

**Prepared Statement of
The Federal Trade Commission**

on

Credit Scoring

before the
**House Banking And Financial Services Committee
Subcommittee on Financial Institutions And Consumer Credit**

Washington, D.C.
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I. Introduction

Madame Chairman and members of the Subcommittee: I am Peggy Twohig, Assistant Director for the Division of Financial Practices at the Federal Trade Commission.⁽¹⁾ I appreciate the opportunity to appear before you today on behalf of the Commission to discuss credit scoring. The Commission is aware of pending bills that address credit scoring and looks forward to working with the Subcommittee on this important consumer issue.

Typically, a credit score is a number generated by a statistical model that is used to evaluate the degree of risk posed by a consumer seeking credit. Credit scoring has been used by some creditors, particularly credit card issuers, for many years as a tool in making credit decisions. Mortgage lenders, however, have only recently begun using credit scoring to decide whether to make a loan and at what price. Because a mortgage is typically a consumer's largest and most costly personal financial obligation, the stakes are much higher for consumers in mortgage lending than in other types of credit transactions. As a result, the use of credit scoring by mortgage lenders has increased consumers' awareness of credit scoring and, at the same time, heightened their concerns about its use.

In connection with its enforcement work in the consumer credit area and its consumer education initiatives, the Commission has long been involved with credit scoring issues.⁽²⁾ The Commission believes that credit scoring and other automated systems can be of great benefit to consumers. With credit scoring, lending decisions are likely to be more objective, faster and less costly than traditional "judgmental" decisions. The objective assessments offered by credit scoring systems should help lead to greater consistency in lending decisions. In addition, scoring models use factors that have proven to be predictive of creditworthiness, as opposed to judgmental assumptions, and should lead to better lending decisions. Nevertheless, many consumers, particularly those who have not been able to obtain their credit scores or useful information about how the scores were derived, have expressed concerns about credit scoring.

The Commission has taken action to heighten public awareness and understanding of this

issue. First, we published a consumer brochure on credit scoring setting forth basic information about credit scoring and its use in credit granting decisions.⁽³⁾ The brochure has been distributed to approximately 200,000 consumers since 1997 in both written and electronic form. Second, the Commission held a public forum on credit scoring on July 21, 1999. The forum was designed specifically to provide an opportunity for industry, government, and consumer and community groups to engage in a public dialogue about the use of credit scoring in consumer lending decisions, particularly in mortgage lending. A transcript of that forum is available on the Commission's Web site at www.ftc.gov/bcp/creditscoring/index.htm.⁽⁴⁾

This testimony summarizes what the Commission learned at the forum regarding information that consumers want about credit scoring, identifies recent industry initiatives to provide consumers with information, and addresses the Commission's position regarding disclosure of credit scoring information to consumers.⁽⁵⁾

II. Credit Scoring Terminology

As risk assessment technology has evolved, terms such as "credit score" have developed multiple meanings, thus causing some confusion. A consumer seeking credit may be subject to various forms of credit scoring models, such as custom scoring models and mortgage scoring models, as well as automated underwriting systems. It is important for consumers to understand that they have not been simply assigned one, universal "credit score" based on information contained in their credit report.

Often, the terms "credit score" and "FICO score" are used generically to mean a score that is obtained from one of the three national consumer reporting agencies ("CRAs"). These are also often referred to as "bureau scores."⁽⁶⁾ Each of the three national CRAs has its own credit scoring model: Trans Union's scoring model is known as Empirica; Experian's as FICO; and Equifax's as Beacon. All three models were developed by Fair, Isaac and Company⁽⁷⁾ and are based solely on the information contained in the CRAs' credit reports. Because the credit data reported to each may differ and each model is unique, the same consumer likely will have a different score from each of the three CRAs at any given time.

While credit scores obtained from consumer reporting agencies are based solely on credit report information, other credit scores are available that are based upon additional or different information. For example, some creditors have developed custom scoring models, either themselves or using modeling experts like Fair, Isaac. These scoring models may be developed based on the lending experience of a specific creditor and are designed to be used by that creditor to make its credit decisions. There are also scores specifically designed to predict the risk of delinquency for a particular type of credit, such as a credit card, automobile loan, or home equity loan.⁽⁸⁾ In addition, some scoring models may incorporate, in addition to the contents of the credit report, information from the consumer's application and information about the terms of the particular loan.⁽⁹⁾ The term "mortgage score" is often used by mortgage lenders to refer to such scores.

Because of the variety of scoring models available, both generic and custom, individual creditors do not necessarily rely upon the same credit score to make their individual credit decisions. Moreover, a single creditor may use a different scoring model for each of its loan products or may consider more than one score in making a single lending decision. It is also important to note that credit scores may be used not only to determine whether a consumer qualifies for a particular product, but also to assess what price a consumer will pay for the loan - a practice commonly known as risk-based pricing.

