Tuscan Club University

FAIR LENDING MANUAL

Tuscan Club University
Fair Lending School

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This is not legal advice, and there is no guarantee that the information
in the course will cover every possible scenario at your organization.

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MODULE 1
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MODULE 1 – OVERVIEW

MODULE OBJECTIVES

In this module, we are going over some basics to get you started on this fair lending journey. We will start with learning about your Compliance Management System and its components. Then we will talk about the life cycle of a loan. There are several components and steps along the way that are the building blocks for this entire course. We will give you some examiner perspective on how they conduct a fair lending review. Then we will go over the basics of a regulation. To understand the regulations, you will need to know what they say and how to navigate them. We have included some valuable resources for you to save for future use. We will also talk about the different regulatory agencies and who regulates your organization.

Compliance Management System

Fair lending is ensuring you are treating applicants fairly and not considering a prohibited basis characteristic in any aspect of a credit decision. That's pretty simple, and we will cover that in great detail throughout this course. But how do you set up your institution to ensure you are doing just that?

Financial institutions must have a Compliance Management System (CMS) in-place to ensure fair lending risk is mitigated. This includes:

- Board and management oversight;
- Policies and procedures;
- Training;
- Monitoring and audit efforts;
- Complaint response procedures

Even if you are not a financial institution, you may still want to use the CMS structure at your organization to help set up and manage both your compliance and fair lending programs.

It is the **Board of Directors'** and **management's** job to establish a program to govern fair lending, but it is your job as compliance and audit staff to implement it. Think of your CMS as a process. First, you need Board and management to set the tone for compliance. It is their job to create the baseline for the program. They must hire compliance staff, ensure they have resources and training, and have review processes in-place to test effectiveness. They need to reassign resources as necessary, ensure that compliance staff members keep up-to-date on regulatory changes, and ensure corrective action is taken as a result from audits and examinations. While they may not be involved in the day-to-day compliance operations, they need to ensure the job is getting done.

Your **policies** and **procedures** are what guide the employees of your organization. Policies lay the groundwork for how you are to do your job, and procedures get into the specifics. Sometimes procedures are built right into policy, while other times they are separated out into separate documents. At smaller organizations, procedures are often informal and unwritten. With only a few employees and low turnover, it may not be necessary to write everything down. The more your organization grows (employees, branches, markets, products, etc.), the more your procedures should be formalized in writing.

Training is key in all areas. Having great policies and procedures are nice, but providing good training to employees is how you ensure they are effective. This isn't just training for your compliance and audit staff but for anyone involved in the loan lifecycle. Each person on the lending team should get good up-front training on fair lending, but follow-up and annual training is also beneficial to keep people engaged.

Monitoring and **audit** efforts are your last lines of defense. If you put the right people in place, give them good procedures, and train them, you will set yourself up for success and the review process can often be more of a formailty. But we are all human. Mistakes can happen, procedures can be ignored, and training can be ineffective. It's monitoring and audit's job to try and catch any issues that fall through the cracks. Monitoring and audit also help us identify big picture items by identifying long-term trends that would otherwise go unnoticed.

Monitoring and audit seem like the same thing, but they are two different processes. Think of **monitoring** as your daily or weekly checks and reviews of different lending areas. Often times monitoring is informal and undocumented. It's ongoing things that you do to ensure compliance. **Audit** on the other hand is a point-in-time pause to look back and review a specific time period.

Let's use denials as an example to better illustrate. If a loan officer sends you an adverse action notice (denial) to review for all compliance requirements before it is sent to the applicant, that's monitoring. If you take a sample of adverse action notices from the past six months and review to see how your lenders are doing, that's auditing. Audits are usually accompanied by reports.

The last component to your compliance program is response to **consumer complaints**. Most organizations have a formal complaint policy. It can be stand-alone or as part of another policy. They are typically basic in nature, but they lay the groundwork on handling complaints. The shortened version is that you need to handle complaints timely and ensure you give an adequate response. Also, you need a compliance expert in the process to help identify underlying compliance issues. Fair lending complaints often carry even more weight. As you will learn in upcoming modules, one simple or seemingly small fair lending complaint can trigger an entire fair lending examination. It is critical that compliance personnel be involved with all complaints, and fair lending complaints receive a thorough review.

PRO TIP

Your entire compliance rating as a financial institution is based on the strength of your CMS. In this course, we are focusing on fair lending, but all consumer protection laws and regulations are tied to your CMS, not just fair lending. If you have access to your compliance Report of Examination, you will likely see this structure throughout your report.

The Lifecycle of a Loan

You will see all of the processes in the loan lifecycle graphic. You will see that graphic a lot through this course. There are many processes in the loan lifecycle and each carry fair lending risk. Once we get to Module 5, we will start digging deep into that lifecycle. Here is a basic breakdown of the cycle we will cover during this course:

Application Process

- Taking applications
- Steering customers in to products

Loan Decision

- Underwriting the loan
- Loan pricing – interest rates, fees, terms, etc.
- Exceptions to loan policy (rates, terms, underwriting, etc.)

Denying a loan

- Denial process
- Adverse action notices
- Comparative file analysis

Other Key Lending Components

- Redlining
- Marketing
- Fair lending Interview
- Risk assessment

We will be breaking down each of the items above, talking about the risks, helping you identify higher risk areas, and how to review and audit those areas. We consider this the loan lifecycle of fair lending risks, and this is the foundation of the fair lending school.

QUIZ QUESTION

True or False – It is legal to discriminate against a loan applicant.

Think about that question as you go through this course. We have conducted fair lending training sessions for countless compliance officers, auditors, lenders, board members, and CEOs. We always ask this question at the beginning of every training. Some jump at the answer while others have a puzzled look on their face.

This may seem like a simple question, but there is a lot to it. Think about this and we will revisit it in a later module.

Thoughts from the Examiners

Regulators often perform some type of fair lending review at nearly every compliance examination, whether you know it or not. Fair lending examinations are risk focused – meaning that they will review your program from a high level and decide where the greatest risk is. The focus on the highest risk areas or areas which you have not put risk mitigation in place. In Module 4, we will break down the risks in a bit more detail before we get into the loan lifecycle.

Regulators review your program as a whole during the pre-examination process. There are many things they will consider, but these are the major factors that will help drive the fair lending review:

- Past examination findings
- Internal and external fair lending audits
- Policies and procedures, including underwriting and pricing
- Turnover in lending staff since the last examination
- Changes in products
- Your assessment area make-up and changes to demographics
- Change in branch structure
- Training – that you have or have not completed
- Consumer complaints
- Overall strength of your Compliance Management System

Examiners use the FFIEC Fair Lending Examination Procedures to conduct fair lending reviews. This is a public document that you can also use to help structure and complete your reviews. The examination procedures were relied upon in creating this course.
https://www.ffiec.gov/pdf/fairlend.pdf

PRO TIP

Major changes in your institution in any of the areas above could very well be the focus of your next fair lending examination. Knowing that, consider making that one focus of your fair lending review.

What is a Regulation?

Before we get too deep into the weeds, we want to make sure we are all on the same page. If you are an experienced compliance professional, some of this will be a review. However, we need to make sure everyone has the same foundation.

Fair lending really starts with Congress passing a law. That law is often called an "Act" in the financial world, like the Equal Credit Opportunity Act. However, Acts are often very lengthy, and it's not that easy to read an Act and know exactly what you need to do to comply. That law must be interpreted. That's where the regulators and regulations come in.

Typically, one of the government regulatory bodies takes the law and writes regulations to tell financial institutions what they need to do to comply with the law. Regulations are not always written by regulatory agencies, however. Regulatory guidance can come from the Department of Defense (military regulations), the Department of Housing and Urban Development (home loans), or the Federal Trade Commission among others.

Most of the banking regulations are written by one of the federal regulatory agencies. They are likely the same agencies that examine your organization. The main financial institution regulators include:

- Federal Deposit Insurance Corporation (FDIC)
- Federal Reserve
- Office of the Comptroller of the Currency (OCC)
- Consumer Financial Protection Bureau (CFPB)
- National Credit Union Administration (NCUA)

Who Writes the Regulations?

Prior to 2010, the Federal Reserve wrote **most** of the banking regulations that cover lending. Those regulations were part of Chapter 12 of Code of Federal Regulations. All of the Federal Reserve regulations were in the 200 series. Regulations were given letters that correspond with the number in the alphabet in which they appeared.

Regulation B – the 2nd letter of the alphabet – Federal Reserve Part 202

Regulation E – the 5th letter of the alphabet – Federal Reserve Part 205

Regulation Z – the 26th letter of the alphabet – Federal Reserve Part 226

Once you got past 226, they would start the alphabet over with double letters. Regulation AA is 227 and Regulation CC would be Federal Reserve Part 229. When the CFPB was created, they took over regulation writing authority for many of the old Federal Reserve banking regulations. They simply changed the numbering system from a 200 series to a 1000 series.

Regulation B – 202 became 1002

Regulation Z – 226 became 1026

Regulation DD – 230 became 1030

Where Can You Find the Regulations?

There are three regulatory sites you can use to look up regulations, and some are a little easier to navigate than others. Not all of the sites contain all of the regulations. You are encouraged to use all three and get comfortable with them. We may use one site for some regulations and another site as a resource for others.

OPTION 1

Bankers Online - Bankers Online is a website that has a ton of great resources including an excellent and easy to use regulations section. This site is also easy to navigate, is updated often, and has most of the consumer protection and banking regulations, not just the CFPB's regulations. While some of the government sites that have regulations posted only include the regulations that they are responsible for, Bankers Online has most of what you need for compliance.
https://www.bankersonline.com/regulations

OPTION 2

CFPB Website - The CFPB has all of the regulations they are responsible for on their website. This one is very user friendly and is straight from the rule writing authority. However, non-CFPB regulations are not included.
https://www.consumerfinance.gov/policy-compliance/rulemaking/regulations/

PRO TIP

Use these regulatory resources often and get used to navigating through them. Nearly all of your answers are there. One of the best skills you can learn as a compliance or audit expert is how to look up regulatory questions. You don't need to know all of the answers in this industry, but you need to know where to find them.

OPTION 3

eCFR - The federal government has their own website called the eCFR (Electronic Code of Federal Regulations). You would think this would be the best source, but it's the hardest to navigate and isn't always up-to-date. This is typically our last resort for finding regulatory answers.

https://www.ecfr.gov/cgi-bin/text-idx?tpl=/ecfrbrowse/Title12/12tab_02.tpl

OPTION 4 – BONUS OPTION

FDIC Compliance Examination Manual - While this source does not have the regulations listed as the others do, it has a ton of great regulatory materials. The FDIC Compliance Examination Manual is an invaluable resource we use often. Even if you are not an FDIC regulated institution or if you are a credit union, this manual has great information in a much easier to read format than the regulations. While the regulation sites are much more straightforward with bits of information, the FDIC manual is more of a narrative form. It helps better tell the story of the regulation instead of just giving you the raw data.

https://www.fdic.gov/regulations/compliance/manual/index.html

Who Regulates Your Organization?

The regulatory agency who oversees your organization has a big part in your fair lending examinations. We won't get into the politics of each agency, but they do have their differences. While all lending institutions fall under the same fair lending laws and regulations, how they are interpreted and reviewed at your organization may differ depending on who your regulator is.

Your organizations regulator is determined by your charter. To operate as a financial institution in the United States, you must have a charter. If you are a credit union, you will get your charter through the NCUA. If you are a bank, you have two options to get a charter. You can either get a bank charter from the state your bank is in or from the federal government. If you get your charter from a state, you are considered a state-chartered institution. You then have the option of being a member of the Federal Reserve. If your bank becomes a member of the Federal Reserve, you're considered a "Fed-Member Bank", and the Federal Reserve is your primary regulator along with your state regulators. If your bank is not a member of the Federal Reserve, the FDIC will regulate your bank along with the state you're in. The FDIC also has back-up regulatory authority over all institutions that have FDIC insurance.

It's common for the state and the FDIC or Federal Reserve to rotate performing safety and soundness examinations of your bank. However, when it comes to compliance, many states do not have compliance examiners. For FDIC regulated banks, the FDIC primarily does your compliance examinations.

If your bank is chartered by the federal government, it is considered a "National Bank." The Office of the Comptroller of the Currency, or OCC, is your primary regulator. National banks are easier to spot because they either have the word "National" right in their name, or they have N.A. behind it (N.A. = National Association). State banks are not required to have the word "State" in their name.

The CFPB is the newest of the federal regulators. The CFPB is a little different than the traditional regulators. For banks, the CFPB supervises those with assets over $10 billion, but they also supervise non-bank companies. If you are not a bank or a credit union, you likely fall under the CFPB. The CFPB is by far the youngest of the regulatory agencies, but they have significant influence. Since they are also in charge of writing most of the rules, everyone needs to pay attention to what they are doing.

MODULE SUMMARY

We've set the basic framework for your organization. We started with discussing your Compliance Management System. Everything you do as a compliance or audit expert in your institution should tie back to a CMS component. We then talked briefly about the lifecycle of a loan. That lifecycle is the structure for this entire course. You will learn about all of those components in greater detail as you complete each module. Then we talked a bit about the examiner perspective. This course is littered with real world examples, many from real examiners and audits we have been a part of. We protected the guilty names and parties, whenever possible. These real world examples will help bring these concepts to life for you. Fair lending theory becomes useful when you can apply it to your organization.

Next, we talked about the anatomy of a regulation. We discussed who writes the regulations and gave you several resources you can use to get regulatory questions answered. Finally, we discussed who the regulators are. How your organization is chartered determines who regulates you. Each of the regulators are a bit different, and each examiner is different. The more prepared you are, the easier your next examination will be.

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MODULE 2

LAWS AND REGULATIONS

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MODULE 2 – LAWS AND REGULATIONS

MODULE OBJECTIVES

In this module, we are going to talk about the four laws that primarily govern fair lending. These laws lay out the prohibited bases and certain data collection requirements for lending organizations. Then we will discuss the different types of discrimination and give you some examples to help illustrate.

Equal Credit Opportunity Act (ECOA)

The ECOA and its implementing Regulation B prohibits discrimination in any aspect of a credit transaction. It applies to ANY extension of credit, including extensions to small businesses, corporations, partnerships, and trusts. That means that every loan your organization makes is covered under this regulation. You will find throughout this course that several of the reviews we will do are based on consumer purpose loans, but keep in mind that ECOA covers all loans.

ECOA/Regulation B has certain criteria which you cannot base your loan decision. While you can decide not to make someone a loan because of a low credit score, you cannot deny them for a loan because of their race. This is called a "prohibited basis", and ECOA has nine of them. Let's take a closer look.

The ECOA prohibits discrimination based on:

- Race
- Color
- Religion
- Sex
- National Origin
- 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 right under the Consumer Credit Protection Act

The CFPB's Regulation B, 12 CFR Part 1002, implements the ECOA. Regulation B describes lending acts and practices that are specifically prohibited, permitted, or required.

PRO TIP

Regulation B covers ALL credit transactions. It doesn't matter if it's consumer, residential, commercial, or agricultural, financial institutions cannot discriminate on any of the prohibited bases for any type of credit. Some commercial and agricultural lenders like to think that fair lending doesn't really apply to them. This is simply not true.

Fair Housing Act (FHA)

The FHA prohibits discrimination in all aspects of "residential real-estate related transactions," including but not limited to:

- Making loans to buy, build, repair, or improve a dwelling;
- Purchasing real estate loans;
- Selling, brokering, or appraising residential real estate; or
- Selling or renting a dwelling

Our second law does differ a bit from ECOA. The FHA only applies to residential real estate-related transactions. The prohibited bases below are in addition to the ECOA prohibited bases, but they do not apply to loans outside of residential real estate lending. You may also notice that the first 5 prohibited bases are the same as ECOA, but the other two are different.

The FHA prohibits discrimination based on:

- Race;
- Color;
- Religion;
- Sex;
- National Origin;

- 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); or
- Handicap

The Department of Housing and Urban Development's (HUD) regulations implement the FHA under 24 CFR Part 100. Because both the FHA and ECOA apply to mortgage lending, lenders may not discriminate in mortgage lending based on any of the prohibited factors from either list.

Don't let your lenders get too hung up on memorizing both lists and the differences. Whenever we teach ECOA and FHA prohibited bases to lenders, we go through both lists, but we always mention that as long as you don't discriminate based on any of these prohibited bases on any loan ever, you don't have to worry. As a compliance professional, you will want to know them by memory.

Let's look at some regulatory guidance from the FDIC Manual.

Under the ECOA, it is unlawful for a lender to discriminate on a prohibited basis in any aspect of a credit transaction, and under both the ECOA and the FHA, it is unlawful for a lender to discriminate on a prohibited basis in a residential real-estate-related transaction. Under one or both of these laws, **a lender may not**, because of a prohibited factor:

- Fail to provide information or services or provide different information or services regarding any aspect of the lending process, including credit availability, application procedures, or 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 loan amount, fees, interest rate, duration, or 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.

Home Mortgage Disclosure Act (HMDA)

HMDA is the third regulation that relates to fair lending. HMDA is different from the ECOA and FHA in the fact that it doesn't have prohibited bases. HMDA's main purpose is to require the collection of key data based on home loans. This information can be analyzed many ways to determine negative lending patterns. HMDA data can help uncover redlining, steering, underwriting, pricing, and other fair lending issues within an institution's home mortgage program.

Not every lending organization is a HMDA reporter, so not every organization has to worry about complying with HMDA. There are guidelines as to which an organization must collect and report HMDA data. Since this is not a HMDA course, we are not going to get deep into HMDA reporting requirements. Here are the basic guidelines on which a lending organization must report HMDA data, and they can/do change over time.

Your institution must meet **ALL** of the following to be a HMDA reporter:

1. **Asset-Size Threshold –** If your institution's assets are over the threshold (changes annually) on December 31 of the preceding year;
2. **Location Test –** On the preceding December 31, you must have had a branch located in a Metropolitan Statistical Area;
3. **Loan Activity Test –** During the preceding year, you must have originated at least one home purchase loan or refinancing of a home purchase loan secured by a first lien on a one-to-four-unit dwelling;
4. **Federally Related Test –** Your institution must be federally insured, or federally regulated, or originated at least one home purchase loan or refinancing of a home purchase loan that was secured by a first lien on a one- to-four-unit dwelling and also (i) was insured, guaranteed or supplemented by a Federal agency or (ii) was intended for sale to the Federal National Mortgage Association (Fannie Mae) or the Federal Home Loan Mortgage Corporation (Freddie Mac);
5. **Loan-Volume Threshold –** You must meet or exceed either the closed-end mortgage loan or open-end line of credit loan volume threshold in each of the two preceding calendar years.

Don't be worried if you are new to compliance or new to your organization. HMDA is a major compliance regulation. It's not one of those regulations that applies to your organization without you knowing about it. Ask your compliance staff and they will let you know if you are a HMDA reporter.

PRO TIP

HMDA carries a massive regulatory burden. It is a regulation that carries significant regulatory scrutiny since the data your organization collects is used by the regulators for conducting a fair lending analysis. Having a strong HMDA reporting program and well-trained lending and compliance staff will pay large dividends in the future. Organizations with weak HMDA programs often pay high prices for data integrity reviews and data resubmission.

Community Reinvestment Act (CRA)

The CRA is the fourth of our regulations that touches fair lending. Like HMDA, the CRA does not have prohibited bases, but there may be data collection requirements based on your organization's size. The CRA is an evaluation regulation that the regulators use to ensure that you are lending to all parts of your assessment area (AA) and to all types of borrowers.

CRA mostly applies to banks, so if you are a credit union, mortgage company, or non-bank lender, there's a good chance you don't have to worry about the CRA. However, a few states do have a CRA state law, so be aware of the laws in the state you operate in as well.

When it comes to an AA, the good part is that your organization's management team gets to choose your AA. There are some regulatory requirements on what your AA has to include, but the basics are that it includes all of your branches, it must be contigious, and where you primarily conduct business. Since this is not a CRA course, we won't get into more details than just a high-level overview.

When examiners conduct a CRA performance evaluation, they look to see if you are making loans to all parts of your AA. There is a little crossover with HMDA in the sense that HMDA data also shows where you are making loans. But remember, HMDA is just home loans. CRA can incorporate other loan types, depending on how many loans you originate. A CRA analysis can help uncover redlining issues if institutions are not lending to all parts of their AA, including low- and moderate-income areas. Some procedures in our redlining module mirror how examiners perform parts of the CRA evaluation. However, the CRA analysis does not review for prohibited bases such as race or ethnicity. In addition, CRA focuses more on the income level of the areas where you lend while fair lending focuses more on the minority level population. While the analysis may look similar, they are different.

Not that there wasn't enough reason to comply with the CRA, but here's one more and maybe the most important. CRA evaluations and ratings are PUBLIC INFORMATION. Your CRA performance evaluation is posted on your regulator's website. At the end of your written evaluation is a section for illegal credit practices. If your institution is found to have severe fair lending findings and consumer harm, it's possible those may end up in your performance evaluation, and then anyone can find that information out.

PRO TIP

CRA evaluations are performed on a cycle based on your asset size. While the size thresholds change, the basic premise is that if you are considered a "Small Bank" under the regulation asset size, you are typically evaluated every 5-6 years (unless your "Small Bank" has assets exceeding a certain asset threshold, then you are evaluated every 3 years). If you are an "Intermediate Small Bank" or a "Large Bank" under the threshold, you are evaluated every 3 years. You can do a simple web search to find the current threshold levels.

Here are the regulator websites to look up CRA performance evaluations:

Office of the Comptroller of the Currency (OCC)
https://apps.occ.gov/crasearch/default.aspx

Federal Deposit Insurance Corporation (FDIC)
https://crapes.fdic.gov

Federal Reserve
https://www.federalreserve.gov/apps/CRAPubWeb/CRA/BankRating

Federal Financial Institutions Examination Council (FFIEC)
https://www.ffiec.gov/craratings/

Types of Discrimination

We're going to switch gears away from the fair lending laws and prohibited bases to talk about discrimination. First, let's look at what discrimination is. There are two main types of discrimination; disparate treatment and disparate impact.

Disparate Treatment

Disparate treatment is when you treat an applicant differently based on a prohibited basis. This can be established by overt evidence or differences in treatment that are not fully explained by legitimate nondiscriminatory factors or comparative evidence.

Overt Evidence of Disparate Treatment

There is overt evidence of discrimination when a lender openly discriminates on a prohibited basis.

These are the most obvious cases of discrimination. Some examples include:

- Offering different credit limits on a credit card to different age groups
- A lender makes a comment about an applicant based on a prohibited basis
- Advertising that contains discriminatory contents

Overt evidence can also be when a lender expresses, but does not act on, a discriminatory basis.

EXAMPLE:

A lending officer told a customer, "We do not like to make home mortgages to Native Americans, but the law says we cannot discriminate, and we have to comply with the law."
FDIC Consumer Compliance Examination Manual

PRO TIP

Overt is the easiest form of discrimination to identify. It's usually an open comment or practice that is discriminatory. It's hard to refute this type of evidence when it's in writing. A spoken comment can lead to an argument about what was actually said. This is one reason that there are typically two examiners in fair lending interviews. We will learn more about that in a later module.

Comparative Evidence of Disparate Treatment

Disparate treatment occurs when a lender treats a credit applicant differently based on a prohibited basis. It does not require any showing that the treatment was motivated by prejudice or a conscious intention to discriminate against a person beyond the difference in treatment itself.

Disparate treatment commonly occurs in the treatment of applicants who are **neither clearly well-qualified nor clearly unqualified**. Discrimination may more readily affect applicants in this middle group for two reasons. First, if the applications are "**close calls**," there is **more room and need for lender discretion**. Second, whether or not an applicant qualifies may depend on the **level of assistance** the lender provides the applicant in completing an application. The lender may, for example, propose solutions to credit or other problems regarding an application, identify compensating factors, and provide encouragement to the applicant. Lenders are under no obligation to provide such

PRO TIP

Disparate treatment that is not overt is a little harder to identify. When applicants are substantially similar on paper, but receive different treatment, that could be evidence of disparate treatment.

assistance, but to the extent that they do, the **assistance must be provided in a non-discriminatory way**. Examiners sometimes refer to this extra assistance as "thick file syndrome."
FDIC Consumer Compliance Examination Manual

Disparate Impact

When a lender **applies a racially or otherwise neutral policy** or practice equally to all credit applicants, but the policy or practice **disproportionately excludes or burdens certain persons on a prohibited basis**, the policy or practice is described as having a "**disparate impact.**"

EXAMPLES:

(1) A lender's policy is to not make loans for single family residences for less than $60,000. This policy has been in effect for ten years. This minimum loan amount policy is shown to disproportionately exclude potential minority applicants from consideration because of their income levels or the value of the houses in the areas in which they live.

(2) A lender has a policy of not making mobile home loans. However, there is a large mobile home park in the community and a majority of the park's residents are minority. Such a policy could have a disparate impact on those minorities.

PRO TIP

Disparate impact issues are higher-level issues. Usually a policy, procedure, or practice impacts a prohibited basis group negatively. Just because there is a business reason for a policy doesn't mean there is not discrimination.

The fact that a policy or practice **creates a disparity** on a prohibited basis **is not alone proof of a violation**. When an agency finds that a lender's policy or practice has a disparate impact, the next step is to seek to determine **whether the policy or practice is justified by "business necessity."** The justification must be manifest and may not be hypothetical or speculative.

Factors that may be relevant to the justification could include cost and profitability. Even if a policy or practice that has a disparate impact on a prohibited basis can be justified by business necessity, it still may be found to be in violation if an alternative policy or practice could serve the same purpose with less discriminatory effect. Finally, evidence of discriminatory intent is not necessary to establish that a lender's adoption or implementation of a policy or practice that has a disparate impact is in violation of the FHA or ECOA.
FDIC Consumer Compliance Examination Manual

MODULE SUMMARY

We started this lesson talking about the fair lending laws and regulations. The ECOA has nine prohibited bases and covers all credit transactions. The FHA has seven prohibited bases and only covers residential real estate transactions. Then we discussed HMDA and the data collection requirements. We finished off our regulations with the CRA – remember: CRA findings are public.

We finished by talking about the three types of discrimination. Remember overt evidence is more open and obvious where comparative evidence of disparate treatment may not be so. Disparate impact is high-level items, usually a policy or procedure, that gets applied to an area that causes the discrimination. You will want to train your loan staff about the basics on the fair lending laws and regulations. They should know and understand the prohibited bases. You will also want to train them on the different types of discrimination.

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MODULE 3

COMPLIANCE MANAGEMENT SYSTEM

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MODULE 3 –

COMPLIANCE MANAGEMENT SYSTEM

MODULE OBJECTIVES

In Module 1, we introduced you to the Compliance Management System (CMS). In this module, we are going to take a deeper dive into your CMS. Your CMS is the basis for compliance at your organization. It is how you manage your compliance with consumer protection laws and regulations, and it is how examiners evaluate and rate your organizations's compliance function. All of your efforts in anything consumer protection-related can be tied back to a strength or weakness within your CMS. Our goal is to set up a strong CMS surrounding fair lending to help you make a solid program before you even worry about starting the loan process.

CMS Overview

Your particular regulator will evaluate your CMS as a whole. Different regulators go to different depths when evaluating your program. For example, the FDIC conducts examinations solely around your CMS and then issues you a multi-page report based on findings and ratings. If you are an OCC regulated institution, it may only be one small section of your entire examination report. Regardless of your regulator, you need to understand your program and actively manage it. This is especially useful when you're building a fair lending compliance program that reduces the risk of having fair lending concerns. For you to fully understand reviewing your CMS, you will need to know the building blocks. Even if you are a non-bank type of lender, you should still study this program setup and use it to model your fair lending program the best you can and where it makes sense.

Components of a CMS

Board and Management Oversight

The Board takes ultimate responsibility for the CMS. Through the Board and management, they need to establish a program with the right pieces in place. They may not oversee the daily compliance operations, but they oversee the program as a whole. Here are some of the responsibilities of the oversight function:

- Establish written policies and procedures to ensure compliance with consumer protection laws and regulations
- Appoint oversight of the compliance program – while an official compliance officer is not required, the oversight function must ensure someone is in charge. That can be a compliance officer, dual compliance officers, a compliance committee, or some other form.
- Ensure compliance staff are appropriately trained to carry out their job duties
- Stay abreast of regulatory compliance changes
- Ensure your institution has a compliance training program for all applicable staff that covers areas commensurate with job duties
- Ensure there is monitoring and/or audits being conducted of your organization's program commensurate with your risk profile – audits can be internal or external, just as long as they are independent and performed by qualified personnel
- Manage third-party risk program
- Ensure adequate complaint response

PRO TIP

Include ANY and ALL compliance related discussions your Board of Directors has within the board minutes. Examiners are looking to see if your board is involved in actively managing your compliance program, but if you don't document it in the one key piece of evidence (board minutes), it's harder to show examiners that your board actively participates in the CMS.

The duties listed above may not all be assigned to the Board or members of management, but they need to monitor your institution's CMS and ensure these duties are being carried out. One of the most common ways Board and management monitor the CMS is through committees and reports. If those reports exist and you can access them, look for compliance related discussions and especially anything fair lending-related.

Compliance Program

The compliance program is the nuts and bolts of the CMS. While the oversight team listed above ensures these items are being implemented, it's up to the compliance and audit staff to carry out many of these duties. The four parts of the program are:

1. Policies and Procedures
2. Training
3. Monitoring and/or Audit
4. Response to Consumer Complaints

In most institutions, the compliance officer and/or compliance committee handle the day-to-day management and implementation of the compliance program. It is these areas that you will want to review when scoping your fair lending review. **Strengths and weaknesses in your overall compliance program will be leading indicators to what fair lending risks you'll dig deeper into and transaction test.**

PRO TIP

Your organization is not required to have a compliance committee, but the larger your organization is, the more helpful it can become. Committee members are typically from different departments within the organization. They discuss findings to examinations and audits, help set compliance training requirements, write policies and procedures, and help guide the compliance staff on managing a strong program. If you have a compliance committee, take good minutes and include all relevant discussions. Provide those minutes to examiners to help show you are actively managing your program.

Policies and Procedures

Any written (and unwritten) policies your institution uses that relate to regulatory compliance are included. Common compliance-related policies that most organizations would have are:

- Loan policy
- Compliance policy
- Regulation specific policies
- Fair lending policy (this is less common for smaller institutions)
- Third-Party risk policy

For procedures, the smaller your organization is, the less likely you will have written procedures. However, you should have at least some written procedures in-place to help your lenders make loan decisions. The need for written procedures increases when an organization has multiple offices or numerous loan officers. There may be some overlap here as to whether an item is a policy or a

PRO TIP

You want to start your fair lending review here and review each of these policies. Policies need to be specific to your institution. We have literally read through an institution's policy (more than once) that had another institution's name at the top of it! They had obviously gotten the policy from another institution, which is fine, but the fact that they didn't even change the name at the top tells us that nobody reads it. You don't have to have super specific policies, but they need to be relevant to your organization. Don't have a general loan policy that includes information on credit cards and student loans when you don't offer each of those products. Take a few minutes and customize them to your organization.

PRO TIP

Many smaller organizations don't have any formal underwriting collection methods. They may have basic underwriting criteria described in a loan policy, but they don't clearly document underwriting for each specific loan (for example, new car loans versus used car loans). If you want to set yourself apart and show regulators that you have formal procedures, a simple underwriting checklist of the information you use to underwrite loans is an easy method to do so. See the Underwriting Module for more information.

procedure, but that's okay. You need to see what is in writing.

Here are some examples of what you will look for:

- Underwriting standards (this is often found within a loan policy) but can be a stand-alone document
- Pricing/rate sheets (these are usually updated frequently)
    - If you are a very small organization, you may not have a formal rate sheet. Some organizations have an informal "base rate" that they use to price loans. This isn't necessarily wrong, but it increases risk. If you use a "base rate", you should at least have that documented in your loan policy.
- Loan analysis worksheets – this one carries many names, but it's often an Excel workbook or checklist that helps you collect all prudent underwriting criteria and analyze a credit application (e.g. credit score, age of collateral, income, loan-to-value, debt-to-income, etc.).

You will want to review any formal or informal procedures your institution has for making loan underwriting AND pricing decisions. The more formal your procedures AND the fact that they are consistently followed, the lower your risk. If you have no written procedures, it's likely you may have to do some transactional testing in those areas.

Training Program

You will want to look for any consumer protection regulatory training your staff receives. For a fair lending review, you will want to target any lending-related training.

Some examples of lending-related training include:

- General Fair Lending (obviously)
- Equal Credit Opportunity or Regulation B
- Fair Housing Act
- Home Mortgage Disclosure Act
- Basic lender training (how are lenders trained to do their jobs)

You will also want to find out what type of fair lending training your compliance and audit staff has taken. Since there isn't much training available outside of high-level theory, there may not be much. Check the dates on the training. How often does the staff take training? Examiners generally recommend fair lending training at least annually. The fact that there is not much fair lending training availble is one of the main reasons why this course was created.

Who else in your organization could benefit from fair lending training? The simple answer is anyone who is involved in the loan process or sees customers directly. This could be any front office personnel that speak to loan applicants (admin assistant or teller), marketing and sales personnel, underwriting team, personal bankers, phone bankers, loan payment processors, etc. Honestly, if someone talks to a potential loan applicant, they have chances to discriminate against that applicant.

Monitoring/Audit

While monitoring and audit are grouped together, they are two separate parts as we discussed in Module 1.

Monitoring – think of monitoring as your day-to-day or weekly reviews. This is often informal and usually undocumented. If you review adverse action notices before they are sent to the applicant, that would be monitoring. If you review pricing or underwriting exceptions and track them on a log (which you should), that would also be monitoring.

PRO TIP

You don't have to document all of your monitoring efforts, but document the fact that you monitor, what types of things you are looking for, and who completes the monitoring efforts. This goes as a strength towards your CMS.

Audit – audit activities are more of a point-in-time pause where you look back and review performance over a certain time period. The time period you cover in your audit should be long enough to capture a useful amount of activity. While conducting a brief review of adverse action notices before they go in the mail would be monitoring, conducting a review of adverse action notices from the prior year would fall under audit. Audits should be "independent" – meaning if you are part of the loan process, you shouldn't check your own work. The tracking of pricing and underwriting exceptions as you go is monitoring, but analyzing them for the year for unfavorable trends and anomalies would be an audit.

Your audit can be internal, external, or a combination of both. Some institutions have a robust internal audit program. They have full-time staff that are devoted to audit. Other institutions outsource all of their audit efforts. Either they don't have the time to do their own audits, the personnel to get the work done, or the internal expertise to do a quality review. While it is true that you cannot outsource your compliance program, there is nothing wrong with getting help. Having external auditors do periodic reviews of fair lending is a great way to get a new set of eyes reviewing your program. When you get experienced auditors in your institution, they have often seen dozens if not hundreds of institutions, and you will have access to the wealth of knowledge and experience they have gained. Finding auditors with good fair lending experience is difficult, so make sure you do good due diligence prior to outsourcing a fair lending audit.

When it comes to differentiating between monitoring and audit, don't worry so much about how you classify your reviews. Use both methods to help strengthen your compliance program. The reviews that you conduct as part of this training program will go as part of your audit function. The on-going reviews you can start doing will be part of your monitoring. The regulators don't care so much about what you call your work; they care that you are finding and correcting your own issues.

Here are some monitoring items that every organization can do to help strengthen your CMS (some we have covered):

- Conduct secondary reviews of denials **BEFORE** they go out the door. A second lender could conduct this review, or it could be someone from your compliance department. You will want to make sure the adverse action notices are filled out properly and denial reasons are accurate and specific and provided within the required timeframe. You will also want to make sure underwriting ratios were calculated correctly and that counteroffers were considered.
- Monitor and record all deviations from underwriting and pricing practices. This can be done in two ways:

1. Train your lenders on proper underwriting and pricing practices and have them inform you when they deviate. Document their rationale for making any deviations. Enter such deviations on a centralized tracking log. Some institutions maintain an exceptions field on their core processor for such deviations
2. Perform periodic reviews of closed loans to ensure they are within policy – those that are outside of policy should have been captured on your exceptions tracking log

- Implement a secondary approval process for policy deviations. Ideally this process is conducted by one person or a small committee that approves deviations. Regardless of how you set up your approval process, aim for tighter controls and centralization. If 20 people are allowed to approve deviations, you have 20 different interpretations of your policies and procedures and potentially 20 different sets of non-conforming data. We have personally seen how markets can have significant fluctuations in their pricing, underwriting, and exceptions because each is being monitored independently. See the Exceptions Module for more details on how to build an exception's monitoring program.
- Conduct fair lending interviews – depending on how many lenders you have, you can easily sit down with a lender and have a 30-minute conversation on how they do their job. In Module 13, we will talk more about the purpose of a fair lending interview. We will also give you the tools to conduct your own fair lending interview. This is a key component to use when testing your fair lending program.

Response to Consumer Complaints

Complaints should not be viewed as a bad thing. They can often inform you of weaknesses in your program that you didn't know exist. You should take fair lending complaints VERY seriously. We have witnessed first-hand how one small fair lending complaint to the regulators can drive an entire fair lending review. If you ever get a fair lending complaint, you need to thoroughly review the complaint. Test all applicable areas to determine if it was an isolated incident or a systemic problem. As you progress through this school, you will learn how to identify if problems are systemic or isolated. Systemic issues are likely to be repeated if not addressed. Isolated are often errors that resulted in one-time mistakes, usually from human input errors.

Having a system to collect and address complaints is an indication of a strong CMS, but a complaint review is just the first step of conducting your own internal fair lending review. Multiple complaints in the same area or against the same lender are much bigger indicators of underlying issues. It is imperative that you investigate thoroughly, take prompt corrective action, and document all of your efforts for examiners. You should also keep the Board of Directors informed. You will learn those tools throughout this course.

Reviewing Your Compliance Management System

Now that you know the parts of your CMS, it's time to go over what we've learned. Your CMS review and findings will help determine which areas of your fair lending program to include within your audit. Regulatory guidance and regulatory examination manuals have several questions you can use to help determine the scope of your review. Those questions, in the form of checklists, are summarized in the following sections for your ease of use. Use these questions to scope your review to focus on the high-risk areas of your lending program. Every organization is unique, so it is imperative that you conduct this exercise. Some areas may or may not apply, so don't feel that you need to address everything and every question.

Section A walks you through the preventative measures of your program. It will help you find gaps within your preventative measures, also known as your CMS.

Section A-1 gets more to the heart of your CMS – policies, procedures, and training. This will help you identify if you have the right system in-place or if you have potential weaknesses.

Section A-2 gets into your monitoring/audit function. The manual's questions talk about Self-Test and Self-Evaluation which we get into in Module 4. Use this section to help you discover how your evaluating yourself, but don't be too discouraged. The whole point of this school is to learn how to evaluate your organization.

Section B wraps it up with what you can do or should have done when you have found issues. Again, if you're not currently reviewing your program, you may not have found issues. Use this as a guide to help you if you do discover issues in your program.

Compliance Management Analysis Checklist

This checklist is for use in conjunction with Part II of these procedures. This is a device for examiners to evaluate the strength of an organization's compliance program in terms of its capacity to prevent, identify, and self-correct fair lending violations in connection with the products or issues selected for analysis.

The checklist is not intended to be an absolute test of an organization's compliance management program. Programs containing all or most of the features described in the list may nonetheless be flawed for other reasons; conversely, a compliance program that encompasses only a portion of the factors listed below may nonetheless adequately support a strong program under appropriate circumstances. In short, the examiner must exercise his or her best judgment in utilizing this list and in assessing the overall quality of an institution's efforts to ensure fair lending compliance.

If the transactions within the proposed scope are covered by a listed preventive measure, and the answer is "Yes", you may then reduce the intensity (mainly the sample size) of the planned comparative file review to the degree that the preventive measures cover transactions within the proposed scope. Document your findings in sufficient detail to justify any resulting reduction in the intensity of the examination.

Preventive Measures – Section A

Determine whether policies and procedures exist that tend to prevent illegal disparate treatment in the transactions you plan to examine. There is no legal or agency requirement for institutions to conduct these activities. The absence of any of these policies and practices is never, by itself, a violation.

1. Lending Practices and Standards:

Principle Policy Issues

Are underwriting practices clear, objective, and generally consistent with industry standards?

Is pricing within reasonably confined ranges with guidance linking variations to risk and or cause factors?

Does management monitor the nature and frequency of exceptions to its standards?

Are denial reasons accurately and promptly communicated to unsuccessful applicants?

