Moderate Income and High-Minority Area Populations 22, Fig. 9 (Aug. 1997).

[37] Robert B. Avery, Paul S. Calem, and Glenn B. Canner, Credit Report Accuracy and Access to Credit, Federal Reserve Bulletin (Summer 2004).

more comprehensive report on credit scoring and disparate impact will be conducted by the FRB, FTC, and HUD pursuant to the 2003 amendments to the Fair Credit Reporting Act.[38]

A study by researchers at the University of North Carolina of borrowers who received community reinvestment mortgages showed that one-third of African Americans in this pool had credit scores under 620, as compared to only 15 percent of whites. Furthermore, this same study found that another one-third of African-Americans had credit scores between 621 and 660 (as compared to 20 percent of whites), which means that two-thirds of African-Americans in this pool had what is considered marginal or poor credit.[39]

If even a single factor in a credit scoring model correlates to race or other prohibited bases, the results of the model may be discriminatory.[40] The Official Staff Commentary to the Equal Credit Opportunity Act, put out by the staff of the Federal Reserve Board, seems to concur, noting that an "empirically derived, demonstrably and statistically sound" credit scoring system may be flawed and thus subject to review and challenge under the ECOA.[41] These concerns are intensified by the "black box" nature of credit scoring systems.[42]

As these new credit repositories and credit score models are being designed to address holes in the system that clearly implicate racial minorities significantly, special care must be

---

[38] Fair and Accurate Credit Transactions Act of 2003, Pub. L. No. 108-159, § 215 (2003); *See also,* Mark A. Fisher, Minorities Score Lower in "Colorblind" Ratings, Columbus Dispatch, Apr. 14, 1999, at 5A. The same survey found that African-Americans who do have credit cards miss their minimum payments more than twice as often as whites do.

[39] Roberto G. Quercia, Michael A. Stegman, Walter R. Davis & Eric Stein, Performance of Community Reinvestment Loans: Implications for Secondary Market Purchases, in Low Income Homeownership: Examining the Unexamined Goal (Nicolas P. Retsinas & Eric S. Belsky eds., 2002), at 363: Table 12-7 (statistics derived from an analysis of 5,549 community reinvestment loans). The credit score cut-offs for what is considered to poor, marginal, and good credit are derived from Freddie Mac's categories used in its Loan Prospector system. Freddie Mac advises lenders that applicants with FICO scores below 620 indicates high risk, between 620 and 660 indicates an uncertain credit profile, and above 660 means they are likely to have acceptable credit reputations. See Freddie Mac, Automated Underwriting: Making Mortgage Lending Simpler and Fairer for America's Families, available at www.freddiemac.com/corporate/reports/moseley/mosehome.htm (Sept. 1996).

[40] *See* Office of the Comptroller of the Currency, Credit Scoring Models (OCC Bull. 97-24, May 20, 1997) (warning against the use of "models that may include characteristics that may have a disparate impact on a prohibited basis or raise other Equal Credit Opportunity Act (Regulation B) or Fair Housing Act concerns"); Press Release, Office of the Comptroller of the Currency, OCC Alerts Banks to Potential Benefits and Risks of Credit Scoring Models (No. 97-46, May 20, 1997), available at www.occ.treas.gov (advising national banks "to avoid illegal disparate treatment by insuring that adequate controls exist during the pre-scoring, scoring, and post-scoring states of the credit application process").

[41] Official Staff Commentary, 12 C.F.R. § 202.2(p)-4

[42] *See* National Consumer Law Center, Fair Credit Reporting, §14.5.1 (5th ed. 2002 and Supp.).

taken to avoid the racial disparities and discriminatory impacts that have appeared to plague the traditional sources of credit scores.

Conclusion

The Committee's consideration of these important issues related to the use of alternative credit data on consumers with no credit histories or with inadequate credit information in their credit files. We hope that the Committee will make strong, pro-consumer recommendations relating to these new credit repositories and scoring systems which will ensure that the the new data and scoring systems are built and used appropriately, as the potential benefits to consumers are significant. Caution should be used, however, because if these systems are built and used incorrectly the danger to consumers could be devastating.