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Fair Lending Risk Management: Lessons from Recent Settlements

Introduction

Fair lending continues to be a major enforcement priority of federal agencies, and the financial implications have increased considerably in recent settlements. The US Department of Justice (DOJ) has filed or resolved a record number of lending matters under the Fair Housing Act and the Equal Credit Opportunity Act within the past two years,[1] and the Consumer Financial Protection Bureau (CFPB) has made fair lending examination and enforcement a top priority.

Allegations of discriminatory pricing, steering, and redlining on the basis of race and national origin have been major focus areas in recent DOJ settlements, but some recent cases have also alleged discrimination on the basis of marital status, age, receipt of public assistance, sex, or familial status. Furthermore, recent DOJ fair lending cases have relied heavily on the disparate impact legal theory under which unintentional differences in lending outcomes among demographic groups are considered to be violations just as serious as intentional discrimination.[2]

The recent mortgage pricing settlements all relate to lending that occurred before new loan originator compensation rules under Regulation Z were implemented in April 2011. While those new rules have helped reduce fair lending risk in pricing, they have not eliminated it or the need to monitor it. Regulators expect lenders to identify and understand the fair lending risk in their operations and to take appropriate corrective action when necessary. Because regulatory enforcement is being driven primarily or exclusively by statistics in many cases, it is of paramount importance that consumer lenders perform statistical analysis to assess and regularly monitor their fair lending risk.

The terms of the recent fair lending settlements provide a useful roadmap to regulatory expectations regarding fair lending risk management. In “Fair Lending Risk Management: Lessons from Recent Settlements,” we distill the key lessons from these settlements that lenders can use to shape and enhance their own fair lending risk assessment and monitoring programs.

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[1] “The Attorney General’s 2011 Annual Report to Congress Pursuant to the Equal Credit Opportunity Act Amendments of 1976,” US Department of Justice, March 2012, accessed November 9, 2012, http://www.justice.gov/crt/about/hce/documents/ecoareport2011.pdf.

[2] Under the disparate impact theory of discrimination, a lender’s policies or practices could be found to have a “discriminatory effect” if statistical analysis shows that they have a disproportionate adverse impact on a prohibited basis, even though the policies or practices are neutrally designed and applied. A defense against such claims is possible by demonstrating the policy or practice is based on a legitimate business justification. Under this theory, the government or private litigants may claim discrimination under the Fair Housing Act and/or the Equal Credit Opportunity Act without having to show an intent to discriminate.

Lessons from pricing and steering settlements

The table summarizes the main discrimination allegations and dollar settlement amounts of the DOJ's fair lending settlements from the past two years related to loan pricing and steering.[3] The pricing cases generally allege that minority borrowers were charged higher interest rates and/or fees for loans than comparably qualified non-minority borrowers, while the steering cases allege that borrowers were "steered" into more costly or otherwise less favorable loan products on the basis of a prohibited factor (such as race or ethnicity). Of course, the costs to the defendants in these matters go far beyond the direct compensation payments, fines and/or penalties provided in the settlements. Other costs associated with the enforcement can also be enormous: costs of defending the cases; complying with the settlement provisions; undergoing enhanced supervision for years following the settlement; paying for any community development, consumer financial education or special financing programs required under the settlement; and suffering associated reputation damage.