Are there clear and objective standards for referring applicants to subsidiaries, affiliates, or other lending channels within the institution, classifying applications as prime or subprime borrowers, or deciding what kinds of alternative loan products should be offered or recommended to applicants?

Are loan officers required to document any deviation from the rate sheet?

Do management monitor consumer complaints that allege discrimination in loan pricing or underwriting?

Do training, application-processing aids, and other guidance correctly and adequately describe:

Prohibited bases under ECOA, Regulation B, and the Fair Housing Act?

Other substantive credit access requirements of Regulation B (e.g. spousal signatures, improper inquiries, protected income)?

Is it specifically communicated to employees that they must not, on a prohibited basis:

Refuse to deal with individuals inquiring about credit?

Discourage inquiries or applicants by delays, discourtesy, or other means?

Provide different, incomplete, or misleading information about the availability of loans, application requirements, and processing and approval standards or procedures (including selectively informing applicants about certain loan products while failing to inform them of alternatives)?

Encourage or more vigorously assist only certain inquirers or applicants?

Refer credit seekers to other institutions, more costly loan products, or potentially onerous features?

Refer credit seekers to nontraditional products (i.e., negative amortization, "interest only," "payment option" adjustable rate mortgages) when they could have qualified for traditional mortgages?

Waive or grant exceptions to application procedures for credit standards?

State a willingness to negotiate?

Use different procedures or standards to evaluate applications?

Use different procedures to obtain and evaluate appraisals?

Provide certain applicants opportunities to correct or explain adverse or inadequate information or to provide additional information?

Accept alternative proofs of credit worthiness?

Require co-signors?

Offer or authorize loan modifications?

Suggest or permit loan assumptions?

Impose late charges, reinstatement fees, etc.?

Initiate collection or foreclosure?

Has the institution taken specific initiatives to prevent the following practices?

Basing credit decisions on assumptions derived from racial, gender, and other stereotypes, rather than facts?

Seeking consumers from a particular racial, ethnic, or religious group, or of a particular gender, to the exclusion of other types of consumers, on the basis of how "comfortable" the employee may feel in dealing with those different from him/her?

Limiting the exchange of credit-related information or the institution's efforts to qualify an applicant from a prohibited basis group?

Drawing the institution's CRA assessment area by unreasonably excluding minority areas?

Targeting certain borrowers or areas with less advantageous products?

Does the institution have procedures to ensure that it does not:

State racial or ethnic limitations in advertisements?

Employ code words or use photos in advertisements that convey racial or ethnic limitations or preferences?

Place an advertisement that a reasonable person would regard as indicating minority consumers are less desirable?

Advertise only in media serving predominantly minority or non-minority areas of the market?

Conduct other forms of marketing differentially in minority or non-minority areas of the market?

Market only through brokers known to serve only one racial or ethnic group in the market?

Use a prohibited basis in any prescreened solicitation?

Provide financial incentives for loan officers to place applications in non-traditional products or higher risk products?

2. Compliance Audit Function: Does the Institution Attempt to Detect Prohibited Disparate Treatment by Self-Test or Self-Evaluation?

NOTE: A self-test is any program, practice, or study that is designed and specifically used to assess the institution's compliance with the ECOA and the Fair Housing Act. 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 (12 CFR 202.15(b)(1) and 24 CFR 100.141). The report, results, and many other records associated with a self-test are privileged unless an institution voluntarily discloses the report or results or otherwise forfeits the privilege. See 12 CFR 202.15(b)(2) and 24 CFR 100.142(a) for a complete listing of the types of information covered by the privilege. 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 and other records used in credit transactions and, therefore, does not meet the self-test definition. See *Using Self-Tests and Self-Evaluations to Streamline the Examination* in this Appendix for more information about self-tests and self- evaluations.

While you may request the results of self-evaluations, you should not request the results of self-tests or any of the information listed in 12 CFR 202.15(b)(2) and 24 CFR 100.142(a). If an institution discloses the self-test report or results to its regulator, it will lose the privilege. The following items are intended to obtain information about the institution's approach to self-testing and self-evaluation, not the findings. Complete the checklist below for each self-evaluation and each self-test, where the institution voluntarily discloses the report or results. Evaluating the results of self-evaluations and voluntarily disclosed self-tests is described in *Using Self-tests and Self-Evaluations to Streamline the Examination* in this Appendix.

Are the transactions reviewed by an independent analyst who:

Is directed to report objective results?

Has an adequate level of expertise?

Produces written conclusions?

Does the institution's approach for self-testing or self-evaluation call for:

Attempting to explain major patterns shown in the HMDA or other loan data?

Determining whether actual practices and standards differ from stated ones and basing the evaluation on the actual practices?

Evaluating whether the reasons cited for denial are supported by facts relied on by the decision maker at the time of the decision?

Comparing the treatment of prohibited basis group applicants to control group applicants?

Obtaining explanations from decisionmakers for any unfavorable treatment of the prohibited basis group that departed from policy or customary practice?

Covering significant decision points in the loan process where disparate treatment or discouragement might occur, including:

- The approve/deny decision?
- Pricing?
- Other terms and conditions?

Covering at least as many transactions as examiners would independently, if using the fair lending sample size tables for a product with the application volumes of the product to be evaluated?

Maintaining information concerning personal characteristics collected as part of a self-test separately from application or loan files?

Timely analysis of the data?

Taking appropriate and timely corrective action?

In the institution's plan for comparing the treatment of prohibited basis group applicants with that of control group applicants:

Are control and prohibited basis groups based on a prohibited basis found in ECOA or the FHAct and defined clearly to isolate that prohibited basis for analysis?

Are appropriate data to be obtained to document treatment of applicants and the relative qualifications vis-a-vis the requirements in question?

Will the data to be obtained reflect the data on which decisions were based?

Does the plan call for comparing the denied applications' qualifications related to the stated reason for denial with the corresponding qualifications for approved applicants?

Are comparisons designed to identify instances in which prohibited basis group applicants were treated less favorably than control group applicants who were no better qualified?

Is the evaluation designed to determine whether control or prohibited basis group applications were treated differently in the processes by which the institution helped applicants overcome obstacles and by which their qualifications were enhanced?

Are responses and explanations to be obtained for any apparent disparate treatment on a prohibited basis or other apparent violations of credit rights?

Are reasons cited by credit decision makers to justify or explain instances of apparent disparate treatment to be verified?

For self-tests under ECOA that involved the collection of applicant personal characteristics, did the institution:

Develop a written plan that describes or identifies the:

- Specific purpose of the self-test?
- Methodology to be used?
- Geographic area(s) to be covered?
- Type(s) of credit transactions to be reviewed?
- Entity that will conduct the test and analyze the data?
- Timing of the test, including start and end dates or the duration of the self-test?
- Other related self-test data that is not privileged?

Disclose at the time applicant characteristic information is requested, that:

- The applicant will not be required to provide the information?
- The creditor is requesting the information to monitor its compliance with ECOA?
- Federal law prohibits the creditor from discriminating on the basis of this information or on the basis of the applicant's decision not to furnish the information?
- If applicable, certain information will be collected based on visual observation or surname if not provided by the applicant?

Corrective Measures – Section B

Determine whether the institution has provisions to take appropriate corrective action and provide adequate relief to victims for any violations in the transactions you plan to review. Who is to receive the results of a self-evaluation or voluntary disclosed self-test? What decision process is supposed to follow delivery of the information? Is feedback to be given to staff whose actions are reviewed? What types of corrective action may occur? Are consumers to be:

- Offered credit if they were improperly denied?
- Compensated for any damages, both out of pocket and compensatory?
- Notified of their legal rights?

Other corrective action:

Are institutional policies or procedures that may have contributed to the discrimination to be corrected?

Are employees involved to be trained and/or disciplined?

Is the need for community outreach programs and/or changes in marketing strategy or loan products to better serve minority segments of the institution's market to be considered?

Are audit and oversight systems to be improved in order to ensure there is not recurrence of any identified discrimination?

MODULE SUMMARY

We walked through the entire CMS of your organization. It is important you know all of the components of your CMS and how they relate to one another. Your CMS is on a linear progression where one item builds to the next.

Board and senior management oversight set up the program. They put the people and resources in-place. Policies and procedures guide employees on how to properly do their jobs. Training is important to ensure everyone knows their specific job functions and the laws and regulations that govern your institution. Monitoring and audit are there as secondary checks on the system to help find issues that slipped through the cracks. Complaints are feedback loops that help us find issues we didn't know existed. You need to have a strong CMS in place to be successful; this is the foundation of your fair lending program.

TUSCAN CLUB
UNIVERSITY

MODULE 4
REVIEWING YOUR PROGRAM

Tuscan Club University
Fair Lending School

MODULE 4 – REVIEWING YOUR PROGRAM

MODULE OBJECTIVES

In this module, we will walk through the areas unique to your organization that you need to consider when risk-scoping your review. Then we will further discuss the loan lifecycle that takes us from the first time an applicant contacts you through to either making a loan or denying the loan. Based on those steps and your organization's risk, you will want to start shaping your review based on the higher risk areas.

Risk Scoping Your Review

There are many parts to the loan lifecycle, and each have their own unique risks. Some areas may be a much greater risk to your organization than to others. Lenders within the same geography or that offer the same types of products may face similar fair lending risks. Your organization could also face completely different risks than the organization down the street. Each lending institution is unique. The products you offer and whether you have referral programs could greatly increase risk in some areas.

The goal of this module is for you to think about your organization and help you identify the major risk areas you are facing. You will want to take notes and answer some of these questions to help steer you in the right direction when it comes to choosing which type of fair lending reviews to complete.

It should not be your goal to conduct all of the reviews within this school, or at least not all of them right away. You should focus your efforts on the higher-risk areas first. If your organization is very large, one or two of the reviews could be a major workload. If you are a smaller organization, you may be able to do all of the reviews in a short period of time. You should not do the reviews just because; you should conduct the reviews where you have high risk.

Module 4 Setup

To write this module, we used the FDIC Compliance Examination Manual. The FDIC Manual gives guidance to examiners on how to conduct a fair lending review. If you want to refer to the manual and use that as your guide, it is a great resource. We have taken out the key bullet point items that could apply to you and summarized them throughout this manual. Let's get started.

Understanding Your Organization and Credit Operations

You will need to understand how your organization operates its lending program. To do this, you will have to gather data from all of your lending channels. Here is some background information you will need to gather:

- What types of credit products your organization offers
- Determine whether your organization offers any special-purpose credit programs or other programs that target underserved populations
- How many of each of the loan products your organization makes a year, and any major growth in those products (loan volume)
- The population demographics of your market area
- How your organization makes credit decisions (underwriting program)
- The extent that your loan staff has discretion to deviate from loan policy, including underwriting, pricing, and setting loan terms
- Any approval authority for the deviations described above
- How your loan officers (and/or brokers) are compensated (i.e. salary, bonus, profit sharing, loan proceeds, etc.)
- Any relevant documentation or data that is available for the various loan products that you can use as part of your analysis

If your organization has multiple underwriting or loan processing centers or subsidiaries, each with a fully independent credit-granting authority, you will want to consider each center and/or subsidiary separately, providing you have sufficient number of loans to support a meaningful analysis. Most smaller organizations will not fall in this category, but those that do will want to consider the following:

- Be aware that regulators will hold financial institutions responsible for violations by their direct subsidiaries, but not typically for those that are affiliates. Reminder – subsidiaries exist when one entity owns another entity.

The most common subsidiary is when a holding company owns a financial institution, or when a financial institution owns an investment or insurance agency. Affiliates are when two entities are owned by the same entity. This is common when multiple institutions are owned by the same holding company.

- Know whether a complete loan decision can be made at one of the several underwriting or loan processing centers, each with independent authority.
- Be aware if decision-making responsibility for a single transaction may involve more than one underwriting center. For example, an organization may have authority to decline mortgage applicants, but only the mortgage company subsidiary may approve them.
- Know if applicants can be steered from your organization to a subsidiary or other lending channel and vice versa, and what policies and procedures exist to monitor this practice.
- Determine if any third parties, such as brokers or contractors, are involved in the credit decision and how responsibility is allocated among them and the organization. The organization's familiarity with third party actions may be important, because an organization may be in violation if it participates in transactions in which it knew or reasonably ought to have known other parties were discriminating.

Evaluating the Potential for Discriminatory Conduct

The FDIC Compliance Examination Manual directs examiners on how to proceed with the fair lending review. While this is good guidance to help determine your review, we are going to broaden it a bit. After you have done your analysis of your institution and credit operations, you will need to determine the information required to conduct your review. The examination manual tells examiners that a single examination cannot reasonably be expected to evaluate an institution's performance for every prohibited basis, and we can apply that same concept to our review. You may or may not be able to review everything, but you do need to identify the highest risk areas and focus your attention on those areas.

Here are some things to consider when deciding on your review:

- What products, processes, or prohibited bases were reviewed during the most recent audit, self-evaluation, or regulatory examination?
- Which prohibited basis groups make up a significant portion of your market?
- Do you have products or referral channels that carry higher risks such as sub-prime lending, higher-fee, or higher-rate products?

The FDIC Compliance Examination Manual provides a list of areas to review and consider. Using the information that you have gathered, you should evaluate the following, as applicable:

- Underwriting guidelines, policies, and standards.
- Descriptions of credit scoring systems, including a list of factors scored, cutoff scores, extent of validation (if the system/model has ever been validated), and any guidance for handling overrides and exceptions.
- Applicable pricing policies, risk-based pricing models, and guidance for exercising discretion over loan terms and conditions.
- Descriptions of any compensation system, including whether compensation is related to, loan production or pricing. (NOTE: You don't need to see the actual salary numbers for lenders, you just need to know the basis for how they are compensated.)
- The organization's formal and informal relationships with any finance companies, subprime mortgage or consumer lending entities, or similar institutions.
- Loan application forms.
- Home Mortgage Disclosure Act – Loan Application Register (HMDA-LAR) or loan registers and lists of declined applications.
- Description(s) of databases maintained for loan product(s) to be reviewed.
- Records detailing policy exceptions or overrides, exception reporting, and monitoring processes.
- Copies of any consumer complaints alleging discrimination and related loan files.
- Compliance program materials (particularly fair lending policies), training manuals, organization charts, as well as record keeping, monitoring protocols, and internal controls.
- Copies of any available marketing materials or descriptions of current or previous marketing plans or programs or pre-screened solicitations.
- The coverage area of any newspapers, radio stations, or other advertising venues you use.
- Maps of your assessment or market areas, noting any minority populations and where those populations live.

The list above is an excellent comprehensive checklist that you can follow to help you find the risk at your organization. A review of these items will greatly help you focus your review.

Deciding on Your Review

After reviewing the areas above, you can start to paint the picture on where the higher fair lending risks are for your organization. Each of the modules to follow focuses on a major risk area. Before we get too far into those areas, let's look at a brief summary first.

Applications

The applications module has a few components to it. The first is the physical paper applications (or online applications) your organization uses. If you purchase your applications from a vendor, they likely have the information required and don't have questions they shouldn't. If you develop your own internal applications, you will have higher risk. You should likely consider reviewing the application in its entirety.

The process you use to take applications is also a key component. You want to ensure that you have a consistent process that is fair to all applicants. If a customer walks through your door and asks to apply for a loan, and your procedures are to have them sit with a lender, do that every time.

Lenders are also likely screening applicants with questions. If they are collecting information and communicating informal underwriting decisions, they are likely discouraging applicants from applying. This can be a major risk factor.

Another critical component in the application process is documenting joint intent. Does your policy or procedures

PRO TIP

All of these areas below will be covered extensively throughout this course. We want to introduce these topics here and get you thinking about these areas before you get really deep into your reviews. As you read through the list of fair lending risks below, do some high-level reviewing and try to determine if these are low-risk or high-risk at your institution. The goal of this course is to teach you about all of the fair lending risks and give you the tools to review for them. The goal is not to have you do an in-depth review of all of the areas of this course. You certainly can do that, but start with the high-risk areas first.

address this? Have your lenders been trained on the requirements? We have seen many times where organizations don't get applicants to sign the joint intent until closing. This is a requirement at application. If you have weaknesses in this area, you may want to consider it for your review.

Steering

Does your institution have high-cost or high-risk products that only certain customers typically get? That's not necessarily a bad thing, but you cannot steer applicants into those products because of a prohibited basis category. Does your organization compensate lenders based on fee income, rates charged, or getting someone into a certain loan product or channel? If so, you could have steering risk. Most smaller organizations have traditional products; few if any, channels to refer applicants; and compensate based on salary and bonus. If you are a larger organization that offers higher-risk products or have more advanced compensation packages, steering risk might be higher at your institution. Selling add-on products like credit life and credit disability insurance and offering government guaranteed loan products also increase steering risk.

Underwriting

Every time we look at an organization's underwriting program, the first thing we typically do is go straight to the loan policy. The loan policy typically contains some or all of the underwriting criteria for consumer purpose loans. It's common to see some loan-to-value (LTV) limits, debt-to-income (DTI) limits, and possibly some credit bureau requirements. Such requirements could be either limited derogatory items, minimum credit score requirements, and certain repayment history. Other factors you might find in a loan policy is some guidance on loan terms, employment history requirements, and residency requirements. Finally, you should likely see references to the fair lending laws and often a list of the different prohibited bases.

In addition to the loan policy, it's fairly common to see an underwriting checklist of some sort. This could be as simple as collecting LTV, DTI, and credit scores or be very complex. It's not necessarily required to write down underwriting criteria, but it will greatly strengthen your program if you do. It can be very difficult to prove that you have a strong underwriting program if guidance is limited and documentation is non-existent.

See what your lenders use for underwriting guidance. Ask them how they underwrite loans (this is done in your fair lending interview) and evaluate how they document this critical step. If underwriting is listed in policy, don't just assume that all lenders are following it. Do the fair lending interview and actually verify that they know, understand, and follow policy. Trust, but verify. If lenders have good guidance, document thoroughly, and follow loan policy, your risk is greatly reduced.

Underwriting guidance must also be clear and concise. Vague underwriting guidance opens the door up for lenders to guess on how to do their jobs. Your underwriting standards should be clear and free from guesswork. All lenders should be able to read the standards and come to the same conclusions every time to ensure fairness and consistency in the loan decision process.

Finally, find out how much discretion lenders have in varying from policy. As with any area, policies are only useful when they are followed. If lenders can make underwriting exceptions without limitation, and they are not tracked for unfavorable trends, having a clearly written and robust policy or checklist will not help. You can simply grab a handful of recently closed loans and find that out. Follow the underwriting trail and see if lenders are following guidance, deviating from policy, getting exceptions approved, and doing their jobs based on loan policy.

Pricing

Step 1 to mitigating pricing risk is having formal pricing guidance like a rate sheet. Step 2 to mitigating pricing risk is making sure your guidance is well defined and easy to follow, just like underwriting guidance. Step 3 is actually following the rate sheet. Step 4 is to limit deviations from the rate sheet and monitor when you do. It's really that simple. Unfortunately, that's not usually the way it works in the real world. Here are some things to consider.

Step 1 - does your organization have a rate sheet for pricing loans? If the answer is no, you have the highest potential risk. That doesn't necessarily mean you have pricing discrimination, but your risk is high, and you will have to review to know for sure. Lenders need guidance on how to price their loans to ensure consistency across the board. If they don't have guidance, they will do the best they can. They may be somewhat consistent in pricing their own loans (or not), but they will likely be inconsistent in pricing compared to other lenders and branches. A majority of the pricing reviews that we have conducted that did not turn out well were of programs with minimal or no pricing guidance.

Having a rate sheet is step 1, but having a **well-defined** rate sheet (a pricing model) is **Step 2**. We've seen rate sheets that told lenders to price consumer loans between 3% - 18%. That was the only guidance given. The institution did no monitoring, never performed an audit, and didn't track exceptions. How can you track exceptions when every rate you ever give is within such a broad range? Your rate sheet should give specific guidance. You can choose whatever factors your management feels are important to determine price. We've seen credit score, age of collateral, loan term, and LTV all drive interest rate pricing.

Step 3 in this process is actually following the rate sheet. You can have the best rate sheet known to exist, but if nobody follows it, all you have is a pretty piece of scratch paper. Make sure lenders are actually following the rate sheet. This is simple to do. Grab a handful of recently closed files and check to see if they were priced based on the rate sheet. Get files from different lenders and different branches and simply spot-check to see if they were priced correctly.

Step 4 is the final step in pricing risk and that is controlling and tracking deviations. If you allow lenders to deviate from the rate sheet, do they need to get approval? If so, deviations from the rate sheet should be tracked and analyzed periodically. What we have found in looking at a rate-deviation tracking log is one lender may give an interest rate break 48 times to men and only 2 times to women. You want to look for those negative trends and find out if rate deviations are being done fairly and consistently or on any prohibited basis.

If you have a strong rate sheet, limit pricing deviations, and track and monitor when you do deviate, pricing risk can be greatly controlled and reduced. If you have a rate sheet with broad pricing guidance or no rate sheet at all, you likely have very high pricing risk.

Exceptions

In order to have loan exceptions, you need to first have guidelines for lenders to follow. These guidelines are often in the form of policies and procedures. For underwriting purposes, the criteria you use to approve or deny a loan is your underwriting guidelines. Any time a lender approves a loan that is outside of your guidelines, an exception to policy is made. For pricing, you will want to have some basic rates set up for lenders to follow. If you have a robust pricing model, it is easier to track exceptions. When, based on the applicant's criteria, they are supposed to get one rate, and for some reason they got a lower rate (or even higher), a pricing exception has been made.

Exceptions to loan policy open your organization up to additional fair lending risk. It is your job to track those exceptions and determine that they are being controlled, approved, and done on a fair basis. If you are not currently tracking exceptions, you should be. If you are tracking exceptions but not performing an analysis of them, the exceptions module (Module 9) will teach you how.

Denials/Adverse Action Notices

Not every loan application turns into a loan. When an applicant does not meet your credit standards, that application is denied, and the applicant is required to get an adverse action notice. The upfront risk for denials is not making loan decisions on a fair basis. You can have two applicants with the same set of ratios, scores, and basic creditworthiness, but one may be approved and one may be denied. This is already a problem, but when the person approved was of a different race or ethnicity than the person denied, the lender may have done it on a prohibited basis. How do you help prevent this from happening? Robust, understood, and consistently followed underwriting criteria. That is your number one defense against denial risk.

In addition to denial risk, there are several things that must be done and included on the adverse action notice. This is an area that often is forgotten and an easy way for examiners to find violations. Fortunately, it's not a hard area to manage and monitor, if you know what to do. Many organizations can easily strengthen their fair lending program simply by increasing their monitoring of the denial process and adverse action notices.

Marketing

Some of the fair lending risks around marketing are obvious. You want your marketing to represent your lending area demographics, meaning the individuals in your marketing materials should represent the individuals living in your market area. You also need to find out to whom are you marketing. Is your marketing staff sending marketing materials to all parts of your assessment area, or are they avoiding high-minority neighborhoods?

What is in your marketing materials? We have been to many organizations where the compliance staff and senior management had no idea what was included in their marketing materials. Compliance reviews of marketing materials should be built into your program.

Finally, social media presence is always expanding. Does your financial institution use any of the social media platforms? If so, who monitors it? Who is allowed to make posts to the sites? Are they being monitored for complaints? Are your messages compliant with all of the regulatory requirements? Does the institution only use sponsored social media advertisements to certain zip codes or people of a certain age? Are employees posting on social media as a way to draw more business to your institution? Have you ever actually looked at employee social media pages to see if they are? Social media can be a great thing for institutions, if properly monitored and controlled.

Redlining

Any and all of the other risks can lead to redlining risk. The basic premise behind redlining is not providing equal access to credit based on geography. The more diverse your market area is by population, the higher redlining risk you have as an organization. If you only have one physical location and are located in a low-minority area, you likely have very low redlining risk. If you are a larger organization with many branches in a highly diverse population, you have much higher risk for redlining. Many cities have pockets of lower-income families or individuals, which crosses over with the Community Reinvestment Act. They also have pockets of higher minority populations. Financial institutions that engage in redlining practices target these areas with products that are higher risk, higher fees, or less advantageous terms, or they might avoid those areas all together.

Where your physical branches are located is also another key factor in redlining risk. We will walk you through two case studies of institutions that were criticized based on the locations of their branches. If you are a growing organization and looking to expand or acquire another lending organization or institution, it is critical you understand redlining risk and how it can affect your overall program.

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Deciding on Your Review

As we get into Module 5 and beyond, we will take a deeper dive into the loan lifecycle components and how to perform reviews of each area. As previously mentioned, you do not need to do a full-scope review of all of these areas. If you are a smaller organization and you have the time and capacity, it's fine to review all of the areas we will be covering. Just know that you may be spending time and resources on low-risk areas. The point of this module is to look at the risks, decide on the higher-risk areas, and that's where you focus on your review.

There is one last concept we need to discuss before we get into the reviews, and that has to do with how you conduct evaluations of your program. This topic was briefly introduced in the CMS module, but we will expand a bit more on it here: self-tests.

Self-Tests

Under the ECOA (Regulation B), financial institutions may perform self-tests. First, let's look at the definition of a self-test:

> *A self-test is any program, practice, or study that:*
>
> *i. Is designed and used specifically to determine the extent of effectiveness of a creditor's compliance with the Act or this part; and*
>
> *ii. **Creates** data or factual information that is not available and cannot be derived from loan or application files or other records related to credit transactions.*

What does this all mean? If your institution conducts a self-test, the findings of that test can be privileged, and you may not have to disclose findings to your regulator. However, there are some pieces that have to fall into place for that to happen.

First, let's look at the gathering of information part. Generally, the reviews in this course would not constitute a self-test under the regulation. If you look at the official interpretation of 1002.15(b)(2)(ii), it says that you have to *"produce new data or factual information that otherwise would not be available and could not be derived from loan or application files or other records related to credit transactions."*

That is a bit confusing, but they give us some examples:

- *A creditor may elect to test a defined segment of its business, for example, loan applications processed by a specific branch or loan officer, or applications made for a particular type of credit or loan program.*
- *A creditor also may use other methods of generating information that is not available in loan and application files, such as surveying mortgage loan applicants.*
- *To the extent permitted by law, creditors might also develop new methods that go beyond traditional pre-application testing, such as hiring testers to submit fictitious loan applications for processing.*

PRO TIP

It is uncommon for institutions to conduct self-tests, but there may be times when it is warranted. If for any reason, you believe your institution will get great value in conducting a self-test, ensure that you read this part of the regulation thoroughly to understand what you can and cannot do, and what is and is not privileged. You can even reach out to your regulators for guidance on how to successfully conduct a self-test.

The reviews we will conduct as part of this school are not creating new data, so they are considered self-evaluations, not self-tests. Since we will be reviewing data already available, there will be no privilege under the Equal Credit Opportunity Act.

MODULE SUMMARY

In this module, we focused on helping you decide what areas to review based on the risks present in your organization. You will need to start with understanding your organization, your community demographics, the products and services you offer, and your operations as a whole. Then we walked through many of the factors you need to consider when deciding on your review. Finally, we introduced you to the basics of the loan lifecycle. It is important that you have a good understanding of your risk to help direct you where to focus your time. The focus of the next modules will be directly on each component of the loan lifecycle, starting with taking a loan application.

TUSCAN CLUB
UNIVERSITY

MODULE 5

APPLICATIONS

Tuscan Club University
Fair Lending School

MODULE 5 – APPLICATIONS

MODULE OBJECTIVES

Module 5 is where we transition from the theory surrounding fair lending and start digging into the actual loan lifecycle and start performing reviews. We have discussed the overview, covered the laws and regulations, and talked about risk-scoping your review. Now we will actually get into the first part of the loan lifecycle – the application process.

In this module, we will define what an application is. We will talk about the process of taking an application and about discouraging and screening applications. We will cover the risks of making your own applications or purchasing them from a vendor. Then we will talk about the importance of having standard application procedures and where you can find pitfalls. We will finish off with some of the details about joint applicants, co-signors, and teach you how to review your program. Let's start conducting our first review.

What is an Application?

Application means an oral or written request for an extension of credit that is made in accordance with procedures used by a creditor for the type of credit requested. This definition is simply straight out of Regulation B, but one of the takeaways here is your organization needs to have some basic procedures in place on what you consider a completed application.

Applications do not have to be written. They can be oral, over the phone, online, or in-person. All applications for credit must get a written response. For home loan applications, the standard government application is preferred. For general consumer purpose loans, you have the choice.

Internally developed applications vs. industry standard applications

You have a choice as an organization to either purchase applications from a vendor or develop your own applications. Here are the pros, cons, and risks for both:

Internally Developed:

Pros	Cons
Cheaper	You must develop
Easy to edit	May not meet reg requirements
	You must keep up-to-date

Industry Standard Apps:

Pros	Cons
Should meet all of the regulatory requirements	Cost
Likely reviewed by regulators	Unable to edit
If there is a regulatory change, simply order new applications	May not be able to use old forms if regulations changed

PRO TIP

If you are going to develop your own applications, you need to make sure you do the following: include all required information; don't include prohibited information (i.e. prohibited basis questions not allowed by regulation); and keep apps up-to-date with all regulatory changes.

Internally Developed Apps – What Needs to Be There?

If you are an institution that creates your own applications, there are items you need to include. Appendix B to Regulation B contains sample application forms. It is recommended that you follow the model forms when creating your internal applications as mcuch as possible. We have included all model forms at the end of this module. You can also follow this link to the CFPB website. **https://www.consumerfinance.gov/policy-compliance/rulemaking/regulations/1002/B/#ImageB3d**

Discouraging Applicants

Any customer-facing employee can discriminate against a loan applicant. You don't have to be a lender to discriminate against someone. Anyone in your branch or who answers the phone or greets customers in the lobby has the opportunity to discriminate.

This includes:

- Tellers
- Administrative assistants
- Loan officers
- Operations staff
- Loan staff
- Phone bankers
- Any other front office or branch employees

PRO TIP

You have the option of building your own applications or buying them. This is a decision for senior management to make, as it carries some costs. If you purchase them, you will need to pay a fee to get the applications. But with that fee, you also get assurance that the applications are in compliance. You will want to weigh the risks and make a decision. We can tell you from experience that a substantial majority of institutions we have reviewed purchase their own applications, and they rarely had issues with the form itself.

Car Loan Example – Consumer Complaints

While serving as a compliance examiner, we received a complaint about one of our institutions that was fair lending-related. The complaint was in regards to an applicant applying for a car loan. The applicant was a minority female, and the loan officer was a white male.

While the applicant was in the loan officer's office, she indicated that she wanted to apply for a car loan. The loan officer's response was "I know how you people are with car loans." Understandably, the applicant was upset and filed a formal complaint, but that's not the end of the story.

When the next compliance examination came around, which wasn't more than a few months from the incident, that complaint became the focal point of the fair lending review. We did not look at pricing, underwriting, denials, or any of the other major risk areas we will be talking about in this school. That fair lending review focused solely on that loan officer, that product, and that prohibited basis.

Complaints should always be taken seriously, but fair lending complaints even more so. One complaint drove the entire fair lending review. If your institution receives a fair lending-related complaint, ensure you investigate that complaint to determine if there is any discrimination present. In this case, we did not find any evidence of disparate treatment. That loan officer had made the same loans to other minority applicants, and they were not priced or underwritten any differently.

In the end, the loan officer did make an overt comment, but we could not prove any discrimination. It was a good lesson learned for that institution, and we have taken that lesson with us ever since. Fair lending complaints should be taken very seriously and investigated thoroughly. If you don't do the work, the examiners likely will. In this instance, the fair lending issue started during the application process. Had that customer not filed a complaint, the institution and regulators may have never known.

Screening Applicants

Lenders often have conversations with applicants during the application process. During these conversations, they often gather information which can be helpful in the process. However, when lenders start collecting informal underwriting criteria and start communicating informal underwriting decisions, they are potentially screening applicants and discouraging them from completing the application process.

There are many ways this can happen, but one of the most common goes like this. Someone comes into your organization and wants to buy a car. During the application process, they say to the lender something like "My credit score is not very good. The last I checked, it was around 500." Not let's say that your minimum credit score requirement for car loans is 650. The lender clearly knows that the applicant is far outside of policy and is very unlikely to get a loan. So, the lender communicates that with the applicant, and the applicant withdraws their application. Why is this an issue?

It's an issue becuase the borrower never went through the process, never got a chance to go through underwriting, was discouraged from applying, and now won't get the required adverse action notice (denial notice) they are required to get by regulation. How could someone like an outside auditor or examiner possibly know that is happening at your organization?

One simple way is to look at the number of denials and compare that to loans. If you make 1,000 loans in a calendar year and have 5 denials, you're either the most generous lender on the planet, or lenders are screening applicants and a majority of individuals who should have got denial letters didn't becuase they were discouraged from completing the application process. Make sure you train all loan staff on the proper way to screen applicants. They should be gathering data but never making informal underwriting decisions. If they are, you will have a ton of denied applications with out denial notices and you risk screening on a prohibited basis group. This is one of the biggest reasons why you want formal application procedures, which we will cover next.

Application Procedures

What is your process when a customer calls your organization? How about when they come into a branch to apply for a loan? You will want to make sure your loan officers have consistent procedures for taking loan applications. During Module 13, we will talk about the application process in the fair lending interview.

How can application procedures go wrong?

Let's run through two different scenarios to show why at least basic procedures are important.

Scenario 1 – A non-Hispanic white applicant walks into a branch and asks if he can apply for a car loan. An employee (could be any employee) hands the man a written application, asks the man to fill it out, and goes and gets a loan officer to help the man. Nothing really out of the ordinary here.

Scenario 2 – The next day, a Hispanic applicant walks into the same branch and asks if she can apply for a car loan. The same employee hands the applicant a written application and asks the applicant to ***mail*** it in.

In these two scenarios, applicants were treated differently, possibly because of a prohibited basis. It is important to have consistent procedures that ALL customer facing employees know. That means that anyone in your branch (teller, administrative assistance, insurance agent, etc.) that works with customers could possibly (intentionally or not) discriminate against an applicant.

PRO TIP

Have some basic application procedures for your staff to use. If you are a small institution with only a few lenders, it might be okay to have informal procedures, but make sure everyone knows the process. As you grow, it may be wise to have written formal procedures. You can test the procedures by simply asking employees to explain the process. This is included within the fair lending interview in Module 13.

If your procedures are to fill out a written application and get a loan officer every time, do that every time. When you go out of your way for some applicants and not others, you run the risk of doing so on a prohibited basis. Have simple procedures in-place and ensure your lobby staff know what to do.

Do not go the extra mile for some applicants but not others. That statement doesn't mean that everyone should get a loan. Applicants still need to be creditworthy, but everyone needs to have the same opportunity to apply for credit. The Equal Credit Opportunity Act literally has "Opportunity" in the name. It's kind of important. If you're willing to go the extra mile for one applicant, you need to be willing to do that for all applicants and give everyone that same opportunity. All lenders need to be trained on this very basic but very critical concept.

Reviewing Your Program

There are three things you should do in this area:

1. Review your current applications to ensure they are in compliance
2. Develop formal procedures on taking applications
3. Train all of your customer-facing staff on your procedures for taking loan applications

Reviewing Applications

You will need to collect all of the different types of written applications your orgnization uses. Make sure you go to all lending channels. Commercial and agriculture lenders may or may not use formal paper applications, but ask anyway. ****Do not forget your online application channels****

Compare your applications with the model disclosure forms in Regulation B. Make sure you know which credit product you are looking at and compare to the right form:

- Open-end, Unsecured Credit
- Closed-end, Secured Credit
- Closed-end, Unsecured/Secured Credit
- Community Property

At the end of this chapter you will find the model form disclosures. They can also be found in Appendix B to Part 1002 – Model Application Forms: **https://www.consumerfinance.gov/policy-compliance/rulemaking/regulations/1002/B/**

It is important that you INCLUDE everything on the model forms and be careful of what you ADD to your applications. If you use purchased, industry-standard applications, you greatly reduce your risk.

Joint Borrowers and Documenting Joint Intent

One of the bigger risks when going through the application process for lenders is documenting joint intent. Let's briefly talk about the risk and then talk about how to mitigate the risk.

It was fairly common years ago to have someone apply for a loan, typically a married person, and that person would be approved for the loan and pledge some sort of collateral for the loan (car, house, business, etc.). When it came time to close the loan, the applicant and anyone else who had ownership in the collateral would have to sign documents (mortgage, security agreement, third-party pledge, etc.) saying that they pledged that collateral against the loan. Then, unexpectedly, the loan officer would hand the promissory note over to the additional collateral owners and have that person sign the note. Why is this a problem?

Let's call our applicants John and Jane Doe. John applies for the loan and is approved on his own. When the loan closes, John and Jane sign the security documents. Jane is required to sign the security documents to acknowledge that she is pledging something she owns against a loan, even though she didn't apply for the loan. Making Jane also sign the promissory note now obligates Jane to repay the debt, but Jane never applied. The only reason that Jane was likely asked to sign the promissory note is because she was married to John, and marital status is a prohibited basis.

Now you can argue that Jane would have been required to sign as an owner or a guarantor, but here's where it starts to fall apart. Now let's imagine John and his brother Joe Doe own a business together. John comes in to apply for a business purpose loan, and Joe also needs to come in to sign any security documents. In this case, however, the loan officer does not make Joe sign on the note like Jane had to. That's where we get into the marital status issue. Both John and Jane owned assets together, and so did John and Joe. Only Jane had to sign the promissory note because she was married when Joe did not. This scenario used to be commonplace in commercial lending and even more so in the farming/agriculture industry. So how do you prove that Jane was truly voluntarily applying for the loan? By documenting joint intent.

Whenever more than one person applies for a loan (all loan types), those borrowers must attest to a statement that says they want to apply for joint credit. For consumer loans, there is typically a spot on the application to sign. However, signing the bottom of the application DOES NOT signify joint intent. Typically, signing the bottom of an application only says the information included is accurate. Joint intent has been such a big issue for so long, Regulation B carves out a separate requirement that says you must sign or attest to a statement that says you intend to apply for joing credit, or something very similar. For residential real estate applications, the joint intent section is right at the top.

Uniform Residential Loan Application

This application is designed to be completed by the applicant(s) with the Lender's assistance. Applicants should complete this form as "Borrower" or "Co-Borrower," as applicable. Co-Borrower information must also be provided (and the appropriate box checked) when ☐ the income or assets of a person other than the Borrower (including the Borrower's spouse) will be used as a basis for loan qualification or ☐ the income or assets of the Borrower's spouse or other person who has community property rights pursuant to state law will not be used as a basis for loan qualification, but his or her liabilities must be considered because the spouse or other person has community property rights pursuant to applicable law and Borrower resides in a community property state, the security property is located in a community property state, or the Borrower is relying on other property located in a community property state as a basis for repayment of the loan.

If this is an application for joint credit, Borrower and Co-Borrower each agree that we intend to apply for joint credit (sign below):

Borrower ______________ Co-Borrower ______________

I. TYPE OF MORTGAGE AND TERMS OF LOAN

Mortgage Applied for:	☐ VA ☐ FHA	☐ Conventional ☐ USDA/Rural Housing Service	☐ Other (explain):	Agency Case Number	Lender Case Number

Here is an example of joint intent on a consumer loan application:

CONSUMER LOAN APPLICATION

CREDIT REQUESTED

Account Requested ☐ Individual ☐ Joint	Amt. Requested	# of Payments	Preferred Pmt. Amt.	Preferred Pmt. Day	Market Survey
We intend to apply for joint credit.	Specific Purpose of Loan				
Applicant ______ Co-Applicant ______	Collateral Offered				

COMPLETION INSTRUCTIONS FOR APPLICANT

In both of the examples above, there is a clear statement that the borrowers either sign or initial that says they want to apply for joint credit. It's common for lenders to not get this part filled out, and that is a regulatory violation, but isolated instances are not the problem. It's when you have a pattern or practice of not having this documented. Why? Because they typically don't use a written application. For commercial and agricultural loans, institutions typically use a separate joint intent form. We have an example coming up of one you may have at your institution.

Regulation B Notice of Intent to Apply for Joint Credit

Regulation B and the Equal Credit Opportunity Act requires that a lender obtain evidence of each loan applicants' intent to apply for joint credit before a credit decision can be made. Failure to complete when required will render the application/request for credit incomplete. If you are curious, the regulatory citation to this part of Regulation B is 1002.7(d)(1) commentary.

