PERSPECTIVES

PERSPECTIVES ON

# CREDIT SCORING AND FAIR MORTGAGE LENDING

## GENERAL INTRODUCTION

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. Utilized for several decades to underwrite certain forms of consumer credit, scoring has come into common use in the mortgage lending industry only within the last 10 years. Scoring brings a high level of efficiency to the underwriting process, but it also has raised concerns about fair lending with regard to historically underserved populations.

The Federal Reserve System's Mortgage Credit Partnership Credit Scoring Committee has produced a five-installment series, which explores the potential impact of credit scoring on mortgage applicants. This brochure is the introduction to all five installments.

## BACKGROUND

A set of Federal Reserve initiatives known collectively as the Mortgage Credit Partnership (MCP) projects, was launched in 1996 by the Reserve Banks of Boston, Chicago, New York, St. Louis and San Francisco. The Federal Reserve Bank of Cleveland launched its MCP project in 1993 and had a follow-up project in Cincinnati beginning in 1996. The MCP projects were designed to identify and address barriers to both mortgage credit and fair housing in traditionally underserved market demographic profiles and communities.

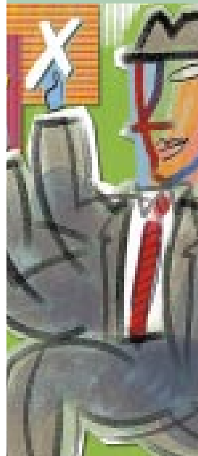
The MCPs engaged a cross-section of housing industry professionals to examine various aspects of the home-buying process. The purpose was to identify areas that might give rise to, or create the potential for, disparities between majority and minority homebuyers and borrowers in the home search or credit application process. With each project, and around each topic, complex and often heated dialogue arose. Topics such as racial steering, the effect of a neighborhood's racial makeup on appraisals, and the effect of a lack of affinity between borrower and lender were confronted by practitioners in the various housing-related industries. Task groups were formed to address specific issues, such as access to homeowners' insurance, fair appraisal practices, fair lending practices and the impact of specific policies on communities.

## MCP METHODOLOGY

Each of the Reserve Banks recruited housing and mortgage industry organizations as partners in the MCP process. The design was to have practitioners discuss the home-purchase and financing process—to break the process into steps and determine where the potential for unequal treatment or discrimination arises. From within the partnering organizations, practitioners—those making line decisions on a daily basis—were recruited to participate in task groups. These task groups were formed around particular issues and key steps in the home-buying process (such as obtaining hazard insurance) where concerns had been identified. The task groups met over a period of months to develop recommendations, which were issued in publications from each Reserve Bank. MCP reports from the individual Reserve Banks are available upon request. The *MCP Resource Guide*, a step-by-step guide on how to form and host a similar collaboration, is available from the Federal Reserve Bank of St. Louis at <www.stls.frb.org>.

Some important results were achieved in each of the markets where MCPs were conducted. For example, in St. Louis two insurance agents opened offices in lower-income communities. A continuing education course for realtors, "Teaching Fair Housing Compliance to Housing Providers," was offered during the St. Louis Fair Housing and Neighborhood Housing Conference in 1999. Also, as a result of the St. Louis MCP, the Community Affairs Department of the Federal Reserve Bank of St. Louis produced two publications: a special credit scoring issue of *Bridges*, Winter 1998, the department's quarterly newsletter, and *The St. Louis Area Homebuyer Counseling Providers* brochure, distributed to lenders, real estate agents and nonprofit organizations.

In Boston, practitioners, regulators and advocates worked on several educational and outreach efforts. In Cleveland, real estate boards, historically divided by race, now share listings and other key information on a systematic basis for the first time. In Chicago, a foreclosure intervention program, targeted to low-income communities disproportionately affected by FHA mortgage defaults, has kept well over 200 families out of foreclosure to date. In New York state, fair lending training is now required in the licensing process for appraisers. And, in San Francisco, revised fair lending "best practices" agreements were initiated between lenders and HUD.



## ISSUES IDENTIFIED IN THE MCP PROCESS OF NATIONAL CONCERN

As an added step to these projects, representatives from the Reserve Banks that conducted MCPs met to exchange their individual findings and experiences and also to discuss areas of common concern. Among the issues of common concern were access to homeowner's insurance, appraisals in redeveloping communities, steering by real estate agents and the use of credit scoring technology in the mortgage underwriting process. The last is the subject of the first installment, which provides the context for the next four installments on fair mortgage lending practices involving the use of credit scoring technology. The Federal Reserve Banks of Boston, Chicago, Cleveland, San Francisco, St. Louis and the Federal Reserve Board have representatives on the research committee, and they all have participated in this series.

