



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**

Ladies and Gentlemen:

This comment letter is submitted on behalf of the American Financial Services Association (“AFSA”)<sup>1</sup> in response to the notice and request for public comment by the Federal Trade Commission and the Federal Reserve Board to conduct a study on the effects of credit scores and credit-based insurance scores on the availability and affordability of financial products. AFSA appreciates the opportunity to comment on this important matter.

*1. Specifically, how are credit scoring models developed? Who develops credit scoring models? What data and methodologies are used to develop credit scoring models? What factors are used in credit scoring models? Why are those factors used? What other factors have been considered for use in credit scoring models, but are not used? Why are those other factors not used? Are there benefits or disadvantages, either to creditors or consumers, from the use of particular factors by credit scoring models?*

In general, credit scoring models use historical data and mathematical techniques to quantify the impact on loan performance of various borrower characteristics, such as delinquencies, defaults, and charge-offs. The main goal of model development is to effectively measure the probability that a borrower will repay a debt, based on the empirical observation of available historical data.

In developing a typical credit scoring model, various data (“variables”) from multiple sources will be analyzed, including income, debt levels, debt type, financial assets, expenses, whether the applicant has ever defaulted, whether debts have been paid as agreed, and other relevant factors. Regression analysis and other well established and

---

<sup>1</sup> Founded in 1916, the American Financial Services Association (AFSA) is the trade association for a wide variety of market-funded providers of financial services to consumers and small businesses. AFSA members are important sources of credit to the American consumer, providing approximately over 20 percent of all consumer credit. AFSA member companies offer or are assigned many types of credit products including credit cards, retail credit, automobile retail installment contracts, and mortgage loans.

proven statistical techniques are then used in order to identify the combination of variables that most accurately predicts loan performance and how much weight should be given to each.

Credit scoring models are developed within a controlled process involving highly trained professionals from several disciplines. Statistical model development requires the involvement of statisticians, analysts, and staff knowledgeable about compliance with laws and regulations. Development proceeds very deliberately in order to avoid risk of material failure, competitive disadvantage or violation of applicable laws and regulations. As the model is built, each iteration is tested for predictive power and statistical significance. The final model's performance is validated on an independent population and must maintain its predictive power and statistical significance. All of this work is documented and is independently reviewed and approved by one or more designated officers prior to implementation. Once in production, the models are monitored to ensure that they perform as intended.

Access to data relevant to a consumer's ability and willingness to repay previous and current obligations, combined with effective mathematical techniques and highly trained statisticians, drives the accuracy and effectiveness of credit scoring models. A well run credit scoring process dramatically improves lending efficiency, which increases access and lowers the average cost for consumers.

*2. How many different credit scoring models are in use today? What different types of general purpose or specialized credit scoring models are available? Who offers credit scores?*

There are a great number and variety of credit scoring models in use today. An institution's size, complexity, and product variety often determine the number of credit scoring models employed by a particular institution. Any single institution may use a handful or hundreds of distinct credit-decision models in its day to day activities.

There are two general model types. Generic credit scoring models are developed and available for purchase across the industry. These models are intended to predict loan performance based on a generalized set of individuals possessing similar characteristics. These models are often developed by companies that service lending institutions, a leading example being Fair Isaac Corporation. The three major credit bureaus are also important sources of credit models and scores. These models may be targeted for specific use: For example, the same company may provide one model to predict performance on auto loans and another to predict performance on credit card accounts, or one model to predict contractual charge-offs and another to predict bankruptcies.

Proprietary or specific credit scoring models are developed based on the lending experience of a particular institution, and are developed in-house or through exclusive agreements with a service provider. The number and variety of these models are driven by a number of factors: use of the model, information available, homogeneity of

populations, etc. As a rule of thumb, the more specific the model is to population, product, and available information, the more effectively the model will perform.

