April 25, 2005

Federal Trade Commission/Office of the Secretary
Room H-159 (Annex Z)
600 Pennsylvania Avenue, N.W.
Washington, D.C. 20580

Re: FACT Act Scores Study

Dear Chairman Majoras:

The members of the Mortgage Bankers Association (MBA) appreciate the opportunity to respond to the Federal Trade Commission's "FACTA Scores Study" enumerating questions, the responses to which will assist in the development of a study due to Congress on December 4, 2005. The MBA's 2900 members represent companies involved in the origination, financing, servicing and securitization of mortgages. Our membership is comprised of mortgage companies, banks, mortgage insurers, thrifts, mortgage brokers, credit unions and commercial banks.

Under section 215 of the Fair and Accurate Credit Transactions Act (FACTA), the FTC and the Federal Reserve Board (the Board), in consultation with the Office of Fair Housing and Equal Opportunity of the Department of Housing and Urban Development, are to conduct a study on the effect of credit scores and credit based insurance scores on the availability and affordability of financial products. Specifically, Section 215 requires a review of "the extent to which, if any, the use of credit scoring models, credit scores, and credit-based insurance scores impact on the availability and affordability of credit to the extent information is currently available or is available through proxies, by geography, income, ethnicity, race, color, religion, national origin, age, sex, marital status and creed, including the extent to which the consideration or lack of consideration of certain factors by credit scoring systems could result in negative or differential treatment of protected classes, under the Equal Credit Opportunity Act, and the extent to which, if any, the use of underwriting systems relying on these models could achieve comparable results through the use of factors with less negative impact."

Before addressing the questions, it is important to note that the mortgage industry is not engaged in the business of creating credit scores but rather uses credit scores as part of the automated underwriting process to underwrite applications for mortgage credit as well as to preserve homeownership (more fully described below). To that end, MBA's responses will address the industry's experience as a user of credit scores rather than as a creator of credit scores. The questions are answered topically rather than *in seriatim.*

The Use of Credit Scores in the Mortgage Market

Credit scores were introduced into the mortgage market in the early 1990's. They are statistically based measures of credit risk that are used by mortgage lenders to determine whether to extend credit because they are reliable indicators of the future performance of a loan. Credit scores are also used on the back end by servicers to protect the lender's security interest in a mortgage by functioning as a future indicator of default.

1. The Use of Credit Scores During the Mortgage Origination Process.

A lender will access a consumer's credit score in connection with underwriting an application for mortgage credit. A borrower will complete an application, authorizing the lender to contact a credit bureau for their credit report and credit score. The lender will then use the credit score, along with other information, not reflected in the credit report, including the borrower's income, loan-to-value ratio, debt-to-income ratio and the type of collateral for which the mortgage is needed, and process the information often through an automated underwriting system (AUS). Fannie Mae, Freddie Mac, and the Federal Housing Administration, as well as some large lenders, have created AUS that lenders often use to process and underwrite loan applications. Most of these systems take into account the credit score in determining whether an applicant will qualify for a loan that will ultimately be sold into the secondary market. Significantly, the AUS decision is not based simply on the credit score, but also on other relevant information that in combination creates a complete picture of the risk of default. The AUS response will indicate to the lender whether or not an applicant's mortgage could be sold into the secondary market.

In addition, there are circumstances in which a mortgage originator will access two credit scores. Before shopping for a home or a mortgage, consumers will often inquire as to whether they could qualify for a mortgage and if so, under what terms, i.e. amount, rate. During this "pre-approval" process, a broker or loan officer will access a borrower's credit score, with the permission of the borrower, to help decide how much financing the borrower would qualify for and at what rate. The lender can make this determination by accessing the credit score, and running it along with unverified, preliminary information that the consumer provides, i.e. income, through an AUS. This very preliminary determination is certainly not an offer of credit, rather it is a preliminary assessment of the amount and rate of the mortgage. When the consumer is ready to apply for a mortgage the lender *may* access a second credit score depending upon how much time has elapsed between the pre-approval stage and actual purchase stage. The second credit score will then be used to determine the terms of the mortgage loan. Many lenders are reluctant to pull two credit scores for fear that in doing so it will lower the borrower's score.

