FEDERAL RESERVE BANK
OF CHICAGO

Banker's Guide To Risk-Based Fair Lending Examinations

Introduction–Banker's Guide To Risk-Based Fair Lending

This publication is a guide to the new Interagency Fair Lending Examination Procedures. It provides an overview of the new risk-based approach that examiners will use when assessing a Lender's compliance with the Equal Credit Opportunity Act (Regulation B) and the Fair Housing Act (FHAct).

The Interagency Fair Lending Examination Procedures (with Appendix) establish a uniform set of procedures for the Federal Financial Institutions Examination Council (FFIEC) member agencies to use in their fair lending examinations. The procedures are available on the FFIEC's web site at http://www.ffiec.gov/fairlend.pdf and http://www.ffiec.gov/fairappx.pdf. Agencies will use the procedures on all fair lending examinations beginning in January 1999, although the phase-in period differs by regulator.

The new procedures are intended to provide a basic and flexible framework to be used on the majority of fair lending examinations. The procedures reflect a determination by the FFIEC member agencies that fair lending compliance examinations should be conducted using a risk-based approach. Each Lender's overall fair lending risk will be assessed by considering its unique loan product mix, market demographics and compliance program. An important feature of the new procedures involves the adjustment of a Lender's "risk rating" based on the Lender's internal monitoring systems and Compliance Management Program, as well as the level of management oversight of higher risk loan products and loan delivery systems. Thus, the new procedures offer each Lender the opportunity to influence both the scope and intensity of its fair lending examination by demonstrating sound fair lending risk management.

These procedures focus on the Lender's compliance with the anti-discrimination requirements of Regulation B and FHAct; they do not address the technical provisions of these regulations, such as the adverse action notice requirements and the collection of government monitoring information. Examiners will continue to use other examination procedures to assess technical compliance with these and other related consumer protection laws and regulations, such as the HMDA and CRA. The procedures emphasize racial and national origin discrimination risk for residential real estate transactions. However, risk-based techniques can, and will be applied to other prohibited bases and loan transaction types as well.

This guide is divided into four sections:

Part I. Examination Scope Guidelines:

This part explains how the examination scope is established. The Examiner will evaluate the Lender's credit operations, market(s) served, including presence of prohibited basis groups and neighborhoods, decision center(s), and compliance management systems. The Examiner will evaluate the potential for discriminatory conduct, as well as the Lender's previous compliance performance. Risk factors (listed in the procedures) and their impact on particular lending products and practices will be used as indicators of potential disparate treatment in the Lender's credit activities. Preliminary "focal points" will be determined at this stage of the examination.

Part II. Compliance Management Overview:

This part explains how the selection of focal points and the intensity with which they are investigated will be finalized based on the Lender's fair lending Compliance Management Program. Final selection of focal points and intensity levels will be influenced heavily by the Lender's demonstrated oversight of products, policies, marketing and delivery to prohibited basis groups and neighborhoods.

Part III. Examination Procedures:

Once the focal points and intensity levels have been determined, the Lender's fair lending performance will be assessed by applying one or more of the analyses (listed on page 3 of this guide) to each focal point. The Examiner will then establish the appropriate loan sample size related to each focal point's intensity level. Loans in the sample will be reviewed at this point.

Part IV. Obtaining and Evaluating Responses from the Lender and Concluding the Examination:

This part describes the agency guidance that the Examiner will use when presenting examination findings, including those related to disparate treatment, level of assistance issues, and evidence of disparate impact or effect. It discusses how the Lender's responses will be evaluated, and the additional steps the agency may take regarding potential violations.

Naturally, there is some interdependence between the four phases and, depending upon the information available to the Examiner, some steps may be unnecessary.

This guide also includes the loan sample size tables and a glossary of terms. For more detailed information, readers should refer to the Interagency Fair Lending Examination Procedures.

