Expanding Fair Access to Credit

A Resource Guide for Massachusetts Lenders on Second Look Policies, Mortgage Broker Oversight and Self-testing

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PREFACE

The Massachusetts Fair Lending Task Force was established in 2005 to promote and ensure fair and equitable mortgage lending to all individuals. Its members included representatives from the Massachusetts Bankers Association (MBA), the Massachusetts Community & Banking Council (MCBC), the Massachusetts Credit Union League (MCUL), the Massachusetts Mortgage Association (MMA), the Massachusetts Mortgage Bankers Association (MMBA), state and federal regulatory agencies and community-based organizations. The Task Force began its work by conducting a survey of Massachusetts lenders to gauge industry fair lending procedures, including effective models and best practices. In late 2005, the Task Force hosted five regional meetings across the state to solicit broad-based industry and community input. Over 175 individuals, representing local mortgage lenders, homebuyer counseling organizations, housing and community development organizations, housing advocates, regional planning groups, community development agencies and others attended those meetings.

Throughout this period, the Task Force also met regularly to review statistical data and to collect and consider information from its members and others that could provide helpful background information or suggest useful strategies and recommendations. The final *Massachusetts Fair Lending Task Force Report & Recommendations* was presented at a Fair Lending Summit in October, 2006. Following the summit meeting, a successor organization, the Massachusetts Fair Lending Coordinating Committee, was established to plan, oversee and manage promotion of the Task Force's recommendations.

Since the issue of denial rate disparities between white and minority mortgage applicants was initially raised in the early 1990s, there have been significant changes in the state's mortgage market. By 2005, mortgage companies and out-of-state banks were making nearly 58 percent of all Massachusetts home purchase loans while the market share of Massachusetts banks and credit unions had dropped below 24 percent to their lowest share ever. The share of home purchase loans made by subprime lenders reached nearly 20 percent in 2005, a significant jump from their seven percent share in 2001. With this expansion of subprime lending to traditionally underserved borrowers and neighborhoods, the type and pricing of credit—not just its availability—became the predominant fair lending concern. Now the Massachusetts mortgage market, like that of the nation, is undergoing yet another transition. During 2006, the loan shares of Massachusetts banks and credit unions showed modest improvement, and by early 2008, none of the top five subprime lenders was still in (the subprime) business in the Commonwealth.

The Coordinating Committee recognizes that its efforts to promote fair lending must reflect these changes in the marketplace. Therefore, as part of its effort to promote implementation of the Task Force's recommendations, it commissioned a series of "best practices" reports, covering second look procedures, self-testing and oversight of mortgage brokers. This guide represents the culmination of that work. Assembled into a single report, its purpose is to assist banks, credit unions, independent mortgage companies, and mortgage brokers seeking to establish review, testing and oversight procedures for the first time, or to expand and improve their existing practices. It is intended to complement the efforts of individual trade associations, advocacy groups, and state and federal government agencies that also are focused on promoting fair and responsible mortgage lending. We hope it does.

CONTENTS

1. INTRODUCTION

Discrimination in the mortgage market continues to be a cause of concern even though laws[1] that directly or indirectly advance the goal of equal and fair access to housing credit have been in place for forty years. The focus of attention has shifted over time as the nature of discrimination has changed: from explicit Federal Housing Administration policies that disadvantaged minority and integrated communities in the 1950s and 1960s, to bank redlining in the 1970s and 1980s, to more subtle—sometimes unintended—forms of disparate treatment in the 1990s. Until recently, most fair lending "best practices" guidance was designed to boost the number of loan applications from low-income and minority communities and borrowers, provide equal effort to qualify all applicants, and reduce denial rate disparities among similarly qualified applicants.

The Federal Reserve Bank of Boston's widely circulated 1993 guide, *Closing the Gap*, described how three distinct levels *within* a financial institution shared responsibility for combating possible discriminatory lending practices: the board of directors, as the governing body of the institution; the managers responsible for the decision-making and supervision necessary to carry out the organization's business plan; and its loan production staff, including originators, processors and underwriters. Now the steps involved in marketing, originating, underwriting, funding, selling, and servicing loans have been uncoupled; they are often performed by entirely separate entities, and so the responsibility for combating discrimination cuts *across* multiple components of a complex mortgage delivery system. Though the various components of this system are subject to numerous laws and regulations, the regulatory framework has not kept pace with the substantial changes that have occurred in the industry.

A number of factors contributed to the revolution in mortgage finance, including: deregulation of the banking industry; increasing use of automated underwriting; credit scoring and risk-based pricing; lender consolidation and specialization; the development of new, high-risk products; the increasing role of mortgage brokers; and an expanded and sophisticated secondary market. The mortgage market is more competitive today and, in many respects, more efficient as a result of these innovations.[2] Increased access to credit by previously underserved consumers and communities has resulted in record high levels of homeownership among minorities and low-income groups. The gains, however, have come largely as the result of subprime lending by organizations operating outside the scrutiny of the established bank regulatory system. Research continues to show that borrower race and neighborhood racial composition affect access to *prime* credit, and this remains a fair lending concern. Attention has shifted to the terms, pricing and tactics by which previously underserved markets are now gaining access to credit. The growth in subprime lending coupled with the increased complexity of product offerings has raised both fair lending *and* responsible lending concerns. With the recent spike in subprime foreclosures nationwide, it has become apparent that many borrowers obtained loans that they did not understand, or that were not suitable for their needs.

In light of these new market realities, the Massachusetts Fair Lending Coordinating Committee and its member organizations have renewed their efforts to ensure equal access to responsible mortgage products for all qualified borrowers, with the goal of expanding *sustainable* homeownership opportunities for Massachusetts residents.[3] The Coordinating Committee is composed of representatives from the Massachusetts Bankers Association; the Massachusetts Community and Banking Council; the Massachusetts Credit Union League; the Massachusetts Mortgage Association; and the Massachusetts Mortgage Bankers Association.

Some participants, including state and federally regulated depository institutions with CRA obligations in the Commonwealth, have had comprehensive fair lending programs in place for more than a decade. The level of "self-regulation" varies widely, however, and what is appropriate and feasible for one size or type of lender may not be appropriate for another. Also, some measures apply specifically to the loan "salesmen" (whether they are in-house originators, correspondents, or mortgage brokers), while others apply to the entities that evaluate and underwrite the requests or to those who fund the loans.[4]

The Coordinating Committee recognizes that efforts to promote fair lending, if they are to succeed, must take into account changes in the marketplace. This report has been designed to do that, but even as it was being prepared for release, new lending standards and federal and state regulations were being proposed. It is likely that some of the practices that contributed to the current disarray in the mortgage market—with its disparate impact on communities of color—will be curtailed by government regulation. In any event, the proactive strategies detailed here can help lenders improve their ability to provide prudent, sustainable and fair lending to residents of the Commonwealth.

The remainder of the report is organized as follows:

- Section 2 briefly describes the high velocity changes that have reshaped the mortgage market over the past fifteen years, explaining why the first generation of fair lending "best practices" have not had the intended result.

- Sections 3, 4, and 4 address the three specific topics—second look procedures, matched pair testing, and mortgage broker oversight—and describe various strategies and activities that are accepted, or emerging, best practices. Also included are examples of lender initiatives, guidance for establishing such programs, and associated pitfalls.

- And finally, Section 6 illustrates why it is essential that these three initiatives be part of a comprehensive fair lending strategy.

2. FAIR LENDING IN A CHANGING MORTGAGE INDUSTRY

Even though discrimination in the credit markets had been documented decades earlier, and laws to combat such discrimination had been in place since the 1960s, it took a series of prominent studies and litigation before a comprehensive approach to fair lending compliance was established in the early 1990s. Debate over the nature and extent of discrimination in mortgage lending had been rekindled by the 1991 release of newly expanded Home Mortgage Disclosure Act (HMDA) data, which showed substantially higher denial rates for black and Hispanic applicants than for whites.

Subsequent studies—including the now famous Boston Fed study—documented that minority applicants, on average, did have less wealth, weaker credit histories, and higher loan-to-value ratios than white applicants and that these disadvantages accounted for much of the denial rate disparity. Still these studies concluded, even after controlling for such differences, a statistically significant gap existed between white and minority rejection rates. Their authors attributed this gap, in part, to differential treatment accorded to minority and non-minority applicants. Other studies from this period focused on the fact that lenders received disproportionately fewer mortgage applications from minority borrowers and low and moderate-income neighborhoods, suggesting less vigorous marketing to those market segments.

Background: Fighting the Last War

In response to these findings, the bank regulatory agencies[5] stepped up their effort to identify and eliminate discrimination in the mortgage market. They described the three types of discrimination that had been recognized by the courts—overt discrimination, disparate treatment, and disparate impact—and issued guidance on strategies for preventing each. They developed and published new examination procedures and began to refer suspected fair lending violations to the Department of Justice for prosecution. Additional guidance on how to detect and prevent illegal lending discrimination came in the form of consent decrees, memoranda of understanding, and settlements of cases that had been pursued by the Department of Justice or in the courts.

Most of the guidance dating from this period focused on techniques for expanding the pool of traditionally underserved applicants and qualifying more of them. A fundamental underpinning of nearly all of the first generation fair lending guidance, most of which applied only to depository institutions,[6] was the assumption that lenders were not as aggressive in pursuing business in low-income communities and communities of color as they were in white markets. **Inset 2.1** identifies some fair lending best practices from that era. In response, many of the nation's leading banks invested considerable energy and resources into developing state of the art fair lending programs during the 1990s.

Inset 2.1

In a 1993 letter to chief executive officers of institutions over which they had oversight, the federal financial institutions supervisory agencies urged lenders to pay special attention to the following 11 activities to improve fair lending performance:

- Use of an internal review system for consumer, mortgage and small business loan applications that would otherwise be denied
- Enhanced employee training that engenders greater sensitivity by financial institution management, and employees, to racial and cultural differences in our society
- Training of loan application processors to assure that any assistance provided to applicants in how to qualify for credit is provided consistently to all loan applicants
- Efforts to ensure that all persons asking about credit are provided equivalent information and encouragement
- Affirmative marketing and call programs designed to assure minority consumers, realtors, and business owners that credit is available on an equitable basis; such marketing might involve sustained advertising programs covering publications and electronic media that are targeted to minority audiences
- Ongoing outreach programs that provide the institution with useful information about the minority community, its resources, credit needs and business opportunities
- Participation on multi-lender Mortgage Review Boards that provide second reviews of applications by participating lenders
- Participation in public or private subsidy or guarantee programs that would provide financing on an affordable basis in targeted neighborhoods and communities
- Use of commissions or other monetary or non-monetary incentives for loan officers to seek and make safe and sound consumer and small business loans in minority communities

Source: May 27, 1993 letter from the Federal Financial Institutions Examination Council (FFIEC) agencies

What Has Changed

The ink was scarcely dry on the first generation of fair lending "best practices" guidance when the mortgage industry underwent a dramatic transformation. Changes in the way applications were generated, evaluated and funded brought new players, products and practices into the marketplace. With these changes came new concerns and new abuses. The regulatory framework for ensuring the fair, safe and efficient operation of the mortgage markets, however, remained largely as it had been when the market was dominated by federal and state regulated depository institutions, making loans for their own portfolios or for sale—with recourse—to Fannie Mae and Freddie Mac.

Even as recently as the late 1990s, consumers were offered a relatively limited choice of loan products. Pricing varied, not by the creditworthiness of the borrower, but by considerations such as the type of loan type requested, the type of structure securing the loan, or whether the borrower intended to occupy the property. Borrowers who met the underwriting criteria for a particular product were approved and generally paid the same price; those who did not, were denied credit. But by the end of 2004, mortgages were being made in what North Carolina Commissioner of Banks Joseph Smith aptly described a "complex network, funded by capital markets, sold by an array of originators, and touched by many hands, such as servicers and securitizers."[7]

According to Smith, the "explosion of product choices" allowed consumers to choose between "practically any combination of fixed, adjustable, or hybrid adjustable rate and amortizing, non-amortizing, or negatively amortizing mortgages, with terms ranging anywhere from 15 to 50 years." In addition, risk-based pricing enabled "more consumers than ever to qualify for home financing sooner than they otherwise could, by trading a lower credit score or down payment for a higher rate." And, Smith acknowledged, the controls that were in place to govern the market were "overwhelmed by the requirements of a commission-driven origination system and a securitization machine built for volume."[8]

This industry restructuring occurred largely during the past decade, set against a backdrop of low interest rates and rapidly rising home prices. The transformation of the mortgage market was made possible by advances in technology, improved access to individual credit histories, increased competition, and the development of a secondary market with an appetite for loans representing the full spectrum of credit risks. The widespread use of "risk-based pricing" and the associated increase in subprime lending were among the most dramatic changes. Individuals, including those with poor or non-existent credit, were able—indeed, encouraged—to buy homes, or to borrow against the equity they had accumulated in their existing homes. While industry analysts believe that responsible subprime lending has an important role to play in expanding credit to traditionally underserved borrowers, most acknowledge that some of the lending undertaken in recent years was neither responsible nor prudent. By the Federal Reserve's[9] own admission, underwriting standards, industry practices, and risk-based pricing evolved along with the market.

The Rise and Fall of the Wild West of Subprime Lending

By 2006, subprime lenders—some affiliated with the nation's largest banks—accounted for over 20 percent of all 1–4 family mortgages nationwide, up from less than 5 percent in 1994.[10] For lower-income households living in lower-income communities, the subprime share topped 10 percent. Prime conventional lenders accounted for nearly three quarters of all home purchase lending to whites, but less than 50 percent of lending to Hispanics and only 40 percent of lending to African Americans in 2001.[11]

In Massachusetts, less than one-quarter (23.6%) of all home-purchase loans originated in 2005 were made by Massachusetts banks and credit unions—that is, by lenders whose Massachusetts lending is subject to evaluation by bank regulators under the federal and/or state Community Reinvestment Act (CRA), down from approximately 78 percent in 1990. All other loans were made by out-of-state banks or by mortgage companies not affiliated with Massachusetts banks—lenders whose local lending is not covered by the CRA.[12] With the demise of so many subprime lenders, this trend now appears to be reversing, and in 2006 Massachusetts banks and credit unions originated 25.6 percent of the state's home purchase mortgages. But at the outset of this project, the Commonwealth's mortgage industry comprised a broad cross-section of lenders, offering myriad products through diverse origination channels, and subject to widely varying levels of oversight. Customers entered the system via mortgage brokers or correspondents acting on behalf of another party (for example, a large national bank or affiliate, or independent mortgage company); retail lenders such as local or regional banks, thrifts, or credit unions; or directly via telephone or internet.

The emergent mortgage brokerage industry allowed loan wholesalers of all sizes to enter the Massachusetts market without establishing a branch office here,[13] and the range of products and services offered through—and by—brokers evolved rapidly. Although independent mortgage lenders and mortgage brokers are subject to most of the fair lending, consumer protection, and disclosure requirements as their depository counterparts, the regulatory oversight of these organizations has been less vigorous than that to which depositories, in their CRA assessment areas, are subjected.

Traditionally underserved markets were aggressively targeted by some of these new players, in particular subprime lenders, who accounted for 19.4 percent of all home-purchase loans in Massachusetts 2005, up sharply from 12.5 percent in 2004 and just 3.3 percent in 1999. (Again, the 2006 results suggest the beginning of a reversal. The subprime lenders share in 2006 had dropped back to 16.6 percent.) **Table 2.1** illustrates how subprime lenders came to dominate the lending in low and moderate-income (LMI) tracts and to minority homebuyers.

Table 2.1

Total 2005 Home Purchase Lending in Massachusetts

2005	Total	MA Banks & Credit Unions	Mortgage Companies & Out of State Banks	Subprime Lenders
Total loans	94,286	22,238	53,719	18,329
Lender Type's Mkt Share		*23.6%*	*57.0%*	*19.4%*
Loans to LMI borrowers	21,531	6,716	10,690	4,125
Lender Type's Mkt Share		*31.2%*	*49.6%*	*19.2%*
Category of Loan as % of Lender Type's Tot MA loans	22.8%	30.2%	19.9%	22.5%
Loans in LMI tracts	20,326	3,825	9,669	6,832
Lender Type's Mkt Share		*18.8%*	*47.6%*	*33.6%*
Category of Loan as % of Lender Type's Tot MA loans	21.6%	17.2%	18.0%	37.3%
Loans to Blks and Latinos	11,925	1,757	3,975	6,193
Lender Type's Mkt Share		*14.7%*	*33.3%*	*51.9%*
Category of Loan as % of Lender Type's Tot MA loans	12.6%	7.9%	7.4%	33.8%

Source: *Changing Patterns XIII: Mortgage Lending to Traditionally Underserved Borrowers and Neighborhoods in Boston, Greater Boston and Massachusetts, 1990–2005*, prepared for the Massachusetts Community and Banking Council by James Campen, November 2006

Changes in the Housing Market

Other important changes have occurred in the years since the first generation fair lending "best practices" were put forth. Minority homeownership has risen dramatically. The number of black homeowners in Massachusetts increased by more than 86 percent between 1990 and 2006, while the number of Latino[14] homeowners soared by more than 225 percent. Minorities experienced similar gains in many other parts of the country. With this sharp increase in minority homeownership came an increase in minority refinancing requests. According to a March 2007 nationwide study by the North Carolina-based Center for Responsible Lending, less than 10 percent of subprime loans nationwide have gone to *first time* homebuyers (of all races); the balance were to existing homeowners or loans to homeowners "trading up" (62%) or borrowers purchasing investment property or second homes (29%). While first time homebuyer programs often included an educational component, subsequent purchases and refinancings rarely did.

Rapidly escalating house prices during the first half of the decade, in Massachusetts and elsewhere, masked the fact that many homeowners were experiencing financial distress. Because they had built up substantial equity during the housing boom, many struggling homeowners were able to refinance their mortgages with subprime loans despite being delinquent on their monthly payments. In some cases, one subprime loan replaced another; in many cases, though, a fixed rate loan or a favorably priced first-time homebuyer loan was refinanced with a high risk, high cost adjustable one. After the Massachusetts residential real estate market peaked in the third quarter of 2005, sales began to slump and housing values started to drop. As a result, selling or refinancing was no longer an option for borrowers who found themselves unable to repay their loans. Foreclosure filings skyrocketed. Through October 2007, more than 24,000 petitions to foreclose had been filed in Massachusetts Land Court, up 63 percent over the same period in 2006, and an increase of more than 130 percent over 2005.[15] (Not all foreclosure proceedings will result in homeowners losing their homes in a foreclosure sale, but the filing is a widely accepted warning sign of financial distress on the part of homeowners.) A similar scenario was playing out across the country.

Implications for Fair Lending Management

This changing landscape has had profound implications for fair lending compliance and management. On the one hand, many traditional prime lenders continue to be frustrated by persistent denial rate disparities, an inability to provide attractive product offerings to applicants with blemished credit, and limited inroads into the minority market. On the other, the new liberalized lending practices—particularly in the subprime market—have left many borrowers saddled with mortgage obligations they neither understood nor could afford, and led to a whole new set of fair lending concerns. These challenges are discussed by Harvard professor and former HUD Assistant Secretary William Apgar in **Inset 2.2**.

Inset 2.2

William Apgar, former Undersecretary of HUD and a leading authority on mortgage markets, and his colleagues at Harvard's Joint Center for Housing Studies have studied the behavior of both consumers and lenders to understand the implications of this complex new landscape for the fair and efficient allocation of mortgage credit. He describes the revolution in mortgage banking this way (from *Working Paper* (2004) and *Understanding Mortgage Markets* (2007)):

The rise of risk based pricing, the growing importance of the secondary mortgage market, and the emergence of mortgage brokers in the marketing and origination of residential home mortgages has keyed a virtual revolution in U.S. financial markets. Today's mortgage market bears little resemblance to the one that existed just a decade ago. The dramatic increase in lending—especially in non-prime lending—facilitated by increased access to the capital markets, has brought with it a diverse array of new mortgage products. This growth expanded access to credit for consumers who had not been well served in the traditional mortgage market, and it enabled millions of homeowners to tap accumulated home equity to help meet their consumption and investment needs.

