

IV. Fair Lending – Compliance Management Review/Exam Procedures

For large institutions reporting small business loans for CRA purposes and where the institution also voluntarily geocodes loan denials, look for material discrepancies in ratios of approval-to-denial rates for applications in areas with relatively high concentrations of minority residents compared with areas with relatively low concentrations.

Articulate the possible discriminatory patterns identified and consider further examining those products determined to have sufficient risk of discriminatory conduct in accordance with the procedures for commercial lending described in Part III, F.

Step Eight: Complete the Scoping Process

To complete the scoping process, the examiner should review the results of the preceding steps and select those focal points that warrant examination, based on the relative risk levels identified above. In order to remain within the agency's resource allowances, the examiner may need to choose a smaller number of Focal Points from among all those selected on the basis of risk. In such instances, set the scope by first, prioritizing focal points on the basis of (i) high number and/or relative severity of risk factors; (ii) high data quality and other factors affecting the likelihood of obtaining reliable examination results; (iii) high loan volume and the likelihood of widespread risk to applicants and borrowers; and (iv) low quality of any compliance program and, second, selecting for examination review as many focal points as resources permit.

Where the judgment process among competing Focal Points is a close call, information learned in the phase of conducting the compliance management review can be used to further refine the examiner's choices.

Part II—Compliance Management Review

The Compliance Management Review enables the examination team to determine:

- The intensity of the current examination based on an evaluation of the compliance management measures employed by an institution.
- The reliability of the institution's practices and procedures for ensuring continued fair lending compliance.

Generally, the review should focus on:

- Determining whether the policies and procedures of the institution enable management to prevent, or to identify and self-correct, illegal disparate treatment in the transactions that relate to the products and issues identified for further analysis under Part I of these procedures.
- Obtaining a thorough understanding of the manner by which management addresses its fair lending responsibilities with respect to (a) the institution's lending practices and standards, (b) training and other application-processing aids, (c) guidance to employees or agents in

dealing with customers, and (d) its marketing or other promotion of products and services.

To conduct this review, examiners should consider institutional records and interviews with appropriate management personnel in the lending, compliance, audit, and legal functions. The examiner should also refer to the **Compliance Management Analysis Checklist** contained in the **Appendix** to evaluate the strength of the compliance programs in terms of their capacity to prevent, or to identify and self-correct, fair lending violations in connection with the products or issues selected for analysis. Based on this evaluation:

- Set the intensity of the transaction analysis by minimizing sample sizes within the guidelines established in Part III and the **Sample Size Table** in the **Appendix**, to the extent warranted by the strength and thoroughness of the compliance programs applicable to those Focal Points selected for examination.
- Identify any compliance program or system deficiencies that merit correction or improvement and present these to management in accordance with Part IV of these procedures.

Where an institution performs a self-evaluation or has voluntarily disclosed the report or results of a self-test of any product or issue that is within the scope of the examination and has been selected for analysis pursuant to Part I of these procedures, examiners may streamline the examination, consistent with agency instructions, provided the self-test or self-evaluation meets the requirements set forth in **Streamlining the Examination** located in the **Appendix**.

Part III—Examination Procedures

Once the scope and intensity of the examination have been determined, assess the institution's fair lending performance by applying the appropriate procedures that follow to each of the examination Focal Points already selected.

A. Documenting Overt Evidence of Disparate Treatment

Where the scoping process or any other source identifies overt evidence of disparate treatment, the examiner should assess the nature of the policy or statement and the extent of its impact on affected applicants by conducting the following analysis:

Step 1. Where the indicator(s) of overt discrimination are found in or based on a written policy (for example, a credit scorecard) or communication, determine and document:

- a. The precise language of the apparently discriminatory policy or communication and the nature of the fair lending concerns that it raises.

- b. The lender’s stated purpose in adopting the policy or communication and the identity of the person on whose authority it was issued or adopted.
- c. How and when the policy or communication was put into effect.
- d. How widely the policy or communication was applied.
- e. Whether and to what extent applicants were adversely affected by the policy or communication.

Step 2. Where any indicator of overt discrimination was an oral statement or unwritten practice, determine and document:

- a. The precise nature of both the statement or practice and of the fair lending concerns that they raise.
- b. The identity of the persons making the statement or applying the practice and their descriptions of the reasons for it and the persons authorizing or directing the use of the statement or practice.
- c. How and when the statement or practice was disseminated or put into effect.
- d. How widely the statement or practice was disseminated or applied.
- e. Whether and to what extent applicants were adversely affected by the statement or practice.

Assemble findings and supporting documentation for presentation to management in connection with Part IV of these procedures.

B. Transactional Underwriting Analysis—Residential and Consumer Loans.

Step 1. Set Sample Size

- a. For each Focal Point selected for this analysis, two samples will be utilized: (i) prohibited basis group denials and (ii) control group approvals, both identified either directly from monitoring information in the case of residential loan applications or through the use of application data or surrogates in the case of consumer applications.
- b. Refer to the **Fair Lending Sample Size Table A** in the **Appendix** and determine the size of the initial sample for each Focal Point, based on the number of prohibited basis group denials and the number of control group approvals by the lender during the twelve month (or calendar year) period of lending activity preceding the examination. In the event that the number of denials and/or approvals acted on during the preceding 12 month period substantially exceeds the maximum sample size shown in Table A, reduce the time period from which that sample is selected to a shorter period. (In doing so, make every effort to select a period in which the lender’s underwriting standards are most

representative of those in effect during the full 12 month period preceding the examination.)

- c. If the number of prohibited basis group denials or control group approvals for a given Focal Point that were acted upon during the 12 month period referenced in 1.b., above, do not meet the minimum standards set forth in the Sample Size Table, examiners need not attempt a transactional analysis for that Focal Point. Where other risk factors favor analyzing such a Focal Point, consult with agency managers on possible alternative methods of judgmental comparative analysis.
- d. If agency policy calls for a different approach to sampling (e.g., a form of statistical analysis or a mathematical formula) for a limited class of institutions, examiners should follow that approach.

