Position on the Dodd-Frank Wall Street Reform Proposed Qualified Residential Mortgage Requirements

The Impact of the Qualified Residential Mortgage Requirements On the Housing Industry and an Alternative Approach for Quality Lending Standards

August 1, 2011

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The Impact of the Qualified Residential Mortgage Requirements on the Housing Industry and an Alternative Approach for Quality Lending Standards

Executive Summary

The Qualified Residential Mortgage (QRM) proposal presents potential needless devastation to the housing industry, and the United States national economy at a time when both are struggling to return to stability. In particular, the requirement referred to as "skin in the game", the retention of a five percent credit risk for mortgage loans originated without criteria set for the "Qualified" loans (comprised of large down payments of up to 20%, strict debt to income ratios, and other overly stringent underwriting standards), would produce a barrier to entry into the mortgage market for many Americans. The proposed QRM program would set up a two tier mortgage origination system, one of preferred rates and easy access to mortgages for the financially privileged and another that is so restrictive it would create an unwarranted elimination of the dream of home ownership for many Americans.

A study of the mortgage industry prior to the decade leading up to the financial crisis, reveals quality loans were underwritten with much less restrictive standards than those outlined in the QRM, which proved high re-payment performance, even through economic downturns. These were loans with zero to less than 10% down payments with high repayment records. One of the best examples of this is the performance of loans made by the Department of Housing and Urban Development's (HUD) Federal Housing Authority (FHA) and Veterans' Administration (VA), in which down payments of three percent or less are common and default rates are very low compared to default rates of other loan types that originated during the same time period of the loans that led to the financial crisis.

One of the issues that led to the financial crisis that has yet to be addressed is a single document that was a common denominator in every toxic loan in the industry meltdown, the consumer's credit report. It is the type of credit report deemed as a preliminary report for prequalification purposes only and substandard as documentation for an actual loan before massive changes swept the industry in the mid 1990's. It is also the same type of credit report used to document a borrower's credit information that contributed to the massive failure of CitiCorp Mortgage in the late 1980's. If we ignore history, we are doomed to repeat the same mistake regarding substandard credit documentation that will lead to future mortgage losses.

This substandard credit report was brought about by the drastic underwriting changes occurring in the mid 1990's. Loan underwriting moved from a manual process to an automated one via use of Fannie Mae's Desktop Originator/Desktop Underwriter (DO/DU) and Freddie Mac's Loan Prospector (LP), using credit score driven risk based pricing models to obtain loan approvals in less than a minute. To make the new automated processes work, the data inputs had to be stripped down, abandoning time tested credit reporting standards that had weathered economic downturns, for a report that could be produced in less than ten seconds.

While many of the modifications to industry standards required for the implementation of the automated underwriting systems worked well, an honest review of the performance of the stripped down credit documentation standards and the new processes that had to be developed to make it "work," raised questions about its reliability. This drastic change in the process for credit evaluation can also be looked at as having a crucial role in the financial crisis by enabling bad lending decisions and the opportunity for suspect lending programs.

Many consumers' credit histories were improperly documented with errors and missing data elements that, when applied to a credit score and risk based pricing model, allowed them to be pushed into higher cost loans that proved to be unsustainable. As the demand for these loans grew, more products were designed for this growing segment with increasingly permissive loan criteria. Other consumers' credit profiles made them look better than their actual credit risks. They were encouraged by the industry itself to borrow beyond their means and to cash in on the "hot" housing market. This fateful recipe created a time bomb that spilled tragically across our nation in a manner in which we are now all too familiar.

Fortunately, there is a simple solution for rectifying these credit reporting issues. It has two distinctive elements that succinctly address the unique challenges of this industry.

First, Make sure the "***Right Report for the Right Person***" is used to properly document their complete credit history dictated by the specific credit needs of that individual. To accomplish this efficiently the solution utilizes a hybrid approach to mortgage credit documentation that maximizes the best aspects of the automated underwriting process. This solution allows for good credit loans to pass through the system with the speed and efficiency it was designed to deliver, while heeding the warnings when the credit report show signs of risk. When specific problematic credit circumstances are present in an individual's credit file, some of the time tested, fraud preventive applications from yesteryear need to be applied to assure the credit report offers the most complete and accurate portrayal of the consumer's credit history.

Second, Eliminate the conflict of interest in credit reporting industry. While Congress and the FTC have taken steps to reduce the harm from the conflicts of interest between the appraisal industry and the mortgage originators and the commercial rating agencies and the companies whose bonds they are rating, there is still a conflict yet to be addressed. That is the one created when the mortgage originator owns or has an interest in the credit reporting agency issuing the report on the consumer they are financing. Just like the property appraisals the credit report should be "***Conflict Free***".

