Order Code RS21298
Updated June 4, 2004

CRS Report for Congress
Received through the CRS Web

Credit Scores: Development, Use, and Policy Issues

Pauline Smale
Economic Analyst
Government and Finance Division

Summary

Credit scores and credit scoring systems were created to provide a tool to evaluate the creditworthiness of prospective borrowers. There are a variety of credit-scoring statistical models, each employing complex formulas to generate credit scores. First used for certain forms of consumer credit (auto loans and credit cards), credit scoring came into common use in the mortgage lending business a decade ago. More recently, credit scores are being used by non-credit-related industries, such as insurance, to evaluate risk and predict behavior. The use of credit scores has streamlined the decision-making process of the lender which can result in more rapid access to credit for the consumer. At the same time, pervasive use of credit scoring has raised concerns about consumer awareness of and access to credit scores as well as the consistency and accuracy of scoring systems. The 108th Congress held a series of hearings on renewing the Fair Credit Reporting Act (FCRA)state law preemption provisions dealing with the exchange of credit information. The hearings provided a forum for discussions on related consumer protection issues. On December 4, 2003, legislation was enacted to permanently extend the federal preemption provisions. The Fair and Accurate Credit Transactions (FACT) Act of 2003, P.L. 108-159, also addressed a wide range of consumer protections including access to credit report and scoring information and the accuracy of that information.

This report gives background on the concept of credit scoring and the issues raised by the pervasive use of credit scores. An overview of the FACT Act provisions dealing with credit scores and credit reports is also provided. This report will not be updated.

Background

The concept of credit scoring was developed several decades ago to measure the risk of delinquency or default presented by a consumer seeking credit. A research firm, Fair, Isaac & Company (FICO), developed the first scoring system, and the "FICO" score remains a credit industry standard. The score, usually a three digit number between 300 and 900, is used by a lender to rank a potential borrower. The higher the score, the lower the risk. This ranking helps to determine whether a consumer qualifies for a loan, the amount of the loan, and the loan rate.

During the 1990s, credit scores began to be widely used by the mortgage industry. Lenders attest to the value of using credit scores. They state that scores provide a fast, accurate risk assessment which can streamline the lending process. By one estimate credit scores are a determining factor in 90% of all U.S. consumer credit decisions.[1] More recently, non-credit-related businesses, including auto and homeowners insurance, have found credit scores to be a useful rating variable. Increased reliance on credit scores by lenders and other businesses raises consumer issues such as access to scores, awareness and understanding of scoring systems, consistency of scores, and accuracy of scores.

Credit scores are not easily explained. The score provides a picture of the consumer's credit history and worthiness at one point in time (when the score is calculated). Lenders and other businesses may use their own credit scoring model, different scoring models for different purposes, or a generic model developed by a credit scoring company. Credit scoring models use complex statistical formulas, and the models vary among creditors and for different types of credit. Technological advances have allowed a large number of predictive variables to be rapidly evaluated during the calculation of a credit score. Models can be solely based on information from credit reports, or the model may include other information found on the credit application, such as income and employment history. The Equal Credit Opportunity Act[2] prohibits certain characteristics from being used in a credit scoring system. These include race, sex, marital status, national origin, and religion. Only recently have scores been made available to the individual consumer. A number of companies now offer to disclose credit scores and provide explanatory information, usually for a fee.

Mortgage lenders primarily rely on credit scores generated by the three national credit reporting agencies (bureaus): Equifax, Experian, and Trans Union. The three bureaus independently collect data on individual consumers and use this information to create a consumer credit report. The Fair Credit Reporting Act (FCRA)[3] provides consumer protections to deal with inaccurate and inappropriate use of personal information. The FCRA sets out requirements for all consumer reporting agencies and users of credit information. Four categories of data are collected for a credit report: personal information, credit history, public record information, and inquiries.[4] Data in an individual's credit report will then be fed into a credit-scoring model and used to calculate a credit score. Credit report files are continually updated as the bureaus receive new information. Since they work independently, the three bureaus do not necessarily collect identical information, and the three use various models. Therefore, not only can credit scores frequently change, but each agency can generate a different score for the same consumer.

---

[1] "Credit Scores And Mortgage Lending," AARP Public Policy Institute. IB Number 52. P.1.

[2] Pub. L. 93-495, tit. 5, 88 *Stat*. 1520, 15 U.S.C. 1691 *et. seq.*

[3] Pub. L. 91-508, tit. 6, 84 *Stat.* 1128, 15 U.S.C. 1681 *et. seq.*

[4] Inquiries are requests by a creditor for a copy of an individual's credit report.

Five Factors

Scoring models generally evaluate five factors from a credit report when calculating a credit score. Different weights can be assigned to each factor for different types of credit applications. The five are payment history, amounts owed, length of credit history, new credit (accounts or requests), and types of credit accounts.