With new low down payment products and a highly automated delivery system, the mortgage industry—often operating through a network of brokers—dramatically expanded lending in the same low-income, low-wealth and minority neighborhoods that were once victimized by mortgage "redlining."

Despite the benefits of the new mortgage market, there are nevertheless reasons for concern. The recent rise in mortgage delinquencies and foreclosures would indicate that some households took on debt that they had little or no capacity to repay. And, there is growing evidence that many families obtained mortgages that they did not understand or that are not suitable for their needs. The fact that foreclosures are higher within non-traditional products may not be a surprise, as these products are priced for greater risk and therefore greater default rates, but the concentration of foreclosures in many of the nation's lowest-income and economically vulnerable neighborhoods threatens to reverse recent gains in efforts to expand homeownership opportunities for all.

Source: 2004 Working Paper, 2007 *Mortgage Market Channels and Fair Lending: An Analysis of HMDA Data*

While much of the first generation of laws and guidance remains valid today, it clearly has been inadequate. The growth in subprime lending and the increased complexity of product offerings have raised new consumer protection concerns; as a result, *responsible* and *fair* lending issues have become increasingly intertwined. The fair lending focus is no longer on access to credit, but on the terms of credit. Widespread foreclosures of recent—mostly adjustable—subprime loans have prompted calls for more consistent and aggressive regulation of the mortgage industry. Specific proposals range from increased oversight of mortgage brokers, regulatory reform at the state and federal level and self-policing by the mortgage industry, to assignee liability and other strategies that would hold accountable those who package and sell mortgage-backed securities.

Notwithstanding all these changes, one thing has remained the same: fair lending risk management continues to operate in a highly fluid, politically charged environment. The definition of "how good is good enough" when it comes to managing fair lending risk continues to evolve; it is still measured largely by a lender's performance, policies and procedures *relative* to others in the industry. While there is no single "right way" to effectively manage the fair lending challenge, most organizations favor a structure that:

- Avoids redundancies and/or gaps;
- Improves effectiveness and efficiency in meeting increased fair lending regulatory requirements; and
- Ensures a consistent corporation wide philosophy and standard in fair lending compliance.

More Important than Ever

A rigorous compliance program, with an organizational structure, procedures and controls to maintain data integrity, monitor performance, and assure regulatory compliance are more important than ever, and all participants in the mortgage industry should carefully evaluate how to invest their fair lending budget and deploy their staff for maximum protection and benefit.

After failing to identify and prevent much of the unfair and/or irresponsible behavior that led to the collapse of the subprime market and widespread allegations of discrimination against racial and ethnic minorities, the regulatory agencies, Congress, the states, and industry and advocacy groups are scrambling to make up for lost time. The Federal Financial Institutions Examination Council (FFIEC) member agencies and their state counterparts—the Conference of State Bank Supervisors, the American Association of Residential Mortgage Regulators and the National Association of Consumer Credit Counselors—have now issued uniform guidance for all lenders offering non-traditional mortgage products or engaged in subprime lending. In addition, there have been several prominent settlements in recent years of alleged fair lending violations, initiated by the Department of Justice or individual state Attorneys General, that spell out best practices. Congress, the trade associations and a number of state legislatures also have taken measures to address the twin issues of fair and responsible lending. (These and other regulatory and enforcement actions are discussed in Section 4, Mortgage Broker Oversight.) Also, **Appendix A: News You Can Use** includes a summary of recent fair and responsible regulatory guidance.

As a result of their combined efforts, there is now a clearer understanding—at least among participants in the loan origination, evaluation and funding stages—of practices to be avoided, practices that may be appropriate under certain circumstances but not others, and the type of monitoring and analysis that is required to ensure that otherwise legitimate practices are not having disparate impacts on protected classes of borrower.

3. SECOND LOOK PROGRAMS

Over the years, many lenders have found that taking a second look at applications slated for denial helped them assure fairness in the lending process. Second look programs differ from comparative file reviews, and other types of self-evaluation that may identify potential fair lending violations—or missed business opportunities—*after* an applicant has been turned down in that they occur in real time. They are designed to prevent problems *before* they occur. In addition, the second look process provides an opportunity to compare performance to policy and to identify areas where additional training is required.

Originally second look programs were designed to ensure that all applicants received similar levels of encouragement and assistance, and that compensating factors or underwriting exceptions were applied consistently. With the advent of widespread automated underwriting, multiple lending channels and product options, and the expanded role of third-party brokers in the loan origination process, the focus of second look policies grew to include assuring fairness in managing overrides (both highside and lowside), pricing and product placement. More recently, in the wake of rising defaults—particularly among borrowers who were approved for risky adjustable rate subprime mortgages—a number of legislators and advocates have suggested that the second look process needs to include a "suitability" or "net benefit" assessment as well.[16]

As discussed in Section 2, the mortgage business has experienced enormous structural changes since the early 1990s when the first "fair lending best practices" guidance was put forth by consumer and civil rights advocates and regulatory and enforcement agencies. The Federal Reserve Bank of Boston and the Massachusetts Bankers Association, through its Fair Lending Initiative, were among the first to offer comprehensive plans to expand access to credit to underserved borrowers and communities, and both recommended that lenders adopt second look policies. Indeed, a number of Massachusetts lenders did implement such procedures, but many of the institutions that emerged as early leaders either no longer exist as independent entities or are no longer in the mortgage business.

In any event, the recent changes in the way business is conducted have necessitated new responses. This section describes various second look procedures, the rationale for their use, and instructions and guidance for lenders who may wish to implement a new program or revamp an existing one.

Background

Federal regulators began to issue guidance that encouraged lenders to take steps to ensure that all mortgage loan applicants received fair and equal treatment in the lending decision process in the early 1990s. This increased focus on equal treatment was initiated after several well-publicized investigations of lending patterns—including the Federal Reserve Bank of Boston's 1992 landmark study—reported that *most* applicants are approved for credit *despite* having flaws in their credit qualifications, suggesting that they benefit from some judgment or initiative that neutralizes the flaws. The Boston Fed study[17] concluded, however, that minority applicants benefit *less frequently* than non-minority applicants, leading its authors to suggest that differential treatment might arise from the presumption that non-minority applicants were creditworthy while minority applicants were required to prove their creditworthiness to the lender. This positive presumption about non-minority applicants *may* have led lenders to justify various accommodations or efforts to help them qualify for loans in spite of their shortcomings. If similar consideration was not extended to minority applicants, the lender could be found to have violated fair lending laws.

At about the same time the Department of Justice (DOJ) reached a similar conclusion. After a three-year investigation into the lending practices of Atlanta-based Decatur Federal Savings and Loan Association, DOJ reported that white applicants who failed to meet certain underwriting standards had "been extended special considerations" not extended to black applicants. DOJ alleged "the lender counseled white applicants about their deficiencies and reworked their applications in order to help them qualify with underwriting guidelines, but did not consistently supply comparable assistance to black applicants."[18]

First Generation Second Look Policies

Second looks—also called second reviews—were recommended as one way of ensuring that all applicants received the same beneficial presumptions and levels of assistance, so that similarly qualified applicants would benefit equally from the discretionary aspects of the lending processes.[19] Complementary activities included:

- Comparative file reviews;
- Self-testing;
- Diversity training for lending officers and support personnel;
- Rigorous compliance and oversight;
- Use of application checklists (required by DOJ in its settlement of the Decatur case) to assure that compensating factors, unconventional documentation of creditworthiness, and explanations of negative information were considered equally for every applicant; and
- Vigilant monitoring of denial reasons to ensure that minorities were not being rejected at a higher rate for reasons such as "lack of verification" or "incomplete information" that might indicate that lending personnel were not working as diligently to qualify them.

The settlement in the Decatur case included a specific requirement for a review underwriter, but by that time, many lenders had voluntarily established review mechanisms that provided a second consideration of denied minority applications. Some extended their reviews to include all proposed denials of low or moderate-income applicants, or all denials for properties in low or moderate-income census tracts. A number of lenders began requiring a second look before *any* application could be denied. Some lenders simply required that a second underwriter sign off on a denial; others instituted formal multi-level review (e.g., requiring signoff by senior underwriter, or underwriting manager plus CRA Officer). Still others established formal review committees. In some cities, including Boston, financial institutions established joint mortgage review boards composed of lending personnel from several financial institutions to review applications rejected by any of the participating institutions to see if they might qualify under another lender's guidelines.[20]

What all of the first generation second look policies had in common was that they were based on the presumption that the fair lending risk associated with inconsistent mortgage loan administration was *denial of credit* on the basis of race, sex or other impermissible factors.[21]

Next Generation: New Challenges

Under increased scrutiny by regulatory and enforcement agencies—as well as advocates and public officials—many institutions *were* able to improve their penetration of minority and low and moderate-income markets and reduce minority denial rates by implementing the recommended fair lending "best practices" listed on the preceding page. Denial rates for black home purchase loan applicants nationwide dropped from 33.9 percent in 1990 to 24.7 percent in 2004; in Boston they went from 32.7 percent to 22.7 percent.[22] Still, disparities persisted. The prime conventional mortgage market—the major source of mortgage capital for most borrowers—was unable to accommodate the mortgage needs of an increasing share of low-income and minority borrowers, and new players, products, and delivery channels emerged to fill the void.

As these new players and new practices began to reshape the mortgage industry, consumer and civil rights advocates became increasingly concerned by reports of abuse and discrimination. In response to these concerns, the Home Mortgage Disclosure Act (HMDA) was strengthened, and beginning in 2004, lenders were required to report pricing data for certain higher-priced loans. HMDA had been the lens through which lending patterns had been analyzed since its enactment in 1975, and the new reporting requirements were an acknowledgement that a fundamental change had occurred in the *nature* of mortgage lending abuses. *Pricing of loans*, not just their availability, had become a potential source of lending discrimination. As a result, even lenders who already had a second look program in place were advised to review their policies and procedures if they employed risk based pricing or originated loans through third parties.

Current Practice Among Massachusetts Lenders

To gauge the level and type of activities being taken to increase lending to targeted populations, including minorities and low and moderate-income households and communities, the Massachusetts Fair Lending Task Force conducted a survey of lenders in 2005. Although over 100 lenders responded, 90 percent of the respondents were Massachusetts banks (or their subsidiaries or affiliates) and credit unions, institutions that collectively commanded less than a 24 percent market share that year.

Of those who did respond to the survey, more than 90 percent reported having some formal second look process, while a number of the others described an informal process. Despite these impressive numbers, the adequacy and utility of their efforts varied widely. Only a small fraction of the respondents tracked the performance of their second look procedures to determine whether the process was effective or to identify potential problem areas: 22 percent tracked loan denials by race and 9 percent by loan production staff. Just 27 percent conducted a regular review of marginal approvals and denials to test for disparate treatment, and only 34 percent reported their findings to senior management.

The lack of tracking and analysis by those lenders that did have second look procedures in place, combined with the low response rate among non-depository institutions, and the increasingly prominent role played by third party originators and automated underwriting, prompted the Task Force to recommend that *all lenders* establish and/or improve second look procedures to ensure that all mortgage loan applicants receive equitable treatment.

Establishing a Second Look Program

Today denial rate disparities continue to challenge the region’s traditional retail lenders, while pricing disparities and allegations of steering and reverse redlining have plagued many of the newcomers. Given these wide ranging concerns, second look activities will fall into one or more of the following three categories:

- Affirmative assistance to qualify marginal applicants;
- Cautionary practices to advise applicants of risks associated with certain products or activities (e.g. pricing), consistent with Federal and State disclosure requirements; and
- Tracking and monitoring to ensure equal treatment by all participants in the origination/approval process.

Lenders have considerable leeway in designing their programs. The type of procedures an institution implements will vary depending, among other things, on the size of the company and its business model. Before it implements a second look strategy, an institution should be very clear about what it wants to accomplish, and how it will know whether it has been successful. A good place to start is by answering a series of questions, dealing with three issues:

- Program focus;
- Management support; and
- Program design.

Determining the Appropriate Focus

Why are you doing this? Does your HMDA data identify you as an "outlier" in terms of denial rate disparities between white and minority applicants, or in market share? Does your HMDA data show pricing disparities along racial lines? Are you worried about inconsistent overrides of automated underwriting decisions? Has management established production goals for minority and LMI lending? Is it a requirement of an enforcement action or litigation settlement?

The first step in developing appropriate second look procedures is to identify your organization's *lending discrimination risk factors*. **Inset 3.1** illustrates some of the factors that could put your institution at risk. They are categorized as "steering," "pricing," and "underwriting" risks. Your risk profile should guide your overall fair lending compliance program, including—but not limited to—second look policies. Second look is, after all, just one of a number of tools that can help an institution improve its minority or low-income lending performance. If your HMDA data indicates that you are not generating loan applications from these markets to begin with, your challenge is on the front end—in marketing, outreach or product development—and a different type of corrective action is indicated. Failure to generate loan applications is indicative of "redlining" or "marketing" risk factors and suggests the need for more responsive products and effective marketing and outreach, not enhanced second look procedures.

> **NOTE:** With concern having shifted to pricing and suitability, "reverse redlining" has become a risk factor that *may* warrant expanded second look procedures by lenders that offer subprime products. A basic tenet of fair lending is that borrowers should be offered loan options commensurate with their qualifications, and these options—including their associated costs, risks and benefits—should be clearly explained so the borrower can make an informed choice. Second look programs can ensure that this is happening.

What do you hope to accomplish? Articulate your goal(s) up front. For most lenders, the overarching goal is to address potential fair lending violations *before* they are booked. Depending on your particular business model, this may mean being able to determine in real time if an applicant was denied who should have been approved, or to prevent an applicant from being overcharged.

Second look procedures help to *assure equitable treatment*. They provide a mechanism for ensuring that underwriting standards and exceptions, such as compensating factors, are applied fairly and correctly. In some cases, they offer the lender an opportunity to identify other options for an individual borrower whom might otherwise be turned down (e.g., an alternative product). They may even lead to the development of new products that can serve a wider market. They are *not* designed to *change the standards* for approval to advantage one group over another. (**See Inset 3.2**)

Inset 3.1

Indicators of potential disparate treatment in Underwriting

Risk Factors:

- Substantial disparities among approval/denial rates and processing times for applicants by prohibited basis characteristics
- Substantially higher proportion of withdrawn/incomplete applications for prohibited basis characteristics group
- Vague or unduly subjective underwriting criteria
- Lack of guidance on making exceptions to underwriting criteria, including credit-scoring overrides
- Lack of documentation regarding reasons for exceptions to normal underwriting standards, including credit-scoring overrides
- Relatively high percentages of exceptions to underwriting criteria or overrides of credit score cutoffs
- Loan officer or broker compensation based on loan volume
- Consumer complaints alleging discrimination

Indicators of potential disparate treatment in Pricing

Risk Factors:

- Relationship between loan pricing and compensation of loan officers or brokers
- Lenders having broad discretion in pricing or transaction fees
- Use of risk-based pricing system that is not empirically based and statistically sound
- Substantial disparities among price quoted or charged to applicants differing by prohibited basis characteristics
- Consumer complaints alleging discrimination in loan pricing

Indicators of potential disparate treatment in Steering

Risk Factors:

- For institutions with subprime subsidiaries, a significant difference, by loan product, in the percentage of prohibited basis group applicants of the institution compared with the percentage of prohibited basis group applicants of the subsidiary
- Lack of clear, objective standards for: (i) referring applicants to subsidiaries or affiliates; (ii) classifying applicants as “prime” or “subprime” borrowers; (iii) deciding what kinds of alternative loan products should be offered or recommended
- For institutions that make both conventional and FHA mortgages, any significant differences in the percentages of prohibited basis group applicants in these two loan products
- For institutions that make both prime and subprime loans for the same purpose, any significant differences in percentages of prohibited basis group borrowers in each of the alternative loan product categories
- Institutions with subprime mortgage subsidiaries or affiliates that integrate loan processing such that steering between the prime and subprime products can occur seamlessly (that is, a single loan processor could simultaneously attempt to qualify any applicant, whether to the bank or the subsidiary, under either the bank’s prime criteria or the mortgage company’s subprime criteria)
- Loan officers having broad discretion and no guidelines to promote conventional or FHA loans to applicants
- A lender has most of its branches in predominantly white neighborhoods, and the subprime subsidiary has branches mostly in predominantly minority neighborhoods
- Consumer complaints alleging discrimination in loan pricing

Source: Interagency Fair Lending Exam Guidance

Inset 3.2

Designing a Second Look Program

In designing a second look program, it is important to keep in mind the following:

Second review programs that apply only to members of a protected class are permissible if their purpose is to ensure that lending standards are applied fairly and uniformly to all applicants. For example, it is permissible to review the proposed denial of applicants who are members of a protected class by comparing their applications to the approved applications of similarly qualified individuals who are not members of a protected class to determine if the applications were evaluated consistently.

It is *not permissible*, however, to review the applications of members of a protected class in order to apply standards to those applications that are different from the standards used to evaluate other applications for the same credit program, or to apply the same standards in a different manner, unless such actions are otherwise permitted by law. The provision of reasonable accommodation to people with disabilities, for example, would be allowed under the Fair Housing Act. Similarly, differential treatment to applicants to address past discrimination *may* be permissible if done in response to a court order or otherwise in accord with applicable legal precedent.

Special Purpose Credit Programs (SPCPs) may be examples of a lawful use of a prohibited factor, but a lender should expect that it may be asked for documentation that such a program conforms to the requirement of Regulation B that the program must have been defined in a written plan that existed before the lender made any decisions on loan applications under the program. The written plan must demonstrate that the program will benefit persons who would otherwise be denied credit or receive credit on less favorable terms; and state the time period the program will be in effect or when it will be reevaluated.

NOTE: The fact that a program is a lawful SPCP is *not* absolute security against legal challenge by private parties, so any institution concerned about legal challenges from other quarters should use exclusions or limitations that are not prohibited by ECOA or the FHAct, such as "first-time home buyer."

Source: 1994 Interagency Q & A

Securing Management Support

Is senior management committed to implementing a second review process? Any successful compliance-risk management program starts at the top. Management controls should reflect the risks associated with the institution's lending strategy. Roles and responsibilities should be clearly defined and communicated throughout the organization. Staff at all levels need to understand the organization's compliance culture, general compliance-risk issues, and compliance policies and procedures. Whether you are initiating or expanding a second look process, it should be clear how that fits in to the larger fair lending compliance framework. More important, it is at this point that an institution needs to determine whether it wants to go the extra distance to be a fair lending leader, or whether a more circumscribed fair lending compliance program will suffice.

What resources (human and financial) will be available? While the incremental cost of a second look program may be modest, the cost of maintaining the comprehensive tracking and monitoring system required to support it over time can be substantial. A second look program that is not imbedded into a larger compliance management system is unlikely to protect an institution from allegations of either disparate treatment or disparate impact discrimination. Nor is it likely to assure that all applicants are treated equally. Appropriate systems, policies, and staffing are all key elements. In addition to asking whether the resources devoted to fair lending are commensurate with the size, complexity and the fair lending risk of your business, it is worth asking how they compare with similar institutions.

Designing the Program

How will you conduct your second look process? Who will conduct the review, what will it entail, how often will it be carried out, and at what point in the processing will it occur? Will every denied minority application be reviewed, or every low or moderate-income (LMI) application. How will the "marginally qualified," or "close call," non-minority (control group) applicants, both approved and denied, be identified? How will you record the findings?

How will you measure the program's effectiveness? Possible measures of effectiveness are whether you have prevented unwarranted denials, improved the ability of your underwriting staff to "get to yes" without a second review, elevated management awareness of a new product opportunity, or some combination of these, or other benchmarks.

How will you train your personnel, including third party originators? Staff training is a crucial component of a financial institution's efforts to combat possible discriminatory lending practices. All employees involved in the loan process should be familiar with the laws—federal and state—that protect prospective borrowers from biased treatment. Also, employees who interact with customers and the public should be trained on how they are expected to treat customers, since poor customer service can be perceived as discrimination. At larger institutions, especially, diversity awareness has increasingly becoming a routine part of the training process for all participants in the mortgage process. In addition, it is important that loan originators, processors and underwriters all understand the purpose of the second look, and feel engaged in the process.

