Banker Teleconference Series:

Fair Lending Topics

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Introduction

- FDIC has a responsibility to maintain an effective examination program to ensure that all Americans have access to credit, based on individual creditworthiness, without regard to a prohibited basis such as race, gender, or national origin.
- FDIC oversees and enforces the Equal Credit Opportunity Act (ECOA) and the Fair Housing Act (FHA) using uniform interagency examination procedures.
- The underlying goal of the FDIC's fair lending exam program is to ensure compliance with legal requirements – not to impede lending.

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Agenda

- Overview of fair lending examination process
- Criteria interviews and statistical analysis
- Third party providers and fair lending risk
- Best practices
- Questions and answers

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Introduction

Resources

- Interagency Fair Lending Examination Procedures
  http://www.ffiec.gov/PDF/fairlend.pdf
- Department of Justice Fair Lending Program
  http://www.justice.gov/crt/about/hce/fair_lending.php

Questions and answers

- Please email questions to BankerTeleconference@fdic.gov.

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Overview of Fair Lending Examination Process

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Fair Lending Examination Overview

***Background*:**

- **Equal Credit Opportunity Act (ECOA)**

  Prohibits discrimination in any aspect of a credit transaction and covers borrowers who are persons or entities, including small businesses, corporations, partnerships, and trusts.

- **Fair Housing Act (FHA)**

  Prohibits discrimination in all aspects of residential real-estate related transactions.

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Fair Lending Examination Overview

Fair lending laws: ECOA and FHA

- **ECOA prohibits discrimination based on:**
  - Race or color
  - Religion
  - National origin
  - Sex / gender
  - Marital status
  - Age (provided the applicant has the capacity to contract)
  - The applicant's receipt of income derived from any public assistance program
  - The applicant's exercise, in good faith, of any rights under the Consumer Credit Protection Act

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Fair Lending Examination Overview

Fair lending laws: ECOA and FHA

- **FHA prohibits discrimination based on:**
  - Race or color
  - Religion
  - National Origin
  - Sex / gender
  - Familial status (defined as children under the age of 18 living with a parent or legal custodian, pregnant women, and people securing custody of children under 18)
  - Handicap

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Fair Lending Examination Overview

Two phases of the fair lending review

- **Off-site: pre-examination planning phase**
  - Risk scoping
  - Identifying potential focal points

- **On-site: examination**
  - Analyzing the selected focal point(s)
  - Documenting the findings

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Fair Lending Examination Overview

Pre-Examination Planning

- **Purpose**
  - To develop a plan of action that will allow examiners to efficiently plan and conduct their work off-site, as well as lessen the amount of time needed on-site.

- **Pre-examination process**
  - Collect and review information:
    - Prior Reports of Examinations
    - Prior ratings
    - Applications
    - Complaints
    - HMDA Data
    - Conduct preliminary telephone interview with bank management.

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Fair Lending Examination Overview

Risk scoping process

- **Understand the credit operations of the bank**
  - Credit products offered
  - Special purpose credit programs
  - Multiple lending units
  - Use of credit scoring models
  - Third party relationships
  - Lending guidelines
- **Market demographics**
- **Assessment area and market area**
- **Lending policies and procedures**
- **Training**
- **Marketing**

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Fair Lending Examination Overview

Risk Scoping Process

- All loan products are considered. For example:
  - Consumer
  - Commercial
  - Residential

- Data accuracy is crucial.
- Identify potential focal point(s).
- Select focal point(s) that will form the scope of the examination.

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Fair Lending Examination Overview

Common red flags:

- Lack of clear pricing and underwriting guidance
- Discretion in pricing and underwriting with no controls in place
- Absence of fair lending training
- Complaints
- Insufficient documentation regarding lending decisions
- Rate sheets without specific criteria for how they are used

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Fair Lending Examination Overview

Management interview

- Purpose is to learn more about the bank's policies and procedures.
- Re-evaluate focal points and determine next steps.
- Review may close if no fair lending concerns exist.

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Fair Lending Examination Overview

Criteria interview

- Purpose of a criteria interview is to obtain more detailed information about the bank's policies relating to a particular loan product.
- Interview bank personnel with in-depth operational knowledge.
- Interview notes will be provided to bank management for review and verification.

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Fair Lending Examination Overview

File review process:

- Extract data from loan files
- Data may be used for:
    1. Statistical analysis;
    2. Comparative file review; or
    3. Both

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Statistical Analysis

Statistical analysis

- Statistical analysis is bank specific and developed based on information gathered during the examination, criteria interview, and file review.

