



IMPACT of CREDIT SCORING on Under-Served Markets: The Association of Risk and Race in America's Financial System



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Credit Scoring Raises Fair Lending Concerns

- Financial mainstream has never primarily serviced communities of color
- Historical and current patterns of discrimination are manifested in data upon which scoring mechanisms are based
- “Tainted” data is replete throughout financial and credit data
- Connection between “race” and “risk” has never been eliminated from our markets

Bifurcated Nature of the US Financial System

Bifurcated U.S. Financial System

Capital Markets

REITs, Mutual Funds, Pensions, 401(k)s, Stocks, Bonds, GSEs
AAA Rated Mortgage-Backed Securities

Mainstream Financial Services

Mortgages, Savings and Checking Accounts, Home Equity
Loans, Lines of Credit, CDs

Prime Market

Jumbo Market

Fringe Financial Services

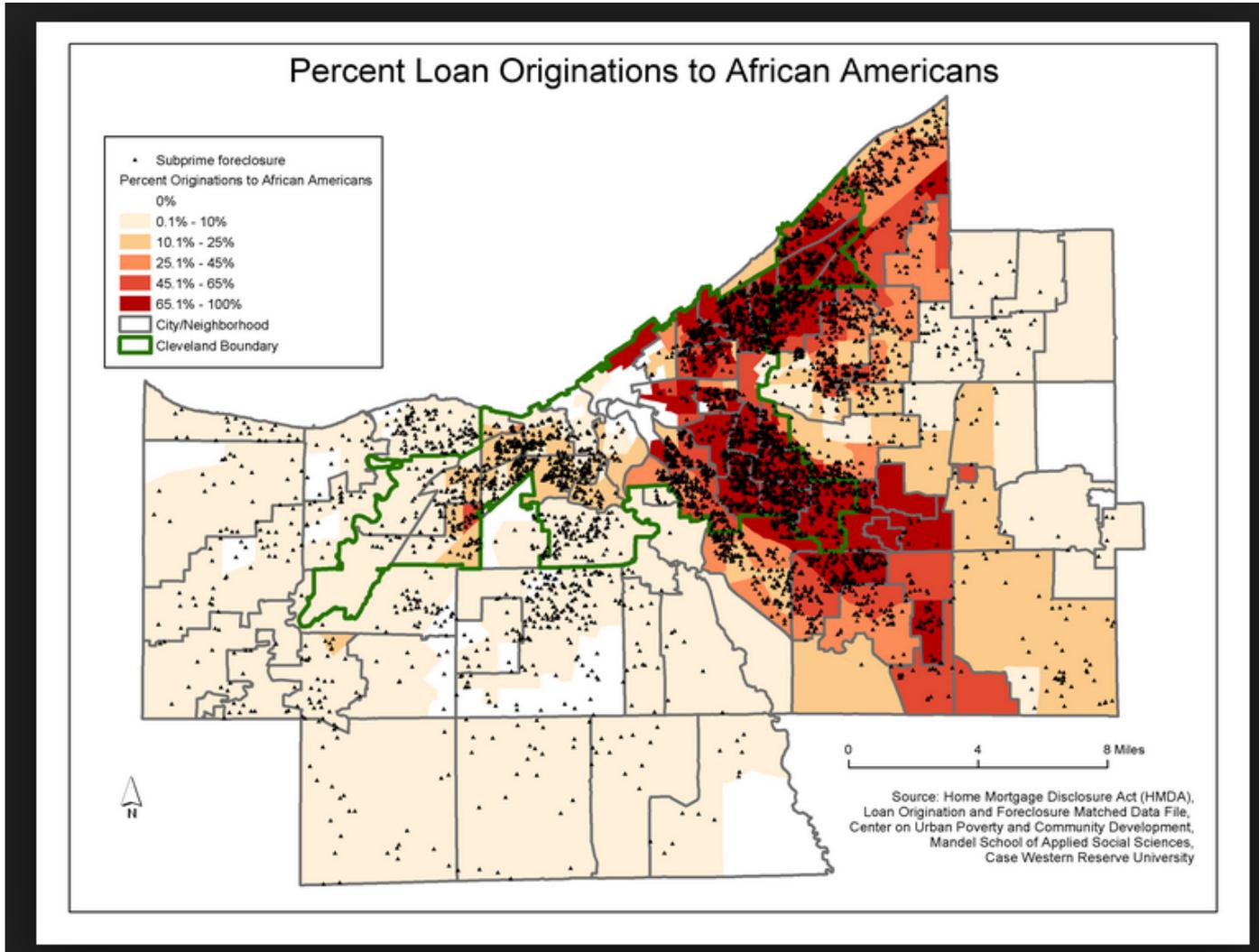
Pawnshops, Check Cashers,
Payday Lenders,
Rent-to-Own Shops,
Title Lenders
Finance Lenders
Sub-Prime Lenders

Lower-Income and Minority
Communities

Middle / Upper- Income and
Predominately Caucasian
Communities

Slide provided by Jim Carr
and augmented by NFHA.

