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PERSPECTIVES ON CREDIT SCORING AND FAIR MORTGAGE LENDING

Third of a Five-Part Series

ALSO IN THIS ISSUE:

Using Account Verification Systems Effectively

Profitwise

Profitwise welcomes story ideas, suggestions, and letters from all bankers, community organizations and other subscribers in the Seventh Federal Reserve District. It is mailed at no charge to state member banks, bank holding companies and non-profit organizations throughout the Seventh Federal Reserve District. Other parties interested in neighborhood lending and community reinvestment may subscribe, free of charge, by writing to:

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In this Issue

PERSPECTIVES ON CREDIT SCORING AND FAIR MORTGAGE LENDING

Credit scoring is an underwriting tool used to evaluate the creditworthiness of prospective borrowers. Used for several decades to underwrite certain forms of consumer credit, scoring has come into common usage in the mortgage lending industry only in the last ten years. Scoring brings a high level of efficiency to the underwriting process, but it also has raised concerns about fair lending among historically underserved populations.

To explore the potential impact of credit scoring on mortgage applicants, the Federal Reserve System's Mortgage Credit Partnership Credit Scoring Committee is producing a five-part series. This is the third installment in the series. The purpose of the committee is to collect and publish perspectives on credit scoring in the mortgage underwriting process, specifically with respect to potential disparities between ethnic majority and minority homebuyers in the home search or credit application process. The introductory article of this series provided context for the issues addressed by the series. The second article focused on lending policy development, credit scoring model selection and model maintenance.

This article examines how lenders oversee the practices of their third-party brokers, especially for compliance with fair lending laws, pricing policies, and the use of credit scoring models. We solicited feedback from industry, consumer and regulatory representatives to ensure a variety of perspectives.

We asked the contributors to this installment to respond to the following:

While lending institutions may actively review and assess their own credit scoring models for potential unlawful disparities, it is also important that they monitor their relationships with third-party brokers. Mortgage brokers make credit available in communities without traditional lending institutions. Lenders establish relationships with third-party brokers to reach these markets.

Lenders need to consider how their third-party brokers comply with fair lending laws and use credit scoring models. Lenders who knowingly work with non-compliant brokers and take no action may be liable as co-creditors. The following situations may lead to increased regulatory risk exposure for the lending institution:

- *The lender may build in a high broker overage tied to the credit score*
- *The broker may obtain a credit report or credit score and use it to underwrite and price a proposed deal before submitting it to a lender*
- *A broker may screen applicants or steer them to higher-priced products even if this is not warranted by applicant's overall risk profile (credit score)*

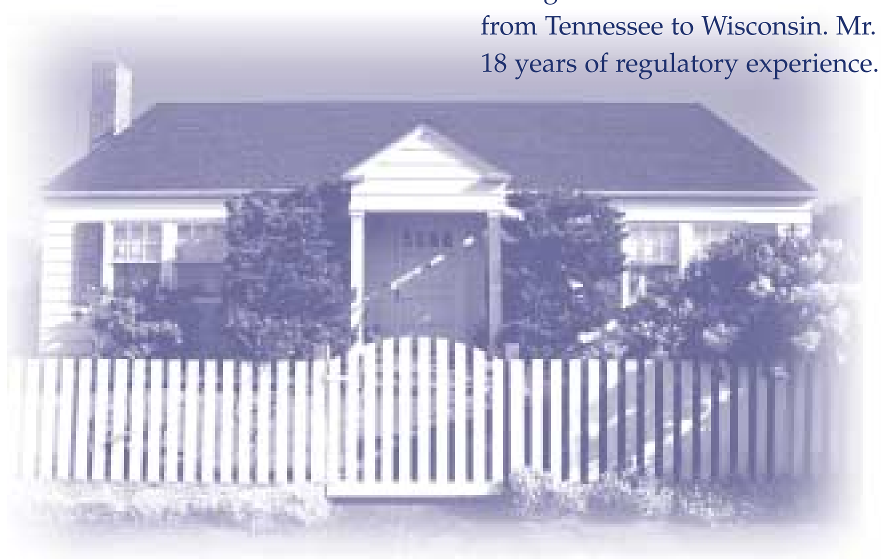
Considering the issues outlined above, what strategies can lenders adopt to better manage their third-party broker relationships? What can third- party brokers do to ensure compliance with fair lending regulations?

The following individuals provided their perspectives for this installment:

Alexander C. Ross recently retired from the Civil Rights Division of the Department of Justice after 35 years. Mr. Ross worked on lawsuits brought by the United States to enforce civil rights statutes forbidding discrimination in voting, employment, education, public accommodations, housing, and lending. His last position was Special Litigation Counsel for the Division's Housing and Civil Enforcement Section. Mr. Ross was the Division's lead lawyer in several landmark fair lending cases.

Edward Kramer is a civil rights attorney, director and co-founder of Housing Advocates, Inc. (HAI), a fair housing agency and public interest law firm founded in 1975 in Cleveland, Ohio. A key program of HAI is the Predatory Lending Project, which provides legal assistance to lower-income residents to address predatory lending and other consumer fraud.

