TESTIMONY
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ON BEHALF OF THE
NATIONAL ASSOCIATION OF REALTORS®

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Introduction

Chairman Roukema, Ranking Member Vento, members of the Subcommittee, I am Jan Barnes, associate broker in the firm of Century 21- New Millennium, Lexington Park, Maryland. I am pleased to be here this morning to present a REALTOR perspective on the credit scoring disclosure bills pending in the Financial Institutions and Consumer Credit Subcommittee. I have been a REALTOR REALTOR is a registered collective membership mark which may be used only by real estate professionals who are members of the NATIONAL ASSOCIATION OF REALTORS and subscribe to its strict Code of Ethics. for more than 15 years. During this time, I have been active in the Maryland State Association as well with the NATIONAL ASSOCIATION OF REALTORS. I served as the 1994 President of the Southern Maryland Association of REALTORS, and held various offices in the Maryland Association, and was named 1994 REALTOR Of The Year. Most recently I was chair of the NATIONAL ASSOCIATION OF REALTORS Public Policy Political Forum and I am a member of the National Association's Conventional Finance and Lending Committee.

I want to thank you, Madame Chairman, for this hearing to focus attention on the need for disclosing credit scores to homebuyers. This is an important consumer question that deserves consideration as information technology starts to have impact on the mortgage lending and real estate transactions. Much like most consumer transactions, mortgage lending is evolving from a time-consuming paper intensive, segmented set of interrelated activities to a more integrated process facilitated with technological applications. The NATIONAL ASSOCIATION OF REALTORS began examining the issues associated with credit risk technologies associated with mortgage lending in 1996, not long after Fannie Mae and Freddie Mac introduced these technologies into their respective automated underwriting technologies. Our concern at the time was focused on understanding the new technology and what the implications were for the real estate transaction. Like any change in a familiar process, REALTORS raised a number of questions. The principal question related to what benefits would there be for homebuyers. Nearly immediately though, problems -- certainly antecdotal problems -- came to light because consumers knew little if anything about credit scoring. Lenders were unfamiliarity how best to use these risk assessment technologies. In some instances though, credit scoring was apparently used as a screen that directed homebuyers unjustifiably into more expensive mortgages. Difficulties associated with efficient data input and correct reporting to credit repositories were also cited in surging mortgage markets like California and to a lesser extent in the Midwest.

Pending Legislation

H.R. 2856, the "Fair Credit Full Disclosure Act," introduced by Rep. Chris Cannon, and H.R. 4644, the "Fair Credit Reporting Act Amendments of 2000," introduced by Rep. Harold Ford, Jr., address important issues as credit and risk scoring becomes more prominent and more widely known to mortgage credit consumers. Rep. Cannon's bill addresses the disclosure of credit scores and other risk predictors that may accompany a borrower's credit history data. Rep. Ford's bill addresses the adverse consequences of incomplete or inaccurate credit history data reporting. REALTORS applaud both of these Congressmen for their efforts. We believe that these bills are an important first step toward raising awareness about the impact that credit scoring may have on homebuyers as these mortgage credit consumers make what for many may be their most important financial acquisition.

On a separate track, REALTORS in California worked closely with state legislators, consumers, housing advocates, credit reporting agencies, and lenders to develop a credit scoring disclosure bill that garnered bipartisan support in both chambers of the State Legislature. In August, the California State Legislature adopted SB1607 by overwhelming votes in the State Senate and Assembly. That bill now awaits the signature of Governor Gary Davis to become law.

Credit Scores and Mortgage Lending

Credit scoring is gaining increasing acceptance in the mortgage lending transaction since Fannie Mae and Freddie Mac adopted automated underwriting technologies and included credit scoring as an element in evaluating mortgage loans that the two corporations purchase. Mortgage lenders have their own proprietary automated underwriting technologies and are also using credit scoring to facilitate their purchase money and home equity lending decisions on the full range of borrower credit quality levels – from conforming, the jumbo, to subprime lending. Daily more than 30,000 mortgage loans are processed through Fannie Mae's and Freddie Mac's automated underwriting technologies. This level of activity suggests a measure of the number of homebuyers affected by credit scoring.