By changing these issues in the credit reporting industry, you will have created the most comprehensive credit investigation process possible. One that is free of conflicts of interest, includes the often currently missing data elements from the system in use today. When completed, consumers will gain a better understanding of their own financial profile and have input into the credit reporting process; a process that includes a more competitive cost structure than the market provides today. ***"The Right Report, for the Right Person – Conflict Free"***

About the National Credit Reporting Association, Inc

Founded in 1992, The National Credit Reporting Association, Inc. (NCRA) is a national trade organization of consumer reporting agencies and associated professionals that provide products and services to hundreds of thousands of credit grantors. Headquartered in the Chicago suburb of Bloomingdale, Illinois, NCRA serves members in the United States and Puerto Rico. NCRA's membership includes 80% of the mortgage credit reporting agencies in the United States that can produce a credit report that meets the requirements of Fannie Mae, Freddie Mac and HUD for mortgage lending.

Problems with the Proposed QRM Rule

NCRA will not address all of the problematic issues of the proposed QRM for the housing industry and the general economy. However, we have provided an overview of our beliefs in the Executive Summary and are confident that there will be a host of both mortgage industry and consumer groups that will provide very detailed itemization of the issues. NCRA's comments will focus on the specific issues regarding the mortgage process we understand best as it directly pertains to the credit reporting process.

With the Current System – How Do You Calculate the Exact Debt to Income Ratio?
One of the credit related problems of the QRM we would like to highlight is the specific 28% and 36% Debt to Income (DTI) ratios required to qualify for the proposed QRM. With the current credit reporting processes, balances on the credit reports are typically 60, 90 and often 120 days old or older. It is estimated that 35 to 54 million Americans have credit accounts that are not being reported currently to the three national credit repositories: TransUnion, Equifax, and Experian[1].

These missing accounts are often referred to now as "Alternative" or "Non-traditional" credit accounts. Over the past several years there has been a significant amount of research regarding the impact of this missing data. Prior to the collapse of the mortgage market, DTI ratios were stretched excessively and we applaud the attempt to correct that abuse; however, there still remains a problem with the QRM proposed solution. Though the proposed QRM rule requires a maximum of 28% and 36% DTI ratios, it does not require a system that has the ability to collect the accurate debt necessary to form the calculations. The problem is that there are significant missing debt amounts contained in the credit reports on a large percentage of the American population[2].

Background on Mortgage Credit Reporting Standards
Before going further in addressing the credit reporting problems within the QRM, it is important to backtrack somewhat and fully understand the two primary types of credit documentation standards in use:

- The Residential Mortgage Credit Report (RMCR)
- The Three Bureau Merge Report (TBM)

Long standing mortgage guidelines required the use of the RMCR for solid underwriting principles that were designed to provide both lenders and consumers the most accurate and complete picture of the credit history possible. The procedures for producing an RMCR varied slightly between the various government housing agencies and the Government Sponsored Enterprises (GSEs, Fannie Mae and Freddie Mac); however, the standards of each required

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[1] New to Credit from Alternative Data. By: Michael A. Turner, Ph.D., Patrick Walker, M.A. and Katrina Dusek, M.A. POLITICAL & ECONOMI.C RESEARCH COUNCIL, (PERC). March 2009, Page 6. http://perc.net/files/New_to_Credit_from_Alternative_Data_0.pdf

[2] PERC has conducted three studies and reports on the subject of Alternative or Non-Traditional Credit Data. The other are (2006) *Give Credit Where Credit is Due: Increasing Access to Affordable Mainstream Credit Using Alternative Data* by PERC and The Brookings Institution Urban Markets Initiative, and *You Score, You Win: the Consequences of Giving Credit Where Credit is Due*. Additionally a study on Alternative data was conducted by Maas, Ericca. (2008) "Credit scoring and the credit-underserved population" The Federal Reserve Bank of Minneapolis. (16 Sep 2008) available at: http://www.minneapolisfed.org/publications_papers/pub_display.cfm?id=2452 with similar supportive findings.

information and research far beyond the basic data found in the national credit bureaus. The data available from the national credit bureaus is commonly referred to as "raw data", versus the data in an RMCR which is often referred to as a "full factual" or "reinvestigated" data. The best source for the specific requirements of the documentation procedures for an RMCR was published by Fannie Mae in 1988.[3] This outline by Fannie Mae concluded a collaborative effort by Fannie Mae, Freddie Mac, HUD, FHA, VA and FmHA to reconcile each of their specific credit RMCR guidelines into a standard format that would be uniform across all entities for residential mortgage loans.

