



TransUnion Testimony  
Before the Oversight and Investigations Subcommittee of the  
Financial Services Committee  
United States House of Representatives

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On the Topic:

“What Borrowers Need to Know about Credit Scoring Models and Credit Scores”

Good afternoon Chairman Watt and Ranking Member Miller. Thank you for your invitation to testify before your subcommittee this afternoon. My name is Chet Wiermanski and I am Group Vice President in TransUnion’s Global Analytic and Decision Systems business unit. It is my pleasure to appear before you today to discuss the important issue of credit scoring.

**The Evolution and Benefits of Credit Scores**

First and foremost, I think it is important to explain what a credit score is. A credit score is simply a numeric estimate of a consumer’s predicted trait (*e.g.*, creditworthiness) based on an evaluation of several factors. Prior to credit scoring, lenders relied on individual loan officers to evaluate a credit application and determine whether the consumer was a good credit risk. Credit scoring standardizes that process within a lender’s company and allows for a more objective and uniform review of applications. It is important to note that there is not “one” credit score for a consumer. The credit score is dependent on the model used to calculate it. Credit scoring models will vary among lenders, consumer reporting agencies, and credit score providers. Credit scoring models can vary within the same lender, such as if a lender uses one scoring model for a credit card, but a different model for a mortgage loan.

Lenders have used various types of scoring models to promote fair and uniform decision-making long before the arrival of generic credit risk scoring models developed using the databases of national credit bureaus such as TransUnion. These models were generally built based on the experiences of the individual lenders using them, and thus were based on a total population of a few thousand loans. Scoring algorithm development companies such as Fair Isaac were at the time, as they remain today, principal providers of these types of tailor-made scoring models, based on an individual lender's experiences and customer footprint.

By the late 1980s TransUnion was completing its journey toward becoming a nationwide consumer reporting agency. Among the many benefits for both lenders and consumers of the existence of nationwide consumer reporting agencies such as TransUnion are the facts that such a large, dynamically updated database, having thousands of active data furnishers, can be used as the basis to accurately and fairly assess credit risk and to develop scoring models which generally have far superior predictive performance than custom models, which were based on the experiences of a single lender. By harnessing the full and complete reporting of positive and negative data from thousands of lenders, generic credit scoring models have allowed lenders to more accurately predict their risk exposure at multiple levels. This allowed implementation of more granular, risk-based pricing strategies, which have in turn led to decreased cost, and increased availability of consumer credit. This phenomenon was described by the Information Policy Institute in their paper, "The Fair Credit Reporting Act—Access, Efficiency and Opportunity. The Economic Importance of Fair Credit Reporting Act Reauthorization." (June 2003)

TransUnion was the first of the nationwide consumer reporting agencies to bring these benefits to lenders and consumers when, in December 1987, we introduced the first generic model as an added dimension to the consumer credit report used to approve credit applicants. This first credit bureau-based scoring model, *Delphi*, which was developed to identify consumers likely to become bankrupt, was produced in conjunction with an Atlanta-based model developer named Management Decision Systems. Later, in conjunction with San Rafael-based Fair Isaac, another generic credit risk model was introduced, *Empirica*. In the ensuing years, *Delphi* and *Empirica* and their successors and competing products at the other nationwide consumer reporting agencies have grown to be more and more commonly used due to the benefits they provide to both lenders and consumers. For example:

