

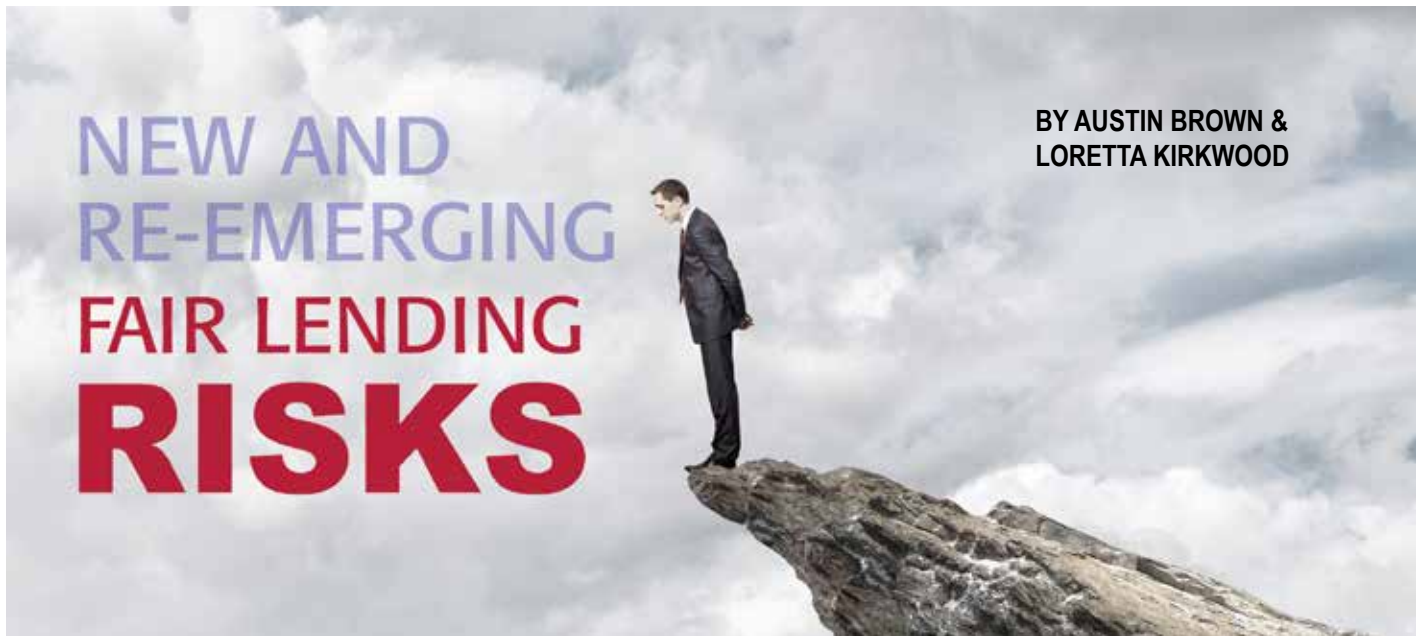


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**New and Re-emerging
Fair Lending Risks**

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NEW AND RE-EMERGING FAIR LENDING RISKS



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Regulators have been focused recently on several new and re-emerging fair lending issues during examinations and investigations of mortgage lenders.

New risks and renewed interest in “old” risks ... These are the continuing challenges in the ever-changing world of fair lending risk management. Regulators have been focused recently on several new and re-emerging fair lending issues during examinations and investigations of mortgage lenders. Some of these issues have been front of mind for compliance personnel for years, while others are a direct result of the new rules that became effective in January 2014.

Two specific issues – redlining and fee consistency – are creating unique challenges that warrant careful review by compliance staff. The first issue, redlining, was the subject of one of the first fair lending enforcement actions by the Department of Justice (“DOJ”) in the early 1990s. Nonetheless, focus by the regulatory agencies on redlining issues has ebbed and flowed over the past decade. Recently, the DOJ, the Consumer Financial Protection Bureau (CFPB), and other regulatory agencies have aggressively pursued redlining cases, and have identified redlining as one of their top fair lending enforcement priorities.

The second issue, fee consistency, relates to the practice of some lenders to waive or reduce fees for certain customers or to vary fees based on specific factors, such as the market in which the borrower is

located. Although regulators have historically focused on APR and overages/underages as metrics for fair lending analysis of mortgage loan pricing, they have recently sought to analyze fees in isolation.