Some of the highlights of this reconciliation of the required procedures include:

- Removal of all duplicate account listings
- All balances reported within 90 days
- Addition of any accounts listed in the loan application not found in the national bureau records
- Investigation of all inquiries for the past 90 days
- Verification of employment for two years
- Update all public records
- Letter to the consumer asking for written explanation on any derogatory items on the report for the consumer to be submitted to the loan underwriter
- Consumer interview to assure completeness of report
- A total of five pages of requirements as shown in Fannie Mae Announcement 88-05
- Statement certifying this report meets these standards

Fannie Mae also clearly stated that "The preparation of a Residential Mortgage Credit Report requires research and quality control procedures that take time for the reporting agency to properly complete. Credit reports that are rushed through to completion are more likely to have errors and omissions and may not include research routines that are necessary to comply with these requirements. Reports generated in this manner are unacceptable".[4]

In the late 1980's, one notable lender negotiated out of following these guidelines; this lender was CitiCorp Mortgage. CitiCorp was aggressively trying to become the nation's largest mortgage lender, and decided that cutting corners in many areas would advance their goals of gaining market share. One such corner cut was the abandonment of the RMCR standards in search of lending speed and cost savings. The result was more than $200 million in mortgage losses, a staggering number in the early 1990's. The Comptroller of the Currency cited "… sloppy practices that exposed the banking company to excessive risk" as a cause of the losses at CitiCorp Mortgage.[5]

"Those who don't know history are destined to repeat it." Sir Edmund Burke (1729-1797)
Within just a couple of years of the joint efforts of the nation's housing giants to reconcile the

[3]Fannie Mae Announcement 88-05 3/22/88 Residential Mortgage Credit Report Standards – see Appendix "A"
[4] Ibid., p.2.
[5] *"Citicorp Criticized on Mortgages That Expose it to Too Much Risk"* The New York Times, 3 September 1992, http://www.nytimes.com/1992/09/03/business/citicorp-criticized-on-mortgages-that-expose-it-to-too-much-risk.html?src=pm

standards for RMCRs, and despite the findings of the Comptroller of the Currency regarding the CitiCorp Mortgage losses, Fannie Mae and Freddie Mac were moving to abandon the RMCR. They made drastic changes and eliminated almost the entire requirement list they previously utilized to reconcile the entire industry in a quest for a technological solution to mortgage underwriting.[6]

The GSEs concept was to switch to the TBM as the standard credit report in the housing finance industry. The goal of Fannie Mae and Freddie Mac when changing to the TBM was to facilitate a totally automated mortgage lending decision, with two priorities in mind:

1. Cost Reduction – in theory the new report saves about $30 per mortgage application.
2. Speed – the credit data needed to underwrite the loan is ready in less than ten seconds.[7]

This quest for cost reduction and speed was the polar opposite of Fannie Mae's concerns just a few years earlier when they chaired the joint housing summit to reconcile the RMCR criteria and make a uniform standard across all government and GSE housing authorities. They moved completely away from quality and suddenly the previous position of "… reports that are rushed through to completion are more likely to contain errors and omissions" was no longer a concern.[8]

Driving this reduction in data quality was a triumvirate comprised of the GSEs, the large lenders, and the national credit bureaus. The GSEs wanted to maximize the advancements in computer technology to create an automated underwriting system and modernize the way mortgages were underwritten. To accomplish this, a credit product was needed within seconds not days, and they were willing to cut a lot of corners to obtain the speed and cost savings they planned via automated underwriting.

What about Accuracy?

The GSEs were told by the national credit bureaus that accuracy was not going to be an issue with this new TBM report. The RMCR only required two of the national credit bureau files to be used as base data from which to build the file. The GSE's believed that by requiring the addition of the third credit bureau, the data that was being manually added to the RMCR would now be included in the TBM.

To quantify this and secure the transition to include a report from each of the three credit bureaus for every mortgage transaction, The Associated Credit Bureaus (ACB), now known as the Consumer Data Industry Association, (CDIA) designed a study to convince the GSEs that accuracy would not be compromised. In 1991, ACB commissioned the accounting firm of Arthur Andersen (ACB/AA) to conduct research on the accuracy of the national credit databases.

The ACB/AA study was reported as a random sample of 15,703 consumers' credit applications from five lenders. These consumers had been denied credit based on the information contained

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[6] "*Many Big Lenders Plan Switch To Quick, Electronic Credit Evaluations*" The Washington Post, 12 February 1994

[7] NCRA representatives met with Fannie Mae officials many times and the "Faster and Cheaper" theme was consistently repeated at every meeting.