*3. How are credit scores used? Who uses credit scores, and how widely are they used? How do they fit into the underwriting process for mortgages, auto loans, credit cards, and other credit products? For what purposes are credit scores used, other than the initial underwriting or pricing decision?*

Credit scores are used broadly by many lenders, insurers, and utility companies. Credit scores are also used to a lesser extent by landlords and employers as part of their leasing and employment screening. Credit scores are important because of the information they provide on such things as likelihood to default on prospective or existing grants of credit, likelihood to file for bankruptcy, and likelihood to forego payment of incurred debt associated with the consumption of services (such as telephone and utility services). Nearly all lenders use credit scores as part of the decision to grant credit. The majority of home and auto insurance companies use credit-derived “insurance scores” as predictive indicators of the cost of policy claims. A study conducted by Conning & Company found that more than 90 percent of personal auto insurers use credit scores in the underwriting process, and 90 percent of insurers writing new business policies use business credit scores.<sup>2</sup>

The goal of every lender is to correlate rates for credit offerings charged to a consumer as closely as possible with the actual cost of granting credit associated with that consumer, including the risk that the loan will not be repaid. In some instances, the likelihood of default for certain prospective borrowers is deemed so high that lenders will deny credit to those applicants, since the granting of credit in those cases would be an unprofitable business decision. A lender uses credit scores as part of its decision of whether or not to grant credit, its determination of the amount to lend, and its determination of the interest rate commensurate with the risk of default. Within the underwriting decision, a lender may use credit scores in conjunction with other eligibility requirements and thresholds, such as payment-to-income ratio and debt-to-income ratio.

Some lenders use credit scores to target-market consumers for pre-approved offers of credit or invitations to apply. The credit scores allow lenders to avoid marketing to consumers who, if they applied for credit, would be declined. Some lenders use credit scores to manage the accounts of existing customers. Credit scores may affect a lender’s decision to increase or decrease of the amount of credit available to the customer, to negotiate the amount of payment the customer is able to make, to allow payment deferrals of past due payment amounts, or to assess the timing of repossession of collateral or home foreclosure for which payments are seriously delinquent.

*4. How has the use of credit scores changed over time? When were they first used for each type of financial product (credit cards, mortgages, auto loans, etc.)? How has their use expanded to encompass different groups of borrowers (e.g., lower income borrowers,*

---

<sup>2</sup> Insurance Information Institute, “The Use of Credit Information in Personal Lines Insurance Underwriting”, Robert P. Hartwig, Ph.D., CPCU, Senior Vice President & Chief Economist and Claire Wilkinson, Director, Global Insurance Issues (June 2003)

*urban/rural borrowers, borrowers with poor credit histories, borrowers with non-traditional credit histories)? If the use of credit scores has expanded to encompass different groups of borrowers, how has this affected the price or availability of credit to those borrowers?*

The credit bureau Experian provides the following useful historical overview on its web-site.

“Credit scores came into wide use in the 1980s. Long before credit scores, human judgment was the sole factor in deciding who received credit. Lenders used their past experience at observing consumer credit behavior as the basis for judging new consumers. Not only was this a slow process, but it was also unreliable because of human error.

“Lenders eventually began to standardize how they made credit decisions by using a point system that scored the different variables on a consumer’s credit report. This point system helped to eliminate much of the bias that previously existed; however, it was still tied to intuitive measures of creditworthiness and was not based on actual consumer behavior.

“Credit granting took a huge leap forward when statistical models were built that considered numerous variables and combinations of variables. These models were built using payment information from thousands of actual consumers, which made scores highly effective in predicting consumer credit behavior. When combined with computer applications, scoring models made the credit granting process extremely fast, efficient and objective, facilitating commerce and helping consumers quickly get the credit they need.”

Fair Isaac estimates that 160 million Americans have credit histories sufficiently documented for calculating classic FICO credit scores, and that an estimated 50 million consumers do not.<sup>3</sup> To better serve those latter consumers, Fair Isaac announced in July of 2004 that it “has extended its standard-setting FICO score to cover an expanded population base. The score will help lenders and other businesses better serve the financial goals of millions of historically credit-underserved U.S. consumers.”<sup>4</sup>

For the effects of credit scores on price and availability of credit, see our response to Question 5.

