STATEMENT OF

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U.S. House of Representatives

On

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

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I. Introduction

Good afternoon Chairman Watt, Ranking Member Miller and Members of the Subcommittee. My name is Stan Oliai, and I am Senior Vice President of Decision Sciences for Experian Decision Analytics. I'd like to thank the Committee for the opportunity to testify here today and provide information that will describe how credit scores are developed and used. I will summarize the longer statement that I have submitted for the record.

I'd like to start with a brief background about Experian. With our North American headquarters in Costa Mesa, California, Experian currently operates in 65 countries with more than 15,000 employees worldwide. Experian is well known in the United States as one of the three national credit reporting agencies. However, Experian is also a global leader in providing information, analytical tools and marketing services to organizations and consumers to help manage the risk and reward of commercial and financial services. My business unit, Decision Analytics, serves as one of the world's largest providers of software for credit scoring, fraud detection and risk-based pricing.

Most lenders use a credit score to estimate the relative risk that a consumer presents in repayment of a loan and use the score as part of a process to price the product accordingly. The use of scores for risk-based pricing has led to significant increases in efficiencies in the market that provides tremendous benefit to both businesses and consumers. Some of the tangible consumer benefits include less cross-subsidization of risk, lower prices, more available capital and real-time lending decisions. Yet despite these benefits, the process is often not fully understood or appreciated.

II. The Role of Credit Reporting Agencies in the Lending Decision Process.

There is often confusion surrounding the role of the credit reporting agency in the lending process. It is worth clarifying one key fact: credit reporting agencies do not make lending decisions; only lenders can do that. Therefore, respectfully, I must say that it is unfortunate that a lender is not part of the today's panel, because only a lender can testify as to how a score is used in the loan underwriting process. You will learn from my testimony that neither companies that develop credit scores nor credit reporting agencies that deliver information to scoring models participate in actual lending decisions. We simply are not in a position to testify as to how scores are weighted or what other information besides a score is considered when a lending decision is made.

Credit reporting agencies do provide credit reports and can generate a credit score at the request of the lender from a model chosen by a lender. These credit scores help lenders make lending decisions. However, credit scores are not the only piece of information upon which lending decisions are made. Each lender has its own proprietary underwriting process and uses information from multiple internal and external sources when making a lending decision. A credit score is only one tool that a lender uses in deciding whether to extend a loan to a consumer. The volume of information sought would depend on many factors, from the type of loan being offered (i.e. small business loan vs. mortgage) to the type of collateral for the loan (i.e. year and model for an auto loan vs. similar sales records for real property). A credit score alone in any of these situations would not and should not be the sole determining factor for the extension of the

loan, but would be balanced against other information included in the consumer's application or obtained by the lender.

III. What Are Credit Scores and how are they Calculated?

A credit score is simply a numerical expression of risk of default produced by a mathematical formula or model. A credit score formula is created based on a statistical analysis of a large, representative sample of historical credit files. There are numerous credit models in use today.

A credit score predicts the relative likelihood that the person will pay his debts in a timely manner. Information used in calculating a credit score comes from an individual's credit file and generally includes credit account history (was the account paid, was it paid on time, how long has the account been open, what is the outstanding balance, etc.), type of account (revolving, installment, mortgage, etc.), public record information (liens, judgments, bankruptcies) as well as those inquiries in the credit file that represent applications for new credit or other consumer-initiated transactions. A credit file does not include information such as income or assets, and does not include demographic information such as race or ethnicity, and those factors are not used in credit risk scores.

It bears noting that a number of other factors, not reflected in a credit report or credit score, go into the underwriting process, such as income, collateral value, debt to income ratios and the like. Each lender decides its own risk tolerance. Many consumers might think they only have three possible credit scores: one from Experian, one from Equifax and one from TransUnion. In fact, a consumer could have many different scores, depending on the lender. Each lender can develop its own in-house "custom" score or

select a model developed by a third party, such as Experian, that reflects the individual lender's own level of risk tolerance and control for different risk factors. There are many vendors offering different scoring models aimed at different types of risk. For example, one lender's risk model may see one 60-day late payment as acceptable, while another would not. Or, another lender may acquire a third-party score aimed at determining whether a person is likely to be progressing toward bankruptcy.

Experian and other model developers design credit score models that are "empirically derived, demonstrably and statistically sound," as required by Regulation B. Regulatory oversight of credit scores is accomplished through routine bank examinations for compliance with a number of laws that govern fair lending, such as the Equal Credit Opportunity Act. This makes sense, because a credit score is a model chosen by a lender to assist in its proprietary underwriting process. The lender is ultimately responsible for demonstrating to regulators that the scoring model it has chosen to use complies with lending laws.

IV. How Consumers Can Obtain a Credit Score and Maintain a Good Score

A consumer can obtain a free disclosure of the credit report from www.annualcreditreport.com. While obtaining an Experian credit report through that website -- or at any time through www.experian.com -- a consumer can obtain their VantageScore for $5.95. This price has not changed since the enactment of FACTA. Since Experian believes it is in the consumer's best interest to acquire the credit report and score at the same time, we offer a combined package for $15. This way, consumers are able to better understand how the score and accompanying reason codes actually relate to the data in the credit report.

The Committee has asked about the total number of scores and consumer disclosures Experian has made to consumers since the FACT Act was enacted. We are pleased to provide an aggregate of those numbers to the Committee through our trade association -- the Consumer Data Industry Association or CDIA -- just as soon as possible.