[8] Op. Cit., Fannie Mae No. 88-05

within their credit reports. These denials were tracked to see if the consumers exercised their rights to obtain a free copy of their credit report after the adverse credit decision. Those consumers who did obtain a copy of their credit report were further monitored in case a dispute was filed challenging the accuracy of the data in the report. After the credit bureaus investigated these disputes, if the dispute resulted in a change in the repository credit file, the original lender was requested to reconsider the consumer's application based on the updated credit data. The final results: the ACB/AA study claimed an error rate of just .02%.[9]

This sealed the GSEs decision to drop the requirement for the RMCR.

NAICRA and other Conflicting Study Results

The result of the ACB/AA study was in direct conflict with other credit report accuracy investigations at the time.[10] The other studies were conducted by consumer advocacy groups with small and non-random samples with vastly differing results; errors rates of 40%, 50%, 60%, even 70%. While NCRA members knew that the data was more accurate than being reported in those limited studies, what was the real error rate and what is the statistical difference between the two report types? NCRA (then known as the National Association of Independent Credit Reporting Agencies (NAICRA)) commissioned its own study via its members using randomly selected live credit reports currently being reviewed for real mortgage applications. NCRA members reviewed 1,460 consumer credit reports, comparing and contrasting the data of both the two bureau RMCR versus the new standard TBM, looking at both data accuracy and data completeness in each report type.[11]

NCRA found significant differences in the two report types, and some troubling findings:

- 50% had duplicate data
- 44% of the TBM had missing balance/payment information
- Most importantly, 30% of the RMCRs had accounts that belonged to the consumer that had been completely missed by the TBM
- 19% of the TBM files had accounts with balances being reporting older than 90 days
- 16.5% of the RMCRs had removed derogatory data that was identified to another consumer
- 3% of the RMCRs had removed current data that was identified to another consumer.

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[9] This full report was never made available; however, the revised calculations conducted via the Executive Summary released and the various article written about in numerous sources including:
Daniel B. Klein and Jason Richner "In Defense of the Credit Bureau" Cato Journal, Vol. 12, No. 2 p. 407-408 (1992) and Federal Trade Commission Report to Congress "Under Sections 318 and 319 of the Fair and Accurate Credit Transactions Act of 2003" December 2004.

[10] In 1990 US PIRG conducted a study and in1991 the Consumers Union also studied credit report accuracy. Both studies found error rates of between 45-80%. http://www.uspirg.org/home/reports/report-archives/financial-privacy--security/financial-privacy--security/mistakes-do-happen-a-look-at-errors-in-consumer-credit-reports and http://www.consumersunion.org/pub/core_financial_services/000287.html

[11] 1994-*NAICRA Survey/Study Three Bureau Merged Infile vs. Two Bureau Residential Mortgage Credit Report* NAICRA Secondary Committee Karen Slezak, Jim Williams and Barbera Meismer March 01, 1994

- 2% of the RMCRs had identified erroneous public record information of another consumer
- 35% was the estimate of the total error rate in the TBM that would have been corrected with an RMCR
- One of the most surprising findings in the study was that the third bureau added only 2% unique data not found on the other two bureau files.[12]

The ACB/AA Study - Flawed Methodology

Fannie Mae and Freddie Mac dismissed all of the consumer group studies and the NCRA study, putting complete faith in the ACB/AA study and moving steadily into the TBM requirement. Real world experiences did not back up the .02% error rate found in the ACB/AA study as complaints about credit report inaccuracies continued. While details regarding the ACB/AA study have never been completely released, information that was released over time revealed that the ACB/AA study contained a serious design flaw that greatly understated the error rates. This flaw in the study methodology was buried in the calculations. The study made a major assumption regarding the accuracy of the data in the credit reports. It assumed that there was an error only if the consumer proactively elected to write to the credit bureau to request a copy of the credit file. The ACB/AA methodology relied on the consumer being proactive; the consumer needed to read and understand the required adverse action notice when being denied credit. If the consumer did not write to the credit bureau seeking a copy of their credit report after being denied credit, the study ***assumed*** that all of the data in the report was accurate.

Of the 15,703 credit reports ACB/AA tracked for this study, 14,480 of the consumers (who had no idea that there was a study going on, or that they were part of it) never requested a copy of the report.[13] It seems completely unreasonable to ***assume*** that just because a consumer did not write to request a copy of his/her credit report that the data in the report is in fact accurate. This methodology further assumes that every consumer who did obtain a copy of their report actually reviewed it, comprehended the data contained within, and took the additional step to write a letter of dispute on any discrepancies found.

A more accurate methodology would have moved any credit reports that were never reviewed by the consumer for accuracy to a neutral stance. By moving the 14,480 "accurate" consumer reports to a neutral position (because their "accuracy" was based on unreasonable assumptions) and then recalculating the rest of the findings, ***the ACB/AA study results produce an error rate of 22%!***

It is important to note that this study only includes significant errors that include enough derogatory data to completely change the outcome of the lending decision from no to yes. Any loans that have misplaced good credit accounts would not be considered, and since risk based pricing models were not in use at the time of this study, any minor errors that today would cost the consumer higher interest rates were also not taken into consideration.[14]

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[12] Ibid. pages 9-12.

