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Keeping Score on Credit Scores:
An Overview of Credit Scores, Credit Reports and Their Impact on Consumers

Before the

SUBCOMMITTEE
ON FINANCIAL INSTITUTIONS AND CONSUMER CREDIT
HOUSE COMMITTEE ON FINANCIAL SERVICES

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Chairman Gutierrez, Ranking Member Hensarling, and members of the Subcommittee, I am Anne Fortney. I am a partner in the Washington, DC office of the Hudson Cook law firm. My practice concentrates on compliance issues under the federal and state consumer protection laws, primarily for the consumer financial services industry. I appreciate the opportunity to appear before you to discuss this overview of credit scores, credit reports and their impact on consumers.

Background and Experience

My first experience in consumer financial services was with the Washington, DC legal office of the JC Penney Company in the late 70's and early 80's – a time when Penney was one of the largest credit card issuers in the country. My principal responsibilities involved legislative and regulatory issues affecting Penney's credit card operations.

My introduction to credit scoring came in 1977. The Equal Credit Opportunity Act (ECOA) amendments were just going into effect, and companies like Fair Isaac were offering credit scoring as a means to assure compliance with this law and enable creditors to underwrite more effectively and price for relative risk. My work included interfacing with Fair Isaac representatives as that company persuaded some very skeptical, experienced consumer credit managers that an empirically derived statistical model could predict risk more consistently and accurately than they could. An important issue, which was also the subject of Congressional hearings, involved the ECOA requirement for a creditor to give reasons for adverse action based on a credit score. Fair Isaac and other credit score developers argued that, in a credit scoring system, the credit score was the only accurate reason for adverse action: If a consumer's score was below the score that corresponded to the creditor's acceptable level of risk, the consumer would be denied credit. Neither Congress nor the Federal Reserve Board staff was persuaded by that argument, and the ECOA rules required creditors to select the four principal factors used in a credit scoring system that contributed to a consumer failing to achieve the necessary score.

My next exposure to credit scores was at the Federal Trade Commission ("FTC"), where I directed the Division of Credit Practices, beginning in 1982. My responsibilities included ECOA enforcement as to creditors under the FTC's jurisdiction. Creditors' wide-spread use of credit scoring greatly facilitated the government's law enforcement efforts because we could evaluate the legality of criteria that creditors actually applied, rather than have to divine the process based on more general guidelines in a judgmental credit underwriting system.

Since the time that I left the FTC and began private practice with a law firm, my work has focused on consumer financial services, particularly involving the Fair Credit Reporting Act (FCRA), the ECOA and other privacy laws.

Nature of Credit Scoring

Credit scoring is a "statistical technology that quantifies the credit risk posed by a prospective or current borrower."[1] Creditors use this technology to evaluate credit applications, identify prospective borrowers and manage existing credit accounts.[2] Credit scores may also be used as a factor in insurance underwriting.

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[1] Board of Governors of the Federal Reserve System, *Report to Congress on Credit Scoring and Its Effects on the Availability and Affordability of Credit*, August 2007 ("FRB *Report to Congress*

In looking at credit scores, it is important to recognize that there are many types of credit scores and many providers of those scores. The Fair Isaac FICO score is perhaps the most recognized, but the Vantage score also has wide distribution. When consumer reporting agencies apply credit scores based on credit report histories, they do so based on scores from a number of credit score developers. Creditors specify which credit score they want delivered with a credit report. Credit scores may also be calculated by mortgage reporting companies that compile consumers' credit reports from each of the national consumer reporting agencies and then deliver the combined reports and scores to a lender. In addition, many large creditors, such as bank credit card issuers and auto finance companies, have developed propriety scores that are most useful in evaluating their particular types of customers. Credit score providers and many of their users continually re-evaluate and update the scoring models based on new information and changes in the marketplace and in consumers' behavior.