*5. Has the use of credit scores affected the price and availability of mortgages, auto loans, credit cards, or other credit products? If so, are there estimates of the type and size of such changes? Have some groups of consumers experienced cost reductions while others have experienced cost increases? Have some groups of consumers experienced greater access to credit while others have experienced reduced access?*

---

<sup>3</sup> Fair Isaac Press Release: July 27, 2004 - (Minneapolis, Minnesota, USA).

<sup>4</sup> Fair Isaac Press Release: July 27, 2004 - (Minneapolis, Minnesota, USA).

Credit scores spurred a dramatic evolution of the consumer credit lending industry during the 1990s that resulted in lower interest rates and greater access to credit for consumers. Credit scores enabled faster and more accurate underwriting. As a result, lenders were able to offer more credit to a broader spectrum of consumers including traditionally underserved segments of the population. In addition, credit scores enabled greater underwriting efficiency which drove the cost of credit lower for nearly all consumer credit products. Numerous studies confirm this evolution:

#### Availability:

Chairman Alan Greenspan recently commented on the role credit scores have played in expanding the availability of mortgage loans. He stated: “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. These improvements have led to rapid growth in subprime mortgage lending; indeed, today subprime mortgages account for roughly 10% of the number of all mortgages outstanding, up from just 1 or 2 percent in the early 1990s.”<sup>5</sup> These numbers reflect large numbers of homeowners today who could not have become homeowners without the use of credit scores.

Consumers have also enjoyed greater access to credit cards during this period. Between 1970 and 2001, previously underserved groups experienced the greatest gains in access to credit. 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, 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%.<sup>6</sup>

#### Price:

Credit scores also dramatically reduced the cost of credit by giving lenders the ability to prescreen consumers for specific credit offers. The Information Policy Institute (“IPI”) surveyed several major credit card providers in 2003 to determine the effect prescreening had on credit markets. They found that prescreening led to dramatically lower interest rates on credit card balances. Their findings, which have also been cited by the Federal Reserve in their recent “Report to Congress on Further Restrictions on Unsolicited Written Offers of Credit or Insurance,” show that credit card interest rates today are lower than they were in 1990. “In 1990, only six percent of card balances were below 6.5 percent, and 93 percent were above 16.5 percent APR. Indeed, by 2002 almost

---

<sup>5</sup> Remarks by Chairman Alan Greenspan at the Federal Reserve System’s Fourth Annual Community Affairs Research Conference, Washington, D.C. April 8, 2005.

<sup>6</sup> Information Policy Institute, “The Fair Credit Reporting Act: Access, Efficiency & Opportunity” June 2003 from Thomas Durkin, “Credit Cards: Use and Consumer Attitudes, 1970-2000,” Federal Reserve Bulletin, September 2000, p. 626. U.S. Surveys of Consumer Finances.

three-quarters (74 percent) of all outstanding balances were at interest rates below 18 percent, while an incredible 15 percent of balances were at interest rates under 5.5 percent. On the other end, only 24 percent of outstanding balances had interest rates above 18 percent.”<sup>7</sup>

Lenders transfer these cost efficiencies to their customers through lower interest rates and better product terms. For instance, one credit card lender offers a “platinum” product with a fixed rate as low as 2.99% through the prescreened direct mail channel, as a result of the more comprehensive credit risk information it is able to obtain through prescreening. In contrast, where such information is not available, such as through a non-prescreened internet channel, that lender balances the higher risk it assumes with a higher rate – for example, an 8.9% fixed rate -- to compensate for that lack of knowledge.

Data from the Federal Reserve Board’s reporting series FR2835 confirms that credit card interest rates fell sharply from mid-1991 through early 1994, after being relatively stable for most of the previous twenty years, and then fell again over the period 1998-2003. Credit evaluation methods such as credit scoring were among the factors to which the Federal Reserve attributed the decline in rates.