In other words, your lenders need to be documenting joint intent around the time of application. This is a common finding. The requirement is the intent to "Apply" jointly, not "Close" a loan jointly. You cannot document joint intent at the time of closing - it's too late. Usually, joint intent is either on the application which is dated or on a joint intent form which also should be dated. If those are dated at or around the time of closing, you will likely face criticism.

PRO TIP

Make sure your loan staff is getting the joint intent statement signed AT APPLICATION. We have often seen where that is signed later in the loan process or even at closing. Joint intent must be acknowledged at the time of application. This is also a common finding, and this fact can easily be identified within a fair lending interview. Train your lenders to get this at application, every time, without exception.

Notice

(Please mark one of the following choices)

☐ I (we) intend to apply for joint credit.

☐ I (we) do not intend to apply for joint credit.

Acknowledgement

(You acknowledge receipt of a copy of this notice on today's date)

________________	________________	__________
Print or type Applicant Name	Applicant Signature	Today's Date
________________	________________	__________
Print or type Applicant Name	Applicant Signature	Today's Date

Borrower

Primary Applicant/
Borrowing Entity Name: ________________________

Applicant Address: ________________________

____

Joint Intent Pitfalls

There are some common misconceptions around joint intent that lenders have. Here are some common situations you may see and hear that do not count as documenting joint intent.

1. Signing the bottom of an application – this is only attesting to the accuracy of the information, not that they intend to apply jointly
2. Applicants submitting joint financial statements – just because married applicants give you joint financial statements does not mean they intend to apply jointly
3. Joint tax returns – again, just because there is more than one applicant's information on the tax return does not mean they intend to apply jointly

Regulators and the written regulations themselves have made it pretty clear that the borrower must sign or initial next to a statement that says they intend to apply jointly. Make sure all of your commercial lenders are doing this and are aware of the importance.

Determining Applicants and Requiring Co-signors

Documenting joint intent is important, and there are often instances where a loan officer will need to determine who is applying. When two or more applicants are in a loan office, a lender can simply ask who is applying for the loan. You can even build this part into your written procedures. Loan officers should never assume whom is applying or pressure anyone to apply for a loan.

What happens if your applicant does not meet your credit criteria, but you allow for co-signors? You should have procedures for that too. Let's say that a male applies for a car loan, but his income just isn't enough to qualify him; however, more income may get the loan approved. Lenders cannot say "If your spouse applies, we might be able to approve the loan." When lenders suggest co-signors, you can start crossing the prohibited basis lines (marital status, familial status, etc.).

The correct way for lenders to handle co-signors is to simply say "If you have a creditworthy co-signor, we can re-evaluate your application." Then if an applicant says, "Can I have my wife apply?", ***they*** are suggesting the co-signor.

In addition, lenders should be aware of the age to enter into a contract in their state. We were examining an institution where a loan officer believed that he could require cosigners for any applicant who was under the age of 21. However, in that state, the age to contract was 18. Therefore, examiners asked the institution to release any cosigners where the applicant was independently creditworthy.

Developing Procedures

All of your front office staff need to know your application procedures. ANYONE in your institution can discriminate against a loan applicant, not just lenders. You will want to develop procedures to ensure your application process is consistent. Procedures don't have to be elaborate or lengthy. Procedures should be commensurate with your organization's size and complexity.

- Small organizations with limited staff may only need informal procedures
- Medium sized organizations might need written procedures
- Large organizations need even more controls to ensure consistency

Revisit your procedures annually to ensure they still match the risk profile of your organization.

Train Your Staff

Make sure all customer-facing staff know what they are supposed to do when a customer wants to apply for a loan. If your procedures are to always give them an application and then get a loan officer, do that every time. Be consistent.

Training on application procedures can be done during annual fair lending training. Knowing if lenders are following procedures can be verified during the fair lending interview (discussed in Module 13).

MODULE SUMMARY

During this module, we discussed the entire application process. What you want to do as a review of this process is find out what application forms your loan officers are using. Explain the importance of them using management-approved applications every time. Also make sure they are kept up-to-date as regulations change.

Ensure your lenders understand the importance of documenting joint intent at the time of application. You can easily sample loan files to see if joint intent is documented. Look for patterns or practices of it not being documented. Often times, you will find certain lenders show patterns of not complying. Retrain them when necessary. While you're talking joint intent with them, discuss the importance of co-signor procedures. If you have written application procedures, this should be within those procedures. If not, you can include it in your loan policy.

Train all of your customer facing staff on the basic application procedures of your institution. While your lenders will need training in all areas, basic application procedures and their importance can be covered in a few minutes at an all-staff meeting. Don't forget to document that training to get credit under your Compliance Management System.

Review the next few pages for regulatory examples of what applications should include. Compare your applications to ensure you are requesting the appropriate information and not requesting something that is not on the model forms. At the top left of each application it tells you what type of credit the form is for. Ensure you are comparing your applications to the correct model form.

[Open-end, unsecured credit]

CREDIT APPLICATION

IMPORTANT: Read these Directions before completing this Application.

Check Appropriate Box

☐ If you are applying for an individual account in your own name and are relying on your own income or assets and not the income or assets of another person as the basis for repayment of the credit requested, complete only Sections A and D.

☐ If you are applying for a joint account or an account that you and another person will use, complete all Sections, providing information in B about the joint applicant or user.

We intend to apply for joint credit. ______________ Applicant ______________ Co-Applicant

☐ If you are applying for an individual account, but are relying on income from alimony, child support, or separate maintenance or on the income or assets of another person as the basis for repayment of the credit requested, complete all Sections to the extent possible, providing information in B about the person on whose alimony, support, or maintenance payments or income or assets you are relying.

SECTION A—INFORMATION REGARDING APPLICANT

Full Name (Last, First, Middle): ______________ Birthdate: / /

Present Street Address: ______________ Years there: ______

City: ______________ State: ______ Zip: ______ Telephone: ______________

Social Security No.: ______________ Driver's License No.: ______________

Previous Street Address: ______________ Years there: ______

City: ______________ State: ______ Zip: ______

Present Employer: ______________ Years there: ______ Telephone: ______________

Position or title: ______________ Name of supervisor: ______________

Employer's Address: ______________

Previous Employer: ______________ Years there: ______

Previous Employer's Address: ______________

Present net salary or commission: $ ______ per ______ No. Dependents: ______ Ages: ______

Alimony, child support, or separate maintenance income need not be revealed if you do not wish to have it considered as a basis for repaying this obligation.

Alimony, child support, separate maintenance received under: court order ☐ written agreement ☐ oral understanding ☐

Other income: $ ______ per ______ Source(s) of other income: ______________

Is any income listed in this Section likely to be reduced in the next two years?
☐ Yes (Explain in detail on a separate sheet.) No ☐

Have you ever received credit from us? ______ When? ______ Office: ______

Checking Account No.: ______________ Institution and Branch: ______________

Savings Account No.: ______________ Institution and Branch: ______________

Name of nearest relative not living with you: ______________ Telephone: ______________

Relationship: ______ Address: ______________

SECTION B—INFORMATION REGARDING JOINT APPLICANT, USER, OR OTHER PARTY (Use separate sheets if necessary.)

Full Name (Last, First, Middle): ______________ Birthdate: / /

Relationship to Applicant (if any): ______________

Present Street Address: ______________ Years there: ______

City: ______________ State: ______ Zip: ______ Telephone: ______________

Social Security No.: ______________ Driver's License No.: ______________

Present Employer: ______________ Years there: ______ Telephone: ______________

Position or title: ______________ Name of supervisor: ______________

Employer's Address: ______________

Previous Employer: ______________ Years there: ______

Previous Employer's Address: ______________

Present net salary or commission: $ ______ per ______ No. Dependents: ______ Ages: ______

Alimony, child support, or separate maintenance income need not be revealed if you do not wish to have it considered as a basis for repaying this obligation.

Alimony, child support, separate maintenance received under: court order ☐ written agreement ☐ oral understanding ☐

Other income: $ ______ per ______ Source(s) of other income: ______________

Is any income listed in this Section likely to be reduced in the next two years?
☐ Yes (Explain in detail on a separate sheet.) No ☐

Checking Account No.: ______________ Institution and Branch: ______________

Savings Account No.: ______________ Institution and Branch: ______________

Name of nearest relative not living with Joint Applicant, User, or Other Party: ______________ Telephone: ______________

Relationship: ______ Address: ______________

SECTION C—MARITAL STATUS
(Do not complete if this is an application for an individual account.)

Applicant: ☐ Married ☐ Separated ☐ Unmarried (including single, divorced, and widowed)
Other Party: ☐ Married ☐ Separated ☐ Unmarried (including single, divorced, and widowed)

[Open-end, unsecured credit]

SECTION D— ASSET AND DEBT INFORMATION (If Section B has been completed, this Section should be completed giving information about both the Applicant and Joint Applicant, User, or Other Person. Please mark Applicant-related information with an "A." If Section B was not completed, only give information about the Applicant in this Section.)

ASSETS OWNED (use separate sheet if necessary.)

Description of Assets	Value	Subject to Debt? Yes/No	Name(s) of Owner(s)
Cash	$		
Automobiles (Make, Model, Year)			
Cash Value of Life Insurance (Issuer, Face Value)			
Real Estate (Location, Date Acquired)			
Marketable Securities (Issuer, Type, No. of Shares)			
Other (List)			
Total Assets	$		

OUTSTANDING DEBTS (Include charge accounts, installment contracts, credit cards, rent, mortgages, etc. Use separate sheet if necessary.)

Creditor	Type of Debt or Acct. No.	Name in Which Acct. Carried	Original Debt	Present Balance	Monthly Payments	Past Due? Yes/No
1. (Landlord or Mortgage Holder)	☐ Rent Payment ☐ Mortgage		$ (Omit rent)	$ (Omit rent)	$	
2.						
3.						
4.						
5.						
6.						
Total Debts			$	$	$	

(Credit References) Date Paid

1. $

2.

Are you a co-maker, endorser, or guarantor on any loan or contract? Yes ☐ No ☐ If "yes" for whom? To whom?

Are there any unsatisfied judgments against you? Yes ☐ No ☐ Amount $ If "yes" to whom owed?

Have you been declared bankrupt in the last 14 years? Yes ☐ No ☐ If "yes" where? Year

Other Obligations—(E.g., liability to pay alimony, child support, separate maintenance. Use separate sheet if necessary.)

Everything that I have stated in this application is correct to the best of my knowledge. I understand that you will retain this application whether or not it is approved. You are authorized to check my credit and employment history and to answer questions about your credit experience with me.

Applicant's Signature	Date	Other Signature (Where Applicable)	Date

[Closed-end, secured credit]

CREDIT APPLICATION

IMPORTANT: Read these Directions before completing this Application.

Check Appropriate Box

☐ If you are applying for individual credit in your own name and are relying on your own income or assets and not the income or assets of another person as the basis for repayment of the credit requested, complete Sections A, C, D, and E, omitting B and the second part of C.

☐ If this is an application for joint credit with another person, complete all Sections, providing information in B about the joint applicant.

We intend to apply for joint credit. ______________ ______________
Applicant Co-Applicant

☐ If you are applying for individual credit, but are relying on income from alimony, child support, or separate maintenance or on the income or assets or another person as the basis for repayment of the credit requested, complete all Sections to the extent possible, providing information in B about the person on whose alimony, support, or maintenance payments or income or assets you are relying.

Amount Requested $ ________ Payment Date Desired ________ Proceeds of Credit To be Used For ________

SECTION A—INFORMATION REGARDING APPLICANT

Full Name (Last, First, Middle): ________ Birthdate: / /

Present Street Address: ________ Years there: ____

City: ________ State: ________ Zip: ________ Telephone: ________

Social Security No.: ________ Driver's License No.: ________

Previous Street Address: ________ Years there: ____

City: ________ State: ________ Zip: ________

Present Employer: ________ Years there: ________ Telephone: ________

Position or title: ________ Name of supervisor: ________

Employer's Address: ________

Previous Employer: ________ Years there: ____

Previous Employer's Address: ________

Present net salary or commission: $ ________ per ________ No. Dependents: ________ Ages: ________

Alimony, child support, or separate maintenance income need not be revealed if you do not wish to have it considered as a basis for repaying this obligation.

Alimony, child support, separate maintenance received under: court order ☐ written agreement ☐ oral understanding ☐

Other income: $ ________ per ________ Source(s) of other income: ________

Is any income listed in this Section likely to be reduced before the credit requested is paid off?
☐ Yes (Explain in detail on a separate sheet.) No ☐

Have you ever received credit from us? ________ When? ________ Office: ________

Checking Account No.: ________ Institution and Branch: ________

Savings Account No.: ________ Institution and Branch: ________

Name of nearest relative not living with you: ________ Telephone: ________

Relationship: ________ Address: ________

SECTION B—INFORMATION REGARDING JOINT APPLICANT, OR OTHER PARTY (Use separate sheets if necessary.)

Full Name (Last, First, Middle): ________ Birthdate: / /

Relationship to Applicant (if any): ________

Present Street Address: ________ Years there: ____

City: ________ State: ________ Zip: ________ Telephone: ________

Social Security No.: ________ Driver's License No.: ________

Present Employer: ________ Years there: ________ Telephone: ________

Position or title: ________ Name of supervisor: ________

Employer's Address: ________

Previous Employer: ________ Years there: ____

Previous Employer's Address: ________

Present net salary or commission: $ ________ per ________ No. Dependents: ________ Ages: ________

Alimony, child support, or separate maintenance income need not be revealed if you do not wish to have it considered as a basis for repaying this obligation.

Alimony, child support, separate maintenance received under: court order ☐ written agreement ☐ oral understanding ☐

Other income: $ ________ per ________ Source(s) of other income: ________

Is any income listed in this Section likely to be reduced before the credit requested is paid off?
☐ Yes (Explain in detail on a separate sheet.) No ☐

Checking Account No.: ________ Institution and Branch: ________

Savings Account No.: ________ Institution and Branch: ________

Name of nearest relative not living with Joint Applicant or Other Party: ________

Relationship: ________ Address: ________

SECTION C—MARITAL STATUS

(Do not complete if this is an application for an individual account.)

Applicant: ☐ Married ☐ Separated ☐ Unmarried (including single, divorced, and widowed)

Other Party: ☐ Married ☐ Separated ☐ Unmarried (including single, divorced, and widowed)

[Closed-end, secured credit]

SECTION D— ASSET AND DEBT INFORMATION (If Section B has been completed, this Section should be completed giving information about both the Applicant and Joint Applicant or Other Person. Please mark Applicant-related information with an "A." If Section B was not completed, only give information about the Applicant in this Section.)

ASSETS OWNED (use separate sheet if necessary.)

Description of Assets	Value	Subject to Debt? Yes/No	Name(s) of Owner(s)
Cash	$		
Automobiles (Make, Model, Year)			
Cash Value of Life Insurance (Issuer, Face Value)			
Real Estate (Location, Date Acquired)			
Marketable Securities (Issuer, Type, No. of Shares)			
Other (List)			
Total Assets	$		

OUTSTANDING DEBTS (Include charge accounts, installment contracts, credit cards, rent, mortgages, etc. Use separate sheet if necessary.)

Creditor	Type of Debt or Acct. No.	Name in Which Acct. Carried	Original Debt	Present Balance	Monthly Payments	Past Due? Yes/No
1. (Landlord or Mortgage Holder)	☐ Rent Payment ☐ Mortgage		$ (Omit rent)	$ (Omit rent)	$	
2.						
3.						
Total Debts			$	$	$	

(Credit References) Date Paid

1. $

2.

Are you a co-maker, endorser, or guarantor on any loan or contract? Yes ☐ No ☐ If "yes" for whom? To whom?

Are there any unsatisfied judgments against you? Yes ☐ No ☐ Amount $ If "yes" to whom owed?

Have you been declared bankrupt in the last 14 years? Yes ☐ No ☐ If "yes" where? Year

Other Obligations—(E.g., liability to pay alimony, child support, separate maintenance. Use separate sheet if necessary.)

SECTION E—SECURED CREDIT (Briefly describe the property to be given as security.)

and list names and addresses of all co-owners of the property:

Name Address

If the security is real estate, give the full name of your spouse (if any): __________

Everything that I have stated in this application is correct to the best of my knowledge. I understand that you will retain this application whether or not it is approved. You are authorized to check my credit and employment history and to answer questions about your credit experience with me.

Applicant's Signature | Date | Other Signature (Where Applicable) | Date

[Closed-end, unsecured/secured credit]

CREDIT APPLICATION

IMPORTANT: Read these Directions before completing this Application.

Check Appropriate Box

☐ If you are applying for individual credit in your own name and are relying on your own income or assets and not the income or assets of another person as the basis for repayment of the credit requested, complete only Sections A and D. If the requested credit is to be secured, also complete the first part of Section C and Section E.

☐ If you are applying for joint credit with another person, complete all Sections except E, providing information in B about the joint applicant. If the requested credit is to be secured, then complete Section E.

We intend to apply for joint credit. ______________ Applicant ______________ Co-Applicant

☐ If you are applying for individual credit, but are relying on income from alimony, child support, or separate maintenance or on the income or assets of another person as the basis for repayment of the credit requested, complete all Sections except E to the extent possible, providing information in B about the person on whose alimony, support, or maintenance payments or income or assets you are relying. If the requested credit is to be secured, then complete Section E.

Amount Requested $ ________ Payment Date Desired ________ Proceeds of Credit To be Used For ________________

SECTION A—INFORMATION REGARDING APPLICANT

Full Name (Last, First, Middle): ________________ Birthdate: / /

Present Street Address: ________________ Years there: ______

City: ________ State: ________ Zip: ________ Telephone: ________

Social Security No.: ________ Driver's License No.: ________

Previous Street Address: ________________ Years there: ______

City: ________ State: ________ Zip: ________

Present Employer: ________ Years there: ________ Telephone: ________

Position or title: ________ Name of supervisor: ________

Employer's Address: ________________

Previous Employer: ________________ Years there: ______

Previous Employer's Address: ________________

Present net salary or commission: $ ________ per ________ No. Dependents: ________ Ages: ________

Alimony, child support, or separate maintenance income need not be revealed if you do not wish to have it considered as a basis for repaying this obligation.

Alimony, child support, separate maintenance received under: court order ☐ written agreement ☐ oral understanding ☐

Other income: $ ________ per ________ Source(s) of other income: ________

Is any income listed in this Section likely to be reduced before the credit requested is paid off?
☐ Yes (Explain in detail on a separate sheet.) No☐

Have you ever received credit from us? ________ When? ________ Office: ________

Checking Account No.: ________ Institution and Branch: ________

Savings Account No.: ________ Institution and Branch: ________

Name of nearest relative not living with you: ________________ Telephone: ________

Relationship: ________ Address: ________________

SECTION B—INFORMATION REGARDING JOINT APPLICANT, OR OTHER PARTY (Use separate sheets if necessary.)

Full Name (Last, First, Middle): ________________ Birthdate: / /

Relationship to Applicant (if any): ________________

Present Street Address: ________________ Years there: ______

City: ________ State: ________ Zip: ________ Telephone: ________

Social Security No.: ________ Driver's License No.: ________

Present Employer: ________ Years there: ________ Telephone: ________

Position or title: ________ Name of supervisor: ________

Employer's Address: ________________

Previous Employer: ________________ Years there: ______

Previous Employer's Address: ________________

Present net salary or commission: $ ________ per ________ No. Dependents: ________ Ages: ________

Alimony, child support, or separate maintenance income need not be revealed if you do not wish to have it considered as a basis for repaying this obligation.

Alimony, child support, separate maintenance received under: court order ☐ written agreement ☐ oral understanding ☐

Other income: $ ________ per ________ Source(s) of other income: ________

Is any income listed in this Section likely to be reduced before the credit requested is paid off?
☐ Yes (Explain in detail on a separate sheet.) No☐

Checking Account No.: ________ Institution and Branch: ________

Savings Account No.: ________ Institution and Branch: ________

Name of nearest relative not living with Joint Applicant or Other Party: ________________ Telephone: ________

Relationship: ________ Address: ________________

[Closed-end, unsecured/secured credit]

SECTION C—MARITAL STATUS
(Do not complete if this is an application for individual unsecured credit.)

Applicant: ☐ Married ☐ Separated ☐ Unmarried (including single, divorced, and widowed)
Other Party: ☐ Married ☐ Separated ☐ Unmarried (including single, divorced, and widowed)

SECTION D— ASSET AND DEBT INFORMATION (If Section B has been completed, this Section should be completed giving information about both the Applicant and Joint Applicant or Other Person. Please mark Applicant-related information with an "A." If Section B was not completed, only give information about the Applicant in this Section.)

ASSETS OWNED (use separate sheet if necessary.)

Description of Assets	Value	Subject to Debt? Yes/No	Name(s) of Owner(s)
Cash	$		
Automobiles (Make, Model, Year)			
Cash Value of Life Insurance (Issuer, Face Value)			
Real Estate (Location, Date Acquired)			
Marketable Securities (Issuer, Type, No. of Shares)			
Other (List)			
Total Assets	$		

OUTSTANDING DEBTS (Include charge accounts, installment contracts, credit cards, rent, mortgages, etc. Use separate sheet if necessary.)

Creditor	Type of Debt or Acct. No.	Name in Which Acct. Carried	Original Debt	Present Balance	Monthly Payments	Past Due? Yes/No
1. (Landlord or Mortgage Holder)	☐ Rent Payment ☐ Mortgage		$ (Omit rent)	$ (Omit rent)	$	
2.						
3.						
Total Debts			$	$	$	

(Credit References)		Date Paid
1.	$	
2.		

Are you a co-maker, endorser, or guarantor on any loan or contract? Yes ☐ No ☐ If "yes" for whom? To whom?

Are there any unsatisfied judgments against you? Yes ☐ No ☐ Amount $ If "yes" to whom owed?

Have you been declared bankrupt in the last 14 years? Yes ☐ No ☐ If "yes" where? Year

Other Obligations—(E.g., liability to pay alimony, child support, separate maintenance. Use separate sheet if necessary.)

SECTION E—SECURED CREDIT (Complete only if credit is to be secured.) Briefly describe the property to be given as security.

and list names and addresses of all co-owners of the property:

Name Address

If the security is real estate, give the full name of your spouse (if any): ____________

Everything that I have stated in this application is correct to the best of my knowledge. I understand that you will retain this application whether or not it is approved. You are authorized to check my credit and employment history and to answer questions about your credit experience with me.

Applicant's Signature ____ Date ____ Other Signature (Where Applicable) ____ Date ____

[Community property]

CREDIT APPLICATION

IMPORTANT: Read these Directions before completing this Application.

Check Appropriate Box

☐ If you are applying for individual credit in your own name, are not married, and are not relying on alimony, child support, or separate maintenance payments or on the income or assets of another person as the basis for repayment of the credit requested, complete only Sections A and D. If the requested credit is to be secured, also complete Section E.

☐ In all other situations, complete all Sections except E, providing information in B about your spouse, a joint applicant or user, or the person on whose alimony, support, or maintenance payments or income or assets you are relying. If the requested credit is to be secured, also complete Section E.

If you intend to apply for joint credit, please initial here. ________ Applicant ________ Co-Applicant

Amount Requested $ ________ Payment Date Desired ________ Proceeds of Credit To be Used For ________

SECTION A—INFORMATION REGARDING APPLICANT

Full Name (Last, First, Middle): ________ Birthdate: / /

Present Street Address: ________ Years there: ________

City: ________ State: ________ Zip: ________ Telephone: ________

Social Security No.: ________ Driver's License No.: ________

Previous Street Address: ________ Years there: ________

City: ________ State: ________ Zip: ________

Present Employer: ________ Years there: ________ Telephone: ________

Position or title: ________ Name of supervisor: ________

Employer's Address: ________

Previous Employer: ________ Years there: ________

Previous Employer's Address: ________

Present net salary or commission: $ ________ per ________ No. Dependents: ________ Ages: ________

Alimony, child support, or separate maintenance income need not be revealed if you do not wish to have it considered as a basis for repaying this obligation.

Alimony, child support, separate maintenance received under: court order ☐ written agreement ☐ oral understanding ☐

Other income: $ ________ per ________ Source(s) of other income: ________

Is any income listed in this Section likely to be reduced in the next two years or before the credit requested is paid off?
☐ Yes (Explain in detail on a separate sheet.) No ☐

Have you ever received credit from us? ________ When? ________ Office: ________

Checking Account No.: ________ Institution and Branch: ________

Savings Account No.: ________ Institution and Branch: ________

Name of nearest relative not living with you: ________ Telephone: ________

Relationship: ________ Address: ________

SECTION B—INFORMATION REGARDING SPOUSE, JOINT APPLICANT, USER, OR OTHER PARTY (Use separate sheets if necessary.)

Full Name (Last, First, Middle): ________ Birthdate: / /

Relationship to Applicant (if any): ________

Present Street Address: ________ Years there: ________

City: ________ State: ________ Zip: ________ Telephone: ________

Social Security No.: ________ Driver's License No.: ________

Present Employer: ________ Years there: ________ Telephone: ________

Position or title: ________ Name of supervisor: ________

Employer's Address: ________

Previous Employer: ________ Years there: ________

Previous Employer's Address: ________

Present net salary or commission: $ ________ per ________ No. Dependents: ________ Ages: ________

Alimony, child support, or separate maintenance income need not be revealed if you do not wish to have it considered as a basis for repaying this obligation.

Alimony, child support, separate maintenance received under: court order ☐ written agreement ☐ oral understanding ☐

Other income: $ ________ per ________ Source(s) of other income: ________

Is any income listed in this Section likely to be reduced in the next two years or before the credit requested is paid off?
☐ Yes (Explain in detail on a separate sheet.) No ☐

Checking Account No.: ________ Institution and Branch: ________

Savings Account No.: ________ Institution and Branch: ________

Name of nearest relative not living with Spouse, Joint Applicant, User, or Other Party: ________ Telephone: ________

Relationship: ________ Address: ________

[Community property]

SECTION C—MARITAL STATUS

Applicant: ☐ Married ☐ Separated ☐ Unmarried (including single, divorced, and widowed)
Other Party: ☐ Married ☐ Separated ☐ Unmarried (including single, divorced, and widowed)

SECTION D— ASSET AND DEBT INFORMATION (If Section B has been completed, this Section should be completed giving information about both the Applicant and Spouse, Joint Applicant, User, or Other Person. Please mark Applicant-related information with an "A." If Section B was not completed, only give information about the Applicant in this Section.)

ASSETS OWNED (use separate sheet if necessary.)

Description of Assets	Value	Subject to Debt? Yes/No	Name(s) of Owner(s)
Cash	$		
Automobiles (Make, Model, Year)			
Cash Value of Life Insurance (Issuer, Face Value)			
Real Estate (Location, Date Acquired)			
Marketable Securities (Issuer, Type, No. of Shares)			
Other (List)			
Total Assets	$		

OUTSTANDING DEBTS (Include charge accounts, installment contracts, credit cards, rent, mortgages, etc. Use separate sheet if necessary.)

Creditor	Type of Debt or Acct. No.	Name in Which Acct. Carried	Original Debt	Present Balance	Monthly Payments	Past Due? Yes/No
1. (Landlord or Mortgage Holder)	☐ Rent Payment ☐ Mortgage		$ (Omit rent)	$ (Omit rent)	$	
2.						
3.						
Total Debts			$	$	$	

(Credit References)		Date Paid
1.	$	
2.		

Are you a co-maker, endorser, or guarantor on any loan or contract? Yes ☐ No ☐ If "yes" for whom? To whom?

Are there any unsatisfied judgments against you? Yes ☐ No ☐ Amount $ If "yes" to whom owed?

Have you been declared bankrupt in the last 14 years? Yes ☐ No ☐ If "yes" where? Year

Other Obligations—(E.g., liability to pay alimony, child support, separate maintenance. Use separate sheet if necessary.)

SECTION E—SECURED CREDIT (Complete only if credit is to be secured.) Briefly describe the property to be given as security.

and list names and addresses of all co-owners of the property:

Name	Address

Everything that I have stated in this application is correct to the best of my knowledge. I understand that you will retain this application whether or not it is approved. You are authorized to check my credit and employment history and to answer questions about your credit experience with me.

Applicant's Signature	Date	Other Signature (Where Applicable)	Date

TUSCAN CLUB

UNIVERSITY

MODULE 6
STEERING

Tuscan Club University

Fair Lending School

MODULE 6 –

STEERING

MODULE OBJECTIVES

In this module, we will look at the process lenders use to get customers into a certain loan product. It's okay and encouraged to learn about your customers and get them in the product that best suits them, but it needs to be done for the right reasons and on a fair and consistent basis. We will discuss some risk indicators that you may have steering risks at your organization. We will go into how to review your program and what to look for when it comes to steering risk. Products, terms, fees, compensation, and referral channels all can lead to higher steering risks. We will wrap up by covering what to do if you find steering risk at your organization.

What is Steering?

Simply put, steering is guiding a consumer into a specific product, feature, or lending channel. It's getting your customer into the best product based on their needs. Steering can be a good thing. When is steering bad?

When it is done based on a **prohibited basis**. Illegal steering centers on whether the organization did so on a prohibited basis, rather than based on the applicants needs or other legitimate factors.

Steering Indicators

Here are some indicators that you have heightened steering risk at your organization:

- Lack of clear, objective, and consistently implemented standards for referring applicants
- Financial incentives for loan officers or brokers to place applicants in nontraditional products (e.g. negative amortization, interest only, payment option adjustable rate mortgages, etc.)
- For organizations that offer different products based on credit risk levels, any significant differences in percentages of prohibited basis groups in each of the alternative loan product categories
- Significant differences in the percentage of prohibited basis applicants in loan products or products with specific features relative to control group applicants
- Lack of monitoring for potential steering activity – examiners will consider your organization to be at higher risk if you have little or no monitoring of your higher risk products
- Consumer complaints

Here are several examples that illustrate potential steering risk:

- An organization that offers different lending products based on credit risk levels may present opportunities for loan officers or brokers to illegally steer applicants to the higher-risk products, when the applicant could have qualified for a conventional product
- An organization that markets special loan programs to only a portion of its community, such as an immigrant on non-English-speaking population
- An organization that offers nontraditional loan products (such as interest-only or negative amortization) or loan products with potentially onerous terms (such as prepayment penalties) may present opportunities for loan officers or brokers to illegally steer applicants to certain products or features
- An organization that offers prime or sub-prime products through different channels may also have potential steering risk
- If a lender denies an applicant in one area of the organization, the applicant can be referred to another area of the organization, or to a subsidiary
- The organization has not conducted steering training or developed any anti-steering policies as required by Truth-in-Lending Section 1026.36(j)

Risks – Products AND Features

Products that differ based on cost, underwriting criteria, terms, fees, etc. can lead to steering risk, but features can also lead to steering risk. Credit life insurance is a perfect example. Does a disproportionate amount of credit life sales go to a certain prohibited basis group?

Small Institution Risk

Typically, smaller organizations with traditional products have lowered steering risk. Your risk mitigation program and reviews for steering risk will depend on the products you offer and compensation employees receive. Just because your organization is small does not mean steering risk does not exist. If you offer solely traditional, in-house products, your risk is likely lower. However, if your organization offers secondary-market loans or government-guaranteed loans, the examiners will likely focus on steering risks associated with having multiple lending channels. When products become more complex, carry higher costs, include add-on products or fees, or are not traditional banking products, your steering risk is elevated.

Complex and Larger Financial Organizations

When the risks above are present at your organization, you need to dig deeper to ensure you mitigate steering risk. Just because your organization is larger also does not mean you have more steering risk. The products, product features, compensation methods, and referral channels are the big drivers of steering risk. You can be a large and complex organization with minimal steering risk.

Reviewing Your Program – Steering

FFIEC Guidance

The Interagency Fair Lending Examination Procedures list steps you can take to review your program for steering risk. Those steps are summarized below:

Step 1 – Clarify what options are available to applicants

1. Research what products and features are being offered to your customers.
2. Understand third-party channels and offerings to your customers.
3. Talk with loan staff, read marketing materials, and review policy manuals to get the best picture.

4. Understand differences in underwriting for each product.
5. Understand cost differences for each product (interest rates, points, and all fees, including private mortgage insurance and other insurance such as FHA funding fees).

Step 2 – Document

1. Gather information on products or features identified in Step 1 directly from the source.
2. If employees use scripts, charts, or decision-making trees to guide customers to certain products, gather those for review.
3. Have basic conversations with loan staff on what products they offer and how they sell those products.
4. Document and summarize discussions with loan personnel and managers.
5. Gather any documentation from subsidiaries, affiliates, or third-party vendors that offer your customers products or features with higher steering risk.
6. Identify any policies and procedures by your organization or any affiliates that discuss any of the following:
   a. If an applicant doesn't meet criteria, guidance for referring them to another lending channel or product;
   b. Offering one or more alternatives to a person who applies for a specific product or feature, but does not meet its criteria;
   c. Referring a person to one product when that person qualifies for multiple products.

Step 3 – Referral decisions

Determine how referral decisions are made and documented.

1. Determine how a referral is made to another internal lending channel, subsidiary, or affiliate.
2. Determine the reason for referral and how it is documented.

Step 4 – Loan officer discretion

Determine how loan officers are able to exercise personal discretion in deciding what loan products or alternatives will be made available to applicants.

Step 5 – Adherence to policy

Determine whether loan officers are following policy/guidance. If the answer is no, does it appear that different policies or practices are actually in effect?

Step 6 – Conduct an analysis

The following steps will help you determine if you have steering risks:

1. Concentrate on only one particular loan type at a time, for example residential real estate loans.
2. Filter your loan trial balance (or your HMDA LAR, if you are a reporter) by loan type.
3. Also, obtain a list of borrowers who received secondary market loans or government-guaranteed loans, such as FHA loans.
4. Assign prohibited bases indicators to each borrower, such as male, female, or minority. For joint borrowers where at least one of the borrowers is male, treat the loan as being made to a "male" borrower. These basis indicators will already be on your LAR if you are a HMDA reporter. Otherwise, you will need to either work with the loan officers to identify prohibited basis or open the loan file and collect the government-monitoring information there.
5. Calculate the percentages of prohibited basis groups that received a particular loan product. For example, you may calculate that 25% of individual female borrowers received secondary market loans (and the other 75% of female borrowers received in-house portfolio loans). Also, calculate the percentages for male borrowers, minority borrowers, and white borrowers. Remember to calculate joint male/female borrowers as though they were in the male group. Doing so will make your comparisons easier in the end (see following steps).
6. Also calculate the percentages of prohibited basis groups that received loans with various features, such as those loans that are FHA insured. Calculate these percentages for male (including male/female), individual female) and minority borrowers.
7. Compare the percentages of each group that went through each channel. For example, if 25% of minority borrowers went to the secondary market, but 50% of white borrowers went to the secondary market, you have adverse findings and a potential steering risk.
8. Save any of your steering-related calculations and share them with examiners during your examination to show them that you are auditing for steering risk.

What to Do if You Have Adverse Findings?

If you review your program and find no steering risk, your review is done. But what do you do if you find steering risk?

You will want to find the root cause of the risk. Root causes could be any of the following:

- Third-party referral channel
- Loan officer compensation method
- Poor guidance from a policy or procedures
- Exceptions to policy or procedures
- Poorly trained lending staff
- Differences in creditworthiness of applicants

Steering Examples

Scenario 1:

Imagine that your organization participates in FHA lending. You have originated this product almost exclusively to minority borrowers. Virtually none of your white borrowers received FHA loans. Since FHA loans have a funding fee, they are more expensive than traditional mortgages. Upon further review, you determined that none of the minority borrowers qualified for traditional mortgages, so the steering risk was mitigated.

Scenario 2:

Imagine that your organization developed an in-house "low-documentation" home loan program for a local Hispanic immigrant population. This low-doc loan has higher fees and higher interest rates. All of the Hispanic borrowers through this program were foreign born and did not speak English well. There were no non-Hispanic white borrowers in this program, and the financial institution did not market this program to non-Hispanic, English-speaking applicants. This program would raise red flags, and examiners would most likely review it. The primary concern is that some of the immigrant applicants may have actually qualified for a lower-cost, traditional mortgage. However, because of their immigrant history and their language skills, lenders may have inappropriately steered Hispanic applicants into this higher-cost program.

Scenario 3:

Sometimes, things like culture can have an impact on your organization and the types of products that you offer. We have participated on examinations near Native American Reservations that had extremely high purchase rates of credit life insurance. This is a higher risk product because it is often costly and it is considered an "add-on" product. What we learned about the local tribe's culture was that is it not good to pass along debt when someone dies, so purchasing credit life insurance was extremely common. The lenders were not steering customers into the product; the Native American customers were asking for it.

We have also observed other cultures that do not allow the paying of interest on debt. Fees are okay, but those individuals are not allowed to pay interest. It can make things a bit uneasy for lenders and compliance staff when it is difficult to meet the needs of your area with such restrictions.

How to Address Consumer Harm

Once you find the root cause, you will want to make appropriate adjustments to your overall compliance management system to prevent further consumer harm. Depending on the extent of the consumer harm caused, you may want to consider providing restitution to those adversely affected. If you are proactive in fixing issues, this will be viewed as a positive for your compliance program. It shows you are finding and fixing your own issues. If you are reactive, this may affect how your compliance management system is rated.

If you still are not sure how to address or correct wide-spread steering issues, you can consult your local regulators and ask for guidance. If examiners determine your corrective action was not sufficient, they may force your hand anyway. You can be proactive and reach out to them first and develop a plan that is appropriate for the situation.

MODULE SUMMARY

You will need to determine your organization's level of steering risk. As most organizations only offer traditional products and features, most likely have minimal steering risk. If you do fall into these categories, here's what you need to do:

- Review the criteria for which customers are placed in certain products or referred to certain channels
- Ensure there is written and prudent underwriting criteria backing these decisions (e.g. if your credit score is less than 600, you get product B instead of product A)
- Sample loan files of customers that were put into all products and make sure that your underwriting criteria was followed – MAKE SURE you sample loans from the best loan products too to ensure that exceptions are consistent and not on a probative basis

Train your loan staff on the importance of following your organization's underwriting guidelines to minimize steering risk.

TUSCAN CLUB

UNIVERSITY

MODULE 7

UNDERWRITING

Tuscan Club University
Fair Lending School

MODULE 7 – UNDERWRITING

MODULE OBJECTIVES

The objective of the underwriting module is to help you understand the critical components that lenders at your organization are using as the basis for approving and denying loans. We will look at an overview of underwriting and the different types of setups you will likely see at your organization. Then we will spend time talking about the industry standards for underwriting criteria. It is critical that you know what criteria your institution is using to underwrite loans. We will wrap the module up with what you need to review for your underwriting program.

What Is Underwriting?

First things first – what is underwriting? Here is the textbook definition:

Loan underwriting is the process of a lender determining if a borrower's loan application is an acceptable risk. Basically, what that means is someone is evaluating an applicant based on a set of criteria to determine whether or not that applicant will get a loan.

Common Underwriting Set-ups

There are many ways to set up an underwriting program. Your organization likely has one of these 5 setups:

1. **Loan officer** – in the smaller and non-complex organizations, the loan officer themselves will underwrite the loan. They will collect all relevant data and make the approval or denial decision. This is the most flexible model, but it

carries the highest risk because the increased human element can lead to more discretionary decisions.

2. **Underwriting department** – in larger organizations, there may be a team of individuals whose sole task is to underwrite loans. The loan officer will collect the information and send it to a centralized team for the loan decision. It is not uncommon for smaller- to medium-sized organizations to have an underwriting team specifically for residential real estate loans. This model provides flexibility while helping to reduce risk because it serves as checks and balances on the program. Individuals that specifically do underwriting and don't actually make loans are removed from the customer aspect of the process and can focus on facts. Loan officers can be just as effective at this process, but the larger your organization becomes, the more loan officers you have making decisions leading to more potential risk. When you centralize those decisions to a small group of underwriters, you can greatly reduce your risk and ensure your process is consistent.
3. **Third-Party Underwriter** – this is most common when you sell residential real estate loans on the secondary market. In many cases, the underwriting may be done by someone at your organization, but all of the underwriting standards are set by a third party. This is not nearly as flexible, but it reduces risk since there is very little, if any, deviation allowed from underwriting standards.
4. **Automated Underwriting** – this is most common in the largest of organizations. Think of your multi-billion-dollar organization with hundreds of branches. They have underwriting software that makes the loan decision for them. This is the least flexible model, but it is the best for controlling fair lending risk because the human element is completely removed.
5. **Hybrid Model** – You could add a fifth model that is a combination of automated and loan officer underwriting. In these cases, an automated system is employed, but decisions can be overridden by a person. This model can provide added flexibility, but it also introduces risk when a person can make exceptions ("overrides") outside of the organization's policies.

