

PERSPECTIVES



PERSPECTIVES ON  
CREDIT SCORING AND  
FAIR MORTGAGE LENDING

PERS

THE THIRD INSTALLMENT  
OF A FIVE-INSTALLMENT SERIES  
The Federal Reserve Bank of St. Louis  
Mortgage Credit Partnership Credit Scoring Committee



Credit scoring is an underwriting tool used to evaluate the creditworthiness of prospective borrowers. Used for several decades to underwrite certain forms of consumer credit, scoring has come into common use in the mortgage lending industry only in the past 10 years. Scoring brings a high level of efficiency to the underwriting process, but it also has raised concerns about fair lending among historically underserved populations.

The purpose of the Federal Reserve System's Mortgage Credit Partnership Credit Scoring Committee is to collect and publish perspectives on credit scoring in the mortgage underwriting process, specifically with respect to potential disparities between white and minority homebuyers. The introductory article provided the context for the issues addressed by the series. The second article dealt with lending-policy development, credit-scoring model selection and model maintenance.

The topic of the third article is how lenders oversee the practices of their third-party brokers, especially for compliance with fair-lending laws, pricing policies and the use of credit-scoring models. We solicited feedback from industry, consumer and regulatory representatives to ensure a variety of perspectives. The following individuals participated.

#### **EDWARD KRAMER**

##### **The Housing Advocates Inc.**

Mr. Kramer is a civil rights attorney and director and co-founder of The Housing Advocates Inc. (HAI), a fair-housing agency and public-interest law firm in Cleveland. The organization, founded in June 1975, receives money from the U.S. Department of Housing and Urban Development, private foundations and various local governments. One of the programs operated by HAI is the Predatory Lending Project. The project provides legal assistance to low- and moderate-income residents to prevent predatory lending activities and other consumer fraud problems, especially in Wards 5 and 15 of the city of Cleveland. When violations of the law are identified, they are referred to private attorneys or to the Fair Housing Law Clinic. The clinic is a joint venture between HAI and Cleveland-Marshall College of Law at Cleveland State University. The program gives second- and third-year law students from Cleveland-Marshall an opportunity to work on real-life cases.

#### **CHRISTOPHER A. LOMBARDO**

##### **Office of Thrift Supervision**

Mr. Lombardo is the assistant director for compliance in the Office of Thrift Supervision's Central Region. Based in Chicago, he manages the compliance examination, community affairs and consumer affairs programs impacting savings institutions in a seven-state area that stretches from Tennessee to Wisconsin. Mr. Lombardo has 18 years of regulatory experience, which includes examination and examination management work with the Office of Thrift Supervision (OTS) and its predecessors; regional office policy and enforcement work with OTS and the Federal Deposit Insurance Corp.; and compliance policy work in Washington, D.C.

Mr. Lombardo has participated in and has led interagency policy initiatives. He has been active in examiner and industry education. The OTS, an office within the U.S. Department of the Treasury, is the primary federal supervisory agency for savings associations. There are approximately 1,050 thrift institutions, and they have assets of approximately \$950 billion. OTS is headquartered in Washington, D.C., and it operates through five regional offices. The agency's mission is to effectively and efficiently supervise thrift institutions to maintain their safety and soundness in a manner that encourages a competitive industry to meet America's housing, community credit and financial service needs and to provide access to financial services for all Americans.

#### KATHLEEN MULLER

##### **HOPE HomeOwnership Center**

Ms. Muller is the executive director of the HOPE HomeOwnership Center in Evansville, Ind. She has been with HOPE for about 12 years. HOPE provides counseling on housing to residents throughout the entire Evansville metropolitan statistical area. For 35 years, HOPE has been providing credit and budget analysis for families to help them determine their ability to buy a house. HOPE also has been certifying their eligibility for special innovative loan packages. During the past year, HOPE served 450 individuals and families.

