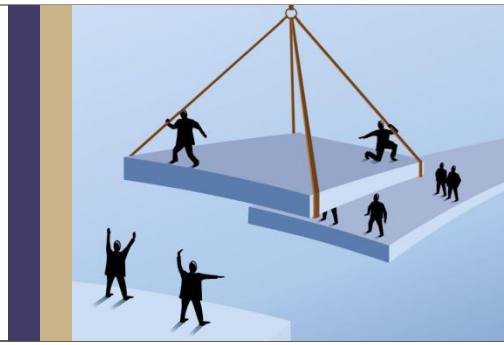
WOODSTOCK INSTITUTE

Advancing Economic Security and Community Prosperity

Credit Scores and Economic Opportunity in Illinois Communities of Color

Symposium on Credit Scoring and Credit Reporting
June 6, 2012 | Boston, Massachusetts



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Overview of Credit Scoring

#Creditscores are based on 8-12 variables, such as payment history, types of credit, outstanding debt, & credit history, says @tfeltner

Credit scores are calculated by credit bureaus from information included in an individual's credit report. Credit reports track information from an individual's financial history including credit use, late payments, and credit inquiries as well as public information related to finances, such as bankruptcies.

Credit scores are based on eight to twelve variables, such as payment history, types of credit used, amount of debt outstanding, and length of credit history. Different credit scoring systems have different score ranges, but scores typically rank between 350 and 850.

Lenders use credit scores to qualify applicants as part of an automated mortgage underwriting decision as well as to determine the cost of credit in risk-based pricing models. In 1995, Freddie Mac and Fannie Mae recommended the use of FICO scores, a universal scoring system developed by the Fair Isaac Corporation, which uses data from the three major credit bureaus, for mortgage underwriting. By 2004, an estimated 75 percent of all mortgage originations used the FICO score.

Impact of Credit Scoring on Communities of Color

.@tfeltner at @suffolk_U: 2010 study says 60% of employers consider #creditscore to inform hiring decisions, up from 34% in 2004

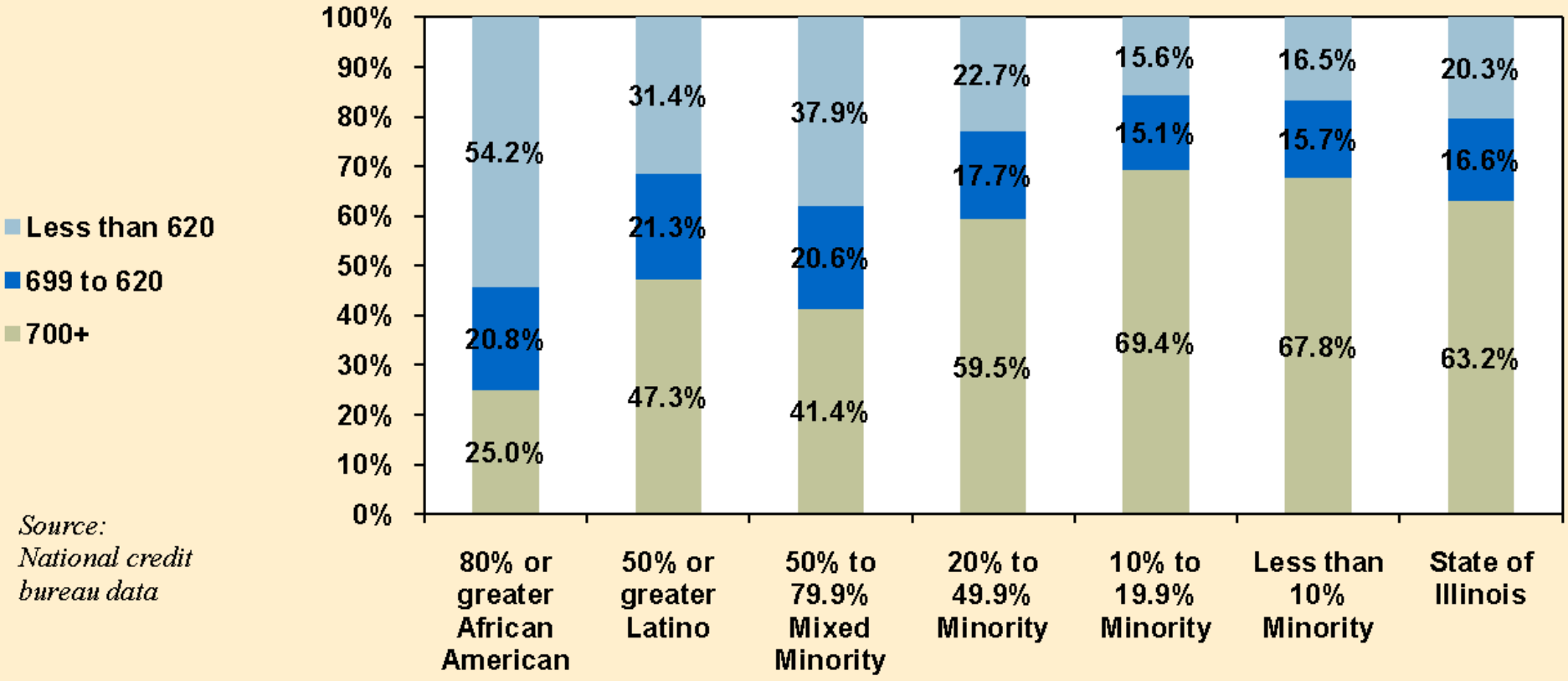
Alternative uses of credit scores and credit data are becoming more common. Landlords use credit scores to screen potential tenants. Insurance companies use credit data to build models that predict the likelihood of an insurance claim and to set price premiums. Utility companies use credit scores to determine security deposit requirements.