Payment history is usually a heavily weighted factor. Payment information on many types of accounts is collected in a credit report. Accounts include credit cards, retail accounts (credit from stores), finance company accounts, and mortgage loans. A consumer's timely payment of bills, such as phone or gas, does not influence this factor unless a consumer's account has been sent to a collection agency. Late or missed payment information would include details such as how late, amount owed, and how recent was the event. Also included in this factor are public record and collection items including bankruptcies, foreclosures, suits, and wage attachments.

Amounts owed is also a significant factor in credit scoring. This factor evaluates the amount of debt a consumer has compared to his or her credit limit. Is the consumer over extended? Any amount owed on all accounts is considered, and different types of accounts are compared. Outstanding debt is compared with the original loan amounts.

The length of a consumer's credit history provides a credit track record. How long have accounts been established? In general, the longer an individual has had a credit history the better. An insufficient credit history — including no credit history — can negatively affect a score.

Applying for new credit can affect credit scores. How many new accounts does a consumer have? Requests for credit generate inquiries (requests by lenders to get a copy of an individual's credit report). Applying for too many new accounts can negatively affect a score. Inquiries by creditors who are monitoring a consumer's account or looking at credit reports to make "prescreened" offers are not counted.

How many and what types of credit accounts an individual has affects one's credit profile. While it is generally good to have established credit accounts, too many or certain types of credit accounts may affect a score negatively. Some scoring systems do not rate loans from finance companies favorably.

Policy Issues

The pervasive use of credit scoring has raised concerns about consumer awareness of and access to credit scores as well as the consistency and accuracy of scoring systems. Credit scores are a standard factor in consumer credit decisions and are increasingly used as a rating variable in insurance underwriting.[5] In addition, employers have used credit scores to evaluate job applicants and landlords have used them judge prospective tenants.

---

[5] For additional information concerning credit scores and insurance see CRS Report RS21341, *Credit Scores: Credit-Based Insurance Scores,* by Baird Webel.

So credit scores are being used not only to measure a consumer's credit worthiness but also as a factor in the evaluation of a consumer's financial stability, responsibility, and potential risk. The use of credit scores in mortgage lending has generated most of the legislative attention. The use of credit scoring in non-credit-related businesses has been increasingly controversial — in part because the connection between credit scores and insurance or renting is not obvious.

Until recently, the credit scoring industry did not provide consumers with access to their credit scores. Public pressure and a 2001 California state law prompted wider availability of credit scores nationwide. Still, many consumers' first knowledge of the existence and importance of credit scores comes as a result of not qualifying for a loan. Consumer advocates state that more needs to be done to educate consumers about credit scores, to make the scoring systems more transparent, and to provide consumers less costly or free access to their scores.

The FCRA permits credit bureaus to charge up to $9.00 for a credit report and allows additional fees for credit scores. For example, FICO scores have been available from Equifax as part of a credit profile package for $12.95. A consumer is entitled to a free report if the consumer was denied credit or was notified by an insurance company of an "adverse action" based on information provided by a credit bureau. The consumer must place a request within 60 days of either of those events. Consumers have been entitled to free annual credit bureau reports upon request under state law in six states (Colorado, Georgia, Maryland, Massachusetts, New Jersey, and Vermont).

A consumer can end up with a multitude of scores depending on the credit data used and the scoring model. Scores are available from a variety of score providers and some lenders (fees vary). In addition, the credit score the consumer pays for may not be the score a particular lender used in the lending decision-making process. A consumer can have a difficult time discovering what score was used; individual lenders or insurance companies do not always provide this information.

Just as important as obtaining the score is understanding what it represents, especially if a consumer wants to improve it. Consumer advocates argue that complete disclosure of exactly what factors were considered and how they are weighted is required to really understand a score. Full disclosure, they say, would also allow testing of scoring models and formulas to determine how accurately they evaluate consumers. The computations involved in scoring models are closely guarded proprietary information. Score providers such as Fair, Isaac & Company have published some explanatory information to help consumers understand scores, but they say to disclose more about their model would hurt the company competitively. They say they would, in effect, be giving away what they are currently selling.

Consumer advocates have argued that steps need to be taken to assure the same credit information is submitted to each bureau to minimize the differences between the credit reports generated. If the information filed with credit bureaus were more consistent, then the scores calculated from their credit reports would vary less. Advocates also backed better and more consistent reporting of positive credit information to enhance the accuracy of credit reports.

