



# **Discriminatory Effects of Credit Scoring on Communities of Color**

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## **About the National Fair Housing Alliance**

Founded in 1988 and headquartered in Washington, DC, the National Fair Housing Alliance is a consortium of more than 220 private, non-profit fair housing organizations, state and local civil rights agencies, and individuals from throughout the United States. Through comprehensive education, advocacy and enforcement programs, NFHA protects and promotes equal access to apartments, houses, mortgage loans and insurance policies for all residents of the nation.

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## Introduction

Our current credit scoring systems have a disparate impact on people and communities of color. These systems are rooted in our long history of housing discrimination and the dual credit market that resulted from it. Moreover, many credit scoring mechanisms include factors that do not just assess the risk characteristics of the borrower; they also reflect the riskiness of the environment in which a consumer is utilizing credit as well as the riskiness of the types of product a consumer uses.

Until only a few decades ago, communities and people of color explicitly were not permitted access to low-cost government and other mainstream loans. In the 1930s the Home Owners Loan Corporation and at least through the 1950s the Federal Housing Administration and the Veterans Administration used blatantly discriminatory rating systems and “Residential Security Maps” to deem communities of color high-risk. Banks, real estate agents, appraisers, and others also perpetuated redlining and segregation in the housing markets. The passage of the federal Fair Housing Act of 1968 improved conditions, but even up until the mid 1970s, federal regulatory agencies refused to acknowledge their enforcement responsibilities under the Act. It was not until civil rights groups sued the agencies that the federal government began to collect information on the mortgage lending practices of the institutions it regulated, and to establish and implement fair lending examination procedures.

Because of this history of racial discrimination, segregated neighborhoods formed and people of color had limited access to affordable, sustainable credit. Instead of accessing mainstream credit available to white borrowers and white neighborhoods, people of color were relegated to using fringe lenders and paying much more than they would otherwise have had to. While segregation and housing discrimination have abated somewhat, we still live in an extraordinarily segregated society.<sup>1</sup> Access to credit is still often based on where we live rather than our individual ability to repay that credit. As this paper will explore, people of color were steered to subprime loans even when they qualified for prime loans, contributing to the fact that the foreclosure crisis has hit communities of color even worse than it has hit the rest of the country.

Credit scoring systems in use today were built upon and continue to rely upon the very dual credit market that continues to discriminate against people of color. For example, these systems penalize borrowers for using the type of credit disproportionately used by borrowers of color. Even fair lending defense attorneys who represent major banks readily admit that credit scoring has a differential impact on people of color. In a recent article, attorneys at K&L Gates assert that, “even the most basic lending standards, such as credit scores and [loan-to-value]

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<sup>1</sup> For example, according to 2010 Census numbers, 65 percent of individuals in large metropolitan areas still live in areas of high segregation between whites and African-Americans. Gurian, Craig, “New maps show segregation alive and well,” *Remapping Debate*, April 20, 2011.

requirements, 'impact' racial and ethnic groups differently."<sup>2</sup> While there has been some discussion recently by the industry about the existence of the disparate impact theory under the Fair Housing Act and other long-established laws, disparate impact has been recognized by all eleven circuit courts that have ruled on the matter as a legally acceptable means by which parties can assert claims under the Fair Housing Act.<sup>3</sup>

As we all look for solutions to the foreclosure crisis, lenders, regulatory agencies and policy-makers promote tighter underwriting standards as a solution to improving the quality of loan performance and strengthening the economy. What they mean in part, however, is requiring higher credit scores for the best and most affordable products. This, of course, places the focus for improving loan performance on borrowers. But many studies and analyses have demonstrated that inappropriate loan products and their components were key factors driving the subprime crisis. Factors including product type, presence of a yield spread premium, distribution channel, inflated appraisals, and prepayment penalties helped significantly to predict whether a loan would fail. Even major credit repositories and credit scoring companies, including Vantage Score and FICO, admit that credit scores declined in predictive value leading up to and during the foreclosure crisis. So why are some looking to increased reliance on credit scoring as a way of originating well-performing mortgages and solving the crisis?

The use of credit scoring and its disparate impact go far beyond the lending sector, affecting access to many other financial products and services. Credit and other scoring mechanisms are being used by employers to evaluate job applicants, insurers to determine auto, life and homeowners insurance, and landlords to screen tenants. Credit scoring modelers and companies are finding even more creative ways to broaden the use of these systems. A recent proposal in the state of Texas would use credit scores to determine utility rates.<sup>4</sup> Credit scores

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<sup>2</sup> Hancock, Paul; Brody, Melanie Hibbs; McDonough, Jr., David G; Malpass, Melissa S.; Shinohara, Tori K., "Supreme Court vs. HUD: The Race to Decide 'Impact or Intent'," *Legal Insight*, K&L Gates, November 17, 2011.

<sup>3</sup> In addition, since the Fair Housing Act was amended in 1988, the U.S. Department of Housing and Urban Development has acted in administrative proceedings and in other contexts with the full understanding that disparate impact claims are cognizable under the Act, as has the U.S. Department of Justice in its actions. Further, the Consumer Financial Protection Bureau recently announced that it would utilize all tools at its disposal, including the disparate impact theory, to pursue lenders who discriminate against consumers in violation of the Equal Credit Opportunity Act. The Bureau specifically stated that it would use the disparate impact theory in bringing actions under ECOA. See <http://www.consumerfinance.gov/pressreleases/consumer-financial-protection-bureau-to-pursue-discriminatory-lenders/>. The Federal Reserve also recognizes disparate impact as a way to prove ECOA claims.

<sup>4</sup> Stillman, Jim, "Your Credit Score Determines the Availability of Credit . . . and the Cost," Yahoo! Voices, June 20, 2007.

are even being used to determine which patients are more likely to take their medication as prescribed.<sup>5</sup>

The expanded use of scoring mechanisms has caused great consternation among consumer and civil rights groups as well as policymakers. For example, insurance companies use credit-based insurance scores to determine pricing. Yet, studies by the Missouri and Texas Departments of Insurance have found that insurance scoring discriminates against low-income people and consumers of color because of the racial and economic disparities inherent in scoring mechanisms.<sup>6</sup> The Missouri study concluded that a consumer's race was the single most predictive factor determining a consumer's insurance score and, consequently, the consumer's insurance premium.

The relationship between insurance credit scores and race is so strong that even though the Federal Trade Commission (FTC) used data selected by the industry in a 2007 FTC report, it found that credit scoring discriminates against low-income people and consumers of color, and that insurance scoring was a proxy for race.<sup>7</sup> The FTC report also confirms that, despite growing reliance on credit-based insurance scores, scant evidence exists to prove there is a causal relationship between a consumer's score and auto insurance losses. Without the need to demonstrate such a connection, insurers could theoretically use any arbitrary consumer characteristic, such as hair color or zodiac sign, that demonstrates a correlation to a specific outcome, to price insurance products.

This report focuses primarily on the use of credit scores by lenders, not other industries. This report provides only an abbreviated overview of other critical issues facing consumers when it comes to credit scoring and reporting. These issues are significant and help to demonstrate the urgent need to reform this system. For example, credit scoring systems are based on information obtained from consumer credit reports, even though credit reports are often rife with errors that are difficult to correct. Credit scoring systems are also a mystery to consumers because credit scoring companies maintain that their systems are proprietary and cannot be revealed. These issues are covered in great detail by recent reports by Demos<sup>8</sup> and the

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<sup>5</sup> The FICO Medication Adherence Score will be used by insurers and medical care facilities to identify patients who will need additional follow up services to insure they take their medication. Parker-Pope, Tara, "Keeping Score on How You Take Your Medicine," *New York Times*, June 20, 2011.

<sup>6</sup> Kabler, Brent, Ph.D. et al, *Insurance-Based Credit Scores: Impact on Minority and Low-Income Populations in Missouri*, State of Missouri Department of Insurance, January 2004.

<sup>7</sup> *Credit-Based Insurance Scores: Impacts on Consumers of Automobile Insurance*, A Report to Congress by the Federal Trade Commission, July 2007.

<sup>8</sup> Fremsted, Shawn, Traub, Amy, *Discrediting America: The Urgent Need to Reform the Nation's Credit Reporting Industry*, Demos, June 2011.

