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External Credit Scores Not a Good Measure of Creditworthiness for Utility Clean Energy Programs.

NOTE TO READERS

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External Credit Scores Unreasonably Harm the Poor, the Young, and the Aged when Used by Utilities to Limit Access to Clean Energy Programs.

FSC was recently asked to comment on proposals to bar utilities from imposing a minimum credit score for accessing certain solar financing programs in New Hampshire. FSC's recommendation was that New Hampshire utilities should be prohibited from making credit decisions based on a credit rating from an external credit agency.

Distinction by Demographic Factors

While credit scoring agencies claim not to take certain demographics such as income into consideration in their determinations, and are barred by law from taking factors such as age and gender into account, substantial research shows that, in fact, credit scorers distinguish based on all three of these factors. As the Board of Governors of the Federal Reserve System reported to Congress in 2007:

By law and regulation, an individual's personal characteristics --such as race or ethnicity, national origin, sex, and, to a limited extent, age—must be excluded from credit-scoring models. A concern exists that, despite that prohibition, a credit characteristic may be included in a model not because it helps predict performance but because it is a substitute, or proxy, for a demographic

characteristic that is correlated with performance.¹

The Federal Reserve study examined data for three credit scores, including the TransRisk Score, the VantageScore, and the Federal Reserve's own estimated score. Results for the three credit scores, the Federal Reserve said were "virtually identical." The Federal Reserve report documents that "credit scores differ widely across populations, with blacks, Hispanics, individuals younger than age 30, unmarried individuals, and individuals residing in low-income or predominantly minority census tracts having lower credit scores than other subpopulations within their broader demographic group."² According to the Federal Reserve:

Differences in credit scores among racial or ethnic groups and age cohorts are particularly notable because they are larger than for other populations. For example, the mean normalized TransRisk Score for Asians is 54.8; for non-Hispanic whites, 54.0; for Hispanics, 38.2; and for blacks, 25.6. Credit scores by age increase consistently from young to old: The mean TransRisk Score for individuals younger than age 30 was 34.3; for those aged 62 or older, it was 68.1.³

The direct impact of these lower credit scores present themselves in higher credit denial rates. The indirect results, however, are more disturb-

ing. The Federal Reserve reported that "individuals with lower credit scores experience higher inferred denial rates. This relationship is found across all population groups; *after controlling for credit score, however, blacks and Hispanics, younger individuals, and individuals that live in low-income areas show somewhat higher inferred denial rates than other groups.*" (emphasis added)⁴ The factors that are implicitly taken into account, in other words, result in higher denial rates based on race, ethnicity, age and income status *even between groups of individuals with the same credit score.*

Given the interrelationship of demographic characteristics, some groups have very little chance of accessing credit given a reliance on credit scores. The Federal Reserve distributed credit scores from lowest to highest and examined the demographic composition in each credit-score decile.

With the exception of sex, the composition of the population varies greatly across deciles. Taking the TransRisk Score as an example, 27.2 percent of the individuals in the lowest decile are black, whereas in the highest decile, 3.0 percent are black. Similarly, 23.7 percent of those in the lowest decile are younger than 30 years of age versus 0.3 percent of those in the highest decile.

Notable differences in the composition of the population are also evident when individuals are sorted by the relative income. For example, 7.9 percent of the individuals in the lowest TransRisk Score decile reside

¹ Board of Governors of the Federal Reserve System (August 2007). *Report to the Congress on Credit Scoring and its Effects on the Availability and Affordability of Credit*, submitted to Congress pursuant to section 215 of the Fair and Accurate Credit Transactions Act of 2003.

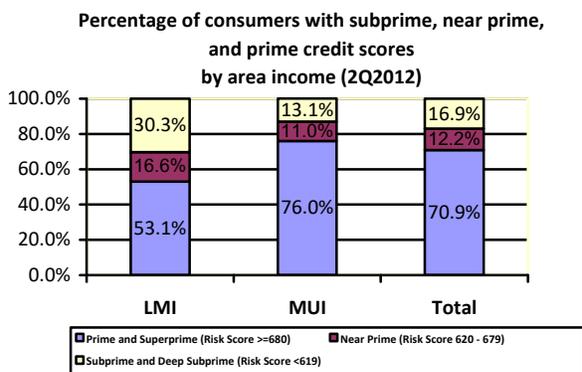
² *Report to Congress*, supra, at O-12.

