Federal Reserve Bank of Dallas

Fair Lending Examination Procedures Summary and Risk Factors Table

This publication is intended as a summary of the Fair Lending Examination Procedures. Also included is a quick reference table of the residential lending discrimination risk factors. It is designed for bank CEOs, presidents, compliance and CRA officers, and others who have an interest in the fair lending examination procedures. The full text of the examination procedures is available on the Internet at www.ffiec.gov/press.htm, January 5, 1999.

The Interagency Fair Lending Examination Procedures were released by the Federal Financial Institutions Examination Council (FFIEC) in January 1999. The document establishes the procedures examiners use when examining financial institutions for compliance with the Equal Credit Opportunity Act and Fair Housing Act. The procedures provide a flexible framework on which to build an examination tailored to a lending institution's circumstances. They take into consideration each institution's compliance management program, loan product mix, market demographics and past performance, as well as the nature and quality of data available from or about the institution.

Although the new procedures are designed to improve the examination's depth and breadth, most aspects are the same. The prohibited bases under the Equal Credit Opportunity and Fair Housing Acts remain unchanged (Table 1).

The procedures emphasize testing for illegal discrimination on the basis of race or national origin in real estate loan transactions, because monitoring information on certain real estate loans and Home Mortgage Disclosure Act (HMDA) data are available for review. However, using proxies or surrogates (name, location, etc.), the same examination techniques can be applied to all credit products and target groups.

Table 1

Prohibited Bases under Equal Credit Opportunity Act (ECOA) and Fair Housing Act (FHA)

ECOA	FHA
Race or color	Race or color
Religion	Religion
National origin	National origin
Sex	Sex
Marital status	Familial status
Age	Handicap
Receipt of public assistance income	
Exercising, in good faith, any right under the Consumer Credit Protection Act	

The Examination Process

The first step in the new procedures requires the examiner to become familiar with the bank's lending activities. This process, typically referred to as "scoping," can be performed off-site or on-site. For small noncomplex banks, it will be done primarily on-site during the actual compliance examination.

The examiner must understand the types of credit the institution offers, its decisionmaking processes, financial condition, document preparation, management information systems, compliance management program and market demographics. This information is used for two purposes. First, it helps the examiner choose loan products for additional review. Second, it helps determine the examination's intensity.

In essence, the "intensity" of the examination refers to the number of loans, if any, that will be reviewed. Generally, the stronger the bank's compliance management program, the smaller the sample size of loans to be tested. If the compliance management program incorporates self-evaluations, the examiner may use some or all of the institution's findings in place of a separate fair lending review. In self-evaluations, an institution would conduct audits, including comparative file reviews. These reviews should enable management to identify and correct any fair lending problems.

As the scoping process continues, credit products are selected for a more in-depth review. Although there is an expectation that real estate loans will be reviewed, they may not be selected for comparative file review at each examination. Factors that could contribute to a product being selected for file review are the transaction volume, both by dollar amount and number; availability of data; guidance provided by the loan policy; products selected at the previous examination; and consumer complaints. For example, two institutions may offer credit cards. At institution A, credit cards make up 2 percent of the loan portfolio; at institution B, they make up 20 percent. Credit cards are more likely to be selected for further review at institution B.

To complete the scoping process, the examiner looks for risk factors in the institution's compliance program, written and stated policies, underwriting, pricing and marketing. The examiner also reviews the institution's activities for evidence of potential disparate treatment in steering customers or by redlining geographies. The potential risk factors are detailed in Table 2.

If sufficient risk factors are identified, a product may be selected for further testing, usually conducted on-site. If adequate data are available, the products will be narrowly defined to determine which decision center, market or branch will be targeted for the on-site examination.

The examination procedures give examiners specific instruction on how to conduct an analysis of the products — or focal points — selected for on-site review. The type of testing performed on each focal point is determined by the risk factors identified. For example, the principal analytical technique used in investigating loan underwriting decisions is a "benchmark/overlap" comparison. This technique requires the examiner to first determine which denied minority applicant had the least deficient credit record for a given denial reason (the benchmark). The examiner then compares the applicant's record against nonminority applicants whose credit records were more deficient, relative to the same denial reason, and yet were approved for a loan. Variations of this technique are used in examining for potential disparate treatment in pricing, commercial loans, credit-scored products and for redlining and steering analysis.

