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OTS 98-84 - OTS Director Proposes 4 Principles for Responsible Risk-Based Pricing

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OTS Director Proposes 4 Principles For Responsible Risk-Based Pricing

WASHINGTON, D.C., Nov. 18, 1998 - Office of Thrift Supervision Director Ellen Seidman today proposed four principles on which to build a sound framework for implementing risk-based mortgage pricing as a means to further expand affordable home-ownership opportunities.

Ms. Seidman acknowledged the serious concerns some have raised that the process will have a disproportionately negative impact on minority applicants. She stated, however, that by following the four principles, "we can maximize our chances of realizing the promise of risk-based pricing while avoiding its pitfalls."

She outlined her four principles at the Neighborhood Reinvestment Training Institute in San Francisco as follows:

- Consumers must be educated about, and empowered to deal with, risk-scoring and its impact on their eligibility for and the pricing of a home mortgage.
- Lenders must be accountable for managing their operations and outlets to assure ethical, non-discriminatory delivery of risk-based home mortgage financing.
- Developers and users of risk-based pricing models must maintain the reliability of their system's performance and evolve to meet changing market conditions and consumer behavior.
- All participants in the mortgage market must encourage the implementation of risk-based pricing as a means of improving service and affordability and must guard

against the possibility of technology producing barriers to home ownership for minority or lower income families and individuals.

Ms. Seidman said that consumer education has "lagged behind the rapid deployment of credit-scoring in the home mortgage," but that she is "happy to see that leaders in the industry are beginning to work together to reduce this gap.

"But education alone is not enough. We must make that education useful. One step in this direction is to integrate education into the housing counseling framework. Further, we need to provide more information to applicants about what factors have caused them to be denied a favorable loan or required them to pay a higher interest rate." Ms. Seidman also urged continuing support for effective housing counseling, cautioning against "taking the easy way out" to increasing loan volumes to first-time low- and moderate-income borrowers by substituting higher interest rates for home buyer education and attentive servicing.

Lenders must actively monitor and manage all their product delivery channels for discriminatory conduct, she said. Lenders offering mortgages differentiated by price on a risk-scored basis need to exercise oversight on how applicants are tracked or "steered" to particular mortgage choices. "If you...are risk-based pricing, be extra vigilant about how applicants are treated wherever they first contact your business network," she urged.

Credit Scoring Still New

Credit scoring and automated underwriting in the mortgage market are still in their infancy, she said, and the early favorable returns have occurred in "some of the most favorable economic circumstances imaginable...good times are not never-ending," Ms. Seidman warned. So as a matter of safety and soundness, "lenders must monitor their risk-based pricing models to ensure their continued predictive powers and to anticipate changing conditions that may adversely affect their future reliability."

She said her fourth principle may be the "trickiest, and most important to apply." Only by implementing risk-based pricing as a means of improving housing affordability, can true mastery over the technology be achieved. This means capturing the cost savings from credit scoring and risk-based pricing to more fully analyze and "work" marginal loan applications. It means supporting quality counseling to enable those who are willing to put forth the effort to get the best pricing. And, especially, it means not taking advantage of the relative lack of sophistication of many first-time home buyers.

"I think it is safe to say that risk-based pricing is here to stay. Our challenge is to employ this new tool to continue our unprecedented run of expanding home ownership," Ms. Seidman added.

Homeownership in America reached a new record level of 66.8 percent of families at the end of September, and during the four years ending in 1997, minorities accounted for 42 percent of the overall growth in ownership.

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The Office of Thrift Supervision (OTS), a bureau of the U.S. Treasury, regulates and supervises the nation's thrift industry. OTS' mission is to ensure the safety and soundness of thrift institutions and to support their role as home mortgage lenders and providers of other community credit and financial services. For copies of news releases or other documents call PubliFax at 202/906-5660, or visit the OTS web page at www.ots.treas.gov.

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