

U.S. Structured Finance Newsletter

Volume 4, Issue 21, May 28, 2008



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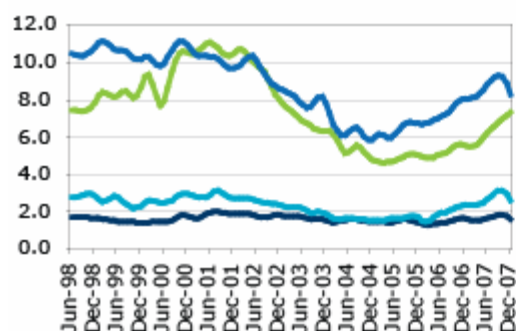
THE RELATIONSHIP BETWEEN CREDIT SCORING AND DELINQUENCY

The Federal Reserve recently submitted the Report to the Congress on Credit Scoring and Its Effects on the Availability and Affordability of Credit.¹ This report, which meets the requirements of the Fair and Accurate Credit Transactions Act of 2003, presents the efforts of the Federal Reserve Board (FRB) to assess the impact of credit scoring on credit markets, including mortgage and other consumer lending, and its conclusions about credit scoring.

Noting that the use of credit scoring has become pervasive, the FRB study attempts to address four primary issues: (1) to broadly identify the impact of credit scoring on the availability and affordability of consumer credit; (2) to establish the relationship, if any, between scores and lender losses; (3) to identify the impact of scoring on subgroups of the general consumer population; and (4) to identify any negative effects on particular subgroups and the means by which negative effects could be eliminated. To conduct the study, the FRB merged personal demographic information from Social Security Administration records, estimates of income by census-block or census-tract place of residence and marital status from a third-party supplier of demographic data with a representative sample of more than 300,000 credit reports from TransUnion LLC, one of the three major credit-reporting bureaus.

The FRB concluded that “the credit history scores are predictive of credit risk for the population as a whole and for all major demographic groups. That is, over any credit-score range, the higher (better) the credit score, the lower the observed incidence of default.”² This theory has certainly proven true over time for the mortgage industry and is described in more detail in the charts below.

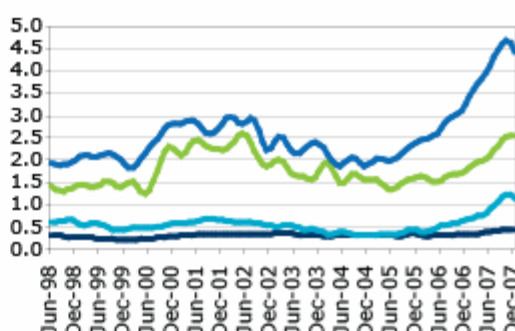
Prime vs. Subprime 30-Day Delinquencies



— Prime Fixed 30 Days Delinquent
— Subprime Fixed 30 Days Delinquent
— Prime ARM 30 Days Delinquent
— Subprime ARM 30 Days Delinquent

Source: MBA and DBRS.

Prime vs. Subprime 60-Day Delinquencies



— Prime Fixed 60 Days Delinquent
— Subprime Fixed 60 Days Delinquent
— Prime ARM 60 Days Delinquent
— Subprime ARM 60 Days Delinquent

Source: MBA and DBRS.

DBRS agrees that credit scores have historically been predictive in determining the likelihood of a borrower to repay a mortgage; however, it should not be used exclusively. While a credit score can suggest strength of character, demonstrated by past credit performance, it cannot address capacity. This has been traditionally accomplished by documenting a borrower’s income, calculating the cost of a borrower’s financial obligations and measuring the relationship between the two. To the extent that the collateral value is well established and that it is greater than the credit extended, the collateral itself may serve to compensate for any deficiencies in the assessment of capacity. DBRS will continue to monitor the industry for credit-scoring trends and its impact on delinquency as well as its use in combination with the risk-layering features outlined above.

For questions or comments, please contact Susan Kulakowski at skulakowski@dbrs.com or Kathleen Tillwitz at ktillwitz@dbrs.com.

1. HTML and PDF copies online at <http://www.federalreserve.gov/boarddocs/rptcongress/creditscore/default.htm>. In a parallel effort, the Federal Trade Commission focused on the effects of credit-based scoring in the auto insurance industry. Its report can be found online at http://www.ftc.gov/os/2007/07/P044804FACTA_Report_Credit-Based_Insurance_Scores.pdf.

2. Page S-1 of the FRB report.