Step 2. Determine Sample Composition.

- a. To the extent the institution maintains records of loan outcomes resulting from exceptions to its credit underwriting standards or other policies (e.g., overrides to credit score cutoffs), request such records for both approvals and denials, sorted by loan product and branch or decision center, if the lender can do so. Include in the initial sample for each Focal Point all exceptions or overrides applicable to that Focal Point.
- b. Using HMDA/LAR data or, for consumer loans, comparable loan register data to the extent available, choose approved and denied applications based on selection criteria that will maximize the likelihood of finding marginal approved and denied applicants, as discussed below.
- c. To the extent that the above factors are inapplicable or other selection criteria are unavailable or do not facilitate selection of the entire sample size of files, complete the initial sample selection by making random file selections from the appropriate sample categories in the Sample Size Table.

Step 3. Compare Approved and Denied Applications

Overview: Although a creditor’s written policies and procedures may appear to be nondiscriminatory, lending personnel may interpret or apply policies in a discriminatory manner. In order to detect any disparate treatment among applicants, the examiner should first eliminate all but “**marginal transactions**” (see 3.b. below) from each selected Focal Point sample. Then, a detailed profile of each marginal applicant’s qualifications, the level of assistance received during the application process, the reasons for denial, the loan terms, and other information should be recorded on an Applicant Profile Spreadsheet. Once profiled, the examiner can compare the target and control groups for evidence that similarly qualified applicants have been treated differently

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as to either the institution's credit decision or the quality of assistance provided.

a. Create Applicant Profile Spreadsheet

Based upon the lender'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 lender 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 lender'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.

b. Complete Applicant Profiles

From the application files sample for each Focal Point, complete applicant profiles for selected denied and approved applications as follows:

- A principal goal is to identify cases where similarly qualified prohibited basis and control group applicants had different credit outcomes, because the agencies have found that discrimination, including differences in granting assistance during the approval process, is more likely to occur with respect to applicants who are not either clearly qualified or unqualified, i.e., "**marginal**" applicants. The examiner-in-charge should, during the following steps, **judgmentally select** from the initial sample only those denied and approved applications which constitute marginal transactions. (See **Appendix on Marginal Transactions** for guidance)
- If few marginal control group applicants are identified from the **initial sample**, review additional files of approved control group applicants. This will either increase the number of marginal approvals or confirm that marginal approvals are so infrequent that the marginal denials are unlikely to involve disparate treatment.
- The judgmental selection of both **marginal-denied** and **marginal-approved** applicant loan files should be done together, in a "back and forth" manner, to facilitate

close matches and a more consistent definition of "marginal" between these two types of loan files.

- Once the marginal files have been identified, the data elements called for on the profile spreadsheet are extracted or noted and entered.
- While conducting the preceding step, the examiner should simultaneously look for and document on the spreadsheet any evidence found in marginal files regarding the following:
 - **the extent of any assistance**, including both affirmative aid and **waivers** or partial waivers of credit policy provisions or requirements, that appears to have been provided to **marginal-approved** control group applicants which enabled them to overcome one or more credit deficiencies, such as excessive debt-to-income ratios; and
 - the extent to which **marginal-denied** target group applicants with similar deficiencies were, or were not, provided similar affirmative aid, waivers or other forms of assistance.

c. Review and Compare Profiles

- For each Focal Point, review all **marginal profiles** to determine if the underwriter followed institution lending policies in denying applications and whether the reason(s) for denial were supported by facts documented in the loan file and properly disclosed to the applicant pursuant to Regulation B. If any (a) unexplained deviations from credit standards, (b) inaccurate reasons for denial or (c) incorrect disclosures are noted, (whether in a judgmental underwriting system, a scored system or a mixed system) the examiner should obtain an explanation from the underwriter and document the response on an appropriate workpaper.

Note: In constructing the applicant profiles to be compared, examiners must adjust the facts compared so that assistance, waivers, or acts of discretion are treated consistently between applicants. For example, if a control group applicant's DTI ratio was lowered to 42% because the lender decided to include short-term overtime income, and a prohibited basis group applicant who was denied due to "insufficient income" would have had his ratio drop from 46% to 41% if his short-term overtime income had been considered, then the examiners should consider 41%, not 46%, in determining the benchmark.

- For each **reason for denial** identified within the target group, rank the denied prohibited basis applicants, beginning with the applicant whose qualification(s) related to that reason for denial were **least deficient**. (The top-ranked denied applicant in each such

ranking will be referred to below as the “**benchmark**” applicant.)

- Compare each marginal control group approval to the **benchmark** applicant in each reason-for-denial ranking developed in step (b), above. If there are no approvals who are equally or less qualified, then there are no instances of disparate treatment for the lender to account for. For all such approvals that appear no better qualified than the denied benchmark applicant
 - identify the approved loan on the worksheet or spreadsheet as an “**overlap approval**”, and
 - compare that overlap approval with other marginal prohibited basis denials in the ranking to determine whether additional overlaps exist. If so, identify all overlapping approvals and denials as above.
- Where the Focal Point involves use of a credit scoring system, the analysis for disparate treatment is similar to the procedures set forth in (c) above, and should focus primarily on overrides of the scoring system itself. For guidance on this type of analysis, refer to **Part C** of the **Credit Scoring** section of the **Appendix**.

Step 4. If there is some evidence of violations in the underwriting process, but not enough to clearly establish the existence of a pattern or practice, the examiner should expand the sample as necessary to determine whether a pattern or practice does or does not exist.

Step 5. Discuss all findings resulting from the above comparisons with bank management and document both the findings and all conversations on an appropriate worksheet.

