

# Focus on fair lending



***Self-assessment and risk review are key to effective compliance in today's regulatory environment***

*By Jeffrey Robb*

As the regulatory environment continues to grow increasingly complex, so does the regulators' focus on fair lending requirements. Along with the changes enacted within the Dodd-Frank Act, one of the major issues will be the collection of additional and more detailed fair and small business lending-related data.

Therefore, any data that your institution uses to make a credit decision or determine how a loan will be priced should be collected. Once this data is collected, you should analyze it during the course of your review.

Making sure your bank is prepared for its next fair lending exam begins

with the basics. At last year's American Bankers Association Regulatory Compliance Conference in Chicago, attendees heard over and over again from bank regulators that the place to start is a fair lending self-assessment.

## Fair lending risk assessment

The first step is to get an overall picture of the fair lending risk that each line of business or product brings to your institution. With each line of business, you should determine the inherent risk by reviewing the fair lending issues with marketing, underwriting, pricing, overt, steering, redlining and operating activities. This risk should be scored and weighted based on volume and probability of occurrence.

Then, determine the residual risk based on six factors: internal controls, training, compliance testing, segment level reviews (quality control), prior regulatory issues and prior consumer complaints, assigning each factor points for the level of reliance. The total level of reliance points are subtracted from the total inherent risk to arrive at the residual risk score.

Failure to complete and have a fair lending self-assessment surely will catch the eye of federal regulators, who are eager to demonstrate more stringent fair lending audits. The mortgage meltdown and a recent letter from the U.S. House of Representatives' Financial Services Committee to the General Accounting Office, asking them to investigate the effectiveness of bank regulators' fair lending oversight, are both motivating factors.

Performing a self-assessment will help your bank determine the process and procedures that will help it prevent fair and anti-predatory lending infractions before they occur, instead of dealing with them after the fact. And that will lead to a more profitable portfolio and happier customers and regulators.

A good fair lending self-assessment forces you to thoroughly examine your portfolio for instances of discrimination and illustrates how some of your policies and procedures may be the underlying cause. It enables you to identify any potential disparate decisioning or pricing before the examiner does, and gives you the opportunity to both find it and fix it. Every regulator appreciates this.

Now that we know the overall risk each line of business brings to your bank, the next step is to per-

form a fair lending review of the riskiest lines of business. So how do you perform a fair lending risk review that helps you make sure your fair and anti-predatory lending program will protect your customers, keep you in the black and continue a good working relationship with regulators? There are eight different steps to do so effectively:

### Step one: Collect and analyze HMDA and other fair lending data

To do a complete Home Mortgage Disclosure Act (HMDA) lending analysis that allows you to identify if your lending and pricing decisions are based on applicant risk or if decisioning and/or pricing is based on borrower characteristics, you will need to collect more than just the required HMDA data. You should start by collecting HMDA data, but then also collect the optional data to be able to calculate rate spreads and then continue to acquire additional "fair lending" data.

This additional data needs to include the data you use to ascertain applicant risk. This can be mostly accomplished by asking two main risk questions: Does the applicant have the ability to repay this loan and does he have the willingness to repay the loan? These questions are usually answered by the applicant's

debt-to-income ratio and credit score.

You also need to collect pricing information, such as annual percentage rate, note rate, fees and points. Also needed is a way to identify the type of loan and where the application came from (for instance, a broker, loan office, loan officer or underwriter). You should also map your fair lending data process flow, understand how the application and loan data gets into your systems, know where it is stored and how the data gets tested and corrected.

### Test data integrity

You must test your data integrity and go beyond the FFIEC Edit Checks. Do your own data quality testing. Utilize the standard summary reports and data quality reports and shoot for a 0 percent error rate, as opposed to the 5 percent specified by HMDA. In your testing, you should share the results with the lending line of business and management, especially if the results are recurring and correctable.

### Step two: Review your last exam and any consumer complaints

Regulators tend to start where the previous exam ended. So in preparing for your next exam or your current fair lending review, one of the best places to start is with any



action items left over from the last exam. You should also review any issues you have identified through your consumer complaint tracking systems if you have them.

This is also a great time to review your policies and procedures for overt discrimination. Know your board's knowledge of fair lending requirements. How often do they discuss or meet to review the bank's fair lending performance? Are there minutes to those meetings you can review?

