PUBLIC FORUM:

THE CONSUMER AND CREDIT SCORING

July 22, 1999

Matter No. P994810

Federal Trade Commission

Room 432

600 Pennsylvania Avenue, NW

Washington, DC

P R O C E E D I N G S

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(9:02 a.m.)

MR. MEDINE: Good morning, and thank you all for coming. This is a tremendous turn out in the middle of the summer on a very, very important issue to consumers. And I would like to begin by introducing the Director of the Bureau of Consumer Protection of the Federal Trade Commission, Jodie Bernstein.

MS. BERNSTEIN: Thank you, David. Thank you for the introduction. And I guess they thought I needed it, because I see they've made two name tags for me, which either means that I won't remember my name, or we need a special introduction.

I'm delighted to be here this morning to welcome all of you to what's going to be a very important forum. And it's particularly important, as David said, that so many of you were able to get here. I know a lot of you travelled from out of town. And we particularly appreciate it, because the diversity here in the room of views and expressions is going to be critical to us.

I can't think of a subject that more consumers have expressed to us their desire to understand exactly what it is. As someone said, when we get a call from consumers -- and we do get lots of calls about a variety of subjects -- it's as if there's a black box somewhere and people -- somebody somewhere is dropping information into the black box and a score emerges. It's just almost that mysterious to people, they tell us.

And then they want to know -- and it really does sound like the SATs -- how can I improve my score. I know that we won't -- we won't produce a list that we can tell consumers how to do that. It's much more complex than that. But I do hope that with this group of experts and the discussion we hope will occur today, that we will all emerge with a good deal more knowledge and understanding of what credit scoring is about. We know it can be a huge benefit to consumers, and we will to be able principally to be able to explain it to them and ensure that they really do understand it and that they're fairly treated.

So with the excellent panelists we have today, again, I want to thank all of you for coming and for agreeing to guide our discussion. I could not close without noting that we have true experts to work with us this morning. And I believe our first speaker this morning is the gentleman sitting to my right, am I right?

MR. MEDINE: He is. I wanted to make a housekeeping remarks first. I'm David Medine, the Associate Director for Financial Practices here at the FTC. This forum, first of all, would not have been possible without the two people to my left, Kellie Cosgrove and Peggy Twohig. And I want to congratulate them for all their tremendous effort in putting this together.

(Applause.)

MR. MEDINE: Cynthia Lamb also was a tremendous assistant in organizing this event, and she's sitting in the back.

A couple of just logistical points before we get started. First, there will be a transcript of today's meeting, and as per Commission practice, a copy of the transcript will be available on our web site at www.ftc.gov once it's been prepared.

As Jodie mentioned, the purpose of today's forum is to discuss a wide range of issues associated with credit scoring. We want this to be a discussion in which everyone has an opportunity to participate, although the first couple of sessions will be laying out some of the background. But as the morning progresses, we're going to encourage people to ask questions and to make comments as we proceed, from the audience as well as from the panel members.

And for those who are in the overflow rooms, feel free to come by and join us with questions and comments, although we may ask you to return to the overflow rooms, given space considerations. But we don't want people not in Room 432 to be denied the opportunity to participate in today's discussion.

If you have any questions or need directions, keep an eye out for the folks with yellow tags on them. They're Commission staff, and they will be happy to direct you to rest rooms, which are just outside and to the left, or to our wonderful Top of the Trade, if you are hungry and need a snack later on, on the seventh floor.

It's my pleasure to start the morning off with a good friend of ours, Pete McCorkell, to give us an overview of credit scoring. Pete is the Senior Vice President and General Counsel of Fair, Isaac and Company. Jodie talked about the black box. Well, Fair, Isaac makes the box, and so this will be a wonderful opportunity for us to get a peak inside the box and get a better sense of how the scores -- credit scores are prepared.

I think we all discovered that credit scoring had entered the mainstream when in an episode of Murder One a couple of years ago, someone talked about their FICO score as if everyone knew what that meant. And so I think credit scoring moved into the mainstream at that point.

Fair, Isaac, of course Pete's company, pioneered the commercial development of empirically derived, predictive models for the credit industry and has really popularized and expanded their use. They are located in California, and they have subsidiaries dealing with the whole issue of decisions using scoring methodology.

Pete supervises Fair, Isaac's legal affairs. He joined them in 1987, and has provided advice and assistance to credit grantors in connection with consumer litigation and regulatory proceedings. He is the company's primary liaison with the federal credit regulatory and enforcement agencies, including the FTC, and has conducted seminars for us and other agencies to educate us about the scoring. And today he'll educate you about the scoring as well.

Pete?

MR. MCCORKELL: Thanks, David. When I came in, I used a line from Butch Cassidy and the Sundance Kid. I said, can I move. So I'm going to get up and move.

Okay. I'm going to sort of approach credit scoring a little bit like peeling back an onion. We've got a lot to cover in the next hour, and so kind of put on your seat belts and try to stay with me.

We're going to cover a number of topics, and really in some sense the most important part of what I've got to say is really bringing everybody's awareness about what the nature of the credit decision is. Because an awful lot of the alleged shortcomings of credit scoring turn out to be problems that are inherent in the nature of the credit decision and applied other ways of making credit decisions.

I'm also going to talk about sort of the differences between statistically based decisions and judgmental decisions. I'm going to then go into a little bit, hopefully in a very nontechnical way, about how credit scoring systems are developed. I'm going to talk about different types of credit scoring systems. I'll focus a little bit on the credit bureau scoring systems, because I think that's probably what most people have in mind when they hear the term credit scoring or FICO scores. And then finally, if there's enough time, touch very briefly on some legal and public policy issues related to credit scoring.

Actually, one more. Casey Stengel actually had it about right. Making predictions about the future can be kind of dangerous. But in fact, that's what credit grantors have to do. They have to make predictions about how borrowers will behalf, how borrowers will repay that obligation. And when you come right down to it, there is no way to predict with certainty how any individual borrower is going to behalf, how they're going to repay.

But what you can do, is that you can predict how groups of borrowers will repay with reasonable certainty. You can predict that if I have a thousand customers with these characteristics, 900 of them, or 950 of them, or 990 of them will repay in a satisfactory manner and the others won't. But nobody can predict that this particular borrower will or will not repay in a satisfactory manner.

And so what we're talking about is not predicting with certainty the behavior of an individual, but really trying to estimate the risk that different borrowers pose. And risk by its very nature is assuming that you're looking at a group of people, because ultimately every borrower is either going to behave in a satisfactory manner or they're not. They're either going to repay in a reasonably satisfactory manner, or they're going to go delinquent. Maybe go all the way into charge off.

So at the end of the day with any particular borrower, you can say, yeah, this was an absolutely great borrower, or this was a terrible borrower. I should never have extended that loan. But when you're making that decision, you can't say for sure that this borrower will or will not repay. And that really gets into kind of the meat of credit scoring and what it's all about.

Basically there are fundamentally two ways of making credit decisions. The sort of old fashion judgmental type of decisions, where somebody takes a look at whatever information is available, and sits down and scratches his or her head, or pats his or her stomach or whatever they do to think great thoughts, and comes to a conclusion that this is a loan that I'm willing to make.

The other type of decision process is -- and in many cases the two are actually used jointly in any given case. But fundamentally the other type is using the statistical method of making decisions, and that broadly is what I'm going to refer to as credit scoring.

Now, a little bit later on I'm going to get into some terminology. In the mortgage industry, at least, credit scoring has come to have, for at least some people, a somewhat more narrower definition. But at least for right now, I'm using credit scoring in kind of the broadest sense of any kind of statistically based credit decision system.

So what are the differences between those two types of decisions? Well, actually what I really want to talk about first is what are the similarities. Both methods assume that the future is in some large measure going to resemble the past. Both methods, you're taking a look at the applicant that you've got to make a decision on today, and comparing that applicant with qualities or characteristics of borrowers that you've had experience with in the past, and making the assumption that if today's applicant looks like the people who generally repaid in a satisfactory manner in the past, then this applicant is likely to repay in a satisfactory manner.

The days of Mr. Bailey and the Savings and Loan from It's a Wonderful Life are long gone. Very few of us are known personally to loan officers. Most credit today is extended by mail, sometimes over the phone and increasingly over the Internet. It's probably been 15 years since I've had an up front personal encounter with a loan officer, and I suspect that the same is true for most consumers.

Today you just don't have that friendly interaction across the desk, and even when you do, you're likely to have -- you're not going to have it with Mr. Bailey who knows everybody in town and has known you and your parents and your grandparents. You're going to have it with somebody that doesn't know you from a hole in the wall.

And so while your own past history is certainly an important part of the credit decision, in many ways whether somebody is making judgmental or statistical decisions, they're comparing what they know about you to what they know about other applicants and how those other applicants behaved as borrowers.

And then finally, it gets back to the idea of trying to grant credit to acceptable risks. Now, a lot of people making judgmental decisions may sort of fool themselves into thinking well, I know for sure this borrower won't repay, or I know that if I extended credit to this guy, he would not repay. But in fact, you just can't make those individual decisions with any degree of certainty, so in either case you're really trying to hit that acceptable degree of risk.

Okay. Now, what are the differences? Well, credit scoring really defines that degree of risk. It allows you to come up with a numerical measure of the degree of risk that any borrower presents. It lets you rank order those borrowers with respect to one another. And I'll get into that a little bit later.

It explicitly lets you make those decisions based on a degree of risk. A lender can say, I can make money if I extend credit on this product to people where 10 of them will repay for every one that won't, and therefore I have to have at least a 10 to one odds of repayment in order to make money. So I'll extend credit to everybody whose odds are 10 to one or better. If they're worse than 10 to one, I'm not going to extend credit to those people.

It lets you track how those borrowers perform based on the criteria that you're using in the credit scoring system. It lets you make adjustments in your policy. If somebody is making judgmental decisions and the boss comes in and says, our losses are too high, we've got to tighten up, every credit officer is going to have a different idea of what tighten up means. Or if the boss says, gee, our market share is slipping, we're losing business to the competition, we've got to loosen up, every loan officer has to figure out what loosen up really means.

With credit scoring somebody could come in and say, we need to tighten up. Let's raise the cutoff by five points. And because of the statistical work that goes into the system, the management knows that if they raise the cutoff by five points, they'll reduce the acceptance rate by X amount and also reduce the delinquency rate by Y amount.

And then finally, credit scoring allows the automation of a lot of credit decisions, which I think some of the other folks are going to talk about, but which has really been a big part of the acceptance of credit scoring. Certainly in small business lending, for example, probably more people have gone to credit scoring for the benefits of automation.

In small business lending, for example, the typical statistics we hear are that it takes 10 to 12 hours of loan officer time to process a small business loan judgmentally. Using credit scoring and automated underwriting, it can be done in 15 to 30 minutes. Now, if you can take 10 or 11 and a half hours out of the process -- and that's not data entry time. That's fairly high paid time. If you take that much time and salary expense out of the process of making a small business loan, you can make a lot more small business loans, especially small dollar small business loans, than you could make if you were doing it judgmentally.

One way to sort of think about the differences is that probably in most cases, even somebody making a judgmental decision has a list of factors that they're going to look at when they are reevaluating an applicant. And, again, to just get some lingo in here, what we call characteristics are really the different types of information that are looked at the decision process.

Another way that you can think about characteristics is that you might think that each characteristic implies a question that you could ask and then get the answer, either from a credit application or from a credit report.

Next slide, please.

And so in this case, at the top of the page we've got some information that you might get from a typical credit application, and then down towards the bottom below the blanks are a number of characteristics that you might get off of a credit bureau report. And somebody making a judgmental decision is going to be able to go through that list of characteristics, and probably about the best that they're going to do is be able to say well, this guy looks pretty good on this, but not so good on that.

In this case, time at present address looks good, and time on job looks good. Oh, but this guy is a renter and not a homeowner, so that's not so good. Debt ratio is good. He's got a good bank reference. The N/A after age doesn't mean that there's no age. It means that legally age is not supposed to be used in judgmental credit decisions because of ECOA in Rate B. But they do allow it to be used in scored decisions.

And so you just go through the list like that, and at the end of the process judgmentally you say, oh, this is an acceptable borrower, and that again implies that this is a borrower who poses an acceptable level of risk. You couldn't begin to site the odds of that borrower if you evaluate that borrower using judgmental processes.

With credit scoring -- and again here is another thing to keep in mind. You're probably going to go through very much the same list of factors that somebody would go through judgmentally. And that's not just sort of, you know, conjecture on our part. One of the things that Fair, Isaac does, is when we build a credit scoring system for somebody that hasn't used credit scoring before, we also build a statistical model of their prior judgmental decision process.

And so we can actually find out how -- what factors at least appear to be important in that judgmental decision process, and almost invariably will find that very much the same factors are being considered -- at least apparently considered -- in the judgmental process as wind up being considered in a credit scoring system.

And so the list of factors, the types of information that are considered, are very similar. They're not -- again, other than age, which for the legal reasons can't be -- or least maybe more accurately, isn't supposed to be used in judgmental decisions. Other than age, the types of information considered are going to be pretty much the same.

But with a credit scoring system, for each of those questions that are implied by the characteristics, each possible answer to that question is going to have a number of points assigned to it. And so you could add up all those points and you get the overall score. In this case, you get the same decision, that is an acceptable borrower. In other words, a borrower that poses an acceptable level of risk.

But you get one very important additional piece of information, and that is, you get told this borrower is 11 to one. In my example earlier, I said we could afford to extend credit to people at 10 to one odds. This guy is 11 to one, so we'll take him.

Next slide, please. This is a sample -- and let me stress a sample -- of what a credit -- the guts of a credit scoring system, the credit scorecard itself, might look like. It is not an actual credit scoring scorecard, so don't go home and try to score yourself on this and get into a major tiz about your score.

I'll just use it to illustrate a couple of points here. First of all, in this case we've got the characteristics down the left hand column. Again, those questions -- those types of information. And now across in each row next to the characteristics, we've got the different attributes. The different possible answers for each of those questions, and you'll see that each of them have a different number of points assigned.

A couple of things that I want to point out on here, you'll see -- and again above the jagged line are pieces of information typically that you get from a credit application, and below the line are characteristics that you would typically get from a credit report.

For all of those application characteristics, and actually implicitly also for the bureau characteristics, at the very far right of each column -- each row -- there is a box labelled NI. That stands for no inform, which is Fair, Isaac speak for no information value. That may be different than the questions not answered.

If you look at the fifth line down, Department Store/Major Charge Card, you'll see there is a box for no answer. Sometimes when a question is asked on an application and the applicant leaves that blank, the fact that they left it blank tells you something. On the other hand, in a lot of cases credit lenders change applications, or for one reason or another a particular piece of information may not be available for a given individual.

We have figured out that it would not be fair to assume that that means that person should get zero points for that piece of information. What they get is what we call the no inform points, which if you go to the next slide, is really can of the neutral value. No inform means that there is no information value to say that this applicant is either better or worse than the average applicant based on that particular piece of information.

So if you have a characteristic like age, where you've got, you know, kind of a nice, smooth numerical scale in most cases, there is going to be some age value that's exactly equal to the no inform points. For a given applicant, not because the applicant refused to answer something, but because you didn't ask the question on an application, if you're missing a piece of information, it will go to the no inform points.

In other words, it says we don't have a piece of information on this factor that tells us that this applicant is likely to be risky or less risky than the average applicant who walks through the door. So that's what the NI or no inform points are about.

Okay. We saw all of those numbers, so where do they come from? Well, we do not sit around the water cooler at Fair, Isaac and kind of pull them out of our ears, which again may come as a surprise to people. I read something just last week that talked about the scoring model assumes that. Well, scoring models don't assume anything. All of the numbers that are in those scoring models are the result of very painstaking, detailed statistical analysis of real data.

The first thing that we have to do in developing a scoring model is to get a sample of borrowers where we can say, this borrower's performance is known to the extent where I'm willing to say that if I knew when I made the decision what I know now about how that borrower has actually performed, I could say either I would make the same decision to extend them credit, or if I had known then what I know now, I wouldn't have extended credit.

And that's what we mean by goods and bads here. I'll use that term again probably throughout the rest of my hour here. That's not a moral judgment or anything else. In some senses, the good and bad refers to the credit grantor's own decision. Did I make a good decision in extending credit to that borrower, or did I make a bad decision. Or in a sense in kind of the way we define it, if, again, knowing how that borrower actually performed you would still extend them credit, then that counts as a good. If you knew how they would perform and you wish you hadn't extended them credit, then that counts as a bad.

For the people that you've been accepting under -- and let's assume this is somebody that's been using judgmental decisions. For the people that have been accepted before, of course it's very easy to figure out who the goods and the bads are. You just wait a couple of years, depending on the type of credit product, and you see how they perform. You ask yourself, am I glad I extended credit or not.

And so you can count the known goods and bads out of that Accepts on the right hand side there. Again, just to use nice round numbers here, we're assuming we start out with 10,000 people. Under the old decision process, 7,000 were accepted and 3,000 were turned down. For the 7,000 Accepts, figuring out the goods and bads is just a matter of counting based on how they actually performed.

But in building a scoring system, we don't want to ignore these 3,000 rejects. The example I gave of somebody saying I've got to have 10 to one odds to make money means that somehow if you could improve your decision process, if you could make sharper decisions about individual risk level, for every 11 people you turn -- if you were turning down people that were below 10 to one, for every 10 people you turn down, in certain groups at least, as many as nine of them would have turned out to be good customers if you would have accepted them.

And, again, that's an important concept to grasp for lots of types of -- in fact, virtually any kind of credit product. To set a cutoff score for economic efficiency, the credit grantor is going to wind up setting the cutoff score at a point where more of the people that are turned down would have been good, and sometimes by a very large majority. Sometimes it may be 10 to one. It may be even more than ten to one. Odds are the point where it becomes unprofitable, because the loss for one bad customer is a lot greater than the profit from any single good customer.

And so when somebody says, you know, our cutoff is 415, that doesn't mean that everybody who scores 414 and lower is going to go delinquent, and in fact at 414, an awful lot of those people would probably have performed just fine if you had accepted them. But it's not economical given the facts of that particular portfolio to extend credit to those people whose odds are worse than that.

We don't want to ignore them, because in fact we know that there is good business in those prior rejects. And so what we go through is a process that has a number of names. The one that I think is most descriptive is Reject Inference. For those of you who paid attention to your high school math classes, you will remember a process called extrapolation, where you could infer where a point was on a line where you didn't actually have any sample points. It went beyond the ends of the line when you're putting stuff on graph paper.

Remember when you were a junior or sophomore in high school, you were putting stuff on graph paper, and if you only had samples, they were sort of in the middle of your graph. You could nevertheless extrapolate to where some points would be outside where you had actual samples.

Well, Reject Inference, you can think of that as kind of a multi dimensional form of extrapolation, where again we look at the rejects. We see how they compared on all of the relevant characteristics to the Accepts, and we infer from that, we estimate from that, we extrapolate from that, how they would have performed.

And indeed we see here, that of those rejects, the odds were about nine to one. They're almost -- they're about nine times as many inferred goods as there are inferred bads in the Rejects. So to build a scoring system, we fold them back in with the known goods and the bads, and, again, hopefully the prior decision process made some sense.

And so the odds from actual performance of the people that were accepted, the overall odds for that group -- not the odds at cutoff. But the odds for that group as a whole are 24 to one. The odds for the Rejects are 8.7 to one. And again, I sort of use these numbers because they will work out well for my next example. The overall odds for that population turn out to be 16 to one.

So if all that I know is that somebody has walked in the door in this population, I can say, well, if I extended credit to everybody that walks in the door, for every 16 people that paid in a satisfactory way, one of them wouldn't. And that's actually pretty -- that's pretty high odds. More typically, in most populations we're going to see something -- in the population odds, we're going to see something on the order of ten to one, eight to one and something like that.

But as I said, that 16 to one number happens to work well for my next slide and actually several slides after this. So we've now sort of divided the world into the goods and the bads. There aren't any uglies, just goods and bads. So now we continue the process of a very careful analysis of actual data, and we see how people -- look at each characteristic, and we look then at each attribute of each characteristic, and we see how those people perform.

And my first example here is age. And we'll see that for people under 30, that group had 10 percent of the goods, but 40 percent of the bads. And so the information value for that attribute is one to four. And again, these numbers here are in percentages, not in absolute numbers. But if all I knew about somebody is that they're in this population and that they are under 30, I can multiple the population odds of 16 to one by the information odds for that one isolated piece of information of one to four, and the first line at the bottom there, I find out that this person is four to one. It's the 16 to one multiplied by one to four.

On the other hand, if I have somebody who is over 50, you've got exactly the reverse situation. Again, this is just a sample -- an example. There 40 percent of the goods are over 50 and only 10 percent of the bads. So the information odds there are the other way around. It's four to one. Multiple that by the population odds of 16 to one, and I can say people over 50 -- my best guess, again, just based on this one piece of information, age, are that they're 64 to one.

Well, now I've started spreading people out away from that overall population odds of 16 to one. I've got the younger borrowers over here riskier than the general population, and the older borrowers a lot less risky than the general population.

Of course, we don't look at just one factor. We may throw in another factor, on the next slide, such as own or rent, or residential status. And again, not terribly surprising, the owners are better than average. They're two to one. The renters are worse than average. They're one to two.

And then on the next slide, I put those two factors together and things started to get really interesting, because now if I have an under 30 renter, I'm taking again the population odds of 16 to one, the information odds for under 30 of one to four, the information odds for renter of one to two, and I multiple that out, and now that under 30 renter is only two to one odds. So if I lend money to three under 30 renters, I can expect two of them to repay in a satisfactory manner for every one that doesn't.

On the other hand, if I take my over 50 homeowner and multiple that out, now I've got odds of 128 to one. So I'm pulling different groups of that population sort of further away from that center line by adding the information value from these various factors.

Now, this example makes the assumption that all of these factors are independent. Those of you who remember the O.J. Simpson trial and the DNA evidence, you'll remember there were some pretty staggering numbers that the DNA experts cited of 9.5 billion to one odds that these DNA markers could have belonged to anybody other than O.J. Simpson.

Well, they were going through very much the same process with a large number of individual DNA factors -- DNA characteristics, if you will. And based on the assumption that they were independent, that's how you get those kind of staggering numbers like 9.5 billion to one. And if all of these factors in a credit decision were also independent, you might get some pretty staggering numbers.

That's not the way it works in credit. And in fact, what we'll find is that there are correlations -- in some cases very high degrees of correlations -- among the different factors that we look at, so we've got to correct for that. We don't assume that they're all separate. We certainly wouldn't ever make a credit decision using just age, or just own or rent, or just those two factors, because in fact one of the things we know -- and it's pretty intuitive if you think about it -- is that as people get older, they're more likely to become homeowners rather than renters.

You know, those of you who are over 30, you know, remember back when you were in your 20's. Probably most of us spent a few years as renters in our 20's, and the chances of becoming homeowners get a lot higher as we get older. And also, except for those who are in their 40's and still living with mom and dad, the time at address is also going to go up as you get older.

And, you know, in a lot of cases, about the same time that you get old enough to be legally able to borrow anything, you're likely to leave home to go to college or join the Navy and see the world or whatever, and so your time at address takes a big hit. And then as you get older, you're likely to be at the same address longer. Homeowners, of course, are less likely to move than renters, so there is a large correlation between time at address and home ownership, as well as with age.

So these overlapping circles here, if you think of the size of each circle independently as the information value in that particular characteristic, the overlap just suggests that because of these correlations, while each of those factors taken individually may have a fairly large information value, as you start adding these correlated characteristics, you then have to correct for that overlap.

And on the next slide, I throw in one more factor. In this case, time on job. Well, of course, time on job is likely to be correlated with those other three factors. Again, unless your parents forced you into child labor in the family business, if you're in your 20's you're probably not going to have been at the same job for very long. Your time at address and time on job frequently go together, because if you get a new job, in a lot of cases you've got to move, or maybe you have an opportunity to move, and again, the home ownership.

So while time on job standing on its own has a reasonable information value, what this represents simply is that where you've already got those other factors -- kind of stability characteristics, age related characteristics in the system -- adding one more factor of the same kind just brings very little additional predictive value.

And that's important for a number of reasons, because typically in building a scoring system, we'll start out with maybe as many as 50, and maybe as many as a hundred, characteristics that independently have a reasonable amount of information value. But because of these correlations -- these overlaps -- as we actually start building the system and we start getting a few characteristics with a lot of information value in there, a lot of those additional characteristics won't get into the final system because of these overlaps. Nevertheless, all of the information value there is still captured by the characteristics that are in the system.

And so frequently somebody that's not sort of familiar with the concepts of credit scoring comes along and says, well, gee, this system doesn't have time on job in it. I know that's predictive with credit performance. There is something wrong with your credit scoring system. No, actually the information value is in there, but it's just picked up by those other factors that have correlated with time on job. And so sometimes somebody will come along and say, well, but you didn't consider such and such. It's not in your scoring system. You didn't consider such and such about me.

Well, we may have considered that implicitly because of all of these other factors that are in the scoring system, and so for a number of reasons, they're characteristics that people try to keep out of scoring systems. One of them -- something that, you know, sort of might be a very obvious characteristic is income. It sounds like a nice numerical characteristic. It's probably got something to do with how people are going to be able to pay their bills.

But it turns out that in practice income is difficult to work with, because no matter how explicitly the application asks the question, people insist on answering it in different ways. You may ask for monthly pre-tax income and you get semi-weekly, before tax and after tax, and you get with and without child support and alimony. And you get the rental property, even though there is another box on the application for that. And it actually turns out to be a very messy characteristic. And so somebody says, well, you didn't ask for my income. How could you possibly make an intelligent credit decision. Well, it's because of these correlations.

If we go to the next slide, sort of the goal of all of this, as I said, we're trying to separate -- move those people apart on the risk scale away from that average that you know just because they walk in the door. And what we really want to do in building this credit scoring system is come up with a system that will separate the eventual goods from the eventual bads by as much as possible, so that -- now there will always be some overlap in the distributions.

Actually this doesn't quite do it justice, because in reality the distribution of goods would go all the way down here to the bottom of the scale, and the distribution of bads would go all the way up to the top of the scale. But what we're trying to do is move those two distributions as far apart as we can, so that the bulk of them in my nice bell shaped curve here -- and of course life isn't usually quite that perfectly drawn, but it kind of approximates that.

What we're trying to do is move those two curves as far apart as possible, so that we can set a cutoff score that turns away as many of the bads as possible, while turning away as few of the goods as possible. Now, these are in percentages. Hopefully in any population the goods would be a lot smaller in absolute numbers -- the bads would be a lot smaller than the goods in absolute numbers. So these are in percentages, which is why the curves are the same size.

But you can see at the top where the two curves are a little further apart, you can set a cutoff that cutoffs most of the bads and only a very small percentage of the goods. Down at the bottom, the two distributions are closer together, and so to turn away the same percentage of bads, you've got to cut off twice as many of the goods.

Now, that's the goal of the credit scoring system. There is no absolute right or wrong, and we call that measure divergence, just how far apart those two distributions are. There is no right or wrong answer for that. The goal is to get those two distributions as far apart as possible in any given case, because then it lets you make more efficient decisions at cutoff.

For example, for a college student population, college students, you know, all look at lot alike in terms of credit factors. Again, unless they're still living at home, they're all renters. They've all been at the address for a short time. If they've got a job at all, they've been on the job for a very short time. They have very little credit history, etc. So you might -- if you had a college student population, you simply couldn't get the two curves as far apart as you could for a more general population.

Next slide. Now, technically what credit scoring systems do is to rank the order of consumers by risk, because they don't consider things like economic changes. If the economy goes south, people that scored 200 in this example that equaled odds of 20 to one, if the economy takes a real downturn, those people that were scoring 200 may find themselves with odds of 18 to one or 15 to one.

And so we don't purport to provide an absolute odds quote, but, of course, what every credit grantor wants to do is to turn that score into an odds quote. And there are ways that they can do that, both from the development statistics and also in terms of watching how their own population performs.

So we get through all of this, and somebody is probably still out there saying, oh, gee, but why do you think scoring can do a better job of predicting credit behavior of estimating risks than judgmental decisions. It's real simple. It's better to count than to guess.

And fundamentally that's the difference between how somebody using a credit scoring system is making decisions. They're counting very carefully the prior performance. They're taking a very hard look at the prior performance of different kinds of people, separating that into individual characteristics, and then comparing that in a very disciplined way to what you know about the next applicant through the door.

If somebody is making judgmental decisions, they're trying to keep all of that in their head and, you know, there is no way that you can juggle 10 or 12 different characteristics, each of which has three to six different attributes. There is simply no way that you can juggle that much information in your head, because if you have 10 or 12 characteristics with three to six attributes each, you have 10 to 20,000 possible combinations in there. There is no way that somebody judgmentally can keep straight 10 or 20,000 different combinations of attributes.

And so to a large extent, they're guessing. They're taking -- making an informed guess, hopefully in most cases. But really they're guessing at how today's applicant compares to the applicants that they have seen in the past and for whom they have actual performance.

Okay. Real briefly I want to talk a little bit about different types of credit scoring systems. Historically most credit scoring systems were built for a particular credit grantor, what we call custom scorecards. The next category of borrowed scorecards is really not terribly relevant these days, although in a few cases it might be possible for one credit grantor to borrow a system from a different credit grantor.

What is becoming very common, and again probably what most people think of when they hear about a credit scoring system, are credit scoring systems built from data across multiple credit grantors. Now, of course, the biggest example of that are the credit bureau systems, that I'll talk about in more detail, and what we call pooled system.

And then in a very few cases, somebody may come along and want to do something kind of entirely new and different. It doesn't happen in the United States, again, very much these days. We do this more overseas. Sometimes somebody will come along and want to do something so new and different. They say well, we don't have any data on this. We don't have any data on similar portfolio. Fair, Isaac, you've been in this business for

40 years, what can you do for me.

And then in that case we can sit around the water cooler and say, well, based on our 40 years of experience in lots of different systems, here are some guesses we can make about the kind of borrowers you're going to see. We can build a judgmental -- what's really a judgmental scorecard, or what we call a launch scorecard, just to get them going until they've got some data.

Next one. The information used in a credit scoring system can come from a variety of sources. Of course, the most common are credit reports and credit applications. A bank may have prior experience with a particular customer. Sometimes demographic information may be useful. For existing customers the issuer's billing file has a lot of good information. And in secured lending, the terms of the deal, the amount down and things like that, can be very useful.

Next. Credit scoring can also be used to make a variety of different types of decisions. Last year there were about three billion pre-screened credit card solicitations mailed in the United States. Probably 2.9 something billion of those were credit scored. Believe it or not, not everybody in the world gets those pre-screened solicitations, and typically one of the screens they go through is credit scoring.

New applications, again, is probably what most people think of in terms of credit scoring, making a decision on an application for new credit. On the other hand, if you pay attention if you own a credit card or two, you'll notice that these days the issuers, for most of you at least, try to do nice things once in a while.

They send you that letter that says because you're such a wonderful customer, you don't have to make the minimum payment this month. Or because you're such a wonderful customer, we're going to increase your limit. Or if you should happen to be standing at the cash register with a purchase that's going to put you over the limit, they want to know whether or not they're going to authorize that transaction.

And finally when that piece of plastic expires, they want to decide should we reissue it at all. If so, should we reissue it for six months or for three years. And so they're using decisions to manage those existing -- they're using credit scoring to manage those existing accounts. They may also be using credit scoring to try to decide whether or not to try to sell you another type of product, based on what they know about your behavior on the one you've got.

And finally, in certain kinds of lending, especially mortgage lending, lenders frequently resell a lot of the portfolio. The lender is using credit scoring to decide which parts of the portfolio it wants to sell versus which ones it wants to keep. And the buyer or investor, on the other hand, may be using credit scoring to decide which loans it is interested in buying.

There are also a number of different performance definitions. Up until now I've sort of talked about good-bad or really a scoring system designed to predict any credit delinquency. We can -- and there are systems designed specifically to predict the risk of bankruptcy, rather than other types of delinquency.

If somebody is making a mailing -- a pre-screen mailing -- they want to know whether somebody is likely to respond, as well as if they do respond and you issue them a card, will they pay. There are a lot of people who are absolutely great credit risks who are literally not worth the price of a stamp for a pre-screen mailing, because they are so unlikely to respond.

And actually I'm kind of in that category. My wife gets a lot more pre-screened mailings than I do, because in fact we have sort of different patterns of credit uses. And so somebody looking at her credit bureau file is more likely to say this is somebody that might be interested in another credit card. McCorkell hasn't gotten another credit card in 15 years. We're not going to waste a stamp on him.

Okay. Really just kind of an intro for the next panel, scoring today in the mortgage industry, which is probably as David and Jodie mentioned, is really how scoring came to kind of the front of public consciousness. Scoring is really used in a couple of different ways. And, again, there is some terminology here.

A lot of the mortgage industry refers -- when they say credit scores, they're referring to scores built just on credit bureau data that are installed at the credit bureau. When you order a credit report, a score is generated. And when people in the mortgage industry talk about credit scoring, they may mean what I would probably refer to as bureau or credit bureau scores.