Depending on what model you fall under, your underwriting risk will vary. As you may have noticed, the more human interaction in the underwriting process, the higher the risk. While the automated underwriting system eliminates a majority of the risk because the underwriting criteria is strictly based on facts, you need to make sure the criteria used to assess a loan application are not discriminatory in nature. This would be rare, but it could happen.

Our original quiz question: True or False – It is LEGAL to discriminate against a loan applicant.

You likely know the answer by now, but that is absolutely true! In fact, if you don't discriminate, you won't be in business very long! Remember, there are many **ILLEGAL** forms of discrimination. Those are the prohibited basis characteristics found within the fair lending laws that made it illegal to discriminate against an applicant based on race, color, religion, etc. The **LEGAL** forms of discrimination – that's called underwriting. If you make loans to everyone that walked through your door every single time, you're going to make a lot of bad loans.

Industry Standard Underwriting Criteria

There are many pieces of information you can use to underwrite a loan. Several metrics exist that can accurately predict the repayment probability of an applicant. Other metrics exist to determine what losses the organization would take on if the loan is not repaid and goes into default. Let's take a look at ten typical underwriting criteria most lending organizations use or consider:

1. **Debt-to-Income Ratio (DTI)** – the DTI ratio is a simple calculation of the monthly debt payments divided by the monthly gross income. Financial Institutions use DTI ratios to determine if someone has enough monthly income to absorb a new debt payment. In order to calculate this ratio, you have to know what the applicant brings in for income and pays out for debt each month.

Monthly debt can include:

- Housing Payment (either rent or mortgage)
- Car payment
- Credit card payment
- Student loans
- Any other revolving credit payment you would find on a credit bureau report.

Income can come from a number of sources:

- Employment
- Self-employment
- Retirement pension

- Social Security
- Military disability or other disability income; however, the lender cannot ask the applicant to provide a note from the doctor confirming the disability or verifying that the disability income will continue
- Alimony or child support (but only if the applicant wants it to be considered, and that statement must be on your application)
- Investment or rental income

If any income an applicant receives is non-taxable, you will want to treat that income the same as you would for employment income. To do that, you will want to consider "grossing up" the non-taxable income. To gross up non-taxable income, you simply add a percentage to the monthly income so it is more comparable to taxable income. Let's use a scenario to illustrate this important topic:

Let's say Borrower A walks into your organization to apply for a car loan. Borrower A has no monthly debt payments and $1,200 in monthly gross income from employment. After taxes, Borrower A has a net income of $1,000. Borrower A wants to buy a car that will carry a $300 per month payment. If you calculate their DTI ratio, you would get $300/$1,200 = 25% (monthly debt/gross monthly income). That is a pretty simple calculation.

Later that day, Borrower B walks in to apply for the same type of car loan. Borrower B also has no monthly debt payments. Borrower B gets $1,000 a month in non-taxed Social Security income. So, Borrower B's DTI ratio would be $300/$1,000 = 30% (monthly debt/gross monthly income).

THE PROBLEM

Both Borrower A and Borrower B have the same $1,000 in their pocket to pay you back with each month, but since Borrower B's income is not taxed, their monthly gross and net income is $1,000. Borrower A gets the benefit of the $200 they paid in taxes which gives them a more favorable DTI ratio (Borrower A is 25% while Borrower B is 30%). While this may not seem like much, if you have underwriting standards that have a maximum DTI ratio, or if you price based on the DTI ratio, you will be treating non-taxable income (remember – income from public assistance is one of the prohibited bases) different than taxable income.

THE SOLUTION

What most organizations do is "gross up" non-taxable income. In other words, they add a percentage onto non-taxable income to make it more comparable to taxable income. What is a fair amount to gross up? Most organizations gross up between 15% - 25%. Another option you have is to look and see what tax bracket the applicant is in and use that percentage. That is a bit more work and can sometimes get confusing, so it may not be the best option. A set percentage is usually best so all lenders and underwriters are doing it the same way.

Let's look back at Borrower B's $1,000 social security income. If we added 20% to that ($1,000 X 1.2) we would get $1,200. That would give us the same DTI as Borrower A with employment income ($300 / $1200 = 25%).

The best way to handle grossing up income is to set a rate for your loans and be consistent. Make sure you gross up the same amount every time and you will greatly reduce your risk. Also be consistent that you gross up for all borrowers, not just some borrowers.

2. **Loan-to-Value Ratio (LTV)** – an LTV ratio is a simple formula of taking the total loan amount divided by the value of the collateral.

An easy example is buying a car. If you get a car loan for $10,000 and the car is worth $10,000, you will have an LTV of 100% (10,000 / 10,000 = 1.00 or 100%).

Let's say the borrower puts $2,000 down towards the purchase of the car. Now they will need to borrow only $8,000. Looking at the new ratio we have $8,000 / $10,000 = 0.8 or 80%. The lower the LTV, the less risky the loan is to make.

When it comes to LTV, many organizations will go to 100% or higher LTV on a car loan. For example, a lender might finance credit life insurance or an extended warranty, resulting in a 100% (or higher) LTV ratio. However, residential real estate lending is much different, and more regulations come into play.

3. **Collateral Value and Appraisal Bias** – When considering the collateral value of residential properties, we often run into the issue of appraisal bias. This happens when an appraiser artificially deflates the value of a home because it is owned by a minority borrower or because it is located in a high-minority neighborhood.

Appraisal bias is a very old concept but a newer hot topic for fair lending. It has been happening for decades, but only recently has it been on the regulatory radar. This is also a harder risk to identify. You will want to make sure that your lending and underwriting staff keep up on property values in the areas where they operate. If they suspect that a property value comes in low, they need to say something. This could lead to a whole new appraisal. There have been court cases settled because of discrimination in the appraisal process, and more are coming. Make sure you are aware of this emerging risk and are monitoring for it.

One way you can use software to help monitor for this risk is by reviewing denial rates to minority individuals and in majority-minority census tracts for collateral value. If you are seeing high denial rates because of collateral value in your HMDA data, that can be an indicator of appraisal bias. It's important to note that HMDA data is a lagging indicator. In other words, if you see high denial rates in your data, that means you have already denied enough applicants for this risk to raise red flags. More current monitoring should be conducted to try and catch these issues before they get to the denial process to help prevent discrimination instead of catching it a year after it has already happened. This is the difference of being proactive as opposed to reactive.

4. **Credit Score** – Most organizations obtain a credit score on new applications for loans. A credit score is a numerical value assigned to a person based on their history of paying back debt obligations timely. Some very large organizations have internally developed credit-scoring models, but they are the exception and won't be discussed here.

Most organizations purchase credit scores from one of the three big credit bureaus:

- Equifax
- Experian
- Transunion

For residential real estate transactions, often organizations will get all three bureau reports at the same time, often called a tri-merge report. Here are two things you need to know when using a credit score purchased from the credit bureaus:

- **Consistency**
  Ensure consistency when using more than one score. If you pull more than one credit score (from multiple credit bureaus), make sure you have procedures to always use the same score. For example – if you always pull a tri-merge and then take the middle of the three scores, make sure you do

that for all applicants. If your procedures are to take the average of more than one score, do that every time. If you have two people applying and always use the higher of all of the scores, make sure your procedures state that and are followed. Using a lower score for a minority applicant that gets denied and a higher score for a non-minority that gets approved is a quick way to have potential discrimination issues.

- **Passing along fees**
  It's perfectly fine to pass along the cost of obtaining a credit bureau to the loan applicant, just make sure of a couple things. You cannot up-charge the credit report fee. First, if it costs you $12 to pull a bureau, you cannot charge the borrower $20. Second, if you get a price break based on how you pull the credit bureau reports, make sure it doesn't have a negative impact on your customers.

Here's an example:

THE PROBLEM

Let's say it costs your organization $10 to pull a single credit bureau on one person. However, if you pull a joint bureau on two people, it only costs $15. That sounds like a good deal, but there's a problem. If Mike and his brother Andy apply for a loan to buy a truck, you may pull separate bureaus. They are not married and have different addresses. So, they each pay $10 for a total cost of $20. The next week, Andy applies for another loan with his wife Cindy. Since they are married and live together, you pull a joint bureau. Now they each pay a lower $7.50 for a total of $15. You've now just treated Andy differently on one transaction than another, and the reason he paid a different amount was because of his marital status.

THE SOLUTION

There are a couple of ways to avoid this. Many small organizations simply don't pass along the credit bureau fee. That's fine if you decide to do that, but that can get costly over time. What many organizations do is not pass on the fee directly but include that within an origination fee. Sometimes it might be called an underwriting fee or even a doc fee or doc prep fee. If you charge a set fee (say $50) for the administration of a loan to all applicants, you will avoid this problem. Other organizations may pull a joint credit report, even for applicants who are not married to each other so they don't treat married and non-married applicants differently.

5. **Age of Collateral** – this criterion is most common on vehicle-titled loans. As vehicles age, their value decreases which raises the risk of using it as collateral. Some lending organizations won't even take a vehicle as collateral if it's older than a certain amount (say 7 or 8 years old). We've seen organizations that use the age of collateral as one of the primary components to approving a loan. The problem with that methodology as many lenders have argued is that collateral does not repay loans; people do.

   Setting up your organization's underwriting program includes input from both the safety and soundness team (risk management) and compliance, so it's important that as a compliance professional, you take those factors into consideration. Regardless of how you use age of collateral, ensure you have consistent procedures. When you establish a maximum age of collateral to approve a loan, and you approve loans with collateral outside of those ranges, you are introducing policy exceptions, which raises risk.

6. **Employment History** – Many organizations choose to require stability in employment before they approve a loan. For example, they may want to see an applicant in the same job for more than 6 months before approving a loan. For those applicants that don't meet that criteria, they may still be able to be approved with an employment contract or if the current job is within the same industry as their past employment. As with age of collateral, if you have minimum length-of-employment standards but make exceptions outside of those standards, you introduce risk that must be controlled and monitored.

7. **Residential History** – Some organizations require you to be in your current residence for 2 years. For applicants that don't meet this requirement, they must have lived in the local area or have a good reason why they don't have 2 years of residential stability. Your organization should also have procedures for evaluating the residency of applicants who are away at college or who are still living with their parents at home. Your lenders should apply those underwriting procedures consistently, regardless of race, gender, or ethnicity.

8. **Loan Term** – The loan term is typically the number of months a borrower will be paying back the loan. For example, a typical loan term for a car may be 60 months (5 years) while a home might be 360 months (30 years). Organizations can choose the term limits. For a vehicle-titled loan, it's common to see shorter repayment terms for older vehicles. While giving someone 6 years to pay back a loan on a brand new $70,000 vehicle might make sense, you may not want to

give someone 6 years to pay back a loan on a vehicle that is 12 years old. The useful life of older collateral has a much lower chance of surviving the term of the loan.

9. **Co-signors** – Some organizations choose to allow co-signors for loans. This is a common industry practice to allow someone to get a loan that doesn't meet certain underwriting criteria. An example may be someone with little to no credit history (younger individual) who doesn't necessarily have bad credit, they just don't have established credit. An organization will want someone with an established repayment history to also be obligated on the loan. Some organizations simply do not allow co-signors. Their theory is that if the applicants do not primarily benefit from loan proceeds, they are less likely to want to pay back the loan when the primary applicant defaults. Those are also valid points. We are not here to steer you one way or the other. We just want to inform you of the risks if your organization decides to allow co-signors.

PRO TIP

Just like our criteria above, if you set loan terms and approve exceptions outside of those loan terms, you are introducing additional risk. If you have a lender who always seems to make underwriting exceptions for men but not women, or for non-minorities but not minorities, they may be doing it on a prohibited basis. Exceptions should be controlled and monitored. We will learn more about policy exceptions in a Module 9.

There are a few things you want to be careful about when you are going to ask for a co-signor:

Requiring Specific Co-signors

You can require an applicant to get a co-signor, but you should not tell, insist, or influence who that person should be. You should never say "we need your spouse to co-sign" or to a younger individual "we will need a parent to co-sign" assuming the applicant is not of legal age.

When you start telling the applicant who the co-signer should be, you run the risk of crossing a prohibited basis boundary (i.e. marital status, familial status). You can tell the borrower they need a co-signer, but don't insist who that should be. Here is the right way to have the conversation:

PRO TIP

In this situation, the applicant has introduced the co-signor, not the lender. It's important as a lender that you do not specify who can co-sign a loan. If you do, you could be crossing some prohibited basis, typically marital status or familial status (on home loans).

Lender – "I'm sorry but you don't quite meet our criteria. If you were to get a credit worthy co-signor, we could re-evaluate your application.

Applicant – "Well can my mom apply to co-sign?"

Lender – "Sure, your mom can apply to co-sign."

10. **Guarantors** – For commercial and agricultural loans, organizations sometimes ask for guarantors. However, guarantors should not be requested based on a prohibited basis, such as marital status. If spouses are involved in the operations of the business or farm, or spouses are officers in the company, then a lender can ask for them to be guarantors. However, if the spouse is NOT involved in the operations of the business or farm, then they cannot be required to guarantee the loan. If an applicant is not qualified on their own, then most lenders would not make the loan. If a guarantor is necessary to approve the application, then the applicant should offer the guarantor.

11. **Customer Performance History** – This is typically an informal process, but it's often observed or noted that customers receive better treatment because they are considered a "long-term" or "good customer." If you use these types of criteria, ensure you define what they truly mean for consistency. If lenders consistently use the "good customer" excuse to approve an otherwise uncreditworthy applicant, they likely are not doing it consistently. You may start looking at that criteria in loan approvals and find trends that this underwriting criterion only seems to be used for male or non-minority applicants. As with all other underwriting criteria, define it, be consistent, and track when you deviate from policy.

How to Conduct an Underwriting Review

Review Your Policies and Procedures

The first step in conducting a review of your underwriting program is to review your underwriting guidelines. As previously mentioned, underwriting guidelines or criteria are often found within one of the following areas:

- Loan Policy
- Stand-alone underwriting standards
- Underwriting workbook (could be a worksheet or Excel spreadsheet)
- Within an automated program

You will want to review your underwriting criteria and make sure that it doesn't include any of the pitfalls described above. If you have underwriting criteria that wasn't listed within this chapter, you will want to make sure that it is fair and not based on any prohibited basis.

You will also want to know if some of your underwriting criteria is more heavily weighted than other criteria. This might not always be formal or written down. For example, if credit score is by far the biggest factor in the loan decision, that will drive your review to focus on credit scores. Factors that receive more weight aren't always so apparent. You may learn this by looking through exception reports or within your fair lending interview.

You also want to look for clarity in your underwriting criteria. We have seen "No recent late payments" written into policy before. What does that mean? What is recent? That could be 3 months, 6 months, 12 months, or any other interval of time. We have also seen "Luxury Vehicle" written in criteria before. What the heck is a luxury vehicle? Everyone may have a different definition.

Underwriting standards and criterion need to be clear, concise, and absolutely free from guesswork. You should be able to hand it to 10 different experienced lenders or underwriters, and all 10 should be able to come up with the same conclusions. If they don't, it's not clear enough. Read through your organization's guidance, and call out and push back on any guidance that you don't think is crystal clear. If there is any way it can be intrepreted more than one way, you open yourself up to risk. That's exactly what we are trying to avoid in this process.

Transactional Testing

Transactional testing can be part of your monitoring efforts or conducted as part of formal audits. The easiest way to transactional test is to pull a sample of loan files and follow the paper trail. Go through the lender's decision-making process, review any documentation they have, and ensure they are following your organization's underwriting criteria. When you are picking your sample, you will want to choose loan files from different locations and different lenders. Make sure their decisions

PRO TIP

You can build periodic monitoring into your Compliance Management System. As a compliance professional, you can periodically check originated loans as part of your monitoring program. Simply grab a sample of loans each month and verify they followed your organization's underwriting standards. If there are deviations from policy, make sure those deviations were documented on your tracking log and were approved by the correct approval authority.

are supported by documentation. If there are policy exceptions, did the lender annotate that fact? You can follow-up with your policy exception's log to ensure that loan file and underwriting exceptions are on the log. You can do a few files on an on-going basis or conduct a point-in-time audit and do several files.

Make this process your own. You don't need anything formal to get going. Just start looking at files and documenting your findings. Eventually, you can create a spreadsheet or checklist of the items you are looking for. This is your process, so customize it to fit your organization's needs. This is part of your CMS, so let the examiners know what you are doing to show the strength of your program.

Comparative File Analysis

If you have poor underwriting guidance in policy, minimal documentation, and/or frequent findings in your monitoring and audits, you may need to perform a comparative file analysis. Don't worry; we will cover the whole comparative file analysis process and how to get started in Module 14. Do not jump ahead quite yet. A comparative file analysis is a last resort review as we will discuss in that module. We suggest you continue on the course in the order that we have it laid out before you get to the file analysis module.

MODULE SUMMARY

In this module, we talked about the basics of underwriting. We went through the underwriting set ups and the 11 most common types of underwriting criteria used by lending organizations. Your organization will likely use some combination of the factors we discussed. There is no "right" or "wrong" set of factors to choose. The management team and risk managers at your organization will help guide those factors. We also discussed the importance of having clear and concise underwriting guidance and how to perform underwriting reviews. It's your job as a compliance professional to ensure underwriting procedures are fair, consistently followed, and deviations from policy are controlled and monitored.

TUSCAN CLUB
UNIVERSITY

MODULE 8
PRICING

Tuscan Club University
Fair Lending School

MODULE 8 –
PRICING

MODULE OBJECTIVES

Welcome to the pricing module. This is, by far, the largest of the modules. There is a lot of information in here, but don't be discouraged. While this is a long module, we will give you step-by-step instructions on how to conduct the pricing review. There are many screen shots within the procedures to help you along the way. Be sure and watch the video on this module to help you as well. It is a great visual representation on what we are doing, and it will greatly help you through the process. You can find the pricing procedures in Appendix A of this manual.

In this module, we are going to talk all about the pricing of a loan. We will check back in with your Compliance Management System, and then we will help you choose the products you will be reviewing. Then it's time to stop thinking about it and get into the heart of one of the most important modules within this course: conducting the pricing review. We will wrap up with what the numbers mean and what you can do if you find higher pricing disparities. Let's get started.

What is Included in Pricing?

Some of what is included within the pricing of a loan is obvious. The interest rate you charge an applicant on a loan is one of the biggest indicators of how much a loan will cost. However, there are other factors that are included. Before we get too far into pricing, let's revisit the loan lifecycle and see where we are.

At this point in the process, you have taken the application (Module 5 – Applications), decided which product to get your customer into (Module 6 – Steering), decided that you were going to approve the loan (Module 7 – Underwriting), and now you have to determine how much you will charge the applicant to get this loan (Module 8 – Pricing).

Elements of Pricing

Pricing is more than just the interest rate you charge. Pricing is an overarching term we will use that considers all aspects of the loan origination process. For the purposes of this module and what we are discussing, pricing includes:

- Interest Rate
- Fees
- Loan Term
- Add-on Products (typically uncommon)
- Collateral Age
- Anything else you use that affects the cost

In order to review your pricing model and do an analysis, we want to step back from the fair lending regulations for a minute and visit a concept under a different regulation.

Truth-in-Lending – Regulation Z

The Consumer Financial Protection Bureau is tasked with implementing the Federal Truth-in-Lending Act. In order to do so, the CFPB issued Regulation Z, or Part 1026. While Regulation Z typically is not a primary regulation when looking at fair lending, there is a concept within that regulation that we want to discuss that will broaden your understanding of reviewing the full scope of pricing risk.

The concept within Regulation Z that we want to focus on is an Annual Percentage Rate, or APR for short. We're sure you have heard this term before and may have a basic understanding of what it is, but we want to use this concept here to help illustrate a point.

An APR is not an interest rate. The simple interest rate someone pays on a loan is a numerical value multiplied by the loan amount. There are some factors that can determine how much interest you actually pay, but the interest rate is simply the amount of interest you pay to borrow money.

The APR factors in ALL costs of credit, to include things like fees and add on products. So, if you have a $100 origination fee, your APR will be higher than your interest rate. Your interest rate may be 5%, but depending on your loan amount and how long you take out the loan, the APR could be much greater. It's a way to factor in the total cost of a loan so borrowers can compare apples to apples when shopping for a loan. APR calculations can get complicated, and that is not the purpose here. The point we want you to take away from this is that there is more to pricing than simply just the interest rate. So, when you are conducting a pricing review, you want to look at more than just the rate the borrower received. The rate is a big focus of our reviews, but think outside of the box when looking at your program because all programs can be a bit different.

Compliance Management System

Before we dig into conducting a pricing review, let's go back and think about your CMS for a moment. Your CMS is a linear progression of interdependent controls that help manage a strong compliance program. Let's discuss how your CMS relates specifically to pricing.

Policies – Do you have a loan policy? The answer to this should be yes. We have yet to find an organization without at least a basic loan policy. This policy should set the standard on how your organization makes loans. You will find many things within a policy like desirable loans, your trade or assessment area, underwriting criteria, and possibly how to price loans.

Procedures – The most common procedures for loan pricing is an interest rate sheet. Interest rate sheets come in many shapes and sizes. Some are very complex with different tiered pricing guidelines while others are more open to interpretation with large interest-rate bands for pricing loans. The tighter your controls over pricing are, the stronger your program will be. It is possible to have tight pricing controls in place, but if loan officers commonly deviate away from the rate sheet, your risk increases.

We can't tell you how many organization managers have said something very similar to this comment: "We have strong pricing practices in place. We have a rate sheet, and lenders rarely go away from it." Then they hire us to do a pricing review, and we find that loan officers hardly ever use the rates on the sheet. The only way to know for sure is to conduct the review. You may also have some type of software that helps you price loans. In these cases, pricing risk can be reduced because it eliminates the human element.

Training – This part of your CMS program is pretty straightforward, but some organizations cut corners here. It's unfortunately common that when an organization needs or wants to cut costs, training is often first to the chopping block. It all ties back to your CMS. By this point you have policies and procedures in place. Now you need to train your lenders to follow them. Your lenders must have a basic understanding of the fair lending laws and regulations and how your organization ensures compliance.

In addition to regulatory training, you will want to focus on training of your policies and procedures; or basic training for lenders if you will. If your organization uses rate sheets, lenders must know the process. If you have an underwriting checklist, lenders must know the correct ways to complete it. When we get to the fair lending interview, we get to test the training of your lenders and see if they truly know your organization's approved way of making loans.

Monitoring – We have found that if organizations are doing ANYTHING for fair lending, this is probably what they are doing, or what they are at least attempting to do. Monitoring of a fair lending program, especially when it comes to pricing, can be as simple as spot-checking loans to see if lenders are using the rate sheet. Some organizations do this on every loan, others may do it every so often, and some never do this. Periodically pulling loan files from different lenders and different branches to see if they are following the rate sheet is a good way to help determine risk, but it may not tell you the whole story.

Audit – This is where we can really find out how strong (or weak) your program is. If you have policies and procedures in place, train your loan staff, and periodically monitor what they are doing, you may not need to ever conduct a pricing audit. I know that sounds like a nice and cozy theory, but it's true. However, the pricing audit procedures we are going to teach you are not terribly difficult, and they don't take days or weeks to do. The more you practice these procedures, the easier they become.

Conducting a full pricing audit is one way to help determine if you are pricing loans fairly. The regulators commonly use this method when they feel there may be pricing risk at your organization. When should you do a pricing review? Here are some things you will want to consider when you are making the decision of whether to do a pricing review:

- Do you have strong policies and procedures in place? We don't mean an aesthetically pleasing policy to look at, but one that is known, read, and understood by your loan staff. We mentioned in a previous module about the institution that had a policy with a different institution's name at the top. It was very clear that the policy held little value; it was just there to say they had a policy.
- Do you have a rate sheet? Many lenders and managers hate them, but this is the simplest way to reduce pricing risk.
- Are you using the rate sheet? Having one but never using it is the same as not having one.
- Are you monitoring for deviations from the rate sheet? If you are deviating from the rate sheet 70% of the time, you either need to greatly tighten up your pricing practices or adjust your procedures to reflect what you are actually doing. Deviations should be the exception, not the norm.

A pricing analysis is not like a comparative file analysis in the sense that it is not a last resort type of review. If you are comfortable with the procedures, you can often do one in a short amount of time. It's a quick way to test your pricing procedures to see if lenders are doing what they are supposed to. However, if your pricing review reveals concerns, you may need to dig deeper. Let's get into actually conducting the review.

Conducting a Pricing Analysis – Getting Started

Review Period

To get started, you will need to determine your review time period. If you are a smaller organization, you may want to review loans for a 12-month period. If you are a larger organization, you may want to do it with a 6-month or even 3-month period. Smaller organizations may only make a few hundred loans a year. Larger organizations could see tens of thousands. It's better to have more data and loans in your sample than less, but once you get over 1,000, you will already have a pretty good indicator of how your organization prices loans. There will be a little leg work in conducting this review, so as we get into it, you will see that you may want to narrow your timeline and scope.

Something else to consider is have you had any major changes that could affect your pricing analysis? If you have had major changes, you may want to consider starting the period of your review after those changes went into effect to ensure consistency. Some examples of changes you may want to consider are:

- Overhaul of pricing guidelines
- Merger or Acquisition
- New credit policy
- New chief credit officer (if they made changes to policy)
- Large financial institution expansion
- Beginning or ending a secondary market loan sales program

There are other areas you may want to consider as well. We want to make sure we are comparing apples to apples. If you had a merger 6 months ago, you merged two organizations that likely have different ways of pricing loans. You will not get useful data comparing loans made prior to the merger.

Product Selection

Pricing analyses are pretty much always consumer purpose loans. While agriculture and business loans can also be at risk, it is often very difficult to compare business loans. With consumers, everyone has the same type of ratios (LTV, DTI, etc.) and everyone has a credit score (yes, we realize some people don't have a long enough credit history to have a score). These are consistent ways to compare one individual to another. In the business world, it's much harder to compare one business to another when they do completely different things.

You will need to determine which loan products you are going to review. For smaller organizations, you may only be looking at one or two loan types. You need enough originated loans to give you valuable and useful data. If you price ATV loans differently than car loans, and you only made seven ATV loans in the past 12 months, you won't get enough data to help you find trends. In these cases, you will likely take ATV loans out of your sample. There are math formulas that determine whether a sample size is statistically significant, but that type of mathmatics is far beyond the scope of this course. If you only have a few loans in your sample, performing this review likely won't give you useful results.

Loan Download

To do this pricing review, you will need to get a copy of your loan download in a spreadsheet format. The basis of this analysis will be using Microsoft Excel. You could likely do this analysis with another program, but the directions that we show will be how to do this analysis in Excel. You should be able to export your loan download from your loan software. This may take a few tries to get the format that you need, so be patient and start early. We have never had a lender that could not produce this, but sometimes it takes a few tries.

It's best to start with 12-months' worth of loan data. We like to cut off our sample around the end of a month. So, if we're doing this review in let's say March, we will just look for a full calendar year loan download of the previous year. If we do the analysis in July, we may take June 1 of last year through May 31 of this year. Start with 12 months, and then you can break it down if your universe sizes are too large.

Next you will group the download by loan product. By grouping similar loan products together, you will be able to easily see how your lenders are pricing loans. Example: some institutions price distinct vehicle loans differently. They might price car-title loans using one set of criteria, and they price ATV, campers, and boats off of a different model. You will want to group like loans into like pricing groups. This will give you an apples-to-apples comparison. You will also be more easily able to identify pricing anomalies.

You will also group your home loans together that way as well. You may offer home equity lines of credit (HELOCs), so you would want to analyze them separately, if they have their own pricing structure. You may price every HELOC at the same rate. That's a simple analysis. You look and make sure every HELOC got that rate, and then you don't need to go through the next steps.

You will also want to identify any non-consumer purpose loans. If a loan is secured by a vehicle, but the loan was made to a business, you will want to remove them from your sample. If something was business- or ag-purpose, you will want to remove those as well. Your loan codes will help you do this.

PRO TIP

Make sure you get all of your loan codes, collateral codes, loan purpose codes, or whatever your institution uses to identify loans. This will help you in grouping together like loans. But be careful! Those loan codes can be wrong. They were usually entered by a person, and it's not uncommon to find mistakes here.

Now that you have your product timeline, product buckets, and universe sizes, it's time to start the pricing analysis.

Conducting the Analysis

By this point, you should have a handful of different products you are going to review. You will need to determine the prohibited basis you are going to base your analysis on. The most common way to do this is to use the borrower and co-borrower's sex. There is a tool that can help you determine sex, and all organizations can use this analysis method. If you have high Hispanic populations in your area, you can also analyze Ethnicity using the Surname Tool. We will get into both tools.

The first analysis we are going to do is using the prohibited basis of Sex. The definitions of sex and gender have changed a lot over the years. In fact, ECOA has expanded on the prohibited basis of sex to be more inclusive. This analysis is not intended to offend anyone or assume anything about any person or groups of persons. This analysis is only a tool we use to see if your organization is pricing fairly, and the gender tool is one of the few tools we have available to help us do that. We are not trying to be discriminatory. It's quite the opposite. We are trying to identify and prevent discrimination based on sex and gender. Please do not read more into it than just one tool to try and help identify, fight, and prevent discrimination.

Ensure you watch the video for a visual presentation on how to conduct this review. This is one of the most crucial reviews of this entire school, so take your time and follow all of the steps. Once you get your loan download prepared, you will be using that for the full pricing review.

Please see Appendix A for Pricing Review Procedures. Once you have completed the pricing procedures, return back here for the summary.

MODULE SUMMARY

First of all, congratulations on making it through the pricing module! There is a lot of information here, and doing the pricing review can take some time. However, this is a critical module and one that can give you concrete numbers to help you evaluate your program.

During this module, we discussed what is included in pricing. We talked about how to set up your CMS to prevent pricing issues before they happen. Then we got into how to set up your review. That section covered how to generate your loan download, prep it for the analysis, find the prohibited basis, and sort into control and target groups. At that point, we were able to run our pivot tables and break it down further by branch and loan officer.

If you find that you have large pricing disparities, you will want to go back to your CMS part of the review and find the weaknesses. Pricing disparities are most commonly traced back to not following rate sheets. You will want to tighten policies and procedures, re-train your loan staff, and monitor to ensure corrective action is effective.

TUSCAN CLUB

UNIVERSITY

MODULE 9

EXCEPTIONS

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Fair Lending School

MODULE 9 -
EXCEPTIONS

MODULE OBJECTIVES

In the exceptions module, we are going to focus on your program to allow, track, and monitor exceptions to policy. We will start by defining exceptions. Then we will give you some common examples before we tie it back to your Compliance Management System. We will discuss your program set up, go over the approval process, and cover how to properly track exceptions.

We will give you some tips on how to organize your data so you can start doing comparisons and a long-term analysis. You can also add prohibited basis data to your tracking sheet, and we have some tips on how to collect that data. We will wrap the module up with giving you some questions for you to answer that can help you get started on your review.

What are Exceptions?

An exception happens anytime a lender approves something that is outside of loan policy. Exceptions can happen in pricing, underwriting, or a host of other parts of the loan process. Exceptions can be viewed as a good thing. It's your lender going out of their way to take care of a customer. That sounds great. What could go wrong, and why would this be a problem? It becomes a problem when it's not done on a consistent and fair basis.

Here are some examples of common exceptions in the loan process:

PRO TIP

There are many ways to make loan exceptions. Your organization should have written standards and guidelines for approving loans. These standards have already been covered in previous modules: interest rates, LTV and DTI maximums, credit score minimums, etc. When you go outside of those standards, you are making an exception.

- Giving an interest rate that is outside of the rate sheet
- Approving a loan that is outside of your underwriting criteria
- Approving a loan outside of your organization's designated trade/market area
- Waiving a fee on a loan for a particular customer
- Giving a longer loan term than what is allowed
- Taking a car as collateral that is older than what is acceptable in loan policy
- Approving a loan that would otherwise require a co-signor

Compliance Management System

Everything you do ties to your CMS. Lending organizations need to plan ahead for policy exceptions, and it's good to have some built within your program. Your senior management and leaders in the credit area will establish how your organization makes loans. It will be up to them to determine how credit is extended (policy) and if lenders are able to deviate from policy (exceptions).

Policies and Procedures

You should have exceptions built within your policies and/or procedures. If you allow exceptions, that should be included in your loan policy. If exceptions require a secondary approval, that should also be in policy. How much lenders can deviate from policy is often built within the procedures (rate sheets, underwriting checklists, loan write-ups). It can be as simple as adding to your policy a statement that "all exceptions to policy require XYZ approval." Some organizations allow lenders to do one policy deviation without approval (LTV too high), but if there are more than one (LTV too high and credit score too low), it needs higher authority approval. Others don't allow any deviations, and some give lenders full discretion. Those organizations carry the highest risk.

Training

Your lenders should be trained on the loan process, and this includes policy exceptions. They need to know the process to make an exception. If you track those exceptions (which you should, and we will discuss), they need to ensure the proper individuals are notified that there is an exception so it can be tracked. If exceptions require an approval by a higher lending authority or committee (a good idea), they need to be trained on that process as well.

Monitoring/Audit

Compliance and audit staff can help monitor for exceptions. That's part of what this training is about. Monitoring comes in when you spot check loans from time-to-time to ensure policy is being followed. When you find a rate was given that is not on the rate sheet, check to see if it is on the exceptions log. Also check to see if approval was given for deviations. If the exception was omitted from your tracking log, did the loan officer comment on the reason for their exception in the file comments? When it comes to audit, look at long-term trends to identify any negative or unfavorable trends developing. Did men get exceptions 90 percent of the time but women only 15 percent? Is one loan officer making significantly more exceptions than everyone else?

Complaints

As with all other areas, any complaints about your process specific to policy exceptions need to be thoroughly reviewed. Remember – complaints are feedback on your process. They will likely be rare in this area, but don't forget this important step.

Risk Management

Let's move away from your CMS for just a moment and talk risk management/ safety and soundness. Risk management may also track exceptions, but their reasoning is often quite different. Risk management may want to track exceptions to see if they are leading to higher default rates. When a loan customer defaults, someone may go back and see if that customer had an exception. If exceptions get excessive and lead to higher default rates, they can lock down the number of exceptions being made in an effort to control overall credit risk.

The important thing to realize is the risk they are worried about is different that what we are worrying about. Risk managers care about reducing credit risk, but that doesn't help with fair lending or general compliance risk. Compliance is looking at exceptions from the standpoint of consistency. Is an organization always making exceptions for men and not women? Are exceptions made in white neighborhoods but not minority neighborhoods? Don't confuse risk management exception tracking and analysis with compliance. Both are useful but for much different reasons. Just because someone tells you at your organization that exceptions are tracked and monitored does not mean they are doing it from a fair lending standpoint.

Let's get more in-depth with how this could actually look in your organization.

Developing a Written Program

The first thing you will want to see is a written program. This will include all of your policies and procedures that tell loan officers how to do their jobs. Many smaller organizations have informal or unwritten policies and procedures. They may work off of a "base rate" to price their loans. If they only have a few lenders that constantly communicate, they can keep their risk lower without having to have written guidelines.

PRO TIP

You will want to make sure that your organization sets a climate that exceptions are just that: the exception.

The larger your organization gets, the more difficult or impossible that task becomes. This is why you will see at the largest organizations that their entire underwriting and pricing models are automated. A loan officer will enter in all of the customer information and the computer makes all of the decisions. You can virtually eliminate exception risk by just not allowing exceptions, but that's not how most of the financial industry works.

If the lenders at your organization are making loan exceptions 60, 70, or 80 percent of the time, they are no longer exceptions. The exceptions to policy are becoming the new norm. In those cases, you either need to significantly cut back on the number of exceptions you allow or re-write your policies and procedures to better reflect what you are actually doing in practice.

Approval Process

The next aspect to your policy exception program is requiring secondary approval of exceptions. If your organization allows loan officers to make any exception they want, anytime they want, you have the greatest risk that they might be doing it on a prohibited basis. Strong programs incorporate a secondary approval process. That could be a second lender review, a senior lender, a market president, or a loan committee that has to sign off on the exception.

You will also want to be sure that your approval process is appropriate for the size and complexity of your organization. If you are a small organization with only a few branches and lenders, you could likely have one person (say the president or chief credit officer) approve all exceptions. As you get bigger (say dozens of lenders or hundreds of lenders), having one person approve all exceptions may no longer make sense. You will want to make sure that the exception approval process is consistent among all of your lending products, channels, and approving officials.

Real World Example

We came across an issue doing a fair lending review where the financial institution had about a dozen different markets, each with their own market president. Each market president was tasked with approving all exceptions for their market. The fact that they had a secondary approval process was good, but we found two of the markets had some major pricing issues resulting from the approval process. Those two market presidents were handling exceptions very differently than the other market presidents.

Management never knew about this issue because the market presidents never communicated on this topic and there was no policy or procedural guidance for the proper way to approve exceptions. So, they all did their best working in their own bubble, but there were vast differences between the markets. They were essentially operating as 12 different lending banks. Not a good way to build consistency. You will want to make sure someone (or a small group of people) has oversight of your organization as a whole in order to apply the exception criteria consistently. This is one of the issues you may discover in an audit.

Tracking Exceptions

All good fair lending programs should have some method of tracking exceptions. The most common method we see of exception tracking is using an Excel spreadsheet. Usually one person (or a small group) is tasked with tracking any exceptions to policy. There are a few things to consider when reviewing your exceptions tracking logs:

1. **Are all exception types included?** We often see organizations that only track interest rate exceptions. While that is a great way to make sure you are pricing loans consistently, you have no idea if your loan decisions are fair and consistent if you don't track underwriting exceptions. Rates, underwriting criteria, fees, loan terms, and any other factor that materially affects the loan should be tracked.

2. **Are all exceptions reported?** You will need to find the person tasked with reporting exceptions. Many times, it is the loan officer themselves that are supposed to report exceptions to loan policy. Other programs may have a loan administrative assistant, loan processor, underwriter, or the approver of the exception report it. How do you know if everyone is reporting exceptions?

One way is to ensure you include the loan officer name and branch on the exceptions tracking log. If you are looking at exceptions for the last 12 months, and there are lenders or branches that don't appear on there once, that could be a red flag that they are not reporting exceptions. Either they don't ever allow exceptions (which is possible) or they are not following reporting procedures.

3. **What data are you collecting?** You will want to make sure all relevant data to the loan is reported on your exceptions tracking log. This will help you when you go to analyze the data. Any key piece of data that is used to make the loan decision, set the interest rate, determine fees, or set terms of the loan should be included. You will also want to include loan officer, underwriter (as applicable), branch/market, and approving official. You may also want to have an explanations section or reason why the exception was being made. Here is an example of what a log could look like:

Loan Date	Borrower First Name	Borrower Last Name	Co-Borrower First Name	Co-Borrower Last Name	Loan Number	Loan Type	Original Loan Amt	Branch Number	Loan Officer	Exception to Policy	Reason

PRO TIP

This example above is a very basic table. You can use this as a starting point and add anything you would like. Some organizations we have seen add a column for the prohibited basis of the borrower (sex, race, ethnicity, etc.). Within the exception to policy column, you would want to put in there what the exception is. You may need multiple columns to accommodate multiple exceptions for the same loan. For example, your lender could make an LTV exception and pricing exception on the same loan.

Analyzing Exceptions

We have roughly estimated that about 50% of the financial institutions we go to don't even track exceptions. It could be that they don't make many exceptions, they don't know to track exceptions, or they just don't see the value in it. An interesting thing we have found is that the other 50% of those that do track the exceptions keep them on a nice spreadsheet throughout the year but do nothing in the way of analysis. Yes, there are organizations that really dig into their exceptions, but too many just keep tracking data and do very little in the way of a useful analysis. They think simply tracking is enough. Sure, tracking looks good to examiners, but it adds no value in determining the risk in your program without the analysis.

Organizing Your Data

Once you have your data, the first thing we always suggest is to put it all on one spreadsheet and put it in chronological order. If you are a very large organization, you may want to break it down by quarters if the data is too much.

We have seen some organizations put the exceptions for each month on a separate tab within a spreadsheet. It's nearly impossible to identify trends when you do this. For example: let's say your loan officer Doug makes two exceptions in January, another two in February, one in March, four in April, three in May, and so on. If you look at any one of those months by itself, Doug likely won't stand out. If you put them together and look at the entire year, you may find that Doug made 41 exceptions in the year and next highest lender had 12. Now Doug stands out as an outlier, but you never would have caught that only looking one month at a time.

