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FAIR LENDING **EXAMINATION** PREPARATION:

HOW TO ENSURE YOUR INSTITUTION IS READY

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Fair lending is nothing less than a force of nature. Since the introduction of the CFPB, fair lending has come into focus more so than ever before. As a result, enforcement actions are on the rise. In 2012, the regulatory agencies, including the CFPB, the FRB, the OCC, and the FDIC, referred a total of 24 instances to the DOJ. In 2013, this number doubled.

It is essential for all institutions to be prepared. Just as with any compliance examination, preparation should not wait until the request letter is received. A proactive fair lending program is necessary. Your institution needs to know what its fair lending risks are, what its lending data indicates, and most importantly, what must be done to ensure its policies and procedures foster consistency and fairness throughout its institutions.

Background Information

The two main fair lending laws are the Equal Credit Opportunity Act (ECOA) as implemented by Regulation B and the Fair Housing Act (FHA). The ECOA and FHA prohibit discrimination based on the following:

ECOA	FHA
Race or Color	Race or Color
Religion	Religion
National Origin	National Origin
Sex	Sex
Marital Status	Familial Status
Age	Handicap
Applicant's receipt of income derived from public assistance	
Applicant's exercise in good faith of any right under the Consumer Credit Protection Act	

The FHA focuses on mortgage lending such as home purchases, refinances, and home improvement loans. The ECOA is all inclusive with a scope that reaches beyond consumer regulation and residential real estate. It touches every lending department of the institution and any aspect of the credit transaction from the cradle to the grave. Although institutions have a tendency to focus on mortgage lending, fair lending examinations do not discriminate based on the borrower and neither should your institution. All lending products need to be understood, analyzed, and reviewed to guarantee your institution fares well at an examination.

Types of Discrimination

There are three types of discrimination:

1. Overt evidence of disparate treatment

2. Comparative evidence of disparate treatment

3. Evidence of disparate impact

It is important that your institution has a thorough understanding of what constitutes each type of discrimination long before examiners walk in your door. You need to understand what discrimination is so you can know that you are not discriminating.

Overt evidence of disparate treatment is when the lender is openly discriminating based on a prohibited basis. It could occur through policies, lender statements, or otherwise specific acts of open discrimination. An example is a loan policy that states the institution will not make small business loans to female business owners without a guarantor, or a loan officer that makes a statement to an applicant that his car loan will likely be denied because he is too young to own a car that costs a certain amount, or that a Jewish applicant cannot apply for a small dollar holiday loan. These policies and statements examples blatantly discriminate on a prohibited basis of sex, age, and religion.

Comparative evidence of disparate treatment is when an applicant is treated differently based on a prohibited basis. The motive behind the differential treatment is not important, only the difference in treatment. This type of discrimination is most likely to occur in your marginal applicants, those who are not clearly approvals or denials such as the people appearing on your exception report. It can often be seen in the levels of assistance offered to applicants. An example would be if a black couple came into your institution to apply for a mortgage loan. Upon initial review, some derogatory items were noted on their credit report. The loan officer denied the loan without asking for a letter of explanation on the derogatory credit. A white couple came in shortly after and applied for the same type of loan. Similar derogatory credit was noted on their credit report; however, the loan officer solicited a further explanation. The couple stated that it was fraudulent activity. Their credit report was cleared, and they were approved for the loan. Had the loan officer treated the applicants the same, both would have been denied immediately or both applicants would have been given the opportunity to explain. Since all things were equal to that point, one could assume the difference was based on the prohibited basis of race.

Disparate impact is the most 'innocent' type of discrimination, but it is important to remember the end result is still discrimination. A disparate impact is when a neutral policy or practice creates a disproportionate effect based on a prohibited basis. An example of this could be a minimum loan amount. The minimum could be set at an amount so high that few minority or elderly applicants qualify based on their incomes or local home values. The minimum loan amount on its surface is not discriminatory. Its intent is not to alienate one or more groups based on a prohibited basis. Intent is not important though as there is a resulting discriminatory effect. The policy may have a business necessity to justify it such as cost or profitability. It is important to look closely at the justification. Was the minimum amount thoroughly analyzed or was it based on an arbitrary number? Was the loan amount analyzed once there was data to determine if there was any adverse outcome, especially one based on a prohibited basis? Was the loan amount determined with fair lending in mind? Even if the policy is justified by a business necessity, it still may be a violation if an alternative policy could have served the same purpose without the discriminatory result.

Proactive Compliance Program

In the white paper regarding general examination preparation, we discussed the key factors for a proactive compliance program as essential for preparing for a consumer compliance examination. Preparing for a fair lending examination should follow that same proactive approach. This paper will look at how some of those factors mentioned in that paper apply specifically to fair lending.

The CFPB's supervision process is governed by three principles; focus on consumers, data driven, and ensure consistency. These three principles apply to any fair lending exams. It is imperative to know who your consumers are, what story your data tells, and that policies and procedures are in place to ensure consistency. Your institution should follow a similar model for its fair lending program.

