Written Testimony
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On

"Fair Credit Reporting Act:
How it Functions for Consumers and the Economy"

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My name is Allen Fishbein. I am General Counsel of the Center for Community Change. I want to thank Chairman Bachus, Rep. Sanders, and other members of the Subcommittee for inviting me to testify today at this hearing on the "*Fair Credit Reporting Act: How it Functions for Consumers and the Economy*." My testimony will focus this morning on issues pertaining to the impact of credit scoring and automated underwriting in providing fair access to mortgage credit.

The Center for Community Change (CCC) is a national, non-profit organization, headquartered in Washington, D.C. For over 35 years, CCC has been an important source of technical assistance, training, and advocacy on behalf of local community organizations working to improve the conditions in low-income and predominately minority communities across the nation. A key component of our work has been devoted to assisting local efforts across the nation aimed improving the flow of responsible mortgage credit to families living in underserved neighborhoods. CCC also released a national study last year entitled, *"Risk or Race: Racial Disparities and the Subprime Refinance Market,"* (www.communitychange.org) that details the disproportionate rise of subprime mortgage lending to minority households and neighborhoods.

My own work in this area spans over twenty-five years in providing technical assistance to local groups and advising lenders and government regulators. I also served for at time as Senior Advisor to HUD for Government Sponsored Enterprises Oversight and on several advisory bodies relevant to today's hearing, including the Federal Reserve Board's Consumer Advisory Council, the Fannie Mae Housing Impact Advisory Council and the Freddie Mac Affordable Housing Advisory Council.

In 1969, during the debate on the original Fair Credit Reporting Act (FCRA), Sen. William Proxmire spoke of the congressional intent behind the law: "The aim of (FCRA) is to see that the credit report system serves the consumer as well as the industry. The consumer has a right to information which is accurate; he has a right to correct inaccurate or misleading information, (and) he has a right to know when inaccurate information is entered into his file . . . The Fair Credit Reporting Act seeks to secure these rights."

Referring to this legislative intent, William N. Lund, with Maine's Office of Consumer Credit Regulation stated last year, " . . . just as the FCRA de-mystified the storage and use of credit information, credit scoring is now serving to re-mystify that process."

I share the regulator's concern. The rapid growths in the use of credit scoring and related technologies have worked to improve access to credit for many, particularly in mortgage lending. However, it also has added an additional veil of secrecy over the credit decision-making process. This veil has created uncertainty and suspicions among consumers about the role that these scoring technologies play as gatekeepers for

obtaining credit. Lifting this veil, particularly in the mortgage lending arena is long overdue, but it is likely to require Congressional action to achieve.

What is credit scoring?

Credit scoring is an underwriting tool used to evaluate the creditworthiness of prospective borrowers. Credit scores are statistically derived measures of creditworthiness that seek to rank credit applicants according to their degree of credit or default risk. In essence, the score represents an odds ratio: how many applicants are likely to become delinquent or default at the corresponding score. Used for many years to underwrite certain forms of consumer credit, scoring has migrated in recent years to other forms of credit, such as mortgage and small business lending.

People with high credit scores may qualify for the cheapest credit on the best terms. Too many negative records and/or too few positive records can add up to a low score. Credit scores are widely used among credit card companies to determine the rates and terms of credit cards. Banks use credit scores to determine who can open checking accounts. Credit scoring is used by virtually all car insurance companies and the vast majority of homeowners insurance companies in determining the type and cost of insurance that will be made available to the applicant. It is even used in some situations to make decisions about whether to offer an individual a job, an apartment, or utility service. Credit scores are believed to be a determining factor in 90 percent of all consumer credit decisions. In short, a person's credit score has become fundamental to successes accessing credit and other financial resources.

Credit scoring and mortgage lending

The advent of credit scoring for mortgage lending occurred very quickly. Up until the mid-1990s, when a family wanted to obtain a home loan they typically went into a financial institution to apply for a mortgage. A loan officer would gather information about the potential borrower and the property for which the family was seeking financing and then make the final judgment about whether or not to make the loan. This process could last weeks.

