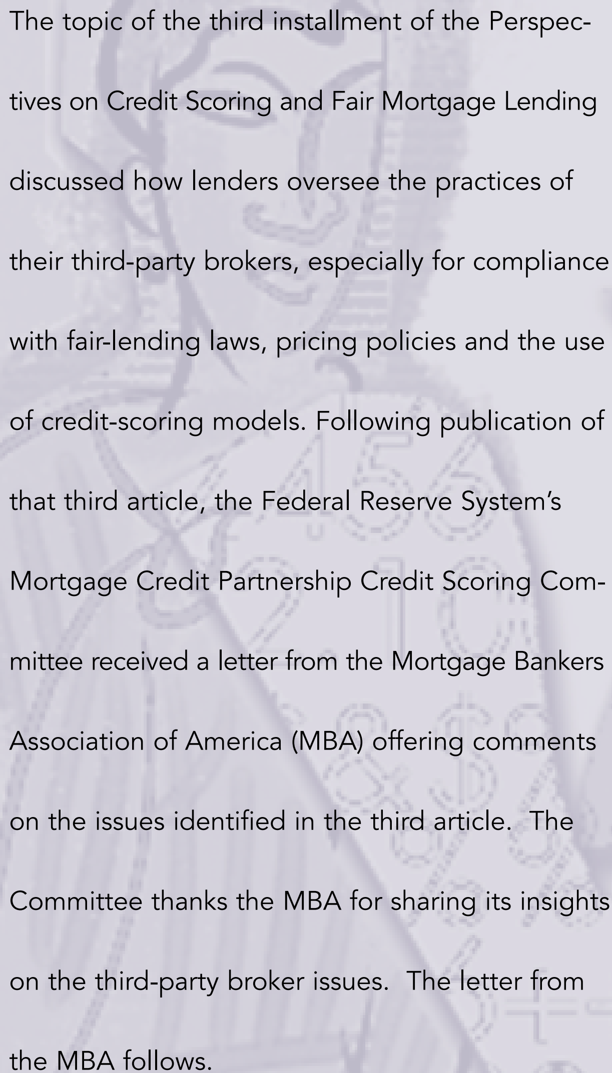
PERSPECTIVES

PERSPECTIVES ON

CREDIT SCORING AND FAIR MORTGAGE LENDING

SUPPLEMENT TO THE THIRD INSTALLMENT OF A FIVE-INSTALLMENT SERIES

The Federal Reserve Bank of St. Louis
Mortgage Credit Partnership Credit Scoring Committee



The topic of the third installment of the Perspectives on Credit Scoring and Fair Mortgage Lending discussed 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. Following publication of that third article, the Federal Reserve System's Mortgage Credit Partnership Credit Scoring Committee received a letter from the Mortgage Bankers Association of America (MBA) offering comments on the issues identified in the third article. The Committee thanks the MBA for sharing its insights on the third-party broker issues. The letter from the MBA follows.

April 24, 2002

Dear Credit Scoring Committee:

The Mortgage Bankers Association appreciates the opportunity to comment on issues being considered by the Federal Reserve's Mortgage Credit Partnership/Credit Scoring Committee. The Mortgage Bankers Association of America (MBA) is a trade association representing approximately 3000 members involved in all aspects of real estate finance. Our members include national and regional lenders, mortgage brokers, mortgage conduits, and service providers. MBA encompasses residential mortgage lenders, both single-family and multifamily, and commercial mortgage lenders.

In order to adequately assess the fair lending responsibilities of mortgage bankers in brokered transactions with regard to the underwriting or pricing of mortgage loans, it is imperative to fully understand the structure of the mortgage banking transaction and distinguish among the roles of the different players involved.

BANKER VS. BROKER

Although there are wide variations in the roles performed by the numerous entities involved in mortgage lending transactions, there are several fundamental distinctions that can be drawn between the functions of the mortgage banker and the mortgage broker. Although entities vary greatly in terms of amounts and types of services they perform, it is possible to provide generalized descriptions of their functions in the mortgage loan transaction.