In addition to credit scoring models, automated underwriting systems are also often used in mortgage lending.⁽¹⁰⁾ Automated underwriting systems may use credit scores or mortgage scores, but do not themselves generate a specific number. Rather, they provide a qualitative recommendation to the user concerning the consumer's application. For example, Fannie Mae's system recommends that the lender "Accept," "Refer," or "Refer with Caution."⁽¹¹⁾ Many mortgage lenders that intend to sell their loans on the secondary market will likely use Fannie Mae's or Freddie Mac's automated underwriting system.

III. Disclosing Information About Credit Scoring

The Commission's July, 1999 public forum, "The Consumer and Credit Scoring," generated vigorous discussions among both the audience members and the panelists. These discussions indicated that consumers are concerned primarily with being able to obtain their credit scores and understand the process by which their scores were generated. Consumers want somebody to open the "black box" and let them see inside so that they can understand what information was considered, who made the decision, and what steps they can take to improve their scores.

A. Consumers Want Information About Credit Scoring

Consumers want answers to what seem to them fundamental and easily addressed questions: What information was used to calculate the credit score? How important is each factor in the analysis? Does it matter if a prior loan was from a finance company or a bank?⁽¹²⁾ If so, why? How many credit accounts or inquiries⁽¹³⁾ are too many or too few? How can I improve my score?

The Commission's forum made clear that consumers and those who counsel them want and need more information about credit scoring so that consumers can obtain the credit they need at the best possible price. One consumer at the forum related his personal experiences in preparing to obtain a mortgage for a home purchase. The consumer was aware he knew he should obtain his credit report and make sure all of the information reported about him was accurate.⁽¹⁴⁾ But, he had only recently learned about the use of credit scores. He was upset that he neither had access to the score nor to information about how that score was calculated. He was able to determine that the number of credit cards he held and the available balance and credit limit on those cards could affect his score. He could not find out, however, how they affected his score and what action he could take to have a positive impact on his score. He was also surprised that the mortgage professionals with whom he consulted were unable to answer his questions and seemed to know less

than he did about credit scoring.⁽¹⁵⁾

A housing counselor who served as one of the panelists advocated education of the mortgage industry, non-profits, and prospective home buyers as the key to fostering an understanding of how scores affect credit decisions. She felt strongly that consumers need to understand where a credit score positions them in the mortgage market. Consumers also need to obtain their credit scores early, before they enter the real estate market. They need to meet with somebody who understands scores and can go through their credit report and assess ways to improve their creditworthiness and thereby improve their credit score.⁽¹⁶⁾

B. Information Must Be Provided In A Meaningful Context

Many at the forum appeared to support strongly the release of scores, but only "with meaningful explanatory data to better shop for mortgages and . . . evaluate lender products."⁽¹⁷⁾ Industry panelists generally believed that providing consumers with scores in the abstract, out of the context of a specific transaction, is not particularly useful. Participants agreed that consumers need to understand what behavior affects their scores so that they can alter their credit activity over time to become better credit risks. The creditor who ultimately makes the decision is the only one who knows what type of score was used -- a credit bureau score or a custom credit or mortgage score -- and what other factors in addition to the score may have been considered in the decision.⁽¹⁸⁾ Loan officers and counselors need to be educated about the lender's particular use of credit scoring so that they can provide consumers with their scores in the context of a particular transaction.⁽¹⁹⁾

C. Complexities Involved In Disclosing Information

The Commission recognizes that providing information that will make credit scores meaningful to consumers is not without difficulty. While the questions consumers want answered seem reasonable enough, such as how many credit cards are too many, the answers are not necessarily that simple. The consumer who wants to know her credit score also needs to understand which credit score she wants -- a score that came from a custom model, a mortgage bureau score, a credit bureau score -- or perhaps she wants access to a decision from an automated underwriting system. If she wants a bureau score, which one should be given? Importantly, if a consumer wants to be provided with the same score the CRA provided to the creditor, she needs to understand that her score may have changed over time.

The Commission is aware that credit scores are not static numbers. Closing an account or missing a credit card payment may affect a consumer's credit bureau score, but so may the simple passage of time. As time passes, the length of the consumer's credit history increases. A longer credit history may improve a consumer's credit score. It also may cause the significance of any late payments to decrease, which in turn may favorably affect the consumer's credit score. Credit scoring models are based on a complex interrelationships of factors. For example, the optimal number of credit cards one should own to maximize a credit score will depend on the circumstances of a particular

consumer. Thus, it may be beneficial for one consumer to close some credit accounts, but, for another consumer, closing accounts and consolidating debt may have a negative effect on other factors, such as credit utilization (that is, the amount of debt outstanding compared to available credit).