Consumer Financial Protection Bureau<sup>9</sup> and a survey by the Consumer Federation of America and VantageScore.<sup>10</sup>

Fixing our current credit scoring system is not only a moral imperative consistent with our national policies and beliefs about fairness and justice; it is also a legal obligation as outlined by the federal Fair Housing Act and the Equal Credit Opportunity Act. We hope this paper will assist with the dialogue at this conference as well as our national dialogue on how to move forward and out of our financial and foreclosure crises.

This paper begins in Section I with a discussion of the historical discrimination that led to our dual credit market, including subprime lending and the foreclosure crisis. Section II contains a detailed analysis of why credit scoring has a discriminatory impact. Section III discusses the legal obligation that the federal government and the financial industry have to promote fair housing. Section IV offers recommendations for how to fix our broken approach to credit scoring.

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<sup>9</sup> "The impact of differences between consumer- and creditor-purchased credit scores," Report to Congress, Consumer Financial Protection Bureau, July 19, 2011.

<sup>10</sup> "New National Survey Reveals What Consumers Know and Don't Know about Changing Credit Score Marketplace," Consumer Federation of America and VantageScore Solutions, February 28, 2011, [www.creditscorequiz.org](http://www.creditscorequiz.org).

## I. The Nation's Dual Credit Market Rooted in Discrimination

Credit scoring systems penalize borrowers who have anything other than mainstream, prime loans. As described below, people and communities have been excluded from mainstream affordable credit based on race and national origin. In the past, this was explicitly promoted by the federal government and the private industry with discriminatory rating systems, and is continued even today by banks like SunTrust and Wells Fargo. And it has been aided by the blanketing of subprime loans in communities of color and fostered by continued patterns of segregation and the dual credit market. Because many of the factors that make up credit scoring systems rely on this dual credit market and its inherent discrimination, credit scoring contributes to the self-perpetuating cycle of restricted access to credit that has a dramatic disparate impact on communities of color.

### A. Overt Historical Discrimination

In the not-so-distant past, government and private industry explicitly used race and national origin in assessing borrower risk. For example, the Home Owners Loan Corporation (HOLC), a federal agency established in 1933 in response to the foreclosure crisis associated with the Depression, institutionalized “redlining.” HOLC utilized a discriminatory risk rating system whereby prospective borrowers were favored if their neighborhood was deemed “new, homogeneous, and in demand in good times and bad.”<sup>11</sup> Properties would be ranked low (and thus judged high-risk) if they were “within such a low price or rent range as to attract an undesirable element,” which often meant that they were located near an African-American neighborhood.<sup>12</sup> The so-called “Residential Security Maps” used to make these classifications labeled the lowest ranking neighborhoods “fourth grade,” and shaded them in red. According to housing scholars William J. Collins and Robert A. Margo, “the agency’s revisions were unprecedented. Private financial institutions incorporated the new rating system in their own appraisals, thereby beginning the widespread institutionalization of the practice known as ‘redlining.’”<sup>13</sup> As discriminatory policies and practices continued to persist within the real estate sector, private banks began to adopt the underwriting guidelines established by the federal government in the HOLC program.

Subsequently, the HOLC risk rating system came to inform the Federal Housing Administration (FHA) and Veterans Administration (VA) loan programs in the 1940s and 1950s. The FHA made it possible to purchase a house with just a 10 percent down payment, as opposed to the customary 33 percent required before its establishment. Loan terms were also extended for up to 30 years. The VA program provided similar benefits, all while following the FHA in rating

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<sup>11</sup> Douglas S. Massey, “Origins of Economic Disparities: The Historical Role of Housing Segregation,” in James H. Carr and Nandinee K. Kutty, eds., *Segregation: The Rising Costs for America* (New York: Routledge, 2008), p. 69.

<sup>12</sup> Ibid.

<sup>13</sup> William J. Collins and Robert A. Margo, “Race and Homeownership, 1900-1900,” available at: [http://eh.net/Clio/Conferences/ASSA/Jan\\_00/margo.shtml](http://eh.net/Clio/Conferences/ASSA/Jan_00/margo.shtml).



properties in large part on the basis of the “stability” and “harmoniousness” of neighborhoods.<sup>14</sup>

As a result, the new benefits of a reduced down payment and better loan terms reached only some Americans. According to FHA’s policy, “If a neighborhood is to remain stable, it is necessary that properties shall continue to be occupied by the same racial and social classes. Changes in social or racial occupancy contribute to neighborhood instability and the decline of value levels.”<sup>15</sup> To implement this policy, the FHA even went so far as to *recommend* the use of restrictive covenants to ensure neighborhood stability and racial homogeneity.<sup>16</sup>

The notion that race had a direct impact on property values was broadly adopted by the appraisal industry, and appraisers were trained to evaluate properties using race as a factor. McMichael’s *Appraising Manual*, for example, provided the following ranking of race and nationality by impact on real estate values (in order of preference):<sup>17</sup>

1. English, Germans, Scotch
2. North Italians
3. Bohemians or Czechs
4. Poles
5. Lithuanians
6. Greeks
7. Russians, Jews (lower class)
8. South Italians
9. Negroes
10. Mexicans

Such lists remained in appraisal manuals long after the Fair Housing Act was passed in 1968.

Similar policies were employed in the insurance industry, as homeowners insurance companies adopted policies that resulted in either the outright denial of insurance in communities of color or the availability only of policies that provided inadequate protection at excessive costs to consumers.

Even after passage of the Fair Housing Act, these discriminatory practices received tacit approval from the federal banking regulatory agencies. It was not until 1976, when a coalition of civil rights groups sued them for failing to enforce the Fair Housing Act, that the federal banking regulatory agencies acknowledged that they had any enforcement responsibilities

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<sup>14</sup> Massey, “Origins of Economic Disparities,” *op. cit.*, p. 71-72.

<sup>15</sup> Frederick Babcock, Director of FHA Underwriting Division, “Techniques of Residential Location Rating,” *Journal of the American Institute of Real Estate Appraisers of the National Association of Real Estate Boards*, v. VI, n. 2 (April, 1938), p. 137.

<sup>16</sup> Massey, “Origins of Economic Disparities,” *op. cit.*, p. 71-72.

<sup>17</sup> *McMichael’s Appraising Manual*, 4<sup>th</sup> Edition, 1951.

under the Act.<sup>18</sup> The settlement required the agencies to collect information on the mortgage lending practices of the institutions they regulated, and to establish and implement fair lending examination procedures.

Understanding the historical context of discrimination and redlining practices is significant in any discussion on credit scoring. Because borrowers of color could not access credit in the mainstream market, a dual credit market developed – a market that was separate and unequal – a market where white borrowers had ready access to more regulated, lower-cost, affordable and sustainable credit products while borrowers of color were relegated to unregulated, higher-cost and more unsustainable sources of credit. These fringe markets were – and in some cases still are – the primary source of credit for communities of color.

### **B. Subprime Lending and Its Long-Term Discriminatory Effects**

In many cases, the banking and insurance industries simply replaced their explicitly discriminatory standards with policies and practices that were non-discriminatory on their face, but maintained a disparate impact. (It is worth noting, as described below, that some companies also maintained overtly racially discriminatory policies.) By setting minimum loan values, employing tiered interest rate policies, refusing to make loans in some neighborhoods, and offering only market value homeowners insurance in some neighborhoods, banks and insurance companies continued to discriminate in the marketplace.

Many lenders, recognizing that borrowers of color represented a growth market, developed initiatives to heavily target this market segment. Indeed subprime lenders (and some subsidiaries of prime lenders) took advantage of communities that mainstream lenders shunned. In a representative case, the St. Louis Equal Housing and Community Reinvestment Alliance alleged that a large local bank had not made a single loan to an African-American borrower from 2003 to 2008.<sup>19</sup> Moreover, all of the banks' branches were located in areas with less than two percent African-American population. Nationwide, African-Americans and Latinos were much more likely to receive a subprime loan than their white counterparts according to HMDA data. In both 2005 and 2006, roughly 54 percent of African-Americans and 47 percent of Latinos received subprime loans compared to approximately 17 percent of whites.<sup>20</sup> A study conducted by the National Community Reinvestment Coalition found that there are fewer commercial bank branches in communities of color.<sup>21</sup>

Instead of targeting this market with safe, lower-cost, affordable and sustainable loans, borrowers of color were targeted for unsustainable, higher-cost, subprime mortgages.

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<sup>18</sup> *National Urban League et. al. v. Office of the Comptroller of the Currency, et al*, 1976

<sup>19</sup> Rivas, Rebecca S., "Housing Alliance calls out Midwest BankCenter for not loaning to blacks." *The St. Louis American*, October 14, 2009.