*7. How has the use of credit scores affected the costs of underwriting and/or the time needed to underwrite?*

Automated credit scores have significantly reduced costs of underwriting credit card lending. The marginal cost to underwrite an application in the credit card industry can be as much as 90% cheaper with automated credit scores than manual underwriting.

It is also much faster to underwrite with automated credit scores. Most credit card issuers can decision applications in less than 60 seconds when a real-time decisioning system is implemented which uses automated credit scores. By contrast, the quickest decision with manual underwriting takes approximately 5 to 15 minutes.

Quick and relatively inexpensive decisioning enables credit card issuers to offer a wider range of products with better features to customers. It also enables customers to choose from a wide range of lending options, lowering overall debt costs for customers.

Most mortgage lenders now use automated underwriting systems (“AUS”) that combine credit scores and other factors, such as the property’s appraised value, the size of the down payment, etc. Mortgage lenders’ use of AUS jumped from 25 percent in 1996 to over 90% by 2002. This growth in the use of AUS has significantly reduced the overall cost of closing a mortgage loan. A recent survey by Fannie Mae found that lenders who integrated automated underwriting at point of sale reduced their overall

---

<sup>7</sup> Information Policy Institute (2003), *The Fair Credit Reporting Act: Access, Efficiency & Opportunity: The Economic Importance of Fair Credit Reauthorization* (Washington: National Chamber Foundation for the IPD), June, p. 57, table 13, [http://www.infopolicy.org/pdf/fcra\\_report.pdf](http://www.infopolicy.org/pdf/fcra_report.pdf)

origination costs by about 50%, or roughly \$1,500 per loan. Applied to the 12.5 million sales of new and existing homes in 2002, this would produce savings of \$18.75 billion.<sup>8</sup>

Before the advent of automated underwriting, approving a loan application took close to three weeks; in 2002, over 75 percent of all loan applications received approval in two to three minutes. Such efficiencies have enabled the industry to handle the massive refinancing waves that have occurred within the last few years.<sup>9</sup>

*8. What impact has the use of credit scores had on the accuracy of underwriting decisions? What impact has the use of credit scores had on the share of applicants that are approved for mortgages, auto loans, credit cards, or other credit products? What impact has the use of credit scores had on the default rates of mortgages, auto loans, credit cards, or other credit products? Have the sizes of such changes or effects been estimated and reported?*

A recent study by Freddie Mac demonstrates that credit scores are significantly more accurate than manual underwriting systems. As part of the study, human underwriters were asked to classify applications from low-income and minority families as either “accept” or “caution.” Researchers then used data drawn from the original applications to re-underwrite every loan using a simplified version of Loan Prospector, the company’s automated underwriting tool. They then compared the assessments of the human underwriters to the classifications produced by Loan Prospector. Not only did they find that automated underwriting did a better job of identifying loans that ultimately perform—that is, loans that did not experience a serious delinquency or default—but they also found that the greater precision of automated underwriting resulted in higher approval rates, especially for underserved populations. In particular, a recent version of Loan Prospector increased “accepts” by 36 percentage points for all affordable loans.<sup>10</sup>

*9. Has the use of credit scores affected the cost and availability of credit to consumers with poor credit histories? If so, how? What effect has it had on the use of credit by consumers with poor credit histories?*

The data supplied in response to the foregoing questions show that using credit scores lowers the cost and increases the availability of credit to consumers with poor credit histories. Credit scoring provides two major benefits to lenders. First, it lowers costs. Credit scores allow faster and more automated decisions by systems instead of people, which lowers the operational costs for lenders. Credit scores also improve the accuracy of predicting the risk of default. Studies have shown that credit scoring is more accurate than human judgment. This is primarily due to the objectivity of credit scores

---

<sup>8</sup> Information Policy Institute (2003), *The Fair Credit Reporting Act: Access, Efficiency & Opportunity: The Economic Importance of Fair Credit Reauthorization* (Washington: National Chamber Foundation for the IPI), June, p.36, [http://www.infopolicy.org/pdf/fcra\\_report.pdf](http://www.infopolicy.org/pdf/fcra_report.pdf)