The core function of the mortgage banker is to supply the funds necessary for the making of a mortgage loan. As the "lender" of the moneys in the transaction, the central role of the mortgage banker entails the performance of all the necessary underwriting analysis on a loan transaction and the actual funding to close a loan, using either its own funds or funds acquired from warehouse lines of credit. Generally, mortgage lenders do not make loans in order to retain the asset as an investment. Rather, a mort-

gage lender will usually sell its residential mortgage loans immediately in the "secondary market."

Mortgage lenders can, and do, engage in "retail loan origination," which is the part of the process that entails everything from advertising and solicitation of the loan product to the taking of the loan application and performing some or all of the processing of the application information. When mortgage lenders engage in the "retail" portion of the loan business, they deal directly with the potential borrowers, and thus perform such "origination" functions as interviewing and counseling borrowers, gathering personal information and taking the necessary steps to process, underwrite, close and fund the loan. The "retailing" of loans requires not only the time of lender personnel, but also the bearing of the cost of real estate ownership or rental, i.e., the "bricks and mortar," as well as the expense of payroll and benefits, business machines, supplies, insurance and other costs necessary to maintain a retail branch.

The mortgage broker, in turn, specializes only in the loan "origination" portion of the transaction. By doing business with a mortgage broker, the lender will save on all these operating costs. In addition to sparing the lender the "brick and mortar" and other retail office expenses, brokers will perform many of the services required to originate loans that the lender would otherwise have to perform. Mortgage brokers also allow a lender to broaden its market and reach customers who, because of geography, or a lack of contact or knowledge, might otherwise have never accessed the lender's products, thereby increasing competition.

As such, the broker will take a consumer's application, will counsel the applicant and process the application, and will then ship the loan package to the lender for proper underwriting, and eventually, closing of the loan. In some instances, the lender may actually close the loan in the broker's name with the lender's funds ("table funding").

It is also worth noting that the role of the mortgage broker vis-à-vis the consumer and vis-à-vis the mortgage lender can vary greatly. In the vast majority of cases, however, the broker will have developed relationships with various lenders, and will serve as the "retailer" of the lenders' loan products to consumers. In that role, the broker serves as an independent contractor with respect to both the consumer and the lender. In such instances, the broker/lender relationship is non-exclusive, and the broker is under no obligation whatsoever to submit any borrower's loan application to any particular lender for approval and funding. On the contrary, brokers are free to choose any one of several wholesale lenders' products for a particular borrower.

AUTOMATED UNDERWRITING

Over the past several years, the process of mortgage loan underwriting has gone through considerable evolution. In today's world, the mortgage industry is increasingly relying on automated underwriting systems to assess the risk of applicants in a more efficient and fair manner. These automated systems function by permitting lenders to input pertinent borrower information into the computer and allowing the program to assess the applicant's risk profile under pre-set lending guidelines. The guidelines used under these systems vary greatly. Most automated systems incorporate guidelines created either by secondary market investors, including the Fannie Mae and Freddie Mac, or mortgage insurers. In some instances, they may be proprietary systems created by the mortgage lender itself based solely on its own lending and risk experience. The common factor under these automated systems is that they perform the underwriting process efficiently and in very quick timeframes, providing fair and non-biased loan decisions based only on the data entered into the system.

It must be noted, however, that even the most advanced automated underwriting systems allow for significant discretion by lenders. These systems are designed to complete a standard underwriting analysis leaving more complicated loan decisions to human underwriters. In fact, automated systems are generally designed so that no applicant is ever denied a loan on the basis of artificial intelligence alone. When an applicant's loan file information does not meet the standards established under the lender's system, the computer will "refer" the loan to "manual" underwriting to allow a human analyst to reconsider the loan file and approve it, determine if it fits into

a special or alternative loan program, or deny it altogether. The important item to note is that although automated underwriting systems increase efficiency and lower cost by quickly approving applicants with clearly satisfactory loan risk profiles, they leave the decision-making in borderline or more complicated cases to lenders, who must still make the hard calls.

