FICO

WRITTEN TESTIMONY OF

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BEFORE THE U.S. HOUSE OF REPRESENTATIVES
COMMITTEE ON FINANCIAL SERVICES
SUBCOMMITTEE ON FINANCIAL INSTITUTIONS AND CONSUMER CREDIT

Mr. Chairman and members of the subcommittee, my name is Tom Quinn. I am a Vice President in the SCORES division of FICO (formerly Fair Isaac Corporation) responsible for the management and delivery of the company's global scoring products and services. Thank you for the opportunity to testify before you today on this important topic of credit scores. I am pleased to share with you my company's perspective as a developer of credit scoring models. Credit scores play a vital role in facilitating millions of lending decisions each year and FICO recognizes the importance of communicating publicly on issues related to the use and impact of credit scores. My testimony will address the following areas: (1) a detailed overview of FICO credit scores; (2) the predictive strength of FICO's scoring model; (3) FICO's efforts to extend risk scoring to credit-underserved consumers; (4) FICO's ongoing commitment to providing helpful educational resources on a myriad of credit scoring topics; (5) FICO's continued support of consumer access to credit scores used by lenders and (6) the important role that consumer credit behavior plays in determining your FICO® score.

WHO WE ARE

FICO was founded in 1956 on the premise that data, used intelligently, can improve business decisions. FICO solutions provide key benefits to both businesses and consumers across the banking, credit card, retail, telecommunications, insurance, healthcare and government markets. These analytic solutions include FICO Falcon® Fraud Manager, the leading credit card fraud detection and prevention application, and the widely used FICO Blaze Advisor® business rules management system that automates complex business operations and processes. However, FICO is still best known for its FICO® scores, first introduced in 1989.

While there are other credit scores available to businesses, FICO® scores are the most widely used credit bureau risk scores in the world, powering about 10 billion decisions a year. The effectiveness of FICO's models at predicting credit risk is continually affirmed by our clients (lenders, insurers and other businesses) through their own validation research. FICO® credit scoring models are empirically derived, demonstrably and statistically sound, built with depersonalized data, and include features that other models may not include, such as authorized user data, that assist our clients in complying with Regulation B and other applicable federal regulations.

FICO® scores are calculated by the use of an algorithm, a mathematical formula that serves as the engine driving the production of the credit score. The fuel for this engine is the information contained in a consumer's credit report. This credit information is housed and maintained at the three major, national consumer reporting agencies - Equifax, TransUnion and Experian (commonly referred to as the major credit bureaus).

It is important to note that FICO develops and provides separate credit scoring models, in the form of unique algorithms, to each of the three credit bureaus. This approach optimizes the unique data differences between each bureau to make the FICO® score as predictive as possible. When a lender requests a FICO® score from a credit bureau, the bureau feeds the relevant consumer credit report information into the algorithm to generate a score that it delivers to the lender. FICO is not a consumer credit bureau or a consumer credit data repository. Since the introduction of the first FICO® score, the company's role in this area has been defined by the work of its scientists who develop scoring models that help businesses better evaluate and manage risk associated with the extension of credit and insurance.

OVERVIEW OF FICO CREDIT SCORES

What is a FICO® credit score?

The FICO® score is a three digit number ranging from 300-850. The score "rank orders" consumers by the likelihood that they will become seriously delinquent (90 days or more) on a credit obligation in the next 24 months. The higher the score, the lower the risk. Lenders use credit scores as a component in their decision process to extend credit as well as to set terms (such as the interest rate). Today, credit scores are a vital part of a consumer's credit health. While there are different credit risk scores in the marketplace, the score most commonly used by lenders is the FICO® score.

What is considered in the FICO® score?

The FICO credit scoring model considers a wide variety of information found in consumer credit reports maintained by the three major credit bureaus. This includes information from credit obligations (e.g., credit card, mortgage and home equity line accounts), consumer-initiated credit inquiries, collections, and derogatory public records (e.g., bankruptcies and liens). The data used to calculate the FICO® score can be grouped into five primary categories as outlined below. The accompanying percentages are meant to give an indication of how important each of the categories is in determining a FICO® score.

