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"What Borrowers Need to Know About
Credit Scoring Models and Credit Scores"

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Subcommittee on Oversight and Investigations
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Mr. Chairman, and Members of the Subcommittee, thank you for the opportunity to testify before the Subcommittee. My name is Evan Hendricks, Editor & Publisher of *Privacy Times*, a Washington newsletter since 1981. For the past 31 years, I have studied, reported on and published on a wide range of privacy issues, including credit, medical, employment, Internet, communications and government records. I have authored books about privacy and the Freedom of Information Act. I have served as an expert witness in litigation, and as an expert consultant for government agencies and corporations.

I am the author of the book, "Credit Scores and Credit Reports: How The System Really Works, What You Can Do." (3rd Edition, Privacy Times 2007)

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Credit Scores & American Consumers: Only Half Way There

This is a very important hearing, as it highlights how far we have come on the issue of credit scores, while at the same time underscoring how far we have to go.

The bottom line is that consumers cannot obtain, prior to applying for credit, the actual credit scores that lenders use to judge them. This is because the three major credit reporting agencies (CRAs) use contracts to prohibit resellers from providing consumers with their "tri-merge reports," the version of credit reports sold to lenders. Tri-merge reports and other creditor-version reports, and the credit scores associated them, are truly where the "rubber meets the road," for American consumers. They remain the "secret sauce" that consumers may not access. Congress can and should change this.

Moreover, the proliferation and sale of credit scores not used by lenders can cause confusion and even mislead consumers in a manner that is patently unfair. At a minimum, Congress can and should provide for greater transparency and fairness.

Accordingly, Congress needs to act to bring the appropriate level of transparency and fairness to credit scoring. In addition, the area of "alternative data" is an important and complex field that requires careful weighing of a myriad of factors. While I applaud the Subcommittee for exploring this area, I would urge it to proceed with caution. Similarly, I would urge caution on another issue before the Committee – amending the law in regards to credit monitoring. This too is a complex area and I fear the current proposals are designed to give undeserved breaks to the credit reporting industry, while at the same time, not advancing consumer protection.

Credit Score: A History of Secrecy

When use of credit scores first became widespread in the mid-1990s, they were completely secret. First, lenders did not inform consumers that credit scores existed or that they were using them. Despite their importance consumers were not told how they were calculated or who was using them.

When people began learning that credit scores existed, and would ask to see them, lenders and the credit reporting agencies (CRAs) refused to provide them.[1]

In fact, the Federal Trade Commission (FTC) put out an opinion stating that federal law did not require the credit bureaus to reveal credit scores to consumers who requested their credit reports. This was in part, because the 1996 revisions to the Fair Credit Reporting Act (FCRA) specified disclosure was not required of "any information concerning credit scores or any other risk scores or predictors relating to the consumer."[2]

Public criticism of this policy mounted as the vital role of credit scores in credit and insurance decision-making became evident. The changing environment was best illustrated by a

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[1] One of the first to report on credit scores and their importance was Michelle Singletary of the *Washington Post* in the mid-1990s.
[2] 15 U.S.C. Sect. 1681g(a)(1)

situation that arose in February 2000 at E-Loan, an Internet lender that could quickly approve mortgage and auto loans, in part because credit scores facilitated automated decision-making. To better advise consumers where they stood, E-Loan decided to tell prospective loan applicants their FICO scores—a radical move at the time. Within a month, thousands of people took advantage of the service.[3]

But the move sparked an uproar in the credit industry, as two of the three national credit reporting agencies (CRAs) moved to cut off E-Loan's use of credit scores. E-Loan ultimately prevailed when California passed a state law, sponsored by State Senator Liz Figueroa, requiring lenders to provide California mortgage and home equity applicants with the score used in their loan decision. The law also required Equifax, Experian and Trans Union to disclose credit scores to consumers who requested them.

"The passage of this law is a giant step forward for California consumers, but there's still more that needs to be done," said Chris Larsen, E-Loan's Chairman and CEO. "This is information that should be readily and freely available to consumers nationwide. There should be very little difference between getting information about a stock or mutual fund and finding out your credit score. Just like consumers can research an investment before they commit their money to it, consumers should have free access to information about their credit score *before* they apply for a loan."[4]

FACT Act: Another Step Forward

In 2003, Congress took a major step forward in fulfilling Larsen's plea.

The Amendments to the FCRA, known as the FACT Act, require credit bureaus, for a "fair and reasonable" fee, to disclose to consumers their credit scores and how those scores are determined. Moreover, the Act for the first time required mortgage lenders and brokers to provide scores that were pulled in connection with their mortgage or re-financing applications. This was important because the CRAs by contract prohibited lenders from giving consumers the actual scores by which they were being judged.

However, the FACT Act does not require CRAs to provide consumers with the scores that lenders *actually use*. Instead, CRAs can disclose "educational scores," meaning FICO "knock-offs" or "FAKOs," that approximate scores used by lenders, but which can differ significantly.