<sup>20</sup> Avery, et. al., "The 2006 HMDA Data", *Federal Reserve Bulletin*, December, 2007.

<sup>21</sup> *Are Banks on the Map? An Analysis of Bank Branch Location in Working Class and Minority Neighborhoods*, National Community Reinvestment Coalition, March 28, 2007.

Subprime lenders have long boasted and prided themselves on being the primary providers of credit to African-American, Latino and other underserved groups. Countrywide, at one time the nation's largest lender and a major originator of subprime loans, boasted that it was the number one lender to borrowers of color.<sup>22</sup> The Department of Justice (DOJ) recently settled an unprecedented \$335 million lawsuit with Countrywide because of its discriminatory practices, which included steering African-American and Latino borrowers who qualified for prime loans into subprime mortgages.<sup>23</sup> Some of the nation's other top subprime lenders have either settled major discrimination lawsuits or are currently defending themselves against such allegations. These lenders include Long Beach, Ameriquest, Delta Funding, Household Finance, Associates, Citi, and Wells Fargo.

And while banks and others continued to defend the use of credit scores as the great equalizer, many borrowers with high credit scores received subprime mortgages even when they qualified for prime credit. Many would-be prime consumers were instead steered into subprime and Alt-A mortgages because of the higher short-term profits lenders could garner. For example, an analysis conducted by First American Loan Performance found that 41 percent of subprime loans made in 2004 went to borrowers who actually would have qualified for a prime rate loan.<sup>24</sup> Another study, commissioned by *The Wall Street Journal*, revealed that in 2005, 55 percent of subprime borrowers would have qualified for a prime loan. *The Wall Street Journal* analysis also found that in 2006 that number had jumped to as high as 61 percent.<sup>25</sup> Federal Reserve Governor Edward Gramlich noted that half of subprime borrowers had credit scores of 620 or higher.<sup>26</sup>

The recently amended lawsuit filed by the City of Baltimore against Wells Fargo provides a glaring example of how lenders purposefully targeted African-Americans and Latinos for higher priced mortgages in outrageously discriminatory ways.<sup>27</sup> Two affidavits filed by former Wells Fargo employees revealed that Wells Fargo:

- Specifically targeted African-American communities for subprime loans but did not do so in white communities;

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<sup>22</sup> Morgenson, Gretchen, "Inside the Countrywide Lending Spree," *New York Times*, August 26, 2007. See also "Countrywide Nation's No. 1 Lender in Emerging Markets", Reported by AllBusiness, available at: <http://www.allbusiness.com/personal-finance/real-estate-mortgage-loans/285920-1.html>.

<sup>23</sup> "Justice Department Reaches \$335 Million Settlement to Resolve Allegations of Lending Discrimination by Countrywide Financial Corporation". Available at <http://www.justice.gov/usao/cac/countrywide.html>.

<sup>24</sup> Klein, Ezra, "Digging into finance's pay dirt: The risky business of payday loans and more," *Washington Post*, July 25, 2010.

<sup>25</sup> "Subprime Debacle Traps Even Very Creditworthy," *Wall Street Journal*, December 3, 2007.

<sup>26</sup> Kirchoff and Block, "Subprime Loan Market Grows Despite Troubles", *USA Today*, December 14, 2004. (At the time of his statement, a score of 620 qualified a borrower for a prime loan.)

<sup>27</sup> *Mayor and City Council of Baltimore v. Wells Fargo Bank, N.A. and Wells Fargo Financial Leasing, Inc.* Third Amended Complaint for Declaratory and Injunctive Relief and Damages, October 21, 2010.

- Targeted African-American churches for the purpose of selling subprime loans. Employees of color were tapped to make presentations to the churches. A white employee was told she could only attend the presentations at African-American churches if she “carried someone’s bag;”
- Used derogatory language to refer to African-American consumers. African-Americans were referred to as “mud people” and “niggers.” And employees referred to loans in African-American neighborhoods as “ghetto loans.” And they referred to Prince George’s County as the “subprime capital” of Maryland. Comparatively, Wells employees felt that predominately white counties like Howard County, Maryland were bad places for subprime mortgages;
- Gave employees substantial financial incentives for steering borrowers who actually qualified for prime mortgages into the subprime market.

America’s separate and unequal financial system is a direct result of the bias perpetuated by both the private and public sectors. Here are some statistics that demonstrate our dual financial system:

- African-American and Latino homebuyers “face a statistically significant risk of receiving less favorable treatment than comparable whites when they ask mortgage lending institutions about financing options;”<sup>28</sup>
- The denial rate for first lien mortgages for African-American borrowers was 2.5 times higher than the rate for Non-Hispanic white borrowers in 2010.<sup>29</sup>
- In 2008, African-Americans were 2.63 times more likely and Hispanics more than two times more likely than their white counterparts to receive a higher-priced loan.<sup>30</sup>
- Even higher-income African-Americans and Latinos received a disproportionate share of subprime loans. According to one study that analyzed more than 177,000 subprime loans, borrowers of color were more than 30 percent more likely to receive a higher-rate loan than white borrowers, even after accounting for differences in creditworthiness.<sup>31</sup>
- Borrowers residing in zip codes whose population is at least 50 percent non-white were 35 percent more likely to receive loans with prepayment penalties

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<sup>28</sup> Turner, et al. *All Other Things Being Equal: A Paired Testing Study of Mortgage Lending Institutions*. The Urban Institute, 2002.

<sup>29</sup> Robert B. Avery, Neil Bhutta, Kenneth P. Brevoort, and Glenn B. Canner. *The Mortgage Market in 2010: Highlights from the Data Reported under the Home Mortgage Disclosure Act*; Table 19, February, 2011.

<sup>30</sup> Avery, et. al; “The 2008 HMDA Data: The Mortgage Market during a Turbulent Year.” *Federal Reserve Bulletin*, October 12, 2009.

<sup>31</sup> See Bocian, D. G., K. S. Ernst, and W. Li, *Unfair Lending: The Effect of Race and Ethnicity on the Price of Subprime Mortgages*, Center for Responsible Lending, May 2006, p. 3.

than financially similar borrowers in zip codes where non-whites make up less than 10 percent of the population.<sup>32</sup>

It follows, then, that borrowers of color are disproportionately represented in foreclosure claims and that communities of color experience higher foreclosure rates than the general population. A recent study released by the Center for Responsible Lending reveals that a home owned by an African-American family is 76 percent more likely to go into foreclosure than a home owned by a white family.<sup>33</sup> The Center for Responsible Lending estimates that African-American and Latino communities will lose \$194 billion and \$177 billion respectively in housing wealth as a result of the foreclosure crisis including the resulting depreciation of living near foreclosed properties.<sup>34</sup>

These high rates of foreclosure caused by discriminatory practices have resulted in thousands of bank-owned (also known as real estate-owned or REO) properties in communities of color. A recent undercover investigation by NFHA and its members shows that discrimination by the banks continues even after foreclosure.<sup>35</sup> The investigation found striking disparities in the maintenance and marketing of foreclosed properties in white areas compared those in neighborhoods of color. Investigators used 39 different factors to evaluate the maintenance and marketing of REO properties, subtracting points for broken windows and doors, water damage, overgrown lawns, no “for sale” sign, trash on the property, and other deficits. Overall, REO properties in communities of color were 42 percent more likely to have more than 15 maintenance problems than properties in white neighborhoods. NFHA has since filed housing discrimination complaints against Wells Fargo and U.S. Bancorp for disparities in the maintenance and marketing of REO properties.

### **C. The Proliferation of Fringe Lenders in Communities of Color**

As described above, fringe lenders – including payday lenders and check cashers – have historically been a primary source of credit for underserved borrowers and are highly concentrated in communities of color. One analysis revealed that there were more payday lender outlets in the country than all McDonalds and Burger King restaurants combined.<sup>36</sup> These fringe lenders saturate predominantly African-American and Latino neighborhoods. A study of fringe lenders in California found that payday lenders were nearly eight times as concentrated in neighborhoods with the largest shares of African Americans and Latinos as

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<sup>32</sup>Bocian, D.G. and R. Zhai, *Borrowers in Higher Minority Areas More Likely to Receive Prepayment Penalties on Subprime Loans*, Center for Responsible Lending, January 2005.

