Written Testimony
of
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BEFORE THE HOUSE FINANCIAL SERVICES COMMITTEE
Subcommittee on Financial Institutions and Consumer Credit

"Fair Credit Reporting Act:
How It Functions for Consumers and the Economy"

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I. Introduction: My name is Shanna Smith, and I am President/CEO of the National Fair Housing Alliance. I want to thank Chairman Spencer Bachus and Congressman Bernard Sanders and the committee for inviting me to speak about the issue of fair access to credit and the use of credit scoring for mortgage loans and homeowners insurance. The National Fair Housing Alliance is a membership organization representing virtually all of the private, non-profit fair housing education and enforcement agencies in the United States.

For the past twenty eight years I have been investigating housing discrimination in the areas of rental, sales, lending and homeowners insurance. As executive director of the Toledo, Ohio Fair Housing Center from 1975 until 1990 and as the President of the National Fair Housing Alliance. Since 1990, I have utilized both the HUD administrative process and the federal courts to challenge violations of the federal Fair Housing Act by mortgage lending and homeowners insurance companies.

My testimony today will focus on fair access to credit and the use of credit scoring models in determining eligibility for and pricing of mortgage loans and homeowners insurance.

II. Fair Access to Credit: Studies as well as lawsuits[1] continue to demonstrate that African Americans, Hispanics, and elderly women are not treated the same as similarly qualified white males when attempting to purchase products such as cars, or secure mortgage loans or homeowners insurance. The terms and conditions for purchase of these products can be driven by the race, national origin or gender of the consumer rather then by their ability to pay or condition of the home. For example, in a recent complaint against Nissan's financing arm,[2] it was alleged that African American buyers were not only charged more for their cars, but charged higher interest rates for the car loan than equally or less qualified white buyers. When this type of practice is repeated against consumers in the purchasing of other necessities such as appliances, furniture, mortgage loans and homeowners insurance products, then we find that people of color and elderly women pay more for products and services because of their race, national origin or gender. As a result, people in these groups end up having less savings because they are paying higher prices and higher interest rates to finance the products. Some scholars refer to this as the "Black tax".

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[1] See *USA v Long Beach Bank*; *NFHA et al v Prudential Insurance Company*
[2] "Nissan's financing arm has agreed to stop marking up loan rates", p.E2; *Washington Post*, February 20, 2003.

Some people argue that the African American, Hispanic or elderly female consumers should be better negotiators for the products. However, testing of these companies for various consumer products as well as testing involving access to mortgage loans and homeowners insurance indicates that white consumers did not have to negotiate to secure the best price or interest rate. Better pricing was offered to the white consumer, not negotiated. So people of color and elderly women will often pay more for the same product or loan and/or pay more for inferior homeowners insurance coverage.[3] Consequently, when there is a downturn in the economy, resulting in layoffs and even higher interest rates, people of color and elderly women are the first to suffer and may end up making late payments, which are subsequently recorded in their credit histories.

III. Credit Scoring Models: All credit scoring models rely on credit reports. The extension of credit in the United States is fraught with discrimination. The foundation for statistical credit scoring models is unreliable and does not accurately reflect the use of credit. In addition, there is no incentive for companies using credit scoring models to use the latest generation of that model. Purveyors of these models concede that older versions may result in consumers paying higher interest rates. Why would a company upgrade if they can charge more?

What actually can improve a credit score? Many housing counselors tell potential homebuyers to pay off old debt and close out accounts because too many open accounts will lower the credit score. However, closing out older accounts and maintaining a newer account that has a lower interest rate will actually lower your credit score rather than raise it. Credit scoring models give a higher ranking to people who have long term established accounts without regard to the logic of closing out an older account because it has a high interest rate.

I have checked my credit score number and I am in the high 700s. However, the credit scoring company informed me that my score could be higher if I did not have so many open lines of credit – allegedly 24 open lines. I do not have double-digit lines of open credit.

When I reviewed my credit bureau file, I found that the credit scoring company is counting as open lines of credit that are in fact closed. Unfortunately over the past ten years, my purse was stolen three times and each time I closed my bank accounts as well as my three credit card accounts. However, it appears that these closed accounts continue to be counted as open. The credit bureau report clearly indicates these are closed accounts. Even though these closed accounts have R-1 or I-1 ratings, my score remains lower because the model used counts closed accounts as open. So am I paying more credit because of these errors? Probably.