One of the greatest misconceptions regarding credit scores is that there are fast and easy tricks a consumer can take to improving a score. This is simply not the case. This misinformation is typically perpetuated by credit repair clinics and other similar organizations. Some of these "tricks" include: closing unused credit accounts, becoming an "authorized user" on another's credit card, and disputing accurate information in the hopes of getting it removed.

While misleading information abounds, the truth is that a bad credit score derived from a credit report with accurate but derogatory information cannot be cleaned-up overnight, despite promises to the contrary. A bad credit score was not created overnight and it cannot be quickly "fixed" with a few simple changes. Improving one's credit score requires time and diligence in changing one's credit behaviors. While these changes are simple in theory, the application can often prove challenging. Simply put, the best way to "fix" one's credit score involves paying bills on time and keeping the debt to available credit ratio low.

Attempts by consumers to use some of these tricks can create secondary issues for the consumers. For example, I know the subcommittee is interested in how authorized user tradelines are treated in scoring models. For background, an authorized user on a credit account has the account holder's permission to charge to that account, but is not

liable to the lender for payment of those charges. This is different than the situation of a joint account where multiple users are each liable for the account. Reg. B under the Equal Credit Opportunity Act requires lenders to report these authorized user and joint accounts that are designated to reflect the participation of both spouses in a manner that allows the reporting of data in both names.

Lenders also may (and do) report all authorized user and joint accounts. These include accounts shared among other family members, siblings, friends, roommates, etc. In many instances, lenders are prohibited from asking whether an authorized user account is held with a spouse. In these situations, a credit report only reflects that an individual is an authorized user of an account, not the relationship (spousal or otherwise) with the account holder.

Offers abound on the Internet to improve a consumer's credit by adding that consumer (for an exorbitant charge) as an authorized user on the credit account of a complete stranger. The account is in good standing, and the consumer added as an authorized user never gets access to the account. Presumably the goal of such offerings is for individuals with bad credit to benefit from others with better credit scores. In many scoring models, this practice will have the effect of increasing the consumer’s credit score. Depending on other factors in the consumer's report, this could result in the consumer qualifying for a loan or a rate on a loan for which they would otherwise have not qualified.

We should label the practice I have just described as what it is: **fraud**. In order to prevent this fraud, some model developers do not consider authorized user accounts. VantageScore is one of those models. Because Reg. B only requires lenders to use data

on spousal authorized user accounts if it is available to them, such models are in compliance with Reg. B. The underlying credit reports on which the scores are based do not (and should not) report which of these accounts are held by spouses, because this data is simply not reported to consumer reporting agencies by lenders.

V. Benefits of Credit Scoring

Credit scores provide a measurable benefit for consumers and a marked improvement over the old process that required every consumer to be subject to a manual review and judgmental decisions. A credit score is calculated strictly based on the information in the credit file, limiting potential subjectivity on the part of a lender. Credit scores promote consistency in decisions, as the same formula is applied evenly to every consumer’s credit file. In fact, for this reason, automated credit scoring leaves much less opportunity for discrimination than a potentially subjective assessment by a lender. Credit scores are blind to the factors protected by the Equal Credit Opportunity Act, which include race, color, religion, national origin, sex, marital status, or age.

Credit scores also have other benefits for consumers. Scores allow for lending decisions to be made accurately, efficiently and in a time frame convenient for consumers. For example, while consumers may not realize it, credit scores allow for quick decision-making in the purchase of a new automobile. When a consumer goes into a dealership, they can drive off the lot with a new or used car even though they do not know anyone at the dealership. Because of automated credit scoring, the bank could pre-approve the consumer quickly for a loan amount before they even enter the dealership. Alternatively, the dealership could also approve the consumer for financing that afternoon.

VI. Alternative Data and Credit Scores

Another issue I would like to address is that of alternative data and credit scores. Questions have been raised by policymakers, consumers and lenders as to what could be done to help more low-income groups and recent immigrants develop a credit history allowing access to credit, financing and mortgages. Many lower-income Americans either do not have access to or choose not to utilize traditional lenders that report information to the credit reporting agencies. As a result, credit reporting agencies are not able to produce a credit score for these consumers that would help them in transitioning to using more traditional lenders. One solution Experian is pursuing is to work with "alternative" credit data sources, specifically utilities and telecommunications providers. These alternative sources of data can provide information that is reliable in a similar way as traditional credit history data in evaluating risks to lenders. For example, indicators that show that individuals pay monthly utility bills on a timely basis can be used to develop reliable scores that may provide lenders with information they previously did not have, but is sufficient to assess the risk of a loan.

While there could potentially be many different sources for alternative credit data, utilities and telecommunications are generally a form of credit services utilized by almost all consumers and therefore are a potentially very important source of information. A recent study by the PERC (Political and Economic Research) Council found that fully reporting energy utility and telecommunications customer payment data to consumer reporting agencies would help up to 70 million Americans gain access to affordable mainstream sources of credit.

It would be immensely beneficial to consumer reporting agencies, potential alternative credit data furnishers, low-income consumers and lenders if Congress clearly encouraged or endorsed the use of such data for these important uses.

VIII. Conclusion

I hope that my testimony today helped to dispel many of the myths surrounding credit scores. Credit scores remain one of the great advancements in consumer lending, and represent enormous opportunity for both consumers and lenders. Experian works hard to ensure that we have the most accurate and up-to-date credit information possible. We do this so that consumers are assured that their credit scores will serve as a useful tool in helping them to obtain the credit they need and deserve. Credit scores remain one of the best and most efficient ways of assessing a consumer’s credit habits, and I hope that my testimony today will help the Committee to consider the importance of credit scores to the lending process.

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