C. Analyzing Potential Disparities in Terms and Conditions.

Step 1. Set Sample Size

For each Focal Point selected for this analysis, two samples will be utilized: (i) prohibited basis group approvals and (ii) control group approvals, both identified either directly from monitoring information in the case of residential loan applications or through the use of application data or surrogates in the case of consumer or commercial applications. Refer to the **Fair Lending Sample Size Table B** in the **Appendix** and determine the size of the initial sample for each Focal Point, based on the number of prohibited basis group approvals and the number of control group approvals received by the lender during the 12 months preceding the examination and the outcome of the compliance management system analysis conducted in Part II.

Step 2. Determine Sample Composition.

Note: Sample composition for a comparison of price and other terms and conditions will initially focus on controlling for two nondiscriminatory variables that can have a significant impact

on loan terms: whether the loan was sold and the loan closing date. Other variables, such as household income and loan amount, will be accounted for on a case-by-case basis during the file comparison process.

a. Disposition of Loan

Determine whether approved loans from which the sample is to be drawn have been consistently sold to the secondary market or held in portfolio. If both, determine the proportion for each category and use that proportion in selecting loans from each category for the sample. If the number of loans in either the sold or portfolio categories is too small to complete the minimum proportional sample size for that category, ignore loans in that category and complete the sample using loans solely from the larger category.

b. Period of Review

Sort loans selected in (1), above, by **date of loan closing** and match batches of prohibited basis and control group loans that closed either on the same date or within a **range of dates** during which the lender’s pricing policies were the same. If dates of loan closing are not consistently available, consider substituting the application date for the closing date.

Step 3. Create Applicant Profile Spreadsheet

Identify data that should be recorded for each loan to allow for a valid comparison regarding terms and conditions and place these onto a spreadsheet. Certain data must always be included in the spreadsheet, while the other data selected will be tailored for each loan product and lender based on loan terms offered and such issues as branch location and underwriter.

Step 4. Review Terms and Conditions; Compare with Applicant Outcomes

- a. Determine which loan terms and conditions (rates, points, fees, maturity variations, LTVs, collateral requirements, etc.) are left, in whole or in part, to the discretion of loan officers or underwriters. For each such term or condition, identify (a) any **approved prohibited basis group applicants** in the sample who appear to have been treated unfavorably with respect to that term or condition and (b) any **approved control group applicants** who appear to have been treated favorably with respect to that term or condition. The examiner’s analysis should be thoroughly documented in the workpapers.
- b. Identify from the sample any **approved control group applicant(s)** who appear to have been treated more favorably than one or more of the above-identified prohibited basis group applicants and who have negative creditworthiness factors (under the lender’s standards)

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that are equal to or worse than the prohibited basis group applicant(s).

- c. Obtain explanations from the appropriate loan officer or other employee for any differences that exist and reanalyze the sample for evidence of discrimination.
- d. If there is some evidence of violations in the imposition of terms and conditions but not enough to clearly establish the existence of a pattern or practice, the examiner should expand the sample as necessary to determine whether a pattern or practice does or does not exist.
- e. Discuss differences in comparable loans with the institution's management and document all conversations on an appropriate worksheet. For additional guidance on evaluating management's responses, refer to the **Part A, 1-6 Evaluating Response to Evidence of Disparate Treatment** in the **Appendix**.

D. Steering Analysis

Institutions that make FHA as well as conventional loans and those that lend in both prime or "A" markets and in sub-prime markets (either directly or through subsidiaries or affiliates), present opportunities for loan officers to refer or "steer" applicants from one product or market to another. Steering is not unlawful *per se* and, in many instances, the availability of a more expensive form of credit may enable an applicant with credit problems to obtain a loan that might otherwise be unavailable. Steering can, however, raise fair lending issues if it occurs differently and less advantageously for prohibited basis group applicants than for similarly-situated non-minority applicants. If the scoping analysis reveals the presence of one or more risk factors S1 through S8 for any selected Focal Point, consult with managers about conducting a steering analysis as described below.

From the perspective of fair lending analysis, all steering scenarios involve a **decision** by the lender's personnel to guide an applicant's choice between a **more favorable** loan and one or more **less favorable** alternatives (e.g., referral to a more expensive subprime mortgage subsidiary). As such, a steering analysis should be focused on answering the following questions:

Step 1. Clarify which of the options available to customers are the more favorable and less favorable.

Through interviews with appropriate personnel of the institution and review of policy manuals, procedure guidelines and other directives, obtain and verify the following information for each product-alternative product pairing or grouping identified above:

- a. All underwriting criteria for the product and for the alternative product(s) that are offered by the institution or by a subsidiary or affiliate.

- b. Pricing or other costs applicable to the product and the alternative product(s), including interest rates, points, and all fees.

Step 2. Document the policies, conditions or criteria that have been adopted by the lender for determining how referrals are to be made and choices presented to customers.

- a. Obtain not only information regarding the product offered by the lender and alternative products offered by subsidiaries/affiliates, but also information on products and alternatives offered solely by the lender itself-, e.g., conventional and FHA, secured and unsecured home improvement loans, prime and subprime mortgages.
- b. Obtain any information regarding a subsidiary of the lender directly from that entity, but seek information regarding an affiliate or holding company subsidiary only from the lender itself.
- c. Obtain all appropriate documentation and document all discussions with loan personnel and managers.
- d. Obtain documentation and/or employee estimates as to the volume of referrals made from or to the institution, for each product, during a relevant time period.
- e. Resolve to the extent possible any discrepancies between information found in the lender's documents and information obtained in interviews by conducting appropriate follow-up interviews.
- f. Identify any policies and procedures established by the institution and/or the subsidiary or affiliate for (i) referring a person who applies to the institution, but does not meet its criteria, to a subsidiary or affiliate; (ii) offering to a person who applies to the institution for a *specific product*, but does not meet its criteria, one or more alternative loan products; or (iii) referring a person who applies to a subsidiary or affiliate for its product, but who appears be qualified for a loan from the institution, to the institution.
- g. Determine whether loan personnel are encouraged, through monetary incentives or otherwise, to make referrals, either from the institution to a subsidiary/affiliate or vice versa.

