Comment #: 92

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By Electronic Delivery

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

Re: FACT Act Scores Study, Matter No. P044804

Ladies and Gentlemen:

This comment letter is submitted in response to the Federal Trade Commission's ("FTC") notice and request for public comment to aid the FTC and Federal Reserve Board ("FRB") in conducting a study ("Study") on the "effects of credit scores and credit-based insurance scores on the availability and affordability of financial products." The FTC has requested comment on several questions about the "prescribed methodology and research design of the study." I appreciate the opportunity to comment on this important Study.

In general, it is widely recognized that the use of credit scoring systems has enabled institutions: (1) to reduce the costs of evaluating credit and insurance transactions and, thereby, pass these costs savings on to consumers; (2) to more efficiently, effectively, and fairly manage risks; (3) to make reliable, quick, and objective decisions; and (4) to increase the overall availability of credit to consumers.[1] I believe that, after reviewing the data, the FTC will conclude that properly designed and used credit scoring systems: (1) result in greater credit availability to consumers; (2) price credit and property and casualty insurance in accordance with the risks and losses; and (3) do not result in negative or differential treatment of Equal Credit Opportunity Act ("ECOA") "protected classes."

For your convenience, I have summarized each of the FTC questions posed in the notice along with my responses.

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[1] *See, e.g.,* FRB Chairman Alan Greenspan, Remarks at the Annual Convention of the American Bankers Association, at 4 (Oct. 7, 2002).

#1) How should the effects of credit scores and credit-based insurance scores on the price and availability of credit products and property and casualty insurance be studied? What is a reasonable methodology for measuring the impact of credit scores and credit insurance scores on those prices and availability?

One way in which the FTC could study the impact of credit scores on the pricing and availability of credit is by comparing pricing and other information for institutions that currently use credit scores with information for those institutions that do not use credit scores. Ideally, the FTC should engage in a "before-and-after" comparison of the availability and pricing of credit products and property and casualty insurance for the same institutions. That is, the FTC should compare the pricing and other information for institutions,prior to their use of credit scores and credit-based insurance scores with those same institutions' experiences after the use of credit scores and credit-based insurance scores.

#2) An effect can often only be measured relative to a "counterfactual," that is, a hypothetical alternative situation. What is a reasonable counterfactual to the current use of credit and credit-based insurance scores?

I believe that a reasonable counterfactual that could be used by the FTC to determine the effect of credit scores (and credit-based insurance scores) on the price and availability of credit products (and property and casualty insurance) would be to compare the price and availability of credit products (and property and casualty insurance) as determined by the use of non-credit scores, that is, by the use of judgmental systems to price and evaluate persons for credit (and property and casualty insurance). However, to produce an accurate study, controls would have to be established that would hold constant other influential factors, such as inflation, competition, and economic changes. This approach would provide a reasonable alternative to the use of credit scores and credit-based insurance scores that is actually used by lenders and insurers.

#3) The study must consider the statistical relationship, using a multivariate analysis that controls for prohibited factors under the ECOA and other known risk factors, between credit scores and credit-based insurance scores and the quantifiable risks and actual losses experienced by businesses. What is an appropriate multivariate technique for studying this relationship?

Assuming that prohibited factor data could be gathered, I recommend that the FTC first evaluate a credit score or credit-based insurance score against the quantifiable risks and actual losses for a sample that represents the entire population. The result of this evaluation would be a formula that relates the score to a measure of the risk (or losses). The next steps would involve evaluating the score(s) and generating a formula for a sample that represents a sub-population with one of the prohibited factors.

The key to this analysis should be evaluating whether or not the generated formulas for the sub-populations show similar parameters to the formula generated on the entire population. The parameters will never be exactly the same, but they should be within a reasonable range. The evaluation should not compare the population distributions given by the scores, because there should be no expectation that the sub-populations will all contain the same number of individuals at any given risk level. That is, it will be important for the FTC to recognize that any differences in score distributions among the two populations may vary, unrelated to any prohibited factor.

#4 & 5) What is an appropriate methodology to determine whether the use of credit scores or credit-based insurance scores, or specific factors used in credit scores, results in negative or differential treatment of ECOA protected classes?