1. A valid credit risk assessment tool for a variety of loan products and credit applications. Most models predict some dimension of creditworthiness, and are used throughout the account life cycle on a wide variety of credit-risk decisions. Other models predict account revenue, likely response rate, and collectability of past-due accounts, among many other outcomes.
2. Fair and objective. Credit bureau scoring models are based exclusively upon the account payment histories, public record information and credit inquiries generated by consumers when seeking credit. Demographic information that may be part of one's credit report, such as age, is not used to develop or calculate a credit score. As a result, the scores generated are fair and objective.
3. Surrogate for individual judgment. An alternative to, or supplement of, the use of automated decision systems using credit scores relies upon the judgment and local knowledge of individual credit or risk managers. If employment of individual decision-makers also results in a more human face being put on the process, this could translate to an advantage. However, this approach is also subject to being less objective, less consistently applied and less scalable from a cost perspective.
4. Uniform application. From the standpoint of risk management, uniform application of a decision criteria results in a loan portfolio (or group of insurance policies) which can be expected to perform uniformly over time. In contrast, the performance of loans or policies that were created using more subjective, individual criteria tends to fluctuate with less predictability. This is important to both risk managers and consumers, because the more predictable the risk, the less hedging must be built into the price of the financial instrument. For example, this is an important part of the reason that mortgage loans in the United States are roughly two hundred basis points less costly than in Europe. This is based on the existence of a reliable consumer credit reporting information infrastructure, which allowed the creation of highly predictable credit scoring algorithms. The GSEs endorsed and encouraged the use of these algorithms because they supported the securitization of mortgage loans.
5. Scalable. Credit decision making systems using credit scoring models can be scaled in two important ways: One, they are independent of volume, which means that they can be used to uniformly evaluate 10 or 1,000 or 1,000,000 decisions each day. Two, they can be calibrated to create precise risk tiers. A binary yes/no credit decision is no longer the

only option. Interest or premium rates or other levels of service can be offered to consumers based on the risk reflected in the score. Because they provide a very granular scale (*e.g.*, VantageScore™ ranges from 501 to 990), risk managers can adjust their decisions based upon the different points assigned by the scoring model.

6. Promote competition. As noted above, the use of risk scores allows financial institutions and property/casualty insurance providers to make decisions without reliance on local credit managers or agents. These systems offer important elements of scalability and objectivity that result in reduced customer acquisition costs and improved portfolio performance. This lowering of barriers to competition lowers costs and thus provides more choices for consumers in the marketplace. The increased competition among financial institutions and property and casualty insurance providers in the U.S. in the past 10 years is in part attributable to the deployment of decision systems that rely upon credit scores.

### **The Underlying Processes of Credit Scores**

The components used to develop credit risk models and subsequently calculate a consumer's credit score are based on an objective approach whereby hundreds of candidate credit characteristics from the credit histories of millions of consumers are empirically evaluated and selected for their ability to distinguish future loan performance. The candidate characteristics evaluated originate from the collective experience of consumer credit risk experts who construct and apply different rules against the underlying contents of the credit reporting system from which the model is developed. The list of candidate characteristics, which grows with each generic model redevelopment effort, are analyzed and tested using advanced multi-variant statistical techniques which find the optimal combination of credit characteristics that are the most predictive of the credit risk for which the model is being constructed. Characteristics that are identified from this process are then evaluated by highly trained and experienced statisticians who review each characteristic identified in terms of their relative importance and relationship with other characteristics selected. Characteristics that cannot be rationalized from this process are then replaced with other characteristics and reevaluated until all characteristics selected for the final model can be logically understood and explained by the team of statisticians involved in the project.

## **What Borrowers Need to Know about Credit Scoring Models and Credit Scores**

We believe that these four major points are important for consumers to understand about credit scoring models and credit scores:

- a. First, consumers should be aware of the major building blocks of most credit scoring models:
  - i. History of prompt payments. An individual's history of prompt payments obviously contains several dimensions—first, what is the frequency and severity of any previous account delinquencies, or instances of non-payment or other default? How recent, or long ago, were these instances? How many years has the individual maintained prompt payments?
  - ii. Capacity to absorb additional debt. How fully has the individual maximized his or her available credit? What is the ratio of current outstanding debt to credit limits on open-ended accounts? How much debt has the consumer taken on?
  - iii. Recent credit-seeking behavior. What are the indications that the individual is actively seeking to obtain additional credit? The number of recent loans and the presence of recent consumer initiated inquiries are often an indicator of this. Many scoring models bundle similar multiple inquiries and count them as one inquiry as they are associated with a single effort such as shopping for home or auto financing.
  - iv. Balanced use of credit (credit cards, mortgages, installment loans). Does the consumer have a healthy mix of credit, such as unsecured credit cards, installment loans for autos or other major purchases, and home mortgages and is the consumer using them responsibly by not overextending their credit obligations?