IV. Market Responses to Consumer Concerns

The market appears to be responding to the consumer demand for information about credit scoring. Several key industry players have acted recently to bring more transparency to credit scoring and automated underwriting systems.⁽²⁰⁾ The Commission encourages the continuation of these efforts. On May 15, 2000, Trans Union, one of the three national consumer reporting agencies, announced plans to provide consumers with a "consumer credit score" to help them more effectively manage their financial health.⁽²¹⁾ Other industry efforts have focused on providing consumers not with scores but with information about the factors considered in credit scoring and automated underwriting.

On June 7, 2000, Freddie Mac released a list of over 15 factors used by its automated underwriting system, Loan Prospector, and informed the public that the three most important individual factors used in its system are: a) the borrower's total equity; b) loan type; and c) credit bureau scores.⁽²²⁾ The following day, Fair, Isaac and Company made available a comprehensive list of the factors used in its credit bureau risk scores. Along with the list, Fair, Isaac is providing descriptions of each of the score factors and how its score uses these factors to evaluate credit history. Fair, Isaac believes that this information is sufficient for borrowers to understand how its individual scores are derived and what actions consumers could take to improve their scores over time. The company also announced that it was holding discussions with the three major credit reporting agencies about changing contract agreements that may prevent lenders from disclosing scores to borrowers.⁽²³⁾

Most recently, Fannie Mae introduced a new version of its automated underwriting system, Desktop Underwriter, which replaces the credit score factor with a variety of credit history elements. To accompany this new technology, Fannie Mae will provide a brochure for customers that explains all of the factors Desktop Underwriter considers in evaluating mortgage loan applications.⁽²⁴⁾

V. Conclusion

The Commission recognizes that credit scoring models are complex and understands that there are not always quick and easy answers to consumer inquiries. Nevertheless, in light of the clear need for more information expressed at our public forum, the Commission supports the disclosure of credit scores and information regarding those scores in a context that is useful and meaningful to consumers. For example, information about credit scoring may be especially meaningful when provided in the context of a specific loan transaction. The lender is in the best position to identify the source and type of score used (*e.g.*, bureau score or custom mortgage score), the impact the score had on that particular lending transaction, and what factors contributed most significantly to the calculation of

the score.

Consumers may also benefit from receiving a credit score directly from a consumer reporting agency, if that score is provided with sufficient explanation. A credit score standing alone has the potential to confuse and mislead consumers. Because the information in the CRAs' files is updated frequently, and the updated information will affect consumers' credit scores, consumers need to know whether the score was generated based on information currently in their credit file or based on previous information that has since been superceded. If the score was generated at an earlier time, it may no longer accurately reflect the consumer's credit risk.

With sufficient knowledge about the score and what it means, consumers may use that information as a valuable shopping tool. For example, in the subprime lending market, consumers with relatively high credit scores have obtained loans from subprime lenders.⁽²⁵⁾

Apparently, these consumers did not know that they may qualify for lower priced loans. Armed with their scores and information about what they mean, consumers may be able to obtain more favorable rates than those offered in the subprime market.

Thank you for the opportunity to appear before you today and speak on this important consumer issue. I would be happy to address any questions you may have.

Endnotes:

1. The views expressed in this statement represent the views of the Commission. My oral presentation and responses to any questions are my own, however, and do not necessarily reflect the Commission's views or the views of any individual Commissioner.

2. The Commission enforces a number of laws that address consumer credit, including the Fair Credit Reporting Act, 15 U.S.C. § 1681 et seq., and the Equal Credit Opportunity Act, 15 U.S.C. § 1691.

3. Facts for Consumers: Credit Scoring (revised August 1998) is available through the Commission's Consumer Response Center and on its Web site at www.ftc.gov/bcp/online/pubs/credit/scoring.htm.

4. References to the transcript will be cited as "Transcript at -."

5. The public forum included general presentations entitled "Credit Scoring: An Overview" and "The Use of Credit Scoring in the Mortgage Industry" as well as more specific panels covering the following topics: "Consumers' Experiences With Credit Scoring," "Is Credit Scoring Fair?" and "What Information Should Consumers Receive About Credit Scoring? Who Should Provide That Information?"

6. Transcript at 38.

7. Fair, Isaac and Company has been a leading producer of predictive models for several decades and is a major provider to the credit industry of credit scoring models.

8. Transcript at 38.

9. Id. at 39.

10. Fannie Mae has developed an automated underwriting system called Desktop Underwriter; Freddie Mac's system is Loan Prospector.

11. Transcript at 63.

12. Consumer advocates have been concerned that obtaining credit from a finance company can adversely affect a consumer's credit score because low income and minority populations disproportionately live in neighborhoods where the only source of credit is a finance company. At the forum, Peter McCorkell from Fair, Isaac explained that, if the finance company characteristic is used by counting the number of finance company accounts rather than by measuring finance company accounts as a percentage of the total number of accounts, there is virtually no difference in the number of finance companies used by low income versus high income borrowers nor minority versus non-minority borrowers. Transcript at 206. Historically, however, the data demonstrate that the group of people that use finance companies is a little riskier than those that do not. Transcript at 216.

