

Fair Lending Monitoring & Self Assessment Basics

What you Need to Know, Now



For many, the hang-up in fair lending is in the getting their hands dirty performing their own fair lending [comparative file review](#) and [performance self assessment](#). It can be mind numbing just thinking about getting started... Hopefully the next few paragraphs will de-mystify some of the fear or hesitation you may have.

Much of the fair lending exam scrutiny has been in mortgage lending, as there is a great deal more data known about each applicant in this lending channel than in either consumer or commercial lending. Data elements like race, ethnicity, gender, etc., are required HMDA fields. Having this data offers both a great advantage to you for self-assessment purposes, but also for the examiners, as well. Self assessments should ultimately include all lines of business including mortgage, consumer and commercial when deemed appropriate and review how you have treated prohibited basis groups. While you can't collect race, gender, and ethnicity information for non-mortgage loans (at least not yet) you can utilize proxy data, such as the use of surname (for ethnicity), a gender-izer, or census tract characteristics - to help determine your performance.

Where do you begin in establishing your own fair lending monitoring program and self assessment? What can you do to "streamline" your fair lending examination? To answer that, we must first identify "what do the examiners expect it to include?" It is our hope that you gain a working knowledge of the basic elements of fair lending monitoring and self assessments from reading the following white paper. You can add greatly to your knowledge by attending conferences hosted by the regulators, vendors and national trade associations. It will also help you to simply, get started. Experience may be the best teacher

Fair Lending Exam Guidelines

A [fair lending exam](#) typically covers transactions that have been concluded within the past twelve to thirty-six months. Essentially, the purpose of the examination is to determine if your Bank is in compliance with the requirements of Regulation B, ECOA and the Fair Housing Act. In other words, are you lending fairly?

To start, you will want to identify areas of risk within your institution. This includes taking into consideration the size, complexity and scope of your institution's lending, the credit products you offer, recent changes to your institution's lending patterns or products, credit decision-making standards / processes, the channels by which a prospective applicant finds your institution, as well as any relevant demographic information about your community. This risk identification process will help you narrow the focus of your self-assessment. The examiners call this step, "establishing the focal points for the examination." By narrowing the focal points of your self-assessment, the hope is that you will eliminate low risk factors from your review. Your fair lending review must focus on the areas of your program where your risk is the highest. If you have identified your high risk areas and performed a self-assessment, then the examiners may reward you with a streamlined fair lending exam. This should be the goal for your institution.



As it relates to your lending performance, the examiners will specifically want you to explore the lending areas where you produce the most volume of activity. If you are a commercial bank, expect them to focus on your commercial lending performance. In the same manner, if your lending volume is greater in mortgage or consumer lending, expect additional scrutiny there.

Understanding the risk factors.

What are the Risk Indicators? What are the questions you need to answer?

The Fair Lending Interagency examination guidelines indicate many risk areas. This paper is intended to only cover the broader categories of compliance management, underwriting, pricing, and redlining. Marketing, loan servicing and loss mitigation efforts are not included in this white paper, but will likely be addressed in subsequent papers.

Compliance Program Management Indicators

The examiners will expect that your institution has a thorough understanding of its Credit Operations. This means that they want you to provide written documents that outline your credit and decision making processes, as well as with whom the decision making responsibility resides for each transaction. This means that you must know and share exactly what your institution's loan policies / guidelines / procedures / and standards are, and provide the documentation to prove it. It goes without saying that the presence of controls that limit and monitor discretion in pricing (or setting of credit terms and conditions) will go a long way in making the examiners more comfortable. This includes having guidance for pricing or risk-based pricing models, as well as guidance for how your team exercises discretion over loan terms and conditions.

So what are the other areas you should understand? You will want to know if you have any affiliates / subsidiaries or third parties, such as brokers or contractors that are involved in the credit process. Why? Because their involvement may indicate a potential "steering" concern. You will also want to be able to thoroughly explain your loan officer's compensation / incentive program, as well as their understanding of your institution's credit processes.

Do you offer special purpose credit products? This is another area that should be considered in your review. You should also review your defined assessment area / markets and their corresponding demographics. As in any review, it is always recommended that your institution have a centralized method for the collection of customer complaints.

Other Compliance Management questions you should ask yourself include:

Do you have a clearly written policy that addresses each of the items above? How often do you review them? It is of vital importance that you can decisively confirm that not only do policies exist but that they have been communicated through the Board of Directors all the way through your organization.



The following discussion of Underwriting, Pricing, Steering and Redlining all speak to your actual “fair lending” performance. To truly self-assess your activity, you will have to get your hands dirty in both analysis and in the loan files themselves.