Type of Trade Line: Credit scoring models penalize the consumer for the type of trade line s/he is using. For example, if my loan is with a finance company my credit score is lowered even if I have paid that loan with a high interest on time every month. Wouldn't it make sense to consider

[3] See NFHA testimony U.S. Senate Banking, Housing and Urban Affairs Committee - 5/94 Prepared testimony for presentation on the nature and extent of homeowners insurance discrimination in the United States.

this consumer a better credit risk if s/he can pay the loan in a timely way – and surely at a minimum the credit scoring company should treat the type of trade line the same. Perhaps companies think if I can only secure a subprime or predatory loan then I am a "risk by association". In fact, I may only have access to a finance company because there are no banks in my neighborhood or because I do not have a home equity line of credit. Some companies might claim that they no longer penalize people for the type of trade line they have, but I have seen no evidence to indicate that this change has been made. In addition, as mentioned above, lenders, insurers and other companies are not necessarily using the latest generation of the credit scoring models.

Questions for Credit Scorers: There are a number of questions that should be asked of credit scoring companies, as well as those companies who use credit scores, which would illuminate this discussion from a fair housing perspective:

- What does FICO/Choice Point do to measure the accuracy of the data in credit history files?
- What does FICO/Choice Point do to measure the completeness of the data in the credit history files?
- Has FICO/Choice Point considered using factors in its algorithm that are NOT typically contained in credit reports? (Rental payment history, utility payment history, etc.)
- Has FICO/Choice Point or anyone else analyzed the distribution of risk scores by race, ethnicity, gender, etc.?
- Has FICO/Choice Point or anyone else analyzed the distribution of risk scores by geography, and if so, at what geographic level (e.g., statewide, city, county, ZIP code, census tract)?

III. Fair Lending Practices and the Use of Credit Scores: Is credit scoring designed to predict which loan will default or which loan will end up in foreclosure? If a loan defaults does that automatically mean a foreclosure will result? According to the lenders and credit scoring companies, credit scoring can predict which loan is likely to default. Default means being failing to make a monthly payment during the month it is due. Can credit scoring predict which defaulted loan will be cured in the next month? Prior to foreclosure? The Center for Community Self-Help, a North Carolina based direct lender specializing in creating ownership and economic opportunities for minorities, women, and rural residents, reports extremely low foreclosure rates with people who have credit scores below the conventional lender cutoff of 620. Since 1980, Self-Help has provided over $1.78 billion in financing to 25,800 small businesses, nonprofits, and homebuyers.

Dr. Calvin Bradford of Bradford & Associates has conducted research which indicates that approximately 90% of the loan applicants whose credit scores are between 580 and 619 will not default on their mortgage loan. However, these people are often denied loans by conventional lenders and pushed into the subprime market which charges higher interest rates and fees.

Mortgage Lending Discrimination: Is the loan applicant entitled to the best rate for which s/he qualifies or is the loan applicant required to negotiate for the best rate? If you go to a federally regulated lender, you should expect to be offered the best loan for which you are qualified and not be required to negotiate. But often, this is not the case.

If a loan originator runs your credit score first, you may be steered to the company's subprime division before an application is completed. If Fannie Mae's Desktop Underwriter (DU) initially alerts the loan originator with a "caution", the loan originator will submit the application to Freddie Mac's Loan Prospector (LP), or vice versa, rather than immediately manually underwrite the loan. If a caution appears because of a credit score below 620, the loan originator should manually underwrite the loan. However, we have found that this is not the case. From interviews with hundreds of loan originators over the past five years, I have learned that at least half of the loan originators will send the applicant to a subprime lender rather than spend the time necessary to manually underwrite the loan. The cutoff of 620 throws many healthy, viable babies out with the proverbial bath water. There is a rumor that lenders may raise the "A" loan standard from 620 to 700 which will result in even more qualified loan applicants paying more for loans than is reasonable according to their credit history, and ability to repay that loan, and likelihood of default.

Because discrimination still exists in the loan process, it is necessary to make certain that new efficiencies in lending – credit scoring and automated underwriting – do not contribute to direct acts of discrimination or result in disparate impacts because of membership in any of the seven classes protected by the Fair Housing Act: race, color, national origin, religion, sex, disability, or familial status.

The National Fair Housing Alliance's testing of mortgage lenders in the prime and subprime markets have shown that white individuals are afforded better treatment and better products because they are white and live in predominantly white neighborhoods. For example, when I contacted the subprime subsidiary of a conventional lender via telephone to refinance, I was asked who held my current mortgage. When I gave the name of the mortgage lender, I was advised to contact them to refinance. African Americans who made the same inquiries were not referred to their mortgage lenders, but invited to refinance with the subprime subsidiary at a higher interest and higher fees. Another example: while speaking with the regional manager of a large mortgage company and sharing with her that my husband and I were new to California and we were looking at homes in Richmond, CA, a city with a substantial African American population, that regional manager said, "After listening to your voice, I suggest that you consider looking in Concord, because you will get better loan terms."