How and to whom will you communicate your findings? Issues identified during the second look process should be resolved by business-line management, but the results of the process should be reported on a regular basis to senior management. Remember, the goal of a second look process is not to make the loan in every case. Not only should you be vigilant about monitoring the results of your second look process to ensure fairness, you also should monitor closely the *performance* of loans approved after a second look compared to others to see how they perform, *even if you are no longer servicing them*.

What will you do if you identify problems? Do you have resources to address problems you may identify, or can you access them? Consider not only what you will do to ensure that the prescribed process is adhered to, but also what you might do if it turns out you do not have an appropriate product (e.g., one that is safe, prime, and/or fixed rate) for marginal nonprime applicants.

Lessons Learned from First Generation Second Look Programs

Second review procedures gained prominence at a time when underwriters manually assessed an applicant's risk. Underwriting was a much slower process than it is in today's automated environment. Analyzing multiple risk factors was complicated—it still is—but much more judgmental. Still, several important lessons were gleaned from the first generation second review procedures.

Critical Success Factors

Involve Senior Management The most effective programs involved senior management in the diagnosis and remedy of the problem. Many fair lending leaders established second review committees composed, at least originally, of senior managers. They included, in addition the leadership of the lending unit, managers from other areas of the organization such as the CRA, law, compliance, or marketing departments. They were serious—and time consuming—activities, but the stakes were high. The bank examiners and the Department of Justice (DOJ) were much more aggressive about referring potential discrimination cases during the 1990s than they had been before, or have been since.

Not all lenders opted for a committee review, and many that did eventually migrated to more efficient mechanisms. But reviews that engaged senior management accomplished several additional goals, beyond ensuring that no differential treatment or discrimination on any prohibited basis occurred, or that no patterns of potential discrimination existed in the underwriting and decision making process:

- They provided the senior business managers with a "window" into their low-income communities and minority customer (or potential customer) base;

- They sensitized management to special needs of these market segments and sent a clear message to loan production staff of the priority the company assigned to those market segments;

- They enabled management to determine whether its loan products were being effectively and appropriately used; and

- As detailed minutes of their deliberations were shared with underwriting staff, they became an effective educational and training vehicle.

Formalize the Process The successful programs established written procedures that became part of the institution's compliance and credit policy manuals; assigned roles and responsibilities; developed appropriate forms/checklists to assure that all applicants received equal assistance; documented and recorded activity in a consistent manner; and trained targeted staff and management. Detailed minutes were shared with underwriters to enable them to understand the analytical basis for the committee's decisions.

Track Loan Performance The institutions that emerged as fair lending leaders maintained a rigorous, well-documented process headed by a knowledgeable, senior staff member who reported results on a regular basis up the chain of command. In addition to tracking, analyzing and reporting results of the second look process, they also tracked the performance of loans approved after the second look.

Include Similarly Situated Non-minority Applicants (both approved and denied)in Review Regardless of the process employed, second reviews *must* determine whether a rejected minority applicant's deficiencies are worse than those of successful non-minority applicants and whether the lender made equal efforts to help all customers qualify, if they are to be effective. They should give the reviewer, and senior management, a sense of how often—and why—non-minority applicants with deficiencies (marginally qualified applicants) are granted loans. A process that simply verifies that denied applicants have deficiencies in their credit qualifications *will not* ensure that they are receiving equal treatment.

Only a comparative review of the minority applicants with similar non-minority applicants—both approved and rejected—can assure that lending standards are being applied consistently, that the rejected minority applicants' deficiencies are indeed worse than those of successful majority applicants, and that the lender has made equal effort to help qualify them. Similarly, only a review of both minority borrowers and similarly qualified non-minority borrowers can determine whether the minority borrower was offered an equally advantageous loan product and terms.

Complementary Measures Remember, you will have a hard time assessing whether you are treating all applicants fairly and consistently, even with a second look program in place, if you do not have: clear, written underwriting guidelines for each of your product offerings; explicit procedures and explanations of judgmental factors covering most or all contingencies; appropriate staff training and testing for staff compliance with policies and procedures; and effective tracking and monitoring. Also, it will be challenging to motivate employees if your compensation policies are not structured in a way that rewards fair and responsible lending (and sanctions undesirable behavior).

When is a Second Look Program Not a Second Look Program?

Many lenders say they have a second look program because they require a senior underwriter, or manager, to sign off on loan denials. They may even use checklists to ensure that all applicants receive a similar quality of assistance. (One example of a thoughtful checklist that can be modified as needed by individual institutions appears in **Appendix B**.) BUT, if you do not review marginally qualified non-minority applicants AND you do not record, analyze, and report to senior management the results of the second review AND you do not take appropriate corrective action, ***you do not have a bona fide second look program***.

Lenders who offer a limited product line of prime loans (e.g., Fannie Mae or Freddie Mac conforming loans, portfolio loans, or targeted first-time homebuyer products such as MassHousing or the Massachusetts Housing Partnership SoftSecond™ Loan Program), and/or those who originate through in-house originators only, may find that the policies referred to in this document as "first generation" second look programs—those designed to ensure that equal and affirmative assistance has been provided to all applicants—are adequate for their purposes. This is especially true if their HMDA data reveal a reasonable flow of applications from low and moderate-income or minority applicants, but a relatively low approval rate for those applicants compared to similarly situated majority applicants. The primary goal, after all, of the first generation second look programs was to assure that every applicant was provided the same quality of assistance to "get to yes."

New Challenges

Lenders with multiple origination channels and third party originators and/or those that apply a risk-based loan pricing policy, however, have a greater challenge to assure that their policies do not discriminate on a prohibited basis against any applicant. As the HMDA reports of some of the largest subprime mortgage lenders reveal, they have aggressively penetrated the minority homebuying market yet evidence little or no denial rate disparity. Their pricing or product placement, however, may indicate disparate treatment on a prohibited basis. (**See Table 3.1**) As a result, the second look procedures of those lenders should assess not only level of assistance, but also pricing and how the assignment of loan type was determined.

Table 3.1

2006 Lending Summary of Major Lenders in the Boston–Quincy MSA/MD

Lender	% of Home Purchase Loans in Minority Tracts *	Black/White Denial Rate Disparity	Hispanic/White Denial Rate Disparity
Bank of America	18.1%	2.36	1.97
Countrywide	20.3%	3.64	2.68
Sovereign	22.6%	2.23	2.15
Eastern Bank	19.4%	2.00	4.02
Wells Fargo	10.4%	3.35	3.49
Option One	23.9%	1.24	1.04
Argent	34.5%	1.05	1.05
WMC	28.2%	1.10	0.82
Long Beach	43.9%	1.15	0.99
New Century	32.7%	1.30	1.08

* Minority tracts are those with a minority population of >50%. Less than 15% of all housing units in 1–4 family dwellings are located in census tracts with a minority population of greater than 15%.

Source: 2006 HMDA

Several issues have made it more challenging to implement and manage an effective second look program in the current environment: automated underwriting, risk based pricing, multiple delivery channels, and an array of complicated mortgage products. Increased competition has put a premium on speedy processing. The unbundling of the loan origination, underwriting, funding, sale, and securitization functions has further complicated matters. For many lenders, even the rationale for having a second look policy has changed. The growth in subprime lending and the increased complexity of product offerings discussed in Section 2 have raised new consumer protection concerns, with the result that responsible lending and fair lending issues have become inextricably linked. The fair lending focus has shifted from access to credit to terms of credit. While a prime credit gap persists in low and moderate-income communities and among minority borrowers, too many loans of the wrong type in recent years went to borrowers who could not afford them.

Some of the steps in a 21st century second look program—such as ensuring that underwriting standards have been applied equally, or that compensating factors have been considered consistently and appropriately—apply across lender types. Others, however, will be very different depending on the institution's business model. It remains as important as ever that the "second look" compares the minority applicant's qualifications and outcome with similarly situated non-minority applicants.[23] Now, however, the pricing of credit, type of credit awarded, and the way in which it was sold also represent possible fair lending violations if protected classes have been disproportionately disadvantaged.

Inset 3.3, A Current Second Look Checklist, identifies issues that warrant special attention as you design or revamp your second look policies. They include credit scoring models, overrides (underwriting exceptions), counteroffers, and pricing.

Inset 3.3

Current Second Look Checklist

- If you provide a range of residential mortgage products with varied features and benefits through both prime and non-prime channels, do you evaluate whether the product the applicant is requesting is suitable?
    - If it is, does the pricing reflect the customer's credit profile, not the channel the request came in through?
    - If it is not, do you have an appropriate alternative product to offer the customer?
- When a broker presents a loan package to you, do you independently evaluate the borrower's ability to repay the loan, as well as the proposed pricing and credit grade offered by the broker?
- What do you do if the product or pricing is unsuitable?
- What do you do if the product or pricing is less advantageous than another product in your line for which the applicant might qualify?
- Do you monitor broker pricing decisions, including the amount of broker compensation sought for loans? If so, how? And do you impose sanctions or take remedial measures against brokers who unjustifiably charge minorities higher prices?
- Do you require brokers to disclose the advantages, disadvantages, and relative costs of different mortgage products and features to applicant? How do you ensure compliance? Do you provide or require use of scripts to explain risks and benefits of various products?
- Do you offer an online or telephone-based second opinion hotline to help consumers navigate the complex process or product offerings?
- Is every transaction monitored? If not, what is the level of review, and is it adequate? Are appropriate personnel conducting the monitoring? Does monitoring include a review of performance by third party service providers?

Credit Scoring

The purpose of a credit scoring system is to provide a lender with an objective estimate of the likelihood that a loan will be repaid as agreed by the applicant. Credit scoring systems are generally designed with the expectation that loan applicants who attain a score that is equal to or greater than the level indicating a likelihood of repayment (i.e., a passing score) will be approved, while those who do not (i.e., who get a failing score) will be denied the loan.

The two common types of credit scores are bureau scores and custom scores. The three major consumer reporting agencies (Experian, Equifax, and TransUnion) develop bureau scores based solely on the information in an individual's credit report. A custom score, on the other hand, is generated by the lender from a scoring system of its own design or purchased from a vendor. It typically will consider information about the applicant and characteristics of the credit transaction (e.g., type of residence, length of time at current residence, type of employment, length of time in current employment, and income) in addition to the credit bureau report.

Proponents of scoring systems contend that their objectivity constitutes a significant fair lending benefit by virtually assuring against disparate treatment on a prohibited basis. Others remain skeptical. Their concerns notwithstanding, there is near unanimous agreement that automated underwriting has contributed to the increase in mortgage lending.

Disparate treatment can occur at three stages in the use of a custom credit scoring system:[24]

❖ *Data development and input* The FDIC offers the following example of how this might occur: A lender credits white applicants with the length of time they have worked in the same field but credits Hispanic applicants only with the length of time they have worked for their present employer. Or, a lender credits white applicants with secondary income (such as bonuses, overtime, or commissions) but credits Hispanic applicants only with base salary. In either example, because discriminatory data are input into the system, the system will produce a discriminatory result.

❖ *Within the credit scoring system* The system could include a prohibited basis as one of the variables, or, if not a prohibited basis itself, a factor that is so highly correlated with a prohibited basis that it serves as a proxy for the basis. The FDIC offers example of a variable that considers the geographic area in which an applicant lives when that geographic distinction is highly correlated with a prohibited basis such as race.

❖ *Discretionary overrides* The more discretion bank staff is permitted in overriding a credit scoring system, and the greater the number of staff with override authority, the greater the risk that the discretion may be exercised discriminatory manner.

Underwriting Exceptions/Overrides

Considering compensating factors and "going the extra distance" to help get an applicant to "yes" in the days before widespread automated underwriting, overrides and counteroffers can expand access to credit today if they are used properly and consistently. Used improperly, or applied inconsistently, they may result in unlawful discrimination. Furthermore, excessive use of overrides suggests that your scoring system may not match your stated credit policies. If you do allow overrides, and most lenders do, you should be able to answer in the affirmative the following four questions:

❖ Do you have controls and policies in place to ensure that your credit scoring models or criteria are not applied in a discriminatory manner, specifically, clear written guidance on using the credit scoring system, on handling overrides, and on processing applicants?

❖ Has management established assurance protocols by which it monitors compliance to see that policies and guidelines are understood and observed by all employees to whom they apply?

❖ Do you have a process by which you can determine whether any of the bases for *granting credit* to non-minority low-side override applicants apply also to minority applicants with equal or better credit scores?

(These are cases—non-minority low-side overrides—that, by definition would be considered "marginally qualified" in your review.)

❖ Similarly, do you have a process by which you can determine whether any of the bases for *denying credit* to minority applicants who are high side overrides are applicable to any non-minority approvals whose credit score was equal to or less than the highest score among the minority high-side overrides?

In addition, if the following apply, you should have clear and consistent standards for ensuring equal treatment of applicants and preventing any unintended disparate impact:

❖ Processing, underwriting requirements, or override policies vary based on geographic factors, or

❖ Credit scores are used to segment applicants into groups that receive different processing or are required to meet additional underwriting requirements

Lenders should routinely track and record *all* underwriting exceptions to ensure that they are granted in a nondiscriminatory manner, *even if they are not subject to a second review*. By definition, any loan approved (or application denied) as an exception can be categorized as a marginal approval (or denial). As such, it should be included in your routine comparative file review. (**Inset 3.4** identifies the characteristics of marginal approvals and marginal denials, from the FFIEC Fair Lending Examination Procedures.) Each exception should be recorded, along with an explanation of why it was made, and who approved it. Periodic analysis of these findings should be conducted to determine whether there are material disparities along racial/ethnic lines in the frequency with which such exceptions are granted. If disparities are found, appropriate corrective action should be taken.

Inset 3.4

Marginal Approvals

Approved applications with any or all of the following characteristics are "marginal," and should be compared to marginal denied applications. Marginal approvals include those:

- Whose qualifications satisfied the lender's stated standard, but very narrowly;
- That bypassed stated processing requirements (such as verifications or deadlines);
- For which stated creditworthiness requirements were relaxed or waived;
- That, if the lender's own standards are not clear, fell short of common secondary market or industry lending standards;
- That a prudent conservative lender might have denied;
- Whose qualifications were raised to a qualifying level by assistance, proposals, counteroffers, favorable characterizations or questionable qualifications, etc.; and/or
- That in any way received unusual service or consideration that facilitated obtaining the credit.

Source: Interagency Fair Lending Examination Procedures, Appendix X

Inset 3.4

Marginal Denials

Denied applications with any or all the following characteristics are "marginal," and should be compared to marginal approved applications. Marginal applications include those that:

- Were close to satisfying the requirement that the adverse action notice said was the reason for denial;
- Were denied by the lender's rigid interpretation of inconsequential processing requirements;
- Were denied quickly for a reason that normally would take a longer time for an underwriter to evaluate;
- Involved an unfavorable subjective evaluation of facts that another person might reasonably have interpreted more favorably (for example, whether late payments actually showed a "pattern," or whether an explanation for a break in employment was "credible");
- Resulted from the lender's failure to take reasonable steps to obtain necessary information.
- Received unfavorable treatment as the result of a departure from customary practices or stated policies. For example, if it is the lender's stated policy to request an explanation of derogatory credit information, a failure to do so for a prohibited basis applicant would be a departure from customary practices or stated policies even if the derogatory information seems to be egregious;
- Were similar to an approved control group applicant who received unusual consideration or service, buy were not provided such consideration or service;
- Received unfavorable treatment (for example, were denied or given various conditions or more processing obstacles) but appeared fully to meet the lender's stated requirements for favorable treatment (for example, approval on the terms sought);
- Received unfavorable treatment related to a policy or practice that was vague, and/or the file lacked documentation on the applicant's qualifications related to the reason for denial or other factor.
- Met common secondary market or industry standards even though failing to meet the lender's more rigid standards;
- Had a strength that a prudent lender might believe outweighed the weaknesses cited as the basis for denial;
- Had a history of previously meeting a monthly housing obligation equivalent to or higher than the proposed debt; and/or
- Were denied for an apparently "serious" deficiency that might easily have been overcome. For example, an applicant's total debt ratio of 50 percent might appear grossly to exceed the lenders guideline of 36 percent, but this may in fact be easily corrected if the application lists assets to pay off sufficient non-housing debts to reduce the ratio to the guideline, or if the lender were to count excluded part-time earnings described in the application.

Managing and monitoring overrides is an area that is receiving increasing scrutiny by regulators and enforcement agencies. Even though there was no allegation of unexplained racial or ethnic disparities in its underwriting exceptions, Countrywide Mortgage agreed as part of its 2005 settlement with the New York State Attorney General (described in Section 4) to develop and implement procedures to track, monitor and analyze its underwriting exceptions to ensure that they were granted in a non-discriminatory manner. If its analysis revealed any disparity, Countrywide agreed to take corrective action, such as employee counseling and training, to correct the problem on a going forward basis.

Loan Pricing

Discretionary pricing may be a legitimate business practice, if properly developed, monitored, and administered. However, when loan officers (whether in-house or third party) are allowed to deviate from rate sheets or determine which rate sheet applies to which borrower, a lender runs the risk that its portfolio may suggest differential treatment on a prohibited basis, even if individual loan officers are treating all their applicants consistently. It is for this reason the federal bank examiners consider flexible, or discretionary, pricing to be a "risk factor" when they examine lenders for possible pricing discrimination. If such practices are part of your business model, it is especially important to track and test to ensure that they don't disadvantage minority applicants. Often, they do. **Inset 3.5** provides some insights about loan pricing from the most recent HMDA filings.

> **Inset 3.5**
>
> ***Insights About Loan Pricing from 2004–2005 HMDA***
>
> According to the Federal Reserve's own analysis, the 2004 and 2005 HMDA pricing data suggested that the delivery channel through which a borrower obtains a loan does affect loan pricing. The incidence of higher-priced lending was significantly higher for borrowers who lived outside the assessment areas of lenders covered by the Community Reinvestment Act than for those who lived inside these areas, a pattern that was noted as well in Massachusetts in James Campen's *Changing Patterns XIII* and *XIV* reports. Fed economists have suggested that the difference may be due in part to the different delivery channels employed within and outside these lenders' assessment areas. They point out, too, that differences in the incidence of higher-priced lending across groups may arise if the various channels serve different customer groups (e.g., if mortgage brokers or loan correspondents that originate loans on behalf of a depository institution focus on the subprime market, while the depository institution offers a broader range of products through its own retail branch network).
>
> If the brokers or correspondents that focus on the subprime market work disproportionately with borrowers from minority neighborhoods, then the depository institution's overall pricing pattern may show a higher incidence of higher-priced lending for minorities than for whites.

Pricing-related discretionary decisions—such as the decision to relax underwriting requirements, the choice of loan products or features to present to customers, and the imposition of discretionary charges—also should be monitored to ensure that minority borrowers are treated fairly. The second look process provides an opportunity to do so, *before* a loan gets booked. Some disparities may not be apparent except in hindsight. Catching and rectifying problems after the fact through your comparative file review is not as desirable as preventing them in the first place. Still, it is far preferable to having someone else discover them.

Borrowers should be offered loan options commensurate with their qualifications, and these options—including their associated costs, risks and benefits—need to be clearly explained so the borrower can make an informed choice. Second looks can ensure that this is happening. Even better is having an explicit policy requiring that applicants be "referred up" to the most affordable and suitable product for which they qualify. A number of studies have found that minority customers with prime credit disproportionately receive higher discretionary pricing, or APRs. In the previously referenced New York case, Countrywide agreed to perform a matched file review of *all* of its 2004 subprime or Alt-A retail mortgage loans made to minority borrowers and to compensate those where the company could not identify a legitimate, nondiscriminatory reason why (s)he was given a nonprime loan product.[25]

Suitability: An Emerging Standard?