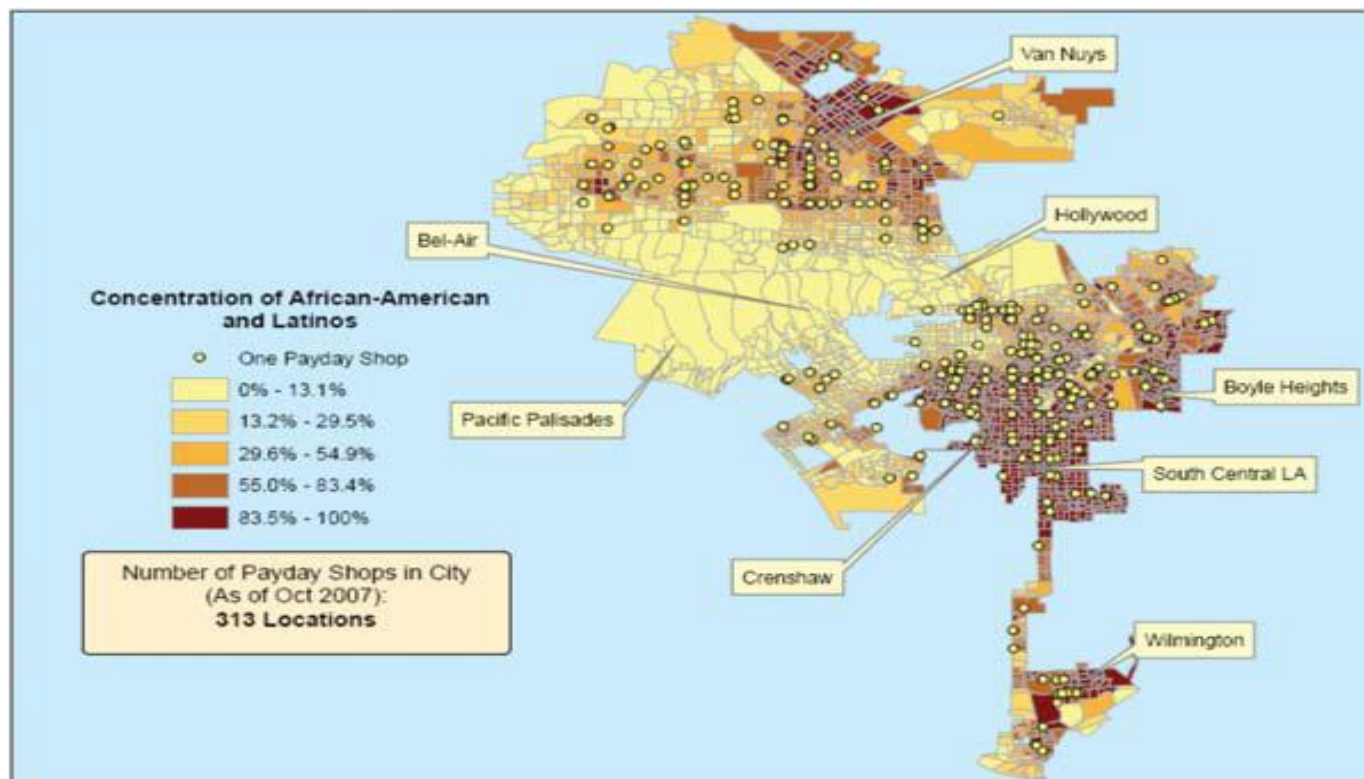
<sup>33</sup> Bocian, et. al., *Foreclosures by Race and Ethnicity: The Demographics of a Crisis*, The Center for Responsible Lending, June, 2010.

<sup>34</sup> Ibid.

<sup>35</sup> *The Banks Are Back, Our Neighborhoods Are Not: Discrimination in the Maintenance and Marketing of REO Properties*, National Fair Housing Alliance, April 4, 2012.

<sup>36</sup> Klein, Ezra “Digging into finance’s pay dirt: The risky business of payday loans and more,” *Washington Post*, July 25, 2010.

compared to white neighborhoods, draining nearly \$247 million in fees per year from these communities.<sup>37</sup> The study includes several maps of communities throughout California showing this pattern. Below is a map of Los Angeles depicting the heavy concentration of payday lenders in African-American and Latino communities. Conversely, there are few mainstream bank facilities in predominantly African-American and Latino communities.



Map: Center for Responsible Lending

Conversely, there are few mainstream bank facilities in predominantly African-American and Latino communities. Borrowers who are targeted by fringe lenders and shunned by mainstream financial institutions are susceptible to volatile credit markets. Consumers who access credit from fringe lenders will undoubtedly have lower credit scores because the products these institutions peddle have abusive terms that carry higher delinquency and default rates.

## II. Credit Scoring Has a Discriminatory Impact and Is Not the Best Measure of Risk

Have a mortgage from a finance company? Your credit will likely be lower than if you had gotten the loan from a depository lending institution. Lose that same home to foreclosure because you can no longer make the inflated payments? Your credit score just went down again.

<sup>37</sup> Li, et. al. *Predatory Profiling: The Role of Race and Ethnicity in the Location of Pay Day Lenders in California*, Center for Responsible Lending, March 26, 2009.

As described above, people of color were disproportionately steered to subprime loans and targeted by fringe lenders. Because credit scoring systems and other automated valuation systems are promoted as a great equalizer and a non-discriminatory way of measuring credit risk, one might then think that credit scores would not rely on discriminatory assumptions to measure risk. In fact, that is exactly what the systems do in some instances. For example, some scoring mechanisms assume that a borrower who received a loan from a finance company is a worse credit risk than one who got a loan from a depository institution – when, in fact, the opposite may be true. A credit scoring system that relies on this false premise penalizes the borrower who simply may not have had access to a mainstream lender but had abundant access to fringe lenders.

Indeed, credit scoring mechanisms are a reflection of the lending and finance systems which produce the data upon which the mechanisms are built. Oftentimes, credit scoring mechanisms assess the riskiness of the lending environment, product type or loan features a consumer uses rather than the risk profile of the consumer.

Let us use an analogy to illustrate this point. Suppose a test has been developed to determine how safe or risky someone is as a car driver. In this test, the driver has to drive through a path and navigate a series of cones and obstacles. However, the driver is placed in a car that is essentially a lemon. The brakes do not work, there is no steering wheel fluid in the car so that it does not turn well, and the transmission is malfunctioning along with other problems. The driver completes the course and is given a low score having knocked over several cones or run into some of the obstacles on the course. But then, this same driver is placed into a different car and asked to drive the same course again. This time the car is not a lemon. It is in pristine condition – with no problems. The second time through, the driver passes with flying colors and receives a high score.

Did the driver change? No. But what did change is the vehicle in which the driver was placed. So the test, while accurately measuring how well the driver navigated the course, was more a reflection of the quality of the vehicle in which the driver was placed than the ability or riskiness of the driver. Similarly, credit scoring mechanisms are often a reflection or measurement of the lending environment or loan product type – and not so much the risk profile of the borrower.

Consumers of color are ill-served by the financial mainstream and disproportionately access credit in more volatile financial environments – these consumers disproportionately get the lemons of the financial services world. As a result, current credit scoring mechanisms which do not evaluate or calibrate scores based on the safety or soundness of the lending environment, may actually cause harm to borrowers of color by misjudging them.

#### **A. Limited Scope, Quality and Transparency of Credit Information**

The information used to build credit scoring models can come from many different sources; however, modelers have tended to rely heavily on credit reporting data from credit bureaus. The quality or accuracy of the scoring model is intrinsically tied to the quality of data upon which the model is based: the better the data quality, the better the scoring system. If modelers are relying on limited data or inaccurate data, they will develop scoring models that are less effective and have limited predictive power and market applicability. The less predictive a scoring model, the greater the likelihood for miscalculating risk.

Companies can use data purchased from third party sources or their own privately held data to develop their scoring systems. Larger companies that have abundant information about a large number of consumers oftentimes use their own in-house data to either develop their own unique scoring systems or to enhance systems that they might obtain from an outside source. But, by and large, the data upon which scoring models are built are purchased from large credit repositories, and these data are often flawed. A study conducted by the National Association of State Public Interest Research Groups revealed the following:<sup>38</sup>

- Four out of five credit reports contained errors;
- 25 percent of credit reports contained significant errors that would result in the denial of credit;
- 54 percent had inaccurate personal information;
- 30 percent listed closed accounts as open; and
- 8 percent did not list major credit accounts.