13. The number of inquiries (*i.e.*, requests by creditors to obtain a credit report) contained in a consumer's file can have an adverse effect on the consumer's credit score. When consumers realized that simply shopping around for the best price on a mortgage or automobile loan was lowering their credit scores, industry reexamined the way inquiries are factored into scoring models. The models now take into account and do not penalize consumers for comparison shopping. *See* Transcript at 42-43.

14. Section 611 of the Fair Credit Reporting Act, 15 U.S.C. § 1681i, sets forth the procedures that must be followed when a consumer reports that the information in his file is inaccurate. Many forum attendees noted that inaccurate information can adversely affect a credit score. The Commission continues to encourage consumers to regularly obtain consumer reports from the three national repositories and request that inaccurate data be corrected.

15. Transcript at 98-101.

16. Id. at 122-26. Members of industry have expressed concern that too much transparency in credit scoring will lead consumers to manipulate their credit records and thereby undermine the predictiveness of the models. They recognize, however, that consumers can, over time, alter their credit behavior and improve their credit risk in a way that does not constitute a false manipulation of their score.

17. Transcript at 250. *See also id.* at 230-273 (panel discussion "What Should Consumers Be Told About Credit Scoring? Who Should Tell Them?").

18. If a consumer has a credit score that is not within the range of risk acceptable to the lender, a lender may examine other characteristics of the borrower, or consider extenuating circumstances that adversely affected the score, and decide to extend credit to the consumer despite the score. This is known as a "low side override." Conversely, if a borrower has a credit score that falls within the range of risk acceptable to the borrower, other factors may lead the lender to nonetheless decline the loan. This is known as a "high side override." Transcript at 163.

19. Lenders who obtain a credit score on a consumer report from a consumer reporting agency receive a list of the four factors that most significantly affected the score. *See* Transcript at 241. These factors are provided to the creditor regardless of the credit score or the lender's decision. If the consumer is denied credit, Regulation B requires that the consumer be provided with specific reasons for the denial. 15 U.S.C. 1691(d). A lender may satisfy Regulation B by providing a consumer with the factors provided to the lender by the consumer reporting agency. In addition, the factors are a good starting point for explaining the credit

score to consumers even in situations where credit is granted or is granted at a different price.

20. Lenders willing to provide credit scores to all consumers are contractually prohibited from doing so by the consumer reporting agencies and/or the company that developed the credit scoring model. Transcript at 151, 273.

21. The score, which will be available by the end of the year, will be offered to consumers, free of charge, when they request a copy of their Trans Union credit report. It is not clear whether this is the same score that creditors receive when they request a consumer's score from Trans Union. Trans Union, *Trans Union Announces It Will Offer Credit Scores Directly To Consumers*, Press Release, May 15, 2000.

Trans Union's announcement followed an aborted effort by E-Loan, an on-line mortgage lender, to provide customers their FICO scores upon request. In addition to the score, E-Loan planned to provide, free of charge, information on how the score was generated and offer generic advice on improving the score. Robert Julavits, *Web Lender Will Report Credit Scores To Consumers*, *American Banker*, Feb. 22, 2000, at 1. In response to E-Loan's announcement, Equifax cut off service to E-Loan and Trans Union threatened to follow suit. The credit reporting agencies appeared to be acting in part based on concerns that the use of their reports to disclose scores to consumers violated the agencies' contracts with Fair, Isaac. Scott Kersnar, *E-Loan Throws in Towel*, *National Mortgage News*, Apr. 17, 2000, at 1.

22. Freddie Mac, *Freddie Mac Releases Automated Underwriting Factors Used By Loan Prospector*, Press Release, June 7, 2000.

23. Fair, Isaac, *Fair, Isaac "Demystifies" FICO Scores With List of Score Factors, Web-Based Explanation Service*, Press Release, June 8, 2000. Although the company also announced a "web-based explanation service" to explain specific FICO scores to consumers, the company still appears to be negotiating with the credit reporting agencies to obtain access to credit reports for the web-based service. See Jane Bryant Quinn, *Credit Industry Flip-Flops Over Releasing Its Ratings*, *Los Angeles Business Journal*, July 2, 2000, at 35.

24. Fannie Mae, *Fannie Mae Introduces Enhanced Desktop Underwriter*, Press Release, July 18, 2000.

25. One panelist at the forum noted that forty percent of consumers that assess themselves as qualifying only for a subprime loan when they visit his on-line mortgage company are actually A paper borrowers. Transcript at 259. Some subprime lenders do currently refer borrowers to affiliates that originate prime loans where appropriate. Transcript at 259, 263, 273.