## BACKGROUND ON CREDIT SCORING ISSUES EXAMINED

To gain an understanding of industry, advocacy group and regulator concerns, the Federal Reserve Banks of Boston, Chicago and San Francisco conducted focus groups in their home cities during the winter of 1998. Committee members developed nine issue statements that encapsulated the findings of the focus groups.

*The nine issue statements follow:*

1. In developing credit scoring policies, a lender may neglect to:
   a. Establish clear risk-tolerance policies and consistent guidelines for how scoring cutoffs are determined and loans are priced;
   b. Ensure that the model accurately reflects the characteristics/demographics of its applicant pool.

2. New models are unlikely to include prohibited basis factors in their programs. However, if models are not well-constructed and updated over time, they could:
   a. Produce unjustifiable disparate impact, or
   b. Become based on a pool of borrowers that is incompatible with a lender's market demographics.

3. Some third-party brokers who fail to comply with fair lending laws may be censured or have their lending licenses placed in jeopardy. It is important that lenders monitor the practices of their third-party brokers, especially for compliance with fair lending laws, pricing policies and the use of credit scoring models. Lenders who knowingly work with noncompliant brokers (and take no action) may be liable as co-creditors.

4. Inadequate staff training and oversight regarding bank credit policy and fair lending guidelines may lead to inconsistent and unlawful treatment of loan applicants.

5. Lack of information regarding the credit (application) process and available loan options could dissuade an applicant from completing the application process. Loan officers who fail to notify the applicant of the nature of a credit rating, and the important role it plays in the approval and pricing of a loan, could unfairly deny or overcharge an otherwise worthy applicant.

6. Credit/mortgage scoring systems are only as effective as the data fed into them. Inaccurate or incomplete data regarding an applicant's income or credit history may adversely affect the applicant's mortgage score. In the process of ensuring accurate data, lenders must treat all applicants consistently. For example, assistance with credit (report) corrections or accounting for protected or nontaxable income must be offered and applied uniformly to all applicants.

7. Credit scoring and counteroffers can serve as important functions to maximize access to credit. However, their nature and usage could result in unlawful discrimination. The need for frequent score overrides could indicate a larger problem with the scoring system. Furthermore, inconsistency in utilizing either "high-side" or "low-side" overrides to alter a credit decision may result in disparate treatment. Finally, inconsistent counteroffers made to applicants who received essentially identical scores also may result in disparate treatment on a prohibited basis as defined in fair lending regulations.

8. If a lender engages in a subjective second-review process, inconsistent practices could result in disparate treatment of applicants. Discriminatory disparities may result from the absence of established and carefully observed second-review guidelines that specify:
   a. The bottom-level mortgage score of applications subject to second review; and,
   b. Explicit procedures and explanations of judgmental factors, covering most or all contingencies.

9. Lenders who do not track loan performance based on their established credit scoring model characteristics may rely on risk limits that are unnecessarily restrictive and also may produce an unjustifiable disparate impact on prohibited basis group applicants.

The two-page flow chart, located on pages five and six, illustrates the process a credit-scored mortgage typically goes through; it also includes the development of a risk management policy. The issues identified in the 1998 focus groups, and the flow chart, were used as exhibits in a survey of industry leaders conducted in 1999. Among the survey responses were the following.

*In developing policy:*

- Changes over a business cycle in the environment of a lender can affect the predictive ability of a credit scoring model; a bank should have a clear methodology for changing its cutoff scores.
- Banks should have a clear plan for handling applicants who do not have established credit and would, therefore, score poorly with most credit scoring models.

*In dealing with loan applicants:*

- Some lenders may provide advice to an applicant—such as closing or paying down credit lines, with the intent of improving the applicant's credit score —but may actually affect the credit score negatively.
- Accuracy of credit reports may vary among population segments; lenders need to recognize the potential need to verify credit report information when the information will be used to score the applicant.

Two additional focus groups, using the findings of the survey as a basis for further discussion, were conducted in Washington, D.C., during the spring of 1999. Based on the findings of this research, the Credit Scoring Committee elected to develop a five-installment series to highlight some of the key issues identified with respect to credit scoring and fair lending.

An important goal of this series is to provide the industry, and concerned groups and individuals, the opportunity to comment on their own related concerns. Each installment incorporates statements we requested from organizations; they were selected because of their interest in, and differing perspectives on, credit scoring and fair lending.