### Step three: Identify focal points

As you review your bank's fair lending performance, start with the focal points identified through your public data. You will want to know if you will be considered an "outlier" bank, which means you have failed in one or more of the marketing, underwriting or pricing benchmarks. First, do you have major marketing concerns? To whom are you lending? Is there a segment of the community that you are missing? Why?

Next, with regards to underwriting, what is your declination ratio to each of the prohibited basis characteristics, borrower as well as tract (i.e., redlining)? Measure these against the industry benchmark of 2 to 1. This ratio continues to make headlines. For example, "blacks are two times more likely to be denied than whites."

Also, test to see, based on percentage and volume, if your results are statistically significant. You may be under the 2-to-1 benchmark but still have an issue.

Finally, what issues does your pricing above the HMDA rate threshold indicate? Again you can utilize the 2-to-1 benchmark, but remember to test for statistical significance. Don't forget to look at the big picture if you are showing issues with marketing, underwriting and pricing to the same prohibited basis group. Could you have a disparate impact and/or treatment issue that you need to review more in-depth?

### Step four: Perform other risk assessment reports

To start the next "more in-depth" portion of your review, you will need to perform and review some other risk assessment reports. Let's start with a steering test. Are a disproportionate volume of loans to prohibited basis groups going to Federal Housing Administration (FHA) or Veterans Administration (VA) loans, which can be more costly to the applicant? Using the FHA/VA vs. conventional test, along with the HMDA rate threshold test, can help determine if more minorities or other prohibited basis groups are getting more costly loans than white applicants or their control groups.

Next, in this current market with housing values dropping instead of climbing, you need to test if a disproportionate number of declines in minority areas are due to collateral. If this is happening, you may be subject to an appraiser review as part of any fair lending exam.

Another test that regulators focus on is credit score overrides. The underwriting override reports use credit score as the determinant for overrides. High side reports look for applications that should be approved but were denied, thus maybe showing one group was held to a higher standard.

Conversely, the low side reports look for applications that should be denied but were given the benefit of the doubt. These override reports provide an indicator that you may have issues with how prohibited basis groups are treated through your underwriting process.

Utilizing a difference of means test, you can start to identify if there is a statistical difference in averages to each of the different borrower and tract characteristics of the factors in your underwriting and/or pricing. These statistical differences can start to help explain disparities in your underwriting and/or pricing.

### Step five: Regression analysis

Regression analysis, a critical component to a fair lending program, is the industry standard for helping to identify and mitigate disparate impact. Regression analysis allows for a 100 percent review of your portfolio for risk and not just a random sample. The results of regression analysis will allow you to be able to combat the results of any negative focal points.

Regression analysis is a statistical operation that calculates the relationship between lending variables used for decisioning and/or pricing and the outcome or the actual decision or price assigned to the applicant(s). This is accomplished by simultaneously controlling for many of the factors that are important in the lending process.

By controlling for the more common factors used in the decision



The fair lending review pyramid.



and pricing process, your bank is able to determine if there is a pattern or practice that favors one prohibited basis group. Also, this method allows your bank to look at all of its applications for pattern or practice and not just a random sample, which may or may not identify issues with regard to disparate treatment or impact.

### **Step six: Comparative file analysis**

Let's continue with the regression results and compare whether product was a factor by looking for comparators that were similarly situated but had a different outcome or price. This truly provides the fair lending officer with a list of applications or loans that must be reviewed. Based on the data that has been controlled for, these applicants or loans are possible proof of disparate treatment.

### **Step seven: Evaluating third party relationships**

If you utilize brokers or dealers, you must conduct an analysis to determine if they are causing prohibited basis groups to be disparately treated or impacted. The bottom line is that you are responsible for their behavior, so you must monitor third-party actions.

### **Step eight: File review**

Our last step in a truly effective fair lending review is a file review.

Now that we have identified applications and/or loans that seem to be proof of disparate treatment, you must determine what actually happened in the underwriting process that is not supported by the data that was provided. Most likely these applications/loans will be the same ones identified by your regulator for review. This clearly allows you to review these applications/loans well before regulatory scrutiny and have the answers ready for discussion.

The basics of your fair lending program must force you to find it, report it and fix it. Look for the focal points that will make you an outlier bank in the eyes of your regulator. Identify files that are outside of your normal decisioning or pricing matrix based on risk and, finally, review those files for disparate treatment.

Performing a fair lending self-assessment is the key to developing and maintaining a strong and effective regulatory compliance program. By following these steps, you can be certain your bank will be prepared to illustrate to regulators it is doing everything possible to underwrite solid, profitable loans that are non-discriminatory. ♦

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