Value of Credit Scoring

Based on my experience, I believe that credit scoring delivered on the score developers' promises in the 1970's of a predictive tool that would assure objectivity and legal compliance in credit underwriting decisions. As a result, in the approximately 35 years since its widespread introduction, credit scoring has become an essential tool for creditors, and has also been proven to be a valuable tool in property and causalty insurance underwriting. At the same time, credit scoring models have become

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on Credit Scoring"*)*, available at https://www.federalreserve.gov/boarddocs/rptcongress/creditscore/creditscore.pdf.

[2] *Id.*

significantly more sophisticated in terms of the data analyzed and the predictive quality. In my work with creditors during this time, I have been consistently impressed at the complexity and value of these systems. Because credit scoring has enabled creditors to price effectively for risk, more consumers have been able to obtain and use credit, and at a significantly lower cost. Thirty-five years ago, bank-issued credit cards were reserved for the more well-to-do customers. Today, they are in almost everyone's wallet. Risk-based pricing, based on credit scoring, made this result possible. Credit scoring also plays a significant role in mortgage lending and auto finance.

Because credit scoring systems play such an important role in credit underwriting, they have a significant impact on consumers' access to credit and the price of credit. For these reasons, it is appropriate that such systems be subject to review for fairness, fair lending, accuracy and predictably, among other issues.

Fairness

Based on my experience, I believe it is beyond question that credit scoring is an objectively fair underwriting tool. These systems eliminate the potential biases, illegal or even benign, that may exist in judgmental credit underwriting systems. They ensure that each consumer will be evaluated only according to attributes that are facially neutral. Ironically, it is the fact that credit scoring focuses only on objective factors, such as credit histories and credit usage, that has engendered some of the criticism. For example, some critics complain that credit scores may reflect circumstances beyond a consumer's control (such as a creditor lowering credit limits due to market conditions, or a natural disaster). While these kinds of events may attract new attention, they are not dissimilar to the kinds of often uncontrollable events that historically have been associated with payment default, such as serious illness, death, divorce or job loss.

In addition, there are proposals to restrict the use of medical debts and student loan default information. These proposals are misguided because they would limit the amount and quality of accurate information in credit report histories.

Regardless of a consumer's personal control over the events leading to default, credit underwriting systems must necessarily focus on the fact of non-payment or default when that is the type of risk they evaluate. This phenomenon is not limited to credit scoring; it is an essential element of credit underwriting. If characteristics such as payment histories or credit limits in credit scoring models were eliminated or restricted regardless of their predictive value, the models would necessarily be less predictive. Less predictive credit scoring models would by definition impair creditors' ability to make sound underwriting decisions or price according to risk. The inevitable result would be less credit availability, at higher prices and/or at prices where good credit risks subsidize the higher credit risks – and none of those results would be more fair than the present systems. In other words, it is neither efficient nor fair to focus on individual circumstances in an underwriting system that is designed to predict risk for an entire population.

Because of our nation's involvement in the conflicts in Iraq and Afghanistan, there is renewed attention to the personal sacrifices of our military personnel, and the effects of deployment on the personal lives and financial affairs of military servicemembers and their families. As the wife and daughter of career military officers, I know first-hand the effects of these deployments, particularly on families. I also know first-hand the strength of the military communities, especially the private volunteer relief societies that help servicemembers solve emergency financial problems.[3] In addition, the Servicemembers Civil Relief Act accords certain protections and rights to individuals who are either on active military duty or recently retired.[4] The purpose of the SCRA is to allow the servicemembers to perform their valuable duties without the worry of civil prosecution, repossession, foreclosure or eviction under most circumstances. If these protections are insufficient to help an individual member of the armed services when faced with financial difficulty, the solution is not to prohibit creditors from furnishing accurate but negative information about the servicemember's credit payment performance to consumer reporting agencies. In fact, the suppression of this information would harm all servicemembers because it would make suspect the accuracy and completeness of their credit report histories. This is an example of how the suppression of accurate credit report information would harm the population it is designed to protect.