³ In order to compare results between the three types of credit scoring, the Federal Reserve Board rank ordered scores from 1 – 100.

⁴ *Report to Congress*, supra, at O-16.

in low-income areas, compared with 1.5 percent in the highest score decile.⁵

It is certainly not only the Federal Reserve which has found these disproportionate impacts. The Federal Reserve Bank of Boston, for example, reported that “scores are strongly correlated with demographic characteristics. For example, older consumers and higher-income earners tend to have higher scores.”⁶ The FRB of Boston found that “in Massachusetts, as of 2Q2012,⁷ 30.3 percent of individuals living in [low and moderate income, LMI] areas had subprime and deep subprime risk scores,⁸ compared to 13.1 percent of those living in [moderate and upper income, MUI] census tracts.”⁹



Consumers with lower credit scores not only face an increased probability that they will be denied credit entirely, but when they do receive credit they will be subjected to higher prices for that credit and will more likely be subject to col-

⁵ Report to Congress, supra, at 82.

⁶ Ana Patricia Munoz (October 2013). *Credit Conditions by Neighborhood Income: The Picture in Massachusetts*, at 16, Federal Reserve Bank of Boston: Boston (MA), citing Joanna Stavins and Fumiko Hayashi (2012). *Effects of Credit scores on Consumer Payment Choice*, Federal Reserve Bank of Boston: Boston (MA).

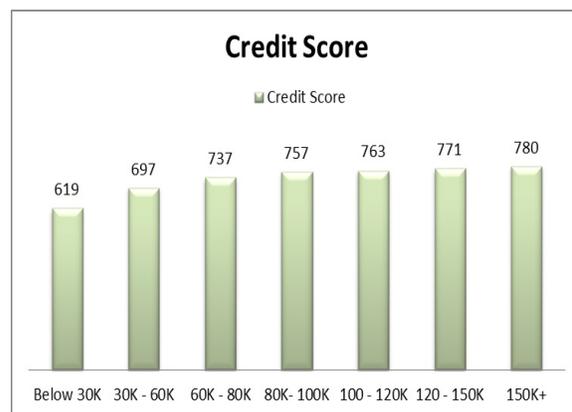
⁷ The second quarter of 2012.

⁸ That is, scores below 680.

⁹ *Picture in Massachusetts*, supra, at 16.

lection action at lower thresholds of payment problems. According to Experian’s 2016 State of Credit report, the average credit score in America is 673.

The fact that credit scores are associated with income can hardly be denied, even though credit scoring agencies assert, probably rightly so, that they do not take income *explicitly* into account. One credit tracking organization, Credit Sesame, unequivocally states that “Despite not being factored into the credit scoring formula, new data from Credit Sesame suggests that income is directly correlated with higher credit scores.” This result, Credit Sesame says, is not simply because lower income households have more delinquencies in their payment histories. It is based, also, in large part on the fact that lower income households have lower credit utilization.



According to their data, households with annual income less than \$30,000 have fewer credit cards, lower automobile loan payments, considerably less student loan debt, and considerably fewer mortgages. While, for example, only 17.81% of households with income less than \$30,000 own their home (and have a mortgage), 70% and more of households with income exceeding \$100,000 have home mortgages. While fewer than 25% of households with income less than \$30,000 have an automobile loan, 45% and

more of households with income \$60,000 and higher have automobile loans. In contrast, while 43% of households with income below \$30,000 have student loans (compared to fewer than 25% with income of \$120,000 or more), the average monthly student loan payment for those lower-income households is only \$92, compared to more than twice that much for households with income of \$120,000 or more. Lower income households, in other words, have considerably less opportunity to access credit and to build a credit history upon which to base a favorable credit score.

Finally, each year, the credit bureau Experian releases a study about credit scores called “State of Credit.”¹⁰ In that study, Experian breaks credit scores down by region and income (amongst other things). Experian even publishes two lists each year: (1) the 10 cities with the best average credit score, and (2) the 10 cities with the worst average credit scores. Experian adamantly denies that good credit scores are related to income (or that income is taken into account in any regard in assessing a credit score). According to Experian, “it’s about credit management. The better you are at paying on time and keeping your balances low, the higher your score will be.”

