CONVERSATIONS
WITH THE ST. LOUIS FED

FEDERAL RESERVE BANK of ST. LOUIS
CENTRAL TO AMERICA'S ECONOMY®

July 31, 2018

1:30PM to 2:30PM CDT

Fair Lending: Can You Make Exceptions?

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Today's Presenters

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Disclaimer

The opinions expressed in the presentations are intended for informational purposes, and are not formal opinions of, nor binding on the Federal Reserve Bank of St. Louis or the Board of Governors of the Federal Reserve System.

Presentation Overview

- Equal Credit Opportunity Act/Fair Housing Act
- Interagency Fair Lending Procedures
  - Consumer loan pricing
  - Consumer loan underwriting
- Controlling fair lending risk

Equal Credit Opportunity Act

- The purpose is to promote the availability of credit to all creditworthy applicants without regard to:
  - Race or color
  - Religion
  - National origin
  - Sex
  - Marital status
  - Age (provided the applicant has the capacity to contract)
  - Income derived from a public assistance program
  - Exercise of any right in good faith under the Consumer Credit Protection Act

Fair Housing Act

- Unlawful to deny a loan or other financial assistance for the purpose of purchasing, constructing, improving, repairing, or maintaining a dwelling based on the applicant's:
  - Race or color
  - National origin
  - Religion
  - Sex
  - Familial status (defined as children under the age of 18 living with a parent or legal custodian, pregnant women, and people securing custody of children under 18)
  - Handicap

Interagency Fair Lending Procedures

Types of discrimination:

1. **Overt** – Loan policy states “we don’t make loans in minority neighborhoods.”
2. **Disparate Impact** – Loan policy states “we will not make home loans less than $75,000” and most homes in the area with values under $75,000 are in minority neighborhoods.
3. **Disparate Treatment** – Similarly situated loan applicants from minority and non-minority neighborhoods experience different treatment without explanation.

Disparate Treatment

- For banks located in diverse metropolitan markets, ***redlining*** analyses evaluate the risk that the bank is treating minority neighborhoods differently than non-minority neighborhoods.
- For banks with multiple lending channels, examiners will ensure that loan applicants are not being ***steered*** towards a particular product on a prohibited basis.
- For all banks involved in consumer lending, examiners will compare the treatment of similarly situated members of different groups in the ***underwriting*** of loan applications and the ***pricing***, terms, and conditions of loan originations.

Disparate Treatment

- How does disparate treatment occur?
  - **NOT** necessarily through intentional actions
  - Bank policies and procedures that allow for **INCONSISTENT** treatment of loan applicants, and the inconsistencies result in less favorable outcomes for members of a prohibited basis group
  - The inconsistencies result in a **PATTERN** of less favorable outcomes along a prohibited basis

Underwriting and Pricing Analyses

- Materiality
- Discretion
- Financial Incentives
- Disparities

Underwriting and Pricing – Materiality

- Underwriting and pricing analyses are focused on loan products that are deemed material by examiners.
- Material products are loan types originated at a high enough volume to show a pattern of disparate treatment over time.
- Loans are grouped for analysis based on the bank's underwriting and pricing policies and procedures (e.g. vehicle-secured, unsecured, home equity lines of credit, indirect auto, etc).

Underwriting and Pricing – Discretion

- If a product is deemed material, examiners determine if there is a possibility that discrimination could occur on a prohibited basis in the underwriting and pricing of a loan.
- If a bank has very specific standards and inability to deviate from the standards, fair lending risk is ***low***.
- If a bank has vague or unwritten standards, fair lending risk is ***high***.

Underwriting and Pricing – Discretion

- Most banks fall somewhere in between:
  - Specific underwriting and pricing standards
  - Lenders have the authority to make exceptions

- The greater the frequency of exceptions, the higher the chance that they could be made in a way that results in a pattern of disparate treatment.

- Unless exceptions rates are very low, the authority to make exceptions represents heightened discretion and therefore elevated fair lending risk.

Examples of Discretion

	Applicant 1	Applicant 2	Applicant 3
Credit Score	775	775	775
Debt-to-Income	30%	30%	30%
Loan-to-Value	96%	96%	96%
Loan Amount	$100,000	$100,000	$100,000
Race/Ethnicity	Not Hispanic	Not Hispanic	Hispanic

Scenario 1	Applicant 1	Applicant 2	Applicant 3
Automated underwriting system; no exceptions	Deny because LTV is outside of policy.	Deny because LTV is outside of policy.	Deny because LTV is outside of policy.

Examples of Discretion

	Applicant 1	Applicant 2	Applicant 3
Credit Score	775	775	775
Debt-to-Income	30%	30%	30%
Loan-to-Value	96%	96%	96%
Loan Amount	$100,000	$100,000	$100,000
Race/Ethnicity	Not Hispanic	Not Hispanic	Hispanic

Scenario 2	Applicant 1	Applicant 2	Applicant 3
Manual underwriting; loan policy doesn't include specifics	Deny; no reason documented.	Approve; no reason documented.	Deny; no reason documented.

Examples of Discretion

	Applicant 1	Applicant 2	Applicant 3
Credit Score	775	775	775
Debt-to-Income	30%	30%	30%
Loan-to-Value	96%	96%	96%
Loan Amount	$100,000	$100,000	$100,000
Race/Ethnicity	Not Hispanic	Not Hispanic	Hispanic

Scenario 3	Applicant 1	Applicant 2	Applicant 3
Manual underwriting; lender applies guidelines in loan policy	Deny because LTV is outside of policy.	Approve because lender and applicant are related and LTV is just barely out of policy.	Deny because LTV is outside of policy.