[13] Op. Cit., FTC Report to Congress, December 2004, p.26 footnote 104.

[14] ACB Andersen and Co calculation: 15,703 consumer denied credit, 1223 consumers requesting a copy of their credit report, 304 consumers responding with disputes, 267 disputes produced changed data, 36 of those changes reversed the outcome of the original decision. An alternative methodology reruns the numbers with 14,480 neutral

The Three Bureau Merge Was Not Working Well, But it Was Too Late

By the time the faulty methodology was discovered in the ACB/AA study, the GSEs decided that the credit files were accurate enough to eliminate the safety features of the RMCR, and the damage to the mortgage credit reporting system was complete. Beginning in the mid 1990's and consistently increasing throughout the decade, the number of lenders using the substandard TBM credit reports was nearly 100% by 2000. HUD's FHA and VA were slower to adopt the new report type; however, lenders wanting flexibility to send the loan file to any funding source used the GSE's new report as the standard. There was also a major financial incentive to use the new AU Systems and the TBM. The GSEs "have agreed to waive certain financial commitments normally required of lenders if the loan sold to them has been underwritten by their automated systems".[15] One of the common waivers provided lenders for use of the new report and the automated systems was a release of recourse to the mortgage originator for a loan buyback based on the new requirements.

There were warning signs that the new system was not working as well as expected, even if one believed that the .02% credit report error rate was accurate. NCRA and some of the consumer groups were not the only ones to raise questions about credit report accuracy and the transition to the TBM. One of the three national credit bureau's affiliated companies was sounding alarms about the TBM report not being reliable as well. A "Special Report" issued by the executive staff of the Commonwealth Information Services, Inc. (now known as Equidata) outlined 16 pages of pitfalls they believed awaited mortgage lenders and consumers if the TBM (which they referred to as a "Merged Infile") became the standard for the industry.[16] Regardless of the protests, the GSEs moved forward as the demand for mortgages was expanding more rapidly each year.

By the early 2000's the problems with the TBM were obvious and some loans were costing consumers much higher interest rates than prior to the TMB's implementation. Correcting errors on the credit report was also an issue. Those that pushed the TBM into the market "solved" the problems by creating a new system called "rescoring" to allow the mortgage credit reporting agency to update the credit data at the repository level on an expedited basis and then re-access the credit bureau to obtain a new score that could then be re-issued into the GSEs' AU systems for approval. By early 2001 rescoring was gaining popularity and making news.[17]

While this was an improvement over the previous solution, it still contained pitfalls as typically the consumer needed to be proactive and seek out the rescore to obtain the best rates. Many lenders were not quick to offer rescoring, finding it preferable to offer the consumer higher interest rates reflective of the consumer's original score. The cost savings promised by the TBM

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reports and then use the same methodology. A minimum 21.8% error rate is now the ACB Andersen and Co findings. http://cdia.files.cms-plus.com/PDFs/andersenexecutivesummary.pdf

[15] Federal Reserve Bank of Minneapolis, "Mortgage Automation Threat" p. 3, Ron J. Feldman, Senior Financial Specialist, December 1996 http://www.minneapolisfed.org/publications_papers/pub_display.cfm?id=3645

[16] "*Special Report – Merged infile vs. Residential Mortgage Credit Report"* Prepared by the Executive Staff of Commonwealth Information Services, Inc. Newport News VA was released providing very similar findings to those of the NCRA. Only these findings were being published by a 100 year old credit reporting company that is affiliated with the national credit repositories and a member of the ACB/CDIA.

[17] *"Improve your Loan Prospects with Rapid Rescoring"* Orlando Sentinal, 15 July 2001, *http://articles.orlandosentinel.com/2001-07-15/business/0107130014_1_credit-scores-fico-scores-credit-files*

were quickly lost as well. Costs associated with the simplest rescores were higher than the cost of the RMCR, which provided every account updated and corrected for a flat rate. Rescores would be billed to the mortgage originator on a per account basis, and per national credit bureau. Average rescore costs were more than 350% of the cost of the RMCR that the TBM was designed to replace.[18]

"Why Don't I Have a Credit Score When I Have Credit Accounts?!"