Step 3. Determine how both the decisions and the lender's policies, conditions or criteria are supposed to be documented in loan files, policy manuals, directives, etc.

Determine how, if at all, a referral from the institution to a subsidiary/affiliate, or vice versa, *and the reason for it*, would be documented in the loan files or in any other records of either the referring or receiving entity.

Step 4. Determine to what extent individual loan personnel are able to exercise personal discretion in deciding what loan products or other credit alternatives will be made available to a given applicant.

Step 5. Determine whether the lender’s stated policies, conditions or criteria in fact are adhered to by individual decision makers. In the alternative, does it appear that different policies or practices are actually in effect?

Enter data from the prohibited basis group sample on the spread sheets and determine whether the lender is, in fact, applying its criteria as stated. For example, if one announced criterion for receiving a “more favorable” prime mortgage loan was a back end debt ratio of no more than 38%, review the spread sheets to determine whether that criteria was adhered to. If the lender’s actual treatment of prohibited basis group applicants appears to differ from its stated criteria, document such differences for subsequent discussion with management.

Step 6. To the extent that individual loan personnel have any discretion in deciding what credit alternatives (e.g., conventional vs. FHA/VA) to offer applicants, conduct a comparative analysis to determine whether that discretion has been exercised in a nondiscriminatory manner.

Compare the lender’s or subsidiary/affiliate’s treatment of control group and prohibited basis group applicants by adapting the “benchmark” and “overlap” technique discussed in Part III, B. of these procedures. For purposes of this Steering Analysis, that technique should be conducted as follows:

- a. For each Focal Point to be analyzed, select a sample of prohibited basis group applicants who received “less favorable” treatment (e.g., referral to a finance company or a subprime mortgage subsidiary or counteroffers of less favorable product alternatives).

Note: In selecting the sample, follow the guidance of **Sample Size Table B** in the **Appendix** and select “marginal applicants” as instructed in Part III, Section B, above.

- b. Prepare a spread sheet for the sample which contains data entry categories for those underwriting and/or referral criteria that the lender identified in Step 1. b as used in reaching underwriting and referral decisions between the pairs of products.
- c. Review the “less favorably” treated prohibited basis group sample and rank this sample from least qualified to most qualified.
- d. From the sample, identify the **best qualified** prohibited basis group applicant, based on the criteria identified for the control group, above. This applicant will be the “**benchmark**” applicant. Rank order the remaining applicants from best to least qualified.
- e. Select a sample of *control group applicants*. Identify those who were treated “*more favorably*” with respect to the

same product-alternative product pair as the *prohibited basis group*. (Again refer to the Sample Size Table B and marginal applicant processes noted above in selecting the sample.)

- f. Compare the qualifications of the benchmark applicant with those of the control group applicants, beginning with the least qualified member of that sample. Any control group applicant who appears less qualified than the benchmark applicant should be identified on the spreadsheet as a “**control group overlap**”.
- g. Compare all control group overlaps with other, less qualified prohibited basis group applicants to determine whether additional overlaps exist.
- h. Document all overlaps as possible disparities in treatment. Discuss all overlaps and related findings (e.g., any differences between stated and actual underwriting criteria) with management, documenting all such conversations.

E. Transactional Underwriting Analysis—Commercial Loans.

Overview: Unlike consumer credit, where loan products and prices are generally homogenous and underwriting involves the evaluation of a limited number of credit variables, commercial loans are generally unique and underwriting methods and loan pricing may vary depending on a large number of credit variables. The additional credit analysis that is involved in underwriting commercial credit products will entail additional complexity in the sampling and discrimination analysis process. Although ECOA prohibits discrimination as to all commercial credit activities of a covered institution, the agencies recognize that small businesses (sole proprietorships, partnerships, and small, closely-held corporations), including those operated by prohibited basis group members, may have less experience in borrowing. Therefore, in implementing these procedures, examinations should generally be focused on small business credit (commercial applicants that had gross revenues of \$1,000,000 or less in the preceding fiscal year), absent some evidence that a focus on other commercial products would be more appropriate.

Step 1. Understand Commercial Loan Policies

For the commercial product line selected for analysis, the examiner should first review credit policy guidelines and interview appropriate commercial loan managers and officers to obtain written and articulated standards used by the lender in evaluating commercial loan applications.

Step 2. Conduct Initial Sampling

- a. Select all (up to a maximum of ten) denied applications that were acted on during the three month period prior to the examination. To the extent feasible, include denied

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applications from businesses that are (i) located in minority and/or integrated geographies or (ii) appear to be owned by women or minority group members, based on the names of the principals shown on applications or related documents. (In the case of banks that do a significant volume of commercial lending, consider reviewing more than ten applications.)

- b. For each of the **denied commercial applications selected**, record specific information from loan files and through interviews with the appropriate loan officer(s), about the principal owners, the purpose of the loan, and the specific, pertinent financial information about the commercial enterprise (including type of business—retail, manufacturing, service, etc.), that was used by the lender to evaluate the credit request. In addition, inquire with the loan officer as to the gender and race, if known, of the principals of the business.
- c. Select ten approved loans that appear to be similar with regard to business type, purpose of loan, loan amount, loan terms, and type of collateral, as the denied loans sampled. For example, if the denied loan sample includes applications for lines of credit to cover inventory purchases for retail businesses, the examiner should select approved applications for lines of credit from retail businesses.
- d. For each approved commercial loan application selected, obtain and record information parallel to that obtained for denied applications, including the gender and race of the principals.
- e. The examiner should first compare the **credit criteria** considered in the credit process for each of the approved and denied applications to established underwriting standards, rather than comparing files directly.
- f. The examiner should identify any deviations from credit standards for both approved and denied credit requests, and differences in loan terms granted for approved credit requests.
- g. The examiner should discuss each instance where deviations from credit standards and terms were noted, but were not explained in the file, with the commercial credit underwriter. Each discussion should be documented.

