Testimony before the

U.S. HOUSE OF REPRESENTATIVE COMMITTEE ON FINANCIAL SERVICES

SUBCOMMITTEE ON FINANCIAL INSTITUTIONS AND CONSUMER CREDIT

regarding

"An Overview of the Credit Reporting System"

September 10, 2014

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INTRODUCTION AND SUMMARY

Madame Chair, Ranking Member Meeks, and Members of the Subcommittee, the National Consumer Law Center thanks you for inviting us to testify today regarding consumer credit reporting and the need for reform. We offer our testimony here on behalf of our low income clients.[1]

Credit reports play a critical role in the economic health and well-being of consumers and their families. A good credit history (and its corollary, a good credit score) enables consumers to obtain credit, and to have that credit be fairly priced. Credit reports are also used by other important decisionmakers, such as insurers, landlords, utility providers, and unfortunately, as we discuss below, even employers. Thus, it is no exaggeration to say that a credit history can make or break a consumer's finances.

[1] The National Consumer Law Center is a nonprofit organization specializing in consumer issues on behalf of low-income people. We work with thousands of legal services, government and private attorneys, as well as community groups and organizations, from all states who represent low-income and elderly individuals on consumer issues. As a result of our daily contact with these advocates, we have seen many examples of the damage wrought by inaccurate credit reporting from every part of the nation. It is from this vantage point – many years of observing the problems created by incorrect credit reporting in our communities – that we supply these comments. *Fair Credit Reporting* (8th ed. 2013) is one of the eighteen practice treatises that NCLC publishes and annually supplements. This testimony was written by Chi Chi Wu, with assistance from Deanne Loonin, Persis Yu, and Carolyn Carter of NCLC.

As Congress stated when it passed the Fair Credit Reporting Act (FCRA), "[t]he banking system is dependent upon fair and accurate credit reporting." 15 U.S.C. § 1681(a)(1). Yet the credit reporting system in this country is neither fair nor completely accurate. As a result, tens of millions of consumers suffer from poor credit histories and low scores that result from unfair practices, inaccuracies, and fundamental flaws in the system. Poor credit histories and scores means these consumers are shut out from fairly priced credit, affordable insurance, and even jobs and apartments. Having millions of economically marginalized consumers, in turn, acts as a drag on our economy. The problems discussed in this testimony include:

- Medical debts that create negative marks on the credit reports of millions of Americans, even when the debt is the result of insurance disputes or billing errors by providers, or is ultimately settled or paid off. While recent industry changes provide a modicum of relief, more reform is necessary to adequately protect consumers from the unfair impact of medical debts on their credit reports. We strongly support H.R. 1767, the Medical Debt Responsibility Act, which would remove paid or settled medical debts from credit reports. This approach will tremendously benefit consumers, and indeed is probably the simplest and easiest "quick fix" out there to improve the credit records of an enormous number of consumers.
- The use of credit reports by nearly half of employers. Credit checks create a fundamental "Catch-22" for job applicants – a job loss prevents a worker from paying his/her bills, and the resulting damage to a credit report prevents him/her from getting a job. Yet there is no evidence that credit history can predict job performance. Its use in hiring discriminates against African American and Latino job applicants. We urge Congress to ban the use of credit reports in employment, with very limited exceptions.

- The foreclosure crisis of the late 2000s damaged the credit reports of millions of consumers, shutting them out of affordable credit, insurance, jobs and apartments. Creating a class of consumers that are shut out of so many economic benefits and necessities created a drag on the nation's economy and slowed our recovery. Helping these consumers fix the credit reporting harms caused by the foreclosure crisis would enable them to move on economically, and would in turn, would help with the nation's recovery from the Great Recession.
- The current credit reporting and scoring system is fundamentally flawed. It is an overly blunt instrument that treats consumers who have fallen on bad luck or hard times as being the same as consumers who are truly irresponsible. Many consumers have low scores because of job loss, illness, other "extraordinary life circumstances" - as well as abuse by lenders, debt collectors and others. Some of these consumers could be good borrowers after their misfortune, and would certainly be good workers.
- Credit reports are plagued by inaccuracies, such as files that mix the identities of different consumers; errors caused by debt collectors, creditors and other providers of information; and the fallout caused by identity theft. The Federal Trade Commission found that 21% of consumers had verified errors in their credit reports, 13% had errors that affected their credit scores, and 5% had errors serious enough to be denied or pay more for credit. Simple, common-sense measures could reduce this error rate.
- The nationwide consumer reporting agencies (CRAs) – Equifax, Experian, and TransUnion -- are in gross violation of the FCRA's requirements to conduct "reasonable" investigations when consumers dispute errors in their credit reports. Instead of hiring trained personnel to conduct real investigations, the nationwide CRAs do nothing more

than forwarding the dispute to the creditor, debt collector or other provider of the information – called the "furnisher" – and then automatically accepting whatever the furnisher states in response. The nationwide CRAs' automatic deference to furnishers is like a judge who finds in favor of the defendant in every single lawsuit.

For these reasons and others, the credit reporting system in the United States is in need of substantial reform. The Consumer Financial Protection Bureau (CFPB) has made significant progress on some of these problems, much to its credit for an agency that has only had authority to supervise this industry for two years. However, Congressional action is necessary for the reforms that are necessary to truly protect consumers and ensure that all Americans can fairly participate in our nation's economic system.

I. MEDICAL DEBT UNFAIRLY PENALIZES CONSUMERS

The National Consumer Law Center, on behalf of its low-income clients, is pleased to support the Medical Debt Responsibility Act, H.R. 1767. Millions of Americans struggle with overwhelming medical debts that they cannot afford to pay because they do not have health insurance. Even consumers with health insurance coverage can find that their credit histories are damaged due to medical bills, because of problems with unaffordable co-pays and deductibles, out-of-network charges, and disputes with insurance companies. While the Affordable Care Act helped by expanding insurance coverage for millions of Americans, medical debt will still remain a problem because it often afflicts consumers with insurance in the form of uncovered expenses, insurance denials, co-pays, deductibles and even billing errors.

The collective scope and impact on medical debt on the credit histories of American consumers is enormous and cannot be overstated. Nearly 75 million working age adults (or about 41%) experienced problems with medical bills in 2012.[2] In addition, 41 million adults (or about 22%) were contacted by a collection agency for unpaid medical bills.[3] Many of these collection agencies provide information about the debts that they collect to the credit reporting agencies. Thus, tens of millions of consumers are likely to have negative information about the existence of medical debt collection account on their credit reports.

Medical debt represents an enormous portion of debt that is collected by debt collectors. A number of studies indicate that the amount of medical debt that is turned over to debt collectors -- and then in turn is reported to the nationwide CRAs (Equifax, Experian, and TransUnion) -- is enormous:

- A 2003 Federal Reserve study found that over ***half*** of entries (52%) on credit reports for collection items are for medical debts.[4]
- An Ernst & Young study published in 2012 confirmed the Federal Reserve's study, finding that medical debts constituted more than ***half*** (52.2%) of the debt collected by debt collection agencies – more than twice as much as credit card and other financial debt.[5]

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[2] Sara R. Collins, et al., The Commonwealth Fund, *Insuring the Future: Current Trends in Health Coverage and the Effects of Implementing the Affordable Care Act*, April 2013, at 6, *available at* http://www.commonwealthfund.org/~/media/Files/Publications/Fund%20Report/2013/Apr/1681_Collins_insuring_future_biennial_survey_2012_FINAL.pdf (hereinafter "*Commonwealth Fund 2012 Biennial Report*").

[3] *Id.*

[4] Robert Avery, et al., *An Overview of Consumer Data and Credit Reporting*, Fed. Reserve Bulletin, at 69 (Feb. 2003).

[5] Ernst & Young, *The Impact of Third-Party Debt Collection on the National and State Economies*, Feb. 2012, at 8, *available at* www.acainternational.org/files.aspx?p=/images/21594/2011acaeconomicimpactreport.pdf.

- A 2007 study by Federal Reserve researchers found that that "health-care providers represented the most important group of customers [for debt collectors], accounting for more than a quarter of all revenues."[6]
- A 2013 Federal Trade Commission report on debt buyers found that one-third of debt purchased by debt buyers from original creditors (i.e., excluding resales) is medical debt.[7]

The vast majority of these medical debts are for small amounts. The Federal Reserve study discussed in the first bullet found that over 85% of medical debts on credit reports were for bills under $500 (about $644 adjusted for inflation).[8]

The tremendous amount of medical debt on credit reports is troubling, because unlike collections for credit accounts, medical bills result from services that are frequently involuntary, unplanned, and unpredictable, and for which prices quotes are rarely provided. Medical debt is different than other types of consumer debt for a number of reasons, including:

- **The presence of a third party payor, *i.e.*, the insurance company.** A medical bill may be turned over to a debt collector as a result of a bill being unpaid due to a dispute between the insurance company and the provider, a provider's failure to properly bill the insurer, or the insurer's failure to properly reimburse the provider. Even when errors are eventually fixed, they result in long delays during which bills

[6] Robert M. Hunt, Fed. Reserve Bank of Philadelphia, Collecting Consumer Debt in America, Bus. Rev., at 13 (2d Quarter 2007), *available at* http://www.phil.frb.org/research-and-data/publications/business-review/2007/q2/hunt_collecting-consumer-debt.pdf.
[7] Federal Trade Comm'n, Structure of Practices of the Debt Buying Industry, at T-4, T-7 (Jan. 2013), available at www.ftc.gov/os/2013/01/debtbuyingreport.pdf.
[8] Avery, et al., *supra* n. 4, at 69 (Feb. 2003).

may be sent to debt collectors. An estimated seven million Americans reported that their medical bills had been sent to a debt collector because of a billing mistake.[9]

- **Consumer confusion over the complexities of health insurance and medical billing.** One study found that nearly 40% of Americans do not understand their medical bills.[10] Some of these consumers will let a medical bill go to a collection agency because of this confusion, or they believe that their insurer will pay it.
- **The availability of insurance coverage or charity care for low-income consumers.** Low-income consumers are sometimes eligible for programs to pay their bills, including government programs (Medicaid, Children's Health Insurance Program or "CHIP," worker's compensation) or charity care.

Moreover, negative marks for medical debt remain on a consumer's credit report even after the medical debt has been fully paid or settled. Even after the bill has a balance of zero, its mere presence as a collection matter remains on the consumer's credit records for seven years and may in some cases adversely impact a consumer's credit score. Previously, medical debt would harm a consumer's credit score in all cases. A May 2014 study by the CFPB found that the presence of medical debt on a credit report unfairly penalized a consumer's credit score, resulting in a credit score that is typically lower by ten points than it should be. For consumers who have medical debt on their credit reports that were paid off, their scores were up to 22 points lower than they should be.[11]

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[9] Collins, *supra* note 2, at 6.

[10] Press Release, *Intuit Financial Healthcare Check-Up Shows Americans Confused about Medical Statements*, Apr. 27, 2010, at http://about.intuit.com/about_intuit/press_room/press_release/articles/2010/AmericansConfusedAboutMedicalStatements.html..

[11] Consumer Financial Protection Bureau, Data point: Medical debt and credit scores, May 2014, available at http://files.consumerfinance.gov/f/201405_cfpb_report_data-point_medical-debt-credit-scores.pdf.

In response to the CFPB study and general criticism over the impact of medical debt, the providers of credit scoring models have made changes to reduce the unfair penalty caused by such debt. Last month, FICO announced that it would no longer consider paid collection items (both medical and non-medical) in the latest version of its scoring model.[12] A second provider of credit scoring models, VantageScore, had already made a similar change to its scoring system in March 2013.[13] In addition, FICO has said it will give less weight to unpaid medical debts; consumers whose only negative item is unpaid medical debt can expect their score to increase up to 25 points.[14]

The changes by FICO and VantageScore will not completely eliminate the negative impact of medical debt on credit reports. The changes are voluntary and non-binding, which means they could be reversed at any time. They probably will not benefit mortgage applicants, because the changes only affect FICO's latest scoring model, FICO 09. Apparently, neither FICO 09 nor VantageScore is used by mortgage industry giants Fannie Mae and Freddie Mac.[15] Finally, they will not help job applicants with medical debt, because employers generally do not use credit scores to evaluate applicants, but review the full credit report, and thus will see the medical debt collection item.

