Federal Deposit Insurance Corporation
Division of Depositor and Consumer Protection

FDIC Newsletter: Implementing a Fair Lending Action Plan to Manage Discretion in Credit Decisions

Discretion: Webster's Dictionary defines it as individual choice or judgment. For lending personnel, discretion could arise due to the ability to deviate from stated policies or procedures, or making credit decisions in circumstances where procedures are unclear. Most loan officers typically have some degree of discretion, and bank management expects them to use good judgment in determining whether to approve an application and how to price loans. The latitude an institution allows its loan officers varies, often depending on the experience of the loan officer or in the controls established by the bank. This article seeks to provide information on effectively managing and monitoring the use of discretion to ensure credit decisions are not based on any of the prohibited bases set forth in either the Equal Credit Opportunity Act or the Fair Housing Act. See the Interagency Policy Statement on Discrimination in Lending[1] for additional information.

When is discretion used? Discretion is often exercised in underwriting and pricing decision processes, but may also exist in other aspects of a credit transaction, including during the application, loan servicing, collections, and post-maturity processes. Discretion may be present within the institution, but may also be granted to third parties, such as automobile dealers who are granted discretion to "mark-up" the institution's "buy rate" or, alternatively, give concessions on granted rates.

The latitude given to bank employees in exercising discretion is unique for each bank, and may vary by product type. In some banks, significant discretion is allowed across all types of bank products, while at other banks discretion is curtailed through in-depth underwriting processes, rate sheets, or other bank-enacted controls. In some cases, no discretion is allowed, such as when credit card applications are underwritten and priced by an automated system with strict credit-related parameters. You may ask, "How much discretion is too much?" There is no single answer appropriate in all cases. Rather, first and foremost, to avoid fair lending problems, an institution may want to ensure it is aware of where discretion exists so it can decide how best to mitigate such risks. This is typically done by conducting a risk assessment that includes evaluating the content of policies and procedures. For example, if an institution is unaware that its policies and procedures are unclear to its loan officers, resulting in an unintended use of discretion by its officers, this could be an area of risk that is currently unknown and unmitigated. Thus, institutions would be well-advised to ensure they have properly identified fundamental areas of risk in their processes, products, and services.

Discretion in and of itself is not prohibited, nor is it discouraged when appropriate controls are in place. As noted previously, banks expect their loan officers to exercise good judgment in determining which loan applications present an acceptable credit risk, and price those loans to earn an acceptable level of return based on the perceived risk. When significant discretion is allowed in credit decisions, it is in the bank's best interest to periodically review various factors for trend purposes such as application processing times, underwriting and pricing, and other credit-related decisions to determine whether an applicant has been treated less favorably on a prohibited basis. In other words, a greater level of discretion warrants heightened scrutiny.

In determining the level of resources to allocate to monitoring the exercise of discretion, a bank may want to consider the elements of an effective compliance management system as it relates to fair lending such as consideration of the size and complexity of the institution's lending program, the tenure and training of staff, and past fair lending findings from internal or external audits or regulatory examinations.[2] Additionally, a bank may want to consider level of centralization in

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[1] https://www.fdic.gov/regulations/laws/rules/5000-3860.html
[2] https://www.fdic.gov/regulations/compliance/manual/2/ii-3.1.pdf

the credit decision process, demographics of its market areas, and other relevant information. Each of these factors affects the fair lending risk inherent in the institution. Also, it would be prudent to review monitoring procedures and adjust them as the bank's fair lending risk profile changes.

It would be wise to look at all types of exceptions during your monitoring process – not only applications approved outside of policy, but similar applications that were not approved. Consider comparing denial rates for a prohibited basis group (the "target" group) to denial rates for the "control" group (for example non-Hispanic whites for a racial or ethnic analysis, and male/joint borrower for a gender analysis).[3] This is relatively easy for residential real estate transactions which require the collection of government monitoring information. For other loan types, tools are available for using given names in a gender analysis or surnames for a racial or ethnic analysis. Banks also may want to consider monitoring pricing decisions for consistent application of pricing policies across prohibited basis groups using a time frame that is long enough to provide a meaningful analysis.[4] Banks can also review consistency in handling collections, loan modification requests, and foreclosures. Monitoring is more effective if it evaluates the extent to which policies and procedures are followed and not simply track exceptions.[5] Remember that reviews at an aggregate level across the institution or branches may uncover issues not apparent from reviews at the loan officer level.

What else can a bank do to mitigate its fair lending risk? Training and clear communication about how to apply policies and procedures consistently among borrowers within each stage of a loan transaction can mitigate risk. Fair lending training will be most useful if it is tailored to your bank's fair lending risk profile and updated as the risk profile changes. Compliance issues can be avoided if all personnel involved in the credit decision process know the bank's policies, and under which circumstances exceptions may be made to policies. Banks may want to consider requiring a higher level of approval for all exceptions. For banks with multiple branches or decision centers, it may be worthwhile to consider defining measurable standards for compensating factors in making exceptions to ensure all eligible borrowers receive the same opportunities for exceptions. Maintaining sufficient documentation supporting the specific circumstances or measurable compensating factors of each exception also may facilitate compliance.[6]

The results of monitoring activities can be used to assess whether fair lending training has been effective and whether the level of discretion allowed is still appropriate. Banks may want to consider adjusting criteria or policy standards to mitigate fair lending risks when exceptions are occurring more than occasionally. Should monitoring reveal disparities, banks may need to take action. Steps bank could take may involve digging further to determine whether the differences are fully explained by pertinent credit factors. If such factors do not fully justify the differences, banks could consider attempting to make harmed parties whole by offering to extend credit, adjusting interest rates, or providing monetary adjustments when appropriate. Bank also may want to evaluate whether additional harmed parties could exist in a larger universe outside of any monitoring sample and whether any corrective actions to make harmed parties whole should be retroactive in time.[7] The Interagency Policy Statement on Discrimination in Lending provides additional information for addressing self-identified instances of discrimination, including notifying the parties of their rights under the Equal Credit Opportunity Act.

Managing discretion in the fair lending process can be challenging, yet beneficial in supporting compliance and business objectives. Examiners consider risk mitigation efforts in setting the scope of fair lending reviews. A robust monitoring program will not only help identify potential issues before examiners do, it may reduce the amount of information requested and files reviewed during examinations. If you have any questions about this article, and how to better manage fair lending risk at your bank, feel free to contact your local FDIC field office or refer to the Interagency Fair Lending Examination Procedures[8] or the FDIC's Fair Lending Scope and Memorandum[9] guidance.

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[3] https://www.fdic.gov/regulations/examinations/fairlend.pdf (page 17)
[4] https://www.fdic.gov/regulations/examinations/fairlend.pdf (page 20)
[5] https://www.fdic.gov/regulations/examinations/fairlend.pdf (page 6)
[6] https://www.fdic.gov/regulations/examinations/fairlend.pdf (page 8 [U6])
[7] https://www.fdic.gov/regulations/examinations/fairlend.pdf (page 7)
[8] https://www.fdic.gov/regulations/examinations/fairlend.pdf
[9] https://www.fdic.gov/regulations/compliance/manual/4/iv-3.1.pdf