And most of those credit scores or credit bureau scores used in mortgage lending, interestingly enough are what I labelled here as generic scores, which are designed to predict the risk of any credit delinquency. There are also some mortgage-specific credit bureau scores that were designed specifically to predict the risk of mortgage delinquency. Actually what we found is that the generic scores do a very good job of predicting mortgage at risk, as well as other types of credit risks.

And then finally, what I've labelled comprehensive mortgage scores, I think a lot of folks just refer to as mortgage scores, where they are looking not just at the credit bureau -- the credit history piece of information, but they're also looking at application information and the deal terms -- the amount down and that kind of thing -- in making a more comprehensive decision. I think the next panel will get into that a little more.

So what I would like to turn to next are specifically the credit bureau scores. And here, first of all just kind of broadly, are the types of information that are considered by the credit bureau scores. Now, these are scores that Fair, Isaac and others -- there are other scoring developers out there. I don't know why anybody would use them, but some people do.

So there are other flavors of credit scores, and occasionally somebody will use a FICO score to mean any kind of credit score or any kind of credit bureau score, even though FICO happens to be a trademark of ours. It's a little like Kleenex. You don't always look at the brand label when you walk into the store and buy a box of Kleenex. You just want tissues to blow your nose. FICO scores have sort of gotten the same kind of generic use of the brand name.

These are scores that are running just on the credit bureau data, and they're looking generally at five types of information. And they're really listed here in the order of importance. First is previous credit performance. Has this person performed well, or have they gone delinquent on other obligations. Not surprisingly, that's the most predictive piece of information we've got.

Secondly, now those for people where the answer is yes, all of their prior credit they've performed in a satisfactory way in the sense that they've met all of the contractual obligations and they've never been late, etc., that accounts for about 85 percent of the population. And so there are only, again, rough numbers, 15 percent of the population that's got serious delinquencies noted on their credit report at any given time.

The other 85 percent of the population does not all present the same degree of risk in terms of future credit behavior. And so we've got to look at other types of information as well to see how those folks are likely to perform in the future.

And the next most predictive piece of information is what's labelled, current level of indebtedness. In one sense, you can sort of think of that as how close to the edge are these folks. Is it somebody -- you know, somebody who has got five credit cards, all of them they have borrowed right up to the max and they're making minimum payments, are a lot riskier than somebody that their balance -- the limit ratio is down in the 10 to 20 percent range.

The amount of time that credit has been in use. And actually that line is a little bit mislabelled. It probably ought to say sort of the amount of credit history available, which is really a combination of the time that credit has been in use and also the number of trade lines that are on the file.

Now, trade lines can be on the file that aren't active any more. In fact, again, those of us who have been around for a while, sort of after we got into the credit world, we probably have a lot of accounts that we've paid off and closed. That good information, in most cases, will stay on the file kind of indefinitely.

And so somebody that's got 20 or 30 years of credit experience and any kind of reasonable number of trade lines, maybe a lot of which have been paid off -- you know, student loans that have been paid off. Mortgages that have been off. You know, your first credit card may have been a gas card or a store card, because that was the only place you could get a credit card when you, you know, first got out of school.

So those have been paid off. All of those historical pieces are likely to still be on the file, and so we look at that. It's really the amount of credit history available.

The next category we look at is the pursuit of new credit. This is where the inquires come in and also new account openings. Somebody that has a lot of inquiries generated by the consumer -- and I'll get into that in a little bit -- or has opened a lot of new accounts recently, is more risky than somebody that hasn't been out there actively pursuing a lot of new credit.

If I could actually then skip down to I think number -- yeah, number 33. There are a few -- I'm skipping a few slides in the presentation, because we're kind of running out of time here. Keep going. Keep going. Bingo. Okay.

I mentioned inquiries. This has been a topic of some controversy. Fair, Isaac about a year ago redesigned our bureau systems to do what we call inquiry de-duping. We know that in a lot of cases somebody shopping for a mortgage or for an auto loan will wind up with multiple inquiries from the same transaction. And of course not many people buy more than one house in any given month, or more than one car.

And so we've sort of been able to say, if we count all of the auto loan inquiries and all of the mortgage loan inquiries within any given 30 day period as a single inquiry, because it's probably only one auto or one house that they're shopping for, that that is really a better representation of their credit behavior.

And then also, again in mortgage lending especially, people may wind up shopping around for some period of time looking for the best rates, going to different lenders or go through a mortgage broker who shops at the different lenders. And so in fact what we've said is, we don't count any inquiries in the 30 days before this particular score is computed.

So you can have a hundred inquiries in the month before the score is computed and they won't count at all. And you can have any number of mortgage or any number of auto loans in any -- I'm sorry. It's a 14 day period at any time before the score is computer, and they'll only count as one inquiry each.

Okay. If we could slip I think two slides. It's just an example of the de-duping. One more. One of the things we've done with the bureau scores is to actually use multiple scorecards rather than a one size fits all scorecard. And that will become relevant later in the afternoon when we talk about what ought to be disclosed.

And I think the question that Jodie posed is, how can I raise my score. Because of the multiple scorecard design, it's not possible to tell somebody, if you do this, your score will go up by X, because in fact the credit bureau information is a moving target. There's always information coming into the credit bureau. Essentially on a daily basis credit bureaus are getting information from credit grantors.

Also, our systems consider the age of certain types of information. A delinquency last week is a lot worse than a delinquency five years ago. A new account that was opened up last month is more significant than a new account that was opened up three years ago in terms of pursuit of new credit.

And so even if you don't do anything with your credit. You don't use your credit card in a given period of time and you don't make a payment. And of course if you don't make a payment for too long, something will happen, because the credit grantor will now start reporting you as delinquent. But, you know, you don't miss a payment, but you don't make a payment. Even if you don't do anything with your credit history, just the passage of time is going to affect some of those things.

And so I could sit there with somebody's credit report and say well, if you close this account, or if you paid off that account, here's what would happen to your score if nothing else changed. But something else will always change. And then one of the things that may change, is that by doing something you may wind up on a different scorecard, because the way that the system is split, is first of all it looks for the presence of serious delinquency information, either in the trade lines or in the public record part of the credit file.

And so we have sort of the goods and the bads -- the previous goods and bads now separated using different scorecards, because if we used a one size fits all scoring system, anybody with any delinquency would get a terrible score. But, in fact, not everybody with a prior delinquency presents the same degree of risk, so we can do a better job.

Now, the people with prior delinquencies as a group are riskier than the people with no delinquencies as a group. But we can do a better job by this split scorecard design of finding the folks with prior delinquencies that today pose a reasonable risk versus the ones with prior delinquencies who are still just terrible risks going forward.

And then depending -- and then after we sort of make the split based on the existence of delinquency, then we also look at some other information: the thickness of the file, in a sort of philosophical sense how many trade lines, etc., there are, the age of the file, how long has this person had established credit.

Again, somebody who is 50 years old and has 30 trade lines, most of which are now closed, that may be a very typical pattern. Somebody who is 22 years old and has 50 trade lines, and they've only been in the file for 24 months and they've got 50 trade lines already, that's probably kind of a strange bird.

And so we're using different scorecards to evaluate those different groups of people and the recency of new trade lines opened. Again, somebody who is kind of out there in a steady state mode who hasn't taken out a lot of credit recently versus somebody who is kind of out there shopping actively, we're using different scorecards to evaluate them.

Now, the same score still means the same thing. If you get a 700 on any of those score cards, it still means the same degree of risk. But we get there by looking at different information and maybe weighing information differently, depending on which of those sub-populations somebody is in.

Okay. If you could again skip two. Just very briefly, sort of the legal public policy issues, I guess I'll save most of that for the panel this afternoon about is it fair. I really just want to describe some of the other slides that are in your packet.

We did two studies -- and if you would go to the next slide, please. We did two studies which are labelled the LMI Study -- low to moderate income. We took data where we had -- where we were developing custom scorecards for specific credit grantors, and in many cases where there were credit grantors who were going from a judgmental decision process to a scoring environment.

We looked at that data. We said sort of how do the low to moderate income folks do when they're scored versus how they were doing when the credit grantors were making judgmental decisions. What is different about the low to moderate income population versus the general population, and sort of is scoring really an effective way of making decisions on those populations.

A lot of people assume that for a lot of low to moderate income borrowers, scoring just can't do a very good job of evaluating credit risks, because they look different than the rest of the population. Well, in fact, what we found out was that not surprisingly the lower income borrowers as a group scored lower. That's why that yellow line is lower than the other lines in this graph.

If you go to the next slide, what we also found out is that at any given score, the risk of those low to moderate income borrowers was in fact at least as great, and usually in most cases just a little bit greater, than the general population. So that if a score in this case of 200 equaled the 20 to one for the general population, for the low to moderate income population it probably equalled 19 to one or 18 to one. In other words, they were just a little more risky than the general population in any score. So, in fact, the scores were doing a very good job of predicting the risk for that population.

The other thing that we looked at -- again, if you would skip two. This is why they were different. If you skip to the next one, there are two pages that look very similar in your set, and unfortunately they are mislabelled in the printed set. They're right on the screen.

Slide number 42 should say "Maintain acceptance rate; compare bad rates." And what we did here, is we took the acceptance rate for the LMI population under the prior judgmental decision process. We looked at the bad rate that was coming up. And in fact, you see in some of these cases -- in fact, in a lot of these cases that bad rate is terrible. It's horrible. The decisions that are being made judgmentally on that LMI population are bad, terrible decisions.

You know, the first couple of lines you've got an acceptance rate of 26 percent and a bad rate of almost 11 percent. The next line you've got an acceptance rate of 24 percent and a bad rate of 18 percent. Nobody is going to live with an 11 or 18 percent bad rate in a bank card portfolio. If you kept making judgmental decisions there, what's going to happen is somebody is going to come along and say, wait a minute. Our bad rate for low income borrowers is totally unacceptable. We just can't lend money to low income borrowers at all.

So what we did is say, well, okay. If you keep the same acceptance rate and now you make those decisions using scoring, what happens to the bad rate -- and in fact you'll see in every case the bad rate goes down, and in many case very dramatically.

The next slide, again, is mislabelled in the printed set. It's okay up here. It should say "Maintain bad rate; compare acceptance rates." Now, again, maintain the bad rate for most of these is probably not a realistic scenario. But using scoring, what you see is if you were willing to live with that bad rate -- and actually the third and the fourth ones, the bad rates may be acceptable, 2.3 and 4.3 percent.

But the acceptance rates judgmentally were very low for those folks. If you evaluated that same population using credit scoring and you're willing to live with that two and four percent bad rate, you could accept in the one case -- in bank card number four you could accept four times as many applicants as you were accepting judgmentally. And that's again very consistent across that.

The next study that we did was using credit bureau information. And there, rather than looking at the low to moderate income population, we looked at consumers in zip codes with a high concentration of minorities, blacks and hispanics. And I could get into a lot detail about why we chose the various categories we did. But basically we looked at zip codes with those high minority concentrations. One of the things we found was that those zip codes represented a little bit less of the credit bureau database than they did of the entire population, although certainly they weren't totally unrepresented, as I think a lot of people assume.

And indeed there are folks in that population that simply don't use mainstream credit. They are never going to have a credit report. But they're never going to go to a lender that would pull a credit report in the first place, and secondly the degree of under representation isn't so great that it would really affect the ultimate scorecard design.

And we see there -- if you would go to the next slide -- that in fact that zip code definition winds up looking a lot like the low to moderate income definition, because those zip codes have approximately -- the average household income in those zip codes -- and this was a few years ago now -- is about two thirds of the average -- or, I'm sorry -- of the household income of the remainder of the population. So not surprisingly in economic terms, those high minority zip code populations look a lot like the low to moderate income populations, and so not surprisingly we came up with very much the same results.

If you go to the next slide, again you'll see the score distribution is a little bit lower, which again means that at any given cutoff score, you're going to accept fewer of those folks. But if you go to the next slide, you'll see again exactly the same pattern. In this case the red line is the minority population. The dotted yellow line is the rest of the population. At any given score those folks represent a slightly higher degree of risk.

So again, the scorecard is doing an effective job of rank ordering risk, and to the extent there is any discrepancy in the risk estimation, it actually favors those high minority areas of borrowers just as it did the low income borrowers. Again, for the credit grantors listening, that difference is very slight. It's not worth getting excited about. But to the extent there was any difference, it was consistently in favor of the low to moderate income and the minority zip code borrowers.

Again, we looked at how those two populations differed, and finally we asked ourselves, well, could we build -- next slide. Could we build a scorecard specifically for that minority population that worked more effectively than the scoring systems that are being used now.

Well -- and next slide, please. What we found out was that if we used a one size fits all credit bureau score, in fact then we could build a more effective minority zip code scoring system. Now, I suspect that the folks from the Fed and some of the other regulatory agencies might want to have a conversation with us if we did that. But this was a research exercise. We found that it would be possible.

But what we also found was that the existing Fair, Isaac credit bureau score using the multiple scorecard approach, where you're looking at different sub-populations separately, where you're looking separately at the folks with prior delinquency, and you're looking separately at the folks that don't have a lot of established credit, that that multiple scoring system that we were using was in fact more effective in predicting risk in that minority zip code population than a scorecard -- a single scorecard developed specifically for that population.

I've run a little bit over my time. I thank everybody for your indulgence, and I'll see you this afternoon. Thank you.

MR. MEDINE: Thank you, Pete, for an excellent overview of a very complex issue.

(Applause.)

MR. MEDINE: Now we're going to take a minute and get our next panel set up here, and then we'll resume in about two minutes.

(Brief recess.)

MR. MEDINE: We just heard from Pete McCorkell on the issue of credit scoring generally. This next panel is going to focus on the use of credit scoring specifically in the mortgage industry. Obviously home purchases are a consumer's largest purchase. And so how credit scores interrelate with that decision is of critical importance to consumers. And the presentations will also include information about mortgage scoring and the automated underwriting process.

We're going to start from my extreme right, so I'll first introduce Pamela Johnson from Fannie Mae. Pam is Vice President of Single Family Mortgage Business for Fannie Mae. She is responsible for new product enhancements to Fannie Mae's automated underwriting tool, the Desktop Underwriter, and is responsible for credit research and data acquisition for Fannie Mae.

We're thrilled to have her here this morning. Thank you, Pam.

MS. JOHNSON: Thank you. Can everybody hear me okay? All right. Are we ready? Let me start first of all by stepping back for a minute, because I think I want to clarify and make sure everybody understands where we are here.

Peter did a fabulous job walking through how does one develop a scorecard. But I want to be clear that there are many different types of scorecards out there. There are many different -- they're used in a variety of industries, not just in the mortgage industry. In fact, the scorecards have been around a lot longer, and used for a longer period of time, than they have in the mortgage industry.

The consumer industry -- for example, credit cards, etc. -- have been using scorecards, I don't know, how long, Peter, 20, 30 or 40 years. But in the mortgage industry it's only been recent that we've adopted the use of credit scoring as a tool in underwriting.

And I want to be clear about which scorecard we recommend, which is the use of the credit bureau scorecards. So Peter spoke a little bit about this in his presentation. And I wanted to point out that the characteristics in the credit bureau scorecard are those listed on page 24 of Peter's presentation, and not the ones that he talks about early on, which could relate to other scoring models.

So in case you missed it, he listed the five characteristics that are most prominent in a credit bureau scorecard. And those were previous credit performance, current level of indebtedness, amount of time credit has been in use, pursuit of new credit and types of credit available. So just as a way of clarification.

First of all, let me say I'm delighted to be here. I thank David and team for inviting me. I think this is a critically important issue, and I think this is a terrific forum.

Credit scores and automated underwriting are a very important tool in the mortgage industry. At Fannie Mae we spent a considerable amount of time researching and analyzing credit scores. And long before we determined that they would be useful in mortgage underwriting, we went through a lot of work to answer some very important questions. Those questions are: do they work, are they predictive of risk as it relates to mortgage lending, are they fair, do they work for all borrowers in the same way, and when used correctly, will they expand home ownership opportunities.

We answered yes to all of those questions after a lot of research, and I want to take you through some of our research and some of the analysis we did to get there.

The first slide, please. So today I'm going to talk to you about credit scoring, mortgage scoring -- because they are different -- and automated underwriting. I'll also discuss how scores should be used to originate and underwrite mortgage loans.

Next slide, please. As Peter indicated, credit scores are empirically derived in a statistical method of assessing risks. A credit score -- and specifically, again, we're talking about a FICO credit bureau score -- is based solely on the information in the borrower's credit report. The evaluation of the information in the borrower's credit report, meaning how the borrower manages credit, has always been an important factor in mortgage underwriting. Credit scores when used correctly are based on information in the credit report that has been proven to be predictive of credit risk and loan performance.

Next slide, please. Mortgage scores, on the other hand, are slightly different. A mortgage score is also based on information that has proven to be predictive of credit risk. A mortgage score is based on information about the borrower obtained from the loan application and the credit report, as well as information about property value.

Mortgage scoring supports a comprehensive analysis of both the borrower's ability to repay a loan and the borrower's management of credit. A mortgage score helps an underwriter perform a more consistent, objective and accurate evaluation of this information than traditional underwriting does.

Next slide, please. Fannie Mae recommends that lenders use credit scores, specifically the FICO credit bureau scores, in their manual underwriting process. In addition, we have developed a more comprehensive customized mortgage scoring model for use in Desktop Underwriter, our automated underwriting system.

Next slide, please. Okay. So why should we use credit scoring in mortgage lending.

Next slide, please. Credit scores are in fact predictive of credit risks for all loans and all borrowers. A borrower with a credit score below 620 is in the neighborhood of two and a half and sometimes three times more likely to default on a mortgage loan than someone with a credit score between 660 and 699.

Next slide, please. Okay. This slide illustrates this point. And if you'll look at the green box in the middle, which indicates a score -- a loan with a score range of 660 to 699, and you compare that to a loan with a score range of less than 620, you can see the dramatic difference in the likelihood of default performance.

Next slide, please. Similarly, this slide shows how default rates on mortgage loans increase as credit scores fall. Specifically, this chart shows that for every 60 points in a decrease -- a 60 point decrease in a credit score, there risk of default doubles. If you'll look at the blue line, the blue line is in fact a geometric curve that shows a doubling of risk every 60 points, and the red lines are the actual default rates by a FICO score. And you can see how closely correlated they are.

Next slide, please. We have learned from the analysis of loans delivered to Fannie Mae that a borrower's management of credit, as measured by a credit score, had little correlation with the borrower's income. In other words, it's just as likely for a low income home buyer to have a high credit score as a high income home buyer.

Specifically, 39 percent of the borrowers whose mortgage loans were delivered to Fannie Mae in 1998 and who had incomes of 80 percent or less of the area median, also had scores over 740. The percentage of borrowers with incomes over 180 percent of area median who had credit scores over 740 was 37 percent.

I think most of you probably know that a 740 credit score represents an excellent credit risk and an excellent credit history, and can be used as a compensating factor for other high risk factors in a mortgage loan, such as a low down payment.

Next slide, please. Okay. The predictiveness of the credit scores allows us to adopt a different and more dynamic view of the risk of borrowers who make low down payment loans -- make low down payments. This is a view of the relationship between FICO credit scores and loan to value ratios. Traditionally, loan to value ratios have served as an important indicator of mortgage default risks with high LTV loans representing a higher degree of default risk than low LTV loans.

This slide shows that when you combine credit scores with loan to value ratio, there is an even greater opportunity to expand home ownership. A borrower who puts less than 10 percent down but has an excellent credit history, as here defined as a credit score above 740, is less likely to default than a borrower who puts 30 to 40 percent down with a poor credit history.

These numbers in this chart -- these are relative numbers. We use as the number one what we call an average loan, which is indicated -- you can see the one in red in the middle, which here is a loan with a 76 to 80 LTV and a credit score between 660 and 699. All of the other numbers on the chart are related to that one, meaning they perform either better than or worse than that average loan.

Next slide, please. Credit scores are an objective measure of credit risk based on information from credit reports that have proven to be statistically predictive of credit risk and loan performance. Fannie Mae has verified that the credit scores are predictive of mortgage loan performance for all loans and for all groups of borrowers regardless of demographic characteristics such as race or income.

Next slide, please. Okay. This slide illustrates this last point. No matter what the race of the borrower, the lower the credit score, the greater the likelihood of default. And we've done this slide over numerous different time periods, and the results continue to be consistently the same.

Next slide, please. Let me tell you what Fannie Mae's policy is on the use of credit scores in mortgage underwriting. We advise lenders that credit scores should be used as a careful -- as part of a careful, comprehensive analysis of each mortgage application. They should not be used in isolation or as the sole factor in making an underwriting decision.

This is the policy that we have communicated with our customers -- our lender customers -- and we've made that point clear in our lender letters that we've issued on credit scoring and how to use it.

Next slide, please. Fannie Mae purchases loans with credit scores below 620. We do not prevent lenders from delivering these loans to us, nor do we make them re-purchase these loans simply because the credit score is below 620. Our mortgage scoring model development data sets, the data sets for the scoring model, include loans with scores below 620, making it possible for our current mortgage scoring models that we use in Desktop Underwriter to accommodate these loans and accurately assess their risk.

Desktop Underwriter will underwrite and approve loans with scores below 620 and does so. In our letters to lenders on credit scoring, we have provided specific examples of situations in which it would be acceptable to sell us loans with credit scores below 620.

Next slide, please. Okay. Over the past several years, Fannie Mae has developed and made available to mortgage lenders our automated underwriting system called Desktop Underwriter.

Next slide, please. Desktop Underwriter has been designed as a decision support tool for lenders. It helps reduce origination time and costs through streamlined processes and opportunities to re-engineer work flow.

For example, Desktop Underwriter facilities point of sale underwriting decisions. Desktop Underwriter also helps lenders make more consistent, objective and accurate underwriting decisions. However, just as with credit scores, the use of Desktop Underwriter is meant to compliment the underwriter's judgment. It does not replace the underwriter's judgment.

Desktop Underwriter performs a comprehensive risk assessment of each loan application. This risk assessment is much more comprehensive than a credit score. It is based on the mortgage scoring model, combined with the rules taken from Fannie Mae's selling guide to determine loan and borrower eligibility.

Next slide, please. Desktop Underwriter, or DU as we call it, issues one of three recommendations for most loans. An approved recommendation, which means that the loan meets Fannie Mae's credit underwriting guidelines and does not need further review by an underwriter. A referral recommendation, which means that the loan may need Fannie Mae's credit underwriting guidelines, but it needs to be reviewed by an underwriter for that determine. Referral with caution recommendation, which means that the loan does not appear to meet Fannie Mae's credit underwriting guidelines, and it must be reviewed by a human underwriter.

And it is in fact the referral and referral with caution loans that we look to our lender partners and underwriters to work with. That's the message we send. Don't deny it; work with the loan. Those are the loans that need extra attention.

Next slide, please. Desktop Underwriter does not approve or decline loans. Underwriters make those decisions. Fannie Mae has not used any prohibited factors, such as race, age, gender, color, religion, national origin or marital status, as characteristics or risk factors in the mortgage scoring models or risk assessment rules in Desktop Underwriter.

Next slide, please. As part of our ongoing effort to validate that our scorecard works in our mortgage scoring model, we consistently look at performance. Now, this slide -- this chart shows the percentage of loans that become seriously delinquent, and that means they've missed three payments, by the age of the loan and the DU recommendation.

Now, the reason why we look at serious

delinquencies as opposed to defaults is that we don't have enough time or history yet with our loans that have been delivered after having been underwritten in Desktop Underwriter. You need several years of history with the loans -- seasoning with the loans -- to really track default performance.

So we're tracking delinquency performance right now, and a loan that misses three payments is considered a high risk loan for foreclosure and default. After 12 months the percentage of the serious delinquencies is more than six times greater for the loans designed refer with caution than for the loans recommended for approval in Desktop Underwriter.

Next slide, please. Desktop Underwriter evaluates the information in a mortgage application based on factors that have proven to be statistically predictive of credit risk and loan performance. DU evaluates the information in each mortgage application the same way each time, consistently, objectively and accurately, and without regard to the demographic characteristics of the borrower.

Next slide, please. Desktop Underwriter does not use -- and I mentioned this before -- any of the characteristics such as race, age, color, religion, national origin or marital status as factors in the scoring model or the risk assessment rules in DU. In addition, where the borrower lives and where the borrower is purchasing a home are factors that are also not used in the mortgage scoring model.

Fannie Mae has verified that DU's recommendations are predictive of mortgage loan performance for all borrowers -- for all groups of borrowers -- for all loans and regardless of characteristics such as race and income.

DU provides opportunity for expansion or broadening of the market by looking at an array of factors that can compensate for other high risk factors in the loan. When used properly, and when the information in the credit report is accurate -- and I want to emphasis that -- credit scores and mortgage scores and automated underwriting support consistent and objective underwriting decisions.

And when you look back at where we've come, for years we've used human underwriting and manual underwriting. And it is my opinion that manual underwriting creates a greater opportunity for discrimination because of the subjectivity associated with manual underwriting. One of the benefits of using credit scoring and using mortgage scoring is it does provide an objective analysis of the likelihood of default or the credit risk of that particular borrower or loan.

And that concludes my remarks.

MR. MEDINE: Thank you very, very much. Let me just -- if I could just ask a quick question -- and Pete eluded to this earlier -- about the comparative benefits of judgmental versus credit scoring.

You mentioned one benefit in terms of the possibility of injecting discrimination into the process?

MS. JOHNSON: Um-hum.

MR. MEDINE: Have you also analyzed whether certain people are more likely to qualify for, say, a loan under a credit scoring system than under a judgmental system? In other words, does it benefit more borrowers to be scored than to have been subject to a judgmental system?

MS. JOHNSON: I think if used correctly. Again, the way we recommend that scores and mortgage scoring is used, is to really take the loans that are sort of the easier ones to do and put those aside, and really work with the loans that are the harder loans. And what we've found is that when you combine credit scoring and other factors to get a mortgage score, that you actually have increased your opportunities for making loans to more borrowers.

Specifically to your question, David, when we looked at the slides around the combination of LTV and the FICO score, and that, you know, a 10 percent down mortgage was in fact performing better than some that -- where someone may have put down 20 or 30 or 40 percent, when you overlay credit scores on top, I think that gives you an example of the opportunity that exists to expand the numbers of loans one can make.

Because no longer is a low down payment loan by itself the highest risk alone in the bucket. And in fact, it may be -- there may be plenty of opportunity to expand into, you know, a greater population of low down payment loans by using credit scores as a compensating factor.

MR. MEDINE: Thank you very much. And Peter is nodding, so why don't we turn next to Peter Mahoney, who is the Associate General Counsel at Freddie Mac. Peter is responsible for legislative and regulatory matters, with a particular emphasis on housing policy and fair lending issues at Freddie Mac.

He's a frequent speaker on housing, fair lending and community reinvestment issues, and has published several articles on community reinvestment and housing issues.

MR. MAHONEY: You can stop reading now.

MR. MEDINE: Thank you for joining us.

MR. MAHONEY: That's the whole version there. It goes on. I've got a home page that's got the whole thing, rotating head and everything.

(Laughter.)

MR. MAHONEY: I'm going to stand up, because I tend to have a lot of nervous tics, and so this helps me get rid of it. I ran for an hour this morning. But this is a pretty big group, and it's also a very impressive group. I recognize a lot of the experts in the industry. A lot of regulators. So I'll stand up and move around a little bit and give the cameraman something to do here.

It doesn't surprise me. Pam and I didn't really get a chance to talk about our presentations too much, because we are fieriest competitors and this is the FTC, and I didn't run the risk of an antitrust violation. But I doesn't surprise me that Fannie and Freddie are saying some of the same things. So my presentation may trod on a little bit of the same ground, so I'll try to go quickly over those issues.

I thought since I knew I was going second and that Pam is so confident and well spoken and does such a great job, that she would hit some of these highlights, so that I could maybe concentrate on some of the touchier questions regarding the use of credit scoring in mortgage lending, and particularly focus on what we think of as a lot of the questions we've heard since 1995 when we first started talking about this, a lot of the questions that we've heard from the community.

We do do a lot of talking and then listening about credit scoring. And we've heard kind of the same questions over and over, so I thought I would put together for you, as soon as Mr. Clark is ready -- you can roll the next one. This is a logo that I have to put on everything I do.

The myths associated with credit scoring -- and I didn't bring copies of this handout, but David Jamison, who is a legal intern with us this summer from Howard Law

School, is the designated person to whom you give your business card or your web address or whatever, and we'll get a copy of this to you. In addition, we had some materials out front. There is a report that we did in 1996 on automated underwriting, and issues regarding fairness and consumer issues. I think those copies are all gone, so we can get a copy of that to you if folks have not already seen that.

Let's go through these myths as quickly as possible. You can go ahead and roll through. These are the ten myths, but I think I'll just get to them as we go, because I know we're constrained for time. And I do give you an instruction to cut me off, because I am Irish.

Go to the next slide. Myth. Only one type of credit score is used in mortgage lending. I think, as Pam aptly pointed out, and I think Pete pointed out the same thing, there are a lot of different types of credit scoring models that are used in the mortgage market. Pete talked at length about FICO scores. The Fair, Isaac score uses only what is in one of the three national credit repositories. So it is only going to deal with credit performance of a consumer. It doesn't include kind of personal type of information, etc. It also doesn't include attributes that are uniquely associated with a mortgage loan.

Most mortgage lenders want to know how much you're going to put down for the house and what the collateral value of the house is. They're going to want to know what type of loan you're looking for. Is it a one year ARM? That's riskier. Is it a 30 year fixed rate mortgage loan? That's less risky. They're looking for characteristics beyond your credit and payment record.

FICO only looks at credit and the payment record. We have our own team of crack scientists at Freddie Mac. We have just -- our Chairman is an economist. He buys economists. We have so many economists, you wouldn't believe it. We have a huge group of folks who do nothing but estimate scorecards all day at Freddie Mac.

And we have built our own custom mortgage scoring model, and we have deployed it in a system called Loan Prospector. It was the first automated underwriting system made available broadly for mortgage lenders, and it is a service that uses a custom mortgage scoring model that is based not only on the information that is in a credit record kept at the repositories. We go and get those and bring them in. But it's also based on a host of other variables that I'll discuss with you in a few moments.

Okay. We strongly endorse the use of automated underwriting. We think that's kind of the A way to underwrite mortgage loans today. However, for lenders who are still using manual underwriting systems -- in other words, they're still going down their kind of written checklist and qualifying people kind of the old fashion way today -- we strongly recommend that they also pull a generic FICO score from each of the three repositories.

And then we tell them to throw out the high one, throw out the low one, and use that middle one as a good benchmark for getting you into assessing someone's credit worthiness. Like Pam said, we tell people don't use it exclusively. But we think it can be used as one tool in the manual underwriting process.

Okay. Second, credit scores make lending decisions. And the question David asked I was interested in, because the fact of the matter is, credit scores are a tool. It's like going to the gas station and saying, you know, is my battery fluid low. And they put something in and a little dial shuts up and says zzzzzzzz. You know, that's the score of your battery.

That's not going to fix anything. That's not going to make a lending decision. That's not going to do anything for anybody. It is simply a ranking tool. And once the result of the credit score is made available to someone who has money in their pocket, then the lender makes a decision on the basis of the information they've learned from the credit score and from other things.

How lenders -- and I include Freddie Mac and Fannie Mae as a lender. How we apply credit scores, what decisions we make in using credit scores, and how we deploy them, that is where you get all of the questions about what is the effective impact of credit scores. Is it constricting credit, or is it going to expand markets. And I'll talk a little bit more about that later, but I did want to drive that point home.

Now, what it does do, is it permits you when you're making decisions to do them consistently and objectively without bringing into account other factors that may raise significant issues about intentional bad will toward a particular applicant.

Credit scoring models are a black box and we don't know how they work. Well, I would beg to differ with that, and I think this is probably one of the most controversial myths. A lot of people are going, well, I still don't know how they work, okay. So credit scoring models rely on common and publicly available variables.

Pete went through, and Pam told you, page 24 of Pete's slide presentation, that shows you the type of variables that are used. And by variable I mean just an input in the FICO generic bureau score. Okay. Now, you can get better than that. You can contact each of the three repositories, and they will give you a list of the feedback messages -- and there's a long laundry list of them -- that each of the three repositories use when they send a credit score. That gives you a very, very good idea of the type of information that the Fair, Isaac model is looking at when it creates one of these generic credit scores.

In addition, Freddie Mac has published information about the variables that we rely on. We rely on all those credit inputs. We also use loan devalue, which is how much money is someone putting down on a house. That's a very, very powerful indication. If someone has one percent down on a house versus 40 percent down on a house, they're going to have a very different risk profile. And we use a lot of other kind of mortgage related factors.

Let me point out one thing, though. With all due respect to Pete, on page seven and eight of his presentation, he listed a bunch of potential application type variables. And I just want to state categorically for the record that Freddie Mac does not use in any of its custom scoring models time at present address, time at present job and residential status. We don't use age. We don't use income. We do not use, do you own or rent, years at address, occupation or any of that stuff.

