



Credit Scores: Issues In a Changing Environment

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Credit Scores are Statistical Measures

- “There are no facts, only interpretations.”
[Frederick Nietzsche (1844-1900)]
- “Essentially, all models are wrong, but some are useful.”
[George E.P. Box (1919-present)]
- “There are three kinds of lies: lies, damned lies, and statistics.”
[Benjamin Disraeli (1804-1881) quoted by Mark Twain/Samuel L. Clemens (1835-1910)]

Credit Scores: Benefit or Bane?

An August 2007 Federal Reserve Board Report to Congress noted these “benefits” of credit scoring:

- Increased use of risk based pricing
- Increased creditor access to capital markets (securitization)

What is Your Credit Score?

- “Your credit score is likely the most important three-digit number in your life.” [MSN Money]
- “There are many different credit scores used by lenders – some estimate more than 1,000.” [Experian FAQ]



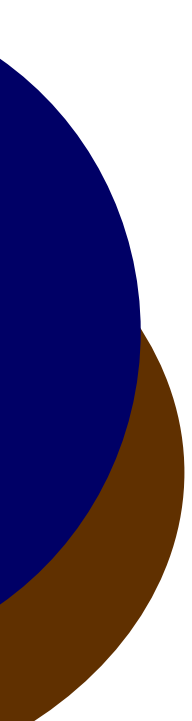
Five Key Issues

- Can scoring models remain relevant in a shifting economy?
- Inherent problems with the “look back” approach.
- Fairness to population subsets and for non-credit uses.
- Garbage in, garbage out.
- New types of scores.



Issue 1: The Shifting Economy

- FICO 8 gives more emphasis to utilization just as credit card banks are cutting credit lines for business reasons.
- Mortgage and utility assistance programs may require late status despite the harm to future credit standing.
- Fundamental demographic shift away from credit cards may be underway.
- Scoring models have no escape hatch for catastrophic events.



Can scoring models keep up with the pace of change?

- Five or fewer FICO models in 20 years.
- Model development takes 2-3 years, more time for adoption.
- Credit usage and patterns are changing much faster than models.
 - Reduced securitization and lower numbers of home equity lines reduced unused credit lines.
 - Will new types of online credit be “finance company” credit?
 - Post-CARD Act marketing may induce consumers to open new credit lines due to teaser rate advertising.

Issue 2: Weaknesses in the “Look Back” Approach

- Credit scores assume that the past predicts the future.
- Seismic shifts not accounted for.
- Changing demographics and credit usage patterns can undermine the value of “look back” approach to predictions.

Issue 2: Weaknesses in the “Look Back” Approach

“In sum, by living modestly, declining to accept debt, pooling resources, deferring consumption in favor of savings, and investing abroad, perhaps half of Latino households are penalized instead of rewarded by traditional credit scoring systems.”

-National Council of La Raza, 2007 Report



Issue 3: Fairness

- Is 7 years too long for small or youthful mistakes to remain on a credit file?
- How long should out of date scoring models be allowed to remain in use?
- No auto or no mortgage loan can depress the score. Impacts on long term renters?
- As younger consumers move from credit to debit, will files be thinner and good risks undervalued?

Is it Fair to Use Credit Information for Non-Credit Uses?

- Studies in auto insurance show correlation to likelihood of a claim, not to an insured incident.
- Should people caught up in the mortgage crisis face reduced job prospects?
- Congress may have to restrict uses or to restrict the time negative information stays on file.



Not Everyone Has a Credit Score

The FTC estimated in 2007 that there is no credit file (or a thin file) for these parts of the U.S. population:

- 9.7% (2.1%) of African-Americans
- 9.2% (2.4%)* of Hispanics
- 7.8% (1.8%) of non-Hispanic whites
- 6.4% (1.8%) of Asian-Americans

* Other estimates are much higher.

Credit Score Disparities

- Mean TransRisk score calculated in the Federal Reserve Board 2007 Study, with SSA data
 - Non-Hispanic whites 54.0 percentile
 - Asian-Americans 54.8 percentile
 - Hispanics 38.2 percentile
 - African-Americans 25.6 percentile



Favorable Credit Scores Are Not Evenly Distributed Among Population Groups

FTC 2007 Report shows these median credit-based insurance scores by group:

- Non-Hispanic white: 54th percentile
- Asian American: 52nd percentile
- Hispanic: 32nd percentile/37th after income adjustment
- African American: 23rd percentile/27th after income adjustment



Issue 4: Credit Report Accuracy

Garbage In, Garbage Out

- Scoring magnifies the harm from inaccurate credit reports.
- Spread of scoring elevates the need for effective correction of credit file errors.
- Spreading uses of credit reports raise a policy question about the contents of credit files.



Issue 5: New Types of Scores

- Account risk management scores
- Bankruptcy risk prediction scores
- Revenue scores
- Mortgage risk analyzer



Policy Recommendations: Transparency

- Every user should be required to send the consumer the actual score and the data file used in connection with a score used for any economic opportunity
 - Not the Fake-O score
 - Not only to those who request it.
- Congress and the states must balance the predictive power of scoring against the social impact of certain information being included in the credit file and used to generate a credit score.



Policy Recommendations: Models

- Do we need a “disaster score card?”
- Should continued use of an outdated model with a more disproportionate adverse impact than a newer model raise fair lending concerns?
- Should lenders be prohibited from using scores or scoring models that have disparate impacts unless those impacts are reasonably essential to obtaining predictive results?
- Should disparate impacts from the use of credit scoring models be addressed by excluding certain types of information from the credit file?



Policy Recommendations: GIGO

- Improve credit report accuracy
- Fix the dispute process for credit reports
 - All info sent to the CRA must go to the creditor
 - Real investigation must be required
 - Audit handling of credit report disputes
- Audit credit reports for accuracy and completeness
- Address debt buying and zombie debt
- Update limits on the age of info in the credit file

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