Myths and Facts About AI in the Mortgage Industry

***Myth*: AI is a new technology recently adopted by the mortgage industry.**

***Fact*: AI has been used safely and effectively by the mortgage industry for decades.**

There are many types of Artificial Intelligence (AI) and no consensus on how to define AI. However, some states have initiated efforts to regulate AI and have broadly defined AI as "any machine-based system that, for any explicit or implicit objective, infers from the inputs the system receives how to generate outputs… that can influence physical or virtual environments."[1] This definition covers the newest forms of AI, such as machine learning, large language models, and other "generative" AI such as Chat GPT, but it also encompasses older technology such as computer algorithm based tools.

This broad definition includes many well-accepted technologies that have been used for decades. Lenders have relied on AI developed by the federal government and the government-sponsored enterprises (GSEs) to make lending decisions or to determine if a loan is eligible for guarantee. These automated underwriting systems (AUS) have been developed and maintained by the Federal Housing Administration, Fannie Mae, and Freddie Mac. For example, Desktop Underwriter (DU) and Loan Prospector Advisor (LPA) are developed and controlled by the GSEs, while the Veterans Administration (VA) and the Department of Housing and Urban Development (HUD), for the Federal Housing Administration (FHA), have their own requirements and certifications to approve vendor AUSs. Additionally, lenders rely on credit scoring models produced by FICO to inform those lending decisions and pricing.

***Myth*: Using AI to guide lending decisions will perpetuate housing inequality.**

***Fact*: There are legal safeguards to prevent algorithmic discrimination.**

Like any tool, the effect of AI depends on how it is developed and deployed by the user. However, in many instances AI has helped reduce bias in the housing system by neutrally evaluating a borrower without considering protected characteristics. The risk of AI or algorithmic discrimination in consumer finance is mitigated by the Equal Credit Opportunity Act (ECOA) and its implementing regulations promulgated by the Consumer

[1] Colo. Rev. Stat. § 6-1-1701(2).

Financial Protection Bureau (CFPB). ECOA regulates the extension of credit by creditors, broadly defined to include other financial services in addition to mortgage lenders. ECOA prohibits lenders from discriminating against a borrower based on a prohibited basis regarding any aspect of a credit transaction. This prohibits lenders from discriminating on the basis of a person's race, color, religion, national origin, sex, marital status, age, whether the borrower's income derives from public assistance programs, or whether the borrower has in good faith exercised any right under the Consumer Credit Protection Act.

In the context of AI, regulations promulgated by the CFPB prohibit the use by mortgage lenders, investors and guarantors of automated decision-making technology that would discriminate against borrowers. In addition, creditors are required to provide prospective borrowers with the underlying reasons to deny credit. This adverse action notice must be specific and indicate the principal reasons for the adverse action. Further, under CFPB Circular 2022-03, lenders cannot merely rely on the output of an automated decision-making technology as a reason to deny credit and must disclose a specific reason for the denial.[2]

Lenders are also subject to the provisions of the Fair Housing Act, which makes it illegal to discriminate in the sale or rental of housing, including against individuals seeking a mortgage or housing assistance, or in other housing-related activities. The Act prohibits this discrimination because of race, color, national origin, religion, sex (including gender identity and sexual orientation), familial status, and disability. The Act is enforced by the Department of Justice (DOJ) and HUD, as well as through a private right of action from individual plaintiffs.

Lenders are additionally subject to Section 1981 of the Civil Rights Act of 1866, which requires that everyone in the United States shall have the same right to make and enforce contracts and receive the full and equal benefit of all laws as white citizens. This law effectively prohibits discrimination on the basis of race or color. Section 1981 is enforced by the DOJ and has a private right of action.

***Myth*: There is no supervision or enforcement of how mortgage lenders use and develop AI.**

***Fact*: The use of AI is heavily regulated and scrutinized in the mortgage industry.**

The mortgage industry is subject to many anti-discrimination laws that are applicable to the use of AI. In addition, prudential banking regulators and consumer protection

[2] The CFPB stated its view that the Circular will helps prevent discrimination because if a lender knows they have to explain their decision, they will be discouraged from engaging in discriminatory practices. https://www.consumerfinance.gov/compliance/circulars/circular-2023-03-adverse-action-notification-requirements-and-the-proper-use-of-the-cfpbs-sample-forms-provided-in-regulation-b/

agencies have the power to enforce these laws against the mortgage industry. ECOA is enforced by the CFPB, which also has supervisory authority to conduct examinations into lenders, both bank and nonbanks alike. The DOJ also has the power to enforce ECOA to stop a pattern or practice of discrimination. Additionally, the OCC, Federal Reserve, FDIC, NCUA, and the FTC can enforce ECOA against entities they regulate.

All of these regulators have emphasized that it is critical for financial institutions to identify, measure, monitor, and manage risks arising from the use of AI, as they would for the use of any other technology. “Advancements in technology do not render existing risk management and compliance requirements or expectations inapplicable,” according to the U.S. Department of Treasury’s March 2024 report, *Managing Artificial Intelligence-Specific Cybersecurity Risks in the Financial Services Sector*. The Federal Reserve, OCC, and FDIC released interagency guidance on risk managing third-parties, stating that “the use of third parties does not diminish or remove banking organizations' responsibilities to ensure that activities are performed in a safe and sound manner and in compliance with applicable laws and regulations.” *Interagency Guidance on Third-Party Relationships: Risk Management*. Lastly, section 5 of the Federal Trade Commission Act prohibits covered persons (e.g., nonbank financial institutions) or service providers of covered persons from engaging in unfair or deceptive acts or practices.

Clearly, lending decisions that rely on AI are subject to these laws and regulations to the same extent as decisions made by humans. Consequently, developers and users of AUSs and other algorithmic underwriting constantly test their results for fair lending compliance.

***Myth*: AI has replaced humans in the mortgage transaction.**

***Fact*: Mortgage transactions require human interaction throughout the origination process.**

Mortgage Loan Originators (MLOs) are responsible for taking a borrower’s information and discussing the terms and pricing of the loan with the prospective borrower and determining whether to accept or deny an application. These MLOs must be licensed and/or registered under the SAFE Act and must provide their unique identifying number (NMLS ID) for a loan to be completed. Borrowers must be evaluated for a credit decision by a licensed or registered MLO. The MLO is also charged with ensuring the borrower understands and agrees with the terms of the loan. Although AI can assist both the borrower and MLO in finding an appropriate loan, only an MLO can accept the consumer’s application after agreeing on the terms of the loan.

Technology plays an important role in the origination process and is used to increase efficiency and lower instances of human error or fraud. In addition to the MLO, the origination process also involves a human underwriter. This underwriter uses forms of AI provided by the GSEs and FHA to determine if a loan is eligible for a guarantee or securitization. The underwriter also has a deeper understanding of investor guidelines and can see nuances to qualifying borrower that AI cannot. They continue to ensure the integrity of the transaction and protect borrowers from erroneous denials.