Instead, what consumers need is for Congress to pass the Medical Debt Responsibility Act, H.R. 1767, which will fix this problem by amending the FCRA to exclude fully paid and settled medical debt from a consumer's credit report. It is a sensible and straightforward

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[12] Tara Seigel Bernard, Credit Scores Could Rise With FICO's New Model, *N.Y. Times*, Aug. 8, 2014, B3.
[13] Kevin Wack, Credit Scoring Model Bucks the Industry Line on Paid Debts, *Am. Banker*, Mar. 11, 2013 (VantageScore removing paid collection accounts from its latest scoring model).
[14] Seigel Bernard, *supra* note 12, at B3.
[15] *Id.*

approach that will prevent the credit records of millions of consumers from being unfairly tarnished.

II. USE OF CREDIT REPORTS IN EMPLOYMENT IS UNREASONABLE AND DISCRIMINATORY

The use of credit reports in employment is a practice that is harmful and unfair to American workers. Despite many good reasons to avoid engaging in this practice, about half of employers (47%) do so today,[16] a dramatic increase from only 19% in 1996.[17] One survey reported that 1 in 10 respondents who were unemployed had been informed that they would not be hired for a job because of the information in their credit reports.[18]

The use of credit reports in employment should be severely restricted for the following reasons.

- **Credit checks create a fundamental "Catch-22" for job applicants.** A simple reason to oppose the use of credit history for job applications is the sheer, profound absurdity of the practice. Using credit history creates a grotesque conundrum. Simply put, a worker who loses her job is likely fall behind on paying her bills due to lack of income. With the increasing use of credit reports, this worker now finds herself shut out of the job market because she's behind on her bills. This leads to financial spiraling effect: the worse the impact of unemployment on their debts, the harder it is to get a job to pay them off.

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[16] Society for Human Resource Management, Background Checking—The Use of Credit Background Checks in Hiring Decisions, July 19, 2012, at http://www.shrm.org/Research/SurveyFindings/Articles/Pages/CreditBackgroundChecks.aspx..
[17] Matt Fellowes, *Credit Scores, Reports, and Getting Ahead in America*, Brookings Institution, May 2006 at n.3 (citing 1996 data from the Society for Human Resource Management).
[18] Amy Traub, Discredited: Employment Credit Checks Keep Qualified Workers Out of a Job, 2012, available at www.demos.org/discredited-how-employment-credit-checks-keep-qualified-workers-out-job.

- **Use of credit checks in hiring prevents economic recovery for millions of Americans.** The use of credit history for job applicants is especially absurd after the massive job losses of the Great Recession, which resulted in unemployment rates at times of nearly 10%. For the many workers who have suffered damage from their credit reports because of unemployment or underemployment, the use of credit histories presents yet another barrier for their economic recovery – representing the proverbial practice of "kicking someone when they are down" for millions of job seekers.
- **The use of credit checks in hiring discriminates against African American and Latino job applicants.** There is no question that African American and Latino applicants fare worse than white applicants when credit histories are considered for job applications. For one thing, these groups are already disproportionately affected by predatory credit practices, such as the marketing of subprime mortgages and overpriced auto loans targeted at these populations. As a result, these groups have suffered higher foreclosure rates. Study after study has documented how, as a group, African Americans and Latinos have lower credit scores than whites.[19] Since credit scores are a translation of the information in credit reports, that means these groups fare worse when their credit reports are considered in employment.
- **Credit history does not predict job performance.** Credit reports were designed to predict the likelihood that a consumer will make payments on a loan, not whether he or she will steal or behave irresponsibly in the workplace. The overwhelming weight of evidence is that people with impaired credit histories are ***not*** more likely to be bad employees or to steal from their employers. The earliest study on this issue concluded

[19] See Appendix A - List of Studies Showing Racial Disparities in Credit Scores.

there is no correlation between credit history and an employee's job performance,[20] while a more recent study from 2011 also failed to find a link between low credit scores and theft or deviant behavior at work.[21]

- **As discussed in Section V, credit reports suffer from unacceptable rates of inaccuracy, especially for a purpose as important as use in employment.**

Fundamentally, the issue at stake is whether workers are fairly judged based on their ability to perform a job or whether they're discriminated against because of their credit history. Congress should ban the use of credit reports for employment purposes, with only very limited exceptions for a few specific job positions.

III. THE FORECLOSURE CRISIS AND GREAT RECESSION CAUSED ENORMOUS HARM TO CONSUMERS' CREDIT HISTORIES

The foreclosure crisis and the massive unemployment caused by the Great Recession saddled millions of consumers with poor credit histories. These include the over 8 million workers who lost their jobs,[22] as well as the 4.5 million families whose homes were foreclosed upon. Many of these 4.5 million foreclosures were not due to irresponsible borrowing, but phenomena such as:

- Abusive and predatory lending, such as mortgage brokers and lenders who targeted low-income and minority consumers for expensive subprime loans that they could not afford.

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[20] Jerry K. Palmer and Laura L. Koppes, *Further Investigation of Credit History as a Predictor of Employee Turnover*. Presentation to the American Psychological Society, 2003. *See also* Press Release, Society for Industrial and Organizational Psychology, Credit History Not a Good Predictor of Job Performance or Turnover, January 16, 2004, *available at* http://www.newswise.com/articles/credit-history-not-a-good-predictor-of-job-performance-or-turnover (summarizing study by Drs. Palmer and Koppes).
[21] Jeremy B. Bernerth et al, *An Empirical Investigation of Dispositional Antecedents and Performance-Related Outcomes of Credit Scores*, Journal of Applied Psychology, Oct. 24, 2011.
[22] Economic Policy Institute, The Great Recession – Job Loss, at http://stateofworkingamerica.org/great-recession/.

- The combination of exploding Adjustable Rate Mortgages (ARMs), negatively amortizing mortgage loans, and the collapse of the housing market, which left many mortgages "underwater," with the homeowner owing more than the home was worth.
- Inability to pay mortgage payments due to unemployment or underemployment caused by the Great Recession.
- Abusive servicing practices, including cramming accounts with illegal fees, failing to process loan modification requests, and gross accounting errors.

These negative impacts of a foreclosure or other mortgage-related event will last for seven years, or ten years in the case of bankruptcies, as these are the current time limits under the Fair Credit Reporting Act for adverse information to remain on a credit report. Thus, consumers who have gone through a foreclosure or other adverse mortgage event are shut out of affordable credit markets for seven years (or ten years, in the case of bankruptcies), and unable to obtain reasonably priced auto loans or credit cards. The damage from a foreclosure or other adverse mortgage-related event could cause a consumer to be denied a job, lose out on a rental apartment after losing his or her home, and pay hundreds of dollars more in auto insurance premiums. The cumulative impact of these financial calamities could strand a consumer economically for years after the foreclosure itself. It could create a self-fulfilling downward spiral in a consumer's economic life.

The depressed credit scores from the foreclosure crisis and the Great Recession also impeded the country's economic recovery. According to some analysts, the Federal Reserve's effort to stimulate the economy with low interest rates has been less than effective because many of the consumers who could most benefit from these rates do not qualify for loans due to low credit scores.[23] In turn, the lack of ability to access low rates means these consumers have less ability to open small businesses or engage in household spending, the very steps needed to help our economy. In an ironic way, credit scoring and reporting have created a vicious cycle – economic harm causes low scores, low scores prevent recovery by shutting out the consumer from benefits that require a high score, and the consumer's lack of recovery drags down the economy as a whole.

The drag on recovery by consumers' low scores is exacerbated by lenders that currently require even higher credit scores to qualify for mortgage loans. The average credit scores required for Fannie Mae/Freddie Mac/Federal Housing Administration (FHA) home-purchase mortgages appears to be 50 points higher than it was before the foreclosure crisis and Great Recession,[24] putting affordable credit even more out of the reach of consumers who were most harmed by these events.

The credit reporting damage from the foreclosure crisis was bad enough, creating an economic blacklist affecting millions of consumers. This damage is exacerbated and compounded by the errors, problems, and anomalies caused by servicers and lenders and the credit reporting industry. Examples of errors and anomalies include:

[23] Jon Hilsenrath, Fed Wrestles with How Best to Bridge U.S. Credit Divide, Wall St. J., June 19, 2012.
[24] Jim Parrott and Mark Zandi, Moody's Analytics and Urban Institute, Opening the Credit Box, Sept. 30, 2013, *available at* www.urban.org/UploadedPDF/412910-Opening-the-Credit-Box.pdf.

- Reporting short sales as foreclosures. This error is caused because there is no specific code in the standardized format for credit reporting (called the “Metro 2 format”) for a short sale.
- Servicers and lenders that seek to collect deficiencies after a short sale or a foreclosure. These collection activities include reporting the deficiency as a collection item on the consumer’s credit report, with the resulting harm to the consumer’s credit score.
- Credit reports not reflecting the terms of a loan modification. Some servicers and lenders continue to report the mortgage as delinquent, per the original terms, even though the consumer is paying in compliance with the terms of the new modified loan terms.
- Issues regarding loan modification reporting. The code used for loan medications, code AC - “Paying under a partial payment agreement”[25] results in a significant lowering of the consumer’s credit score.[26]

These issues are discussed in depth in our report, *Solving the Credit Conundrum: Helping Consumers' Credit Records Impaired by the Foreclosure Crisis and Great Recession*, which is attached to this testimony.

Congress should act to protect consumers and jump start the economy. In particular, Congress should:

1. Require that adverse information be removed earlier than seven years. The FCRA should be amended to shorten the time periods for negative information to three or four years. There is nothing special about the current seven-year time limit for negative information under the FCRA. It is certainly not universal. For example, the time limits

[25] Consumer Data Industry Association, Credit Reporting Resources Guide (2012), at 5-21 (a.k.a. the Metro 2 Manual).
[26] Experian, *Ask Max Credit Advice--Negotiating Reduced Payments Can Hurt Credit Scores*, Oct. 28, 2009, *available at* www.experian.com/ask_max/max102809a.html.

in Sweden and Germany – countries that are as economically vibrant and prosperous as the United States – are three and four years, respectively.

2. Require that adverse mortgage information be completely removed in certain circumstances. Negative mortgage-related information should be removed even before a three- or four-year period if the consumer was the victim of lender abuse, or has taken steps to mitigate the loss to the lender, such as a short sale, a deed-in-lieu of foreclosure, or a loan modification. Negative information should also be removed if the mortgage is eligible for relief under settlements negotiated by government agencies with mortgage servicers or lenders, such as the National Mortgage Settlement and the Independent Foreclosure Review (IFR) Payment Agreement. These settlements address abuses by servicers and lenders that resulted in foreclosures, and the borrowers who are entitled to relief should not have their credit reports marred by negative information caused by the servicer or lender.

IV. NEGATIVE CREDIT REPORTS MORE OFTEN REFLECT BAD LUCK, NOT BAD CHARACTER

One of the most pernicious aspects of the use of credit reporting is its use as a proxy for “character.” There is a popular conception, not just in the credit industry, but also among employers and the average layperson, that a poor credit score means that the consumer is irresponsible, a deadbeat, lazy, dishonest, or just plain sloppy. However, this stereotype is far from the truth. A bad credit record is often the result of circumstances beyond a consumer’s control, such as a job loss, illness, divorce, or death of a spouse, or a local or nationwide economic collapse.

The current credit reporting and scoring system is fundamentally flawed because it is an overly blunt instrument that lumps together defaults and negative events that are caused by very different triggers. Credit scores assume that a foreclosure due to illness resulting in job loss and crippling medical bills should be treated the same, and has the same predictive value, as a foreclosure because the borrower was a real estate investor who abandoned the property. Yet these are two fundamentally different phenomena, and likely two very different consumers.

