

Building & Repairing Credit

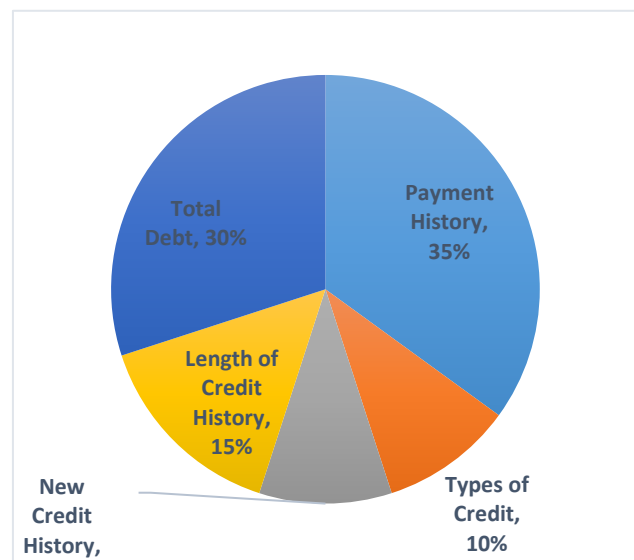
Credit reporting agencies (CRAs) or “credit bureaus” collect and use data to rate consumers’ “credit-worthiness.” These reports and scores have far-reaching implications for Hoosiers’ lives; they not only factor into who can get a loan and on what terms, but they can also affect insurance coverage and costs, job opportunities, housing, and other basic services. Accordingly, there has been significant interest in how scores are developed, how to improve their accuracy, and how to help individuals with impaired or non-existent scores.ⁱ

While policymakers and community leaders may be limited in their capacity to change how scoring models work, there are a number of concrete steps they can take to ensure that borrowers have the greatest opportunity possible to establish and benefit from positive credit. Bolstering incomes and consumer protections, providing education and tools, and adjusting certain features of scoring models would be positive steps forward.

What is in a Credit Score?

Three nationwide bureaus – Equifax, Experian, and TransUnion – collect data on consumers’ relationships with creditors, in addition to several smaller specialty CRAs. Using scoring models, this data is transformed into three-digit numbers that are intended to represent predictions about borrower behaviors, such as the likelihood that he or she will pay bills on time. Typically, payment history, the amount of debt a borrower has, the length of his or her credit history, any recent credit applications, and the types of credit a borrower has will factor into the score. As an example, Figure 1 shows the component parts and relative weight of each element in a Fair Isaac Corporation (FICO)ⁱⁱ score.

FIGURE 1. FICO Credit Score Factors



A credit score affects how much a borrower will pay for loans – or whether they are offered credit at all. For example, an individual with a FICO score of 720 can expect to pay over \$4000 less for a 5-year, \$10,000 auto loan as compared to someone with a score of 500.ⁱⁱⁱ Especially for individuals in low-wage jobs, these differences are not insignificant and influence their ability to remain financially stable or save for the future.

Beyond lending, credit reports and scores are also used in some employment and housing decisions. An estimated one in four unemployed adults goes through a credit check when applying for a job, and one in ten have reported that they were told information on their credit report led to them being denied a job opportunity.^{iv} Similarly, many landlords run credit checks when evaluating prospective tenants – approximately 43%, according to a 2014 Transunion survey.^v Insurance companies also use credit report data to determine how likely an individual is to make a claim and set premiums.^{vi}

Given the wide array of uses of credit reports and scores, working with individuals to establish, correct, or repair their credit can unlock opportunities and save families money. But as Table 1 indicates, between one in six and one in four borrowers has a “poor” score. In 2018, the average Vantagescore in Indiana was 675, slightly lower than all our neighbors except Kentucky (668).

TABLE 1. Score Ranges and Percentage of Consumers within each Range

FICO			VantageScore		
Score Rating	Range	Percent of Scored Consumers	Score Rating	Range	Percent of Scored Consumers
Exceptional	800-850	21%	Excellent	781-850	23%
Very Good	740-799	25%	Good	661-780	38%
Good	670-739	21%	Fair	601-660	13%
Fair	580-669	17%	Poor	500-600	21%
Very Poor	300-579	16%	Very Poor	300-499	5%

Source: Experian Information Solutions, 2019

Challenges with the Current Credit Scoring System

There are a number of challenges for consumers within the current credit scoring system. While the consequences may be similar, the sources of low or non-existent credit scores differ, suggesting that a variety of remedies may be necessary to improve outcomes for Hoosier consumers.