I. Examination Scope Guidelines

The Examiner will:

1. **Gather initial information (as applicable)**

   Regulator's in-house information: Previous reports of examination and workpapers; complaints; HMDA data; surveillance data; population demographics and other performance context data on the Lender's assessment area (as identified by Lender); regression analysis results; etc.

   Information from Lender: Description of Lender's Compliance Management Program; products offered; new products; approval/declination volumes; audit reports; credit scoring information; use of indirect dealers or independent brokers; Lender/broker compensation plans; loan-related ad copy; HMDA and CRA data; loan-related forms/applications; lists of service providers such as realtors, appraisers, etc.; pending litigation; Internet sites; delegation of lending authority; loan officer discretion of pricing/credit terms/conditions etc.; community information; consumer complaints; marketing efforts.

2. **Perform initial analysis** - Select products for in-depth scope review, based on loan types, loan/denial volume, and products reviewed at the previous examination.
3. **Gather additional information for products selected for in-depth review** - Information may include underwriting criteria, pricing policies, compliance management information, advertising data and other relevant data.
4. **Conduct interviews/discussions with Lender's management and appropriate staff to gain a better understanding of the Lender's credit operations.**
5. **Identify risk factors** - Common risk factors related to overt discrimination, redlining, underwriting, steering, marketing and pricing are listed in the fair lending procedures.
6. **Select focal points** - Focal points with the most serious or greatest number of risk factors will be selected.

The Examiner will collect and analyze additional information under the following circumstances:

- **For "complex institutions":**
  - Obtain all regular scoping data for Lender's subsidiaries and affiliates (if they act as agents for the Lender).
  - If not scheduled as part of the full examination, obtain subsidiary and affiliate underwriting standards and procedures, and analyze to identify risk factors.
- **When the Lender's portfolio contains purchased loans or applications from a newly acquired Lender**
- **When the Lender operates loan underwriting or processing centers with independent credit approval authority**
- **When credit approval for a single transaction involves more than one underwriting center or when third parties, such as brokers or contractors, are involved in credit underwriting decisions**
- **For large and geographically diverse assessment areas, the Examiner will target those geographies with the highest degree of "discrimination risk" for in-depth review (such as areas with large minority populations)**
- **When credit scoring is used, Examiner will complete the "Credit Scoring Analysis"**

II. Compliance Management Review

Note: The thoroughness and quality of a Lender's Compliance Management Program in preventing fair lending violations, and the adequacy of corrective actions will influence the selection of focal points and increase or decrease the intensity level of the examination.

1. **Examiner will assess the preventive measures used by the Lender by reviewing:**
   a. Lending practices, policies and procedures
   b. Clarity of underwriting criteria
   c. Reasonableness of pricing and fees
   d. Management monitoring of exceptions to articulated lending standards
   e. Accuracy and timeliness of denial notices to loan applicants
   f. Employee training and specific initiatives to prevent forms of unintentional discrimination

2. **Examiner will assess Lender's efforts in correcting discriminatory conduct:**
   a. Did management take appropriate corrective action?
   b. Did management provide adequate relief to victims?

3. **The Examiner will then finalize the focal points and intensity levels for the examination, based on the level of "discrimination risk" presented by various policies, products, and practices.**

III. Examination Procedures

Step One: Sampling analysis

Loan sample sizes are determined as follows (see page 6 for sample tables):

1. Consumer focal points:

- Table A for the "underwriting" analysis (includes control group approved loans and prohibited basis group denied loans)
- Table B for the "terms/conditions" analysis (includes approved loans from control and prohibited basis groups)

2. Small business/small farm focal points:

To the extent possible, denied applications and approved loans should include:

a. Businesses under $1 MM in annual gross revenues and farms under $500M in annual gross revenues

b. Transactions acted upon within the 3 months immediately prior to the start of the examination, up to a maximum of 10 transactions

c. Transactions from or made in minority and integrated geographies

d. Minority and women applicants

e. Loan applications with similar business and financial characteristics

3. Additional sampling and "benchmarking" guidance:

- The Examiner will judgementally select marginal transactions and/or additional loans from outside the sample period. The sample sizes may also include withdrawn and incomplete applications.
- Consumer applications/loan transactions will generally be compared *directly to each other;* commercial applications/loan transactions will be compared to the *articulated lending standards/policies.*
- The Examiner will use "benchmarking" when reviewing samples.