Indeed, many foreclosures were not caused by bad decisions that borrowers made. Going back more than a decade, origination fraud and abuse by the mortgage industry was endemic – mortgages brokers falsified applications, obtained inflated appraisals, and sold unaffordable products to unsuspecting homeowners, such as adjustable rate mortgages in which the interest rate skyrocketed after the initial “teaser” period. When a loan is abusive, the failure to repay it tells nothing about the borrower’s creditworthiness. Another problem is that during the foreclosure crisis, many homeowners who should have been processed for a loan modification were not provided with one. If two homeowners are identically situated, and one gets a loan modification but the other does not, it’s hardly fair or useful to reflect that arbitrary result in their credit scores.

The overly crude lumping together of very different consumers makes credit scores less than optimally predictive. This is reflected in, and probably responsible, for the fact that scores are actually quite inaccurate and unpredictive on an individual level. While they can predict the probability that as a group, low-scoring consumers will have a certain percentage of defaults, they cannot predict if any particular person will actually engage in the behavior. *In fact, often the probability is greater that a particular low-scoring person will not engage in the negative behavior.*

For example, a score of between 500 and 600 is generally considered to be a poor score. Yet at the beginning of the foreclosure crisis in 2007, only about 20% of mortgage borrowers with a credit score in that range were seriously delinquent.[27] Thus, if a score of 600 is used as a cut-off in determining whether to grant a loan, the vast majority of applicants who are denied credit would probably *not* have become seriously delinquent.

A study by a Federal Reserve researcher and a Swedish scientist, based on consumers in Sweden, similarly found that most consumers with impaired credit did not engage in negative behavior again. The study found that, from the population of consumers with negative information in their credit reports who received credit after the mark was removed, only 27% defaulted again within two years.[28] The researchers reached a conclusion that the reason for this low level of default is that many of the consumers with impaired credit ended up with negative marks due to circumstances outside of their control. The researchers noted that their results suggested:

> the possibility that for some proportion of the borrowers, the credit arrear may have been due to some temporary factor or tremble – illness, accident, or mistake – that was not reflective of their underlying type, and that [a] fresh start may improve the accuracy with which these borrower types are reflected. It is possible that, in this case, lenders punish trembles that they cannot easily differentiate from the behavior of bad types.[29]

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[27] Yuliya Demyanyk, *Did Credit Scores Predict the Subprime Crisis*, The Regional Economist (Federal Reserve Bank of St. Louis Oct. 2008), *available at* www.stlouisfed.org/publications/re/articles/?id=963. *See also* VantageScore Solutions, L.L.C., VantageScore 2.0: A New Version for a New World, 2011 (consumers with VantageScore of 690 - 710, or borderline between “C” and “D” grade, have about a 9% risk of default).

[28] Marieke Bos and Leonard Nakamura, Federal Reserve Bank of Philadelphia, Working Paper No. 12-19/R, Should Defaults Be Forgotten? Evidence from Quasi-Experimental Variation in Removal of Negative Consumer Credit Information, Apr. 2013, at 1, *available at* www.philadelphiafed.org/research-and-data/publications/working-papers/2012/wp12-29R.pdf

[29] *Id* at 4.

Thus, it is such "extraordinary life circumstances" within a consumer's life that are often responsible for the delinquencies, defaults, and foreclosures – *not* bad character, but bad luck. The problem with scoring and reporting is that it exacerbates and entrenches the harm from such circumstances, perpetuating the consumer's decline for at least another seven years. Not only might a consumer lose her home due to these events, but the foreclosure notation will hinder her recovery by denying her future credit, an apartment, and perhaps even a job. Even if the consumer gets a new job, the black marks from the foreclosure will follow her and result in higher prices for credit and insurance, costing hundreds or thousands more. This will, in turn, make it harder for her to pay those insurance or credit bills, and strain her economic recovery.

Furthermore, the credit reporting system, especially foreclosure and adverse mortgage-related information, perpetuate and exacerbate the income and wealth gaps between whites and minority groups. Because African American and Latinos were disproportionately targeted for predatory credit practices, such as the marketing of subprime mortgages and overpriced auto loans targeted at these populations, these groups have suffered higher foreclosure rates.[30] In addition, numerous studies have documented how, as a group, African Americans and Latinos have lower credit scores than whites.[31]

We need a better way to judge consumers. We need a system that can distinguish between consumers who are truly irresponsible and those who simply fell on hard times. We need a system that can take into account both economic factors and extraordinary life circumstances particular to an individual consumer. And, we need a system that does not further widen the huge economic chasm between whites and minorities.

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[30] Debbie Gruenstein Bocian, Wei Li, and Keith S. Ernst, Center for Responsible Lending, Foreclosures by Race and Ethnicity: The Demographics of a Crisis, June 18, 2010, *available at* www.responsiblelending.org/mortgage-lending/research-analysis/foreclosures-by-race-and-ethnicity.pdf.

[31] *See* Appendix A - List of Studies Showing Racial Disparities in Credit Scores.

V. HIGH STUDENT LOAN DEBT DAMAGES BORROWERS' CREDIT REPORTS

The amount of student loan debt in this country is exploding, burdening millions of consumers. Currently, there are more than 39 million borrowers carrying over $1 trillion in federal student loan debt, and there are billions more in private student loan debt. All of these loans show up on the credit reports of these borrowers.

Large debt loads can be harmful, especially for young graduates who are unemployed or employed in low-paying jobs. Their inability to make payments will damage their credit records, creating negative marks that will follow them for seven years or – in the case of some federal student loans – much longer. Unmanageable student loan debts can cause also financial distress that affects the borrower's ability to pay other loans, such as credit cards and auto loans. These issues are especially pronounced for students who obtained little benefit from their "education," such as victims of trade school fraud or other abuse.

Even when the borrower is able to make payments, large debt loads can also be harmful. High debt loads could lower a credit scores, since one of the factors in a credit score is how "maxed out" a consumer is. Large amounts of student loan debt will make the borrower appear very maxed out, especially if the debt exceeds the original loan amount as in the case of student loan deferments. Also, employers use credit reports in hiring, and some may look disfavorably upon high student loan debt loads in their employment decisions. Indeed, one survey reported that 67% of surveyed employers had "little-to-no interest" in job applicants with student loan debts over $50,000.[32] The same survey found that nine out of ten hiring employers reported they are reviewing the credit reports of job applicants to get an idea of applicants' total student loan debt.

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[32] Press Release, Black Book Research Releases 2014 Student Loan Data: Fewer Major Companies Hiring High Debt College Grads, More Grads Expect Government Loan Bailout to Erase Debts, June 13, 2014, available at http://www.prweb.com/releases/2014/06/prweb11928115.htm.

VI. COMMON ERRORS IN CREDIT REPORTING

Despite the importance of accurate credit reports and the purpose of the FCRA to promote accuracy, systematic errors are unfortunately common in the credit reporting system. In December 2012, the Federal Trade Commission (FTC) released the definitive study on the level of inaccuracies in credit reports.[33] The study, found that about 21% of consumers had verified errors in their credit reports, 13% had errors that affected their credit scores, and 5% had errors serious enough to be denied or pay more for credit.

The rate of inaccuracy found by the FTC study is unacceptable. It translates into 40 million American who have errors in their credit reports, 26 million of whom have lower scores as a result, and 10 million of whom have errors seriously damaging enough to cause them to be denied or charged more for credit or insurance or even be denied a job.

There are many types of errors in credit reports; we focus on a few of the most egregious. Most importantly, these errors are entirely preventable with some common-sense measures.

A. Mixed Files

One of the most intractable and damaging types of credit reporting errors are mixed or mismerged files. Mixed files occur when credit information relating to one consumer is placed in the file of another. Mismerging occurs most often when two or more consumers have similar names, Social Security numbers (SSNs), or other identifiers (for example, when information relating to John J. Jones is put in John G. Jones' file).

Mixed files are unfortunately not an uncommon problem. When the *Columbus Dispatch* conducted a year-long investigation of credit reporting errors that included a review of credit reporting complaints to the FTC and state Attorneys General during a 30 month period, the

[33] Federal Trade Comm'n Report to Congress Under Section 319 of the Fair and Accurate Credit Transactions Act of 2003 (Dec. 2012).

reporters found that about 6% of the 21,600 complaints to the FTC and 8% of 1842 complaints to state Attorneys General involved mixed files.[34]

Mixed files occur largely because the nationwide CRAs do not use sufficiently rigorous criteria to match consumer data precisely. Mostly importantly, they do not match information based on all nine (9) digits of the consumer's SSN. Instead, they will match information based on seven of nine (7 of 9) digits of an SSN if the consumers' names are also similar.

Mixed files could be prevented by requiring the nationwide CRAs to use stricter matching criteria when placing information into a consumer's credit report, most critically an exact match of SSNs. However, the nationwide CRAs have chosen to be excessively and unreasonably over-inclusive because, as the FTC once noted: "lenders may prefer to see all potentially derogatory information about a potential borrower, even if it cannot all be matched to the borrower with certainty. This preference could give the credit bureaus an incentive to design algorithms that are tolerant of mixed files."[35]

The nationwide CRAs have been aware of mixed file errors for decades. In the early to mid-1990s, the FTC reached consent orders with the nationwide CRAs requiring them to improve their procedures to prevent mixed files.[36] However, nearly two decades later, mixed files remain a significant problem.

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[34] Michael Wagner and Jill Reipenhoff, *Credit Scars: Mixed and Marred*, Columbus Dispatch, May 7, 2012.
[35] Federal Trade Commission, *Report to Congress Under Sections 318 and 319 of the Fair and Accurate Credit Transactions Act of 2003*, at 47 (Dec. 2004).
[36] FTC v. TRW, Inc., 784 F. Supp. 361 (N.D. Tex. 1991), *amended by* (N.D. Tex. Jan. 14, 1993); In the Matter of Equifax Credit Information Services, Inc., 61 Fed. Reg. 15484 (Apr. 8, 1996) (consent order).

B. Identity Theft

With an estimated eleven million consumers victimized by some form of the crime every year,[37] identity theft itself presents a serious source of inaccuracies in the credit reporting system. The identity thief, however, is not the only culprit. The nationwide CRAs and furnishers bear a share of the blame as well.

The nationwide CRAs' loose matching procedures, discussed above, contribute to identity theft problems. For example, if a thief has only adopted the victim's first name and SSN but not his or her last name or address, the algorithm used by nationwide CRAs to "merge" information often will incorporate the thief's information into the victim's file at the time the bureau compiles the report. Once the fraudulent debt is reported, often after default and non-payment, and especially when collectors begin attempting skip trace searches, the account ends up merged into the victim's file even though many of the identifiers do not match. Accordingly, the "identity theft" can be characterized as a special type of mixed file problem.

C. Furnisher errors

Furnishers can often be the source of errors in credit reports. A furnisher might report the consumer's account with an incorrect payment history, current payment status, or balance. The error might be due to a misapplied payment or data entry error. In the most egregious cases, furnishers will identify the incorrect consumer as owing a debt.