Credit scoring is now used by most mortgage lenders as a key-underwriting tool to determine the credit worthiness of prospective borrowers. It is estimated that 60-70 percent of all home mortgage loan decisions involves the use of credit scoring in the approval process. In today's market, credit scores are used not just to determine whether an applicant qualifies for a mortgage, but also to determine the size of the loan, and increasingly, to set the interest rate and terms the borrower will be charged.

"FICO" is the most commonly used type of scoring in the mortgage market. It is devised by the California-based Fair, Isaac and Co., which provides the scoring analytics. The score is produced for lenders by running a consumer's raw credit-bureau data through proprietary statistical modeling software marketed by the company. FICO scores range from 300 on the low side to 800 on the high side. The score is not actually generated by

the lender (many lenders are unable to explain much to borrowers about how their score was derived). Instead the lender requests it as part of the credit report it obtains from one of the three national credit-reporting agencies (bureaus). Each bureau has proprietary components of their models that generate unique scores, and consequently, consumers can have more than one credit score.

Five areas of information are gathered from credit reports and used to calculate credit scores: previous payment history, amount of money owed, length of credit history, amount of new credit sought, and the mix of types of credit. The FICO model also allows users of their model to weigh each variable differently. Thus, some lenders may choose to customize the model they use. The credit bureaus emphasize that their scores are snapshots of a borrower's credit history at the time the score is generated. Scores are regularly updated and therefore, a consumer's score is, theoretically at least, always changing.

Another key development that changed mortgage lending is the rise of automated underwriting (AU). AU systems represent the fusion of statistical scoring scoring methods and high tech processing. Previously used in credit cards and auto lending, proprietary automated underwriting systems developed by Fannie Mae, Freddie Mac, the two government sponsored housing enterprises (GSEs), along with several large mortgage insurers and mortgage lenders are now used for home loan purposes. The GSEs' AU systems are also used by the U.S. Department of Housing and Urban Development (HUD) for FHA lending approvals, although the department is expected to unveil its own AU system at some point. Through the emergence of these systems and the scores they provide, a relatively small number of companies, some public chartered and some not, have a great deal of say in determining who qualifies for prime mortgage credit and who does not.

The AU systems can quickly evaluate mortgage applicants based on information in credit reports as one component of broader mortgage score. Mortgage scores quantify many aspects of risk associated with a particular application – including loan to value ratio, borrower characteristics, and loan type, in addition to credit history. A mortgage lender can submit a mortgage application to AU prior to approving the loan and receive a quick indication as to whether the secondary market will purchase the loan.

Officials at Fannie Mae and Freddie Mac believe that their systems vastly improve their ability to rank borrower risk and to determine eligibility standards for loan purchases. Both GSEs launched their systems in the mid-1990s and they quickly replaced the traditional manual approach to making loan decisions. Because they purchase such a high share of all mortgages underwritten, most mortgage lenders are influenced by the standards set by GSEs' AU systems, even if they choose to hold these loans in portfolio. The GSEs point to how the efficiencies achieved through AU has translated into increasingly higher acceptance rates as evidence that these systems are expanding opportunities for approval of more marginal, yet creditworthy, applications. Some observers believe that recent gains in homeownership rates for underserved segments of our population can be attributed, at least in part, to the underwriting standards that have

emerged as a result of the AU systems now in place. But no one outside the purveyors of these systems can say for sure.

The Fannie Mae AU system is known as Desktop Underwriter; the Freddie Mac version is known as Loan Prospector. Each system relies on range of indicators, including numerical scores, loan to value ratios and other data submitted by the borrower to calculate a mortgage score. These scores, in effect, represent the willingness to accept the loan application, or to refer it for further review through more costly manual underwriting. However, those customers that do not meet the required minimum cut-off scores are likely to pay a stiff price. If their loan is not approved, the borrower in all likelihood is relegated to the higher cost subprime market. Subprime interest rates, on average, range from two to three interest points higher than those charged for loans approved by the AU systems. Subprime loans also generally entail much higher points and fees for the borrower than do prime loans.