In response to a question posted in the proposal, credit scores do not impact a borrower's loan-to-value ratio. They do have an effect on the amount of mortgage credit an applicant can borrow. As discussed earlier, however, the credit score is not the only factor in determining the amount or characteristics of the offer of credit.

2. The Use of Credit Scores in Servicing

Credit scores are also used on the back end – or when a loan is closed and shipped to a servicer responsible for collecting the monthly mortgage payment. Credit scores along with payment histories with that servicer, loan characteristics, customer demographics, and property record information and other data is used collectively by servicers to better understand and to more accurately predict customer behavior in a wide range of areas, including servicing, collections, retention, cross-selling and other customer relations.

Credit scores along with other information are tools servicers use in loss mitigation efforts. Many servicers maintain lists of customers who pose default risk. This risk is determined in part by that consumer's credit score. If there is a significant drop in the credit score, a servicer will contact that borrower, often before a mortgage payment is due, in an effort to provide any assistance to help that consumer avoid default. This puts the lender and consumer in communication early on, putting the parties in the best position to address the particular situation of the borrower. It also enables the servicer to more accurately assess the potential risks of their portfolio.

Credit Scores and the Availability of Mortgage Credit

The mortgage market has become a capital market whereby the majority of loans are securitized and sold into the secondary market. This infrastructure is based on risk-based pricing or the notion that the cost of credit for an applicant will be based on the risk of default that they pose. The greater an applicant's risk, the greater the cost of credit. As noted above, several factors are taken into account to determine this risk and credit scores are just one factor. MBA does not have data that isolates the credit score from other items considered in the underwriting process to determine its direct impact on the transaction. It is true, however, that the mortgage industry considers credit scores a statistically viable indicator of risk, but credit scores alone do not create the full picture of risk needed to underwrite a mortgage loan.

Academics have found that the use of credit scores in the mortgage underwriting process has made homeownership opportunities available to more Americans.[1] To date almost 70 percent of Americans own their own homes as compared to 64 percent in 1990. This is due in part to the use of credit scores and the advent of AUS.

In the past, the mortgage industry relied on manual underwriting whereby a mortgage originator would collect information from an applicant and personally make a lending determination. This determination was by definition more subjective than an automated process. Loan officers and brokers could be potentially accused of making unfair credit determinations depending upon their relative weighting of different credit characteristics. During the middle 1990's, AUS were developed by incorporating credit scores as one of the variables considered by the system. Since their inception, these systems have

[1] Calem, P.S. and S.M. Wachter, 1999. Performance of Mortgages in a Community Reinvestment Portfolio. *Real Estate Economics* 27: 105-134.

been continually refined. These systems require the input of strictly quantitative information and do not take into account certain items, for example, race. Most mortgages in the United States are originated using some form of AUS. The expansive use of these objective systems significantly lessens the likelihood that minorities are discriminated against in the mortgage process.

Further, the use of risk-based pricing in the mortgage market has increased the availability of credit to many Americans. Risk-based pricing makes more credit available to more Americans and gives those traditionally underserved an opportunity to be a homeowner. The use of credit scores as part of the risk-based pricing decision are a significant part of this success.