The data doesn’t quite support that assertion. One study by an on-line journalist writing about personal finance examined median income and “baseline cost-of-living” in the top five and bottom five cities identified in Experian’s annual credit report.¹¹

	City	Median Income	Self-Sufficiency Income
1.	Mankato (MN)	\$63,488	\$45,837
2.	Rochester (MN)	\$63,472	\$50,078
3.	Minneapolis (MN)	\$71,008	\$50,603
4.	Green Bay (WI)	\$55,638	\$34,493
5.	Wausau (WI)	\$40,464	\$41,453

This study concluded that “based on the income numbers we gathered from the cities with the best and worst credit scores, we’d say income has a lot to do with scores.”

	City	Median Income	Self-Sufficiency Income
1.	Greenwood (MS)	\$26,156	\$41,004
2.	Albany (GA)	\$26,156	\$34,419
3.	Harlingen (TX)	\$34,868	\$40,548
4.	Riverside (CA)	\$56,592	\$49,315
5.	Laredo (TX)	\$39,408	\$41,189

The study noted: “Simply put, the top five cities have significantly higher income than the bottom five cities:

- Four of the top five cities have median incomes at least \$10,000 above cost-of-living calculations for livable incomes.
- All but one of the bottom five cities have median incomes below cost-of-living calculations.”

Inability of Consumers to Challenge

Even when credit scores are reported for lower income consumers, they are more likely to be in error and without adequate mechanisms through

¹⁰ Experian reports what is known as the VantageScore.

¹¹ <http://www.highya.com/articles-guides/do-location-income-or-age-influence-your-credit-score>

which those scoring errors can be effectively challenged. This inability to correct information is particularly problematic to those with lower incomes and, therefore, with lower credit scores. Perhaps the pre-eminent study of data errors, by researchers for the Federal Reserve Bank of D.C., have documented that “individuals with scores below 600 tended to have the highest frequency of data problems, and those with scores above 660 had the lowest incidence.” Those errors make a substantive difference. According to the FRB of D.C. study, “Generally, individuals with scores below 600 were the most likely to experience a score increase of 10 points or more in response to corrections of data problems.”¹² The study reported that “In general, older individuals and those living in higher-income and nonminority neighborhoods had the lowest incidence of data problems.”¹³

In sum, Avery et al. found that while errors in credit reporting *overall* may be relatively small, “the analysis suggests. . .that the effects of data problems may be more substantial in some cases than in others. In particular, problems with collection accounts are much more likely to have significant effects on the credit history scores of affected individuals. Missing credit limits, simply because they occur so frequently, also represent an important data quality problem. In general, individuals with relatively low credit history scores or those with thin files are more likely to experience significant effects when a data problem arises.”¹⁴ As noted above, customers with low-incomes are precisely the types of customers to have the factors leading to these data quality problems.

¹² Robert Avery, et al. (2004). *Credit Report Accuracy and Access to Credit*, Federal Reserve Bulletin, 297, 318-319.

¹³ *Credit Report Accuracy*, supra, at 319.

¹⁴ *Credit Report Accuracy*, supra, at 319 – 320.

Consumers generally do not have the ability to effectively challenge credit determinations based on consumer credit scores. When a utility obtains a rating from Equifax, for example, the underlying details are not known by the utility. In performing a credit check based on a particular credit score, the utility is generally provided with a credit score or a response that credit information is not available.¹⁵ For privacy reasons, the utility neither obtains nor records the underlying credit file details.

The use of third-party supplied credit information as a basis for making utility credit decisions constitutes a problem when the third party information is not itself comprised of utility payment histories. Several reasons support this conclusion. First, substantial research has found that consumers tend to pay their utility bills before paying nearly any other outstanding credit (other than rent or mortgage obligations). Second, it has been found that low income consumers frequently acquire poor credit ratings by refusing to complete payments on abusive credit card terms.¹⁶ Finally, persons who have never borrowed from a reputable institutional lender, or maintained a charge account at a large store, may have difficulty establishing that their credit is good.

Moreover, the sharing of personal information precludes the ability of utility consumers to access, review, and correct (where appropriate) er-

¹⁵ Sometimes, the utility is provided with a “pass” or “fail” recommendation without even being provided the underlying rationale for the recommendation. The utility would not know, in other words, if the credit score was inadequate or whether there was a lack of sufficient credit history upon which to make a recommendation.