Technology Applications

During the 1990s, the residential mortgage delivery system evolved in unexpected ways from what was anticipated at the end of the previous decade. Technology was a driving force for this change. Technology touched borrowers at loan application and moved through the process, enabling lenders and investors to process, service, price and trade more mortgages more quickly and efficiently. Loan servicing was the primary area of technology application in the 1980s. Loan servicing became highly automated in discharging lender's servicing department's traditional responsibilities for overseeing tax and insurance payments, monitoring delinquent loans, managing foreclosures and real estate-owned (REO), reporting to investors, and communicating changing loan terms to borrowers.

In the 1990s, technology became a facilitator of change for the origination and secondary market operations of mortgage firms. Development of automated underwriting systems (AUS) completely changed the credit granting activity of the mortgage firm, while systems like the Mortgage Electronic Registration System (MERS) changed the way ownership of mortgages is recorded.

There are three basic components of mortgage underwriting: determining the ability of the consumer to make the monthly mortgage payment; determining the willingness of the consumer to pay his debt in a timely manner; and determining the value of the collateral underlying the mortgage. In the mid-1990s, AUS revolutionized how residential mortgages were underwritten. AUS replaced rules of thumb human underwriters with computer-assisted decision tools that more accurately assessed the ability and willingness of consumers to repay their loans.

Credit Scoring Models and Mortgage Credit Risk

There are three distinct statistical models which are interchangeably referred to as "automated underwriting" -- credit scoring models, mortgage scoring models, and mortgage delinquency models. All three of these models are used in underwriting potential mortgage borrowers, however, it is important to note that these models are evaluating different aspects of credit performance. The distinction here is credit scoring models relate data to the outcome of credit performance (successes). Mortgage scoring models relate data to the outcome of mortgage performance (successes). Mortgage delinquency scoring models relate the outcome of mortgage delinquency (failures). All three models use data present in credit bureau files combined with application data collected directly from the credit applicant.

Because these systems have been successful in identify risk, AUS now is being used to price residential mortgages. More specifically, the mortgage finance industry has shifted from using AUS just to underwrite mortgages to pricing mortgages based on a consumer's specific risk characteristics. The actual implementation of risk-based pricing has been more difficult to implement than anticipated, however. Modeling credit risk through the AUS systems has come a long way, although embedding collateral risk, individual lender's tastes for business risk and prepayment risk into an AUS system has yet to occur.

Credit scoring, long used in the consumer lending and credit card arena, is now being used by the lending community in evaluating applicants for mortgage loans. Credit bureau scoring is a statistical assessment of how likely a borrower will repay a consumer loan. A credit bureau score is based on the data available in the borrower's credit report, and measures the relative degree of risk a potential borrower represents to the lender.

The three major credit repositories (Equifax, TransUnion, and Experian) prepare credit scores based on credit scoring models developed originally by Fair, Isaac and Company, Inc., called FICO scores. Although widely used by the mortgage industry, FICO is not the only credit score used by mortgage lenders. Many national lenders and mortgage insurance companies have developed their own proprietary risk models for internal use. All of these models look at the following items:

- past delinquencies;
- derogatory payment behavior;
- current level of indebtedness;
- length of credit history;
- type of credit used;
- how often credit is applied for during last 12 months; and
- number of credit inquires within the last 12 months.

Since credit scores are calculated at the repository and are based solely on the data within that repository's credit file, the three credit models above can generate different scores for the same borrower. These scores can differ because no single bureau has all of a person's credit history, and bureau files differ based on geographic area. Additionally, the computer systems weigh all information to determine scores according to proprietary algorithms that differ from Equifax to TransUnion to Experian. Consequently, secondary market and mortgage insurance firms require two credit scores be obtained per borrower and mandate the use of the lowest of the two scores. If three scores are obtained, the middle score is used.

While automated risk scoring both underwrites the consumer and prices the mortgage products offered, consumers are unable to obtain the actual score generated by the model. This lack of specific information puts the consumer at a competitive disadvantage when they shop for mortgage credit. Since mortgage lenders only advertise their best rate for highly qualified borrowers, consumers begin the process by not knowing whether they will qualify for the advertised rate. Under the current system, consumers must make a formal mortgage application that requires an up-front expenditure to the lender to cover a credit underwriting of the consumer and an appraisal of the property. This expenditure generally runs between $200 and $300. This fee compensates the lender for his due diligence costs of underwriting both the consumer and the property, but it also identifies those consumers who are seriously interested in a mortgage.