- Payment history (35%)
- Amounts owed (30%)
- Length of credit history (15%)
- Pursuit of new credit (10%)
- Mix of credit (10%)

As noted above, payment history and amounts owed (level of indebtedness) are the two strongest predictive categories in the FICO® score. For payment history, the score assesses both positive and negative payment information as reported in the consumer's credit file. When negative payment information is present, the score assesses the magnitude, frequency, and recency of missed payments or other derogatory information in the credit report such as bankruptcies and collections. For amounts owed, the score considers how much a consumer owes to various lenders, including the relationship between outstanding debt and the total amount of credit that is available to the consumer. The remaining three predictive categories are length of credit history, pursuit of new credit and mix of credit. Generally speaking, consumers who have demonstrated a longer history of positive credit behavior have been shown to expose lenders to less credit risk. Those who are seeking credit as measured by excessive inquiry behavior or the opening of multiple new credit obligations have been found to pose more risk to lenders than those who have not been aggressively pursuing new credit (see below for more discussion on the treatment of rate-shopping activity). Finally, the FICO® score examines the mix of credit that a consumer possesses such as credit cards, retail cards, and installment loans. Consumers who demonstrate the ability to successfully manage a variety of different credit types generally pose less credit risk.

A few additional comments regarding the score composition are worth noting:

- The FICO® score takes into consideration all of the above categories of information, not just one or two. Also, the importance of any factor depends on all of the information in the consumer's credit report. For some people, a particular factor may be more important to their score than for someone else with a different credit history.

- The FICO® score incorporates special logic in the treatment of inquiries. First, the score is focused on inquiries where a consumer is actively seeking credit. Second, the score contains rate-shopping logic to ensure that multiple inquiries associated with a single search for a mortgage, auto, or student loan are treated as a single inquiry. In addition, the score ignores inquiries related to rate-shopping that are made within 30 days of scoring.

What is not considered in the FICO® score?

It is also important to know what information is not considered by the FICO scoring model. FICO® scores do not consider:

- A consumer's race, religion, national origin, sex or marital status
- A consumer's age
- A consumer's income, occupation, title, employer, date employed or unemployment history
- A consumer's address
- Any interest rate being charged on a particular credit or other account
- The value of a consumer's assets
- Certain types of inquiries (e.g., requests by consumers for their own credit report or score)
- Any information not found in the consumer's credit report
- Any information that is not proven to be predictive of future credit performance

How is the FICO scoring model developed?

FICO pioneered the way automated credit scoring systems are developed. The creation of the FICO scoring model requires FICO to obtain from each of the major credit bureaus representative national samples of depersonalized credit reports spaced two years apart for the same set of consumers. FICO's analytic scientists then study the data in the earlier data snapshot to isolate and prioritize factors that consistently predict the credit account performance observed two years later in the second data set. Those factors found to be most powerful and consistent in predicting credit performance, individually and in combinations, form the basis for the complex mathematical algorithms which become the predictive scoring models.

How are FICO® scores generated?

A lender seeking to use a consumer's FICO® score as part of a credit decision will contract with one or more of the credit bureaus. In response, the bureau assembles information from the consumer's credit file and feeds it into the FICO algorithm housed within their system which calculates the FICO® score. The bureau delivers the FICO® score to the lender along with up to five reason statements that explain which credit report factors had the greatest influence on why the FICO® score was not higher.

Who uses FICO® scores and what are the benefits?

Credit scores are used by businesses in a wide range of industries and across the consumer credit lifecycle:

- Acquisition: Lenders leverage credit scores to help them identify those lower risk consumers to whom they wish to offer pre-approved credit.
- Origination: When a consumer applies for a car loan, mortgage, home equity line, credit card or subscribes to a cell phone plan, the creditor may check the consumer's FICO® score to help determine whether they will decline or approve the application for credit and to help set loan terms such as interest rate and credit line assignment.
- Account management: Lenders use credit scores to help determine what actions to take on their existing customers. For example, a credit card issuer may consider the FICO® score of a current customer when deciding whether to increase the customer's credit line or to cross sell other financial services.