Step Two: The Examiner will focus on marginal transactions for each focal point, and perform the following analyses, as appropriate

1. Disparate treatment in underwriting analysis: The Examiner will compare a Lender's underwriting decisions to determine whether the Lender treated applicants more or less favorably on a prohibited basis. Applicant profiles will be compared to ensure that the Lender provided the level of assistance, waivers, or acts of discretion, etc. in a nondiscriminatory way. For loans not subject to HMDA reporting, "surrogate" information may be used to determine the applicant's race, gender, age, etc. Marginal transactions and evidence of prescreening will also receive special attention.

2. Loan terms and conditions analysis: The Examiner will evaluate a Lender's loan terms and pricing decisions, including interest rate, points, fees, collateral requirements, etc., to determine whether the Lender treated borrowers more or less favorably on a prohibited basis. Evidence of selectively quoting harsher terms and conditions to discourage prohibited basis group applicants will also be reviewed.

3. Disparate treatment analysis: In addition to information obtained from the loan sample review and other statistical analysis of lending data, the Examiner may identify evidence of possible disparate treatment through: written policies, employee interviews, observed unwritten practices, information obtained from community representatives, and complaints filed against the Lender.

4. Disparate impact analysis: The Examiner may identify disparate impact through sample file comparisons and other statistical analysis of lending data and community demographics, accompanied by information obtained from: written policies, employee interviews, observed unwritten practices, information obtained from community representatives, and complaints filed against the Lender. Note that the procedures do not call for examiners to plan examinations to identify or focus on potential disparate impact issues.

5. Steering analysis: The Examiner will review the credit operations of the Lender, and any subsidiaries and affiliates, particularly: written policies and procedures for offering of alternative loan products; marketing materials; information provided by community representatives; and complaints filed against the Lender. The Examiner will also review the extent of loan personnel's discretion in deciding credit alternatives and determine if credit alternatives are offered to applicants without respect to prohibited basis characteristics. May include conducting a comparative terms/conditions analysis of loans.

6. Redlining analysis: The Examiner will identify excluded or underserved prohibited basis group geographies and compare loan activity to activity in control areas. The Examiner will obtain the Lender's explanation for the apparent differences in treatment between the areas, and may obtain and evaluate other information that supports or contradicts the Lender's explanations. Information reviewed by the Examiner may include: HMDA data, marketing, information received from third parties, complaints, observed Lender behavior, and contents of loan files.

7. Marketing analysis: The Examiner will review the Lender's marketing plan, content of marketing materials, media usage, other marketing distribution methods, self-produced promotional materials, and marketing produced by third parties (realtors, brokers, contractors, etc.). This information is reviewed to determine if a lower level of marketing effort was made toward prohibited basis groups or geographies, or whether the content would tend to discourage prohibited basis group applicants or geographies from seeking a loan.

8. Credit scoring analysis: The Examiner will review the credit scoring system's structure, organization, adverse action notices, use of age, the system's empirical derivation and statistical soundness, and the use of judgmental overrides. The Examiner will determine if application of the credit scoring system has resulted in disparate treatment of prohibited basis groups. Loan files will be reviewed to determine whether loans were properly underwritten and that terms were set in accordance with credit-related criteria. The number and basis of overrides made to the credit score will also be reviewed to ensure that override decisions are applied consistently among applicant groups.

Step Three: INTENSITY – Additional Analysis and Examination Procedures

1. Management Discussion

The Examiner will maintain ongoing dialogue with management regarding examination procedures and findings, especially related to overt or comparative disparate treatment in underwriting or pricing/terms, possible pre-screening, disproportionate adverse impact, and discriminatory marketing.