Not only can the data that credit modelers use be flawed but it can be incomplete. Not all creditors report consumer information to credit repositories. Indeed, some positive credit information from fringe lenders is typically not reported while negative information is almost always reported. Take the case of payday lenders, which, as illustrated above, are concentrated in communities of color. According to the Community Financial Services Association of America, "Payday advances are not reported to traditional credit bureaus."<sup>39</sup> If a consumer obtains a payday loan, the fact that the consumer has paid off the debt on time is not reported to credit bureaus. However, unpaid payday loans are often reflected on the consumer's credit report. The Consumer Federation of America reports that unpaid payday loans can lead to negative credit ratings as well as difficulty in opening bank accounts.<sup>40</sup>

Creditors are not required to report consumer data to the credit repositories. Nor, if they do report, are they required to report positive data as well as negative data. A creditor can decide to forgo submitting any data, or to report only negative data to the credit repositories. Some

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<sup>38</sup> Cassady and Mierzewski, *Mistakes Do Happen: A Look at Errors in Consumer Credit Reports*, National Association of State PIRGs, June, 2004.

<sup>39</sup> The Consumer Financial Services Association of America is a national organization for "small dollar, short-term lending or payday advances." <http://cfsaa.com/about-cfsa.aspx>. See especially <http://cfsaa.com/what-is-a-payday-advance/frequently-asked-questions.aspx>.

<sup>40</sup> See "How Payday Loans Work," at <http://www.paydayloaninfo.org/facts>.



creditors may opt not to submit data because they do not wish to pay reporting costs. Others may not want other companies to be able to identify – and poach – their best paying customers. And while a creditor may not be able or willing to report positive data on a regular basis, the creditor can report negative data to the credit repositories by having the matter referred to a collections agency or by filing an action against the consumer to collect on the alleged debt. This tilts the entire system against the consumer, especially those who access credit outside of the financial mainstream.

Smaller creditors like community development financial institutions (CDFIs) that want to report positive data may be prohibited from doing so because of their size. An informal survey conducted by NFHA underscores the difficulty of collecting comprehensive information on consumer credit habits. The major credit repositories are structured to collect data from larger creditors with a large number of consumer files. Some repositories require creditors to have at least 500 files when reporting data; others require 1,000 files. These numbers are often beyond the reach of CDFIs and other community-based institutions.

In addition to posing accuracy and access challenges, credit scoring mechanisms lack transparency. The formulas are proprietary and not disclosed to the public. In addition, there are a number of individual factors that help determine the score, only some of which are public. It is not clear exactly how the factors used in the credit scoring systems affect a consumer's score. There are potentially thousands of variables that can be included in a scoring system. These variables can be comprised of individual components as well as combined components and might include such elements as the number of: 30-day late payments; inquiries; inquiries by subprime lenders; open trade lines; late mortgage loan payments; or installment loans. They might also include length of employment or length of individual revolving loan accounts.

Each variable is purportedly tested to determine first if it is related to a particular outcome, such as likelihood for a mortgage loan default or for filing an insurance auto claim. Then the variables are tested to determine how they should be weighted within the credit scoring formula. There is a level of subjectivity to the process and experts who develop the systems make the final determination as to which variables are to be included in the formulas and how much weight each is given.

It is important to note that credit scoring modelers are trying to determine whether a particular variable has a correlation to a particular outcome. But the mere presence of a correlative relationship between a particular variable and a certain outcome does not in and of itself indicate a causal relationship. For example, variable testing may indicate that there is a correlation between gas company credit cards and higher rates of mortgage loan defaults; but this does not mean that having a gas company credit card will cause a consumer to default on a mortgage.

It stands to reason that not all variables with a correlative relationship can or should be used in a credit scoring system. For example, some analyses have shown that hair or eye color can

correlate to certain types of insurance claims. Other analyses have revealed links between zodiac signs and frequency of auto claims.<sup>41</sup> If we were to follow these data, those born under the sign of Taurus or Virgo would pay higher premiums than Cancers or Aquarians. It also follows that neither race nor national origin nor any proxies that stand for them should be used in a credit scoring system, not only because it flies in the face of our nation’s laws and policies, but because it makes as little sense as using a zodiac sign to price car insurance.

## B. Disparate Impact of Credit Scoring Factors

While it is no longer legal to evaluate risk using protected class characteristics, current credit scoring systems still have a significant disparate impact on people of color and other underserved consumers because some seemingly facially-neutral factors actually have discriminatory effects.

Take, for example, the factors used by the FICO scoring system, which is widely-known and often touted as the industry standard for use in mortgage lending. While many independent variables and their weighting in the FICO scoring system are unknown and proprietary, several broad categories that impact the score are public: payment history; amounts owed; length of credit history; new credit; and types of credit used. The chart below from one of FICO’s websites illustrates the value assigned to each of these categories.<sup>42</sup>

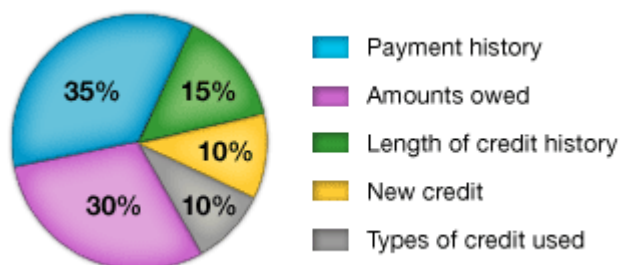


Chart: [www.myfico.com](http://www.myfico.com)

All of these categories pose concerns about disparate impact and unintended discriminatory outcomes, and affect access to sustainable, affordable, and fair credit. Below is a more detailed description of the fair lending concerns related to each category of the FICO scoring system.

### *Payment History – 35% of FICO Score*

<sup>41</sup> “Allstate: Virgos have most crashes,” United Press International [http://www.upi.com/Odd\\_News/2011/01/28/Allstate-Virgos-have-most-crashes/UPI-28291296246090/](http://www.upi.com/Odd_News/2011/01/28/Allstate-Virgos-have-most-crashes/UPI-28291296246090/). While the Allstate press release announcing the findings was tongue-in-cheek, the data and analysis were real. “Allstate zodiac joke bombs,” CNN Money, February 2, 2011. [http://money.cnn.com/2011/02/02/news/companies/allstate\\_zodiac/index.htm](http://money.cnn.com/2011/02/02/news/companies/allstate_zodiac/index.htm) See also “Aquarius with the fewest claims, Taurus lives more dangerously,” Allianz Suisse, February 17, 2011. [https://www.allianz.com/en/press/news/studies/news\\_2011-02-17.html](https://www.allianz.com/en/press/news/studies/news_2011-02-17.html)

<sup>42</sup> Chart developed by Fair Isaac: <http://www.myfico.com/CreditEducation/WhatsInYourScore.aspx>.

The payment history component of the score includes information about whether borrowers make timely debt payments, including some subprime loans. As mentioned above, subprime loans carry much higher default and delinquency rates<sup>43</sup> – not necessarily because of the borrower traits, but more often because of the aspects and features of the loans themselves. Because African-Americans and Latinos are targeted for subprime loans, the data suggest that these groups will undoubtedly experience higher rates of poor performance in payment history.

A unique study that compared two similar groups of low- and moderate-income borrowers demonstrates this point.<sup>44</sup> The study compared two mortgage loan portfolios, one comprised of loans made through a program that provided low-cost fixed rate loans, and the other a portfolio of subprime loans. Using propensity score match methodology, the researchers were able to isolate borrowers with similar characteristics in the two groups. The divergent variables between the two groups were the loan terms and conditions, and the channel borrowers used to obtain the mortgages. While the traits of both groups of borrowers were similar, the loan performance outcomes were not. The default rate for the subprime portfolio was *four times higher* than that for the lending program portfolio for low- and moderate-income borrowers.

Moreover, the study found compelling evidence that loan characteristics and origination channel had a significant impact on loan performance. Specifically, the existence of prepayment penalties, adjustable interest rates, and elevated costs negatively impacted the loans' performance – even after controlling for credit score. Additionally, loans originated through broker channels resulted in higher default rates.

