CRA Insights
Financial Economics

CRA Charles River Associates

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Fair lending considerations in bank or finance company mergers and acquisitions

Regulatory agencies review many aspects of bank and finance merger and acquisition applications, among these are fair lending considerations. While it may seem tangential, fair lending considerations have the ability to put at risk the success of the merger application and the success of the merged entity.

The FDIC requires that fair lending due diligence should include:

> "… a comprehensive Fair Lending review to ensure the acquired loans reflect: consistency in pricing and underwriting; no impermissible redlining or steering practices; fair marketing practices; and a strong CMS (Compliance Management System) as it relates to Fair Lending."

In addition, they counsel that one should:

> "Analyze the assessment area and determine if any newly acquired loan(s) could adversely affect the Fair Lending posture of the surviving institution. Any material inconsistency(ies) between the provisions of an acquired loan and the surviving institution's policies should be identified and monitored to ensure the loan is administered in a manner that is consistent with all applicable Fair Lending laws and regulations."[1]

What does that look like in practice? In this *Insights*, we highlight two areas – redlining and discretion – that can either impact the merger itself or cause substantial post-merger fair lending challenges. For both, special consideration should be provided during the due diligence process.

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[1] "Mergers and Acquisitions: A Compliance Perspective," *Supervisory Insights*, Summer 2013, Division of Risk Management Supervision of the Federal Deposit Insurance Corporation, available at https://www.fdic.gov/regulations/examinations/supervisory/insights/past.html.

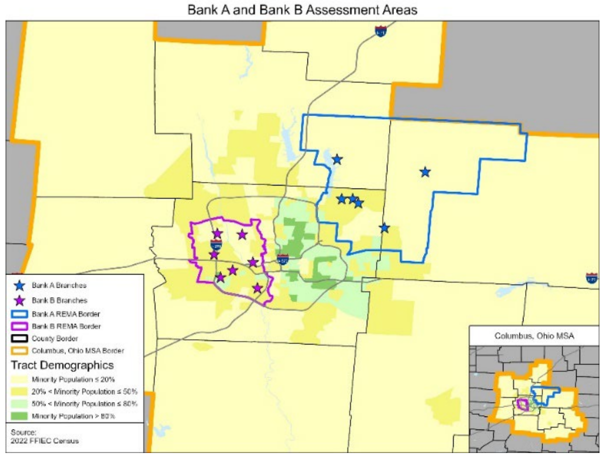
Redlining

"Redlining is an illegal practice in which lenders avoid providing services to individuals living in communities of color because of the race or national origin of the people who live in those communities."[2]

In practice, redlining assessments use publicly available Home Mortgage Disclosure Act (HMDA) data and compare the share of an institution's loans that are in minority areas to the share for some peer group of lenders in a particular geography. The geography may include metropolitan statistical areas (MSAs), counties, or sets of contiguous counties. These geographies may overlap or differ from the assessment areas identified by the financial institution for Community Reinvestment Act purposes and may expand to what the FDIC refers to as a "Reasonably Expected Market Area" or REMA.[3] While it is important to assess both acquiring and potentially acquired institutions for redlining risk individually, it is also crucial to understand how the combined entity might be viewed. If the potentially acquired company operates in markets that are geographically close, but different, from the acquiring company, analyses that separate the two may miss important redlining risks.

Suppose an institution has a presence in a relatively non-Hispanic white neighborhood(s) of an MSA and that the MSA has other neighborhoods with large minority populations. If this institution is interested in acquiring an institution with a presence in a different relatively non-Hispanic white neighborhood(s) in the same MSA, the combined entity may appear to be redlining around the minority areas of the MSA (see the map below for an example of two theoretical institutions). While neither entity's REMA may include the minority neighborhoods, when the institutions are combined, a regulator may consider the entire MSA to be its REMA. In this situation, if the combined institution is not serving minority neighborhoods, there may be elevated redlining risk.

Bank A and Bank B Assessment Areas



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2 Department of Justice, "Justice Department Announces New Initiative to Combat Redlining," news release, October 22, 2021, https://www.justice.gov/opa/pr/justice-department-announces-new-initiative-combat-redlining#:~:text=Redlining%20is%20an%20illegal%20practice,who%20live%20in%20those%20communities.