My access to better loan terms as a white female, results in lower monthly payments and which then allows me to direct my money to savings, other investments and wealth building. Therefore, when credit scoring companies state emphatically that their models are race and gender neutral, this simply is untrue. Race, national origin and gender continue to control the type and terms of credit available.

IV. Fair Insurance Practices and the Use of Credit Scoring Models: Consider the fact that a homebuyer can be approved for a mortgage loan but denied homeowners insurance based on the same information in her credit history. What does an insurance credit score allege to predict? The answer depends upon when you asked.

Initially, credit scoring companies marketed the homeowner's insurance score stating that it could predict who would file fraudulent claims. This marketing scheme was quickly dropped when fair housing groups challenged the veracity of the claim. Lately the credit scoring companies are marketing their products by stating that insurance credit scores can predict who will file a claim. This is interesting because a large percentage of claims are weather-related. Will credit scores become the almanacs of the future? Insurance companies have stated that claims are related to two factors: weather and the filing of previous claims. While the credit scoring companies state that there is a correlation between credit and homeowner claims, they can show no causal relationship.

Why have insurance companies turned to credit scoring? Companies have acknowledged that during the 1990s, they were under-pricing some premiums for homeowner products in order to stay competitive in certain markets. Their decision to under-price products for some homeowners, predominantly white homeowners, is causing price increases today so companies are relying on credit scoring models as an excuse to charge more. Unfortunately, the higher premiums based on credit scoring are going to have a disparate impact on neighborhoods of color, regardless of the quality of housing in those neighborhoods, because credit has never been equally available to similarly qualified applicants.

Since 1991, testing conducted by the National Fair Housing Alliance has demonstrated that white homeowners living in predominantly white neighborhoods pay less for the best coverage while African American or Hispanic homeowners living in comparable homes in integrated or predominantly minority neighborhoods pay more for inferior coverage. In the mid 1990s, the Missouri Insurance Commissioner reported that African American homeowners in St. Louis were paying higher premiums for inferior coverage (market value policies) but were reporting fewer claims and lower costs per claim than their white counterparts reporting more claims with higher costs per claim. Since that time, investigations conducted by the National Fair Housing Alliance and HUD found similar disparities in pricing and policy type occurring Toledo, Ohio, Richmond, VA, Milwaukee, WI, New Orleans, LA, Chester, PA, Chicago, Il, Los Angles, CA, Memphis, TN, Cincinnati, OH, Washington, DC, Louisville, KY, Akron, OH, and Atlanta, GA.

As mentioned earlier, oftentimes insurance companies justify this discriminatory behavior with credit scoring. The National Fair Housing Alliance believes it is unfair and in violation of the Fair Housing Act to increase premiums even higher for neighborhoods of color. How long will people living in minority and integrated neighborhoods continue to subsidize bad business practices that favored white neighborhoods?

The insurance companies state that they are losing money on their homeowner products, but isn't this because they under priced the true cost of the product to their "preferred" customers? Their reserves are still more than sufficient to cover any catastrophe as well as anticipated claims.

Insurers are also developing new schemes to deny homeowners insurance to qualified buyers. The latest tactic is to deny insurance to a new homebuyer if the sellers of the home they are buying filed claims related to that home! The insurance companies are using the Comprehensive Loss Underwriting Exchange (CLUE) to identify homes that have had claims filed. So now the insurers are saying that "accident prone homes"[4] exist – not just accident prone people. Fire is becoming a major reason for homeowner claims and losses and the popular burning of candles is the top cause of these fires. The home did not light the candle that started the fire. The home did not cause the wind storm to knock over the tree that hit the roof. The home did not leave the door unlocked so a thief could run off with property. Congress should put an immediate halt to the use of CLUE information for this purpose.

V. Conclusions and Recommendations: The insurance industry, like the lenders, must underwrite real risk, not race or national origin or gender. Credit scores cannot predict who will file a claim or who will commit a fraud. Credit scores are not predicting which loan will end in foreclosure. The insurance industry has acknowledged that both weather and past claims filing history are the best predictors of who files future claims. I think we should even be skeptical about past claim filing because we know that insurance agents have encouraged customers to file claims; in addition, the industry supported the filing of small claims because they paid them and did not cancel or non-renew the policy holders, especially those living in white neighborhoods.

If policy holders understood that the insurance companies see homeowners insurance as protection for serious losses, then people would file only serious claims. However, that is not how the products have been marketed.

- **Underwriting guidelines of insurance should become open to the public.** Lenders complained in the 1980s that if there underwriting were public, they would lose market share to competitors. This never happened.