These data conflict with the underlying assumption behind scoring mechanisms. This study and others suggest that a borrower may well end up with a damaged credit score not because the borrower was more risky or negligent but rather because the borrower obtained a loan through a broker or received loan terms that increase the likelihood of delinquency and default. Existing credit scoring systems do not distinguish between risk caused by borrower behavior and risk caused by loan terms and conditions. Thus, risky loans are likely to have a negative

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<sup>43</sup> According to Mortgage Bankers Association National Delinquency Survey Data released 5/19/2010, the seasonally adjusted delinquency rate was 6.17% for prime fixed loans, 13.52% for prime ARM loans, 25.69% for subprime fixed loans, 29.09% for subprime ARM loans, 13.15% for FHA loans, and 7.96% for VA loans. Foreclosure starts rate was .69% for prime fixed loans, 2.29% for prime ARM loans, 2.64% for subprime loans, 4.32% for subprime ARM loans, 1.46% for FHA loans, and .89% for VA loans. These trends have held steady. The same data released 8/29/2009 revealed the following: the seasonally adjusted delinquency rate was 6.41% for prime loans, 25.35% for subprime loans, 14.42% for FHA loans, and 8.06% for VA loans. The foreclosure inventory rate was 3% for prime loans, 15.05% for subprime loans, 2.98% for FHA loans, and 2.07% for VA loans.

<sup>44</sup> Lei Ding, Roberto G. Quercia, Janneke Ratcliff, and Wei Li, *Risky Borrowers or Risky Mortgages: Disaggregating Effects Using Propensity Score Models*, Center for Community Capital, University of North Carolina at Chapel Hill, September 13, 2008.

impact on the borrowers' credit scores, even though those borrowers may have had a perfect payment record had they been able to obtain a less risky loan.

### *Amounts Owed – 30% of FICO Score*

The FICO score calculation of amounts owed is comprised of multiple factors and FICO does not reveal in detail all of these factors and how they are weighted. However, the company does report that this category takes into consideration the amount of credit available to a borrower for certain types of revolving and installment loan accounts. To the extent that underserved communities have restricted access to credit, and in particular, the type of credit that will likely be reported in a positive fashion to credit repositories, this category can pose a disparate discriminatory impact.

A study by the San Francisco Federal Reserve Board provide an analysis of individuals who do not have a checking or savings account in the region. These “unbanked” tend to be low-income, young, non-white adults who lack a college degree.<sup>45</sup> The analysis goes on to reveal that approximately half of African-Americans and Latinos fall into this category and that the unbanked are concentrated in lower-income census tracts without a checking or savings account. This analysis also documents the preponderance of payday lenders and check cashers in predominately African-American and Latino neighborhoods.

The lack of access to mainstream lenders may well impact the ability of underserved consumers to obtain revolving or installment lines of credit from such lenders. And if these borrowers experience undue difficulty in accessing quality credit, they may well suffer a lower credit score from a system that considers how much “extra” credit they may have available in certain revolving and installment accounts.

Here again, this component is not only measuring the ability of the borrower to effectively manage credit accounts but is also measuring the extent to which a consumer actually has access to certain types of credit accounts.

### *Length of Credit History- 15% of FICO Score*

Presumably, the longer a borrower has had an account, and to the extent that the account is reported to the credit repositories, the higher the borrower's credit score. If this is indeed the case, then borrowers with little access to credit that is reported to the credit repositories will be negatively impacted by this component.

We provide a fairly detailed analysis above of how mainstream creditors historically discriminated against communities of color. Moreover, as referenced above, borrowers of color

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<sup>45</sup> “Understanding the Unbanked Market in San Francisco”, Federal Reserve Bank of San Francisco. Presentation available at <http://www.frbsf.org/community/resources/banksfpresentation.pdf>.

are much less likely than their white counterparts to have access to mainstream banks and consequently are much more likely to access credit from fringe lenders who do not report positive data to the credit repositories. This means that borrowers of color will be less likely to have trade lines with a significant amount of history.

This factor also penalizes borrowers who deal on a cash basis, access credit outside of the financial mainstream, have been shut out from accessing traditional credit, or obtain credit from lenders who do not report positive data. Borrowers with these circumstances are disproportionately persons of color.

### *New Credit- 10% of Credit Score*

This component takes into consideration the number of newly opened accounts a consumer has. FICO does not provide details on just how a consumer's credit score will be affected if the consumer establishes new credit. FICO advises consumers to avoid opening new lines of credit as this *might* result in lowering the credit score.<sup>46</sup> Further, opening new accounts will lower the average account age of credit lines and this will result in a lower credit score.

This component also considers the number of credit accounts a consumer pursues. So if a consumer is shopping for a mortgage or applying for credit at different places, the consumer's credit score can be negatively impacted. To guard against any negative impact, FICO advises consumers to shop for a mortgage loan within a short window of time.

There are two areas of concern with respect to disparate outcomes under this component. The first is the higher likelihood that consumers of color will be among those who are accessing new credit accounts. As discussed above, credit access is a major challenge for underserved groups and these groups are much more likely to be unbanked. It stands to reason, therefore, that underserved groups will be among those who are newly entering the credit markets and therefore, establishing new accounts.

The second area of concern emanates from the higher mortgage loan declination rates for borrowers of color. As described earlier, HMDA data reveal that borrowers of color are much more likely than their white counterparts to be declined for a loan. These higher declination rates suggest that borrowers of color may be more likely to apply to additional lenders for a loan approval.

If mortgage loan inquiries or applications are undertaken in a short time frame, there may be no negative impact on a consumer's credit score. However, if a consumer applies for a mortgage with one lender, is declined, and then applies for a mortgage with another lender, this process may well negatively impact the consumer's credit score due to the longer lapse in time between

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<sup>46</sup> "How to Repair Your Credit and Improve Your FICO Credit Score," Available at: <http://www.myfico.com/crediteducation/improveyourscore.aspx>

loan inquires. More analysis and research needs to be conducted to determine if borrowers of color have a higher incidence of shopping for a mortgage with different lenders over longer periods of time and ultimately how that might impact their credit scores.

### *Types of Credit Used – 10% of FICO Score*

Again, FICO does not reveal exactly how it calculates the type of credit a borrower may use in generating a credit score; however, there is evidence that certain types of credit, like credit provided by finance companies, are treated less favorably than credit provided by mainstream lenders, like depository banking institutions. According to the Federal Reserve Board, “Many credit-scoring models consider the number and type of credit accounts you have. A mix of installment loans and credit cards may improve your score. However, too many finance company accounts or credit cards might hurt your score.”<sup>47</sup> If this is indeed the case, this category also presents dangerous implications for borrowers of color.

FICO, in a guide developed to advise consumers on how to improve their credit scores, suggests that consumers who have installment loans and credit cards that are reported to the credit repositories will have a more favorable analysis in the FICO credit scoring system.<sup>48</sup> Here again, consumers who access credit outside of the financial mainstream will be penalized by this type of an analysis.

This component may more largely assess the quality of the environment or type of loan product a consumer accesses rather than the risk characteristics of the consumer.

### **C. Existing Credit Scoring Systems Do Not Adequately Predict Risk**

The current crisis has revealed that credit scoring mechanisms are an insufficient measure for predicting and managing performance. While FICO is designed to assess risk and predict a borrower’s performance, recent analyses demonstrate the ineffectiveness of the scoring mechanism. Default rates for all borrowers have increased precipitously, regardless of credit score, and one study found that “higher FICO scores have been associated with bigger increases in default rates over time.”<sup>49</sup>

In the years before the economic crisis, it was common for lenders to put aside more thorough and comprehensive underwriting criteria which allowed unique and compensating factors to be evaluated, and instead to substitute them with flimsy underwriting standards. If a borrower had a higher credit score, the lender could truncate the underwriting process by foregoing a fully documented underwriting review. In order to maximize short-term profits, lenders took

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<sup>47</sup> See “5 Tips: Improving Your Credit Score,” available at: [http://www.federalreserve.gov/consumerinfo/fivetips\\_creditscore.htm](http://www.federalreserve.gov/consumerinfo/fivetips_creditscore.htm).

<sup>48</sup> Ibid.

<sup>49</sup> Demyanyk, Yuliya, “Did Credit Scores Predict the Subprime Crisis?” *The Regional Economist*, Federal Reserve Bank of St. Louis, October, 2008.

great strides to increase volume. One way to increase volume was to shorten the time it took to approve a loan.