MS. JOHNSON: Ditto for Fannie Mae.

MR. MAHONEY: Okay. I just want everyone to get that down. We're aware of some factors. A first time home buyer is a predictive factor. We don't use it, because our statutory purpose -- one of them -- is to expand home ownership opportunities for people who want to go from renting to owning. So we don't use that.

And even our written underwriting guidelines have been modified heavily in the last ten years to eliminate some of those old customs and practices of mortgage underwriting, and to say, don't look at how long someone has been on a job. Look at what their income projection is for the next couple of years. That's kind of the way we look at things.

Okay. We can go to the next one now. This gives you a little snapshot of how the credit score model that we deploy in Loan Prospector works and how it's kind of related to standard, traditional underwriting criteria for mortgages. We use collateral, down payment. We use credit reputation, history of repayment, current account balances, inquiries and new accounts. The same kind of thing that a FICO score measures.

We use a debt to income ratio. We look at how much cash reserves you have when your down payment is done and you've closed your deal. Those factors are then cooked in a big mathematical equation, with guys and gals in white lab coats. And I don't understand them and I don't get any of it.

But I do understand what the variables are, and I understand that what they produce then is a set of inputs that creates a very comprehensive statistical profile of how -- what your odds are of defaulting on your mortgage in the future, based on the information going in compared with this very wide range of other folks. And it's as simple as that.

Now, credit scores are not based upon a representative population sample. I think this is an issue that's largely going to be going away, because we have confirmed that generic credit scores -- the stuff that's in FICO scores that we've recommended -- are based upon a representative sample based on some of the stuff that Pete showed you, which is that there is a 6.7 percent on minority area representation versus an 8.3 percent of the overall population. We think that's very good, given how many folks have credit records, etc.

For our own custom mortgage scoring models, we have ensured that there is a representative sample used. We look at demographic characteristics. We look at geographic characteristics to try to make sure that when we're kind of creating the sample from which we build the scorecard that those kind of factors are used.

But the proof of the pudding is in the tasting. And the representative -- we believe representativeness is best demonstrated by the fact that, as I'll show you, credit scoring models that we use are predictive for those neighborhoods and for those folks, and therefore we think that that is a very strong indication of fairness in the fact that it's taken into account on enough different folks' behavior.

Credit scoring has not been independently validated. That is not an accurate statement. The Federal Reserve Board -- actually Bob Avery is here, and you can ask him about this. They obtained some credit scores. They tested it against low income populations, as well as a broad sample of populations. Their findings were published in the July 1996 Federal Reserve Bulletin. I'm still looking for my autographed copy.

Recently -- very recently HUD economists have been working for a couple of years with Fair, Isaac on estimating their own scorecard based on FHA borrowers.

FHA borrowers, as you know, tend to be much lower income and to have a higher concentration of minority households, particularly African American and Hispanic households.

They recently reported at a Fannie Mae research round table that mortgage scorecards are successful in predicting risks for FHA borrowers. There is also evidence that mortgage scorecards are predictive within subgroups such as low income and minority borrowers. And that's an article that was put together by three economists at HUD, so that's a very strong, independent corroboration.

And then we've published our own stuff, which I told you about, this automated underwriting report which came out in 1996. And I'm about to show you some additional information.

Credit scoring is unfair to low and moderate income borrowers. Now, Pam showed you her statistics, and mine don't look much different. We both buy millions of loans, so they probably wouldn't look different. Actually, FICO scores and Loan Prospector scores that we have do not vary much by income. And I think the reason why is that income is a very lousy proxy for wealth. There are people who live in Beverly Hills who are low and moderate income, because they live in a census track that happens to be very high income.

So income is a -- as Pete said is a notoriously difficult thing to measure. So while we take some comfort from the fact that we think across -- you know, we try to drill down into that and confirm that our scoring models work for truly low income neighborhoods where the median income is very low, and they do. But I guess what I'm suggesting is they're flat across the board, simply because income is a notoriously difficult thing to track.

And now I'm going to show you a picture. Yeah. This is based on our 1994 mortgage purchases. This is a Loan Prospector scoring model, okay, and what we did is, we just cut this thing up into tenths. And we're showing you, these are the high risk guys over here, and these are the low risk guys over here as identified by our scoring model, and these are the actual default rates. Okay. This is from 1994, and we measured this earlier in 1999. Over a million loans. And these are low income, middle income and high income folks. And I can define that for you if you want me to, but trust me.

And what you're seeing is a very, very similar distribution, okay. So the folks that are identified by our model as low risk, actually are barely defaulting. Those folks in the last three buckets particularly, very high risk and very high default rates. Anyone in the mortgage business knows if you're approaching an eight or 10 percent default rate, you're in a lot of trouble.

Next one. The next myth is that credit scoring is unfair to minority borrowers. I would like to put on the table once again and emphasize something I think we looked past. Over the last ten to 15 years the industry, with a lot of help from public policy and housing advocates, has made an enormous amount of progress in the way we treat a broad cross section of borrowers who want to purchase a home. We have made enormous strides, and there is a lot of statistical evidence to back that up.

And I think that one of the things we loose sight of when we talk about credit scoring and the progress we've made, and how rapid technological change is, is that we're saying, you know, oh gosh, you know, I have problems with credit scoring. Well, the solution would be to go back to the way we used to be doing it, where you had a single loan officer kind of deciding whether a person got a loan. I don't think anyone wants that system.

Now, as to the statistical results, again, credit scores very accurately predict borrower default, regardless of race or ethnicity, and in our view, again, ensure a level playing field.

We can go to the next one. Again, this shows you the demographic results. This is 1994 borrowers.

This is just a sample. But I can tell you that I've seen a lot of samples and this is quite representative of the African American households, Hispanic households and non-minority households.

Now, you do see a slightly higher default rate as you get really all across here. And again, what accounts for that, I'm not completely sure. I believe it's a wealth factor. If I have an income of $150,000 and you have an income of $150,000, but I'm the first person in my family that ever went to college and I'm supporting my grandmother, my mother and I'm helping out over family members, if I lose my job, I'm going to have a higher likelihood of defaulting.

If I make 150 grand and I lose -- I have the same income as this other person. I lose my job, but I can call up my mother and say, hey, can you give me $5,000, I need to make some mortgage payments and pay my credit cards, those are the kinds of things that we really can't measure by income statistics. But I think they do have a profound effect on some of these results, and it is a generational issue that, you know, God willing will obviate over time.

Go to the next one. Here is a myth that I --

you know, I hope people recognize. Credit scores are always predictive for every single person. That is not true. And so I know we're going to hear from some folks who believe that credit scores were not fair and that there were perverse results created by use of credit scoring.

I am not up here to attempt to deny that there are folks who could pay off a home mortgage loan or some other trade account, and the credit score may indicate that they are higher risk than they believe themselves to be or that some other piece of evidence they have would indicate. There are inaccurate credit records out there, and the FCRA and other statutes are there to correct that.

But even beyond that, a credit score is simply going to say your odds versus a bunch of other people across the spectrum or that you're a higher risk. And that is not a moral condemnation of those folks. It is what we believe to be a very accurate picture. And so again, all that we're saying is that credit scoring improves the odds that we're going to get it right, okay, in predicting mortgage performance. Moreover, we believe that over time our models will get better. We're collecting more and better information on folks, and this first generation of models should not be thought of as fixed in stone.

People without credit scores cannot obtain a mortgage. As Pam said, that's just not true. We buy a lot of below 620 FICO scores. That number comes from the industry letters that Fannie and Freddie published in 1995, and some folks had believed that lenders were going to turn that into kind of a bright line below which you are sent into the darkness to wail and gnash your teeth.

But we buy a lot of particular loans that have gone through automated underwriting. We will balance off the risks, and if someone has a dinged up credit record indicated by a credit score, that can be offset by compensating factors. In addition, if there are particular life circumstances when we refer the loan back that a borrower can work through with the lender, we will buy those loans.

We have a lot of underwriting guidelines designed to deal with extenuating circumstances and difficulties in life history that mean that a credit score is not indicative of the actual future mortgage performance. And we take those seriously, and we buy a lot of mortgage loans on that basis.

Now, we also work with a lot of people. I know Marcia Griffin is here. I don't see her, but I know she's here from Home Free USA. We work with a lot of credit counseling agencies and housing counseling agencies. And again, people can reestablish credit or establish credit for the first time within a couple of years, and that to me is one of the best roads to go, which is get a good track record and then get the responsibility of home ownership under your belt.

Next slide, please. Okay. And finally, credit scoring reduces the availability of low cost mortgage credit. I can tell you that there is an article right here that David actually pulled off the Lexis/Nexis for me, which estimated that the efficiencies of automated underwriting systems have cut costs for originators which have been passed onto consumers in the form of lower fees and points at closing.

And this guy from Nomura Securities, whom I've never met, said that closing points and fees in July of last year on a 30 year mortgage averaged 1.1 percent versus 1.6 percent in 1993. Okay. So points have gone down. Closing points have gone down. It takes four minutes to approve a mortgage loan application now, whereas in 1993 we were still dealing with a couple of weeks for many applicants, okay.

We're talking about efficiencies. We're a macro economic deal, Freddie and Fannie are, and what we're trying to do is make the system more efficient. And scoring allows us to bring technological efficiencies to bear. And we can predict risks, which means we can creep down on that risk spectrum. We can offer our low cost financing to more people because we understand their risks.

And we're doing that right now. We're buying loans right now today that are under automated underwriting that are scored that a year ago or two years ago would have been called A minus. And those people have a lower mortgage interest rate because of our ability to tap low cost funds.

So we believe that over time credit scoring will dramatically -- dramatically -- reduce costs, and that most of the folks who have been shut out of the prime market and into the sub-prime market are a disproportionately higher share of those are low income and minority folks. So our fervent belief is that this is an excellent and promising development for mortgage markets and that scoring properly understood is a great tool to achieve our objective of expanding markets.

And that's all I got. Thank you.

MR. MEDINE: Thank you very much for your high energy presentation. We next turn to Carroll Justice from FT Mortgage. Carroll began his mortgage banking career in 1984 and is currently Executive Vice President at FT Mortgage Companies, where since 1992 he has served as head of Secondary Marketing with responsibility for interest rate management, private investor applications, and private investor and agency relations.

Carroll?

MR. JUSTICE: Thanks, David. Good morning. I want to thank you all for the opportunity to allow FT to talk about an issue that has become very critical and very beneficial to our industry.

FT Mortgage Companies is a Dallas-based residential A quality mortgage lender. In 1998 we originated roughly 24 billion dollars in mortgage loans. We have 167 offices in 31 states. Our originations are 55 percent retail and 45 percent wholesale. We service loans in all 50 states. We have over 450,000 loans in our servicing portfolio.

Sixty percent of our loans are sold to Fannie Mae and Freddie Mac. Twenty percent of our loans are FHA and VA loans and are securitized in Ginny Mae Mortgage Back Securities. And the remaining loans are sold to private investors. As a typical mortgage banker, 100 percent of our loans are sold into the secondary market. We portfolio no loans that we originate.

We began using credit scores, and in our case FICO scores that we talked about this morning, with the release of Freddie Mac's Bulletin 96.6 in September of 1996. With this Bulletin Freddie Mac strongly -- and I'll emphasize that -- strongly recommended the use of credit scores on all loans we sold to them. Fannie Mae quickly followed suit, and now all of our significant investors require some form of credit score usage. That is, with the exception of FHA and VA.

Now, to facilitate loans moving from one program to another, even though all of our investors don't require them, we require a FICO score as part of the credit report on the loans we originate. Now, if a credit score is in dispute or not available, we use other credit information and totally disregard the credit score.

Disputed credit scores represent basically one percent of our originations. Loans with no credit scores are roughly one to two percent. So in effect we're able to generate a credit score of somewhere between 97 and 98 percent of the loans that we originate.

Now, besides meeting investor requirements, we also use credit scores because we found them to be a very good predictor of credit quality. To validate this, we took a look at our 1998 originations. And what we did, is we looked at those loans that went 90 days into default within the first 12 months or origination. Now, we picked 90 days, because it's a very significant level of default in a very short period of time.

In looking at these loans, we went into our servicing system and tried to make sure -- or I shouldn't say tried. We made sure there was no noise coming out of our servicing system, such as loan not being set up properly or the borrower not receiving coupons. Any reason or any time the loan went into suspense in our servicing system, we threw that loan out.

Looking at that population and that criteria, we found that loans with FICO scores below 585 were ten times greater to go into a 90 day default rate in the first 12 months than loans with FICO's of 660 or higher. Loans with FICO scores between 585 and 620 had a seven times greater probability of going into default.

Now, when you consider the cost of default services for a mortgage banker like us, it can be as high as 40 percent of the cost of servicing. The average servicing cost probably runs between 60 and 70 dollars a loan per year. We, with over 450,000 loans in our servicing portfolio, think that credit quality is a very important item in our originations.

A third reason for using credit scores is that they are a critical component of automated underwriting systems. With the introduction of Fannie Mae's Desktop Underwriter and Freddie Mac's Loan Prospector, mortgage lenders had new tools that allowed them to use the power of the computer to analyze a very complex credit and collateral decision that was required to make a sound credit decision.

Before automated underwriting, manual processes followed rules based models. If the loan didn't fit the rules, it could get rejected or at least covered up with paper to cover the underwriter's decision. This not only increased the time and the cost to originate a loan, it also increased the probability the loan could get rejected.

After using automating underwriting systems for two years, it's our experience that AU -- or automated underwriting -- makes it easier to get a loan. It not only reduces processing and underwriting times. It reduces documentation requirements and also makes a better credit decision than manual processing and underwriting. You know, the additional documentation that's required of traditional underwriting by itself can cause borrowers to become discouraged and perhaps even give up on the process.

In 1989 we pioneered a limited documentation -- alternative documentation is probably a better term -- an alternative documentation quick closing system. We did this with the approval of Fannie Mae and Freddie Mac. What we had found that caused us to do this, is that our industry typically made the loan process and underwriting requirements a very onerous process for most borrowers. And we decided that whatever we could do to reduce the documentation and the time required would improve the likelihood that more borrowers would get loans.

Roughly -- or currently, I should say. Currently roughly 80 percent of our loans -- of our conventional loans -- go through DU or LP. We do not have a proprietary system of our own. We are currently using LP on our FHA and VA loans, and we were one of the pilots for the Fannie Mae DU system for FHA loans.

Now, in addition to the agencies, many of our nonconforming investors accept DU or LP for loans sold to them, or they at least have their own proprietary system. What we've seen over the last two years is a widespread expansion of automated underwriting throughout the mortgage finance industry. And a critical component of that automated underwriting has been the use of credit scores.

I want to stop here just a moment and kind of explain how we use credit scores, or how we use DU and LP. We gather the information. If a loan is an accept on either of the systems that we use, the loan is automatically approved. If a loan is a caution or a reject, it then goes through our manual underwriting process. What the automated underwriting system does for us on the caution loans, is that it allows us to focus on a specific area and makes the process much easier to decide whether or not we have a good credit or we have a bad credit.

Now, I understand that many of you question the use of automated underwriting and credit scores because of their potential for disparate treatment. Our experience does not support your concern. We found a five to ten percent increase in the number of high risk loans that get approved with the use of automated underwriting. We believe this is due to the system's ability to examine all data available and quickly compare compensating factors. A human underwriter using traditional rules based systems can't make the same complex decision on what has historically been a high risk loan.

At FT the credit score is usually the -- the credit score is usually first available at the time of underwriting when the credit report is ordered. Technology constraints currently restrict us from viewing it at the point of sale. In spite of this, we are, however, moving towards a point of sale automated origination system. In the future many of our customers will know their rate, price and underwriting decision when they meet with a loan officer.

Now, the important point to remember here is not how technology is going to be used. However, it is that we don't use credit scores to pre-qualify, but rather as a part of the total credit picture. Credit scores are used at the underwriting decision point, not to pre-screen applications. No borrower at FT is denied a loan because of a credit score. As I said earlier, if there is any question about the validity of a score, or no score exists, we manually underwrite the loan using traditional credit information.

Now, to answer how these disputed loans or no credit score loans perform, we've also looked at that. And what we have found is that borrowers with no credit score have this 90 day, early payment default rate, slightly worse than our average EPD rate. Borrowers with incorrect or disputed scores have default rates roughly equal to those default rates on borrowers with FICO scores less than 620, or roughly seven times our 660 rate.

Now, in addition to not using disputed credit scores, we don't have cutoff levels on FICO scores for our loan products unless the investor requires it. For conventional or FHA loans with FICO's under 585 that are manually underwritten, we do require two levels of underwriting approval. That's not only to make sure we're getting a good loan, but it's to make sure that we don't have disparate treatment against somebody who has a low FICO score. If DU or LP approves the loan, we accept that approval, even though it may have a low FICO score, without any further underwriting.

After using credit scores for roughly three years, we have made the following conclusions about credit scores and automated underwriting. Credit scores have helped us identify superior quality loans, and therefore will help control future servicing and origination costs. This will help us lower our overall costs to produce and therefore our pricing to customers.

As Peter pointed out, we feel that the lower costs -- lower operating costs associated with credit scores and automated underwriting will be passed on directly to the consumer. For those of you who are very familiar with mortgage bankers, you'll know there are no subsidies that we don't like. If we have an opportunity to pass it on to the borrower, we're going to pass it on to the borrower primarily for competitive reasons.

We have found that a higher percentage of our high risk applicants are being approved because of a combination of credit scores and automated underwriting, because this provides a superior credit, analysis and underwriting decision to manual underwriting.

We now look at credit differently than we used to. We used to just consider payment histories. Now, the amount, frequency and recent use of credit are just as important, if not more so. We now have a credit measure that helps us equate credit quality with the cost of default. Credit abusers will be penalized by driving up the cost of housing for themselves. Credit scores will help us develop an automated risk-based pricing model that will allow more credit to become available to high risk borrowers.

And finally, the use of credit scores in conjunction with automated underwriting will help lenders become more efficient in making loans, investors more efficient in providing funds for the housing industry, and improve the ability of borrowers to get housing credit.

Thanks.

MR. MEDINE: Thank you. Peggy?

(Applause.)

MR. MEDINE: Peggy Twohig is the Assistant Director for Financial Practices, has a question for Carroll.

MS. TWOHIG: Carroll, I just wanted to make sure I understood correctly one thing you said. Did you say you do not use credit scores at the pre-qualification stage at all?

MR. JUSTICE: No.

MS. TWOHIG: You do not?

MR. JUSTICE: No. What we've found, Peggy, is that with a lack of technology to be able to deliver a credit score into the origination process, we found that we're better off using it as part of the total credit report and using it in conjunction with automated underwriting.

MS. TWOHIG: So your pre-qualification decisions are judgmental only?

MR. JUSTICE: Yes. For the most part they are.

MS. TWOHIG: Okay. And do you know if that's typical among lenders?

MR. JUSTICE: I'm not sure if it is or not.

MS. TWOHIG: Okay. Thanks.

MR. MEDINE: Okay. I want to thank Pam, Peter and Carroll for excellent presentations. We're going to take a 15 minute break and resume with consumers' experiences with credit scoring. Thanks again.

(Brief recess.)

MS. TWOHIG: As David mentioned, my name is Peggy Twohig. I'm one of the Assistant Directors with the Division of Financial Practices with the Federal Trade Commission.

Good morning everyone. I have the pleasure of introducing some panelists who are going to talk about some of these issues from the consumer perspective. We had excellent presentations this morning about what the perspective is on credit scoring from the industry's view, what credit scoring is and how it's used in mortgage lending. And jumping ahead, also we heard some perspectives that address some of the issues we're going to talk about this afternoon. And that was very helpful in laying the ground work.

So now we would like to move to credit scoring from the viewpoint of consumers and those that help consumers with mortgage lending. Is anything wrong with this picture? What are the questions? What are the concerns? What are the issues that they see in credit scoring?

And we're going to let our three panelists speak, and then we would like to open it up to you all. We are running a little bit late, but I think we can still accommodate questions and issues raised by the audience. Our purpose here in this session this morning is to raise the issues -- ask the questions and get all the issues and questions out on the table. And then this afternoon we'll try to make sure that our panelists address those questions.

Our first panelist on this panel is Simi Batra, who is representing himself as a consumer who first encountered credit scoring several months ago when he began thinking about purchasing a home. Simi?

MR. BATRA: Good morning. First of all, I want to put a disclaimer here. I speak for myself, not for my employer on this matter. I don't expressly represent his views.

I am planning on buying a house in the District. And about a year ago -- almost a year ago I ordered my credit reports. Everyone tells me, clean up these things way ahead of time. It takes a while. Look for inaccuracies. And I did that. And it wasn't such a tough endeavor cleaning up the credit reports.

But now after this process -- or most of the way through this process, I understand that -- I was under a crazy impression that a mortgage banker was going to open up my credit reports, go through my payment history here, and ask me questions about my payment history. And I guess that's not the case.

This is going to boil down to a number. I'm not sure who boils down this number, if it's the credit bureau or if it's the mortgage broker himself or herself. But my credit history is going to be boiled down to a number. I have no idea where that number comes from or what it means. It will be rated on a scale. I'm not privy to this number. I'm not privy to the scale. I'm not privy to what creates this number.

So I meet with a mortgage broker in two days. I guess I'll find out my number then and see if I was successful over the last year in doing the right things and everything I was supposed to do.

Along those lines, I have a few points to make with regard to credit scoring. Some are pretty specific and some are more general. Generally proponents of credit scoring have two opposing things they're talking about. One, they say we don't need to know the specific factors of what goes into a credit score. If we knew these factors, we might be able to manipulate our credit scores and that would be bad.

But on the other hand, if a credit score is indicative of our future repayment, how can it be so easily manipulated? It doesn't really make sense to me. If this is supposed to be a seven year history of your credit repayment, and based on these solid factors and this is how you're going to pay your mortgage in the future, why does it really matter if I know what goes into a credit score then?

I shouldn't be able to change these things. It's predictive. It's a matter of a credit card balance or a ratio. I mean, it shouldn't be that arbitrary. So it's kind of -- it's an opposing thing you get with the credit score folks.

And there are many -- one thing I'm kind of concerned about is, I called some mortgage brokers on the phone. I say what's your latest balance -- or what's your latest interest rate, and they'll say -- they'll ask me the question, what's your credit score? A lot of the mortgage brokers themselves have no idea that we are not privy to credit scores. Not only are we not privy to it, the law says they don't have to give us our credit scores specifically.

And a lot of the mortgage brokers themselves assume that these credit scores are coming from the credit bureaus. I don't think a lot of them realize that they themselves -- their company -- has ordered these credit scores. They're paying for them. And they kind of think it comes with the consumer and we know what our credit scores are. I mean, there's 40 or 50 credit scoring models out there. I have no idea and I don't know what my credit scores are.

So one thing, I think part of this needs to be education of the mortgage brokers and those folks. Let them know that consumers do not know this information. We are not privy to this information.

Okay. What goes into a credit score? That's something that I'm concerned about. I'm not really worried about my payment history, or where I've lived, or how long I've been at my job. Things that I can't change. More things like credit card balances, the balance of your debt to your available credit, the number of credit cards you have open.

Over the last year in cleaning up my credit reports, what I've tried to do is consolidate my credit card debts. You know, that department store thing I opened ten years ago to get 10 percent off, I forgot I even had it. You know, I ripped it up right away, but I forgot it was still open. So I just wanted to close that out.

But in doing so, the economy being so good, I've gotten a hundred credit card offers in the mail with really low interest rates. So what I did, was I -- like a lot of people -- consolidated all my debt unto one credit card. And as I'm going through this process of consolidating my debt, I'm assuming day by day as I cut up a credit card, or close out one or open one to move it, my credit score is changing, because the ratio of my debt to my available credit changes and the number of open credit cards I have changes.

At some point in there, and over the last year, I probably had an ideal credit -- an ideal balance of available debt -- debt to available income or credit and the perfect amount of open credit cards. I don't know what that perfect balance is. And somehow this is supposed to be predictive of my future repaying my mortgage.

Well, if it's so predictive -- it just seems very arbitrary. If I applied for a mortgage half way through this process, maybe I would have had the perfect ratio then. I don't know. Maybe I have it now. I don't know. And the point is, it's not predictive. It's arbitrary. It's entirely arbitrary. It's not really based on any scientific factor.

It's something you can change so easily. I can call my credit card company tonight and ask for a greater balance. You know, greater available credit. And maybe they'll give it to me. And if I do, that will change my credit score. I'm not sure that's really predictive of anything, or it's a matter of me asking for the right amount of -- it's just a matter of luck.

Now, I have a couple real specific points with regard to credit scoring. I mean really specific, and it's part of -- I don't know what goes into the charge cards. For example, American Express. These things don't have balance limits on them. Now, what are they using for a balance. I mean, these things are getting plugged into my credit score. I have no doubt, including my payment history, which is easier. It's late payments or it's not late payments.

But in terms of your high credit limit, your available credit and things like that, I'm under the impression from looking at my three credit reports that charge cards -- they use the highest amount you've ever charged in a single month and it's essentially viewed as your credit limit. That's kind of what I'm thinking about. Whereas your current balance is what you have on there now, and the difference between the two is your available credit.

Now, if that's the case, that's good to know. But maybe I should have known that six months ago, and I would have charged a whole bunch on a charge card, paid it off, and this month charged about 20 percent of that amount, so I have that perfect little ratio that I don't know. What if I were getting married next week and my charge card -- this was the month I maxed it out. Maybe I should have done it a month ahead of time and then paid it off. I don't know. It's arbitrary and I just wish I knew that.

And one of the credit bureaus does not report American Express correctly. They do not -- what they do is, every month they change -- they essentially put your credit -- your debt is equal to the highest you've ever owed. And that's -- so it almost looks like you have 100 percent debt ratio in there. And that's problematic if that is going into my credit score. I don't know, because I don't know what goes into a credit score.

And the last specific point I want to make about credit scoring is inquiries. Now, this concept is so ridiculous to me. And this is something that I encountered and it was very problematic. I opened up my credit report and there were like 20 inquiries for auto insurance. I mean, I must have called every 800 number I saw a commercial for on TV to get the best auto insurance rate, not knowing -- no one told me, by the way, this phone call will lower your credit score. This phone call will lower your credit score. I wish I had known that.

Inquiries are treated as applications for credit, whether or not you were just inquiring in a dictionary sense as to just asking a question, what is the rate you will give me, as opposed to actually I applied for credit. Well, I'm not applying for credit. I just want to know what's the rate you're going to give me.

And I wasn't aware that a lot of these auto insurance companies will look at your credit reports to do that, and they will then show up on the inquiry section in your credit report as an application for credit. And I encountered that problem and had many of those removed, which is another problem with this. It's not easy to remove inquiries from your credit reports. It's very hard to remove.

Credit bureaus will not investigate them as they do a normal late payment. Therefore, the obligation is up to the consumer to do that. And to try to call an 800 number that really doesn't exist, it's just -- they don't exist. I mean, people do not work behind these numbers. And it's unbelievable the amount of time you have to spend to get an incorrect inquiry off your credit report. It takes forever. It's a multi month process.

And once you do finally get that letter from that auto insurance saying we did not mean to look at Mr. Batra's credit file, the credit reporting agencies will say, well, we will take up to 90 days to then correct that information. So you spent, you know, six months on this process, and then they'll tell you they have another 90 days to correct that information.

I find that a bit problematic, and especially since I don't know how that's going to be affecting my credit score. And 90 days is a long time just to correct information that's already been presented to them.

What's really ridiculous about the insurance -- the auto insurance thing is, you apply -- you do a price quote for insurance, that goes on your credit. But once you get the insurance policy, that's not on your credit report.

(Laughter.)

MR. BATRA: So it's strange. Asking Geico how much they're going to charge you for insurance shows up as an inquiry, but your insurance policy doesn't. So it just completely makes absolutely no sense to me. And I think that's a glaring example that can be fixed rather easily. All they have to do is code an inquiry versus an application for credit. Did you actually apply for credit, or did you just ask them what the price would be.

And there is a big difference between the two. And that would be a simple coding in any formula. It's just these formulas seem to be so rigid and they're probably very much -- they're very long. Not a simple thing to do and very expensive, but something that needs to be done. And that's a very simple thing I think they should do, and rather quickly.

But these are a few of the things I've come across in cleaning up my reports. And the concept of credit scoring is foreign to me and to everyone I've talked to at work, my friends, my roommates and my family. No one has heard of it. Everyone is like, I pay my bills on time. I have no credit card debt. Well, there's one more step there that you don't know about.

And maybe blissful ignorance is good if you have a good credit score. You never even knew that there was such a thing. I have friends who have bought houses. They never knew about a credit score. That's all right. I mean, everything worked out okay for them. Maybe it was fine. But it just should be a little more brought forth to the public. Let them know this thing exists.

It's a tool. It's only a tool, but some mortgage brokers are using it as more than a tool. It's kind of a lazy way out to say here's a number, yes or no. Does it meet our criteria, yes or no. And it should be just a tool and I think it's being abused a bit. And I think some education in the lending sector and the consumer sector is really necessary.

Thank you.

MS. TWOHIG: Thank you, Simi. I think everybody should know that Simi took time away from his very demanding professional job to come and talk about his experiences, so he did not have the benefit of hearing what Pete McCorkell said this morning about inquiries and how they're counted and not counted. But I think actually this is almost better, because he can say what his impression is from he just knew as a general member of the public, or didn't know or understand, or does not understand about credit scoring.

Moving to our next panelist, Caryl Iseman is the owner of Action Mortgage Group in San Diego, California. Caryl has 26 years of experience in real estate and mortgage financing, concentrating on finance in the past nine years. In the process of helping borrowers attain a home loan or refinance their current loans, and in counselling them and helping them with their credit problems, Caryl has encountered several issues with credit scoring that she will identify for us today.

MS. ISEMAN: I, too, have to stand up. I spent a lot of time sitting on the phone flying from San Diego. So forgive me. I tend to move around a little bit, too. And I want to say thank you very much to the Federal

Trade Commission for putting on this panel. Because what my hope is, is that at the end of this day with the presentations that are being made, that we will walk out with the benefit of knowing (1) what credit scoring is, but (2) with potentially some resolutions.

The system is broke. I am sorry to say. But I don't believe in throwing out the baby with the bath water. We do have to finally decide what we're going to do to make this a fair process so that Mr. Batra and thousands and thousands of consumers like him do not have to go through the process that he has gone through.

And by the way, when Mr. McCorkell was talking, I was thinking, gosh -- you know, I know that what he was talking about was consumer lending. And I thought, boy, I must have a really high credit score. I'm over 50. I've been in my residence for -- I own my residence. I've been there over seven years. I only have a few credit lines. I have low balances. I should have a very high credit score.

But unfortunately I don't. And part of my -- well, it depends on what day I pull the credit. Because, see, my ex-husband tends to marry women with names very similar to mine. And I was wife three. My name is

Caryl. Wife four's name was Carmen, and Carmen's credit always shows up on my report. And that's good old Experian. I do have to tell you that is not Trans Union and Equifax, but it does happen with Experian.

And by the way, I think we need to also understand that there are three scoring models. Everybody has heard FICO. And if I understand right by what I've been told, Fair, Isaac does do the scoring models for all three of these repositories that we're most familiar with. One which is Equifax, the second being Trans Union and the third being Experian, which we all know was TRW.

Experian uses FICO. Equifax uses Beacon and Trans Union uses Empirica. So when you get a credit report -- and by the way, all the credit reports I have with me and a couple that I will talk about, are with the okay from my clients, who said, go get them, Caryl.

(Laughter.)

MS. ISEMAN: Clients that are paying higher interest rates than they should because the credit bureaus wouldn't do their jobs. But you'll see that there are three scoring models on each of these reports. And as a mortgage broker, I get to pull the reports. I get to see the credit scores. And, yes, my clients do, too, because I give them a copy, even though the credit scores are on there. And technically I understand that I can do that.

So let me get to the issues of what I want to cover, and I only have 15 minutes so I'm going to have to talk fast. What you heard this morning was great, and I really do believe that Fannie and Freddie are trying to help the home buyers. But you know what? This morning what you heard was the abstract. What you heard Mr. Batra mention is the reality, and what I'm going to talk about is the reality.

I'm going to talk about what was mentioned this morning, number one, when they said, you know what? We take anything through Desktop Underwriting. It doesn't matter what the credit score is. You put it through and we're going to try and get it through. Well, that's great. The problem is, I'm a lender -- I'm the mortgage broker, and I have to go to the lender to do the Desktop Underwriting.

Now, this is one of my lenders. This is the form. This is my cover form that I extend through for Desktop Underwriting. And one of the things that you're going to see on here, the third box down says, FICO score. Now, what they really mean is not a FICO score. It's the middle of the three scores. And whether that be Empirica or Beacon or the Fair, Isaac -- either one. Whichever is the middle of the three. Not the average, but the middle of the three. That's what they want me to put on there.