In addition to rescoring (and its invention due to need), the TBM report lacks certain consumer credit accounts that are not found within the data of the three national credit bureaus. This additional data is reported on an RMCR. To avoid being considered a bad credit risk when they had no credit reported, a new product was needed for some consumers to avoid being pushed into higher cost sub-prime loans. FICO estimates that 25% of the US adult population (about 50 million individuals), lack enough traditional credit data to generate a FICO score.[19] The need for obtaining the non-traditional or alternative data has grown as the national credit bureaus have consolidated and creditors now face higher active account requirements to report to the national bureaus.[20] To try to combat this, Fair Isaac, the creators of the FICO Score, added the FICO Expansion Score on a limited basis to some credit reporting agencies. The product helps some people obtain a better rate; however, like rescoring, it is often only offered to the consumer if the higher cost loans are rejected.

With the RMCR, the options created for the TBM that corrected errors and added missing accounts onto the consumer's credit history were not options at all, but actual requirements that the credit reporting company had to certify were included in the report. All of these investigations were done as a matter of course on the RMCR, in two to three business days, at a flat rate of about $50.

The loss of these data quality elements is the reason why we refer to the TBM report as an enabling factor for some unscrupulous mortgage originators (brokers and bankers alike) to use the substandard credit report as an enabling factor in the financial crisis.

Consumers who were not given the opportunity to correct their credit issues in time to close the loan were forced to accept higher cost credit terms or find another lender after they corrected the issues on their report. Often that was impossible as many lenders had taken the RMCR out of their lending options even though it is still widely recognized as the most complete and accurate

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[18] RMCRs had a national average of about $50 flat, regardless of the number of accounts needing corrected or updated. Rescores had an average cost of $50 to $60 per account, per credit bureau needing changed, the average rescore fee at approximately $200.

[19] http://www.fico.com/en/Products/Scoring/Pages/FICO-Expansion-Score.aspx

[20] At the peak in the 1980's there were more than 1,500 credit bureaus in the US, each affiliated with one of the national credit bureau networks often referred to as a national credit repository. These affiliates actual owned the data being collected from creditors in their geographic territory and sold it via the national credit repository with which they were affiliated. Today there is only one affiliate remaining, CSC Corporation (a former repository itself) being serviced by Equifax. When the affiliates existed, creditors only had to meet the minimum reporting requirement of their local affiliate to be able to report to the credit bureau. Now, creditors have to report to the national credit bureau and many smaller creditors do not qualify to report as their business does not meet the minimum number of active credit accounts (between 250 and 500 per month) to qualify for adding their account histories to the credit bureaus.

report available.[21] Too often it was only the most financially literate consumers that would push the lender into correcting or adding the alternative data needed to obtain the proper interest rate based on their true credit risk. By using the right credit report for the consumer the cost of the credit report can often be recovered in a single month due to savings in the interest rate.[22]

Another issue: Conflict of Interest

Another cause of concern in the mortgage credit reporting industry has the potential to impact quality lending standards, it is conflict of interest. Certain lenders own or participate in a joint venture/partnership with the credit reporting company producing the consumer credit reports on the loans being funded. As the TBM credit report became the dominate reporting method in the mortgage industry, the previous tradition of an "arm's length" relationship between the lender originating the loan and the credit reporting agency supplying the credit report for the transaction ended. The earliest example of this change in the lender credit reporting agency ownership was in 1996 when Countrywide Funding creating a wholly owned subsidiary called Landsafe.[23]

The credit reporting agency produces the single most important factor in determining if the consumer gets the loan and at what cost. The interest rate is based on the credit score and the quality of the processing of consumer credit data disputes directly impacts the score. This compilation of information can dictate a greater cost to the consumer than even the purchase price of the home over the life of a 30 year mortgage. Since the lender's profit on the loan is based on the interest rates charged, the conflict of interest here is obvious.

After the recent financial crisis the potential harm of conflicts of interest were exposed and Congress moved to correct some of these conflicts. The Federal Reserve Board announced an interim final rule as part of the of the Truth-in-Lending Act (TILA), revisions of the Dodd-Frank Wall Street Reform to address conflicts in the relationship between home appraisal providers and the mortgage originators. TILA section 129E establishes new requirements for appraisal independence with amendments designed to ensure that "… real estate appraisals used to support creditors' underwriting decisions are based on the appraiser's independent professional

[21] A review the website product offerings of most mortgage credit reporting agencies today and you will see them tout the RMCR as their premium credit report product. " Credco's RMCR is our most comprehensive and complete credit solution. Meeting or exceeding Fannie Mae, Freddie Mac and Industry standards, it's the ideal report for complex credit histories that require verification of multiple items. " Credco is the largest reseller credit reporting agency and part of the First American/Corelogic companies. The credit bureau Experian holds stock in the parent company of Credco.
http://www.credco.com/uploadedFiles/Credco_Site/Products/Instant_Merge_Suite/instant_merge_upgrades_ds.pdf

[22] "*The Cost of Bad Credit*" The Washington Post, 16 July 2011. http://www.washingtonpost.com/wp-srv/special/business/cost-of-bad-credit/ Even at below 5% interest rates a 40 point change in a consumer FICO score, a movement from 660 to 700, will save the consumer $39 per month per $100K in loan amount.