Compare Ratios – Real World Example

Once you get all of your exceptions for your time period, do some simple math and find out the percentage of total exceptions each of your lenders had. You may often find outliers like Doug. But is Doug really an outlier, or is there another reason for his number of exceptions?

We did a fair lending review of a client that was tracking exceptions. They had a beautiful spreadsheet with a ton of great data, but they fell into the mindset that tracking was enough. We helped them take it a step further by doing the analysis.

PRO TIP

No disrespect to anyone named Doug. We know many Dougs, and they are great people. We have to choose a name, so Doug it is.

Sure enough, they had a Doug at their institution. Their Doug had 26% of the total exception's, and the lender with next highest percentage was around 12%. At first, Doug appears to be an outlier, but there is another step. The next thing we did was found the percentage of total consumer loans Doug made in the year. This was quite easy as we already did a pricing review so we had the entire loan download for the same time period as the exceptions. You may have to generate and sort your loan download so you can find how many loans each of your lenders made. In Doug's case, he made relatively few loans. In fact, Doug made only 4% of the loans. Why did Doug have 26% of the total exceptions but only made 4% of the loans? We now know he was an outlier, so we need to find out why.

That's when we started discussing Doug's situation. During conversations we learned that Doug was a market president, so it was very common that the borderline creditworthy customers were funneled to Doug. He had the most experience, knew policies and procedures well, but often had to make exceptions to customers because they were the borderline approval/denial types.

In Doug's case, this made sense that he had by far the most exceptions. There could be a host of other reasons, however, and that would require further investigation. You would keep digging until you found out why numbers don't match up. In the end, you may find that Doug just makes too many exceptions. If you analyze his exceptions and determine they are fair and consistent, you may be done. If they are not fair and consistent, you will need to take corrective action (likely more training, greater oversight, and less exception approvals for Doug).

Using a Prohibited Basis

If you have prohibited basis data, you can also use that to determine if exceptions are made fairly and consistently. Often times we see that pricing exceptions are made at a much higher rate to men than women. It is possible that you can use the Surname tool as discussed in Module 8 to see if they are made fairly to Hispanics and non-Hispanics. If you are looking at home loan exceptions, you will have additional prohibited basis data on your applications or within your HMDA data. You want to look for any unfavorable trends to ensure that you are not treating one prohibited basis differently than another. That is the ultimate goal of this module and fair lending risk. Control exceptions, track them, and monitor/audit this area to ensure they are done on a fair basis and not a prohibited basis.

PRO TIP

The additional value of tracking exceptions – If you track exceptions, then you already have a concise collection of loans that were marginal approvals. You can use your exception log for conducting your comparative file analysis, as we will discuss in Module 14.

Your Review:

You will need to analyze your program to learn how your organization handles loan policy exceptions. Here are some questions you need to answer:

- Are lenders allowed to make exceptions?
- If so, what kinds of exceptions can they make? (rate, underwriting, fees, etc.)
- Are those exceptions tracked?
- Are all relevant data points included within the tracking data? (LTV, DTI, credit score, loan term, etc.)

- Does your organization ever evaluate the raw data?
- Are ratios of loans and exceptions by lender fairly consistent or are there outliers?

The answers to these questions will determine how you perform your own analysis.

MODULE SUMMARY

In this module we defined what exceptions to policy are. We discussed reviewing your program and looking at your exception approval process. We then talked about tracking those exceptions. Without an exception tracking log, you will have little way of knowing if you have risk in this area. With the tracking data, you are able to perform an analysis and look for any unfavorable trends. We talked about organizing your data and comparing ratios you have calculated. This is a key area that all organizations should build a strong program around.

If you are an organization that is tracking this data but not analyzing it, take that extra step and build out an analysis. Exception tracking can help strengthen both your monitoring and audit functions of your CMS. If you find unfavorable trends in the data, bring it up to management and find ways to change procedures and mitigate that risk. Showing examiners that you are doing this will help display to them the strength of your CMS.

TUSCAN CLUB
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MODULE 10
DENIALS

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MODULE 10 – DENIALS

MODULE OBJECTIVES

In this module, we are going to focus on the process of denying a loan. During the underwriting process, lenders collect certain pieces of data to determine if an applicant meets their organization's criteria (underwriting). That step is very important in the process, and it's also important to document that criteria for future analysis. When applicants don't meet the loan policy standards (and are not approved for a policy exception), they are denied and are required to get an adverse action notice (denial notice).

During this module, we will check in with the loan lifecycle to see our progress. We will cover the regulatory requirements of Regulation B (ECOA) before getting into the notification requirements. We will discuss counteroffers and take a deep dive into the adverse action notices. There are Fair Credit Reporting Act requirements along with several model form disclosures we will look at. We will also touch on business applicants and get into including specific denial reasons on the notices. There are combined disclosures that you can use, and we will cover those in more detail. We will wrap up the module by tying it to a CMS component: monitoring.

Loan Lifecycle

We have made it through the application process, our customer has provided us details on what type of loan they want, and we have completed the underwriting process. If the loan is originated, we continue on; but what happens if the customer does not meet your underwriting criteria? That's what triggers the denial process.

Back in ***Module 2 – Laws and Regulations***, we talked about the illegal forms of discrimination. Those are the prohibited bases that we CANNOT base our loan decisions on: race, color, religion, sex, national origin, etc. In ***Module 7 – Underwriting***, we talked about the legal forms of discrimination: credit score, debt-to-income, loan-to-value, etc. The legal forms of discrimination are what we CAN and SHOULD base our approval and denial decisions on. You will see throughout this module that denial risk is very much tied to underwriting risk.

Adverse Action Notices

When an applicant does not meet your organization's underwriting criteria, a decision to deny the loan is made (taking adverse action), and the applicant is entitled to an Adverse Action Notice. Regulation B gives us the textbook definition of adverse action (denial), and there are three parts:

(i) A refusal to grant credit in substantially the amount or on substantially the terms requested in an application unless the creditor makes a counteroffer (to grant credit in a different amount or on other terms) and the applicant uses or expressly accepts the credit offered;

> ***Official Interpretation:*** **Application for credit.** If the applicant applied in accordance with the creditor's procedures, a refusal to refinance or extend the term of a business or other loan is adverse action.

(ii) A termination of an account or an unfavorable change in the terms of an account that does not affect all or substantially all of a class of the creditor's accounts; or

> ***Official Interpretation:*** **Move from service area.** If a credit card issuer terminates the open-end account of a customer because the customer has moved out of the card issuer's service area, the termination is adverse action unless termination on this ground was explicitly provided for in the credit agreement between the parties. In cases where termination is adverse action, notification is required under § 1002.9.
>
> **Termination based on credit limit.** If a creditor terminates credit accounts that have low credit limits (for example, under $400) but keeps open accounts with higher credit limits, the termination is adverse action and notification is required under § 1002.9.

(iii) A refusal to increase the amount of credit available to an applicant who has made an application for an increase.

Timing of Notices

When your organization has one of the scenarios above, an adverse action notice is required. Fortunately, Regulation B tells us when the notifications are required and what needs to be included.

§ 1002.9 Notifications Regulation B covers the requirements of the adverse action notice. There are important timeframes that your institution must meet when taking adverse action. Let's look at those now.

When notification is required. *A creditor shall notify an applicant of action taken within:*

(i) 30 days after receiving a completed application concerning the creditor's approval of, counteroffer to, or adverse action on the application;

(ii) 30 days after taking adverse action on an incomplete application, unless notice is provided in accordance with paragraph (c) of this section;

(iii) 30 days after taking adverse action on an existing account; or

(iv) 90 days after notifying the applicant of a counteroffer if the applicant does not expressly accept or use the credit offered.

The first thing we need to establish is the application date. You will notice that you generally have 30 days from the application date to provide notice to the applicant. What you need to determine is the actual application date. Sometimes customers will mail in an application with only part of it filled out. Other times a lender may take an application over the phone but not have all of the details. The regulation gives guidance on when the application date is:

> ***Timing of notice - when an application is complete.*** *Once a creditor has obtained* ***all the information it normally considers in making a credit decision****, the application is complete and the creditor has 30 days in which to notify the applicant of the credit decision. (See also comment 2(f)-6.)*

Once you have the information you normally collect to make a credit decision, you have a completed application and the 30-day window starts. This is not an area you want to test the waters on. Ensure your lenders clearly know when a completed application is received.

PRO TIP

Define what pieces of information the lenders at your organization need to make a credit decision and write it into your lending policy or procedures. This makes it clear to everyone what date an application is "received."

When an application is approved, you can simply tell the applicant or it may be implied. Here's what the commentary says about the approval process:

> ***Notification of approval.*** *Notification of approval may be express or by implication. For example, the creditor will satisfy the notification requirement when it gives the applicant the credit card, money, property, or services requested.*

What happens when you don't have enough information to deny or approve the application? Those are considered "Incomplete" applications, and they also have their own procedures. Here's what the commentary says about incomplete apps:

> ***Incomplete application - denial for incompleteness.*** *When an application is incomplete regarding information that the applicant can provide and the creditor lacks sufficient data for a credit decision, the creditor may deny the application giving as the reason for denial that the application is incomplete. The creditor has the option, alternatively, of providing a notice of incompleteness under § 1002.9(c).*

You may also not have all of the information that you requested, **BUT** you have enough to make a credit decision. This is common when you request a list of information need to approve a loan but you don't get everything you need. However, you have enough information to run a credit bureau report, and you find that the customer's credit score is 490. In that instance, you likely have enough information to deny the loan. In this case, you may still have an incomplete application, but the denial reason is not for incompleteness because you know that loan would have never been approved. These situations are handled a little differently. Here's what the commentary has to say:

> ***Incomplete application - denial for reasons other than incompleteness.*** *When an application is missing information but provides sufficient data for a credit decision, the creditor may evaluate the application, make its credit decision, and notify the applicant accordingly. If credit is denied, the applicant must be given the specific reasons for the credit denial (or notice of the right to receive the reasons); in this instance missing information or "incomplete application"* ***cannot*** *be given as the reason for the denial.*

The biggest difference here is that you have the key data to make a denial decision, so the applicant must be given specific denial reasons. In this case, "incomplete application" cannot be given as the denial reason.

You get two options for incomplete applications, but both require a notice. You can either deny the application and indicate that it was incomplete, or you can provide a notice of incompletion as part of 1002.9(c).

Counteroffers

When an applicant is creditworthy but does not meet all of the underwriting criteria, an institution can make a counteroffer. These are common when an applicant doesn't qualify for the amount of credit requested but is still a creditworthy applicant, so a lower loan amount is offered to the applicant.

If you provide the applicant with a counteroffer, and the applicant does not accept the counteroffer, you must send a follow-up adverse action notice. This adds steps and leaves your organization open for potential mistakes.

Model Form C-4 has a combined counteroffer and adverse action notice. If the borrower later does not accept the counteroffer, there is no further notification requirement because you gave the adverse action notice with the counteroffer.

What about taking applications over the phone? The commentary to the regulation also addresses this situation:

> ***Denial of a telephone application.*** *When an application is made by telephone and adverse action is taken, the creditor must request the applicant's name and address in order to provide written notification under this section. If the applicant declines to provide that information, then the creditor has no further notification responsibility.*

There is certain content that must be included within the adverse action notices. At the end of this section you will find Model Forms C-1 through C-8. These model forms cover all of the information required, depending on the different scenarios we just discussed.

Purchased Adverse Action Notices

There are companies that will sell adverse action notices, or it's possible you can have them printed out with your credit bureau reports. These are often good and viable methods to providing the notice to your borrowers, but they still need to be filled out correctly. Like with paper applications, you can develop your own adverse action notices. This route could be cheaper, but then you need to ensure all compliance and disclosure requirements are present. Most organizations choose not to go down this route and simply pay for the notice to be created.

Model form disclosures – Let's briefly discuss the different model form disclosures and when their use is appropriate. Appendix C to Part 1002 contains all of the sample notification forms. One of the biggest differences in the different model forms depends on whether or not your organization used information from a credit bureau in making the credit decision. There are many times that regulations overlap or intersect, and this is another example of one.

Fair Credit Reporting Act (FCRA)

The FCRA (implemented by Regulation V) requires certain disclosures to loan applicants when information from a consumer reporting agency (credit bureau report) is used in connection with making a loan decision. Additional information is also required when a credit score is used.

Broken down in its basic parts, the regulatory requirements are quite simple.

1. Disclosures are required when you use a credit bureau report in the loan decision; {*Section 615(a)*}
2. More disclosures are required when you use a credit score; {*Section 615(a)*} and
3. More disclosures are required when you obtain information from an affiliate that is not a credit bureau {*Section 615(b)*}

Model Forms

Let's look at the model forms and talk about the differences between the options. The commentary to the regulation discusses how these are sample forms and may be (and often should be) edited, as necessary.

The sample forms are illustrative and may not be appropriate for all creditors. They were designed to include ***some of the factors*** *that creditors most commonly consider. If a creditor chooses to use the checklist of reasons provided in one of the sample forms in this appendix and if reasons commonly used by the creditor are not provided on the form,* ***the creditor should modify the checklist by substituting or adding other reasons.*** *For example, if "inadequate down payment" or "no deposit relationship with us" are common reasons for taking adverse action on an application, the creditor ought to add or substitute such reasons for those presently contained on the sample forms.*

Model Form C-1 – Use this form when you use a credit bureau report **AND** information obtained from an affiliate. This is a less commonly used form.

- This form contains the FCRA disclosure as required by 615(a) and 615(b) of the Act.
- A creditor must provide the section 615(a) disclosure when adverse action is taken against a consumer based on information from a consumer reporting agency.
- A creditor must provide the section 615(b) disclosure when adverse action is taken based on information from an outside source other than a consumer reporting agency.
- In addition, a creditor must provide the section 615(b) disclosure if the creditor obtained information from an affiliate other than information in a consumer report or other than information concerning the affiliate's own transactions or experiences with the consumer.

Model Form C-2 – Use this form for general credit denials when you want to list specific reasons. This form also has the credit bureau and credit score information required by 615(a) under the FCRA. This is a commonly used form.

Model Form C-3 – This form is similar to C-2, but it is used when you use a credit scoring model to assign a numerical value to the creditworthiness of an applicant. This is not simply when you use a credit score. Typically, only the largest institutions use a credit scoring model, but you need to know if your institution has and uses one. It's unlikely that smaller institutions have an internally developed credit scoring model.

Model Form C-4 – Use this form when you want to make a counteroffer and include the adverse action within the same form. If you make a counteroffer without the statement of adverse action, you may later have to issue an additional adverse action notice. That creates extra work for tracking and disclosing the information at a later date. Model form C-4 lets you do it all in one form, so if the applicant decides not to take the counteroffer, you have already issued the adverse action notice.

PRO TIP

If you decide to go this route, set up tracking methods and notice delivery procedures (including timing) to help lenders send requested denial reasons quickly and accurately.

Model Form C-5 – Use this form when you don't want to provide specific reasons for denial. Applicants are entitled to specific reasons why they were denied, but it doesn't have to be given up front. If your institution only wants to provide those specific reasons upon request, use this form. This does create more work and tracking on your compliance staff.

Model Form C-6 – Use this when you have an incomplete application and need more information. If you simply do not have enough information to deny a loan, use this form. The regulation states that you need to give the applicant a "reasonable period of time" to provide that information, which means the regulation doesn't specify. It's typical for many institutions to give the applicant 30 days to provide the information. If the applicant responds after the time period given, the lender is allowed to have the applicant fill out a new application (but it's not required to fill out a new app). This notice is all that is required to be provided to the borrower.

Model Form C-7 – Use this form for business applicants when you want to give specific reasons for denial. Just like with a consumer, you can decide to give specific denial reasons on the adverse action notice or have the borrower request them.

PRO TIP

Set up a calendar to track the 60 days if you have a lot of business loan denials to keep track of.

Model Form C-8 – Use this form when you don't want to give specific denial reasons on the initial adverse action form. Business applicants then have 60 days to contact you for those reasons.

Adverse Action for Business Applicants

Business applications can be treated a bit differently than consumer applications. Regulation B allows you a little more flexibility on how to notify business applicants.

Here's what the regulation says about business applicants:

Notification to business credit applicants. *For business credit, a creditor shall comply with the notification requirements of this section in the following manner:*

(i) With regard to a business that had gross revenues of ***$1 million or less*** *in its preceding fiscal year (other than an extension of trade credit, credit incident to a factoring agreement, or other similar types of business credit), a creditor shall comply with paragraphs (a)(1) and (2) of this section, except that:*

> *(A) The statement of the action taken* ***may be given orally or in writing,*** *when adverse action is taken;*
>
> *(B) Disclosure of an applicant's* ***right to a statement of reasons may be given at the time of application,*** *instead of when adverse action is taken, provided the disclosure contains the information required by paragraph (a)(2)(ii) of this section and the ECOA notice specified in paragraph (b)(1) of this section;*
>
> *(C) For an application* ***made entirely by telephone,*** *a creditor satisfies the requirements of paragraph (a)(3)(i) of this section by an* ***oral statement of the action taken and of the applicant's right to a statement of reasons for adverse action.***

(ii) With regard to a business that had gross revenues in ***excess of $1 million*** *in its preceding fiscal year or an extension of trade credit, credit incident to a factoring agreement, or other similar types of business credit, a creditor shall:*

> *(A) Notify the applicant, within a reasonable time,* ***orally or in writing****, of the action taken; and*
>
> *(B)* ***Provide a written statement of the reasons*** *for adverse action and the ECOA notice specified in paragraph (b)(1) of this section* ***if the applicant makes a written request for the reasons within 60 days*** *of the creditor's notification.*

If that all seems confusing (because it is), you can follow the same notification procedures as you do for consumer applicants. Send a denial notice with the denial reasons within 30 days of application. There is no reason that you have to complicate your procedures just for business applicants.

The ECOA Notice

What is the ECOA notice? You will find on many of the examples a disclosure that refers to the Equal Credit Opportunity Act. That "ECOA" notice is required on adverse action notices. As a lending organization, you are required to include it on your notices and fill in the appropriate regulatory name and address, depending on who your regulator is. If a third-party prepares the adverse action notices for you, it's likely built in. Review a sample of your organization's adverse action notices and ensure it is included and accurate.

The regulation says that the notice you provide should be "substantially similar" to what is listed in the regulation. Here is the verbiage they use:

The Federal Equal Credit Opportunity Act prohibits creditors from discriminating against credit applicants on the basis of race, color, religion, national origin, sex, marital status, age (provided the applicant has the capacity to enter into a binding contract); because all or part of the applicant's income derives from any public assistance program; or because the applicant has in good faith exercised any right under the Consumer Credit Protection Act. The Federal agency that administers compliance with this law concerning this creditor is ***[name and address as specified by the appropriate agency or agencies listed in appendix A of this part].***

Statement of Specific Reasons

One of the most common violations in reviewing adverse action notices is the specific reasons, or lack of specific reasons, on the adverse action notices. The regulation is very clear that reasons must be specific, but lenders across the country still struggle with this concept when filling out these forms. Here's what the regulation says:

Statement of specific reasons. *The statement of reasons for adverse action required by paragraph (a)(2)(i) of this section must be specific and indicate the principal reason(s) for the adverse action. Statements that the adverse action was based on the creditor's internal standards or policies or that the applicant, joint* *applicant, or similar party failed to achieve a qualifying score on the creditor's credit scoring system are insufficient.*

The whole idea behind this part of Regulation B is to inform applicants why they were not granted credit so they can work on fixing those issues to qualify in the future. Saying someone is not creditworthy does not tell them specifically what they can do to improve their creditworthiness. Letting someone know that a collection action is affecting their creditworthiness helps them know what to work on.

There are some other items in the commentary regarding denial reasons that are also important to cover.

Number of specific reasons. *A creditor must disclose the principal reasons for denying an application or taking other adverse action. The regulation does not mandate that a specific number of reasons be disclosed, but disclosure of more than four reasons is not likely to be helpful to the applicant.*

PRO TIP

Financial institutions are required to list the principle reasons for denying an application. If there is only one principal reason, only list one reason. Compliance officers have told us that examiners said they need more than one denial reason. DO NOT pile on denial reasons just to have more than one, but more importantly, do not make up denial reasons. Tell the applicant why they were denied, and that's it. This part of the commentary specifically mentions that more than four reasons is not likely to be helpful to the applicant. Nowhere does the regulation say you need more than one denial reason, if you truly only had one.

Description of Reasons

A creditor need not describe how or why a factor adversely affected an applicant. For example, the notice is allowed to say "length of residence" rather than "too short a period of residence."

This part of the commentary tells you that you don't have to describe factors like the example above. Just like many other areas of compliance, make sure you don't go too far the other direction. Remember, denial reasons must be specific, but you don't have to go into great detail.

Combined ECOA-FCRA Disclosures

One other major area of this part of the regulation we should discuss is how the Equal Credit Opportunity Act (ECOA) and the Fair Credit Reporting Act (FCRA) crossover. Both have requirements (if you used a credit report in making the denial decision) and they are similar, but they are different requirements. Below is the part of the regulation we should dig into.

ECOA *- requires disclosure of the* ***principal reasons for denying*** *or taking other adverse action on an application for an extension of credit.*

FCRA *- requires a creditor to disclose* ***when it has based its decision in whole or in part on information from a source other than the applicant or its own files.***

Disclosing that a credit report was obtained and used in the denial of the application, as the FCRA requires, does not satisfy the ECOA requirement to disclose specific reasons. For example, if the applicant's credit history reveals delinquent credit obligations and the application is denied for that reason, to satisfy § 1002.9(b)(2) the creditor must disclose that the application was denied because of the applicant's delinquent credit obligations.

PRO TIP

The FCRA notices are only technically required when you used a credit bureau report in the loan decision; however, take caution that you do not walk the fine line of pulling a credit bureau report and not including the FCRA disclosures because the principal reason for denial was not from information on the credit bureau report. You may see criticism during a regulatory exam if you are pulling credit bureau reports, using them for underwriting, and not including the FCRA disclosures on your adverse action notices.

The FCRA also requires a creditor to disclose, as applicable, a credit score it used in taking adverse action along with related information, including up to four key factors that adversely affected the consumer's credit score (or up to five factors if the number of inquiries made with respect to that consumer report is a key factor). Disclosing the key factors that adversely affected the consumer's credit score does not satisfy the ECOA requirement to disclose specific reasons for denying or taking other adverse action on an application or extension of credit. Sample forms C-1 through C-5 provide for both the ECOA and FCRA disclosures.

It is a common mistake for loan staff and even compliance staff to confuse or even crossover the two lists of reasons. As stated above, you must list the principal reasons for denial under ECOA. For this, you only list the principal denial reasons and list no more than 4 reasons. For FCRA, you need to list the factors that affected the credit score. These are typically taken right from the credit bureau report, and you must list 4. You must list a fifth factor ONLY if that fifth factor is because of the number of inquiries made.

Let's go back to denial reasons for a moment. A common pitfall with adverse action notices is crossing over the factors that affected a credit bureau score (FCRA requirement) as denial reasons (ECOA requirement). Remember, denial reasons must be specific, but they must also make sense. We have seen institutions list "Number of inquiries" as a denial reason. While that may 100% be a reason that affect the credit score (FCRA requirement) of that applicant, it's highly unlikely that the particular applicant was denied for credit because of credit bureau inquiries (ECOA requirement). So not only make sure your denial reasons are accurate, make sure they also make sense.

Unsecured Credit – Another common pitfall is using "Insufficient Collateral" as a denial reason when the customer applies for unsecured credit. Yes, it may be true that you will likely need collateral for someone applying for an unsecured loan, but you cannot use collateral as a denial reason when they applied for an unsecured loan product. If someone applies for an unsecured loan, and the only way you would approve the loan is if they offered up collateral, you cannot deny it for insufficient collateral. You must use the principle reason why you denied the loan. It's likely the reason you wanted collateral could be their credit score wasn't high enough. This is a very common finding, so make sure your lenders know this.

Multiple Applicants - When an application involves more than one applicant, notification **need only be given to one of them** but must be given to the primary applicant when one is readily apparent. Most organizations give all applicants a denial notice. The denial notice must be specific to the applicant you are giving it to.

Performing Secondary Reviews (CMS: Monitoring & Audit)

An easy way to strengthen your CMS is by performing reviews of adverse action/ denial notices. Secondary reviews of denials do not need to be completed by compliance or audit (although that is common), but they need to be completed by someone who knows the regulatory requirements discussed within this module. In addition, the secondary reviews should focus on all of the compliance disclosure requirements. Having a second loan officer review the loan file and denial notice to confirm the underwriting decision was correct is a good and useful step, but that typically doesn't cover the compliance technical requirements (such as timing and content). Your review should focus on compliance as well as denial decisions.

There is no regulatory requirement to perform secondary reviews, but it is wise to do so as it helps strengthen your CMS. If you are performing compliance reviews of adverse action notices before they are mailed to the customer, ensure you let the examiners know this. It's likely to show up in your exam report under monitoring activities. Performing this review prior to the adverse action being sent to the customer would qualify as Monitoring under the CMS umbrella.

Stopping every 3/6/12 months and reviewing past adverse action notices for compliance requirements would qualify under the Audit function of your CMS. Those reviews will typically be completed by someone in compliance or audit, depending on the size of your organization. It's common for organizations to have an outside firm also conduct these reviews. During the audit portion, you are going through the entire adverse action notice to ensure all compliance requirements are met. This is similar to the monitoring activities, but this review will likely be documented and findings summarized in a report. Your audit will not be a timely review like monitoring efforts.

You can do adverse action audits as often as monthly or on an annual basis. You should base your decision on how often to audit this area based on your risk. Make sure that the person doing the audits is not the same that is doing the on-going monitoring reviews. Here are some things to consider when deciding on how often to audit adverse action notices:

1. Do you have strong monitoring in place? If someone is reviewing them before they go out the door, you MAY not have to audit as often.
2. Are monitoring efforts always finding issues? If they continue to find items to address, you may want to audit more often.
3. Do you have new loan staff? This could be lenders or processors, depending on whom is filling out the notices. If you have turnover in that area, you may want to audit more often until you feel comfortable that they are trained and issues are minimal.

Long-Term Trend Analysis

In addition to conducting monitoring and audits for adverse action notices, you can also do some long-term trend analysis. This analysis is very similar to how you would analyze exceptions to loan policy. You can collect your denial notices for a certain timeframe (depending on the size of your organization) and see what types of trends may be present. The same types of trends you would see in your exception analysis could also be present here. Here are some examples of things you might find:

- Do you have a disproportionate amount of denials to a particular prohibited basis?
- Maybe a higher denial rate to Hispanics, Asians, or females? It's possible they are not making exceptions to borderline creditworthy applicants in these

classes but are making exceptions to others.

- Does one lender or branch have a much higher rate of denials than others? They could be just simply taking more applications.
- Do some lenders or branches never have denials? If so, they may be discouraging people from applying.

The long-term trend analysis is an additional step you can add to strengthen your program. For smaller organizations, it's not so common to perform this type of analysis. Some of the smallest organizations may only have a handful or more of denials a year. Larger institutions that have say 500 or 1,000 or more denials a year could benefit from this analysis. Simply set up a spreadsheet just like you would for exceptions and enter in your data. Make sure to include relevant underwriting criteria like credit score, LTV, and DTI. You will also want to include lender and branch information. Finally, you can include address information to conduct a redlining review. Now that you know more about adverse actions, you can re-visit the CMS section to evaluate your own adverse action review and audit procedures.

PRO TIP

All secondary reviews, whether it's monitoring or auditing, help show the strength of your CMS. It is strongly recommended that you incorporate some type of secondary review process of your denials **BEFORE** they are sent to the customer. This is an easy way to get a positive comment in your report of examination and show the regulators that you are reviewing your program.

A Real-Life Story about Denials

We were in a very small institution that was a HMDA reporter, and the institution had only a small handful of denials on its loan application register for our 3-year lookback. So, we asked the sole loan officer about his application process. He proceeded to explain what would happen if a prospective applicant came to the institution inquiring about a home loan. First, the loan officer would ask about the loan amount, the estimated value of the home that might be bought, and what the prospective applicant believed their credit score to be.

This loan officer would do a quick calculation of the LTV and assessment of the prospective applicant's supposed credit score. If the information was not satisfactory, the loan officer told us that he would inform the prospective applicant that the institution did not make home loans exceeding 80 percent LTV (which, in this explanation, the prospective applicant exceeded), and the institution did not make loans to applicants with such low credit scores. The loan officer would tell the person that they could apply for a loan if they wanted to, but if they did, he would have to send them a denial notice! That is a perfect example of circumventing the regulation, and examiners typically frown on that.

Long story short, the loan officer did not take many weak applications because he discouraged those applicants upfront. This is not a good idea, and is addressed in Regulation B. Specifically, Section 1002.4 addresses discouragement and Section 1002.2(f) discusses when an inquiry becomes an application. Make sure your loan officers are aware of these sections.

MODULE SUMMARY

After completing this module, you should have the tools you need to set up and monitor an effective denial process. We do a deep dive into performing a comparative file analysis in Module 14; however, a successful comparative file analysis is only useful when you have a strong denial program. Documenting underwriting criteria used in the loan decision, having specific denial reasons, and following your organization's policies and procedures are the best ways to minimize risk in this area. We strongly recommend setting up a secondary review process for your adverse action notices and providing some basic training to your lenders on the importance of this topic.

As with all risks, the stronger you set up your CMS, the less risk you will have. If you have good underwriting policies in place, train your staff well, and minimize deviations, you greatly reduce fair lending risk in this area. At that point, set up a good review program of adverse action notices and you will have a strong program in this area. Let's look at those model forms now…

Form C-1 - Sample Notice of Action Taken and Statement of Reasons

Statement of Credit Denial, Termination or Change

Date: ______________________________

Applicant's Name: ______________________________

Applicant's Address: ______________________________

Description of Account, Transaction, or Requested Credit: ______________________________

Description of Action Taken: ______________________________

Part I - Principal Reason(s) for Credit Denial, Termination, or Other Action Taken Concerning Credit

This section must be completed in all instances.

__Credit application incomplete

__Insufficient number of credit references provided

__Unacceptable type of credit references provided

__Unable to verify credit references

__Temporary or irregular employment

__Unable to verify employment

__Length of employment

__Income insufficient for amount of credit requested

__Excessive obligations in relation to income

__Unable to verify income

__Length of residence

__Temporary residence

__Unable to verify residence

__No credit file

__Limited credit experience

__Poor credit performance with us

__Delinquent past or present credit obligations with others

__Collection action or judgment

__Garnishment or attachment

__Foreclosure or repossession

__Bankruptcy

__Number of recent inquiries on credit bureau report

__Value or type of collateral not sufficient

__Other, specify: ______________________________

Part II - Disclosure of Use of Information Obtained From an Outside Source

This section should be completed if the credit decision was based in whole or in part on information that has been obtained from an outside source.

__Our credit decision was based in whole or in part on information obtained in a report from the consumer reporting agency listed below. You have a right under the Fair Credit Reporting Act to know the information contained in your credit file at the consumer reporting agency. The reporting agency played no part in our decision and is unable to supply specific reasons why we have denied credit to you. You also have a right to a free copy of your report from the reporting agency, if you request it no later than 60 days after you receive this notice. In addition, if you find that any information contained in the report you receive is inaccurate or incomplete, you have the right to dispute the matter with the reporting agency.

Name: ____

Address: ____

[Toll-free] Telephone number: ______________

[We also obtained your credit score from the consumer reporting agency and used it in making our credit decision. Your credit score is a number that reflects the information in your consumer report. Your credit score can change, depending on how the information in your consumer report changes.

Your credit score: ____

Date: ____

Scores range from a low of ____ to a high of ____.

Key factors that adversely affected your credit score:

Reason #1 ____

Reason #2 ____

Reason #3 ____

Reason #4 ____

[Number of recent inquiries on consumer report, as a key factor]

[If you have any questions regarding your credit score, you should contact [entity that provided the credit score] at:

Address: ____

[[Toll-free] Telephone number: ______________]

__Our credit decision was based in whole or in part on information obtained from an affiliate or from an outside source other than a consumer reporting agency. Under the Fair Credit Reporting Act, you have the right to make a written request, no later than 60 days after you receive this notice, for disclosure of the nature of this information.

If you have any questions regarding this notice, you should contact:

Creditor's name: ____

Creditor's address: ____

Creditor's telephone number: _______________

Notice: The Federal Equal Credit Opportunity Act prohibits creditors from discriminating against credit applicants on the basis of race, color, religion, national origin, sex, marital status, age (provided the applicant has the capacity to enter into a binding contract); because all or part of the applicant's income derives from any public assistance program; or because the applicant has in good faith exercised any right under the Consumer Credit Protection Act. The Federal agency that administers compliance with this law concerning this creditor is (name and address as specified by the appropriate agency listed in appendix A).

Form C-2 - Sample Notice of Action Taken and Statement of Reasons

Date ____

Dear Applicant: Thank you for your recent application. Your request for [a loan/a credit card/an increase in your credit limit] was carefully considered, and we regret that we are unable to approve your application at this time, for the following reason(s):

Your Income:

__is below our minimum requirement.

__is insufficient to sustain payments on the amount of credit requested.

__could not be verified.

Your Employment:

__is not of sufficient length to qualify.

__could not be verified.

Your Credit History:

__of making payments on time was not satisfactory.

__could not be verified.

Your Application:

__lacks a sufficient number of credit references.

__lacks acceptable types of credit references.

__reveals that current obligations are excessive in relation to income.

Other: ____

The consumer reporting agency contacted that provided information that influenced our decision in whole or in part was [name, address and [toll-free] telephone number of the reporting agency]. The reporting agency played no part in our decision and is unable to supply specific reasons why we have denied credit to you. You have a right under the Fair Credit Reporting Act to know the information contained in your credit file at the consumer reporting agency. You also have a right to a free copy of your report from the reporting agency, if you request it no later than 60 days after you receive this notice. In addition, if you find that any information contained in the report you receive is inaccurate or incomplete, you have the right to dispute the matter with the reporting agency. Any questions regarding such information should be directed to [consumer reporting agency]. If you have any questions regarding this letter, you should contact us at [creditor's name, address and telephone number].

[We also obtained your credit score from the consumer reporting agency and used it in making our credit decision. Your credit score is a number that reflects the information in your consumer report. Your credit score can change, depending on how the information in your consumer report changes.

Your credit score: _______________

Date: _______________

Scores range from a low of ________ to a high of ________.

Key factors that adversely affected your credit score:

Reason #1 ____

Reason #2 ____

Reason #3 ____

Reason #4 ____

[Number of recent inquiries on consumer report, as a key factor]

[If you have any questions regarding your credit score, you should contact [entity that provided the credit score] at:

Address: ____

[[Toll-free] Telephone number: _______________]

Notice: The Federal Equal Credit Opportunity Act prohibits creditors from discriminating against credit applicants on the basis of race, color, religion, national origin, sex, marital status, age (provided the applicant has the capacity to enter into a binding contract); because all or part of the applicant's income derives from any public assistance program; or because the applicant has in good faith exercised any right under the Consumer Credit Protection Act. The Federal agency that administers compliance with this law concerning this creditor is (name and address as specified by the appropriate agency listed in appendix A).

Form C-3 - Sample Notice of Action Taken and Statement of Reasons (Credit Scoring)

Date _______________

Dear Applicant: Thank you for your recent application for _____. We regret that we are unable to approve your request.

[Reasons for Denial of Credit]

Your application was processed by a [credit scoring] system that assigns a numerical value to the various items of information we consider in evaluating an application. These numerical values are based upon the results of analyses of repayment histories of large numbers of customers.

The information you provided in your application did not score a sufficient number of points for approval of the application. The reasons you did not score well compared with other applicants were:

- Insufficient bank references
- Type of occupation
- Insufficient credit experience
- Number of recent inquiries on credit bureau report

[Your Right to Get Your Consumer Report]

In evaluating your application, the consumer reporting agency listed below provided us with information that in whole or in part influenced our decision. The consumer reporting agency played no part in our decision and is unable to supply specific reasons why we have denied credit to you. You have a right under the Fair Credit Reporting Act to know the information contained in your credit file at the consumer reporting agency. It can be obtained by contacting: [Name, address, and [toll-free] telephone number of the consumer reporting agency]. You also have a right to a free copy of your report from the reporting agency, if you request it no later than 60 days after you receive this notice. In addition, if you find that any information contained in the report you receive is inaccurate or incomplete, you have the right to dispute the matter with the reporting agency.

[Information about Your Credit Score]

[Information about Your Credit Score]

We also obtained your credit score from the consumer reporting agency and used it in making our credit decision. Your credit score is a number that reflects the information in your consumer report. Your credit score can change, depending on how the information in your consumer report changes.

Your credit score: ________________

Date: ________________

Scores range from a low of ________ to a high of ________.

Key factors that adversely affected your credit score:

Reason #1 ____

Reason #2 ____

Reason #3 ____

Reason #4 ____

[Number of recent inquiries on consumer report, as a key factor]

[If you have any questions regarding your credit score, you should contact [entity that provided the credit score] at:

Address:____

[Toll-free] Telephone number: ____]

If you have any questions regarding this letter, you should contact us at

Creditor's Name: ____

Address: ____

Telephone: _______________

Sincerely,

Notice: The Federal Equal Credit Opportunity Act prohibits creditors from discriminating against credit applicants on the basis of race, color, religion, national origin, sex, marital status, age (with certain limited exceptions); because all or part of the applicant's income derives from any public assistance program; or because the applicant has in good faith exercised any right under the Consumer Credit Protection Act. The Federal agency that administers compliance with this law concerning this creditor is (name and address as specified by the appropriate agency listed in appendix A).

Form C-4 - Sample Notice of Action Taken, Statement of Reasons and Counteroffer

Date _______________

Dear Applicant: Thank you for your application for _____. We are unable to offer you credit on the terms that you requested for the following reason(s): ______________________________________

We can, however, offer you credit on the following terms: ___________________________________

If this offer is acceptable to you, please notify us within [amount of time] at the following address:

____

Our credit decision on your application was based in whole or in part on information obtained in a report from [name, address and [toll-free] telephone number of the consumer reporting agency]. You have a right under the Fair Credit Reporting Act to know the information contained in your credit file at the consumer reporting agency. The reporting agency played no part in our decision and is unable to supply specific reasons why we have denied credit to you. You also have a right to a free copy of your report from the reporting agency, if you request it no later than 60 days after you receive this notice. In addition, if you find that any information contained in the report you receive is inaccurate or incomplete, you have the right to dispute the matter with the reporting agency.

[We also obtained your credit score from the consumer reporting agency and used it in making our credit decision. Your credit score is a number that reflects the information in your consumer report. Your credit score can change, depending on how the information in your consumer report changes.

Your credit score: _______________

Date: _______________

Scores range from a low of ________ to a high of ________.

Key factors that adversely affected your credit score:

Reason #1 ____

Reason #2 ____

Reason #3 ____

Reason #4 ____

[Number of recent inquiries on consumer report, as a key factor]

[If you have any questions regarding your credit score, you should contact [entity that provided the credit score] at:

Address: ____

[Toll-free] Telephone number: ____________]

You should know that the Federal Equal Credit Opportunity Act prohibits creditors, such as ourselves, from discriminating against credit applicants on the basis of their race, color, religion, national origin, sex, marital status, age (provided the applicant has the capacity to enter into a binding contract), because they receive income from a public assistance program, or because they may have exercised their rights under the Consumer Credit Protection Act. If you believe there has been discrimination in handling your application you should contact the [name and address of the appropriate Federal enforcement agency listed in appendix A].

Sincerely,

Form C-5 - Sample Disclosure of Right To Request Specific Reasons for Credit Denial

Date ____________

Dear Applicant: Thank you for applying to us for ____________________________

After carefully reviewing your application, we are sorry to advise you that we cannot [open an account for you/grant a loan to you/increase your credit limit] at this time. If you would like a statement of specific reasons why your application was denied, please contact [our credit service manager] shown below within 60 days of the date of this letter. We will provide you with the statement of reasons within 30 days after receiving your request.

Creditor's name ____

Address ____

Telephone number ____________

If we obtained information from a consumer reporting agency as part of our consideration of your application, its name, address, and [toll-free] telephone number is shown below. The reporting agency played no part in our decision and is unable to supply specific reasons why we have denied credit to you. [You have a right under the Fair Credit Reporting Act to know the information contained in your credit file at the consumer reporting agency.] You have a right to a free copy of your report from the reporting agency, if you request it no later than 60 days after you receive this notice. In addition, if you find that any information contained in the report you received is inaccurate or incomplete, you have the right to dispute the matter with the reporting agency. You can find out about the information contained in your file (if one was used) by contacting:

Consumer reporting agency's name ______________________________________

Address ____

[Toll-free] Telephone number ____________

[We also obtained your credit score from the consumer reporting agency and used it in making our credit decision. Your credit score is a number that reflects the information in your consumer report. Your credit score can change, depending on how the information in your consumer report changes.