The proliferation of product offerings and increased use of risk-based pricing makes it much more difficult for underwriters to determine whether all applicants receive equal treatment. It is not uncommon for a lender to offer many different products, each with its own pricing based on the borrower's credit risk. Applications may be submitted for approval under a particular program from any of several sources, including in-house originators, correspondent lenders, mortgage brokers, or telephone/internet channels, and they may have received differing levels of assistance along the way. Most lenders interviewed for this project indicated they did not routinely second guess whether the loan applied for was the "best fit" for the customer.

While the larger debate over what constitutes "suitability" and "net benefit" remains unresolved, there is growing sentiment among regulatory and enforcement agencies, elected officials, and consumer and civil rights advocates that lenders need to do a better job of assessing what is appropriate. Some loans, they argue, are so clearly inappropriate that their origination constitutes an unfair and deceptive practice. The rising rates of serious delinquency and foreclosures on recent subprime loans bolster that argument. *The Mortgage Reform and Anti-Predatory Lending Act of 2007* (approved by the U.S. House of Representatives in November 2007) requires creditors to make a determination at the time the mortgage is consummated that the consumer has a reasonable ability to repay the loan or, in the case of a refinancing, that the refinanced loan will provide a net tangible benefit to the consumer. The Senate has not yet acted on similar legislation.

Ultimately, "bad products" may be regulated out of existence. Unless, and until they are, second look procedures provide a level of protection for both the borrower and the originating lender.

Resources

The FFIEC bank examiners use a compliance management questionnaire in fair lending examinations to evaluate the quality of an institution's policies and procedures to prevent illegal disparate treatment. The questionnaire is not an absolute test of a lender's compliance management program—there is no legal or agency requirement for institutions to conduct these activities—but lenders should find the questionnaire a useful framework in which to evaluate their own policies and procedures, including second review procedures.

http://www.ots.treas.gov/docs/4/422333.pdf

The Boston Fed's quarterly publication, *Communities and Banking*, carried an informative article on the impact of overrides (when the scoring system suggests one outcome and the lender chooses another) in the mortgage credit-scoring process as part of its 2002 series on credit scoring and automated underwriting.

www.bos.frb.org/commdev/c&b/2002/fall/CS5.pdf

The Joint Center for Housing Studies at Harvard University has taken a lead in examining the increasingly complex mortgage market and identifying strategies for ensuring that financial innovation benefits all participants. One of its recent reports, in particular, sheds new light on the behavior of mortgage market participants. *Understanding Mortgage Behavior: Creating Good Mortgage Options for All Americans*, by Ren Essene and William Apgar, is available at:

http://www.jchs.harvard.edu/publications/finance/mm07-1_mortgage_market_behavior.pdf

A recent, related, report was released just as this guide was going to print. *Consumer and Mortgage Credit at a Crossroads: Preserving Expanded Access while Informing Choices and Protecting Consumers*, by Eric Belsky and Ren Essene, is available at:

http://www.jchs.harvard.edu/publications/finance/understanding_consumer_credit/papers/ucc08-1_belsky_essene.pdf

4. MORTGAGE BROKER OVERSIGHT

The turmoil in the mortgage market—particularly the subprime market—has focused the attention of regulatory and enforcement agencies, public officials, the media, consumer and civil rights groups, and even the general public on the role of mortgage brokers, and they have borne much of the blame for the current subprime mortgage crisis. While the marketing and sales practices of some mortgage brokers certainly contributed to the problem, the broker can only participate to the extent [s]he can obtain funding for a loan. Mortgage lenders, securitizers, rating agencies, investors, and those charged with protecting consumers and the safety and soundness of the nation's financial institutions also share responsibility for the failure of so many recent loans. In many cases, individual borrowers do as well.

Even so, reigning in mortgage broker excesses and abuses through increased oversight should be a high priority for all participants in the system. While there are differences of opinion as to what can be accomplished with self-policing and what requires increased government regulation, there is widespread agreement on many of the best practices—both for improving mortgage broker conduct *and* enhancing mortgage broker oversight.

Background

Growth of the Mortgage Brokerage Industry

Section 2 described the dramatic changes that have occurred over the past two decades as the mortgage market moved from its historic reliance on bank deposits to fund mortgages to capital market funding. The new entities spawned by this transformation included independent mortgage banking companies as well as subsidiaries and affiliates of banks, thrift institutions and other financial services companies. As national players commanded an ever larger market share, many smaller banks and thrifts either exited the mortgage business entirely or continued in a correspondent role to the larger companies. The new industry giants required a fresh sales strategy and distribution system to reach individual borrowers, and a network of correspondents and mortgage brokers responded to provide it.

Correspondent lenders, of which there were about 3,400 nationally in 2006,[26] are predominately financial intermediaries—community banks, thrifts, credit unions—and privately-owned finance or mortgage banking companies that operate like retail lenders. They take in applications and underwrite and fund mortgages, which they sell to the wholesale lender under prearranged pricing and delivery terms. Mortgage brokers, on the other hand, are independent agents who identify customers and match them to mortgage products from one of any number of lenders. Typically, they provide the same services as retail loan officers do: taking the application, obtaining the credit report and appraisal, counseling the consumer on the loan process, and collecting the necessary documents. Their role is to help the borrower submit the application to the wholesale lender, who makes the credit decision and funds the mortgage.

The broker model enables mortgage lenders to react quickly and efficiently to changing market conditions. An expansive national mortgage broker network (more than 50,000 companies employing an estimated 375,000 people in 2006), allowed loan wholesalers of all sizes to gain a national presence without incurring the expense of advertising, hiring additional permanent staff, or establishing branch offices. By some estimates, the mortgage brokers' share of new loans rose from 20 percent in 1987 to nearly 60 percent in 2006,[27] and they have played a particularly prominent role in subprime lending.

While the industry is now in retrenchment mode, the broker business model will most certainly survive as it is one that can provide substantial benefits for both borrowers and lenders. Because they typically deal with several different lenders, brokers can provide borrowers with a variety of loan options in a single "one-stop" shop. This can reduce borrowers' search costs and enable them to obtain lower cost credit than they might find themselves. And because the broker may also be able to originate loans at a lower cost through economies of scale and specialization than a lender originating loans through a branch office, the lender benefits. By doing business with multiple brokers, a lender may be able to reach many more borrowers than it could on its own.

Current State of Affairs

Over the past year the combined effect of the housing market downturn, rising defaults and foreclosures, tightening lending standards, a shakeout of mortgage products for sale, and expanded regulatory oversight has forced a number of mortgage brokers and brokerage firms to exit the business. Whereas the nation's 50,000+ brokerage firms handled roughly 60 percent of all home loans in 2007, estimates are that number could be reduced by half by 2009, with a corresponding drop in the number of active firms to 30,000.[28] The Mortgage Bankers Association has reported that at least 100 mortgage companies ceased operations, closed, or were sold in 2007. Other sources put the number at over 200 since 2005.[29]

A winnowing out process is taking place in Massachusetts as well, and the mortgage brokerage industry that endures will be a more highly regulated one. (The Commonwealth's new mortgage broker regulations and *Chapter 206 of the Acts of 2007*, its new comprehensive mortgage and foreclosure prevention legislation, are described later in this chapter.) Many investors have stopped providing funding for subprime loans, forcing several large subprime lenders to close. Nine of the 20 largest mortgage lenders in Massachusetts last year have suspended all or a significant part of their lending as record levels of foreclosures suppressed demand from investors who buy mortgage-backed assets. Most of the suspended businesses and lending units specialized in subprime lending.

Several lenders active in the Massachusetts market—including the #1 lender, Bank of America; National City; and Webster Bank—have announced recently that they will no longer work with independent mortgage brokers. Wells Fargo, the state's third-largest lender in 2007, has announced that it will change the way it pays mortgage brokers in Massachusetts, from a sliding fee based on loan's profitability to a flat 1.5 percent of the loan amount. And Washington Mutual (WaMu) has announced that it will require its 19,000 independent mortgage brokers (nationwide) to show evidence that they have explained to borrowers key terms of their loans, including the amount, whether the interest rate or the payments may change, and if the loan has a fee for prepayments. In addition, WaMu brokers will be required to disclose to their borrowers the total amount of compensation the borrower will pay for the broker's services, including broker points, or administrative or processing fees, and whether the broker has requested a yield spread premium. WaMu also recently announced it intention to try to call every borrower represented by a broker to review the terms of a loan before closing. Finally, as this guide was going to press, the acquisition of Countrywide Financial—the nation's largest mortgage originator in 2006, and #2 in Massachusetts—had just been announced by the state's #1 lender, Bank of America.[30]

Lender Liability for Third Party Behavior

The issue of lender liability for fair lending violations committed by third party mortgage originators has received considerable attention in recent years because a lender can be subjected to civil lawsuits and government enforcement actions if a broker with whom it works is found guilty of discriminatory behavior.[31] At the same time, concerns about the pricing, terms and conditions of loans—particularly subprime loans—have blurred the boundary between the traditional fair lending statutory framework (the Fair Housing and Equal Credit Opportunity Acts) and the consumer protection framework (Federal Trade Commission Act, the Truth in Lending Act, and the Real Estate Settlement Procedures Act). Increased enforcement activities by state Attorneys General, and class action suits where violations of various statutes were alleged to have occurred, also make it more important than ever that lenders keep abreast of current laws, litigation, federal guidance, and legislation in these evolving areas. These changes have posed challenges even for institutions that rely on their own employees to originate loans. The challenge is much greater for lenders that originate through brokers and correspondents.

A 1996 case involving Long Beach Mortgage Company[32] became the bellwether for enforcement actions involving third parties. The Department of Justice Department (DOJ) alleged that Long Beach was directly liable, under fair-lending laws, for pricing differentials within its overall portfolio. The DOJ sought to create a common law of lender liability for the acts of independent mortgage brokers. Because Long Beach was responsible for underwriting the loans, and it had allowed the brokers to charge discriminatory prices, the Justice Department asserted that the company was liable for the alleged discrimination. The case was settled for $3 million before the courts had an opportunity to render an opinion, either in support of or against DOJ's action, but the Department has invoked similar theories of third-party liability in subsequent cases.[33]

In other cases lenders have been held liable for fraudulent activities, or unfair and deceptive practices, carried out by third parties. Increasingly, consumer protection violations that disproportionately impact a protected class—as so many do—can turn a consumer violation into a fair lending one. There are many recent actions where this has occurred. Competent legal counsel, well versed in fair lending *and* consumer protection, is always an essential team member—more so for any lender that conducts business with mortgage brokers, or other third parties.

The Framework for Mortgage Broker Oversight: Recent Guidance

Guidance from the Federal Regulators

Much of what are emerging as "best practices" in the area of third party oversight have been articulated in the past three to five years by the regulators or as the result of enforcement actions and litigation. The rules of engagement and the sanctions for violating them are still being devised, but all lenders—including those that are not federally regulated depository institutions—can benefit from the guidance that has been put forth by the federal regulators. Moreover, all lenders should understand that there is growing sentiment among advocates and public officials that the existing guidance has been ineffective in ridding the industry of the "bad actors," and increasing regulations and oversight are likely. While this section focuses on mortgage broker oversight in particular, there is increasing concern about the practices of other third parties such as appraisers and loan servicers. (**See Inset 4.1.**)

Inset 4.1

Oversight of Other Third Parties

While the focus of this guidance is on mortgage broker oversight, there is concern also about the behavior of other third party service providers. One particularly timely concern is the behavior of loan servicers.

In an action settled in 2002, the Justice Department asserted that Fidelity Federal Bank, FSB had violated the Equal Credit Opportunity Act by, among other things, permitting a collections agency to harass customers on the basis of their Hispanic origin. There was no assertion that any of the alleged collections abuses were perpetuated directly by Fidelity, but DOJ nonetheless sought to hold Fidelity liable. Fidelity vigorously denied the allegations but agreed to injunctive relief, including training and monitoring, and establishment of a $1.6 million compensation fund.

Among the many issuances put forth by the regulators, the following four warrant particular attention by any lender that utilizes third parties in the origination of loans. **Appendix A** provides links to other relevant guidance.

Avoiding Predatory and Abusive Lending Practices in Brokered and Purchased Loans[34] In a 2003 advisory letter to national banks and their operating subsidies, the OCC identified the risks associated with predatory and abusive lending practices in brokered and purchased loans, prominent among which was the fair lending risk. The advisory reinforced the OCC's earlier guidance that institutions originating loans through brokers should have policies and procedures in place to ensure that the loans they obtain comport with the policies they apply to loans they make directly, and with applicable safety and soundness standards and consumer protection laws. It also reiterated that mortgage lenders need effective management information systems to monitor the performance of brokers and originators from whom they acquire loans. The Advisory identified several additional measures that can mitigate against third party risks. They include having in place:

- ❖ Policies to address when to purchase loans with certain characteristics (e.g., refinance of a subsidized loan; financed single-premium credit insurance, negative amortization, default interest rates, mandatory arbitration clauses, high cost loans)
- ❖ Policies to address points and fees caps and compensation issues, such as the use of overages and yield spread premiums
- ❖ Appropriate initial and ongoing due diligence protocols
- ❖ Agreements with brokers and correspondents that reiterate the institution's lending policies and contain appropriate recourse for originations that do not adhere to those policies
- ❖ A systematic review of individual loan file reviews to ensure compliance with the bank's policies and, in the case of brokered loans, that there is appropriate documentation of a relationship between the consumer and the broker

Guidance Establishing Standards for Residential Mortgage Lending Practices[35] In 2005 the federal regulatory agencies jointly issued guidelines that described, among other things, terms and practices that warranted a "heightened degree of care by lenders" because they were conducive to "predatory, abusive, unfair, or deceptive lending practices." The guidelines also identified steps that banks should take to mitigate risks associated with their purchase of residential mortgage loans and use of mortgage brokers to originate loans. These guidelines also put federally regulated institutions on notice that loans they purchase, or make through a mortgage broker or other intermediary, should reflect standards and practices consistent with those applied by the bank in its direct lending activities. Examples of appropriate measures to mitigate risk included the following:

- ❖ Criteria for entering into and continuing relationships with intermediaries and originators, including due diligence requirements
- ❖ Underwriting and appraisal requirements
- ❖ Standards related to total loan compensation and total compensation of intermediaries, including maximum rates, points, and other charges, and the use of overages and yield-spread premiums, structured to avoid providing an incentive to originate loans with predatory or abusive characteristics
- ❖ Requirements for agreements with intermediaries and originators, including with respect to risks identified in the due diligence process, compliance with appropriate bank policies, procedures and practices and with applicable law (including remedies for failure to comply), protection of the bank against risk, and termination procedures
- ❖ Loan documentation procedures, management information systems, quality control reviews, and other methods through which the bank will verify compliance with agreements, bank policies, and applicable laws, and otherwise retain appropriate oversight of mortgage origination functions, including loan sourcing, underwriting, and loan closings
- ❖ Criteria and procedures for the bank to take appropriate corrective action, including modification of loan terms and termination of the relationship with the intermediary or originator in question

The Interagency Guidance on Nontraditional Mortgage Products[36], issued in the fall of 2007, and the companion guidance adopted the following month by the Conference of State Banking Supervisors and the American Association of Residential Mortgage Regulators specifically identified four areas of concern involving third-party risk[37] and recommended activities to mitigate these risks:

- ***Disclosure Practices***—Institutions must be sensitive to the marketing and disclosure practices of third-party originators, such as brokers and correspondents. Guidance stresses that promotional materials, oral statements, etc. must inform the consumer about the relative benefits and risks of these products, including the risk of payment shock and negative amortization.

- ***Underwriting Standards***—Underwriting should not be ceded to third parties with different business objectives, risk tolerances, and core competencies (e.g., care must be taken in outsourcing programs).

- ***Due Diligence and Monitoring***—Initial and periodic due diligence of third-party originators is stressed, as is the need for monitoring procedures to track the quality of loans by both origination source and key borrower characteristics.

- ***Compensation***—Guidance stresses the need for establishing third-party compensation criteria that avoids incentives for unsafe and unsound originations.

The Statement on Subprime Lending, adopted by the agencies in July 2007, similarly emphasized strong initial and ongoing due diligence of third parties. As with the Guidance, there was an emphasis on making sure that third-party originators make appropriate disclosure to the consumer of the risks and benefits in subprime loan transactions. The statement addressed certain risks and issues relating to subprime mortgage lending practices, including adjustable-rate amortizing mortgages, which had not been specifically addressed in the earlier Non-Traditional Guidance. The Conference of State Banking Supervisors and the American Association of Residential Mortgage Regulators adopted parallel recommendations regarding subprime lending for the brokers and lenders they license as well.

Recent Enforcement Actions and Litigation

Among the recent legal actions from which lenders can draw guidance on mortgage broker oversight, two stand out:

Countrywide Settlement with New York AG's Office In 2006, Countrywide Home Loans entered into a settlement with then New York State Attorney General Eliot Spitzer, who had alleged pricing discrepancies between loans made to Hispanic/black borrowers and non-Hispanic white borrowers. The alleged discrepancies were due, in part, to pricing exceptions in Countrywide's retail channel and broker compensation (combined front and back-end) in its wholesale channel. As part of the settlement,[38] Countrywide agreed to:

- Modify its existing models, methodologies and analyses, as necessary, to perform periodic broker compensation regression analysis to identify whether there are material pricing disparities between Hispanic/black borrowers and similarly situated non-Hispanic white borrowers, and whether brokers with a significant black or Hispanic customer base have materially higher broker compensation than brokers with a predominantly non-Hispanic similarly-situated customer base within the same MSA

- Institute corrective action for brokers (from training and education to termination of the relationship), focused especially on any broker with a pricing disparity of more than 65 basis points

- Instruct its New York brokers to disclose to applicants that reduced documentation loans generally are more expensive, and should offer to quote the applicant a price for a full documentation loan

- Notify its New York brokers that fair lending training is available; that Countrywide has processes to monitor loans at the individual broker level for compliance with fair lending laws; and that Countrywide can take various remedial action against the brokers, including reducing compensation or terminating the relationship

FDIC Cease and Desist Order Against Fremont Investment & Loan Under the terms of a March 2007 Consent Agreement with the FDIC,[39] California-based Fremont Investment and Loan was required to put in place policies, procedures and control systems that addressed not only bank personnel, but also brokers and correspondents. In addition, the agreement required Freemont to develop a mortgage broker monitoring program and plan, which—at a minimum—provided for:

- A due diligence process for entering into and maintaining relationships with brokers
- A broker selection process that evaluates the integrity, character and financial viability of potential brokers
- Compensation criteria designed to avoid giving incentives for broker originations that are inconsistent with "sound underwriting and consumer protection principles"
- Procedures for monitoring broker compliance with agreements, bank policies and applicable law, and appropriate corrective action where a broker does not
- Procedures for tracking which brokers generate substantial "putbacks" (measured as a fraction of the broker's loan volume) and implementing appropriate corrective action

Freemont was the second most active subprime lender in Massachusetts in 2005 and a major player nationally at the time the FDIC filed its Cease and Desist Order. It exited the subprime business in 2007 and, as this guide was going to press, federal regulators had given the company 60 days to raise capital or cease operation.

Recent and Proposed Legislation at the Federal and State Level

The legislative response to the problems that have come to light in the mortgage industry remains a work in progress, but three recent actions should be of particular interest to Massachusetts lenders originating loans through a mortgage broker or correspondent network. In October 2007, Massachusetts Attorney General Martha Coakley promulgated new regulations that expanded the scope of the Commonwealth's existing mortgage lender and broker regulations prohibiting certain unfair and deceptive practices (found at 940 CMR 8.00). Those regulations previously applied only to home improvement loans; as amended, they apply to all mortgage loans except open-end home equity loans. The new regulations, which took effect in January 2008:

- Prohibit mortgage brokers or lenders from making a loan if they do not have a reasonable belief that the borrower is able to repay the loan
- Require mortgage brokers or lenders to disclose how the interest rates or other charges will increase under a "no-doc" or stated income loan, and obtain the borrower's signed statement of income in order to process those types of loans
- Prohibit mortgage brokers from arranging or processing loans that are not in the borrower's interest, and prohibit brokers from brokering loans if the broker's financial interest conflicts with the borrower's interest
- Prohibit mortgage lenders from steering borrowers to loan products that are more costly than those for which the borrower qualifies, and prohibit lenders from discriminating between similarly qualified borrowers

A month later (November 2007), Governor Patrick signed into law comprehensive mortgage and foreclosure prevention legislation. Most of the provisions of *Chapter 206 of the Acts of 2007* took effect immediately; several will become effective over the next six months. The statute creates a centralized statewide foreclosure database at the Division of Banks to monitor and analyze foreclosures and foreclosure patterns and provides borrowers with a statutory 90-day right-to-cure. Further, the statute requires mortgagees to receive consumer counseling prior to obtaining subprime variable rate mortgage loans.