Step 3. Conduct Targeted Sampling.

- a. If deviations from credit standards or pricing are not sufficiently explained by other factors either documented in the credit file or the commercial underwriter was not able to provide a reasonable explanation, the examiner should determine if deviations were detrimental to any protected classes of applicants.
- b. The examiner should consider employing the same techniques for determining race and gender characteristics of commercial applicants as those outlined in the consumer loan sampling procedures.

- c. If it is determined that there are members of one or more prohibited basis groups among commercial credit requests that were not underwritten according to established standards or received less favorable terms, the examiner should select additional commercial loans, where applicants are members of the same prohibited basis group and select similarly situated control group credit requests. These additional files should be selected based on the specific applicant circumstance(s) that appeared to have been viewed differently by lending personnel on a prohibited basis.
- d. If there are not enough similarly situated applicants for comparison in the original sample period to draw a reasonable conclusion, the examiner should expand the sample period. The expanded sample period should generally not go beyond the date of the prior examination.

Sampling Guidelines

- a. Generally, the task of selecting an appropriate expanded sample of prohibited basis and control group applications for commercial loans will require examiner judgement. The examiner should select a sample that is large enough to be able to draw a reasonable conclusion.
- b. The examiner should first select from the applications that were acted on during the initial sample period, but were not included in the initial sample, and select applications from prior time periods as necessary.
- c. The expanded sample should include both approved and denied, prohibited basis and control group applications, where similar credit was requested by similar enterprises for similar purposes.

F. Analysis of Potential Discriminatory “Redlining”

Overview: For purposes of this analysis, “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.

The redlining analysis may be applied to determine whether, on a prohibited basis:

- a lender fails or refuses to extend credit in such an area;
- makes loans in such an area but at a restricted level or upon less-favorable terms or conditions as compared to contrasting areas; or
- a lender omits or excludes such an area from efforts to market residential loans or solicit customers for residential credit.

This guidance focuses on possible discrimination against racial or national origin minorities. The same analysis could

be adapted to evaluate relative access to credit for areas of geographical concentration on other prohibited bases—for example, age.

Note: 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 it as prohibiting lenders 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.

Like other forms of disparate treatment, redlining can be proven by overt or comparative evidence. If any written or oral policy or statement of the lender (*see* risk factors R5, R6, and R7 in Part I, above) suggests that the lender links the racial or national origin character of an area with any aspect of access to or terms of credit, the examiners should refer to the guidance in section A of this Part III, on documenting and evaluating overt evidence of discrimination.

Overt evidence includes not only explicit statements, but also any geographical terms used by the lender that would, to a reasonable person familiar with the community in question, connote a specific racial or national origin character. For example, if the principal information conveyed by the phrase “north of 110th Street” is that the indicated area is principally occupied by Hispanics, then a policy of not making credit available “north of 110th Street” is overt evidence of potential redlining on the basis of national origin.

Overt evidence is relatively uncommon. Consequently, the redlining analysis usually will focus on comparative evidence (similar to analyses of possible disparate treatment of individual customers) in which the lender’s treatment of areas with contrasting racial or national origin characters is compared.

When the scoping process (including consultation within an agency as called for by agency procedures) indicates that a redlining analysis should be initiated, examiners should complete the following steps of comparative analysis:

1. Identify and delineate any areas within the lender’s CRA assessment area or market area for residential products that are of a racial or national origin minority character;
2. Determine whether any minority area identified in step 1 appears to be excluded, under-served, selectively excluded from marketing efforts, or otherwise less-favorably treated in any way by the lender;

3. Identify and delineate any areas within the lender’s CRA assessment area or market area for residential products that are nonminority in character and that the lender appears to treat more favorably;
4. Obtain the lender’s explanation for the apparent difference in treatment between the areas and evaluate whether it is credible and reasonable; and
5. Obtain and evaluate other information that may support or contradict interpreting identified disparities to be the result of intentional illegal discrimination.

These steps are discussed in detail below.

Using information obtained during scoping

Although the five tasks listed are presented below as examination steps in the order given above, examiners should recognize that a different order may be preferable in any given examination. For example, the lender’s explanation (step 4) for one of the policies or patterns in question may already be documented in the CRA materials reviewed (step 2) and the CRA examiners may already have verified it, which may be sufficient for purposes of the redlining analysis.

As another example, as part of the scoping process, the examiners may have reviewed an analysis of the geographic distribution of the lender’s loan originations with respect to the racial and national origin composition of census tracts within its CRA assessment or residential market area. Such analysis might have documented the existence of significant discrepancies between areas, by degree of minority concentration, in loans originated (risk factor R1), approval/denial rates (risk factor R2) and/or rates of denials because of insufficient collateral (risk factor R3). In such a situation in which the scoping process has produced a reliable factual record, the examiners could begin with step 4 (obtaining an explanation) of the redlining analysis below.

In contrast, when the scoping process only yields partial or questionable information, or when the risk factors on which the redlining analysis is based are complaints or allegations against the lender, steps 1, 2, and/or 3 must be addressed.

Comparative analysis for redlining

Step 1. Identify and delineate any areas within the lender’s CRA assessment area or market area for residential products that are of a racial or national origin minority character.

Note: The CRA assessment area can be a convenient unit for redlining analysis because information about it typically already is in hand. However, the CRA assessment area may be too limited. The redlining analysis focuses on the lender’s decisions about how much access to credit to provide to different geographical areas. The areas for which those

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decisions can best be compared are areas where the lender actually marketed and provided credit and where it could reasonably be expected to have marketed and provided credit. Some of those areas might be beyond or otherwise different from the CRA assessment area.

If there are no areas identifiable for their racial or national origin minority character within the lender's CRA assessment area or market area for residential products, a redlining analysis is not appropriate. (If there is a substantial but *dispersed* minority population, potential disparate treatment can be evaluated by a routine comparative file review of applicants.)