<sup>9</sup> Information Policy Institute (2003), *The Fair Credit Reporting Act: Access, Efficiency & Opportunity: The Economic Importance of Fair Credit Reauthorization* (Washington: National Chamber Foundation for the IPI), June, p.37, [www.infopolicy.org/pdf/fcra\\_report.pdf](http://www.infopolicy.org/pdf/fcra_report.pdf)

<sup>10</sup> Susan Wharton Gates, Vanessa Gail Perry, and Peter M. Zorn, “Automated Underwriting in Mortgage Lending: Good News for the Underserved,” *Housing Policy Debate*, Volume 13, Issue 2, 2002.

and the ability of multivariate statistical techniques used in the scoring process to capture patterns of behavior that cannot be seen directly by people.

Lower costs and increased accuracy from credit scoring expand the availability of credit to consumers with poor credit histories. Lenders are able to better control and understand risk, allowing them to market products to a broader population. The increased accuracy enables lenders to lend with confidence, instead of pulling back due to perceived risks that have not been quantified. Lenders can also make modifications to the products they offer so that the revenue created is sufficient to cover losses.

The overall cost of credit for consumers is lower due to the reduced operational costs and increased accuracy derived from using credit scores. The costs to individual consumers may be higher or lower, depending on their risk level. For example, under traditional underwriting, a certain population segment may be charged a 10.9% APR based on the risk of that segment. With credit scoring, the overall average APR could be reduced to 9.9%, but this would be associated with pricing customers according to their predicted risk (i.e. lower risk gets 7.9%, medium risk gets 9.9%, and higher risk gets 11.9%). However, the overall lower cost of credit is lower, and credit is more available.

The credit card business shows these results clearly over the last 10 years with the expanded use of credit scores. The norm 10 years ago was a high-priced credit card marketed to a limited population. The APR was around 20% and was only available to low-risk segments. Consumers with poor credit histories were not offered credit cards, and often only had high-priced finance companies as an option, with APRs often above 25%. Today, much better products are offered to consumers that would not have been considered 10 years ago. Lenders are competing for the business of customers with subprime credit histories. Accurate credit scoring has been a primary enabler of this expansion of credit availability and the more attractive products offered. This phenomenon was described by Federal Reserve Chairman Alan Greenspan in the speech quoted above:

“With these advances in technology, 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. These improvements have led to rapid growth in subprime mortgage lending; indeed, today subprime mortgages account for roughly 10 percent of the number of all mortgages outstanding, up from just 1 or 2 percent in the early 1990s.”<sup>11</sup>

---

<sup>11</sup> Remarks by Chairman Alan Greenspan at the Federal Reserve System’s Fourth Annual Community Affairs Research Conference, Washington, D.C. April 8, 2005.



10. *How has the use of credit scores affected the cost and availability of credit to consumers with no credit history? What effect has it had on the use of credit by consumers with no credit history?*

While the increased sophistication of credit assessment by mass-market lenders, of which the use of credit scores is a part, has contributed to those lenders' ability to offer some credit even to consumers with no credit history, credit scores themselves are not used in the decision whether to lend to such a consumer and on what terms.

12. *Has the use of credit scores and credit scoring models impacted the availability or cost of credit to consumers by geography, income, ethnicity, race, color, religion, national origin, age, sex, marital status, or creed? If so, how has it impacted each such category? What are the estimated sizes of any such changes for each of the above categories?*