THE NATURE OF THE CREDIT DECISION AND THE ROLE OF CREDIT SCORING

The ultimate decision of whether to lend to any specific applicant, is not a "science" involving strict mathematical formulas. Rather, it is an "art" that relies heavily on various underwriting factors that are assigned differing weights depending on the experience or risk preference of the lender or investor. There are a myriad of factors that come into play in mortgage lending determinations. Some of the more common factors analyzed by underwriters are loan-to-value ratios, debt-to-income ratios, bank reserves, down-payment size, down-payment source, loan type, loan duration, among many others. Credit scoring is just one factor in the analysis. The "art" of underwriting does not lie in assigning numerical values to any of these factors, along with "pass" or "fail" ratings. Underwriting requires that each factor be accounted for and interpreted in light of the other factors and in the context of each applicant and property. In the end, the final decision is based on a judgment call regarding the full set of circumstances that are unique to each borrower and each transaction.

PRICING OF THE LOAN

In wholesale broker transactions, lenders will generally offer a variety of loan products to the broker, along with prices at which it will purchase each product. Using complex and proprietary computerized models, lenders will generate prices for their wholesale mortgage products, and these prices will typically change daily. This pricing information is then transmitted to the approved mortgage brokers in what are known as "rate sheets."

In general terms, the "price" that a lender is willing to offer for a particular loan product is a function of the predicted value of that loan when it is resold in the secondary market. The pricing may also differ based on the credit quality of the loan. Furthermore, numerous other price adjusters may be imposed by the lender to reflect risk characteristics, such as loan amount, two to four family dwellings, high rises, loan-to-value ratios, etc. Furthermore, the wholesale price lenders make available to mortgage brokers differs from the "retail" price in that it excludes many of the costs that are necessary to advertise and originate the loan to the consumer such as the cost of the broker's services.

In wholesale loan transactions, it is the mortgage broker who ultimately sets the "retail" price that the consumer eventually pays for the loan. The fact that brokers have the ultimate role in establishing final "retail" prices is vital. As described above, the broker has a crucial role in the transaction. The broker serves as the "retailer" of the loan in providing the "bricks and mortar" that would otherwise be provided by the lender. The broker markets and advertises the lenders' loan products. The broker also provides an array of originating and processing services to the borrower and lender. The broker then executes the loan documents in favor of the lender or closes the loan in its own name ("table funding"). In all instances, the broker is performing real services, providing real goods, and interfacing with consumers. As the provider of such services, mortgage brokers require compensation. It is the broker—not the lender—who in negotiation with the consumer must appropriately make the final determination of how the broker will price its own services.

It is essential that brokers retain the independence to price their own services in order to assure that they meet the individual needs of their customers, as well as their cost structures and operating expenses. In today's mortgage market, mortgage brokers will retail the products of various lenders to consumers and recover their own costs (plus profits). The flexibility in pricing allows them to receive their payment in a way that accommodates the borrower's available cash for closing. For instance, the borrower can pay all of the broker's costs directly, or alternatively they

can have the lender pay some or even all of these costs (a payment commonly called a yield spread premium) in exchange for a slightly higher interest rate. When the process works right, brokers and borrowers select the best loan options to meet the consumers' needs and negotiate the terms of the loan within the constraints imposed by the lender's rate sheet. Lenders are "once-removed" from this negotiation process, and are generally indifferent as to the pricing option combination of interest rate and upfront closing costs selected by the borrower and broker pursuant to the lender's rate sheet except insofar as the lender ultimately receives the same return after it sells the loan on the secondary market.

Lenders recognize that some brokers may attempt to gouge consumers. For this reason, many lenders cap the fee that the broker can receive in order to protect customers. However, such caps are designed only to limit discretionary pricing not eliminate the negotiation process between the broker and borrower. Caps therefore are not intended to and do not ensure that all borrowers pay a uniform price. In fact, the unavoidably individualized nature of each loan transaction would dictate otherwise.

COMMENTS ON SPECIFIC QUESTIONS

As demonstrated by the description of the lending process set forth above, the framing of certain questions posed by the Committee reflect certain misconceptions about the lender-broker relationship.