From the consumers perspective, however, not knowing whether they qualify for the best rate and paying a substantial dollar amount to one lender has a tendency to "lock" the consumer to one mortgage lender. If the consumer qualifies for that lender's best rate, there is no problem, since the consumer has already compared prices across lenders. However, if the consumer's score does not qualify him for the best rate, one of two things happens. Either the consumer is denied credit or they are offered a loan product with terms commensurate with the risk they represent to that particular lender. The problem lies in the fact that the consumer does not know what other lenders are charging riskier borrowers since these rates are unadvertised. The consumer has no idea if he is getting a good deal from the lender to whom he is now "locked". If the consumer were armed with his credit score, it could be much easier to compare lenders and loan products based on the score. A mortgage credit consumer can ask critical, well-informed questions of the lender such as: What are your terms and rates for a borrower with a 615 credit score, for example?

Consumers are at an even greater disadvantage in the subprime mortgage market, since unlike the prime conventional market, these loan products are not homogeneous. Some may contain prepayment penalties, balloon payment features, or negative amortization while others do not. Consumers must acquire much more information on the mortgage loans in the subprime market when shopping for mortgage credit. Without knowing their score, Consumers currently can not do this.

Credit scoring may be pervasive in the mortgage lending transaction and is fundamental in the decision to fund a mortgage application. Increasingly the credit score has impact on the pricing of a mortgage loan and influences the terms and rates. This is a consumer issue that better arms the home buyer with information to evaluate the mortgage loan terms and rates offered by any given lender.

What REALTORS Want In Credit Score Disclosure

REALTORS believe that the mortgage lending and credit scoring landscapes are sufficiently changed to require rethinking some basic assumptions about credit score disclosure. The National Association of REALTORS supports disclosure of the credit score, risk score, or risk predictor that would lead the mortgage lender to fund or not fund a mortgage credit application. The score should be accompanied by sufficient information to explain the credit score and provide a rationale for the offer of a mortgage and related terms.

REALTORS support the following regarding credit score disclosures:

- The credit score and the range of possible credit scores;
- No less than four key factors that adversely affected the credit score in the model used, including any reason code generated with respect to the credit score;
- An explanation of the credit score and reason code;
- The date the credit score was created;
- The name of the person or entity that provided the credit score or credit file upon which the credit score is based.

The FICO score and similar scoring models drive the mortgage score that lenders derive when credit history data is linked to mortgage application information. In the past, the argument ran that credit scores were too dynamic, too short-lived, and too complex for meaningful disclosure to consumers. Arguably this may be true, yet consumers should not be keep ignorant of their credit score. Now the credit score is integral to the mortgage lending decision and consumers do not have enough information regarding their credit scores to make an informed decision about mortgage products offered by lenders or to judge whether the lender is steering them into a more expensive product. Without knowing their score and important evaluative information that puts the credit score into context, consumers are at a disadvantage. That situation should end.

Consumers need to be fully informed as they make the decision to accept a mortgage offered by a lender. The disclosure should permit a borrower to evaluate the situation if denied credit, or if the rate or credit terms do not meet the borrower's criteria. Consumers should be empowered to ask the lender if a credit scoring system was used; what characters or factors are used in that system; and the best ways to improve the mortgage application.

Where mortgage credit is granted, the consumer should be able to know whether their received the best rate and terms available. If the borrower does not desire the terms offered, they should be able to continue comparison shipping for a more acceptable mortgage and terms based on the credit score data. If a borrower is not offered the best rate available because of inaccurate information in a credit report, the borrower should be able to dispute the information.

California Experience

NAR supports the thrusts of H.R. 2856 and H.R.4644, with the prospect of amending these bills along the lines of SB 1607, as adopted in by the California State Legislature. NAR has had long discussions with Rep. Cannon about the bill, the prospect of amendment and getting the bill to a hearing. NAR advocates lender disclosure of the credit score used in the mortgage application funding decision. Specifically NAR advocates disclosing the credit score and an explanation of the credits score; the four key reason factors for the score not being better than it may be; the date of the score; the model used.