Using credit scoring, lenders can focus on facts scientifically proven to be related to credit risk, rather than intuition. As a result, lenders can approve more loans, because credit scoring gives them more precise information on which to base credit decisions. This allows lenders to identify individuals who are likely to perform well in the future, even though their credit report shows past problems. The use of credit scores gives lenders the confidence to offer credit to more people, since they have a better understanding of the risk they are taking on. When lenders switch from judgmental decision-making to credit scoring, it is common to see a 20 to 30 percent increase in the number of applicants accepted, without a proportional increase in the lender's losses.<sup>12</sup> Federal Reserve Chairman Alan Greenspan agrees that increased access to credit has coincided with the proliferation of credit scoring.<sup>13</sup> Similarly, Treasury Secretary Snow has noted a study demonstrating that lenders' use of credit scores improved the approval rates for minority borrowers by 29 percent.<sup>14</sup>

13. *To what extent does consideration or lack of consideration of certain factors by credit scoring systems result in negative or differential treatment of those categories of consumers who are protected under the Equal Credit Opportunity Act ("ECOA") (e.g., race, color, religion, national origin, sex, age, and marital status)?*

Before the use of models, the credit granting process could be slow, inconsistent and sometimes unfairly biased. By contrast, credit scoring assures that each consumer will be evaluated empirically and objectively, according to the same criteria as other credit applicants. Credit scoring models do not consider prohibited factors such as sex, race, religion, national origin and marital status.<sup>15</sup> Credit scoring instead takes into

---

<sup>12</sup> Fair Isaac Corporation, Statement before the Senate Committee on Banking, Housing, and Urban Affairs, Hearing on Consumer Awareness and Understanding of the Credit Granting Process, at 5 (July 29, 2003).

<sup>13</sup> "Unquestionably, innovation and deregulation have vastly expanded credit availability to virtually all income classes. Access to credit has enabled families to purchase homes, deal with emergencies, and obtain goods and services. Home ownership is at a record high, and the number of home mortgage loans to low- and moderate-income and minority families has risen rapidly over the past five years. Credit cards and installment loans are also available to the vast majority of households." Remarks by Chairman Alan Greenspan at the Federal Reserve System's Fourth Annual Community Affairs Research Conference, Washington, D.C. April 8, 2005

<sup>14</sup> Treasury Secretary Snow, Remarks Advocating the Renewal of the Fair Credit Reporting Act, at 3 (June 30, 2003).

<sup>15</sup> The Equal Credit Opportunity Act and its implementing regulations prohibit lenders from discriminating on a prohibited basis.

account only factors related to creditworthiness, including payment history and whether the applicant has defaulted on prior loans, amounts presently owed by the applicant, length of the applicant's credit history and types of credit used—types of information that can be obtained from consumer loan applications and from consumer reporting agencies. Therefore, credit scoring does not, and cannot, lead to discriminatory practices that would result in, for example, reduced credit approval for minority applicants. Instead, credit scoring has proven to be an accurate and consistent measure of repayment for all people who have some credit history because, at a given score, non-minority and minority applicants are equally likely to pay as agreed.

*14. To what extent, if any, could the use of underwriting systems that rely on scoring models achieve comparable results through the use of factors with less negative impact on those categories of consumers who are protected under the ECOA?*

For the reasons discussed above, the belief that there can be less discriminatory alternatives to model variables with comparable results is a fallacy. Credit scoring models do not take into consideration prohibited variables, and the process for developing credit scoring systems ensures that only the most statistically predictive and relevant factors are included in the models. Therefore, removal of some variables, or their replacement with others thought to be more favorable to protected classes of consumers, cannot reasonably be achieved without degrading the performance of the models.

In recognition of this, the Office of the Comptroller of the Currency (“OCC”) has set out a business-necessity analysis for use by its examiners and by national banks that does not require attempted identification of comparable but less discriminatory alternatives. The OCC provides a two-step analysis to determine that a variable is justified by business necessity and, therefore, does not warrant further scrutiny.<sup>16</sup> One consumer lender has implemented the OCC’s guidance in the following manner:

[1] *Is the variable statistically related to loan performance?*

- Model developers must be aware that each variable provides incremental predictive power to the model to a statistically significant degree.
- A proposed variable will be included in the model only if it is determined that removing it would significantly reduce the model’s overall predictive power.
- Must have evidence that each variable in a model, if removed, would significantly reduce the predictability of the model as a whole.

