Dallas Region Fair Lending Update
2013-2014

Talking Points To Cover:

- **Pricing/Underwriting**
  - Risk Indicators
  - Case Study Exercise
- **Indirect Auto Lending**
- **Redlining**
- **Best Practices for Internal Process – What you can do to Mitigate Risk**
- **Q&A**

Brief Overview

There Remains No cause for Panic!

- **The Vast Majority of Banks, both nationally and within Dallas Region, are doing a good job with respect to fair lending compliance**
- **The number of instances in which significant issues arise to FHA/Reg. B Violations/Referrals remains very few**

Underwriting/Pricing Tenets

- **Always on the Radar Screen:**
  - Pricing Risk
    - Interest rates, points, and fees – Residential RE and Consumer
      - Risk-based pricing without objective criteria or risk-based pricing that is not applied consistently
      - Disparities in interest rates and/or fees on a prohibited basis
  - Underwriting Risk
    - Substantial denial rate disparities on a prohibited basis, such as Race, Sex, or National Origin
    - High level of exceptions to underwriting policies

Underwriting/Pricing Tenets

- **Root Cause #1: <u>Discretion</u> in pricing or underwriting**
  - Broad vs. Controlled or Centralized
- Vague or subjective underwriting criteria
- Lack of clear guidance on exceptions to criteria
- Poor loan file documentation standards
- Lack of clear guidance on setting rates and fees
- Deviation and override allowance:
  - High and Low Side (underwriting)

Underwriting Pricing/Tenets

Other Points To Consider/Possible Issues:

- Pricing – further subjective standards/application:
  - Renewal Loans – How are such handled
  - Guarantor/Co-signer transactions – how are such handled
- Lack of clear and objective standards for

  -Referring applicants to subsidiaries, affiliates or other internal lending channels

  -Classifying applicants as prime or sub-prime

  -Offering alternative loan products

Primary risk indicators

- **Additional review during examinations commonly evidence the 4 "L's":**
  - Lack of internal monitoring
  - Lack of communication of policy among loan officers/bank management
  - Lack of internal review process to ensure consistent application of guidelines in everyday practice
  - Lack of appropriate, proactive follow-up action

Disparity calculations

(HMDA Reporters) Rate Spread Rate = $\dfrac{\text{Number of applications with rate spread}}{\text{Total number of originations}}$

(HMDA) Rate Spread Disparity Ratio = $\dfrac{\text{Rate spread rate of prohibited basis group}}{\text{Rate spread rate of control group}}$

Denial Rate (pct.) = $\dfrac{\text{Number of applicants denied}}{\text{Number approved}^{1} + \text{number denied}}$

Denial Rate Disparity Ratio = $\dfrac{\text{Denial rate of prohibited basis group}}{\text{Denial rate of control group}}$

Other Calculation points: Average interest rate and average fees per designated target/control group separately

[1] ***Number approved*** **includes loans originated and applications approved but not accepted.**

Pricing Case Study

Unsecured Consumer Loan Product

-Bank has Rate Sheet in place
-Assigns the following categories per dollar amount:

- Under $2000: 18%
- $2001-4999: 16.5%
- $5000 – 9999: 12.0%
- $10000+: 8.5 – 9.5%

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Pricing Case Study

- **<u>Per Bank loan policy:</u>**
- Exceptions allowed but must be approved by Executive loan committee (ELC)
- Factors Meriting Possible Pricing Exceptions include the following
  - DTI – Strong ratio needed; customer must exhibit good cash flow
  - Credit Score – 650 "desired" Minimum
  - "Good" Loan & Deposit Relationship/History with Bank
  - Employment – Proven stability (generally one yr minimum in same job)
  - If Auto Debit - .25%

Pricing Case Study (Con't)

Price 4 Loans – Approved in Underwriting :

<u>Customer A: Loan Amount 1750</u>

CS 725, DTI 48%, Good 20+Yr Dep/Loan History, +1Yr Employment, $7500 deposit balance; no auto debit

<u>Customer B: Loan Amount: 1350</u>

CS 610, DTI 50%, No History, New $100,000 CD Deposit; just recently moved to area; Retired; auto debit

<u>Customer C: Loan Amount: 1200</u>

CS 675, DTI 60%, No History but father is local physician with commercial deposits > $500K; >1yr employment; auto debit

<u>Customer D: Loan Amount 1800</u>

CS 658, DTI 36%, Good 5+Yr Dep/Loan History, +1Yr Employment, >$2000 Checking Bal; auto debit

Pricing Case Study (Continued)

- How would you price the 4 loans stipulated above?

