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The Curious Case of High Consumer Credit Scores

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The COVID-19 pandemic has caused tremendous economic disruption for many households. The unemployment rate surged last year and remained around 6% in March 2021, leaving 9.7 million workers looking for jobs.¹ Many small businesses affected by the shelter-in-place orders are still struggling to recover. Consumer optimism about the future of their finances and the state of the economy is about 80% of that in February 2020.² Although the economy will continue to improve and there has been significant progress, many Americans are still climbing out of a financial slump.

However, consumer credit scores—a measure that predicts the likelihood a borrower will be able to repay loans on time—demonstrate a different trend.³ Credit scores never dipped; on the contrary, they increased steadily throughout 2020. By this measure, one would not have guessed that the U.S. was in a recession. This issue brief discusses the disconnect between credit scores and other economic indicators, the public policies that drove the rise in credit scores, and considerations to alleviate the potential negative impacts.

CREDIT SCORES MATTER

It is hard to overstate the importance of credit scores. They are used in more than 90% of loan underwriting decisions, including mortgages, car loans, and credit cards.⁴ The scores are essential even when people are not applying for loans. Landlords or utility companies may use credit scores to assess payment risks, or decide

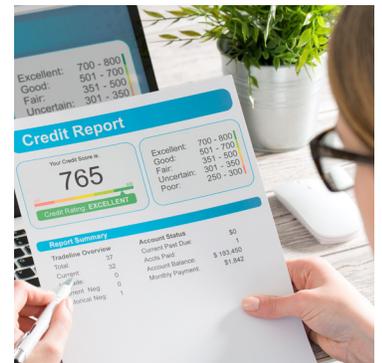
whether a potential customer should pay a higher deposit or designate a co-signer. Some employers may perform credit checks when making hiring decisions, especially for positions that involve money transactions, or job duties that include access to sensitive consumer data or confidential company information.⁵

Two companies, FICO and VantageScore, created the statistical models that generate credit scores. Typically, lenders or creditors (also known as furnishers) provide financial information about individual consumers to the credit reporting agencies that compile credit reports, which in turn serve as inputs to the credit models that are used to calculate credit scores.

The FICO model and its related score were developed in the 1950s and widely adopted by the 1990s. Their use benefitted consumer credit markets through higher transparency, increased competition, lower transaction costs, and reduced lender default losses. Over the years, numerous improvements have been made to refine the models. However, the traditional credit models used to generate credit scores are subject to significant limitations, as evidenced during the pandemic.

BEHIND THE SURGE

The average FICO score was 703 at the beginning of 2020; it then increased to 711 in July 2020 and remained stable through the end of the year.⁶ While an upward trend in scores during a recession is unexpected, the scale of increase is even



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more unusual: the average FICO score has grown at around one point per year over the past decade; last year, it increased by eight points within six months.⁷

Industry practitioners attribute the sudden jump to reduced credit utilization and lower delinquency. Shelter-in-place orders resulted in lower consumer spending, as Americans were unable to travel, take vacations, dine out, or continue their typical lifestyles. Business activities similarly contracted as states ordered temporary closures of nonessential operations. Both led to lower demand for credit as consumers and businesses used a smaller portion of their available credit.

At the onset of the pandemic, credit card debt and delinquency were expected to increase, similar to the rise after the Great Recession. However, on the contrary, both consumer demand for new credit and the delinquent rate were substantially lower than their pre-pandemic levels. For instance, data from the Federal Reserve Board of Governors show that outstanding consumer revolving loan balances (a category dominated by credit card balances) dropped by 12% in January 2021.⁸ A separate report by the Federal Reserve Bank of New York similarly illustrates the downward trend of credit card delinquency across 2020. In the fourth quarter of 2019, which was prior to the pandemic, 5.32% of credit card debt was 90 days or more delinquent; the comparable figure was 4.12% in the fourth quarter of 2020.⁹

PUBLIC POLICY RESPONSES

Many believe that reduced debt balances, lower delinquencies, and higher FICO scores are attributable to government stimulus payments and mandated deferrals for certain loans.