2. Community Contacts

The number, type and location of community representatives contacted is determined by the Examiner based on the potential for "discrimination risk" presented by a number of factors, including:

a. The location or demographic characteristics of geographies within or near the Lender's assessment area (for example, are geographies low- and moderate-income and/or minority?)
b. Lender's loan policies and practices
c. Lender's products and lending volume
d. Lender's use of third party loan originators or brokers
e. Lender's procedures for underwriting and setting of loan terms
f. Lender's marketing practices
g. Consumer complaints

Note: Community contacts are also conducted as part of the CRA evaluation.

3. Branch Visits

The number and selection of branch offices to be visited, and the intensity of the visits, are determined by the level of "discrimination risk" presented by a number of factors, including:

a. Loan volume generated from the branch office
b. Branch location and demographic characteristics of the customer base
c. Degree of branch independence in marketing, underwriting, or other key lending-related functions
d. Complaints against certain branches or the branch network
e. Information from community representatives

Note: Branch visits are also conducted as part of the CRA evaluation.

A key feature of the risk-based fair lending examination procedures is the Examiner's assessment of the self-evaluation portion of the Lender's Compliance Management Review.

1. The quality and comprehensiveness of a Lender's self-evaluation can impact the Examiner's selection of both examination focal points and sample sizes.
2. The Examiner can opt to substitute different focal points for those originally selected for review through the scoping process, if the Lender has demonstrated adequate review of the focal points through its self-evaluation.
3. The Examiner can opt to use smaller sample sizes in a given range if the Lender has demonstrated an adequate level of file review and preventive measures through its self-evaluation.
4. There is no legal or agency requirement for Lenders to conduct these activities. The absence of any of the policies and practices listed in the Compliance Management Checklist is never, by itself, a violation.
5. The importance of the Compliance Management Program, including the Lender's self-evaluation, is related to the level of discrimination risk presented by the assessment area, product mix and product delivery systems.

IV. Obtaining And Evaluating Responses From The Lender And Concluding The Examination

As indicated above in Section III, Examination Procedures, the Examiner will maintain ongoing discussion with the Lender's management regarding examination findings, including those findings related to possible disparate treatment or impact. If any (a) unexplained deviations from credit standards, (b) inaccurate reasons for denial, (c) incorrect disclosures, or (d) evidence of control group applicants receiving more favorable terms and conditions are noted, the Examiner will obtain and document explanations from the Lender. If there is some evidence of violations in the underwriting process or in the imposition of terms and conditions, the Examiner may expand the samples to determine whether a pattern or practice of discrimination does or does not exist. Based on the results of these discussions, the Examiner may refer findings to agency management for further guidance and investigation.

Findings of particular concern to the Examiner are the following:

1. *Comparative evidence:* Examiner will follow agency guidance in discussing evidence of disparate treatment with the Lender and in assessing and verifying the Lender's response.
2. *Overt evidence:* Includes use of descriptive references to applicants versus lending considerations; personal opinions versus lending considerations; stereotypes used in relation to credit decisions; indirect references to prohibited factors; and the lawful use of a prohibited factor – i.e., application of this targeting technique (such as a Special Purpose Credit Program) should not deprive applicants who are not part of a targeted group of rights or opportunities they otherwise would have.

Refer to the Appendix for a summary of possible responses that a Lender may offer to explain instances of possible disparate treatment. Examples of overt evidence of discrimination, evidence of disparate treatment, and evidence of disparate impact are in the Interagency Policy Statement.

Additional Guidance For A Lender's Self-Evaluation

Product and issue self-evaluation can be an important part of a Lender's overall Compliance Management Program. For self-evaluations to qualify as a basis for eliminating focal points and/or reducing sample sizes, the program must meet each of the following criteria, as specified in the Interagency Guidelines:

A. The self-evaluation covers transactions consummated within two years prior to the current examination.

B. It covers the same product, prohibited basis, decision center(s), and stage of the lending process as planned for the examination.