[23] "*The LandSafe story: born as a subsidiary of Countrywide Financial Corporation, LandSafe has emerged as a powerful competitor for other lenders' closing-services business*", CBS Money Watch, August 2003, Steve Bergsman, http://findarticles.com/p/articles/mi_hb5246/is_11_63/ai_n29019050/pg_3/?tag=content;col1

judgment, free of any influence or pressure that may be exerted by parties that have an interest in the transaction."[24]

Specifically, one of the appraisal independence provisions in Dodd-Frank prohibits appraisers and appraisal management companies from having a financial or other interest in the property or the credit transaction.[25]

The conflict of interest between the credit ratings agencies and the bonds they rate is an interesting parallel to this issue, on the commercial side of the transaction. This conflict was also exposed during the recent financial crisis and Congress held "heated" hearings over these abuses and the damages they caused.[26] Although the Congressional corrections to this conflict did not make it into the final bill, the Securities and Exchange Commission (SEC) was instructed by Congress to continue investigating this issue and have come to similar troubling conclusions. SEC Chairman Christopher Cox reported finding, "… insufficient attention to conflicts of interest."[27]

While the Dodd-Frank is clearing up the conflicts of interest in the mortgage appraisal portion of the transaction and the SEC is addressing the commercial conflicts of interest from the ratings agencies, consumers are still exposed to conflicts of interest and the inherent problems they bring. Two of the nation's largest banks, Wells Fargo and Bank of America, own directly or have a joint venture in credit reporting agencies that evaluate consumers for their loans.[28]

As the originator and source of the funding for the loan, the greatest possible financial interest in the outcome of that loan transaction is present in this conflict of interest and Congress missed this relationship in the Dodd-Frank revisions. NCRA believes the relationship between the mortgage originator, the funding source, and the provider of the credit report, needs to maintain that "arm's length" relationship for the safety of the consumer and the investors.

The Solution:
Blending the Best of the Old and the New Reporting Standards for Greater Efficiencies

Surprisingly, the solution to return quality to the mortgage underwriting process without cutting off access to credit to millions of American is not a complex one. Lenders can simply adopt it, if required to do so as the tools are all still available in the market currently, but just not readily used due to pressures to use the TBM.

[24] "*Fed Implements Dodd-Frank Appraisal Independence*" Wall Street Reform.org, 3 December 2010, http://www.wallstreetreform.org/2010/12/03/fed-implements-dodd-frank-appraisal-independence-requirements/

[25] Ibid. p. 2.

[26] "*Credit-Rating Firms Grilled Over Conflicts*" The Washington Post, 23 October 2008, Amit R. Paley, http://www.washingtonpost.com/wp-dyn/content/article/2008/10/22/AR2008102202311.html

[27] Securities and Exchange Commission. "*SEC Examinations Find Shortcomings in Credit Rating Agencies' Practices and Disclousures to Investors*" July 2008. http://www.sec.gov/news/press/2008/2008-135.htm

[28] Bank of America, via its acquisition of Countrywide Funding now operates Landsafe as a wholly owned subsidiary. Wells Fargo and CoreLogic/Credco have a joint venture called RELS Reporting Services LLC.

The proposed QRM Rule needs to implement a mortgage credit reporting and underwriting process that blends the best of both worlds. A relatively small adjustment in the manner in which the industry operates will yield huge positive outcomes. This adjustment allows for total automation when appropriate, but also *REQUIRES* the safeguards that protect both the consumer and the mortgage lender when there are signs in the consumer's credit profile that problems may exist.

The key to this solution is the word *REQUIREMENT*. A mandate to the lender to initiate an investigation and obtain a standardized explanation from the credit reporting agency who furnished the mortgage report after investigating the differences in the credit data when the credit scores vary by a significant factor.

A "Mortgage Credit Reporting Agency" (a "Reseller" as defined in the Fair Credit Reporting Act, (FCRA)) can investigate these discrepancies for accuracy within 72 hours in most cases, allowing for a better lending decision to be made in a timely fashion when specific credit conditions warrant caution.

