Chapter 8: Credit Investigation

Synopsis

Thorough investigations help banks make sound credit decisions and limit open-end credit use by applicants who are not qualified. A lender initiates the credit investigation after formal application is made for a new loan, or to analyze risk on an existing account.

The primary objectives of credit investigation are to verify that application data are accurate and complete; conduct the investigation in an efficient, cost-effective manner; identify negative trends or potential problems that may affect the consumer's creditworthiness; and acquire enough information to make a sound credit decision. The basic steps in a credit investigation are to review the application for information that warrants immediate rejection; check bank files to determine the applicant's account history; obtain a credit agency report; contact employers and creditors for references; and verify the value of any collateral securing the loan.

The information needed by the investigator depends on the type, size, and risk of the loan. Most investigations review the applicant's credit history, income, employment, time at residence, and the value of the collateral. In evaluating credit history, the lender wants to know from whom applicants have borrowed, what type of accounts they have used and still have available, how long the accounts have been open, how the accounts have been paid, current obligations, and potential credit exposure.

Credit history is available from the application, the bank's own files, other financial institutions, consumer reporting agencies, and public records. Income, a principal indicator of the applicant's capacity to repay the loan, is investigated for source, reliability, frequency, and probable continuity over the term of the loan. To verify income, credit investigators may contact employers directly or rely on information from pay stubs, W-2 forms, tax returns, legal documents, and direct payroll deposits. The major elements of employment to investigate are type of job, time on the job, employer's business and stability, and applicant's employment history. Residence information can evidence an applicant's stability and character. Investigators seek information on type of residence, time at residence, and previous residence.

Investigators must determine the value and ownership of collateral offered to secure a loan. For purchase-money loans the bill of sale, invoice, or purchase order should reveal the actual selling price, the amount and composition of any down payment, and a complete description of the item being purchased. Investigators also check public records and valuation guidebooks and obtain appraisals. Documents like deeds, titles, or bills of sale can establish ownership.

Consumer reporting agencies and the applicant's personal financial statements and tax returns offer the most comprehensive information. Credit reports contain information gathered from lenders and public files, consumer identifying information, trade lines, inquiries, and public record and collection information, such as judgments, liens, and bankruptcy. Personal financial statements give details on the consumer's assets, liabilities, and net worth.

In addition to the red flags that may arise during the credit investigation investigators need to watch for other warning signs of potential problems: gaps in information, information inconsistent with the applicant's age, and the applicant's behavior during the loan interview, such as being aggressive or too anxious.

Prescreening and account monitoring are credit investigation techniques used particularly for open-end loan products. Prescreening compares consumer reporting agency information on potential applicants with the bank's defined credit requirements. The bank receives only the names and addresses of consumers who meet the requirements. When monitoring current accounts, the bank compares files on its current loan customers with consumer reporting agency files using bank-defined criteria. Consumers who no longer meet the bank's requirements are subject to further screening, and a determination is made whether to continue the account, block it from use, or reduce the credit limit.

The Fair Credit Reporting Act (FCRA) is directed primarily at consumer credit reports and applies primarily to consumer reporting agencies, although banks may occasionally fall within its purview. Its objectives are to establish acceptable purposes for which a credit report may be obtained; to define consumer rights related to credit reports, including the right to request reports annually or in the event of a denial and the procedures for correcting inaccurate information; to set requirements for reporting adverse credit decisions resulting from credit report information to consumers; and to define the responsibilities of a consumer reporting agency.

When banks pass along information about a customer's account with another institution, they become furnishers of consumer information and thus fall under the FCRA. However, because most banks are simply users of credit reports, they must abide only by the rules on notifying consumers about negative information in credit reports that result in an adverse action. Consumers have the right to order free credit reports once every 12 months as well as when they are notified by a bank that they have been denied credit.

The Fair and Accurate Credit Transactions Act (FACT Act) amends FCRA to prevent identity theft, improve accuracy, better protect privacy, and require more disclosures to consumers, including credit scores and notifications of negative credit reports. The FACT Act also prohibits creditors from obtaining or using medical information in credit decisions, with certain exceptions; restricts consumer reporting agencies from disclosing medical information; and gives consumers more control over the type and number of marketing solicitations they receive.

Each bank regulator has its own regulations to implement the FACT Act. The primary regulation that addresses the act is CFPB Regulation V.