Example

To demonstrate the process of selecting focal points and determining the type of analysis to perform, let us look at a hypothetical bank, Alpha Bank, which is located in a 40 percent Hispanic community. During the scoping process, the examiner notes that for used-car loans, the loan officer receives the surplus interest earned when the loan is priced above the base rate. There are no caps on what the consumer may be charged, other than the state's usury limit. In addition, a consumer complained that the lending standards for home improvement loans at the Midway Branch are stricter than at other branches. At the same time, HMDA data indicate a significantly higher denial rate for female loan applicants at the Midway Branch than at the bank as a whole. No risk factors are noted on other products. The examiner will perform a pricing analysis on used-car loans to ensure that the broad discretion in pricing has not resulted in unexplained discrepancies among similarly situated borrowers. Also, the examiner will conduct an underwriting analysis on home improvement loans made at the Midway Branch to determine if some applicants are being held to a different underwriting standard.

Concluding the Examination

If, after review of the loan files and discussions with the loan officers, the examiner believes some instances may reflect illegal discrimination, the bank will be asked to discuss the apparent differences in treatment. This is designed to bring in information that has not been considered that might show a nondiscriminatory explanation for the apparent disparate treatment. Examiners are charged with providing full information to the lender about what differences appear to exist in the treatment of similar applicants and how the examiners reached their initial conclusions. The appendix to the examination procedures gives examiners guidance in evaluating management's response to evidence of possible disparate treatment. (The full text of the examination procedures and the appendix are available at www.ffiec.gov/press.htm, January 5, 1999.) The appendix also gives examples of responses a lender may offer — separately or in combination — which, if true, would explain that the appearance of illegal disparate treatment is misleading and indicate that no violation has occurred. Once the institution's response is evaluated, the examiner prepares conclusions regarding the institution's fair lending performance.

New Areas of Analysis

The fair lending examination procedures include two new areas of analysis. The first is a review of the decisionmaking process used when guiding an applicant's choice between loan products — often referred to as steering. Steering is not unlawful per se, and in many instances the availability of a more expensive form of credit may enable an applicant with credit problems to obtain a loan that might otherwise be unavailable. Illegal steering is defined as referring, or steering, applicants to products or affiliates (such as subprime loans or finance companies) that result in less advantageous terms or treatment for a targeted group. Steering raises fair lending issues when it occurs differently and less advantageously for a group of applicants. If steering risk factors are present, the steering analysis is likely to be performed.

The second new area is credit scoring. The analysis will focus on the use of overrides — granting or denying credit outside the parameters of the credit-scoring system. A strong compliance management program would restrict the use of overrides and would include audits to ensure that overrides are being used in accordance with bank policy. From a fair lending perspective, the greater the number of overrides, the less reliable the bank's credit-scoring system.

The Report of Examination

The examination report also has changed to reflect the new risk-focused approach to examinations. Consumer compliance examination reports will now include a fair lending section addressing, as needed, violations of Regulation B and the Fair Housing Act, the bank's compliance management system, internal controls, training, self-evaluations and recommendations. Weaknesses in the fair lending compliance program will be incorporated into the institution's overall consumer compliance rating.

Table 2

Compliance Program and Residential Lending Discrimination Risk Factors for Scoping Analysis

Area of Analysis	Risk Factors
Compliance Program adequacy for determining the intensity of the examination	• Institution's compliance record is weak • Prohibited basis monitoring information is incomplete • Data and/or recordkeeping problems in previous examinations • Fair lending problems previously found • The compliance management program and senior management's involvement are materially inferior to standard programs • Compliance guidance not updated to reflect current law and agency policies
Indicators of **Overt** discrimination	• Explicit prohibited basis identifiers in underwriting and pricing criteria • Collecting information, conducting inquiries or imposing conditions contrary to Regulation B • Use of credit-scoring system variables prohibited by Regulation B and FHA • Statements indicating one or more bank employees have engaged or do engage in discrimination in a credit transaction • Statements that evidence attitudes based on prejudices or stereotyping • Consumer complaints alleging discrimination
Indicators of potential disparate treatment in **Underwriting**	• Substantial disparities among approval/denial rates and processing times for applicants by prohibited basis characteristics • Substantially higher proportion of withdrawn/incomplete applications for prohibited basis characteristics group • Vague or unduly subjective underwriting criteria • Lack of guidance on making exceptions to underwriting criteria, including credit-scoring overrides • Lack of documentation regarding reasons for exceptions to normal underwriting standards, including credit-scoring overrides • Relatively high percentages of exceptions to underwriting criteria or overrides of credit score cutoffs • Loan officer or broker compensation based on loan volume • Consumer complaints alleging discrimination