Statistical Analysis

Regression analysis

- Regression analysis is a statistical technique that allows us to analyze many loans and multiple lending decisions at the same time.
- With regression analysis, we are able to determine the impact of each factor in the lending decision while holding the other factors constant.
- It is the statistical analogue to a comparative file review.

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Statistical Analysis

Building the regression analysis model

- The regression analysis model will include controls for the pricing factors identified during the criteria interview and related documents.
- We can include controls for factors used in an automated process, rate sheet criteria, and other identifiable borrower or loan characteristics.
- The objective is to determine if the prohibited basis is a statistically significant predictor of pricing, after all of the allowable pricing criteria have been accounted for in the regression analysis.

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Statistical Analysis

Help us get it right, quickly

- The bank should make sure that its representatives at the criteria interview includes someone knowledgeable of the pricing related to the loan products being reviewed.

- **The criteria interviews help us get it right:**
  - When the information provided by the bank is comprehensive and accurate
  - When the information provided is supported with documentation in the file

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Fair Lending Examination Overview

Findings and concluding the examination

- **If warranted, conduct comparative file review.**
  - Review loan files to compare similarly situated applicants or borrowers.
  - Determine if there is a disparity on a prohibited basis.

- **Discuss preliminary findings with the loan officer and management:**
  - Obtain an explanation from the appropriate loan officer.
  - Re-analyze the loan based on the information provided by the loan officer.
  - If response is supported, close the review.
  - If disparity remains, issue 15-day letter.

Fair Lending Examination Overview

Findings and concluding the examination

- **Issuance of the 15-day letter** – The FDIC will officially notify the bank of its preliminary conclusions that there is reason to believe that the bank has engaged in a pattern or practice of discrimination.

- **Purpose of 15-day letter** – To provide bank's board and management 15 days from receipt of the letter to submit additional information for the FDIC to consider.

- **Bank response** – Examiner will review and conduct a final analysis depending on the response provided by the bank.

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Fair Lending Examination Overview

Concluding the examination

- ***Violation***
  - **If the FDIC has reason to believe that the bank is in violation of ECOA or the FHA, a violation will be cited in the Compliance Report of Examination and may have an adverse affect on the compliance and CRA ratings.**

- ***Referrals***
  - If the FDIC has reason to believe that there is a pattern or practice of discrimination under ECOA, the FDIC, like the other federal banking agencies, has a statutory responsibility under that Act to refer the matter to DOJ.
  - In many cases, the referrals are returned by DOJ for our consideration of administrative enforcement remedies.
  - In many cases DOJ returns the referral because DOJ believes that the primary regulator is best suited to address the fair lending violations for the institution and the affected consumers.
  - DOJ's return of a matter is not a reflection of the merits of the case.

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Third Party Providers and Fair Lending Risks

Identifying and Mitigating Risks

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Third Party Providers and Fair Lending Risks

Benefits of using third party providers

- **If appropriately managed, third-party relationships can help a bank by:**
  - Reducing costs
  - Enhancing competitiveness
  - Strengthening safety and soundness
  - Strengthening the institution's compliance management system (CMS)

- **Banks are responsible for the activities of third parties with which they engage.**

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Third Party Providers and Fair Lending Risks

FDIC guidance

- **Financial Institution Letter (FIL) 44-2008, *Guidance for Managing Third Party Risk***
  - Available at www.fdic.gov/news/financial/2008/fil08044a.html
  - Identifies potential risks
  - Recommends procedures for risk assessment and mitigation
  - Underscores the fact that a bank is ultimately responsible for banking activities conducted through a third party relationship as if the activity were being conducted by the bank itself.

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Third Party Providers and Fair Lending Risks

Risks associated with third party providers

- **Strategic** – third party does not perform in a way that is consistent with the bank's goals.
- **Reputational** – third party conduct results in dissatisfied customers, security breaches, or violations of law.
- **Operational** – third party conduct involves failed or inadequate processes or systems.
- **Credit** – third party is unable to meet the terms of its contract with the bank.
- **Compliance/Legal** – products or activities of third party violate laws, regulations, policies, or ethical standards.
- **Transactional** – Third party is unable to perform due to inadequate capacity, technological failure, human error, or fraud.