Christopher A. Lombardo is the Assistant Director for Compliance in the Office of Thrift Supervision's (OTS) Central Region. The OTS, an office within the U.S. Department of the Treasury, is the primary federal supervisory agency for the nation's roughly 1,050 savings associations. Based in Chicago, he manages the compliance examination, community affairs, and consumer affairs programs impacting savings institutions in a seven-state area extending from Tennessee to Wisconsin. Mr. Lombardo has 18 years of regulatory experience.



Kathleen Muller is the executive director of the HOPE Home Ownership Center in Evansville, Indiana. She has been with HOPE for 12 years. HOPE provides housing counseling services to residents throughout the entire Evansville metropolitan area. HOPE has helped families with housing and related needs for 35 years.

ALEXANDER C. ROSS

Depending on whether credit scores are to be used in the accept/deny context or for placing borrowers in different price tiers, the answers may be different. In either case, however, it is essential that the broker be fully informed about the lender's underwriting criteria. Further, whenever the scores themselves are affected by the information the broker gathers, the broker must do as good a job as the lender in documenting the borrower's qualifications.

When credit scores are used to accept or deny, the broker's obligation is the same as it would be with manual underwriting. If the broker (a) fails to obtain documentation or (b) screens out applicants without adherence to the same processes the lender does with its direct applicants, both the broker and the lender are headed for trouble.

When credit scores affect pricing, the broker must depend on its full and accurate use of the lender's pricing criteria in order to avoid surprises and legal problems. For example, if the broker presents [what he considers] a "B" quality loan and has priced it with the borrower accordingly, the deal may not work if the lender prices it at "B-" [i.e. higher]. On the other hand, if a broker knows the borrower has "A" credit but places the loan with a subprime lender at an unnecessarily high price to increase the broker's profit (when that lender would accept higher broker fees), the broker risks involving itself and the lender in deceptive practices or RESPA (Real Estate Settlement Procedures Act) violations. If members of protected groups are adversely affected, possible violations of the fair lending laws pose further risk.

EDWARD KRAMER

Financial institutions can have a great deal of control over the practices of their third-party mortgage brokers, especially in the areas of compliance with fair lending laws, pricing policies and the use of credit scoring models.

There is a very close relationship between traditional financial institutions, mortgage brokers and real estate agents. Brokers know where to get their clients financed and lenders have a history of doing business with certain mortgage brokers and real estate agents. It is a symbiotic relationship. Lenders know who is breaking the law and who is skirting the law. They know who the "bad guys" are. In fact, those were the words used by a mortgage broker who recently confided, "We know in our industry, and certainly the financial institutions know, which mortgage brokers are really doing a disservice to clients."

Mortgage lenders know the "good guys" from the "bad guys" from past dealings. Where excessive [loan] defaults are seen from the same mortgage broker, or if defaults often occur within several months after the loans, it is not difficult for a financial institution to gather evidence of potential wrongdoing. Problems may include falsified applications, inflated income, inconsistencies on the credit report, or a credit score that is not sufficient to justify the loan.

On the opposite end of the spectrum, it would be relatively easy for financial institutions to identify mortgage brokers who try to maximize their commissions by charging some borrowers more than what is usual and fair in points, rates and fees. These are situations where borrowers should be able to qualify for traditional "A" loans but are being offered subprime "C" loans.

AVOIDING POTENTIAL LIABILITY STEMMING FROM THIRD-PARTY RELATIONSHIPS

One strategy a financial institution can use to avoid third-party liability is to test loan application files. In this fair lending review, the Truth in Lending Act (TILA) statement and the HUD Good Faith Estimate documents regarding the costs of the loan are examined. Look at the cost of the appraisal and other fees to determine if they may be excessive or unusual. Look for credit life insurance packages built into the loan and see whether the consumer is being required to pay up front for the insurance, or [through monthly premiums] for the life of the loan. If the financial institution sees inconsistencies from broker to broker, that should send up a red flag. Such a pattern should elicit closer scrutiny of all new loans submitted by that mortgage broker.

Unfortunately, these predatory lending practices are often funded by financial institutions. This practice may be driven by the need to comply with their Community Reinvestment Act (CRA) obligations. The Act was meant to help meet the credit needs of all communities in a bank's assessment area, including low- and moderate-income (LMI) neighborhoods. However, in a perverse way, the CRA has sometimes had the opposite effect. Rather than trying to find and use their own branch system of loan offices, banks instead closed down their own branches and limited access and services to these customers. These banks have relied upon third parties, mortgage brokers, and real estate agents to generate CRA loans.