Table 2 *(continued)*

Compliance Program and Residential Lending Discrimination Risk Factors for Scoping Analysis

Area of Analysis	Risk Factors
Indicators of potential disparate treatment in **Pricing**	• Relationship between loan pricing and compensation of loan officers or brokers • Lenders having broad discretion in pricing or transaction fees • Use of risk-based pricing system that is not empirically based and statistically sound • Substantial disparities among price quoted or charged to applicants differing by prohibited basis characteristics • Consumer complaints alleging discrimination in loan pricing

Indicators of potential disparate treatment in **Steering**	• For institutions with subprime subsidiaries, a significant difference, by loan product, in the percentage of prohibited basis group applicants of the institution compared with the percentage of prohibited basis group applicants of the subsidiary
	• Lack of clear, objective standards for:
	  • referring applicants to subsidiaries or affiliates;
	  • classifying applicants as "prime" or "subprime" borrowers;
	  • deciding what kinds of alternative loan products should be offered or recommended
	• For institutions that make both conventional and FHA mortgages, any significant differences in the percentages of prohibited basis group applicants in these two loan products
	• For institutions that make both prime and subprime loans for the same purpose, any significant differences in percentages of prohibited basis group borrowers in each of the alternative loan product categories
	• Institutions with subprime mortgage subsidiaries or affiliates that integrate loan processing such that steering between the prime and subprime products can occur seamlessly (that is, a single loan processor could simultaneously attempt to qualify any applicant, whether to the bank or the subsidiary, under either the bank's prime criteria or the mortgage company's subprime criteria)
	• Loan officers having broad discretion and no guidelines to promote conventional or FHA loans to applicants
	• A lender has most of its branches in predominantly white neighborhoods, and the subprime subsidiary has branches mostly in predominantly minority neighborhoods
	• Consumer complaints alleging discrimination in loan pricing

Table 2 (continued)

Compliance Program and Residential Lending Discrimination Risk Factors for Scoping Analysis

Area of Analysis	Risk Factors
Indicators of potential discriminatory **Redlining**	• Significant differences — in number of loans, approval/denial rates for all applicants and denial rates based on insufficient collateral — in areas with high concentrations of minority group residents compared with areas with relatively low concentrations of minority residents • Patterns of lending identified during the most recent CRA examination that differ by the concentration of minority residents • Having credit product markets that exclude geographic areas that have relatively high concentrations of minority residents but are within the institution's lending market • Loan-related policies that vary between areas with relatively high concentrations of minority residents and those with relatively low concentrations • Employee statements that reflect an aversion to doing business in areas with relatively high concentrations of minority residents • Most of the lender's branches are in predominantly white neighborhoods, while branches of its subprime subsidiary are primarily in predominantly minority neighborhoods • Complaints or allegations that the lender has specific practices or incidents of restricting credit access in areas with relatively high concentrations of minority residents

Indicators of potential disparate treatment in **Marketing**	• Advertising patterns or practices that indicate prohibited basis customers are less desirable
	• Advertising only in media serving nonminority areas
	• Marketing through brokers or other agents that the lender knows (or has reason to know) would serve only one racial or ethnic group
	• Marketing programs that exclude geographies that have significantly higher percentages of minority group residents than does the remainder of the assessment or marketing area
	• Using marketing techniques for prescreened or other loan product offerings that:
	  • explicitly exclude groups of prospective borrowers on a prohibited basis; or
	  • exclude geographies that have significantly higher percentages of minority group residents
	• Proportion of prohibited basis applicants is significantly lower than that group's representation in the total population of the market area
	• Consumer complaints alleging discrimination in advertising or marketing of loans