#### ALEXANDER ROSS

##### **Retired, Department of Justice**

Mr. Ross recently retired from the Civil Rights Division of the Department of Justice. For more than 35 years, he worked on lawsuits brought by the United States to enforce civil rights statutes forbidding discrimination in voting, employment, education, public accommoda-

tions, housing and lending. His position for many years prior to retirement was special litigation counsel for the division's Housing and Civil Enforcement Section, where he investigated and prosecuted matters involving a pattern or practice of discrimination in home mortgage and consumer lending. Mr. Ross was the division's lead lawyer in several landmark fair-lending cases.

The contributors to this article were asked to respond to the following statement:

*While lending institutions may actively review and assess their own credit-scoring models for potential unlawful disparities, it is also important for lenders to monitor their relationships with third-party brokers. Mortgage brokers make credit available in communities that do not have traditional lending institutions. Lenders establish relationships with third-party brokers to reach these markets.*

*Lenders need to consider how their third-party brokers comply with fair-lending laws and use credit-scoring models. Lenders who knowingly work with noncompliant brokers and take no action may be liable as co-creditors. The following situations may lead to increased regulatory risk exposure for the lending institution:*

- *The lender may build in a high broker overage tied to the credit score.*
- *The broker may obtain a credit report or credit score and use it to underwrite and price a proposed deal prior to submitting it to a lender.*
- *A broker may screen applicants or steer them to higher-priced products even if the applicant's overall risk profile (credit score) does not necessarily warrant it.*

*Considering the credit scoring issues outlined above, what strategies can lenders adopt to better manage their third-party broker relationships? What can third-party brokers do to ensure compliance with fair-lending regulations?*



## STATEMENT OF ALEXANDER ROSS

### Retired, Department of Justice

The answers may be different, depending on whether scores are to be used in the accept/deny context or for placing borrowers in different price tiers. In either case, it is essential that the broker be fully informed as to the lender's underwriting criteria. Further, whenever the scores themselves are affected by the information gathered by the broker, the broker must do as good a job as the lender in documenting the borrower's qualifications.

When credit scores are used to accept or deny, the broker's obligation is the same as it would be with manual underwriting. If the broker (a) fails to obtain documentation or (b) screens out applicants without adherence to the same processes the lender does with its direct applicants, both the broker and the lender are headed for trouble.

When credit scores affect pricing, the broker must depend on the full and accurate use of the lender's pricing criteria to avoid surprises and legal problems. For example, if the broker thinks he is presenting a "B" quality loan and has priced it with the borrower accordingly, the deal may not work if the lender prices it at "B-." On the other hand, if a broker knows the borrower has "A" credit but places the loan with a subprime lender at an unnecessarily high price to increase the broker's profit (when that lender would accept higher broker fees), the broker risks involving himself and the lender in deceptive practices, violations of the Real Estate Settlement Procedures Act (RESPA) and, if members of protected groups are adversely affected, possible violations of the fair-lending laws.

## STATEMENT OF EDWARD KRAMER

### The Housing Advocates Inc.

Financial institutions can have a great deal of control over the practices of their third-party

mortgage brokers, especially for compliance with fair-lending laws, pricing policies and the use of credit-scoring models.

There is a very close relationship among the traditional financial institutions, mortgage brokers and real estate agents. Brokers know where to get their clients financed, and lenders have a history of doing business with certain mortgage brokers and real estate agents. It is a symbiotic relationship. Lenders know who is breaking the law and who is skirting the law. They know who the "bad guys" are. In fact, those were the words used by a mortgage broker who recently confided, "We know in our industry, and certainly the financial institutions know, which mortgage brokers are really doing a disservice to clients."

The reason lenders know the "good guys" from the "bad guys" is that they have dealt with them over a number of years. In a situation where there have been excessive defaults on loans from the same mortgage broker, or if defaults often occur within several months after the loans, it is not difficult for a financial institution to gather evidence of what happened and of potential wrongdoing. There may have been problems with these loans: The applications are being falsified, the income levels are being falsified, the credit report has inconsistencies on it or credit scoring doesn't really match. The credit score is not sufficient to justify the loan.