Case	Main Allegation(s)	Settlement Amount
United States v. Countrywide Financial Corporation (2012)	Disparate impact on the basis of race and national origin from the use of discretion in retail and wholesale mortgage pricing and product placement. Marital status discrimination resulting from encouraging non-applicant spouses to sign quit-claim deeds when not required.	$335 million
United States v. Wells Fargo Bank, N.A. (2012)	Disparate impact on the basis of race and national origin from the use of discretion in both mortgage broker pricing and the placement of borrowers in non-prime loan products for which brokers earned greater compensation.	$175 million and potential additional liability with respect to retail borrowers
United States v. SunTrust Mortgage, Inc. (2012)	Disparate impact on the basis of race and national origin from the use of discretion in retail and wholesale mortgage pricing.	$21 million
United States v. GFI Mortgage Bankers Inc. (2012)	Disparate impact on the basis of race and national origin from the use of discretion in retail mortgage pricing.	$3.555 million
United States v. PrimeLending (2011)	Disparate impact on the basis of race from the use of discretion in retail mortgage pricing.	$2 million
United States v. C&F Mortgage Corp. (2011)	Disparate impact on the basis of race and national origin from the use of discretion in retail mortgage pricing.	$140,000
United States v. Nixon State Bank (2011)	Disparate impact on the basis of national origin from the use of discretion in pricing unsecured consumer loans.	$100,000
United States v. Bank of America, N.A. (2012)	Discrimination on the basis of receipt of public assistance income or handicap.	$1,000–$5,000 per borrower, plus $25,000 and $50,000 for complainants
United States v. Luther Burbank Savings (2012)	Disparate impact on the basis of race and national origin from imposing a minimum loan amount of $400,000 in wholesale mortgage lending.	$91,600

[3] See the website of the DOJ's Housing and Civil Enforcement Section for the settlement documents in each case. The US Department of Justice, accessed November 9, 2012,http://www.justice.gov/crt/about/hce/caselist.php.

In addition to the DOJ fair lending settlements listed in the chart, the CFPB and Federal Deposit Insurance Corporation recently reached a series of consent orders with American Express that dealt with credit card marketing practices but also included an allegation of age discrimination based on the use of a credit scoring system.[4] The American Express case highlights the fact that automation of lending decisions, alone, is not sufficient to ensure fair lending compliance. Credit scoring systems and automated decision engines must be scrutinized and monitored for fair lending risk.

Common themes in the allegations of discriminatory pricing or steering

Though each case is unique, some common themes run through them in terms of the lender practices alleged in the enforcement actions:

- broad discretion allegedly resulted in a "disparate impact" on a prohibited basis;
- a lack of clear policies and/or controls governing the exercise of discretion (e.g., "subjective and unguided pricing adjustments…not based on a borrower's objective credit characteristics"[5]);
- little or no documentation of the business rationale for discretionary pricing adjustments;
- financial incentives for loan originators to charge higher rates or fees or to steer borrowers to higher cost products; and
- a lack of effective fair lending monitoring or corrective action.

The settlements, and broader experience with enforcement actions, also have important implications for the level of fair lending risk and financial exposure facing lenders:

- potential liability can extend several years into the past (e.g., as far back as 2004 in some recent cases);
- broadly ranging investigations can be spawned from a statistical disparity in a single geographic area or from a consumer complaint or consumer interest group study alleging discrimination; and
- lenders face potential liability for the actions of third parties such as mortgage brokers.

Key themes in settlement provisions

The terms agreed to by the defendant lenders in the various DOJ settlements include a series of policies and practices that must be implemented to reduce the potential for fair lending issues. These provisions have tended to become more expansive and more detailed with each successive settlement. They include:

- Policies and procedures designed to avoid discrimination;
- Policies defining standards for discretionary pricing and fees, such as:
  - defined limits on pricing discretion,
  - written explanations for amounts charged in excess of some benchmark (including from brokers),
  - pre-funding review to ensure that loans comply with pricing policies,
  - a prohibition on funding loans that do not comply, and

[4] "CFPB orders American Express to pay $85 million refund to consumers harmed by illegal credit card practices," Consumer Financial Protection Bureau, accessed November 9, 2012, http://www.consumerfinance.gov/pressreleases/cfpb-orders-american-express-to-pay-85-million-refund-to-consumers-harmed-by-illegal-credit-card-practices/.

[5] *United States v. GFI Mortgage Bankers, Inc.*

  - refunds for inadvertently funding loans that do not comply;
- Documentation of rate reductions provided in exchange for discount points;
- A fair lending monitoring program that includes:
  - quarterly reviews of pricing outcomes in terms of note rate, APR, broker compensation, and any fees the lender retains for itself or pays to employees (as applicable),
  - aggregate-, MSA-, branch-, and originator-level monitoring (subject to a "30-30-100" sample size threshold),[6]
  - monitoring results presented to and approved by the board of directors,
  - corrective action for "unjustified" disparities that are statistically significant at the 95% confidence level, including potential financial remediation, policy/procedure changes, and/or disciplinary action, and
  - monitoring of product placement (in steering cases).
- Equal credit opportunity training for managers, loan originators, and other employees/agents in the loan origination process;
- A complaint resolution process, including documentation of complaints and resolutions;
- Retention of records related to monitoring and corrective action;
- Documentation in loan files of the objective criteria used in pricing, including the rate sheet relied upon; and
- Policies and procedures to explain the benefits and costs of alternative loan products to borrowers (in steering cases).