Pricing Case Study (Con't)

Further review of files during examination note the following:

<u>Customer A</u>

Male – no co-borrower

<u>Customer B</u>

Male – no co-borrower

<u>Customer C</u>

Male – no co-borrower, no co-signor

<u>Customer D</u>

Female borrower; no co-borrower

Only Customer D was subject to review for rate considerations by the ELC; other loans were not brought before ELC (rates were set by loan officer handling transaction).

Pricing Case Study (Continued)

- If examiners wanted to discuss this as a possible instance of gender-based disparate treatment (borrower D – female only borrower), what would be your reaction?

INDIRECT AUTO LENDING

- **CFPB Bulletin 2013-02, Indirect Auto Lending Compliance with the Equal Credit Opportunity Act**
  - Issued March 21, 2013
  - Explains that the standard practice of indirect auto lenders likely make them “creditors” under ECOA;
  - Explains that a lender’s discretionary markup and compensation policies may alone be sufficient to trigger liability under ECOA; and
  - Explains how indirect auto lenders can mitigate the risk of discrimination resulting from dealer markup and compensation policies

INDIRECT AUTO LENDING

- **You may be a Creditor, if…. (definition under ECOA)**
  - Any person that participates in the credit decision
    - Sets terms
    - Assignee or potential purchaser who in any way influences the credit decision
      - Pricing or underwriting
    - Transferee
    - Subrogee
  - Knew or had reasonable notice of an act, policy, or practice that would constitute a violation

INDIRECT AUTO LENDING

- **Equation – IF/THEN Statement:**
  - IF the bank is a creditor THEN you must ensure fair lending compliance as if the transaction was your own

INDIRECT AUTO LENDING

- **Dealer Markup and Fair Lending Risk**
  - Allowing dealers discretion to increase consumer interest rates is a source of fair lending risk
  - Dealer markup may result in disparities on the basis of race, national origin, and potentially other prohibited bases
  - Markup policies resulting in dealer-level or portfolio-wide disparities on prohibited bases could violate ECOA

INDIRECT AUTO LENDING

- **Best practices to help ensure compliance:**
  - Impose controls on dealer markup and compensation policies, or otherwise revise dealer markup and compensation policies
  - Monitor and address the effects of those policies, through
    - Dealer communications
    - Regular analysis
    - Prompt corrective action
    - Consumer remuneration
  - Closely monitor or if necessary, eliminate dealer discretion to mark up buy rates by compensating dealers using another mechanism such as a flat fee per transaction

INDIRECT AUTO LENDING

- **Proactive Internal Review Components for Dealers or any 3rd Party:**
  - Communicate clearly that discrimination is not tolerated
  - Check their policies on discrimination
  - Require clear guidelines for processing applications
  - Insist on a system for recording how and why decisions were made, with explanations for departures from ordinary rules
  - Ensure third parties train employees on fair lending issues
  - Review data for indicators of risk that need to be addressed

Redlining

- **Always on the Radar Screen:**
  - Not just HMDA loans
  - Consumer and Commercial or Small Business Loans are reviewed as well
  - Should not assume that just because the bank's assessment areas do not exclude minority geographies that everything is OK

- Focus – 4 Key Points
  - Where are loans being made/applications received?
  - Are you providing services to meet deposit/credit needs relative to your assessment or trade area?
  - Are there lending gaps in high-minority geographies or are any of these areas arbitrarily excluded from your assessment area?
  - If issues or deficiencies are identified
    - *Is this a continuing trend?*
    - *What has the bank done to address the problem?*

Redlining

- Are there significant differences in the number of applications received, withdrawn, approved not accepted, and closed for incompleteness or loans originated in those areas in the institution's market that have relatively high concentrations of minority group residents;