This step may have been substantially completed during scoping, but unresolved matters may remain. (For example, several community spokespersons may allege that the lender is redlining, but disagree in defining the area). The examiners should:

- a. Describe as precisely as possible why a specific area is recognized in the community (perceptions of residents, etc.) and/or is objectively identifiable (based on census or other data) as having a particular racial or national origin minority character.
 - The most obvious identifier is the predominant race or national origin of the residents of the area. Examiners should document the percentages of racial or national origin minorities residing within the census tracts that make up the area. However, they should bear in mind that it is illegal for the lender to consider a prohibited factor *in any way*. For example, an area might be only 20% black, but if a lender refuses to extend credit there because the lender believes the area is “changing to black,” that too is a violation. Contacts with community groups can be helpful to learn whether there are such subtle features of racial or ethnic character.
 - Geographical groupings that are convenient for CRA may obscure racial patterns. For example, an underserved, low-income, predominantly minority neighborhood that lies within a larger low-income area that primarily consisted of *non*minority neighborhoods may seem adequately served when the entire low-income area is analyzed as a unit. However, a racial pattern of underservice to minority areas might be revealed if the low-income minority neighborhood shared a border with an underserved, *middle*-income, minority area and those two minority areas were grouped together for purposes of analysis. Review the analysis from prior CRA examinations of whether the assessment area appears to have been influenced by prohibited factors. If there are minority areas that the lender excluded from the assessment area improperly,

consider whether they ought to be included in the redlining analysis.

- b. Describe how the racial or national origin character changes across the suspected redlining area's various boundaries.
- c. Document or estimate the amount, within the minority area, of types of housing for which the lender offers residential credit. If the minority area does not have a significant amount of such housing, the area is not appropriate for a redlining analysis.

Step 2. Determine whether any minority area identified in step 1 is excluded, under-served, selectively excluded from marketing efforts, or otherwise less-favorably treated in any way by the lender.

The examiners should begin with the risk factors identified during the scoping process. The unfavorable treatment may have been substantially documented during scoping and needs only to be finished in this step. If not, this step will verify and measure the extent to which HMDA data show the minority areas identified in Step 1 to be underserved and/or how the lender's explicit policies treat them less favorably.

- a. Review prior CRA lending test analyses to learn whether they have identified any excluded or otherwise under-served areas or other significant geographical disparities in the institution's lending. Determine whether any of those are the minority areas identified in Step 1.
- b. Learn from the lender itself whether, as a matter of policy, it treats any separate or distinct geographical areas within its marketing or service area differently from other areas. This may have been done completely or partially during scoping analysis related to risk factors R5, R6, and R7. The differences in treatment can be in marketing, branch operations, appraisal practices, application processing, approval requirements, pricing, loan conditions, evaluation of collateral, or any other policy or practice materially related to access to credit. Determine whether any of those less-favored areas are the minority areas identified in step 1.
- c. Obtain from the lender: (i) its reasons for such differences in policy, (ii) how the differences are implemented, and (iii) any specific conditions that must exist in an area for it to receive the particular treatment (more favorable or less favorable) that the lender has indicated.

Step 3. Identify and delineate any areas within the lender's CRA assessment area or market area for residential products that are nonminority in character and that the lender appears to treat more favorably.

To the extent not already completed during scoping:

- a. Document the percentages of whites and of racial or national origin minorities residing within the census tract(s) that comprise(s) the *non*minority area.
 - b. Document the nature of the housing stock in the area.
 - c. Describe, to the extent known, how the lender's practices, policies, or its rate of lending change from less- to more-favorable as one leaves the minority area at its various boundaries (Examiners should be particularly attentive to instances in which the boundaries between favored and disfavored areas deviate from boundaries the lender would reasonably be expected to follow, such as political boundaries or transportation barriers).
 - d. Examiners should particularly consider whether, within a large area that is composed predominantly of racial or national origin minority households, there are enclaves that are predominantly *non*minority or whether, along the area's borders, there are irregularities where the *non*minority group is predominant. As part of the overall comparison, examiners should determine whether credit access within those small *non*minority areas differs from credit access in the larger minority area.
- c. Obtain explanations from the lender for any apparent differences in treatment observed by the examiners but not called for by the lender's policies.
 - If the lender's explanation cites any specific conditions in the *non*minority area(s) to justify more favorable treatment, determine whether the minority area(s) identified in step 1 satisfied those conditions. If there are minority areas for which those conditions existed, ask the lender to explain why the areas were treated differently despite the similar conditions.
 - If the lender's explanation cites any specific conditions in the minority area(s) to justify less favorable treatment, determine whether the *non*minority area(s) had those conditions. If there are *non*minority areas for which those conditions existed, ask the lender to explain why those areas were treated differently, despite the similar conditions.
 - d. Evaluate the lender's responses by applying appropriate principles selected from the **Appendix on Evaluating Responses to Evidence of Disparate Treatment**.

Step 4. Obtain the lender's explanation for the apparent difference in treatment between the areas and evaluate whether it is credible and reasonable.

This step completes the comparative analysis by soliciting from the lender any additional information not yet considered by the examiners that might show that there is a nondiscriminatory explanation for the apparent disparate treatment based on race or ethnicity.

For each matter that requires explanation, provide the lender full information about what differences appear to exist in how it treats minority and *non*minority areas, and how the examiners reached their preliminary conclusions at this stage of the analysis.

- a. Evaluate whether the conditions identified by the lender in step 2 as justifying *more* favorable treatment pursuant to institutional *policy* existed in minority neighborhoods that did *not* receive the favorable treatment called for by institutional policy. If there are minority areas for which those conditions existed, ask the lender to explain why the areas were treated differently despite the similar conditions.
- b. Evaluate whether the conditions identified by the lender in Step 2 as justifying *less* favorable treatment pursuant to institutional *policy* existed in *non*minority neighborhoods that received favorable treatment nevertheless. If there are *non*minority areas for which those conditions existed, ask the lender to explain why those areas were treated differently, despite the similar conditions.