Sound underwriting criteria such as verifying savings and other deposits, income and employment or documenting timely rental payments were largely disregarded. Lenders gave substantially more weight to the credit score factor. In that environment, the FICO score became a proxy for sound underwriting. Whereas the credit score might have been an important tool to add to the underwriting toolbox, instead it was over-valued in the underwriting process. Even FICO admits that lenders were too reliant on the model.<sup>50</sup>

A study published by the Federal Reserve Bank of St. Louis looked at credit scores and borrowers who received subprime mortgages.<sup>51</sup> The study revealed that, for borrowers with the lowest FICO scores (500 – 600), the rate of seriously delinquent loans was twice as large in 2007 as it was in 2005. Comparatively, for borrowers with the highest FICO scores (above 700), the rate of seriously delinquent loans was almost four times as large in 2007 as it was in 2005. Borrowers with lower FICO scores saw a 100 percent increase in seriously delinquent loans while borrowers with higher FICO scores saw a 300 percent increase in seriously delinquent loans. The study's author concludes that "the credit score has not acted as a predictor of either true risk of default of subprime mortgage loans or of the subprime mortgage crisis." The heavy reliance on FICO during the most recent housing boom has contributed to the system's ineffectiveness. Even industry analysts have recognized the flaws in FICO.<sup>52</sup> In a document written to clients, an analyst at CIBC World Markets called FICO scores "virtually meaningless."<sup>53</sup>

Borrowers with higher FICO scores are in many cases acting the way borrowers with very low scores are predicted to act. Some analysts in reviewing private loan portfolios have found that in some cases loan characteristics were more predictive of loan performance than the borrower's FICO score. Indeed, both FICO<sup>54</sup> and TransUnion have released reports that indicate that borrowers with higher FICO scores are performing in uncharacteristic ways. These borrowers, in a trend never before seen, are more likely to pay their credit card debt than their mortgage loan debt. This offers additional proof that a credit score alone cannot predict long-term mortgage performance.

Many lenders that either do not rely on credit scoring mechanisms at all or minimally rely on them experience default rates that are lower than the industry average. For example, Golden West Financial, a lender that did not rely on the FICO score because of its non-predictive nature,

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<sup>50</sup> Sullivan, Bob. "Credit Scores 102: A Crisis, and Some Changes," MSNBC, The Red Tape Chronicles, March 18, 2008.

<sup>51</sup> Ibid footnote 49.

<sup>52</sup> Gandel, Stephen, "Lenders Look Beyond Credit Scores to Gauge Who's a Risk", *Time*, January 9, 2009.

<sup>53</sup> Foust, Pressman, "Credit Scores: Not-So-Magic Numbers," *Bloomberg Businessweek*, February 7, 2008.

<sup>54</sup> Tedeschi, Bob, "Even High Score Borrowers at Risk of Mortgage Default," *New York Times*, March 10, 2010.

experienced a default rate of 0.75 percent while the industry average for the same class of loans was 1.04 percent.<sup>55</sup> Golden West relied on careful underwriting, including income and asset verification and employed a different mechanism for compensating appraisers. Instead of compensating an appraiser based on the number of appraisals completed, Golden West compensated appraisers on the accuracy of the appraisal over the life of the loan. Underscoring the tenuous reliability of the FICO score, a Golden West representative reported that some of Golden West's best clients had very low FICO scores and some of their worst clients had high FICO scores. In addition, the North Carolina State Employees' Credit Union indicated that for their borrowers who would be classified as subprime, the default rate is 1.25 percent, well below the industry average. NCSE attributes the higher default rates among subprime loans to higher interest rates and poor underwriting practices.<sup>56</sup>

#### **D. Risky Loan Products and Unsafe Lending Environments – Not Borrowers – Were Clearly the Culprit**

When looking at which loans failed and which were successful over the past ten years, the picture becomes clear. Loan terms and conditions were the largest part of the problem, not the borrowers. Failed underwriting processes and unsuitable loan products were higher contributors to poor loan performance than were the credit characteristics of the borrower. Even borrowers with good credit who paid their bills on time, quickly found themselves in trouble after getting a predatory or subprime loan or accessing credit in an unsafe environment.

We saw similar outcomes among corporations like Lehman Brothers and Bear Stearns that turned more and more to risky investment products and tenuous financial deals. Just as the creation and sale of unregulated complex derivative investment products was a bad idea, and led otherwise sound companies into ruin, so was the creation and sale of unwise mortgage loan products with highly risky features, like pre-payment penalties, and negative amortization which led otherwise good consumers into default.

Some lenders might improve overall loan performance by improving the quality of the underwriting process. In a presentation on the impact of the Qualified Residential Mortgage requirements, a number of organizations, including NFHA, the National Association of Realtors® and the Mortgage Bankers Association, highlighted a number of factors that are most important in decreasing default risk. Those factors included full loan documentation and verification processes. These critical underwriting components were identified as key elements in improving loan portfolio performance and management.<sup>57</sup>

The organizations also cite risky loan features including:

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<sup>55</sup> Ibid.

<sup>56</sup> Ibid.

<sup>57</sup> The presentation deck is available by contacting the National Fair Housing Alliance or any of the other sponsoring organizations.



- negative amortization loans;
- interest-only loans;
- loans with balloon payments;
- loans exceeding 30 years in maturity;
- prepayment penalties;
- unverified income, employment, assets and other debts i.e., no-doc or low-doc loans;
- underwriting for ARMs based on an introductory rate rather than the fully-indexed interest rate;
- total points and fees exceeding three percent of loan amount;
- unstable or undocumented payment history;
- ARM reset caps above two percentage points per year;
- investor loans;
- yield spread premiums; and
- piggyback seconds.

These same risky loan features have been identified in proposed regulations for the Qualified Mortgage and Qualified Residential Mortgage requirements.

Perhaps instead of concentrating so much of the risk analysis on the borrower, more attention should be paid to evaluating the products themselves, the environment in which the credit is provided and the underwriting process used by the mortgage lender.

### **III. Why the Federal Government and Lenders Have an Obligation to Change the System**

All federal agencies and their grantees associated in any way with housing and community development have a special obligation to further the purposes of federal Fair Housing Act. The law covers policies and practices that have a disparate impact on protected classes. To the extent that credit scoring has a disparate impact, the federal government and its grantees must take action.

The federal Fair Housing Act – passed in 1968 – has the dual mission of eliminating housing discrimination and promoting residential integration. The Fair Housing Act requires that government agencies spend funds dedicated to housing and community development in a manner that “affirmatively furthers fair housing.” This obligation is not limited to the Department of Housing and Urban Development; rather it applies to a wide range of government agencies, including those with regulatory or supervisory authority over financial institutions, as stated in Section 808(d) of the Fair Housing Act:

All executive departments and agencies shall administer their programs and activities relating to housing and urban development (including any Federal agency having regulatory or supervisory authority over financial institutions) *in a manner affirmatively to further the purposes of this subchapter* and shall cooperate

with the Secretary [of Housing and Urban Development] to further such purposes.<sup>58</sup> (*emphasis added*)

Executive Orders and other provisions of the Fair Housing Act related to affirmatively furthering fair housing provide additional guidance on this obligation.<sup>59</sup> The Obama Administration has also affirmed its commitment to fair housing and fair lending.<sup>60</sup>

This affirmative obligation has been interpreted to apply to efforts to eliminate segregation. This is important to the well-being of our nation because where we live determines our access to opportunities, wealth, and resources.<sup>61</sup> In this context, equal access to credit, financial services and products cannot be overstated. The largest federal housing program ever, the Troubled Asset Relief Program (TARP) provided funding for major banks and insurance companies. As recipients of these funds, these entities are also required to affirmatively further fair housing with TARP and any other government funds.<sup>62</sup> Credit scoring systems, which are clearly related to housing and community development, are also covered by this provision of our nation's fair housing laws.

#### **IV. Policy and Enforcement Solutions to Improve Credit Scoring Systems**

Because of the significance that credit scoring has for a wide range of access issues, such as credit access, employment opportunity, and insurance availability, credit scoring mechanisms need major improvements if not a complete overhaul. Intrinsic and persistent discrimination in the lending markets and America's dual and unequal credit market have contributed to serious credit access problems for borrowers and communities of color. Below are some recommendations on how to improve credit scoring mechanisms and suggestions on how to monitor and evaluate these systems.

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<sup>58</sup> 42 U.S.C. Sec. 3601 et seq.

<sup>59</sup> Section 805 of the Fair Housing Act lays the groundwork for this mandate by detailing discrimination in residential real estate-related transactions; Section 808 of the Act spells out the responsibility of the Secretary of Housing and Urban Development (HUD) to administer the Act, and the Act's application to other federal agencies; and Executive Order 11063,<sup>59</sup> signed on November 20, 1962, and Executive Order 12892,<sup>59</sup> signed on January 17, 1994, together state the responsibilities of all federal agencies to administer their programs in a manner that affirmatively furthers fair housing and clarify what is meant by programs and activities relating to housing and urban development.

