



Past Imperfect: How Credit Scores and Other Analytics “Bake In” and Perpetuate Past Discrimination

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Credit reports and scores reflect stunning racial disparities. Credit reporting and credit scoring are supposed to be entirely objective, with no room for flawed tools such as human judgment (and the biases built into human minds). Yet for the past two decades, study after study has found that African American and Latino communities have lower credit scores as a group than whites (and Asians, when the data is available). For a list of studies, see page 5.

Why do all these studies show such racial disparities in credit scores? Is it because communities of color are somehow less responsible? Are there cultural differences? No, these are not the explanations. Instead, the explanation lies in the very nature of judging humans based on past behavior. By doing so, credit scores necessarily incorporate elements of past inequality.

Communities of color have [less income](#) than white Americans – African Americans earn only 64 cents for every dollar earned by whites, and Latinos earn only 73 cents. This difference is due to racial inequality in many settings, such as segregation in education, hidden biases in employment, and the collateral consequences of mass incarceration. But the [disparity in assets](#) is even more stunning: African American families own less than seven cents for every dollar in wealth owned by white families, while Latino households own less than eight cents for every dollar of white wealth. With fewer assets to draw on, people of color – and the friends and family who they might turn to – are far less able to cushion the blow of financial catastrophes, such as job losses, income reductions, sickness, or unplanned expenses.

How Discrimination Lowers the Credit Scores of Communities of Color

The racial wealth gap has a very real impact on the ability of consumers to pay their bills. For example, a [study](#) by investigative journalists at *ProPublica* found that, even accounting for income, the rate of judgments from debt collection lawsuits was twice as high in mostly black communities as it was in mostly white ones. *ProPublica's* conclusion as to the reason for this

disparity: the racial wealth gap makes it far more difficult for African Americans to recover from a financial setback or come up with a few hundred dollars to pay an emergency bill.

This racial wealth gap didn't happen by accident. It was caused by [centuries of discrimination](#), redlining, and exclusion. For example, the very practice of redlining was invented by the Federal Housing Administration, which refused to guarantee home loans made in African American communities, thus depriving them of the ability to accumulate wealth through homeownership. During the early years of Social Security, unemployment insurance, and the minimum wage, these programs did not cover domestic and agricultural workers — two of the most significant occupations for African Americans.

This discrimination is not ancient history. In the years before the most recent foreclosure crisis, homeowners of color were disproportionately targeted for predatory mortgages. These communities suffered grossly higher rates of foreclosure, wiping out [nearly \\$400 billion](#) in their wealth, and having a devastating impact on their financial health and their credit scores. Current discriminatory practices that have an outsized economic impact include racial profiling/law enforcement bias, employment discrimination, housing segregation, and the re-emergence of old-fashioned redlining. When minorities are disproportionately targeted by law enforcement, it has a devastating economic impact, not only on offenders but also on their families and communities. African Americans and Latinos are also disproportionately affected when municipalities discriminatorily imposed fees and fines to obtain revenue, i.e., the "[Ferguson](#)" issue. All of these practices drain precious dollars from minority families, making it a struggle to keep up with everyday bills, with one resulting risk being harm to credit histories.

Using the Past to Judge Carries on its Biases into the Future

Credit scoring is a reflection of the racial economic divide and wealth gap in this country. Its use also perpetuates that same racial and economic inequality. The use of credit reports and scores entrenches and reinforces inequality by dictating a consumer's access to future opportunities. Credit history is used as a gatekeeper for many important necessities — employment, housing (both rental and homeownership), insurance, and of course, affordable credit. Because of poor credit histories, minority consumers are disproportionately denied jobs, credit, insurance, housing and other services, or are forced to pay more. The drain on income affects their ability to pay their current bills, let alone build assets to move ahead. They cannot obtain loans on affordable terms to buy homes or start small businesses. The historic and current discrimination that is reflected in credit histories causes communities of color to move even further and further behind.

Challenging Economic Racism

In light of the troubling racial disparities reflected in credit reports and scores, they should not be used outside of the credit context absent the most compelling justification. For example,

there's no evidence that credit history is a valid predictor of job performance and, with extremely limited exceptions, employers simply shouldn't use credit reports in employment.

With respect to insurance, insurers claim that there is a correlation between credit scores and insurance losses. However, there is no good explanation for *why* a person with a lower credit score is supposedly more likely to cause greater losses to insurers. Insurers argue that this correlation is because someone "who is reckless with credit may also be reckless with driving or irresponsible about maintaining a home" – a weak argument since many people have poor scores due to job loss or illness. More importantly, correlation may simply be due to correlation with income and wealth. Consumers with lower scores simply may have fewer financial resources, and thus are more likely to file a claim rather than "eating" the loss. Consumers shouldn't be penalized because they don't have resources to forego filing a claim that they are legitimately entitled to file.

With respect to lending, the quandary is that credit histories and scores are useful tools for lenders, but they perpetuate past inequalities. The issue for our society is whether we continue with these same tools knowing that it not only hurts communities of color, but that the disparate impact of this tool reflects centuries of discrimination, exclusion, and exploitation.

