Outdated Credit Scoring Models Shut Minorities Out Of Housing Market

At a time when the U.S. economy continues to struggle to create jobs, we cannot afford to leave potentially hundreds of billions of dollars of lending activity and tens of thousands of possible jobs go untapped.

But that's exactly what we're doing based on research presented last week by Urban Institute researcher Laurie Goodman and her colleagues. Between 2009 and 2013, mortgage lenders could have originated more than 4 million additional home loans while maintaining relatively conservative lending standards.

These missing 4 million loans reflect the extreme degree to which the housing finance system has over-corrected from the reckless lending behavior in the years before the housing crisis. Today's loan approval practices can be considered exclusionary because they limit access to mortgage credit without materially improving the safety or soundness of lending.

Equally important, unnecessarily rigid lending practices are not impacting all households the same way. People of color are disproportionately shut out of the mortgage market. Lending to African Americans and Latinos in 2012 was down by more than 50 and 45 percent, respectively, relative to 2001, a period that preceded the explosion of irresponsible predatory subprime lending.

The imperative to improve access to mortgage credit cannot be overstated. A study released last month by the Institute on Assets and Social Policy (IASP) and the public policy organization Demos found that African Americans and Latinos have only 6 percent and 8 percent, respectively, of the wealth held by the typical non-Hispanic white household.

That report also concluded that if African Americans and Latinos were to attain homeownership at the same rates as non-Hispanic whites, wealth disparities could be reduced by just under a third for the former two groups.

Discussions that address improving access to credit are often couched in the rhetoric of "loosening credit standards." That framing of the issue is misleading and disingenuous since it implies that improving access for people of color

Goodman's research dismisses the notion that eliminating overly rigid lending standards represents irresponsible "loosening" of credit standards.

Fannie Mae, Freddie Mac, and the Federal Housing Administration (FHA) rely on credit-scoring models developed more than a decade ago. Over the past 10 years, however, newer and more predictive models have been created.

African Americans and Latinos, for example, are less likely to have traditional sources of credit, such as credit cards or mainstream consumer or business loans, all of which constitute the basis of older scoring models.

A recent credit scoring forum sponsored by the National Association of Realtors highlighted the fact that we can have safe and sound lending if we use more accurate tools to determine the credit worthiness of borrowers, such as such as timely utility or rent payments.

Recent research by the credit repository agency Experian finds that the inclusion of utility payments in a credit-scoring model could reduce the number of borrowers considered to be subprime by half.

Both Fair Isaac, the firm that created the current industry standard credit-scoring technology and its competitor, VantageScore, produce scoring models that are better at predicting the risks posed by consumers, particularly African Americans and Latinos, than those now employed by Fannie Mae, Freddie Mac and FHA. The reasons for failing to adopt more sophisticated credit scoring models by federally-supported housing agencies are varied and include the justifications that incorporating models would be costly and present significant technological and operational challenges.

Yet according to research by VantageScore Solutions, employing new scoring models at the Fannie Mae and Freddie Mac could increase lending to Latinos and African American households by nearly a third and grow revenues by as much as $544 million without loosening credit standards. *(Disclosure note: While I was not involved in this study, I am a consultant to VantageScore.)*

Improving access to mortgage credit would not only meaningfully help to narrow the large and growing differences in wealth attainment for people of color relative to non-Hispanic white households, it would also provide a much-needed boost to the U.S. economy.

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