Consumer Concerns for Older Americans

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Understanding Credit Scores

For years, creditors have been using credit scoring systems to determine whether a consumer is a good risk for credit cards and auto loans. More recently, credit scoring has been used to help creditors evaluate a consumer's ability to repay home mortgage loans and whether to charge deposits for utility services. Many auto and home insurance companies use special credit scores to decided whether to issue a policy and for how much.

Here's how credit scoring works in helping decide who gets credit -- and why.

What is credit scoring?

Information about consumers and their credit experiences, such as bill-paying histories, numbers and types of accounts, collection actions, outstanding debt, and the age of accounts, is collected from a consumer's credit application and credit report. Using a statistical program, creditors compare this information to the credit performance of consumers with similar profiles. A credit scoring system awards points for each factor that helps predict who is most likely to repay a debt. A total number of points--a credit score--helps predict how creditworthy a consumer is, that is, how likely it is that a consumer will repay a loan and make the payments when due. The most popular type of credit score is usually between 300 and 850. A higher number is considered a better score.

How is a credit scoring model developed?

A creditor selects a random sample of its customers, or a sample of similar customers if their sample is not large enough, and analyzes it statistically to identify characteristics that relate to creditworthiness. Each of these factors is assigned a weight based on how strong a predictor it is of credit risk. Each creditor may use its own credit scoring model, different scoring models for different types of credit, or a generic model developed by a credit scoring company.

Under the Equal Credit Opportunity Act, a credit scoring system may not use certain characteristics like -- race, sex, marital status, national origin, or religion -- as factors. However, creditors are allowed to use age in properly designed scoring systems. Any scoring system that includes age must give equal or better treatment to elderly applicants.

What can consumers do to improve credit scores?

Credit scoring models are complex and often vary among creditors and for different types of credit. Only the creditor can explain what might improve a score under the particular model used to evaluate a credit application.

Scoring models generally evaluate the following types of information:

- *Payment history*. It is likely that a score will be affected negatively for late payments, accounts referred to collections, or bankruptcies.
- *Amount of outstanding debt.* Many scoring models evaluate the amount of debt compared to credit limits. Debt amounts that are close to the credit limit will likely have a negative effect on a score.
- *Length of credit history. G*enerally, scoring models give more points the longer a consumer's credit track record is. An insufficient credit history may have an effect on a score, but that can be offset by other factors, such as timely payments and low balances.
- *Recent applications for credit.* Many scoring models consider whether a consumer has applied for credit recently by looking at "inquiries" on the credit report. A lot of inquires can negatively affect a score. However, not all inquiries are counted. Inquiries by creditors who are monitoring an account or looking at credit reports to make "prescreened" credit offers are not counted. Credit inquiries made by consumers of their own credit records aren't included either. Some creditors and credit bureaus claim that they do not even consider inquiries. Others claim that a lot of inquiries will have only a small impact on a credit score.
- *Number and types of credit accounts.* Although it is generally good to have established credit accounts, too many credit card accounts may have a negative effect on a score. In addition, many models consider the type of credit accounts and give more points to what they consider a healthy "mix." Under some scoring models, loans from finance companies may negatively affect a credit score.

Scoring models may be based on more than just information in a credit report. For example, the model may consider information from a credit application as well as information about jobs or occupations, length of employment, and homeownership.

To improve a credit score under most models, it is best to concentrate on paying bills on time, paying down outstanding balances, and not taking on new debt. It's likely to take some time to improve a score significantly. Errors involving negative information should be disputed. (See Consumer Facts for Older Americans, "What You Should Know About Your Credit Report").[1]

How reliable is the credit scoring system?

Although a credit scoring system may seem arbitrary or impersonal, it can help make decisions faster, more accurately, and more impartially than individual judgment when it is

[1] See generally National Consumer Law Center, Fair Credit Reporting (5th ed. 2002 and Supp.); National Consumer Law Center, Guide to Surviving Debt (2005 ed).

properly designed. And many creditors design their systems so that in marginal cases, applicants whose scores are not high enough to pass easily or are low enough to fail absolutely are referred to a credit manager who decides whether the company or lender will extend credit. This may allow for discussion and negotiation between the credit manager and the consumer.