Now, right next to that this says, minimum 620. Now, this was dated February of this year. That means if you don't have a 620 medium score -- or middle score -- don't send it to me. I'm not interested.

Now, here's my next one. This is the same lender. By the way, this lender, I use them a lot for my really good clients, because they have the best rates. And I want my clients to have the best rates, and I really, really would like to have most of my clients go to them.

FICO score, the same thing, minimum, 640. So from February to May, they said we don't want 620's any more. You know why? Because this lender has good rates, and they're going to skim off the top all the good loans at the expense of the borrowers that have the 620 and the 630 and maybe even a little lesser score.

And if you think that that's just one, I'm not going to go through them all. But I have different lender sheets -- Chase and some other lenders here. I think this is the best, though. Oh, I can't leave Freddie Mac out, by the way. Freddie Mac has got a great program. A hundred percent affordable goals. You heard Freddie Mac say, oh, we want to look at them all. It's a great loan. This is dedicated to low income borrowers, minimum credit score, 660.

Okay. And then -- oh, we don't deal with professions or anything. Now, I understand -- I spoke to Fannie and Freddie today. I have to find it in here. I know I'll find it. But if you're a doctor, please step forward. First Union. Is there a doctor in the house? if you're a doctor, they came out with a special loan for you. You don't even have to have a 700 credit score. You can do this with a 680. Or you can even be a D.O.

But we don't pay attention to any of these things. Now -- I mean, what you heard this morning, let's look at everybody. We don't care. We don't pay attention to minority people. We don't pay -- we feel everybody is on the same boat.

I didn't even realize this was going to be out there today, but any of you that picked it up, turn to page 27. On page 27 it says, who has riskier scores. Now, what I have underlined here said, borrowers with high risk scores particularly in light of various studies indicating that minority families tend to experience greater credit difficulties.

African American borrowers, for example, were about three times as likely to have high risk credit bureau scores, defined as FICO scores, below 620 as were white borrowers, based on Freddie Mac's 1994 mortgage purchases. And Hispanic borrowers were about twice as likely as white borrowers to have high risk scores. But excuse me. Let's ignore this. We're color blind. It doesn't matter.

Let's get to talk a little bit about the inaccuracies, because this is really where the problem lies. Where you have mistakes on a credit report and the borrower cannot get it off. And how prevalent are these mistakes? I will tell you that of every ten credit reports I pull, seven of them are incorrect. And the other three we may not pay much attention to, because the borrower had high credit scores on it and so we didn't go through the report.

But even when you do -- and I have one here, and my borrower's average mid score is like a 780. And even he has two incorrect credit lines that are still showing on there that showed -- you know, that were paid off. They're still showing balances. But he has such a high credit score they don't care.

This was an article that appeared Friday, March 13, 1998. This was done by the Public Interest Research Group. And again, I'm not going to go into the specifics on the numbers here, but they point out all the inaccuracies on the credit report. But there are two, though, that I have to mention.

Nineteen percent -- and these were the 133 consumer credit bureau reports. Nineteen percent contained accounts that could not be identified or did not belong to the consumer. Twenty six percent contained credit accounts that had been closed by the consumer but that were listed as open. And three percent had incorrect Social Security numbers. That was a line that was just total strangers. I know that feeling.

The inaccuracies are what effects the credit scores. So that if I have mistakes on someone's credit report that is pulling down their credit score, and they have found this great house, and they have not 90 days to close this transaction but 30 days to close that transaction, it's only going to be by an act of God that we're going to get it done. And my clients work with me. God bless them. They follow everything I tell them. They send return receipt requested letters.

I found phone numbers, by the way, where I actually get a live person. Of course, you can't be sure of what they're going to tell you. Because a gentleman and I was on the phone -- he didn't know I was on the phone -- from Equifax told my borrower -- and this was just a week ago -- that Equifax had nothing to do with the credit scores, that each creditor that submitted their credit accounts decided the credit score. Of course I had to hit the mute button at that point in time and kind of let him know that I was listening and that he needed to stop lying to my client.

I have to share with you where we get the greatest inaccuracies and where it really hurts people the most: medical, bankruptcies, medical collections, people that have had catastrophic illnesses. Of course, based on the predictability -- that is, of course, unpredictable and inconsistent. Based on this predictability these people, because they've got these low credit scores because they had to file bankruptcy, out the window with them.

What do you mean? Because they had a catastrophic illness, they're at 20 percent that their share was maybe of their insurance policy, of maybe 50, 60 or a hundred or $200,000, and they could not pay it and they were forced into bankruptcy. People that are hard working people that had never paid a bill late in their life ever. Never had a mortgage payment late if they did own a home. They are so now unable to get the A paper for a finance loan.

Now, can I get them a loan? Yes, I can get them a loan at two percent or three percent higher than anybody else. And I can get some of the stuff off when they have filed that bankruptcy. Guess what? It still shows as open as collections. And again, anyone who wants to see this, I will show this.

I have one gal here, right in the process right now of her loan. Her bankruptcy, which was partly medical and partly not, was discharged 8/16/94. We are in just about to be August 1999. She still has three items that are showing up as unpaid collections. Guess what happened to her credit score? Guess what happened to the loan that we have to close in two weeks? I'm getting her a loan, two and a half percent higher than what she should be getting.

So all the savings that Fannie and Freddie spoke to you about, that's great. But do you know at whose expense those savings are? They are at the person who could not get rid of his inquiries. They are at the expense of the people that are going through catastrophic illnesses and had to file medical bankruptcies.

And I want to give you another one. You know, supposedly it's not only -- are we supposed to look at someone predicting the future and how they're going to pay, because this is what we're looking at. Right Fannie? You want to know you're going to get paid. And the same thing with Freddie Mac. So they look at how somebody paid their previous bills.

Well, what about with downsizing. How many people have been put out of work? I know we had a lot of that happening in San Diego. I know that even in this great economy, you have people that get unemployed, and they may have to go for three or four months where they become a little slow paying. But for the 30 years before, they never had a late payment, ever. So for three or four months, they have a car payment that's maybe 60 days later or whatever. Are these people bad risks if they want to go and buy a house right now? The guy is back working.

I have that. I have an airline pilot. And by the way, not in San Diego, in Michigan. He was out of work. He flew for 30 years. They have a great credit record, because as Mr. McCorkell told you, all the good stuff does remain. It stays on there. You look at it. They had a house. I mean everything. Never a late payment. He was out of work for six months. They had a 60 day car payment -- 60 days late on a car payment and two credit cards. Two credit cards that had 30 day lates.

And I have to tell you where their credit scores are, because it's recent. Anything recent takes really from that credit, and they have to do a refinance on another property that they own. We're at a very, very low loan to value. But because it's nonowner occupied and they want to do the loan to fix the house up because the tenant just died, I have to tell you, they're a B paper loan. And should they be 54 percent loan to value, someone who for 30 years never missed a late payment?

But the predictability, these people are going to be lousy borrowers. They're not going to pay back, because they have a 610, I think from one of the bureaus, and a 600 -- oh, no. They're not going to make the payback. That's why I have difficulty with the setup with the credit scoring.

Now, I said before, do we throw the baby out with the bath water? No. Could credit scoring be a tool and a useful tool? Absolutely. Because people who really don't fall into any problems and keep making their payments on time, they have a really, really good payment history. But I don't need a statistic to tell me that. Any underwriter could look at that type of file and say, hey, I can approve it. I don't need someone to give me a credit score.

But let's say so they have really good credit scores, and because of that we can move real quickly. Well, that's great, because that person maybe should be compensated and have really a loan move through the system quickly and should have a little better interest rate. I have no problem with it.

But the process as it is right now has got to be changed. The scoring models have to allow for some flexibility. It has to take into account medical bankruptcies or that type of concern, or the short term unemployment. There's got to be some flexibility. Right now there is absolutely none, and that's why I have a problem with the system.

These are my suggestions -- because I know I have to cut myself short. Number one, everyone in this room that is either representing a regulatory or a credit agency, or represents a lender, or whoever you represent, if you are part of this process, we must work together to get this worked out.

Now, there are three bureaus that are going to go kicking and screaming to work this out, and that's Trans Union, Equifax -- and I know there's a gentleman here who is representing the three bureaus. I don't know if anyone from those -- from the three repositories are here. But you've got to clean up your act. It shouldn't take 30 days for a bureau -- for a mistake -- an inaccuracy -- on a credit report to be done, not in this day and age of technology.

And also creditors have to start reporting more promptly and correctly. And when they increase someone's credit balance so that there will be a greater disparity between what the client owes and what their balance is, they have to report that, and it has to be not three months old. It has to be current, so that we're on par with everything.

And inquiries, unless -- not only if somebody even checks for an inquiry and, you know, was really sincerely checking on it. But only -- only -- if an account came as a result of that should that be counted. And why do we deal with this mortgage thing and 30 days of shopping for a car? If someone is shopping for a mortgage, isn't it their entitlement to get the best rate and find the best mortgage? And it might take them 60 days and it may take them a hundred calls.

And they should have the right to do that and not be penalized, which they are now. If it takes them more than 60 days and it carries over, and they have five or six new inquiries, guess what. Their credit score goes down for trying to do for themselves the best job.

And the same thing with credit cards. Don't you want to get the best interest rate on your credit cards? Shouldn't you have the right to shop around. Well, don't do it anywhere near the time that you're thinking of doing a refinance or buying a home. And you should have the right, and you should have the right to consolidate all your monies. You should have the right to do that, and only if a new account results as an effect of that, that is the only time that inquiry should be counted.

And I think we all really need to start paying attention to this. I know we're going to have a question and answer session, and I know that a lot of other people have things to say, so I'm going to thank you all for listening to what I've had to say. I'll be glad to answer any questions when they come up later.

Thank you.

(Applause.)

MS. TWOHIG: Thank you very much, Caryl. Our next panelist is Marcia Griffin, who is founder and President of Home Free USA, and the former Vice President of a mortgage servicing firm. Home Free USA is a HUD approved, nonprofit membership organization that promotes home ownership and assists perspective home buyers with such things as education and counseling on the home buying process, credit counseling and repair, and offers other guidance.

And we welcome Marcia to give us some comments also.

MS. GRIFFIN: Thank you. Thank you. Well, I'm going to just give a different perspective here, if I might. I represent hundreds and thousands. Last year we interacted with over 10,000 perspective homeowners. One of the issues that I think that we're -- as we discuss credit scoring today, I want you to know that we use credit scoring every day, and we use it in the first meeting that we have with every homeowner -- every perspective homeowner.

One of the issues that I would like to also bring up is that through education of the credit scoring issue, education of how lenders work, what Freddie and Fannie are looking for, the education is key. Education to the mortgage industry. Education to the nonprofits. And education to the perspective homeowners, which is what we're attempting to do here.

We have had good and bad results with the credit score. You know -- and I must say, though, and let me just give you a little bit of sort of background. In Home Free we do a lot of education. We have anywhere between eight and 21 classes a month, because people need to know. They need to know their credit score, and they need to know it early from our advantage point. They need to know what they need to do, how their credit needs to be cleaned up. They need to know the good, the bad and the ugly before they go to Caryl.

From our advantage point, if people are prepared, they will get approved. In Home Free we have a 100 percent approval rate. Every single person that has been through our process. Now, let me just tell you, some people can fly. Others have to walk, crawl or take a boat or train. I mean, it really varies in terms of the time that we spend with them.

But the reality is that from our perspective, and through the perspective of our partners -- Freddie Mac has been a wonderful partner. We've learned a lot through credit scoring with them. Chevy Chase Bank has been a great partner. We're in partnership with other lenders.

But the reality is that it is important that people understand where a credit score positions them and what they need to do. Now, from the education standpoint, the reality is that a lot of the nonprofits -- and we're in the counseling mode -- don't -- we're not really in sync on what people need to do to make themselves better, even if it's going to be, you know, a six month period with the nonprofit. This is where the education of the nonprofits need to occur.

But in this class that I conducted -- in fact, I certainly open an invitation to any of you. I have this class every Thursday night at 6:30 at my office here in Washington. It's called Ten Home Buying Secrets Everyone Ought to Know.

And the first secret is that the mortgage process has changed, that people should not think about home ownership and just, you know, jump out here, go to a realtor, sign a contract and go to lender. They don't know where they stand financially. You know, they know that their credit situation might not be the best. But there is no preparation at all.

So from our advantage point, the process has changed. They need to get prepared. People need to get prepared before they go to a lender so that they can be assured of getting the best rates -- the most money, because that -- the money issue I know we're not talking about this today. But I can tell you, in Home Free USA, 65 percent of our people have credit scores of over 620. We deal only with under served populations: minorities, African Americans, Latino populations, immigrant populations and also whites.

So the credit score issue is one factor. Clearly, the other factor, certainly in our environment, is that we have people with a 700 credit score and no cash. I mean, this is a big issue that we've got to deal with.

But let me just get back to my class for a minute. So the first part -- the first secret is that the process has changed. And the second secret is to get your credit score. Get your credit report immediately, not from the credit reporting agencies, because when you write, they don't give you your credit score. They need to really get their credit report with a credit score, so that they can understand where they are. And they need to meet with an organization like Home Free, like the NHS's and, you know, other nonprofits around, and perhaps even lenders, to examine that credit report and begin making these changes early on.

Clearly, where Fair, Isaac, Freddie and Fannie need to come to the table, we need to clearly understand what the impact is if, you know, a person's credit score -- let's say -- and I've heard several things from Fair, Isaac. You can't have, you know, too many credit cards, and they can't be up to the limit.

Well, you know, we need to have some clear factors. In fact, I would love to have someone to produce just a little report, something like 30 essential things to know about your credit score. Things that you -- I mean, and basically how you can improve it. You know, what's causing the problems. I mean, there seems to be a little bit of question about this across the board.

So from our advantage point, clearly education is the key. We use the credit score at the very beginning in what we call our mortgage profile. I mean, that is the first one on one meeting that we have with the person. We pull a three merge credit report, and we see the credit score, and we work with that. And we have seen that, you know, when they go to the lender, that credit score, you know, has improved.

The issues, though, are that, you know, what's going to make it improve significantly and what's holding it back. It's a very interesting part that you brought up here, Caryl, about, you know, the inaccuracies. Well, we know the inaccuracies with a credit report. But, you know, we haven't run across, you know, many issues that sort of relate to how we could tell -- I mean, the question about the scoring. I mean, you can't really -- no one has a feel for how these scores -- how they even come up with the scores. So it's difficult to really assess whether the score is right or wrong or just whatever.

But I can tell you that, you know, there are people who certainly when they have a credit score of 500 -- when we see a credit score of in the 400's, we tell them to just stop. There is nothing more -- stop. Hold it. Let us take your hand and walk you through a process. Because while there may be some errors there, we doubt if the credit score is showing up at 490 that it's going to -- there is enough error in there to make it a 700 credit score.

Where we are finding some issues, however, is right now we have -- one of our members has a 710 credit score. Now, this is pretty good, you know. She has a 710 credit score, and the lender is having question after question after question about this loan. Clearly -- we talked earlier about the Desktop Underwriter and the Loan Prospector. We have asked Freddie Mac to give us the

Loan Prospector, because we have found that when several of our members have gone to lenders and they've begun questioning certain aspects of whether that loan should be approved, then they've gone -- we've sent them to another lender and the loan has gotten approved using these technological methods here with Loan Prospector and Desktop Underwriter.

I'm sort of betwixt and between, as I said, you know, as I represent under served people, as I represent home buyers -- future home buyers -- and as far as the credit scoring issue, I think it's a great tool. Quite frankly, I think we need to be better informed and better educated about what's going to make the difference in enhancing that credit score in our environment.

At Home Free USA we have on average between 45 and 150 people per class. I mean, this is -- and we have three classes a week. People have a thirst for knowledge. Under served people in this country are trying to do better. We preach to them, through churches and through employers and through, you know, unions and the like, that look, we have got to go into the next millennium better off than we have been. People want to be informed. They want to get their credit score up.

But we just need to have consensus about what it's going to take and what people need to do. And it doesn't need to change every five minutes. But what they need to do and basically how we can all be on the same level so that we can increase home ownership. People want to become homeowners.

And, you know, there are a lot of people that are pretty bad off, but even those people -- you know, what we tell our people is that despite where you are today, you can be better off tomorrow. A misty morning does not signify a cloudy day. You come on and we're going to work with you with that credit score, with the credit, with these statements and everything else.

You know, it is from that advantage point that I sort of represent other nonprofits who work with the people, who if we can get this thing together, by the time the people get to Caryl and all of the mortgage lenders in here, the loans will be right. We won't have to send them to B, C and D paper lenders, which I think is the worse thing of the world.

And certainly when they get to Freddie and Fannie through counselling, through education and also pulse purchase counselling -- you need to stay with these people for at least two years -- at least at Home Free this is what we do -- and keep them with you and teach them what they need to do to better themselves financially. Everybody wants to be better, and this is what the objective of, I think, all of us would be.

Thank you very much.

(Applause.)

MS. TWOHIG: Thank you very much, Marcia. We're running a little late, but as promised we would like to give the audience a chance to raise some questions and issues so that we can be sure to cover them this afternoon.

So why don't we take a few minutes and do that now. And there are hand held microphones, so if you raise your hand you can be given the microphone. And those of you in the overflow room, if you have questions at this point, if you come to the main room we can try to get your questions and comments in.

MR. PREUDHOMME: Hi, can you hear me?

MS. TWOHIG: Yes.

MR. PREUDHOMME: Okay.

MS. TWOHIG: And please first identify yourself and identify any affiliation you have.

MR. PREUDHOMME: Yes. Hi. My name is Bruce Preudhomme. I'm here not only representing myself and my family -- okay. Somebody wants the spelling of my name. It's Bruce Preudhomme. That's P-R-E-U-D-H-O-M-M-E.

As I said, I'm not only representing myself and my family, I'm also representing two consumer activist organizations I work closely with. One is called the Victims of Chevy Chase Bank. Sorry.

(Laughter.)

MS. TWOHIG: Okay.

MR. PREUDHOMME: And the second is the Economic Justice Alliance. Okay. In both cases what we're dealing with has to do with credit scoring, credit reporting and problems centered around that whole arena. The biggest problem I see -- well, there's really two big problems. The data, as has already been mentioned. In my field of computers, we have a term called garbage in, garbage out.

Okay. And we've got that going on big time in the credit bureaus. The data they get in is garbage. It comes from the lender. It can actually be used as a tool to attack somebody that has been a vocal person. I for one -- after closing an account I paid off, I had a lender a year after it was closed, report me as 60 days delinquent, which I had to battle and go through the whole 90 day process. I just got my letter the other day saying okay, yeah, you were right. It's not that. And then they put in some other verbiage, okay, which is another pack of lies that I have to battle.

The data as far as inquiries is totally bogus, too. Back in 96 I had my credit rate increased on my gold MasterCard from 18 percent to 25.99 percent. Not because I was paying late. Not because I was paying slow. But because of information contained in my credit bureau. And one of the big factors was the number of inquiries.

Well, I checked. The number of inquiries that I had during the last year was nine, okay. It happened to be that year I bought two car phones. And because I run an on-line site where I dial up access, I got another four phone lines in the house. Most of those credit inquiries were for phones. Now, I don't know why that would affect me. Why that would justify Chevy Chase Bank raising my interest rate, but they did, okay.

I battled this and in -- you know, it took I guess two years to go through the process, trying to go through the system. And, you know, in every step, you know, I contacted the FTC. I contacted the OTS. You know, they didn't want to deal with it. They would rather just say, oh, well, you know, do a better job at paying your bills. I pay them off, you know, so that wasn't the problem. Then they say, okay, well, maybe you should get an attorney. And I have a real problem that I have to get an attorney to get the laws in this country enforced, and to get the laws in this country done right.

Now, back to what I was saying, there are two basic problems. Data, as I said, is one. The other is the whole credit system. We've got the cart before the horse. We have lenders funneling garbage data into the credit bureaus. Instead, that data should come to the consumer first. You know, the consumer should have the right to say, hey, wait a minute, this is totally bogus.

I should be granted permission to say hey, this never happened before it gets posted. I should get a 60, 90 or 120 day period where I can clean it up before it gets posted, rather than waiting until after it's posted and I happen to stumble upon it, you know, and that's the way it is right now.

So basically one of the premises that this country was founded on that you're innocent until proven guilty, the reverse is happening. You are presumed guilty, okay. There's a lot more that I could say, but I want to give other people a chance to talk.

MS. TWOHIG: That would be great.

MR. PREUDHOMME: Thank you for listening.

(Laughter.)

MS. TWOHIG: Are there any -- no, we appreciate your comments, but it would be good if people could somewhat limit their comments. Does anyone else want to raise questions or make a comment at this point? Again, we're just trying to get issues out on the table so we can maybe get some responses and answers this afternoon.

MR. LE FEBVRE: Do you need my name and everything first?

MS. TWOHIG: Yes. Please identify yourself.

MR. LE FEBVRE: Richard Le Febvre. Affiliation is AAA American Credit Bureau. I'm here for --

MS. TWOHIG: Oh, could you spell your name for the record?

MR. LE FEBVRE: Le Febvre, L-E-F-E-B-V-R-E. We're a mortgage credit reporting bureau, and we service most of the United States. And in listening to Fannie and Freddie and Fair, Isaac, we're -- and the repositories -- we're in the trenches every single day. When a consumer goes to Caryl or anybody else that is a mortgage broker, we're actually pulling the report and actually analyzing it and seeing it on a daily basis.

And, of course, the repositories take a lot of the blame. Every consumer group from the legal side to the consumer groups blame them. But a lot of the times, in my own personal experience and in the reports that we do each and every day, it's the creditor that's reporting that data. And one of the things that I feel real strongly about is back in 72 when the Congress enacted the Fair Credit Reporting Act and then amended it again in 97, they knew at that particular time with no blame that the data was wrong. There were creditors misreporting and there are certain things are there.

And then DU and LP come along. And my biggest concern is if Congress passed the Fair Credit Reporting Act knowing there were inaccuracies and gave consumers certain rights, why does Fannie and Freddie don't think that they have to give that consumer those same rights as it stands right now.

In the old days what would happen if Mr. Batra had gotten his credit report from us, a credit report is generated. He's sent a consumer copy. He then has the right to dispute that data. Now, because of the 30 day turnaround, the repositories cannot get that data verified that quickly. That's why mortgage credit reporting companies came into effect, because they can represent or protect both consumer and lender to verify that data when Mr. Consumer says it's inaccurate.

Now, in the system -- Fannie Mae, to get on their system, comes to me and asks for $75,000 if I could, but I can't. Then they ask for transaction fees to come through a system that they don't give the consumer the same right. My proposal, and one of my biggest issues is, if that data is wrong, Fannie and Freddie must then allow third party intervention, either by the repository level or by a mortgage credit reporting company that's out as a third party to verify that data to show it.

A lot of credit -- now that Fair, Isaac uses a scoring model, a lot of creditors -- and if you talk to the repositories, all creditors don't report the same way. High credit to one creditor is different than high credit to another. And if that model is looking at the balance -- the high income ratio, and if you have a Discover Card or an American Express card, every single month you're at your limit, even though you're truly not.

And there must be a mechanism in place that both Fannie and Freddie will allow third party intervention and to then correct that file and then send it back through. LP and DU is a great operating system. One, I don't think I need to pay to get on their system because mortgage companies like to use my company or Credco -- I know they're represented here -- and numerous other companies. But there has to be a way that the consumer and both Fannie and Freddie will then allow third party intervention, and then accept that data, which in turn then will recalculate the score.

Right now to talk to Equifax -- Equifax right now, out of the three national repositories, has what they call an expedite program. That means, I'm a mortgage credit reporting company, and if a consumer or Caryl or anybody else in this room has inaccurate data that we're able to prove, they then send me a document. We at the mortgage credit reporting company authenticate that document, send it to Equifax, and Equifax is committed to correcting the file within 24 to 48 hours.

Which in turn -- then we pull the file, which in turn recalculates the score.

The other two bureaus have not done it yet. And I think if the repositories working together with mortgage credit reporting companies -- and I'm sure there has to be a code of ethics. There has to be certain fraudulently -- something in place that they don't receive fraudulently done documents.

But my proposal would be, if the document is then faxed from the consumer -- if Mr. Batra was able to verify that Discover Card misreported his credit card and received a letter from Discover Card, then it would be sent to my company. We would authenticate that letter, by calling the person -- the author of that letter -- and then forwarding that on to the repositories, and having a relationship between the repositories and us, so that data they feel comfortable correcting.

And that's the system that needs to be in place, because when you talk to everybody, they're upset about the credit scoring system. They're upset with the repositories. And I'll be honest with you, the repositories -- all they are is an acceptance of data. It is impossible for them to turn around and look at every trade line that's reported to them every single month and know if it's right or wrong.

The only way the repositories know if it's right or wrong is if the creditor corrects the file, either by magnetic tape or any other means, or if the consumer disputes. So a lot of the pressure is put on the repositories, and they're not the problem.

We had a file a couple of weeks ago where we were dealing with BankOne, and BankOne reported a gentleman's perfect BankOne account as a Chapter 7 bankruptcy. It decreased his scores by over 70 points. And the only one of the repositories -- in dealing with BankOne, he received a dispute letter that said it would be corrected in 30 days. This is now 90 days later and it still hasn't been corrected.

At the same time, three of his credit card vendors had notified him that the increase in his credit report went from 9.9 to 22 and a half. And he never had a Chapter 7 bankruptcy at all. He always paid as agreed. So the repositories themselves, I believe, need to lead the front in dealing with third party intervention to get this stuff.

And one other quick example, and my biggest concern, is discrimination towards Hispanic or minority, blacks, whites or whatever it may be. We did a file the other day, and I analyzed it. And a file was pulled by my company on 6/7 and then it went through the DU system on 7/9, which is one month and two days later.

I analyzed the raw credit from all three repositories. Equifax had four trade lines, TU had five and Experian had seven. The only thing this gentleman did was miss a $20 monthly payment to Discover. And of course he disputed it. He said he was not late. But Experian increased his -- not Experian. Fair, Isaac showed his score 76 points higher with Experian, 151 deduction with TU, and 178 deduction with Equifax. But he paid his mortgage -- and he only had one derogatory item on his credit file, and it was a $20 payment. And he's had a mortgage history for three and a half years that was paid on time.

So my analysis of it all, since we're in the trenches each and every day, is that something needs to be done, and it needs to be done drastically. Because right now about 80 percent of our incoming phone calls are why is my score this, and how do I increase it, and so on and so forth.

Thank you.

MS. TWOHIG: Thank you very much for your comments. I think it's important as we think about these issues to think of something -- I think Pete McCorkell first suggested this afternoon. That we also have to think of what issues are we talking about that have to do with credit scoring, and what are just the credit processes that would also exist in a judgmental decision.

As I understand it, your first comment that you made did have to do with the speed of automation, that makes it more difficult for the consumer, necessarily in the course of that decision making process, maybe at that same time to dispute errors.

Are there other questions or comments? Yeah.

MR. SMITH: I'm Don Smith. I'm the President of Great Arizona Mortgage Corp. in Scottsdale, Arizona. And this is my first visit to Washington, and what a great town. And I want to thank you for having me at the hearing today.

With regards to why I'm here, those two loans that Richard just brought up were loans that were done in my office. The second one was a Hispanic couple that had 700 and some change in their FICO scores, and they're now

500 and something in less than 30 days, and there is no difference in the file. Try to figure that out and explain that to a borrower that barely speaks English, why when I told him 30 days ago he would have no problem whatsoever. He's made arrangements for his move. And before I came out here, I had to look him in the eye and say, we may be having a problem.

Now, of course, if you listen to Fannie Mae and Freddie Mac, they explained to you that there are ways that we can go about this. We can expedite it. There are no changes on the report. The numbers have shifted. As a lender -- I've been doing this 19 years as a mortgage lender. I've been a realtor for 22 years. I have done thousands of FHA loans, VAs and conventionals.

And I love what we've done with the automated system. Unfortunately, the premise that this is based upon is based upon a perfect world or in a vacuum. We are not living in a perfect world. And we need to take the time as we talked about -- you know, let's talk about what makes up the scoring system with Fair, Isaac. Let's talk about if you have a $1,500 limit on your credit card, that it says you only owe $200 and it's a $1,500 limit.

But we've got numerous credit reports that I'm sure that everybody in the room has seen over and over, where it says high balance is zero and you owe $1,500. How do they let you do that? I want to know how you do that. How do you borrow $1,500 more than your high limit? It's calculating under scores. And if it's not, I want somebody here to tell me that that's not how it's being done, so I can go back and tell my clients, the ones that I see on a consistent basis, that look, this is how we work it.

This is what's important. Instead of saying well, you know, if you pay your bills on time, if you go to church every week and you pay tithe, you do this and you do that, God is going to take good care of you and don't worry about Fair, Isaac. That is not the case. What we need to take care of, is let's kind of get down to it. Let's crunch the nuts and the bolts of this issue and come up with it and say -- just like we're talking here with Simi. I don't know. I don't know.

You know, it just comes across the paper, and by god, you're either going to get approved or you're not. Unless you take it to an underwriter that knows you and trusts you, and she's willing to step out on a limb and say, well, I don't give a damn if they're going to buy it or not. You know what? This loan is worth underwriting, and we're going to make the loan.

The biggest issue that I've got still is the reporting issues that we have from banks. By the way, that one file, the first one that he mentioned to you, the borrower was buying a $300,000 house in north Scottsdale. It was up to $400,000 before he closed. I had approved him. He had great credit overall going into the transaction.

We're getting ready to close on the deal. I said come on back in the office. Let's take a look at it. BankOne -- and I'll tell you the name of it, because I've got all the documentation here with me. BankOne rates him on his credit report now as being six times 90 days late and bankrupt. His credit score is in the porcelain convenience. The man is livid. His wife had a miscarriage over this period of time. They did not close on the house.

I had him come in. I have a letter in the file that I was asked to give you a copy of so you could review it and take a look at it. I have the documentation. In their infinite wisdom, BankOne, when we called them on the telephone and explained to them that -- and we got the automated first. We did the 1-800, wait in line and die.

(Laughter.)

MR. SMITH: We did that and got that information. And you know what it said to me? Never been late. Well, okay, fine. So I hit the O button, the one you're supposed to keep hitting until you get a live person. They got on the telephone. She says, well, Mr. Smith -- and I told her who I was and that the client was sitting there. It's a mutual client of ours. And explained to her, your system says that he has paid right on time. She said that's absolutely correct.

And I said well, why is it being reported on the credit bureau, and she goes, I have no idea. And I said well, what's your position. Well, I'm the supervisor. How long have you been doing this? Well, what's it to you, is how she came back to me. And I said no, I'm serious. How long have you been doing this? Are you familiar with the Fair Credit Reporting Act? And she says well, yes. And I said are you familiar with it, like have you read it? And she said well, yeah, I'm familiar with it.

And I said well, you have an obligation. You need to get me a piece of documentation. We are trying to close on this man's home. I have less than two weeks. This is a surprise. You've already told me that it's not his information. You need to send this information out to me right now. I said, here's his name. You have it. Here's his Social Security number. You need to reference the account. And I need that letter, and you need to fax it to me immediately. I'll give you to Friday. This is Wednesday. It should be easy for you to do. I know you feel bad.

(Laughter.)

MR. SMITH: I got the letter Friday. And I have a copy of the letter, and I'll be glad to show it to you, because this is what goes on in the real world out there for many of these people out here that are doing these.

The letter says: Dear Mr. Smith. Reference the account. Please be apprised we have removed this line item from your credit bureau. For mine. They didn't take it off his. They took it off of mine.

(Laughter.)

MR. SMITH: She doesn't even know my Social Security number, but I'm sure that all Don Smith's don't have a BankOne account number. Well, it gets better. I called her back up. I was on that terminal hold thing again. Okay. My client's in the office. He's a big guy. Don't make him mad. Thank God he's a friend. So we're standing there waiting, you know, on hold.

We get them back on the line. Noel Simpson, how are you? Who is this? It's Don Smith again. Oh. I noticed the letter that you wrote me. You know, it was a pretty good written letter, but I've got a couple of items I would like to bring up to your attention. You've left out Mr. Acton's name and Social Security number, and you just said that you removed the item.

We don't want the item removed. It's his credit. He's had it. He's been paying on it. You've told me that. I want you to take it and state that he's never been late, and he's never been bankrupt, and we are sorry and apologetic. Well, that's going to take a little while. No, Noel, we've been through this. Let's try this again. Get it taken care of.

She sent me out another letter. She removed it completely off his credit report. There is no trade line. It doesn't show any payment history. It doesn't show any balance. So we can't figure out if he still owes the money or not. But guess what's still in the column? He's still showing bankrupt. His credit scores have depreciated and depleted over this period of time. He is now in the mid-500's, when he started -- I mean, he's dropped over a hundred points. The man lost over a $100,000 of equity on the house.

And I'm going to shut down right now. I see you all looking at the clock. But this is what the rest of us are doing business with out there. This is what we need your help on. Let's put some teeth in the FTC, if you're going to have issues for the credit bureaus with what they have to do, and for the people that provide the information.