Examples of Discretion

	Applicant 1	Applicant 2	Applicant 3
Credit Score	775	775	775
Debt-to-Income	30%	30%	30%
Loan-to-Value	96%	96%	96%
Loan Amount	$100,000	$100,000	$100,000
Race/Ethnicity	Not Hispanic	Not Hispanic	Hispanic

Scenario 4	Applicant 1	Applicant 2	Applicant 3
Automated underwriting system; lenders have discretion to make exceptions for any reason	Deny because LTV is outside of policy.	Approve because the applicant was a strong negotiator and the lender got documentation that a competitor will make this loan.	Deny because LTV is outside of policy.

Examples of Discretion

	Applicant 1	Applicant 2	Applicant 3
Credit Score	775	775	775
Debt-to-Income	30%	30%	30%
Loan-to-Value	96%	96%	96%
Loan Amount	$100,000	$100,000	$100,000
Race/Ethnicity	Not Hispanic	Not Hispanic	Hispanic

Scenario 5	Applicant 1	Applicant 2	Applicant 3
Automated underwriting system; lenders have discretion to make exceptions for certain reasons	Deny because LTV is outside of policy.	Approve because the LTV maximum can be overridden if the applicant qualifies for the unsecured credit equal to the loan amount in excess of 95%.	Deny because LTV is outside of policy.

Pricing – Financial Incentives

- Fair lending risks associated with discretion are exacerbated by financial incentives to exercise that discretion.
- A 2011 update to Regulation Z prevents mortgage loan originators from receiving additional compensation from marking up mortgage interest rates.
- It is common in indirect automobile lending arrangements for the dealer to have the ability to increase its compensation on a loan by increasing the interest rate over the bank's risk-based rate.

Underwriting and Pricing – Disparities

- If examiners determine that fair lending risk associated with discretion (and financial incentives for pricing) is elevated, the next step is to review the bank's electronic data to look for statistical differences along a prohibited basis.
- For underwriting, examiners will look at denial rates and/or underwriting exception rates.
- For pricing, examiners will look at average interest rates, fees, APR, and/or pricing exception rates.

Underwriting and Pricing – Disparities

- Examiners will focus on areas where there are ***statistically significant*** disparities between a control group and prohibited basis group – looking for a pattern.

	# Single Female	# Single Male	Disparity	# Hispanic	# Non-Hispanic	Disparity	# Majority Minority Tract	# Non Majority Minority Tract	Disparity
Direct Vehicle	71	185	-0.21	3	547	0.52	0	388	0.00
HELOC	35	42	0.25	4	227	-0.21	0	200	0.00
Other1	13	11	0.13	1	40	-0.17	0	32	0.00
Secured Personal	5	40	1.24	1	95	2.13	0	68	0.00
Unsecured	34	73	0.35	2	204	0.63	0	145	0.00

Statistical Significance of <1% or <5%
Statistical Significance of <10%
Statistical Significance of >10%

Underwriting and Pricing – Disparities

- Statistical significance does not mean a violation has occurred.
- Examiners will use these calculations to further focus efforts and collect additional information that could potentially explain any disparity (credit risk, loan terms, etc).

Underwriting and Pricing – Disparities

- Lack of statistical significance likely indicates that there is not a strong pattern of discrimination.
- BUT this doesn't always mean that there is no risk.
- Examinations that identify high risk of future violations may result in requirements that the bank enhances its controls.
  - Most of the time this will involve implementing specific pricing and underwriting criteria.
  - Additional controls are determined by the frequency with which the bank chooses to allow exceptions to these criteria.

Can You Make Exceptions?

Can You Make Exceptions?

Yes!*

*If You Are Controlling Fair Lending Risk

- Exceptions to policy are normal.
- But without controls, individual exceptions can develop into a pattern of discrimination.
- Controls should be right-sized to the frequency of exceptions.

Controlling Fair Lending Risk

- Controlling fair lending risk is effectively maximizing consistency.
- Ensure consistency by:
  - Clearly defining pricing/underwriting criteria and acceptable exception reasons,
  - Requiring secondary approval for exceptions,
  - Tracking exceptions over time,
  - And if necessary, conduct fair lending monitoring or internal reviews to prove that exceptions do not indicate a pattern of discrimination.

Controlling Fair Lending Risk

- If exceptions are frequently occurring, this may be an indication that lending standards need updating.
- Periodic monitoring should be an early warning system used to prevent fair lending violations.
- Contact your regulator if your periodic reviews raise concern regarding fair lending risk.

Recap

- Making exceptions to policy is normal and completely acceptable from a fair lending standpoint.
- Examiners are not scrutinizing individual exceptions to identify discrimination.
- Examiners are concerned with identifying a pattern of discrimination along a prohibited basis.
- Banks just need to ensure that the risk associated with making exceptions is being identified and properly controlled.

Questions

Via webinar chat: You can submit a question via the **Ask Question** button in the webinar tool. Your question will only be seen by our presenters.

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Appendix

- FFIEC Interagency Fair Lending Examination Procedures: https://www.ffiec.gov/pdf/fairlend.pdf

- Tools for Monitoring: https://www.consumercomplianceoutlook.org/outlook-live/2013/indirect-auto-lending/