Employers increasingly rely on credit information to screen potential employees. A January 2010 survey conducted by the Society for Human Resource Management found that 60 percent of companies used credit reports to inform hiring decisions, up from 34 percent in 2004.

Low Credit Scores Concentrated in Communities of Color

.@tfeltner of @woodstockinst at @suffolk_U: In Chicago, 54% of people in African Am communities have #creditscore < 620 #racialwealthgap

Chart 1. Distribution of sample population within credit score ranges by zip code racial composition, June 30, 2009

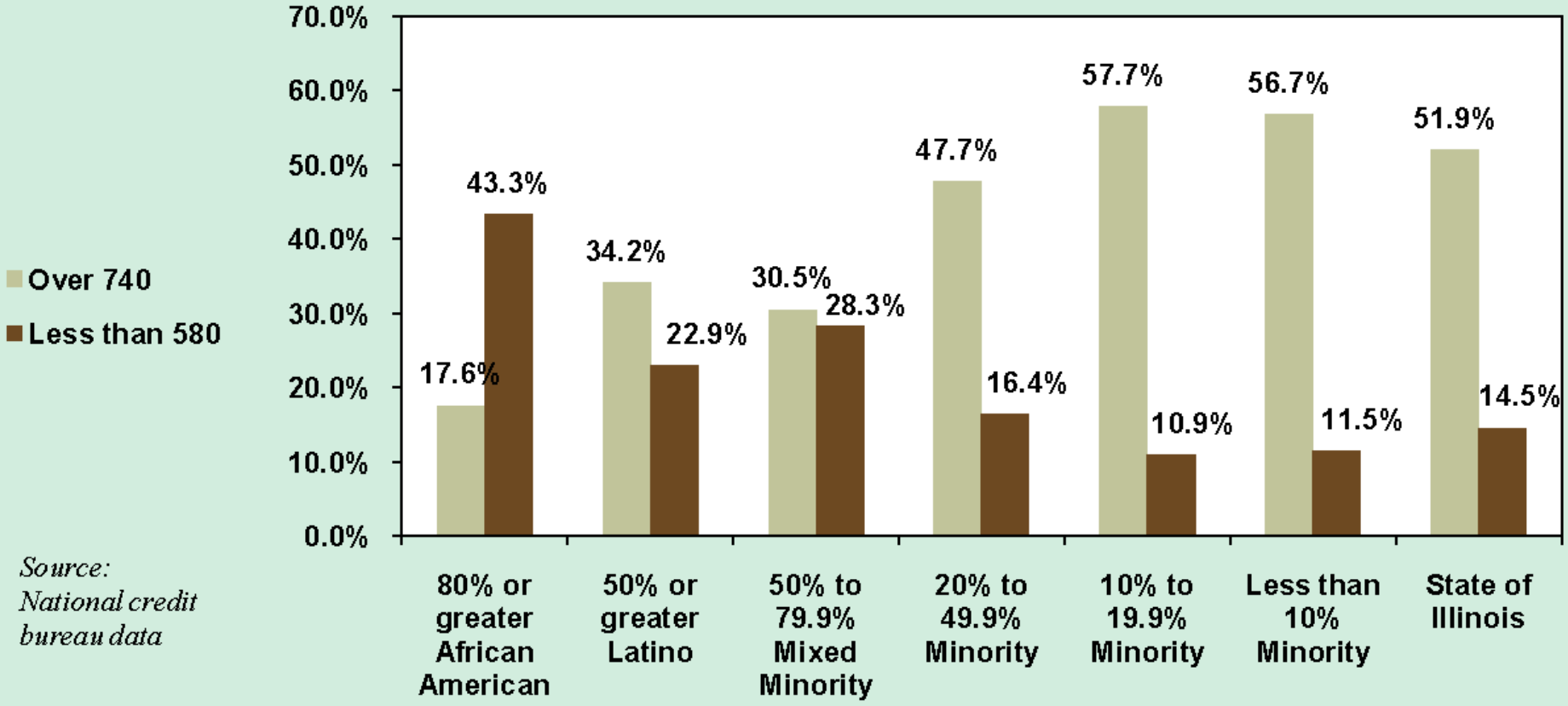


Source: National credit bureau data

There is Tremendous Polarization in Credit Score Distributions

.@tfeltner at @suffolk_U: In African Am communities just 18% have #creditscores > 740, in white communities 57% do #racialwealthgap

Chart 2. Percent of sample population in highest and lowest credit score ranges by zip code racial composition, June 30, 2009