How this System Works

The first step is exactly the same as the current process: access each of the three national credit bureaus for a TBM report with credit scores. Of the three, the middle credit score is the most important as it is used to price the loan by the lenders. If that score is more than the score level pre-determined by the lender at which consumers receive the best interest rate (we will use 700 as the score required for the best rate in this example), the lender proceeds with the totally automated report and lending process that is currently in place. If the middle score is less than our 700 example, and the other two credit scores are not used in the pricing of the loan (the high and low of the three scores) have less than a 25 point difference between them, the lender again proceeds as before using a risk based pricing model that is currently a standard practice in mortgage lending. Or, at this point the lender may decide to deny the loan if the risk is too great.[29]

The change in the process occurs when consumer specific credit situations warrant an additional credit review. A review would be appropriate when the middle score is below the level of risk needed to qualify for the lender's best interest rate, so risk is being priced into the loan, and the difference between the high and low credit scores is greater than 25 points. When these conditions are present, this application has some significant credit data variances that would ***require*** some additional credit analysis (an RMCR) prior to approval. It is imperative for both the safety of the lending institution and the mortgage applicant that this application is not underwritten with questionable credit data, especially considering that the data can be investigated and returned to the lender in a reasonable amount of time (less than three business days).

[29] A 25 point variance was selected as most mortgage lenders price their loans in 20-25 point increments and this represents a change in interest rate for the loan.

This hybrid approach incorporates the best practices of the automated underwriting technology systems that revolutionized the mortgage process in the mid-1990's with the safeguards that protected the lending industry for decades. Let us not ignore history and doom ourselves to its repetition. Let us learn from the mistakes that led to the recent housing finance crisis and, in so doing, implement a common sense based system that will efficiently and effectively serve us and future generations to come.

Are Changes Really Necessary,
Based on Recent Improvements to Consumer Credit Report Accuracy?

In May, 2011 PERC released a report commissioned by the CDIA to study data accuracy.[30] This peer reviewed study is well crafted and to the notable academics who participated in its preparation, it is impressive industry analysis. However, to credit reporting and banking professionals willing to provide an honest analysis of the data they see daily, the findings are suspect. The lead finding of the study was that the error rate found in the credit reports reviewed was .93% and that 95% of the consumers who knowingly participated in the study were satisfied with the way the credit reporting system handles disputes.[31] This study was designed and funded by the trade association and lobbyist team for the companies it is studying. This is the same sponsor (with the new name) as the 1992 ACB/AA study conducted nearly 20 years ago that was designed to under report the error rate in credit reports. No other studies of credit information have found error rates anywhere near these low levels.

A review of the study details provides questions and insights into how this low of an error rate was obtained.

- The consumer selection criteria were not disclosed. Have the selected consumers been recently or currently enrolled in a credit monitoring program?
- The reports used for the study were consumer disclosure reports and not lending reports. Consumer disclosures require strict data inputs and have tighter matching criteria that are known to filter out some of the most common errors, credit files that have data mixed between more than one individual.
- A correction made due to a consumer dispute required a change of at least 25 points to the credit score to count as an error, claiming that would be the point change needed to have an impact on the loan costs. The change of a single point can have as much of an impact on the cost of the loan as 25 points, if the consumer is one point below one of the risk based pricing tiers then the price of the loan is subject to change.
- When processing the consumer disputes, were the study participants routed to the general customer service centers or the V.I.P. customer call centers?[32]

While the study is impressive for its professional design and depth of research, the findings just do not match the real world experiences of the average American consumer. Based on the aforesaid issues and considering the methodology of the previous study funded by the national

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[30] "*U.S. Consumer Credit Reports: Measuring Accuracy and Dispute Impacts*" Policy & Economic Research Council (PERC), May 2011, page 4, http://perc.net/files/DQreport.pdf
[31] Ibid. p. 8.
[32] Ibid., Multiple pages throughout report.

credit bureaus, (the 1992 ACB/AA study) it looks very likely that the methodology behind this study has been carefully crafted to obtain the unrealistically low error rate it claims.

Conclusion

Now more than ever, changes are needed to properly document a consumer's credit history. Millions of consumers have recently experienced the heartache and despair of foreclosure and the embarrassment associated with adverse credit circumstances. For the economy to recover, consumers who have been trying to pay down their obligations need the benefits of a more comprehensive credit reporting system for mortgage lending. By eliminating conflicts of interest and returning to the proven elements of the RMCR credit investigation for those consumers whose credit specifically dictates the added analysis will resulted in increases in fraud prevention, consumer education, data accuracy, and quality to the lending process.

The proposed QRM would be devastating to the housing industry and American consumers. The requirement for a "quality" residential mortgage can be obtained without the high down payment and other overly strict requirements that would create a barrier into the mortgage market for many Americans. By implementing the recommended solution of using a mortgage credit reporting system that maximizes the best aspects of automation and returns some of the RMCR procedures that provided both lenders and consumers a safety net to ensure accurate credit data, lending quality can be improved without the restrictive standards the proposed QRM rule would create.

The Right Report for the Right Person – Conflict Free!