



CRA Insights: Financial Economics

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July 2016

Redlining Risk – Walking a Fine Line

This article was originally published in the July 2016 issue of *Mortgage Banking* magazine. Reprinted with permission.

Underserved markets can be a business opportunity if lenders approach them with a thoughtful action plan.

Fair lending compliance is about more than just fairness in underwriting and pricing. Regulatory enforcement agencies are also concerned that minority neighborhoods have equal access to mortgage credit.

Among other things, this translates into an assessment of whether mortgage lenders are marketing and offering credit in neighborhoods with high concentrations of minority residents to the same extent they do in neighborhoods with predominantly white or diverse residents, and offering credit on equal terms--what is typically referred to as “redlining risk.”

In this article, we provide an overview of how to identify and evaluate potential fair lending redlining risk, and how mortgage lenders can reduce redlining risk by pursuing more diverse lending opportunities.

What is redlining and why should mortgage bankers pay close attention?

According to the *Interagency Fair Lending Examination Procedures*, “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. Redlining may violate both the [Fair Housing] Act and the ECOA [Equal Credit Opportunity Act].”

More simply, redlining can be thought of as lender behavior that unjustifiably denies or limits credit in neighborhoods with a predominantly minority population.

There are several ways in which access to credit may be denied or restricted to minority areas. For instance, a lender might:

- Fail to actively advertise in or market to qualified borrowers in minority areas;
- Otherwise discourage those borrowers from applying;

- Unjustifiably deny credit to those borrowers who apply; and
- Only grant credit on less favorable terms than to borrowers in other areas.

The concept of discriminatory redlining goes beyond the explicit demarcation of market areas in a way that excludes metropolitan areas, counties, census tracts or other geographic areas that have relatively high concentrations of residents of a particular racial or national origin group. Redlining allegations may also be made based on statistical indications that a lender appears to avoid certain geographic areas on a prohibited basis, or treats predominantly minority areas less favorably than predominantly non-minority areas.

Historically, redlining enforcement activity has focused on depository institutions subject to the requirements of the federal Community Reinvestment Act (CRA). Indeed, all of the public redlining enforcement actions undertaken by the Department of Justice (DOJ) and other federal agencies in the past have focused on depository institutions that are subject to the CRA.

Most recently, this has included the Department of Housing and Urban Development's (HUD's) conciliation agreements with First Federal Bank of Kansas City earlier this year and with Associated Bank in 2015; the DOJ's settlement with Eagle Bank and Trust Company in 2015; and the DOJ's and Consumer Financial Protection Bureau's (CFPB's) joint settlement with Hudson City Savings Bank in 2015.

The historical focus on banks arises in part from the affirmative obligations the CRA imposes on them to define "assessment areas" that they will serve and to help meet the credit needs all parts of those areas. Thus, regulatory agencies have viewed a failure by a bank to serve all parts of its assessment areas, or a bank's defining its assessment areas in such a way as to exclude nearby minority neighborhoods, as evidence of an intent to discriminate based on race or ethnicity.

However, CFPB and DOJ representatives have stated publicly that the Fair Housing Act and ECOA prohibitions on discriminatory redlining apply, as well, to non-bank lenders.

While a redlining legal case may be more difficult to construct for non-bank lenders absent a well-defined "lending area" or "market area," we are aware that the CFPB has included redlining risk assessments in its examinations of independent mortgage companies, and has advised them to monitor for potential fair lending redlining risk. How the agencies would pursue a redlining case against a non-depository institution, however, is yet to be seen.

How does redlining arise?

Mortgage bankers often fail to see they are at risk of violating fair lending laws with respect to redlining. Unless they have experienced an issue before with a former employer or a regulatory agency, the issue rarely resonates.

A popular phrase is, "We don't discriminate--we treat everyone equally and the only color we care about is green."

If it were only that simple, then few lenders would have to worry about fair lending because the vast majority of lenders in today's society do not overtly discriminate. Mortgage bankers now need to pay

attention to the issues of lending diversity and access to credit that banks have faced for years. This is where redlining risk evaluation becomes very important.