Credit Scores and the Secondary Market

Credit scores play an important role in the underwriting and pricing of mortgage loans to investors in the secondary market. Generally, investors utilize sophisticated mathematical pricing models that take into account credit scores to determine the prices they are willing to pay for loans with different expected net yields (i.e. investment returns), which are a function of the loans' stated interest rates as well as the probability that they will go into default at some point during their stated lives. Because a loan's yield is subject to significant reduction if a borrower defaults on his/her mortgage payments, a borrower's credit score (a mathematically based indicator of default probability) is considered the best indicator of a loan's risk profile, or more specifically, of the risk that the loan will return to the investor at less than its stated interest rate. To compensate for this risk, investors will either discount the price they are willing to pay or, alternatively, demand a higher yield (i.e. a higher interest rate) for a loan with higher than normal risk profile. Lenders, in turn, must adjust the interest rates on loans offered borrowers with a higher risk profiles or suffer less than reasonable compensation, and potentially even losses, on sales of their loans to investors. This process for assessing and measuring risk among secondary and primary market participants is of paramount importance because it facilitates and encourages a healthy and vibrant source of mortgage capital for all borrowers regardless of their individual risk profile.

Credit Scores and the Cost of Credit

It is also noteworthy that credit scores have helped increase the speed with which an underwriting decision is made. The efficiency that the use of credit scores creates in underwriting mortgage loans results in lower origination costs, increases competition and results in a cost savings to the homeowner.

Components of a Credit Score

As noted above, mortgage lenders are not creators of credit scores but users of credit scores. MBA members support the continued development and evolution of credit scoring. We support exploration by the credit scoring industry of ways to efficiently include additional data, such as rental payment history, childcare expenses, and utilities into the calculation of credit scores. We believe the continued adoption of additional data could improve the predictive value of credit scores and allow even greater precision in evaluating the credit worthiness of many traditionally underserved populations.

Consumers who do not have a credit history are adversely affected by credit scores. Where for example, consumers do not engage in financial activities that trigger credit reporting, for example, paying student loans, using credit cards or paying an auto loan, there is little information in their credit report on which to create a credit score. However, the mortgage industry has partially responded to this situation by developing loan products that compensate for this lack of credit information. These products, though, do carry greater risk. Mortgage lenders can also manually underwrite a mortgage, and though it is a lengthier and more expensive proposition, it does allow for an underwriter to consider information not captured by current credit scoring.

To respond to specific questions in the proposal, credit scores have no impact on a borrowers' loan-to-value ratio. They do have an affect on the amount of mortgage credit an applicant can borrow. As discussed earlier, however, the credit score is not the only factor in determining the amount or characteristics of the offer of credit.

Credit Scores and Accurate Credit Reports

Accurate risk assessment requires that the items considered in underwriting an application for mortgage credit be accurate. If credit scores are based solely on the credit report, then a valid credit score must be based on an accurate credit report. If information in the credit report is inaccurate, it results in a faulty credit score that does not mirror the risk posed by a borrower. This error can either raise or lower the credit score depending upon the inaccuracies in the credit report. In either case, the offer of credit could be considerably affected, even though other factors are considered in the underwriting decision. The mortgage industry fully supports accurate credit reports resulting in accurate credit scores.

Prescreening

Mortgage lenders purchase lists of consumers from credit reporting agencies for the purpose of making offers of credit. The mortgage lender requests lists from the credit reporting agency of consumers with certain credit characteristics including a credit score. The lender often makes a particular credit score threshold one of the eligibility standards for creating the list. The credit reporting agency will sell the list to the lender who will then make all consumers on the list a firm offer of credit. As a highly predictive risk factor, the use of credit scores in developing a prescreening list allows lenders to more accurately market products to credit – worthy consumers.

Conclusion

Credit scores have had a large impact on determining risks associated with mortgage lending. The members of the MBA rely heavily on these statistical tools and support their continued refinement. Credit scores have resulted in greater access to financial services for those who have not had access to credit in the past. They also help facilitate the development of innovative mortgage products that help more Americans own homes.

Thank you for considering MBA's comments. Please do not hesitate to contact Mary Jo Sullivan, Director of Government Affairs, at (202) 557-2859 or msullivan@mortgagebankers.org with any questions or comments.

Most sincerely,

Jonathan Kempner