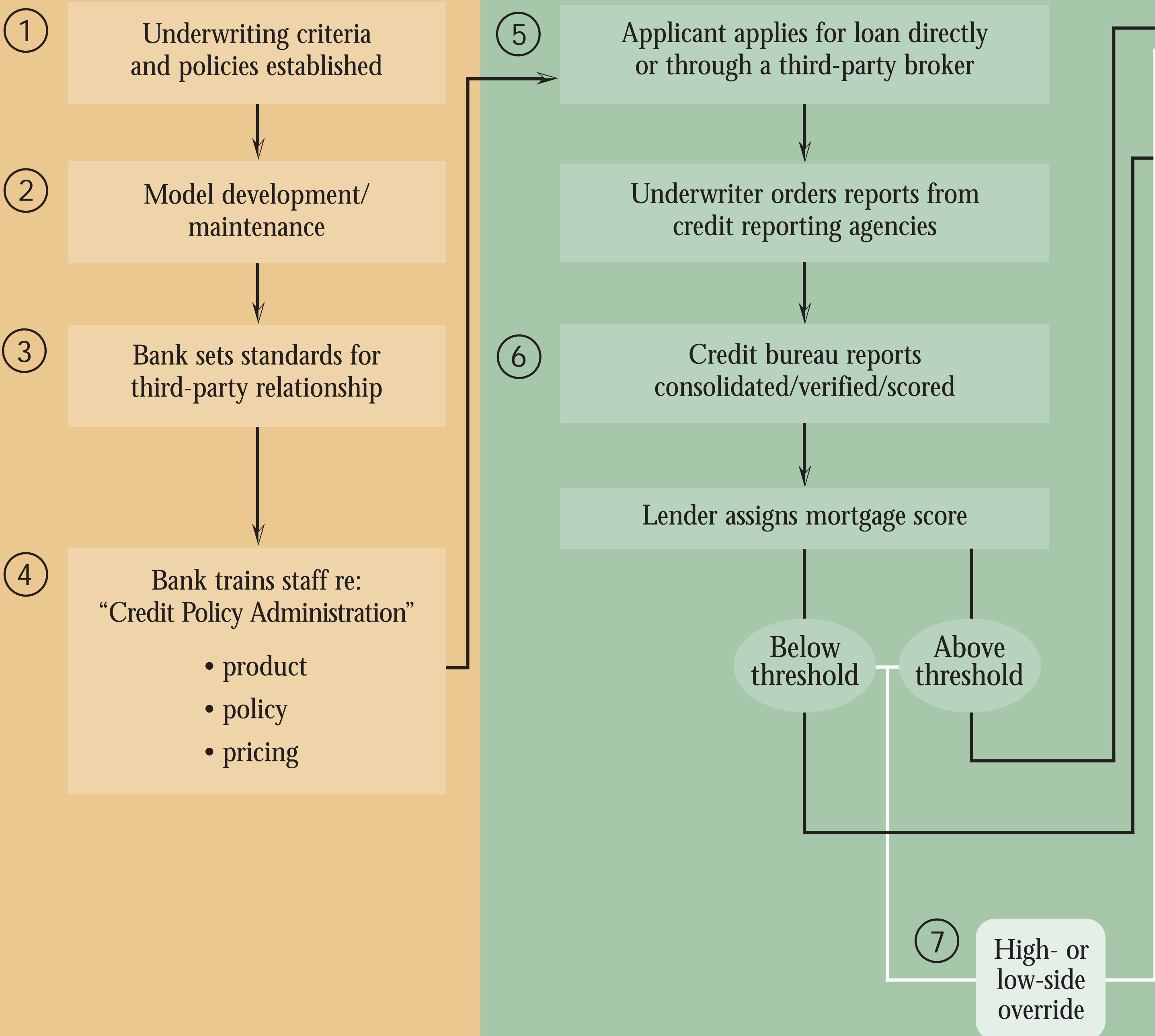
Once the comments were received, committee members edited them to capture the key points made and to bring some level of uniformity to the length of each response. The original respondents then approved the edited versions of their comments. These edited comments are presented in the following five installments.

# THE LIFE OF A CREDIT-SCORED MORTGAGE

BANK POLICY DEVELOPMENT

APPLICATION PROCESS

*The numbers correspond to the nine issue statements defined on pages three and four of this introduction brochure.*



*The flow chart below offers a basic interpretation of a credit-scored mortgage loan. This chart does not attempt to provide a comprehensive view of all the steps in the loan process. Rather, it is intended to illustrate those steps where poorly crafted or managed credit scoring policies/practices could result in fair lending violations.*