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

FACT Act Scores Study
70 *Federal Register 9652*
February 28, 2005

The American Bankers Association ("ABA") is pleased to submit our comments to the Federal Trade Commission's ("FTC") request for public comment seeking comment on any evidence the Federal Trade Commission and the Federal Reserve Board ("Board") should consider in conducting the study on the effects of credit scores and credit-based insurance scores on the availability and affordability of financial products as mandated by the Fair and Accurate Credit Transactions Act of 2003 (FACTA). The notice identifies 45 categories of questions covering the use and impact of scoring in credit and insurance contexts.

The American Bankers Association, on behalf of the more than two million men and women who work in the nation's banks, brings together all categories of banking institutions to best represent the interests of this rapidly changing industry. Its membership--which includes community, regional and money center banks and holding companies, as well as savings associations, trust companies and savings banks--makes ABA the largest banking trade association in the country.

Introduction

As observed by Federal Reserve Board Chairman Greenspan, in remarks before the Federal Reserve Systems' Fourth Annual Community Affairs Research Conference on April 8, 2005:

> Lenders have taken advantage of credit-scoring models and other techniques for efficiently extending credit to a broader spectrum of consumers. The widespread adoption of these models has reduced the costs of evaluating the creditworthiness of borrowers, and in competitive markets cost reductions tend to be passed through to

borrowers. Where once more-marginal applicants would simply have been denied credit, lenders are now able to quite efficiently judge the risk posed by individual applicants and to price that risk appropriately.

ABA concurs with Governor Greenspan that credit-scoring has been a force for significant consumer good and financial industry efficiency. It has also been a dynamic tool that has grown in sophistication and improved in its ability to predict credit performance risk over time. Empirically based and statistically sound, credit scoring models have deservedly been championed as underwriting mechanisms devoid of discriminatory prejudices and have withstood the test of supervisory examination.

Illustrating how credit scores have expanded access to credit is the fact that the percentage of households in the lowest income quintile with a credit card has increased from 2% in 1970 to 38% in 2001, while the share of families with credit cards in the highest income quintile increased by a factor of just under 3, from 33% in 1970 to 95% in 2001. Minority access to credit has also grown rapidly. For instance, the percentage of African-American households with credit cards has more than doubled, from 23.6 percent to 55.8 percent from 1983 to 2001, while the growth for non-Hispanic whites has been significantly less with 46.4% carrying cards in 1983, compared to just over 78% in 2001 – an increase of 69.1%.[1]

Regulation B sets the standard for empirically derived, demonstrably and statistically sound credit scoring systems by requiring that they be:

- developed from past performance experience;
- applied to evaluate legitimate performance characteristics;
- methodologically reliable; and
- monitored and adjusted for continued predictive validity.

These criteria place the regulatory expectations for credit scoring squarely on the side of factually demonstrating a performance-justified business purpose and use. It is an expectation far more rigorously enforced than any that a judgmental underwriting system faces.

This last point is worth remembering when considering the effectiveness and fairness of credit scoring. We urge the Commission, the Federal Reserve, and the other contributing agencies not to evaluate credit scoring models against an unattainable presumption of perfect information freely accessible, but instead to compare scoring against other available methods of making similar decisions taking into account their

[1] Updated from Thomas Durkin, "Credit Cards: Use and Consumer Attitudes, 1970-2000," Federal Reserve Bulletin, September 2000, p. 626. U.S. Surveys of Consumer Finances

records of performance and their ability to be used cost-effectively in the contemporary credit market.

Recommended Source of Evidence

Despite the extensive enumeration of questions about the use of credit scoring systems recited in the request for comment, there is no set of questions that focuses on the experience of federal banking agencies examining scoring models for safety and soundness or compliance. Given the standards imposed by Regulation B and the examination programs followed by the agencies, a prime source of evidence on the performance justification of scoring models should be available from the banking agencies.

Particularly relevant to the primary purpose of the mandated study is the Office of the Comptroller of the Currency's ("OCC") fair lending examination guidance that states:

> The OCC may evaluate the variables used in a validated credit scoring system to determine whether they have a disparate impact on any basis prohibited by the fair lending laws. However, the OCC will conclude a variable is justified by business necessity and does not warrant further scrutiny if the variable is statistically related to loan performance and has an understandable relationship to an individual applicant's creditworthiness.

We recommend that the study include evidence from federal banking agency reviews of scoring systems. We believe this evidence will illustrate the extensive record of business validation of credit scoring models and their evolution to maintain predictive power while minimizing unwarranted differentiation of underwriting results along prohibited basis categories. After all, investigating the utility of credit scoring is not an academic exercise. Rather it is a practical review of a functioning system of underwriting that has been subject to regulatory oversight since its inception.

Implications for the Study of the Incentive for Scoring Deployment

The motivating concern behind the Study called for by the FACT Act is whether variables contained in scoring models, or the fact that other variables may be left out of models, result in "negative or differential treatment" of applicants on a prohibited basis. In other words, does credit scoring yield credit decisions that improperly under-include or over-price creditworthy borrowers on a prohibited basis? ABA believes that the incentive for using scoring militates against this hypothesis. Scoring is the mathematical modeling of facially neutral criteria used to predict the risk of unacceptable credit performance. The lender's incentive is to make as many loans at such prices as can be made for the risk of non-performance

assumed and the return on capital that the market demands. If the scoring system excludes otherwise creditworthy, profitable borrowers of any race, creed, or other prohibited characteristic, the incentive would be to use whatever information and methodology was economically available and materially predictive to improve the performance of the scoring model, i.e., capture the under-included applicants. This is precisely the incentive that Regulation B reinforces.

This premise has two significant implications for the Study:

- First, focus on the barriers to economically available and materially predictive information. It is no mystery why FICO bureau scores developed—credit bureaus were where the information was. The question really is how to expand the availability of clean-enough predictive performance information under a voluntary reporting system where the interests in participating are attenuated for those with limited use of the data repository's output.
- Second, recognize that scoring is not the only factor at work in underwriting or pricing loans in the market. Departure from the expected rational result of a scoring model is often due less to the invalidity of the model than it is to external forces including improper administration of the automated underwriting system or the imposition of intermediary market agents or delivery channels. In addition, credit decisions generally, and mortgage underwriting in particular, include other indicia of credit performance beyond the scoring model—such as debt-to-income ratio, loan-to-value ratio, and collateral quality. (Factors acknowledged by agency examination procedures.)

ABA urges the FTC and the Board to reduce the scope of the study implied by the breadth of the questions recited in the notice. We do not believe that the agencies can do justice to such a sweeping scope in the limited time allotted. Rather, we encourage the agencies to focus its study on the practical solutions to realizing the promise of empirically derived, demonstrably and statistically sound scoring models by exploring the means to improve access to alternative predictive credit performance information and by evaluating those practices that impair the rational results of credit scoring from being fully implemented.

In addition, we recommend that the agencies conduct a symposium to present the draft study in a format that would include industry, consumer organization and academic discussants of discrete segments of the draft. By publicly vetting the draft in this way, interested stakeholders can more constructively exchange ideas and comments on the analysis of the study that can improve the final report and facilitate the development of feasible recommendations for enhancing the fairness and public acceptance of credit scoring.

ABA appreciates the opportunity to provide our comments on what evidence the FTC and Board should consider in conducting this study. We are happy to provide any additional information.

Regards,

Richard R. Riese