Resources and Advance Preparation

- Prepare to project textbook exhibits 8.1, 8.2, 8.4A, 8.4B, 8.4C, 8.4 D, 8.4E, 8.4F, and 8.5.
- Prepare to project or hand out copies of instructor's manual visuals 8.1 and 8.2.
- Be prepared to discuss the general economy in your area, especially the economic condition of several large employers and the likely effect on local job stability and wage levels. The Federal Reserve's Beige Book is a good resource for this information. (www.federalreserve.gov/fomc/beigebook/2011). Another source is the FDIC State Profiles, a quarterly summary of state banking and economic conditions, www.fdic.gov/bank/analytical/stateprofile. Sample state profiles for Virginia, Michigan, and Colorado are included for this chapter.
- Obtain sample credit reports from consumer reporting agencies that serve your area.
- Optional: invite a representative from one of the consumer reporting agencies or a credit investigator from a local bank to talk to the class. For contact information, call the local

representatives listed in your telephone book or the national headquarters of the major consumer reporting companies:

Equifax, www.equifax.com
Trans Union, www.transunion.com
Experian, www.experian.com

- Set up and test a laptop computer and an LCD projector, and set up a white board or flip chart.

Learning Objectives

After successfully completing this lesson and chapter, students should be able to

8.1 describe the objectives of and steps in a credit investigation
8.2 explain the types of information obtained in a credit investigation
8.3 identify credit investigation information sources and warning signs
8.4 explain the Fair Credit Reporting Act and the FACT Act rules that apply to credit investigation
8.5 define the terms that appear in bold type in the text

Topical Outline

The following numbered outline presents the names of the sections (the heads and major subheads in the chapter in the textbook). These numbers are not printed in the textbook. They appear in this instructor's manual after the answers to review or test questions. The purpose of the number key is to make it easier for you to refer students to particular places in the text for review.

8.0 Introduction
8.1 Credit Investigation Defined
8.1.1 Credit Investigation Objectives
8.1.1a Verify Application Accuracy and Completeness
8.1.1b Conduct Investigation Efficiently
8.1.1c Identify Potential Problems
8.1.1d Acquire Information to Support a Sound Decision
8.1.2 The Credit Investigation Process
8.1.2a Review Application for Information Warranting Rejection
8.1.2b Check Bank Files for Applicant's Account History
8.1.2c Obtain Credit Agency Reports
8.1.2d Contact Employers and Creditors for References
8.1.2e Verify Collateral Value
8.2 Types of Credit Information
8.2.1 Credit History
8.2.1a Bank Files
8.2.1b Public Records
8.2.1c Consumer Reporting Agencies
8.2.1d Public Records
8.2.2 Income
8.2.2a Employer Verification
8.2.2b Pay Stub

8.2.2c W-2 Forms
8.2.2d Personal Tax Return
8.2.2e Legal Documents
8.2.3 Employment
8.2.3a Type of Job
8.2.3b Time on Job
8.2.3c Employer's Business and Stability
8.2.3d Employment History
8.2.3e Verifying Information
8.2.4 Residence
8.2.4a Type of Residence
8.2.4b Time at Address
8.2.4c Previous Residence
8.2.4d Verifying Residence
8.2.5 Collateral
8.2.5a Collateral Value
8.2.5b Collateral Ownership
8.2.5c Collateral Identification
8.3 Sources of Credit Information
8.3.1 Consumer Reporting Agencies
8.3.1a Consumer's Identifying Information
8.3.1b Trade Lines
8.3.1c Inquiries
8.3.1d Public Record and Collection Information
8.3.2 Personal Financial Statements
8.3.3 Personal Tax Return
8.3.4 Warning Signs
8.3.4a Gaps in Information
8.3.4b Information Inconsistent with Applicant's Age
8.3.4c Aggressive or Anxious Applicant
8.3.5 Open-End Loan Product Considerations
8.3.5a Prescreening
8.3.5b Account Monitoring
8.4 Laws and Regulations
8.4.1 Fair Credit Reporting Act
8.4.1a Banks as Furnishers of Information
8.4.1b Banks as Users of Information
8.4.2 FACT Act
8.4.2a Identity Theft and Privacy Concerns
8.4.2b Medical Information

Suggested Learning Activities

Specific prompts for breaks have not been included because the timing is left to your discretion. The schedule allows for one 10-minute break for each 50 minutes of classroom instruction.

Review

Begin the session by asking whether students have any questions or comments related to exercises or reading that they have done since the last session. Review the current session's agenda.

Bridge the learning objectives from chapter 7 to chapter 8, providing students with a point of reference and continuity in the course. Review the objectives listed on the chapter title page in the text. Discuss the plan for the chapter

Credit Investigation Objectives and Process

Lecture and Discussion

Discuss the primary objectives of credit investigation: verify that the application is accurate and complete, conduct the investigation efficiently, identify negative trends or potential problems, and obtain information to support a sound decision. Discuss why these objectives are important to consumer lending and what might happen if any objective is not met.