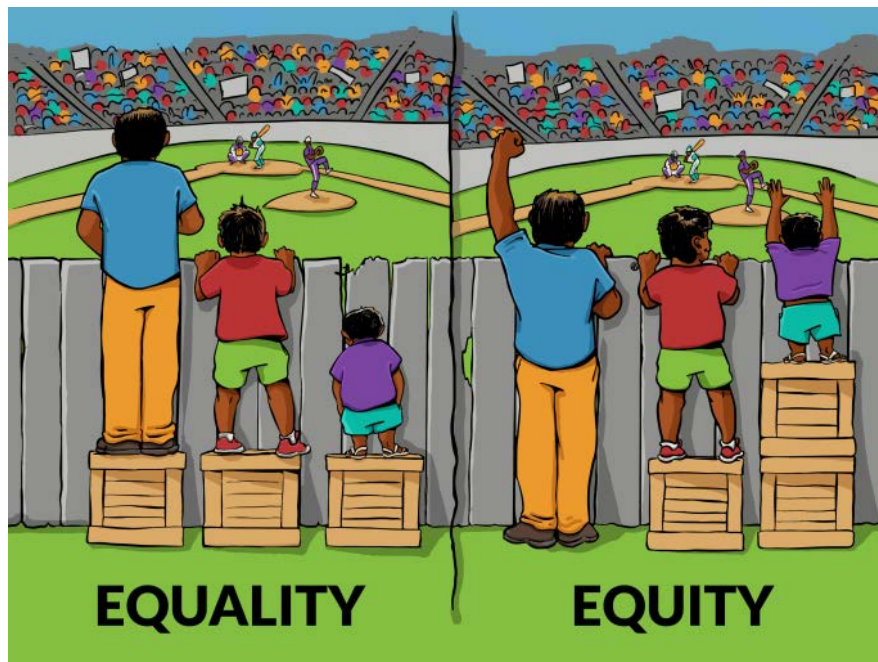
One simple reform is to restrict or even eliminate the practice of risk-based pricing, in which lenders charge higher rates to consumers with lower credit scores. While lenders argue that higher prices are justified as compensation for the risk of lending to lower-scoring borrowers, expensive loan terms can make the loan much more onerous and difficult to repay. Given that consumers of color have historically been targeted for predatory lending, credit scores should not be used to justify high-rate loans.

Another straightforward reform is to expand the use of "second chance" or special purpose programs. Second change programs, sometimes offered by community development financial institutions, give consumers who have fallen on hard times a chance to rebuild their credit histories. Special purpose programs are specifically aimed at increasing access to for minority communities, especially small business credit, and are explicitly permitted under federal law. Another [option](#) is to reduce the time limits on negative information in credit reports to three years as a way to minimize the vicious cycle aspect of low credit scores. There is nothing special about the current time limits of seven years for most information and ten years for bankruptcies, and some countries have shorter limits.

A deeper but more difficult reform, which would require significant research by data scientists, would be to develop new tools or to adjust the current tools to account for discrimination. New methods of analysis should be explored. Such tools might include the use of Big Data, i.e., analysis of massive amounts of data consumers generate through every day activities that is not traditionally used in underwriting. Currently, there are very real and significant concerns about the accuracy, predictiveness, and relevance of [Big Data](#). The use of Big Data itself can also result in disparate impacts on minority communities, especially if the data is linked to a borrower's social circles. Furthermore, there is no good explanation for why certain types of data that may statistically correlate with greater risk to lenders are relevant. However, there is

the possibility that Big Data could also be part of the solution one day, if a predictive and accurate type of analysis could be developed that is free of disparate impact.

There should also be research as to whether modifications could be made to current credit scoring models that could reduce racial disparities while maintaining – and hopefully, improving -- predictiveness. While credit scoring may have predictive value, it can also be an [overly blunt](#) instrument. Credit scoring models could be refined and modified so as to reduce racial disparities, a concept that legally is known as “a less discriminatory alternative.” Such modifications might need to actively take race into account. But that is not a radical concept. As former Supreme Court Justice Harry Blackmun once noted, “In order to get beyond racism, we must first take account of race. There is no other way.” Or as the following graphic illustrates, achieving justice or equity and eliminating the impacts of past discrimination may require treating disadvantaged groups differently.