Implications of settlement provisions fair lending risk management

The terms of regulatory settlements tend, over time, to become regulatory expectations. Thus, it is important for lenders to study the settlement provisions, incorporate their key elements into the assessment of fair lending risk exposure, and consider whether business and risk management practices need to be adjusted to reduce risk. Specifically, the settlement provisions outlined earlier suggest that lenders should consider taking the following steps to control and monitor fair lending pricing risk.

- Review, revise, and monitor policies, procedures, and practices with respect to product offerings and pricing outcomes:
  - Establish policies regarding the appropriate bases for discretionary pricing adjustments or exceptions, and
  - Include a defined path for corrective action, including potential disciplinary action, in pricing policies and in fair lending-related policies generally,
- Control, manage, and monitor discretion and outcomes:
  - Manage discretionary pricing as you would exceptions, whether or not they are considered policy exceptions,
  - Document business justifications for discretionary pricing and underwriting decisions,

6 "30-30-100" means that monitoring must be conducted for each MSA, branch, and originator for which there are at least 30 loans for each of the two race/ethnicity group being compared and 100 total loans in the data sample for the two groups combined.

  - If possible, place a copy of the relevant rate sheet with all adjustments, or similar documentation of the interest rate derivation, in every loan file or maintain similar information in your loan origination system or pricing engine,
  - If a borrower pays discount points, maintain documentation (possibly in the form of a rate sheet) or data to demonstrate that the points paid were to reduce the rate according to an established trade-off schedule,
  - Use quality control testing and/or regular reporting to monitor adherence to policies,
  - Conduct periodic statistical monitoring (e.g., annually, semi-annually, or quarterly):
    - Test for differences in APR, the discretionary component of pricing and broker compensation (as applicable) on the basis of race, ethnicity, and gender,
    - Test for differences in underwriting outcomes on the basis of race, ethnicity, and gender,
    - Investigate at least those differences that are statistically significant at the 95% confidence level to determine whether they represent potential fair lending concerns or instead reflect legitimate differences in borrower credit characteristics or circumstances,
    - Take corrective action as necessary, and
    - Maintain documentation of the monitoring process, including any corrective action.
- Ensure systems are capturing the data needed for monitoring and capturing it accurately, including the relevant measure of discretionary pricing (e.g., overage/underage or premium/discount, exceptions, fee waivers, and lender credits),
  - Conduct periodic training—not just on fair lending regulations per se but also on aspects of employees' jobs relevant to ensuring consistency in customer treatment.

It is also important to scrutinize why pricing concessions are required and whether the frequency of concessions may be driven by the general level of your pricing relative to competitors. If a large proportion of loans or particular loan programs require pricing concessions in order to meet competition, consider whether rate sheet pricing levels can be adjusted to reduce the need for discretionary concessions.

In addition, lenders that offer non-conventional products that may entail higher costs to consumers or carry more restrictive terms should establish policies and procedures to limit the risk of discriminatory steering and should monitor for potential disparities in product placement. For example, statistical regression modeling can be used to evaluate whether differences in the shares of minority and non-minority borrowers receiving FHA and conventional loans reflect underlying differences in credit characteristics (such as credit scores and loan-to-value ratios). Alternatively, data mining together with file review can be used to evaluate whether any borrowers who received FHA loans would have qualified for a conventional loan at a lower cost.