Provisions of the new law pertaining to mortgage brokers include:

- ❖ Improved oversight and monitoring of certain mortgage lenders
- ❖ Requiring loan originators to be licensed by the Division of Banks and providing a $3 million appropriation to the Division to implement the provisions of the bill. (Employees of banks, credit unions, savings and loan associations and insurance companies are exempt from the licensing requirement.) All mortgage loan originators subject to the new law will be required to complete a residential mortgage lending course prior to obtaining a license and then undertake at least eight hours of continuing lending education every three years in order to maintain eligibility.
- ❖ Requiring every mortgage to have endorsed on it the name, address, and license number of the mortgage broker and mortgage originator, if applicable
- ❖ Prohibiting a subprime adjustable rate mortgage for first time homebuyers unless they a) affirmatively opt into a subprime adjustable rate product, and b) get in-person counseling from a certified counselor. (A link to Regulatory Bulletin 1.3-104, which implements these counseling provisions, is provided in the Resource section of this chapter.)

Also in November, the U.S. House of Representatives passed *The Mortgage Reform and Anti-Predatory Lending Act of 2007*. This bill creates a licensing system for residential mortgage loan originators, establishes a minimum standard requiring that borrowers have a reasonable ability to repay a loan and attaches a limited liability to secondary market securitizers. The legislation will also expand and enhance consumer protections for "high-cost loans," will include protections for renters of foreclosed homes, and will establish an Office of Housing Counseling through the Department of Housing and Urban Development. Similar legislation is pending in the Senate.

Establishing a Program for Mortgage Broker Oversight

With guidance from so many sources, mortgage broker oversight is one area where lenders not only have been given clear direction about where the industry is headed, but also a roadmap of how to get there: what practices are to be avoided at all costs; what practices are to be carefully monitored; and what practices should be standard operating procedures. The previously cited documents should become the core curriculum for any lender that originates loans through third parties and/or includes subprime or nontraditional mortgages in its product line.

The first step for any institution wishing to develop a third party risk management strategy is to candidly assess the risks associated with its business model. Lenders may find **Inset 4.2**, excerpted from the FFIEC's 2005 White Paper on detecting and deterring fraud involving third parties, a useful guide as they identify risks and craft responses. The White Paper does not explicitly address fair lending issues, but the practices it discusses have become, *de facto*, fair lending issues because minorities and other protected classes have been disproportionately impacted by them.

Inset 4.2

In 2005, the FFIEC issued *The Detection, Investigation, and Deterrence of Mortgage Loan Fraud Involving Third Parties: A White Paper*, focusing on ways that financial regulators and the industry could detect, investigate, and deter third party mortgage fraud. The white paper, issued as a complement to existing examination policies and practices, does not explicitly address fair lending issues. But because minorities and other protected classes have been disproportionately impacted by predatory lending practices carried out by third parties, the practices the paper discusses have become, *de facto*, fair lending issues. Predatory lending often violates fair lending laws as well as state and federal consumer protection laws.

The following signs were identified as "red flags" for financial institutions dealing with mortgage brokers:

- No attempt is made to determine the financial condition of the broker or obtain references and background information.
- A close relationship exists between the broker, appraiser, and lender, raising independence questions.
- The broker acts as an advocate for the borrower instead of serving as the financial institution's representative/agent.
- High "yield spread premiums" are paid by the financial institution.
- Original documents are not provided to the funding financial institution within a reasonable time.
- An unusually high volume of loans with maximum loan to value limits have been originated by one broker.
- An uncommonly large number of foreclosures, delinquencies, early payment defaults, prepayments, missing documents, fraud, high-risk characteristics, quality control findings, or compliance problems exist on loans purchased from any broker.
- A large volume of loans from one broker arrives using the same appraiser.
- High repurchase volume exists for a specific broker.
- Numerous applications from a particular broker are provided possessing unique similarities.
- A high volume of loans exist in the name of trustees, holding companies, or offshore companies.
- An unusually large increase is noted in overall volume of loans during a short time period.

The following internal controls/best practices were recommended for financial institutions that originate loans through mortgage brokers:

- Conduct an initial acceptance review and obtain documentation to support broker approval. Examples of actions to be taken include:
  - Review the broker's financial information as stringently as for other real estate borrowers.
  - Ensure the financial institution's broker agreements require brokers to act as the financial institution's representative/agent.
  - Independently verify the broker's background information by checking business history outside of given references.
  - Obtain a new credit report for the broker and check for recent debt at other financial institutions.
  - Obtain resumes of principal officers, primary loan processors, and key employees.
  - Conduct state license verification.
  - Conduct criminal background checks and adverse data base searches, i.e., MARI (fraud repository).
- Conduct an annual re-certification of brokers.
- Conduct pre-funding reviews on all new production utilizing a prefunding checklist.
- Conduct quality control underwriting reviews.
- Base broker compensation incentives on something other than loan volume, i.e., credit quality, documentation completeness, prepayments, fraud, and compliance.

Inset 4.2 (continued)

- Establish measurable criteria that trigger recourse to the broker, such as misrepresentation, fraud, early payment defaults, failure to promptly deliver documents, and prepayments (loan churning).
- Hold brokers and third party contract underwriters responsible for gross negligence, willful misconduct, and errors/omissions that materially restrict salability or reduce loan value.
- Establish a broker scorecard to monitor volume, prepayments, credit quality, fallout, FICO scores, LTVs, DTIs, delinquencies, early payment defaults, foreclosures, fraud, documentation deficiencies, repurchases, uninsured government loans, timely loan package delivery, concentrations, and quality control findings.
- Perform detailed vintage analysis, and track delinquencies and prepayments by number and dollar volume.
- Closely monitor the total number of loans and products from a single broker.
- Establish an employee training program that provides instruction on understanding common mortgage fraud schemes and the roles of a mortgage broker, as well as recognizing red flags.
- Establish a periodic audit of the brokered mortgage loan operations with specific focus on the approval process.
- Perform social security number validation procedures to validate borrower identity.

Source: *The Detection, Investigation, and Deterrence of Mortgage Loan Fraud Involving Third Parties: A White Paper,* FFIEC, issued February 2005

Identifying the Risks

The following series of questions are designed to help lenders that employ third party originators determine their risk exposure in light of the foregoing regulations and guidance.

Due Diligence

- ❖ Do you verify that the mortgage broker has a current MA state license? Do you check renewal dates?
- ❖ Do you check business practices, character references, financial condition, internal controls, current and prior litigation, etc. prior to entering into (and maintaining) a relationship with a broker?
- ❖ Do you monitor new brokers, correspondents and products?
- ❖ What sanctions do you impose if a broker is found not to comply with all applicable federal, state and local laws?
- ❖ Do you maintain a roster to track individuals with whom you will no longer do business.

Policies and Procedures

- ❖ Do you have written agreements with third-party brokers and originators that specifically identify the responsibilities and expectations of each party?
- ❖ Do you require brokers to sign a “commitment to responsible lending” or similar document, which includes pledge to comply with the letter and spirit of all fair lending laws and practices?
- ❖ Do you move quickly to terminate your relationship with brokers who have committed fraud and report them to the state licensing-agency and/or to federal, state or local law enforcement agencies?
- ❖ Do you have a “suitability standard” or require that brokers make certain that the loans they are selling are suitable for the applicant?

- Do you allow third parties to underwrite loans on your behalf?

Education and training

- What, if any, educational materials/training do you provide your brokers?
- Do you have any mechanisms for keeping brokers current on laws, trends, policies, etc.?
- Do you review and approve all customer information that brokers distribute for accuracy and completeness?

Pricing policies

- Do you prohibit mortgage originators from steering[40] consumers into mortgages with higher interest-rates than they could otherwise qualify for? If so, how do you check and what do you do if they have?
- What is your policy on points, fee caps, compensation issues? On yield spread premiums?
- Do your originator compensation policies contribute to pricing disparities?

Monitoring performance

- Do you have routine quality assurance procedures in place (e.g., periodic file reviews)?
- Do you check to ensure that no loan application contains false or misleading information and that it has been analyzed to determine the borrower's actual financial situation and true ability and willingness to repay the loan?
- Have you developed a broker scorecard (using such objective criteria as loan volume, prepayments, credit quality, fallout, FICO scores, loan to values, debt to income ratios, delinquencies, early payment defaults, foreclosures, fraud, documentation, deficiencies, repurchases, timely loan package delivery, concentrations, and quality control findings)?
- Do you know if you have pricing inconsistencies? If so, to what are they attributable? (e.g., certain brokers or branches, channels, geographies, product types?)

Evaluating the Risks

Once a lender has identified areas where it might be vulnerable, it can begin to evaluate its level of risk exposure and its options for mitigating those risks. Some practices, or breaches, may pose significant risk but be relatively easy to address, for example, insufficient broker training or inadequate due diligence before entering into broker relationships. The former can be rectified by expanding in-house fair lending and consumer protection training programs to third parties with whom you do business. If you have not yet conducted in-house staff training that incorporates the new non-traditional mortgage and subprime lending guidance, new state regulations, and the lessons learned from recent enforcement actions, you have doubled your risk exposure.

Mitigating the latter risk—background checks, licensing, etc.—is also getting easier. The Massachusetts Division of Banks is a part of the new Nationwide Mortgage Licensing System (NMLS), launched by the state mortgage regulators to bring greater efficiency and accountability to the supervision of the mortgage industry. Starting in January 2008, each state licensed mortgage lender, banker, broker company, and each of their owners and executive officers will be able to electronically complete a single registration form (regardless of the number of states they are licensed in or the number of companies they are affiliated with). The system will assign each mortgage company, owner or executive officer, branch and loan officer a unique, permanent identifying number, which will allow state regulators to track companies and individuals across states and over time. The new centralized database—comprising all loan originators, including those who work for federally regulated depositories—will enable regulators, consumers and the mortgage industry to check on the license status and history of individual brokers. As such, it is expected to play an important role in restoring consumer confidence in the mortgage industry.

In addition, several resources already exist that can guide you through the process of establishing appropriate checks on third party originators. One of the most useful is Freddie Mac's guide, *Discover Gold Through Quality: Wholesale Originations Best Practices*. (See description under Resources.)

Instituting a more rigorous schedule of file reviews or developing a "commitment to responsible lending" for third party originators to sign are relatively easy fixes as well. If, however, you determine that you may be at risk because of pricing inconsistencies—you allow discretionary pricing, for example, but don't know what an analysis of your portfolio would reveal about disparities—the stakes are higher. The risk is greater, *and* the corrective action(s) are more involved.

Best Practices

The following strategies have been widely accepted as "best practices" for managing the fair lending risks associated with third party loan originators. While the sophistication of management information systems or the schedule and nature of management reporting will depend on the size and complexity of the organization, the fundamental framework applies to any lending institution that originates loans through mortgage brokers or correspondents.

Due Diligence

Establish clear written procedures for entering into and continuing relationships with third-party mortgage loan brokers and originators, and perform thorough due diligence prior to entering into such relationships. Minimum performance standards should be stipulated as well as the sanctions for failing to meet them and termination procedures. Due diligence should include background checks into the party's reputation, business practices, financial condition, internal controls, compliance with applicable licensing, current or prior litigation, etc. Brokers and correspondents should be required to agree in writing that they will:

- Adhere to your lending policies
- Comply with all applicable laws, including safety and soundness standards and laws prohibiting lending discrimination and unfair or deceptive practices
- Agree in writing to make best efforts to ensure that the loans offered to borrowers are consistent with their needs, objectives, and financial situation

Policies and Procedures

Every lender that sources loans through third party originators should have clear written policies regarding compensation, product placement, underwriting standards, required documentation and disclosures. Policies should clearly spell out the conditions, if any, under which the lender will make or acquire a loan with features associated with abusive or predatory lending practices. Policies should specify loan pricing parameters and compensation policies. Lenders should also ensure that brokers are familiar with the underwriting standards and documentation requirements for each of its loan products. Brokers should be put on notice if you have a "refer up" policy (that is, you will qualify an applicant for the most advantageous product/pricing for which she qualifies, regardless of how the broker submitted it).

Education and Training

Lenders should ensure that their brokers and correspondents are adequately trained on the new Massachusetts laws and regulations as well as the interagency guidance on non-traditional and subprime loans, and any changes in made in their sales and underwriting policies to conform to those new laws and guidance. Appropriate compliance controls should be implemented to ensure adherence to any new policies and procedures. Broker training should include, not only a review of the relevant laws, regulations and lender policies—and the sanctions for violating them—but also trends and current concerns. Third party originators should understand that you will be monitoring their individual performance, as well as their performance compared to other originators with whom you do business and other lenders operating in the same geography.

With the new Massachusetts regulations, and recent guidance from the GSEs and federal and state regulators on non-traditional loan products and subprime lending, it is likely your in-house staff is due for an update as well. You may wish to share the educational and training materials you prepare for your in-house personnel with your brokers. At the very least, you should review and approve all customer information that they distribute for accuracy and completeness.

Periodic review of individual loan submissions for quality assurance is a key component of a comprehensive compliance management program. It can also be a valuable training tool, and is particularly appropriate now as new standards take effect.

Pricing, Compensation, and Steering

Compensation criteria should encourage brokers to make fair and consistent pricing decisions and to discourage them from originating loans that are inconsistent with sound underwriting, fair lending, and consumer protection principles. The use of employee or broker incentive programs (yield spread premiums or overages) is not unlawful *per se*. It becomes unlawful, however, if it exceeds the limits established under the new Massachusetts regulations, 940 CMR 8.00. It also becomes unlawful if applied so as to extract higher prices from minorities or women because of their race, national origin or gender (or other protected class).[41] Effective January 2008, every lender doing business in the Commonwealth must have in place a third party pricing program that complies fully with the new state regulations.

Section 8.06(18) of the revised Massachusetts regulations requires that a "lender's pricing model and loan cost features be based on a borrower's qualification criteria," thus preventing loan originators from steering borrowers to higher cost loans or charging increased costs and fees that bear no relation to the borrower's qualifications or the credit risk posed by borrower. The regulation does not dictate the "qualification criteria" that may be considered by a lender, although it does require that those criteria be reflected in a written loan underwriting or origination policy. Even with appropriate pricing policies in effect, a lender must institute rigorous compliance controls and testing to ensure that its policies do not result in disparate treatment or disparate impact discrimination.

Lenders also should review written agreements between the borrower and the broker to ensure that they conspicuously and accurately disclose the fees to be paid to the broker for his/her services. Such agreements should contain a specific request for such broker services at that fee, and a signed and dated acknowledgment of receipt by the consumer before the broker commences services. The federal regulators recommend that the lender retain copies of this documentation.

Monitoring Performance

The key to a successful compliance program for any lending institution that employs third party originators, and allows discretion in pricing, is effective tracking and monitoring. The lender needs to know four things:

- If there are pricing disparities in its portfolio
- What the source(s) of those disparities are (For example, are certain loan originators overcharging minority applicants compared to white applicants, or do brokers in minority markets tend to charge higher rates than their counterparts in non-minority markets? What are the components of discretionary pricing? Yield spread premiums, broker fees? The appropriate corrective action strategy will depend on the answer.)

- ❖ How significant the differences are
- ❖ Whether there are non-pricing vulnerabilities as well (e.g., brokers providing improper disclosures or inadequate documentation; engaging in steering; generating loans with poor performance records)

The more origination channels an organization utilizes, the more critical the monitoring system becomes. Some large lenders have developed sophisticated in-house systems for monitoring their own employees as well as third party agents. Others have opted to use outside vendors. Either way, an institution needs to be able to analyze pricing and performance, in aggregate, and by origination channel, originator, product, metro area, and applicant characteristics. In its simplest form, a monitoring system must capture broker and borrower ID, product type, property type and location, pricing (APR, discretionary pricing), loan amount, DTI, LTV, credit score, applicant characteristics, quality control assessment, and loan performance (default, prepayment, loan losses). By careful tracking of these characteristics, a lender can identify and take corrective action against agents who fail to adhere to the company policies and practices.

Analysis of findings should be reported to senior management on a regular basis (frequency will depend on loan volume). Business unit and/or compliance personnel should be able to access data in real time so that it can be incorporated into their second look program, to prevent problem loans from being booked. Failing that, they should be included in routine comparative file reviews.

Corrective Action

Lending institutions should take prompt and appropriate corrective action if brokers or originators violate the terms of their agreements, the lender's policies, or applicable state or federal laws. Corrective action may include additional education and training, or it may include modification of loan terms (and/or pricing), restricted pricing discretion, or termination of the broker/correspondent relationship.

Resources

Massachusetts Division of Banks Regulatory Bulletin 1.3-104, issued January 2008,
Counseling And Opt-In Requirements For Subprime Adjustable Rate Mortgage Loans Made To First Time Home Loan Borrowers

http://www.mass.gov/?pageID=ocaterminal&L=7&L0=Home&L1=Business&L2=Banking+Industry+Services&L3=Banking+Legal+Resources&L4=Laws+%26+Regulations&L5=Division+of+Banks+Regulatory+Bulletins&L6=Banks%2c+Credit+Unions%2c+and+Licensees&sid=Eoca&b=terminalcontent&f=dob_1_3-104&csid=Eoca

The Detection, Investigation, and Deterrence of Mortgage Loan Fraud Involving Third Parties: A White Paper, FFIEC, issued February 2005

http://www.compliancehome.com/whitepapers/FFIEC/abstract10195.html

OCC Advisory Letter 2003-2, Guidelines for National Banks to Guard Against Predatory and Abusive Lending Practices

http://www.occ.treas.gov/ftp/advisory/2003-2.pdf

OCC Advisory Letter 2003-3, Avoiding Predatory and Abusive Lending Practices in Brokered and Purchased Loans

http://www.occ.treas.gov/ftp/advisory/2003-3.doc

OCC Bulletin 2001-47, Third Party Relationships

http://www.ffiec.gov/ffiecinfobase/resources/outsourcing/occ-bul_2001_47_third_party_relationships.pdf

Discover Gold Through Quality, includes section on Wholesale Best Practices, Freddie Mac
Originally issued in 1999, and updated in November 2005, *Discover Gold* covers best practices for establishing wholesale contacts, evaluating and approving mortgage brokers and correspondents, monitoring the quality of wholesale loans, and provides a useful guide for broker background checking (items to be checked, process for checking, sources to investigate) It also includes sample reference letters, application questionnaires, approval checklists, etc.

http://www.freddiemac.com/dgtq/pdf/dgtq_wo.pdf

The new Massachusetts mortgage broker and lending regulations are found at 940 CMR 8.00: Mortgage Brokers and Mortgage Lenders. These regulations are issued by the Attorney General under the Consumer Protection Act, M.G.L. c. 93A. They can be accessed by going to www.mass.gov/ago and entering 940 CMR 8 in the search box.