2005 – 2006 Subprime Loan Originations 2005 – Early 2008 Loan Foreclosures





DISPARITY ISSUES

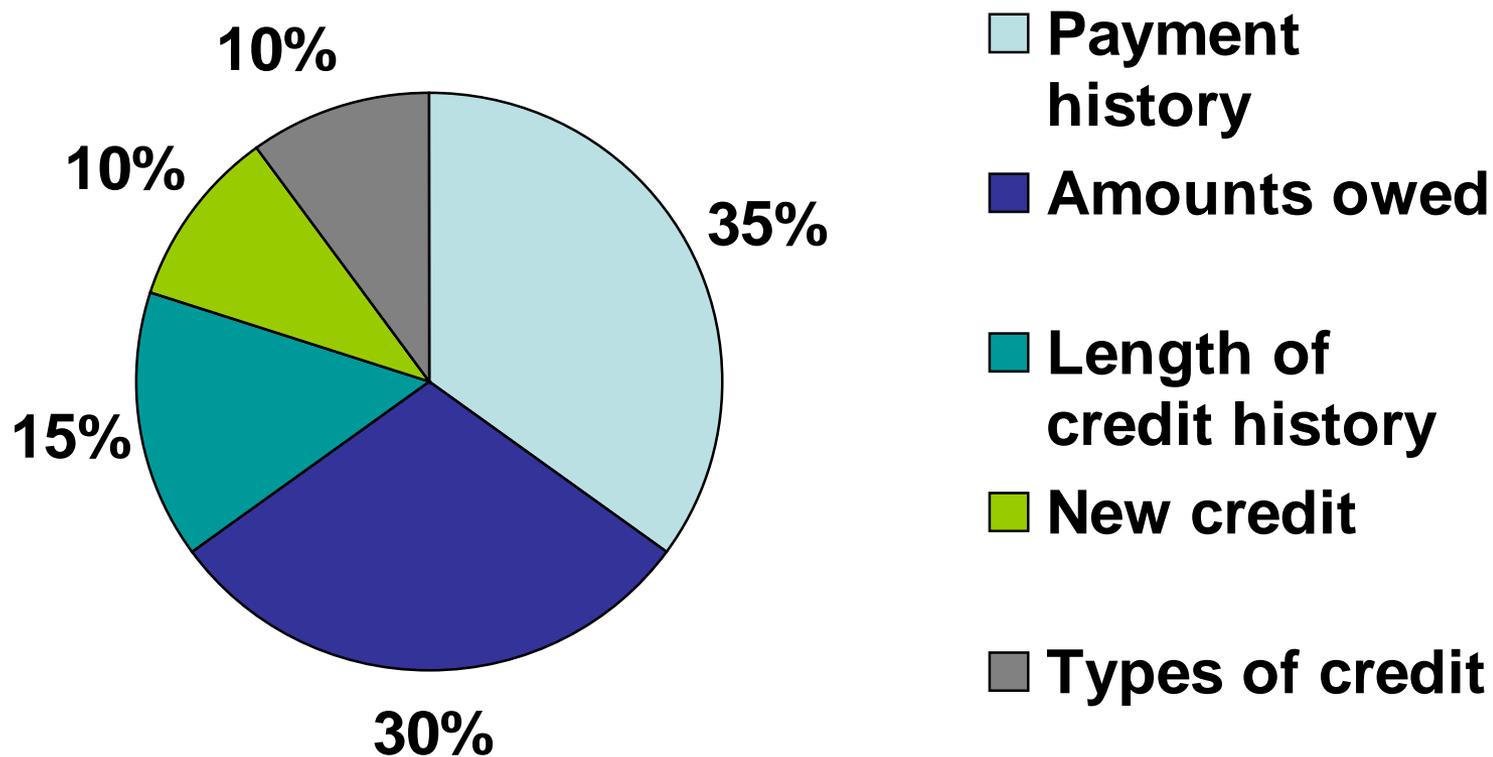


Chart adapted from content from Fair Isaac, available at: <http://www.myfico.com/CreditEducation/WhatsInYourScore.aspx>

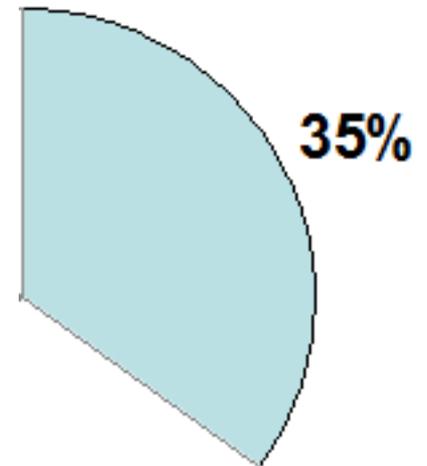
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DISPARITY ISSUES

- **Payment History**

- Subprime loans and non-traditional credit information is not reported to repositories when the payments are timely made.
- Negative data is reported to the repositories.
- People of color have higher uninsured rates and therefore may be more likely to have medical debt collections which can unfairly cause lower credit scores.
- Scoring mechanisms do not control for predatory loan terms, distribution channels or debt collection procedures, which can negatively impact borrowers of color.
- Borrowers may unduly have a lower credit score not because they themselves were risky but rather because the product they obtained, the distribution channel they used, their loan servicer or debt collection agency caused the risk.