PROFITABILITY AND CRA

Lending to LMI borrowers can be profitable for financial institutions, but it sometimes causes severe hardships for the consumer, who is often a minority and/or female head of household. A third-party arrangement allows unscrupulous mortgage brokers or real estate agents to misuse or abuse the system. The banks are really asking, "Will this help me meet my CRA needs and will it meet our profit motive?" So when some argue that this third-party system is more efficient, what they really mean is that it is more profitable. However, this is not necessarily what financial institutions should do to be good neighbors and good businesses for our community. They need to make a commitment to the community. The original purpose of the CRA was to require banks to commit themselves to the community, to those neighborhoods in their credit service areas identified as underserved.

PREDATORY LENDING AND THIRD-PARTY RELATIONSHIPS

What are the risks if financial institutions don't respond to predatory lending issues being raised today? They face new and costly legislative and regulatory initiatives. More importantly, they face substantial litigation risk. Unlike the Truth in Lending Act (TILA) or other consumer laws, the federal and Ohio fair housing laws place special obligations on the entire housing industry, including financial institutions. One of these obligations is that the duty of fair housing and fair lending is non-delegable. Almost a quarter century ago, in one of the first cases involving a racially discriminatory refusal to make a home loan, our federal court found in favor of the discrimination victim in Harrison v. Otto G. Heinzeroth Mortgage Co., 430 F. Supp. 893, 896-97 (N.D. Ohio 1977):

Thus the Court has no difficulty in finding the defendant Haugh liable to the plaintiff. Under the law, such a finding impels the same judgment against the defendant Company and the defendant Heinzeroth, its president, for it is clear that their duty not to discriminate is a non-delegable one, and that in this area a corporation and its officers are responsible for the acts of a subordinate employee, even though these acts were neither directed nor authorized. This ruling troubles the Court to some extent, for it seems harsh to punish innocent and well-intentioned employers for the disobedient wrongful acts of their employees. However, great evils require strong remedies, and the old rules of the law require that when one of two innocent people must suffer, the one whose acts permitted the wrong to occur is the one to bear the burden of it. [citations omitted]

This decision is not unique. The courts have rejected arguments from real estate brokers that they should not be held liable for the discriminatory acts of their independent agents.[i] Furthermore, using the analogy to the Fair Housing Act, the courts have found that finance companies have a non-delegable duty not to discriminate under the Equal Credit Opportunity Act, which cannot be avoided by delegating aspects of the financing transaction to third parties.[ii]

Now apply this case law to financial institutions that refuse to monitor their relationship to mortgage and real estate brokers. These lenders can be subjected to substantial damage awards. Playing ostrich will not insulate them from any illegal actions of mortgage brokers and real estate agents with which they deal. If a pattern of practice is shown, then financial institutions are assumed to have control. They have the ability to say “yes” or “no.” They have a right to monitor and determine whether or not these “independent actors” are breaking the law. If they knew or should have known, they can be held liable.

COMPLIANCE TRAINING

Financial institutions and mortgage brokers should also follow another example from the real estate industry. The larger real estate firms have their own, in-house Fair Housing Program to train their staff. Large companies have their own programs because they want to make sure that their real estate agents are aware of the law and of company policies. They want these policies implemented. All employees and independent contractors must know the law, the company’s policies, and that everyone will uphold fair housing and fair lending laws.

CHRISTOPHER LOMBARDO

Before addressing a financial institution’s relationships with mortgage brokers, we ought to identify three undeniable facts that represent changes in the mortgage business landscape over the past decade.

First, financial institutions increasingly rely on fee income. Interest rate spreads are, and are likely to remain, razor thin. Second, automation (including credit scoring), securitization and specialization have revolutionized who does what and how they do it. Third, financial institutions rely on independent mortgage brokers to maintain a steady supply of loan originations. Employees in financial institution branches typically no longer generate the business. Call this progress-in-action in a free enterprise system, or call this a recipe for disaster. In reality, the system is far from free: it is heavily regulated. With the scourge of predatory lending, personal and individual disasters have become more common, or at least more widely recognized. Systemic disasters remain rare.

TERMINOLOGY

We also ought to clarify our terminology. As is most common, I will consider the financial institution (insured depository institution) to be the funding, originating lender, and the independent broker to be the point of contact with the applicant/borrower and the processor of the loan. The lender/broker relationship is covered by a mutual agreement that the other party is suitable and reliable. The lender provides the broker with their underwriting guidelines, highlighting any deviations from market standards. The lender provides the broker with rates, fees and term information weekly, daily, or as needed. Operating under a lender/broker arrangement, the broker registers a rate lock-in and processes the paperwork. The loan passes down one of two main paths: the lender table-funds the loan and reviews it afterward, or the lender reviews and approves each loan package prior to closing.

Numerous custom and hybrid lending arrangements exist. However, one ought to consider what a financial institution examiner sees: performing loans; the occasional rejected deal, if the lender documented it; and the occasional defaulted loan. The examiner does not know what transpired between the broker and the borrower. The examiner does not know who ordered, paid for, or prepared the application. Lenders should know this information and ought to be highly selective about the brokers who bring them business, and lenders ought to be expert in spotting a loan that yells: "Run, don't walk, from this deal!" The general standard to which the lender should be held responsible for the broker's act, error, or omission is a "knew-or-should-have-known standard."

