How traditional credit scoring can be a barrier for many consumers

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Traditional credit scores don't always accurately reflect repayment ability, and they might disproportionately punish certain consumers.

More than ever, consumers are barraged with media messages—including advertising enticements and warnings—about credit scores. While the public might generally know that credit scores are important, they might not know that traditional scoring methods don't always present a level playing field.

In a June 2023 *Economic Review* article, Kansas City Fed Economist Ying Lei Toh asserted that while credit scores are intended to help lenders make informed decisions about the risk of default, they don't always accurately reflect a borrower's ability to repay. In addition, Toh concluded, traditional credit scores may disproportionately punish consumers from economically disadvantaged groups.

"The disparity in access to credit reflects some of the socio-economic inequalities in society," Toh said. "The credit scoring system may actually perpetuate this disparity by the way it confers benefits and advantages to people who come from more privileged backgrounds with good access to credit."

Meanwhile, Toh said, people who come from less-privileged backgrounds "are in a sense penalized because they are more likely to have experienced negative events that would pull down their credit scores, like debt collections and bankruptcies."

History of credit scores

Credit scores in the format that we know today—with a numbering system ranging from 300 (for an extremely poor credit risk) to 850 (for a superb credit evaluation)—date roughly to the late 1980s. However, efforts in the United States to standardize evaluation of creditworthiness can be traced to rudimentary local credit bureaus in the mid-1800s.

In the 1950s, Bill Fair, an engineer, and Earl Isaac, a mathematician, joined to create Fair, Isaac and Company and market a standardized credit scoring system.

Their service evolved to be known as FICO, the leading measure in traditional credit scoring.

Barriers

Toh's research shows that lenders' heavy reliance on FICO and a similar measure known as VantageScore not only affects loan approval decisions, but also the interest rates that consumers pay. That reliance can produce strong barriers for lower-income and Black or Hispanic consumers, who have lower credit scores on average, Toh said.

She cited data from the Federal Reserve's Survey of Consumer Finances showing that consumers who were below age 65, earned less than $75,000 a year, or were Black or Hispanic were substantially more likely to have their credit needs unmet or under-met. Lower-income consumers—particularly, those making less than $50,000 a year—and Black or Hispanic consumers were less likely to have applied for credit and more likely to be denied conditional approval on applying compared with consumers earning $75,000 or more a year and white consumers. Toh noted that one dilemma is that these consumers likely would benefit the most from access to lower-cost credit, as lower-income and Black or Hispanic consumers tend to lack savings that could help them cover unexpected emergencies.

Additional hurdles can emerge through an individual's lack of awareness. That's something that Lance Triggs has seen over the years at Operation Hope, an Atlanta-based non-profit organization that has been providing one-on-one personal finance coaching, credit building and other services since 1992. Triggs, president of the organization's Program Operations Division, said those services include helping broaden people's knowledge base as a path not only toward financial literacy but toward "financial dignity."

"At the very basic level, there are a lot of consumers who still don't really understand how the credit scoring model operates and the various factors that improve or decrease a credit score," Triggs said. "So we spend a lot of time educating people about that."

One example of what Triggs called an educational "disconnect" for consumers is that "a person can be taught about a FICO score, but there are different FICO score models," and lenders don't all use the same model.

In the Tenth District, Ponca Tribe of Nebraska member Pete Upton sees some of those same credit-awareness challenges within tribal communities. Upton, a member of the Kansas City Fed's Community Development Advisory Council, is executive director of the Native360 Loan Fund, a certified Native Community Development Financial Institution (CDFI) providing lending services throughout Nebraska and Iowa and in parts of Kansas and South Dakota. Upton said that Native Americans comprise the CDFI's primary market, including low- to moderate-income individuals. Along with lending, providing financial literacy training is part of Native360's mission.

“Sometimes a Native CDFI can change the life of someone by helping them understand good credit,” Upton said. “The communities that we serve struggle enough making ends meet, and it’s our mission to bring them affordable capital.” Upton noted that Native360 takes credit scores into account, but “It’s not our mission to penalize them for a low credit score; it’s just to get an understanding of how we can help them.”

In Oklahoma, where the Citizen Potawatomi Community Development Corp. (CPCDC) provides economic-empowerment services within tribal communities, the challenge of seeking affordable credit can go beyond financial literacy.

“With Native communities there’s a general mistrust of the federal government, and that can run over to the banking system,” said Cindy Logsdon, the organization's chief executive officer and director. She said individuals might think “ ‘The bank isn’t even going to look at me or give me favorable terms.’ We try to bridge that gap when they’re ready to form a relationship with the bank.”

Logsdon also is a board member of the Credit Builders Alliance, a 600-member national network of non-profits working with lenders and community members to move toward equitable access to credit for everyone.

Alternative measures

In recent years, the marketplace has seen the rise of “alternative” lending models, fintechs and “Buy Now/Pay Later” services that don’t rely solely or at all on traditional credit scores.

For example, some fintech lenders minimize their exposure by lending based on alternative metrics, such as bank account data. Others weigh nonfinancial data, including public records, educational history, employment history, relationships and digital footprints. These alternative methods are explored in a Kansas City Fed *Payment System Research Briefing* published in June 2023 by Senior Payments Specialist Terri Bradford. Bradford said that it’s important to understand the scope of credit evaluations and how lenders are using certain data because a consumer’s behavior can be read differently by traditional and non-traditional lenders.

“You may be doing things that demonstrate your ability to repay, but those aren’t the things that the credit bureaus are basing their decisions on,” Bradford said, explaining that her study illustrates “the ways that our financial lives have changed beyond the traditional measures.”

“It just highlights the fact that the old method is missing a whole lot of people, and the consequence of that has ripple effects in a whole lot of areas,” Bradford said.

Although alternative data has potential to improve credit-scoring accuracy and credit access, it might take some time for the benefits to gain wide adoption among financial institutions, Bradford said.

Toh, whose study focused on traditional credit scores, added that although using more sophisticated statistical techniques in credit scoring could alleviate some disparities, “clearer regulatory guidance and more research will likely be necessary to promote the development and adoption of alternative credit-scoring models.”

What consumers can do

To help shore up credit scores, individuals can:

- Check credit reports for errors. Once a year, an individual can request a free credit report from the three leading credit bureaus.
- Keep credit utilization low.
- Pay off balances rather than carry a balance from month to month.
- Carefully investigate credit-builder loans and similar products designed to help boost a credit profile.

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