On the opposite end of the spectrum, it would be relatively easy for financial institutions to identify mortgage brokers who try to maximize their commissions by charging some borrowers more than what is usual and fair in points, rates and fees. These are situations where borrowers should be able to qualify for traditional "A" loans but are being offered subprime "C" loans.

One strategy for the financial institution to avoid third-party liability is to test loan application files. In this fair-lending review,



the Truth in Lending Act (TILA) statement and the U.S. Department of Housing and Urban Development's Good Faith Estimate documents regarding the costs of the loan should be examined. Look at the cost of the appraisal and other fees to determine if they may be excessive or unusual. Look for credit life insurance packages built into the loan and see whether the consumer is being required to pay up-front for this credit life insurance or for the life of the loan. If the financial institution begins to see inconsistencies from broker to broker, that should send up a red flag. Such a pattern would result in a closer scrutiny of all new loans being submitted by this particular mortgage broker.

Unfortunately, these predatory lending practices are often being funded by financial institutions. This practice may be driven by the need to comply with their Community Reinvestment Act (CRA) obligations. The act was meant to help meet the credit needs of all communities in a bank's assessment area, including low- and moderate-income (LMI) neighborhoods. However, in a perverse way, the CRA has in some cases had the opposite effect. Banks, rather than trying to find and use their own branch system of loan offices, instead closed down their own branches and limited access and services to these customers. These banks have relied upon third parties, such as mortgage brokers and real estate agents, to generate CRA loans.

Lending to LMI borrowers can be profitable for financial institutions, but it causes severe hardships for the consumer, who is often a minority and/or female head of household. A third-party arrangement allows unscrupulous mortgage brokers or real estate agents to misuse or abuse the system. The banks are really looking at, "Will this help me meet my CRA needs and will it meet our profit motive?" So, when some argue that this third-party system is more efficient, what they really mean is that it is more prof-

itable. However, this is not necessarily what financial institutions should do if they are going to be good neighbors and good businesses for our community. They need to make a commitment to the community, which was the original purpose of the CRA. It was to require banks to commit themselves to the community, to those areas in their credit service areas that have not been served by them in the past.

What are the risks if financial institutions don't respond to predatory lending issues being raised today? They face new and costly legislative and regulatory initiatives. More importantly, they will face substantial risk of litigation. Unlike TILA or other consumer laws, the federal and Ohio fair housing laws place special obligations on the entire housing industry, including financial institutions. One of these obligations is that the duty of fair housing and fair lending is non-delegable. Almost a quarter century ago, in one of the first cases involving a racially discriminatory refusal to make a home loan, our federal court found in favor of the victim of discrimination in *John and Susan Harrison, Plaintiffs, v. Otto G. Heinzeroth Mortgage Co. and Otto G. Heinzeroth and John Haugh, Defendants*, 430 F. Supp. 893, 896-97 (N.D. Ohio 1977) and held that:

*Thus the Court has no difficulty in finding the defendant Haugh liable to the plaintiff. Under the law, such a finding impels the same judgment against the defendant Company and the defendant Heinzeroth, its president, for it is clear that their duty not to discriminate is a non-delegable one, and that in this area a corporation and its officers are responsible for the acts of a subordinate employee, even though these acts were neither directed nor authorized. This ruling troubles the Court to some extent, for it seems harsh to punish innocent and well-intentioned employers for the disobedient wrongful acts of their employees. However, great evils require strong remedies, and the old rules of*

*the law require that when one of two innocent people must suffer, the one whose acts permitted the wrong to occur is the one to bear the burden of it. [citations omitted]*

This decision is not unique in the law. The courts have rejected arguments from real estate brokers that they should not be held liable for the discriminatory acts of their independent agents. (*Marr v. Rife*, 503 F.2d 735 [6th Cir. 1974]; *Green v. Century 21*, 740 F.2d 460, 465 [6th Cir. 1984] ["Under federal housing law a principal cannot free himself of liability by delegating a duty not to discriminate to an agent."]). Furthermore, using the analogy to the Fair Housing Act, the courts have found that finance companies have a non-delegable duty not to discriminate under the Equal Credit Opportunity Act, which cannot be avoided by delegating aspects of the financing transaction to third parties. (*Emigrant Sav. Bank v. Elan Management Corp.*, 668 F.2d 671, 673 [2d Cir. 1982]; *United States v. Beneficial Corp.*, 492 F. Supp. 682, 686 [D.N.J. 1980], *aff'd*, 673 F.2d 1302 [3d Cir. 1981]; *Shuman v. Standard Oil Co.*, 453 F. Supp. 1150, 1153-54 [N.D. Cal. 1978]).