COMPLIANCE EXAMINER ROLE

The compliance examiner assesses how well a financial institution manages its compliance risks and responsibilities. Regarding relationships with mortgage brokers, this most notably includes compliance with laws such as the Fair Housing Act, Equal Credit Opportunity Act, Home Mortgage Disclosure Act, Fair Credit Reporting Act, Real Estate Settlement Procedures Act and Truth in Lending Act. These laws are relatively new; in addition, there are rules governing the privacy of consumer financial information, consumer protection rules for insurance sales, and the Flood Disaster Protection Act. This demonstrates that we're not describing free enterprise as envisioned in the eighteenth century by Adam Smith.

Beyond the U.S. Department of Housing and Urban Development's advertising rules implementing the Fair Housing Act and the Federal Reserve Board's advertising rules implementing the Equal Credit Opportunity and Truth in Lending Acts, thrift institutions are prohibited from any inaccuracy or misrepresentation regarding contracts or services, including any and all aspects of their mortgage lending. The examiner gets a glimpse of lender activities and an even briefer look at what the broker has done. Well-managed financial institutions make it a point to take a good look at what the broker has done, but it is very difficult for the lender to police the broker's activities. With the growing awareness of predatory lending, most lenders now have systems in place to detect transactions that involve fee packing[iii], equity stripping[iv], and flipping[v]. Lenders have shifted from presuming that the refinancing deal presented for funding is what the borrower originally needed or wanted, and many are applying some sort of benefit-to-the-borrower standard.

CREDIT SCORING AND MORTGAGE BROKER RELATIONSHIPS

As a general observation, mortgage market automation (including the general use and acceptance of credit scoring), standardization and specialization have not posed great hazards for most financial institutions. They have internally motivated systems for identifying and correcting problems outside the supervisory and enforcement process. The fee-driven nature of the business and reliance on broker business does pose hazards, however. Every financial institution has stories of mortgage brokers who proposed compensation arrangements that would violate the Real Estate Settlement Procedures Act allows. Most lenders have stories of broker efforts to push unsophisticated individuals (with or without marginal credit scores) into higher priced deals that offer greater compensation to the broker. The former issue of unearned fees and kickbacks is fairly easy to spot. The latter defies detection, often until much damage has been done.

The uniform interagency examination procedures adopted by the federal banking supervisory agencies for fair lending focus on activity at the margin. In general terms, it is in transactions involving marginal applicants that underwriting discrimination may be identified. The same holds for pricing and the use of credit scoring. A financial institution needs to have a vigorous review system in place for the actions of brokers in this regard. This review system should reinforce the lender's message about the kinds of deals it is seeking and the kind of treatment that will be extended to individuals who are prospective customers of the institution.

Aside from individual credit transactions, it is lenders straying far from the mainstream market who are most exposed to allegations of credit discrimination. Regulators are more sensitive to issues involving innovation, automation, cost control, and stability of income. It is in this testing of new ideas that we try to draw a line between acceptable and unacceptable risk taking. Financial institutions whose stated or unstated goal is to skate on the edge of the law should expect and be prepared to deal with problems – some of them potentially huge.

DOCUMENTING CREDIT WORTHINESS OF BORROWERS

Lenders need to seek assurance that scoring representations accurately reflect their applicants' scores, particularly when the score drives the approve/deny decision, but also when it results in a loan pricing or product steering decision, and ultimately, when it impacts broker or lender compensation, even indirectly. Aside from scrutiny of documents, lenders should require that the broker provide copies of all credit reports and scoring information generated in connection with a mortgage application. The lenders should also require copies of all loan applications generated. The final application that the borrower sees, but may not read, at closing may bear little resemblance to the representations of the broker and borrower from start to end of the transaction.

The lender may be restricted under his/her correspondent agreement from making direct contact with a mortgage applicant. However, the broker should be willing to encourage lender contact to learn the applicant's understanding of the lending process, rather than lose all of that lender's business and see the borrower damaged along the way.

A short post-closing lender survey completed by the borrower can be a very useful evaluation tool for lenders. The purpose is to identify and isolate to particular brokers, deals closed under some duress or involving fees and terms to which the borrower did not agree or did not understand. These issues are best dealt with before the borrower is in default or sitting in the office of his or her congressional representative.

SUMMARY

In closing, the vast majority of financial institutions manage their mortgage broker relationships in an acceptable manner, as we have found from years of regular compliance examinations. Our more recent and detailed inquiry into the ability of financial institutions to steer clear of predatory lending practices while working through independent brokers and seeking fee income has both reinforced the observation that the industry is doing a good job and highlighted some new concerns. That credit scoring and improved access to individual credit information has added speed and reduced cost is generally accepted. What has been done with that new information remains an open question for both lenders and regulators.