Your credit score: _______________

Date: _______________

Scores range from a low of _______ to a high of _______.

Key factors that adversely affected your credit score:

Reason #1 ____

Reason #2 ____

Reason #3 ____

Reason #4 ____

[Number of recent inquiries on consumer report, as a key factor]

[If you have any questions regarding your credit score, you should contact [entity that provided the credit score] at:

Address: ____

[Toll-free] Telephone number: _______________]

Sincerely,

Notice: The Federal Equal Credit Opportunity Act prohibits creditors from discriminating against credit applicants on the basis of race, color, religion, national origin, sex, marital status, age (provided the applicant has the capacity to enter into a binding contract); because all or part of the applicant's income derives from any public assistance program; or because the applicant has in good faith exercised any right under the Consumer Credit Protection Act. The Federal agency that administers compliance with this law concerning this creditor is (name and address as specified by the appropriate agency listed in appendix A).

Form C-6 - Sample Notice of Incomplete Application and Request for Additional Information

Creditor's name ____

Address ____

Telephone number _______________

Date _______________

Dear Applicant: Thank you for your application for credit. The following information is needed to make a decision on your application: ____

We need to receive this information by _______________ (date). If we do not receive it by that date, we will regrettably be unable to give further consideration to your credit request.

Sincerely,

Form C-7 - Sample Notice of Action Taken and Statement of Reasons (Business Credit)

Creditor's name ____________________

Creditor's address ____________________

Date: ____________

Dear Applicant: Thank you for applying to us for credit. We have given your request careful consideration, and regret that we are unable to extend credit to you at this time for the following reasons:

(Insert appropriate reason, such as: Value or type of collateral not sufficient; Lack of established earnings record; Slow or past due in trade or loan payments)

Sincerely,

Notice: The Federal Equal Credit Opportunity Act prohibits creditors from discriminating against credit applicants on the basis of race, color, religion, national origin, sex, marital status, age (provided the applicant has the capacity to enter into a binding contract); because all or part of the applicant's income derives from any public assistance program; or because the applicant has in good faith exercised any right under the Consumer Credit Protection Act. The Federal agency that administers compliance with this law concerning this creditor is [name and address as specified by the appropriate agency listed in appendix A].

Form C-8 - Sample Disclosure of Right To Request Specific Reasons for Credit Denial Given at Time of Application (Business Credit)

Creditor's name ____________________

Creditor's address ____________________

If your application for business credit is denied, you have the right to a written statement of the specific reasons for the denial. To obtain the statement, please contact [name, address and telephone number of the person or office from which the statement of reasons can be obtained] within 60 days from the date you are notified of our decision. We will send you a written statement of reasons for the denial within 30 days of receiving your request for the statement.

Notice: The Federal Equal Credit Opportunity Act prohibits creditors from discriminating against credit applicants on the basis of race, color, religion, national origin, sex, marital status, age (provided the applicant has the capacity to enter into a binding contract); because all or part of the applicant's income derives from any public assistance program; or because the applicant has in good faith exercised any right under the Consumer Credit Protection Act. The Federal agency that administers compliance with this law concerning this creditor is [name and address as specified by the appropriate agency listed in appendix A].

TUSCAN CLUB
UNIVERSITY

MODULE 11
MARKETING

Tuscan Club University
Fair Lending School

MODULE 11 -

MARKETING

MODULE OBJECTIVES

This is truly where the fair lending process starts. The marketing materials your organization puts out to the public is often the first step in the fair lending process and loan lifecycle. It is important that you understand the marketing risks and have steps built in to mitigate those risks. We put marketing at the end because we wanted to introduce you to all of the fair lending risks so you can consider them when developing your advertising messages to the industry.

In this module, we will take a look at your marketing process as a whole. You will need to determine what marketing channels your organization uses and where you market geographically. We will discuss using third-party marketing firms and walk you through how to review your marketing program. We also discuss targeted marketing efforts before finishing on social media.

Determining Your Marketing Efforts

The first step to conducting a marketing review of your organization is to find out what types of marketing your organization does. That sounds simple, right? It's not always so straight forward. There will be times you have to dig to find what you are looking for.

If you are a larger organization, you likely have a person dedicated solely to marketing or possibly a marketing department. You will want to start with the head of marketing. A marketing interview is much like a fair lending interview that we will discuss in Module 13.

You want to find out what the organization is doing, what channels they are using for marketing, and what risk mitigation procedures they have in place.

Some of the most common methods for organizational marketing include:

- Television
- Radio
- Internet search engines
- Targeted marketing online
- Social Media
- Mailers and other printed materials
- Your organization's own website
- Signage outside your physical offices
- Billboards

Simply looking at an organization's marketing efforts gives some good insight on how that organization likely operates. Organizations that really push the envelope on marketing often tend to take more risks, and they will likely have more risk in their fair lending program. These types of organizations are much more "creative" with their marketing and push boundaries past traditional lending organization's marketing messages. That "creativity" can create a lot of headaches for compliance and audit staff. The most successful organizations we have seen for controlling marketing risk have good working relationships between the compliance and marketing departments.

Smaller (often rural) organizations often do very little, if any, marketing. The most you might see is holiday messages in the newspaper or online, general information and hours of the organization, or congratulating the senior high school class on graduation. The number of marketing efforts and variety of marketing channels are a great way to gauge the level of potential risk.

Where Are You Marketing? (Geographically)

Another aspect you will want to consider when reviewing your organization's marketing efforts is ***where*** you are marketing. With mass marketing efforts like radio, television, and the internet, you are likely marketing to a broader regional area. Direct mailers, however, can pose risks such as redlining. Also, if you have billboards, you will want to know which neighborhoods they are located in.

We once had a marketing professional tell us that the institution's president did not want home loan marketing materials sent to XYZ zip code. When we looked up to see what that zip code was, we found it to be a very high minority area. That area was part of the institution's trade/assessment area, and they took deposits from those customers, but they were purposely avoiding making home loans in that area. There are many other examples just like this, but the intended outcome is usually the same: heightened redlining risk.

PRO TIP

You will want to review all mailers that go out, but make sure you get a list of where those mailers went. A well-trained marketing professional will keep a list of all of the zip codes where mailers went. Make sure your marketing staff knows these risks and keeps good records of the marketing efforts of your organization. You should ensure that your direct mailings are also reaching the higher-minority census tracts in your assessment area.

You will also want to know if your organization sends out any type of pre-approved solicitations. Let's say an organization does a credit bureau inquiry to find everyone in a certain area that has a credit score above 700, and they want to send marketing materials to those customers about a new product. You will want to thoroughly review that process to ensure that it is free of discrimination. How is your organization selecting recipients for the mailers? Does the pre-screened list of higher credit scores include zip codes and census tracts with higher-minority populations?

Third Party Marketing Firms

At a minimum, your organization should excel at one thing: financial products and services. If you're not a good at financial products, you won't be around very long. Something your organization may not be good at is creating professional and effective marketing materials. There is nothing wrong with hiring a third party to help in areas where your organization is not strong. Many organizations hire marketing firms for this reason. However, you should have a good working relationship with the marketing firm and ensure they are trained on unacceptable industry marketing practices.

While a marketing firm has the best intentions of making your organization successful, they might not understand all of the nuances of financial industry marketing, especially when it comes to fair lending and compliance laws and regulations.

Some organizations utilize radio stations to help create marketing material. They tell the radio station generally what they want included, and the radio station makes an ad for them. We have been to several institutions and asked to see their radio scripts, only to get blank stares in return. They don't review the radio ads before they go live. In fact, we have talked with senior managers and compliance staff, and they didn't know what was in their radio ads and had never even seen a script.

PRO TIP

Make sure your compliance department is involved in the process to review ALL third-party marketing materials before they go out the door. Marketing materials can incorporate many different regulations, so it's critical that a well-trained compliance person be part of the review process. If you decide to have your marketing staff conduct the review, ensure that they are trained on all of the risks.

Reviewing Marketing Materials

Just like with third-party marketing firms, the strongest fair lending programs have solid controls over internal marketing materials. Compliance officers should be in the approval process of all marketing materials. We have seen many strong programs that always send compliance everything marketing related before it goes out. These are typically successful programs.

We have also seen several programs that do not include compliance at all. In fact, the compliance staff really have no idea what is going on in marketing. Sometimes, the first time they see their marketing material is after it has been released. Marketing is not the time to leave compliance out of the loop.

Population-Inclusive Advertising

A common regulatory criticism over marketing is when it is not inclusive of the population. The easiest example would be marketing materials for a large metropolitan area that only included non-minority (white) individuals within the advertising. You need to understand the make-up of your area, and your marketing efforts should reflect the demographics you are in.

One financial institution had a fair lending finding because their home loan marketing material included print flyers and billboards that said, "We want people like you to be our neighbors!" with a large photo of a white family with a big arrow pointing to them. This was determined to be a "discouraging" ad that would keep minority applicants from applying for home loans.

Another aspect of population-inclusive advertising is the language(s) you're using for your print, radio, and social media marketing. If you operate in a community with a large population who speak a language other than English, you might want to consider advertising in their native language. Be careful though! The advertisements should include the same information as your English language marketing.
An additional consideration is steering risk. If you advertise a certain product in a secondary language and that product's features are found to be less desirable than your other products that are only advertised in English – you might have a problem. See Module 6--Steering for a scenario regarding targeted marketing to non-English speakers.

PRO TIP

Be sure to document your business reasons for the marketing strategy including why you decided to market certain products, which groups you're targeting (in which languages if applicable), and where the marketing will take place.

Your website is also an area where you should focus your attention. Does your website represent your market area? If you used the FFIEC demographics and found your assesement area population demographics like we showed in the redlining module, you have a pretty good idea of the make-up of your area. If not, simply do a Google search to find a rough estimate of your population demographics. This doesn't have to be perfect. The idea is if 1/3 of your assessment area is made up of minority individuals, how many pictures of people on your website do you think should also be represented by minority individuals? I think roughly 1/3 sounds reasonable, don't you? How about 1 out of 34? We have seen it. Actually count the people on your website and make sure it is representative, and if it's not, push back and get it updated.

Targeted Marketing

Targeted marketing continues to grow. It's more cost effective to market to only a few key individuals than it is to do mass marketing to many people who will likely never be your customer. Often times you can market to certain consumers based off of their computer usage or social media profiles. For example, we were once at an institution that used targeted Facebook advertisements to market its loan products to Facebook users between the ages of 25 and 35. We really had to dig deeply into the business necessity of the institution's marketing decision.

If your marketing is targeted to certain individuals, you need to understand how those individuals are chosen as part of the target group. You will want to make sure any targeted marketing campaigns are free from discrimination and are not being driven by a prohibited basis.

Search-Engine Marketing

Some organizations use Google marketing and other search engines to get their organization's website pushed up to the top of a search screen. For example, when a person searches the internet for "home loans," the search engine will push paid advertisers to the top of the list. The search engine will place a small tag next to the websites showing that it is an advertisement, and they likely showed up in your search because of where you are located geographically.

Smaller organizations may only pay for these types of search-engine ads that are pushed out to certain web browsers in certain geographies. We were at one organization that was able to limit their search-engine push to certain zip codes. We looked very carefully at the list of selected zip codes to ensure that the organization included zip codes with higher-minority census tracts. You should do the same.

Social Media

Social media marketing is also a great way to reach many customers. It can also be a cost-effective way to reach your target market. You will want to keep the same concepts in mind as with targeted marketing. This is especially true if your marketing strategy includes use of automated targeting features of your social media platforms where you do not select the features. However, there is another elephant in the room when it comes to social media marketing – your employees.

PRO TIP

Any current or past employee who wants to connect their social media account to your organization can do so. If you don't have an official organization page, an unclaimed page can be made without you ever knowing it. Conduct searches on the social media pages to see if you have a page out there that you didn't know existed.

We can't tell you how many times we have conducted a fair lending review and asked the organization's management if they have a social media presence, only to hear in response – "No, we don't do any social media marketing." "Okay," we respond. Then we start the review. The first thing we do is a simple search of the organization on the social media platforms. We have found profiles on Facebook and LinkedIn that management didn't even know existed. They didn't know because they never looked.

The next thing we do is look at the loan staff. Countless times we have seen lenders making posts about an organization's products, features, and sometimes even interest rates. They are trying to get business through social media, and management has no idea what is going on. As part of your review, you need to do your own independent searches of not only your organization, but your employees (focusing on those that would push for sales). Your mortgage loan originators love to find new business through social media, so you need to train them on what is and is not appropriate.

Does your organization have its own social media page? If so, that's great! It's a great way to stay connected with your customers, but it brings additional risks that you need to be aware of. Many organizations allow their employees to share marketing posts on social media. That's fine, but you want to ensure that the employees are not adding things to the message.

For example: Let's say you want to make a general post about offering different types of home loans. One of your mortgage loan originators shares that post on their personal page and says "Come and see me and I will get you an interest rate at X.XX percent!" These types of things happen often, and you should be looking for them. If lenders are quoting rates, terms, fees, or specific features, not only could this increase fair lending risk but there are likely other consumer protection regulatory requirements. Ensure you train your lenders on what is appropriate and periodically monitor what they are posting.

If your organization does not have a social media policy, you need one. Just like acceptable employee behavior is laid out within an employee handbook, acceptable social media practices tied to the organization should also be laid out. Lenders especially need to know what they can and cannot do to help promote your organization on social media platforms.

Static vs. Dynamic Social Media Presence

What do we mean by a static presence or a dynamic presence? Let's use Facebook as the sample.

Static Presence

If your organization has a static presence on Facebook, that means that you can make posts on your profile page, but nobody can comment on your posts. It also means that others cannot make posts on your page. This is the best way to reduce risks on social media because you can lock down the content that appears on your page and nobody can really make posts directly to your page. People can only read and see what you post, so there is very little, if any, customer interaction.

Dynamic Presence

If your organization has a dynamic presence on Facebook, customers can go and post to your page whenever they want. They can also comment on anything that you post. Some lenders like this because it gives them a chance to interact with their customers, but you also open your organization up to additional risk. Now customers can say whatever they want, including making complaints. Do you want a customer complaint to be posted all over social media? If you have a dynamic presence, you need to make sure you are monitoring on an ongoing basis for any customer complaints.

PRO TIP

You can select the level of controls on your Facebook page to require comments to be reviewed before releasing them for public view.

We have seen organizations use both methods and do them successfully. We have also seen very large institutions have a dynamic Facebook page and the only thing that customers ever post to their page is complaints and negative comments. You will need to understand what type of presence your organization has, and your monitoring and auditing of that area should match the level of risk.

Your Review

Now it's time to conduct your review. If you are a smaller organization, there is likely a marketing folder that you can use to start your review. If you are larger and have a marketing department, that's a great place to start.

Here are some items to work on:

- Find out how your organization markets products and services
- Find out where you are marketing geographically (and maybe geographic areas where you might be skipping over)
- Does your organization use a third party for help with marketing?
- Sample your marketing materials for all regulatory compliance requirements and the risks we have discussed
- Review criteria for targeted marketing campaigns
- Find all of your organization's social media pages
- Review employee social media pages whenever possible

Based on the information above, you can get a good picture on how your organization markets its products and services. Find the risks, and ensure your organization has procedures in-place to mitigate those risks. Ensure you have a secondary review program and that you know where marketing materials are going. You need to know where you are marketing just as much as where you are not marketing. If your organization chooses not to market in high-minority areas, and they are part of your market area, there better be a great explanation why.

Marketing is often a leading risk indicator of redlining risk, and this is a quick and early way to figure that out. It is critical to have controls over your organization's social media posts. The number of employees allowed to make social media posts should be limited, and those individuals need to be properly trained. Finally, social media needs to be monitored for any potenial customer comments or complaints so they can be routed and properly resolved.

MODULE SUMMARY

We covered the basic risks of marketing in this module. We talked about the marketing methods your organization likely uses and where they are marketing. It's important as a reviewer to know all of the ways your organization markets to customers. We discussed the use of third-party marketing firms and the risk they pose. We covered reviewing your materials, targeting marketing efforts, and the use of social media.

TUSCAN CLUB
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MODULE 12
REDLINING

Tuscan Club University
Fair Lending School

MODULE 12 -

REDLINING

MODULE OBJECTIVES

During this module, we are going to talk specifically about risks that redlining poses. We will define redlining before getting right into two real-world examples as case studies. These case studies serve as a reminder of what could happen if you are not monitoring your organization's redlining risk. With the tools that you will learn in this module, we will help you review your own redlining risk and greatly reduce the chances of your organization going through these issues. We will cover some lessons learned from those two cases before we get into conducting a redlining review at your organization.

We will give you step-by-step procedures on how to conduct a redlining analysis. If you conducted the pricing review, you already have your loan download ready to go, so you have already given yourself a big head start. We will walk you through picking your sample, geocoding loans, and building pivot tables.

We will finish off the module by showing you how to analyze your data and giving you another real-world example of a redlining review that we conducted. This is one of the bigger modules, but a very important one. Let's get to work.

Definition of Redlining

The FFIEC Examination Procedures gives a text book definition for Redlining:
Redlining is a form of illegal disparate treatment in which a lender provides unequal access to credit, or unequal terms of credit, because of the race, color, national origin, or

other prohibited characteristic(s) of the residents of the area in which the credit seeker resides or will reside or in which the residential property to be mortgaged is located. Redlining may violate both the Fair Housing Act and the Equal Credit Opportunity Act (Regulation B).

Simple terms – Redlining means a creditor is lending differently to different neighborhoods or areas.

The redlining analysis may be applied to determine whether, on a prohibited basis:

- an institution fails or refuses to extend credit in certain areas;
- an institution targets certain borrowers or certain areas with less advantageous products;
- an institution makes loans in such an area but at a restricted level or upon less-favorable terms or conditions as compared to contrasting areas; or
- an institution omits or excludes such an area from efforts to market residential loans or solicit customers for residential credit.

PRO TIP

It is true that neither the Equal Credit Opportunity Act (ECOA) nor the Fair Housing Act (FHA) specifically uses the term "redlining." However, federal courts as well as agencies that have enforcement responsibilities for the FHA have interpreted redlining enforcement as prohibiting institutions from having different marketing or lending practices for certain geographic areas, compared to others, where the purpose or effect of such differences would be to discriminate on a prohibited basis. Similarly, the ECOA would prohibit treating applicants for credit differently on the basis of differences in the racial or ethnic composition of their respective neighborhoods.

Redlining poses risks for both a fair lending review and a Community Reinvestment Act evaluation. For fair lending, redlining would occur when an institution provides unequal access to credit based on race, ethnicity, national origin, or another prohibited basis. For CRA, redlining occurs when an institution provides lower access to credit based on the income level of the community (especially low- and moderate-income areas).

Redlining risk can be in any loan product. While most redlining cases involve home loans, redlining can be found in any lending area of your organization. Commercial lending portfolios are also a major risk for redlining. If an organization is not providing business loans to residents of a specific area, redlining risk may be present.

Case Studies

There have been several examples of redlining cases over the past 20 years, but there are two that we will focus on:

Midwest BankCentre – St. Louis, Missouri (2011)

KleinBank – Minneapolis, Minnesota (2017)

We will refer to both of these cases throughout this module. Let's look into each of them a little more deeply now.

Midwest BankCentre (MBC)

Background

According to the formal case against MBC recorded on June 16, 2011, the bank was headquartered in St. Louis, MO. At the time, they offered mainly traditional loan and deposit products and services. Their primary market was the St. Louis metropolitan area. On January 1, 2010, the bank had assets totaling just over $1.1 billion and was regulated by the Federal Reserve.

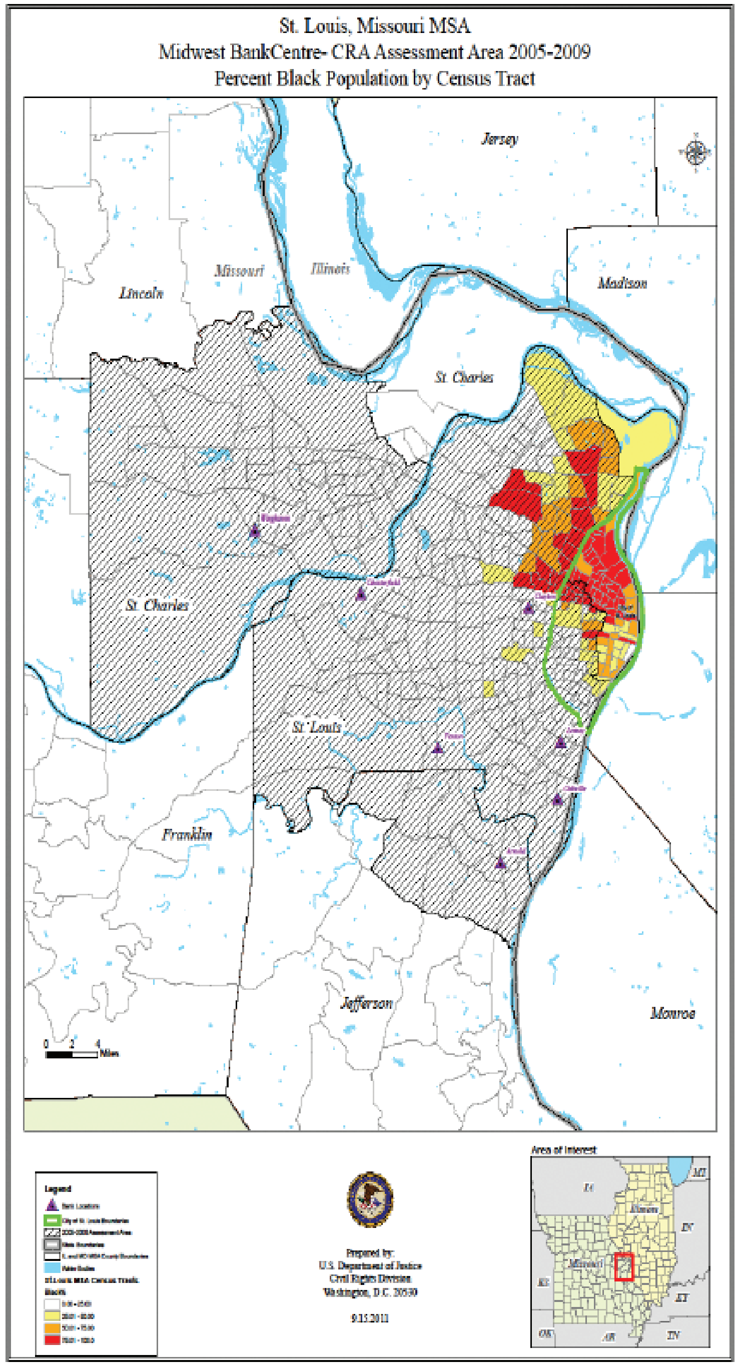
MBC had seven full-service branches and four partial-service branches, all in the metro area. The full-service branches offered deposit products and services and loan products, including home-mortgage lending. The four partial-service branches, which offered only deposit services, were located within retirement communities and were only open to those community residents. They also had one full-service branch about 350 miles away from St. Louis in Rockford, IL.

The Complaint

The government's complaint revolved exclusively around MBC's mortgage lending, which many redlining complaints do. The government claimed that MBC's mortgage lending activities in the metro area are almost exclusively confined to the Missouri portion of the St. Louis Metropolitan Statistical Area (MSA).

This issue was first discovered during a Federal Reserve consumer compliance examination in 2009. The regulators analyzed the bank's HMDA data from 2006-2008 and found reason to believe that MBC was engaging in a pattern or practice of discrimination in violation of the Equal Credit Opportunity Act.

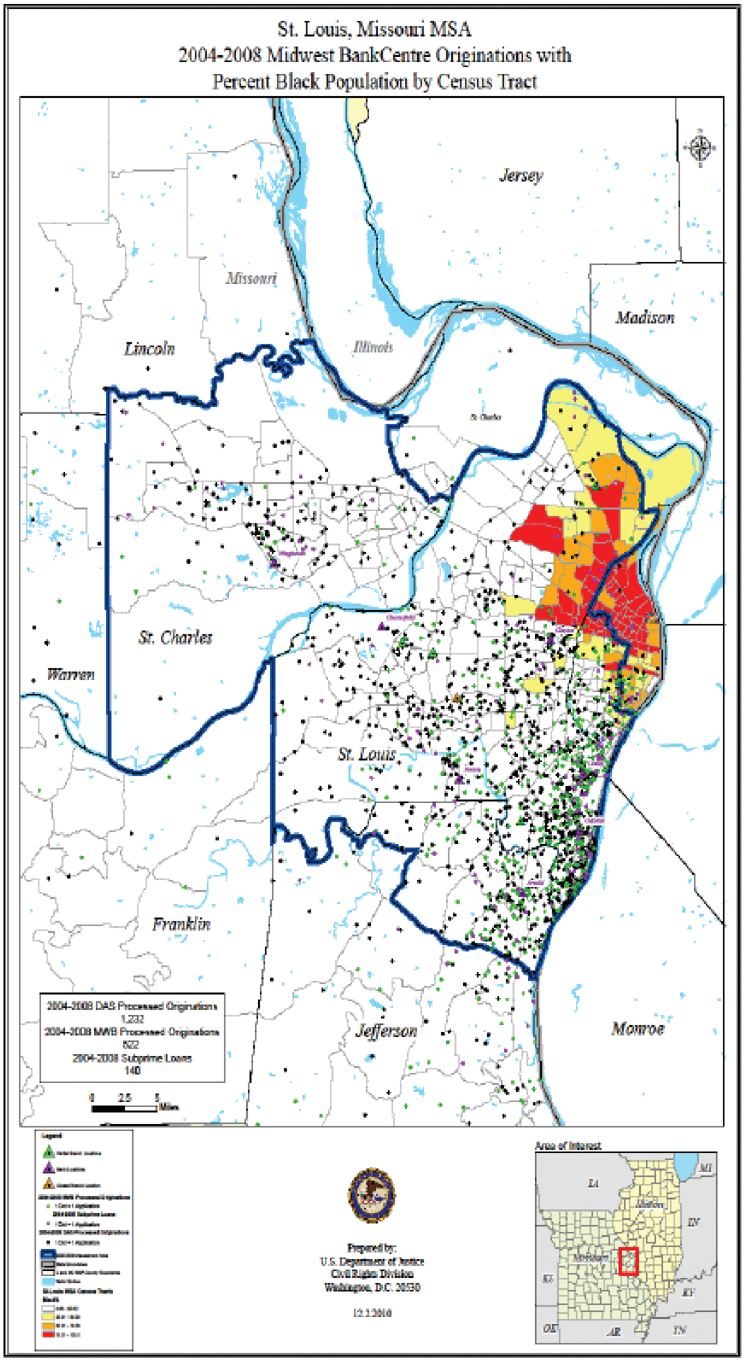
Demographic data of the MSA showed that the African-American population was mostly concentrated in the northern part of St. Louis and the neighboring northeastern portion of St. Louis County. The complaint claims that MBC was avoiding these high minority areas.



In addition to the lending practices, the government also claimed that MBC engaged in a race-based pattern of locating its branch offices. The branches were located in a manner designed to serve majority-white census tracts but not those of residents in majority-black census tracts. Since 1990, the bank had opened or relocated six full-service branches in majority-white neighborhoods and none in majority-black neighborhoods. The government presented the bank's assessment area map and branches to illustrate.

On the right, you can see what the bank's assessment area map looks like. The assessment area is the area with the gray, diagonal lines. The bank has unreasonably excluded much of downtown St. Louis from its assessment area. The small triangles represent all of the bank's full-service branches (and excludes the branches located in retirement communities). The branches create somewhat of a "horseshoe" shape around the higher minority neighborhoods to the north and avoided the downtown higher minority areas of St. Louis.

This second map on the next page shows all of the home loans plotted on the map to give a visual representation of where MBC was making home loans. It seems



clear when you can see it plotted out on a map. In fact, MBC's map shows that MBC was doing a much better job at lending outside its assessment area (to the south, in Jefferson County) than it was doing at lending in the higher-minority census tracts of downtown St. Louis.

PRO TIP

Have you ever seen your loans plotted out on a map? If you have fair lending software, they will do this for you. If not, you can do this manually. Later in the module we will find where your loans are made and determine if you are lending to different parts of your area.

Community Reinvestment Act (CRA)

The government also indicated that the bank's unlawful consideration of race in its business practices is also evident from the assessment areas the bank established and maintained pursuant to the CRA. The government claimed that MBC had delineated its CRA assessment area to include most of St. Louis County, portions of St. Charles and Jefferson Counties, and the southern part of the City of St. Louis. However, the assessment area excluded the northern part of St. Louis as well as the northeast corner of St. Louis County, forming a virtual horseshoe around the majority-black census tracts. MBC excluded 47 of the 60 majority-black census tracts with the City of St. Louis.

Reasonably Expected Market Area (REMA)

To counteract the effect of any "horseshoes" when reviewing an institution's assessment area, examiners will create what they believe to be a "reasonably expected market area" or REMA, for short. Generally, when creating a REMA, examiners will use whole counties to help ensure that no higher-minority areas are unreasonably excluded.

Examiners will create a REMA and use it for analyzing an organization's lending distribution (geographic distribution) and comparing that distribution to either the demographics of the area, the lending performance of other lenders (the "peer group"), or both. It's important to note that the concept of a REMA is a newer concept and did not exist at the time of this complaint.

HMDA Data

MBC employed a consulting firm to analyze its HMDA data from 2004 – 2006 for compliance with the CRA and fair housing requirements. Each of the resulting annual reports stated that MBC was making a smaller portion of its HMDA-reportable loans in majority-minority census tracts than its peer groups. The data showed several facts about the bank's home mortgage program and lending practices within minority census tracts:

- 2004 Peer Group Lending – 6.5% of loans; MBC Lending – 1.7%
- 2005 Peer Group Lending – 7.8% of loans; MBC Lending – 1.4%
- 2006 Peer Group Lending – 8.9% of loans; MBC Lending – 4.9%
- From 2004-2008, MBC generated 2,250 single-family residential loan applications in the MSA – only 61 (2.7%) were from majority-black tracts
- During that same time, peers received 10.7% of home loan apps from majority-black census tracts, nearly 4 times the rate of MBC
- Of the 1,861 home loans MBC originated from 2004-2008, only 42 (2.3%) were in majority black census tracts
- Peer group performance in that same period showed 8.6% of loans were made in majority black census tracts

The Findings

The government showed that the totality of MBC's policies and practices constituted redlining of majority-black areas of the St. Louis MSA. The bank's policies and procedures were intended to deny and discourage the residents of the majority-black neighborhoods of the MSA. The government also indicated that the policies and procedures were not justified by business necessity or legitimate business considerations.

Corrective Action

As a result of the findings, MBC was ordered to:

- Invest $900,000 in a special financing program to increase the amount of credit the bank extends to majority African-American areas in the Missouri portion of the St. Louis MSA;
- Spend $300,000 for consumer education and credit repair programs;
- Spend $250,000 for outreach to potential customers and promotion of their products and services;
- Open a full-service branch in a previously redlined community;
- Conduct fair lending training for its employees; and
- Pay $25,000 to compensate the Metropolitan St. Louis Equal Housing Opportunity Council for the resources that it diverted to investigating this matter.

Midwest BankCentre Today

MBC has long put these redlining issues behind them. They have opened new branches to better serve the communities of St. Louis. They have expanded their market outreach, and they are thriving. They have used this as a learning opportunity to grow as an organization. While redlining issues are a risk, they also point out areas for growth. As you review your data and find areas you are not lending in, those are growth opportunities as much as they are risk.

KleinBank

Background

KleinBank was a family-owned bank in Minnesota with just under $2 billion in assets at the time of its redlining case in 2017. The bank was over a century old and primarily operated to the south and west of the Minneapolis-St. Paul, MN Metropolitan Statistical Area (MSA). The bank was headquartered in Chaska, MN and operated 21 branches.

KleinBank offered traditional deposit and loan services. Their primary regulator was the FDIC. The complaint against KleinBank acknowledged that the FDIC had never conducted a redlining examination of KleinBank or commented on or approved KleinBank's CRA assessment area.

The Complaint

The Department of Justice filed a formal complaint against KleinBank on January 13, 2017, but the story starts much before that. The formal complaint claims that from 2010 to 2015, KleinBank had denied residents of the majority-minority neighborhoods of the MSA, an equal opportunity to apply for and obtain residential real estate-related loans, because of the racial and ethnic composition of those neighborhoods.

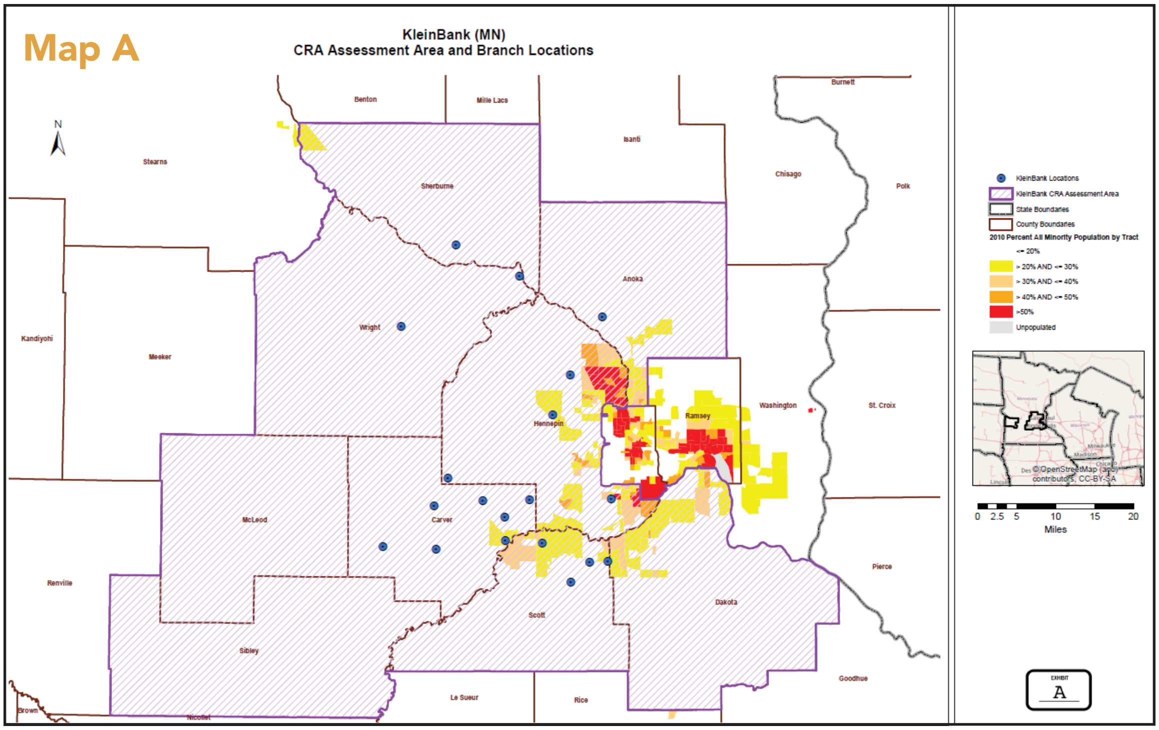
The complaint goes on to claim that for each year from 2010 to 2015, statistical analyses of KleinBank's residential real estate applications and originations showed that the bank served the credit needs of the majority-white census tracts to a significantly greater extent than it served the credit needs of majority-minority census tracts.

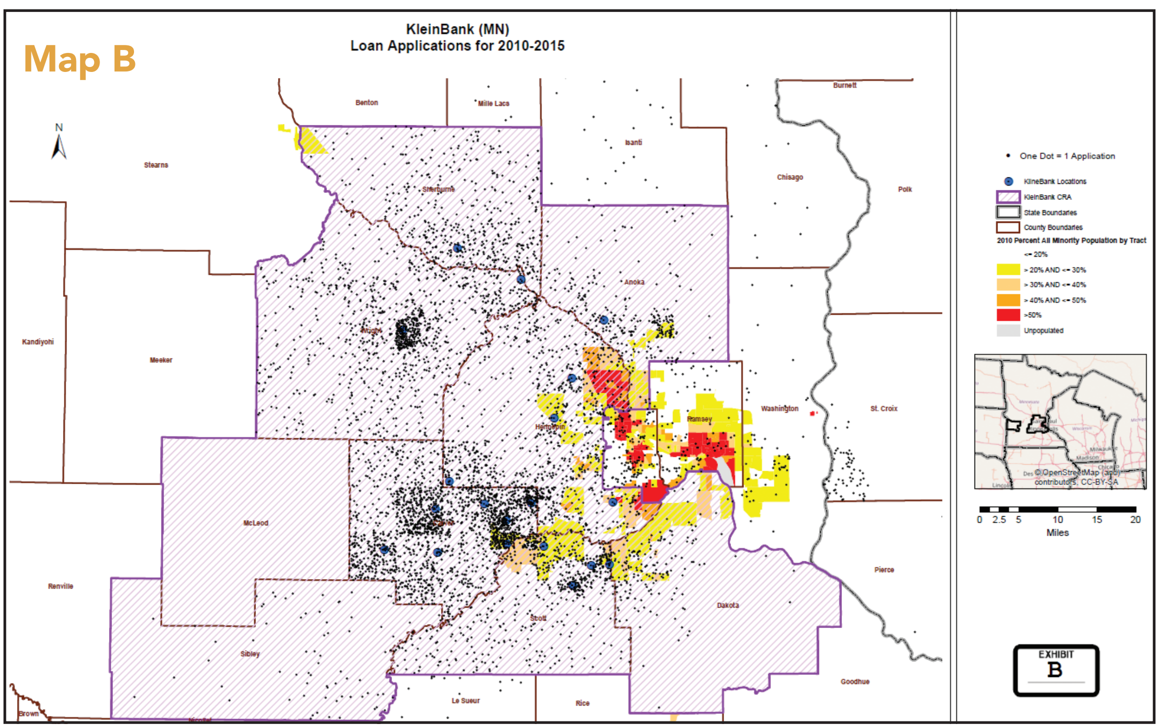
The government claimed that KleinBank's practices denied or discouraged an equal opportunity to residents of majority-minority census tracts from applying for or obtaining a residential mortgage loan from KleinBank included:

- Excluding most majority-minority census tracts in the MSA from the bank's CRA assessment area;
- Locating branch offices and mortgage loans officers in majority-white census tracts, but not in majority-minority census tracts; and
- Targeting marketing and advertising toward residents of majority-white census tracts, excluding majority-minority neighborhoods.

Just like in the case against MBC, the government claimed that KleinBank drew its main CRA assessment area to be horseshoe-shaped, including majority white suburbs while carving out the inner-city, urban areas of the MSA that have higher proportions of minority populations. Let's take a look at their maps.

You can see from **Map A** that the bank's locations (blue dots) are to the west, south, and north of the higher-minority areas. The bank's CRA assessment area is indicated by the purple-shaded areas and purple line. You can see that the city of Minneapolis and Ramsey County are excluded from the assessment area. The purple-shaded areas curve around, but exclude, Minneapolis and Ramsey County, creating a virtual horseshoe.





If KleinBank had used whole counties in delineating its assessment area, like examiners do when creating a REMA, KleinBank would have at least included the entire City of Minneapolis within its assessment area.

The government also made another map with all of KleinBank's home mortgage loans plotted on **Map B**.

It's clear to see from **Map B** that a majority of the bank's lending was outside of the MSA downtown area, which included the higher-minority census tracts.

Community Reinvestment Act

The government claimed that KleinBank's unlawful consideration of race and national origin in its business practices is evident from the assessment area that the bank established under the CRA. The government claimed that KleinBank drew its CRA assessment area to be horseshoe-shaped; it includes the majority white suburbs and carves out the urban areas of Minneapolis and St. Paul that have the higher proportions of minority populations.

KleinBank's assessment area excluded 78 of the 97 majority-minority tracts in the MSA. The assessment area excluded all 37 majority-minority census tracts in Ramsey County and 39 of the 58 majority-minority census tracts in Hennepin County. In addition, the bank had no branch offices in a majority-minority census tract.