The Coronavirus Aid, Relief, and Economic Security Act (CARES Act) passed in March 2020 specifies that consumers have the right to request forbearance for government-backed mortgages.¹⁰ Those holding federal student loans can also request a suspension of loan payments with no accrued interest through September

2020; this was later extended to September 2021.¹¹ On the other hand, for private mortgages, nongovernment student loans, and other types of loans such as car loans or credit cards, it is up to the lender to decide whether to offer any accommodations and the terms of such arrangements. These arrangements can take many forms, including agreements to defer, forbear, modify, or reduce payments for a limited period of time.

Although a borrower's ability of getting an alternative arrangement depends on the lender and the type of loan, the CARES Act requires lenders to report a borrower's loan status as current if an accommodation is made and the borrower has been meeting requirements under the revised agreement. In addition, if a borrower was delinquent before the pandemic, the furnisher cannot report the borrower as more delinquent.¹²

These provisions greatly benefit mortgage and student loan borrowers because most of these loans are government-backed. At the end of 2019, about two-thirds of mortgages and over three-quarters of student loans in the U.S. were federally backed and therefore qualified for forbearance under the CARES Act. However, auto and credit card debts are not automatically covered by the CARES Act, and many lenders do provide certain forms of accommodation.

The second policy leading to a different credit market experience this time involves stimulus checks, formally known as "economic impact payments." Census data on the first and second stimulus checks show that a substantial portion of recipients either saved the funds or used the money to pay off debt.¹³ Similarly, a Federal Reserve survey that includes results from actual use of the first two checks and expected use of the third check shows consistency regarding their use: most funds went to savings and debt payments. Specifically, the portion of households that spent their stimulus checks on consumption decreased from 29% to 26%, then to an expected 25% for the last check. On the other hand, the percentage of households that directed the funds toward savings and debt payments increased from 71%, 74%, to 76%.¹⁴ These statistics reveal

that given the uncertainty ahead, a fair portion of consumers used stimulus checks to strengthen their financial positions, which contributed to lower credit utilization and debt balances.

THE COMPLICATIONS

While the government policies generated positive outcomes for consumers, it is uncertain if these benefits will be long-lasting or transient. However, two potential challenges, some described as unintended consequences, are emerging. First, lenders now face difficulties determining borrower risks. In addition, loan defaults could increase when borrower forbearance ends.

Under the CARES Act, furnishers are required to report loans in forbearance as current. As a result, financial institutions may find that the ability of credit scores to predict borrower creditworthiness is compromised. In addition, a potential borrower's financial condition could deteriorate rapidly in the current economic environment. The lag between a borrower's adverse economic event (such as job loss) and its impact (via reporting to a credit bureau) may render credit scores obsolete.

The reduced predictive value of credit scores led lenders to adopt both defensive and offensive measures. In recent months, concerns about the validity of existing credit score models prompted many lenders to tighten their lending criteria and underwriting standards, such as requiring higher minimum credit scores for new loans. Many lenders also pulled back on marketing initiatives.¹⁵

These defensive measures may harm consumers who do not have loan deferrals or are not in these agreements, because they now are being grouped together with borrowers in forbearance. Borrowers with forbearance agreements face the Federal Housing Finance Agency's general guidance requiring consumers to make three consecutive timely payments after the end of forbearance before applying for new credits or refinancing a loan; however, this requirement is being applied on a case-by-case basis.¹⁶ Some believe the requirement

may have prevented some consumers from taking advantage of record low interest rates.

Many lenders have taken offensive position, proactively adopting measures to more effectively evaluate a borrower's financial capacity, such as using new information sources, predictive models, or their proprietary analyses. For instance, traditional FICO score calculations do not consider income, assets, cash flow, or employment history. In recent months, lenders have been supplementing credit reports with real-time income or cash flow data from borrowers' bank accounts.¹⁷ The pandemic has enabled new thinking and accelerated the adoption of alternative measures to improve the current process that relies heavily on FICO scores.

Initiatives to improve current credit models were under way before the pandemic. Some recommend including rental and utility payment history, bank transaction records, cash flow and reserves data, and increasing the use of data aggregators to expand the current models.¹⁸ However, the formal adoption or implementation of these measures as comprehensive industry standards could still be years away due to legal and privacy concerns.