KATHLEEN MULLER

The use of credit scores alone does not insure that credit remains available to persons who would qualify for a low-interest loan. Lenders should always have multiple criteria to help balance or offset shortfalls in a person's credit score, which could be reduced by the [past] use of subprime lenders or by a hesitancy to use credit at all. For example, if a customer scores

10 to 25 points less than the minimum score determined to be necessary for loan qualification, but they have three or more years on the job, that strength of character could offset the low score. In addition, third-party mortgage brokers who do not try to look at credit scoring in a flexible way—such as looking at work history—and rely on poor scores without honest subjective analysis may benefit from higher-cost loans.

During a recent training session in Evansville on "Predatory Lending: A Professional Alert," for brokers, appraisers, inspectors, title agents—all those who deal with the consumer along the path to getting a mortgage—Nick Tilima of Education Resources suggested that, "Most consumers who contact a mortgage broker expect the broker to arrange a loan with the best terms and at the lowest possible rate. Most mortgage brokers do just that, and charge a reasonable fee for their services. However, in the subprime market, there are mortgage brokers who do just the opposite. That is, the broker will attempt to sell the borrower on a loan with the most fees and highest rate possible so that the broker will get more compensation. Some of these brokers may charge fees of 8 to 10 points. In addition, the broker may get additional compensation from arranging a higher than necessary interest rate for the consumer. For example, the consumer may qualify for an 8 percent interest rate, but if the broker can sell the consumer a 9 percent rate, he can keep the differential." To address this issue, standardized fee schedules would go a long way to provide fair lending to individuals with lower credit scores.

Brokers and lenders also should be aware that high credit scores do not necessarily mean a loan is guaranteed. The ability to handle many credit lines on a timely basis enhances most credit scores. However, the lender is ignoring the fact that multiple obligations also burden the person's ability to repay a new debt.

Since lenders and brokers may take advantage of a consumer's lack of knowledge or poor credit rating to charge high interest rates and hidden fees, disclosure and pre-loan education is a must. At a minimum, everyone should be required to have some sort of education before buying or refinancing a house.

Consumers would be well advised to address the credit problems that keep them from being considered for a prime loan; but if they cannot correct these problems, they should be aware of the availability of subprime loans that are not predatory.

CODE OF ETHICS FOR LENDERS

As part of its efforts to fight predatory lending in Evansville, the Tri-State Best Practices Committee, of which I am a member, developed a Code of Ethics for Lenders. Lenders should require their third-party brokers to adopt this Code to help ensure compliance with fair lending laws:

- *Protect all they deal with against fraud, misrepresentation or unethical practices of any nature*
- *Adopt a policy that will enable them to avoid errors, exaggeration, misrepresentation or the concealment of any pertinent facts*
- *Steer clear of engaging in the practice of law and refrain from providing legal advice*
- *Follow the spirit and letter of the law of Truth in Advertising*
- *Provide written disclosure of all financial terms of the transaction*
- *Charge for their services only such fees as are fair and reasonable and which are in accordance with ethical practice in similar transactions*
- *Never condone, engage in or be a party to questionable appraisal values, falsified selling prices, concealment of pertinent information and/or misrepresentation of facts, including the cash equity of the mortgagor in the subject property*
- *Never knowingly put customers in jeopardy of losing their home, nor consciously impair the equity in their property through fraudulent or unsound lending practices*

- *Avoid derogatory comments about their competitors but answer all questions in a professional manner*
- *Protect the consumer's right to confidentiality*
- *Disclose any equity or financial interest they may have in the collateral being offered to secure the loan*
- *Affirm commitment to the Fair Housing Act and the Equal Credit Opportunity Act*

This concludes the third installment in our series. The committee would like to thank the individuals who provided their perspective for this installment. The fourth installment will deal with training of staff, the level and consistency of assistance provided to prospective borrowers in the loan application process, and the degree to which applicants are informed about the ramifications of credit scoring in the mortgage application and underwriting process.

ENDNOTES

i Marr v. Rife, 503 F.2d 735 (6th Cir. 1974); Green v. Century 21, 740 F.2d 460, 465 (6th Cir. 1984) ("Under federal housing law a principal cannot free himself of liability by delegating a duty not to discriminate to an agent.").

ii Emigrant Sav. Bank v. Elan Management Corp., 668 F.2d 671, 673 (2d Cir. 1982); United States v. Beneficial Corp., 492 F. Supp. 682, 686 (D.N.J. 1980), aff'd, 673 F.2d 1302 (3d Cir. 1981); Shuman v. Standard Oil Co., 453 F. Supp. 1150, 1153-54 (N.D. Cal. 1978).

iii The practice of adding (often inflated) fees to the loan balance for services that are either not rendered or do not serve the interests of the borrower.

iv Charging one to three "points" (a point is one percent of the amount borrowed) to a borrower is a commonly accepted industry practice. If a borrower pays points, there is ordinarily a corresponding reduction to the interest rate of the mortgage loan. In most cases, the borrower has the option to add the points to the loan balance to avoid paying them in cash at closing. So-called "equity stripping" is the practice of adding points (sometimes five, ten, or more) to the loan balance, representing a claim against the equity in the property used as security for the loan, with no corresponding reduction in the interest rate.

v Mortgage borrowers generally refinance to take advantage of a drop in interest rates. "Flipping" refers to the practice of encouraging a borrower to refinance primarily to generate fees for the originator and/or mortgage lender, with no discernible benefit to the borrower.

