Credit Scoring Transparency – Can Germany learn from the U.S.?

THE DEMAND FOR EFFICIENT MEASURES FOR PREVENTING CONSUMER CREDIT RISKS SUCH AS CREDIT SCORING IS GROWING ACROSS INDUSTRIES. IN GERMANY, SCORE CALCULATIONS AND UNDERLYING CONSUMER DATA ARE STILL A WELL-GUARDED SECRET. THE MARKET LEADER IN THE U.S. NOT ONLY DISCLOSES THE CREDIT SCORING VARIABLES TO THE CUSTOMERS BUT MOREOVER OFFERS THEM ADVICE ON HOW TO QUALIFY FOR BETTER INTEREST RATES.

According to the Federal Statistical Office, German insolvency courts reported an outstanding balance of receivables of €33 billion in 2006. Consumer insolvencies (including formerly self-employed persons and deceased persons' estate insolvencies) represent approximately 40% and have been growing from 3,357 in 1999, the year of its introduction, to 92,844 in 2006. How does the finance sector cope with this challenge?

Credit bureaus within the banks and independent service providers collect data on consumers´ credit history, e.g. from local courts or collection agencies, and offer analysis to help companies preventing defaults and losses. Over the past years, key players such as Schufa or arvato infoscore have developed from 'pure' credit information providers to 'providers of credit decisions' by linking their data pools with credit scoring systems. Credit scoring allows companies to more accurately predict the level of risk for each customer.

What industries use credit scoring and how transparent is it to consumers regarding data that are considered in the score calculations?

Credit scoring is being used across industries, e.g. at credit institutions to calculate the risk related capital requirements (Basel II) and interest rates or at distance sellers to provide consumers with payment methods dependent on their individual credit risk. Last year, an experts report initiated by the German Federal Ministry of Food, Agriculture, and Consumer Protection highlighted the lack of transparency regarding the credit variables in score calculations and its weighting. Concerns have been raised that consumers could be discriminated, e.g. because of their age or neighbourhood. For instance, consumers could get a low score because people in their neighbourhood don't pay their bills.

Having in mind that Schufa, for example, stores 362 million data records of about 62 million Germans, whereof 7% are classified as default risks, it would be interesting to know what information is effectively used in the score. Sure, the German economy demands efficient measures to prevent losses. However, data protection laws and consumers´ right of informational self determination may not be violated.

Do consumers have more transparency to credit scoring in other countries, e.g. the U.S.?

Credit scoring was introduced in the U.S. by Fair Isaac Corporation in the 1960s and up until a few years ago, the situation was comparable to that of Germany today. The calculations and the underlying credit variables were treated as a trade secret. In recent years, various acts, e.g. the Equal Credit Opportunity Act, first enacted in 1974, and the Fair Credit Reporting Act, have evolved into a complex statute and prohibit creditors from discriminating against credit applicants on the basis of e.g. race, marital status, age, or because an applicant receives income from a public assistance program. Fair Isaac, today's market leader in developing scoring systems in the U.S., responded and disclosed the credit variables and its weighting schema (e.g. payment history 35%, amounts owed 30%). They even offer consumers to get an alert of a change on their credit report to find out when their score changes enough to qualify for better interest rates on a home mortgage or auto loan. Furthermore, consumers can examine their data at credit bureaus free of charge every 12 months and correct it if needed. This increases the quality of the database and the quality of risk estimation. More transparency balances the interests of all stakeholders – a successful model for Germany.

Thank you for the interesting conversation.

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