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Credit Scores in Business: The Good, Bad, and Ugly

Deana Wilson & C. W. Von Bergen
Southeastern Oklahoma State University

C. W. Von Bergen, Ph.D.
John Massey Professor of Management
John Massey School of Business
Department of Management & Marketing
Southeastern Oklahoma State University
211 Russell Building
1405 N. 4th Avenue, PMB 4103
Durant, Oklahoma 74701-0609
Voice Mail: 580-745-2430
Fax: 580-745-7485
E-mail: cvonbergen@se.edu
Web Page: http://carmine.se.edu/cvonbergen

Abstract
The three digit number known to most of us as a credit score or FICO score is creating quite a stir among job applicants and insurance subscribers. It appears that employers and insurance companies are turning to credit information to make decisions about one's integrity, job performance, and to determine their probability of filing an insurance claim. It is thought that minorities will be most affected by the decision to use credit information in these types of decisions due to the fact that they typically have lower credit scores and appear to be at a higher risk of default. This paper offers insight into a growing concern about how an individual’s credit score can affect their ability to obtain employment and insurance. In particular, it will take a
close look at the disparity among credit scores for minorities and how this growing trend may affect them more than others.

Credit Scores in Business: The Good, Bad, and Ugly

When most people think about their credit score they think about mortgage, loan, or credit cards. Today credit scores are being used for much more than assessing an individual’s default risk on a loan. Employers claim that credit reports are a useful tool during pre-employment screening, especially for jobs where an individual might have access to large sums of money. Coombes (2004) reported that organizations feel the use of credit reports “minimize organizational risk” because individuals with low credit scores might be more susceptible to stealing from an organization.

Insurance companies also claim that credit ratings are a necessary tool for them to accurately determine premiums for subscribers. According to insurance underwriters, research shows that an individual with a poor credit rating is at higher risk of filing a claim for damages. Kenton Brine, Property Casualty Insurer's assistant vice president, stated that “Credit-based insurance scoring is a fair, long-established tool that saves the typical insurance consumer anywhere from 30 to 59 percent on auto insurance due to the proven correlation between insurance scores and risk. The Federal Trade Commission, St. Ambrose University, the Texas Department of Insurance, and independent actuaries have all released studies in recent years confirming that credit-based insurance scores are predictive of risk” (Washington Commissioner Criticizes, 2010).

An important point to note is that credit-based insurance scoring saves the “typical” consumer money on their auto and home insurance. The focus here is on minorities and how using credit-based insurance scores or pre-employment screening credit checks may negatively or disproportionately affect them. Credit scores are not just used to determine if a person is eligible for a loan, mortgage, or credit card. Today, employers, insurance companies, and utility providers such as Texas Utilities are using this information to determine if an individual is trustworthy or to determine what rate should be charged (Wozniacka & Sen, 2004). The Wall Street Journal reported in 2004 that TXU raised rates for individuals with low credit scores. Rates were based on an individual’s creditworthiness using past payment history. The use of
credit reports was defended by stating that past credit history is an accurate predictor of future payment history (Smith, 2004).

Minorities, as well as other individuals with low credit scores, will not only suffer in terms of insurance premiums and in obtaining employment, but also when trying to access basic utilities such as electricity, cable, or phone. Having a low credit score typically means that one is unable to meet financial obligations and this is usually due to a lack of income. When credit scores are used as employment-screening tools, and to determine insurance and utility rates, it becomes difficult for individuals already struggling to meet their financial obligations. It is difficult for individuals to solve their financial problems when they are unable to obtain satisfactory employment and are expected to pay rates higher than those with higher income or higher credit scores.

**Credit Scoring**

A growing concern is that individuals are uneducated with respect to how credit scores are determined or how their financial habits affect those scores. Richards, Quinlan, and O’Leary (2009) found that most people do not fully understand the meaning of a credit score when 69.2 percent of respondents selected the wrong answer when asked to identify the correct definition of a credit score. Many of these same respondents indicated that they had never checked their credit score. For individuals to understand how their credit score affects their ability to gain employment and obtain insurance, they must be educated as to what a credit score is and they must obtain their score.