The Q and A prepared by the Massachusetts Attorney General's Office can be found at:

http://www.mass.gov/Cago/docs/Consumer/940CMR8_guidance_121807.pdf

5. SELF-TESTING

One of the most effective ways to ensure fair and equal treatment of customers—regardless of race, national origin, age, or sex—is to expose and correct any deficiencies in marketing, sales and service *before* they result in customer complaints or allegations of discrimination. By self-testing, a financial institution can compare the treatment of customers and potential customers in a controlled manner. Testing for discrimination in this way can help identify potential problems, or it can reassure an institution that it does not discriminate. Equally important, an institution can gain insight into how its lending practices appear from the loan applicant's perspective, valuable feedback not readily available through other internal audit methods.[42]

The most common methods of self-testing are pre-application matched-pair tests and post-application customer interviews. Pre-application testing can be used by financial institutions to uncover instances of overt or subtle discrimination against individuals protected under the ECOA and the Fair Housing Act. To detect illegal discrimination, testers visit financial institutions posing as prospective loan applicants. While they do not actually complete a loan application, they do experience the important pre-application phase of the loan process. After discussing loan possibilities, they record how they were treated and what information was provided them by the institution's personnel. Testers are instructed to report unequal treatment, whether more or less favorable to the protected class. They do not have to admit they are testers, even when asked directly.

Post-application surveys can detect disparate treatment by identifying whether applicants received different levels of assistance, or were steered to certain products. A well-structured survey can also provide an opportunity to gauge the applicant's understanding of her transaction and the terms of the product she received or applied for.

Civil rights and consumer advocacy groups use matched pair testing to identify disparate treatment at the pre-application stage, and bank regulators and enforcement agencies (HUD and the Department of Justice) have encouraged lenders to self-test. It has been a condition in the settlements of several prominent fair lending legal actions as well. If you do business in a large metropolitan area, or even a smaller community with a diverse population, you very likely have been, or soon will be, "tested" by someone. (Tests conducted on, but not initiated by, an institution are called "targeted tests" as distinguished from "self-tests.")

Background

History

Matched-pair testing had been widely used to test for discrimination in the housing market, but it was not until the early 1990s that it began to be used in the mortgage industry. In 1994, the OCC launched its own pilot testing program to assess whether national banks and their mortgage subsidiaries treated consumers of different races and nationalities similarly during the pre-application phase of the mortgage process. In addition to conducting actual tests of a sampling of its banks, the OCC examined and evaluated the testing processes being used by other regulatory agencies, fair housing organizations, and mystery shopping vendors who had experience with matched-pair testing. In a joint statement with the Departments of Housing and Urban Development and Justice, and the Federal Trade Commission, the regulatory agencies addressed the subject of self-testing in a 1994 Q and A. To the question of whether a lender should engage in self-testing, the agencies responded as follows:

> Principles of sound lending dictate that adequate policies and procedures be in place to ensure safe and sound lending practices and compliance with applicable laws and regulations, and that a lender adopt appropriate audit and control systems to determine whether the institution's policies and procedures are functioning adequately. This is as true in the area of fair lending as in other operations. Lenders should employ reliable measures for auditing fair lending compliance. A well-designed and implemented program of self-testing could be a valuable part of this process. *Lenders should be aware, however, that data documenting lending discrimination discovered in a self-test generally will not be shielded from disclosure.*

Inset 5.1

Note: There are important distinctions between "self-testing" and "self-assessment."

The FFIEC Fair Lending Examination Procedures describe a self-test as any program, practice or study that is designed and specifically used to assess the institution's compliance with the ECOA and the Fair Housing Act *and* "creates data or factual information that is not otherwise available and cannot be derived from loan, application, or other records related to credit transactions" (12 CFR202.15(b)(1) and 24 CFR 100.141). (emphasis added)

The report, results, and many other records associated with a self-test are privileged unless an institution voluntarily discloses the report or results or otherwise forfeits the privilege. A self-evaluation, while generally having the same purpose as a self-test, does not create any new data or factual information, but uses data readily available in loan or application files and other records used in credit transactions and, therefore, does not meet the self-test definition. While they may request the results of self-evaluations, bank examiners are specifically instructed not to request the results of self-tests. If an institution discloses the self-test report or results to its regulator, it will lose the privilege.

In order to meet the definition of a "self-test," the efforts *must have* fair lending compliance as their *primary objective*. In addition, self-tests *must produce new data* or factual information that is not contained in and cannot be derived from loan or application files or any other existing records. *Self-tests must meet both of these requirements in order to obtain the privilege.* Pre-application matched-pair testing and post-application surveys of customers are specifically identified as examples of activities that meet the definition of a "self-test." In the pre-application testing, the testers pose as customers seeking credit, and the new information they create is the record of their experience. Post application, the customers being surveyed are those who recently applied for credit, and the new information created is their responses to questions about their experience between the time of their initial inquiry and final disposition of their application.

Compliance activities such as analysis of loan applications, comparative file reviews, and other audits that are based on existing files are not considered "self-tests" because they do not generate new data or factual information. The OCC refers to these compliance efforts, which meet the first part of the "self-test" definition but not the second, as *self evaluations* to distinguish them from *self-tests*.

Other activities may meet the second part of the definition, but not the first. For example, some lenders have tried to incorporate fair lending testing into their routine service quality mystery shopping program by reporting results based on whether the shopper is a member of a protected class. Such multi-purpose tests may not meet the "self-test" definition, however, in which case the results would not be privileged. This is just one of many reasons an institution considering self-testing should engage its in-house or outside legal counsel early in the process. (NOTE: A program that qualifies for the privilege because it is designed and used specifically to create information for fair lending compliance purposes *may generate*, *as a by-product*, valuable service quality information.)

Source: Definition of self-test and instructions to examiners from *FDIC Compliance Handbook*, June 2006; examples from ADI Consulting

If a lender *voluntarily* conducts or authorizes a third party to conduct a self-test, the report or results of the self-test are privileged, *provided that the lender has taken or is taking appropriate corrective action* to address any likely violations identified by the self-test. The Interagency Fair Lending Examination procedures specifically instruct examiners *not* to request the results of self-tests. *If an institution discloses the self-test report or results to its regulator, it will lose the privilege* (emphasis added).

The scope of the privilege extends to examinations or investigations into fair lending complaints or to efforts to prove a violation of fair lending laws. The privilege encompasses actions by a government agency or an applicant. The official staff interpretations from the Board of Governors of the Federal Reserve state that "government agency" encompasses all levels of government, but not all attorneys are convinced that it is entirely clear that the self-testing privilege would apply in cases brought exclusively under state antidiscrimination statutes.

> Corrective actions should always be taken by any lender that discovers discrimination. *Self-testing and corrective actions do not expunge or extinguish legal liability for the violations of law, insulate a lender from private suits, or eliminate the primary regulatory agency's obligation to make the referrals required by law. However, they will be considered as a substantial mitigating factor by the primary regulatory agencies when contemplating possible enforcement actions.* In addition, HUD and DOJ will consider as a substantial mitigating factor an institution's self-identification and self-correction when determining whether they will seek additional penalties or other relief under the FHAct and the ECOA. *The Agencies strongly encourage self-testing and will consider further steps that might be taken to provide greater incentives for institutions to undertake self-assessment and self-correction* (emphasis added).[43]

By 1998, the regulatory agencies were seeing a rise in discrimination complaints against banks based on matched pair testing conducted by consumer and civil rights groups. OCC Deputy Comptroller for Community and Consumer Policy Stephen Cross was quoted at the time as saying[44] that the quality of tests coming into the agencies was not very good, and that the OCC had been working with HUD, which had funded many of the tests, to try to tighten oversight of its projects to ensure quality results. Among the concerns he cited:

❖ There should be only one prohibited basis variable (e.g., gender, race, or age). Everything else in the test should be constant or slightly favor the minority tester.

❖ There must be enough tests to support a finding. Many of the tests used as the basis of discrimination complaints involved only one to three matched pair tests at one lender. Cross noted this might provide sufficient information to initiate a complaint against the bank, but it was unlikely to support a conclusion.

❖ The tests should be controlled for location and loan officer.

Used properly, Cross concluded, matched pair testing was the best way to identify pre-application discrimination. He cautioned banks that there a was a growing likelihood that they would be tested by someone and advised them to make front line staff aware of how to treat customers in a consistent and non-discriminatory way; he also warned that complaints based on scanty evidence might be filed.

Legal Privilege for Self-Testing

Even though the regulatory agencies were strongly urging banks to self-test in this way, the fact that they reserved the right to use the results against the lender had a chilling effect. Since self-tests generate new information, lenders ran the risk that the results of their self-tests would later be used against them, not only by regulators but also by private litigants. To allay the lending community's concerns, a legal privilege for self-testing was established through new rules from the Board of Governors of the Federal Reserve System and the Department of Housing and Urban Development. Following extensive commentary and debate, the new rules went into effect on January 30, 1998. (The self-test legal privilege, found at 12 CFR 202.15, appears as **Appendix C**.)

The regulators define self-testing as voluntary activities carried out by a third party that collect information assessing compliance that is not readily available or collected in loan files, in applicant records, or through normal, everyday business practices. (**Inset 5.1** illustrates the distinction between self-testing and self-evaluation.) The self-testing privilege was based upon a series of consent decrees and policies that had been evolving for more than twelve years. It was designed to give lenders an incentive to get the information they need to correct conditions that foster lending discrimination or discriminatory behavior by employees, and to encourage them to use more creative measures—in particular matched pair testing, post-application interviews, and customer feedback—to help them do so.

There are other limitations. The privilege applies to new information generated and to any analysis of that new information. It also covers reports on the self-test as well as data sheets filled out by testers, and analysis of the findings. Recommendations also can be subject to the privilege. (See **Inset 5.2**.) The fact that a self-test was conducted, its scope, and methodology *are not* privileged. And where a violation of the ECOA or FHAct has been proven without the results of the self-test, the self-test data could be used to determine the penalty or remedy. There are several activities that can trigger the loss of privilege, most having to do with disclosing results or failure to produce written or recorded information about the self-test. Perhaps most important, the privilege applies only if, upon finding a "likely violation," the lender takes "appropriate corrective action."

Inset 5.2

Self-Testing Q&A

Why should we consider self-testing?

There are several reasons, including:

- to ensure that front line employees are providing all customers and potential customers with the same level of service
- to ensure that they are complying fully with the ECOA and FHAct
- to protect your company's reputation
- to ensure that the third-party with whom you do business adhere to protocols, laws and
- to gain insight into how your company's practices appear from the loan applicant's perspective

Who and what would we examine?

The likely candidates include:

- point of contact employees and their performance
- sales and service practices
- treatment of protected and non-protected classes
- degree to which customers feel welcome to do business with your institution
- ability and willingness of loan officers to assess customer needs
- suitability of products offered
- access to service and information
- courtesy and comfort in dealing with protected and non-protected classes of consumers

What self-testing methods might we consider?

- pre-application testing by one of three techniques: pair testing, multi-layered, or sandwich
- post-application interviews, or assistance audits

What do we do with the results?

- communicate results with senior management
- develop and implement a corrective action plan
- work with legal counsel
- keep the results privileged

Inset 5.2 continued

Isn't this still kind of risky?

Lenders can use the privilege to their advantage by strategically revealing information outside the privilege that sheds positive light on fair lending compliance efforts, while maintaining the shield to protect what could be construed as likely violations. For example, the fact that a lender has conducted a self-test is not privileged, and volunteering that a pro-active compliance program is in place *may* demonstrate management's commitment to fair lending compliance. In several cases where lenders entered into consent decrees with the DOJ to settle alleged fair lending violations, their self-testing results and responsive actions were not used against them, but were considered risk mitigating factors by DOJ in determining the remedies.

Are there complementary activities that do not meet the self-test standard for legal invoking privilege, but may nonetheless generate valuable information and feedback as part of a broader self-assessment?

Yes. They include:

- mystery shopping
- focus groups
- complaint monitoring, and
- file reviews

Source: Adapted from *Self-Testing to Ensure Fair and Equal Treatment*, by Paul Lubin and Bob Homeyer

While some financial institutions remain uncomfortable with the ambiguity of these definitions and the risks associated with testing, the legal privilege has given many others the confidence to add self-testing to their fair lending tool kit. Most institutions that implement testing programs do so under the attorney-client privilege, which provides additional assurance that the results will remain confidential.

Self-Testing v. Targeted-Testing

Whether or not a lender elects to self-test, it is likely that they will be tested, or shopped, by someone. There is a long list of high profile test cases that have resulted from pre-application testing, and HUD funds fair housing organizations and other non-profits specifically to conduct matched pair testing through its Fair Housing Initiatives Program (FHIP). Many of the most prominent tests conducted over the past decade reported strikingly similar results, as this sample documents:

❖ In the early 1990s, audits were conducted by fair housing enforcement organizations including the National Fair Housing Alliance (NFHA) in seven cities (Atlanta, Chicago, Dallas, Denver, Detroit, Oakland, and Richmond). NFHA concluded that lenders often appeared to be less interested in giving information to black customers than to whites; urged black customers, but not whites, to go to another lender; and emphasized to black customers, but not whites, that application procedures would be long and complicated. The audits also indicated that blacks were more likely than equally qualified whites to be told that they did not qualify for a mortgage before they had filed a formal application, and whites were more likely to be "coached" on how best to handle potentially problematic aspects of their credit profile.[45]

❖ In 2001, HUD contracted with the Urban Institute (UI) to assess the effectiveness of paired testing for determining whether minority homebuyers receive the same treatment and information as whites at the pre-application phase of the mortgage lending process, and to produce rigorous measures of the incidence of unequal treatment in two metropolitan areas. The UI study involved approximately 250 paired tests of a representative sample of mortgage lending institutions in Los Angeles and Chicago, using a standardized set of protocols. Institutions were tested if they accepted at least 90 loan applications per year and had offices in the region that a first-time homebuyer could realistically find and visit. In the majority of cases, minorities and whites received equal treatment, or when differences occurred, they were equally likely to favor the minority as the white. Still, in both metropolitan areas, the paired testing revealed statistically significant patterns of unequal treatment that systematically favor whites. The final report[46] concluded that paired testing can indeed be an effective tool for research and enforcement.

❖ In the summer of 2007, the National Community Reinvestment Coalition (NCRC) filed a civil rights complaint with HUD against Houston-based Allied Home Mortgage Capital Corporation, the nation's largest privately held mortgage broker/banker, based on NCRC's first Broker Fair Lending Audit. NCRC's 2005–2006 audit involved over 100 tests in the Atlanta, Baltimore, Chicago, Los Angeles, St. Louis, and Washington, D.C. metro areas. NCRC reported that Allied and its brokers engaged in a pattern and practice of discrimination by: quoting different interest rates and fees on the basis of race; steering African American consumers to more expensive non-prime products; not treating African-American applicants for mortgages as seriously as their white counterparts, despite their being more qualified; providing African-Americans with substandard and discourteous treatment; limiting access to credit on the basis of race; differential treatment on the basis of race in representing policies and practices, and making inappropriate comments regarding the characteristics of communities.

Closer to home, the Fair Housing Center of Greater Boston, also funded under a HUD FHIP grant, conducted lender testing in 2005 and 2006 to determine the extent and nature of discrimination against African American, Latino, Asian, and Caribbean homebuyers seeking mortgages in Boston. Their results mirror those of the other tests described here. (See **Inset 5.3**.)

More Important Than Ever

Monitoring the marketing and sales practices and quality of assistance encountered by consumers has become even more important as lenders have expanded their product offerings and employed multiple sales channels, personnel, and third parties to market them. Without adequate oversight, such expansion can result in increased risk. Self-testing, which limits the risk associated with these new activities, can help a financial institution safely expand into new product lines and sales channels. As lenders consider self-testing, they should carefully consider the entire spectrum of their fair lending compliance activities to determine if and how self-testing efforts complement the other parts of that spectrum (data analysis, comparative file reviews, second review programs, fair lending training, review of policies and procedures, and other compliance measures).

Current Practices

While half (51%) of the institutions that responded to the Massachusetts Fair Lending Task Force's 2005 survey reported that they conduct some form of regular *self-evaluation*, only 12 percent reported that they engaged in *self-testing* by means of "mystery shopping loan originators." The *self-evaluation* techniques most respondents employed included mystery shopping of branches and regular reviews of: denial rates by applicant characteristics, such as race and income; approved and denied loans to test for disparate treatment; denial rates and/or disparity ratios, including how/if they have changed over time. Regular self-evaluation was strongly linked to the size of the institution. At the smallest firms (those generating fewer than 50 originations per year), just over 20 percent conducted regular self-evaluation compared to more than 90 percent of the largest firms (those originating over 1,000 home purchase loans per year).

Inset 5.3

The Gap Persists

The Fair Housing Center of Greater Boston is a full service fair housing center offering education and training, community outreach, case advocacy, testing, research, and policy advocacy. It receives funding under HUD's Fair Housing Initiative Program (FHIP). In 2005 and 2006, the Center conducted twenty matched pair tests to determine the extent and nature of discrimination against African American, Latino, Asian, and Caribbean homebuyers seeking mortgages in Boston. The Center used trained volunteers to call and visit banks and mortgage companies to record their experiences. Overall, the investigation revealed differences in treatment, which disadvantaged the homebuyer of color, in 9 of the 20 matched paired tests conducted, or 45 percent. The findings were summarized in *The Gap Persists*, released in May 2006.

In each case, testers requested that the mortgage provider give them any information or quotes available but were instructed not to pursue the full application process. Half of the testers (ten pairs) had good credit, with credit scores of approximately 750, and half had mediocre credit, with credit scores of approximately 650. In each case, the tester of color was assigned a credit score 30 points higher, a higher income and somewhat less debt than the white tester. All testers inquired about a $475,000 mortgage with $25,000 down payment.

Overall, the Fair Housing Center found differences in treatment that disadvantaged homebuyers of color in nine of the twenty matched pair tests. In seven of these tests, the agency concluded the differences in treatment were large enough to form the basis for legal action, while the evidence in the remaining two tests may or may not have risen to that level.

Summaries of a sampling of the tests with differences are detailed here:

- An African American tester with a credit score of 770 and a white tester with a credit score of 740 inquired at a mortgage lending company. The lender gave the white homebuyer an explanation of six different types of mortgage loans, naming advantages and disadvantages of each. The white homebuyer asked about getting a blended loan to avoid PMI, and the lender replied that the second loan in the two-loan "blended loan" has high interest, so a blended loan is a bad idea. At the end of the meeting, the lender asked the white homebuyer for her address so that he could send a thank-you card. When the African American homebuyer visited, she was told about one loan product only: the blended loan. The lender did not mention the high interest on the second loan or any other loan products.
- An African American tester with a credit score of 770 and a white tester with a credit score of 740 visited a bank. Their visits to the lender were comparable, but after the visit, only the white tester received a follow up email with more information about different loan products and a $500 certificate toward the closing fee. The African American tester did not receive follow up contact or the $500 offer.
- An African American tester with a credit score of 670 and a white tester with a credit score of 640 visited a mortgage lending company. The lender provided informational pamphlets about mortgages to the white tester, but not the African American tester.
- A Latino tester with a credit score of 670 and a white tester with a credit score of 640 inquired at a bank. Both were told about 30 year fixed and unspecified blended loans (that is, the lender did not tell either tester the specific terms of the blend), but the white home seeker was also told about an ARM loan. The white home seeker was encouraged to submit an application as soon as possible, while the lender did not talk about applying with the Latino home seeker. The white home seeker was given pamphlets about different mortgages, a guidebook about mortgages, a worksheet for the cost of mortgage, and an application; the Latino home seeker received none of these materials.

Deciding Whether to Test

Institutions of varying sizes and business models have engaged in self-testing. It is especially appropriate for any HMDA-reporting institution with an origination channel where customers can meet with a loan originator (or support staff). Increasingly, it may be appropriate to test telephone channels for treatment of customers with limited English proficiency. As noted in the previous section, even if an institution does not initiate testing, it is increasingly likely that it has been, or will be, tested by others: civil rights groups, community activists, government regulators and enforcement agencies, the media, etc.

Determining Whether Self-Testing is for You

The first step for anyone contemplating a self-testing program is to perform a comprehensive fair lending risk assessment to determine whether its activities even warrant testing. It is not uncommon for smaller institutions, or those with a limited product line and distribution channels, a strong fair lending culture, and adequate training and controls in place to prevent discrimination, to conclude that it is not. As has been recommended throughout this guide, *all entities engaged in mortgage origination, including brokerage firms, are advised to evaluate their risk exposure in the way the federal regulators do for the institutions they supervise*. The Interagency Fair Lending Examination Procedures and the Conference of State Bank Supervisors recently released Model Examination Guidelines provide step-by-step guidance.