b. Consumers should be aware that there are many different types of credit scoring models, and often many components—both generic and proprietary—to a lender's decision-making process. Creditors often apply additional, proprietary decision steps to supplement the credit scores received from their proprietary models and generic credit bureau models. It is often a combination of credit scores and the creditor's internal logic driven from credit applications completed by the borrower and information about the terms of the particular credit transaction, which together form the basis of the credit-granting decision. While a general awareness of credit scores and credit scoring is useful knowledge for individual consumers, we believe that it is a mistake to communicate to individual consumers that a specific score using a specific model will necessarily result in a particular outcome, irrespective of other circumstances.

c. In the long term, the most effective strategy for an individual is to focus on the accuracy and completeness of the underlying information in his credit report. It is the consumer's credit activity, as reflected on an accurate and complete credit report, rather than any particular credit score, that is key to producing the terms and conditions of offers which lenders and insurers are able to make to that particular consumer. (Credit reports can be checked annually at no cost through accessing [www.annualcreditreport.com](http://www.annualcreditreport.com)).

d. Credit history, and credit scores are essentially individual, although spousal and other authorized user behavior on shared accounts can impact the credit reports of both persons. At TransUnion, credit files are maintained and updated at the individual consumer level. Accounts jointly shared among two or more individuals will thus appear on the individual credit histories, and will impact the individual credit scores, of each. Therefore, the payment behavior of an individual who shares an account with others can impact the scores of each of those other individuals. The effect can endure after the account sharing has ended (*e.g.*, in the case of a divorce) since the liability for the debt incurred during the time in which the account was shared may continue to inure to each of those account participants.

### **Common Misconceptions About Credit Scoring Models and Credit Scores**

Consumers should be aware of these misconceptions:

- Myth: My score will drop if I check my credit.  
Fact: Inquiries associated with checking your own report and credit score are considered "soft inquiries" and have no negative impact on your credit score.
- Myth: There's only one score that all lenders use to determine my credit-worthiness.  
Fact: There are literally hundreds of different credit scoring models used by lenders in the marketplace today. To see where you stand from a lender's perspective, scores can be purchased online, but it's important to select a service that provides summaries that are easy to understand.
- Myth: Closing old credit card accounts will clean up your credit report and improve your credit score.  
Fact: Some people advocate closing old and inactive accounts as a way to manage their credit. In most cases, closing your older accounts will make your credit history appear shorter, which can negatively impact your overall credit score.

- Myth: Once you pay off a delinquent loan or credit card balance, the item is removed from your credit report.  
Fact: Negative information such as late payments, collection accounts and bankruptcies remain on your credit reports for up to seven years. Certain types of bankruptcies appear for up to 10 years. Paying off a delinquent account won't remove it from your credit report, but it will update the account to indicate it as "paid" and will over time improve your credit score
- Myth: If I don't pay a medical bill on time because I believe it is incorrect, I can't be held accountable.  
Fact: If you fail to pay a medical bill in a timely manner, the delinquent payment may be reported as late to a credit bureau. If you believe a medical bill you have received is wrong or was sent to you in error, it's best to contact the provider to resolve or discuss the matter prior to the bill becoming past due. (N.B.: The most recent versions of TransUnion's credit risk models (versions 3.0) do not consider medical collection accounts when calculating a consumer's credit score.)
- Myth: The credit bureaus report people as having either good or bad credit.  
Fact: Credit reporting companies compile information that is provided directly and voluntarily by lenders. If you have a credit card, home or auto loan, or make other monthly payments, details of your use and payment track record on these are likely being reported by those parties.

### **The "Authorized User" Issue**

Some widely used scoring models have included authorized user accounts in their credit score calculations. This has produced an opportunity for score manipulation and fraud. Specifically, credit repair clinics and others have taken advantage of the fact that financial institutions generally have not scrutinized "authorized user" requests. Often for a substantial fee, the scam artist is therefore able to add his client as an authorized user to an otherwise creditworthy account (although the client is usually not provided use of the account in any real sense). Websites by persons seeking to cash in on this fraud by helping consumers exercise the scam sprang up and still exist today. As general awareness of this caper grew, some adjustments within the industry, among model developers, credit reporting agencies, and financial institutions have occurred.