- *The lender may build a maximum broker overage tied to the credit score.*

It is generally true that lenders may impose "caps" or maximum limits on the compensation that brokers can collect on any given transaction. These "caps" are generally imposed in order to assure that loans originated by mortgage brokers are fully compliant with applicable RESPA and Fair Lending requirements. It is important to note, however, that these "caps" are generally not structured on the basis of maximum limits on the points charged over the 'par' rate. Rather, lenders generally set maximums based on <u>fees</u> that they will pay to the broker for origination services performed. The broker, on the other hand, determines what dollar amount it must collect on any given transaction (limited, of course, by the "cap" that may be specified by the lender), and then builds this fee into the yield spread pricing that is ultimately offered to, and negotiated with, the consumer.

Although the credit score is an important tool in the underwriting of the loan, many lenders do not use the credit score to set the maximum broker's compensation. Nevertheless, mortgage brokers may access the applicant's credit score directly prior to submission to a lender in order to assess the applicant's creditworthiness and the lenders and products that may be best for the applicant. Mortgage brokers may also price differently based on the credit score as a proxy for how difficult the loan approval process likely will be. As per federal law requirements, the broker's compensation is calculated on the basis of services performed or goods provided by the mortgage broker so the mortgage broker can charge more for loans that will require more work on the mortgage broker's part. Other than by perhaps setting outside numerical caps, and requiring adherence to applicable state and federal laws, lenders are not involved in the setting of broker compensation on individual loans.

It is not possible for a lender to stop mortgage broker price discrimination without fixing loan prices, which it cannot do. Furthermore, a lender is unlikely to have all loans originated by a broker and thus does not know the broker price on all of the broker's loans in order to perform a fair lending analysis. Even if the lender had the data and could engage in such an expensive and onerous review, the only recourse would be to stop doing business with the broker thus reducing the access of credit to borrowers in that marketplace.

- *The lender may provide brokers with access to the lender's scoring programs.*

This statement is generally inaccurate, and to the extent such access occurs, it is of negligible impact in the market. As set forth above, lenders use scoring programs that are developed by large industry players such as Fannie Mae or Freddie Mac, as well as programs developed in-house, on the basis of the lender's own lending experience. In the latter case, the pro-

grams are proprietary and are therefore not shared with third party originators. Even in cases of lenders that employ programs used by large industry participants, such programs may be "tweaked" and altered to reflect the lender's experience, regional variations and/or risk preferences of the particular lender.

- *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.*

The "pulling" of credit scores or credit reports by mortgage brokers prior to the submission of the loan package to the lender is a longstanding and non-controversial practice in the mortgage industry. In fact, mortgage brokers must be able to ascertain an applicant's credit background in order to perform the critically important duties of properly advising and counseling borrowers. The fact that this practice is generally accepted is demonstrated by HUD pronouncements under existing RESPA rules and regulations. In a statement of policy issued in 1999 (64 FR 10080), HUD identified various services that are normally performed by brokers in the origination of a loan. Among those items, HUD describes various counseling-type activities that specifically include "prequalifying prospective borrowers" and "assisting the borrower in understanding and clearing credit problems." Under each of these functions, brokers must have access to credit reports and credit scores in order to properly guide and counsel prospective borrowers.

Although brokers may do a preliminary underwriting review in order to assist the consumer in choosing a lender and product, typically, the broker does not perform the final underwriting nor make the credit decision. Many broker agreements with lenders do not have a repurchase obligation because the broker does not have the capital or access to capital required to fund a loan. As a result, only correspondent lenders would have the ability to make a credit decision since they would also have a repurchase obligation if the loan did not meet the lender's underwriting requirements. In the rare instance that a broker is engaged in underwriting, it performs this function under some type of outsourcing agreement, following the lender's strict guidelines, and acting as the lender's agent. In this capacity, and pursuant to federal law, it is clear that the lender would remain liable for all fair lending consequences that flow from the actions and decisions of its "broker-agent."

Stephen A. O'Connor
Vice President, Government Affairs
Mortgage Bankers Association of America
1919 Pennsylvania Avenue, NW
Washington, D.C. 20006-3438
www.mbaa.org

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.

Community Affairs Department
411 Locust • St. Louis, MO 63102
314-444-8317 • www.stls.frb.org

CA0208