This means that a consumer, who is trying to be diligent and find out what his or her credit score is before applying for credit, will pay for a "FAKO" score that might be higher than the one ultimately pulled by the lender. When the consumer applies for credit, she learns that she was not as creditworthy as she thought, and doesn't qualify for the interest rate she expected. We have heard of several such anecdotal cases.

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[3] E-Loan Opens Over 10,000 Personalized Loan Management Accounts In First Month," E-Loan Press Release, March 23, 2000
[4] E-LOAN, Inc., A Full Credit Score Disclosure Pioneer,
Calls For National Legislation," E-Loan Press Release, June 27, 2001

Two of the major CRAs – Experian and TransUnion – prominently push their own knock-off scores – the Experian Plus score and the TU TrueCredit score. The Plus score is also pushed at the notorious FreeCreditReport.com, which is run by Experian subsidiary ConsumerInfo.com. While the traditional FICO score on which consumers are judged uses a range of 350-850, TrueCredit Score uses a different range, going up to 950. Neither Experian nor TransUnion prominently inform consumers that the scores they are selling are not used by lenders and may differ significantly from the FICO scores used by lenders.[5]

To top it off, the three CRAs joined forces to create the "VantageScore," which features a range of 501 to 990. Although it was unveiled with great fanfare in March 2006, it does not appear that VantageScore has achieved significant market penetration. However, it has added to the confusion that uninitiated consumers experience when they try to understand what their actual score is.

At a minimum, fundamental fairness dictates that sellers of knock-off scores clearly and conspicuously disclose that their scores are not used by lenders and may differ significantly from the ones that are.

Epitome of Unfairness: No Consumer Access To Actual Credit Scores

Consumers can purchase their FICO scores through Equifax or through Fair Isaac's Web site, www.myfico.com. These are likely to be the closest to the actual scores pulled by lenders when the consumer applies for credit. Moreover, knowledgeable consumers who know to ask can obtain, after-the-fact, their actual FICO scores that were pulled by lenders – thanks to the FACT Act Amendments.

However, consumers, prior to a major credit application, still cannot even purchase the actual scores that lenders pull.

Why? It is an artificial barrier unilaterally imposed by the three CRAs through their contracts with "resellers," i.e., which include the small, independent credit bureaus that compile "tri-merge" reports for the mortgage industry. Tri-merge reports are the "subscriber" (i.e., creditor) versions of the credit report. They can have more information because the CRAs attempt to include in them the maximum possible information that *might* relate to the consumer – in essence, so no negative item is missed. Thus, Tri-merge reports and "subscriber" versions of

[5] In its terms and conditions, Experian and its subsidiary ConsumerInfo.com, which runs FreeCreditReport.com, states, "The PLUS Score(R), developed by Experian, and the different risk levels presented by it, are for educational use only. The PLUS Score(R) is not currently sold to lenders, and is not an endorsement or guarantee of your credit worthiness as seen by lenders.

Please be aware that there are many scoring models used in the marketplace. Each scoring model may have its own set of factors and scale. The information and credit scoring model may be different than that used by a lender. The PLUS Score(R) may not be identical in every respect to any other credit score produced by another company or used by your lender. The PLUS Score(R) is not a so-called FICO score, and may differ for a variety of reasons."

credit reports are the "secret sauce" to which consumers still do not have access in advance of applying for credit.

This is unconscionable, in my opinion. Congress should make it illegal for CRAs to prohibit by contract or any other means the sale or purchase of tri-merge reports or subscriber versions, and the actual credit scores associated with them. This is not only patently unfair to consumers, it is an unacceptable barrier to commerce. Not only would some educated consumers be interested in buying their actual scores, but enterprising companies that base their business model on serving as the consumer's advocate would also greatly expand the market.

It is important to understand that even if a consumer buys his FICO score, it could differ significantly from the FICO score pulled by the lender.

This is because the CRAs use "partial matching" algorithms in determining what information to sell to lenders, but use more exact matching of identifiers when determining what information to include on a report disclosed directly to a requesting consumer.

The following passage from my book, <u>Credit Scores & Credit Reports: How The System Really Works, What You Can Do</u>, helps explain:

> The three CRAs each store this information in their own massive database. The CRA databases include data on virtually all American adult users of credit—an estimated 205 million people.[6]
>
> A credit report is not fully assembled until the CRAs have a reason to assemble one. For instance, when a consumer applies for credit, the credit grantor or "subscriber" relays to the CRA identifying data from the consumer's credit application, at a minimum, name and address, often the SSN, and sometimes date of birth. (It's worth noting that the CRA can return a credit report to the credit grantor <u>without</u> an SSN.)
>
> This is when the key moment occurs. Applying this identifying or "indicative" data, the CRA's algorithm then decides which information in the database relates to or "matches" that consumer, and then "returns" to the credit grantor (subscriber) a consumer credit report consisting of this information. Thus, it is the algorithm, or "business rule," that decides which data go into your credit report.
>
> **The Search Logic/Algorithm**
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> In the Matthew Kirkpatrick trial cited in the previous chapter, Equifax Vice President Phyllis Dorman said that when "building a file" after receiving data from a creditor, or when deciding what data to include on a credit report that will be disclosed to the creditor, the first factor considered by the Equifax system is geographic region.