Now apply this case law to financial institutions that refuse to monitor their relationship with mortgage and real estate brokers. These lenders can be subjected to substantial damage awards. Playing ostrich will not insulate them from any illegal actions of mortgage brokers and real estate agents with which they deal. If there can be shown a pattern and practice, then financial institutions are assumed to have control. They have the ability to say "yes" or "no." They have a right to monitor and determine whether or not these "independent actors" are breaking the law. If they knew or should have known, they can be held liable.

Financial institutions and mortgage brokers should also follow another example of the real estate industry. The larger real estate

firms have their own in-house fair housing program to train their staff. Large companies have their own programs because they want to make sure that their real estate agents are aware of the law and of company policies. They want these policies implemented. All employees and independent contractors must know the law, the company's policies and that everyone will uphold fair housing and fair-lending laws.

#### STATEMENT OF CHRISTOPHER A. LOMBARDO Office of Thrift Supervision

Before addressing a financial institution's relationships with mortgage brokers, we ought to identify three undeniable facts that represent changes in the mortgage business landscape over the past decade.

First, financial institutions increasingly rely on fee income. Interest rate spreads are, and are likely to remain, razor thin. Second, automation (including credit scoring), securitization and specialization have revolutionized who does what and how they do it. Third, financial institutions rely on independent mortgage brokers to maintain a steady supply of loan originations. Employees in financial institution branches typically no longer generate the business. Call this progress-in-action in a free enterprise system or call this a recipe for disaster. In reality, the system is far from free: It is heavily regulated. With the scourge of predatory lending, personal and individual disasters have become more common or at least more widely recognized. Systemic disasters remain rare.

We also ought to clarify our terminology. As is most common, I will consider the financial institution (insured depository institution) to be the funding, originating lender and the independent broker to be the point of contact with the applicant/borrower and the processor of the loan. The lender-broker



relationship is covered by a mutual agreement that the other party is suitable and reliable. The lender provides the broker with the bank's underwriting guidelines, highlighting any deviations from market standards. The lender provides the broker with rates, fees and term information—weekly, daily or as needed. Operating under a lender-broker arrangement, the broker registers a rate lock-in and processes the paperwork. The loan passes down one of two main paths: The lender table-funds the loan and reviews it afterward, or the lender reviews and approves each loan package prior to closing.

Numerous custom and hybrid lending arrangements exist. However, one ought to consider what a financial institution examiner sees: performing loans; the occasional rejected deal, if the lender documented it; and the occasional defaulted loan. The examiner does not know what transpired between the broker and the borrower. The examiner does not know who ordered, paid for or prepared the application. Lenders should know this information and ought to be highly selective about the brokers who bring them business, and lenders ought to be expert in spotting a loan that yells: "Run, don't walk, from this deal!" The general standard to which the lender should be held responsible for the broker's act, error or omission is a "knew-or-should-have-known standard."

The compliance examiner assesses how well a financial institution manages its compliance risks and responsibilities. Regarding relationships with mortgage brokers, this most notably includes compliance with laws such as the Fair Housing Act, Equal Credit Opportunity Act, Home Mortgage Disclosure Act, Fair Credit Reporting Act, Real Estate Settlement Procedures Act and Truth in Lending Act. These laws are relatively new; in addition, there are rules governing the privacy of consumer financial information, consumer protection rules for insurance sales and the Flood Disaster Protection Act. This demon-

strates that we're not describing free enterprise as envisioned in the 18th century by Adam Smith.

