

Fair Lending – What are the Basics?

What You Need to Know, Now



The sharks are swimming.

U.S. Assistant Attorney General for the Department of Justice (DOJ) civil rights division, Thomas Perez (along with other federal officials) has been all too clear that a crackdown on Fair Lending is coming. They have repeatedly talked about a focus on new areas of lending and warned of enforcing new penalties, including wide-ranging community restitution on institutions that fail to comply with fair lending statutes.

To further complicate the situation, the Department of Justice has created a new fair lending enforcement unit. This unit within the DOJ's civil rights division is staffed with three economists, dozens of attorneys and an executive-level counsel for fair lending in the assistant attorney general's office. It is sure to keep this issue on the front burner.

So we have expanded enforcement and increased public scrutiny. Now instead of just our State and Federal Banking Regulators & the Department of Justice, we are seeing others tasked with the fair lending offensive including U.S. Attorneys, State Attorneys General, Federal Trade Commission, HUD, City Government as well as an increase in civil litigation. And, we now have the forthcoming Consumer Financial Protection Bureau. This Bureau will be following the new articulated policies in cooperative efforts with the DOJ. This Bureau is expected to generate hundreds of regulations. So now we have to deal with the complexity of the regulations, multiple enforcement agencies and multi-layered regulations all going forward at the speed of light so it will be inconceivable to have everyone on the same page at the same time.

In the past, while you may have felt it was optional (although it really wasn't) to monitor your institution's fair lending program, process, and performance ... it for darn sure isn't any more. Examiners today expect you to know your fair lending program and have robust monitoring and oversight processes and procedures in place, as well as annual self-assessments. And while you may not find that requirement in the regulations, this expectation carries significant weight. Some bankers have even claimed that increased regulatory burden, specifically "Fair Lending" may be the straw that breaks the camel's back.

What are the Primary Statutes and Implementing Regulations?

Equal Credit Opportunity Act – (Regulation B)

The Equal Credit Opportunity Act, which is implemented by the Federal Reserve's Regulation B (12 CFR 202), prohibits discrimination in any aspect of a credit transaction. It applies to any extension of credit, including residential real estate lending and extensions of credit to small businesses, corporations, partnerships, and trusts.

Fair Housing Act

The Fair Housing Act, which is implemented by HUD regulations, prohibits discrimination in all aspects of residential real estate-related transactions.



What are the factors that you are not allowed to discriminate upon in any aspect of a credit transaction for purposes of Equal Credit Opportunity Act (ECOA) Regulation B and Fair Housing Act?

The prohibited bases for ECOA and FHA are as follows:

Segment	ECOA	FHA
Race	X	X
Color	X	X
Religion	X	X
National Origin	X	X
Sex / Gender	X	X
Familial / Marital Status	X	X
Age	X	
Income Source	X	
Handicap		X

In addition, with respect to residential real estate-related lending, under both laws, a lender may not, on the basis of a prohibited factor,

- Fail to provide information or services relating to, or provide different information or services relating to, any aspect of the lending process, including credit availability, application procedures, and lending standards
- Discourage or selectively encourage applicants with respect to inquiries about or applications for credit
- Refuse to extend credit, or use different standards in determining whether to extend credit
- Vary the terms of credit offered, including the amount, interest rate, duration, and type of loan
- Use different standards to evaluate collateral
- Treat a borrower differently in servicing a loan or invoking default remedies
- Use different standards for pooling or packaging a loan in the secondary market



What are the Basic Terms?

In general, fair lending isn't about treating someone badly; it is about treating someone better! So let's start with the basics! In the world of fair lending, there are many phrases or concepts to grasp. The first terms you might hear are: Disparate Impact, Disparate Treatment, Overt Discrimination, and Comparative. What do these phrases mean?

Disparate Impact: When a policy or practice negatively impacts individuals on a prohibited basis, even when consistently applied (by excluding applicants or burdening applicants). Examples: Having minimum loan amounts, excluding certain types of properties from accessing credit (row houses), NOT grossing up non-taxable income, developing non-traditional products, etc.