A credit score is a three digit number typically ranging from 300-850 and is used to determine a person’s default risk. Credit scores are sometimes referred to as FICO scores. FICO is an acronym for Fair Isaac Company, which is the company that has the most widely used credit scoring model (Smith, 2006). An individual with a high score, for example 750 or above, is considered at low risk of defaulting, whereas, an individual with a low score, 599 or below, is considered high risk. Table 1 below provides information on the distribution of credit scores across the U.S. It is important for consumers to be aware that their financial habits are being monitored and reported to three national credit reporting agencies: Equifax, Experian, and TransUnion (Education-credit, n.d.).
Credit-scoring models are used to calculate scores and consider non-financial information such as occupation, length of employment, and whether or not an individual rents or owns a home. Credit reporting agencies use different models depending on what type of credit an individual is requesting. For example, auto financing and installment loans would not use the same model. Unfortunately the details and exact formula for these models remain mostly a mystery to the public. Important factors such as payment history, which can account for up to 35% of a person’s credit score, vouch for ones ability to meet financial obligations in a timely manner, and play a significant role in these models. Other factors include: the amount of money owed to debtors, length of credit history, and credit type (Electronic Privacy Information, n.d.).

Fair Isaac Company, a Minneapolis based company that specializes in decision management, began computing credit scores in the 1950s but the first general-purpose FICO was created in partnership with Equifax in 1989 and is the most widely used score today. A mathematical algorithm is used to compute a consumer’s credit score and it is then compared to others with similar profiles to determine the consumer’s creditworthiness (Smith, 2006). Credit data is usually grouped into five categories: payment history, amounts owed, length of credit history, new credit, and types of credit used. The following examples could be helpful when examining the factors that contribute to consumer creditworthiness.

Payment History – determines about 35% of creditworthiness score

- Current payment information for account such as car loans, mortgage, and credit cards
- Presence of bankruptcies, collection accounts, or delinquent accounts
- Severity of delinquency
- Amount past due on delinquent accounts or collection items
- Time lapsed since past due item, adverse public records, or collection items
- Number of past due accounts
- Number of accounts paid as agreed

**Amounts Owed – determines about 30% of creditworthiness score**

- Amount owed on accounts
- Number of accounts with balances
- Proportion of credit lines used
- Proportion of installment loan amounts still owing

**Length of Credit History – determines about 15% of creditworthiness score**

- Time since accounts opened
- Time since accounts opened, by specific type of account
- Time since account activity

**New Credit – determines about 10% of creditworthiness score**

- Number of recently opened accounts
- Number of recent credit inquiries
- Time since recent account opening
- Time since credit inquiry
- Re-establishment of positive credit history following past payment problems
Types of Credit Used – determines about 10% of creditworthiness score

- Number of various types of accounts (Barrett, 2009).

Achieving and maintaining a high credit score is a difficult task for the average American. It is thought that majority of minorities are under or unemployed, do not own their home, or maintains lines of credit (Logan & Westrich, 2008). Using this information to determine a credit score is going to result in a low credit rating for most minorities.

Credit scores as Pre-employment Screening Tool

Many people as well as legislators are fighting back against the use of credit reports in employment selection. “Legislators in more than a dozen states have introduced bills to curb the use of credit checks during the hiring process, and three states (Illinois, Oregon, and Washington) have passed such laws” (Martin, 2010). Nonetheless, there still appears to be valid arguments coming from both sides, job seekers and employers, as to the legitimacy of credit scores as a employment screening tool. Those seeking employment feel they are being discriminated against when their credit history is preventing them from gaining employment. Job seekers might find it hard to rationalize why they cannot gain employment, especially when the poor credit score is due to a layoff, medical bills, or factors beyond their control. Employers feel that credit reports not only assist them in predicting employee behavior, but are also useful when verifying the accuracy of application information given that a person’s credit report includes address and employment history (Neilsen & Kuhn, 2008). A study by Palmer and Koppes (2004) present three rational arguments as to why an applicant’s credit history might predict subsequent behavior: “1) That credit history reflects past applicant conscientiousness, 2) that credit history might indicate whether an applicant is currently in financial trouble, and that this could be indicative of the likelihood or temptation to steal or leave the company for another, better paying job, and 3) to avoid a negligent hiring claim” (P. 1).

A 2005 report by Spherion, a U.S. recruiting firm, revealed that the number of employers using credit scores and credit reports to determine the suitability of a candidate had increased 55
percent over the previous five years (Smith, 2006). Despite the fact that there is no known research to support the employer's argument for the use of credit reports, they continue to insist that credit scores are valuable pre-employment screening tools. In fact, research has shown that "employees who had a higher number of 30-day late payments were slightly more likely to receive higher performance ratings" (Palmer & Koppes, 2004). This information might suggest that a person could use their financial struggles as motivation to perform above standards in an effort to gain a promotion or pay raise. Furthermore, Palmer and Koppes (2004) concluded that "no published empirical evidence for the criterion validity of credit history exists. We thus recommend discontinuing the use of credit history for selection decisions unless and until this validity is demonstrated" (P. 6). Given this information, it can be assumed that there is little support for employers who use credit reports to screen all applicants. There is however, some support for employers who use credit reports to screen applicants applying for positions in financial institutions or positions where large amounts of money are handled (Lawyers USA, 2010).