Then discuss the steps in the credit investigation process: review the application for information warranting immediate rejection, check bank credit files for applicant's account history, obtain credit agency reports, contact employers and other creditors for references, and verify the value of any collateral to secure the loan. Discuss how these support the objectives of credit investigation.

Discuss some ways banks have used automated systems to improve these processes. Ask students for examples of how their banks manage each step.

Class Activity 1

Break the class into groups. Using exhibits 8.1 and 8.4A ask the groups to analyze the application for data that can be accepted and data that need to be verified. Reconvene the groups and have them share their answers. Review exhibit 8.4A and discuss why the answers of the groups may vary. Some students may want to verify more information than is noted in exhibit 8.1.

Suggested Response:

Data that can be accepted: There are none.

Data that are verifiable:

- Address information will be on the credit report and in the bank's central information file. The applicant is a customer of the bank.
- Time at residence information will be in the credit report.
- Check and savings account balances will be in the central information file.
- Auto loan balance will be in the credit report.
- Employment information will be in the credit report. It can also be verified directly.
- Income for both applicants can be verified by the tax return, pay stubs, and W-2 forms.

Types of Credit Information

Lecture and Discussion

Discuss why the information provided to the credit investigator will vary by type of loan, size, and risk. Discuss how these differences relate to bank loan objectives and credit investigation objectives. Review the types of information credit investigators typically look into: credit history, income, employment, residence, and collateral.

Begin the analysis with a discussion of the need for proper identification of the applicant. Have students suggest several names under which they could legitimately obtain credit. They should soon see the difficulty inherent in verification.

Emphasize that credit history is one of the most important decision-making variables. Familiarize students with the five primary sources of credit history information: the application, the bank's internal files, other financial institutions, consumer reporting agencies, and public records.

Give examples of how each source is used. Then discuss problems, such as incomplete information and the operations of "credit repair clinics."

For your discussion of income, emphasize that verifying the amount of the applicant's income is only one factor to consider. Stability of income and economic conditions are important. Be prepared to discuss the economic condition of several major employers in your market area. Ask students how a lender might consider an application from an employee of one of those employers, given the current economic situation. Then ask students to describe types of evidence that are useful for verifying income.

Employment stability is also important. The type of job the applicant has and the status of the industry it is in give insights into current and future income potential. Review important employment considerations, such as title, time on the job, and employment history. Remind students that because today's workers may have several jobs and careers in their lifetime, a brief time on the job or frequent job changes are not always a sign of instability.

Residence information is a general indicator of stability rather than a measure of credit risk. After reviewing the types and uses of residence information, impress on students how this information could be misused. Discuss how redlining and other practices have been used in the past to discriminate against applicants.

The final step in determining creditworthiness is to identify and value collateral. Discuss the following: identifying terms on purchase-money loans, determining the value of collateral, and identifying the owners of collateral. Using exhibit 8.2, ask students to share their experiences in using various sources to verify collateral.

Class Activity 2

Use the sample loan in the text, exhibit 8.4A, as the basis for discussion. The tax forms and credit report (exhibits 8.4C through 8.4E) provide additional information. Divide the class into groups and have each group analyze the loans. Group members should list the information they learned from the personal financial statement and tax return. They also should list information they want to investigate further and the sources they would use. Ask the groups to present their findings and recommendations to the class.

Sources of Credit Information

Lecture and Discussion

Students will have seen the personal financial statements and tax returns in the text. Review the value of these documents as a source of credit information. Then discuss consumer reporting agencies. Bring in sample credit reports and use exhibit 8.4F, or the sample TransUnion report in the appendix. Review the contents and explain how students can get copies of their own credit reports.

Using exhibit 8.3 as a reference, discuss credit-quality red flags at different stages of the consumer loan process and other types of warning signals, such as the consumer's behavior during an interview and information gaps. Discuss how banks have the obligation to send either a Notice of Incomplete Application or a Notice of Adverse Action within 30 days after receiving an application if there are information gaps that cannot be, or have not been, verified by the consumer.

Compare credit-quality red flags to identity theft red flags, which will be discussed later with regard to the Fair Credit Reporting Act (FCRA) and the FACT Act. Discuss how each type of indicator can be noted during the application and credit investigation process.

The growth of open-end credit product portfolios, prescreened loan solicitation programs, and account monitoring programs has raised new issues for credit investigators. Discuss prescreening and account monitoring as credit investigation responsibilities supporting open-end lending. Use exhibit 8.5 to discuss prescreening and preapproval.