Source: Interaction Institute for Social Change | Artist: Angus Maguire interactioninstitute.org and madewithangus.com

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. *Source: Consumer Financial Protection Bureau, Analysis of Differences Between Consumer- and Creditor-Purchased Credit Scores*, at 18, Sept. 2012, available at http://files.consumerfinance.gov/f/201209_Analysis_Differences_Consumer_Credit.pdf.
- 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. *Source: Sarah Duda & Geoff Smith, Woodstock Institute, Bridging the Gap: Credit Scores and Economic Opportunity in Illinois Communities of Color* 8 (Sept. 2010), available at http://www.woodstockinst.org/sites/default/files/attachments/bridgingthegapcreditscores_sept2010_smithduda.pdf.
- 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), 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). *Source: 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) available at <http://www.federalreserve.gov/boarddocs/rptcongress/creditscore/creditscore.pdf>.
- A 2007 study by the Federal Trade Commission (FTC) on racial disparities in the use of credit scores for auto insurance, also mandated by the 2003 FACTA amendments, found substantial racial disparities, with African Americans and Hispanics strongly over-represented in the lowest scoring categories. *Source: Federal Trade Commission, Credit-Based Insurance Scores: Impacts on Consumers of Automobile Insurance* 3 (July 2007) available at <https://www.ftc.gov/sites/default/files/documents/reports/credit-based-insurance->

[scores-impacts-consumers-automobile-insurance-report-congress-federal-trade/p044804facta_report_credit-based_insurance_scores.pdf](https://www.federalreserve.gov/trade/p044804facta_report_credit-based_insurance_scores.pdf).

- A 2006 study from the Brookings Institution 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. *Source:* Matt Fellowes, Brookings Inst., *Credit Scores, Reports, and Getting Ahead in America* 9-10 (May 2006) available at <https://www.ciaonet.org/attachments/2800/uploads>.
- A 2004 study by Federal Reserve researchers found 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. *Source:* Robert B. Avery, Paul S. Calem, & Glenn B. Canner, *Credit Report Accuracy and Access to Credit*, Federal Reserve Bulletin (Summer 2004) available at https://www.federalreserve.gov/pubs/bulletin/2004/summer04_credit.pdf.
- A 2004 study published by Harvard's Joint Center for Housing Studies found 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. *Source:* 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) available at http://www.jchs.harvard.edu/sites/jchs.harvard.edu/files/babc_04-5.pdf.
- A 2004 study conducted by the Texas Department of Insurance on insurance scoring found 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. *Source:* Tex. Dep't of Ins., *Report to the 79th Legislature--Use of Credit Information by Insurers in Texas* (Dec. 30, 2004) available at <http://www.tdi.texas.gov/reports/documents/creditrpt04.pdf>.
- 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 18th percentile, while the average consumer in a "no minority" neighborhood had a credit score that fell into the 57th percentile. *Source:* Brent Kabler, Missouri Department of Insurance, *Insurance-Based Credit Scores: Impact on Minority and Low Income Populations in Missouri* (Jan. 2004) available at <https://insurance.mo.gov/reports/credscore.pdf>.
- A 1997 analysis by FICO showed that consumers living in minority neighborhoods had lower overall credit scores. *Source:* Fair, Isaac & Co., *The Effectiveness of Scoring on Low-to-Moderate Income and High-Minority Area Populations* 22, Fig. 9 (Aug. 1997) available at <http://market360online.com/sqlimages/1261/36693.pdf>.

- A 1996 Freddie Mac study 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. *Source: See Freddie Mac, Automated Underwriting: Making Mortgage Lending Simpler and Fairer for America's Families* (Sept. 1996) available at http://www.housingfinance.org/uploads/Publicationsmanager/9706_Aut.pdf.

Other Resources

Amy Traub, et al., Demos and Institute for Assets & Social Policy, Brandeis University, *The Racial Wealth Gap: Why Policy Matters*, Mar. 10, 2015, available at http://www.demos.org/sites/default/files/publications/RacialWealthGap_1.pdf.

Paul Kiel and Anne Waldman, *ProPublica*, *The Color of Debt: How Collection Suits Squeeze Black Neighborhoods*, Oct. 5, 2015, available at <https://www.propublica.org/article/debt-collection-lawsuits-squeeze-black-neighborhoods>.

Meizhu Lui, et al., *The Color of Wealth: The Story Behind the U.S. Racial Wealth Divide* (The New Press 2006).

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 <http://responsiblelending.org/research-publication/foreclosures-race-and-ethnicity>.

United States Department of Justice – Civil Rights Division, *Investigation of the Ferguson Police Department*, Mar. 4, 2015, available at https://www.justice.gov/sites/default/files/opa/press-releases/attachments/2015/03/04/ferguson_police_department_report.pdf (discussing how law enforcement practices in Ferguson, MO were “shaped by the City’s focus on revenue rather than by public safety needs” and showed “clear racial disparities that adversely impact African Americans.”)

Persis Yu, National Consumer Law Center, *Big Data: A Big Disappointment for Scoring Consumer Credit Risk*, Mar. 2014, available at <http://www.nclc.org/issues/big-data.html>.

Chi Chi Wu, National Consumer Law Center, *Solving the Credit Conundrum: Helping Consumers’ Credit Records Impaired by the Foreclosure Crisis and Great Recession* (Dec. 2013), available at https://www.nclc.org/images/pdf/credit_reports/report-credit-conundrum-2013.pdf (discussing bluntness of credit scoring and arguing for shorter time limits for negative information).



The **National Consumer Law Center’s (NCLC) Racial Justice and Equal Economic Opportunity** initiative addresses the abusive and exploitive practices in the marketplace that decimate the finances of communities of color. <http://bit.ly/1rye4mw>