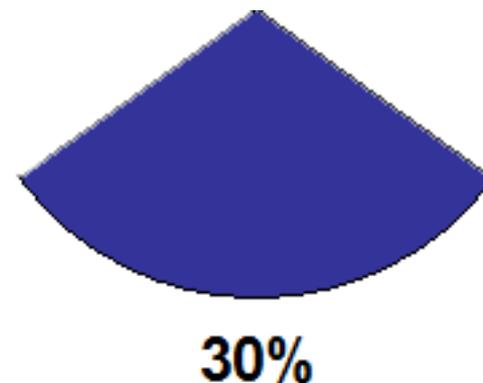




DISPARITY ISSUES

- **Amounts Owed**

- Borrowers who use payday lenders, check cashers, rent-to-own facilities, etc. will be negatively impacted as these creditors typically do not report tradeline information to the repositories.
- Scoring models cannot pick up the fact that a consumer has credit available to use when the source of the credit is from a fringe lender.

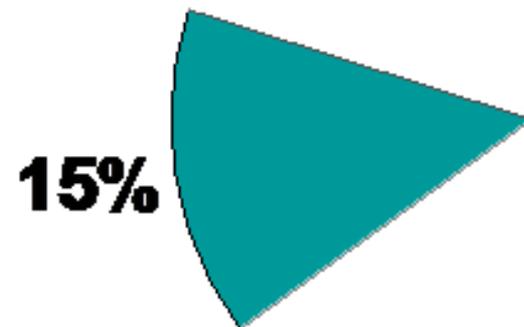




DISPARITY ISSUES

- **Length of Credit History**

- Borrowers of color and borrowers who use non-traditional credit will be less likely to have trade lines with a significant amount of history.
- Consumers of color are disproportionately “un-banked” and “credit-invisible” since the type of credit that they primarily use is not picked up by credit repository data.

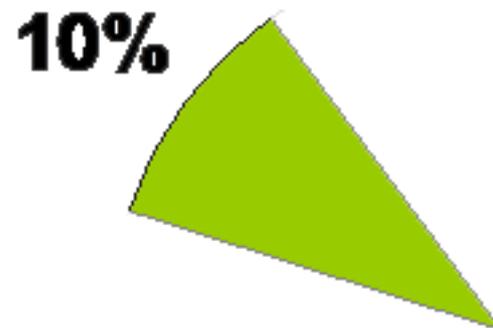




DISPARITY ISSUES

- **New Credit**

- Opening a new credit account will lower the credit score.
- Pursuing credit accounts will lower the score.
- Borrowers who face discrimination and therefore must pursue multiple lenders to seek credit will have a negative impact on their scores.





DISPARITY ISSUES

- **Types of Credit Used**

- Even if the account is paid on time, the borrower will still be dinged for having a certain type of credit.
- Presumably, subprime creditors or finance accounts carry the stigma.
- According to FICO, consumers who have installment loans and credit cards will have a more favorable analysis in the FICO scoring system.
- This component can negatively impact borrowers of color who disproportionately have subprime mortgage loans and other types of “finance” debt.

10%





SOLUTIONS

- Broaden the scope of financial data fed into underwriting and credit scoring models.
 - State Housing Finance Agency data
 - CDFI data
- Include the use of non-traditional credit, such as rental and insurance payments, in credit scoring systems.
- Increase the usage of other underwriting considerations which impact loan performance but may not harbor discriminatory effect, such as distribution channel, appraisal quality, loan suitability, etc.
- Remove shields from the system to make it more transparent.
- Support educational initiatives that re-teach consumers how to manage and access credit.
- Rating agencies must include fair lending considerations in their rating indices.
- Reduce the over-reliance on credit score and down-payment in the underwriting process.
- Include residual income analysis in the underwriting process.
- Regulators must adequately assess the impact of credit scoring mechanisms on under-served groups.
- Regulators and lenders must engage in efforts to better understand how credit scores really impact loan performance and how they impact borrowers of color.
- GSEs must broaden the scoring mechanisms accepted by their underwriting, compliance and securitization systems to include scores that, in part, are built on non-traditional financial data such as the VantageScore.
- Credit repositories must improve their processes for allowing consumers to correct erroneous information.