Non-bank financial institutions have always been able to originate where they want (subject to licensing). Given that mortgage originators are typically compensated based on commission, one can see why the higher-income neighborhoods that have the appearance of “easier” and higher-dollar loans are often their target market. After all, if you were paid 100 percent on commission, you might follow this same approach. However, this way of doing business leaves your company with potential redlining risk.

This leads to the next logical question, which is why don't lenders just advertise more in underserved markets, hire loan originators to go into those markets or develop more real estate agent relationships in those markets? After all, those approaches worked in the well-served markets. Unfortunately, taking such an approach could backfire unless the marketing is strategically focused and rolled out in the right way.

For example, a marketing strategy that is not strategically targeted for the specific community could result in many applications from marginally qualified or unqualified consumers rather than consumers who are ready to become homebuyers, creating a perception on the lender's part that the community cannot be served profitably.

Broadly based advertising and relationships with real estate agents may be less likely to yield homebuyer-ready consumers than relationships with organizations in the community that can assist with vetting potential homebuyers and serving them in a responsible manner.

When traditional marketing approaches don't pan out, lenders tend to write off underserved markets with perceived “business justifications” such as:

- “Those loans take too long to do and I lose money.”
- “They affect my Federal Housing Administration [FHA] compare ratio and I'm not willing to jeopardize my company's ability to do FHA loans.”
- “My denial rates in minority areas go up, so I look worse than if I don't do those loans.”
- “If there are good loans there, it takes too long to vet them all-- and my operations staff is at capacity right now with the good loans.”
- “None of my originators want to do loans there because they make less money than they could make elsewhere.”
- “I'm not in the business to do low-credit-score loans, with low loan amounts in high-default areas. That's how we survived the financial crisis.”

The problem is that these types of broad generalizations generally are not accepted by regulators, and may be viewed as tacitly discriminatory. If you plan on using these justifications to support your lending patterns, they will need to be backed up with cold, hard facts--not just opinion--and that can be difficult and time-consuming.

A secret that your company may not know is that mortgage loans in underserved markets can be great loans and often can generate the same or even more profit than loans in well-served areas. Before we reveal that secret, let's take a look at how redlining risk is assessed.

Assessment of redlining risk

Diagnosing redlining risk usually involves a combination of statistical analysis and qualitative analysis.

On the statistical side, enforcement agencies examine whether a lender's history of lending activity suggests a tendency to avoid or fail to reach predominantly minority areas within its general market footprint, or indicates a tendency to fail to serve those areas to a similar extent as other lenders serve those areas.

Home Mortgage Disclosure Act (HMDA) data is often used as a screening tool to identify lenders in a given metropolitan area that appear to be making few or no loans in minority areas, especially in comparison with other lenders.

With the required amount of HMDA data expanding, we fully expect to see further scrutiny in the future. In particular, regulatory agencies will have access to a richer set of data for benchmarking lenders against each other in terms of their lending channels, product mix, pricing and other loan terms.

On the qualitative side, regulatory examiners assess such things as whether:

- a lender has a policy of not lending in specific areas that have predominantly minority populations or characterizes such areas as less desirable;
- the lender's employees make statements indicating that minority neighborhoods within their general market footprint are undesirable;
- a lender fails to market its loans in minority neighborhoods;
- a lender provides a more limited product set in minority neighborhoods or has product terms (such as a minimum loan amount) that tend to disqualify borrowers in those areas; and
- a lender has no branch offices or broker relationships in or near minority neighborhoods, but has branches or broker relationships in predominantly non-minority neighborhoods nearby.

Regulatory agencies considering a redlining enforcement action usually weigh a combination of statistical and other qualitative evidence that together may suggest an intent to discriminate.

It is also important to note that geographic expansion or acquisitions by a lender have sometimes created situations in which agencies have alleged discriminatory redlining.

For example, a lender that has historically done business outside of a given metropolitan area where there are few minority neighborhoods might, by virtue of acquiring or merging with another institution, see its market footprint expand into a nearby metropolitan area that includes a considerable section of minority neighborhoods. If the acquired institution did not have much lending presence in the minority neighborhoods, the lending pattern of the combined institutions may create an appearance of focusing on non-minority areas and avoiding adjacent minority areas.