FICO® scores offer a wide range of benefits to both lenders and consumers. FICO® scores give lenders a fast, objective estimate of a consumer's credit risk. This results in quick decision making, faster processing of loans and fewer defaults. Consumers can take comfort in knowing that FICO® scores only focus on the facts related to credit risk, rather than personal opinions or potential biases. The use of these scores helps customers receive fast and fair decisions from lenders and gain access to a wider availability of credit.

PREDICTIVE STRENGTH OF FICO'S SCORING MODELS

The FICO credit risk model is not static – it undergoes continual innovation. FICO analytic scientists regularly study credit bureau data samples to test the predictive value of the factors considered by the FICO scoring model. Through empirical analysis of the data, FICO has consistently been able to update its algorithm resulting in a more predictive scoring model. In fact, the latest scoring model – FICO® 8 – generates the most predictive FICO® score in history.

Lenders and insurers' use of credit-based scoring models to effectively evaluate risk has been validated by a wide range of research, including two 2007 studies conducted by the Federal Reserve and the Federal Trade Commission (FTC) respectively, pursuant to Section 215 of the Fair and Accurate Credit Transactions Act of 2003 (*Report to the Congress on Credit Scoring and Its Effects on the Availability and Affordability of Credit* and *Credit-Based Insurance Scores: Impacts on Consumer Automobile Insurance*). While the Federal Reserve's study focused on credit risk scores and the FTC research examined credit-based insurance scores, both studies concluded that credit-based scores are effective predictors of risk in both the credit and insurance markets.

EXTENDING RISK SCORING TO CREDIT-UNDERSERVED CONSUMERS

FICO has been a leader in the use of alternative data to improve risk assessment for consumers with "thin" or no traditional credit bureau files. In 2004, FICO launched its FICO® Expansion Score to address the estimated 30-50 million consumers for whom insufficient credit history data exists at the three major credit bureaus to calculate a traditional FICO score. The FICO® Expansion Score model evaluates both positive and negative nontraditional credit history information provided by specialized credit bureaus, including payment performance records for purchases such as furniture bought on lay-away, verified bill payment information, membership account performance at retail vendors and selected performance involving bank deposit accounts such as the propensity to overdraw checking accounts. Like the FICO® score, the FICO® Expansion Score model uses the same score range and rank orders consumers by the likelihood that they will become seriously delinquent (90 days or more) on a credit account within the next 24 months. The FICO® Expansion Score provides lenders with a credit risk score they can use to more effectively evaluate and extend credit to underserved customers that may include recent immigrants, young adults and those who have not used traditional credit in the recent past.

COMMITMENT TO CONSUMER EDUCATION

FICO is strongly committed to providing consumers with freely accessible educational resources on credit scores. More than nine years ago, FICO launched its consumer website, www.myFICO.com, which quickly became a central source of information for consumers and others interested in learning about credit scores and related topics. The educational resources contained on the website include a list of credit factors that are assessed by the FICO scoring model and explanations that address what information the model ignores, how consumers can take action to manage their scores over time, how to prepare for a loan, and much more. Also, myFICO® created an 18-page booklet for consumers titled "Understanding Your FICO Score" which is available in hardcopy and can be downloaded from the website. In addition, myFICO®

has partnered with the Consumer Federation of America on a consumer-focused pamphlet called "Your Credit Scores" which has been distributed to thousands of consumers nationwide and is available through the U.S. General Services Administration's Federal Citizen Information Center (FCIC) and on the FCIC website. More recently, FICO created a permanent, public online discussion forum for consumers called FICO Forums. Currently, more than 340,000 users have registered at the FICO Forums to discuss and compare notes on hundreds of credit scoring topics and related issues. Some consumers are not only active in the Forum but have accumulated sufficient knowledge to now serve this community as voluntary Forum moderators.