A recent CFPB enforcement action demonstrates how furnishers can cause errors. In that case, a subprime auto lender systematically made errors over about a two-year period that affected thousands of consumers. The lender over-reported the number of late payments, over-reported the amount of delinquencies, and under-reported the amount of payments actually made

[37] Javelin Strategy & Research, 2010 Identity Fraud Survey Report: Consumer Version 5 (2010) .

by consumers. It also erroneously reported instances in which a consumer voluntarily surrendered a vehicle as "involuntary repossessions."[38]

Another type of common error is the failure to mark accounts as disputed when the consumer has a legitimate bona fide dispute with the furnisher. Marking an account as disputed is required both under the FCRA as well as numerous federal consumer protection laws, such as the Fair Credit Billing Act, the Fair Debt Collection Practices Act and the Real Estate Settlement Procedures Act. One of the CFPB's first enforcement actions (conducted jointly with the FDIC) involved allegations that American Express failed to report disputes about credit accounts to the nationwide CRAs, in violation of Section 623(a) of the FCRA, 15 U.S.C. § 1681s-2(a).[39]

Debt collectors and debt buyers present their own special types of credit reporting errors. These include errors created by the fact that debt buyers and collectors often obtain nothing more than a list of names and SSNs of alleged debtors. Typically, the debt buyer or debt collector does not get any of the critical supporting documentation to establish that the consumer actually owes the debt, it is the correct amount, whether there are any disputes, or even if the collector is dunning the correct consumer. Another problem is the "re-aging" of old accounts so that they stay on the credit report past the FCRA's seven year limit. [40]

A report issued by the CFPB indicates that a disproportionate number of credit reporting errors involve debt collectors. This December 2012 CFPB Report finds that debt collectors

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[38] *See* Consent Order, In the Matter of First Investors Financial Services Group, Inc., Administrative Proceeding File No. 2014-CFPB-00012 (CFPB Aug. 20, 2014), *available at* http://files.consumerfinance.gov/f/201408_cfpb_consent-order_first-investors.pdf.
[39] CFPB/FDIC Consent Order with American Express subsidiaries (*In Re: American Express Centurion Bank*, File No. 2012-CFPB-0002; *In Re: American Express Bank, FSB*, File No. 2012-CFPB-0003; and *In Re: American Express Travel Related Services Co. Inc.*, File No. 2012-CFPB-0004, all issued Oct. 1, 2012) *available at* http://www.consumerfinance.gov/pressreleases/cfpb-orders-american-express-to-pay-85-million-refund-to-consumers-harmed-by-illegal-credit-card-practices/.
[40] The CFPB enforcement action, *supra* note 38, involved re-aging. In that case, the furnisher reported an incorrect "Date of First Delinquency," which is the operative date that starts the FCRA time limits for obsolete information, for up to 7,000 accounts.

generate 40% of disputes to the nationwide CRAs, despite providing only 13% of the account tradeline information in credit reports.[41] The FTC study on errors in credit reports similarly found that 32.2% of disputed items were collection accounts.[42]

D. Solutions

The solutions necessary to solve some of the above problems and to ensure "maximum possible accuracy" for credit reports are simple and straightforward. They include:

1. Requiring the nationwide CRAs to use stricter matching criteria, including matching information based on all nine digits of the consumer's SSN. At a minimum, the CFPB should engage in a rulemaking that considers imposing such a requirement.

2. In general, the CFPB should establish certain minimum procedures required of the nationwide CRAs to maintain the "maximum possible accuracy" required by the FCRA.

3. The nationwide CRAs should be required to screen and audit data from furnishers, including analyzing whether certain furnishers are significant sources of errors. They should be required to stop accepting data from furnishers with excessively high numbers of errors.

Finally, one of the most important safeguards for accuracy is the dispute system mandated by the FCRA. Yet as discussed in the next section, this dispute system is broken, and needs significant reform.

[41] Consumer Financial Protection Bureau, *Key Dimensions and Processes in the U.S. Credit Reporting System: A review of how the nation's largest credit bureaus manage consumer data*, December 2012, at 14, 29, available at http://www.consumerfinance.gov/reports/key-dimensions-and-processes-in-the-u-s-credit-reporting-system.

[42] Federal Trade Commission, *supra* note 33, at 51.

VII. THE FCRA-MANDATED CREDIT REPORTING DISPUTE SYSTEM IS A TRAVESTY OF JUSTICE

The FCRA dispute system developed by the credit reporting industry is a travesty of justice. The FCRA requires both CRAs and furnishers to conduct "reasonable" investigations when a consumer disputes an item in his or her credit report as inaccurate or incomplete. However, the system created by the nationwide CRAs to handle disputes is anything but reasonable. Instead, it is a perfunctory process that consists of nothing more than forwarding the consumer's dispute to the furnisher, and parroting whatever the furnisher states in response.

Indeed, prior to mid-2013, the nationwide CRAs did not even bother to send the entire dispute to the furnisher. Instead, the CRA's offshore vendor[43] merely reduced the dispute to a two or three digit code and sent that code alone and without supporting documentation provided by the consumer - documents such as account applications, billing statements, letters, payoff statements and even court judgments that showed overwhelming and even conclusive proof.

After over a decade of criticism by consumer groups and courts, the nationwide CRAs finally began to send the entire dispute to the furnisher in the middle of 2013 – coincidentally the year after the CFPB began supervising the nationwide CRAs. However, this change is a necessary, but not a sufficient, measure to reform the credit reporting dispute system.

The fundamental problem with the credit reporting dispute process is the utter and complete bias against consumers by the nationwide CRAs. After a furnisher responds to an FCRA dispute, the nationwide CRAs' main response is to parrot whatever the furnisher says. The CRAs will accept the results of the furnisher's "investigation" even when a simple check would reveal inconsistent information. In other words, the nationwide CRAs' policies are that what the furnisher says is gospel, even when that furnisher is a bad actor with a history of

[43] Usually located in India, the Philippines, Chile, or Costa Rica.

violations.   We believe this absolute bias in favor of the furnisher in dispute investigation violates the FCRA.

In fact, a number of courts have chastised the nationwide CRAs for this parroting, and their general failure to do no more than send an ACDV to the furnisher and accept its response. In *Saindon v. Equifax Information Services*,[44] the Northern District of California noted in 2009 that:

> …the monitoring and reinvestigation procedures could be seen as quite limited. The procedures could be seen by a jury as merely basic automated checks that catch missing data fields on submitted forms, which do not go to the heart of whether a source of information is trustworthy. For example, when a consumer files a complaint contesting the accuracy of an item on his or her credit report, the sole action taken by Equifax is to contact the source of the information to verify if it is accurate. If the source says that it is, the inquiry ends (Rittelmeyer Decl. ¶ 8.). This does virtually nothing to determine the actual credibility of the source--which is what plaintiff asserts is lacking--or so a jury could reasonabl[y] conclude.

Another judge in this same district noted in 2010 that Equifax's history of deferring to furnishers rather than performing independent investigations, along with consent agreements with FTC and state Attorneys General, provided sufficient evidence for jury to find that the CRA ran an unjustifiably high risk of violating the FCRA.[45]   In *Dixon-Rollins v. Experian Info.*

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[44] 608 F. Supp. 2d 1212, 1217 (N.D. Cal. 2009).

[45] Drew v. Equifax Info. Serv., 2010 WL 5022466 (N.D. Cal. Dec. 3, 2010), *aff'd*, 690 F.3d 1100 (9th Cir. 2012). *See also* Gorman v. Experian Info. Solutions, Inc., 2008 WL 4934047, at *6 (S.D.N.Y. Nov. 19, 2008)("Given the standard articulated in *Cushman* and Experian's claimed sole reliance on the information it received from HSBC, a jury could conclude that Experian did not reinvestigate Plaintiff's dispute in accordance with the requirements of the 15 U.S.C. § 1681" and acted in reckless disregard of the law).

Solutions,[46] the Eastern District of Pennsylvania noted that "the Third Circuit had already warned Trans Union that its reinvestigation procedures were deficient. The *Cushman* decision clearly instructs consumer reporting agencies that they must go beyond the original source in certain circumstances." The District Court characterized Trans Union's behavior as reprehensible, stating "because Trans Union has been warned of its inadequate reinvestigation practices in prior cases, it may be considered a repeat FCRA offender."[47]

The nationwide CRAs' bias in favor of furnishers – their unquestioning acceptance of the furnisher's response despite being presented with evidence and documentation by the consumer – violates the FCRA's protection for consumers. The FCRA places the burden of proof in a dispute investigation *on the furnisher*, not the consumer, as the Act provides that if disputed information is inaccurate *or cannot be verified*, it should be deleted. *See* 15 U.S.C. § 1681i(a)(5)(A). Thus, if a consumer provides evidence and documentation that she is correct, and the furnisher responds without such evidence, the disputed information is "unverifiable" by nature, and should be deleted. Yet the nationwide CRAs not only illegally place the burden of proof on the consumer, they go further by always siding with the furnisher and automatically accepting the furnisher's position – even when, in 40% of the cases, the furnisher is a debt collector or debt buyer.

For their part, some furnishers also conduct non-substantive and perfunctory "investigations." These procedures consist of nothing more than verifying the challenged data by comparing the notice of dispute with the recorded information that is itself the very subject of the dispute. For example, in its enforcement action against debt buyer Asset Acceptance, the FTC also noted that Asset only employs 14 to 20 "ACDV specialists" despite receiving half a

[46] 753 F. Supp.2d 452, 464 (E.D. Pa. Sept. 23, 2010)
[47] Id. at 465.

million credit reporting disputes each year, and expects each each specialist to process at least 18-20 ACDVs per hour – ***or one dispute every 3.33 minutes***.[48]

Unsurprisingly, this last example involves a debt collector. As the CFPB's December 2012 report noted, and as mentioned above, debt collectors represent 40% of all credit reporting dispute, a disproportionate share given that they only provide 13% of the account tradelines on credit reports. Furthermore, debt collectors have little incentive to correct errors in response to a dispute, especially since removing negative information may mean losing the opportunity to collect the debt, which is their main objective. Unlike with a creditor, the consumer is not the debt collector's customer, and has no reason to maintain a good relationship with the consumer. To a debt collector or buyer, it does not matter if the amount is wrong, there is a dispute as to liability, or they have the wrong consumer – so long as they can use the credit report to pressure the consumer to pay up.

It is well past time for the credit reporting dispute system to be reformed. For too long, consumers with the misfortune of being plagued by errors have suffered under an illegal, illogical, and unjust system. Reforming the system will take the efforts of both the CFPB and Congress.

First, the nationwide CRAs must be required to have sufficient trained personnel to actually review and conduct real, independent investigations of consumer disputes. They must be required – as the FCRA and court decisions mandate – to undertake "reasonable" investigations that consist of a "detailed inquiry or systematic examination"[49] of the evidence. This means talking to consumers and furnishers, examining documents in a meaningful manner,

[48] Complaint, United States v. Asset Acceptance, LLC, Case No. 8:12-cv-182-T-27 (M.D. Fla. Jan 30, 2012), at ¶¶44 and 45.
[49] Johnson v. MBNA, 357 F.3d 426, 430-431 (4th Cir. 2004).

using human judgment to analyze a dispute, and making independent decisions. Thus, the nationwide CRAs must provide skilled trained personnel with the discretion to make decisions.

This will require a significant investment of resources by the nationwide CRAs, especially in terms of personnel. But as the court in the Eastern District of Virginia noted:

> While this obligation to conduct a reasonable investigation may increase the cost and expense to a CRA, it is the necessary cost associated with discharging the congressionally mandated duties placed upon a company choosing to engage in a business that can have such a profound and lasting impact on consumers,…[50]

The credit reporting industry will complain, as it often does, that it is not a tribunal or a small claims court. But a CRA need not act as a small claims court to simply determine that information that a consumer owes a debt is inaccurate when the consumer has a bank statement, an executed loan modification, or even a judgment showing that he or she does not owe the debt. Furthermore, in those circumstances where the CRA personnel truly cannot determine whether the consumer or the furnisher is correct, the information should be deleted. After all, the FCRA requires information to be deleted if it "cannot be verified." *See* 15 U.S.C. § 1681i(a)(5)(A).

Another measure to protect consumers when they have a good faith dispute with the furnisher is to mark the debt as such, and exclude it from the credit score. Currently, only some types of disputed debt are excluded from a credit score, and the dividing line is unclear and shifting. Furthermore, exclusion of some disputed debts from the credit score is entire voluntary and the industry could change its mind any time and start scoring all disputes. Congress should require that all debts that are the subject of a dispute on a credit report must be excluded from a credit score, unless the furnisher or CRA can prove that the dispute is frivolous or irrelevant. Lenders should be prohibited from using disputed information adversely.

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[50] Burke v. Experian Info. Solutions, 2011 WL 1085874 (E.D. Va. Mar. 18, 2011).

Debt collectors must be subject to even stricter screening and oversight. When a debt collector is involved, it is even more critical to have independent review, given the incentives discussed above for the debt collector to ignore disputes and leave errors uncorrected. And there should be a flat-out prohibition against the nationwide CRAs to engage in parroting when a debt collector is involved. It is simply outrageous and unacceptable for the nationwide CRAs to take the unsupported, unsubstantiated word of a debt collector over a consumer, given the incentives that exist and the well-documented abuses of debt buyers.[51]

Finally, we urge Congress to give consumers the right to ask a judge to tell a furnisher or a CRA: "fix that error." With one minor exception, the FCRA does not provide for declaratory or injunctive relief in actions by private parties. Providing courts with explicit authority to issue injunctive relief would further the purpose of the FCRA to "assure maximum possible accuracy."