USING ACCOUNT VERIFICATIONS SYSTEMS EFFECTIVELY

John W. Connery
Consumer Regulations Director, Federal Reserve Bank of Chicago

The Federal banking agencies have advised banking institutions to develop programs for assessing products and services that pose risk to the institution and its customers. Policies and procedures should be developed for identifying, monitoring and managing those risks. One of the most significant risks posed to financial institutions is that of account fraud.

Check fraud and other account abuse is a significant and growing problem that is costing the financial services industry billions of dollars a year. Increasingly criminals, either independently or through organized gangs, are defrauding banks through a variety of check fraud schemes. According to the results of a survey conducted by an industry group in 1998, financial institutions were hit with $1.3 billion in check fraud losses, and they spent more than $200 million to prevent, detect and prosecute check fraud. Merchants lost a staggering $13 billion to fraud that year.[i] Costs associated with losses from account fraud and beefing up fraud prevention measures are eventually passed on to consumers in the form of costlier products and services.

To help prevent fraud, most financial institutions closely scrutinize the consumers and businesses that apply to open an account. In addition to collecting and verifying identification information about the applicants, most financial institutions inquire about the applicant's prior banking relationships. Many financial institutions verify the information given through reports from consumer reporting agencies that provide new account verification services. These agencies maintain databases with information regarding accounts that have been closed for reasons other than the account holder's request. Some financial institutions also use these reports in deciding if applicants qualify for credit cards.

The largest account verification database in the U.S. is maintained by ChexSystems - an account verification database operated by eFunds Corp. The ChexSystems database contains data about approximately 22 million accounts that were closed for cause.

Reasons for closing an account other than at the request of the account holder are normally fraud or a negative balance for an extended period of time. Some account verification systems also provide information about the applicant's credit history. Account verification systems do not make the decision to approve or reject an applicant's new account application. The information is provided so that the financial institution can make an informed decision. The weight the institution gives the information is a function of its own internal policies.

Critics of account verification systems, particularly ChexSystems, contend that financial institutions are using these systems to effectively blacklist all consumers entered in the databases and are not using these systems to properly exclude those individuals that pose a significant risk of overdraft or fraud.

HOW CHEXSYSTEMS WORKS

More than 87,000, or approximately 80 percent of the bank and credit union locations in the U.S. use the ChexSystems to screen new account applicants. ChexSystems neither approves nor denies new account applications for financial institutions. Each financial institution develops its own policy. ChexSystems provides the following information about account applicant in its reports:

- *If there is a closure on file*
- *Whether any outstanding debit balances owed have been paid*
- *Whether Social Security numbers of the applicant(s) and the ChexSystems' data match*
- *If the applicant(s) has checks outstanding on eFunds' retail database, which alerts retailers to non-sufficient-funds (NSF) checks that have not been paid*
- *How many accounts the applicant(s) has applied for in the past 90 days*
- *If the applicant(s) driver's license number is accurate and issued to the applicant*

Financial institutions that use the database provide the relevant data to ChexSystems. ChexSystems also contains the names of account holders who reported lost or stolen checks. If none of the above information applies, the bank is simply told that there is no record of closure on the ChexSystems database.

As a consumer reporting agency (CRA), ChexSytems and other similar account verification systems are subject to the Fair Credit Reporting Act (FCRA). Consumer reporting agencies must maintain accurate and up-to-date records of their data. They also must make sure that only authorized people access their files.

Consumers can view the information in their file and consumer reporting agencies must assist consumers by explaining any information in their file. Consumers may dispute any information in their file and, if requested, consumer reporting agencies must assist consumers in filing a dispute when consumers say the information is incorrect.

Consumers have the right under the FCRA to insert a statement into their file explaining the cause of a debt or providing additional information regarding a closure. But a CRA is not required to remove records from its database unless the financial institution that submitted the information makes a request. Closure records remain in the ChexSystems reporting file for five years, two years less then the seven-year retention period permitted by the FCRA.

CRITICISMS OF THE CHEXSYSTEMS DATABASE

Banks and eFunds say that the database is a valuable tool for mitigating risk by minimizing fraud and screening high-risk customers. Critics of the system appreciate the fact that check fraud is a serious problem for the banking industry and do not dispute the need to take steps to prevent criminals from opening deposit accounts. However, many have complained that the over-reliance by financial institutions on the database has caused institutions to lose good customers and has kept some locked out of the banking system altogether. They contend that the consequences of being in the system amount to disproportionate punishment for people who are not criminals but have simply made a mistake.