Thank you very much, and you all have a nice day. A great city.

(Laughter.)

MS. TWOHIG: You know, when we announced this conference and we started getting feedback, we knew we were going to get some lively comments, but I think we under estimated how lively.

Any other quick comments before we break?

MR. EVANS: Right here.

MS. TWOHIG: Mike?

MR. EVANS: I'm Mike Evans, Fair Lending Specialist with the FDIC. And I noticed this morning that the individuals with Fair, Isaac and some other individuals dealing with credit scoring have said how credit scoring helps fair lending.

Well, I want the issue addressed. How does it help fair lending when you look at the data from the Home Mortgage Disclosure Act that is released every year. The denial rates for minorities continue to increase every year. And I also noticed that in the data that will be released in the next couple of days, if you look at closer, denial rates for whites are increasing, also.

MR. MEDINE: I think, Mike, that's an excellent question, and we're going to have a panel on fairness after the break, and why don't we have that as the first topic during that panel.

MS. TWOHIG: We're going to need to -- okay?

MS. PRATT: Hi. Sarah Pratt, now with the National Fair Housing Alliance. I'll be very short. It seems to me that there are a couple of really important questions that we need to continue to deal with.

One is a synapsis of the issues raised earlier. And that is, what difference -- what are the sources of the various items in the credit scoring technique? How are things weighed? What difference does it make if you have a trade line from Household Finance versus a MasterCard, and why should it make a difference? Where do these scores come from? That's the first item, and we don't know the answers to those questions.

The second question it seems to me that ought to be talked about some is the relationship of credit scoring to the availability of loan products, and in particular to referrals to the sub-prime market. In other words, where -- what difference does it make if you have a particular credit score as to what loans are actually available and are the most favorable loan products available to you based on your scores? Why not, if not? And at what point do you end up in the sub-prime market because you have a particular score, and what impact does that have on your finances for the future? And even what impact does it have on your future credit scores?

Thank you.

MS. TWOHIG: Thanks, Sarah. One or two more questions or comments, and I think we'll need to break for lunch.

MR. FISHER: It will be quick. Greg Fisher, creditscoring.com. I've listed 25 questions on the web site, creditscoring.com. And that's G-R-E-G, F-I-S-H-E-R. And I have copies of them here, if you would like them. But I would like to ask the first five here.

What percentage of loans evaluated by Fannie Mae and Freddie Mac automated mortgage underwriting use scores created by Fair, Isaac? Will the credit reporting agencies release data to anyone who wants to create a new scoring system? If I'm applying for a mortgage, how much does it cost to have a score updated immediately, if I find errors on my report? Do you allow creditors to see scores for the purpose of evaluating existing customers? Do credit card companies access credit scores months or years after issuing the card to determine the risk of a cardholder to raise or lower his rate? And the fifth one out of the 25, how can I tell how many credit cards to have to avoid that factor lowering my score?

MS. TWOHIG: Thank you for those questions. There was someone else, I think, who had their hand up. Yes?

MR. MANALP: My name is Yuksel Manalp.

MALE SPEAKER: Spelling?

(Laughter.)

MR. MANALP: First name is Y-U-K-S-E-L. Last name is Manalp, M-A-N-A-L-P.

MS. TWOHIG: Can everyone hear? Okay.

MR. MANALP: Okay. Nobody is talking about the car industry today, so I thought maybe I'm in the wrong place.

MS. TWOHIG: No, you're not in the wrong place. We were focussing on credit scoring in the mortgage industry. But we are interested in comments that are broader than that.

MR. MANALP: My observation has been -- I'm a Finance Manager of a dealership. My observation has been that the credit scores provided by FICO are somewhat less accurate than they would like for it to be. That's obvious from the comments Caryl made there and several other people. Because the basis of the information is the database supplied by credit reporting agencies. And if the information is wrong, of course scores are going to be wrong.

So I have two cases that I brought with me that I can just briefly describe. I had a customer who is a physician. He makes a lot of money. His wife is a physician. They make a lot of money. And they go back to 1983 in the credit bureaus. And I counted three late payments, and they still have 77 percent of their credit line that is still available. There are thousands of payments they made on time. And the three late payments added up to $175 or something like that. And his score was 585.

That combined with how the banks are training me, or telling me what to do -- they send me a piece of paper at the beginning of each month. If the guy's credit is such and such, this is the rate he gets. If it's less than six points, they don't even look at it, and it's very difficult to change their minds.

So I'm just going to take a couple of minutes, and I'm going to read to you what one of the credit reporting agencies had us sign, because we're a subscriber. Okay.

Here we signed. The subscriber recognizes that factors other than the Empirica score must be considered in making a credit decision, including the credit report, the individual credit application and economic factors, which is what I also believed. The factors that are provided by Trans Union as significantly contributing to the score may be disclosed to consumers as the reasons for taking adverse action, as required by Regulation B. However, the score itself is proprietary, may not be used as the reason for adverse action under Regulation B, and accordingly shall not be disclosed to credit applicants.

Two things. Number one, the banks are forcing us and themselves -- any of us -- to use it 100 percent of the time. Some banks are. Number two, we're not allowed to disclose to the customer, so the customer has no idea what his score is, not much less try to figure how to straighten it up.

There are errors. The example I'm going to go back to -- I have another example.

MS. TWOHIG: Would you use the mic, please?

MR. MANALP: Yeah.

MS. TWOHIG: Thank you.

MR. MANALP: I have another example to go with it. I pulled another bureau for a student. He's a full time student and has part time work. The only credit line on there he had is a Cellular One for something like $36 a month for ten months. He had no other credit lines. He had a score of 715.

(Laughter.)

MR. MANALP: The bank's idea would allow me to spot a $20,000 car to this person because of his score. And the bank's idea would allow me to turn down the physician, unless he paid 50 percent down and he paid 22 percent interest.

The credit scores are not accurate. And I think the public should be allowed to find out what their score is, and that would allow them to straighten it up. There's only one way.

MS. TWOHIG: Thank you very much for your comments.

(Applause.)

MS. TWOHIG: We're running late, but I think we've had some excellent speakers this morning and some very important issues put on the table. The agenda calls for returning from lunch break at 1:30, which does not give you much time to eat. So why don't we all try to be back in an hour. I guess it's 12:50 now, so at 1:50 we'll start up again.

Thank you very much.

(Lunch recess.)

AFTERNOON SESSION

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MR. MEDINE: Thanks very much. If we can have half as lively a discussion this afternoon as we had this morning, I think we'll be doing very well. First, before we get started with the panel, Pam Johnson, who is here from Fannie Mae, will have to leave shortly, and just wanted to make some brief comments based on the morning's discussions.

Pam?

MS. JOHNSON: Thanks. Is this working?

MR. MEDINE: Yes.

MS. JOHNSON: Okay, good. I asked David if I could just make a few comments, because unfortunately I am going to have to leave, and I didn't want to leave before having an opportunity to comment on a few of the comments and questions that came up.

I guess there are two things that struck me about some of the discussion this morning. One is obviously there is a fairly significant degree or level of suspicion and doubt about credit scoring. It goes without saying. And that seems to be fueled in part by personal and professional experiences, and also by a lack of information. We don't know they work, and therefore, you know, we're uncomfortable with that. A perfectly good reason to have this forum, and I think it's an excellent opportunity to bring all these issues to bear.

The second thing that struck me is that there is a significant level of mis-information about -- and I can only speak for Fannie Mae and the secondary market -- about the role that we play, and also what our position is relative to credit scoring. And perhaps I didn't do as good a job this morning trying to describe our position, but I would like to take another minute to do that, because I think it's important.

Before I do that, I think I would like to say that for those of you who don't know this, and I'm sure most of you do, there is a difference between the secondary and the primary market. Lenders and brokers originate loans in the primary market. They take the loan application. They do the underwriting, now of course using our automated underwriting systems -- you know, there is a role for us there -- and they sell the loans to Fannie and Freddie. And we purchase loans directly from lenders and seller servicers to Fannie and Freddie.

Now, what does that mean. Well, it means that as the investor, we actually are providing -- we do provide guidance around what types of credit quality -- credit standards we expect when we purchase a loan, and we provide that guidance in a lot of ways. And one of the ways we provide that guidance is through written communications with lenders.

Now, many of the questions or issues that came up today are directly answered in some of those written communications. And I just want to bring that up, because I think it's important to know what our position is. For example, Caryl raised a situation with a borrower who had extenuating circumstances. A very low credit score, but extenuating circumstances, such as a medical -- some sort of medical circumstance that created some difficulty with credit. Or a divorce, for example.

Now, if you turn to some of our lender letters -- and I'll be happy to send you one, Caryl -- they're very specific about that being used as an extenuating circumstance for making a loan. And so we try to provide the kind of guidance that lenders need to know when to sort of look beyond the score, and look beyond something that's determined to be high risk.

As far as the automated underwriting is concerned, the way it works is that we provide a recommendation around whether or not we think the loan should be approved. And for Desktop Underwriter -- I can't speak for Loan Prospector. But for Desktop Underwriter that recommendation on average occurs about 75 to 80 percent of the time. So Desktop Underwriter users are getting an approved recommendation out of the system about 75 to 80 percent of the time, meaning they do not need to further look beyond that decision and do any more underwriting.

Now, the other 25 -- 20 to 25 percent of the time, the message is very clear. We want experienced underwriters to look at that loan, because there is something about that loan, at least according to the data that the system has taken in, that appears to be high risk. There may be extenuating circumstances for the high risk. There may be problems with the credit report.

And again, another specific written guidance that we give back is that if the credit report is wrong or inaccurate, or there is information in it that's inaccurate, the lender is instructed to disregard the credit score, because it cannot be right.

So we do provide a lot of guidance around these issues. I can tell you that based on conversations with Caryl and others that it does not always get translated in the lending community. But I think it's important to know that, you know, we are looking to buy those loans that experienced underwriters and experienced mortgage professionals say are good quality loans. That's the business we're in, and we have every interest in getting those loans from lenders.

On the numbers -- the examples that Caryl cited, you know, I have no doubt that some lenders put limitations on the loans they will sell. But I will state again unequivocally -- did I say that right -- that we do not have a minimum credit score in our automated underwriting system. Again, we do not have a minimum credit score in our automated underwriting system.

So, you know, do we think that the low score represents on average a high degree of credit risk? It does, but that assumes that the information is correct. Again, a problem we all know. And it does not necessarily pick up those extenuating circumstances. And we would like and hope that the mortgage professionals who are dealing with those loans will work through those extenuating circumstances and make those loans.

It behooves us to buy them as opposed to them having to go to a sub-prime market, for example. We want the loans that perform, and so we have the same goal in mind. And I just wanted to make those comments, because I know it's very easy to assume that there is -- you know, we're on different pages. And I know that there are issues here, but I just wanted you to know we are all on the same page about making more loans and as many loans as possible to credit worthy borrowers.

MR. MEDINE: Thank you. Pam, just while you're here. The FDIC before the break raised a question, and I just was wondering if you had a perspective on Fannie Mae's point of view. And the question was, if scoring is injecting more fairness in the lending process, why is it that over the years we're seeing approval rates for minority applicants declining rather than increasing on lending?

MS. JOHNSON: Well, it's an excellent question. First of all, let me say this. There is no denying that there is discrimination in the mortgage lending process, like there is discrimination in many industries. And I think this is something that we all have to continue to work to combat.

And if you go back to the Boston Fed study that was done in what, 1993?

MALE SPEAKER: 1992.

MS. JOHNSON: Thank you. You know, it's clear that one of the primary reasons for mortgage discrimination has to do with subjectivity of the loan officer making the decision, so that they are actually weighing into their decision or to their underwriting -- or to their decision to make that loan, they're weighing in the fact that this person is African American or Hispanic, etc.

And one of the things that we view automated underwriting as helping in this regard is that it takes that subjectivity out of the equation. Now, automated underwriting has not been around for a long, long time, and it doesn't represent a hundred percent of the loans that we purchase, certainly. And so it is not necessarily used as widespread as one might think. We would like it to be used on a broader basis. But I think over time it is our belief that the use of automated underwriting will in fact have a positive effect on mortgage lending in minority communities.

And lastly, I guess I would say that we all know that minority communities are the fastest growing, along with immigrant communities. The fastest growing population in this country. And the fastest growing opportunity for those of us in this business. Besides the moral imperative that discrimination is wrong, there is a business opportunity here that we certainly don't want to ignore, which is, there are plenty of loans out there that should be made that aren't being made today.

And we would like to get at that. I mean, that's the business we're in. So ultimately I think that we will see a shift in this issue. That's our hope. That's why we keep working at this. And we're hoping that the subjectivity will, you know, over time be eliminated with the use of tools that don't allow the person inputing the data to make that choice.

MR. MEDINE: Okay. Thank you very much for your comments. We're going to turn now to the Is Scoring Fair panel, where we're going to discuss -- as we have been to some extent throughout the day -- whether the use of scoring adequately assesses risks for various populations, and how overrides are used and if they're done in a fair way or not.

We've had the pleasure of hearing from Peter McCorkell already, so Pete will be around for the question and discussion period. But each of the other panelists will make some brief comments and then we'll engage in discussion among ourselves and with the audience.

Bob Cook is the Senior Fair Lending Specialist at the Federal Reserve Board, and has been in that position since 1994. He serves as the in-house consultant on fair lending policy and enforcement issues involving bank exams, complaint investigations, merger, acquisition and expansion applications and regulatory comment and review.

Bob?

MR. COOK: Good afternoon. It's a pleasure to be here. Is this mic turned on? Can everybody hear?

MR. MEDINE: People can hear.

MR. COOK: The Federal Reserve's responsibility with respect to credit scoring has to do largely, of course, with examination of institutions that are subject to its regulatory review. We have recently, along with the other agencies, issued a set of interagency fair lending exam procedures. And within those procedures we have a set of review steps that we use in credit scoring systems.

We take the approach in the front end of the exam now that we look for risk factors. And in some instances, a lender that uses credit scoring is going to find a risk factor relative -- or several risk factors relevant to the credit scoring system that will cause us to treat the credit scored product as perhaps one of the focal points of the exam.

Once we make that review, our primary focus with respect to credit scoring systems is in disparate treatment. Now, that doesn't mean that we look to see if a lender has purchased a system from Pete here, where Pete snuck in females as a factor in the scoring process. We don't think he does that any more. He's promised us he won't.

(Laughter.)

MR. MCCORKELL: When did I stop beating my wife.

MR. COOK: That's right. What we looked at, and primarily from the disparate treatment side, is whether or not there is a judgmental creep back into the system that uses scoring, such that all of the promised benefits of using scoring that you eliminate disparate treatment because everybody gets treated the same, has kind of turned on its ear. Because after the scoring process is all done, you come in and perhaps ignore -- but I think the proper term is that you take into consideration what Pam described as extenuating circumstances, or you override what the score seems to be saying. The score seems to be saying this is a score of 440. It probably shouldn't be made.

But there are reasons, many of which we've heard about today, why a lender might want to make that loan. The extenuating circumstances can go from -- as both Pete and Peter said, the score doesn't predict how individuals are each going to perform. It predicts how a given segment of the population that made up the scoring development process indicates that a similar group of people would perform. But as to each individual, that score is not going to say whether that person is going to default or going into bankruptcy depending on what the purpose of the score is.

So somebody with a very brief band of

delinquency that reflects a short term economic downturn for that person might look the same to the scoring system as a sort of habitual credit delinquent, and overrides or extenuating circumstances provide a means to overcome that. As a consequence, you can see that we kind of favor it. We believe that overrides have a definite place to play.

And the only area that we -- well, one of the principal areas that we are concerned about is in the fair lending area. And that is, are the overrides being used on a basis that doesn't take a prohibited basis into consideration. It doesn't end up allowing what we call low side overrides, where the score is low and it's a decision to make the loan anyhow, or high side overrides, where the score is 770 and the bank says yeah, but I don't like his looks and denies the loan.

Our principal concern, as you can imagine, is with low side overrides. As I said, we look in the exams at risk factors. And one of the risk factors before we select a credit score product would be, doesn't there seem to be a lot of overrides. And that in itself is not necessarily bad. Maybe this is a bank that pays extensive attention to extenuating circumstances. But it is a red flag for us to see a very high percentage of overrides of an otherwise -- of an initially scoring system. So that's going to become a focal point of the exam.

The use of the override, to the extent that it seems to be producing disparate outcomes for, let's say, male versus female borrowers, or minority versus white borrowers, is something where primarily we looking for an analysis. The examiners are doing an analysis of the quality of assistance given to those people who they decide to assist in overriding a score, or in taking into consideration extenuating circumstances. Does everybody get kind of the same effort by the lender in attempting to find ways to explain why this person ought to be granted a loan, or are those granted on a disparate basis. So that's sort of a primer on how we are taking a look at credit scoring for the most part.

There is -- and I know Pete sort of glossed over it a little bit this morning, but promised to get back to it this afternoon, as he knew we would want him to -- the issue of disparate impact, where the system itself, although it essentially treats everybody the same, produces different outcomes because of the very nature of the system as it relates to differences in the population that it scores.

So, for instance, one of the factors might be -- and I'm not saying that it's yours. One of the factors might be that people have -- and I believe somebody mentioned it this morning -- finance company trade lines versus bank trade lines, and that people with finance company trade lines receive less of a score or fewer points for that than somebody with a comparable bank trade, perhaps of the same amount, the same duration and otherwise similarly situated. To the extent that minorities or single females, for instance, might be over represented in the population that uses finance companies more often than they use bank trades, you could come up with a disparate impact.

So one of the concerns we do have is whether or not disparate impact is an issue. And one of the questions I guess that I'll toss out to Pete to respond to when he gets his turn after this entire table discussion, is to what extent do the Fair, Isaac's of the world -- and I suspect you can speak for how some of the other systems operate, but certainly Fair, Isaac -- go when they evaluate various possible criteria or factors to put in the system to kind of weigh the relative impact that one factor may have against another. So that's another issue that I think we do -- we are concerned about. I must say that it's not a factor that we have the same concern about as the use of overrides in these scoring systems.

That factor brings in another issue, and that is -- the disparate impact factor -- and that is the lender's liability for disparate outcomes. A lender is responsible under a ECOA and Reg. B for disparate outcomes. And that's kind of a neutral term. That could be disparate treatment or disparate impact, but disparate outcomes from a credit decision process.

If scoring -- if they follow Pete's book and don't use overrides, and they're rejecting females at a rate of 1.6 times males, then you could say that there seems to be a disparate impact. The lender, however, while it's being held responsible under Reg. B for explaining that disparate impact -- indeed, a lender is given the opportunity under sort of the order of proof of disparate impact to offer a business justifiable reason -- a business justification for why those outcomes are different.

And yet it doesn't know what -- it may not know what factors are in the box. It may not know what weights are there. And it may not have the capacity to make an evaluation that regulators are going to believe. You know, the necessary credibility to say that yes, you provided a justification for the difference in outcome between male and female borrowers.

So that's an issue which I want Pete to address, because it's been raised by lenders fairly recently as to what do they do. Some of them have asked, how do I know that my program that I've bought from a developer program has been validated. Another obligation that lenders have is to make sure that their program is validated. In many instances, a validation is done by the producer of the system who sold the system to the lender. And we suspect that those validations are done well and wisely. But, again, the lender hasn't got the capacity to show what he did to validate, except to point to Pete and say, well, Pete tells me that my system was properly validated.

So there is this kind of disconnect, despite the fact that, you know, as a general matter when you've got, you know, a firm like Fair, Isaac, that is too big to discriminate

MALE SPEAKER: It's like a bank being too big to fail.

MR. COOK: Too big to discriminate because there is so much at risk, that we expect that validations are going to be done well and wisely.

Another Fed focus --

MR. MEDINE: You have about a minute.

MR. COOK: Okay. Another Fed focus is on what Carroll Justice spoke about, and that's the use of scoring to support a risk based pricing of loans. And really we're talking in many ways about sub-prime lending there.

To the extent that a FICO score can differentiate risk levels, it offers lenders a more precise way to quantify the difference in the cost of that risk, or in the way that that risk ought to be priced for as between, let's say, a B and B- and a C+ and a C loan. And to that extent, scoring serves a very useful purpose in the sub-prime lending area, a risk based pricing area.

The danger that we see -- one of the dangers -- is the extent to which a lender doesn't pay close attention to the risk differential that the credit score is describing and takes sort of a more pull it out of the blue approach to pricing for risk, adding a little extra just to be sure that they've got it right. And there is a challenge in pricing sub-prime loans, and a lot of lenders -- A lenders -- who try to get into it, learn that it's a very different task.

At any rate, that's something we're concerned about, is that the price differential between one risk level and the next ought to bear some reasonable relationship to the actual difference in risk. The cost of that risk.

And finally, from a consumer concern not knowing their score -- we heard some talk about that today -- I think -- I'm not so sure that I share that concern to the same degree that it was expressed today, and I'll tell you why.

To an individual -- as opposed to a lender trying to see what the band of scores are of this customer for some such analytical purpose, to an individual customer it's probably more valuable to know that he's got a score that's low, that's hurting his capacity to either get a loan or to get an A loan. It's probably more valuable to know what the various reasons are that are driving that score down, rather than the score itself, because he then has valuable -- he or she has valuable information about whether it's something they can do something about in a short term, or whether it's something that's going to have to heal over time.

And Reg. B requires lenders to provide the --

MR. MEDINE: I'm going to have to ask you to wrap it up.

MR. COOK: Okay. Provide the most important reasons why -- not only as to judgmental systems, but also as to scored systems, what most adversely affected the score.

So with that, I turn it back to you.

MR. MEDINE: Thank you. Thank you for highlighting, I think, some of the challenges in this area, where we on the one hand have heard scoring can be used to eliminate some of the bias and judgmental systems, but yet disparate treatment may be inherent in the scoring system itself, and where overrides take into account some of the sympathetic concerns and/or unusual situations, but again could also be used in a discriminatory manner. So some of these are some of the challenges in using a scoring system.

MR. MCCORKELL: I hope you meant to say disparate impact might be inherent. Disparate treatment would not be.

MR. MEDINE: Well, hopefully it wouldn't be. Thank you. Turning to Debby Goldberg, Debby is the Acting Director of the Neighborhood Revitalization Project of the Center for Community Change. The project provides assistance to groups that are concerned with the availability and affordability of credit and other banking services in their communities. Debby is also involved with the Center's public policy work on reinvestment and fair lending issues.

MS. GOLDBERG: Thanks. I think it's been a very interesting discussion here so far today. The earlier panels really laid out a lot of the issues that are challenges for people who are working in this field, or for consumers who are dealing with these questions. And at the risk of -- I'll make an effort not to repeat what people have said before, but maybe to give you a slightly different perspective than some of the people who have spoken before me.

One of the things that I see when folks talk about credit scoring and automated underwriting systems

-- and I think we see this from a community reinvestment perspective in other ways when you talk about technology and its use in the banking industry and its impact on consumers and their access to banking services, whether those are mortgages or other forms of banking services -- is that there is this tremendous promise that technology holds. And I think people want to believe that technology can work to everybody's advantage, and it's clear that it can work to some people's advantage.

But I think what you learn if you watch how these systems play out over time, is that you can't assume that the use of technology, whether that's credit scoring, automated underwriting or anything else, will necessarily work to the advantage of everybody in our country. And the folks who are particularly at risk of either not being served well or actually being disadvantaged tend to be low and moderate income people, people of color and other folks who are protected under our fair lending laws.

And so I think it's very important not to assume that just because something can be described as being objective, that it will be used in an objective way. And I think our quest to eliminate all subjectivity from the mortgage lending process as a way of making sure that nobody gets discriminated, is in fact a quest that's going to be vain. And I'm not sure that we ought to be pursuing it in the way that I think some folks are.

I think we ought to be looking perhaps at other ways of ensuring that discrimination and unfair treatment doesn't creep into the system, because I don't believe that you can have a mortgage lending process that is completely objective, no matter how you go about it. And I think that that has actually been illustrated by some of the remarks, as I said, of the folks who have gone before me, and perhaps most effectively by this last panel, who made it clear that at every step along the way there is -- as you know from the Wizard of Oz, there is a man behind the curtain. You may have this wonderful, you know, image projected on the screen, but there is in fact a person, or in some cases a series of people, who are involved in the process and who have an impact on the way that the process and the system works.

I want to just try and kind of highlight for you what I think are some of the points along the way in the use of credit scoring and automated underwriting systems where bias, whether that's illegal or just unfair, may creep into the system.

One of those is at the front end with the data entry. And the gentleman over here talked about, you know, garbage in and garbage out. And I think that's something that we all have to keep in mind, that not only are there problems with the credit reporting system in this country. But as I tried to listen carefully to the speakers who were explaining how credit scoring works, it seems to me that there are elements of the system at the front end that are subject to manipulation, which can be a good thing or it can be a bad thing, depending on whether it's done in a way that helps you or done in a way that hurts you.

The Boston Fed study that someone referred to earlier actually identified that as one of the key factors in explaining the disparate levels of mortgage lending to minorities and non-minorities in Boston. And that was how much assistance were people given in being on paper the best qualified applicant that they could.

And I think when you talk about this kind of a system, you still have that issue that you have to grabble with. How much help does someone get at the front end to look as best as they can look on paper, so that the data going into the system is going to serve them in the best possible way, and are people given different levels of treatment.

The second question -- or the second place where I think unfairness or discrimination can creep in is in the scoring system itself. And I think that, you know, the example that has been cited a couple times now, of how the use of nontraditional sources of credit -- the household finances or others of the world -- affect someone's score and the way that they get treated by the system, is a very good example of what the potential problems may be.

What happens to someone who has mostly paid in cash over the years and doesn't have much or any credit record? You know, the kinds of things that we tend to see more in low and moderate income communities and communities of color, I am troubled are not necessarily treated adequately by credit scoring systems. And I don't think anyone will ever be able to satisfy me, and I think a lot of other people, on the question until there has been somebody who does an impartial and thorough analysis of these systems, with access to all of the details about the way that they work, and can say definitely at least at some point in time that there is no bias built into the system itself. And that kind of scrubbing of the credit reporting system -- or, excuse me -- the credit scoring system simply has not happened to date.

And, you know, in this same light, I want to make a different point about the use of nontraditional sources of credit. Because I think when you talk about fairness, one of the issues that low income people in particular, and again people of color, have faced is that their access to credit sources in many cases has been limited, and people have been forced to use high cost sources of credit, to pay more for basic credit, regardless of what form that may take.

And particularly when you're talking about low and moderate income people, although not exclusively in that case, if you're paying more for credit, then the chances that you're going to have problems in paying on time seem to me to be increased. And I'll come back to this in a minute.

But I think one of the issues when we talk about fairness is how do we make sure that people who are good credit risks get access to the best priced, best structured credit that they ought to be able to have access to. How do we change the dynamics of the system that have led to some of the statistical results that maybe we see in the analysis that's done so far.

And then the third point along the way where I think bias and unfairness can creep in is at the back end. And again, people have talked about how that can play out. Once you get a score, or once you get the result of the automated underwriting system, then what happens. Are you -- you know, has your file gone back through and underwritten manually? You know, are compensating factors then taken into account? Does that happen on a fair and equal basis or not?

In this area, one of the points I want to make sure we're all clear about is that there is a very large part of the mortgage market that is not subject to review by my colleagues who are here on this panel who work for the government -- the banking and regulatory agencies. And so even though some lenders have bank examiners who come in and look over their shoulders to try and make sure that these kinds of judgmental aspects of their mortgage lending process doesn't play out in a way that may be biased, there are a lot of other lenders out there who are never subject to that kind of review. And I think when we look at the impact of credit scoring and automated underwriting, we have to look at the whole market and not just the regulated part of the market.

And then the other thing I wanted to mention at this point in terms of the back end is, once you get a score -- once you get an outcome, how do you then know that an applicant gets the best possible product that they qualify for. Or to what extent, as, you know, Bob Cook was just saying, does, you know, a little padding get added on to the cost of that loan, whether that's in the form of the interest rate or in the form of other fees that may get tacked on. And who are the people who get the best deals and who are the people who get the worst deals. And how does somebody know what is the best deal that they ought to qualify for.

I think the mystic that we see associated with credit scoring systems is particularly problematic in that way, because people don't know what they ought to be able to get. And it's very hard for a consumer to be an effective advocate on their own behalf, given that kind of mysterious nature of the system.

I want to just close with two quick points. And that is -- and I think Margot will probably talk about this more a little bit later on. But for me it's really impossible to look at credit scoring and automated underwriting without also then making the linkage to risk based pricing and sub-prime lending. Because in the communities where the groups that the Center for Community Change works, low and moderate income and minority communities across the country, that is a very big issue.

The presence of sub-prime lenders and predatory lenders, and the way that they use credit scoring, is a very big problem that groups are really struggling with. And on the one hand we have community groups who have been working for years to develop the kind of mortgage counselling programs that some of the earlier panelists talked about -- I guess Marcia Griffin, in particular -- as a way of taking people who in the kind of, you know, system that we're talking about, might not qualify for A credit and making them qualify for A credit, and getting them access to A credit.

And I think that's a good thing. And I'm very concerned that the widespread use of automated systems and the fear that many -- either the fear that some lenders will have that if they use any kind of judgmental -- if they have any kind of judgmental part of the process, that they're going to be, you know, straying into areas of discrimination, so that they'll just kind of shut that down altogether.

And they will be -- despite all of the letters that Fannie Mae and Freddie Mac may send out, they're just not going to want to deal with applications where somebody's credit score is too low. That and the increased use -- or increased activity by sub-prime lenders in low income neighborhoods, I'm afraid may really undermine the success and the continued benefits that housing counselling I think has brought to many communities across the country.

And I also worry about the notion that the best way to deal with people who don't on their face -- or as a result of this kind of allegedly objective analysis -- look like good credit risks, is just to give them credit at a higher price. I think that's a very dangerous notion.

And I guess I've been in this business long enough to be mindful of some of the lessons that we've learned from FHA lending over the years, where there were certain neighborhoods and certain types of people that got labelled -- I'm kind of simplifying the process here. But got labelled as FHA communities. And the only kind of credit that was available in those communities was credit from FHA, which in many cases was very poorly underwritten with disastrous consequences for individual homeowners and for the communities in which they lived.

And I think if we replace that kind of system with one where the only credit that is available in certain kinds of neighborhoods, or just certain kinds of borrowers, is high priced credit, and in some cases predatory credit, that we run the risk of having exactly the same problems that we suffered with poor use of the FHA program in the past. And I don't think that that works to the benefit of the country as a whole, let alone to the individual consumers who are affected.

And let me stop there.

MR. MEDINE: All right. Thank you very much, Debby. If I could follow up on one of the points you made earlier, as I understand it, you're suggesting that there might have been a bias in lending that occurred in the past --

MS. GOLDBERG: Right.

MR. MEDINE: -- that might have shifted certain consumers from, say, banks and traditional financial institutions to finance companies at higher rates, and that those consumers, as a result of that bias, were ending up paying higher rates and then more likely to default, and therefore a scoring system would essentially perpetuate --

MS. GOLDBERG: Right.

MR. MEDINE: -- some of that discrimination that occurred in the past. If that's your point --

MS. GOLDBERG: Yes.

MR. MEDINE: -- the question is, how do you today address that concern in evaluating an individual's credit worthiness?

MS. GOLDBERG: Well, I think, you know, one of the ways to get at that is through the kinds of counselling programs that were, you know, described and that I talked a little bit about, where you work with someone to both overcome the problems that they may have experienced because they've been forced to use high cost credit, so that they repair their credit record, and then also to make sure that they are really prepared to become a homeowner, if we're talking about mortgage credit.

That they know what to expect in terms of future costs associated with home ownership.

You know, one of my colleagues has called it the Hechinger's tax. You know that every month you're going to have to go down and spend 25 bucks at Hechinger's or whatever to repair something around your house. And there is not a landlord that you can call to do that, so you've got to built that cost into your future household budget.

So that people do become good credit risks, and then you give them access and a shot at a loan that's at the same price as, you know, somebody who has had different advantages in the past -- may have had. And I think the experience with the programs that have done that has for the most part been excellent.

When I talk to groups around the country that are involved in housing counselling programs, and they talk about the default and delinquency rates associated with the portfolios of loans, you know, where they've done counselling, those default rates are often as low as or lower than the rest of the customers for those particular institutions.

And so I think the success is very good, and we don't want to prevent that from happening in the future.

MR. MEDINE: Great. Thank you very much. I'm turning now to Russ Bailey. Russ is the Fair Lending Team Leader in the Community and Consumer Policy Division at the Office of the Comptroller of the Currency.

Oh, George Knight? Is George Knight here? Okay. Returning to Russ. He's with the Office of the Comptroller of the Currency, and he has held his position as Fair Lending Team Leader since 1995. He's responsible for developing and implementing the OCC's Fair Lending supervision and Enforcement Program, and for providing advice and counsel on fair lending issues.

Russ?