VIII. OTHER ISSUES

Beyond the issues addressed above, there are other areas where Congressional action is necessary to ensure that our nation's credit reporting system works fairly for consumers and the general marketplace. They include:

A. Free Credit Scores

Currently, consumers do not have the legal right to a free credit score, unless they are denied credit, must pay a higher price, or after they apply for a mortgage. Consumers should have the right under the FCRA to a free credit score on an annual basis. Ideally, they should

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[51] See Federal Trade Commission, Repairing a Broken System: Protecting Consumers in Debt Collection and Arbitration (July 2010), *available at* http://www.ftc.gov/os/2010/07/debtcollectionreport.pdf; Robert Hobbs and Rick Jurgens, National Consumer Law Center, The Debt Machine (July 2010), *available at* http://www.nclc.org/images/pdf/debt_collection/debt-machine.pdf; Claudia Wilner and Nasoan Sheftel-Gomes, Neighborhood Econ. Dev. Advocacy Project and Urban Justice Center, Debt Deception: How Debt Buyers Abuse The System To Prey On Lower-Income New Yorkers 1 (May 2010), *available at* http://www.nedap.org/pressroom/documents/DEBT_DECEPTION_FINAL_WEB.pdf.

have the right to obtain a copy of the credit score most commonly used by lenders. Consumers should also have the right to obtain other types of scores based on their credit or consumer reports, such as insurance credit scores, tenant screening scores, or healthcare scores.

B. Credit Monitoring

The nationwide CRAs and other companies market "free" consumer reports that are not free at all, but are only introductory teasers that convert to an expensive "credit monitoring" subscription. The nationwide CRAs heavily promote these products, including on their websites, in effect steering consumers away from the centralized source for federally-mandated free credit reports, annualcreditreport.com. As a result, more consumers actually ended up obtaining their credit reports through these products than through annualcreditreport.com. According to the CFPB, 15.9 million consumers obtained free annual credit reports through annualcreditreport.com, but 26 million obtained them through various credit monitoring services.[52]

These credit monitoring services are often marketed as a way to prevent identity theft, but they can be ineffective in detecting certain forms, such as when a thief uses the consumer's Social Security number, but not the consumer's name, to obtain credit. Also, the manner in which these credit monitoring products are sold has been questionable at best. The CFPB has taken four enforcement actions over the sale of credit monitoring and other add-on products by credit card companies.[53]

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[52] Consumer Fin. Prot. Bureau, Key Dimensions and Processes, *supra* note 41, at 27 (2012).
[53] *See* Consent Order, In the Matter of Bank of America, N.A., Administrative Proceeding File No. 2014-CFPB-0004 (CFPB Apr. 9, 2014), *available at* http://files.consumerfinance.gov/f/201404_cfpb_bankofamerica_consent-order.pdf; Consent Order, In the Matter of JPMorgan Chase Bank, N.A., Administrative Proceeding File No. 2013-CFPB-0007 (CFPB Sept. 18, 2013), *available at* http://files.consumerfinance.gov/f/201309_cfpb_jpmc_consent-order.pdf; Stipulation and Consent Order, In re Capital One Bank, Admin. Proc. File No. 2012-CFPB-0001 (CFPB July 17, 2012), *available at* http://files.consumerfinance.gov/f/201207_cfpb_consent_order_0001.pdf;

C. Utility Data

We remain concerned about efforts to encourage utility companies to report payment information on a monthly or regular basis to credit reporting agencies without adequate consumer protections. A discussion of our concerns is set forth in detail in our prior testimony to this subcommittee.[54]

IX. CONCLUSION

American consumers deserve a credit reporting system that is accurate, fair and just. Helping consumers obtain such a system also helps the American economy. To achieve these goals, Congress should:

- Pass the Medical Debt Responsibility Act, H.R. 1767, which would exclude fully paid and settled medical debt from a consumer's credit report.
- Ban the use of credit reports for employment purposes, with very limited exceptions for only a few specific job positions.
- Shorten the time periods that negative information stays on a credit report to three or four years.
- Require that adverse mortgage information be completely removed in certain circumstances, including if the consumer was the victim of lender or servicer abuse, or the mortgage is eligible for relief under government settlements.

Joint Consent Order, Order for Restitution, and Order to Pay Civil Money Penalty, In re Discover Bank, Greenwood, DE, Docket Nos. FDIC-11-548b, FDIC-11-551k, and 2012-CFPB-0005 (FDIC/CFPB Sept. 24, 2012), *available at* http://files.consumerfinance.gov/f/201209_cfpb_consent_order_0005.pdf.

[54] Examining the Uses of Consumer Credit Data, Hearing Before U.S. House Comm. on Fin. Serv, Subcomm. on Fin. Institutions and Consumer Credit , 113th Congr. (2012)(testimony of Chi Chi Wu, National Consumer Law Center).

- Require the nationwide CRAs to use stricter matching criteria, including matching information based on all nine digits of the consumer's SSN, or require the CFPB to engage in a rulemaking that considers imposing such a requirement and in general establishing minimum procedures to ensure "maximum possible accuracy."
- Require the nationwide CRAs to have sufficient trained personnel to actually review and conduct real, independent investigations of consumer disputes.
- Require that all debts that are the subject of a dispute on a credit report be excluded from a credit score, unless the furnisher or CRA can prove that the dispute is frivolous or irrelevant, and prohibit lenders from considering disputed debts adversely.
- Provide consumers with the right to seek injunctive and declaratory relief.
- Provide consumers with a free annual credit score.

Appendix A

List of Studies Showing Racial Disparities in Credit Scores

- A 2012 study by the CFPB examining credit scores for about 200,000 consumers found that the median FICO score for consumers in majority minority zip codes was in the 34th percentile, while it was in the 52nd percentile for zip codes with low minority populations. Cite: Consumer Financial Protection Bureau, Analysis of Differences Between Consumer- and Creditor-Purchased Credit Scores, at 18, Sept. 2012.

- A 2010 study by the Woodstock Institute found that in predominately African American zip codes in Illinois, over 54.2% of the individuals had a credit score of less than 620. In comparison, 20.3% of Illinois residents statewide had a credit score of less than 620, and only 16.8% of individuals in predominately white zip codes had a credit score of less than 620. In white zip codes, 67.3% of residents had a better than a 700 credit score, while 25% of individuals in predominantly African-American zip codes had credit scores above 700. In zip codes that were majority Latino, 31.4% of individuals had a credit score of less than 620, and only 47.3% had credit scores greater than 700. Cite: Sarah Duda & Geoff Smith, Woodstock Institute, Bridging the Gap: Credit Scores and Economic Opportunity in Illinois Communities of Color 8 (Sept. 2010).

- A 2007 Federal Reserve Board report to Congress on credit scoring and racial disparities, which was mandated by the 2003 Fair and Accurate Credit Transactions Act of 2003 (FACTA). This study analyzed 300,000 credit files matched with Social Security records to provide racial and demographic information. While the Federal Reserve's ultimate conclusion was to support credit scoring, its study found significant racial disparities. In one of the two models used by the Federal Reserve, the mean score of African Americans was approximately half that of white non-Hispanics (54.0 out of 100 for white non-Hispanics versus 25.6 for African Americans) with Hispanics fairing only slightly better (38.2). Cite: Board of Governors of the Federal Reserve System, *Report to the Congress on Credit Scoring and Its Effects on the Availability and Affordability of Credit* 80-81 (Aug. 2007).

- A 2007 study by the Federal Trade Commission on racial disparities in the use of credit scores for auto insurance, also mandated by the 2003 FACTA amendments. The FTC study found substantial racial disparities, with African Americans and Hispanics strongly over-represented in the lowest scoring categories. Cite: Federal Trade Commission, *Credit-Based Insurance Scores: Impacts on Consumers of Automobile Insurance* 3 (July 2007).

- A 2006 study from the Brookings Institution which found that counties with high minority populations are more likely to have lower average credit scores than predominately white counties. In the counties with a very low typical score (scores of 560 to 619), Brookings found that about 19% of the population is Hispanic and another 28% is African American. On the other hand, the counties that have higher typical credit scores tend to be essentially all-white counties. Cite: Matt Fellowes, Brookings Inst., *Credit Scores, Reports, and Getting Ahead in America* 9-10 (May 2006).

- A 2004 study by Federal Reserve researchers finding that fewer than 40% of consumers who lived in high-minority neighborhoods had credit scores over 701, while nearly 70% of consumers who lived in mostly white neighborhoods had scores over 701. Cite: Robert B. Avery, Paul S. Calem, & Glenn B. Canner, *Credit Report Accuracy and Access to Credit*, Federal Reserve Bulletin (Summer 2004).

- A 2004 study published by Harvard's Joint Center for Housing Studies finding that the median credit score for whites in 2001 was 738, but the median credit score for African Americans was 676 and for Hispanics was 670. Cite: Raphael W. Bostic, Paul S. Calem, & Susan M. Wachter, Joint Ctr. for Hous. Studies of Harvard Univ., *Hitting the Wall: Credit As an Impediment to Homeownership* (Feb. 2004).

- A 2004 study conducted by the Texas Department of Insurance on insurance scoring finding that African-American and Hispanic consumers constituted over 60% of the consumers having the worst credit scores but less than 10% of the consumers having the best scores. Cite: Tex. Dep't of Ins., *Report to the 79th Legislature--Use of Credit Information by Insurers in Texas* (Dec. 30, 2004).

- A 2004 study conducted by the Missouri Department of Insurance found insurance credit scores were significantly worse for residents of high-minority zip codes. The average consumer in an ''all minority'' neighborhood had a credit score that fell into the 18.4th percentile, while the average consumer in a ''no minority'' neighborhood had a credit score that fell into the 57.3th percentile. Cite: Brent Kabler, Missouri Dep't of Ins., Insurance-Based Credit Scores: Impact on Minority and Low Income Populations in Missouri (Jan. 2004).

- A 1997 analysis by Fair Isaac itself showing that consumers living in minority neighborhoods had lower overall credit scores. Cite: Fair, Isaac & Co., *The Effectiveness of Scoring on Low-to-Moderate Income and High-Minority Area Populations* 22, Fig. 9 (Aug. 1997).

- A 1996 Freddie Mac study which found that African-Americans were three times as likely to have FICO scores below 620 as whites. The same study showed that Hispanics are twice as likely as whites to have FICO scores under 620. Cite: *See* Freddie Mac, *Automated Underwriting: Making Mortgage Lending Simpler and Fairer for America's Families* (Sept. 1996).

ATTACHMENT 1

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Solving the Credit Conundrum: Helping Consumers' Credit Records Impaired by the Foreclosure Crisis and Great Recession

December 2013

Chi Chi Wu
National Consumer Law Center®

ABOUT THE AUTHOR

Chi Chi Wu is a staff attorney at the National Consumer Law Center. She is an expert on consumer credit issues, including credit reporting, tax-time financial products, credit cards, and medical debt. She is co-author of the legal manuals Fair Credit Reporting Act and Collection Actions, and a contributing author to Consumer Credit Regulation and Truth in Lending. Wu has testified in Congress and presented at numerous conferences on credit reporting issues. She authored the groundbreaking report *Automated Injustice: How a Mechanized Dispute System Frustrates Consumers Seeking to Fix Errors in Their Credit Reports* (Jan. 2009). Wu frequently serves as a resource for policymakers and the media on consumer credit reporting issues. Previously, Wu worked in the Consumer Protection Division at the Massachusetts Attorney General's office and the Asian Outreach Unit of Greater Boston Legal Services.

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ABOUT THE NATIONAL CONSUMER LAW CENTER

Since 1969, the nonprofit National Consumer Law Center® (NCLC®) has used its expertise in consumer law and energy policy to work for consumer justice and economic security for low-income and other disadvantaged people, including older adults, in the United States. NCLC's expertise includes policy analysis and advocacy; consumer law and energy publications; litigation; expert witness services, and training and advice for advocates. NCLC works with nonprofit and legal services organizations, private attorneys, policymakers, and federal and state government and courts across the nation to stop exploitive practices, help financially stressed families build and retain wealth, and advance economic fairness.