When creating a fair lending program, the key source to base your program on is the Interagency Fair Lending Examination Procedures. These procedures are used by all regulatory agencies when conducting fair lending exams. They apply to both large and small institutions, as well as institutions with varying risk factors. The procedures outline the exact steps regulators will take from preparation for the exam through any potential referrals to the DOJ or the like. Although the CFPB will most likely add to or alter these procedures as time goes on, for right now they are what are currently being utilized by all the regulatory agencies.

Risk Assessments

There is no one way to do a fair lending risk assessment, however, it is important to ensure your institution has one that identifies the inherent risks, mitigating controls, and residual risks throughout the organization.

The risk assessment should look at the entire loan process from the time the applicants walk into the institution to the time that loan pays off. The exam manual identifies the varying types of risks breaking them down by compliance program, overt indicators of discrimination, underwriting, pricing, steering, marketing, loan servicing and loss mitigation, HELOC modifications, and discriminatory redlining.

The financial institution should have a thorough understanding the products it offers, the market area it lends in, and how policies and procedures are set. Appendix A of the exam procedures contains a Compliance Management Checklist. The checklist is a great start to determine if your program includes everything it needs to include as well as identify any weaknesses.

To determine where your institution's risks are within these categories, you will need to closely review all loan policies and procedures, as well as the underwriting and pricing processes and guidelines including actual rates and fees charged. You will also have to review items such as loan application forms, marketing materials, exception reports, loan officer compensation programs, and how the CRA assessment area is drawn from a fair lending standpoint.

You will also need to review actual lending data. HMDA loans are a great place to start as you have actual information regarding race, ethnicity, and sex available to you. From this data, you can ascertain whether there are any risks relating to approval/denial rates as well as pricing based on one of those prohibited basis. You can also look at the demographic data for the census tracts where applications are being taken, and see how this relates to the outcomes of the applications. This will help you identify any potential risks for redlining and marketing.

After the inherent risks are identified, you need to identify all the controls in place to determine the residual risks. Fair lending controls might include things such as second review for denials, set pricing and underwriting standards without exceptions, and a strong audit/self-assessment program conducted by an experienced independent reviewer. Controls can help mitigate potential fair lending risks and determine the areas where additional controls may be warranted.

The resulting residual risks should identify the areas where further action should be taken. An action plan should be created to determine how weaknesses can be strengthened. The risk assessment should also identify the areas requiring further reviews through self-assessments and audits. Finally, the risk assessment should set the tone for the training that should occur as well.

Self-Tests

Any areas outside of risk tolerances as identified by the risk assessment should warrant a further review. There should also be an assessment of technical compliance with Regulation B, FHA, and HMDA.

If possible there should include a comparative file analysis, which will compare applicants from a prohibited basis group to a control group based on the results of the risk assessment. Following the exam manual allows you to complete a self-test in the same way that examiners will complete their review during the exam. For HMDA loans, race, ethnicity, and sex are readily available. For other consumer loans and small business, you may need to rely on surrogates such as first names to determine sex or surnames to determine ethnicity.

To complete an underwriting comparative file analysis, you need to identify any marginal transactions. Marginal transactions are those that are not clearly qualified or unqualified. For denials, those are the loans that were close to qualifying for the specific underwriting standard that caused the denial, those that were denied using subjective standards, or those that were denied for a so-called deficiency that could have been easily overcome. Marginal approvals are those that barely qualified or were made as an exception. If possible, sample sizes should be at least as stringent as those identified in Appendix D of the manual.

To complete a pricing comparative file analysis, you should look at a full file review over a specific period of time to see whether there were any variances based on a prohibited basis. In either review, you will look for any similarly situated applicants. A similarly situated applicant is one from the prohibited basis group that appears to have similar credit characteristics to an applicant from the control group. When similarly situated applicants are identified, you will need to explain the reasons for the different outcomes. When all else appears equal, it may be assumed that the differing outcomes were due to the prohibited basis.

Regulation B allows the results of a voluntary self-test to remain privileged and therefore results are not required to be shared with examiners. Certain information such as the methodology, scope, time period, or the loan files themselves are not considered privileged. A risk of sharing a self-test is that any apparent violations identified by your institution are still subject to potential referrals to the DOJ and or HUD.

That said, one benefit to giving examiners access to your self-test is that examiners could rely on your review if it is determined to be appropriate and accurate. Examiners would not need to repeat those steps during the examination and use only the data that you reviewed. It may streamline the exam. In addition, knowing any potential issues in advance allows you to take corrective action and stop the discriminatory behavior prior to the examination rather than waiting to be told. It shows a proactive approach to compliance, which goes a long way come exam time.

Legal counsel may be beneficial when determining the best way to approach providing any findings to examiners during exam time.