Finally, I have heard the complaint that credit scoring models may penalize consumers who are conservative in their use of credit or who, because of age or other circumstances, may have limited credit histories. If this allegation is true, the obvious solution is to increase the amount of information available to credit score developers. Without credit histories and similar empirical information, creditors are unable to assess the relative risk of a consumer's default. By analogy, a 16 year-old has a perfect driving record when she obtains her first driver's permit.

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[3] There are four private, nonprofit societies serving servicemembers and their families: Army Emergency Relief, Air Force Aid Society, Navy-Marine Corps Relief Society and Coast Guard Mutual Assistance. Each has local representatives on military installations, usually in family centers.

[4] The SCRA, 50 App. U.S.C.A. §§ 501 *et seq*., is the successor to the Soldiers and Sailors Relief Act. *See* http://www.servicememberscivilreliefact.com.

Fair Lending

It is significant that in the last 30 years, fair lending cases brought by the FTC and the Department of Justice have not involved credit scoring. Instead, in the vast majority of those cases, as well as in private litigation, the focus has been on "discretionary pricing," where mortgage originators or auto dealers are alleged to have increased the cost of credit for minorities without regard to risk. In fact, in the auto finance litigation, consumers alleged that the "buy rates" at which the auto finance companies or banks offered to purchase dealer retail installment sales contracts were risk-based but that the dealers' mark-ups were based on non-risk related criteria and resulted in a disparate impact for African Americans and other minorities.[5] In other words, the complaint was that, as lenders allowed pricing that was not based on credit scoring models and similar risk assessment, the resulting pricing adversely affected African Americans and other minorities. Because the consumer credit industry has so long relied on credit scoring as a means of fair lending compliance, the value of these systems in assuring fair access to credit may be overlooked or taken for granted.

Because credit scoring is an effective tool for creditors' compliance with the fair lending laws, it is ironic that credit scoring models have been attacked on the basis that they may have an adverse effect on minorities and other protected groups. In response to such criticisms, Congress directed the Federal Reserve Board to study credit scoring and also directed the FTC to study the use of credit scores in property and casualty insurance

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[5] *See, e.g.,* Cason v. Nissan Motors Acceptance Corp., No. 3-98-0223 (M.D. Tenn., filed April 29, 1998); Claybrook et al. v. Primus Automotive Financial Services, Inc., No. 02-CV-382, (M.D.Tenn., filed Apr. 16, 2002); Coleman v. General Motors Acceptance Corp., No. 3-98-0211 (M.D.Tenn., filed April 29, 1998); Jones v. Ford Motor Credit Co., No. 00-CIV-8330 (S.D.N.Y., filed Nov. 2, 2000); Osborne v. AmSouth Bankcorp., No. 02-CV-577 (M.D.Tenn., filed Jun. 18, 2002); Osborne v. Bank of America N.A., No. 02-CV-364, (M.D.Tenn., filed Apr. 12, 2002).

underwriting. Both of those studies demonstrated the predictive value of credit scoring and their benefit to consumers regardless of race, ethnicity, or gender.[6] The Federal Reserve Board reported that "credit characteristics included in credit history scoring models do not serve as substitutes, or proxies, for race, ethnicity, or sex."[7] The Board found that certain credit characteristics serve, in part, as limited proxies for age. As a result, credit scores for older individuals are slightly lower, and those of younger individuals somewhat higher, than would be the case had these credit characteristics not been partial proxies for age. However, the Board also reported that "mitigating this effect by dropping these credit characteristics from the model would come at a cost, as these credit characteristics have strong predictive power over and above their role as age proxies."[8] In other words, while there may be some limited impact on consumers based on age, that impact is off-set by the predictive value of the credit score models.

