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# Fair Lending Update: What are the Critical Issues

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# Indirect Auto Lending and its Legacy

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- Class action litigation settlements with major auto dealers that have captive auto financing companies due to allegations that dealers were charging higher and more frequent mark-ups to customers in protected classes.
- CFPB and DOJ enforcement actions:
  - *Ally* – Alleged dealer markups against African Americans and Hispanics
  - *Nara Bank* – Alleged pricing discrimination against non-Asians
  - *Nationwide Nevada, LLC* – Alleged discrimination against Native Americans living on reservations
  - *Compass Bank* – Alleged discrimination on basis of marital status
- Less of a concern in 2017
  - But what has the result been?

# Proxy Analysis

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- Use of assumptions based on information lender has (name, address) to proxy race, ethnicity, and gender
  - Surname and geography used to proxy race and ethnicity
  - First name used to proxy gender
- Methodology utilized by the CFPB and DOJ
  - BISG (Bayesian Improved Surname Geocoding)
    - How reliable is it? Not very, according to empirical analysis
  - What are examiners' expectations?

# Other Products in Focus

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- Credit cards
  - Treated as an unsecured loan
  - CFPB complaint data
  - Rewards
- Overdraft protection
  - Inconsistent application of fee waivers
  - Disclosures surrounding how and when overdraft fees assessed
  - Reg. E violations relating to handling of electronic fund transfer error notices
  - Controlling outlier or “excessive use”
  - CFPB rulemaking
- Non-HMDA residential real estate
- Servicing issues

# Current Regulatory Environment

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- Significant regulatory focus on lending discrimination and “fairness” concepts in banking practices:
  - U.S. Department of Justice (DOJ) Fair Lending Enforcement Unit within its Civil Rights Division
  - CFPB Issues
    - CFPB’s Office of Fair Lending & Equal Opportunity will enforce federal fair lending laws and unfair and deceptive acts and practices (UDAP) laws for banks over \$10 billion in assets
    - Increased fair lending and UDAP enforcement actions by federal banking agencies, FTC and state attorneys general, including increased referrals to DOJ for “pattern or practice” discrimination allegations

# Third-Party Activities

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- Fair lending concepts cover third parties that perform any credit-related activities on behalf of banks.
  - Regulators expect that lenders will holistically manage fair lending compliance risks posed by activities conducted directly by third parties.
- Contracts should require compliance with all applicable laws and regulations, including fair lending.
- Banks should expect third parties to maintain their own controls and training related to fair lending, and banks should conduct periodic audits of third parties to ensure compliance.

# CFPB's Fair Lending Priorities

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- CFPB's Director of the Office of Fair Lending and Equal Opportunity announced fair lending priorities for 2017.
- Blog post: CFPB will increase its focus and concentrate on:
  - Small business lending – whether women-owned and minority-owned small businesses experience discrimination when applying for credit
  - Redlining – whether lenders are intentionally avoiding lending in minority neighborhoods
  - Mortgage and student loan servicing – if delinquent borrowers face more difficulty in working out payment arrangements with mortgage or student loan servicers because of their race or ethnicity

# Small Business Lending

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- Steps to take now:
  1. Define “small business loan” for your bank
    - No controlling regulatory guidance
    - How should you define a small business?
      - Revenue
      - Loan amount
      - Assets
      - Number employees
  2. Formalize the small business application process
    - Many institutions currently lack a written application form for business credit.



# Small Business Lending

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- Steps to take now:
  3. Standardize lending procedures
    - Underwriting standards
    - Loan policy
    - Counter-offer processes
    - Pricing
    - Exceptions
    - Servicing
  4. Determine data collection processes

# Small Business Lending

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- Steps to take now:
  5. Update your Fair Lending CMS
    - Policy and procedure
    - Risk assessments
    - Self assessments/ongoing monitoring
    - Model validations
    - Complaint management
    - Management and board reporting

# Small Business Lending

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- Steps to take now:
  6. Look at your fair lending training
    - Are business lenders covered?
    - Include technical compliance and fair lending principles
    - Examples of fair and unfair practices in small business lending
  7. Determine proxies
  8. Perform fair lending analyses
    - Underwriting and pricing regressions
    - Exception distribution
    - Redlining
    - Steering
    - Complaints analysis

# Small Business Lending

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- Steps to take now:
  9. Perform file reviews
    - Drill down into results from statistical analyses
    - Consider product type, industry, collateral types, and geography
    - For banks with 3rd party lending relationships, consider performance by partner
  10. Remediate
    - Remediate any CMS or line of defense controls necessary as a result of the review findings
    - Examples: underwriting policy, pricing policy, second reviews of denied applications, ongoing monitoring, etc.

# The (Re-) Return of Redlining

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- Redlining is the practice of unlawfully restricting or denying credit to geographic areas with high concentrations of protected class residents
  - Reverse redlining
    - Practice of unlawfully targeting protected class consumers for credit products with unfavorable terms, conditions, or pricing
- Protect your institution through self assessments
  - Perform proactive monitoring and analysis to identify conspicuous gaps and disproportionate lending patterns in the geographic distribution of marketing and origination activities
  - Monitor all major lending portfolios, including small business.
  - Consider majority-Black, majority-Hispanic, or majority-Black and Hispanic census tracts as well as all majority-minority census tracts
  - Perform annually, at minimum

# Focus on Redlining

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- Redlining is different than it has been traditionally
  - 3 “types” of issues:
    - Intrabank redlining – what is the bank doing?
    - Interbank redlining – comparison against peers
      - Who are your peers?
    - Environmental factors
- Reasonably Expected Market Area (REMA)
  - Also trade area, market area, or service area
  - Relationship to CRA assessment area
  - Defined by regulators, not the bank