Previous Exam and Audit Reports

It is always important to review previous exam and audit reports. You need to confirm that all recommended corrective action has been taken. If it has not been completed, there should be a legitimate explanation for why it is still outstanding. When it comes to a fair lending violation, the institution could be at risk for discriminatory behavior. You would be hard pressed to find an excuse for why that would be allowed to continue.

Any potential fair lending issues should have an escalation process to ensure it reaches the top, including the Board of Directors. The issue should be dealt with immediately, and the severity of the allegations should be understood. Legal assistance may be necessary to determine what, if any, corrective action is necessary.

Previous examination findings indicate a weakness in the overall fair lending program. It is important to document how those weaknesses have been corrected including any policies and procedures that were altered and/or any training that occurred. As with everything compliance, documentation is key.

Training

Training is essential to a fair lending program. All areas of the bank that are involved in the lending process – from the people that greet the applicants at the door to the loan servicing department and up to the Board of Directors – should be trained.

Training should be specific to the job. It should include items such as what constitutes discouraging applicants, the basics such as that anyone that enters the financial institution should be treated equally, credit decisions should be based on written lending standards and criteria that is not subjective, advertising should be inclusive, use inclusionary photos, and ensure no prohibited basis are used in prescreened criteria, the fair lending implications for the CRA assessment area, and so on.

Training should be tracked and well documented. It should include both computer based training as well as face to face training. Training should be based on current policies and procedures. Key lending personnel should have an opportunity to ask questions or bring up any concerns.

Complaint Management Program

The CFPB has put a renewed focus and energy on the importance of complaints. As a result, it is imperative your institution has a clearly defined complaint management program that discusses what constitutes a complaint, and how a complaint is tracked, treated, and escalated. Complaints should be analyzed to determine if there are any patterns and practices that are indicative of a more serious situation.

Complaints that have underlying fair lending or unfair, deceptive, or abusive acts or practices should be escalated appropriately. These types of complaints may raise legal issues beyond the regulatory compliance violations. You want to ensure that appropriate action has been taken long before the exam occurs. Your complaint management program should address how these are handled.

Fair lending complaints should be monitored for similarities and patterns. A root cause analysis should be completed to determine whether an operational or organizational changes are necessary, additional training is needed, or if disclosures are unclear. The root cause analysis should result in an action plan. Similar to the corrective action spreadsheet, this action plan should be detailed and completed, or documented as to why not completed, prior to the exam.

Regulatory Changes

Although there have been minimal changes to Regulation B and the FHA to date, changes are in the works. It is important to stay on top of any potential changes as they occur. The changes proposed by Dodd-Frank to HMDA Reporting and CRA Small Business Reporting will have a significant impact on fair lending once they are implemented. Your program needs to stay current and as regulatory changes are implemented, it is essential for your program to be updated.

There is currently a Federal Interagency Task Force on Fair Lending that includes the CFPB, FTC, DOJ, HUD, FDIC, NRB, NCUA, OCC, and the FHFA. The purpose of the task force is to discuss fair lending enforcement efforts, supervisory processes, and to ensure consistency in fair lending policies. There is also an Interagency Working Group on Fair Lending Enforcement that meets to discuss trends, developments, and the coordination of enforcement efforts. Examiners are taking a unified approach to fair lending, which illustrates just how important it is for your institution to stay on top of the output of these task forces. Fair lending is a major issue as it should be. Your program should be growing and evolving at the same pace as the enforcement efforts are doing.

Additional Efforts to Help You Prepare

Another key item is to make sure your lenders are prepared. It is essential to thoroughly understanding fair lending. They should follow the same process for each and every applicant. They need to rid themselves of preconceived prejudices and notions. Everyone deserves to be treated equally.

Examiners may want to interview loan officers, underwriters, and other key personnel to determine if they have an in-depth knowledge of fair lending as well as ensure consistency in their answers on how the loan process works and credit decisions are made. Appendix J offers an extensive interview guide that can be utilized to help prepare for the exam. It is a good idea to ask your loan officers, underwriters, and anyone you deem necessary to make certain there is consistency to their answers.

It is not a bad idea to conduct these interviews long before the exam, such as during the risk assessment process, as any discrepancies in answers may indicate potential fair lending risk and may require additional training or even a change to policy.

Also important is comprehensive documentation of your fair lending efforts. Documentation must be clear and understandable. Be sure you are providing everything that is being requested. Be prepared with any back-up documentation not requested in the letter, but may be requested at a later date. Better to be over prepared than not prepared during an exam. If any fair lending complaints have been received, make sure any action taken is well documented. A self-test may be privileged, but a complaint received is not.

Conclusion

As with any compliance exam, a proactive fair lending program is the best way to prepare for a fair lending examination. A thorough read of the Interagency Examination Procedures will provide great insight to the exam process and allow you to know what to expect when examiners are onsite. Fair lending is constantly evolving and growing, your program should be no different.