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.
September 21, 2000

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.

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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 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)]

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 compreheTf 12 J ET.vel l dayeTf /TT0 1 Tf 1( )-107io10(w)2(i)-2Dn(e)40 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.

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