Subprime loans are typically refinancings of existing mortgages and are made disproportionately to lower income, elderly, and minority homeowners. African-Americans homeowners are nearly three times and Latino homeowners almost two times more likely to receive subprime loans than their white counterparts. Thus the stakes are great for borrowers, which reaffirms the importance of ensuring for the accuracy and fairness of the scoring systems that are used for making these loan decisions.

Increasingly, the GSEs and lenders are using risk-based pricing to make loan decisions in both the prime and subprime markets. And in fact, the difference in the cost of credit some someone with a high credit score and someone with a low score can be quite substantial. At current interest rates, for a $100,000 mortgage made for a property in Maryland, an applicant with a credit score in the highest tier (720 or higher) will qualify for a loan with an interest rate of 5.564%, carrying a monthly payment of $572.00. In contrast, an applicant with a credit score in the lowest tier (under 559) will qualify for a loan with an interest rate of 7.945%, carrying a monthly payment of $730. This means that over the life of a 30 year loan, the higher rate will cost the borrower with the lower credit score $56,924 in additional interest payments.

As credit scoring and AU systems are increasingly used to determine the cost of credit (as opposed to access to credit), new questions arise about the relationship between risk and price. Research by Freddie Mac, for example, suggests that many customers in the subprime mortgage market are being charged interest rates that are higher than would be required to cover the risk they pose to their lenders. AU systems permit the GSEs' entry into the higher end of the subprime market, which can reduce costs for borrowers. However, this “expanded approval” comes with a price, applicants that do make the cut-off for prime loans find themselves paying a higher price for their loan.

Questions remain about the validity and accuracy of scoring and the models used for mortgage lending

Fundamental questions remain about the validity and accuracy of scoring systems being used. These questions linger, in no small part, because the systems and the algorithms they use are proprietary, and held closely by the companies that develop them.

For one thing, the accuracy of the credit score generated by any scoring system rests on the quality, consistency, and completeness of the credit information going into the system. A study published last year by the Consumer Federation of America in conjunction with the National Credit Reporting Association looked at credit scores and the information that went into formulating these scores. The study found wide variations in the scores assigned to consumers based on credit information from each of the three major credit repositories. As many as one in three files had a variation in credit score of 50 points or more, and one in twenty had a range of 100 or more points. This led researchers to conclude that one in five consumers is at risk of being mis-classified into the subprime market due to inaccurate information in the credit reports. (CFA/NCRA. 2002. Credit Score Accuracy and Implications for Consumers).

Further, other research has raised concerns about whether certain creditors may manipulate the credit reporting system to prevent competitors from enticing their best customers away. Some lenders have deliberately failed to report current and accurate information about their borrowers to the credit reporting agencies. The consequence for the borrowers involved has been to depress their credit scores falsely and artificially. Information that creditors were gaming the system led federal banking regulators several years ago to take steps to discourage this practice. However, it is not clear whether financial institutions that are not federally regulated continue to engage in this practice.

Issues about the methods used for computing scores have also been raised. For example, some research has found that developing bureau credit-scoring models through national population samples may omit potentially important variable relating to local and regional economic conditions. The study suggests that credit scores calculated from samples not adjusted for local and regional economic conditions could result in inaccurate credit scores.

Moreover, other important methodological issues regarding the accuracy and fairness of computing scores for mortgage lending purposes still remain. These concerns tend to be of three kinds:

1) Concerns that low-income, minority borrowers, and persons living in older urban areas may be underrepresented in the bureau files. Consequently, the information provided for computing scores may not accurately portray the creditworthiness of underrepresented groups in the applicant pool and thus, may result in inaccurate scores;

2) Concerns that the scoring models used typically omit certain nontraditional indicators of credit performance, such as rent, utility payments, and other non-traditional credit histories which are important components of credit performance for many low-income and disproportionately minority applicants. Conversely, there are also concerns that the models fail to adequately take into account important positives or compensating factors, such as the use of pre-purchase and post-purchase housing counseling which many experts believe can affect projected risk.