Third Party Providers and Fair Lending Risks

Risk assessment and mitigation

Four elements identified in FIL 44-2008:

1. Risk Assessment
   - Is the proposed relationship consistent with the strategic goals of the bank?
   - Does bank management have the expertise and resources to adequately oversee the third party?
2. Due Diligence
   - Is the third party financially and operationally capable of the functions in question?
   - Is the bank able to review and monitor the third party's performance on an ongoing basis?

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Third Party Providers and Fair Lending Risks

Risk assessment and mitigation

Four elements identified in FIL 44-2008:

3. Contract Structuring and Review
   - Does the contract contain the necessary terms?
   - Has the contract been reviewed by legal counsel and approved by the bank's board of directors?

4. Oversight
   - Does the bank have a monitoring program with appropriate reporting and tracking mechanisms, including periodic review by management and board of directors?

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Third Party Providers and Fair Lending Risks

Third party oversight

- **Bank management should monitor the third party's activity on an ongoing basis.**
  - Is the relationship working as planned?
  - Is the third party financially sound?
  - Does the third party have robust internal controls and security protocols?
  - Does the third party adhere to bank policies and procedures?
  - Does the third party comply with all applicable laws, regulations, regulatory guidance, and statements of policy?

- **Bank management should report to the bank's board on the third party relationship on a regular, periodic basis.**

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Third Party Providers and Fair Lending Risks

Examples: Sources of third party fair lending risks

- Mortgage brokers
- Automobile and motorcycle financing through dealers
- Rent-a-BIN relationships (*e.g.*, credit cards)

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Third Party Providers and Fair Lending Risks

Conclusion

- Third party relationships may be beneficial to a bank.
- Banks should assess risks and take appropriate measures to mitigate risks, including adoption of policies and practices that ensure adequate oversight of the third party's conduct.
- Banks may outsource tasks, but they cannot outsource responsibilities.
- Banks that use third parties remain ultimately responsible for the conduct of those parties.

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Best Practices

Commitment from Board and senior management

1. To maintain an effective fair lending compliance management system at their institution; and
2. To allocate the appropriate amount of resources to ensure that the compliance function can mitigate fair lending risks.

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Best Practices

Proper documentation

- Institutions benefit from a clear set of policies and procedures that require thorough documentation of all their activities.

Consistent policies and procedures

- Financial institutions should develop, implement, and distribute clear, formal policies and procedures for the pre-application and application processes.

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Best Practices

Fair lending risk assessments

- Risk assessments allow an institution to develop an effective fair lending compliance management program to mitigate fair lending risks.

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Best Practices

Self Tests and Self Evaluations

Self-tests and self evaluations can serve as important components of an institution's fair lending compliance management program.

1. A self-test is any program, practice or study that is designed and specifically used to determine the extent or effectiveness of the institution's compliance with the ECOA and the FHA. It creates data or factual information that is not otherwise available and cannot be derived from loan, application or other records related to credit transactions.
2. A self-evaluation, while generally having the same purpose as a self-test, does not create any new data or factual information, but uses data readily available in loan or application files other records used in credit transactions.

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Best Practices

Know your data:

- Banks should carefully review their data and assessment area information for any potential fair lending concerns (such as prohibited basis disparities in pricing and underwriting, irregular assessment areas, etc.).

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Best Practices

Know your products:

- Institutions should incorporate a compliance review of all proposed products and services early in the development cycle, before the product is offered to consumers, to proactively address potential fair lending risks.

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Best Practices

Second Review Processes:

- Institutions should consider implementing second review processes to ensure that all credit decisions receive a “second look” to monitor whether these decisions are consistent with its policies and procedures and not made on a prohibited basis. This review process should carefully monitor any exceptions and decisions where discretion is allowed.

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Best Practices

Avoid discouraging applicants: Institutions should carefully review their lending process to avoid discouraging applicants.

- Refrain from making potentially discriminatory comments or stating personal opinions about the location of a home.
- Avoid requiring prospective applicants to provide their social security number and/or have their credit report pulled before providing basic loan product information.
- Avoid inconsistency in referrals.

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Best Practices

Avoid potential steering:

- If financial institutions have multiple lending options available to customers they should advise the potential applicants of the options and explain the advantages and disadvantages of each.

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Best Practices

Fair lending training:

- A formal fair lending training program, tailored to the institution, should be implemented to remind employees about the requirements of fair lending laws, and to reinforce policies and procedures. The training should address all aspects of the application process.

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Questions and Answers

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