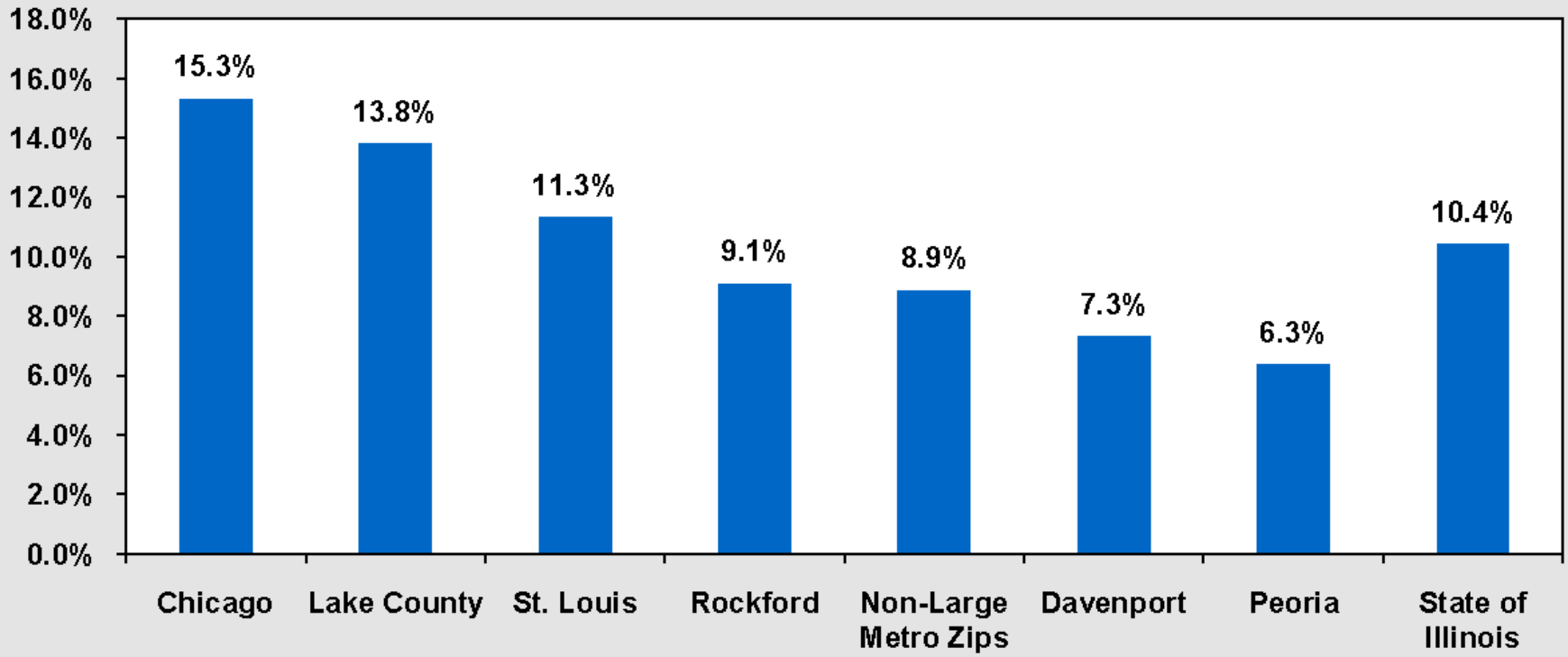


Source: National credit bureau data

Large Metro Areas See Larger Number of Low Scoring ZIP Codes

In Chicago, more than 25% of people
have #creditscores < 580 in 15% of ZIP codes

Chart 3. Percent of zip codes in metropolitan area where more than 25 percent of individuals had credit scores below 580



Source: National credit bureau data

Examples of Credit Tightening

Increasing cutoffs for #creditscores impacts access to mortgage and small business credit in communities of color

Federal Housing Administration (FHA) has implemented tighter credit score standards for FHA loans

Under the proposed rules, borrowers with less than a 500 credit score would no longer qualify for an FHA loan

Borrowers with credit scores between 500 and 579 would be required to make a minimum 10 percent down payment.

Borrowers with a credit score of 580 or better would be required to have only a 3.5 percent down payment.

Conventional mortgage lending

In September 2009, Fannie Mae announced it was increasing its minimum credit score requirement from 580 to 620.

This was in conjunction with other credit tightening changes designed to reduce the risk in Fannie Mae's lending portfolio going forward.

Small business lending

In recent years there has been a significant shift away from larger, manually underwritten small business loans towards smaller loans that use automated underwriting and rely heavily on individual credit scores.

Additionally, some banks have recently begun reporting the performance of small business loans to credit bureaus. Previously, small business loans were not reported on an individual's credit report.