Step 5. Obtain and evaluate specific types of other information that may support or contradict interpreting identified disparities to be the result of intentional illegal discrimination.

As a legal matter, discriminatory intent can be inferred simply from the lack of a legitimate explanation for clearly less-favorable treatment of racial or national origin minorities. That might be the situation after step 4. Nevertheless, if the lender's explanations do not adequately account for a documented difference in treatment, the examiners should consider additional information that might support or contradict the interpretation that the difference in treatment was intended.

- a. **Comparative file review.** If there was a comparative file review conducted in conjunction with the redlining examination, review the results; or, if it is necessary and feasible to do so to clarify what appears to be discriminatory redlining, compare denied applications from within the suspected redlining area to approved applications from the contrasting area.
 - Learn whether there were any denials of fully qualified applicants from the suspected redlining area. If so, that tends to support the view that the lender wanted to avoid doing business in the area.
 - Learn whether the file review identified instances of illegal disparate treatment against applicants of the same race or national origin as the suspected redlining area. If so, that tends to support the view that the lender wanted to avoid doing business with applicants of that group, such as the residents of the suspected redlining area. Learn whether any such identified victims applied for transactions in the suspected redlining area.

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- If there are instances of either of the above, identify denied *non*minority residents, if any, of the suspected redlining area and review their application files to learn whether they appear to have been treated in an irregular or less favorable way. If so, that tends to support the view that the character of the area rather than of the applicants themselves appears to have influenced the credit decisions.
- Review withdrawn and incomplete applications for the suspected redlining area, if those can readily be identified from the HMDA-LAR, and learn whether there are reliable indications that the lender discouraged those applicants from applying. If so, that tends to support the view that the lender did not want to do business in the area and may constitute evidence of a violation of Section 202.5(a) of Regulation B.

Conversely, if the comparisons of individual transactions show that the lender treated minority and nonminority applicants within and outside the suspected redlining area similarly, that tends to contradict the conclusion that the lender avoided the areas because it had minority residents.

- b. Interviews of third parties.** The perspectives of third parties will have been taken into account to some degree through the review of available materials during scoping. Later in the examination, in appropriate circumstances, information from third parties may help in interpreting whether the lender's apparent differences in treatment of minority and nonminority areas were intended.
- Identify persons (such as housing or credit counselors, home improvement contractors, or real estate and mortgage brokers) who may have extensive experience dealing with credit applicants from the suspected redlined area.
 - After obtaining appropriate authorization and guidance from your agency, interview those persons to learn of their *first-hand experiences* related to:
 - oral statements or written indications by a lender's representatives that loan applications from a suspected redlined area were discouraged;
 - whether the lender treated applicants from the suspected redlining area as called for in its own procedures (as the examiners understand them) and/or whether it treated them similarly to applicants from nonminority areas (as the examiners are familiar with those transactions);
 - any unusual delays or irregularities in loan processing for transactions in the suspected redlining area;
 - differences in the lender's pricing, loan conditions, property valuation practices, etc., in the suspected redlining area compared to contrasting areas.

Also, learn from the third parties the names of any consumers they described as having experienced the questionable behavior recounted by the third party, and consider contacting those consumers.

If third parties witnessed specific conduct by the lender that indicates the lender wanted to avoid business from the area or prohibited basis group in question, this would tend to support interpreting the difference in treatment as intended. Conversely, if third parties report proper treatment or positive actions toward such area or prohibited basis group, this would tend to contradict the view that the lender intended to discriminate.

- c. Marketing.** A clear exclusion of the suspected redlining area from the lender's marketing of residential loan products supports the view that the lender did not want to do business in the area. Marketing decisions are affirmative acts to include or exclude areas. Disparities in marketing between two areas may reveal that the lender prefers one to the other. If sufficiently stark and supported by other evidence, a difference in marketing to racially different areas could itself be treated as a redlining violation of the Fair Housing Act. Even below that level of difference, marketing patterns can support or contradict the view that disparities in lending practices were intentional.
- Review materials that show how the lender has marketed in the suspected redlined area and in nonminority areas. Begin with available CRA materials and discuss the issues with CRA examiners, then review other materials as appropriate. The materials may include, for example, the lender's guidance for the geographical distribution of pre-approved solicitations for credit cards or home equity lines of credit, advertisements in local media or business or telephone directories, business development calls to real estate brokers, and calls by telemarketers.
- d. Peer performance.** Market share analysis and other comparisons to competitors are insufficient by themselves to prove that a lender engaged in illegal redlining. By the same token, a lender cannot justify its own failure to market or lend in an area by citing other lenders' failures to lend or market there.
- However, a lender's inactivity in an underserved area where its acknowledged competitors are active would tend to support the interpretation that it intends to avoid doing business in the area. Conversely, if it is as active as other lenders, that would suggest that it intends to compete for, rather than avoid, business in the area.
- Develop a list of the institution's competitors.
 - Learn the level of lending in the suspected redlining area by competitors. Check any public evaluations of similarly situated competitors obtained by the CRA

examiners as part of evaluating the performance context or obtain such evaluations independently.

- e. **Institution's record.** Request from the lender information about its overall record of serving or attempting to serve the racial or national origin minority group with which the suspected redlining area is identified. The record may reveal an intent to serve that group that tends to contradict the view that the lender intends to discriminate against the group.

Step 6. For any information that supports interpreting the situation as illegal discrimination, obtain and evaluate an explanation from the institution as called for in Part IV.

Note: If the lender's explanation is that the disparate results are the consequence of a specific, neutral policy or practice that the lender applies broadly, such as not making loans on homes below a certain value, review the guidance in the Appendix on Disproportionate Adverse Impact and consult agency managers.