Disparate Treatment: Discrimination that occurs when applicants are treated differently based on a prohibited factor. Examples: Limiting the term for borrowers over 65, marketing ONLY to "selected" areas, special credit card programs for Hispanic borrowers that result in higher rates, NOT lending in high minority areas, or having different appraisal practices like using in-house appraisers for some neighborhoods versus hiring outside appraisers for "blighted" areas.

Overt Discrimination: Evidence identified by references to the applicant and prohibited factors (open discrimination of a prohibited basis or when a lender expresses, but does not act on a discriminatory reference). Examples: Appraisal comments related to the "type" of neighborhood, credit counseling letters ONLY in certain files, credit report fees higher for non-spousal applicants, higher interest rates for non-spousal applicants where credit was not a factor, etc.

Comparative: Similarly situated applicants receive different treatment that cannot be explained by non-discriminatory factors (statistical analysis or file review, "disallowed" compensating factors, matched pairs identified – but not eliminated or explained). Examples: Higher denial/withdrawal rates, greater frequency of high cost loans, or the distribution of products.

What are the Areas of Fair Lending Risk?

So what's next? You need to identify areas of risk. What are the specific areas of fair lending risk in your organization? What are the other key terms you need to master? Because you must monitor your institution's fair lending risk...how do you get started? That is what we will discuss in these next few pages. To start, where are the major areas of risk within your organization?

1. **People** – This includes Lenders, Employees, Customers, Marketing, Servicing, Collections, Senior Management, and your Board of Directors. This also includes Board and Management Support, as well as the institution's organizational structure, and experience and knowledge of all individuals with fair lending responsibility. Are all customers provided the same levels of assistance?



2. **Policies/Procedures/Processes Practices** – This includes both articulated and written policies, procedures, practices and guidelines, etc. All policies should be clear, complete, quantifiable, understood, and most importantly, enforced.
3. **Discretion** – Do you allow broad discretion in pricing and /or underwriting the loans?
4. **Products / Services Offered** – Are there any that are unfair and/or deceptive? Are they too complex?
5. **Training** – Are all employees trained to understand how fair lending impacts their job?
6. **Lack of Oversight Monitoring** – Is the compliance management program strong? Are exceptions monitored frequently? Are there sufficient controls in place to detect any problems? If problems are detected, are corrective actions taken?
7. **Marketing** – Do marketing efforts reach the institution's entire area without respect for prohibited bases, or do they exclude low- or moderate-income or high minority populated areas?
8. **Servicing** – Is the institution consistent in its servicing, collections, loan modification and foreclosure areas? Is the service level consistent for all customers?

What are Areas of Fair Lending Risk?

What forms does risk take? You must master these definitions as well.

Inherent Risk: Risk associated with applicable regulations and the institution's policies, procedures and practices. This includes credit policy vs. actual practice, pricing and underwriting disparities, gaps in lending, diversity in lines of business, and customer complaints.

Control Risk: Risk that internal controls will NOT identify, prevent, detect, measure nor correct.

People = Lender & Customer

Policies = What you say you do

Practices = What you actually do

Residual Risk: Risk which is likely to remain after implementing effective fair lending controls and monitoring. These elements are usually associated with simply being in this business but include: Higher cost loans (HMDA), economic impact, competitive influence, consumer credit needs, and individual perception.

More specifically, take these three fair lending risk concepts and apply them to the following areas, where the examiners will look specifically.