Statistical analysis process

Redlining risk statistical analysis focuses on the distribution of a lender's loan originations and applications in relation to the minority concentrations of geographic areas, usually at the census tract

level. The statistical analysis is comparative in nature: The lender of interest is compared with other lenders in a given market area--usually a metropolitan statistical area (MSA) or metropolitan division.

The reason for the comparative nature of the analysis is that a lack of lending by a given lender in minority neighborhoods may simply be attributable in some cases to a lack of viable lending opportunities in those areas (e.g., due to a predominance of multifamily or other rental housing, or due to the economic status of the neighborhoods). By making comparisons with other lenders, the regulator attempts to gauge whether a specific lender is making few or no loans in minority neighborhoods when other lenders are succeeding in finding lending opportunities there.

HMDA data is used to examine the percentage of an institution's lending that is in majority minority census tracts within a given MSA compared with the corresponding percentage of a group of so-called peer lenders in that MSA.

"Majority minority" census tracts are usually defined as those in which more than 50 percent of the population is Hispanic/Latino or a non-white race. Depending on the geographic area of interest, majority minority areas could also be defined in terms of a specific race/ethnicity group (e.g., Hispanic/Latino and African American only).

If the institution's lending percentage is substantially lower than that of a group of similarly situated peer lenders in the same market for similar loan products, and the difference relative to the peer group is statistically significant, that shortfall could be an indication of fair lending redlining risk that may attract regulatory scrutiny.

The selection of a set of peer lenders for comparison can be as much art as science, and there are no clear regulatory standards for defining an appropriate peer group for such comparisons. Typically the analysis should focus on lenders with generally similar characteristics.

Regulatory agencies often use a fairly general peer group definition for purposes of screening for potential redlining risk, such as defining the peer group to include all lenders that have loan origination volume in a given MSA and a given year that is within one-half to twice that of the lender of interest. But additional criteria may be overlaid on that peer volume range, such as excluding lenders with a high percentage of loans with HMDA-reportable rate spreads if the lender of interest has a low rate-spread percentage.

Other criteria that may be appropriate to consider include the types of lending institutions, distribution channels, product focus (such as conventional versus government-backed lending, home purchase versus refinance or home improvement lending, or first-lien versus subordinate-lien lending) and whether the candidate peer lenders have a physical presence in the MSA.

When a lender is responding to a redlining regulatory investigation, considerable attention should be paid to identifying a peer group that provides a reasonable basis for comparison.

A simplified hypothetical example of the typical peer analysis is shown in Figure 1. In this example, the lender under examination made 2.6 percent of its loans in majority-minority census tracts, while the peer group of similarly sized lenders made 17.5 percent of its loans in majority-minority tracts--and that difference in percentages is highly statistically significant. Furthermore, the lender ranked second to last among the peer group lenders. The lender in this example would appear to be an outlier in the

market in terms of its low minority tract lending percentage, which could lead a regulatory examiner to investigate the lender’s marketing and lending practices further.

Figure 1: Example of Peer Comparison

Lender	Total Originations	Originations in Majority Minority Tracts		
		Number	Percentage	Significance
Target Lender	2,172	57	2.6%	.
Peer Group	28,242	4,946	17.5%	< 1%
Peer Lender 1	4,040	1,262	31.2%	
Peer Lender 2	1,846	428	23.2%	
Peer Lender 3	1,154	244	21.1%	
Peer Lender 4	1,180	240	20.3%	
Peer Lender 5	1,938	378	19.5%	
Peer Lender 6	1,882	344	18.3%	
Peer Lender 7	1,964	346	17.6%	
Peer Lender 8	1,658	284	17.1%	
Peer Lender 9	1,462	216	14.8%	
Peer Lender 10	3,418	482	14.1%	
Peer Lender 11	1,668	230	13.8%	
Peer Lender 12	1,768	196	11.1%	
Peer Lender 13	1,598	172	10.8%	
Peer Lender 14	1,342	106	7.9%	
Peer Lender 15	1,324	18	1.4%	

Source: Fair Lending Diversity Inc., Charles River Associates

Statistical analysis is typically augmented with mapping to visually analyze the locations of an institution’s loan applications, originations and branch locations in relation to predominantly minority census tracts.