Credit Scoring Benefits and Concerns

Anticipated benefits of credit scoring include a faster, streamlining lending process; reduced lender and, eventually, homeownership costs; wide mortgage credit availability to borrowers that appropriately considers credit history; reduced subjectivity in mortgage lending decisions.

Continuing concerns include an overarching fear that lenders may misuse credit scoring and keep borrowers ignorant of the role and importance of credit scoring in the lending decision. Credit worthiness is being redefined, as risk-based pricing becomes a reality. Credit scores should not be the sole determinant that a lender may use to fund a mortgage. There is evidence that lenders may use credit scoring as a screen to funnel borrowers into more expensive purchase money and home equity loan products. Though difficult, credit scores and credit behavior data can be used to abuse some mortgage borrowers. Without sufficient education and disclosure consumers remain disadvantaged about the "how" and "why" of lender credit risk assessment and decision-making.

Why Disclose Credit Scores

Homebuyers need mortgage credit scores – with meaningful explanatory data – to shop for mortgages and to evaluate lender performance and mortgage products better. Recently the California State Legislature adopted SB 1607, a bill sponsored by State Sen. Barbara Figureoa, by an overwhelming majority in both legislative chambers. This new legislation once signed into law would require a consumer credit reporting agency to disclose a credit score, risk predictor, or reason code and explanations if a credit score was furnished to a recipient of a credit report and would require a financial institution to provide a copy of information receive in connection with a residential loan application.

The California bill is a harbinger of a new direction regarding the disclosure of credit scores and supporting data. The California results should be the subject of federal attention as automated underwriting and credit risk assessment are integrated into the mortgage lending transaction.
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In an environment when few anticipated just how widespread credit scoring would become and how insistent investors would be in relying on credit scored mortgages that are pooled into securities, credit reporting agencies successfully argued to discontinue_credit scoring disclosure because consumers would be confused by the data disclosure and the credit scoring process is so dynamic. That was then, but times certainly changed.

Opponents of credit score disclosure often make contradictory arguments. Credit scores are complicated and borrowers would only be confused. Borrowers will "game" the score seeking to raise a score and thus invalidate their predictive power. Some lenders admit confusion about credit scoring, but they use credit scores because the GSEs insist on using their automated underwriting technologies to review loans purchased. There are some lenders that may argue against credit score disclosure on grounds of cost. Yet other lenders will disclose credit scores and explain their role in the mortgage funding decision as marketing strategy.

The prospect of credit scoring legislation in California contributed to recent lender and industry changes regarding credit score disclosure. Both Fannie Mae and Freddie Mac made public the factors used by their automated underwriting services to analyze mortgages sold to the two government-sponsored enterprises. Freddie Mac called on Fair, Isaacs, Inc, the originator of the FICO scoring model that dominates the industry, to take whatever steps are necessary to ensure that borrowers can receive and interpret the FICO scores used in mortgage funding decisions. Fair, Isaac recently announced the comprehensive list of factors used in its FICO credit bureau risk scores. Fair, Isaac is also developing a Web-based service that will explain individual FICO scores. The NATIONAL ASSOCIATION OF REALTORS congratulates these actions and urges additional industry effort toward more transparency regarding credit score disclosure.

Conclusion

Madame Chairman, the credit score bills pending in this Subcommittee are an important initial step in focusing attention on the role that credit scoring plays in the mortgage transaction. Credit risk assessment and automated underwriting technologies when used properly have the potential to broaden mortgage credit availability to more homebuyers whether their credit history is pristine or not. REALTORS believe that disclosing the credit score, the range that the score is in, the key factors that account for the score, and other supporting information will facilitate the mortgage lending process.

Knowledgeable consumers will be better able to select the appropriate mortgage for their financial needs. Moreover, consumers in the subprime mortgage market would also be less likely to become prey to predatory lending practices.

Madame Chairman thank you for the opportunity to present REALTOR views on pending credit scoring disclosure legislation. I conclude may remarks and will be pleased to respond to questions from you and the Subcommittee members.