Overview of Recent Fair Lending Enforcement

As compliance personnel know, the Equal Credit Opportunity Act (ECOA) and the Fair Housing Act (FHA) are two of the most important consumer compliance statutes applicable to the mortgage industry. Each statute prohibits discrimination with respect to certain “prohibited bases,” such as race, ethnicity, or gender, and each can be an important focal point in compliance-related examinations. Fair lending examinations by regulators typically include a review to determine whether pricing or underwriting practices have resulted in a disparate impact on a prohibited basis, or whether data shows evidence of disparate treatment.

Compliance with the ECOA and the FHA has also been the subject of a number of enforcement actions over the past two decades, resulting in significant restitution to borrowers. For example, in 2013, the Department of Justice entered into four Consent Orders relating to fair lending matters in the mortgage industry, with restitution to

borrowers totaling more than \$41 million. Likewise, in 2012, the DOJ entered into four fair lending-related mortgage settlements, with approximately \$208 million returned to borrowers.

The prudential regulators have also played an active role in fair lending enforcement recently, referring more than 20 fair lending matters to the DOJ during 2013. DOJ, 2013 Annual Report to Congress Pursuant to the Equal Credit Opportunity Act Amendments of 1976 (July 2014). In fact, the number of public enforcement actions relating to fair lending in the mortgage industry paints only a small part of the fair lending picture, as several of the referrals from the prudential regulators to the DOJ have been returned to the agencies for non-public resolution.

Just as the number and magnitude of fair lending settlements have grown in recent years, so has the breadth of issues involved in the settlements. In 2013, the fair lending allegations in DOJ and HUD enforcement actions ranged from standard pricing and underwriting disparities to maternity leave discrimination and discrimination against disabled applicants. Despite this evolution of fair lending enforcement, however, several common issues continue to appear as focal points in fair lending matters, or have re-emerged in recent years.

Redlining

One issue that has re-emerged recently as a fair lending enforcement priority is “redlining,” or the practice of excluding high-minority communities from lending activities, including marketing. In general, the bank regulatory agencies and the DOJ initiate fair lending enforcement relating to redlining when they believe that a lender has served the credit needs of non-minority neighborhoods to a significantly greater extent than it has served the credit needs of majority-minority neighborhoods.

When alleging redlining practices in violation of the ECOA or the FHA, the enforcement agencies often rely on circumstantial evidence of intent to exclude high-minority communities from an institution’s lending or marketing. For example, the DOJ has alleged the following facts, among others, in recent redlining complaints:

- The percentage of an institution’s lending in high-minority census tracts or to minority borrowers is low in comparison with other institutions in certain geographic regions.
- The institution’s application or origination volume is concentrated in low-minority areas surrounding

high-minority areas.

- The institution has defined its assessment area with “partial geographies” to exclude high-minority areas.
- The institution has excluded minorities or high-minority areas from marketing efforts.
- The institution has placed branches predominately in low-minority areas.

Not surprisingly, lenders that face redlining allegations seek to resolve the matters as soon as possible, with as little publicity as possible. Since the first DOJ redlining complaint in 1994, no lender has litigated a redlining complaint against the DOJ to verdict. Perhaps as a result, the monetary commitments made by lenders to resolve allegations of redlining have been significant. For example, in a 2011 case, *United States v. Citizens Republic*, the Bank agreed to resolve redlining allegations by opening a loan production office in an African-American neighborhood and invest more than \$3.6 million in the community. Settlement Agreement dated June 23, 2011, *United States v. Citizens Republic Bancorp, Inc.*, No. 2:11-cv-11976-LPZ-LJM (E.D. Mich. June 28, 2011), available at: <http://www.justice.gov/crt/about/hce/documents/citizenssettle.pdf>.

Given the significant focus on redlining by the CFPB, the DOJ and prudential regulators, lenders should consider taking a number of steps to proactively assess their redlining risk. As an initial step, lenders should identify relevant markets for analysis. For example, banks should analyze their assessment area data, while other lenders may need to define their own market areas for analysis. In addition, banks should analyze data for Metropolitan Statistical Areas (MSA), to the extent their assessment areas do not include entire MSAs.