Reducing the Impact of Low Credit Scores on Communities of Color

.@tfeltner to @suffolk_U: In IL, employers are prohibited from using #creditscores to hire, promote, or terminate certain employees

Support efforts to build credit for credit-underserved populations.

Resources and standard curriculum should be made available to credit counselors to help them reach individuals with low credit scores and help them build their credit.

Use additional data to build credit.

Alternative data on repayment patterns can be utilized to capture the true default risk for individuals who have limited histories with traditional credit. Such variables might include on-time payments for utilities, cell phone bills, insurance premiums, rent, consumer loans, or health care.

Many states have responded to the increased use of credit scores and reports for non-traditional uses.

For example, in August 2010, Illinois prohibited employer use of credit reports to screen certain job applicants or to promote or terminate employees. The use of credit scores by insurance companies in auto or home owners insurance pricing is banned in four states.

Utilize manual, relationship-based underwriting.

Some borrowers with low credit scores could benefit from manual underwriting in certain mortgage and small business lending transactions. Many community banks, credit unions, and community development financial institutions have, for years, worked closely with customers to make sure that borrowers who are good credit risks can still obtain responsible loans.

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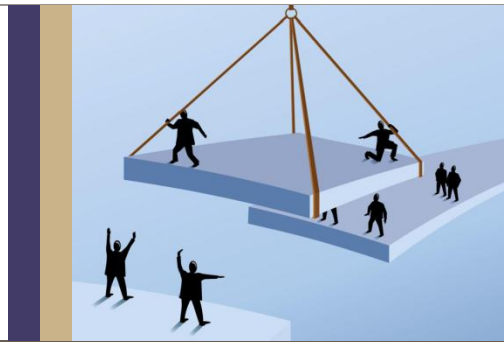

The full report is available at:
http://bit.ly/woodstock_creditscores