As a preliminary matter, I believe that if an analysis shows that the use of credit scores or credit-based insurance scores does not result in a "negative or differential treatment of ECOA protected classes," there should be no reason to analyze whether specific factors used in credit scores or credit-based insurance scores may create this result. That is, I believe it is unnecessary for the FTC to analyze specific factors, if the FTC concludes that credit scores or credit-based insurance scores do not result in negative or differential treatment.

One method that might be used to evaluate credit scores would be to use a specific score range and measure the delinquency, pricing, losses, or other risk factors associated with that score range for the population as a whole, excluding the protected class. For the same score range, the risk factors (delinquency, pricing, losses, etc.) would be evaluated for the population of the ECOA protected class. However, I believe this analysis must be performed for multiple score ranges, and not merely for one point in the score range or one range of scores, to evaluate whether credit scores result in negative or differential treatment.

To evaluate whether a scoring system results in negative or differential treatment, I believe the study should measure whether the losses, risks, or other factors, are systematically different and statistically significant for the ECOA protected class compared with the rest of the population. In particular, if the losses, risks, or other factors are similar to, or higher for, the ECOA protected class than for the rest of the population, the scoring system does not result in a negative or differential treatment of a protected class.

Moreover, I believe it will be important for the FTC to separately evaluate the system for multiple ECOA protected classes. For example, assume a system appears to result in negative treatment of protected class "X," but does not result in negative treatment of protected class "Y." Further assume that the scoring model is, solely for purposes of the study, modified and eliminates any negative result for protected class "X," but, due to the change, appears to result in negative treatment for protected class "Y." I believe it is essential for the FTC to perform this additional analysis before reaching any tentative conclusion that credit scores result in the negative treatment of protected class "X," because any such conclusions could negatively impact other protected classes.

I also believe that prior to the FTC reaching a conclusion that credit scores result in negative treatment of protected class "X," the FTC should determine whether there are other factors that could be used that result in less of a negative treatment, on a statistically significant basis, while at the same time providing at least as strong a correlation with losses, risks, or other factors. That is, even if the FTC tentatively finds that credit scores appear to result in negative treatment of a protected class, the FTC should not conclude there is negative treatment, unless it can demonstrate that other factors could be used that result in less negative treatment, on a statistically significant basis, and that are equally or more predictive of risks, losses, or other factors.

#7) Data are needed on geography, income, race, and other characteristics of borrowers, potential borrowers, insurance customers, and potential insurance customers. Are these data available?

As the FTC and FRB are aware, subject to an exception for loans secured by an applicant's dwelling and certain other narrow exceptions, Regulation B prohibits creditors from gathering information about the race, and other specified characteristics, of borrowers. In addition, we understand that state laws may prohibit the gathering of racial and other customer characteristics for insurance transactions. Nonetheless, information on geography, income, and age may be available from applications for credit and insurance, at least for some transactions.

#8) If the data discussed in the prior question are not available, what proxies are available for geography, income, race, and other characteristics for borrowers and insurance customers? In addition, if there are proxies for these factors/characteristics, what type of analysis would allow inferences using the proxies instead of the actual data on individual characteristics? What limitations are there to the inferences that can be drawn using proxies in place of data on individual characteristics? Finally, one potential proxy may be Census data. What type of analysis would allow inferences using data about the characteristics of the location where the borrower or insurance customer resides instead of data on individual characteristics? What limitations are there to the inferences that can be drawn in these circumstances?

There would be flaws in using proxy data such as U.S. Census data at the ZIP Code level, and projecting the Study's results to imply that they are an accurate portrayal of the results that would have been observed had the individual-level data been available. For example, consider that by using ZIP Code level data, the credit behavior of minority individuals who live in predominantly majority areas would be lost—all the subjects in the given ZIP Code would, to some extent, be treated as majority subjects; and likewise the credit behavior of majority subjects who live in predominantly minority areas would be lost. The results of the Study would potentially be inappropriately magnified (or, in all fairness, diminished) than the results of a study using individual-level data. In addition, the Census data will necessarily be "outdated" with regard to changes in the racial and other make-up of the population in specific areas. To the extent those changes are significant, they create risks in using such information as a proxy for race or other characteristics.

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I appreciate the opportunity to comment on this important matter. If you have any questions about these comments, or if I can otherwise be of assistance in connection with this matter, please do not hesitate to contact me, at (202) 887-8778.

Sincerely,

Leonard N. Chanin