Lessons from redlining settlements

Redlining continues to be another enforcement focus for the DOJ. Aside from having an outright policy or practice of not lending at all in certain areas that have high minority concentrations, there appears to be no universally accepted definition of what constitutes discriminatory "redlining."[7] For example, even if a lender has lending activity in predominantly minority areas, the fact that the lender has less lending concentration than other comparable (or "peer") lenders could be viewed as discriminatory redlining or at least as a disparate impact on the basis of race or ethnicity.[8] Redlining cases have typically been brought against banks, which are rated on their record of helping to meet the credit needs of the entire communities in which they operate, under the Community Reinvestment Act (CRA). It is not yet clear how CFPB will apply the notion of redlining to non-bank lenders who do not face similar obligations.

The most recent redlining cases settled by the DOJ are:

- *United States v. Midwest BankCentre* (2011, based on the St. Louis, MO area); and
- *United States v. Citizens Republic Bancorp, Inc.* (2011, based on the Detroit, MI area).

Typical allegations in these cases have included,

- serving the credit needs of predominantly non-Hispanic white areas while avoiding serving the needs of majority-minority areas;
- maintaining policies or procedures that had the effect of denying or discouraging loans to borrowers in majority-minority areas;
- failing to make available or to market mortgage loans equally in all parts of bank's CRA assessment areas (including via branches);
- appearing to have a race-based pattern in the locations of branch openings or acquisitions; and
- defining CRA assessment areas that exclude nearby majority-minority areas.

Implications of redlining risk for fair lending risk management

As in the case of managing fair lending pricing and steering risk, managing redlining risk requires a combination of diligence regarding business practices and statistical monitoring for potential risks. This may include:

- Comparing lending penetration in majority-minority census tracts to "peer" lenders who offer similar products within CRA assessment areas and/or major markets. This includes evaluating whether there are majority-minority areas within or near your main market areas in which competitors are lending successfully but your institution is not lending much or at all.
- Mapping loan applications, originations and branches in relation to minority populations within CRA assessment areas and/or major markets and (for banks) mapping CRA assessment areas in relation to concentrations of minority population.

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[7] The Interagency Fair Lending Examination procedures define redlining as "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" and defines several indicators of potential discriminatory redlining. However, there is no formal guidance on how such indicators are to be evaluated in order to conclude whether illegal discrimination actually occurred. "Interagency Fair Lending Examination Procedures," Consumer Financial Protection Bureau, accessed November 9, 2012, http://www.consumerfinance.gov/guidance/supervision/manual/interagency-fair-lending-examination-procedures/.

[8] What constitutes a "peer" lender is subject to considerable uncertainty. Size, measured by lending volume within a market area, is one criterion that enforcement agencies such as the DOJ have used to identify potential peer groups. However, it is also useful to consider whether potential peers are comparable in other respects, such as business model (e.g., retail versus wholesale, brick-and-mortar versus call center or Internet), product mix (e.g., conventional versus FHA and VA or prime versus subprime), and entity type (e.g., national bank versus community bank versus independent mortgage company).

- Scrutinizing business or branch expansion and consolidation plans. Specifically, it is helpful to ask such questions as:
  - Do the plans follow logically from objective market analysis?
  - What are the credit needs of minority areas in your markets, and is there a way to serve them better?
  - Are areas characterized as "less attractive" or "more attractive" in business or marketing strategies in a way that correlates to race/national origin?
- Evaluating potential impacts on redlining risk of acquisitions and mergers.
- Scrutinizing any geographic restrictions in underwriting guidelines (whether unique to your institution or handed down from an investor).

Incorporating servicing into fair lending risk assessments

The recent financial crisis has brought loan servicing to the fore as a key area of focus for compliance oversight and enforcement. Although there have been no recent settlements specifically focused on discrimination in loan servicing, the theme of fair treatment of consumers runs through the joint state-federal settlement with five major mortgage servicers that was reached in February 2012,[9] and the servicing issues addressed in those settlements (and poor customer service in general) have the potential to raise fair lending issues. In addition, the National Fair Housing Alliance has filed discrimination complaints with the US Department of Housing and Urban Development alleging that Bank of America, U.S. Bancorp, and Wells Fargo have not maintained foreclosed properties in predominantly minority neighborhoods as well as those in predominantly white neighborhoods.[10]

The continued enforcement and litigation focus around mortgage servicing suggests a need for diligence with regard to fair lending risk, and the lessons from other fair lending settlements apply here as well. Specifically, it is important to evaluate fair lending risk in servicing by

- understanding the business processes and controls;
- reviewing decision rules and models used in servicing, work-outs, and collections;
- determining where discretion is exercised and examining the guidelines for exercising discretion;
- monitoring quality control results to gauge adherence to policies;
- understanding outreach processes for delinquent borrowers;
- evaluating whether there is appropriate accommodation of borrowers with limited English proficiency;
- evaluating the processes and controls of any vendors used in loan servicing; and
- evaluating and monitoring practices regarding the maintenance of foreclosed properties.