[2] *Does the variable have an understandable relationship to an individual applicant's creditworthiness?*

---

<sup>16</sup> OCC Bulletin No. 97-24 (“Safety and Soundness and Compliance Issues in Credit Scoring Models”). In the Appendix to the OCC Bulletin, the OCC state that “. . . a variable is justified by business necessity and does not warrant further scrutiny if the variable is [1] statistically related to loan performance, and [2] has an understandable relationship to an individual applicant's creditworthiness.”

- Model developers must document a variable's intuitive connection to credit-worthiness.
- Compliance staff will assess whether the proposed connection is, in fact, understandable and reasonable.

*15. What steps, if any, do score developers, lenders, or other users of credit scores take to ensure that the use of credit scores does not result in negative or differential treatment of protected categories of consumers under the ECOA? Have score developers, lenders, or other users of credit scores changed the way credit scores are developed or used in order to avoid negative or differential treatment of protected categories of consumers under the ECOA? Are any particular credit history factors not used because of actual or potential negative or differential treatment of protected categories of consumers under the ECOA? If so, what are they?*

The process followed by one consumer lender is as follows:

This lender periodically creates models to evaluate applicants for various credit products that it offers. These models use available objective information relating to applicants in order to determine whether to extend credit to them, and if so, in what amount. This lender's use of scoring models greatly improves the objectivity of the loan approval process and reduces the risk of discrimination. The lender's credit scoring systems are empirically derived, demonstrably and statistically sound within the meaning of ECOA as implemented in Regulation B.<sup>17</sup> Credit scoring creates uniformity in the credit decisioning process. Therefore, basing credit decisions solely upon these credit scoring models minimizes fair lending issues.

This lender's models are reviewed and authorized by groups other than those which create the models (including the credit department and the compliance department). Personnel in these groups, as well as the model developers, understand the anti-discrimination provisions in the ECOA, and actively work to ensure that its credit scoring systems do not include prohibited variables. In addition, this lender does not use any factor which it determines to be closely linked to a prohibited basis category (*e.g.*, language preference) to evaluate the creditworthiness of applicants in credit transactions. Accordingly, if two applicants have different scores, it is because they are not similarly situated in terms of creditworthiness, and not because discrimination has occurred.

Finally, this lender also has in place a process to demonstrate the business necessity for the inclusion in credit models of all the variables that it uses. As suggested in the OCC Bulletin, the review first assesses whether each variable in the model is statistically related to loan performance. In implementing this step, the model developers and owners are made aware that each variable must provide incremental predictive power to the model to a statistically significant degree. Following the OCC's guidance, a

---

<sup>17</sup> Based on data derived from an empirical comparison of sample groups or the populations of creditworthy and non-creditworthy applicants who applied for credit within a reasonable preceding period of time; developed for the purpose of evaluating the creditworthiness of applicants with respect to the legitimate business interests of the creditor; developed and validated using accepted statistical principles and methodology; and periodically revalidated by the use of appropriate statistical principles and methodology and adjusted as necessary to maintain predictive ability.

proposed variable is included in the model only if it is determined that removing it would significantly reduce the model's overall predictive power. The second step is to analyze whether a variable has an understandable relationship to creditworthiness. In conducting this analysis, personnel trained in compliance with laws and regulations play a key role in analyzing whether a variable has an intuitive connection to creditworthiness.

*16. Has the use of credit scores caused a change in the rate of home ownership? What is the estimated size of such a change?*

Federal Reserve Chairman Alan Greenspan, quoted above, has identified "rapid growth" in subprime mortgage lending, and hence presumably increased home ownership by subprime borrowers, as a result of the widespread adoption of credit scoring models.

*17. Has the use of credit scores caused a change in the method and amount of pre-screening consumers for credit offers? What effects has this had on the terms offered to consumers?*

Prescreening is the most important method of acquiring new customers in the credit card industry. The IPI study found that across the industry prescreened offers of credit account for more than two-thirds of all new credit card customers acquired. In contrast, the next most popular method, direct mail not prescreened, accounted for only 17 percent of the new credit card customers acquired.