MR. BAILEY: Thank you, David. Many of you may not know what the Office of the Comptroller of the Currency is. It is the government agency that regulates national banks and their direct subsidiaries. We are to national banks what the Federal Reserve is to state member banks as far as regularly examining them for, among other things, fair lending matters. We appreciate the invitation to speak to you today and deal with some of these very thorny issues.

The OCC issued a bulletin in 1997. It's OCC

Bulletin 97-24. It deals with credit scoring issues. And I put 200 of them on the table outside the door. I would recommend this publication to you if you are interested in credit scoring issues.

Let me just explain a little bit about what it contains. About the first 7 and 1/2 pages it is fairly arcane. Safety and soundness information on how to develop and validate credit scoring systems and some of the issues that the OCC looks at from a safety and soundness standpoint. And then there are several pages that discuss the OCC's concerns about some of the compliance issues that arise in credit scoring. And if you're more interested in those compliance issues, you might want to skip the first 7 1/2 pages with lots of detailed charts and complicated issues.

The basic question before this panel is, is credit scoring fair. And to answer that from OCC's perspective in some of the terms that have been used today, I think I would have to say that it is impossible to predict on an individual basis. But we think the odds ratio is that credit scoring systems make an underwriting system likely more fair.

Is that okay, Pete?

MR. MCCORKELL: Yes.

MR. BAILEY: Is that stated in credit scoring terminology? We would second Bob Cook's remarks that we think that the greater danger with credit scoring systems is that they still can be used in a discriminatory manner. It is not a panacea. Just because somebody has a credit scoring system, that doesn't mean okay, the underwriting system is, therefore, going to be fair.

We have cited four of our institutions for fair lending violations involving credit scoring systems and made referrals to the Department of Justice. I would just like to talk about those real quickly. Debby said that there always is a person behind the curtain. Well, sometimes the person behind the curtain does stupid and unlawful things. It doesn't happen very often, but it does sometimes occur.

We had one institution that set up their credit scoring system so that if co-applicants were married, they were entered -- a little j was entered in a certain field in the credit scoring database. And then the credit scoring system combined their credit histories, eliminated redundancies, and produced one credit score. It also combined their incomes and produced a combined debt to income ratio.

But if the co-applicants were not married to each other, that little j wasn't entered in that one field in the system. And so what was designated as the primary applicant was scored, and only the income of the primary applicant was counted in computing a debt to income ratio. So they set that system up to begin with to treat unmarried co-applicants differently than married co-applicants, and that's discrimination on the basis of marital status, and that's prohibited by the Equal Credit Opportunity Act.

We had another situation in which a bank had an age-split scorecard. Now, age is the one prohibited basis that Regulation B permits a creditor to take into account in a credit scoring system that is validated. Or in the language of the reg, empirically derived, demonstrably and statistically sound.

But this credit scoring system had not been validated. Therefore, it's use of age in an age-split scorecard was inherently in violation of Regulation B and the Equal Credit Opportunity Act. So they just skipped a fundamental step that they had to take care of in order to use an age-split scorecard.

We had another situation in which the same scorecard was used to process all applications for credit. However, if an applicant applied on the Spanish language application, it took a higher score to pass. Let me say that again. If an applicant applied on a Spanish language application, it took a higher score to pass. In the internal memos in the institution, the group of people who applied on Spanish language applications were referred to as "the Hispanics."

Whenever you get into credit segmentation, and large credit card operations can have lots of segmentations, you run the risk of segmenting the population into some group that is highly correlated with a prohibited basis.

Now, I've heard this -- an anecdotal story when I was making a presentation. Someone said to me, you know, several years ago I ran across a situation where a credit card operation had one scorecard. It was an affinity card for subscribers to Town & Country magazine, and then they had an affinity card for subscribers to Ebony magazine. And they used different scorecards to process those applications.

Now, wouldn't most of us think, whoa, there might be a problem there? Okay. And I think many times people don't realize how many segmentations there might be in a credit operation. It's rare to find it in the mortgage market, the home purchase market, that much of the discussion has been about today. But it's very, very common to find it in other kinds of credit products.

We also made a referral to the Department of Justice on a case in which credit scoring was used as part of the underwriting process for home improvement loans. Since home improvement loans are residential real estate related transactions, we had the government monitoring information on those decisions, which gave us the race of the applicant. And if you made a passing credit score, your odds were six times greater of being denied anyway if you were black than if you were white. And if you made a failing credit score, your odds were twice as great that you would be approved anyway if you were write than if you were black.

We wound up actually going in and pulling a sample -- a random sample of files in doing our own logit regression model of the underwriting decisions that were made at this institution, and race turned out to be a very significant variable. And the loan officers were simply using their override discretion to make a pattern of decisions that we believe was discriminatory. And we referred that case to the Department of Justice as well.

We have a couple of other cases in the early stages. Another situation in which it looks like a bank has built into their system treating married co-applicants differently than unmarried co-applicants. That's in the early stages, however. And we also have another case in which it appears that an institution may have a completely different scorecard for people who apply on a Spanish language application. So we have the credit segmentation problem arising again, at least possibly, in a case.

So those are some of the kinds of things that we run into from a disparate treatment standpoint. We think that there is much less likelihood of a problem from a disparate impact standpoint, and we believe it's a very difficult issue when you talk about impact in credit scoring.

The OCC has decided that it will not cite a bank for a violation of fair lending laws using a disparate impact theory applied to a credit scoring system, until and unless we have developed guidance for the institutions that we regulate, issued that guidance, and then if they violate the guidance, we would not be happy.

One other thing I want to mention. Our Comptroller has spoken out publicly recently about a trend that's developing in the industry of not reporting information to credit reporting services. A number of sub-prime lenders are not reporting performance on those loans, which tends to make it more difficult for someone who is forced into the sub-prime market because of some past credit problems to rehabilitate their credit history and move back into the less expensive market.

Some lenders have acknowledged that they have stopped reporting credit limit and balance information. The Comptroller's concern is that this lack of reporting of data may contribute to the inaccuracy of credit scoring, since the credit scoring is based on the information that's reported to the credit bureau. So that's another issue of concern to us.

Thank you very much.

MR. MEDINE: Thank you.

MR. MCCORKELL: I would like to point out that you've all witnessed an historic occasion. This is probably the first time in memory that Russ and I have ever been on the same panel and haven't disagreed about anything.

(Laughter.)

MR. BAILEY: Well, I wouldn't say we haven't disagreed.

(Laughter.)

MR. MCCORKELL: Well, I don't disagree with anything you just said, Russ.

MR. MEDINE: Thanks, Russ. I just wanted to point out that the opposite can be true from your experience. We've seen the reverse of a company that used a judgmental system, where they failed to aggregate the income of unmarried co-applicants and got such an off the shelf scoring model that did. And so they essentially backed themselves into complying with the law, because the scoring developer knew what the law was, even though their judgmental system didn't provide for that.

So it can work both ways. I'm turning now to Margot Saunders. Margot is the Managing Attorney of the Washington office of the National Consumer Law Center. Her duties include representing low income clients in Congress on financial credit issues. And she has testified on numerous occasions before congressional committees on the impact of various proposals on low income households, and is the author of numerous articles on consumer and utilities law as they affect low income people in the United States.

Margot?

MS. SAUNDERS: Thank you. And it's a pleasure to be here today. The National Consumer Law Center is a public interest law firm that has its main offices in Boston. But we represent low income people through the legal services programs all over the country, and I've been doing this for over 20 years.

So it's with that perspective that I bring this information to you. Much of what I was going to say has been said. I'll only repeat some of it. My folks, the experts in credit at the National Consumer Law Center, are unequivocally convinced that credit scoring is biased against poor people. And some of the reasons that we expect that to be true are some that have been mentioned already today.

For example, as was just mentioned by Russ from the OCC, some major providers of mortgage credit and other credit in the sub-prime market are not reporting information at all. Those are most likely to be low income people who are not getting the benefit of positive credit scores from this. Much of the credit obtained by my clients from finance companies, rent to own companies or payday loans, either is not reported or is reported in a way that will result in a lower credit score. And the cost of the credit, as Debby mentioned, is very high. If they do get it, it is far more likely that they will default, which will lead to a bad credit rating.

Credit scoring is based on statistical relationships, not causal links. I'm a Jewish woman. There is a statistical relationship between Jewish women and a certain kind of breast cancer. That does not mean because I am Jewish that I will get breast cancer. And it's the distinction between a statistical relationship and a causal link that we think has to be made before credit scoring can truly be evaluated.

For example, when you look at Fannie Mae's numbers, according to Pam Johnson's presentation, if you have a credit score of less than 620, then there was a 3.1 percent chance that you would default, as opposed to if you had a credit score of greater than 720, I think was the number, then it would be less than a one percent chance that you would default.

Well, what about if you've got a credit score less than 620? That means you also have a 96.9 percent chance that you won't default. And has anybody done the analysis between the people in that group to see the distinction in that group and what might be causing those two very different numbers? And guess what's happening to those -- that's a hundred people -- those 97 people who are not defaulting and yet are paying the price for being somehow lumped in the group where there is an extra two percent chance that they will default.

And I want to reemphasize something that Debby said. Credit scoring is intended to provide guidance to multi affiliated lenders to steer riskier borrowers to higher price lenders. But will the reverse also be true? If I walk into Nation's Credit, or a finance company that is affiliated with a bank, and I qualify for the finance company loan, but I also would qualify for the bank loan at a much lower rate, will I be sent down to the bank? No. But if I go into the bank and I don't qualify for anything but the finance company loan, I'm sure that I will be sent over to the finance company. And that is something that I know -- I understand the Federal Reserve

Board is concerned about, but let's see some action on it.

(Laughter.)

MS. SAUNDERS: I'm very popular. The greater --

MR. COOK: More than you know.

MS. SAUNDERS: We really get most concerned about credit scoring, because it's going to lead to this new thing of risk based pricing. Well, risk based pricing has been in existence for years. When I started practicing 20 plus years ago, we had finance companies in North Carolina that were, and still are, allowed to charge 36 percent. And the stated reason in the laws that created the small loan acts all over the country that purported to allow 36 percent -- that did allow 36 percent, was that these were riskier loans.

Well, the question becomes, at what point does higher risk cause risk. If you -- if Peggy and I have the same amount of income, and I get a loan for 100,000 at seven percent, and she gets a loan for 100,000 at 12 percent, guess who's got a higher chance of defaulting. That's obvious.

The other very important point that applies to my clients, is that there is a tremendous difference between risk of loss and risk of default. When you are dealing with a loan which is more than adequately secured by a home, which sub-prime lending mortgage loans are always -- they're very often a very high loan to value ratio. There may be a very high risk of default and rollover -- flipping of the loan. In fact, we think -- or we are convinced that that is an intent -- the intent of some of the lenders. They like the rolling over of the loans, because that way they get to charge more points and closing costs next time and strip more equity out of the home.

But there is never a risk of loss to the lender, because there is so much equity in the loan -- in the home, excuse me -- that even when there is a default and a foreclosure, the loan and all the associated costs with the foreclosure will be covered by the sale of the home. So risk of loss should be what's measured, not risk of default, in creating -- in justifying risk based pricing.

And as I was happy to hear Robert Cook say, when you do risk based pricing, the risk base -- the extra cost of the loan should be closely tied to the extra actual risk imposed by that loan. Well, let me tell me. We've got lots of numbers already which show that riskier loans -- sub-prime loans -- are far more profitable to the lending industry than the A loans are. Which means that if they're more profitable, then the amount of interest or the payments on those loans are covering a lot more than just the added risk.

We know this by comparing banks' income and profit and loss statements to finance companies' profit and loss statements. For years we have been able to see that finance companies have a return on the dollar that's two or three times what banks have, which is why banks are now moving into the sub-prime market.

So I think you already have some jobs cut out, regulators, and we'll be glad to help nudge you along. Thank you.

MR. MEDINE: Margot, I wanted to raise a question that you didn't touch on, which is it has been suggested in the past that certain low income people do have spending histories, but they're not with credit cards. They're with utilities. They're with landlords. And those are not reported on the credit reports, which then serve as the basis for risk scores.

Do you have a view on how important that is to the fairness of the scoring process, that certain payment type experiences are not incorporated into the score?

MS. SAUNDERS: I think it's unfair. I mean, I was actually struck by the Freddie Mac presentation, where it was said unequivocally that they do not look at the neighborhood, which is a related issue -- the neighborhood that the customer lives in or where the house will be purchased -- as indicators of whether they will make that loan. But those issues are already probably subsumed within the credit score, which is a factor in their overall mortgage underwriting.

So I think there is -- and the reason I didn't address the utility question was because I missed the first section this morning, so I wasn't quite sure what he said on that, to tell you the truth.

MR. MEDINE: Okay. Well, maybe we'll have people comment on that later on.

MS. SAUNDERS: And I also thought, you know, when Pam said that -- Pam pointed out that there was very clear numbers that 39 percent of very poor people had credit scores over 740, and 38 percent of very rich people had credit scores over 740. I wonder, though, exactly which poor people those are, because I have trouble --

(Laughter.)

MS. SAUNDERS: Trouble assuming that they're many of my clients. Yeah. I think they may be med students and so on.

MR. MEDINE: Okay.

MS. SAUNDERS: Thank you.

MR. MEDINE: Thanks very much, Margot. Our last presentation is from Raj Mehra, who is the Director of Financial Risk Management Consultant Practice of PricewaterhouseCoopers, with responsibility for mortgage and a specialty of finance risk consulting. He clients include mortgage and specialty finance companies, commercial banks and thrifts. He has over 12 years of experience in mortgages in the capital markets. And prior to joining PricewaterhouseCoopers, Raj spent several years on Wall Street as a Senior Mortgage Strategist.

Raj?

MR. MEHRA: Thanks, David. Glad to be here this afternoon. I just want to talk about a couple of things. Many of my clients are mortgage lenders. A good portion of them are sub-prime mortgage lenders, residential mortgages, as well as manufactured housing that no one has spoken about out here this afternoon. I just want to talk about a couple of things that some of the folks in the panel made mention of.

It was interesting that Bob Cook made mention of overrides, and said what really concerned the Federal Reserve Board more than anything else were the low side overrides. That kind of makes sense when you're talking about safety and soundness of the bank. The sub-prime lenders that we work with do a pretty good job tracking low side overrides, because it affects the bottom line. If you make a loan that turns out bad, well, you know, that's bad, right.

The one thing that they do not do as good a job tracking -- and we're constantly talking to them about it -- is the high side overrides, where the scorecard model says that it's a good credit, accept it, and they don't. That's a high side override, and the lenders don't do quite as good a job tracking the high side overrides. And I guess what I mean by tracking, it often boils down to -- if you have a low side override, you can track the performance of the loan with the decision that was made to make that loan.

And you ought to be able to do the same thing with the high side overrides. Loans that you did not make, you ought to be able to track that performance to see if it was a good loan or a bad loan. In fact, a couple of days ago I was speaking with a client of mine, a lender, and I pointed out to the gentleman that the percentage of high side overrides that his firm had made were 30 percent over the last year. And he said, you've got to be kidding. That much? He said that's a lot of business profit we're giving up.

So I would argue that for purposes of consumers and discriminatory lending, maybe high side overrides is an area that ought to be talked about more frequently than low side overrides for the purpose of this panel.

The second thing -- and this really talks to another thing that members on the panel have spoken about, which is the whole issue of is credit scoring a black box or is it not. I believe someone from Freddie Mac spoke this morning and said well, it's not going to be a black box. We've got all the stuff.

I can tell you that with the exception of some large, sophisticated lenders primarily in the A market, there are many lenders out there for whom credit scoring models are literally a black box. For sub-prime lenders, for the most part, once again, unless they're very experienced, large companies and been there for many years, for them to buy an off the shelf system -- and for a lot of them, it is a black box.

I think Debby made a very good point when she said there are a large number of lenders out there that are not regulated. You've got banks that are regulated by the OCC and the Federal Reserve Board. There are a good portion of lenders out there, sub-prime lenders, monoline independent lenders not affiliated with banks and not affiliated with any other regulatory corporation. They're not regulated at all.

And I think it's an issue of -- you know, the process needs to be fixed. And that's all I'm going to say for now.

MR. MEDINE: Thanks. Maybe you could just give your views as to why as many high side overrides occur as do. It seems somewhat counter intuitive, and I guess the corporate executives had the same reaction. Can you explain some of the factual circumstances that would lead to someone with a high score going to a sub-prime lender and not getting a loan?

MR. MEHRA: I think there are a variety of factors. It could be as simple as -- I mean, lenders will never document the information. But it could be as simple as, you know, a judgmental call based upon, you know, some things that are not captured in the scoring model, or that they cannot possibly include in the scoring model. But nonetheless the lending officer -- because the whole point of overrides is that it gets reviewed.

If someone decides to accept or reject a score, it has to get reviewed by a human underwriter. At that point, judgment enters into the equation. And, you know, if an individual is bias, or an institution is bias, it could enter into that decision. It could be as simple as, I think as Bob mentioned, you don't like the face or didn't like the way credit was performing. Didn't like the way the defaults had been occurring in that particular part of the country.

And geographics is a very -- studies have shown that geographics statistically are quite important predictors of default. They may not be included in the credit scoring model, but by the same token, if you have an override situation, someone may well just apply that. We would never know.

MR. BAILEY: Can I help?

MR. MEDINE: Sure.

MR. BAILEY: In answer to that question, David, it's our experience that you'll almost always find significantly more high side overrides than low side overrides, because there is almost always other criteria than the credit score. Just to simplify it, let's say it's only a credit score and a debt to income ratio. You must score at least 200 and your debt to income ratio shall not be more than 40 percent.

Well, if somebody has a 220 credit score, but their debt to income ratio is 45 percent, and they turn it down for the debt to income ratio, that will be counted as a high side override, because they passed the credit score part of it. And there are typically more than just the one other policy criteria, and so that's how you get so many high side overrides.

MR. MCCORKELL: There's also a cover your tush aspect to that. If you make a low side override and the loan goes bad, the boss may come back and say, why the heck did you do that one. That was a stupid decision. If you make a high side override and you turn it down, that loan is not going to come back to haunt you, because there's no performance there to come back and bite you.

MR. COOK: And just a footnote on what Russ said, there are pet reasons. And DTI may, because the GSE's have done studies and shown that DTI is not a particularly --

MR. MEDINE: You may want to not use quite as many acronyms here, even though we are in Washington.

MR. COOK: Debt to income ratio is not as predictive a factor as, for instance, loan to value, and therefore many scoring systems don't point up. Don't weigh debt to income as heavily as, for instance, loan to value, and therefore a low debt to income ratio might pass the scoring system.

But a particular lender, perhaps a lender who is still in the dark ages, may love debt to income. It's his favor ratio. And despite the fact that it's already been taken into consideration for its predictiveness in the scoring system and passed, the lender decides no, I'm not going to give a 44 debt to income ratio alone. And that's a high side override.

MR. MEDINE: Pete, we didn't give you an opening statement, but why don't you take a few minutes, if you would like, to respond to some of the questions that have come in before we open it up for discussion.

MR. MCCORKELL: Thanks, David. First of all, this morning I mentioned the LMI and HMA studies we did. They are written up in detail in a booklet. I sent some of those ahead. They apparently got hoovered up by about 8:30 this morning by the early arrivals. If you want one of these and you didn't get a chance to pick it up, give your card either to me or to one of the people on the Commission staff and I'll make sure you get one.

Secondly, Margot, I think you actually mis -- kind of misquoted what Pam Johnson said. The three to one was a relative ranking. Those were not default percentages. She was saying that the low score folks had a three times high default rate than the ones in the average group that had the one as the reference point. It wasn't one percent and three percent.

MS. SAUNDERS: The slide went by so fast, that's very likely. But is the message not still the same?

MR. MCCORKELL: Well, yeah.

MS. SAUNDERS: It's still not a huge majority of people in that last group?

MR. MCCORKELL: Sure. And I brought that out this morning, that for most lenders in order to make money, you've got to set your cutoff at a point where there would be more goods if you accepted those people than bads. But because the loss from a bad, however that's defined, is going to exceed the profit from a good, you can't wait until you're absolutely sure that everybody you turned down would go delinquent or go into default.

First of all, you can't know for sure how individuals are going to perform. And if you try to extend money to everybody, unless you are absolutely sure they will go delinquent on you, you're going to be bankrupt.

To address some of the things that Bob really kind of threw my way early on, first of all I very much agree with the concerns about disparate treatment relative to overrides and quality of assistance. But I would argue that those are not credit scoring issues. In fact, if you're not using credit scoring, in a sense all of your decisions are overrides.

The overrides are when you are ignoring what the credit scoring system tells you. So I don't consider that a credit scoring issue. It is certainly an issue that remains for somebody using a credit scoring system, but not using a credit scoring system doesn't make that problem go ahead. It just makes it true for your entire decision set.

In terms of a disparate impact analysis and really defense of disparate impact challenges, for custom systems, actually, the credit grantor would get the statistics to sort of answer those questions that Bob posed. For a system like the credit bureau system, in fact, we do have the statistics that say that we put a finance company in there because in the development sample, people with finance company histories were three times more likely to go delinquent on a subsequent obligation than people with no finance companies. And we will provide those statistics to a credit grantor if they are challenged.

Finally, on the finance company issue, that's probably the one factor that's in the credit bureau system that people consistently ping on, because they're convinced that it's unfair to minority and low income borrowers. In fact, the research that we did and that is detailed in here indicates that if you use a finance company properly, which is to use it in terms of the number of finance companies, rather than finance companies as a percentage of total trade lines, there is virtually no difference between high income and low income and between minority and non-minority borrowers in terms of the number of finance companies they have used.

So the argument that it even has a different impact, while it certainly has a lot of intuitive appeal, it does not seem to be backed up by the data.

MR. MEDINE: Well, I guess two more points that were raised. One is the issue of utility and other nontraditional credit reporting and what impact that would have on low and middle income people. And then the second one was raised by Russ about the trend among some sub-prime lenders of not reporting to credit bureaus.

MR. MCCORKELL: Okay. Well, in both cases, you know, Fair, Isaac's position would be that we would love to have the data. And I'm sure that if you march down to the Hill tomorrow and tell Congress that they ought to pass a law requiring utilities to report to credit bureaus, all of the credit bureau folks would be very happy, and so would we. I don't know that that's politically a realistic ambition.

There are certainly certain kinds of lenders and others who are extending utility credit that simply don't routinely report to credit bureaus, and some of that is a cost issue, quite frankly. That data might very well be predictive. The fact is that it's generally not there. All that is there are the negative reports when somebody goes into collection.

The same thing is actually true of a lot of mortgage lenders. We know mortgage loans are vastly under reported. Rental obligations are almost never reported unless they are delinquent. We would love to see them report it and collected in such a way that we could explore those data. But right now the data are simply not available in any way that is reasonable to get at.

The same thing with the sub-prime folks not reporting, apparently to try to protect the low risk sub-prime customers from being picked off by non-sub-prime lenders. I agree that's a problem, but I don't know what to do about it. Again, if somebody thinks you can get mandatory credit reporting through Congress, I'll testify in favor of it.

MR. MEDINE: I guess the question that turns around, though, is have you been able to assess what impact it has on scores and their predictiveness to not have the sub-prime lender reporting, and to not have the utility and other information in the database.

MR. MCCORKELL: Well, it's hard to assess the impact of information that you don't have and have never had. The one -- the other sort of non-reporting issues that came up recently is some credit card issuers not reporting limits. There for a long time we did have that information. We did do an assess there, and it turns out not to have a drastic impact on our credit scores to date.

And I sort of need to qualify that a little bit. Credit scoring systems, if they're well designed, are designed to be fault tolerant in a sense, that if some information is missing, the scoring system will still do a good job of giving you an accurate risk assessment. So if somebody takes a piece of information out of the system, like balances on some credit card accounts, the scoring system is designed to still continue to provide a pretty decent risk indicator. And the indications are that it's doing the job.

Now, it does -- the loss of that information has impacted the system slightly. No clear indication yet that it's either favoring or not favoring consumers in general, or favoring or not favoring particular classes of consumers. It is making the system a little bit less predictive. But I have to stress little.

Our big concern there is that that doesn't become just the first loop of a death spiral, where we get into this kind of tit for tat game among credit issuers, were the first guy says, well, I'm not going to report limits any more. And then somebody says, well, I'm not going to report limits, nor am I going to report high balance. And the next guy comes along and says, well, I'm not going to report limits, high balance or current balance. And all of a sudden not very much is getting reported.

And certainly we are concerned about that. I know the credit bureaus and ACB are concerned about that. A lot of the regulatory agencies are concerned about that. Again, the only foolproof solution may be mandatory credit reporting. I'm all for it If you think you can sell it down the street, let me know. I'll go with you.

MR. MEDINE: Okay, thanks. Why don't we take this chance to open up the discussion to the audience. I know people from earlier -- people have a lot of strong views in this area. And if people would like to focus in particular on the fairness issue with regard to scoring, that would be great.

Why don't we want until you get a microphone, and then once again, identify yourself, and please for the reporter, spell your name.

MS. ISEMAN: It's Caryl Iseman. And, Peter, this question is to you. The thing that puzzles me when I look at reports -- and this is a report I have right in my hand. Under the scoring models that I'm looking at for Trans Union and TRW and Equifax, one of the things that this borrower is being dinged on is the number of recent inquiries, and he has one. One. I have another one that has none on it.

And I guess what I have, it always says --

MR. MCCORKELL: Has no inquiries and that's still cited as a reason?

MS. ISEMAN: Yes. He has one inquiry.

MR. MCCORKELL: No, I'm sorry.

MS. ISEMAN: Thank you.

MR. MCCORKELL: One inquiry in fact is a little bit riskier than no inquires. That's probably not the first reason cited. It's probably the fourth, and they are cited in order of importance. And the one inquiry probably made very little difference in the score, but the system is set up to provide the top four reasons, whatever they are.

The third and fourth reasons may have very little contribution to why the score is less than wonderful, if in fact that's somebody that's got a less than wonderful score. If it's somebody that's got a bankruptcy, a whole string of delinquencies and one inquiry, the one inquiry is not their problem.

MS. ISEMAN: Well, then I guess my question to you would be, if one is too little and maybe ten is too much, what's perfect?

MR. MCCORKELL: Well, unfortunately that all depends. We talked about the segmented scorecards. One inquiry for somebody that's got one trade line and has only been in the file for six months may be more than ideal. And again, understand that we're talking the points off of maximum here. We're not talking about what's average.

One inquiry in fact is average for the entire credit bureau population. So the one inquiry there, they may have gotten fewer -- they would have gotten more points if they had no inquiries instead of one. They might have gotten three more points.

MR. SMITH: How do you know?

Well, I don't know, unless I have a chance to review that credit report in detail and see everything on that credit report and compare that against the scorecards.

MS. ISEMAN: Okay.

FEMALE SPEAKER: Can I --

MR. MEDINE: Wait, one person at a time. We only have one mic out.

MS. ISEMAN: Just going along with this, too, because -- and, yes, sometimes the three points does mean something. You have -- again I'm back to a required 640 credit score, and I have to use the mid score. And I've got a 639 and a 637 and a 625, and the mid score might be that 639. But I can't use it, and because of the 639 and because this guy had one inquiry, he lost three points.

That's where my problem is, too. One of the other things -- and by the way, this is a good -- this particular person has over 700, but I'm just pointing this out.

MR. MCCORKELL: Okay. They had -- you know, 700 is not a perfect score. Almost nobody gets a perfect score. Somebody could have an 880 and they would still get four reasons back.

MS. ISEMAN: I understand that. I'm just saying that I see this on -- I just happen to have this report in front of me. The other thing here that we have is insufficient length of credit history. They have accounts on here since 1994, and most of their accounts are 1994 and 1995.

My question is -- and they have quite a few accounts that are paid off, etc. What is pp

MR. MCCORKELL: It would be better if they had 10 or 20 years of credit history instead of four or five.

MS. ISEMAN: So you're telling me that six years -- five years of credit history is insufficient?

MR. MCCORKELL: I'm telling you it's not ideal. I'm telling you that that's why they got a 770 instead of an 870. I'm not telling you that they are a bad credit risk. There's no lender in this room who would tell you that 770 is a bad risk, and you know that.

MR. MEDINE: Okay. Why don't we just get some comments.

MS. ISEMAN: I guess the problem I have is the inconsistency. Because I can pull an entirely different report that also shows up where the people have credit maybe two years, and I would not see a statement on there that says anything about, you know, lack of credit history.

MR. MCCORKELL: Well, in this case -- in this case you probably don't have any serious delinquencies, because you're dealing with somebody in the 700's. And so we're talking about why they're not perfect. Not why they're not a good credit risk. They are a good credit risk. We're talking about why aren't they -- why didn't they get a perfect score.

Somebody who has some delinquencies, some public record items or some collections, the length of credit history and the number of inquiries may be essentially -- they may be down -- they may be the seventh and eighth reasons on that report, not one of the first four.

MR. MEDINE: Well, let's get --

MS. ISEMAN: What I'm trying to point out --

MR. MEDINE: You know what --

MS. ISEMAN: It's not the perfection. It's the scoring models don't make sense. And when you tell me -- and by just what you said, okay -- that one is worse than none, I have a problem with that. So we do have a problem with the scoring models.

And can I ask --

MR. MEDINE: No. No, you can't. There are a lot of other people who would like to chat. And if we have some time, we'll certainly be happy to come to you. If there is anyone who has not had a chance to speak today who would like to make a comment? All the way in the back. And just a reminder. If there are folks in the overflow rooms who would like to come down and ask a question, they're very welcome to do so.

If you could just identify yourself and spell your last name.

MS. HUMPHRIES: Kim Humphries, H-U-M-P-H-R-I-E-S. There are about three points I would like to make. And, Mr. McCorkell, if you addressed this in your comments on the finance company, I apologize. I missed it. But I believe you were stating that there was not really any statistical difference between the amount of usage of finance companies?

MR. MCCORKELL: Number of finance companies.

MS. HUMPHRIES: The number.

MR. MCCORKELL: Which is the way it's in our scorecard.

MS. HUMPHRIES: Okay.

MR. MCCORKELL: Now, if you had a characteristic that was percentage of finance companies, or percentage of balances on finance companies versus other kinds of lenders, then there would be a difference. But that's not how we use it in our bureau scoring system.

MS. HUMPHRIES: Well, I question the negative viewpoint of that at all, given, I guess, you know, particularly when a lot of those offer 60 days or six months same as cash and, you know, the convention wisdom of financial planners is using other people's money. If you can have that free cash for six months, why not.

MR. MCCORKELL: Well, again, it's in the scoring systems, because the historical data shows that as a group people that use finance companies are a little bit riskier than people who don't use finance companies. If you remember from the presentation this morning, I listed the five categories of credit bureau information that we look at. Type of credit was the last one. It's the least important of those categories. And so even where it comes up, it's not a dominant feature in the credit scoring systems.

But statistically there is still evidence that the use of finance companies indicates a higher level of risk with respect to future credit performance. Now, I can tell you that because of the 60 days same as cash or the six months same as cash kind of programs that we're seeing from a lot of retailers, where in fact if you sign up for that you wind up with a finance company account, that the predictive value of finance companies is going down over time. But it hasn't gone away entirely.

MS. HUMPHRIES: Okay. And what is the lowest credit score? Is there a minimum?

MR. MCCORKELL: Well, there are many different credit scoring systems. In the Fair, Isaac credit bureau systems, which is probably what you've got in mind, the range is from somewhere in the low 300's to something close to 900. Again, you don't see many 900's. You don't see many 325's. That's kind of where the rubber meets the road in terms of decisions. In most cases it's somewhere in the 600's.

For most kinds of credit, 700 or maybe a little bit up in the 700's. Anything above that is considered golden for most kinds of credit. Anything below about 550 is considered awful. And so the range where decisions are really being made typically is in that high 500's to low 700's range.

MS. HUMPHRIES: Okay. I think -- I was looking through some of the brochures I picked up outside this morning, and several of them -- and these are consumer directed literature. Several of them state that, you know, consumers have the right to everything in their credit report, and that's not true. I think it's deliberately misleading them. I mean, the credit score is a part of the credit report, and they don't have the right to that information.

And I guess what I haven't heard is a good reason as to why not. Certainly it is helpful to have the supporting information, sort of the narrative explanation of what your credit report is and what on your credit report is being a problem with you getting a loan. But it's also helpful for the consumer to have the actual score, so that they can evaluate for themselves where they stand in relation to everyone else.

I really would like to hear, I guess, some rationale as to why not. Why don't they have the right to that?

MR. MEDINE: I think that's an excellent

question that will actually be discussed in the next panel. The short answer is that Congress in 1996 changed the Fair Credit Reporting Act to tell credit bureaus they did not have to provide that information. But we will be discussing the pros and cons of that in the next panel.

If there are any -- did any questions come up that any panelist wants to weigh in on?

MS. GOLDBERG: Yeah. I just wanted to kind of speak back to this last question about the impact of things like finance company usage and kind of take away from you the statistical analysis and the defensive, is credit scoring inherently good or inherently bad, or is the FICO system or any other inherently good or inherently bad.