# Focus on Redlining

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- Key factors to review in a redlining assessment:
  - Geographic distribution of lending activity
  - Location of branches and loan production offices (LPOs)
  - Marketing practices
  - Product availability, terms, and conditions
  - Market demographics

# 6-Step Review Process

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1. Define review scope
2. Identify in-scope geographies
3. Select target peer groups (HMMDA only)
4. Run redlining analytics
5. Compile and analyze composite results
6. Summarize and document review



# REMA Factors

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- Location of applications and loans
- Location of deposit customers
- Marketing and outreach efforts
- Distribution of brokers or realtors
- Business model
- History of mergers and acquisitions
- Complaints related to your service or market area or lending patterns

# Performance Context: Tell Your Story

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- A set of conditions, both internal and external, which mediate, support, and influence an institution's lending performance in a certain geographic area
- Analysis of demographics and dynamics of a particular market, including:
  - Share of majority-minority and LMI census tracts
  - Key demographic and economic factors
  - Barriers to lending
  - Market rankings (loan and deposit share)
  - Extent of competition and lending trends for the entire market
  - Branch locations
  - Outreach and marketing activities
  - Lending strategies
  - Market capacity and need to borrow
  - Product set

# New Twist – Digital Redlining

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- Digital redlining is a form of discrimination where lenders restrict access to credit, or offer credit on unequal terms, because of the applicants' digital footprint.
- It occurs when products or pricing offered or displayed vary by digital channel, with channels with greater minority usage offered adverse terms and conditions.
- Digital redlining can also occur when lenders curate online advertising or set loan terms and conditions based on internet tracking or big data.

# Digital Redlining Risk Factors

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- How do you use web and mobile app location data?
- Do you use big data or alternative data in credit marketing, underwriting, or pricing algorithms?
- What criteria are you using to place digital advertising?

# Managing Digital Redlining Risk

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- Review marketing plans:
  - Avoid prohibited bases in marketing funnels and inclusion/exclusion criteria
  - Ensure the marketing plan covers all neighborhoods in your REMAs
  - Understand third-party ad placement criteria.
- Review websites and mobile applications:
  - Are they ADA compliant?
  - Are they data-intensive?

# Managing Digital Redlining Risk

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- Review product offerings by channel:
  - Do products, terms or conditions vary by channel?
  - If so, evaluate potential disparate impact
- Review credit models:
  - Avoid prohibited bases
  - Be prepared to justify data points without a clear connection to creditworthiness
  - Adopt strong model validation practices incorporating fair lending considerations

# Other Emerging Issues

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- Emphasis on data integrity
  - Pricing cannot be examined if the data is flawed
    - Recent enforcement action as evidence and a warning
  - No mandates as to exactly *what* you should do, but you should have a good idea of what your data says about you
- CFPB's Reg. B commercial reporting rule
  - Cultural impact will be more important
  - Focus on operational rather than fair lending impact
- CRA as a fair lending tool

# What is Fair Servicing?

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- Fair lending requirements apply throughout the life of the loan, including servicing, line management, loss mitigation, workouts, collections, and foreclosure
- Borrowers, especially distressed borrowers, should be treated fairly and appropriately
- Servicing and loss mitigation patterns should not result in disparities in methods or outcomes based on geography or protected class membership
  - Outcomes – disparate impact
  - How did borrower get to the result – disparate treatment
- Servicers should be responsive to borrower needs



# Fair Servicing Analytics

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- Evaluate servicing outcomes and methods for UDAAP and fair lending
  - Are servicing practices unfair, deceptive, or abusive?
    - What would be UDAAP here?
  - Do borrower outcomes differ on a prohibited basis?
    - How did this borrower end up with this solution?
    - Evaluate propensity to keep or lose home by demographic group
    - Drill down into details of loss mitigation activities to evaluate propensity for foreclosure, deed in lieu, short sale, forbearance, term extension, interest rate reduction, etc.

# Fair Servicing Analytics

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- Evaluate servicing outcomes and methods for UDAAP and fair lending
- Examples of items to examine:
  - Modifications/general loss mitigation decisions – look to:
    - Denial disparities – who got what and why? Who didn't get help at all?
      - Perform regression or other statistical analysis on this
    - Correlation between default population and modifications
      - Similar to a approve/deny decision in originations

# Fair Servicing Analytics

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- Challenges with analyzing modifications/loss mit
  - Data – do you have it?
    - Servicing and loss mit data is historically unreliable
    - May be housed in different systems
    - Consistent data collection and retention is rare
  - Often don't have GMI
    - Sometimes you will, sometimes you won't
    - Proxy challenges
  - Comparing solutions
    - Apples to apples?
    - But this is the true analysis – why was this solution provided for this borrower?

# Fair Servicing Analytics

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- Servicing – fair lending risk factors
  - Fee waivers
  - Default fee amounts, including capitalization
  - Contact frequency and method
  - SPOC assignment
  - Consistency of credit reporting
  - Classification of defaulted borrowers

# Additional Servicing Issues

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- Look to complaints for data points
- How are LEP borrowers treated?
- Don't forget HELOCs
- Is fair servicing addressed in your FL CMS? In a FL risk assessment?
- Are third parties involved?
- Are servicing and loss mit personnel trained in fair lending and UDAAP?
- Are methods and results reviewed by compliance or audit for UDAAP and/or fair lending issues?
- Is discretion reported and reviewed?

# Foreign Language Challenges

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- Limited English Proficiency (LEP)
- Should lenders advertise loan products in languages other than English?
  - Yes, but...
- “Expectation” that the entirety of the transaction will then be conducted in that language?
  - Servicing – particular challenge for distressed borrowers (loss mit activities) and foreclosure
  - State law requirements
- Translation difficulties (dialects, etc.)

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