C. It includes a comparative file review.

D. It defines control and prohibited basis groups consistent with the ECOA and FHAct.

E. It selects transactions from marginal applicants or, alternatively, selected randomly (Examiner will sample 10% to verify).

F. It uses accurate data that was actually relied upon by credit decision-makers (Examiner will sample 10% to verify).

G. It demonstrates that customer assistance and Lender judgement were recorded consistently and accurately, and analyzed to identify prohibited basis group differences.

H. It compares prohibited basis group applicants (related to the underwriting factor in question), to the corresponding qualifications of control group approvals.

I. The self-evaluation sample initially covers at least as many transactions as would be included by using the examination sampling guidelines. The Examiner can follow alternative procedures if the Lender's sample size is smaller than that dictated by examination guidelines.

J. If relevant, it identifies instances in which equally or better qualified prohibited basis group applicants were less favorably treated than control group applicants.

K. If relevant, it records explanations from decision-makers responsible for the disparate treatment identified in J. above.

L. If relevant, were such explanations cited by the decision-makers in K. above supported by legitimate, persuasive facts or reasoning?

TABLE A

Underwriting (Accept/Deny) Comparisons

Sample sizes for comparing and analyzing the Lender's underwriting practices of approved and denied loans to evaluate if a "prohibited basis" influenced the Lender's credit decision

	Sample 1: Prohibited Basis Denials			Sample 2: Control Group Approvals		
Universe of Denials or Approvals	5–50	51-150	>150	20-50	51-250	>250
Minimum to Review	All	51	75	20	51	100
Maximum to Review	50	100	150	5X prohibited basis sample (up to 50)	5X prohibited basis sample (up to 125)	5X prohibited basis sample (up to 300)

TABLE B

Terms and Conditions Comparisons

Sample sizes for comparing pricing and other terms and conditions of approved loans to analyze for potential disparities

	Sample 1: Prohibited Basis Approvals			Sample 2: Control Group Approvals		
Universe of Approvals	5–25	26-100	>100	20-50	51-250	>250
Minimum to Review	All	26	50	20	40	60
Maximum to Review	25	50	75	5X prohibited basis sample (up to 50)	5X prohibited basis sample (up to 75)	5X prohibited basis sample (up to 100)

Samples generally drawn from the twelve months prior to the examination

For additional sampling guidance, including guidance on minimum sample sizes, refer to the "Explanatory Notes to Sample Size Tables" in the Guidelines.

Glossary of Terms

This Glossary contains definitions for some terms frequently used in the Interagency Fair Lending Examination Procedures

Approval Overlap - All control group approvals that appear less qualified than the Benchmark.

Benchmarking - The method used to analyze the Lender's treatment of marginal applicants. The Examiner first establishes the denied prohibited basis group applicant deemed best qualified (that most closely meets or exceeds the specific underwriting factor(s) used to approve the least qualified control group applicant) as the benchmark. The remaining denied prohibited basis group applicants will be top-ranked from best to least qualified to identify other applicants that may meet or exceed the standard used to approve the least qualified control group applicant. Approval and denial overlaps will be identified in this process.

Comparative Evidence of Disparate Treatment - Establishing the existence of illegal disparate treatment when the differences in the treatment are not fully explained by legitimate nondiscriminatory factors. It does not require showing that the treatment was motivated by prejudice or conscious intention to discriminate.

Community Reinvestment Act (CRA) - Act by which regulators assess a Lender's record of helping to meet the credit needs of its entire community, including low- and moderate-income neighborhoods and individuals, consistent with the safe and sound operation of the Lender.

Control Group - Applicants/borrowers not covered as a "protected class" by ECOA and FHAct.

Denial Overlap - Prohibited basis group denials that appear less qualified than the benchmark but better qualified than the least qualified approval.