At TransUnion, it has been our position that authorized user trades were not appropriate to include in credit scoring models and other risk evaluation products we developed. An authorized user has no contractual liability for the account—he or she has only been added to the account as an “authorized user”, at the courtesy of the account holder. Some have argued that federal law (Regulation B, implementing the Equal Credit Opportunity Act) requires lenders in certain limited circumstances to consider spousal authorized user information when making a credit decision. This is a very nuanced issue, but existing available guidance does not appear to require the countenance of “authorized user” fraud. Furthermore, as noted above, consumer reports from consumer reporting agencies such as TransUnion do not contain information regarding marital status or spousal relationships. Therefore, TransUnion is not equipped to provide information regarding whether an authorized user is the spouse of the accountholder. However, we are committed to working with our customers to address any compliance issues that may arise in connection with the use of our scores.

### **Score Disclosures to Consumers—Room for Improvement but still a Positive Trend Toward Financial Literacy**

TransUnion was the first nationwide consumer reporting agency to announce, in May, 2000, our plans to make scores available to consumers, upon request. In 2001, we implemented that plan, providing consumers with our proprietary *TransRisk*<sup>TM</sup> score—a scoring model used by hundreds of lenders in making millions of lending decisions. A growing marketplace soon evolved, to the point that today information on credit scores is widely available to consumers.<sup>1</sup> Our own affiliate, TrueCredit<sup>TM</sup>, provides unrestricted daily access to an individual’s TransUnion credit report information and his or her VantageScore<sup>TM</sup>, in addition to file monitoring and other services, for a monthly fee of \$11.95. (Access to credit reports and scores from all three of the major nationwide consumer reporting agencies [TransUnion, Equifax and Experian] is offered for \$14.95 per month.) In addition, consumers exercising their rights to a free annual disclosure

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<sup>1</sup> The disclosure of a consumer’s credit score from a credit bureau is sometimes referred to as an “educational” credit score. We believe this term can cause misunderstanding. The term “educational score” suggests that the score in question is not used by actual lenders or insurers to make actual, real-world risk decisions. At TransUnion, the scores we provide to consumers are used by lenders and insurers. We believe that effective disclosure of many different scores, with the appropriate factors and the underlying credit report, can be educational for the consumer.



of their TransUnion credit report at the centralized site ([www.annualcreditreport.com](http://www.annualcreditreport.com)) maintained in conjunction with the other nationwide consumer reporting agencies, may also obtain their VantageScore™ for a fee of \$7.95.

This balance between the right to obtain a free annual credit report and the right of the consumer reporting agencies to charge a reasonable fee for the sale of credit scores, subject to FTC oversight, was carefully crafted by the Congress in the 2003 amendments to the Fair Credit Reporting Act, in the FACT Act. Today, millions of consumers each year exercise their rights to obtain a free annual credit report, and many of these also opt for credit score disclosure. In addition, there are many other score disclosure services, such as those maintained by credit scoring providers, that also sell consumers credit scores based upon the underlying information contained in a credit report.

The Subcommittee has specifically asked whether a consumer can obtain a “stand-alone” credit score. TransUnion strongly feels that a credit score, derived from the contents of a particular credit report, must be understood in terms of that particular credit report. The score factors<sup>2</sup> which are normally provided to the consumer with the score are best viewed as pointers back into the detail of the credit report. If, for example, one of the factors indicated too much outstanding credit, or serious delinquency, the details essential to understanding those evaluations are contained in the credit report. We believe that, in terms of financial literacy and consumer education, a score alone, without the factors and the credit report upon which it is based, is inherently meaningless.

It is also worth noting that proposed regulations recently promulgated jointly by the Board of Governors of the Federal Reserve and the Federal Trade Commission under their rulemaking authority provided by the FACT Act’s risk-based pricing notification provision may offer another opportunity to consumers applying for new credit to obtain a free credit score disclosure in certain circumstances.