As in the case of pricing and underwriting, statistical monitoring may be used to evaluate the risk of disparate treatment or disparate impact. In the area of default servicing and loan work-outs, areas of focus for statistical analysis and monitoring include differences on a prohibited basis in:

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[9] "Federal Government & Attorneys General reach landmark settlement with major banks," National Mortgage Settlement, accessed November 9, 2012, http://nationalmortgagesettlement.com.

[10] "Group accuses BofA of bias in managing foreclosed homes," Reuters, accessed September 25, 2012, http://www.reuters.com/article/2012/09/25/us-bankofamerica-foreclosures-complaint-idUSBRE88O1A920120925.

- the relative incidence of seriously delinquent borrowers or borrowers who enter the loss mitigation process receiving different loss mitigation outcomes (e.g., payment plan, forbearance, modification, short sale, deed-in-lieu of foreclosure, or foreclosure);
- processing times;
- rates of response to outreach efforts (e.g., work-out/modification solicitations to delinquent borrowers); and
- for borrowers receiving a loan modification, the amount of relief granted (interest rate reduction, forbearance, principal forgiveness, term extension, monthly payment reduction, payment-to-income ratio reduction), and rates of fall-out for borrowers with trial modifications (i.e., trial modifications that do not convert to permanent status).

Statistical disparities on a prohibited basis in terms of such measures do not necessarily indicate that there is a fair lending issue, but they can help to identify areas of greater and lesser fair lending risk that may require additional investigation and monitoring.

Conclusions

Fair lending compliance is an area rife with unclear and evolving standards. Differences in outcomes among consumers with apparently similar credit qualifications can pose a risk, even if they flow from objective business decisions or criteria, unless the business reasons for those differences are demonstrable. However, with a program of appropriate diligence, analysis, and monitoring, lenders can limit their compliance risk. Recent DOJ settlements provide useful guidance to help avoid fair lending issues. A key lesson from these settlements is that enforcement agencies expect any kind of discretion in lending that may affect consumers to have boundaries, and they expect business justifications for judgmental decisions to be demonstrable. The CFPB's examination manual is another source for insights to regulatory expectations and how fair lending examiners will analyze financial institutions.[11]

Beyond the specific recommendations outlined above, lenders should proactively examine all aspects of their credit operations for potential disparate impact risk—including policy rules and decision criteria that may be correlated with race, ethnicity, gender, or other prohibited bases—and automated decision engines and credit scoring systems that may contain criteria that proxy for prohibited bases. Where there appears to be a risk of disparate impact:

- scrutinize the business justification and necessity of the policy or criteria;
- determine whether there is sound analysis and documentation to support the business justification or necessity;
- evaluate whether the same business objective could be accomplished through means that pose less of a disparate impact risk; and
- periodically review business justifications to confirm that they continue to hold in light of market and business changes.

[11] "Supervision and Examination Manual—Version 2.0," Consumer Financial Protection Bureau, accessed November 9, 2012, http://www.consumerfinance.gov/guidance/supervision/manual/.

Finally, it is always advisable to consult legal counsel regarding fair lending analysis and monitoring matters and to consider whether they should be performed at the direction and under the supervision of counsel.

About the Financial Economics Practice at CRA

CRA's Financial Economics Practice provides economic and financial analysis and advice to financial institutions, financial regulators, and counsel representing financial institutions. Our experts are skilled in quantitative modeling and econometrics, particularly as applied to issues in credit and compliance risk in primary and secondary consumer lending markets. To learn more about the practice, visit **www.crai.com/financialeconomics**.

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