Lack of credit score. Approximately ten percent of consumers are “credit invisible” and another seven percent are unscored. Disproportionately, these are African-American and Latinx consumers. Some may be deliberately avoiding the use of credit, while others no longer need or use it. However, for those seeking credit access, credit invisibility or remaining unscored can be problematic.

- **Credit invisible:** Consumers without credit records.
- **Unscored:** Consumers may have too few accounts or accounts that are too new to contain sufficient payment history or payment history is old.

Consumer understanding of what goes into a credit score. Beyond these problems, recent surveys suggest that consumer understanding of credit scores – while never excellent – have declined over time.^{vii} While a majority of consumers understand some of the key facts, many failed to correctly answer other important questions. Table 2 summarizes a few of the findings from the survey.

TABLE 2. Key facts about credit scoring and consumer awareness

Fact:	Percent correct:
Mortgage lenders use credit scores.	83%
Making loan payments on time helps a consumer raise a low score or maintain a high one.	87%
Keeping a low credit card balance helps raise low credit scores or maintain high ones.	66%
People have more than one credit score.	62%
Cell phone companies might use credit scores in pricing services.	41%
Opening several credit card accounts at the same time might lower scores.	38%

Source: Consumer Federation of American and VantageScore, 2019

Inaccuracies. Another challenge for consumers is inaccuracies in their credit report. The FTC found that as many as one in four consumers had a material error on at least one of three of their credit reports. By correcting the reports, many borrowers see their scores rise.^{viii} However, the onus is currently on borrowers to request, analyze, and correct their scores.

Default & bankruptcy haunts consumers for a long time. The length of time that negative information remains on a credit report also creates challenges for consumers. Defaults typically remain for seven

years and bankruptcy for ten. These can limit borrowers' access to checking accounts and lower-cost loans.^{ix}

Past inequalities show up in credit scoring. Finally, while credit agencies are not allowed to collect information on race, gender, or other protected statuses, these groups experience disparities in credit scores. These are likely due to persistent wage and wealth gaps that make it more difficult for some groups to pay bills on time, access mainstream financial services, or maintain a low credit use ratio.^x

Policy Recommendations

There are a number of steps policymakers and other community leaders can take to help Hoosiers establish and improve their scores, thereby accessing less costly credit, job opportunities, and housing.

Invest in financial capability programs. Financial *literacy* programs have received mixed reviews on effectiveness, suggesting that alone, they are not sufficient to bring about positive changes in financial well-being. However, when coupled with tools, some programs have shown positive results in establishing and increasing credit scores.^{xi} Just six months of on-time payments on a small (\$100) installment loan can boost a low score by 35 points or move an individual with no credit score to a prime credit score.^{xii}

Provide opportunities to build positive credit history – with caution. Given the problems with credit scoring models, new models, products, and data sources have all been proposed as potential solutions. It is important to ensure that the cure isn't worse than the disease.^{xiii} Some strategies could help some borrowers while hurting others, such as reporting rent and utility payments, for example. Some research indicates that using this data would enable 74% "of those with no or thin credit files to obtain credit scores, notably impacting Latinos, African Americans, youth between 18 and 25, and seniors."^{xiv} However, such data could damage the scores of those struggling with repayment. For these, an "opt in" option might be the best approach. Other solutions, such as high-cost loans, will cause damage; even if borrowers repay on time (and, given the default rates), use of alternative financial products is typically scored negatively.

Shorten the length of time negative tradelines remain on a person's credit report. Negative tradelines like loan defaults or bankruptcy can currently haunt consumers for up to a decade. Reducing the impact of past harms might allow more borrowers to access prime credit.

Protect consumers from predatory lending. High interest rates and up-front fees allow lenders to be profitable even when they are lending to borrowers who will ultimately default. Defaults negatively impact borrower's scores, and, since high-cost lenders often take secure access to a borrower's checking account as collateral and can debit payments on the borrower's payday, may cause consumers to fall behind on

other bills as well. Strong rate caps and protections against up-front fees that can be used in loan flipping schemes ensure that lenders make a good faith effort to assess borrowers' ability to repay the loans.