Employers as well as organizations such as TransUnion, share the opinion that credit scores are a valid way of screening employees. Employers believe that by looking at a person's credit report they can predict if the individual is likely to steal from the organization. Martin reported in The New York Times that Eric Rosenberg of TransUnion, a national credit reporting agency that sells credit reports to employers, believes credit reports are a vital piece of the screening process since companies are losing billions each year to theft, embezzlement, and fraud. However, Rosenberg later admitted that to his knowledge there was no evidence supporting his opinion that there is a direct relationship between poor credit ratings and employee performance (Martin, 2010).

Even with research currently discouraging the use of credit reports by employers, such a practice is legal and employers reserve the right to continue using it as a screening method. Bill Dolphin (2007), V.P. of Asset Control, an employment screening company, suggests that employers consider the following items when using credit reports in employee selection:

- Use "Employment Credit Reports" that meet the Fair Credit Reporting Act (FCRA) standards and do not show credit scores.
• Avoid developing rules, standards, or numeric guidelines for screening out applicants based upon the information contained solely in the credit report.

• Make sure that the use of the credit report is closely related ("job relatedness") to the position applied for.

• Reserve credit reports for management level candidates such as: Manager, Director, Vice president, etc.; then, only for positions in which the employee has control over company accounts and funds.

• Document reasons for using a credit report for a position. The process of reasoning through each justification will help identify positions for which credit reports should not be used.

• Be familiar with the FCRA requirements regarding the use of consumer reports. Be aware that credit reports are not always accurate. If employment is denied based on information obtained in a credit report, an adverse action letter must be provided. An adverse action letter is a written notice to the applicant informing them that they have been denied based on information in their credit reports. This notice must include the credit reporting agency that the report was obtained from and inform the applicant that they are entitled to a copy of this report. An employer must comply with FCRA guidelines and avoid violating applicant’s rights.

The Equal Employment Opportunity Commission (EEOC) has identified problems with employers using credit reports due to the fact that some minority groups might have lower credit scores. Minorities tend to have higher rates of delinquent accounts, bankruptcies, and credit defaults and tend to hold jobs that have a lower credit value. “In other words, credit reports by there vary nature have a racially disparate impact” (Dolphin, 2007). The EEOC found it necessary to release a legal advisory letter warning employers that the use of credit reports could become illegal if it disproportionately excludes women or minorities. Title VII, of the Civil Rights Act of 1964, prohibits an employer from using screening tools that intentionally exclude minorities or other protected groups unless they can demonstrate that it is directly linked to the safe operations or efficiency of the firm (Lawyers USA, 2010).

**Credit-Based Insurance scores**

Credit scores are also playing a significant role in determining an individual’s insurance premium. It is argued that the ability to predict future claims allows insurance companies to accurately price policies. Many believe that there is a strong relationship between a person’s
credit score and future insurance claims. It is believed that an individual with a lower credit score is more likely to file a claim for damages and possibly even exaggerate this claim in an effort to receive more money. Brockett and Golden (2007) propose that there is a biological and psychological relationship between risky driving and financial decision making, which suggests that an individual who makes poor financial decisions will also take greater risks when driving. A study conducted by the Texas Department of Insurance in 2006 supported the conclusion that there is a link between credit scores and insurance risk. According to the study “as credit scores improve, the pure premium or average loss per vehicle decreases. Conversely, as the credit scores worsen, the average loss per vehicle increases” (Texas Department of Insurance, 2006). A study by the Federal Trade Commission (FTC) in 2007 also came to a similar conclusion. They found that credit scores were an effective way of predicting policy rates as well as predicting the number of claims and cost of those claims (Federal Trade Commission, 2007). On the other hand, the Missouri State Insurance Department released a study detailing how the use of credit scoring may harm minority populations. The findings show:

1. On average, residents of areas with high minority concentrations tend to have significantly worse credit scores than individuals who reside elsewhere.

2. On average, residents of poor communities tend to have significantly worse credit scores than those who reside elsewhere.

3. Credit scores are significantly correlated with minority concentration in a zip code, even after controlling for income, educational attainment, marital status, urban residence, the unemployment rate and other socioeconomic factors.

4. The minority status and income levels of individuals are correlated with credit scores, regardless of place of residence (Kabler, 2004).