Other critics claim that ChexSystems is allowing banks to abuse the system. They charge that banks are not only using it to reduce risk, but they are also using it as a tool to eliminate the bottom tier of consumers - those who maintain low account balances.

Some consumers are registering their displeasure with ChexSystems using methods other than filing a consumer complaint. One vocal critic, who claims he was temporarily placed in the database due to an error by his former bank, has established a Web site critical of ChexSystems. The man says he closed a checking account two years ago but forgot to inform his insurance company, which made quarterly withdrawals of $60 from the account. When the insurance company debited the account shortly after it was closed, the bank paid the money and reported to ChexSystems that the man had withdrawn money from a deactivated account. According to the man, only after repeated calls did he persuade the bank to report to ChexSystems that he had repaid the $60 and the overdraft penalties.

Due to his concern that ChexSystems was unresponsive to consumer complaints, he created the ChexSystems Bites! Web site. The Web site is described as a consumer advocate site that helps provide information to individuals that have been denied a checking account based on a search of the ChexSystems network. The Web site claims that ChexSystems allows banks to abuse the system. According to the Web site, banks are not only using it to reduce risk, but they are also using it as a tool to eliminate the bottom tier of consumers - those who maintain low account balances. The Web site includes:

- *Tips for maintaining a checking account in good standing and resolving account problems*
- *A list of "good" financial institutions that either don't use ChexSystems or try to accommodate applicants that have a negative ChexSystems report*
- *The ChexSystems Bites Hall of Shame that lists financial institutions with practices the Web site finds objectionable*

There is also the "ChexVictims" web site to help build a case for a class action lawsuit against ChexSystems. Denied access to checking, those in the database are forced to use expensive check-cashing services, such as currency exchanges, and undergo the inconvenience of paying bills with money orders or cash for up to five years.

According to the 1998 Survey of Consumer Finance that was sponsored by the Federal Reserve System, 9.5 percent of families in the U.S. did not have some type of transaction account – a category comprising checking, savings and money market deposit accounts. As the ChexSystems database expands, the number of families locked out of the banking system may continue to grow.

A SURVEY OF SOME FINANCIAL INSTITUTIONS' CHEXSYSTEMS POLICIES

In November of 2000, the National Community Reinvestment Coalition (NCRC) sent a survey form to 12 major U.S. banks asking them how they used ChexSystems when deciding whether to open new accounts, and also how they refer their customers' names to ChexSystems[ii]. It also inquired if the banks' policies had changed from 1999 to 2000. Six of the banks responded to the survey. They all indicated that they use ChexSystems in determining whether to open checking accounts.

Despite some indicators of positive change, NCRC concluded that the banks use information in the ChexSystems in an inflexible and reflective manner when processing new account applications. Some survey results include:

Use of ChexSystems Reports

- *During 1999, five of the six banks indicated that they deny checking account applications even if the ChexSystems record is five years old*
- *Two banks indicated that they recently adopted a three-year threshold in cases in which a consumer's account was closed due to insufficient funds; all banks continue to maintain the five-year standard in cases of fraud*
- *Four of the banks responded that they considered whether a ChexSystems' entry stated that the consumer repaid the debt; two banks indicated that this decision varies on a case by case basis at the discretion of local branch managers*
- *Starting in late 2000, two banks indicated they disregard a ChexSystems entry if it is more than one year old and the consumer has repaid the debt*

Bank Referrals to ChexSystems

- *Five banks indicated that they applied both dollar amount and time thresholds when determining when to report borrower account information to ChexSystems*
- *One bank waited 60 days before reporting an overdraft; one bank waited only 30 days before reporting an overdraft; the average time period for the surveyed banks was 45 days*
- *Two banks did not report customer account information to ChexSystems until the overdraft exceeded $100; one bank reports overdrafts that exceed $35; the average dollar threshold was $67 in 1999*
- *One bank indicated that it changed its dollar-reporting threshold from $50 in 1999 to $100 in 2000*

POSITIVE STEPS TAKEN BY FINANCIAL INSTITUTIONS

Beginning in August 2000, the Greenlining Institute, a public policy center headquartered in San Francisco, and the Federal Reserve Bank of San Francisco held four meetings to discuss possible reform in the treatment of individuals reported to ChexSystems. These meetings included a discussion of potential best practices which a financial institution could implement to reduce its dependence on ChexSystems data in its decision process on opening accounts. Practices identified include:

- *Training staff to use judgment to assess risk when opening accounts*

- *Setting minimum limits to activate the use of ChexSystems*

- *Considering the possible override of a customer denial for situations that are beyond the customer's control, such as a prolonged illness*

Since the meetings at the Federal Reserve Bank of San Francisco, all participating financial institutions have announced that they will implement positive changes in the way they use ChexSystems.[iii]

In September 2000, Bank of America was the first financial institution to announce specific changes in its use of ChexSystems. Revised practices include:

- *Disregarding all ChexSystems entries greater than three years old provided the entry is not fraud-related*

- *Disregarding all ChexSystems entries greater than one year old if the consumer has repaid the debt*

- *Disregarding certain other ChexSystems entries if the consumer has repaid the debt and completes a course in financial responsibility*

- *Increasing the loss threshold for reporting closed accounts from $50 to $100 in overdrafts*

- *Increasing the length of time a customer has to repay the debt*

During a December 2000 meeting, Bank of America reported that in the first two months under the revised standards, its new ChexSystems policies had resulted in approximately 1,800 ChexSystems "overrides." This allowed 1,800 individuals to open deposit accounts that would have been denied under the bank's former policies.