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"There are no second acts in American lives."
— F. Scott Fitzgerald

"Forgiveness is the attribute of the strong."
— Mahatma Gandhi

I. INTRODUCTION

The foreclosure crisis of the late 2000s left an enormous trail of economic destruction in its wake. Most Americans are familiar with the obvious damage -- the crisis cost nearly $200 billion in lost wealth,[1] resulted in over 4.5 million Americans losing their homes,[2] and triggered the worst recession since the Great Depression. One long-term result of the foreclosure crisis, however, is less familiar to many Americans – the impact on the credit reports of millions of consumers.

The most obvious credit reporting impact to consumers was the damage caused by foreclosure entries on millions of credit reports. These black marks can cause a decrease of 100 to 150 points to a consumer's credit score. The impact also includes the damage wrought by adverse mortgage-related events other than foreclosure, such as short sales or loan modifications. As discussed in Section II.A on page 3, many of these foreclosures and other adverse mortgage events were not caused by bad decisions made by the borrowers, but both economic forces out of their control and fraud or abuse by servicers/lenders.

Damaged credit reports and plunging credit scores means, of course, reduced access to credit. Even if the consumer can obtain credit, it will be at a much higher cost – a practice called "risk-based pricing" which ironically can cause defaults because the high cost of the credit makes it harder to repay. However, the credit reporting damage from the foreclosure crisis extends beyond the immediate impact on the availability and price of credit. Impaired credit reports also affect the ability of consumers to obtain employment, rental housing, and insurance. On a broader macro-level, the credit reporting harm from the crisis slowed the nation's economic recovery and created a class of consumers shut out of mainstream financial services.

Some of these consumers could be good borrowers after their foreclosure, and would certainly be good workers. They are not bad or irresponsible people, but simply unlucky. Helping these consumers rectify the credit reporting harms caused by the foreclosure crisis would enable them

[1] Ben Henry, Jill Reese, and Angel Torres, Alliance for a Just Society, Wasted Wealth: How the Wall Street Crash Continues to Stall Recovery and Deepened Racial Inequity in America, May 2013, p.8.
[2] CoreLogic, CoreLogic National Foreclosure Report, May 2013, p.2, *available at* www.corelogic.com/research/foreclosure-report/national-foreclosure-report-may-2013.pdf (visited Dec. 2013).

to move on economically. Their recovery, in turn, would help with the nation's economic recovery from the Great Recession.

This white paper explores the scope of the credit reporting harms caused by the foreclosure crisis and the Great Recession. It reviews both the harm to individual consumers and the wider impact on economic recovery. It also documents the credit reporting problems caused by inaccuracies and anomalies in the system. This paper discusses the broader problem of relying on past credit history to judge future performance, arguing that such a broad-brush approach fails to distinguish between consumers who are simply unlucky and those who are truly irresponsible. Finally, it suggests a number of solutions to assist consumers whose credit reports have been damaged by the foreclosure crisis and Great Recession.

II. SCOPE OF THE PROBLEM

A. Credit Harms from the Foreclosure Crisis and Great Recession

Credit reporting has become the determining factor for many essentials in a consumer's financial life – not only credit (mortgages, auto loans, credit cards) but insurance, employment and rental housing. It is no exaggeration to say that a credit history can make or break a family's finances. The Big Three credit bureaus (Equifax, Experian, and TransUnion) stand as gatekeepers – and solely profit-motivated ones at that – to many economic essentials in the lives of Americans.

The foreclosure crisis and the massive unemployment caused by the Great Recession saddled millions of consumers with poor credit histories. These include the over 8 million workers who lost their jobs,[3] as well as the 4.5 million families whose homes were foreclosed upon. Many of these 4.5 million foreclosures were not due to irresponsible borrowing, but phenomena such as:

- Abusive and predatory lending, such as mortgage brokers and lenders who targeted low-income and minority consumers for expensive subprime loans that they could not afford.
- The combination of exploding Adjustable Rate Mortgages (ARMs), negatively amortizing mortgage loans, and the collapse of the housing market, which left many mortgages "underwater," with the homeowner owing more than the home was worth.
- Inability to pay mortgage payments due to unemployment or underemployment caused by the Great Recession.
- Abusive servicing practices, including cramming accounts with illegal fees, failing to process loan modification requests, and gross accounting errors.

[3] Economic Policy Institute, The Great Recession – Job Loss, at http://stateofworkingamerica.org/great-recession/ (visited Dec. 2013).

Millions of other families did not have a foreclosure completed, but still have undergone adverse mortgage-related events, such as:

- **A short sale**, which is when a mortgage servicer or lender agrees to let the homeowner sell the home and release the mortgage lien, even if the proceeds of the sale will not cover the amount due on the mortgage.

- **A deed-in-lieu of foreclosure**, which is when the mortgage servicer or lender accepts a voluntary surrender of the property by the homeowner as an alternative to foreclosure.

- **A loan modification**, which is an agreement between the servicer or lender and the homeowner to change the terms of the mortgage so that it is easier for the homeowner to make timely mortgage payments. Changes may include reducing the interest rate or principal amount, changing the mortgage product (for example, from an adjustable to a fixed rate mortgage), extending the loan term, or adding delinquent payments to the loan principal.

- **A Chapter 13 bankruptcy** to prevent or slow a foreclosure.

Foreclosures, short sales, loan modifications, and other mortgage-related events cause significant damage to the credit reports of consumers. The impact varies based upon what credit score the consumer originally had prior to the event. According to FICO, the developer of most-often used credit scoring model, the following events lower a credit score by these amounts:

Starting FICO Score	680	720	780
30 days late on mortgage	600-620	630-650	670-690
90 days late on mortgage	600-620	610-630	650-670
Short sale/deed-in-lieu/settlement (no deficiency)	610-630	605-625	655-675
Short sale (with deficiency balance)	575-595	570-590	620-640
Foreclosure	575-595	570-590	620-640
Bankruptcy	530-550	525-545	540-560

Source: FICO (r) Banking Analtyics Blog. (c) 2011 Fair Isaac Corp.

VantageScore, which is a joint venture of the Big Three credit bureaus that sells a competing credit scoring model, provides similar information:

	All accounts in good standing	1st Mortgage in good standing; other accounts delinquent	1st Mortgage delinquent; other accounts in good standing	1st Mortgage delinquent; other accounts delinquent
VantageScore Starting Score	**862**	**830**	**722**	**625**
Loan Modification (various circumstances)	842-892	815-860	710-742	620-643
Short Sale	732-742	720-730	672-682	600-610
Foreclosure	722-732	710-720	667-677	605-615
Foreclosure initiated, payment made	737-747	715-725	682-692	615-620
Bankruptcy – mortgage only	687-697	670-680	652-662	595-605
Bankruptcy – all accounts	497-507	500-510	502-512	505-515

Source: VantageScore, Impact on Consumer VantageScore Credit Scores Due To Various Mortgage Loan Restructuring Options, January 2010, at p. 9 (Note that this chart was based on the prior VantageScore scoring range of 501 to 990. VantageScore has since revised its scoring range to match that of FICO, from 300 to 850).

These negative impacts of a foreclosure or other mortgage-related event will last for seven years, or ten years in the case of bankruptcies, as these are the time limits under the Fair Credit Reporting Act for adverse information to remain on a credit report. Thus, consumers who have gone through a foreclosure or other adverse mortgage event are shut out of affordable credit markets for seven years (or ten years, in the case of bankruptcies), unable to obtain reasonably priced auto loans or credit cards. They may end up paying exorbitant amounts for fringe credit, such as payday loans with APRs of 400% or more, or "buy here, pay here" subprime auto loans.

More disturbingly, credit reports are used for other purposes, such as employment, rental housing, and insurance. Thus, the damage from a foreclosure or other adverse mortgage-related event could cause a consumer to be denied a job, lose out on a rental apartment after losing his or her home, and pay hundreds of dollars more in auto insurance premiums. The cumulative impact of these financial calamities could strand a consumer economically for years after the foreclosure itself. It could create a self-fulfilling downward spiral in a consumer's economic life.

Indeed, there are indications that the negative impact of a foreclosure or other adverse mortgage event has a ripple effect even after the black mark is removed after seven years, continuing to weigh down the consumer. One study found that only 30% of foreclosed homeowners return to mortgage market within 10 years.[4] Furthermore, some studies show that it takes even longer for African Americans and Latinos to recover homeownership after a foreclosure.[5]

Another study found that, for many previously-prime homeowners, their scores did not return to pre-foreclosure levels even after seven years had passed.[6] In the years after a foreclosure, these consumers had persistently higher levels of delinquency on auto, credit card, and other loans. The authors speculate that this phenomenon could be caused by several reasons, including lingering effects of the economic difficulties that caused the foreclosure or a change in the consumer's behaviors toward delinquency due to reduced stigma associated with default. A third potential reason would be subsequent difficulties attributable to having a poor credit record, such as inability to access jobs, apartments, credit, or insurance, or being required to pay exorbitant prices for the latter two.

Finally, it appears the depressed credit scores from the foreclosure crisis and the Great Recession have impeded the country's economic recovery. According to some analysts, the Federal Reserve's effort to stimulate the economy with low interest rates has been less than effective because many of the consumers who could most benefit from these rates do not qualify for loans due to low credit scores.[7] In turn, the lack of ability to access low rates means these consumers have less ability to open small businesses or engage in household spending, the very steps needed to jump start the economy. In an ironic way, credit scoring and reporting have created a vicious cycle – economic harm causes low scores, low scores prevent recovery by shutting out

[4] William Hedberg and John Krainer, Credit Access Following a Mortgage Default, FRBSF Economic Letter 2012-32, Oct. 29, 2012.

[5] Donald R. Haurin and Stuart S. Rosenthal, Dept. of Housing and Urban Development, Sustainability of Homeownership: Factors Affecting the Duration of Homeownership and Rental Spells, Dec. 2004.

[6] Kenneth P. Brevoort and Cheryl R. Cooper, Federal Reserve Board and Urban Institute, Foreclosure's Wake: The Credit Experiences of Individuals Following Foreclosure," Nov. 18, 2010, *available at* www.federalreserve.gov/pubs/feds/2010/201059/201059abs.html.

[7] Jon Hilsenrath, Fed Wrestles with How Best to Bridge U.S. Credit Divide, Wall St. J., June 19, 2012.

the consumer from benefits that require a high score, and the consumer's lack of recovery drags down the economy as a whole.

The drag on recovery by consumers' low scores is exacerbated by lenders that currently require even higher credit scores to qualify for mortgage loans. The average credit scores required for Fannie Mae/Freddie Mac/Federal Housing Administration (FHA) home-purchase mortgages appears to be 50 points higher than it was before the foreclosure crisis and Great Recession,[8] putting affordable credit even more out of the reach of consumers who were most harmed by these events.

B. Errors, Problems, and Anomalies

The credit reporting damage from the foreclosure crisis was bad enough, creating an economic blacklist affecting millions of consumers. This damage is exacerbated and compounded by the errors, problems, and anomalies caused by servicers and lenders and the credit reporting industry. Examples of errors and anomalies include:

1. Reporting short sales as foreclosures

This error is caused because there is no specific code in the standardized format for credit reporting (called the "Metro 2 format") for a short sale. Instead, a short sale is reported under the Metro 2 format as a loan that is "settled for less than full amount," and in many cases also as "foreclosure started." The courts have differed as to whether such reporting is inaccurate because it is misleading or incomplete.[9] While reporting a short sale as a foreclosure might not make a significant difference in terms of a credit score,[10] it can cause problems when a user views the full credit report. For example, until recently, Fannie Mae guidelines prevented consumers who had an incorrect foreclosure notation from obtaining another Fannie-backed mortgage for seven years (versus two to four years for a short sale).[11]

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[8] Jim Parrott and Mark Zandi, Moody's Analytics and Urban Institute, Opening the Credit Box, Sept. 30, 2013, *available at* www.urban.org/UploadedPDF/412910-Opening-the-Credit-Box.pdf (visited Dec. 2013).
[9] *Compare* Williams v. Wells Fargo Bank, 2012 WL 5510747 (N.D. Tex. Nov. 14, 2012) *with* Co v. JP Morgan Chase Bank, 2013 WL 1788061 (N.D. Cal. Apr. 26, 2013).
[10] Frederic Huynh, Are Short Sales Really That Bad? FICO Banking Analytics Blog, August 28, 2012, at http://bankinganalyticsblog.fico.com/2012/08/are-short-sales-really-that-bad.html (visited Dec. 2013).
[11] Fannie Mae Selling Guide, B3-5.3-07, Significant Derogatory Credit Events — Waiting Periods and Re-establishing Credit, October 22, 2013, p. 485, *available at* www.fanniemae.com/content/guide/sel102213.pdf (visited Dec, 2013).