The Federal Reserve Board study also found that different demographic groups had substantially different credit scores, on average. "For example, on average, blacks and Hispanics have lower credit scores than non-Hispanic whites and Asians, and individuals younger than age 30 have lower credit scores than older individuals. Also, for given credit scores, credit outcomes—including measures of loan performance, availability, and affordability—differ for different demographic groups."[9]

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[6] FRB *Report to Congress on Credit Scoring*; Federal Trade Commission, Report to Congress: *Credit-Based Insurance Scores: Impacts on Consumers of Automobile Insurance* (July 2007), ("FTC Report on Credit-Based Insurance Scores"), available at http://www.ftc.gov/os/2007/07/P044804FACTA_Report_Credit-Based_Insurance_Scores.pdf.

[7] FRB *Report to Congress on Credit Scoring* , p. S1Ss2.

[8] *Id*. at S-2.

[9] *Id*.

At the direction of Congress, the FTC conducted a study of the use of credit scores in automobile insurance.[10] The FTC's study found that credit-based insurance scores are effective predictors of risk in automobile policies and that they may benefit consumers through lower premiums and wider availability.[11] The FTC also found that credit-based insurance scores have only a small effect as a "proxy" for membership in racial and ethnic groups in estimating insurance risk, while they remain strong predictors of risk when controls for race, ethnicity and income are included in risk models. The FTC was unable to develop an alternative credit-based insurance scoring model that would continue to predict risk effectively, yet decrease the differences in scores on average among racial and ethnic groups.[12]

These results are consistent with my experience while serving at the FTC and in working with creditors. Characteristics that correlate to lower credit scores (such as credit payment histories, available credit, wealth, employment, and education) are unevenly distributed across demographic groups and may also correlate to race, ethnicity and other protected characteristics. However, this phenomenon is reflected in credit underwriting in general. The solution is to increase educational and employment opportunities for underserved populations and to provide for alternative sources of data that may predict creditworthiness, such as rent, utility and telecom payments. In other words, the solution is to increase opportunities and available data, which in turn should or could raise credit scores for these underserved groups.

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[10] FTC Report on Credit-Based Insurance Scores.
[11] *Id.* at 3.
[12] *Id.* at 4.

Accuracy and Predictability

Criticism of credit scoring's accuracy and predictability is not new. I recall the arguments of the credit managers as they resisted the introduction of credit scoring in the late 70's. To alleviate these concerns, creditors often instituted judgmental over-rides in credit decisioning, where credit analysts were able to second-guess the credit scoring results. Those over-ride systems were found to be less accurate and predictable than credit scoring outcomes and in time were eliminated.

The 2007 Federal Reserve Board Report on Credit Scoring confirmed the early impressions of the effectiveness of credit scoring, finding that credit history scores "are predictive of credit risk for the population as a whole and for all major demographic groups. That is, over any credit score range, the higher (better) the credit score, the lower the observed incidence of default. . . ." Evidence provided by commenters, previous research, and the present analysis supports the conclusion that credit has become more available over the past quarter-century. Credit scoring, as a cost- and time-saving technology that became a central element of credit underwriting during that period, likely has contributed to improved credit availability and affordability."[13]

Today, concerns regarding the accuracy and predictability have a new criticism: If creditors lower credit limits and lines of credit in open-end credit in response to safety and soundness concerns and market conditions, the affected consumers' credit scores will decline, even if their credit payment histories or credit usage remains unchanged.

There are several responses to this criticism. First, particularly in the area of credit card accounts, many consumers had their credit limits raised when the economy

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[13] FRB, *Report to the Congress on Credit Scoring* at S-1.

appeared to be going well. Creditors' lowering of credit limits may simply reflect widespread awareness that these high credit limits are no longer consistent with current economic conditions. If that is the case, one would expect minimal impact on the affected consumers' credit scores.