Best practices to address the barriers ChexSystems reports may create for low-and moderate-income individuals include:

- *Increasing the negative balance threshold for reporting customers to ChexSystems from $25 to $100*

- *Removing customers from the ChexSystems database if the negative balance is repaid within 90 days (previously, repayment was required within 30 days)*

- *Improving the overdraft notification process to include more visible language that explains how the institution uses ChexSystems and the consequences of being reported*

- *Refraining from reporting customers until numerous attempts have been to contact them and providing ample opportunity to settle their accounts before a report is submitted to ChexSystems*

MARKETING OPPORTUNITIES

Recognition by financial institutions that they may be turning away business with manageable risk is a strong incentive to revisit internal new account procedures and ChexSystems policies. The Wall Street Journal recently reported that Charter One Financial Corp., a Cleveland based bank, is testing a program aimed at customers who regularly overdraw checking accounts and offers to reduce their overdraft fees by more than half. Banks typically cover checks in overdraft situations as a service to upstanding customers, so bad checks do not always "bounce" back to payees. But banks will charge an overdraft fee whether they pay the check or not. Charter One rolled out its new low-fee Ready Cash Checking account in Illinois and Michigan in August. According to a bank spokesperson, the purpose of the program is to lighten the load of increasingly onerous fees and reduce the chance of people losing their bank accounts altogether.

Mark Grossi, the head of Charter One's retail banking, noted that many people who overdraw their checking account aren't deadbeats, but young adults just learning to manage their money. He further stated that high overdraft incidents cut across all economic backgrounds; the bank assumes most are inadvertent. Charter One hopes the gesture will help it retain customers who might someday be more dependable and more affluent.[iv]

CONCLUSION

Senior management at each financial institution is responsible for understanding the risks associated with the products and services offered and ensuring that effective risk management practices are in place. Financial institutions need to establish and maintain procedures that protect the institution from individuals who abuse demand accounts. ChexSystems and other account verification report information systems can be effective tools in verifying and identifying the potential risk posed by an individual for repeated overdrafts and fraud. However, financial institutions should explore ways to use these systems judiciously.

Certain individuals have demonstrated that they are not capable of maintaining a checking account in a responsible manner. Criminals are also increasingly targeting financial institutions in check, credit and debit card fraud schemes. Financial institutions must protect themselves from these individuals. However, financial institutions should review their procedures to determine if they are fair or make economic sense if it is their policy to turn down a new account application based on a ChexSystems report. In many cases a ChexSystems record is the result of a single event that occurred as many as five years prior.

Procedures should ensure that the overall risk factors of potential customer are considered and carefully assess which variables contained in account verification report accurately predict the potential for overdraft activity. As financial institutions conduct a review of their account verification system procedures they should consider the following recommendations:

- *Shorten the period of review of transgressions in an account verification report from the standard five years, provided the entry is not fraud-related*
- *Take into consideration the fact that a consumer or business has paid the overdraft*
- *Provide consideration to individuals who have completed a course in financial responsibility subsequent to the overdraft*
- *Increase the loss threshold for reporting accounts due to an overdraft*
- *Increase the length of time a customer has to repay the debt*
- *Consider offering a consumer with a ChexSystems checking account record, an alternative account with limited withdrawal capability such as a savings account (provided the entry is not fraud-related)*
- *Advise customers that if they fail to pay an overdraft they will be reported to ChexSystems; ensure they understand that once reported to ChexSystems, they may find it very difficult to open another account for up to five years*

Increasing access to banking services across all income spectrums is a continuing challenge for financial institutions. The adoption of "best practices" for the use of ChexSystems data by the institutions participating in the meetings at the Federal Reserve Bank of San Francisco is a model for financial institutions in the 7th Reserve District to follow in helping to provide greater access to financial products and services.

ENDNOTES

i TowerGroup, "Check Fraud Prevention Update: Can New Technologies Reduce Check Fraud Losses?" September 1999.

ii National Community Reinvestment Coalition. "ChexSystems: Disenfranchisement or Risk Management Tool?" Web Site: www.ncrc.org.

iii Fiene, Laura & Lavaroni, Laurie, "ChexSystems: A Call For Voluntary Industry Reforms, Community Liason," Volume No. 2001-03, June 2001, Web Site www.ots.treas.gov

iv Coleman, Calmette, "Bank Offers Check Bouncers A Break in Fees," *Wall Street Journal*, August 30, 2001

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