*19. How has the use of credit scores affected companies' ability to enter new lines of business or expand activities in the various credit industries?*

Credit scoring has accelerated the ability of financial institutions to enter diverse lines of business, whether they be installment loans, auto loans, or small business lending. For example, the mortgage industry has seen growth due in part to lenders' abilities to offer more home mortgage products with greater loan-to-value ratios – this can be attributed to the effective risk management afforded by the usage of credit scores. In new lending activities, credit scores offer a safer and more cost effective way to make educated estimates on risk of applicants while a lender entering the new line of business gains experience in that business.

*20. What role does credit scoring play in secondary market activities? In what ways has the availability of credit scores affected the development of the secondary market for credit products? Has the use of credit scoring increased or decreased creditors' access to capital? In what ways?*

Credit scores play an important role in obtaining funding for lending activities. Lenders provide credit scoring information to the rating agencies who rate the securities issued by lender's securitization trusts. Investors too are increasingly interested in credit scores. In recognition of this, the SEC recently adopted Regulation AB, which by early next year will require the disclosure of credit scores in securitization transactions.

*21. How are credit scores used to manage existing credit accounts, such as credit card accounts? How has the use of credit scores affected the way credit accounts are managed? How are credit scores used in the servicing of mortgages, and how has the use of credit scores affected the way mortgages are serviced?*

Credit scores measure the risk that a consumer will not be able to meet their debt obligations. That risk measurement is often used by lenders when determining consumer eligibility for a variety of account management offers such as credit limit increases. While important, credit scores are seldom the only factor considered when making offers to a consumer.

The use of credit scores has made it unnecessary for lenders to undergo a full manual review of a customer's account whenever a new offer is being made to that customer. This improvement in efficiency has enabled lenders to more frequently re-assess each customer's needs and better serve them.

*22. How are records of inquiries used by credit scoring systems? Does concern about the possible effects on their credit scores affect consumers' credit shopping behavior? If so, what impact does this have on the consumers or on competition in the various credit markets?*

Credit scoring systems often consider the number of inquiries in its calculation. However, the effect is difficult to quantify because most credit scoring systems are proprietary. Typically, bureaus or score developers like Fair Isaac give the following guidance to consumers regarding number of inquiries:

Applying for credit many times within a short period can hurt a consumer's credit score. When a consumer applies for any type of credit (such as an auto loan, credit card, department store card, or mortgage), the lender considering the credit application checks the applicant's credit history. This is recorded in the consumer's credit report as a "hard inquiry." Although inquiries are an unavoidable result of applying for credit, lenders dislike seeing many within a short period (such as 6 months). This is because they do not know whether the consumer is shopping for the best offer, or is desperately trying to get credit because of financial trouble. Statistically, numbers of "hard inquiries" correlate with higher risk.

Inquiries made by lenders in the course of prescreening are referred to as "soft inquiries" and do not affect a consumer's credit score. Bureau reports requested by a lender with respect to an existing borrower are known as "account reviews" and also do not affect the consumer's credit score.

*23. How does the use of credit scores affect consumers with inaccurate information on their credit reports? How does the use of credit scores affect consumers who have been the victims of identity theft?*

Inaccurate information in a credit report that is identified and disputed by the consumer, whether it results from error or fraudulent activity, is excluded from credit models and scores and therefore has no effect on them.

\* \* \*

**Conclusion**

We appreciate the opportunity to comment on the Proposal and again thank the Commission and the Board for their efforts. Should you have any questions about this letter, please do not hesitate to contact the undersigned at (202) 466-8606.

Respectfully submitted,

A handwritten signature in black ink, appearing to read "Robert E. McKew", with a horizontal line extending to the right.

Robert McKew  
Senior Vice President and General Counsel  
American Financial Services Association