1. **“Board of Directors Approved” fair lending policy.** A Board of Directors should write and approve a strong fair lending policy. It should then in turn be communicated to each and every employee.
2. **Management Support for Fair Lending.** Every member of senior management must carry the burden of insisting that this policy is carried out by every line of business, every employee, and the compliance team as well.
3. **Compliance Staff Expertise.** The Board and senior management must invest in qualified and experienced compliance staff who understand the regulations, and also understand how to mitigate risk from any and all regulations.
4. **Training of staff, Management, and the Board of Directors on Fair Lending** and other regulations. The regulators expect that you annually provide adequate training on fair lending to all personnel. You should also review how you are introducing newly hired employees to fair lending.
5. **Organizational Structure.** The more complex your institution, the greater the risk. If you have a mortgage subsidiary or third party relationships (think auto lending) then you have an additional burden in both assessing risk and measuring performance. Your organizational structure also speaks to how accessible it is to get credit from your institution. In addition, do you have centralized underwriting? Not doing so enhances your risk.
6. **Clearly written lending policies and procedures.** Are these in writing? Based upon recent fair lending cases, do your policies have an “overt” fair lending risk? Where does lending authority reside? Review your compensation/incentive programs to examine if “how you pay” influences improper lending behavior. Ensure that you don't have interest rates or fees that far exceed the true risk and cost of making the loan. Have you reviewed your disclosures to ensure they include the true costs and risks of loan transactions? Have you reviewed your policies / practices to ensure none are fraudulent, unfair, deceptive, abusive, coercive, or otherwise illegal? Have you made sure that your loan terms and structures don't make it difficult or impossible for borrowers to reduce their indebtedness?
7. **Discretion in Underwriting / Pricing?** Do any of your officers have the discretion to over-ride a credit decision? Any discretion increases your risk, but well articulated and narrowly employed discretion may be appropriate.
8. **Levels of Assistance.** Do you offer assistance to applicants? Are the levels of assistance consistently offered and provided?
9. **HMDA Lending Performance.** Upon review of your actual mortgage applications, will there be any evidence of discrimination based upon underwriting, pricing, redlining, steering, or servicing? Have you performed a comparative file review/ matched pairs self test?



10. **Consumer Lending Performance.** Upon review of your consumer loans and third party relationships, is there any evidence of discrimination based upon underwriting, pricing, redlining, steering, or servicing?
11. **Commercial Lending Performance.** Upon review of your actual commercial lending, is there evidence of discrimination based upon underwriting, pricing, redlining, steering, or servicing?
12. **Marketing. Are all marketing materials reviewed by compliance?** Are you excluding geographic areas or offering some products to one group and not to others? Think about the implications of pre-screened solicitations, advertising materials, or product offerings.
13. **Social Media.** Are you involved in any aspects of social media? Have you considered the fair lending implications?
14. **Website.** Have you reviewed your institution's website recently for potential fair lending issues?
15. **Data Integrity.** Do you have your data in an electronic format for both filing (HMDA LAR & CRA LR) and for analysis? Does this information match the information in the loan/application files? This is absolutely a must! Do you review your data on an ongoing basis?
16. **Customer/Account Management.** This area speaks to customer service, collections, complaints, loss mitigation and servicing.
17. **Systemic Controls.** Do you have system level controls before, during and after the application and loan process to account for evidence of fair lending issues?
18. **Loan Servicing, and Loss Mitigation activities, including HELOC.**

While this isn't exactly a short list, it does provide you with an overview of what the regulators will want to know. Actually, they will want to know if you know...



What You Need to Know

Over the course of a few thousand words we have covered a great deal. Hopefully you have gleaned a few new thoughts about what is required of your organization regarding fair lending. Ultimately, you should have received the message that fair lending isn't what it used to be. Can you use this information to sell your management in helping you meet this compliance challenge and regulatory burden that is a real and present danger? That would be wonderful.

What have we not discussed? A great deal, unfortunately. As the goal of this white paper was to discuss the new realities of fair lending and introduce you to the basics, many subtle but important exam preparedness recommendations had to be left out. Please find and read the companion white paper "Fair Lending - Self Assessment Basics." It covers relevant and timely information that will help you perform your own fair lending self assessment.

Fair lending seems like one of those Russian nesting dolls. Open the lid on one doll and another is underneath. It sometimes seems as if there is no end. Hopefully you won't find the DOJ in the spot where you would normally find the littlest doll.

Can you manage this fair lending burden? Of course you can. Will your management get behind the effort? A simple exploration of what the examiners expect should make the answer to that, "They have little choice." As a compliance officer, it is incumbent on you to educate them on your organization's fair lending risk and their obligations. It is also your obligation to begin performing fair lending file reviews and self assessments.

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