  Insurers claim that underwriting guidelines are proprietary, but when you speak with them they say they follow the practices of largest insurance companies – State Farm, Allstate or Nationwide. Note: All three of these companies have changed their underwriting guidelines to be non-discriminatory, due to the efforts of the National Fair Housing Alliance. State Farm and Allstate both changed their guidelines following a HUD conciliation agreement; Nationwide changed following litigation and a settlement with the National Fair Housing Alliance members.

  Already, the state of Connecticut maintains and releases to the public insurance company underwriting guidelines – and competition continues to be healthy in Connecticut. I have reviewed many underwriting guidelines of insurance companies and there are few and only minor differences, except for those that include discriminatory statements such as limiting or denying homeowners policies because of subjective issues including family composition, presence of disable occupant, quality of housekeeping or pride of ownership. Making these

[4] "Accident prone home" is a term coined by Lisa Rice, Executive Director of the Toledo Fair Housing Center to challenge use of CLUE in this manner.

underwriting guidelines public would allow homeowners, housing counselors, fair housing practitioners, and consumer activists to teach people how to be responsible consumers of homeowners insurance.

- **Congress should enact disclosure legislation which will provides, at a minimum, the following:**

  1. **Disclosure of Underwriting Guidelines.** Several years ago, mortgage lenders claimed their underwriting guidelines were "trade secrets" and that they would lose their competitive edge if forced to reveal the guidelines. What has happened since the lenders made their underwriting standards public? Better underwriting policies and practices are being put into place. Antiquated and discriminatory guidelines were identified and removed. Sound lending in urban areas is underway in many cities. The insurance industry should be required to do the same.

  2. **Disclosure of Loss Data.** The industry must present information about the number, type and amount of claims filed. Without this information, Congress and the public will not know if higher premiums charged in minority, integrated, older or lower income neighborhoods are based upon higher risks or whether these high premiums are being used to subsidize other neighborhoods, as some studies reveal.

  3. **Disclosure of Type and Cost of Policies.** Certainly insurers will come forward with numbers showing they are writing policies in some of the same neighborhoods where we have documented discrimination, but do these policies include their top of the line packages or are they minimum insurance at maximum price? Remember when lenders made loans in minority neighborhoods, but the terms and conditions were more restrictive, not based on risk ,but based on race? The insurance industry must provide documentation that their business decisions are based on risk and not race.

  4. **Reporting Race, National Origin and Gender of Policyholders.** Just as mortgage lenders record the information or have the loan applicant complete the section on race, insurance companies can include this information on their application. As with Home Mortgage Disclosure Act (HMDA) data, this information may be used to see who is being covered.

  5. **Reporting Information By Census Tract.** Currently, insurance companies keep information by zip code. Zip codes are large geographic areas that encompass many minority and non-minority neighborhoods. An insurance company could report that it is writing 20% of the policies in the zip code, but that 20% could be confined to the high income white neighborhood. Census tracts, however, have approximately 5,000 people within their boundaries and provide demographic data that is essential to determining the characteristics of neighborhoods such as race, income, age of housing. Census tract reporting is required of mortgage lenders, and Congress gave them one year to convert from zip code to census tract after passing the Home Mortgage Disclosure Act. It is certainly much easier and less expensive now to convert.

6. **Reporting for ALL Metropolitan Statistical Areas.** The federal Fair Housing Act provides protection based upon race, color, religion, sex, familial status, disability or national origin. It also protects people who live in minority and integrated neighborhoods. Clearly the MSAs in the United States include people and neighborhoods represented in the protected classes. How can we justify protecting some, but not all, of the residents in the country? Reporting must be inclusive.

- **Lenders should follow the policies and procedures of the Center for Community Self-Help and dig deeper into the default versus foreclosure issues.** Certainly, if there are higher costs for servicing a loan that is predicted to default in order to cure the default before it ends in foreclosure, then a higher interest is justified. But if the vast majority of the people between 580 and 620 pay on time and be responsible consumers, they should not be charged higher rates because credit scoring models fail to deal with the race, national origin and gender discrimination inherent in the credit system.

- **Credit history should never be the sole reason for denial of homeowners insurance coverage.**

- **No annual credit report reviews by insurance companies should result in increased premiums unless there is sufficient reason to believe that a real risk is posed for fraud.**

It is important that Congress take swift and comprehensive action to address discrimination in the homeowners' insurance industry. For more than twenty years, the mortgage lending industry claimed that denial of loans in minority neighborhoods was based upon sound lending practices. We are confident that insurance companies will claim they are insuring risk, not race. But we believe the evidence disclosed to you today is simply the tip of the insurance discrimination iceberg. America's neighborhoods are counting on you to provide the public with the tools necessary to identify and eliminate discrimination in all forms.

I would like to thank the Committee once again for inviting me to testify before you today.