2. **Servicers and lenders that seek to collect deficiencies after a short sale or a foreclosure.**

Some servicers and lenders attempt to collect the "deficiency," which is the difference between the amount realized at the short sale or foreclosure sale and the balance due on the mortgage. This tactic is arguably an unfair practice in a short sale where the lender has agreed to accept the sale proceeds knowing they are less than the mortgage, or in the many jurisdictions that prohibit a lender from recovering a deficiency after a foreclosure. Collection activities include reporting the deficiency as a collection item on the consumer's credit report, with the resulting harm to the consumer's credit score.[12] These deficiencies are also often sold to third-party debt buyers, which are notorious for abuses they commit against consumers.[13]

3. **Reporting the entire balance of a mortgage as unpaid after foreclosure.**

When a home is foreclosed upon, it is usually sold at auction. Some servicers and lenders apparently have failed to credit the proceeds of the auction against the amount owed. Instead, they have reported the entire balance of the mortgage as unpaid, even though a portion of it was satisfied from the auction sale proceeds.[14]

4. **Credit reports not reflecting the terms of a loan modification.**

This problem occurs after a servicer or lender has agreed to a loan modification with the homeowner. The servicer or lender continues to report the mortgage as delinquent, per the original terms, even though the consumer is paying in compliance with the terms of the new modified loan terms.[15]

5. **Issues regarding loan modification reporting.**

Loan modifications are reported under the Metro 2 format using the code AC, which stands for "Paying under a partial payment agreement."[16] The AC code will result in a

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[12] *See, e.g.*, Rex v. Chase Home Fin. LLC, 905 F. Supp. 2d 1111 (C.D. Cal. 2012) (class action against lenders that attempted to collect short sale deficiency and reported plaintiffs' failure to pay to credit reporting agencies).

[13] *See* National Consumer Law Center, Fair Debt Collection § 1.5.4 (7th ed. 2011 and Supp.).

[14] *See, e.g.,* Abdelfattah v. Carrington Mortgage Servs. L.L.C., 2013 WL 495358 (N.D. Cal. Feb. 7, 2013).

[15] *See, e.g.*, Henderson v. Chase Home Finance, LLC, 2012 WL 4006686 (D. Ariz. Sept. 12, 2012)(servicer promised no negative reporting); Bourdelais v. JPMorgan Chase Bank, N.A., 2012 WL 5404084 (E.D. Va. Nov. 5, 2012); Bradshaw v. BAC Home Loans Servicing, Ltd. P'ship, 816 F. Supp. 2d 1066 (D. Or. 2011); Darrin v. Bank of America, N.A., 2013 WL 877087 (E.D.Cal. Mar. 7, 2013); Pundt v. Select Portfolio Service, Inc., 2012 WL 2312074 (N.D. Iowa June 18, 2012).

[16] Consumer Data Industry Association, Credit Reporting Resources Guide (2012), at 5-21 (a.k.a. the Metro 2 Manual).

lowering of the consumer's credit score.[17] In at least one case, even asking about a loan modification resulted in a drop to the homeowner's credit score of 125 points.[18] The practice of using the AC code for loan modifications has been criticized as unfairly burdening consumers.

Under pressure, the credit reporting industry did change this coding for modifications of mortgages under the federal government's Home Affordable Modification Program (HAMP) by adding a new Metro 2 code.[19] It is unclear whether the FICO algorithms were adjusted to treat this "HAMP" code as a negative factor. Furthermore, while HAMP involves two stages-–temporary or trial modifications and permanent modifications--only permanent modifications are reported using the special HAMP modification code.[20] This is especially problematic given that some HAMP trial modifications have lasted more than a year, even though they are only supposed to last three to four months.

C. The Trembles

"Character - From your credit history, the lender attempts to determine if you possess the honesty and reliability to repay the debt." [21]

— Visa's website

"When wealth is passed off as merit, bad luck is seen as bad character. This is how ideologues justify punishing the sick and the poor."[22]

— Sarah Kendzior

One of the most pernicious aspects of the use of credit reporting is its use as a proxy for "character." There is a popular conception, not just in the credit industry, but also among employers and the average layperson, that a poor credit score means that the consumer is irresponsible, a deadbeat, lazy, dishonest, or just plain sloppy. However, this stereotype is far from the truth. A bad credit record is often the result of circumstances beyond a consumer's control, such as a job loss, illness, divorce, or death of a spouse, or a local or nationwide economic collapse.

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[17] Experian, *Ask Max Credit Advice--Negotiating Reduced Payments Can Hurt Credit Scores*, Oct. 28, 2009, *available at* www.experian.com/ask_max/max102809a.html (visited Dec. 2013).

[18] Loomis v. U.S. Bank Home Mortgage, 912 F. Supp. 2d 848 (D. Ariz. 2012).

[19] Consumer Data Industry Association, *Mortgage & Home Equity Reporting Guidelines In Response to Current Financial Conditions*, June 2010.

[20] *Id.*

[21] Visa, *Credit Reports - The 3 C's of credit: character, capital, and capacity*, undated, at http://usa.visa.com/personal/using_visa/personal_finance/credit_reports.html (visited Dec. 2013)

[22] Sarah Kendzior, A government shutdown, a social breakdown, Al Jazeera English, Oct. 4, 2103, at www.aljazeera.com/indepth/opinion/2013/10/a-government-shutdown-a-social-breakdown-201310491015764779.html (visited Dec. 2013).

The current credit reporting and scoring system is fundamentally flawed because it is an overly blunt instrument that lumps together defaults and negative events that are caused by very different triggers. Credit scores assume that a foreclosure due to illness resulting in job loss and crippling medical bills should be treated the same, and has the same predictive value, as a foreclosure because the borrower was a real estate investor who abandoned the property. Yet these are two fundamentally different phenomena, and likely two very different consumers.

Indeed, many foreclosures were not caused by bad decisions that borrowers made. Going back more than a decade, origination fraud and abuse by the mortgage industry was endemic – mortgages brokers falsified applications, obtained inflated appraisals, and sold unaffordable products to unsuspecting homeowners, such as adjustable rate mortgages in which the interest rate skyrocketed after the initial "teaser" period. When a loan is abusive, the failure to repay it tells nothing about the borrower's creditworthiness. Another problem is that during the foreclosure crisis, many homeowners who should have been processed for a loan modification were not provided with one. If two homeowners are identically situated, and one gets a loan modification but the other does not, it's hardly fair or useful to reflect that arbitrary result in credit scores.

The overly crude lumping together of very different consumers makes credit scores less than optimally predictive. This is reflected in, and probably responsible, for the fact that scores are actually quite inaccurate and unpredictive on an individual level. While they can predict the probability that as a group, low-scoring consumers will have a certain percentage of defaults, they cannot predict if any particular person will actually engage in the behavior. *In fact, often the probability is greater that a particular low-scoring person will not engage in the negative behavior.*

For example, a score of between 500 and 600 is generally considered to be a poor score.[23] Yet at the beginning of the foreclosure crisis in 2007, only about 20% of mortgage borrowers with a credit score in that range were seriously delinquent.[24] Thus, if a score of 600 is used as a cut-off in determining whether to grant a loan, the vast majority of applicants who are denied credit would probably *not* have become seriously delinquent.

[23] FICO, myFICO Insider's Guide to 2010 Credit Card Reform and New FHA Mortgage Rules (2010), (noting that under the Federal Housing Administration rules, "it may be difficult for a borrower to even begin the process [of getting a mortgage] with FICO scores below 600."), *available at* www.myfico.com/Downloads/Files/myFICO_Guide_CCFHA.pdf (visited Sept. 29, 2013).
[24] Yuliya Demyanyk, *Did Credit Scores Predict the Subprime Crisis*, The Regional Economist (Federal Reserve Bank of St. Louis Oct. 2008), *available at* www.stlouisfed.org/publications/re/articles/?id=963. *See also* VantageScore Solutions, L.L.C., VantageScore 2.0: A New Version for a New World, 2011 (consumers with VantageScore of 690 - 710, or borderline between "C" and "D" grade, have about a 9% risk of default).

A study by a Federal Reserve researcher and a Swedish scientist, based on consumers in Sweden, similarly found that most consumers with impaired credit did not engage in negative behavior again.[25] The study found that, from the population of consumers with negative information in their credit reports who received credit after the mark was removed, only 27% defaulted again within two years.[26] The researchers reached a conclusion very similar to our thesis, which is that the reason for this low level of default is that many of the consumers with impaired credit ended up with negative marks due to circumstances outside of their control. The researchers noted that their results suggested:

> the possibility that for some proportion of the borrowers, the credit arrear may have been due to some temporary factor or tremble – illness, accident, or mistake – that was not reflective of their underlying type, and that [a] fresh start may improve the accuracy with which these borrower types are reflected. It is possible that, in this case, lenders punish trembles that they cannot easily differentiate from the behavior of bad types.[27]

An earlier Federal Reserve study similarly found that local economic factors, such as unemployment rates, have a significant impact on the ability of credit scores to predict risk. The researchers pointed to the omission of these factors in credit scoring as a possible flaw, stating:

> failure to consider situational circumstances raises important statistical issues that may affect the ability of scoring systems to accurately quantify an individual's credit risk. Evidence from a national sample of credit reporting agency records suggests that failure to consider measures of local economic circumstances and individual trigger events when developing credit history scores can diminish the potential effectiveness of such models.[28]

Thus, it is such situational circumstances or "trembles" within a consumer's life that are often responsible for the delinquencies, defaults, and foreclosures – *not* bad character, but bad luck. The problem with scoring and reporting is that it exacerbates and entrenches the harm from such circumstances, perpetuating the consumer's decline for at least another seven years. Not only might a consumer lose her home due to these events, but the foreclosure notation will hinder her recovery by denying her future credit, an

Situational circumstances or "trembles" within a consumer's life that are often responsible for the delinquencies, defaults, and foreclosures – not bad character, but bad luck.

[25] Marieke Bos and Leonard Nakamura, Federal Reserve Bank of Philadelphia, Working Paper No. 12-19/R, Should Defaults Be Forgotten? Evidence from Quasi-Experimental Variation in Removal of Negative Consumer Credit Information, Apr. 2013, at 1, *available at* www.philadelphiafed.org/research-and-data/publications/working-papers/2012/wp12-29R.pdf (visited Dec. 2013).

[26] *Id.* at 1.

[27] *Id.* at 4.

[28] Robert B Avery, Paul S Calem, and Glenn B Canner, Consumer Credit Scoring: Do Situational Circumstances Matter? BIS Working Papers No 146 (Jan. 2004).

apartment, and perhaps even a job. Even if the consumer gets a new job, the black marks from the foreclosure will follow her and result in higher prices for credit and insurance, costing hundreds or thousands more. This will, in turn, make it harder for her to pay those insurance or credit bills, and strain her economic recovery.

Furthermore, the credit reporting system, especially foreclosure and adverse mortgage-related information, perpetuate and exacerbate the income and wealth gaps between whites and minority groups.[29] For one thing, African American and Latinos are disproportionately targeted for predatory credit practices, such as the marketing of subprime mortgages and overpriced auto loans targeted at these populations.[30] As a result, these groups have suffered higher foreclosure rates.[31] In addition, numerous studies have documented how, as a group, African Americans and Latinos have lower credit scores than whites.[32]

We need a better way to judge consumers. We need a system that can distinguish between consumers who are truly irresponsible and those who simply fell on hard times. We need a system that can take into account both economic factors and extraordinary life circumstances particular to an individual consumer. And, we need a system that does not further widen the huge economic chasm between whites and minorities.