More recently, there have been media stories that borrowers participating in government assisted mortgage modification programs may experience credit score declines. These stories overlook the fact that the borrower is seeking a modification because the borrower cannot sustain the current mortgage payments. A borrower in that situation may present an increased risk of default because debt to income ratios may be excessive. In fact, the media stories profile consumers who entered into these mortgage modification programs because they were experiencing difficulty meeting all their credit obligations, often due to a job loss or a new job at a significantly lower income than their previous employment.[14] Because these consumers present an imminent risk of default, they are a greater credit risk. When a credit scoring model lowers their credit scores, it may be revising their credit profiles to reflect their current level of risk.

However, to the extent that any lower scores may not reflect consumers' real risk, credit scoring systems should address these anomalies as the systems are periodically reevaluated and updated. Credit scores are never static, and a temporary depression in a consumer's score should be corrected by changes to credit scoring models and the passage of time. Moreover, creditors would undoubtedly report to credit score providers any declines in the predictability and reliability of credit scoring models. This kind of

[14] *See e.g.*, http://finance.yahoo.com/news/Credit-scores-can-drop-after-apf-1601705094.html?x=0.

feedback and the competition among score developers will address anomalies in the systems far better than any external interference. At the end of the day, credit score developers and the users of credit scores are in the best position to evaluate the accuracy and predictability of credit scores because of their impact on the bottom line.

Consumer Protection

I believe a lot of concerns about credit scoring stem from a perceived lack of transparency – while consumers may understand the effect of credit scores on their lives, they may not understand how credit scoring works. As a result, they may feel that their lives are affected by a system that is beyond their control. In reality, however, there are important ways in which consumers can become more informed about credit scores and use that knowledge to their advantage.

First, there are important rights and remedies for consumers with respect to credit scores. There are numerous laws and regulations designed to ensure that consumers understand that credit scores are used in the decision process and what they should do if they believe that information might be inaccurate.

Early Notice: In the near future, consumers will be entitled to notices under the Fair Credit Reporting Risk-Based Pricing Regulations.[15] A consumer who receives a risk-based pricing notice will have the right to obtain a free copy of his or her consumer report. As an alternative to the risk-based pricing notice, creditors may also give a credit score disclosure notice to consumers. This credit score disclosure notice will explain to consumers how their credit scores compare to other consumers. The risk-based pricing

[15] 16 CFR Part 640; 12 CFR Part 222, Subpart H.

notice and credit score disclosure notice give consumers a valuable opportunity to understand that credit scores are being used, where the consumer might fall in relation to others, and alert the consumer to the possibility of inaccuracies in his or her consumer report. The risk-based pricing and credit score disclosure notices will put consumers in a position to take action to cure any inaccuracies and obtain credit on the best terms under the circumstances.

Early Notice for Home Loan Applicants: Consumers applying for loans secured by residential real property already receive a notice required under the FCRA -- "Notice to the Home Loan Applicant."[16] The Notice to Home Loan Applicant has always included the credit scores and the key factors affecting the score. Now, the notice may include additional information as a result of the risk-based pricing regulations because creditors may add information to the notice that explains how a consumer compares to other consumers.

When consumers understand how they compare in relation to other customers of the creditor or consumers in the marketplace, they will have a better understanding of the credit terms they receive.

Notice After Denial or Adverse Change: The ECOA and Regulation B require a creditor to send a written adverse action notice to an applicant within 30 days after taking adverse action on a completed application or taking adverse action on an existing account.[17] When a creditor relies on information from one of the consumer reporting

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[16] FCRA § 609(g).

[17] 12 CFR § 202.9(a)(1)-(2). Adverse action covers situations when a consumer did not receive credit on the terms requested, when a consumer's account was terminated or terms change in an unfavorable way, or when a consumer was denied a request for an increase in the amount of credit available. 12 CFR 202.2(c)(1).

agencies to take adverse action, the creditor has additional notice obligations under the FCRA. The FCRA notice informs the consumer that the user's decision was based on information in a consumer report, the name of the company that provided the report, and a statement that the consumer has the right to obtain a free copy of the report and dispute any information that might be inaccurate.[18]

When consumers receive notices under the ECOA and/or the FCRA, the consumer will learn that there may be negative information in their credit reports. The consumers will have the opportunity to obtain their credit report and to correct any inaccurate information. This process gives consumers another opportunity to monitor the information that is included in their files at the consumer reporting agencies.