3) Concerns that scoring models result in disparate impacts for protected classes and fails to adopt less discriminatory alternative measures. Disparate impact may occur in a credit scoring system when a variable used in the scoring system is facially neutral and applied evenly, but the variable disproportionately adversely affects a segment of the population protected by the fair lending laws (such as racial minorities).

   This point is a particularly sensitive one since all parties – credit score providers, lenders, and the GSEs, quietly acknowledge that racial minorities, on average, have significantly lower credit scores than whites in the scoring models that are employed. In essence, the lower distribution of scores for minorities in means that credit scoring being used today disproportionately rejects minority applicants or means that on the whole they tend to pay more to obtain mortgage credit.

In response to these issues, the credit scoring industry and the proprietors staunchly defend that their systems are predictive of future loan performance and that scoring increases the accuracy of risk assessment. They insist that that they do not explicitly use prohibited factors, such as the borrower's race, ethnicity, age and gender in formulating scores. They point to some research that suggests that scoring can serve the interests of borrowers by expanding credit opportunities for many and improving efficiency of the credit review process.

Nevertheless, the key scoring models used in mortgage lending today, such as the Fair, Isaac & Co. and GSE systems have never been subject to independent verification to ensure that are indeed fair and unbiased and consistent with the nation's fair lending laws. The formulas for these models are closely guarded secrets and therefore, the methodological questions of the type that I have discussed have not been adequately addressed.

Discrimination has been a persistent problem in home finance markets in the United States. To be sure, the mere existence of disparate impact resulting from the application of scoring methodologies does not necessarily constitute the existence of discrimination or illegal treatment. However, given the legacy of lending discrimination, we believe that a high level of scrutiny should be required to ensure that the scoring models used today in mortgage lending are working a manner that is fully consistent with fair lending requirements.

Finally, let me emphasize that my testimony today focuses on the accuracy and fairness of scoring. I do not touch on a host of other real problems that may result from the improper use by creditors of scoring models. These include creditors that do not perform ongoing and effective oversight of the credit scoring model's performance. It also includes improper application of credit scoring models on products, particular subset of applicants, or geographic areas for which they were not developed and the inconsistent use of credit scoring models, including excessive overrides. All of which are real problems that may occur in today's marketplace.

What needs to be done?

De-mystify credit scoring by removing the veil of secrecy that currently pervades this industry.

First, we strongly recommend that Congress mandate the establishment of an effective and meaningful federal agency oversight process of all statistical scoring systems, including automated underwriting systems that are used for mortgage lending purposes. These reviews should be conducted on a regular basis and should focus on the fairness and validity of these systems. The results of these reviews must be released in a timely fashion.

HUD, which has oversight responsibility for Fannie Mae and Freddie Mac, is the only agency we know of that has undertaken a comprehensive review of the automated underwriting systems operated by the GSEs. Unfortunately, the results of this study which were completed more than two years ago is long overdue.

Second, we believe that consumers must have greater access to the scores that are being used to make credit decisions than they have now. Lenders may reveal to a consumer the score that is being used to evaluate their mortgage application, but this is generally too late for the consumer to do much about that score. In response to the California law that requires lenders to give customers a copy of their credit score, Fair, Isaac & Co. reversed its policy several years ago and began selling consumers their own scores. Customers may also obtain their scores from several of the three major credit repositories. Yet there is some question as to whether scores and the scoring model consumers are provided with represents the same ones that a lender may be using at any given time.

Lastly, we concur with the recommendations for improving the credit scoring industry contained in the recent CFA report on credit scoring accuracy. These include the following:

- Require creditors to provide borrowers with a copy of the report resulting in adverse action on a consumer's credit standing.
- Require the automatic re-evaluation of any adverse information resulting in a reduced credit score to determine its accuracy.

- Strengthen requirements for complete and accurate reporting of account information to credit repositories with added oversight and penalties for non-compliance.

In sum, providers of credit scores should be required to share responsibility for ensuring the accuracy of the underlying data, for correcting that data, and for disseminating the correct information if requested by the consumer. Removing the mystery about credit scoring should be on everyone's agenda.

This concludes my testimony. I will be happy to answer any questions that you have.