Just kind of think of it from a bigger consumer protection and fairness perspective. And I think -- to me it seems like it is very important for us to realize that we are not starting from square one in this country. We do not have a perfect economic system. We have a system that has a long history of discrimination, and of restricting the access of some people in this country to mainstream credit and limiting them to what some people have termed the fringe banking system with all that goes along with that.

And I think one of the questions that we have to answer in trying to figure out is this kind of approach to allocating credit not -- don't get nervous now, regulators. You know, to making credit decisions. Let me put it that way. A good one or a bad one, from kind of a larger public policy question, is -- you know, it's important to understand what it means to have been someone who lives in a community, or who for other reasons has only been able to get high cost credit, who, you know, maybe they're good and their credit record doesn't show up in a credit bureau, because it is cash payments, or because it's been sub-prime lenders who aren't reporting that back to the credit bureau.

And do people get stuck in the fringes of the banking system, where they are going to be paying more, even though they are good at paying, and even though if they could have credit on terms that were more affordable, they would be even better at paying.

And to me, that's one of the big questions that kind of remains unanswered. We tend to focus on the statistical question of, you know, is this a good predictor or is this not a good predictor. And not so much on what is the impact on individuals' lives, and how do we make it possible for everybody in this country to get access to the best possible credit when they need it. Best possible meaning the lowest cost and the safest terms.

And I think that's something that we really need to focus on more.

MR. MCCORKELL: Okay. I actually agree with you very much there, Debby. You know, I may have a suit on, but I'm actually a Berkeley grad, a Kennedy Democrat -- and I mean John Kennedy, Sr., not any of the current crop. Well, maybe some of the current crop. Not all of the current crop.

And clearly we're not starting from a level playing field, and clearly I believe, personally, that there is still subsidies and other forms of special assistance that are going to be required to get people out of that kind of vicious cycle. And unfortunately subsidies or affirmative action have become a dirty word in this town and across the country, and especially in California.

So, you know, you've got to live with that political reality, as much as it may gaul you. But credit scoring is not the answer to those bigger social issues. Credit scoring is intended to provide the most accurate possible risk assessment that we can without regard to race or gender or any other prohibited basis. And all of the evidence is that it does that.

Having said that, there may be people that need some help to get out of that vicious cycle that has still large segments of the population as second class citizens when it comes to economic factors.

MR. MEDINE: Any other first time commentors?

MS. MS. WELSH: Hi. Kristy Welsh, K-R-I-S-T-Y, W-E-L-S-H, and I'm with creditinforcenter.com. And I had a question about what Mr. Cook said, that the Federal Reserve Board regulates or somehow evaluates the FICO scoring.

How is this done? How is it tested? Are we going through a statistical analysis? Do we take case A, B, C and B and run them through the scoring? Hey, we know for sure that it matches what it should match. And if so -- I mean, you said that this was done. Is this published anywhere? Can we get a copy of it?

MR. COOK: Well, I may have mis-spoke. I don't think I said that we evaluate credit scoring systems per se. I will say that HUD has currently embarked on a study of the scoring systems of the GSE's -- Fannie and Freddie.

No. I do -- I can tell you that in 1996 -- and, Bob can correct me if I'm wrong, if he's still here -- the Fed did undertake an analysis of credit scoring systems in the sense of trying to determine whether or not there were solid correlations between low scores and poor performance. And generally they found that there were. That credit scoring systems do tend to be predictive of behavior.

But that leaves a lot of room, I think, for issues today.

MS. WELSH: Right. So they haven't been evaluated for bias or discrimination or any of these kinds of things?

MR. COOK: No. This was not an exhaustive study of each factor in a given scoring system and a relationship. I guess one of the questions that I didn't quite follow up on with Pete, you stated that the statistics are available for your clients to understand and appreciate the various risks associated with each of the factors, so that if they're called upon to justify the inclusion of a particular factor, it's predictiveness can be quantified for them based on the statistics that you've done.

But let me ask you this, sort of a further question. Recognizing -- sort of taking off on Debby's approach -- that we're talking perhaps more than just the legal requirements here. Recognizing that probably you don't have a legal obligation to do the rest of the analysis, to do the third stage of a -- what did we call it -- disparate impact analysis, that while there may be a justification for using something like finance companies -- a number of finance companies -- is that the least -- does it produce the lowest impact, or is there another set of factors that you could have used that would produce a lesser impact?

MR. MCCORKELL: Well, of course the lesser impact is only half of the third leg of a disparate impact case. Is there something that is equally effective but has a less discriminatory impact. And with the dearth of data on protective classes, especially race and ethic origin, accept in mortgage lending it's very difficult to do that. Is there a less discriminatory alternative analysis?

We have tried to do that using the zip code surrogate that I talked about this morning in the HMA study and, indeed, in a sense our choice of number of finance companies rather than some other way that we might have used finance companies, reflects that kind of decision. We said if we use number of, it won't have a disparate impact, whereas if we use percentage of trade lines that are finance companies, that, at least arguably, looks more like it has a disparate impact.

So where we have any evidence of that sort, we certainly can take advantage of it to try to minimize that problem for ourselves and our client. But, in fact, probably in most cases, the leg that we would expect to stand on is that if we've done the best job of selecting the most predictive set of characteristics.

And the weighing for that set of characteristics, you're going to be hard pressed as a regulator or as a private plaintiff to come along and say here's an alternative that's less discriminatory but equally effective, because we think we've kind of foreclosed the equally effective part of the argument by building this system that's most predictive.

MR. MEDINE: We have time for maybe one or two more comments. I see Frank Torres from Consumers Union in the back. Welcome.

MR. TORRES: Oh, good. That means I don't have to say my name and spell it then?

MR. MEDINE: T-O-R-E-E-S.

MR. TORRES: I just have three questions, and they're all interrelated, to the whole idea behind garbage in and garbage out. And the first goes towards an issue that I don't think has been adequately addressed here, and maybe we need to have a whole other workshop on it.

And that's the ability for consumers to easily fix problems that they see in their credit report. And I know Congress has done some things, and the FTC has been good on that. But I think that will help ease some of the pain of consumers, who when they go and apply for credit and they're subjected to higher rates and higher fees because of their credit scores -- the credit report coming back and there are some problems with it, and then you seem to be at the mercy of the credit issuers for reporting things in -- to try to get it fixed. And I think there is still a lot of confusion and concern about that.

The second point is, will it make any difference if your good payment history is reported if the factor that lowers your score is the fact that you've gone to a finance company? Because if that's the case, then we're talking about perhaps a bigger difficulty in the system that doesn't seem to be quite logical, at least to me.

If I'm pulling myself up from the bootstraps, I may not have a credit history to begin with, so that's almost a strike against me, that I haven't gone out there and gotten a lot of credit, because I may not trust credit card companies.

MR. MCCORKELL: You're better off to have a good history with a finance company than no history at all.

MR. TORRES: Yeah. But there are still problems if I have a history with a finance company rather than a bank, though, right? Is that right?

MR. MCCORKELL: Well, you would be better if you had a good history with a bank than if you had a good history with a finance company. But, again, I'm speaking in terms of -- you know, in relative terms. A good history with a finance company and everything else looks goods, you may be just fine.

MR. TORRES: And my final question is -- and I just, you know, was in some discussions over lunch, and I saw in some literature that actually if you are a consumer and you want to try to do kind of the responsible thing in some cases -- and that is, you know, perhaps consolidate some of your credit cards because you've gotten a lower -- you've gotten one of the -- you've taken advantage of a teaser rate or something, let's say, and you think you can kind of work the system so that you are lowering the cost of your credit. And you actually consolidate maybe three or four cards into one.

And that actually can hurt you on your credit score, is that right?

MR. MCCORKELL: Could it? The answer is yes. Would it always? No. Again, I would have to see the entire credit report, and I could tell you if this person does this and nothing else changes, then here is the effect that consolidating those three accounts into one would have. But as I mentioned this morning, something else will change, and I can't tell you what will be, because of the passage of time.

MR. MEDINE: Let's put it another way. It is partly the relationship between credit balances and credit limits?

MR. MCCORKELL: Yeah.

MR. MEDINE: Consolidation could actually give you a much closer tie to those two if you pull all your debt into one account?

MR. MCCORKELL: Yes. Yeah.

MR. MEDINE: Okay. We have -- Frank, did you have another question?

MR. TORRES: No, that's it.

MR. MEDINE: Okay.

MR. TORRES: I think it just goes to the point that especially if there is going to be a movement towards more risk based pricing that there is still a lot of seemingly unanswered questions or kind of quirky areas that need to be resolved if consumers are to be helped and not hurt by this system.

MS. SAUNDERS: David?

MR. MEDINE: Sure, Margot?

MS. SAUNDERS: I would like to respond or follow up a little bit on what Frank was saying. I think it disturbed a lot of us to hear Peter say that you're better off having a good history with a bank than you are having a good history with a finance company.

There are some -- obviously, I would guess, that you have found that the statistics are that people who have a good history with a bank will have a higher probability of paying on time than those who have a good history with a finance company?

MR. MCCORKELL: Yea.

MS. SAUNDERS: So you have numbers to back up that statement. But intuitively it feels wrong, and that's -- let me give you some reasons why it feels wrong. I think some of it has been stated already. One is that there are no banks in low income neighborhoods, so the people who have no choice but to go to finance companies are getting dinged because that choice is not wrong -- that choice is not available.

Number two -- and number two is, in some ways a good history with a finance company borrowing the same amount of money should give you a better credit score than the same -- than a good history with a bank --

(Applause.)

MS. SAUNDERS: Because --

MR. MCCORKELL: Well -- okay.

MS. SAUNDERS: Because you're paying a higher rate, so that repaying the same amount of money is that much more difficult. Then when you add to that the factor that you're probably poorer than the people who are borrowing the same amount of money from the bank. This is why it feels wrong.

MR. MCCORKELL: I understand why it feels wrong. All I can tell you is that the data don't support the argument in terms of predicting future credit performance.

MR. MEDINE: Why don't we -- I'm going to -- right. We're going to leave it -- I think Margot's question and Pete's response demonstrate that the issue of fairness -- that this is just the beginning of a discussion and not the end. But it's the end of this session.

We're going to take a 15 minute break, and we'll come back again. Thank you.

(Brief recess.)

MS. TWOHIG: Thanks. We're running a little bit late, but I think what we'll do is, we'll try to give this discussion -- give it its full due. And I think we'll just probably make closing remarks pretty brief. So I think we'll still be able to cover the subject adequately, which, of course, has already been touched on.

Our last panel is going to talk about what information should consumers receive about credit scoring, and who should provide it to them. What should they know and who should tell them about it. Some very strong feelings have been expressed so far. Why shouldn't consumers know their scores. Why shouldn't consumers learn the factors that go into that. And those are some of the questions I would like these panelists to address.

In addition, one question I have is, how do whatever consumers know or don't know about their scores -- how does that relate to shopping and whether they can get the best price, or know what the best price is they could get. So those are some of the questions we would like this panel to address. And then as we did before, we'll open it up for questions from the audience.

One thing I would like to say just as background, just so we all understand the legal situation, as David mentioned earlier, the Fair Credit Reporting Act currently states that consumers have a right to all information in their credit file, except their credit scores.

But something that has been eluded to by some of the speakers, I want to make sure everyone also understands that there is nothing in the Fair Credit Reporting Act that says that consumers -- that the credit bureaus cannot voluntarily give consumers their scores, nor is there anything that says that lenders could not voluntarily choose to give consumers their scores.

So just because the law says consumers don't have a legal right to it doesn't mean that that could not be done as a matter of voluntary choice.

With that background, we would like to start with Virginia Ferguson. Ginny is Vice President of the National Association of Mortgage Brokers. She has over 18 years experience in the real estate industry, and is a loan originator and currently is the co-owner and broker of Heritage Valley Mortgage in California.

She has acted as co-chair for the National Association of Mortgage Brokers Credit Scoring Task Force for the past three years, and is an industry spokesperson and trainer on credit scoring.

Ginny?

MS. FERGUSON: Thank you very much, and thank you for having us share and participate in this forum today. I think if we've learned nothing else today, it's that credit scoring is a very large mystery to everybody in the industry. The lack of education out there is incredible on both sides of the fence, whether you are a consumer or whether you are a member of our industry.

To that end, this panel was asked to address who should be educating the consumer. And whether that is a consumer counselling group or the front line mortgage originator that is meeting with that consumer, that individual has to make sure that they are extremely well schooled in what makes -- goes into credit scoring and what impacts the score. Because until you can explain that thoroughly to a consumer, there is no point in even reviewing a credit report with them. All you're going to do is confuse them.

And unfortunately today they are being bombarded with bad information from all venues, and the media being one of them. Many of the consumers out there are arbitrarily being told to go out and consolidate credit before anybody reviews what their credit picture looks like. They are being told to close credit card accounts without someone reviewing what that is going to do to the overall picture and how that may or may not skew the overall perception of their credit utilization.

And, in fact, consolidation is not a bad thing. But if it artificially skews what your credit utilization looks like to a system and causes a negative impact to the consumer, they've done something with the best of intentions, but because they have not been well educated as to what they should be doing, they're hurting themselves.

And there are many instances today that because of lack of education on the part of any or all of us in this industry, when credit scoring came to the marketplace three years ago, we have allowed the consumers to do a lot of things that have not necessarily been in their best interest.

So to that end, we first need to, in our industry, to be thoroughly educated about the ends and outs of credit scoring. Our Association has put out a piece that is geared specifically to explaining credit scoring in simple terms to the mortgage professional. We have another piece that is being done to explain credit scoring and the ends and outs of credit scoring to the consumer in lay person terms, that tells them what it's about, what goes into it, how it's weighted and the things that they can do to help themselves or hurt themselves. It's their choice.

One of the things that consumers have to realize out there is that they have to be proactive in what they do with their credit. But they have to know what they're doing first before they can do that.

And so that front line person needs to be able to sit down with a credit report and review that credit report for all aspects of that credit report, whether it's good, bad or indifferent. I heard someone earlier today talking about the fact that many times, I think, many originators do not worry about something being on a credit report that really is inaccurate if the score is fine and they can get the loan done.

We should be reviewing good credit as well as bad credit, because while it's good today, that doesn't mean that just because it's good today it isn't going to necessarily be bad six months from now. So that consumer needs to review their credit report in full and make sure that all of the information that is reported there should be reported there.

The next issue that we have to deal with is explaining the other components of credit scoring to the consumers, so that they aren't doing things like taking five charge cards and consolidating them into one charge card and closing out the rest of the charge cards, thereby looking as though they have maxed out the only card in their life. And the next time they have an inquiry, it looks like they're looking to live on credit. That skews the perception of somebody's credit risk.

Credit scoring in and of itself is a very fine tool. And I think one of the things that we all have to remember is that underwriting didn't start with credit scoring. We have been underwriting for years, and we've had all sorts of benchmarks to try and measure people's capability of repaying a loan against. For years in the industry we used a very huge measure, which was called debt to income ratios -- percentages of gross income -- that someone was earning to identify whether the payment that they were asking for on an application was good, bad or indifferent.

Now, for many years I butted heads against many underwriting walls, because I had a consumer that was already making the payment that they were looking to acquire as a rent payment with no tax write off ability, only to be told that because it was outside of guidelines that they either had to come in with more money or accept a lesser quality loan. That really didn't seem too terribly beneficial to me, and it made no common sense whatsoever.

But because of credit scoring today, we no longer have to deal with that kind of nonsense. Ratios are not as much of an issue as they have been in the past. So we do have positives to this scenario as well as negatives, and I think we need to remember that as we move through this.

The person that needs to explain this is the person that understands underwriting guidelines as well as what is available out there. How can the consumer know whether they're getting the best pricing and what they should be getting. They're going to have to shop, and they're going to have to ask questions. And that goes along with the actual education process about what loan products are available to them and what their choices are.

And, again, if they're dealing with a good, well educated, competent loan originator or counselor up front, that person's job is to educate the consumer to all of their options and what the repercussions are of those choices that they may make, not to twist their arm to do something bad to them. And that may sound very Polyanne-ish, but that is the way I believe probably 95 percent of the people in the lending industry function.

Somebody asked me if the repositories should be the ones explaining credit scoring. The tough thing for a repository to explain as far as credit scoring goes is they don't have the personnel that are schooled in underwriting criteria, so that's a very major reason not to have them explaining credit scoring. But to explain an exact score from the repository level, they have no benchmarks to put it against. It has to be explained in tandem with the underwriting criteria.

A score taken out of context is a snapshot that unless it has a reference point means nothing. So when you as a loan originator sit down with a consumer and take that number, you must take that number in reference to some type of loan product. You must, in addition, rather than just saying your score is good, bad or indifferent, utilize those reason codes that are there to assist you in why the score was not higher than it actually could have been.

Now, the thing about reason codes, scores, etc., the higher the score, the less impact the reason code has. So if we're dealing with somebody that has an 800 credit score, the reason codes may be very, very minute. They're simply telling you why that person didn't score 900. Does it make a difference? Heck no. But at 620 a reason code is going to have a substantial impact, and it's going to give that loan originator a reason to be able to point to and say, Mr. Consumer or Mis. Consumer, this is what you need to chance in your credit profile to be able to be on track to start to improve your credit picture and the availability of the best credit out there for you.

Again, it has to be the consumer's choice. If a consumer chooses to make their payments pass the due date on a regular basis, with the impression that because they have paid the late charge it's no big deal, they have to understand that they are going to represent to a lender, and the people that are putting up the money for that lender to make that loan with, a higher risk. Because somebody is going to have to chase them every month, and that means they're going to have to pay a salary to get that somebody to remind them every month to make the payment.

If they have someone who has consistently paid their payments on time, whether that individual makes $1,800 a month or $7,500 a month, they made an agreement. They made a pact with someone when they signed a contract for credit, and they have followed through on that. They have not just decided that it's okay to be late if I pay somebody an extra ten bucks a month. That's being proactive and consumers need to understand that.

So front line people have to be there. It's not something that a repository can do. Why do consumers not get a score on the report that they get from the repository? Because it has no point of reference. They can get a number. What does that mean to the average person on the street? They don't know whether it's good, bad or indifferent, and they don't know what to do with it once they have it. It has to come on a full report, through a lender, so that the lender has the opportunity to review it with them, otherwise they lose the benefit.

As far as correcting errors, that is also that counselor's job to instruct them on how to go about correcting those errors. And the Fair Credit Reporting Act that went into place in October of 97 gives a very defined time line on what is supposed to happen.

Now, we all know that in the real world what is supposed to happen happens most of the time, and what's supposed to happen does not happen all the time. But you can't say that it's all bad simply because it doesn't always work. We have to continue to look at those issues, take those infractions and work toward making the system better.

If in fact -- as an originator I know for a fact that I get credit reports that have errors on them, just like anybody else in this industry. That is not the repository's fault. It's a trade line reporting to the repository. However, the repositories do have a certain amount of input in their relationship with those trade lines.

MS. TWOHIG: Ginny, if you could wrap up?

MS. FERGUSON: Will do. And they can in fact start to create those kinds of expectations from their trade lines.

So I think we have a place to go with this. It has to start at the front line and work its way through. It has to be a partnership in our industry. But I think that education for everybody in the industry is where we have to start.

MS. TWOHIG: Thanks, Ginny. Just one point of clarification. You said you think it should start at the front line and that the repositories are not the best places for the consumers to learn their scores from or talk about their scores.

Do you think lenders and counselors and brokers should tell consumers their scores?

MS. FERGUSON: I think that they need to tell them the score in relationship to the reason code. You can't just hand somebody a number.

MS. TWOHIG: Okay.

MS. FERGUSON: Because as we've all heard today, there are various types of scores, and every investor out there uses a different scale to benchmark.

MS. TWOHIG: And just for a point of clarification also, because not everyone might know the terminology. The reason codes that you are referring to are the reasons for a denial under Regulation B?

MS. FERGUSON: Absolutely not. On a credit report -- when a score is issued from each repository on the credit report, it is followed by four reason codes or four reason explanations. And those are listed in the order of significance of weight as to why a score did not come in at the maximum. It is not a denial.

MS. TWOHIG: Okay. So that's available even if the loan is going to be granted?

MS. FERGUSON: Oh, heavens, yes.

MS. TWOHIG: Because, as some of you know from the consumer standpoint, the law does not entitle the consumer to know those reasons unless the loan is being denied. If there is a counteroffer situation and the consumer accepts whatever counteroffer is given, there is no legal right under the Equal Credit Opportunity Act to know those reason codes.

But, again, like the Fair Credit Reporting Act, that does not mean that it can't be told to the consumer in those situations.

MS. FERGUSON: And I think that's just common good business practice. If we are in the industry to work with consumers, our job as the professionals is to educate. And we can't do that if we don't share that information with them.

MS. TWOHIG: Thanks, Ginny. Our next panelist, Ray Crescenzo is going to speak. Ray has been with the Associated Credit Bureaus since 1981, when he joined the staff as Director of Education. Today as Vice President of ACB, Ray is responsible for industry relations. He serves as staff liaison to ACB standards Committees and task forces, the credit reporting, mortgage reporting and specialized reporting divisions, the federal insuring and lending agencies, and various credit grantor and mortgage lending interested groups.

And we are trying to focus in this panel on what information should be given to consumers about scoring, but I've also told Ray that since there has been quite a few comments so far today about credit bureaus, he should feel free to respond to those comments at this time.

MR. CRESCENZO: And what did I say --

MS. TWOHIG: You said --

MR. CRESCENZO: -- to all those questions? We'll see what I can do. First, let me start by saying that we've been attempting to listen to what's been going on in the mortgage lending arena for the last ten years, it seems. This is an internal process that you all have adopted and turned into a public exercise in frustration.

Internal credit scores are the risk management tools of thousands of major credit grantors around the country. Pete won't tell you this, but they start with FICO scores and then they figure that they can have their own internal expertise hired, and they begin to develop their own scores.

So one of the challenges that the Federal Trade Commission had earlier in this decade was whether a risk score should be included -- a credit score should be included in a credit report. That was a can of worms. It was difficult to deal with because of the myriad numbers of score models that were out in the marketplace, and how can one person attentionally explain in the details that you require and you need in a manner that would allow us as credit reporting agencies to do that for the consumers that are in the marketplace. That exercise resulted in credit scores not being included with the new law in 1997, the new Fair Credit Reporting Act. Credit scoring is not included as part of the credit report.

So that in and of itself is the challenge. It's an internal risk management took that now has become very public. We have been trying to stay ahead of the evolution. Stay up with the evolution of its implementation in the mortgage community. In the course of doing that, we've been working with organizations such as the American Homeowners Education and Counselling

Institute, Fannie Mae, Freddie Mac, the National Association of Realtors, the National Association of Mortgage Brokers, the Mortgage Bankers Association. All of the industry players that are being impacted by this new technology. This new information -- this new knowledge based risk management exercise requires communication and education.

We've been trying to facilitate that communication and education process. Not getting in the way of it, but making sure that the people that are trying to develop these messages so the consumers can understand them have consistent information coming out of FICO or Trans Union or Equifax or Experian or ACB. Consistent messages so that consumers aren't getting told one here and another thing there. Consistent messages so that the education process can begin.

I won't steal Forrest's thunder. You know, he might think that the realtor should be on-line and talking to the consumer about this process and about the scores that they have. There are -- this is not a lack of interest or willingness on the part of all the participants who take a part in this. So it's not a single contact point solution, I don't think, and we've been trying to work with all participants in trying to enhance the communications that takes place.

One of the questions that came up earlier had to do with credit data -- credit grantor information that's coming into the credit bureaus. This is a three legged stool. I've been in this industry for over 20 years, and I've been saying this for 20 years. It's a three legged stool.

The credit granter has a responsibility to report complete and accurately. The consumer has a responsibility, especially if they're going to be credit active, to check out their credit report. See what's inside of it and make sure that it's accurate on a regular basis, on an annual basis or if you -- you know, obviously with all that you've learned today, you would probably want to do that prior to getting involved in a home purchase.

But if there is something that goes beyond the home purchase, you want to check your credit to make sure that it is accurate and ready for when you need it. You deserve to use your good credit when you need it, and in order to protect it, you have to look after it.

The other leg of the stool is the credit reporting agency. We have a responsibility to make sure we're doing our jobs also. There hasn't been a year at ACB in the 18 years that I've been there that we haven't had complete and accurate reporting as not only a goal, but have had programs to facilitate complete and accurate reporting. As recently as March and April, we have programs for major credit grantors around the country. Two years ago we had programs similar to this to educate credit grantors and how to report completely and accurately. We're putting it into the budget for the year 2000. It's a continual process.

We have tried to facilitate also an automated system to facilitate consumer disputes being handled in an automated basis. There are over 20,000 data furnishers. There are over 20,000 credit reporters -- excuse me -- credit grantors reporting to the bureaus. They are -- we have over 1,000 mail boxes on the system right now, and that doesn't -- that's just over 50 percent of the disputes that come into the credit bureaus.

So we are challenged now. And we've just moved forward with a RFP today. It's going out next week to enhance that system. We want to remove barriers to its usage by the credit granting community. We don't want them to have to use its software, and we don't want them to have to sign contracts with the network. All the barriers that we have identified to them getting on the system are trying -- we will be trying to remove those in our business solution that will be coming out within the next 12 to 18 months. By the end of next year -- by the end of year 2000 it will be implemented.

So it's -- I said it's an evolving process. We are trying. We are listening. You told us that inquiries were a problem relative to too many when a person is shopping for a mortgage and that's going against the consumer. We worked with the national systems and the mortgage brokers and mortgage bankers to get FICO to understand that issue, and we changed that and within six months they were blocked.

We're hearing now that some other things need to be considered, and we're listening again. So that's it, Peggy.

MS. TWOHIG: Thanks, Ray. I have one question about something Peter Mahoney said this morning. When he was arguing that the black box was a myth, which, I think, a lot of folks in the room since disagreed with, he said that you can contact each of the three repositories and they will give you what he called a feedback list. I'm not sure if that's the same as a factor list.

And I was just wondering if you know anything about that?

MR. CRESCENZO: The list of factors that are part of -- that could be construed as a full list?

MS. TWOHIG: I assume that's what he was referring to. Yeah. That's what he was referring to.

MR. CRESCENZO: Well, I have a full list right here.

MS. TWOHIG: So that is the case, that those factors that are used by the --

MR. CRESCENZO: The whole list is available.

MS. TWOHIG: Okay. I just wanted to clarify that. And if anybody called and asked for that, would you mail it out to them?

MR. CRESCENZO: I would.

(Laughter.)

MS. TWOHIG: Call Ray.

MR. CRESCENZO: We have been also -- one of our other staff members has been working with the scoring development folks to try to expand the comment factor codes -- the explanation codes -- so that there is an educational message besides just the statement of lack of payment. So it's, you know, more of the evolution process that continues.

MR. MEDINE: Ray, do you want to make that part of the record of this, so that people can have access to it and have a better understanding of how the process works?

MR. CRESCENZO: The list?

MR. MEDINE: Yes.

MR. CRESCENZO: Yeah, sure.

MR. MEDINE: Okay.

MS. TWOHIG: And Ginny already stated that she doesn't think it would be helpful for consumers to obtain their scores from the repositories, that it needs to be from a person who understands the score. And I take it you would agree with that?

MR. CRESCENZO: Yes, at the delivery point.

MS. TWOHIG: Right, at the delivery point. But what would be the problem, though? Would it be so horrible for the consumers to see that score when they got their credit report? I think somebody posed that question earlier.

MR. CRESCENZO: When they got their credit report at the re-seller location or at the --

MS. TWOHIG: No. If they just got their credit report. They order their credit report. Would it be so terrible if they see what scores had been calculated on them? Or what are the problems with that?

MR. CRESCENZO: Well, again, what scores? Was it Providian out in San Francisco that believes they have the best analysts and statisticians in the country and, you know, produce scores for their own lending decisions, or are we talking about Chase Manhattan's scores, or are we talking about a FICO score?

MS. TWOHIG: FICO, I think people wanted to know. If it was just a FICO score?

MR. CRESCENZO: It's an issue I'm not going to be able to address today.

MS. TWOHIG: Okay. We'll continue with our panelists. Our next panelist is Forrest Pafenberg, who is Director of the Real Estate Finance Research in the Research Division of the National Association of Realtors. In that position he has responsibility for conducting research on primary and secondary market mortgage finance, conducting quarterly surveys of current financing techniques for both residential and commercial real estate, and preparing materials for members of Congress and their staffs concerning finance issues.

Forrest?

MR. PAFENBERG: Hello. Thank you, Peggy. I would like to thank the FTC -- or commend the FTC for holding this hearing. I think it's very important. I'm going to skip a lot of things I was going to say, and talk just -- address a couple of issues.

First, I would like to pose the question of why disclose mortgage credit scores. And I would say home buyers need to know their credit scores with meaningful explanatory data to better shop for mortgages and to basically evaluate lender products.

I would also say that credit score disclosure legislation is pending in at least California state legislature, so this is not a trivial issue. It is, I think, in a harbinger of a new direction that automated underwriting is taking as it becomes more completely integrated into mortgage lending transactions.

Another reason why I think mortgage scores should be -- mortgage credit scores should be disclosed is effectively some lenders are disclosing the credit scores, and I think it's a fairness issue as much as anything else.

The National Association of Realtors supports disclosure of the credit score if it would lead the mortgage lender to fund or not fund the mortgage application. And it raises a question of who discloses what to whom and when. Ideally the consumer should be the whom, and the lender should be the who. I'll speak about the what in a minute. And the when should be generally when the borrower is shopping for a mortgage.

The details of the disclosure clearly should be worked out and agreed to by the credit reporting industry and lenders. However, the benefits to the consumer should override any other issues in there. Consumers need to be fully informed as they make the decision to accept a mortgage that is being offered by the lender.

And I want to just clarify what I mean by disclosure. Disclosure is not an explanation of how a credit scoring model works, but what the effects the score will have on the terms and conditions of the loan that would be offered to the consumer.

And let me just shorten up a lot and just talk about what should be disclosed, because I think this is a very, very complicated issue. Now, clearly the score should be disclosed. But along with that score, you need to know what is the scale of the model that's being used. If you're using a scoring model, the type of the model, i.e., is this a credit scoring model, is this a mortgage scoring model, and I'm surprised not to have heard it mentioned, a debt scoring model, which is effectively looking at your credit. Excuse me, your credit card behavior, which is a model that's been developed and is in use for those with what are called the thin file, i.e., little credit history.

In addition, you need to know who is the vendor, i.e., whose model is it. Is this Desktop Underwriter or Loan Prospector? Is it developed by an MI? Is it developed by a lender? You also need to know what data was used in the scoring. Now, again, it hasn't been discussed in detail, but you can generate using the same information multiple score values from the different repositories, primarily because (a) the models are slightly different, if it were even FICO model, and (b) the data that is in the repositories does vary by geographic area.

So that not all of the information that's in one repository is in the other. So it's extremely important to know what data is being run on what model and what type of model it is that's being used. In addition, as it relates to the data, is this a merged score or a single source. So that these are all elements that come in play.

Additionally you need to have reason codes. This is really to educate the consumer. Again, I think the discussion has been pretty full on the reason codes. I won't go into it. And clearly you need to know the date. Now, clearly the consumer knows when he applied, but he needs to know the date when the credit granting was done. We've already heard how dynamic the score is. So you need to have a point in time to know when that score was granted.

And just to comment on the list that Ray was mentioning, these are a list of variables that potentially may be used in any model. So that it is information that would be present within the repository, but it doesn't mean any particular model uses those variables or that all models use any one. So that knowing what the list is, is not going to tell you a whole lot of anything.

And I think I will just end it there, because there are more to speak.

MS. TWOHIG: Thanks very much, Forrest. And I think that's a good segue to our first lender on the panel. Dusty Lashbrook joined mortgage.doc, which is based in Plantation, Florida, last fall as Executive Vice President and Chief Operating Officer of its Consumer Direct Division. Mortgage.com is a private label, technology based, outsourcing company and a national residential mortgage lender.

And Dusty is a nationally known speaker -- I know I've heard him speak before -- on the subjects of risk management and secondary market, and a guest author for Mortgage Banking and Secondary Market Executive. Dusty?

MR. LASHBROOK: Thank you, Peggy. It's a pleasure to be here today. One of the good things about going late in the day, besides the fact that the crowd thins out a little bit, you do get a chance to listen to what everybody has said so far and maybe alter what you're going to say so you're not going to antagonize any of the group out there.

Anyway, to follow up and just give you a couple more seconds of background on where my perspective is coming from, because I think that's important, I'm going to try to hit really what we think the consumer really wants to see today. And this comes from a lot of surveying that we as a company are doing.

We are primarily a consumer direct Internet based lender. We are the outsource partner for Intuit on the Quicken mortgage site, and we act as the fulfillment side behind six of the lenders on the Quicken site, ad well as serving as the lender on the site ourselves. In addition, we have a substantial origination operation through our own web site, mortgage.com.

From that, because on-line lending is so new -- the first on-line lending really started in about 1993 -- became our Consumer Direct part of our company. It was American Finance and Investment based here in Washington, DC, which we purchased. But it's so new that we're still trying to learn what motivates the consumer on-line and what the consumer wants to see.