<sup>60</sup> See Remarks by Shaun Donovan at the National Fair Housing Alliance Conference available at: <http://www.hud.gov/news/speeches/2009-06-08.cfm> See also HUD Statement No. 09-206 available at: [http://portal.hud.gov/portal/page/portal/HUD/press/press\\_releases\\_media\\_advisories/2009/HUDNo.09-206](http://portal.hud.gov/portal/page/portal/HUD/press/press_releases_media_advisories/2009/HUDNo.09-206).

<sup>61</sup> Carr and Kutty, p. 2.

<sup>62</sup> Swesnik, Deidre; Clark, Benjamin; Goldberg, Deborah. *How Tarp Funds Could (and Should) Be Used to Improve Our Neighborhoods*, National Fair Housing Alliance, November 2009.

### ***Broaden the scope of financial data utilized by underwriting and credit scoring models***

One way to improve credit scoring models is to broaden the scope and quality of data upon which the systems are based. Currently the primary source of data is major credit repositories.

Credit repositories should make it easier for smaller financial institutions to report positive data. Moreover, credit repositories must be proactive and ensure that positive data from non-traditional sources can be submitted. Data should also be included from state housing finance agencies, community development financial institutions, micro-lending organizations, credit unions, and affiliation or community groups such as churches, faith-based institutions and benevolent organizations.

Broadening the scope of credit information will create a more robust data pool with additional information about and from consumers who access credit in safe, but non-traditional environments. It will also enable the credit scoring systems to more accurately assess a broader range of consumers. This will in turn lessen the likelihood that a consumer will be incorrectly characterized or categorized in various credit scoring systems.

Finally, credit repositories must create mechanisms to correct the current system's slant toward the reporting of only negative data. For example, a mechanism that allows consumers to report and submit verifiable and documented information about their credit payment histories could be designed. Consumers are paying debt obligations on time that do not get reflected in the credit repository data and this has a huge negative impact on communities of color.

### ***Improve the quality of data***

Credit bureaus must make it easier for consumers to correct erroneous information on their credit reports. Incorrect information can lead to low credit scores and credit denials and limit access to quality, affordable credit.

Improving data quality will also contribute to better scoring models that more accurately assess consumer risk. Improving the performance of scoring models should be the goal of everyone involved with providing credit to consumers. It should also be the goal of regulators that oversee financial institutions and credit reporting agencies. Ensuring that consumers have access to quality credit will expand opportunities for consumers, promote healthy financial practices, and contribute to the growth of consumer net worth.

### ***Make the system more transparent***

It has taken years to get agencies to reveal the limited information that they currently do about how various factors impact a consumer's credit score. Yet, there is much we don't know. This can lead housing professionals and credit and housing counselors to give inaccurate information to consumers about how effectively to manage their credit. Moreover, since

different scoring mechanisms are used for different reasons, it may well be the case that when a consumer does something to improve their insurance score, for example, the consumer's credit score will be negatively impacted.

Consumers and consumer counselors are generally uninformed about what should be done to impact positively the consumer's score. Making the scoring systems more transparent will help consumers better manage their financial affairs. Making the system and the data more transparent will also help advocates, financial institutions, federal regulators, and legislators.

### *Adequately assess the impact of credit scoring mechanisms on underserved groups*

The Consumer Financial Protection Bureau, other federal banking regulators, and federal enforcement agencies including DOJ and HUD should examine the impact of credit scoring mechanisms on underserved groups and the population as a whole. The regulators should also conduct disparate impact analyses of credit scoring systems. It is imperative that the data that regulatory and enforcement agencies use to undertake these analyses come from a broad range of sources. For example, regulators cannot rely predominantly on industry-developed data upon which to conduct these evaluations.

Credit score developers should also conduct similar analyses of their own systems to identify any fair lending concerns and to implement less discriminatory alternatives.

### *Reduce the over-reliance on credit scoring mechanisms*

Credit-scoring mechanisms are an insufficient measure for predicting and managing performance as the current crisis has revealed. Borrowers are not behaving as their credit scores would indicate. Lenders, investors, regulators and legislators must caution against using credit scores as a replacement for underwriting or the only assessment of risk. There are many factors that affect loan risk including the presence of pre-payment penalties, inefficient appraisals, poor documentation practices, and other abusive loan features. The credit score may be the least significant factor when it comes to risk analysis. Therefore, lenders, investors, regulators and legislators must adopt approaches that objectively consider other elements that impact risk.

### *Evaluate product risk*

In addition to reducing the reliance on credit scoring systems, federal regulators and legislators should push for the evaluation of credit and financial services products. Additionally, underwriting systems and practices should be evaluated for their level of risk. This information should be readily available so consumers will know which products and which underwriting practices pose the most risk and will therefore likely contribute to a negative credit score. Providing objective information to consumers about threats associated with the products or

services they are considering will enable consumers to make informed and sound financial decisions.

As discussed above, multiple studies reveal that unsafe products and unsavory underwriting practices have a significant impact on loan performance and credit risk. It therefore is quite practical to consider these functions in the risk analysis. Focusing analyses on borrower characteristics will not improve the quality of the assessment of risk; rather, objectively considering all factors that contribute to credit risk will result in a better analysis of risk exposure.

### *Fix credit scores for victims of discrimination*

Repairing credit scores damaged by discrimination or any other practice should be included in complaint settlements and remedies. For example, the recent Justice Department settlement with Countrywide demonstrated the discrimination against African Americans and Latinos in steering and fees. Thousands of families who should have received prime loans were steered to subprime loans. It is reasonable to assume that their credit scores were negatively impacted by the mere fact that they received a more expensive subprime loan. Those borrowers should be made whole and their remedies should include restoring their damaged credit scores.

Regulators, enforcement agencies, and the courts should fix credit scores as a matter of course as part of remedies and settlements. In fact, this has already been done in some settlements between banks and fair housing organizations and consumer groups. When predatory lending was especially rampant in the early 2000s, fair housing organizations were sometimes successful in complaint settlements in getting a borrower's credit history amended. In consultation with the credit reporting agency, the bank would have the trade line that applied to the predatory loan deleted from the borrower's credit report. This, in turn, erased the loan from the borrower's history as if it had never been made. In recent years, however, some lenders have not agreed to delete the trade line entirely and instead have agreed only to report the loan as "satisfied." This means that the credit report shows that there is no debt remaining on the loan but any history of late payments and other blemishes remains on the credit report for the time allotted by the credit scoring agency. Unfortunately, because of the opacity of credit scoring mechanisms, it is hard to tell which approach might be best for a specific consumer at any given time.

## Conclusion

By 2042, the majority of people in this country will be people of color. Given these changing demographics, it is past time to figure out how to make our nation's credit system work equally for everyone. When civil rights groups called for a foreclosure moratorium on subprime loans more than five years ago, predicting that the nation was headed for a financial and foreclosure crisis and referencing the disproportionate damage these loans were causing in communities of color,<sup>63</sup> Federal Reserve Chair Ben Bernanke told the groups that the problem of foreclosure would be contained and restricted to the subprime market. The Mortgage Bankers Association responded that, "Each loan is an individual transaction and situation, one which needs to be addressed individually between the lender and the borrower."<sup>64</sup>

We all know now that these responses to the burgeoning crisis did not make sense and that regulators and the industry failed to see the breadth of the ensuing crisis, despite the warnings made by civil rights and consumer protection groups. The foreclosure problems not only went beyond the U.S. subprime market but turned into an international economic crisis of proportions not seen since the Depression.

Credit scoring mechanisms are negatively impacting the largest growing segments of our country and economy. America cannot be successful if increasing numbers of our residents are isolated from the financial mainstream and subjected to abusive and harmful lending practices. Credit scores affect more and more of our daily activities and determine everything from whether we can get a job and provide for our families to whether we will be able to successfully own a home and build wealth for future generations. The current credit scoring systems work against the goal of moving qualified consumers into the financial mainstream because they are too much a reflection of our broken dual credit market. This paradigm must change.

We believe that the recommendations presented here are important steps towards broadening access to good credit for all qualified borrowers.

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<sup>63</sup> "Civil rights groups urge freeze on foreclosures," *Los Angeles Times*, April 6, 2007.

<sup>64</sup> "MBA Chairman Robbins Responds to Call for Moratorium on Foreclosures," Mortgage Bankers Association news release, April 4, 2007.