Lending patterns that enforcement agencies have considered to be indicative of discriminatory redlining include a doughnut or horseshoe pattern in which a lender’s loan applications and originations are concentrated in low-minority areas that surround high-minority areas, but the high-minority center is devoid of much lending.

What can a lender do?

Once a lender has identified an area of potential redlining risk, it’s time to start working on fair lending strategy. Lenders that are told they may have elevated redlining risk often have few points of

reference for how to fix the issue. Minimizing redlining risk can be a challenging problem to solve if not done correctly.

Recent Department of Justice, CFPB and HUD settlements illustrate how banks have been required to correct alleged redlining issues, and provide some guidance on approaches lenders might take to proactively reduce redlining risk.

The settlements have required the banks to:

- Pay civil penalties;
- Open branches or other loan production facilities in underserved neighborhoods;
- Invest a certain amount of money each year into nonprofit homeownership initiatives;
- Commit funds to loan subsidies;
- Provide financial education programs;
- Conduct targeted advertising to the underserved communities;
- Conduct employee fair lending training;
- Conduct a credit-needs assessment of underserved areas; and
- Hire third-party providers for community-needs analysis and a compliance plan of action, which has been a part of DOJ fair lending settlements.

These settlements also can be very costly, generally starting at \$1 million and escalating into tens of millions of dollars, depending on the severity of the issue, the size of the institution and its financial capacity. This, of course, does not count the money required to defend the enforcement action, negotiate a settlement, and hire attorneys and consultants to assist with the process.

Pre-emptive actions

As you can see from the typical settlement requirements, this all adds up to a lot of money.

The key to avoiding these costs is to do what needs to be done before it is mandated. A strong fair lending strategy will require an in-depth knowledge of the lender's workflow, sales, marketing and underwriting, paired with expertise in compliance and specific expertise in serving underserved communities.

One of the first steps is to look at the extent of the risk, based on the statistical evidence and legal assessment of the issue. This will help to identify the highest-risk areas and prioritize them for corrective action.

Next, an action plan should be designed based on a comprehensive baseline review of each department within the company. This includes policies, practices, training, marketing, underwriting, closing, pricing and sales.

This baseline analysis is then used to:

- Compare your company to your peers and their offerings;
- Perform a community-needs analysis;

- Set up partnerships within the underserved communities that will generate qualified homebuyers;
- Structure a profit model that will generate income on underserved loans that meet or exceed your target profit margin, while charging the consumer the same rates and costs as consumers in well-served markets;
- Offer recommendations to all departments and throughout the entire workflow to address policies or program decisions that may trigger fair lending concerns;
- Structure an action plan to address the expectations of regulatory examiners,
- Assist in the rollout of your action plan; and
- Show the lender how to bundle loans from underserved communities for additional profit.

In particular, strong relationships with HUD-approved home-buying counselors can assist in finding qualified candidates who are ready to buy homes.

Counselors' knowledge of the community in conjunction with their financial education and outreach makes them a great partner if the relationship is set up correctly. Remember: There is a distinctly different mindset between a for-profit company and a nonprofit organization. The nonprofit community organization can do most of the work of preparing consumers for the home-buying experience, and this can set up a virtuous cycle of referrals between the community organization and lender.

One of the keys to success in this process is to view outreach to underserved communities as a potential profit opportunity while at the same time designing an approach that meets both business objectives and the credit needs of the community.

The action plan and your execution on that plan prior to a regulatory examiner finding an issue is far less costly than the alternative. As with all regulatory requirements, a lender is expected to perform proper due diligence, detect issues, formulate an action plan around those issues and self-remediate. This process helps to demonstrate to the examiners that you are a responsible lender with an active and effective compliance management system.

Lenders that view a redlining risk assessment as a way to identify potential business opportunities will likely achieve far more success. After all, if other lenders in your market areas are substantially more successful in making loans in minority neighborhoods than you are, this suggests that there could be profitable lending opportunities your company is missing out on.

Pursuing those opportunities could reduce regulatory risk while also benefiting the company financially if a strong strategy is in play to reach those markets.

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