As you conduct your assessment, remember that the activities of brokers, subsidiaries and affiliates can all pose significant fair lending risks to financial institutions (e.g., pre-screening, steering, and pricing) if controls are not implemented to manage and monitor their activities. Institutions *are* responsible for violations by their subsidiaries. They are *not* typically held responsible for those of their affiliates, with one important exception: where the affiliate is acting as agent or the violation *was known* to the institution *or should have been known* before it became involved in the transaction (emphasis added).

Remember, testing for discrimination—unlike mystery shopping to test service quality—is not about whether your employees or agents provided poor service to a protected class member (although poor customer service is never to be condoned). It is about whether they provided better service to non-protected classes. If you do decide to initiate a self-testing program, it is essential that you be guided at every step of the way by competent legal counsel, and that you have the full support and buy-in from the board of directors and senior management.

Choosing the Right Program

Programs can be designed to test various product lines and delivery channels, such as mortgage loans originated through the bank, mortgage company, and broker network or consumer and home equity loans sold through bank branches, the telebanking or the internet. They can also be designed specifically to detect patterns indicative of misleading sales and service practices and violations of Section 5 of the Federal Trade Commission Act, or to help detect patterns indicative of predatory lending. A multi-state lender can examine its pre-application loan process in a few key high risk markets (those where it has a major market presence or ones with high proportions of protected classes). Still another approach is to target markets and products where HMDA data or some other diagnostic tool indicates a greater source of risk, e.g., substantially higher minority denial rates, disproportionately fewer minority loan applications, higher minority application withdrawal rates, or a disproportionate number of minorities and older customers carrying credit insurance.

The most common methods of self-testing—regardless of your reason for testing—are pre-application matched-pair tests and post-application customer interviews. In pre-application tests, trained testers pose as potential customers or loan applicants and inquire about the available products. The testers enact scenarios designed to mirror the approach of the average customer so as not to arouse suspicion, and to create an environment in which the representatives are providing their normal day-to-day service. Depending on your primary area of interest and business, you can test for discrimination or violation of the law (ECOA, the FHAct, or the Truth in Lending Act), regulatory guidelines (e.g., non-deposit products), as well as misleading sales practices (Federal Trade Commission Act). The inquiries can cover mortgage products, home equity products, refinance loans, unsecured or consumer loans, small business loans, auto loans, non-deposit investment products, insurance, deposit products, or a combination of these.

Pre-application tests are typically structured in one of three ways:[47]

- ❖ A paired test consists of separately sending two testers (or sets of testers), posing as potential applicants for the same type of loan, to an institution to collect detailed information about its lending practices. Their experiences would then be compared to determine if the individual(s) in the protected class may have been the victim of discrimination. NOTE: It is important in matched pair tests that the testers have no knowledge of each other or the purpose of the test.

- ❖ Multi-layered, or "sandwich," testing is similar, but uses three or even four testers, only one of whom is a protected class member. As with paired testing, the testers should be similar except for the variable being tested.

- ❖ Complaint testing uses a single tester to evaluate the experience of an actual loan applicant who believes that an illegal discriminatory event has occurred. In such cases the tester assumes characteristics similar to the complainant's and attempts to obtain information about the same loan product.

In all three types of testing—paired, multi-layered and complaint—the testers prepare an objective, factual written account of their experiences on a standardized report form.

Post-application interviews provide another way to ensure that loan applicants have received fair and equal treatment in their requests for credit. It can also help an institution understand customer perceptions of the service they receive. Self-testing through customer surveying can be an effective way to learn about these perceptions. Survey questions can be formulated so that they cover all phases of a credit transaction, and the sample can be drawn so that it allows for effective analysis to compare the treatment given to protected and non-protected class customers. A comprehensive fair lending compliance program is likely to use pre-application testing *and* post-application interviews to evaluate the process from start to finish.

In addition to selecting the type of testing program best suited to your needs, another choice you will need to make is whether to self-test with the institution's own employees or contract-test with an independent contractor. There are pros and cons to both approaches, but most lenders interviewed for this guide who self-tested—and it was a minority—hired one of the professional firms that specializes in this type of testing. Often firms that specialize in discrimination testing also offer mystery shopping programs, which many Massachusetts institutions use routinely to gauge service quality, product knowledge, etc. Comparing feedback from mystery shoppers of different age, race or ethnicity, can provide an institution with valuable insights into how different groups perceive service quality. If the purpose of the shop is not specifically fair lending, however, the results would not be subject to the fair lending legal privilege.

Securing Management Support

It is important that the board and senior management be fully committed to, and engaged in, all aspects of an institution's fair lending compliance strategy, but in no area is this more important than in the area of self-testing. They should understand what protection legal privilege accords, what it does not cover, and how it can be compromised. Moreover, they should understand that following through with corrective action based on the findings is essential to retaining privilege and that failing to do so may subject the institution to severe consequences. Depending on the results of the test, corrective action may be difficult and expensive to implement.[48]

If the board and management of an institution conclude that the risks do not warrant self-testing, they should ensure that the (other) elements of a comprehensive fair lending program are in place.

Establishing the Testing Focus

Differential treatment based on race/ethnicity is the most common factor that is tested in mortgage lending, but in the context of other products—small business loans, or auto loans, for example—a financial institution might seek to uncover gender or age bias. In establishing the focus of its testing an institution should be guided by its lending record, fair lending risk factors, business model, customer base and local demographics, complaints, and other pertinent information.

While it would be preferable to be able to test every branch or delivery channel, budgetary constraints typically do not allow that. You may have to make compromises in the scope or methodology. Your self-testing program must be specifically designed to measure compliance with the ECOA and FHAct in order to maintain the legal privilege that protects the test results, but there are several approaches you can take. Testing expert Paul Lubin[49] of Informa Research Services, one of the nation's foremost authorities on fair lending testing, categorizes the major approaches:

- ***Broad diagnostic testing program*** to test for adherence to the law and regulatory guidelines across the organization
  Specific objective—to identify patterns and practices that may constitute violations under the fair lending laws by testing various product lines and delivery channels, such as mortgage loans originated through the bank, mortgage company, and broker network.

- ***Tests designed to detect patterns indicative of misleading sales and service practices*** and violations of Section 5 of the Federal Trade Commission Act
  Specific objective—to detect patterns indicative of predatory lending.

- ***Evaluation test***, or "temperature check," a smaller but more concentrated battery of tests, conducted in selected major markets and delivery channels
  Specific objective—to measure adherence to fair lending laws by focusing on select major markets, or markets with high proportions of protected classes.

- ***Targeted testing*** in markets and for products where HMDA data and other statistical analysis indicate a greater source of risk (e.g., substantially higher minority denial rates, disproportionately fewer minority loan applications, higher minority application withdrawal rates)
  Specific objective—to determine whether the cause is due to disparate treatment (e.g., prescreening, discouraging minorities from applying, steering).

A major national institution with multiple delivery channels may be advised to implement a permanent, on-going broad diagnostic testing regimen. Smaller institutions, or those with low lending volume, may find more than a few tests impractical. For them, the "temperature check"—testing a representative sample of an institution's lending staff over time—might be the solution. Regardless of the approach, the self-test will detect risk at the branch and employee levels that can be used to determine whether violations of fair lending laws and disparate treatment occurred.

Implementing a Best Practices Pre-Application Self-Testing Program

Choosing a Testing Contractor

Once you've committed to a testing program, you will have to select a testing contractor. The major testing firms will have testing protocols and questionnaires, but you may wish to customize them to suit your particular concerns or circumstances. An example of one testing questionnaire is provided in the FDIC Guide to Self-testing, *Side by Side*. (First issued in 1994 and updated in 1996, *Side by Side* remains a valuable resource, although it predates the privilege and does not address issues of current concern such as predatory lending.)

Planning Considerations

Most practitioners recommend that employees be informed that you intend to test and provide feedback to them as part of your fair lending compliance strategy. Before the testing program is implemented, they should be well trained in the protocols they are expected to follow, know how performance will be measured, and understand the reasons for the self-testing. However, you should not alert them as to testing schedule, methodology, locations to be tested, etc. In scheduling tests, care should be taken to ensure that the testers are not detected. Considerations that could bias the outcomes, such as branch staffing, peak hours, and customer traffic should be factored in to the schedule. Institution size and loan volume also will determine the testing schedule. In a financial institution that typically has few minority loan applicants, it would be inadvisable to perform all the tests for race based discrimination in a single week. Similarly, the total number of tests each week should not exceed the institution's weekly average of loan applications.

Tester Selection and Training

The major independent testing contractors generally have a pool of testers, but all testers should undergo a comprehensive training at the launch of each testing program (4–6 hours is not uncommon). Testers should not be informed that the objective of the study is compliance related because this may bias them to discover or amplify treatment issues. Generally they are told the study is being conducted as a quality control audit. Testers also should not be provided with information about the identities of the other testers. Testers should be comfortable with their assigned identity and not have had any prior contact with the institution to be tested or with members of the institution's staff. If the tester is known to institution personnel, or otherwise uncomfortable with the assignment, the test may be compromised.

In addition to their basic training on confidentiality, objectivity, accuracy, reporting requirements, etc., tester training should include information specific to the institution to be tested. Testers should be provided with background information and identity, instruction on completing test report forms, and how to handle unexpected questions. They should understand that their role as a tester is as an objective and consistent observer and recorder of facts.

Conducting the Test

In the case of testing for discrimination, the testers are matched by age, credit score, price of home and/or amount of loan desired, stage in the application process, debt-to-income ratios, income, available down payment, etc. Identity information should be sufficient for testers to answer adequately most questions asked by a lender. The protected class tester's qualifications should be somewhat better than those of the control tester, but the differences should be slight so as to suppress all socioeconomic factors except one: status in a protected class. Pre-application testers are not actually applying a loan, but they are experiencing the important first phase of the loan application process. They are responsible for maintaining confidentiality and objectivity, following the established test protocols, interviewing using their assigned tester identity, completing the tests as scheduled, and carefully document the test experience.

Analyzing the Results

After completing the test, the results must be carefully analyzed, interpreted and tabulated in order to determine whether any illegal discrimination occurred during the test and, if so, what corrective measures should be considered. Testers must be debriefed and their test forms all completed. Each test must be carefully analyzed and the results written up. Areas of review will include the lender's access, courtesy and manner as well as her helpfulness in identifying various products that might be appropriate for the tester (applicant) and their benefits and drawbacks; whether she offered suggestions for how the tester (applicant) might improve her chances of being approved for a loan; terms, rate and fees quoted; and closing actions, such as whether the tester was encouraged to apply.

The final step is sharing the critical findings with management and legal counsel. Your testing may well reveal one or more problem areas, either at the employee level, the branch or loan center level, or system wide. While it is unlikely that you will find incidences of overt discrimination, disparate treatment may be evident, of the types reported in the tests described in the previous section. Even subtle differences might exist and warrant attention.

Protecting the Confidentiality of the Results

Because of the sensitivity of the information collected, you should take steps to keep the information privileged and protected. Whether you use the company's legal department or outside counsel, be sure that program findings and the data generated are communicated to counsel under the attorney client privilege. Distribution should be limited to a controlled number of "need to know" individuals who are in a position to correct the legal and business issues that self-testing programs uncover.[50]

Fixing the Problem

The final step, of course, is fixing the problem. A corrective action plan should be developed to address any of the issues identified as a result of the self-testing program. It should include a timetable and description of how progress will be measured. Follow-up testing and/or disciplinary action may be warranted.

Lenders have—or should have—a variety of resources in their fair lending toolkits. Self-testing is an important tool, but it is a diagnostic tool. For testing to be valuable, it must be used in conjunction with the other tools and activities:

- A top down commitment to using the results of self-testing to help eradicate discrimination in all forms from the workplace
- Employee training programs that educate and communicate that fair treatment is good business
- Tools and protocols that help employees or third parties adhere to the law and provide fair and consistent service treatment (e.g., scripts, quality of assistance checklists)
- Monitoring, tracking and management reporting by employee, branch, channel, etc.

Resources

The most current (March 2007) version of the Federal Financial Institutions Examination Council (FFIEC) Fair Lending Examination Procedures is available at:

http://www.ots.treas.gov/docs/7/74829.pdf

The legal privilege for self-testing is codified in 12 CFR 202.15, Incentives for Self-testing and Self-correction, found at:

http://www.fdic.gov/regulations/laws/rules/6500-2900.html#6500202.1

12 CFR 202 is the codification of Reg B, the Equal Credit Opportunity Act, in its entirety. The legal privilege is a single page, and well worth printing out.

California-based Informa Research Services is one of the largest national firms offering pre-application matched pair testing and post-closing customer surveying. It is a leader in fair treatment, fair lending, and compliance marketing research for the financial industry. An excellent article discussing considerations for institutions considering implementing a testing program is available on the company's website.

http://www.informars.com/articles/SelfTesting.pdf

As this guide was going to press, Informa's Paul Lubin, one of the nation's foremost experts on self-testing, released a comprehensive paper on the subject for the Joint Center for Housing at Harvard University. It provides an especially good summary of the types and incidence of disparate treatment that have been identified in pre and post application testing programs over the years. It also discusses testing in the context of products other than mortgages (e.g., small business loans, credit cards). *Fair Lending Testing: Best Practices, Trends and Training* is available at:

http://www.jchs.harvard.edu/publications/finance/understanding_consumer_credit/papers/ucc08-4_lubin.pdf

Other compliance consulting firms include Virginia-based ADI Consulting. An excellent, concise article on self-testing and the privilege for self-testing can be found on the company's website.

http://www.adiconsulting.com/Docs/2006%20FL%20Self-Testing%20Privilege.pdf

Another excellent article is *Striking a Fair Balance: Managing Fair Lending Risk Without Betting the Bank*, by Debbie Ray, whose Texas-based consulting firm also provides fair lending consulting services. Her article, which appeared in the ABA Bank Compliance magazine, March/April 2004 can be found at:

http://www.aiizcompliance.com/FairLendingRaywebsite.pdf

The Fair Housing Center of Greater Boston, funded in part under HUD's Fair Housing Initiative Program, offers education and training, community outreach, case advocacy, research, and policy advocacy, in addition to its testing programs.

http://www.bostonfairhousing.org

Side by Side, FDIC Guide to Self-testing. (First issued in 1994 and updated in 1996, *Side by Side* remains a valuable resource, although it predates the privilege and does not address issues of current concern such as predatory lending.)

http://www.nationalmortgagealliance.com/pdf/GuideToFairLending.pdf

6. LINKING VARIOUS BEST PRACTICES

To assure full compliance with the spirit and the letter of all fair lending (and related consumer protection) laws, lenders need to manage risk in multiple areas—both within their own operations and with third parties with whom they do business. Areas of focus include policies and procedures; training, compensation, rewards and sanctions; outreach, product development and marketing; and audit and oversight.

Effective second look procedures, mortgage broker oversight and self-testing as described in the preceding sections are important tools for managing fair lending risk, but there are many others. They include comparative file reviews; product and policy reviews; regression analysis, if justified by loan volume; enhanced fraud detection and protection measures; oversight of other types of third parties (e.g., appraisers, loan closers); operations testing; and improved education and disclosures.

The Compliance Framework

All participants in the mortgage process are advised to have compliance programs in place to effectively manage fair lending risk and while these programs will vary, they should be guided by certain underlying principles. Speaking to the American Bankers Association in June 2006, Federal Reserve Board Governor Mark Olson identified the following as key components of a well-managed compliance function:

Board and Senior Management Oversight

- ❖ A successful compliance-risk management program starts at the top of the organization. Roles and responsibilities should be clearly defined and communicated—and understood—throughout the organization.
- ❖ The organization's risk assessment should accurately identify its compliance risks and communicate material risks to the board.
- ❖ Risk assessment serves as the foundation for risk-based policies, procedures, and internal controls.
- ❖ Human and financial resources are critical to effective performance.

Policies and Procedures

- ❖ Policies and procedures define and communicate key goals and processes of an organization's compliance program, and should provide for adequate risk identification, assessment, measurement, and control.
- ❖ Examiners expect to see a well-defined process for ensuring that when compliance risks or potential breaches are identified they are elevated to the appropriate level, in keeping with the risk to the organization.

Internal Controls

- ❖ Internal controls are crucial, and an essential part of the internal control framework is periodic testing to determine how well the framework is operating so that any required remedial actions can be taken. The frequency of testing should be risk-based.
- ❖ Compliance-testing exceptions should be reported to senior management and resolved by business-line management. It's important to track exceptions until they are resolved and escalated to appropriate management.
- ❖ In complex banking organizations that may have a corporate compliance function, examiners will want to know how the compliance function maintains its independence from the business lines it advises on compliance requirements and the implementation of required controls.

Monitoring and Reporting

- ❖ The fundamental purpose of compliance-risk management programs is to identify, monitor, and manage compliance risk more effectively. Monitoring involves identifying and communicating compliance concerns to the appropriate parties within the organization.

- ❖ The level of sophistication of banking organizations' monitoring activities generally varies according to the size and complexity of the organization, and examiners' expectations will vary accordingly. Large complex organizations are typically supported by information systems that provide management with timely reports related to compliance with laws and regulations at the transaction level.

Training

- ❖ Training policies, procedures, and associated controls are an important component of compliance-risk management that should not be overlooked.

- ❖ While the depth and breadth of training that an employee receives depends on that employee's role and responsibilities, examiners generally assess whether staff at all levels understand the organization's compliance culture, general compliance-risk issues, and high-level compliance policies and procedures.

Seasoned compliance managers will recognize Governor Olson's recommendations as essential ingredients in any compliance management program. All are important, but tracking and monitoring warrant special attention.

Management Information Systems Are Key

Timely access to accurate information on which informed decisions can be made is essential, but not all lenders, or loan originators, have the capacity in-house to identify and correct potentially damaging lending practices. Detecting fair lending issues is complex and time consuming.

Options for Loan Tracking

Options for tracking, monitoring and analyzing applications and loans include:

- ❖ Developing capacity in-house (This can be automated or not, depending on loan volume and business model complexity);

- ❖ Purchasing a tracking system from an outside vendor; or

- ❖ Outsourcing specific tasks to the vendor.

A good automated tracking system can perform a full range of fair lending compliance tasks: risk assessment, matched pair testing, regression analysis (if the institution has sufficient loan volume), and reporting. Even for small scale mortgage operations, tracking is essential. It may be no more sophisticated than an excel spreadsheet with HMDA data plus other key information: LTV, DTI ratios; credit score; credit scoring outcome; override, if any; broker/loan officer identifier; product code; etc. The point is, management should be reviewing this information on a regular basis for irregularities and taking corrective action if necessary. (**See Inset 6.1**.)

Lenders often outsource time-intensive tasks such as geocoding, and using an outside vendor can also be cost effective for identifying similarly situated minority and non-minority files for a comparative file review or a second look program. Most vendors use the same methodology as the examiners do, in effect, providing lenders with an "outside expert" opinion. Many Massachusetts lenders are familiar with PCi, a company founded in Boston and now part of Wolters Kluwer Financial Services. PCi's Fair Lending Wiz is an example of a comprehensive automation and management control system that can help reduce the risk of discrimination at multiple points in the lending process. In recent years the company has introduced several complementary web-based products for managing third party lending and other compliance risks. Florida-based RATA Associates is another vendor that some Massachusetts lenders have used, and there are others as well.

Inset 6.1

Accurate HMDA Reporting is More Important Than Ever

HMDA's utility as a management tool for monitoring loan performance cannot be overstated, nor can the importance of *accurate* HMDA data-collection and reporting. All institutions should have procedures in place for ensuring the integrity of their HMDA data, and they should be reviewing that data on a regular basis—quarterly, or even monthly—to identify trends and risks. You will be well advised to assess your performance the way others will:

- Look for disparities in rate of loans closed, loans denied, pricing.
- Examine disparity ratios by race/ethnicity.
- Analyze results at the MSA, business unit and corporate levels.