The Internet gives you a great opportunity to apply technology. It gives you a great opportunity to change what is an extremely ugly process. Today what you're seeing on the Internet is a lot of -- a web facade in front of the same ugly process out there. And what we believe is that there is a great opportunity to change the whole process, some of which is what we're talking about here today. And to make it an experience for the consumer that is truly different than what they experience today. It's worse than a root canal to get a mortgage.

But anyway, also we think the Internet gives you an excellent opportunity to provide education, and that is what the consumer wants. The consumer wants to know more about this process. They want to know how to get a mortgage loan. They want to know why they don't get the same rate as someone else that applies. And so we feel that there is a great opportunity to provide that information over the Internet.

Through our surveying process -- and we survey every applicant at three points in the process through an outbound survey and through a survey they complete at closing. And besides learning about our service levels, we're learning about what does a consumer want to see and how should we change the process to make it a better experience for them.

This is what the consumer tells us this is what they want to see. Number one, they want to be treated fairly, and they want to be treated fairly in relation to another applicant, and they want to be priced fairly on that. It's not that they want to have the absolute best price. They want to be priced fairly on that.

Number two, they want to understand the process. They want to know what this mystic called Underwriting is. You know, what is that process. What goes into it. They want also to be able to -- before they purchase or go out to look for a home, they want to know exactly or roughly what they can qualify for. So they want to be really pre-qualified. They want to have the ability to do that. They know that credit is going to come into play in regard to that.

And today it's extremely important that they're pre-approved. As I think Forrest could probably tell you today, it's a very hot real estate market out there today. And the ability for the consumer to be approved ahead of time, and to know what they can buy, and to basically go out there knowing that they can make an offer on a property, as fast as properties are being snatched up in some of the hot areas today, that's important.

They also want to know, though, if in fact -- and they want to have a quick timely decision made so they can move onto another lender, if they have to, or they can actually go ahead and put behind them this decision process and get ready for the move into the property.

And the last thing is, if in fact they are not approved, or if in fact they have to settle for a lesser -- I wouldn't call it a lesser quality -- a higher risk mortgage which they're going to pay a higher rate for that, they want to understand how to change that situation. How over time can I become a borrower that gets as good as a rate as anyone else out there.

And that is what the consumer tells us that they want. And I'll make one other note, because I think this is important, too. We offer full credit spectrum lending, all the way from A all the way down to D paper, and we do it on a fully automated basis with six underwriting engines employed. And the sub-prime engine is one that actually does both credit analysis and also risk based pricing.

We also don't allow our people to charge a higher rate or a higher point structure and make overage on that. So it's a very fair process that we put them through, and the consumer likes that today. They love being able to get an answer on a sub-prime loan within 30 seconds on that.

What is interesting is that in our site and the Quicken site, we allow the consumer to self assess themselves. And if you've looked at the site, or if you go look at it, you can see they get to answer questions about themselves, and it puts them down a channel to get a quicker answer on their loan. Forty percent of the people that self assess themselves as sub-prime and put themselves into what we call a custom credit solution or A paper borrowers.

Now, I know that's a surprising statistic, but that's an accurate statistic today. So the consumer doesn't know enough about what goes into making a credit decision that puts them into a high risk category to be able to properly assess themselves. And that's something we're addressing right now.

Now, we in turn take those borrowers and move them back over into the A paper channel, and they're the happiest people in the world, I will tell you, because they thought they're going to get a high interest rate loan. Not every lender does that, as you all well know. Many lenders look at that as a profit opportunity there.

What we think that should be provided to the consumer -- this is kind of a list. They need a full explanation of what the mortgage process is all about. They need a full explanation of credit scoring and how credit scoring goes into the approval process. And that approval process may be different for different lenders, if you're using an automated engine, or if you're using an automated engine, which we do, with also a live body underwriters on the loans that are referred out of there. They need to understand how credit scoring factors into that. They need to understand what goes into the credit score and how can I approve my credit score.

They also, we think, need the ability to have, in our case, on-line credit counselling. So if you're not able to -- were not able to get a loan at a rate today that makes sense for you, how do I get there. What do I need to do. Do I need to work with a local organization that specializes in this. How can I make my credit better.

And we also think that as risk based pricing comes on -- and we obviously use risk based pricing in what we call our custom credit solutions or the sub-prime side. But they need to understand what goes into credit grading and how those grades equate to what interest rate I'm going to end up paying on that, and that it is based on the risk out there associated with the loan, and what are the factors that go into making a riskier loan.

So in our estimation, these are the things the consumer needs. We feel that the lender is the one that needs to provide that information on that. The lender is the one that knows the whole process, or should know the whole process, and should be the one that should be able to communicate that to the consumer.

Now, there is obviously other partners in this. Our real estate partners out here have a good opportunity to help the consumer very early on in the process on that. We are seeing more and more consumers, though, that are actually -- and maybe this is just due to the adoption to the Internet -- that are actually coming in before they ever find a realtor and looking to pre-qualify themselves. Then they go find the realtor. Then they go find the property after that.

So we're seeing a big change that is occurring out there today. But I will say in just kind of wrapping up, the consumer wants to know more. The consumer wants to be taken out of this mystic, taken off of the lending process, so they can feel more comfortable with it and know how they can control their own destiny.

MS. TWOHIG: Thank you, Dusty. Well, I think we're pretty readily debunking -- or pretty much establishing that there is a black box still that consumers -- that everybody seems to be in agreement, except maybe Peter Mahoney, that there is a need for a lot more information from customers. And there seems to be a consensus forming, among this panel in any event, that lenders are the key communicator of what is going on.

Dusty, you raised a very important issue, I think, in terms of sub-prime borrowers or consumers who think they might be -- need to go to the sub-prime market. If they weren't working with mortgage.com, they very likely might call up, phone or otherwise contact a sub-prime lender, just assuming that same thing, that some credit problems mean they have to go to that. And I suspect -- in fact we've heard -- that if that sub-prime lender then pulls their credit score and it is very good, that nevertheless the consumer won't likely be told about that.

Is that your impression of what happens in -- of course, you know, not your company, but other companies? And if so, what could be done about that?

MR. LASHBROOK: Well, first of all, I think that it happens less, maybe, than you think, because the consumer doesn't typically go to one person to look for a mortgage loan. They're shopping, and it's a competitive market out there today. And if I'm able to put a borrower in a mortgage at seven percent, and someone else is trying to sell them a nine and a half percent sub-prime, then it's going to be very difficult for them to get that business.

Now, I will say that we are seeing more and more of a move on the part of the larger, more established sub-prime lenders to where they are looking to take their A paper borrowers, who come into them really for a sub-prime loan that are definitely A paper, and handing them off to an A paper lender. We're working with relationships right now where we're doing that, where we're taking the A paper business from some of the major sub-prime lenders, and actually going ahead and processing that into an A paper loan.

So I think there is a move a foot to try to get away from what you're talking about. And I don't think it occurs as much as you think. But my point really was trying to say that the consumer doesn't know what they are today. They need to have more information about how do they fit in from a risk standpoint. A lot of them think that if you're over 50 -- you know, if you get a late notice that that's looked at pretty derogatory as it relates to a mortgage loan. Unless it's 30 days late, it doesn't show up as a late on the credit report.

There are things like that that the consumer needs to know more about.

MS. TWOHIG: Right. I guess I was asking, if the consumer, though, was given its credit score and then had some sense that that was a pretty good score, don't you think that would help in the instances where it did happen?

MR. LASHBROOK: Absolutely. And you would be surprised at how many e-mail responses we get when people come to our site where they know their credit score. I don't know where they're getting it. They know their score, and they are telling us what kind of rate will I get if I -- you know, I've got a 740 FICO score. And, I mean, they know exactly what it is, and so they are bargaining with that.

MS. TWOHIG: Very interesting. Moving to our next panelist, Elizabeth Prentice. Beth is the New York/Puerto Rico District Director of the Neighborhood Reinvestment Corporation. The District Office provides technical assistance, training and grants to the 27 affiliated Neighbor Works Organizations in New York and Puerto Rico. Beth is a founding member of the Neighbor Works campaign for home ownership, and serves as a chair of its National Loan Product Committee.

Beth?

MS. PRENTICE: Thank you. And also the chair of the Predatory Lending Committee. So this is an issue that is near and dear to my heart, and something that we're very concerned about, obviously.

Just in terms of background, our organization, the Neighborhood Reinvestment Corporation, comes at this probably from the same perspective, to some extent, as Marcia Griffin -- are you still here -- does, in that the local organizations with which we work are working very hard to educate generally first time home buyers and prepare them for the mortgage buying process, and to the extent possible, prepare them to move into the A market rather than the B and C market.

We don't have, I don't think, as many borrowers as mortgage.com does, who come in with a credit report in hand knowing their credit score, nor is there typically in the under served population a population that feels all that comfortable shopping around for the best rates. It's often a population that has not done well in terms of being accepted by mainstream lenders, and so is not that comfortable shopping around.

So our perspective comes from that of a group that is trying to get fairly priced, regularly available, mainstream capital back into under served parts of the country.

That said, in answer to the two questions that were put before us for this panel -- what information should consumers receive about credit scoring and who should provide it -- I think I -- and probably Marcia and other people who are on the direct lines working with the under served population, first time home buyers -- would say that the more information and the earlier, the better everybody is.

To the extent that we're talking about credit information, I do think there is a role very early in the process for a mortgage counselor or a loan officer, whoever the consumer is talking to first, to look at the credit report with them. And I think they should have a credit score as part of that early information.

Now, the question is, as someone said earlier, which credit score? What I would propose for the early part of the process, before someone has gone in to apply for a loan, is that probably the most readily available credit score to pull at that point and disclosure would be the FICO score, because that is the most widely used sort of generic score in this industry.

But, again, a score does not stand by itself and needs to have someone explaining to the consumer what part of the mortgage application or credit approval process will be dependent upon this score and how they fit within the scheme.

So in our world, we're very strongly encouraging people to pull their credit report early, understand what they're getting into, understand whether they would be looked at as a good credit profile or a bad credit profile, and work very closely to move them over -- I don't mean just to clean up your credit situation. You know, you've taken the Kaplan test and now instead of scoring your 580 on the SAT, you're going to score the 670, but your brain is no different.

We're looking to work with people so that in fact they do understand their credit and budget and financial behavior much more thoroughly, so that by the time they get to a mortgage application, they are indeed credit worthy and that credit worthy shows on their FICO score.

Secondly, I would say that the other point at which the credit score and credit information should be disclosed is at the point of underwriting. Whatever credit information is being used at that point in time, I think it's important that the consumer get that one. So let's say you came into a counselor to begin with. You are using a FICO score, but you ended up going to maybe Chase, which is using a proprietary mortgage scoring process. I do think that if in fact you're going to be turned down by Chase, you need to be given the credit score and what that means within their system, along with the reason codes.

So that's my answer to the two questions.

MS. TWOHIG: Thank you, Beth. And what about if you're not turned down, but you're just given a counteroffer?

MS. PRENTICE? Yes.

MS. TWOHIG: But a higher price?

MS. PRENTICE: I think that's the other -- thank you for asking that. To me, being turned down and being given a counteroffer are kind of the same thing in some regards, in that most of us would hope to get the best priced credit available. And if you're turned down for that best priced credit and you're then given an alternative, then I would yes, in that case these things should also be disclosed to you. And, if you are being given a different offer, you need to understand the difference in the terms, because people don't.

And I think until people have more information about this, they're not going to be able to scream in an informed manner as they should if they're given an unfair, quote/unquote, risk based price. You know, if you've gone from a seven percent, 30 year loan with two points, and then because you didn't make the lender's 640 or whatever it is, you then are thrown into a seven and a half percent, three points, you should understand that and be free to shop around some more.

MS. TWOHIG: Thank you very much, Beth. And our final panelist is Kirk Willison. Kirk is Senior Vice President and Director of Government Affairs for Countrywide Home Loans, which I'm sure everyone knows. Countrywide -- and since 1992 Kirk has been responsible for corporate policy related to legislation and regulation at the federal and state levels.

And for the past two years, Kirk is very well known to many of us in this room for his efforts at facilitating and directly and cajoling the mortgage reform working group, which is an ad hoc organization of industry and consumer groups that are -- were -- are trying to reach consensus on modernizing laws related to mortgage originations.

Kirk?

MR. WILLISON: Thank you. And thank everyone for staying. Can you imagine the size of the straw that I drew to be the last panelist?

(Laughter.)

MR. WILLISON: On the last panel of the day? So you're to be commended for staying around. Listening to the day's activities and the frustrations that I hear from consumer groups and lenders and even some of the credit reporting agencies, I'm reminded of that wonderful line in the movie, Cool Hand Luke: what we have here is a failure to communicate.

You look at a situation where, let's say, some credit provides bad information to the credit reporting agency. The credit bureau passes on that information to the consumer's potential lender. And then the lender turns around and likely denies credit on the basis of the bad information to begin with. And if you're in the case of someone like Countrywide, our agreement with Fair, Isaac says we're not allowed to disclose to the consumer what their score is.

Any of you who have lived in the Washington area for a while will remember the ad slogan for a men's -- and I guess women's -- clothing store, Sy Sims. He would say that an educated consumer is our best customer. And at Countrywide, we really do feel that way. And after listening to a lot of discussion today, I've become convinced that Congress was wrong, in that Congress should not have said that consumers really aren't entitled to their scores.

I think consumers need as much information as they possibly can, particularly as we get now to the slicing and dicing of risk based pricing. They need to know how close might they be to that A loan versus a premier loan or a A minus loan or a B loan. Maybe you're never are going to see inside that black box and you can take a look at this large list of all the characteristics that make up a credit score. But it's not going to tell you looking at that what the most important characteristic on your experience -- his credit experience -- has kicked you out of, perhaps, getting that A loan.

We need to have an opportunity -- Countrywide, like I think probably a lot of different organizations, provides a booklet, Credit Scoring and You, for consumers as they come in and get the application. And any of you who want a copy of that -- it's written in very lay terms and easily understandable -- leave me your business card. I'll make sure that you get sent a copy of that.

But we really do feel that we ought to at least have the opportunity to do a better job explaining to consumers what their score is, and then the steps that they need to take. Countrywide also runs a counselling center. And if we could get the opportunity to talk to the consumers well beforehand, we could save them a lot of frustration.

A few years back -- and this is no affront at the realtors here for us -- the mortgage banking industry -- and Countrywide was pretty active in it -- began a campaign to see your lender first instead of seeing your realtor first. I think I would abridge that to say see your credit report first. Because you look at your credit report first, see what dings you have in it, then go in to either a counseling organization or your lender and say, how can we work together to get me the absolute best loan possible.

As a lender -- and I think I want to make this really clear to, I think, a lot of consumer groups who may have the assumption that we're eager to turn down loans. We're in the business of making loans. We're in the business of evaluating credit, but we're in the business of making loans.

Countrywide was very reluctant to be pushed in a situation of having to rely on credit scores -- FICO scores -- to the degree that we have been. And my CEO made it very clear when we finally made the decision that that would be part of the underwriting process that he would dismiss any loan officer who used credit scoring alone as a decision to turn down a loan. That's not permitted at Countrywide.

And we've got to push everyone to realize that there's got to be other factors, because if we get a borderline score, we will do everything we can to push with the GSE's to accept that loan. And given our size, perhaps we're in a better situation than a couple others.

Finally, let me just wrap up here, because I know that there has been some discussions about how sub-prime lenders work. And not to make this a commercial, but others have had a chance to get a few comments in. Countrywide's sub-prime lender does move its -- recommend its borrowers up to our prime lending office if we realize that the buyer is qualified. And we'll actually do one better. If you have a Countrywide sub-prime loan and you have a good credit payment history, we will, after a certain period of time, automatically move that up to a better interest rate.

So we are trying to do our steps to make sure that consumers are getting the best deal possible. Thanks.

MS. TWOHIG: Thank you very much, Kirk.

(Applause.)

MS. TWOHIG: Kirk, I just want to make sure I understood one thing. Is it the case, though, that you don't give consumers their actual score when you explain to them the reasons why they might be denied?

MR. WILLISON: Again, the agreement that we have with Fair, Isaac, is that we are not to release that score.

MS. TWOHIG: Okay.

MR. WILLISON: Our hands are tied.

MS. TWOHIG: Pete, do you want to say something about that?

MR. MCCORKELL: Thanks. Actually this is a question that you or David, I think, threw at Ray, and Ray kind of threw back at you. You know, what would be so terrible about giving consumers their scores? And my answer to that is nothing. And I don't have a problem with consumers getting their scores and the reason codes.

What I do have a problem with is then getting into the discussion of well, my score is 680 but I need a 685. What can I do to change it? Because while Beth and Marcia made it clear that their aim in their programs is to try to change the credit behavior of their clients so that in fact they are different credit risks, unfortunately there are an awful lot of people when they hear that score and they are some number of points away from a cutoff or from a lower rate, they want to know what can I do to change it.

And in fact, I'm sorry to tell you this, but Fair, Isaac's job is not to tell you how to get a better score. Our job is to produce a score that is the best possible predictor of your credit performance. And so we want to score your behavior. We don't want you altering your behavior to change the score, what I think Beth described as okay, I took the prep course for the SATs, and so I don't know anything more now, but I'm just a better test taker.

We don't want to have consumers trying to alter their behavior in short term ways that will -- regularly has nothing to do with their long term credit risk. And we don't want to get into that discussion with consumers. And unfortunately, we have an awful lot of experience, that when a consumer hears a score, especially when they have it in the context of, but you needed five points more or ten points more to qualify for this loan, then they want to have that discussion about well, what can I do this afternoon so that my score tomorrow will be higher.

MS. TWOHIG: Thanks, Pete. Any reactions to that from the panel? Joe? Identify yourself, please.

MR. GOLDBERG: Joe Goldberg from the Pennsylvania Attorney General's office and the Bureau of Consumer Protection. I have a very serious concern with what you said, and I also have a very serious concern with the credit bureaus. Nobody wants to take responsibility for the information that you are transferring.

What Fair, Isaac is doing and what the other systems do, is making a statement about the character -- the financial character -- of a consumer, and you are conveying that to a third party. It's not purely internal. And there is a reliance on that statement for better or for worse.

What you do need to do is, if you're going to take that step, I think you have the responsibility to tell the consumer the basis for the statement about the character, and the effect that changes in their behavior will have on that statement. I disagree that you don't tell them that. You are making a statement and conveying that to a third party. You have an obligation to allow this consumer to act. And by just giving a list of four factors, if that consumer adds to the consumer's detriment, in my opinion that's an unfair or a deceptive trade practice.

(Applause.)

MS. TWOHIG: I think we've now officially opened it up to questions and comments.

(Laughter.)

MS. TWOHIG: We do need to try to wrap up. So anybody who hasn't spoken here today? No? All the hands are of people who have already spoken. So let's take them in turn. Caryl? And again, it's getting late in the day, so if you could just try to keep your points brief.

MS. ISEMAN: Well, this is again to what Peter has said, and it's also to something that Virginia said, that the credit scoring is altering the way people do business. Virginia made a statement that she would not allow or would suggest that a customer not go out and consolidate their debts. No. It's better that we keep them paying higher interest rates on their credit cards. I mean, if they get an invite to accept eight percent on their credit card -- no. She did.

MS. FERGUSON: That's not what I said.

MS. ISEMAN: Well --

MS. FERGUSON: No.

MS. TWOHIG: Wait, one at a time. Caryl, why don't you finish up your point, and then Ginny can respond.

MS. ISEMAN: Well, what I'm saying is, is that one of the counseling things that we do do when a consumer comes to us is to take a look at their credit cards and the balances that they have outstanding, and find out maybe what the interest rates are, and do suggest that they do go ahead and consolidate or to lower their payments, or to close out some of the accounts. And not only pay off the balances, but actually close the account. And, yes, in many cases or in most cases that will help their credit score.

I think that that is good principal. It's a good ethical thing to do. It is a good economical thing for the borrowers to do. And in no way should that -- is that cheating or should that be held against them.

MS. TWOHIG: Okay. Ginny, do you want to say something:

MS. FERGUSON: Okay. I'm not arguing the point What I said is, they should not arbitrarily go out and consolidate debt without first having their overall picture reviewed by an expert, so that they aren't doing something to damage themselves inadvertently. I firmly believe that people don't need 16 pages of credit cards. I firmly believe that there are instances when certain accounts need to be closed, but they need to do that with the benefit of someone counselling them up front.

And unfortunately the media has put out there that people need to close accounts and consolidate debt. But they are doing that without the benefit of any guidance, and that can in fact hurt someone.

MS. TWOHIG: Okay. Russ?

MR. BAILEY: Just a question for the lenders who are engaged in risk based pricing. Could I ask if you use the same scorecard to price the loan that you do to underwrite it, and if you do not, does the pricing scorecard include information other than the likelihood of repayment like a pre-payment risk or the likelihood of selling ancillary services?

MR. LASHBROOK: I'll be glad to address it from our standpoint. On our risk based pricing, we are using a combined engine that does both risk based pricing and also the actual credit grading of the loan. The two are tied together. So the same -- you know, if you want to look at it from a scorecard standpoint, the same scorecard is actually used. It's the same engine that's actually doing it.

And I agree with what Russ is saying. If you do the two separate from each other, then you've got some issues or got some potential for problems there as it relates to maybe the effects that it might have on the price, or you might not be getting the desired effect overall. But we believe strongly in doing that.

Now I think the last part of your question was?

MR. BAILEY: Well, if it's the same one, you probably don't have the problem that I was asking about. But I think some institutions that use a separate pricing model include factors such as the likelihood of repayment, or the likelihood of selling the consumer ancillary services. So what they call a risk based model is actually a profitability based model, and it doesn't really consider just the likelihood of the person being able to repay the loan.

MR. LASHBROOK: Ours doesn't do that, but you're absolutely right. There are people out there that in their pricing formula -- whether it's on an A paper also, as opposed to it's also -- I've seen it where those factors actually do go in. But they do also contribute to the overall value that the company obtains from that loan, whether they're going to retain the servicing or whether they're going to sell the servicing.

And all of us in the mortgage industry basically set pricing off of a margin off of the ultimate value of that loan as we perceived it. So those factors do go into most companies' calculations of how they're going to price a loan to the consumer.

MR. WILLISON: And that's exactly the same way we are, and it's clearly the same in the A when you're talking about the opportunity to sell, just like any other bank product is done as it relates to the risk based pricing. And mortgage.com would probably be pretty much in the same situation. As a true mortgage bank, we don't retain -- we don't portfolio any of those loans.

So it also depends on what the market is like for being able to sell those loans in the secondary market, and we have to price off of that as well. So it's not just a pure -- I mean, you can't say someone who comes in with a 619 is going to get a better, you know, rate than someone who comes in at 620, if that's the only factor that you're considering, because there are so many other factors out there in the market. And it all depends also on the type of -- you know, you may be trying to pull a certain type of loan, and those type of things are certainly affected in a price.

MS. FERGUSON: Peggy?

MR. MR. BAILEY: I just -- I think most consumers when they hear risk based pricing think one thing, when the person saying it may mean something completely different. It's sometimes good to define the term.

MS. TWOHIG: Okay. Ginny, you wanted to add something?

MS. FERGUSON: Yeah. I think that there is a little bit of a misconception. When people start talking about risk based pricing, it doesn't always mean that somebody is getting a worse interest rate. Today we see many people in the high 700's that are getting lower interest rates because their credit scores are good. And I think a lot of people fail to take that into consideration. And that's in the A paper arena.

MS. TWOHIG: Okay. A few more questions or comments.

MR. PAFENBERG: Peggy, could I make a comment?

MS. TWOHIG: Sure.

MR. PAFENBERG: Just to follow up on her comment. Risk based pricing is actually present within the system now, you know. I mean, you've just got to consider that it's really there. But when people talk about risk based pricing in the future, they're trying to price basically four elements of risk: collateral risk, credit risk, business risk and pre-payment risk. These will all be elements of a future risk based pricing.

It's going to be a tough decision when you start disclosing to consumers that I think you're going to prepay your mortgage in two years, so that I'm going to charge you a higher price. But that's the reality of risk based pricing. The investor community is demanding of the lender that this be priced. I mean, they're demanding a premium.

MS. TWOHIG: We have questions here. The microphone is closer to there. Why don't you go first, sir, and then we'll take you two.

MR. PREUDHOMME: Hi. Thanks for the opportunity to speak again. I'll try to keep it brief. I guess I came here today with a lot of different expectations and coming out of here with not too many answers.

But I see some big problems, one of which we're sort of all agreeing on that the consumer needs to get more information. I think that's a good thing. I think the lady over there brought up the fact that a very big problem we have is that the credit scoring systems have not been evaluated for bias and fairness and so forth. That needs to be done.

Something else -- and I might be inaccurate on this. But it seems like we almost have a monopoly. I keep hearing Fair, Isaac, Fair, Isaac, and everybody is like this to Fair, Isaac. And I think something is terribly wrong if we've got a monopoly really going there where the three main repositories go to them for their scoring information. That's wrong. And I thought that FTC was all about breaking up monopolies and everything else.

(Laughter.)

MR. PREUDHOMME: You know, this is like --

MS. TWOHIG: Different bureau.

MR. PREUDHOMME: -- a bad situation.

(Laughter.)

MR. PREUDHOMME: And that to me is a big problem. I mean, it really is.

MR. MEDINE: Mr. Preudhomme, I think we're only against breaking up ill gotten monopolies, not monopolies per se.

MR. PREUDHOMME: Well, I don't know. I mean, a monopoly has a lot of inherent problems. If they don't have to answer to anyone else, they don't have competition. I think on your web page you talk about competition, and there doesn't seem to be. And I hear a great deal of arrogance from a lot of these type of people.

But anyway, just let me hit five other topics that are sort of related that I'm only going to -- they're just little one sentence things that I think need to be thought about.

Okay. We talked about education. Another type of education -- just a word that need to get back to Congress -- is education in school doesn't occur. People don't even know how to balance a checkbook. They don't know what a loan to value ratio is. They don't know any of that kind of stuff. That needs to be addressed. I don't know that this group can do it.

There is a lot of privacy issues. Just yesterday the Commissioner was speaking on H.R. 10 to Congress about concerns they have about privacy, okay. And I think there are a lot of privacy issues involved in this data that gets so eagerly thrown around, shared, scored, rated and gyrated.

(Laughter.)

MR. PREUDHOMME: I mean, that needs to be -- you know, somebody has got to look at that, okay. A real big problem that I see that's going on related to what I talked about earlier with Chevy Chase Bank. Okay. More and more banks -- and I heard Citibank came out and said if you have with any company one late payment, we're going to raise your interest rate because you're now a risk. And then I heard GM has come out and said that. And one bank after another after another. They're using this risk based mentality.

And I think this is very scary, okay, that they're going to -- based on not your payment history or what you're doing with them. Based on what they get on this credit bureau report that we know is filled with holes. It's bogus. It's not checked. I mean, this data is garbage.

MS. TWOHIG: You promised one sentence.

MR. PREUDHOMME: Okay. Sorry. All right. The targeting of youth is another big serious problem. There have been articles, several of them -- L.A. Times has published some on that. That issue needs to be looked at. Targeting of youth as well as elderly and the naive. There is a lot of naivety out there as far as all this stuff. Just like I said before, people don't understand what it means to only pay your minimum payment.

Okay. There needs to be a national user limit. Okay. We've got to have a ceiling somewhere. And I don't know --

MS. TWOHIG: I think we're going beyond credit scoring issues at this point.

MR. PREUDHOMME: Okay.

MS. TWOHIG: Why don't we give some other people a chance to say a few words, and then we really do have to wrap up.

MR. MANALP: I'll keep this very short. I brought you up the FICO information scoring sheets. You're more than welcome to pass out copies to everyone in here that would like to see how the scores are figured, if you don't know how already.

One of the things that you -- yeah, those are presented by FICO, right. That is their information that they have passed out to me as the mortgage broker. I think you need to keep in mind that you're talking about the educational process that the mortgage lenders are going to be responsible for to pass on to the consumer.

I think that if you really haven't had the opportunity to be out there, you ought to go out one of these days and go talk to a mortgage broker. Mortgage brokers, I just found out this last month -- it was in one of the periodicals that we receive -- are doing 75 percent of the business in the marketplace right now.

If you went out and talked to your average mortgage broker or loan officer that's out there on the front line, he was flipping burgers at Arby's about eight or ten weeks ago. He does not have an education. You are relying upon somebody with an I.Q. slightly hotter than that hamburger that's been sitting on the counter shelf out there to pass quality information on with regards to his financial future.

So we've either got to start looking at the industry itself and how to take care of ourself and get some education to the people in our industry, so they know this information. And let's get the black box opened up a little bit to people that they can take it and read it. And the black box that I look at is the perpetual motion machine. We're told that it works, and that it works on a regular basis. We just don't know how, but we're supposed to believe in it. It's that curtain that the wizard is behind.

Thank you.

MS. TWOHIG: Okay.

MR. WILLISON: Now, you know why Countrywide gets go much business, right? They don't want to have to deal with those flippers.

MS. TWOHIG: Thanks very much. One more comment and then we're going to need to close.

MR. LE FEBVRE: I have a -- is Pete still in the room?

MALE SPEAKER: No.

MR. LE FEBVRE: Okay.

MS. TWOHIG: You drove him away.

MR. LE FEBVRE: Oh, no. Then I'll just make a comment with regards to Fair, Isaac, and then I want to address Ray that my association is.

When Congress amended the Fair Credit Reporting Act, it made all repositories to come up with an 800 number that both -- with a human being that answers the phone. So my question is, as far as credit scoring is concerned, since there is so much ambiguity out there, why do we not force Fair, Isaac to handle 80 percent of my phone calls that I can't answer and call forwarded right to their office? Because right now, we can't answer the questions.

Then my question to Ray is, when the FTC -- and this is kind of to David and Peggy at the same time. When you guys made your ruling against Credco, you were real clear that you do not desiferate (phonetic) -- whatever that word goes -- between repository and credit reporting companies. When I read the statute it says I must, when a consumer disputes, to report that data and get it accurate.

Now, the only repository, Ray, that is allowing mortgage credit reporting companies to do that is Equifax. Right now I have the ability to take that verified data, have it then sent to Equifax within 48 hours, get the file corrected and recalculate the score.

Why can we not push Trans Union and Experian to follow that same length, and this whole credit scoring thing that we're all talking about here, will be then corrected, at least to a point. So I want to kind of hear your comments.

MR. CRESCENZO: A marketplace event. It means each one of them makes their own decisions about how they're going to address market needs. Equifax decided that they would do a test, and they have and it's working. How long has it taken anyone of the three national systems to decide that a good idea across the hall is a good idea to install in their environment.

You know, it's a migrating marketplace. If somebody's got a good idea, it doesn't stay a secret long. The marketplace is going to allow to work itself out.

MS. TWOHIG: Thanks very much. It's getting late. I know we've kept all of you way past the time we had anticipated that we would close. But I think it's just a testament to the interest in this subject, and we've had lots of good presentations and comments.

And David Medine is going to close for us.

MR. MEDINE: Kirk thought he drew the short straw, but I drew a shorter straw than Kirk, and so I'm going to be extraordinarily brief.

I wanted to thank Kellie Cosgrove, Cynthia Lamb and all the staff here for putting this together. It may look seamless, but it wasn't.

(Applause.)

MR. MEDINE: I also want to thank all of today's panelists for really engaging in a very good faith dialogue about the subject. And I also want to thank Pete especially for taking a lot of heat and being willing to stand up and answer the questions. I don't think it's an easy job. Of course we get that sometimes ourselves, so we can sympathize with that.

I think that the theme that we heard from this last session is, I think, really the theme for the day, which is communication. And I think we started off the day by hearing how credit scores were created. We moved on to how they were used, what the benefits are. Then raised some of the concerns about their use and their fairness. And then wound up with how to best communicate with consumers what the credit scoring process is all about.

We hope today's discussion really is the beginning of a dialogue among all the players here on how we can make scoring fairer, easier to understand and really to test the marketplace. If it works, if it gets people better loans, if it's effective, that's great. If there are problems with it and if it has kinks in it, let's work on those. Let's work on better disclosures and better understanding.

So thank you all for coming.

(Whereupon, the meeting was concluded at 5:16 p.m.)

C E R T I F I C A T I O N   O F   R E P O R T E R

DOCKET/FILE NUMBER: P994810

CASE TITLE: Credit Scoring Workshop

HEARING DATE: July 22, 1999

I HEREBY CERTIFY that the transcript contained herein is a full and accurate transcript of the notes taken by me at the hearing on the above cause before the FEDERAL TRADE COMMISSION to the best of my knowledge and belief.

DATED:

JOEL ROSENTHAL

C E R T I F I C A T I O N   O F   P R O O F R E A D E R

I HEREBY CERTIFY that I proofread the transcript for accuracy in spelling, hyphenation, punctuation and format.

JACKY KARNCHANAPHATI