Class Activity 3

Using visual 8.1, ask students to read the situations and respond to the questions.

Suggested Responses

Situation 1

The lender may call Foreman to remind him that the information is needed. If the lender does not obtain the income information within the next three days, a Notice of Incomplete Application must be sent to Foreman. Because the application was dated April 20 and today is May 17, the lender has only three more days to send the notice. The lender also may decide to deny the application because it is incomplete. If so, the lender must send Foreman a Notice of Adverse Action.

Situation 2

The lender needs to verify the value of the collateral. To do so, the lender must order an appraisal of the home. If the customers are creditworthy, the lender may approve the application subject to verification of the value of the home.

Situation 3

The lender may send a Notice of Incomplete Application or may deny the credit and send a Notice of Adverse Action. Either must be done quickly to meet the 30-day deadline.

Situation 4

For the 20 percent that passed the screening, the manager may increase their credit limits and notify them. For the 15 percent that failed, the manager may decide to block the accounts or reduce the limits; in either case, a Notice of Adverse Action must be sent.

Laws and Regulations

Lecture and Discussion

Explain the four objectives of the Fair Credit Reporting Act (FCRA), which are to

- establish acceptable purposes for which a consumer credit report may be obtained
- define consumers' rights to credit reports: the right to request and receive their reports and the procedure to correct inaccurate information

- set the requirements for handling adverse credit decisions that result from information in a credit report
- define the responsibilities of consumer reporting agencies

Discuss the difference between being a furnisher and a user of consumer information and the obligations of the user. Most banks are users of credit reporting information. Using exhibit 8.3, discuss the provisions of the FACT Act that relate to negative reported information and protections against identity theft. Then discuss the rules governing use of medical information.

Class Activity 4

Hand out visual 8.2. Have the students read the situations and respond to the questions.

Then discuss their experiences with negative information reported to consumer reporting agencies, privacy issues, and the use of medical information.

Suggested Responses

Situation 1

Giorgio should deny the application because Dana has a poor history of repaying debts. He is using medical information in a manner and to an extent no less favorable than he would use comparable nonmedical information.

Situation 2

Patricia may grant the loan request. She has used medical information in accordance with an exception allowed by the FACT Act.

Situation 3

Jim may verify with the surgeon that the procedure will be performed. If it will, Jim should follow the bank's loan policy to investigate other items on the application, evaluate it, and make a decision just as he would for any other loan. However, if the surgeon reports that the surgery will not be performed, Jim may use that medical information to deny Marilyn's application for a loan, because the loan would not be used for the stated purpose.

Situation 4

A credit freeze is a red flag for identity theft. Luisa, or her financial institution, should ensure that Mr. Ledbetter's identity is valid before processing the loan application.

Wrap-up and Assignment

- Summarize the material covered.
- Assign chapter 9 to be read before the next lesson.
- Describe the next lesson's content.
- Suggest to students that they visit some of the websites listed as Additional Resources at the end of chapter 8.
- Advise students that answers to the Situations and the Self-check & Review questions appear at the end of the textbook for their convenience in checking their understanding of the topic.

Chapter Evaluation

Chapter evaluations may be completed at the end of each class or assigned as homework for the next session.

Chapter Evaluation–Chapter 8: Credit Investigation

Part A: True/False

Circle the letter T if the statement is true, F if it is false.

1. T F Consumer loans usually are repaid monthly from recurring income.
2. T F Indirect references from employers are the best source of income verification.
3. T F The bank's internal files are a valid source of credit history information.
4. T F Banks ordinarily do not verify credit history information by directly contacting another financial institution.
5. T F It is necessary and desirable to investigate and verify all the data on the application.
6. T F Banks are restricted in their use of medical information to make a credit decision.

Part B: Completion

Fill in the blank with the word or words that correctly complete the sentence.

7. Current quotes from an Internet source, such as the *Wall Street Journal,* are a good source for verifying the value of ________________ and ________________.
8. Credit information on judgments, bankruptcies, and liens recorded is usually obtained from ________________ records.
9. ________________are the largest providers of consumer credit information to the banking industry.
10. Characteristics that may indicate a problem on an application are called ________________.
11. For ________________ programs, the bank identifies minimum acceptable credit requirements and has potential applicants evaluated against those requirements.
12. For ________________ programs, the bank runs the names of its current customers against a consumer reporting agency's files, using defined criteria to identify positive or negative trends.

Part C. Multiple Choice

Instructions: Circle the letter that **best** answers the question.