[6] www.experian.com/small_business/knowledge.html, visited 9/14/07.

Then its "matching algorithm," known as L90, relies on 13 matching elements. Two of the elements that constitute a distinct category are: (1) exact Social Security number (SSN) and (2) partial SSN (meaning that most, but not all digits are the same).[7]

The remaining elements are (3) last name, (4) first name, (5) middle name, (6) suffix, (7) age, (8) gender, (9) street number, (10) street name, [8] (11) apartment number, (12) City, state and zip, and (13) trade account number.

There is a very important difference in how the system works when you ask to see a copy of your own credit report as opposed to how it works when a subscriber asks the CRA for your credit report. One reason for this is that the CRAs have a duty to ensure that they do not give your credit report to anyone who does not have a permissible purpose to see it—particularly someone who is trying to impersonate you or otherwise do you harm. Accordingly, when you ask for your own report, you are required to give extensive identifying information to authenticate yourself—to prove that you are really you. This also enables the CRA's algorithm to more concisely assign the proper accounts to your credit report.

However, it can be a very different story when a credit grantor or other subscriber asks for your credit report. For starters, the setting is different. To have instant access to credit reports, subscribers must sign contracts pledging to only use credit reports for permissible purposes, to abide by other restrictions, and comply with the FCRA. CRAs look at their subscribers as members of a trusted circle who know and play by the rules.

More importantly, the priorities are different. Since the subscriber is buying the credit report in order to decide whether or not to grant you credit, the CRA wants to ensure that it does not leave out anything that *could* be relevant to that decision. After all, if the CRA failed to include evidence of late payments in your credit report, and you default, the credit grantor is going to blame the CRA. Another factor is the credit grantor might only have limited information about the consumer, like name and address, and no SSN, or its employee might have written down the SSN incorrectly. Therefore, the CRA seeks to maximize disclosure of any *possible* information that might relate to the consumer about whom a subscriber inquires. This becomes trickier when the CRA conducts the search based upon very limited, or even imperfect, identification information.

To accomplish this, the CRAs' algorithms are designed to accommodate such errors as transposed digits within SSNs, misspellings, nick names, and changed last names (women who marry), and different addresses (people who move), by accepting "partial matches" of SSNs and first names, and in some circumstances, assigning less importance to last names.

Thus, while you must provide an exact match of your SSN to obtain your own credit report, a subscriber can still obtain your credit report even if there is a

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[7] Testimony of Phyllis Dorman, Matthew Kirkpatrick v. Equifax Credit Information Services, U.S. Dist. Ct., Oregon, CV-02-1197-MO; 1/20/05

[8] Some algorithms may only use the first 4-to-6 characters of the number-address field, which would mean that "123 Main Street" would match "123 Mainwright Street."

> match of only seven of the nine digits in your SSN. What's more: if the SSN on the credit application exactly matches yours, the CRAs' algorithms often will tolerate major discrepancies in last name, street address, city, and state.
>
> Accordingly, it's quite possible that the "subscriber" credit report sent to the company holding your credit application will have more data than the credit report you obtained directly from the credit bureau. There have been occasions when a subscriber will reject an application for credit based on information in a credit report, but when the consumer gets her own report, the information isn't there. It was only in the subscriber report.
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> [*End of book passage*.]

Alternative Data

There continue to be quality studies about the use of alternative data – mainly from utilities and telephone companies – in credit reporting and scoring. I am familiar and somewhat sympathetic to the arguments that an expansion of credit reporting by utilities and phone companies would benefit significant sectors of the population, particularly those that do not participate in mainstream credit.

However, a word of caution. Because of decades of practice, there is an expectation that utilities and phone companies do not report data to CRAs (except seriously derogatory data in some circumstances). Accordingly, I see serious problems with making people aware that a fundamental change had occurred and that their data would be regularly reported. One cause for concern is that people who are generally responsible but occasionally late could suffer significant blows to their creditworthiness, without realizing that such a blow was possible. The harm would be greatest to the very "thin-file" populations that alternative reporting was supposed to help because one derogatory item would have a greater negative impact on a thin file versus a full file.

Moreover, the systematic reporting of data like utilities', which traditionally has not been reported, has implications for privacy that should be carefully weighed.

That is why if there is to be movement in this area, I favor an opt-in approach. My understanding is that such an approach is embodied in the proposed legislation (CA AB 588) introduced by California Assistant Assembly Majority Leader Kevin de León (D-Los Angeles) that would to allow consumers to authorize utility payment information to be incorporated into consumers' credit profiles."

Credit Monitoring Legislation

The Committee in May held a hearing on "Legislative Proposals to Address Credit Monitoring Services." I would urge caution on this issue. This too is a complex area and I fear the current proposals are designed to give undeserved breaks to the credit reporting industry, while at the same time, not advancing consumer protection.

Mr. Chairman, thank you again for this opportunity. I would be happy to answer any questions.