Discrimination Risk Factors - Indicators, such as vague underwriting criteria or high minority applicant denial rates, considered when conducting the product and practices risk review during the scoping process (see procedures for a complete list).

Disparate Impact - When a racially or otherwise neutral policy or practice that is applied to all credit applicants disproportionately excludes or burdens certain persons on a prohibited basis.

Disparate Treatment - Form of discrimination occurring when applicants are treated differently on a prohibited basis. The existence of illegal disparate treatment may be established either by statements revealing that a Lender explicitly considered prohibited factors ("overt evidence") or by differences in treatment that are not adequately explained by legitimate nondiscriminatory factors ("comparative evidence"). Disparate treatment could more likely occur where there is room for Lender discretion, such as in the treatment of marginal applicants.

Equal Credit Opportunity Act (ECOA) - Federal law prohibiting credit discrimination based on race, color, national origin, religion, sex, marital status, age (provided that the applicant is of an age sufficient to enter a binding contract); receipt of public assistance; or the good-faith exercise of rights under the Consumer Credit Protection Act. ECOA applies to consumer and business/farm loans.

Fair Housing Act (FHAct) - Federal law prohibiting discrimination in any aspect of housing, including residential housing-related credit. FHA prohibited bases include race, color, national origin, religion, sex, familial status, and handicap.

Focal Point - A product, or underwriting or pricing practice that, in combination with other scope elements, is selected for review. Examiners will select the focal points that pose the greatest level of discrimination risk to the Lender. Focal point(s) form the main emphasis of the examination. Three examples illustrating the combination of elements in a focal point that may be reviewed are: (1) the disposition of broker generated real estate loan applications from Hispanics residing in a minority neighborhood; (2) the pricing of indirect auto loans made to female public assistance recipients; and (3) the terms and conditions of loans made to women-owned small businesses or small farms.

Home Mortgage Disclosure Act (HMDA) - Federal law requiring certain Lenders to record and report applicant race and gender, location of the residential property to be mortgaged, and other information for home purchase, refinancing and home improvement loans. HMDA data, particularly approval/denial rates and the geographic distribution of loans and denied applications, will be used for scoping and file selection. Examiners will use other procedures to review the accuracy of HMDA data.

Intensity - The breadth and depth of the fair lending analysis that Examiners will conduct on selected examination focal points; "sample size" is one measure of intensity.

Marginal Applicants - Applicants who are neither clearly qualified, nor clearly unqualified for the credit they requested. Marginal approved and denied transactions are compared by the Examiner to ensure that the level of assistance, waivers, or acts of discretion were consistently applied between applicants.

Overt Discrimination - Open discrimination on a prohibited basis. Can also occur when a Lender expresses but does not act on a discriminatory reference.

Prohibited Basis - A factor that may not legally form the basis for a credit decision. See ECOA and FHAct.

Redlining - A form of disparate treatment in which a Lender provides unequal access to credit or unequal credit terms because of a prohibited basis characteristic of residents of the area where the credit seeker resides or will reside, or where the residential property to be mortgaged is located.

Scope - The loan products, markets, decision centers, time frames, prohibited bases and control groups that Examiners select for a fair lending assessment.

Self-Evaluation - Any assessment a Lender conducts of its own fair lending compliance that does not constitute a self-test under Regulation B. A self-evaluation is part of the Compliance Management Program, and can be used to eliminate focal points or modify intensity levels. Examiners may ask to see documentation from a Lender's self-evaluation, but not a Lender's self-test.

Steering - The act of referring applicants from one product, market, or Lender to another. Fair lending issues can arise if steering occurs differently and less advantageously for prohibited basis group applicants than for similarly situated control group applicants.

Surrogate - Any factor, such as surname, related to a loan applicant that potentially identifies the applicant's race, color, gender, or other prohibited bases characteristic. Surrogates are used to identify possible prohibited basis group applicants of credit card, automobile, home equity or other consumer, small business or small farm loans where certain data on the applicants may not be legally collected by the Lender.

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