13. What is a notation on a credit report that indicates the applicant has applied for credit from a specific organization or that an existing creditor has ordered an updated report?
    a. trade line
    b. inquiry
    c. legal notice
    d. direct verification

14. Which of the following actions taken by a creditor is NOT an adverse action?

    a. denying the consumer's request for credit based on credit history
    b. approving the request but at a higher interest rate
    c. reducing the credit line limit when the account is delinquent
    d. reducing the credit line limit when the borrower's credit score deteriorates

15. What is the credit investigation procedure that involves the lender contacting creditors, employers, and landlords to confirm information on an application?

    a. information request
    b. direct verification
    c. trade lining
    d. credit reporting

Answers to Chapter Evaluation–Chapter 8

	Learning Objective	*Topical Outline Section*
1. T	8.2	8.2.2
2. F	8.1	8.1.2d
3. T	8.3	8.2.1a
4. T	8.1	8.2.1
5. F	8.1	8.1.1b
6. T	8.4	8.4.2b
7. stocks and bonds	8.2	8.1.2e
8. courthouse (public) records	8.2	8.2.1b
9. consumer reporting agencies	8.2	8.2.1c
10. red flags	8.2	8.2.2a
11. prescreening	8.3	8.3.5a
12. account monitoring	8.3	8.3.5b
13. b. inquiry	8.3	8.3.1c
14. c. reducing the credit line limit when the account is delinquent	8.4	8.4.1b
15. b. direct verification	8.2	8.2.4d

Visual 8.1: Class Activity 3, Sources of Information

The date is May 17. A loan officer must make some decisions. The following items are in the lender's bank loan policy:

- The bank must receive verified income information on all applications before making a final credit decision.
- The bank requires a written appraisal on property securing loans of $10,000 or more.
- Credit history must be obtained for all applicants.
- If an applicant has some derogatory credit history, the bank will consider the application with a statement of mitigating circumstances from the applicant or the creditor that reported the history.
- If an open-end credit customer fails to pass the bank's account monitoring screening, the account must be blocked from further use or the credit limit reduced. If the customer passes the screening, the account may remain as it is or the customer may be given better terms, such as a higher credit limit.

Read the situations and answer the questions.

Situation 1

Alexander received an application dated April 20 from Jim Foreman, a self-employed building contractor. The loan requested is $25,000 to purchase a new automobile. No income verification is attached to the application.

What should the investigating lender do?

Situation 2

A lender received an application dated April 18 from Todd and Linda Sanchez for a $15,000 home equity line of credit. The purpose is to pay some recurring medical expenses. The lender has verified their income and employment and has ordered their credit history. One other important piece of information for this loan request is missing.

What is that information piece and what must the lender do today?

Situation 3

A lender received an application dated April 19 from Ann Willis for a $5,000 loan for vacation expenses. Ms. Willis has one piece of derogatory information on her credit history—a repossessed automobile, four years ago. The lender asked for an explanation, Ms. Willis promised to send it, but it has not arrived.

What must the lender do?

Situation 4

The credit investigation manager in charge of monitoring open-end credit accounts has received a results report from the consumer reporting agency. About 20 percent of current customers passed the screening with high scores; another 15 percent failed.

What may the banker do?

Visual 8.2: Class Activity 4, FCRA, the FACT Act, and Medical Information

Read the following situations and respond to the questions.

Situation 1

Dana Samuels notes on her application for credit information two $15,000 debts, one to General Hospital and the other to Macy's department store. Main Street Bank's lender, Giorgio Pucci, contacts General Hospital and Macy's to verify the amount and payment status of the debts. He learns that both are more than 90 days past due. Any two debts of this size that are more than 90 days past due would disqualify Dana under the bank's loan policy for underwriting criteria.

Given that one of the debts is to General Hospital, what should Giorgio do?

Situation 2

Edward Johnson lists on an application for a $10,000 home equity loan that he has a $50,000 debt to General Hospital's cancer center. Patricia Collins contacts the cancer center to verify the debt and obtain the repayment history and status of the loan. She learns that the debt is current. Johnson meets the creditor's income and other underwriting requirements.

Having learned that the debt is to a cancer center, what can Patricia do?

Situation 3

Marilyn applies for $10,000 of credit to finance vision correction surgery. Jim receives the application and notes the medical information.

What can Jim do?

Situation 4

Luisa is a credit investigator and application fact checker for her bank. She receives an application from Robert Ledbetter through the Internet. She obtains a credit report and notes that there is a credit freeze on it.

What should Luisa and her bank do?