HMDA Data

Here is a breakdown of the HMDA data from 2010 to 2015:

- KleinBank generated 5,837 single-family applications. Only 62 applications (1.06%) were from majority-minority census tracts.
- During that same time period, comparable lenders generated 5.58% of their applications from majority-minority census tracts – more than 5 times the rate of KleinBank.
- Of the 4,392 loans made, 51 (1.16%) were in majority-minority neighborhoods
- Comparable lenders originated 5.15% of their loans in the same areas – more than 4 times the rate of KleinBank.

Additional Findings

The government claimed that from at least 2010 to 2015, KleinBank engaged in limited marketing outside of its assessment area and failed to advertise meaningfully in majority-minority neighborhoods. KleinBank made strategic decisions to market its residential mortgage lending products to residents of majority-white neighborhoods. Your marketing efforts should cover your entire reasonably expected market area.

The Results

KleinBank did not turn out quite the same as MBC. These are both quite complicated cases, and both banks are unique. KleinBank chose to fight the allegations against them, and they were supported by dozens of banking organizations around the country. KleinBank indicated that Minneapolis and St. Paul were not part of their market and had virtually no business there. They went on to further point out the highly competitive market in the metro area by well-established financial institutions.

As a result, KleinBank did not pay any penalties or damages. They did agree to expand services into Minneapolis by establishing a $300,000 loan subsidy fund and allocating $300,000 for advertising, outreach, credit repair, and financial education. In 2018, KleinBank was acquired by Old National Bank.

KleinBank Today

KleinBank ended up selling and becoming part of Old National Bank after this complaint. As irony would have it, Old National Bank would face it's own redlining issues in Indianapolis in 2021 based on applications, lending, and it's branching structure. While we don't include the details on Old National Bank in the manual, we do discuss that case in the videos.

PRO TIP

Anytime a lending organization is considering a merger/acquisition, purchasing of branches, or opening of a new branch, consider the locations of the new branches and their relationship to higher minority areas. Ensure you know where the majority of your loan applications and originations are coming from to ensure you are penetrating all parts of your assessment area and not arbitrarily excluding higher minority areas. We will share the steps you can take so you can see the branches and loans on a map.

Lessons Learned

There are lessons to be taken away from both of the case studies. In both cases, the banks' branch locations were scrutinized. The government pointed out the strategic locations of the branches that created a horseshoe shape around the high minority neighborhoods of the downtown metro areas of Minneapolis and St. Louis.

Plotting the loans on a map showed a visual representation of both banks' lending patterns. Using loan plotting software is a quick and easy way to visually see where your bank is lending.

A Brief Note about HMDA Data:

If your organization is a HMDA reporter and you have made a large number of closed-end loans as reported on your loan application register (say several hundred), examiners will likely compare your organization's performance to other lenders that also serve your reasonably expected market area. They will run numerous reports using fair lending software. If you have not seen this type of comparison before, it may be a real eye-opener. In this course, we will not be running peer data to compare against your organization. We will be taking a higher-level approach to analyze whether you are redlining against higher-minority census tracts.

Conducting A Redlining Review

There are several ways to conduct a redlining review. There is software available that will help you analyze your organization's lending patterns and show the penetration of your loans to all parts of your assessment area. Fair Lending and CRA software add cost, but as your organization grows, it may be a valuable resource to ensure you understand your lending patterns.

Many compliance and audit professionals have asked us at what point should they be investing in software. We don't have a firm answer on that, but what we can say is that we have found rural organizations typically invest in such software when their total assets cross over the CRA threshold from an Intermediate-Small Bank to a Large Bank. When your organization becomes a Large Bank under CRA, you will have additional loan reporting requirements. Software can help you with your loan reporting and also be used for CRA and Fair Lending purposes. If you are in a major metro area or have a significant amount of HMDA reportable loans, you may want to look into software much sooner.

We want to show you how to conduct a redlining review using data you already have available to you. This process can be a bit labor intensive, but it will give you an excellent picture of whether you are penetrating your entire assessment area. The process is enumerated in the following steps:

NOTE: The data in the examples does not tie to any particular organization. The data was made up and created for the purposes of this course; however, the street addresses within the data are real addresses. In order to actually geocode loans, real street addresses must be used. Street addresses were randomly chosen, and actual address data has been hidden. The census tract data is the data required for this analysis.

Please see Appendix B for Redlining Procedures. Return back to the Module Summary after reviewing the redlining procedures.

MODULE SUMMARY

During this module, we discussed the major provisions around redlining before quickly jumping into two real-world examples. Midwest BankCentre and KleinBank are two examples of financial institutions in metro areas that were not monitoring their risk.

We then went through step-by-step procedures on how to conduct your own redlining review. Some of the data you need to go out and find, but we gave you the tools and showed you how to conduct the analysis.

We finished off the module with another example. In the real-world example at the end of this module, we were able to mathematically prove that they were penetrating all parts of their assessment, most notably the higher-minority areas and Hispanic residents. If you are able to go through your data and come to similar conclusions, you have minimized your redlining risk. If your numbers more closely resemble Midwest BankCentre, you will want to take appropriate corrective action to address the issues.

TUSCAN CLUB
UNIVERSITY

MODULE 13

FAIR LENDING INTERVIEW

Tuscan Club University
Fair Lending School

MODULE 13 – FAIR LENDING INTERVIEW

MODULE OBJECTIVES

In this module, we will be covering the fair lending interview. We will discuss what the interview is and its purpose. We will cover how and why examiners use this very useful tool. Then we will actually get into the interview itself so you can use this tool at your organization. The fair lending interview is a great way to wrap up your reviews to ensure that the end product (how loan officers actually make loans) has risk-mitigation procedures built in.

What is a Fair Lending Interview?

The fair lending interview is a valuable tool that examiners use to help determine the strength of your fair lending program. In its simplest form, the fair lending interview is a series of questions to find out how loan officers do their jobs. Examiners want to know the process loan officers go through so they can match that up with your organization's policies and procedures. You will want to read through all policies and procedures first to understand how lenders are supposed to operate. Become the expert before you conduct the interview.

Examiner Perspective

Before the fair lending interview happens, examiners will do the same thing as you should and review all of your lending and compliance related policies and procedures. They will read through your program and find out how lenders are supposed to do their jobs. Here are some examples of things you will want to review in preparing for a fair lending interview:

1. Loan policy
2. Underwriting guidelines
3. Underwriting worksheets

4. Pricing practices
5. Interest rate sheets
6. Loan officer compensation
7. Fair lending training
8. Exceptions practices and approval procedures
9. Application process
10. Assessment area maps containing information about minority levels in each census tract.
11. Assessment area demographics

If the list above looks very similar to all of the modules we have completed in this course, that's not by accident. Examiners first need to understand how lenders are "supposed" to do their jobs. They need to know what all of your policies and procedures are before the interview. The interview is simply asking the questions of a loan officer on how they do their job.

Examples of fair lending questions are:

- How do you take an application?
- How do you underwrite a loan?
- How do you price loans?
- What are your procedures in handling co-applicants?
- Are you allowed to deviate from procedures?

PRO TIP

Think of all of your lending-related policies and procedures as the baseline of your fair lending program. All of those pieces in place are important, but the fair lending interview is a way to determine if they are being effectively implemented.

We have an entire list of questions at the end of the module, but we wanted to illustrate a bit here. The answers examiners are looking for are to see if your loan officers know, understand, and follow your organization's procedures. Let's say that during the pre-examination process examiners are reading through your rate sheets to find out how your organization prices loans. During the interview, we ask a loan officer how they price loans. Their response is that they have never even seen a rate sheet. Then it is obvious that there are weaknesses in the program.

Discriminatory Comments

Another thing examiners look for in fair lending interviews is any discriminatory practices or comments. Despite popular belief, we can tell you that this is not the primary reason for conducting a fair lending interview.

You would think that a lender would not make a discriminatory comment directly to an examiner, but that would be a faulty assumption. We had a lender tell us that they always make the spouse sign on loans, even when the spouse did not apply. It was immediately concerning during the interview that we could possibly have discrimination based on marital status, but we let the conversation play out.

We rephrased the question several times to clarify the loan officer's practices. The loan officer confirmed multiple times that it was common practice for him to require the spouse to sign on the note. At that point, we had no choice but to investigate the issue. We did find discrimination based on marital status, and the institution had quite a few loans to go back on and release spouses as being obligated on the loans.

In another fair lending interview, a loan officer stated that he always took into consideration the number of children loan applicants had on their income taxes as dependents. Do you remember when this would apply? The FHA prohibits discrimination based on familial status. Upon further review, examiners found that the loan officer did write notes in the loan application package about how many children were appropriate given the applicant's income (and it included some unkind comments against the number of children as well). This review would not have been expanded if the comment was not made in the fair lending interview. This led to a fair lending finding and recommendations to the institution.

Multiple Examiners

It is common practice to have two examiners present during a fair lending interview. The reason for this is if there is a discriminatory comment, there will be another party there to hear it. Often times one examiner will lead the discussion while the second simply takes notes. The practice isn't quite as common as it used to be, so you may see just one examiner, likely due to just staffing issues.

We have also had many instances where the compliance officer or a supervisor asks to sit in on the interview. The examiners may allow this, but they will typically ask the compliance officer to refrain from answering any questions. They want to hear straight from the loan officer on how they do their job. We encourage you to sit in on a fair lending interview so you can see how they work.

Who Gets Chosen to Do the Interview?

In smaller organizations, there may only be a couple loan officers. In those cases, there might not be much of an option on whom to choose for the fair lending interview. Typically, you don't want to interview loan officers who have been at your organization for a really long time. Someone that has been at your for 20 years should understand the loan policy and general loan practices. On the other hand, you don't want to interview someone who is really new to your organization either. People need time to learn their jobs.

PRO TIP

Periodically offer fair lending training to your staff so they keep their skills sharp, and ask them to raise any concerns they might have about your lending program after taking the training. It will help you see your lending program with fresh eyes and view your practices from a different perspective.

We have found that the best candidates for fair lending interviews are those that have been working as lenders for around 2-6 years. They have been there long enough at that point where they should fully understand your loan program.

Conduct Your Own Interviews

Fair lending interviews are a great tool for examiners to test the implementation of your program, but there is no reason that you can't use the tool for your own self-testing. Typically, a fair lending examination includes only one fair lending interview, but you have the time to conduct as many as you feel necessary. Some of our organizations send out a questionnaire to their lenders and the lenders write in their responses to the questions. This technique can also work in identifying red flags.

At the end of this module, there is a sample questionnaire to help you get started. When you conduct your interview, think of all of the steps within the loan life cycle. Start at the application step and find out how loan officers take an application. Each question should get at a key step in the process. Let's look at some examples:

- When you have more than one applicant come in your office, how do you determine who is applying for the loan? ***(Joint intent)***
- How do you determine the loan product that is the best fit for the customer? ***(steering risk)***
- What is your underwriting process? ***(underwriting and denial risk)***
- How do you set the interest rate and fees? ***(pricing risk)***
- How do you determine in what locations or neighborhoods you can approve loans? ***(redlining risk)***

- In what situations are you allowed to deviate from underwriting or pricing guidelines? ***(exceptions risk)***
- If you are allowed to deviate, what are the steps of the approval process? ***(exceptions tracking and procedures)***
- How/what methods do you use to personally advertise loan products and specials? ***(marketing risk)***
- What type of fair lending training have you completed? ***(overall compliance management system)***

The questions you ask follow the different risks discussed in this course. The answers you get should match your organization's policies and procedures. If the answers don't match, you probably have more training to do. If you have loan officers that make discriminatory comments, you will likely have to dig deeper to find the extent of the issue.

PRO TIP

Use this fair lending tool as a training opportunity for your lenders, but make sure you let them answer the questions. If you lead them to the correct answer, you will not know for sure what your lenders are "actually" doing.

Question Structuring

Make sure you ask open-ended questions. You want to lead the discussion, but make sure you give the lenders chances to elaborate. And finally, don't lead them to the answer you want to hear. Don't ask "You always document joint intent, right?" Of course, they will say yes. Lead them to the risks, but let them tell you how they actually do their job, not what they want you to think on how they do their job. Think of it as like a job interview and has behavioral based questions, not yes and no questions.

MODULE SUMMARY

In this module, we covered the purpose of the fair lending interview. We discussed how and why examiners use this important tool. We covered the items that you will want to review before conducting your own interview, and we finished up with an interview questionnaire that you can use at your organization. See the next pages to find an example fair lending questionnaire.

Fair Lending Interview Sample Questions

Lender Name: ____

Position/Title: ____

Years with the institution? ________ Years as a lender? ________

What types of loans do you make? __________________________________

Compliance Management System

Have you received fair lending training? What type?

Have you ever been informed by your compliance department that you have underwritten loans improperly or that you have priced loans outside of the rate sheet?

Application Process

How do you determine who is applying with multiple applicants? (documenting joint intent)

Are there any applications that you do not take in writing?

How do you accept applications from individuals who do not speak English?

Underwriting Process

What is the minimum credit score you will accept?

Which credit score do you use when there are co-applicants, co-signers, or guarantors?

Which credit score do you use when you have a tri-merge credit report? Are you consistent?

What do you do when an applicant does not have a credit score?

What is your maximum DTI ratio?

What is your maximum LTV ratio? (itemize various loan products)

How do you calculate the LTV ratio? For car loans, do you use the NADA loan value or a different value?

Do you "gross-up" public assistance or other non-taxable income?

Exceptions Practices

Are you able to deviate from underwriting practices?

Who has to approve such deviations?

Are deviations tracked anywhere?

Pricing Process

How do you determine interest rates on loans?

When pricing a loan, do you consider the creditworthiness of a cosigner or a guarantor?

Do the borrower's existing loans (including agricultural and commercial) affect the rate that you would charge for a consumer product (such as a car loan or residential real estate loan)?

Does your rate sheet address pricing of loans secured by older cars or cars that have salvage titles?

How do you price loans to match your competition?

How do you price loans to insiders/institution employees?

Exceptions Practices

Are you able to deviate from pricing guidelines?

If yes, by how much?

Would you seek prior approval?

Would you document the deviation and the approval?

Are you able to waive fees? If yes, by how much?

Would you document the waiver or seek approval? Under what circumstances would you waive a fee?

Compensation Practices

Do you receive any additional compensation from entities connected to the loan process for placing borrowers into certain loan products? For example, do you receive compensation from secondary market investors or from realtors?

Joint Applicants

Signing the promissory note and securitizing documents

Which documents do you have owners of jointly held collateral sign?

Does it make a difference if the collateral is a car or real estate?

What is your process for requiring co-signors?

What is the minimum age to enter into a contract in this state?

How do you determine whether a younger borrower should have a cosigner?

Charging for Credit Bureau Reports

How much do you charge for an individual credit report?

How much do you charge for a joint credit report?

Are you able to pull a joint credit report on unmarried co-applicants?

Denial Process

Secondary Reviews of borderline credit approval or denials?

Who prepares the adverse action notice?

Does anyone review it before it goes to the applicant?

Steering

How do you present loan options to applicants?

Is your bonus based on the volume of loans that you keep in house?

Have you received anti-steering training?

Are you aware of your institution's anti-steering policy?

Redlining

Are there any portions of your community that you won't lend in or have not been able to penetrate?

Does competition from other institutions prevent you from lending in certain areas of your community?

Has the demographic composition of your community changed in the past few years? For example, has there been an influx of minorities or immigrants? How have you served those communities?

Marketing

Do you use social media to promote the institution, products, or services?

If your institution has social media profiles, who controls them?

Are customers allowed to make posts to the institution page?

Does someone monitor the institution's profiles for comments or complaints?

Are lenders allowed to post on social media?

Does anyone review advertising materials before they are published?

Do you have any referral relationships with area real estate agents?

Does the department use any third-parties to help develop marketing materials?

Tuscan Club
University

MODULE 14
COMPARATIVE FILE ANALYSIS

Tuscan Club University
Fair Lending School

MODULE 14 – COMPARATIVE FILE ANALYSIS

MODULE OBJECTIVES

In this module, we will go over the entire process of conducting a comparative file analysis. It is important you read through this portion of the manual and watch the module video before starting this analysis. During this module, we will discuss who should conduct the analysis. We will walk through some past experiences and give you real world examples on some comparative file analyses we have conducted. Then we will actually get into the heart of the review and talk about the step-by-step procedures to conduct the analysis. This is a very labor-intensive process, so make sure you understand everything within this module before you commit to performing an analysis at your organization. Later in this module, we will give you an example spreadsheet that you can use to do your own comparative file analysis.

What is a Comparative File Analysis?

A comparative file analysis is an in-depth review of underwriting criteria used to make loan decisions to determine if those decisions were made consistently and based on prudent characteristics, not on a prohibited basis.

Up-front Warning

One major point that needs to be made up front is a comparative file analysis should be used as a last resort review. Think of a comparative file analysis like putting on a tourniquet. If someone has a bleeding finger, there are many steps to stop the bleeding before you use a tourniquet. A comparative file analysis is not the type of review you initially start with, for a few reasons:

- The analysis requires many hours and can be costly
- In the end, you may or may not be able to prove or disprove discrimination through the analysis
- More questions can be raised along the way, based on the data uncovered in the analysis

When Should You do a Comparative File Analysis?

When you are not able to explain findings, data, or anomalies by other methods, and you are reasonably sure the results of the analysis will explain the non-discrimination factors that have led to the difference in underwriting results or will help you diagnose and correct an issue.

Past Experiences

We have performed countless fair lending reviews for financial institutions of varying sizes, but only a handful have ever led to a comparative file analysis. Here are two real-world examples that we were a part of.

First National Bank (FNB)

The bank in this scenario was not named First National Bank. We are using that name as a generic name for privacy and confidentiality reasons.

THE PROBLEM

FNB was a bank of less than $1 billion in assets. They had over a dozen branches and were required to report HMDA data. Through the HMDA data, we found one product in particular had a high denial rate to black applicants. The denial rates to black applicants was 90% on this particular product while the denial rate to white applicants was 50%. Since there was no other explanation as to this discrepancy, the only way to determine if there was discrimination was through a comparative file analysis.

THE RESULTS

Throughout the analysis, we looked at about 70 different applications (some were originated as loans and some were denials). We used several pieces of underwriting criteria to tell the story of each applicant. After nearly two weeks of collecting and organizing data, we were able to conclude that those black applicants that were denied were because of legal and prudent underwriting criteria and not based on race. The lenders and underwriters did an excellent job of documenting loan files, credit decisions, and adverse action notices. Because of their diligent practices and thorough documentation efforts, our examination team was able to recreate decisions and prove the bank was not discriminating. If documentation was poor or non-existent (more common than you might think), the outcome could have been negative at best.

Second National Bank (SNB)

SNB (name changed) was fairly similar in size and complexity to FNB.

THE PROBLEM

SNB was also under $1 billion in assets with over a dozen branches. This example was more of a pricing issue that led to the analysis as opposed to FNB being an underwriting issue, but the concepts and procedures are similar.

SNB's story that led to a comparative file analysis came from a pricing review we conducted. The pricing review we did is the same one that we described in the pricing module (Module 8). We compared the average rates on car loans to males and to females. (If it was a joint loan and one of the borrowers was male, we categorized the loan as being in the "male" group.) Particular products were grouped together to determine the average rate given to males and compared to the average rate given to females.

Based on the pricing analysis, it was determined that males got a much lower rate than females (an average of 70 basis points) for title-secured loans. As a result of the findings, management made significant changes to their pricing model. Deviations from pricing were now more tightly controlled, rarely approved, and tracked. Management went in and basically tightened up all the pricing guidelines to help minimize pricing disparities.

Fast forward to one year later. We redid the pricing analysis to see if there were improvements in the disparities. When the pricing analysis was completed a second time, the rate disparities between men and women did not shrink. In fact, they got slightly bigger. Since there was no other way to explain the anomalies, a comparative file analysis needed to be completed.

For the analysis, we reviewed the underwriting criteria that were factored into the pricing decision. SNB used credit score, age of collateral, and term of the loan to set interest rates on their car loans. Each factor was collected for all loans and compared to pricing criteria.

THE RESULTS

There were several factors that were contributing to the large disparities in rates. One factor was that with multiple applicants, the single highest credit score was used. Those in the "male" group often had a female co-borrower with a higher score. Often those in the female group did not have a co-borrower. See the pricing module for further explanation on target and control groups. That means that it was common for the control group (male group) to get a better rate because they had a female coborrower with a higher credit score, but most applicants in the target group (female group) did not have a coborrower to help get that better rate.

Borrowers were also broken out and placed into one of four pricing buckets depending on their creditworthiness (as determined by credit score). Borrowers in pricing buckets A and B received relatively lower rates. The increase in rates to borrowers in buckets C and especially D were significant. So, those with lower credit scores were penalized much more in the rate they received, which is reasonable as they are a much riskier customer. There were other factors as well, but these were the largest contributors.

The reason for conducting SNB's comparative file analysis was that we could not tell the story without digging deep into the files.

Conducting a Comparative File Analysis

Conducting a comparative file analysis is a labor-intensive process. There is a great deal of information gathering before the actual analysis can be accomplished. There are several steps to the process, and along the way, you may uncover additional anomalies within your lending program that will need further explanation and possibly research.

As previously mentioned, a comparative file analysis is a "last resort" type of review. This review should only be conducted when you cannot explain decisions or there is reason to believe that you may have underwriting issues (such as inconsistency) or actual discrimination. Let's get started.

Step 1 – Selecting Your Sample

Choosing your sample size is a critical step in the process. Your sample size needs to be big enough to gather the amount of data required to form conclusions about the fairness of your program but not too large that it leads to unnecessary or additional work.

If you want to ensure your sample size will stand up to regulatory scrutiny, it must be statistically significant. If you use the examiner guidance for sample sizes based on the FFIEC Fair Lending Examination Manual, you will meet this requirement. Before we get into those sample sizes, let's take a look at your universe sizes.

When referring to loans and fair lending, a "universe" is simply the total number of approved loans or denied applications for a particular product in a particular timeframe. For smaller- to medium-sized organizations, the universe of loans is typically those originated within a 1-year timeframe. For larger organizations, that number may be quite large. Loans originated within a single quarter might be more appropriate if you make thousands of loans a quarter. In addition, if there was some factor that affected the timing of loans made, you may use that as a guide for your universe size. For example, if you made significant or key changes to your underwriting process, team, or criteria, let's say six months ago, you may not want to include loans prior to the change date as different criteria was being used.

Focal Points

You will need to set focal points for the analysis. The focal point will be the driving factor for the review and help determine your universe size. Focal points are not complicated. It's simply a single piece of underwriting criteria that you want to use to compare loan decisions.

Examples of review focal points include:

1. Debt-to-income (DTI) Ratio
2. Loan-to-value (LTV) Ratio
3. Credit Score
4. Age of Collateral
5. Employment History
6. Residential History
7. Loan Term
8. Co-Signors
9. Guarantors

You may notice that this list comes from the list of underwriting criteria in Module 7. Any one piece of underwriting criteria can be used as a focal point within a comparative file analysis. You can choose either one focal point or multiple, but they are reviewed and analyzed separately at the outset.

How do you choose your focal point? The simplest answer is to ask yourself this question: What is the reason I need to do a comparative file analysis? Customer complaints could be a good reason. Maybe you had a customer that comes in and says that her neighbor got the same loan she was just turned down for, and that neighbor has a much worse credit score. One simple complaint doesn't necessarily trigger a comparative file analysis, but in that scenario, you would look at credit score as your focal point. If you are looking at your loan data and see several costumers get approved for home loans with a DTI above your organization's threshold, that could be your focal point. Pricing data like we had could be another reason.

Identifying Marginal Transactions

Before you choose your sample size, you must determine the full universe of loans and applications. We use the terms loans and applications/denials because if the underwriting was approved, the customer got a loan. If they were denied, it was simply just an application/denial. You will be reviewing both.

PRO TIP

If you have been maintaining a database of your loans with exceptions, then you already have a good listing of marginally approved loans. Examiners are enthusiastic about comparing exceptions to denials when conducting a comparative file analysis. Module 9 covered everything you need to know about exceptions.

For both loans and applications, you must identify the marginal transactions. You will have files that fall into one of two categories: originated loans that were marginally approved and applications/denials that were marginally denied. Marginal transactions are those that are not a clear-cut approval or a denial.

Let's say your credit score minimum is 600 to approve a loan. Someone with a 750-credit score that was approved would not be part of your universe. That's an obvious approval loan, at least based on credit score underwriting criteria, and there is no question that customer meets your standards. Those in the range of say 580-620 may be considered marginal transactions. We only use that as an example range because those scores are really close to the 600 cutoff scores for denying or approving a loan. You're range of marginally approved may be smaller or larger.

Within the Appendix to the Interagency Fair Lending Examination Procedures, there are lists of how to determine marginal denials and marginal approvals. Those will be listed below; however, they can become a bit cumbersome and confusing. **Don't be discouraged;** there is a better way that we will show you. But first, let's look at the examination procedures and what they say on this topic.

Marginal Denials

Denied applications with any or all of the following characteristics are "Marginal." Such denials are compared to marginal approved applications.

Marginal denied applications include those that:

- Were close to satisfying the requirement that the adverse action notice said was the reason for denial;
- Were denied by the institution's rigid interpretation of inconsequential processing requirements;
- Were denied quickly for a reason that normally would take a longer time for an underwriter to evaluate;
- Involved an unfavorable subjective evaluation of facts that another lender might reasonably have interpreted more favorably (for example, whether late payments actually showed a "pattern," or whether an explanation for a break in employment was "credible");
- Resulted from the institution's failure to take reasonable steps to obtain necessary information;
- Received unfavorable treatment as the result of a departure from customary practices or stated policies. For example, if it is the institution's stated policy to request an explanation of derogatory credit information, a failure to do so for a prohibited basis applicant would be a departure from customary practices or stated policies even if the derogatory information seems to be egregious;
- Were similar to an approved control group applicant who received unusual consideration or service, but were not provided such consideration or service;
- Received unfavorable treatment (for example, were denied or given various conditions or more processing obstacles) but appeared fully to meet the institution's stated requirements for favorable treatment (for example, approval on the terms sought);
- Received unfavorable treatment related to a policy or practice that was vague, and/or the file lacked documentation on the applicant's qualifications related to the reason for denial or another factor;
- Met common secondary market or industry standards even though failing to meet the institution's more rigid standards;

- Had a strength that a prudent institution might believe outweighed the weaknesses cited as the basis for denial;
- Had a history of previously meeting a monthly housing obligation equal to or higher than the proposed debt; and/or
- Were denied for an apparently "serious" deficiency that might easily have been overcome. For example, an applicant's total debt ratio of 50 percent might appear grossly to exceed the institution's guideline of 36 percent, but this may in fact be easily corrected if the application lists assets to pay off sufficient non-housing debts to reduce the ratio to the guideline, or if the institution were to count excluded part-time earnings described in the application.

Marginal Approvals

Approved applications (loans) with any or all of the following characteristics are "Marginal." Such approvals are compared to marginal denied applications.

Marginal approvals include those:

- Whose qualifications satisfied the institution's stated standard, but very narrowly;
- That bypassed stated processing requirements (such as verifications or deadlines);
- For which stated creditworthiness requirements were relaxed or waived;
- That, if the institution's own standards are not clear, fell short of common secondary market or industry lending standards;
- That a prudent conservative institution might have denied;
- Whose qualifications were raised to a qualifying level by assistance, proposals, counteroffers, favorable characterizations or questionable qualifications, etc.; and/or
- That, in any way, received unusual service or consideration that facilitated obtaining credit.

If you use this method to find your universe size, you will now be ready to choose your sample size. The Examination Procedures list sample sizes to guide you. Those tables can be found at the end of this module.

Let's look at another way to find our sample size - Overlaps

What are Overlaps?

There is another way to identify marginal transactions. Using "overlaps" is a much more straight-forward way to identify which transactions you will want to review. The concept of an overlap is fairly simple. You may want to read this more than once, but we will give you some examples to help illustrate.

An overlap is when:
An applicant was denied for a loan product, based on a particular piece of underwriting criteria, that was more favorable than someone who was approved.

If you decide that you have weaknesses or inconsistencies for loan approval based on credit scores, that will be the direction you take your comparative file analysis. If you have reason to believe there are issues with LTV-related denial and approval decisions, you would select that as your review criteria. You can select more than one criterion if necessary, but each criterion must be analyzed separately.

How to Find Overlaps

Let's use a few simple examples to illustrate overlaps.

1. An applicant was denied for a particular loan product with a 650-credit score, but another applicant was approved for the same credit product with a 600-credit score.
2. An applicant was denied for a particular loan product with an LTV of 90%, but another applicant was approved for the same credit product with an LTV of 100%.
3. An applicant was denied for a particular loan product with a DTI of 43%, but another applicant was approved for the same credit product with a DTI of 50%.

PRO TIP

Build a spreadsheet listing out the underwriting criteria factors. You can sort based on any of the factors. This will help you see the overlaps more clearly. We have an example of what it may look like later in this module.

In order to find your overlaps, you need to choose your product and your underwriting criteria that you want to analyze. Then you will find the worst approved applicant and the best denied applicant. All of the denials between your overlaps will be part of your universe. Let's go back to our three previous examples and explain further:

1. **Underwriting Criteria – Credit Score** - Our "worst approved" applicant was approved for this particular loan product with a credit score of 600. That is our lower baseline. Our "best denied" applicant was denied with a credit score of 650. That is our upper baseline. You will want to find all applicants that were denied for this loan product that had a credit score between your baselines. Those denied applicants are your credit score overlaps. **we do NOT need to analyze approved applicants with credit scores within those limits, only those that were denied**
2. **Underwriting Criteria – LTV** – Our "worst approved" applicant was approved for this particular loan product with an LTV of 100%. That is our upper baseline. Our "best denied" applicant was denied with an LTV of 90%. That is our lower baseline. You will want to find all applicants that were denied for this loan product that had an LTV ratio between your baselines. These are your LTV overlaps.
3. **Under Criteria – DTI** – Our "worst approved" applicant was approved for this particular loan product with a DTI of 50%. That is our upper baseline. Our "best denied" applicant was denied with a DTI of 43%. That is our lower baseline. You will want to find all applicants that were denied for this loan product that had DTI ratio between your baselines. These are your DTI overlaps.

PRO TIP

Unless you are a very large organization, your sample size may very likely be all overlapping denied loans for your underwriting criteria you are analyzing. If you are a much larger organization, you will likely want to use the sampling guidelines at the end of this module.

That same methodology can be reproduced for any underwriting criteria that you use to approve loans. You will do a full and separate analysis of each underwriting criteria that you are looking to analyze. Now that you have your overlaps, you will need to select your sample size.

Step 2 – Compare Approved and Denied Applications

Now that you have your samples selected, you will need to compare your approvals to your denials (overlaps). We will do this by creating an applicant profile spreadsheet.

The directions for creating your applicant profile spreadsheet come straight from the FFIEC Examination Manual.

> *Based upon the institution's written and/or articulated credit standards and loan policies, identify categories of data that should be recorded for each applicant and provide a field for each of these categories on a worksheet or computerized spreadsheet. Certain data (income, loan amount, debt, etc.) should always be included in the spreadsheet, while the other data selected will be tailored for each loan product and institution based on applicable underwriting criteria and such issues as branch location and underwriter. Where credit bureau scores and/or application scores are an element of the institution's underwriting criteria (or where such information is regularly recorded in loan files, whether expressly used or not), include a data field for this information in the spread sheet.*
>
> *In order to facilitate comparisons of the quality of assistance provided to target and control group applicants, respectively, every work sheet should provide a "comments" block appropriately labeled as the site for recording observations from the file or interviews regarding how an applicant was, or was not, assisted in overcoming credit deficiencies or otherwise qualifying for approval.*

PRO TIP

Document why you chose each underwriting criterion and note why the loans were chosen. If your process is ever examined, you may need to explain why each loan was selected.

What does that all mean? Basically, what we are doing is collecting all relevant underwriting criteria your lenders or underwriters used to make the approval/denial decision. Then we determine if there are mitigating factors that explain those marginal transactions.

Let's use some examples:

1. Doug – Doug is applying for a car loan, but his credit score doesn't quite meet your criteria. Let's say your minimum credit score is 620, but Doug's credit score is 600. Doug would likely fall within your baseline ranges of a marginally approved file. The simplest question we are trying to answer is "Why did Doug get approved with a 600 credit score when others were denied with a higher score?" When we build our customer profiles, we are trying to answer that question. We will look at all factors about Doug to tell the story. By all factors, we mean whatever criteria were used to approve Doug's loan. Let's say your lender also considered the LTV. Doug was willing to put 50% down on his car purchase, so his LTV was 50%. That is a favorable characteristic, and may explain Doug's approval. If other denied applicants with a higher credit score all had LTVs of 100% or higher, we may have just identified why one marginally approved loan was approved and other marginally denied applications were not.

2. Judy – Judy applied for a home loan at your institution, but her LTV was just over your approval threshold. Let's say your maximum LTV is 90%, and Judy was at 92% but was still approved. We gather all other underwriting criteria that was used to make the loan decision. Now let's say her credit score was 805, so that might have helped in the loan decision as all marginally denied files were in the 600s. Maybe her DTI ratio was only 20%? Judy is buying a modest house and has no other debt. If we look at the marginally denied files and find all of their DTIs were in the 50% range, that could explain why Judy was approved with a higher LTV. Remember, we are not necessarily comparing Judy's LTV to your organization's standards, we only use that as an example. We will find the best denied LTV (let's say someone was denied at 80%), and that's what we compare Judy's LTV to.

These two examples help illustrate the process. You will collect all relevant data on each of your denied files and compare those numbers to your worst approved loan data. You will have customers with low credit scores that were approved because of very favorable other criteria (such as low LTV or DTI ratios). So, while their credit score may be worse than someone who was denied, other underwriting criteria made up for it.

PRO TIP

You do not review the **approved** loans within your baseline ranges. Those customers actually got the loan, so they are not part of the review. Only the customers who were treated adversely (denied overlaps) are part of this review.

At this point, you may be asking yourself "but what if all of the approved borrower's criteria were worse than someone who was denied?" My question back to you would be – then why was the loan denied? That's exactly what we are trying to do: tell the story why some marginal applicants were approved while others were denied. If you cannot explain it through the applicant profile spreadsheet, you likely have weaknesses in your program. Take any and all findings from this review and help build up your program. Tighten underwriting criteria, minimize exceptions, and train your loan staff.

When Does this Become Discrimination?

When these loan decisions are not made based on underwriting criteria but based on a prohibited basis. If all of your marginally denied loans were to Hispanic borrowers and your marginally approved loans were to non-Hispanics, you could have discrimination.

If you remember back to our example of First National Bank. When we reviewed FNB's applicant profiles, we were able to show that each of our baseline approvals, across all underwriting criteria we reviewed, had other much more favorable factors that led to the loan approval. Because FNB had such well-documented files and well-documented loan decisions, we were able to prove that discrimination was not present.

What do You do if You Find Unfavorable Results?

There are several things you should do. Here are some critical steps you can take:

1. **Train!!** You will want to present the results to management and come up with a training plan for lenders and underwriters.
2. **Tighten up criteria** – You will want to make sure that underwriting criteria are clearly defined. For example, if you give a credit score approval range of 600-650 to decide on loan approval or denial, you will have loan officers denying and approving applicants all within that range. Instead, set a hard and fast cutoff score and stick to it.
3. **Control Deviations** – If you allow lenders to deviate from underwriting criteria, you open yourself up to possibly deviating for the wrong reasons. If your credit score cutoff is 620, and a lender wants to approve a loan with a lower score, you may want to have procedures in-place to ensure that application requires a higher lending authority's approval.
4. **Track Exceptions** – You will want to track all exceptions to policy for underwriting, pricing, fees, and terms. You will need to periodically analyze that data to ensure you are deviating for the right reasons (legitimate underwriting mitigating factors) and not the wrong reasons (prohibited basis). We took a deep dive into exceptions to loan policy in Module 9. Remember: you will likely use your list of exceptions to help find marginally approved applications.
5. **Consider Corrective Action** – This can be tough. If you are reviewing a denied application file that is six months old, it's likely that customer is long

gone and received financing somewhere else. However, if there is a chance to still make that loan, you might want to reconsider it.

Wrapping Up Your Analysis

Once you have collected all relevant data and completed your customer profiles for your marginally denied applications, you will analyze each to determine why they were denied when other similar applicants were approved. If you can tell the story why decisions were made and they were based on the legal forms of discrimination (e.g. LTV, DTI, Credit Score, etc.), you have helped mitigate your risk. If you cannot tell the story, and it appears denials were made on a prohibited basis, you will need to go back and strengthen areas, provide training, and take whatever corrective action your management team deems appropriate.

If your findings are very worrisome or egregious, and it's obvious that you have discrimination on a prohibited basis, you may need to take more drastic measures to correct issues. What do those measures look like? It depends on how serious you are on admitting the mistake and correcting it. That doesn't mean you have to publicly admit the issue, but you should take significant measures to correct it. This is not the time to do the bare minimum for corrective action. Make strong and significant changes to your program to prevent these issues from recurring.

Finally, you can consider bringing your findings to your regulator. Yes, this is handing them this issue on a silver platter, but being forthcoming can be a big step in correcting your issues, and the regulators may be able to guide you on what appropriate corrective action is.

Let's look at this another way. If you decide on corrective action, but it is a weak reactive at best, the regulators may cite significant regulatory violations and make you do what you should have done in the first place anyway. It's also likely that those findings could impact your examination rating. If your examiners are made aware in advance and sign off on the corrective action, when your next exam comes around, they will be looking at what you did to fix it and not performing a new in-depth review, or in rare cases, submitting the findings to the Department of Justice.

Do not forget that significant fair lending issues can also end up in your CRA Performance Evaluation, and that document is public. Organizations have been able to rebound from discriminatory practices, but those that hide it or fight it can have a much longer, tougher, and more expensive road to get there.

Creating an Applicant Profile Spreadsheet

To create an applicant profile spreadsheet, you can simply use Microsoft Excel or any other comparable spreadsheet program. This spreadsheet does not need to be flashy or fancy by any means. The key part to creating a good spreadsheet is the quality of the data that you are gathering. You will want all underwriting criteria that your loan staff uses to make loan decisions. You will also want to include a column for notes.

Here is an example of what it might look like:

XYZ Bank - Applicant Profile Spreadsheet

Borrower First Name	Borrower Last Name	Co Borrower First Name	Co Borrower Last Name	Loan Product	Loan Officer	Branch	Credit Score	LTV	DTI	Loan Term	Age of Collateral	Interest Rate	Loan Fees	Notes

The spreadsheet above is just an example of what your spreadsheet may look like. We have included the most common underwriting criteria you might use. If you use other underwriting criteria that we discussed in the underwriting module such as having a co-signor, employment history, or residential history, you would want to include those columns in your table.

If you are doing a comparative file analysis based on underwriting (approvals and denial decisions), you will want to use only the underwriting criteria you use to make the loan decision. For example, if you don't consider the loan term to determine whether someone qualifies, you would not include it within the analysis.

If you are doing a comparative file analysis based on pricing (includes interest rate, fees, term, etc.), you would only include those factors that you consider when setting the rate. Again, we can use the loan term as an example. Let's say you don't consider loan term when deciding whether to approve a loan, but the loan term you give your customer affects the rate they will get. You would want to include the term within your pricing analysis. Typically, the longer the loan term, the higher the interest rate. This is

PRO TIP

Don't get into the habit of always putting down "good customer" as reasons for underwriting exceptions. It's so common for lenders to want to use that as a reason, but if it's not defined, there is no way to compare what that means from one customer to the next. Be specific.

very common for automobile loans. Giving someone 6 years to pay back a car that rapidly loses its value is much riskier than giving someone 3 years to pay it back.

Adding Prohibited Basis to your Spreadsheet

You can also add columns for prohibited basis, depending on the reason for your review. For example, if you are doing the analysis because you believe there may be discrepancies in your program that are harming Hispanic borrowers, you could add a column that lists whether the applicant was Hispanic or non-Hispanic. The same goes for sex, race, marital status, or any other prohibited basis group. There is a good chance that examiners will review your loans this way, so analyzing by a prohibited basis can give you a head start if you need to correct any issues. Just remember to include joint male/female loans in your "male" group. Furthermore, if you have joint white/minority applications, include those in your "minority" group.

PRO TIP

Setting up a strong program UP FRONT will help prevent the need for this review, but it will also help ensure this review is successful, if necessary.