When the Consumer Obtains a Report: Today, consumers have easy access to their credit reports. If a consumer believes that information in his or her credit report is inaccurate, the consumer can dispute the information in two ways: (1) through the consumer reporting agency and (2) directly with the person who furnished the information. The remedies are not mutually exclusive.[19] The consumer's ability to dispute information through two channels provides the consumer with an even greater ability to understand what is being reported and to ensure that the information being reported about the consumer is accurate.

Changes to Terms of a Credit Card: The new CARD Act rules generally prohibit increasing rates on accounts, except under certain limited exceptions, including

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[18] FCRA § 603(k)(1)(A) and (B)(iv); FCRA § 615(a). This FCRA notice requirement also applies to consumers in the insurance context. Under the FCRA, adverse action also includes cancellation or denial of insurance coverage, an increase in rates, a reduction or other unfavorable change in coverage or the amount of insurance. If an insurer takes any of these actions, then the insurance must send the same FCRA notice a creditor would be required to send.

[19] FCRA § 615(a).

with advance notice. The FRB proposed rules to implement provisions of the Act that become effective on August 22, 2010 will also impose notice requirements designed to help the consumer understand the reasons for the change. The proposed CARD Act rule includes examples of information that a consumer might receive: If a notice of a rate increase is triggered by a decrease in the consumer's credit score, the card issuer may tell the consumer that the increase is due to a decline in creditworthiness or a decline in the credit score. Limitations and notices under the CARD Act rules should ensure that consumers have a better understanding of the nature of and reason for the changes being imposed.

Second, consumers have important educational opportunities regarding their credit scores. The FTC has issued an informative Facts for Consumers, "Need Credit or Insurance? Your Credit Score Helps Determine What You'll Pay."[20] Consumers can also learn about credit scoring through websites such as myFICO.com, and from consumer reporting agencies on their websites. Much of the information is free, and consumers can apply that information to their own credit reports for a nominal fee.

Based on my consumer protection experience at the FTC, I firmly believe that consumer education plays a large role in consumers' abilities to protect themselves and secure their financial futures. At the same time, I do not believe that consumer reporting agencies or other providers of credit scores should be required to give away their product for free. Proponents of this view share a fundamental misunderstanding with those that criticize the educational credit scores that Experian or others may provide to consumers on their website. They persist in the mistaken belief that there is only one credit score,

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[20] http://www.ftc.gov/bcp/edu/pubs/consumer/credit/cre24.shtm

and that Fair Isaac is the provider of that score. In fact, as discussed above, there are many credit scores provided by many different sources. Moreover, it would be fundamentally unfair to require any credit score provider, such as a consumer reporting agency, to give away credit scores. The important information for consumers is how their credit report affects their credit scores and what steps they can take to improve their credit histories. That information is currently available, and federally-mandated disclosures such as adverse action notices and risk-based pricing notices should improve consumers' awareness of their credit scores and access to this educational information.

Conclusion

Credit scoring has been widely adopted as an effective tool in credit and insurance underwriting. It enables creditors and insurers to predict accurately the risk associated with a consumer's application for credit or insurance. Because credit scoring models are devoid of characteristics with respect to race, gender or other prohibited factors, credit scoring facilitates fair lending compliance and assures treatment based on objective criteria. Many concerns about credit scoring can be attributed to a lack of transparency and a lack of understanding about the factors applied in credit scoring. These concerns can be addressed through the implementation of required notices and increased consumer education and awareness of the process.

Thank you for the opportunity to testify. I will be glad to answer your questions.