Generally, when reviewing your [Fair Lending Performance](#), please explore the following

- Substantial disparities among the approval / denial rates for applicants reviewed.
- Substantial disparities among the application processing times for applicants (especially within denial reason groups)
- Substantially higher proportion of withdrawn/incomplete applications
- Vague or unduly subjective underwriting criteria
- Lack of clear guidance on making exceptions or underwriting criteria or overrides of credit score cutoffs.
- Loan officer or broker compensation based on loan volume (especially loans approved per period of time).
- Consumer complaints alleging discrimination in loan processing or in approving / denying loans.

Underwriting Indicators

The examiners expect that you will examine your underwriting performance by doing a [comparative file review](#) (matched pairs) as applicable. Generally this analysis looks to find denied applicants, whose credit status is comparable to other applicants for whom you approved a loan (where the credit status is similar.) Obviously, you cannot (nor can the regulators) look at every file. They are looking (as should you) only for “comparable” files.

In performing your own underwriting [performance self-assessment](#), you should select transactions from marginal applications whose credit criteria were within a credit tolerance or range, that placed them in a “why did we approve or deny credit to these folks, in comparison to similarly situated borrowers?” This list of applicants & loans is created by doing a comparative file review. This means that you should compare prohibited basis group applicants to the corresponding qualifications of control group approvals. Sound like gobbledygook? It may now, but hopefully you will grasp these basic terms and exam processes so that you can do exactly what the examiners will do when they look at your activity.



Let's re-state the comparative file review elements into a simpler to understand manner. The comparative file review enables you to see only those instances where applicants with similar credit may have been treated differently (one got a loan, the other didn't). Make sense? Let's explore an example...your underwriting performance on owner occupied, 30 year, fixed rate, conventional first lien, owner occupied, home purchase mortgage loans. Remember, the goal of a comparative file review is to find denied applicants, whose credit status is comparable to other applicants for whom you approved a loan (where the credit status is similar.) Did you treat some applicants better? In our example, imagine we found an approved application for someone borrowing \$200,000, with a credit score of 670, yet you denied another, whose credit score was 680...why? These are potentially comparable files. By looking at the rest of the credit/underwriting information in these two comparable files, you will likely be able to explain why one was approved, and the other not approved. In the end, the examiners want to know if there are any comparable files that can't be explained by "credit."

To narrow the number of files to review, you can eliminate many files by setting a series of tolerances on the credit criteria programmatically (this is why fair lending software is so valuable!) As an example (keep in mind this is a basic example), let's review all loan applications with the same mortgage product, where the credit score is within 25 points (north or south), Debt to Income ratio (DTI) is within 10% (north or south), the Loan to Value (LTV) is 20% (north or south), and the application date (or rate lock) of the applicant is no more than 15 days (north or south). By setting these tolerances against the files in question, we can narrow the number of relevant comparable files.

Now what do you do? You look at each applicant that was not approved, and find the credit reason(s) that was the basis for the denial, or find the unique reason for the approval (e.g. established business relationship). What if you can't find one? Unless someone dropped the ball, you will find the reason. How does someone drop the ball? Typically, problems occur when the credit decision is overridden by someone outside the bounds of your stated underwriting policy, with no evident documentation. This is why it is smart to eliminate any such actions or at least monitor all underwriting over-rides in real time or in a second review process.

Pricing Indicators

Examining your institution's "Pricing Performance" is also important in a fair lending self-assessment. How do you price your products? Is your pricing policy employed evenly? Might your loan officer compensation program impact the fees and pricing offered to your borrowers? Might your pricing policy itself discriminate, as has been the case in a few recent DOJ cases? Each of these "pricing" considerations must be examined.

Most "pricing" self assessments focus exclusively on actual lending performance. When performing a pricing self-assessment, you will want to review your actual lending performance related to how you price (interest rates, fees, or points). To explore these borrowers, build the same kinds of tolerances like you did for underwriting above, but



only borrowers (not applicants), and add pricing data, like interest rate, points, and fees. Establish narrow tolerances (such as .51% (north or south) for each rate, and \$250 (north and south) for fees, and review the files. Then, simply examine the files that fall through the filter. Clearly you want to have very few of these show up. Your pricing should be evenly administered. Discretion in pricing can wreak havoc on a fair lending pricing performance self-assessment and in an exam.

Additionally, don't forget to review loan programs that contain only borrowers from a prohibited basis group, or products that reflect significant differences in the percentages of prohibited basis groups.

So to recap, you want to see if you have broad discretion in loan pricing and how you monitor any deviations. Hopefully you don't have broad discretion. Regardless, you want to evaluate whether your use of risk based pricing is based upon objective criteria that is consistently applied. Remember, you want to identify substantial disparities among prohibited basis versus control groups. In mortgage pricing, look for disparities in the incidence of rate spreads by prohibited basis characteristics as reported on your institution's HMDA Loan Application Register. Also examine the incentives you pay to your loan officers, third parties, or brokers...and if this results in higher prices (including interest rate, fees, and points) to borrowers.