Boost incomes and close wage gaps. With more dependable, family-sustaining incomes, Hoosiers could keep up with bills and budget effectively. Closing wage gaps by race, gender, and ability is especially important to ensure that these disparities do not continue to spill over into the credit, job, insurance, and housing markets, compounding inequality.

Credit scores have become a ticket to high-quality credit and a factor in job opportunities, housing, and access to basic services. Ensuring that consumers are scored fairly and accurately and making sure they have opportunities to build positive credit history would allow more Hoosiers to experience financial security and reach their full potential.

This policy brief was made possible through generous funding from the Glick Fund.

Our thanks to the many individuals who informed or supported this work, including Marie Morse, Executive Director of Homestead Consulting Services.

FOR MORE INFORMATION, PLEASE CONTACT:

Erin Macey, Senior Policy Analyst, Indiana Institute for Working Families

Phone: 317-638-4232

Email: emacey@incap.org

Web Site: <http://www.incap.org/iiwf.html>

-
- ⁱ C. R. Cooper & D. E. Getter, Consumer credit reporting, credit bureaus, credit scoring, and related policy issues (2019), *Congressional Research Service*, accessed September 30, 2019 from <https://fas.org/sgp/crs/misc/R44125.pdf>.
- ⁱⁱ What is a FICO score? (2019), accessed September 30, 2019 from <https://www.myfico.com/resources/credit-education/what-is-a-fico-score>
- ⁱⁱⁱ Asset Funders Network, The Power of Credit Building (n.d.), accessed September 30, 2019 from https://assetfunders.org/wp-content/uploads/power_of_credit_building_brief.pdf
- ^{iv} A. Traub, Discredited: How employment credit checks keep qualified workers out of a job (2012), accessed October 1, 2019 from <https://www.demos.org/research/discredited-how-employment-credit-checks-keep-qualified-workers-out-job>
- ^v A. Collatz, Non-payment is top landlord concern, TransUnion study finds (2014), accessed September 30, 2019 from <https://www.mysmartmove.com/SmartMove/blog/landlord-top-tenant-concern-study.page>
- ^{vi} National Association of Insurance Commissioners, Credit-based insurance scores: How an insurance company can use your credit to determine your premium (2012), accessed September 30, 2019 from https://www.naic.org/documents/consumer_alert_credit_based_insurance_scores.htm
- ^{vii} Consumer Federation of American and VantageScore, Annual Survey Reveals that Consumer Knowledge about Credit Scores has Steadily Declined over the past Eight Years (June 10, 2019), accessed September 30, 2019 from <https://www.vantagescore.com/news-story/309/annual-survey-reveals-consumer-knowledge-about-credit-scores>
- ^{viii} Federal Trade Commission, Fifth Interim Federal Trade Commission Report to Congress Concerning the Accuracy of Information in Credit Reports (December 2012), retrieved September 30, 2019 from <https://www.ftc.gov/reports/section-319-fair-accurate-credit-transactions-act-2003-fifth-interim-federal-trade>
- ^{ix} C. R. Cooper & D. E. Getter, Consumer credit reporting, credit bureaus, credit scoring, and related policy issues (2019), retrieved September 30, 2019 from <https://fas.org/sgp/crs/misc/R44125.pdf>
- ^{ix} Asset Funders Network, The Power of Credit Building.
- ^x National Consumer Law Center, Past imperfect: How credit scores and other analytics “bake in” and perpetuate past discrimination (2016), accessed September 30, 2019 from https://www.nclc.org/images/pdf/credit_discrimination/Past_Imperfect050616.pdf
- ^{xi} L. I. Gomez & I. Alisultanov, Asset building through credit pilot: Client gains in credit scores and financial capability, *FIELD at the Aspen Institute*, accessed September 11, 2019 from https://assets.aspeninstitute.org/content/uploads/2014/02/FIELD-ABC-ClientGains.pdf?_ga=2.153616699.2028811473.1568140587-683051580.1565282361
- ^{xii} Asset Funders Network, The Power of Credit Building.
- ^{xiii} National Consumer Law Center, Past Imperfect.
- ^{xiv} D. Thompson & R. Walker, The case for rent as a credit builder in affordable housing, accessed September 30, 2019 from <https://www.whatworksforamerica.org/the-case-for-rent-as-a-credit-builder-in-affordable-housing/>