Beyond the U.S. Department of Housing and Urban Development's advertising rules implementing the Fair Housing Act and the Federal Reserve Board's advertising rules implementing the Equal Credit Opportunity and Truth in Lending acts, thrift institutions are prohibited from any inaccuracy or misrepresentation regarding contracts or services, including any and all aspects of their mortgage lending. The examiner gets a glimpse of lender activities and an even briefer look at what the broker has done. Well-managed financial institutions make it a point to take a good look at what the broker has done, but it is very difficult for the lender to police the broker's activities. With the growing awareness of predatory lending, most lenders now have systems in place to detect transactions that involve fee packing, equity stripping and flipping. Lenders have shifted from presuming that the refinancing deal presented for funding is what the borrower originally needed or wanted, and many are applying some sort of benefit-to-the-borrower standard.

As a general observation, mortgage market automation (including the general use and acceptance of credit scoring), standardization and specialization have not posed great hazards for most financial institutions. They have internally motivated systems for identifying and correcting problems outside the supervisory and enforcement process. The fee-driven nature of the business and reliance on broker business do pose hazards, however. Every financial institution has stories of mortgage brokers who proposed compensation arrangements that would violate the Real Estate Settlement Procedures Act. Most lenders have stories of broker efforts to push unsophisticated individuals (with or without marginal credit scores) into higher-priced deals that offer greater compensation to the broker. The former issue of unearned fees and kick-

backs is fairly easy to spot. The latter defies detection, often until much damage has been done.

The uniform interagency examination procedures adopted by the federal banking supervisory agencies for fair lending focus on activity at the margin. In general terms, it is in transactions involving marginal applicants that underwriting discrimination may be identified. The same holds for pricing and the use of credit scoring. A financial institution needs to have a vigorous review system in place for the actions of brokers in this regard. This review system should reinforce the lender's message about the kinds of deals it is seeking and the kind of treatment that will be extended to individuals who are prospective customers of the institution.

Aside from individual credit transactions, it is lenders straying far from the mainstream market who are most exposed to allegations of credit discrimination. Regulators are more sensitive to issues involving innovation, automation, cost control and stability of income. It is in this testing of new ideas that we try to draw a line between acceptable and unacceptable risk-taking. Financial institutions whose stated or unstated goal is to skate on the edge of the law should expect and be prepared to deal with problems—some of them potentially huge.

Lenders need to seek assurance that scoring representations accurately reflect their applicant's score, particularly when the score drives the approve/deny decision but also when it results in a loan-pricing or product-steering decision and, ultimately, when it impacts broker or lender compensation, even indirectly. Aside from scrutiny of documents, lenders should require that the broker provide copies of all credit reports and scoring information generated in connection with a mortgage application. The lenders should also require copies of all loan applications generated. The final application that the borrower sees, but may not read, at closing may bear little resemblance to the

representations of the broker and borrower from start to end of the transaction.

The lender may be restricted under his correspondent agreement from making direct contact with a mortgage applicant. However, the broker should be willing to encourage lender contact to learn the applicant's understanding of the lending process, rather than lose all of that lender's business and see the borrower damaged along the way.

A short survey completed by the borrower after the closing can be a very useful evaluation tool for lenders. The purpose is to identify particular brokers' deals that were closed under some duress or involved fees and terms to which the borrower did not understand or agree. These issues are best dealt with before the borrower is in default or sitting in the office of his congressional representative.

In closing, the vast majority of financial institutions manage their mortgage broker relationships in an acceptable manner, as we have found from years of regular compliance examinations. Our more recent and detailed inquiry into the ability of financial institutions to steer clear of predatory lending practices while working through independent brokers and seeking fee income has both reinforced the observation that the industry is doing a good job and highlighted some new concerns. That credit scoring and improved access to individual credit information have added speed and have reduced cost is generally accepted. What has been done with that new information remains an open question for both lenders and regulators.