Once the appropriate geographic areas have been identified, the type of redlining analysis required depends upon a number of factors, including distribution channels and products. For example, lenders may consider comparing the demographic composition of the markets that they serve to the demographic composition of their applicants. Similarly, lenders should consider reviewing their percentages of applications and originations in specific census tracts in light of relevant demographic and housing factors, such as the distribution of census tracts between high-minority and low-minority, the availability of owner-occupied housing, the unemployment rate, and the poverty level.

Lenders should also consider comparing their ap- ►

plication and origination data to other HMDA-reporting institutions in the relevant geographic areas, including “peer” institutions, to identify any statistically significant differences. Although defining a “peer” institution can be difficult and can take many different forms, the Federal Reserve has stated, for example, that it considers peers to be those institutions with 50%-200% of the comparator’s application volume, with a rate spread incidence of less than 25%. Maureen Yap, Fair Lending Webinar Questions and Answers, Federal Reserve Board Consumer Compliance Outlook, Second Quarter 2013, at 15.

Finally, in addition to analyzing lending performance data, lenders should consider analyzing, where applicable:

- Whether branches or sales offices are located exclusively, or almost exclusively, in low-minority census tracts.
- Whether the institution’s marketing efforts are disproportionately focused on low-minority communities.
- Whether the institution excludes from its assessment or market area high-minority geographies that surround low-minority geographies.

By addressing these issues proactively, lenders may be better prepared to answer questions that arise during compliance examinations or investigations relating to their lending performance, and may also be able to take steps to improve their lending performance for future examinations.

Fee Consistency

A second fair lending issue that has arisen recently during fair lending examinations is fee consistency. Historically, regulators have focused on determining whether loan pricing practices, such as assessing overages, have resulted in disparities based on ethnicity, race, gender or other prohibited bases. Recently, however, regulators have analyzed fees in isolation. For example, regulators have sought data relating to underwriting and processing fees during recent examinations of mortgage originators.

This recent focus on fee consistency likely results from two important factors. First, the Federal Reserve amended Regulation Z effective as of April 1, 2011 to prohibit compensation to loan originators based on the terms or conditions of loans. The purpose and effect of this change was to eliminate the

practice of compensating loan originators based on overages, which incentivized loan officers to charge rates above par. Now that this incentive has been eliminated, however, regulators have shifted their attention to other pricing metrics.

A second important factor in the recent focus by regulators on fee consistency is the fact that many loan originators continue to have discretion to vary fees on a transaction-by-transaction basis. Likewise, some lenders charge different fees or waive fees to customers based on a number of factors, such as where the customer lives (regional fee differences) and, for banking institutions, whether the customer has a significant amount of funds on deposit.

Variations in fees on a transaction-by-transaction basis can lead to disparate treatment or disparate impact concerns if average fees differ between borrowers on a prohibited basis. Accordingly, lenders should carefully evaluate their practices to ensure compliance with the fair lending laws.

First, lenders should consider conducting analyses of standard fees that are charged to customers to determine whether they differ, on average, based on race, gender, ethnicity, or other prohibited bases. Any differences would not necessarily indicate fair lending violations, but would warrant additional analysis to determine the reasons for the differences.


Second, lenders should consider preparing written “business necessity” documents that explain the reasons for any fee differences based on geography, deposit relationships, or other factors. For example, a business necessity document relating to fee differences based on geography may describe practices by specific competitors and explain that the fees established by the lender are necessary to compete in the market. By documenting the business necessity, lenders will be better prepared to address any disparate impact concerns that regulators may raise during examinations or investigations.

Third, in order to effectively monitor fee exception activity, lenders should consider establishing a list of acceptable and quantifiable reasons for fee waivers or reductions and requiring loan officers to document the reason for any exceptions in the loan file. The lender should also periodically audit fee exceptions to ensure compliance with established policy and to address any evidence of potential disparate treatment.

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Wrap-Up

Compliance staff face a number of complex challenges in monitoring fair lending compliance. Redlining and fee consistency are just two focal points identified in recent fair lending examinations of mortgage lending institutions. We expect that many lenders will face questions about these issues in the near future. By taking steps to address these risks now, compliance staff may be better equipped to answer, and hopefully resolve, any concerns that regulators may raise. 

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