- Are there significant differences between approval and denial rates for all applicants in areas with relatively high concentrations of minority group residents;

Redlining

- **Do bank operations differ in services available or hours of operation at branch offices located in areas with concentrations of minority residents; and**

- **Does your “CRA defined” assessment area appear drawn to exclude areas with relatively high concentrations of minority residents.**
  - Key point: CRA Focus = Income; Redlining (Fair Lending) Main Focus = Minority Composition

Redlining

Examiners will review:

- Bank Assessment Area/lending area to determine the composition of "significant" minority-comprised census tracts and non-minority census tracts

- If significant minority census tracts (or neighborhoods) are evidenced, examiners will conduct a geographic distribution of Residential/Consumer Loans to determine where you are originating loans.

Redlining

Examiners will review:

- **The reasonableness of the banks lending as compared to a number of factors including:**
    - The percentage of significant minority tracts comprised within the assessment area
    - Branch locations and lending strategies
    - Demographic data
    - Marketing Strategies
    - Record of other banks (Peer) operating within the significant minority areas.

Redlining

- **Helpful Hints – How to Avoid Redlining Pitfalls**
  - Have a clear understanding of assessment area demographics
  - Know where applications are coming from and geographies of loan originations
    - Map loan apps and originations by tract racial composition
    - If gaps are apparent, why is the bank not getting applications or making loans in certain areas?
    - Understand market share and competitors
  - Develop marketing or outreach programs targeting specific areas
    - Be proactive
      - Understand that a "once and done" approach generally not successful
    - Determine what lending or services needs are present that your bank can address
  - Ensure policies do not adversely impact high-minority areas

What's On the Horizon: Other Items for Consideration

- **QM vs. Fair Lending:**
  - 10/23/13 Interagency Press Release Link:

http://www.fdic.gov/news/news/press/2013/pr13091a.html

- **Dodd Frank: Possible Recordkeeping Changes**

- **Disparate Impact**

Fair Lending- What Can you Do?

- **What Banks Can Do to Mitigate Risk?**
  - First identify what your risks are by conducting periodic fair lending risk assessments:
    - The risk assessment should evaluate all of the credit products and services the bank offers, its organizational structure and lending channels, as appropriate.
      - Keep in mind that the collections and loss mitigation areas of your credit operations should also be evaluated to ensure consistent treatment between borrowers in determining whether to arrange a loan modification or a workout arrangement and the terms and conditions offered.
    - Based on the results of your risk assessment, adopt a **Proactive** approach to developing sufficient internal controls to reduce fair lending risks to your institution.

Fair Lending- What Can You Do?

- **What Banks Can Do to Mitigate Risk?**
  - The Board and Senior Management should clearly understand and convey to all personnel that everyone is responsible and accountable for complying with the fair lending laws and regulations.
  - The Board and Senior Management should ensure that underwriting and pricing criteria is clearly defined and understood by all lending personnel.
  - If lending personnel are allowed to deviate from underwriting or pricing criteria, the Board and Senior Management should ensure that the reason for deviations are clearly defined and documented.
  - Monitoring of pricing decisions is essential!!! This is very important and a key component of an effective fair lending compliance management program!!!

Fair Lending – What Can You Do?

- Fully addressing discretion in pricing/underwriting decisions reduces risk of discrimination
- Documentation minimizes questions
- Comprehensive information enables accurate analyses

Fair Lending – What Can You Do?

- **HMDA Lenders:**
  - The accuracy of the HMDA data is crucial.
  - Ensure that personnel responsible for maintaining and reporting your HMDA data clearly understand the collection and reporting requirements related to all data elements, especially the pricing and government monitoring information fields (ethnicity, race and gender)

Fair Lending – What Can You Do?

- Monitoring and Assessment of your “Paid Off Loans” during Fair Lending Review timeframe is also crucial!
- Spousal Signature Provisions: Please ensure that Senior Management and loan officers are fully aware of Reg. B Spousal signature Do’s and Dont’s!
  - Guarantee Provisions
  - Joint Intent Importance
- Fully Understand Branch/Market considerations – especially if different markets = different pricing/underwriting in operations

Thank You

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QUESTIONS???