#### STATEMENT OF KATHLEEN MULLER HOPE HomeOwnership Center

The use of credit scores alone does not ensure that credit remains available to persons who would qualify for a low-interest loan. Lenders should always have multi-criteria that help to balance or offset shortfalls in a person's





credit score, which could be reduced by the use of subprime lenders or by a hesitancy to use credit at all. For example, if a customer scores 10 to 25 points less than the minimum score determined to be necessary for loan qualification but he has three or more years on the job, that strength of character could offset the low score. In addition, third-party mortgage brokers who do not try to look at credit scoring in a flexible way—such as looking at work history—and rely on poor scores without honest subjective analysis may benefit from higher-cost loans.

During a recent training session in Evansville, Ind., on “Predatory Lending: A Professional Alert” for brokers, appraisers, inspectors, title agents—all those who deal with the consumer along the path to getting a mortgage—Nick Tilima of Education ReSources suggested that “most consumers who contact a mortgage broker expect the broker to arrange a loan with the best terms and at the lowest possible rate. Most mortgage brokers do just that and charge a reasonable fee for their services. However, in the subprime market, there are mortgage brokers who do just the opposite. That is, the broker will attempt to sell the borrower on a loan with the most fees and highest rate possible so that the broker will get more compensation. Some of these brokers may charge fees of 8 to 10 points. In addition, the broker may get additional compensation from arranging a higher-than-necessary interest rate for the consumer. For example, the consumer may qualify for an 8 percent interest rate, but if the broker can sell the consumer a 9 percent rate, he can keep the differential.” To address this issue, standardized fee schedules would go a long way toward providing fair lending to individuals with lower credit scores.

Brokers and lenders also should be aware that high credit scores do not necessarily mean a loan is guaranteed. What may have generated the score to begin with—the ability to handle many credit lines on a timely basis—enhances

most credit scores. However, the lender is ignoring the fact that multiple obligations also burden the person’s ability to repay a new debt.

Because lenders and brokers may take advantage of a consumer’s lack of knowledge or poor credit rating to charge high interest rates and hidden fees, disclosure and pre-loan education is a must. At a minimum, everyone should be required to have some sort of education before buying or refinancing a house. Consumers would be well-advised to address the credit problems that keep them from being considered for a prime loan, but if they cannot correct these problems, they should be aware of the availability of subprime loans that are not predatory.

### **Code of Ethics**

As part of its efforts to fight predatory lending in Evansville, the Tri-State Best Practices Committee, of which I am a member, developed a Code of Ethics for Lenders. Lenders should require their third-party brokers to adopt this code to help ensure compliance with fair-lending laws:

- Protect all they deal with against fraud, misrepresentation or unethical practices of any nature.
- Adopt a policy that will enable them to avoid errors, exaggeration, misrepresentation or the concealment of any pertinent facts.
- Steer clear of engaging in the practice of law and refrain from providing legal advice.
- Follow the spirit and letter of the law of Truth in Advertising.
- Provide written disclosure of all financial terms of the transaction.
- Charge for their services only such fees as are fair and reasonable and which are in accordance with ethical practice in similar transactions.
- Never condone, engage in or be a party to questionable appraisal values, falsified selling prices, concealment of pertinent

information and/or misrepresentation of facts, including the cash equity of the mortgagor in the subject property.

- Not knowingly put customers in jeopardy of losing their home nor consciously impair the equity in their property through fraudulent or unsound lending practices.
  - Avoid derogatory comments about their competitors but answer all questions in a professional manner.
  - Protect the consumer's right to confidentiality.
  - Disclose any equity or financial interest they may have in the collateral being offered to secure the loan.
  - Affirm commitment to the Fair Housing Act and the Equal Credit Opportunity Act.
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This concludes the third installment in our series. The Federal Reserve System's Mortgage Credit Partnership Credit Scoring Committee thanks the respondents for their participation. The fourth installment will deal with training of staff, with the level and consistency of assistance provided to prospective borrowers in the loan application process and with correcting credit history. It also will deal with the degree to which applicants are informed about the ramifications of credit scoring in the mortgage application and underwriting process, including loan pricing.

*The views expressed in this series are not necessarily official opinions of the Federal Reserve System or of the Federal Reserve Bank of St. Louis.*







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