MODULE SUMMARY

Conducting a comparative file analysis is a very labor-intensive process. This type of review should only be accomplished when all other review methods do not answer anomalies within your program. In this module, we walked through two real-world examples of performing a comparative file analysis. We then covered how to get started on your own analysis. You will need to choose your focal points, identify your marginal approvals, and find your denied overlaps. At that point, you can start comparing your transactions by gathering information from your loan files. We finished off with talking about the applicant spreadsheet.

Performing a comparative file analysis is only as successful as the quality of the documentation you have available. If your files are well organized, loan staff do a good job of documenting comments and underwriting, and your denial files contain necessary information, this review can be quite useful. If your files have little to no information, you will not be able to re-create the loan officer's decision-making process which will lead to inconclusive results. This is but another example of why strong policies and procedures and well document files are important.

Table A **Underwriting (Accept/Deny) Comparisons**						
	Sample 1 **Prohibited Basis Denials**			**Sample 2** **Control Group Approvals**		
Number of Denials or Approvals	5–50	51–150	>150	20–50	51–250	>250
Minimum to Review	All	51	75	20	51	100
Maximum to Review	50	100	150	5x prohibited basis sample (up to 50)	5x prohibited basis sample (up to 125)	5x prohibited basis sample (up to 300)

Table B **Terms and Conditions Comparisons**						
	Sample 1 **Prohibited Basis Denials**			**Sample 2** **Control Group Approvals**		
Number of Approvals	5–25	26–100	>150	20–50	51–250	>250
Minimum to Review	All	26	50	20	40	60
Maximum to Review	25	50	75	5x prohibited basis sample (up to 50)	5x prohibited basis sample (up to 75)	5x prohibited basis sample (up to 100)

1. Examiners should not follow Table B when conducting a pricing review that involves a regression analysis. Consult with agency supervisory staff for specific protocol in these cases.

2. When performing both underwriting and terms and conditions comparisons, use the same control group approval sample for both tasks.

3. If there are fewer than 5 prohibited basis denials or 20 control group approvals, refer to "Sample Size" instructions in the procedures.

4. "Minimum" and "maximum" sample sizes: select a sample size between the minimum and maximum numbers identified above. Examiners should base the size of their review on the level of risk identified during the preplanning and scoping procedures. Once the sample size has been determined, select individual transactions judgmentally. Refer to procedures.

5. If two prohibited basis groups (e.g., black and Hispanic) are being compared against one control group, select a control group that is 5 times greater than the larger prohibited basis group sample, up to the maximum.

6. Where the institution's discrimination risk profile identifies significant discrepancies in withdrawal/incomplete activity between control and prohibited basis groups, or where the number of marginal prohibited basis group files available for sampling is small, an examiner may consider supplementing samples by applying the following rules:

   - If prohibited basis group withdrawals/incompletes occur after the applicant has received an offer of credit that includes pricing terms, this is a reporting error under Regulation C (the institution should have reported the application as approved but not accepted) and therefore these applications should be included as prohibited basis group approvals in a terms and conditions comparative file analysis.

   - If prohibited basis group incompletes occur due to lack of an applicant response with respect to an item that would give rise to a denial reason, then include them as denials for that reason when conducting an underwriting comparative file analysis.

Tuscan Club University

MODULE 15
RISK ASSESSMENTS

Tuscan Club University
Fair Lending School

MODULE 15 –

RISK ASSESSMENTS

MODULE OBJECTIVES

In this module, we are going to talk about everything risk assessments. We are going to discuss what risk assessments are, how to develop/utilize the risk assessment template, and the purpose it serves. We will finish up with how often you should update your risk assessment. Let's get started.

What Is a Risk Assessment?

Risk assessments document the key risks and controls relative to the applicable topic. Risk assessments, if utilized effectively, can act as a repository and roadmap to your fair lending program at your organization. It also allows stakeholders (i.e. the business lines, auditors, and examiners) to easily peel back layers of the program in a manner that reduces time spent on examinations and audits.

A good risk assessment will ask you probing questions up front. These questions are designed to get you thinking about where risks in your fair lending program might come from. The questions in a risk assessment are likely broad, but you will want to consider each of the loan life cycle risks discussed in this course to determine your level of risk.

For example – we may be talking about steering risk. What is the level of steering risk at your organization? That's a good general steering risk question to get you started. To answer that question, however, you need to understand steering and where the major risks are. Do you have differing products, some of which may have higher rates and fees? Do you have add-on products? Can lenders refer applicants to different channels or third-party products? How is your lender compensation program structured? These are the specific things you will need to know in order to appropriately assess your steering risk.

If you have completed all of the modules in this school, you have already conducted an informal risk assessment. In fact, Module 4, in a way is a risk assessment. You should be reviewing your program as a whole and deciding what reviews you will be conducting. You chose those reviews based on the level of risk, and you should be doing reviews in areas with higher risk first. What we are going to do in this module is formalize the process and assign some values to these risks.

Disclaimer – Before We Start

Before we get into the risk assessment itself, we feel it's appropriate to put in a disclaimer. There are many ways to do a risk assessment, and there are many different opinions on how to get to the end result. Smaller organizations will likely do a risk assessment of their fair lending program as a whole while larger organizations may do a risk assessment by business line or department. It has to make sense for the size and complexity of your organization.

What we want you to keep in mind is the end goal and answering this simple question:

Where is our fair lending risk?

How you get there is not near as important as answering that question. Ultimately, you will need to identify how to allocate your institution's resources to mitigate fair lending risk. What do we mean by resources? All of the Compliance Management System (CMS) tools that you have at your disposal.

- Where do you need to strengthen policies and procedures?
- How much training is required?
- How often do we monitor these areas of higher risk?
- How often do we audit?
- Do we need software to help manage a risk?
- Do we need to hire more people?

Based on your higher risks, you will be able to appropriately allocate your resources to strengthen your CMS.

Most risk assessments assign numbers based on risk, and those numbers generally assign a value on the amount of risk you feel you have. Those numbers are very subjective. One person could assign a totally different set of numbers than another person. You may weigh some risks as more critical than others. Two people conducting the same risk assessment at the same institution will likely have different conclusions.

In the end, it's not the numbers that you need to worry about. Regardless of the numbering system that you use, when this is all over, everyone on your team should be able to agree where your highest risks are. Remember the ultimate goal here – answering the question of **where is our fair lending risk?**

Breaking Down The Risk Assessment

Risk Assessments have multiple pieces, each of which are defined below:

Risk Factors – The individual risk factors which may present risk to the organization. The template provided generally utilizes the risk factors within the FFIEC Fair Lending Examination Procedures.

Inherent Risk – The level of risk in place in order to perform operational activities before controls are taken into account to alter the risk's impact or likelihood.

Impact – The extent and pervasiveness for which a single event that poses risk to the organization might affect the enterprise. Generally, this is both a qualitative (i.e. consumer harm, public perception) and quantitative factor (i.e. dollar amount of loss).

Likelihood – The probability of which a single instance or event that poses risk to the organization may occur. Generally, this is only a quantitative factor.

Control(s) – The individual control(s) associated with a given risk factor. There may be multiple controls assigned to an individual risk factor.

Assurance – The assessment of the control(s), specifically based on (1) the design of the control and (2) historical effectiveness of control(s) in place to mitigate inherent risk. The assurance rating is an assessment of applicable controls for an individual risk. The assurance rating should be determined when including how all applicable controls mitigate the inherent risk.

Some organization's may utilize a Governance, Risk, Compliance (GRC) tool. In those cases, users may be able to build this risk assessment within their own GRC utilizing their internal risk assessment methodology. Otherwise, you may choose to utilize the template we have built to develop/enhance your current fair lending risk assessment.

The risk assessment template provided has two sections – the questionnaire and the risk assessment itself. The questionnaire helps guide the process to think critically about the common pitfalls for applicable risk factors. Each question provides detail to which applicable risk factors they are linked to so that controls can be effectively reviewed by individual risk factor.

The Questionnaire tab generally follows the FDIC's Fair Lending Scoping and Conclusions Memorandum to ensure that questions typically asked by the regulators during the examination are proactively answered prior to a Compliance Examination. While you may or may not be an FDIC regulated financial institution, the guidance will still help you in building a quality risk assessment. Additional questions relative to emerging risks have been added to ensure that those issues are proactively considered.

The Risk Assessment tab acts as a risk-control library and evaluation tool. All sections can also collapse to provide executive management and the Board high-level information. These sections are built to provide high-level detail to avoid providing in-depth detail to stakeholders focused on high-level oversight.

Identifying Risks & Determining Controls

The first step in conducting any risk assessment is to identify the inherent risks. Since our risk assessment is specific to fair lending risks, that is where we will focus. If you have completed all of the modules of this course, you already have a good idea of what your risks will be.

The second step is to determine what controls you have in-place to mitigate the risk. Thinking back to Module 3, we talked all about your CMS. What do you have in-place for policies, procedures, training, monitoring, audit, and complaint response to help control each risk? Those controls that you have at your disposal are how you lower your risk, so it's time to rack your brain and think about what we have learned up to this point. Also include system controls, limitations, and overrides as controls. System controls can be the most effective ways to mitigate fair lending risk.

Let's break down the loan life cycle and look at each risk individually. These are high-level overviews of each area, as the risk assessment provides more pointed questions, examples, etc. Some of the areas below will follow our methodology of the loan lifecycle of fair lending risks and what we teach in this school. Some of the concepts will align directly with the FFIEC guidance. You may see us cross over some concepts in different areas. The idea here is to understand all risks and ensure that they are all addressed. Let's look at the loan lifecycle now and cross reference some FFIEC guidance along the way.

Application Risk

Identifying the Risk

If we go back to Module 5, you may remember that some of the major risks in this area are the physical applications that your organization uses and your procedures for employees who are taking those applications. Your rate at which you receive applications from different prohibited basis groups, such as what you would find in your HMDA data, can also fall under application risk. However, we will address that in redlining.

By now, you will know which physical application forms your organization uses. In addition, you should know your basic application procedures. If you use application forms that you know are compliant and have procedures on how to take applications, your risk in this area is likely lower.

Data disparities in your application rates is also a major part of application risk, but this crosses over with other potential areas like underwriting, denials, and most notably - redlining. Where you are receiving applications from and where you are not receiving them from drives a major part of fair lending risk. This data can often be learned from fair lending software by reviewing your HMDA data.

Determining Controls

Your controls over physical applications are pretty straight forward. Do you develop your own applications or do you purchase them? You may find that your paper applications are purchased, but your online applications had to be built by someone at your organization (or a vendor). The second part of your control is a little bit harder to identify - your application procedures. Most smaller organizations do not have formal or written application procedures. Customers simply fill out a form online, walk in the door, or call a lender and apply. Even the largest organizations may not have written procedures. That doesn't necessarily mean that your institution does not have any procedures in place, it just means they are not written or formal.

In order to determine if you have procedures, you may need to interview personnel. What you learn by reading formal procedures and interviewing personnel will help you determine the controls in-place. Remember, don't just interview loan officers. Any customer-facing employee of your organization could potentially discriminate, so talk to different people in your physical locations and ask them what they do when a customer wants to apply for a loan.

You also want to know how your online applications are routed. When a customer fills out an application online, that has to go somewhere. How and to whom those are routed can present control and risk issues. You want to make sure that certain applications are not always routed to certain areas on any type of prohibited basis. For example, are home loan applications from certain neighborhoods always routed to a certain channel? This could have a discriminatory impact such as disparate impact or redlining if that channel has less advantageous products.

The final control is training. Has anyone ever conducted training for customer facing personnel when it comes to taking loan applications? Some annual or periodic basic training can surprisingly go a long way and be a simple and cheap solution to lower risk in this area.

Steering Risk

Identifying the Risk

In Module 6 we talked about the different steering risks. You will need to know what types of products your organization offers and what type of risk they carry. Do your lenders sell add-on products? Do you have agreements with third parties for referring applicants? You can also look at your HMDA data to see if you have high rates of prohibited basis group individuals in government guaranteed loans compared to peer lenders. What about your loan officer compensation?

Most organizations addressed loan officer compensation for mortgage loan originators (MLOs) years ago when the regulations finally required it. However, do not make the mistake in assuming your MLO compensation program meets regulatory requirements. Always trust but verify. Have you looked at how other lenders in your organization are compensated? All of these factors will decrease or increase steering risk and should all be considered.

Determining Controls

One of the best ways to mitigate steering risk is good procedures and training. If you offer add-on products, you should have some basic procedures on how to sell them. If you have different referral channels for loan products, you should have some guidelines in place on how, when, and where to deliver loan applicants based on their creditworthiness or other legal criteria you set.

If you compensate lenders based on criteria such as products, rates, and fees, you need to make sure that their compensation package does not increase your steering risk. Finally, you will want to train your lenders not only on steering risk but how they are supposed to do their jobs. Scenario based training can be very effective. For example – if Customer A has a 680-credit score, they qualify for loan product B. That is a simple, straight-forward procedure that can take the guess work out of who can/should get that loan product. If you don't have strong procedures, employees will make judgement calls, and that increases risk.

Underwriting Risk

Identifying the Risk

Module 7 covers underwriting risk. When you are assessing your organization's underwriting risk, you may want to break it down by loan product or channel and do multiple assessments. If you are a smaller organization, and some lenders originate several different types of loans, you can possibly review underwriting risk as a whole. Larger organizations may have to assess their underwriting risk by channel, department, or even by product.

In order to assess this risk, you first need to know what products are offered. The more products you offer, the more potential risk you have. You also need to know who is doing the underwriting? Is it lenders, an underwriting team, software, or some combination making it a hybrid program? Next, do you have any third parties making decisions for you? Another thing to consider are policy deviations. Are loan decision makers allowed to deviate from policy? As with any of the fair lending risks, the more employees can deviate from loan policy, the more risk you will have.

Determining Controls

Controls fall into multiple buckets - training, policies/procedures, monitoring, 2nd line testing, system parameters, and more. Control ratings are largely determined by two factors - control effectiveness and control design as defined above. As an example, procedures may provide comprehensive detail and historical effectiveness, but could still be rated 'effective'. Controls that are human have room for override, error, or deviation from policy. However, if an automated control requires or guides employees to avoid or minimize human error, those controls are more often rated as 'strong' when coupled with an effective historical effectiveness.

There are several controls that you can put in-place to mitigate underwriting risk. One important example is strong written underwriting procedures. If your lenders and underwriters have good descriptive procedures in-place, you can greatly reduce risk in this area. Checklists, Excel workbooks, and/or underwriting software are all effective ways to create written procedures. As with any written procedures, however, they are only effective if they are followed. Having great procedures that nobody uses does little to mitigate risk.

Another way to mitigate fair lending risk is to minimize exceptions to policy. As we just mentioned, strong procedures are only effective if they are consistently followed. Frequent exceptions to policy can reduce or effectively eliminate the benefit of strong procedures.

Additional controls to mitigate underwriting risk is to perform monitoring. Monitoring can be done in many ways, either through periodic reviews or ongoing monitoring. One way to do a periodic review is by conducting monthly or quarterly sampling. Start by picking a small sample of loan files from different branches and lenders. Simply re-create the loan decision steps and see if the lender or underwriter followed policy. This is a simple review that can be an effective CMS control.

An example of effective ongoing monitoring would be comparing a proposed application denial to a list of approved policy exceptions. This helps ensure you do not deny an application with an overlap of an approved loan. Fair lending software can help automate this process. Depending on the size and risk of your organization, implementing these tools can help you quickly and easily find matched pairs, identify outliers, and see risks you cannot easily see through a file review alone. This type of analysis can take your fair lending program review to a whole new level. Any significant outliers discovered should be reviewed and discussed.

Training for lenders and underwriting staff goes a long way in mitigating risk. Not just onboarding training either. Have periodic discussions with loan staff on how they do their jobs. Talk about specific examples, cover basic policy requirements, and ask questions to see if your policies are clearly understood.

Pricing Risk

Identifying the Risk

In Module 8 we covered everything pricing. The major risk in pricing is the interest rate charged at loan origination. Module 8 has procedures on how to analyze your pricing performance. If you are a larger organization, you may have software to help you analyze pricing risk. Interest rate risk is not the only risk included in pricing. Don't forget about setting loan terms and fees.

What kinds of loan products do you offer? The more consumer products you have, the higher your potential pricing risk. What are the demographics of your assessment area/market area? If you have large populations of prohibited basis group individuals, there is higher risk of not pricing fairly to those groups. Do you have loan referral channels, or is a third-party setting the rate? Are you lacking formal pricing procedures like an interest rate sheet?

On the other side, are lenders allowed to deviate from pricing procedures? If so, does that deviation require secondary approval (this is part of your controls)? Just because you need to get secondary approval to deviate from the rate sheet does not mean your risk disappears.

Determining Controls

Pricing controls virtually mirror those of underwriting. Having written and formal interest rate sheets is the best control you can put in-place to mitigate pricing risk.

Limiting interest rate exceptions is another strong control to mitigate this risk. If lenders are allowed uncontrolled pricing discretion, rate sheets lose effectiveness. Even if lenders are required to get approval, fair lending risk specific to pricing still increases. Having a formal approval process for rate exceptions may help reduce risk, but it doesn't eliminate it.

You can do periodic monitoring of loan files to determine if lenders are truly following the rate sheet. This control can be completed at the same time as the underwriting review we previously discussed. While you are checking to see if lenders are following underwriting criteria, you can also verify if they are following the rate sheet. This simple monitoring step will go a long way to help strengthen your fair lending program. Ensure you review the risk assessment for other potential controls for pricing.

Exception to Policy Risk

Identifying the Risk

By now it should be well ingrained in you that a strong CMS is the best way to mitigate fair lending risk. Having strong policies and procedures, training your staff, and monitoring their performance is the best way to lower fair lending risk. However, strong policies and procedures can only be effective when they are followed.

This is where exception risk comes in. If you are a small organization that rarely deviates from loan policy, your risk in this area is low. Even large organizations can mitigate this risk by strictly adhering to underwriting and pricing guidelines and minimizing exceptions. Do not let asset size or loan origination numbers fool you. If you are an organization that commonly allows lenders and underwriters to make exceptions to policy, you carry higher risk regardless of your organization's size.

You will want to determine the level of the risk present at your organization. If your organization is not currently tracking policy exceptions, you can still help determine this risk. This is where your fair lending interview becomes critical. If you have developed good rapport with the lenders and underwriters you are interviewing, they will be open and honest with you on policy exceptions. We have done many fair lending interviews where lenders and underwriters tell us that policy exceptions are very common. So, even without data, you can still get a good picture of your risk just through interviews. There are automated software tools available to help determine if applications have exceptions to stated underwriting rules. This is also something you may want to consider adding to your fair lending review.

Determining Controls

As discussed in the underwriting and pricing sections above, the most effective way to reduce exception risk is to reduce the number of exceptions. The fewer underwriting and pricing exceptions your loan and management staff approve, the less risk you will have in this area. These decisions are not always within your control. So, what controls can you put in-place to help mitigate this risk when exception numbers are high?

You want to make sure that your organization has a formal approval process for all policy exceptions. It is best to limit the number of people that can approve policy exceptions, and every lender and underwriter should know what the process is (and actually follow the process) to get a policy exception approved. Too many organizations have a formal process that is never followed, so it never has a chance to be an effective risk mitigation tool.

By now you should know that tracking policy exceptions is your first critical step in identifying risk. Make sure that your organization tracks all underwriting and pricing exceptions. Remember, tracking is only the first part of mitigating this risk.

The second part is performing an analysis of your exception data. As we talked about in Module 9, you should periodically review exception data for negative trends. You will want to make sure that lenders are making exceptions on a fair basis and not on a prohibited basis. You may also strengthen your program by using exception reports to cross reference when conducting secondary review of denials.

Denial Risk

Identifying the Risk

Consistent underwriting helps mitigate denial risk. Let us say that again – consistent underwriting helps mitigate denial risk. If you have determined that you have a strong underwriting program and deviations are minimal, you will likely have lower denial risk. However, you will also want to look at your loan data to see if you have higher denial rates to different prohibited basis groups.

For small organizations, you may only have a few denials in the whole year. Larger organizations can have hundreds if not thousands of denials per year. Those organizations may want to have software to help review denial rates. Good fair lending software can run all of the numbers for you on your HMDA data. It can show you not only your performance, but how peers in your area also performed.

Determining Controls

There are different types of reviews that you can be doing to help reduce denial risk. The first review is looking at the overall denial rates to different prohibited basis groups. This may be difficult to do if you don't have software, so it may be more of a manual process.

You can also perform monitoring similar to the underwriting and pricing section above. You can periodically review a sample of denials and re-create the loan decision. Tracking denial decisions and ensuring that lenders are making decisions based on loan policy and underwriting criteria and on a consistent basis will help you reduce denial risk.

Finally, a simple technical review of denied applications and adverse action notices, prior to being mailed, is a good way to reduce regulatory and technical violations. This is typically done by a trained compliance professional. You could incorporate the underwriting decision into this review and do both reviews at the same time.

Marketing Risk

Identifying the Risk

Your organization's general marketing risk can be quickly determined through a simple review of your marketing program as we discussed in Module 11. Organizations that frequently market specific product features carry higher marketing risk. If your organization has a significant online presence either through targeted marketing campaigns or social media, you also likely have heightened marketing risk. In addition to reviewing a sample of marketing materials, an interview with marketing personnel is a great tool to help determine your organization's level of risk.

Just like with many other risks, there is also crossover from marketing with other areas. The effectiveness of your marketing has a direct impact on application and redlining risks. Again, you will need software to analyze this. For example, your organization may likely market home loan products in a metro area. The rate at which you take applications in high minority areas compared to demographic data is important to understand the effectiveness of marketing efforts. If the metro area is 36 percent majority-minority census tracts but only 12 percent of your HMDA applications come from those census tracts, you are lagging behind demographic data by a 3-to-1 ratio.

The same goes for peer performance. When you utilize fair lending software, you can see how you are performing in comparision to peers in your area. If peers are taking applications in that same metro area at a rate of 15 percent, your application rates are inline with peers. You are still lagging significantly behind the demographics of your area, but you are more inline with what other lenders are doing.

One last hard to swallow pill. Let's argue that a metro area is made up of 36 percent majority-minority census tracts, and all lenders in that area are taking applications from those census tracts at a rate of 15 percent. That's more than a 2-to-1 ratio of those neighborhoods being served less than low minority neighborhoods. There's a good chance that most lenders in that metro could have redlining risk as it seems nobody is appropriately serving the majority-minority census tracts. Don't get caught up in the old "we're aligned with peers, so we're good" thought. If everyone is discriminating, that does not make it right. This is a chance for your organization to be a leader in that community. The time to act is now.

Determining Controls

One simple control to mitigate marketing risk is to ensure that a trained compliance professional is involved with marketing material approval. Some larger organizations outsource this process. They will have outside third party compliance personnel review all marketing materials prior to being published. Smaller organizations typically handle these reviews by internal compliance personnel. Either way can be effective, but make sure the individuals reviewing marketing materials are well trained in all compliance regulations.

Another major marketing control is the monitoring of social media. Somebody at your organization should be getting notifications for all social media posts. Any time there is a complaint, somebody at your organization needs to be notified so it can be handled as soon as possible.

You should also be monitoring what your employees are posting on their company pages, if applicable. Some organizations will have professional social media pages for certain loan and sales staff. Those pages should be closely monitored and have an approval process for posts. It's not a bad idea to periodically monitor personal employee social media pages, but privacy settings can greatly reduce what you can see or do.

The final marketing control would be a strong marketing and social media policy. You should ensure that all employees of your organization understand acceptable social media use. This should include their own personal profile, sharing organizational marketing posts, and creating their own posts on either business or personal pages.

Redlining Risk

Identifying the Risk

We are going to break this risk down into two separate sections. Branching structure and lending performance.

To determine your organization's redlining risk, you will need a general understanding of your area demographics. You will want to find out where your low- and moderate-income and higher minority (higher risk) census tracts are located. You will also want to geocode all of your physical branch locations. If your branch locations are not in or near these higher-risk census tracts, you likely have an elevated risk specific to your branching structure.

For lending performance, you will want to determine your lending performance in your higher risk census tracts. Remember the example we talked about in Marketing? If 36 percent of your assessment area or market area is majority-minority census tracts but only 12 percent of your loans are made to those census tracts, you likely have heightened redlining risk.

Depending on the make up of your operational area, you need to determine your overall redlining risk. The reviews that you conduct need to make sense for your organization and the demographics of your area.

In the marketing section, we talked about analyzing your HMDA data and determining your performance in majority-minority census tracts. You should be comparing your performance to demographic data. In addition, you need to compare your performance to peer data if it is warranted by the size, complexity, and geographic location of your organization's physical locations.

When redlining cases are considered, a substantial majority of the facts surrounding these cases are based on the numbers. The reasoning behind strategic decisions like where should we open branches, where should we market, and what products should we offer can be subjective and open to intrepretation. However, the outcome or impact of those decisions (what the numbers say) can not be argued.

If you significantly lag behind demographic and peer data, you have work to do. Many of the redlining cases you see, those organizations lag behind peer data by 3 or more times. In other words, peers are taking more than 3 times as many applications or making 3 times or more loans than the redlining organizations were. However, we have heard of cases where organizations were lagging behind peers by as little as 1.5 times. That's a very low threshold to cross over. Data is important.

Also, just because you have a location or lenders working in majority-minority census tracts does not mean the problem has been solved. You need to look at their performance. Are they actually bringing in applications and converting them to loans? Your branch analysis might look good but if your lending is still lagging, having the location in a higher minority area may not be helping.

Determining Controls

For your branching structure, it's a bit more difficult to mitigate redlining risk. The best thing you can do for your organization, if you determine you have high risk in this area, is to inform management. If you find out your branches are avoiding higher risk areas, management will need to know so that they can make future strategic decisions on expansion. There also might be solutions in marketing or your online product platform to reach the areas that your organization likely should be serving but does not currently have a physical presence.

For lending performance, continually monitoring your organization's performance is an effective way to keep up on your redlining risk. Knowing how peer lenders are performing will help you determine if you are penetrating certain areas, geographies, or prohibited basis groups.

If weaknesses are identified, your organization may have marketing opportunities to help reduce this risk. Training is also an inexpensive way to mitigate redlining risk. If you perform your analysis and your organization is just not making loans or getting applications from certain areas, let your staff know about it and come up with ways to penetrate those markets. Ensure that marketing staff is also trained on redlining risk as they are essential in mitigating risk in this area.

REDLINING CAN BE VIEWED AS A RISK, OR IT CAN BE VIEWED AS AN OPPORTUNITY TO EXPAND AND GROW.

Complaint Risk

Identifying the Risk

While we do not have a specific module dedicated to complaints, this risk is present in the entire loan life cycle process, and it is part of a CMS. You will want to know what your organization's complaint processing procedures look like. If you work in the compliance department, there is a good chance you are part of the resolution procedures. It's common practice to route all complaints through the compliance department, or at least have the compliance officer be part of the process. If you are in the audit department, you may or may not be part of the complaint procedures.

You will want to know the number of complaints your organization receives on an annual basis. Most smaller organizations may only get a few complaints in a calendar year. We have seen many organizations go years without receiving a consumer complaint. Not having any complaints or very few complaints is not always a positive. It may not be that you are not getting complaints but more likely that you are not properly identifying complaints.

If you are over a billion dollars in assets, and you haven't received any complaints in two years, it's likely those complaints are not being recorded or reported. Examiners have a good idea at the number of complaints an organization should be receiving, so make sure you train your staff to properly record and report all complaints.

As your organization grows, you should see the number of complaints increase. If you offer higher risk consumer products like credit cards, you will likely see a larger volume. Mortgage servicing, student loans, short-term lending, and other higher risk credit products may also increase your amount of complaints.

You also want to track complaint trends. If you see an unusual increase of complaints in a certain area, there's a red flag that something might be wrong. If you recently introduced a new product, you could see a rise in complaints. If you increase fees and did the bare minimum to inform your customers, you will almost surely see an uptick in complaints. Larger organizations flag complaints based on topic/regulatory area to ensure that all fair lending complaints are reviewed as a group to identify patterns/trends.

When it comes to doing a fair lending risk assessment, you want to focus specifically on lending-related complaints. If you remember back to Module 5 the Applications Module, we told you a story of a single fair lending complaint that triggered an entire fair lending review. As a reminder, take all fair lending complaints very seriously, and if you have higher volumes of them, your risk can increase quickly and easily.

Let's share one more real-world example. Documenting pattern/trend analysis by category can really help from a fair lending standpoint. Not only do you have the data in the risk assessment, but separating it by category may reveal a greater picture - even over long stretches of time where it otherwise might be lost. This helped us understand circumstances in where misquoting rates was applied by a single individual a few times per year. At first glance, complaints regarding misquoting a rate seem harmless, but once reviewed on a year-by-year trend, we identified a single employee who did this frequently. As a result, he was referring to outdated information and didn't realize what they had was not the most recent rate offerings.

This example clearly illustrates how monitoring complaint trends can help you identify internal issues that would otherwise go unnoticed.

Determining Controls

Strong policies and procedures are the most common control to help mitigate complaint risk. Everybody at your organization should know the procedures of how to process or properly route a complaint.

Training is also an effective control over complaints. All organization staff should be trained on how to identify complaints. You do not want to be the organization that is questioned by the examiners as to why you never receive complaints. Employees need to be trained and knowledgeable on how to identify complaints and also how to record and report them.

Finally, monitoring complaint trends helps you keep up on the pulse of your organization. As previously mentioned, a large increase of complaints in a particular area is a good indication there is something wrong. Also note, a fair lending-related complaint will likely raise the inherent risk on your fair lending risk assessment in the associated area.

Other Risks

You likely have other risks than what we have identified here. You should use the risks we have identified as a starting point to conduct your own risk assessment.

Every organization will likely face the risks that we have discussed. However, you may have additional risks that are specific to your own situation. For example, if you have recently introduced a new product to the industry, you likely have new product risk.

If you have recently merged with or acquired another organization, you may have a host of new risks to deal with. You have a whole new market you need to learn. You have new employees that need to be trained on how your loan program works. You may have also inherited some new products you are not familiar with. A software program that aggregates HMDA data for all lenders can help you evaluate your company and the company being acquired or that was recently acquired.

Loan servicing is a whole other area that you can consider. We don't cover loan servicing in this course because it is not part of the loan decision; however, loan servicing sometimes gets combined under fair lending. While it's not part of the loan decision process, it can be considered the very last part of the loan lifecycle. Loan servicing brings an entirely new set of risks. The FFIEC does not define risk factors in loan servicing, but the OCC examination manual has guidance you can follow if you are looking for additional resources.

Do not limit your risk assessment to just the items we have included. Add in any risks specific to your situation and come up with metrics on how to rate those risks.

Residual Risk

What is residual risk? Most simply, it your left-over risk after considering any controls in-place.

(Initial Risk) – (Controls/CMS elements) = (Residual Risk)

This is the basic formula for risk, but it is a bit more complicated than what we have listed here. We wanted to show you the core components you should consider, and this is the basic formula our risk assessment will use. Other elements will be added and considered within the formula. Your risk complexity and methodology will vary based on your organization.

While determining residual or "left over risk" is the most subjective step in the risk assessment, it is also the most important. This is where you determine which areas have the highest risk and ultimately where you need to focus your time and effort. You may think that your areas with the highest ***initial*** risk carry the ***overall*** highest fair lending risk. However, if you have strong CMS elements in-place to mitigate the risk, your residual risk may likely be low.

The reason that this area is subjective comes from the different ways of how to calculate and measure residual risk. For example, we can use a numbering system to assign risk. Let's say for a moment that we have a risk rating scale of 1 to 5. A rating of 1 represents the lowest risk and 5 represents the highest risk. We could assign underwriting risk as a 5. Right away, you may think that underwriting is going to be a problem and the major focus of the fair lending review. But, after reviewing the entire program, we determine that there are strong policies and procedures in-place, a solid training program for lenders and underwriters, formal monitoring of loan files and decisions, and limited exceptions. Therefore, our controls may reduce the underwriting risk to a risk-rating of 2. In this case, 5 is our initial risk, and based on the strong controls in-place, we determine our residual risk to be a 2.

Now let's look at another risk – marketing risk. Let's argue that our organization engages in some product-specific marketing. We also have a strong social media presence. However, nobody reviews marketing materials prior to being published, and social media monitoring is minimal. Our initial risk-rating might be assigned a 3. With no controls in-place, the residual risk may also be a 3.

Using these two examples we can see how initially, underwriting appeared to be the much greater risk. But when looking at the whole picture, marketing is actually the higher risk. The subjective part is assigning the initial risk ratings, reducing those ratings based on your controls, and determining what scale you want to use. In this example we used a scale of 1 -5. You can use 1 – 3 or even 1 – 10. The scale is not important. Determining your highest risks is what matters. You are answering the question: **What is our fair lending risk?**

Performing the Risk Assessment

We have options to help you complete a risk assessment. We have created an Excel workbook that you can download and complete. You will see all of the loan life cycle risks we teach in this school. We have also included complaint risk and new product and market risk. You are encouraged to add any additional risks that you feel apply to your organization. This will help you assign your initial risk rating. You will then need to review your controls and come up with a residual risk rating.

If you already have a risk assessment or a Governance, Risk, and Compliance (GRC) tool, great! Use what you have learned from this course to strengthen your risk assessment. Also, consider the items included in the risk assessment we provided to ensure your assessment also includes them.

We recommend completing our risk assessment after you have finished this course. Prior to conducting the risk assessments, however, you should have conducted a CMS review of your organization. You should be reviewing all lending-related policies and procedures; your organization's training program; any monitoring efforts in-place; prior audit reports and findings; prior examination findings; and your complaint procedures, complaint log, and complaint responses.

As you go through each risk, you will want to consider what fair lending risk is present. This will be your initial risk-rating score. **Do not consider the controls you have in-place when assigning this initial risk rating.**

Let's go back to our underwriting risk rating example from earlier in this module. If you have many different high-risk/high-cost products, high lender turnover, de-centralized underwriting, and a high minority population, you may rate your initial underwriting risk at a 5.

Once you look at the controls in-place, you will adjust that rating for your residual risk rating. Let's stick with the underwriting example and argue that you have a strong loan policy that clearly spells out underwriting guidelines, step-by-step checklists that loan staff use each time, periodic training of the process, frequent monitoring, and minimal policy deviations. These factors could support your argument that your residual risk is a 2.

Assigning the initial risk rating is what risk you have before any controls are considered. This can be difficult, so it may be beneficial to conduct this assessment in a small group and talk it out. Be sure that you are not considering controls until the second step. Also, you will want to ensure that you have buy-in from the different departments or business units to ensure that all applicable parties understand the risks. It may help shape business practices, resources, and other key decisions.

In the end, you will have to adjust your initial risk rating to reach your residual risk rating. Again, this is very subjective. How much do you lower the rating if you have good policies and procedures in-place? Well, that depends. Having well-written policies and procedures in-place are great, but if they are never followed, they do little, if anything, to reduce your initial risk rating.

Once you have completed the risk assessment, communicate risk to senior and executive management as applicable. This process may vary by organization. Some leadership teams prefer to see only major issues, while others prefer to see a full picture.

Conclusions & Next Steps

Now that your risk assessment is complete, you should know where your higher risk areas are. This is where you will want to focus your resources. By resources, we mean your CMS elements. If your residual risk in an area is high because of a lack of policies and procedures, it makes sense that you will want to spend time developing them. If areas lack any monitoring or audit, you should focus your compliance review and audit resources accordingly.

You should also consider your organization's risk appetite and determine if it aligns with your organization's framework? Every organization has a risk appetite, or a desired level of risk if you will. Some organizations are very conservative. They offer industry standard products and services and seek slow and steady growth. Other organizations are aggressive and push the envelope. They seek to grow quickly and expand market share. After you have completed your risk assessment, does your framework align with your risk? If you are on the aggressive side of the risk spectrum, you will need a much stronger and well documented CMS in place.

In Module 4, we discussed Reviewing Your Program. Your risk assessment should be paired with your program review. We put the risk assessment after the loan life cycle risks because you need to learn what those risks are before you can properly assess what risks you have.

Remember – the risk assessment is only one tool. Use it as such.

Final Quick Case Study

One of our team members was working for a multi-billion dollar bank that doubled in size between exams due to a merger. Our internal risk assessment kept us on pace to effectively document the program for the examiners. The regulators essentially told us that they took our risk assessment and copy/pasted directly into theirs. Our assessment made their life easier, and we actually helped frame the narrative. This especially helped in particular areas that would have warranted much further discussion.

One specific example was exceptions to policy, but the risk assessment clearly documented the mortgage lending process for approving exceptions and the compliance process for reviewing/performing reviews. This also shortened the exam by one week because the exam team had a much better picture of risk and was able to more effectively scope the review. We are not trying to imply that the examiners did not do their jobs by properly evaluating the institution. What we're saying is that a risk assessment needed to be completed, and we took the time to do a thorough job creating one. This meant the examiners did not have to recreate the wheel and could leverage off of the work we already did. It was a win-win for everyone.

Updating Your Risk Assessment

How often should you perform a fair lending risk assessment? Again, the answer here is a bit subjective and open to opinions. At a minimum, you should be conducting your risk assessment on an annual basis. However, if you ever have major changes in your program, you can update the parts of your risk assessment that are affected. For example, if you acquire another institution or start a whole new business line (like credit cards), it might be a good idea to update the assessment at that time. Finally, retain your risk assessments for at least 3 years. Risk assessments help document the program and changes in the event of turnover, significant change to products, services, business strategy, etc.

MODULE SUMMARY

You should have a pretty good idea on how to conduct a risk assessment. This process is part art and part science. You may want to have discussions with your team members or management before you come to any conclusions. Be open to such discussions. As a compliance or audit professional, you should have a pretty good picture of the overall risk of your institution; however, you likely won't be an expert in many of these areas. Rely on others to explain how products and processes work, and work together to help determine your fair lending risk.

Remember – this is only a tool. Use it to help you find risk and determine where to allocate your limited resources.

1071 - SMALL BUSINESS DATA COLLECTION

This is a topic that will gain a lot of traction in the years to come for fair lending. Right now, it is a very technical regulation. During the implementation of 1071, our industry will be in the data collection phase of small business data. Much like with HMDA data, this process is very technical in nature. While the data will have a major impact on your organization's fair lending program, it will be some time yet before we will see what any of that data looks like and how the regulatory agencies will intrepret that data.

It is hard to predict the future on 1071. It is hard to say today what 1071 data will look like for your organization years down the road after you have reported small business data for several years and get to your first fair lending review, so we don't want to pull out the crystal ball just yet. However, we do have a template. 1071 is not HMDA, and 1071 is not HMDA data, but it is similar. It is demographic and geographic data on small businesses much like HMDA is on home loan applications. Therefore, it is not a stretch to believe that we won't be able to do similar reviews on 1071 in the future.

We do plan to add to this course a 1071 module once we have enough information on what this data will look like and its impact on fair lending. For now, it's only data collection. What we can say is that you need to be prepared to have your commercial loan department scrutinized as harshly as consumer and mortgage lending is today.

What does that mean? Everything in the loan lifecycle will be up for grabs in commercial lending. Let's briefly walk through what that means for you today.

Application Risk - Your application process and discouraging applicants. If your organization is one of those that never seems to have commercial loan denials (most that we have been to are guilty of this), be prepared to be criticized. Start training your commercial lenders now that they need to actually take applications, process them, and issue actual adverse action notices.

Steering Risk - Make sure you are not steering women and minority owned businesses into government guaranteed loan programs like SBA loans when they may qualify for cheaper conventional financing.

Underwriting Risk - Your denial rates to different prohibited basis groups will be scrutinized, and your policies and procedures need to be clear and concise.

Pricing Risk - Be ready to see pricing reviews for commercial loans similar to what we teach in this course. Establishing good pricing practices for commercial lending and consistently following them is a strong step in the right direction today.

Exception Risk - Make sure you have a process to approve exceptions, you're tracking them, and monitoring much like you would for consumer lending.

Denial Risk - Your denial rates will be a big risk. If you are an organization that has very few commercial denials, the time to start fixing that problem is now, not when you are reporting a year or two worth of data confirming that fact.

Marketing Risk - Make sure you are marketing commercial loans in all parts of your area, but this will be different as you will be marketing more in commercial parts of your community. Marketing needs to make sense for commercial lending, so commercial loan marketing may not always be in majority-minority areas.

Redlining Risk - Be performing an analysis of your commercial lending now to see how your organization is performing. If you are a large bank under the CRA, you already have the data available. If you are not, use the procedures we taught in the redlining module and start geocoding. We fully anticipate to see redlining cases in the next few years specific to commercial lending once more data is available. Do not let that be you.