FAIR LENDING

The mortgage crisis has created an enhanced interest in fair lending principles. Congress, regulators, and the press are all expressing concern that predatory lending practices, particularly in the subprime market, have contributed to problems with regard to foreclosure. Furthermore, the expanded data on the Home Mortgage Disclosure Act (HMDA) reports have provided more fodder for review. Unfortunately, even with the expanded information on the HMDA report, it still does not include all of the information that reflects a lender’s underwriting decision. This is a two-edge sword as it would be very expensive for lenders to also track credit scores and include those on HMDA LARS as well as the other information currently required.

We are also seeing more fair lending examinations as the HMDA analysis reflects so-called “outliers.” Thus, even though a compliance exam has reflected that an institution’s underwriting is nondiscriminatory, a fair lending examination may still be imposed if the HMDA data indicates that there are statistically significant differences in interest rates between different groups.

What is “fair lending”? There isn’t actually a single “fair lending” act. Rather, this is a shorthand way of referring to several laws applicable to nondiscrimination in the lending area. These include the Equal Credit Opportunity Act as implemented by Regulation B, the Fair Housing Act, which prohibits redlining, and the Community Reinvestment Act. HMDA is the mechanism by which reports are generated to evaluate mortgage compliance with the fair lending laws.

What is prohibited? Basically, it is unlawful for a creditor to discriminate against any applicant with respect to any aspect of a credit transaction (which includes not only a decision to make a loan but also its terms) on the basis of race, color, religion, national origin, sex or marital status, or age; because all or part of the applicant’s income derives from public assistance programs; or because the applicant has in good faith exercised any right under the Consumer Credit Protection Act. These protective classes are found in the Equal Credit Opportunity Act. The Fair Housing Act is very similar but it also applies to real estate transactions more broadly including sale of property, rental, and advertising as well as lending. In addition to race or color, national original and religion and sex, the Fair Housing Act also prohibits discrimination based on familial status and handicap.

What constitutes discrimination? Although the statutes do not explicitly provide for different tests, the regulators have used an employment style analysis with regard to lending discrimination. Thus, discrimination could be overt, disparate impact, or disparate treatment. Overt discrimination is fairly straight forward. This is where an individual transaction decision about credit is made based impermissibly on a prohibited basis. Disparate treatment can be established either by statements revealing that a lender explicitly considered prohibited factors or by differences in treatment that are not fully explained by legitimate nondiscriminatory factors. Disparate impact occurs when a lender applies a facially neutral policy or practice equally to all credit applicants but that policy or practice disproportionately excludes or burdens certain persons on a prohibited basis. An example given by the regulators is a policy by which loans for single family residences are not made for less than $60,000. If that minimum amount
disproportionately excludes potential minority applicants, then this could have a disparate impact on minorities. [note: For home equity loans, the bank may have a business reason for setting a threshold size in order to recover costs of making the loan.] Disparate treatment is often shown where a particular group is steered into a particular type of product that is less favorable than a non-protected class is directed to.

What are the consequences of fair lending violations? First, individuals have certain civil rights and can bring a civil suit for damages. That is not as likely to be a major consideration for most lenders. The most significant issue is regulatory enforcement. Depending on the number of violations and whether there is a pattern or practice, a regulator may seek prospective and retrospective relief. Prospective relief could include adopting corrective policies and procedures, training, community outreach, better internal audit controls and oversight systems, and monitoring of compliance with periodic reports to the primary federal regulator. Retrospective relief could include identifying customers who are subject to discrimination and offering them credit that they were improperly denied or requiring restitution to injured parties. Civil money penalties are also possible.

What should banks do to avoid fair lending problems? First, make sure that you have good policies in place to prohibit discrimination. Next, consider using internal testing, pairing a minority with a comparable Anglo applicant to determine whether there is any disparate treatment. Self-testing is protected under Regulation B. Be sure that you have good training in place to assure that loan officers do not inadvertently steer protected classes into a more expensive product. In addition, be sure that you have good HMDA reporting systems in place to make sure that the data submitted is as accurate as possible. Remember that it is HMDA reports that trigger additional questions. All too often HMDA reporting is inadequate or incorrect.

Resources. The publication “A Guide to HMDA Reporting: Getting It Right!” is an excellent resource. It is available online at the FFIEC website. There are also some HMDA training programs available at the FFIEC website. Also consider reviewing the FDIC publication “Side by Side: A Guide to Fair Lending.” For national banks, look at the Comptroller’s Handbook on Fair Lending Examination Procedures. All of these are excellent tools that can assist you in making sure that your programs are in good shape.