III. POLICY RECOMMENDATIONS

The solutions to the issues discussed are not easy or simple. They require a fundamental rethinking about how credit reports are structured and how we judge creditworthiness in the United States. The following are ideas about how to help consumers impacted by the foreclosure crisis and the Great Recession, as well as helping the nation's economy recovery.

These ideas vary in terms of their developmental stage and how much they have been fleshed out. Some of these ideas were previously proposed, extensively discussed, advocated for, and even implemented on the state level (such as banning the use of credit reports/scores for employment and insurance). Others may benefit from more exploration and refinement.

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[29] *See* Chi Chi Wu & Birny Birnbaum, National Consumer Law Center & Center for Economic Justice, Credit Scoring and Insurance: Costing Consumers Billions and Perpetuating the Economic Racial Divide (June 2007).

[30] *See* National Consumer Law Center, Credit Discrimination §§ 1.1.1 and 8.4 (6th ed. 2013) (summarizing studies).

[31] Debbie Gruenstein Bocian, Wei Li, and Keith S. Ernst, Center for Responsible Lending, Foreclosures by Race and Ethnicity: The Demographics of a Crisis, June 18, 2010, *available at* www.responsiblelending.org/mortgage-lending/research-analysis/foreclosures-by-race-and-ethnicity.pdf.

[32] *See* National Consumer Law Center, Credit Discrimination § 6.4.1 (6th ed. 2013).

A. Recommendations to Lessen the Negative Impact of Foreclosures and Other Adverse Mortgage Events

1. Remove adverse mortgage information earlier than seven years.

The FCRA should be amended to shorten the time periods for adverse mortgage-related events – and other negative information -- to three years. There is nothing special about the current seven-year time limit for negative information under the FCRA. It is certainly not universal. For example, the time limits in Sweden and Germany – countries that are as economically vibrant and prosperous as the United States – are three and four years, respectively.[33]

Negative mortgage-related information should be removed even before a three-year period if the consumer has taken steps to mitigate the loss to the lender, such as a short sale, a deed-in-lieu of foreclosure, or a loan modification. Negative information should also be removed if the mortgage is eligible for relief under settlements negotiated by government agencies with mortgage servicers or lenders, such as the National Mortgage Settlement[34] and the Independent Foreclosure Review (IFR) Payment Agreement. These settlements address abuses by servicers and lenders that resulted in foreclosures, and the borrowers who are entitled to relief should not have their credit reports marred by negative information caused by the servicer or lender.

2. Prohibit insurers, employers, and landlords from considering credit reports at all, and particularly a foreclosure or other adverse mortgage event.

The use of credit reports or credit scores has been a controversial practice for these purposes. Negative credit information has no clear relationship with work performance or driving history, and is often caused by economic forces outside of a consumer's control. For rental housing, denying a consumer who has lost his or her home to foreclosure from the ability to find an apartment contributes to the already appalling amount of homelessness in our country. Furthermore, as discussed in Section II.C on page 12, there are significant racial disparities in credit scores. The use of credit reports and scores for employment, insurance, and rental housing likely causes a disparate impact on minority groups.

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[33] Marieke Bos and Leonard Nakamura, Federal Reserve Bank of Philadelphia, Working Paper No. 12-19/R, Should Defaults Be Forgotten? Evidence from Quasi-Experimental Variation in Removal of Negative Consumer Credit Information, Apr. 2013, at 21, *available at* www.philadelphiafed.org/research-and-data/publications/working-papers/2012/wp12-29R.pdf (visited Dec. 2013).

[34] http://www.nationalmortgagesettlement.com/

In general, employers, insurers, and lenders should not be permitted to consider credit reports or scores at all (with perhaps some very limited some exceptions). Prohibiting them from considering foreclosures or other adverse mortgage-related events is a first step toward protecting consumers from unfair harm.

3. Create exceptions or models to consider extraordinary life circumstances.

The rules for credit reporting, as well as the algorithms for credit scoring models, should be revised to lessen or eliminate the impact of situational or "extraordinary life circumstances," by minimizing or excluding negative information that can be attributed to job loss, medical causes, or other similar causes. Creditors should be required to make allowances for extraordinary life circumstances, or even prohibited from denying credit based on negative information caused by such circumstances.

There is precedent for special consideration of extraordinary life circumstances. A number of state laws governing the use of credit information for insurance require insurers to consider or grant reasonable exceptions based on the impact of extraordinary life circumstances.[35] Even Fannie Mae recognizes their presence, by acknowledging the existence of "extenuating circumstances," which it defines as "nonrecurring events that are beyond the borrower's control that result in a sudden, significant, and prolonged reduction in income or a catastrophic increase in financial obligations."[36] However, Fannie Mae primarily uses these extenuating circumstances to shorten certain waiting periods before a consumer can seek another mortgage. It does not *require* lenders to take these circumstances into account, much less mandate that the lender exclude negative information that the consumer can show was the result of extraordinary life circumstances. The FHA similarly recognizes "extenuating circumstances" but uses them mostly to shorten certain waiting periods.[37]

B. Fixing Errors, Problems, and Anomalies

There are a number of measures that the industry or regulators can take to prevent the errors, problems, and anomalies discussed in Section II.B on pages 7-9.

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[35] *See, e.g.,* Conn Gen. Stat. § 38a-686; 215 Ill. Comp. Stat. § 157/22; Iowa Code § 515.103; Kan. Stat. Ann. §40-5115; Ky. Rev. Stat. Ann. § 304.20-040; La. Rev. Stat. Ann. § 22:1507; Mich. Comp. Laws § 500.2154; Minn. Stat. § 72A.20, subd. 36; Mont. Code Ann. § 33-18-605 ; Nev. Rev. Stat. § 686A.685; N.M. Stat. § 59A-17A-5.

[36] Fannie Mae Selling Guide, B3-5.3-08, Extenuating Circumstances for Derogatory Credit, October 22, 2013, p. 488, *available at* www.fanniemae.com/content/guide/sel102213.pdf (visited Dec, 2013).

[37] *See* HUD Mortgagee Letter 2013-26: Back to Work - Extenuating Circumstances, August 15, 2013, *available at* http://portal.hud.gov/hudportal/HUD?src=/program_offices/administration/hudclips/letters/mortgagee (visited Dec. 2013).

1. **The credit reporting industry should revise the Metro 2 reporting format to include:**

    - A special code for short sales.
    - Requirements that borrowers who are complying with the terms of a modification be reported as "paying as agreed," and not reported using the AC code or any code that results in significant harm to their credit score.
    - More detailed reporting regarding the terms of loans, including the annual percentage rate (APR), so that users of a credit report can tell whether the terms were reasonable or were so abusive that they actually led to the default.

2. **Lenders and servicers should have better compliance and audit procedures to ensure that they are properly follow the Metro 2 format, including filling out all applicable fields and using the proper codes, to avoid erroneous reporting.**

C. Make Lending More Available

The following reforms would address the larger economic problems caused by the inability of consumers with impaired credit records to access reasonably-priced credit:

1. **Capacity should count more than credit score.**

Lenders should be required to place more emphasis on capacity, *i.e.*, residual income and debt-to-income ratio, instead of so-called "character" (credit score). The touchstone of all lending should be the consumer's ability to pay, not his or her credit score. Ironically, such a reform would constitute a return to traditional underwriting standards. It would also prevent future foreclosures and other adverse mortgage-events. For example, Veteran Administration (VA) loans have significantly lower default rates than FHA loans given the same credit scores —and FHA loans in turn are significantly better performing than other loans.[38] The big difference is underwriting, because the VA is the only one of the three that currently requires analysis of residual income.[39]

New requirements established by the Dodd-Frank Act represent an important step forward. These requirements institute a minimum ability-to-pay standard, which should result in less reliance on credit scores for *approvals* on mortgage lending. However, lenders will probably continue to *deny* applicants for too-low scores.

[38] *See* National Consumer Law Center, Comments to the Department of Housing and Urban Development- Qualified Mortgage Definition for HUD Insured and Guaranteed Single Family Mortgages, Oct. 30, 2013, pp 12-14, *available at* www.nclc.org/images/pdf/foreclosure_mortgage/dodd-frank/comments-fha-oct2013.pdf (visited Dec. 2013).

[39] The FHA is in the processing of adding a residual income option for its underwriting.

Applicants with sufficient residual incomes but low credit scores should not be automatically denied or sent to a manual underwriting process that is effectively a denial.

2. While ability-to-pay requirements should be tightened, credit score requirements should be loosened.

The trend toward requiring higher credit scores for mortgages and other loans should be reversed. Some lenders, particularly auto lenders, are moving in this direction by loosening requirements for consumers who have experienced adverse mortgage events.[40] In contrast, Fannie Mae, Freddie Mac and the FHA still rely heavily on credit scores.[41] And a step in the wrong direction is the recent increase of fees by Fannie Mae and Freddie Mac for borrowers with credit scores below 780.

There may be some types of credit for which credit reports and scores should not be used at all. For example, a credit history analysis should not be used to deny seniors the ability to obtain reverse mortgages under the Home Equity Conversion Mortgage (HECM) program proposed by the Department of Housing and Urban Development (HUD).

3. Alternatives to traditional credit scores should be considered.

The credit industry should be encouraged to consider alternatives to the traditional credit score. Some potential ideas for exploration include:

- Alternative scoring systems, such as the Credit Capacity Score offered by the RDR Institute, which focuses on a net cash-flow analysis.[42]

- Some subprime lenders use alternative criteria to differentiate among low-scoring consumers to determine who is more likely to pay. While we

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[40] Ruth Simon, Auto Lenders Speeding Past Mortgage Troubles, Wall St. J., Jan 5, 2012.
[41] *See* 75 Fed. Reg. 54,020 (Sept. 3, 2010) (FHA setting a minimum FICO score of 500, as well as requiring a higher loan-to-value threshold for borrowers with scores of 500 to 590). Fannie Mae generally will not buy mortgages when the borrower has a FICO scores under 620. *See* Consumer Fin. Prot. Bureau, Analysis of Differences Between Consumer- and Creditor-Purchased Credit Scores, p. 6 (Sept. 2012), *available at* http://files.consumerfinance.gov/f/201209_Analysis_Differences_Consumer_Credit.pdf (visited Dec. 2013).
[42] Press Release, Responsible Debt Relief Announces Pathbreaking Housing Counseling and Mortgage Modification Assessment System, October 31, 2011, *available* at www.prweb.com/releases/2011/10/prweb8919333.htm (visited Dec. 2013) (key features include "net cash-flow algorithm/software that calculates net, after-tax household income based on such factors as federal, state and local taxes, household structure, tax filing status, regional cost of living, home ownership status, federal approved deductions such as retirement and charitable contributions, and court-mandated payments such as child support and garnishments").

certainly believe the products offered by these lenders are bad for consumers and should be banned, the criteria that these lenders use to differentiate consumers are worth exploring, albeit with a skeptical eye.

- Requiring lenders to use information that is voluntarily submitted by consumers regarding payments that are not typically reported to the credit bureaus. Lenders should be required to do more than just "consider" this voluntarily-submitted information, which is actually already required by federal regulation.[43] Lenders should be required to treat voluntarily-submitted information in the same manner as traditional credit reporting information, if it is certified as accurate by a trusted third-party verification company.

D. More Research

Finally, we need more research on how to improve the methods we as a society use to judge who is worthy of reasonably-priced credit. Our society has made great strides in information technology in the last few decades, with the explosion of the Internet and ever-more powerful computer hardware and software. Yet our assessment of creditworthiness is still stuck in methodologies invented in the last century.

Our nation devotes billions of dollars every year for medical research. We should be willing to devote a fraction of that amount into research to ensure that consumers are treated fairly in credit decisions and to promote economic growth that is dependent on this fair treatment. It's time for a new paradigm to judge consumers so that they are not unfairly penalized by economic and life circumstances outside of their control.

[43] Under Regulation B, which implements the Equal Credit Opportunity Act, lenders are already required to consider "[o]n the applicant's request, any information the applicant may present that tends to indicate the credit history being considered by the creditor does not accurately reflect the applicant's creditworthiness." 12 C.F.R. 1002.6(b)(6)(ii).

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