myFICO.com also has served as the primary destination for consumers who wish to obtain their FICO® scores. For a modest fee, consumers gain access to the same credit scores that are most widely used by lenders. The information provided includes the FICO® score, the underlying credit report on which it was generated, a detailed explanation of the score, the score range, a distribution chart that indicates where the consumer stands within a national distribution of consumer credit scores and the primary reasons why the score is not higher. To date, more than 20 million FICO® scores have been delivered directly to consumers via myFICO.com and other affiliates. Also, myFICO.com has introduced additional products to help consumers monitor their FICO® scores and credit reports, protect against fraud and identity theft, and provide coaching on successful credit management practices.

In addition to the educational resources published on the myFICO.com website, FICO participates in numerous speaking and education training events and serves as a resource for government and non-profit groups. In the past few months, FICO staff has spoken at Federal Reserve Bank, Federal Deposit Insurance Corporation and National Association of Insurance Commissioners events, provided credit score information to state attorneys general and the U.S. Government Accountability Office and appeared on a panel at the annual Consumer Federation of America Consumer Assembly conference.

CONSUMER ACCESS TO CREDIT SCORES USED BY LENDERS

FICO continues to support efforts to ensure that consumers have access to credit scores used in making lending decisions. While a variety of credit scores are available to consumers, FICO believes that consumers benefit most when they can obtain credit scores that are actually used by lenders to make credit decisions. There are a number of ways that consumers can gain access to these credit scores, including:

- **myFICO.com**. As previously mentioned, FICO® scores from Equifax and TransUnion are available for $15.95 at www.myfico.com.
- **When applying for a home mortgage**. Pursuant to the 2003 FACT Act, Section 609 (g) requires that all lenders who use a credit score in connection with an application for a home mortgage provide the applicant with a current credit score that was calculated for a purpose related to the extension of credit.
- **Via FICO® ScoreView**. FICO is working with several large banks to introduce a program called FICO® ScoreView in which bank customers view their FICO® score when they access their accounts electronically. Through an agreement with FICO, banks provide consenting customers with free FICO scores monthly, along with score

explanations and extensive credit management educational content via participating lenders' secure banking websites.

- **In circumstances when risk-based pricing is used.** On December 22, 2009, the Federal Reserve Board and the Federal Trade Commission issued a final rule that generally requires a creditor to provide a risk-based pricing notice to a consumer when the creditor uses a consumer report to grant or extend credit to the consumer on material terms that are materially less favorable than the most favorable terms available to a substantial proportion of consumers from or through that creditor. The final rule includes an exception for creditors to provide a consumer with a disclosure of the consumer's credit score in conjunction with additional information that provides context for the credit score disclosure. We expect the credit score disclosure exception to be the most widely used method of complying with the rule. If this holds true, many consumers who apply for credit will begin receiving credit scores as early as January 1, 2011, the effective date of the new rule.

FICO remains committed to supporting these and other efforts that put meaningful information in the hands of consumers and empower them to become better-educated as well as to develop successful credit management practices.

CONSUMER BEHAVIOR DRIVES CREDIT SCORES

In my role at FICO, I am often asked, "How can a person improve his or her credit score?" Credit scores are not static; they are constantly changing based on a consumer's credit behavior. There are no silver bullets for rapidly raising a low score, but there are a few guidelines that, if adopted, will very likely impact a consumer's score in a positive way.

- First, pay your bills on time – consistently.
- Second, keep credit card balances low.
- Third, don't open new credit accounts you don't need.
- Fourth, check your credit report to ensure its accuracy.
- Finally, be patient – demonstrate your responsible credit habits over time.

Improved credit scores are a natural byproduct of healthy credit habits and sound financial management practices.

Thank you for the opportunity to testify before you today.