¹⁶ Colton (1993). *The Use of Consumer Credit Reports in Assessing the Creditworthiness of Residential Utility Customers*, prepared for Montana Public Service Commission: Helena (MT).

aneous information that is used “downstream.” When personal information is sold or shared (e.g., from a credit reporting agency to a utility), the consumer no longer is in privity with the entity holding and using his or her personal information. To the extent that the personal information has been combined with other information to create a new information product/digital dossier, it is impossible for the consumer to make corrections. Any modification would exist only until the information-combiner obtains a new set of (incorrect) information to incorporate into the information product/digital dossier.¹⁷ Even if a correction in the new information product/digital dossier could be made, in other words, the correction exists only until it is subsequently overwritten by the next new set of external data from which the new information product/digital dossier was compiled with which to begin. Indeed, the frequent response by information-combiners is that consumers can only make corrections by going to the original source of information.¹⁸

Other reasons exist why it is particularly inappropriate to use credit agency scores to impose credit restrictions on low- and moderate-income households. It has been found that low income consumers frequently acquire poor credit ratings by refusing to complete payments on installment

¹⁷ GAO (April 2006). *Agency and Reseller Adherence to Key Privacy Principles*, GAO-06-421, at 48 (“resellers stated that making corrections to their databases could be ineffective because the data are continually refreshed with updated data from the source, and thus any correction is likely to be changed back to its original state the next time the data are updated.”) While this GAO report references “information resellers,” the conclusions are applicable to any information combiners.

¹⁸ Id., at 48. When information is combined into a new information product/digital dossier, however, the “original source” is not necessarily known to the consumer. See generally, GAO (June 2006). *Personal Information: Key Federal Privacy Laws do not Require Information Resellers to Safeguard All Sensitive Data*, GAO-06-674.

purchases of defective or shoddy merchandise. According to one study, 35 percent of the debtors in default who were studied “gave reasons for their default that implicated the creditor in varying degrees.”¹⁹ According to this study, “by far the largest category of credit-related reasons consists of allegations of fraud and deception. Nineteen percent mentioned such wrongdoing by the seller as part of the reason for their default, and for 14 percent of all debtors, it was the *primary* reason.” (emphasis added).²⁰ The problems experienced by low-income households included defective merchandise coupled with breach of both express and implied warranties, the delivery of wrong or “used” merchandise, the failure to deliver all merchandise ordered, and deceptive pricing practices.²¹

The study found that not only were low-income households more likely to face these types of problems,²² but that they were more likely to pay higher prices as well.²³ Nearly 40 percent of the households who purchased from merchants serving primarily low-income households were not told the true price of their purchase,²⁴ with the actual cost being understated by more than 25 percent in roughly one-in-five cases.²⁵ Moreover, the study found that low-income merchants often tend to circumvent interest rate ceilings “by having exorbitant markups on their goods.”²⁶ “Bound by law not to charge more than 18 percent interest on a credit sale, the ghetto merchant does not hesitate to mark up his

¹⁹ Caplovitz, *Consumers in Trouble: A Study of Debtors in Default*, at 91 (MacMillan Publishing: 1974).

²⁰ Id.

²¹ Id., at 92.

²² Id., at 37.

²³ Id., at 33.

²⁴ For example, the customer may have been quoted a cash price rather than a credit price.

²⁵ Id., at 39.

²⁶ Id., at 303.

goods by one, two, or even three numbers, each number, in this quaint jargon of the trade, representing a 100 percent increase of the wholesale price."²⁷

Summary and Conclusions

Based on the above data and analysis, FSC concluded that the use of credit scores in New Hampshire's solar programming would have an inexorable and unavoidable adverse impact on low- and moderate-income New Hampshire consumers. This use of credit scores is not a fair reflection of the creditworthiness of such New Hampshire residents and would inappropriately exclude such customers from having an ability to participate in clean energy programs.

For more information regarding the use of credit scores in determining utility creditworthiness, please write:

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Fisher, Sheehan and Colton, Public Finance and General Economics (FSC) provides economic, financial and regulatory consulting. The areas in which *FSC* has worked include energy law and economics, fair housing, affordable housing development, local planning and zoning, energy efficiency planning, community economic development, poverty and telecommunications policy, regulatory economics, and public welfare policy.

²⁷ Id.