Another issue is whether borrowers are prepared to exit their loan accommodation and resume payment when forbearance ends. For instance, the Consumer Financial Protection Bureau (CFPB) indicates that at the height of the pandemic, 6.9 million mortgage borrowers entered a forbearance program, and 2.7 million borrowers were still in forbearance in January 2021.¹⁹ If a homeowner requested forbearance in March 2020 or April 2020 for the maximum time allowed, typically 18 months, the forbearance period will end around September 2021 or October 2021.²⁰ Industry data predicts that about 800,000 borrowers will exit forbearance in September or October, and the rest will gradually exit the program over the few months that follow. Researchers also warn that delinquencies or loan defaults on a large scale may stress the financial system, reducing available credit in the future.²¹

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Two potential challenges emerge as a result of stimulus policies: lenders may face difficulties determining borrower risks. In addition, loan defaults could increase when borrower forbearance ends.

After the forbearance period ends, borrowers typically have a range of options to repay the amount owed, such as attaching the missed payments to the end of the loan, paying a smaller additional amount each month over a long period of time, or making alternative payment plans. Practitioners stress the importance of discussing such options with the lender before the forbearance ends to protect the borrower's credit scores. Without any action, the worst case could be that lenders stop offering any further accommodations and borrower defaults surge—at which point credit scores will have already been damaged.

Although a wave of delinquent loans could be ahead, any kind of forbearance is intended to be a short-term measure, and does not cancel or forgive unpaid loan balances. These plans essentially revise the contract between borrowers and lenders, and temporarily provide borrowers favorable terms so they have extra time to repay the amount owed. A Congressional Research Service study states that the longer the economic impacts of the pandemic last, the less likely a loan forbearance will prevent consumer default.²²

Industry experts agree. They state that although loan forbearance plans can protect consumers from negative consequences such as credit score declines, debt collections, or foreclosures, these plans are most helpful for borrowers experiencing temporary hardships. Loan forbearance is a less viable measure for prolonged financial disruptions that cause borrowers to habitually rely on the provisions.²³ Borrowers may temporarily make their loan repayment obligations a lower priority and allocate funds for spending. As a result, an extended forbearance period may only delay the day that consumers become delinquent—and not instead be used to catch up on debt repayment.

AFTER THE MUSIC STOPS ...

Certain public policy responses to the pandemic have boosted FICO scores. The seemingly high-performing consumer credit market has disguised several important

signals, which have prompted lenders to adopt alternative measures when evaluating borrower creditworthiness. As borrowers exit forbearance in the next few months, their credit standing could deteriorate if they are unprepared to pay off outstanding debts.

The pandemic has provided an opportunity for all stakeholders to review the existing credit underwriting process and incorporate meaningful improvements. Policymakers can be more engaged in the discussion to facilitate a more inclusive recovery. For instance, if factors such as utility payment history and cash transaction records are considered as industry participants revise credit model designs, potential borrowers who can repay but are scored unfavorably under the current system will be able to obtain credit.

Although some have advocated extending consumer loan forbearance, the current recovery trajectory and the existence of other assistance programs make it unlikely that Congress will pass another large-scale relief package; private lenders may also stop offering additional forbearance.

In early April 2021, the CFPB notified mortgage servicers that a surge of homeowners may exit mortgage protection programs and need assistance as early as this summer.²⁴ The CFPB encourages servicers to proactively dedicate resources and reach out to homeowners to prevent avoidable foreclosures. The agency also emphasizes foreclosure prevention and loss mitigation as enforcement priorities.

Consumer advocates suggest that borrowers in forbearance should start budgeting, cut spending, and avoid incurring additional debt. In addition, if borrowers do not fully understand the terms of their revised agreements, including what happens when the current relief period ends but the borrower still needs financial help, they should reach out to lenders as soon as possible. Finally, consumers can also take advantage of free credit report offers that were just extended until April 2022.²⁵ If consumers diligently manage their credit, the pandemic may become an opportunity for some to strengthen their financial record and turn the temporary credit score surge into a fundamental improvement.

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