In December 2002 the Consumer Federation of America and the National Credit Reporting Association published a study of the accuracy of credit scores and credit report information.[6] The study was based on a survey of 502,623 archived credit files generated by a request for the reports and scores from all three national credit reporting agencies. The study found that scores from the three bureaus for a consumer varied substantially. Many credit files had additional reports that did not belong to the consumer's file and many had conflicting information. The reports provided limited information to help individuals understand their particular score. The study concluded that while many consumers are unharmed by these findings, millions of consumers are at risk of being adversely affected by inaccurate information and incorrect scores. The potential exists for individuals to either be denied credit or be placed into a more expensive pricing range.

Consumers can take steps to ensure the calculations are made on accurate information. Individuals can request their credit reports from all three major bureaus and check for incorrect or obsolete information. Correcting mistakes can be costly, time-consuming, and frustrating. The bureau has 30 days to confirm an entry with the reporting creditor and must make changes to the credit report if the mistake is confirmed. If a creditor fails to respond the entry must be removed. This may require a follow up inquiry by the consumer to make sure correcting steps were taken. Therefore, a consumer may need to begin the process well in advance of applying for credit to guard against an adverse lending decision.

While correcting mistakes can improve a consumer's score, this is not a guaranteed outcome because the consumer does not know how a particular entry fits into an individual scoring formula. In addition, scoring models may be based on more than the information found in a credit report. For example, the model may include data from the loan application such as employment history.

Legislation

Congress established consumer credit protections with the enactment of several laws dealing with specific credit practices, including the FCRA in 1970. The FCRA has been amended to meet the developing needs of consumers for credit protections. Congress continues to monitor the effectiveness of the FCRA's provisions as the use of consumer credit information grows. Complaints by consumers and criticism by consumer advocates have drawn congressional interest to issues raised by credit scoring.

The 108th Congress considered issues raised by credit reports and credit scoring during the debate over whether to renew FCRA state law preemption provisions dealing with the exchange of credit information.[7] A series of hearings held before the House Financial Institutions Subcommittee and the Senate Committee on Banking, Housing and Urban Affairs on the provisions evolved into a forum for discussions on a number of

---

[6] "Credit Score Accuracy and Implications for Consumers", a report by the Consumer Federation of America and the National Credit Reporting Association, Dec. 17, 2002,p.47.

[7] For more information on the preemption provisions see CRS Report RS21449, *Fair Credit Reporting Act: Preemption of State Law,* by Angie A. Welborn .

consumer protection issues. Concerns included access to credit report and scoring information and the accuracy of that information. Identity theft and financial literacy were also addressed during the hearings. Legislation, the Fair and Accurate Credit Transaction Act of 2003 (H.R. 2622), was introduced and passed to reauthorize and make permanent national credit reporting standards. The FACT Act (P.L. 108-159) was signed by the President on December 4, 2003. The law addresses a variety of consumer protection measures that were raised during the hearings.[8] Consumer advocates were generally supportive of the improved consumer protections but were opposed to the permanent preemption provisions.

Major provisions of the FACT Act address credit reports and scores. Title II of P.L. 108-159 deals with the use of and consumer access to credit information. Title II provides consumers the right to request a free credit report from national consumer reporting agencies (bureaus) annually. Consumer will place a request by mail, phone, or the Internet through a centralized system established by provisions in the act. Consumers will also be able to request reports from specialty bureaus, for example landlord or insurance reporting services. Financial institutions that furnish negative information regarding credit extended to a customer to a reporting agency are required to notify the consumer concerned in writing. Credit bureaus must provide credit scores and key disclosure information on how the credit score was derived (including factors that adversely affected a consumer's score) upon request. In addition, the bureau must include a statement indicating that the information and the credit scoring model may be different from the credit score used by the lender. A reasonable fee may be charged for providing credit scores. Mortgage lenders must disclose the credit score used by the lender in connection with a home loan and the key factors affecting the credit score to the home loan applicant. No fee is authorized for this disclosure.

Title III addresses the accuracy of information. Title III requires the creation of guidelines for furnishers of information regarding the accuracy and completeness of the information they provide to consumer reporting agencies. Consumers will be able to dispute the accuracy of information directly with the furnisher. In addition, new procedures for addressing consumer complaints by the Federal Trade Commission (FTC) and credit bureaus are created. A risk based pricing notice will be required when credit is extended on terms "materially less favorable than the most favorable terms available to a substantial proportion of consumers"from that creditor.

P.L. 108-159 requires the FTC to conduct a number of studies. One study will report on the effects of credit scores and credit-based insurance scores on the availability and affordability of financial products. The FTC will study improving the accuracy and completeness of information contained in consumer credit reports. The FTC must conduct a study on ways to improve the FCRA. In an effort to increase and enhance consumer knowledge, the FACT Act establishes a financial literacy and education commission.

---

[8] For a detailed summary of the key provisions in the FACT Act, see CRS Report RL32121, *Fair Credit Reporting Act: A Side-By-Side Comparison of House, Senate and Conference Versions,* by Angie A. Welborn and Loretta Nott.