3 "Are You at Risk for Redlining? Understanding Your Reasonably Expected Market Area (REMA) and CRA Assessment Area," San Francisco Region Bankers' Forum, FDIC, March 14, 2018, https://www.fdic.gov/news/events/sf-region/2018-03-14-rema-cra-presentation.pdf.

With the implementation of Section 1071 of the Dodd-Frank Act, data on small business lending will soon become available, aiding regulators in additional redlining analyses. Even without peer data, lending institutions can look at maps of their own lending to understand the potential redlining risk in non-mortgage lending products.

The use of discretion

Understanding the impact of discretion across demographic groups when approving applications or pricing loans has been the focus of fair lending testing for decades. Acquiring institutions should understand how discretion and judgment are used in the potentially acquired institution and their importance to the business model of that institution. While the questions are similar for both mortgage and non-mortgage products, there are special considerations for non-mortgage products because those lack the race and ethnicity information provided in HMDA data and which may be available for small businesses with the potential implementation of Section 1071 of the Dodd-Frank Act.

Mortgage products

Using HMDA data has made the analysis of application and pricing outcomes routine for mortgage products. Based in part on regulatory oversight, lenders have tried to minimize discretionary underwriting and pricing decisions to improve consistency in mortgage lending outcomes across demographic groups. Notwithstanding this, regulators have had a renewed focus on discretionary pricing adjustments made to consumers in 2022. For example, several institutions are being examined with respect to pricing exceptions, even if such adjustments are made consistent with a bank's policies, including when the reasons for the adjustments are fully documented by the institution. If a financial institution has a high share of loans made with such price adjustments, there may be heightened fair lending risk.

Potential fines or remediations could result from findings of fair lending violations with respect to price exceptions, and completely eliminating such practices may have substantial detrimental effects on the business model of the potentially acquired firm. A firm that sets baseline rates at a relatively high level and meets market rates only for those who price shop, may make a disproportionate amount of profit on loans made to borrowers that do not have competitive matches. Because of this, refining such a pricing strategy in a way that sets initial pricing at the rates currently provided to those with competitive matches may be challenging and costly. Alternatively, if no price matches are made, the institution may see a degradation in market share and loan volume.

Non-mortgage products

While key demographic information (race/ethnicity/gender) for fair lending testing is only available for mortgage products, fair lending tests can still include non-mortgage lending products using proxies (e.g., Bayesian Improved Surname Geocoding (BISG)).[4] Lenders should

[4] Consumer Financial Protection Bureau, "Using publicly available information to proxy for unidentified race and ethnicity," Summer 2014, https://files.consumerfinance.gov/f/201409_cfpb_report_proxy-methodology.pdf or CRA report for American Financial Services Association, "Fair Lending: Implications for the Indirect Auto Finance Market," November 19, 2014, https://media.crai.com/wp-content/uploads/2020/09/16164405/Fair-Lending-Implications-for-the-Indirect-Auto-Finance-Market.pdf.

understand if there are differences in outcomes in underwriting or pricing in non-mortgage consumer products that cannot be explained by objective underwriting and pricing factors. While most lenders have good systems for tracking the information for such testing in mortgage products, many do not have the systems needed to track such data, including the reasons, for underwriting or pricing decisions in non-mortgage products. The less data available, the greater potential there is for underwriting or pricing differences across groups to remain unexplained by statistical models (which increases fair lending risk). This is important for products that will be covered by Section 1071 of the Dodd-Frank Act (the final rule is expected by the end of March 2023), as once it is implemented, regulators will have substantially more data with which to assess potential fair lending violations.

Additionally, as there has traditionally been less scrutiny on many of these products, the merger due diligence should fully understand the extent to which discretion or judgment is used in the application process. All else equal, the more judgment or discretion there is, the higher the fair lending risk. The same concern for pricing exceptions and competitive matching that applies to mortgage lending also applies to non-mortgage products.

About the Financial Economics Practice at CRA

Our consultants provide 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 consumer lending markets. We provide fair lending analyses of underwriting, pricing, redlining, and servicing practices for use in litigation and regulatory investigations. We also provide ongoing statistical monitoring of fair lending risk, including monitoring required under the terms of consent orders with federal regulatory agencies.

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