Steering Risk Indicators

You should review whether or not your sales team is steering certain prospective borrowers into specific products. Look to ensure that your standards are clear, objective, and consistently applied throughout all lending channels within the Bank. Ensure that your documentation supports you. Make sure you don't have financial incentives for your loan officers or brokers to place applicants in nontraditional products or higher cost products. If you offer different products based on credit risk levels, make sure you understand the differences in the percentages by prohibited basis groups. Try to determine if there are significant differences in the percentage of prohibited basis group applicants in loan products with specific features such as nontraditional mortgages, those products with prepayment penalties, lack of escrow requirements, etc.

For institutions with one or more lending channels that originate the same loan product, make sure there aren't significant differences in the percentage of prohibited basis group applicants by channel. Also, look for significant differences in the proportion of loans made predominantly in particular racial or national origin geographic areas between a prime lender and its subprime subsidiary. Finally, if you have both prime and subprime operations, please make sure you evaluate the differences between both units.

Redlining Indicators

One area that has been evaluated from a Fair Lending perspective is redlining. Quite frankly, what is old is new again. This area has seen increased scrutiny. Institutions should map where their branches and/or loan production offices are in comparison to their lending patterns.



Institutions should also look for significant differences in HMDA data; in the number of applications received, withdrawn, approved not accepted or closed for incompleteness -- in those areas that have a relatively high concentration of residents of a particular racial or national origin group as compared to areas with relatively low concentrations of residents of such racial or national origin group. You should look for significant differences between approval and denial rates within the same areas, differences between denial rates based upon insufficient collateral, and differences in the number of originations of higher priced loans or loans with potentially negative consequences for borrowers in these same areas.

Reviews should consider any lending patterns identified during the most recent CRA examination that differ by the concentration of residents of a particular racial or national origin group; or perhaps the lack of lending by credit products within these same areas. Quite candidly, you should evaluate your institution's assessment areas annually to determine if it has been drawn to exclude areas with relatively high concentrations of residents of a particular racial or national origin group. Through loan officer interviews, you should identify if any employees exhibit an aversion to doing business in a particular area. Finally, look for policies on the receipt and processing of applications, pricing, conditions, or appraisals and valuation or on any other aspect of providing residential credit that vary between areas.

Self Assessment Analyses

Now that you have conducted your matched pair file review, what types of global performance analyses should you conduct? We discussed the risk indicators above so you are familiar with the basic areas of examiner concern. Now let's recap the specific analyses that should be conducted.

Analyses should include, but is not limited to:

- Demographic review of your assessment area(s)
- Lending / Volume distribution analysis by designated line of business
- Application Disposition by action taken
- Level of Assistance review
- Decision Disparity analysis
- Pricing Analysis
- Redlining and Reverse Redlining Analysis
- Steering Analysis
- Loan Officer Compensation

In the end, the performance part of your self-assessment is only that, a part of your overall fair [lending self-assessment](#). In consideration of the whole, your self-assessment should have clear objectives. The following chart highlights this in general terms.



<u>Goal</u>	<u>Method/Action</u>
Identify	Performance/ Process Analysis - Quantify
Prevent / Control	Clear Policies & Exception Limits
Detect /Monitor	Exception Monitoring & Audits
Measure	Self-Assessment
Correct	Communication & Corrective Action

Important Fair Lending “Self-Assessment” Tips

Based upon many such engagements, we have found a number of common sense ways to help you make quick work in establishing your fair lending monitoring program. Keep in mind these are simply a few examples.

- Do ongoing data integrity review and create exception monitoring programs
- Do monitor the distribution of higher priced loans
- Do review loan files
- Do implement a second review of pricing decisions
- Do monitor credit decisions
- Do develop a second tier/review of denials
- Don't implement “no high rates” policy for minorities
- Don't raise fees to offset lowering rates.
- Do periodic Self Assessments / Performance / Process reviews

When doing a self-assessment, it has also been recommended by seasoned litigation counsel (with an up close view of ongoing fair lending litigation) to look at evidence of discretion, denial disparities, details/dust of secondary review policy, UDAP fairness issues, and data integrity.

Gotcha?

So, is there anything not yet covered? It seems like everything is up for grabs in one big “gotcha.” Fair lending is fast becoming one giant umbrella that opens the door to examining everything you do in very uncomfortable ways. Yet the best approach to managing the risk for your bank is to perform a self-assessment.

Look closely at what you say you do (policies, procedures, pricing, training, etc) and *confirm your actual practice* by looking at your comparable loan applications and borrower data. Doing this yourself (or having an expert do it for you) will go a long way in satisfying the appetite of the examiners. They now expect it of you, after all.

Don't be afraid to establish your own fair lending self-assessment. You can do this.

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