We feel that access for consumers to information about their credit scores, and the factors that are used in calculating scores, is, manifestly, widely available. We believe that the challenge for all of us is to support efforts to increase the financial literacy of individuals about the operation of the credit reporting system in the United States which supports so much of our country’s economic prosperity.

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<sup>2</sup> The factors which most negatively impacted the score, as calculated by that particular scoring model.

To that end, TransUnion is proud to support several initiatives in the United States aimed at boosting Financial Literacy:

- Through our website, [www.transunion.com](http://www.transunion.com) and that of our affiliate, [www.truecredit.com](http://www.truecredit.com) we provide educational information on credit reports and credit scores.
- As a proud national sponsor of the non-profit organization, Operation Hope.<sup>3</sup> Operation Hope is a leading global nonprofit social investment banking and financial literacy organization. Through various initiatives and programs, TransUnion is helping to educate inner-city families and youth on banking and credit financial principles.
- As a sponsor of the JumpStart Coalition for Personal Financial Literacy.<sup>4</sup> The JumpStart Coalition supports educational programs in personal finance. JumpStart's website states that: "The Coalition's direct objective is to encourage curriculum enrichment to ensure that basic personal financial management skills are attained during the K-12 educational experience."

We believe that, by seeking to improve financial literacy, and by increasing the full-file reporting of "non-traditional" furnishers of credit/payment information from providers such as energy utilities, telecommunications companies, apartment rental management firms, among others, that more consumers can, at once, be brought into the mainstream credit economy and become more financially literate.

### **The TransUnion Perspective on the Alternative Data Issue**

For more than 15 years, TransUnion has encouraged the full-file reporting of such "non-traditional" information furnishers as energy utilities and telecommunications providers. The positive benefits accruing to consumers, especially those with thin files, was examined and documented in the 2006 paper by the Political and Economic Research Council (PERC) and the Brookings Institute in their study, "Give Credit Where Credit is Due",<sup>5</sup> which TransUnion proudly supported. Just yesterday, on July 28<sup>th</sup>, PERC announced an update on this work with a new study entitled, "You Score You Win: The Consequences of Giving Credit Where Credit is Due." Also, earlier in 2008, TransUnion published our own white paper on the subject, zeroing

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<sup>3</sup> <http://operationhope.org>.

<sup>4</sup> <http://www.jumpstartcoalition.org>.

<sup>5</sup> Turner, Michael A., Alyssa Stewart Lee, Ann Schnare, Robin Varghese and Patrick Walker. "Give Credit Where Credit is Due." Chapel Hill, NC and Washington, DC. The Political and Economic Research Council & The Brookings Institution Urban Markets Initiative. 2006.

in on the impact of full-file reporting by these industries on consumers with impaired credit, “Alternative Data: How the Use of Utility Data in Credit Reporting Impacts Both Lenders and Consumers with Blemished Credit.”

In general, we believe the following points are worth emphasizing:

- There is a net benefit to consumers, particularly those with “thin files” to promoting more “full-file” reporting by new sectors of service providers, in particular energy utilities and telecommunications services providers.
- There is sufficient flexibility in the reporting framework to allow for exceptions created by special payment agreements to mitigate, or eliminate, adverse impacts on consumers in special, distressed, conditions.
- Best practices by service providers to notify their customers before inception of full-file reporting are critical—both to the provider and to consumers.
- The federal Fair Credit Reporting Act provides a robust, world-class, set of consumer rights covering access, rights to dispute, rights to correction, etc. to protect consumers.

We are presently engaged in a follow-up study with PERC to learn more about the impediments—whether systemic, political, legal or otherwise—which are faced by the utilities and telecommunications companies who might otherwise wish to begin full-file reporting. It may very well be that Congress may have a role to play in removing roadblocks and encouraging voluntary full-file reporting.

## **Conclusion**

Chairman Watt and Ranking Member Miller, thank you again for the opportunity to present our views on this important matter this afternoon. We stand ready to work with you to provide additional information to support your efforts to explore the use of credit scoring models and credit scores.