The insurance industry strongly defends their use of credit scores but many critics question the validity of their presented research. Shortly after the release of the FTC study it was condemned by several consumer representatives and civil rights organizations stating that it was “biased insurance industry propaganda” (Center for Economic Justice, CFA, NCLA, NFHA, 2007). “Representatives of the Consumer Federation of America, the National Fair Housing
Alliance, the National Consumer Law Center, and the Center for Economic Justice said the FTC study is fatally flawed because the insurance industry controlled the data used in the analysis" (Center for Economic Justice, CFA, NCLA, NFHA, 2007). These groups felt that the FTC ignored evidence that other factors might contribute to consumer risk and focused solely on credit-based insurance scores. Shanna L. Smith, President and CEO of the National Fair Housing Alliance indicated that “To add insult to injury, the FTC report mimics the insurance industry blaming-the-victim psychobabble of claiming credit history is related to responsibility and risk management. A look at the actual scoring models shows that socio-economic factors have more impact on the score than loan payment history and that an insurance credit score has little to do with personal responsibility and everything to do with economic and racial status” (Center for Economic Justice, CFA, NCLA, FHNA 2007). These groups asked Congress to reject the study and request that the FTC conduct their own independent study. Based on the evidence of racial discrimination, they also asked that insurance-based credit scoring be banned all together.

An analysis by Stutz (2009) showed that “drivers and home owners in North Texas with poor credit ratings are paying on average at least 35 percent more for insurance coverage than those with good credit even when all other factors, such as driving records and recent damage claims on homes, are identical.” A majority of the auto insurance companies in Texas rely on a person’s credit score to determine rates, which has created problems for many consumers. They see this as a “double whammy” considering the current economic state of the United States and feel that low income individuals, particularly minorities, will be forced to pay far more in insurance premiums than the average consumer based on one factor credit scores (Stutz, 2009). “Texas Watch has cited statistics indicating that roughly 65 percent of drivers with the worst credit are minorities, while 90 percent of drivers with the best credit are white” (Stutz, 2009). Alex Winslow from Texas Watch, an advocacy organization working to improve consumer and insurance protections, also noted that insurance companies prefer a more “affluent” consumer because they are more likely to cover some claims, around $1,000, whereas lower income individuals are unable to afford such an expense and therefore are more likely file a claim with their insurance company (Stutz, 2009) This study might suggest that the reason higher income individuals with better credit scores are less likely to file a claim is because they can afford the expense. Those with lower incomes and usually lower credit scores cannot afford such expenses.
This might suggest that the strong correlation is not with credit scores and claim history but more with socio-economic class and claim history.

Research has also found that many people are unaware that their credit score plays a role in determining their insurance rates. Richards et al. (2009) found that only 8.7 percent of individuals surveyed were aware that their credit scores helped determine their premium or was used as an “indicator of a tendency to file claims.” Insurance providers do not promote their use of credit scores and may need to educate consumers on how their credit scores impact their policy rates. Part of the conclusion reached by the researchers was that “consumers are seriously uninformed about insurance fundamentals” (Richards et al., 2009). Not understanding the factors that contribute to an individual’s policy premiums makes it difficult to lower those rates to a more affordable price. Most states have laws in place that require consumers to carry auto insurance. Due to high rates based on credit scores, many consumers are forced to try and pay unaffordable rates or risk legal ramifications. There appears to be a need for states to work closely with consumers in assuring that insurance can be affordable, especially for those such as minorities that are subject to higher rates but have lower incomes.

Minority Credit Scores

Research using full credit reports of 301,536 anonymous individuals by the Board of Governors of the Federal Reserve (2007) found that credit scores are indicative of credit risk for the population as a whole and that credit scores in themselves are not racially biased. However, credit scores do vary significantly between race and ethnic groups. Credit scoring models do not take race into account when calculating scores but minorities tend to fall victim to lower scores. What must be considered are the factors that play a role in determining ones credit score and how those might be affected by race.

In response to the significant credit score differences among races, the Board of Governors of the Federal Reserve (2007) developed their own credit-scoring model “mimicking the process used by the credit-scoring industry” (P. O-18). With this model researchers were able to manipulate the process by adding, removing, or altering the way contributing factors affect credit scores. Results from this model showed that adding or dropping a single factor had very minimal impact on score differences across population groups. These finding indicate that race or ethnic group status do not play a role in the individual factors but when combined tend to result in lower scores for African Americans and Hispanic Americans.
African Americans and Hispanic Americans seem to be most affected by these factors and therefore on average have lower credit scores than white or Asian individuals. As mentioned before, payment history, debt amounts, occupation, and whether or not a person owns a home can be contributing factors when calculating credit scores. The Center for American Progress (Logan & Westrich, 2008), a liberal public policy research and advocacy group, reports that African Americans and Hispanic Americans have seen an increase in unemployment and poverty rates since 2000. 20.6 percent of Hispanic Americans and 24.2 percent of African Americans were living in poverty, whereas only 8.2 percent of whites were in poverty in 2006 (Logan & Westrich, 2008). With this information it could be assumed that these specific groups tend to have lower incomes, which could account for their tendency to have poor payment history and higher rates of bankruptcy. With payment history accounting for up to 35 percent of one’s credit score, this could be a significant factor.