On the other hand, credit scoring does have some flaws. Credit scoring is only as good as the information in the credit report - garbage in, garbage out - and credit reports are notorious for containing errors. Credit scoring programs often cannot generate a score if the consumer has no recent activity on an account, usually within the last six months. This can be a problem for seniors who have paid off all their loans and do not use credit cards. Lack of a score can mean denial of credit or auto or homeowner's insurance. Finally, there are serious concerns that credit scoring disproportionately hurts certain minority groups.

What happens if a consumer is denied credit or does not get the terms she wants?

If a consumer is denied credit, the Equal Credit Opportunity Act[2] requires that the creditor give a notice that tells the consumer the specific reasons that the application was rejected or the fact that the consumer has the right to learn these reasons. Indefinite and vague reasons for denial are illegal. Acceptable reasons include: "Your income was low" or "You haven't been employed long enough." Unacceptable reasons include: "You didn't meet our minimum standards" or "You didn't receive enough points on our credit scoring system."

Sometimes consumers are denied credit because of information from a credit report. If so, the Fair Credit Reporting Act requires the creditor to give out the name, address and phone number of the credit reporting agency that supplied the information. Consumers should contact that agency to find out what the report said. This information is free if requested within 60 days of the credit denial. (See Consumer Facts for Older Americans, "What You Should Know About Your Credit Report" and consumer brochure, The Truth About Credit Reports). The credit reporting agency can tell consumers what is in their reports, but only the creditor can tell them why applications were denied.

If a consumer has been denied credit, or did not get the rate or credit terms he wanted, he should ask the creditor if a credit scoring system was used. If so, a consumer should ask what characteristics or factors were used in that system, and the best ways to improve the application. If the consumer is offered credit, she should ask whether she got the best rate and terms available and, if not, why. Asking about the best rate is very important. If the consumer is not offered the best rate available because of inaccuracies in the credit report, it is important to dispute the inaccurate information.

How To Obtain Credit Scores

Until 2004, federal law did not require the disclosure of credit scores to consumers. This was changed by the Fair and Accurate Credit Transactions Act (FACTA) of 2003,[3] which

[2] 15 U.S.C. §§ 1691-1691f.
[3] Pub. L. No. 108-159 (2003).

amended the Fair Credit Reporting Act (FCRA)[4] to require disclosures of credit scores. This became effective on December 1, 2004. Now, upon request, and for a fee that is to be determined by the FTC, credit reporting agencies must disclose the following:

- A consumer's current credit score or most recent score that was calculated by the credit reporting agency relating to the extension of credit.
- A statement indicating that the information and credit scoring model may be different than the credit score used by the lender.
- The range of credit scores of the model used to generate the credit score.
- The key factors that adversely affected the consumer's credit score, listed in order of impact. The agency cannot list more than four (4) key factors, unless one of the factors is the number of inquiries, in which case that factor must be included.
- The date on which the credit score was created.
- The name of the provider of the credit score or the credit file used to generate the credit score.[5]

The new law also requires mortgage lenders who use credit scores in connection with an application for residential real estate secured credit to provide, free of charge, the consumer's credit score and associated key factors.[6]

More Information from the Federal Trade Commission (FTC)

The FTC works for the consumer to prevent fraudulent, deceptive and unfair business practices in the marketplace and to provide information to help consumers spot, stop and avoid them. To file a complaint or to get free information on consumer issues, visit www.ftc.gov or call toll-free, 1-877-FTC-HELP (1-877-382-4357); TTY: 1-866-653- 4261. The FTC enters Internet, telemarketing, identity theft and other fraud-related complaints into Consumer Sentinel, a secure, online database available to hundreds of civil and criminal law enforcement agencies in the U.S. and abroad.

Publications and Web Sites

National Consumer Law Center, Fair Credit Reporting (5th ed. 2002 and Supp.).
National Consumer Law Center, Guide to Surviving Debt (2005 ed.).
Call 617-542-9595 or visit www.consumerlaw.org for more information about NCLC publications.

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This publication was supported, in part, by a grant #90AP2483 from the Administration on Aging, Department of Health and Human Services, Washington, D.C. 20201. Grantees undertaking projects under government sponsorship are encouraged to express freely their findings and conclusions. Points of views or opinions do not, therefore, necessarily represent official Administration on Aging policy.
July 2005.

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[4] 15 U.S.C. §§ 1681 – 1681x.
[5] 15 U.S.C. § 1681g(f).
[6] 15 U.S.C. § 1681g(g)(1).