G. Analysis of Potential Discriminatory Marketing Practices.

When scoping identifies significant risk factors (M1-M7) related to marketing, examiners should consult their managers and experts about a possible marketing discrimination analysis. If the managers agree to proceed, the examiners should collect information as follows:

Step 1. Identify the bank's marketing initiatives.

- a. Pre-approved solicitations
- Determine whether the bank sends out pre-approved solicitations:
 - for home purchase loans,
 - for home improvement loans, and
 - for refinance loans.
 - Determine how the bank selects recipients for such solicitations:
 - Learn from the bank its criteria for such selections.
 - Review any guidance or other information the bank provided credit reporting companies or other companies that supply such lists.
- b. Media Usage
- Determine in which newspapers and broadcast media the bank advertises.
 - Identify any racial or national origin identity associated with those media.
 - Determine whether those media focus on geographical communities of a particular racial or national origin character.

- Learn the bank's strategies for geographic and demographic distribution of advertisements.
 - Obtain and review copies of the bank's printed advertising and promotional materials.
 - Determine what criteria the bank communicates to media about what is an attractive customer or an attractive area to cultivate business.
 - Determine whether advertising and marketing are the same to racial and national origin minority areas as compared to nonminority areas.
- c. Self-produced promotional materials
- Learn how the bank distributes its own promotional materials, both methods and geographical distribution.
 - Learn what the bank regards as the target audience(s) for those materials.
- d. Realtors, brokers, contractors, and other intermediaries
- Determine whether the bank solicits business from specific realtors, brokers, home improvement contractors, and other conduits.
 - Learn how the bank decides which intermediaries it will solicit.
 - Identify the parties contacted and determine the distribution between minority and nonminority areas.
 - Obtain and review the types of information the bank distributes to intermediaries.
 - Determine how often the bank contacts intermediaries.
 - Determine what criteria the bank communicates to intermediaries about the type of customers it seeks or the nature of the geographic areas in which it wishes to do business.

Step 2. Determine whether the bank's activities show a significantly lower level of marketing effort toward minority areas or toward media or intermediaries that tend to reach minority areas.

Step 3. If there is any such disparity, document the bank's explanation for it.

For additional guidance, refer to **Part C** of the **Special Analyses** section in the **Appendix**.

H. Credit Scoring.

If the scoping process results in the selection of a Focal Point that includes a credit or mortgage scored loan product, refer to **Part B** of the **Credit Scoring Analysis** section of the **Appendix**.

If the institution utilizes a credit scoring program which scores age for any loan product selected for review in the scoping stage, either as the sole underwriting determinant or only as a

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guide to making loan decisions, refer to **Part D** of the **Credit Scoring Analysis** section of the **Appendix**.

I. Disparate Impact Issues.

These procedures have thus far focused primarily on examining comparative evidence for possible unlawful *disparate treatment*. *Disparate impact* has been described briefly in the Introduction. Whenever an examiner believes that a particular policy or practice of a lender appears to have a *disparate impact* on a prohibited basis, the examiner should refer to **Part A** of the **Special Analyses** section of the **Appendix** or consult with agency managers for further guidance.

Part IV—Obtaining and Evaluating Responses from the Lender and Concluding the Examination

Step 1. Present to the institution’s management for explanation:

- a. Any **overt** evidence of disparate treatment on a prohibited basis.
- b. All instances of apparent **disparate treatment** (e.g., overlaps) in either the underwriting of loans or in loan prices, terms, or conditions.
- c. All instances of apparent **disparate treatment** in the form of discriminatory steering, redlining, or marketing policies or practices.
- d. All instances where a denied prohibited basis applicant was not afforded the same **level of assistance** or the **same benefit of discretion** as an approved control group applicant who was no better qualified with regard to the reason for denial.
- e. All instances where a prohibited basis applicant received **conspicuously** less favorable treatment by the lender than was **customary** from the lender or was **required** by the lender’s policy.
- f. Any statistically significant average difference in either the **frequency** or **amount of pricing disparities** between control group and prohibited basis group applicants.
- g. Any evidence of neutral policies, procedures or practices that appear to have a **disparate impact or effect** on a prohibited basis.

Explain that unless there are legitimate, nondiscriminatory explanations (or in the case of disparate impact, a compelling business justification) for each of the preliminary findings

of discrimination identified in this Part, the agency could conclude that the lender is in violation of the applicable fair lending laws.

Step 2. Document all responses that have been provided by the institution, not just its “best” or “final” response. Document each discussion with dates, names, titles, questions, responses, any information that supports or undercuts the lender’s credibility, and any other information that bears on the issues raised in the discussion(s).

Step 3. Evaluate whether the responses are consistent with previous statements, information obtained from file review, documents, reasonable banking practices, and other sources, and satisfy common-sense standards of logic and credibility.

- a. Do not speculate or assume that the institution’s decision-maker had specific intentions or considerations in mind when he or she took the actions being evaluated. Do not, for example, conclude that because you have noticed a legitimate, nondiscriminatory reason for a denial (such as an applicant’s credit weakness), that no discrimination occurred unless it is clear that, at the time of the denial, the lender actually based the denial on that reason.
- b. Perform follow-up file reviews and comparative analyses, as necessary, to determine the accuracy and credibility of the lender’s explanations.
- c. Refer to **Evaluating Responses to Evidence of Disparate Treatment** in the **Appendix** for guidance as to common types of responses.
- d. Refer to the **Disproportionate Adverse Impact** portion of the **Special Analyses** section of the **Appendix** for guidance on evaluating the institution’s responses to apparent disparate impact.

Step 4. If, after completing steps one through three above, you conclude that the institution has failed to adequately demonstrate that one or more apparent violations had a legitimate nondiscriminatory basis or were otherwise lawful, prepare a documented list or discussion of violations, or a draft examination report, as prescribed by agency directives.

Step 5. Consult with agency managers regarding whether (a) any violations should be referred to the Departments of Justice or Housing and Urban Development and (b) enforcement action should be undertaken by your agency.