The Center for American Progress also notes (Logan & Westrich, 2008) that the home ownership rate for 2006 was 49.7 percent for Hispanics and 47.9 percent for African Americans. This is significantly lower than the home ownership rate for whites, which was 75.8 percent. Home ownership is a contributing factor when looking at credit scores; therefore, it can be concluded that African Americans and Hispanic Americans would again rank lower than white Americans (Logan & Westrich, 2008).

McGraw (2007) reported that while African Americans might be interested in building a prime credit score, they could be “trapped.” Research conducted by the University of Denver Center for African American Policy showed that while bank branches are present in low-income, high minority populated areas, they do not provide access to the same services offered by branches in higher income areas. Without access to loans or other credit building opportunities it becomes easy to see why large numbers of minorities maintain low credit scores. Their “on-time” payment histories usually include things such as basic utilities, rent, or lines of credit not reported to credit bureaus. This prevents them from building a positive line of credit or prime credit score and thus hinders their access to services needed to establish wealth (McGraw, 2007).

Another aspect that must be considered is that lenders do not just use credit scores to determine if a person is eligible for a loan or line of credit. Credit scores do play a significant role but lenders will also consider factors such as employment status or history, current financial state, education, and assets (Blankson, n.d.). Being unable to show satisfactory results in each of
these categories could result in a denial. This creates a situation that might be difficult to escape. When a poor credit score prevents an individual from obtaining employment and lack of employment prevents that same individual from improving their credit score, it becomes difficult to find a way to remedy this problem.

**Conclusion**

Credit scores tend to be lower for individuals with lower incomes and those who hold blue collar or nonprofessional positions. A high percentage of African Americans and Hispanic Americans fall into these two categories, which leaves them with a good chance of having a poor credit history. These same individuals are among those struggling to find employment and with the increased usage of credit reports in pre-employment screening this may become even more difficult. Current standards, though not racially biased when considered individually, have a negative affect on minorities when combined to determine credit scores and tend to leave minorities at a disadvantage compared to white and Asian Americans. Minorities are not the only group affected by these standards. All races and ethnic groups that are considered low income and young in age are prone to lower credit ratings because of how the “system” is set up. Credit scoring models appear to favor white or Asian Americans around the age of 50 who hold professional positions, own their own home, and are conscious about how their financial habits affect their credit report.

The research presented here appears to support the proposition that a person’s credit score is predictive of credit risk and is a necessary tool. The mathematical formula used to calculate credit scores has also shown to be not racially biased. Overall, the credit-scoring system is “fair” across populations. A closer look must be taken at the circumstances that appear to place African Americans and Hispanic Americans at a risk of having poor credit scores. The problem appears to be that these groups tend to be underemployed or unemployed, live in low-income areas, and have less access to credit building services. Without examining these factors, these particular minority groups will be unable to pull themselves out of this dilemma creating a cycle that will continue to put them at a disadvantage compared to others. The question that must be answered is why these groups tend to have a high rate of poverty and unemployment compared to other minority groups.

The information presented here indicates that the general public does not support the use of credit scores when screening employees and determining insurance rates. No research has
been presented to support a relationship between credit history and employee performance and many critics question the research presented in support of insurance-based credit scores. Credit scores are intended to assess default risk, which in general has little to do with employee performance and probability of filing an insurance claim.

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Author Biographies

Deana Wilson is an MBA student at Southeastern Oklahoma State University where she also
earned a Bachelor of Science in Biology in 2007. She has spent the past 6 years in various
management positions for organizations such as The Renfrew Center and Lifepath Systems.
Upon completion of her MBA, Deana plans to continue her career in Healthcare Administration.

C. W. Von Bergen (Ph.D., Purdue) is the John Massey Professor of Management at Southeastern
Oklahoma State University, Durant, Oklahoma and has been at Southeastern since 1997. Before
entering higher education Dr. Von Bergen held management positions over a 17 year period in
which he worked for several organizations including Kellogg Cereal Company and Associates
Financial Services Corporation. He is the author of numerous publications emphasizing both
behavioral and strategic dimensions of management.