Among the benefits an organization needing to analyze, verify, and document compliance with fair lending and predatory lending rules may realize by engaging an outside consultant are:

- ❖ Reduced labor cost and time associated with the collection, analysis, and reporting of loan data for fair lending purposes
- ❖ Increased quality—the use of statistics and focus on quantitative analysis provides solid foundation to support conclusions and proposed corrective action
- ❖ Reduced chance of missing individuals or groups whose loan applications have been mishandled or unfairly priced
- ❖ The ability to manage complex data without overburdening internal resources
- ❖ Increased management control—Fair Lending Wiz and similar programs enable management to view fair lending risks at multiple levels (branch, product, geography) to identify areas and loans that pose the greatest risk

In-house programs, of course, can be structured to provide this type of analysis as well.

Conclusion

Disparities along racial and ethnic lines persist in access to credit, as they do in many areas: income, education, employment, and healthcare, to name a few. That illegal discrimination—whether intentional or not—contributes to these credit gaps remains a concern for all participants in the mortgage business. Fair lending is a critical civil rights issue and when done successfully, it is good business and good for the economy. Current economic conditions, however, illustrate what can happen when it is not done well.

There appears to be consensus that the nation's economy is unlikely to recover until the mortgage market is resuscitated. Moreover, there is growing concern that it will take structural reforms and greater accountability from participants throughout the lending process—including mortgage brokers that process applications, investment banks that bundle mortgages into securities, bond rating agencies, home appraisers and mortgage servicing companies—to enable that to happen. While some reforms may be regulatory, others can be initiated by individual lenders committed to maintaining a "best practices" fair lending program. **Table 6.1** illustrates what an updated version of the "Fair Lending Best Practices" matrix might include.[51]

Table 6.1

Best Practices Matrix

CATEGORY	RECOMMENDED PRACTICE
Goals, mission, strategy	Incorporate fair lending goals into corporation's mission statement, and make fair lending a primary strategic goal of the institution
	Establish a corporate culture in which fair lending and serving minority markets are seen to contribute to shareholder value and are rewarded. Modify established policies and develop new procedures to better reach underserved markets
Staff training	Enhanced employee training to engender greater sensitivity to racial and cultural differences
	Training of loan originators/processors to assure that a consistent high level of assistance is provided to all loan applicants
Hiring/promotion practices	Equal employment opportunity and affirmative action at all levels
Compensation, pricing structure	Compensation structure that does not discourage loan production staff from working with lower income or financially unsophisticated applicants
	Compensation structure that does not encourage exploitation of financially unsophisticated applicants
	Analyze risk based pricing practices for disparate treatment and disparate impact
	Ensure sub-prime lending programs are free from disparate treatment and impact and referrals up and down are evenhanded
	Limit use of overages and yield spread premiums; carefully monitor for disparate treatment and/or impact. Ensure policies are clear, consistent and adhered to
	Eliminate minimum loan amounts
Underwriting standards/practices	Flexible underwriting and appraisal standards that preserve safety and soundness criteria while responding to special factors in low- and moderate-income and minority communities
	Review products and policies for possible disparate impact
	Periodically analyze credit scorecard, and update if appropriate
	Limit judgmental overrides on credit scored products; monitor for disparate treatment and impact
Alternative loan products	Development of alternative loan products including participation in public or private subsidy or guarantee programs that expand affordable homeownership opportunity
	Ensure that alternative mortgage products are safe, suitable and sustainable for the homeowner

Second review policies	Second review policy for mortgage, consumer and small business loan applications that would otherwise be denied
	Participation in external mortgage review boards
Marketing/outreach	Review scope of lending community to ensure that minority areas are appropriately included
	Affirmative marketing and call programs targeted to minority audiences
	Ongoing outreach programs to identify needs and opportunities within the minority communities
	Avoid reverse redlining—the targeting of high cost, high risk products to low-income or minority neighborhoods
	Assure that borrowers are offered the most appropriate and most affordable product for which they qualify
Consumer education	Prepare and utilize educational and promotional materials in languages other than English, where appropriate
Third party involvement	Buyer education programs including credit and homeownership counseling
	Monitor behavior and policies of third parties involved in the loan process
	Hold all third parties with whom you do business to the same standards to which your employees are held. Sever relationships with those who do not comply
	Develop, or support the development of "non-conforming" loan programs through existing secondary market or new credit enhancements
	Monitor pricing practices of brokers, correspondents, agents
Equal treatment assurance measures/testing	Efforts to ensure that all persons inquiring about credit are provided equivalent information and encouragement
	Institute a program of systematic comparative review of denied and approved applications (file review)
	With appropriate legal safeguards, engage in self- testing programs
	Analyze and use HMDA and other data; know the demographics, housing stock and market conditions of your community
	Routinely self-assess compliance with fair lending regulations
Other	Adopt procedures and controls to assure integrity of HMDA data
	Implement routine operations testing to ensure that company practices are consistent with company policies
	Designate an ombudsman
	Other initiatives to prevent discrimination and expand lending and banking services to minorities and low- and moderate-income communities

ENDNOTES

[1] The principal federal fair lending laws are the Fair Housing Act of 1968 and the Equal Credit Opportunity Act (1974). Other laws that relate to fair lending include the Truth in Lending Act, Real Estate Settlement Procedures Act, Home Ownership and Equity Protection Act, Fair Credit Reporting Act, and the Home Mortgage Disclosure Act. The Community Reinvestment Act—enacted in 1977 to prevent redlining and to encourage banks and thrifts to help meet the credit needs of all segments of their communities, including low- and moderate-income neighborhoods—does not directly address discrimination against protected classes, but it has nonetheless become an important tool in combating discrimination. Similarly, Section 5 of the Federal Trade Commission Act, which prohibits unfair and deceptive acts and practices in general, is emerging as an important tool in the effort to combat discrimination in the mortgage market.

[2] *The Dual Mortgage Market: The Persistence of Discrimination in Mortgage Lending*, William Apgar and Allegra Calder, working paper W05-11 published by the Joint Center for Housing Studies, Harvard University, December 2005. Dr. Apgar and his colleagues at the Joint Center for Housing Studies have written extensively on the recent revolution in the mortgage market, examining the behavior of market participants as well as the new mortgage delivery channels linked to the rapid growth of subprime mortgages.

[3] In November, 2006, the Task Force established the Massachusetts Fair Lending Coordinating Committee to promote and encourage implementation of the Task Force recommendations.

[4] The secondary market entities that purchase and/or sell or securitize the loans, and the investors who purchase the securitized loans play a critical role—perhaps the most critical—but oversight of their activities is beyond the scope of this project.

[5] Unless otherwise noted, as used in this guide, the term “bank regulatory agencies” or “agencies” refers to the federal banking regulators—the Office of Thrift Supervision (OTS), the Office of the Comptroller of the Currency (OCC), the Board of Governors of the Federal Reserve System (THE Fed, or FRB), the Federal Deposit Insurance Corporation (FDIC), and the National Credit Union Administration (NCUA). These agencies are collectively known as the Federal Financial Institutions Examination Council (FFIEC).

[6] *Changing Patterns VII, Mortgage Lending to Traditionally Underserved Borrowers and Neighborhoods in Greater Boston, 1990–2000*, by James Campen, reported that 78% of home purchase loans made in the Boston area in 1990 were made by a Massachusetts-based bank or credit union.

[7] Joseph A. Smith testimony before the Senate Committee on Banking, Housing and Urban Affairs on behalf of the Conference of State Bank Supervisors, March 22, 2007

[8] Ibid.

[9] Testimony of Federal Reserve Board Governor Randall Kroszner’s testimony on loan modifications and foreclosure prevention before the Committee on Financial Services, U.S. House of Representatives, December 6, 2007

[10] Federal Reserve Chairman Ben Bernanke, quoting *Inside Mortgage Finance*, at the National Community Reinvestment Coalition Annual Meeting, March 14, 2008

[11] *The 2006 HMDA Data*, Avery, Canner and Brevoort
http://www.federalreserve.gov/pubs/bulletin/2007/pdf/hmda06final.pdf

[12] *Changing Patterns XIII*, James Campen

[13] It is estimated that brokers represented nearly 60 percent of the home loans originated in 2005 and 2006 nationwide, making them the largest single loan source in the country.

[14] This guide uses the terms Latino and Hispanic interchangeably; the official HMDA taxonomy is Hispanic.

[15] The Warren Group Publications

[16] A suitability standard applies to the securities industry that some advocates have argued could serve as a model for the mortgage lending industry.

[17] *Mortgage Lending in Boston: Interpreting HMDA Data*, Alicia H. Munnell et al., 1992 Working Papers 92-7, Federal Reserve Bank of Boston

[18] The suit was settled in September 1992, with the lender agreeing to certain corrective actions, including the creation of a $1 million fund to provide relief to 48 black credit seekers.

[19] Specific guidance for national banks was included in the OCC’s 1992 bulletin *Guidance on Second Look Policies BC 263*.

[20] The original Boston Mortgage Review Board was voluntary, but in the mid-1980’s it was expanded statewide with the establishment of four regional Mortgage Review Boards. These boards were formally established by the Massachusetts Legislature in 1990 (Massachusetts General

Laws Chapter 167, section 14A and now mandate that any mortgage lender making five or more mortgage loans in any calendar year on owner-occupied 1 -to- 4 family residential property located in Massachusetts is required to notify consumers of their right to appeal the denial of their mortgage applications to the Mortgage Review Boards.

[21] "A Look at Fair Lending through the Lens of the New HMDA Data," remarks by FRB Governor Mark Olson before the Consumer Bankers' Association Fair Lending Conference, November 7, 2005, Arlington, VA

[22] *Changing Patterns XIII*, James Campen, 2006

[23] This document uses the term "minority" throughout, but the fair lending laws apply equally to all protected classes.

[24] FDIC *Supervisory Insights 2005*

[25] In addition, the company agreed to pay $200,000 to cover the AG's investigation costs.

[26] Wholesale Access Mortgage Research & Consulting, Inc., a Columbia, MD firm that tracks mortgage lending patterns, 2007

[27] Wholesale Access, a Columbia, Maryland firm that tracks mortgage lending patterns.

[28] Ibid.

[29] Ml-implode.com (Mortgage Lender Implode-o-Meter)

[30] http://newsroom.bankofamerica.com/index.php?s=press_releases&item=7956

[31] The Equal Credit Opportunity Act provides for successor liability by defining the term "creditor" to include "any assignee of an original creditor who participates in the decision to extend, renew, or continue credit."

[32] http://www.usdoj.gov/crt/housing/documents/longbeachsettle.htm

[33] Joseph L. Barloon, Skadden, Arps, Slate Meaghter & Flom, LLP, quoted in ABA Banking Journal, July 3, 2003

[34] OCC *Advisory Letter (AL) 2003-3 Avoiding Predatory and Abusive Lending Practices in Brokered and Purchased Loans*. The guidance applies to traditional broker transactions; table funded transactions; and loan purchase transactions where the loan is initially made and funded by a third party who subsequently sells the loan to the bank (whether or not the bank participates in the underwriting). AL 2003-3 was issued in conjunction with OCC *Advisory Letter (AL) 2003-2 Guidelines for National Banks to Guard Against Predatory and Abusive Lending Practices*.

AL 2003-2 provided examples of lending practices that had been criticized as "predatory" or "abusive" and guidance on how national banks should avoid engaging in such practices. Noting that national banks and their subsidiaries faced significant risks of indirectly and inadvertently facilitating predatory lending practices through the use of third-party loan brokers and in connection with loan purchases, the OCC issued the companion AL 2003-3. The latter sets forth the OCC's expectation that national banks would establish appropriate due diligence and monitoring procedures adequate to address these risks.

[35] *Final Guidance Establishing Standards for Residential Mortgage Lending Practices* (Appendix C to 12 CFR Part 30, Safety and Soundness Standards), OCC, 2005

[36] 71 Fed. Reg. 58609 (October 4, 2006)

[37] Regulators specifically rejected industry calls to eliminate the third party provisions. The industry had argued that the proposal would force lenders to have an awareness and control over third-party practices that was neither realistic nor practical, particularly with regard to marketing. The agencies reiterated their stance that reliance on third-party relationships can significantly increase an institution's risk profile, and that institutions do need to exercise appropriate due diligence prior to entering into a third-party relationship and to provide ongoing, effective oversight and controls.

[38] http://skaddenpractices.skadden.com/cfs/index.php?documentID=475&sectionID=37
The investigation was launched based on pricing disparities noted in the 2004 HMDA data, the first to include such information.

[39] http://www.mortgagebankers.org/files/Conferences/2007/2007LIRC/FremontInvestment&Loan.pdf

[40] Steering has been identified as a widespread practice in the subprime mortgage market, with a number of studies concluding that many subprime borrowers who could have obtained loans in the prime market based on their credit status were steered by brokers toward higher interest rate loans (20–30 percent in Massachusetts, according to Boston Fed research). In large part steering is driven by payment of "yield spread premiums" to brokers, as a reward for originating loans at above-market interest rates and fees relative to the borrower's credit risk.

[41] Fair Lending Enforcement Program, U.S. Department of Justice, 2001
http://www.usdoj.gov/crt/housing/bll_01.htm

[42] *Side by Side*, FDIC 1996 version

[43] FDIC Bulletin 5000, April 1994

[44] *Compliance Management*, 1998

[45] *Interagency Policy Statement on Discrimination in Lending*
http://www.fdic.gov/regulations/laws/rules/5000-3860.html

[46] *All Other Things Being Equal*, by Margery Turner *et al.*

[47] *Side by Side*, FDIC, 1996

[48] *Striking a Fair Balance: Managing Fair Lending Risk Without Betting the Bank*, Debbie Ray, 2004

[49] *Self-testing to Ensure Fair and Equal Treatment*, Paul Lubin and Bob Homeyer, in ABA Compliance March/April 2003

[50] Lubin and Homeyer

[51] The "Best Practices" framework was developed by the Federal Reserve Bank of Boston in 1992. The strategies shown in plain text were identified as best practices at that time. Those shown in italics reflect the new realities in the mortgage market.

Summary of Recent Fair and Responsible Regulatory Guidance

Guidance on how to ensure responsible *and* fair lending has come from a number of fronts during the past two years, including: federal and state regulatory agencies, enforcement actions and litigation, legislative initiatives, industry-initiated self-policing, and government-sponsored enterprise announcements, among others. This summary highlights and reviews some of the recently released guidance and provides links of where to go for additional information:

Interagency Guidance on Nontraditional Mortgage Product Risks

Published in Federal Register / Vol. 71, No. 192 / Wednesday, October 4, 2006 / Notices
http://www.ots.treas.gov/docs/4/480273.pdf

The *Interagency Guidance*, issued by the five federal agencies (FRB, OCC, FDIC, OTS, NCUA) addresses the potential increased risks associated with nontraditional mortgage products such as interest only and payment option adjustable rate mortgages and sets forth the recommended practices to ensure that borrowers have sufficient information to clearly understand loan terms and associated risks. It directs lenders to:

- Provide consumers with clear and balanced promotional information that highlights both the relative benefits and the risks of nontraditional mortgage products at a time that will help them decide whether to select such products.
- Disclose to consumers—using realistic hypotheticals—that monthly payment amounts could increase in the future, explaining how new payment amounts will be calculated.
- Disclose in product descriptions, when applicable, the possibility of negative amortization and the potential consequences of increasing principal balances and decreasing home equity.
- Ensure that monthly payment statements related to payment option loans provide information that enables consumers to make responsible payment choices, including information about the consequences of selecting different payment options on the current principal balance.
- Avoid practices that obscure significant risks to the consumer.
- Adopt compliance control systems to ensure actual practices remain consistent with policies and procedures.

State Guidance Conference of State Bank Supervisors (CSBS) and the American Association of Mortgage Regulators (AAMR) endorsed the interagency guidance and released *The CSBS/AARMR Guidance on Nontraditional Mortgage Product Risks for State-licensed Entities* on November 14, 2006. The CSBS/AARMR Guidance applies to non-depository mortgage brokers and lenders and is substantially similar to the federal agency guidance for insured financial institutions and affiliates.

Illustrations to Accompany Guidance on Nontraditional Products

In May and June of 2007, the agencies issued illustrations of the consumer disclosures it described. The illustrations of consumer information were designed to help institutions implement the consumer protection portion of the *Interagency Guidance on Nontraditional Mortgage Product Risks*. The consumer protection section of the guidance recommends practices to ensure that consumers have clear and balanced information about nontraditional mortgages before choosing a mortgage product or before selecting a payment option for an existing mortgage.

Those illustrations can be found at the following links:

- Final Guidance—Illustrations of Consumer Information for Nontraditional Mortgage Products –16 pages (05/31/2007)
  http://www.ots.treas.gov/docs/4/480957.pdf
- Final Guidance—Illustrations of Consumer Information for Nontraditional Mortgage products: download and print in English or Spanish, Illustrations 1, 2, & 3; & template for Illustration 2. –9 pages (06/18/2007)
  http://www.ots.treas.gov/docs/4/480963.pdf

Statement on Subprime Mortgage Lending

Published in Federal Register / Vol. 72, No. 131 / Tuesday, July 10, 2007 / Notices
http://www.ots.treas.gov/docs/4/480966.pdf

This *Statement*, issued by the federal financial regulatory agencies in June 2007, addresses issues relating to certain adjustable-rate mortgage products that can cause payment shock, such as hybrid ARMs (e.g., 2/28 and 3/27 ARMs). It supplements the *Interagency Guidance on Nontraditional Mortgage Products*, which was limited in scope to products that have the potential for negative amortization such as “interest-only” and “payment option” mortgages.

The statement describes prudent safety and soundness and consumer protection standards that institutions should follow to ensure borrowers obtain loans they can afford to repay. Standards include a fully indexed, fully amortized qualification for borrowers and cautions on risk-layering features, including an expectation that stated income and reduced documentation should be accepted only if there are documented mitigating factors that clearly minimize the need for verification of a borrower’s repayment capacity. Consumer protection standards include: clear and balanced product disclosures to customers and limits on prepayment penalties that allow for a reasonable period of time, typically at least 60 days, for customers to refinance prior to the expiration of the initial fixed interest rate period without penalty.

The statement reinforces an April 2007 ***Statement on Working with Borrowers***, in which the agencies encouraged institutions to work constructively with residential borrowers who are financially unable or reasonably expected to be unable to meet their contractual payment obligations on their home loans. The April statement noted that workout arrangements that were consistent with safe and sound lending practices were generally in the long-term best interest of both the financial institution and the borrower.

On July 17, 2007, the Conference of State Bank Supervisors, the American Association of Residential Mortgage Regulators, and the National Association of Consumer Credit Administrators released a substantially similar statement that applies to non-depository mortgage brokers and lenders.

Proposed Amendments to Reg. Z, Truth in Lending

In December 2007 the Federal Reserve Board released for public comment new regulations to address predatory lending. The proposed regulations would amend Regulation Z (Truth in Lending) for the purpose of protecting consumers from unfair or deceptive home mortgage lending and advertising practices. See link:
http://www.federalreserve.gov/newsevents/press/bcreg/20071218a.htm

Model Examination Guidelines for State Mortgage Regulators

In August 2007, the Conference of State Bank Supervisors and the American Association of Residential Mortgage Regulators (CSBS/AARMR) released model examination guidelines for use by state mortgage regulators in the examination of state licensed lenders and brokers that offer subprime/nontraditional loans. The Guidelines cover a number of areas, including marketing/origination, underwriting, operational/risk management, servicing, secondary market activities, investment lending, indirect origination through third parties, practices for

institutions to avoid, and controls/policies and procedures. If adopted by the states, the guidelines would provide a uniform set of examination standards with which examiners may test compliance with the nontraditional and subprime guidances. The Model Guidelines specifically address interest only; option-ARMs; option-FRMs; hybrid ARMs; "subprime ARM products", and "subprime extended amortization products" (amortization period longer than term of loan). The Model Guidelines can be found at:
http://www.csbs.org/Content/NavigationMenu/RegulatoryAffairs/MortgagePolicy/MEGs-Version1.pdf

The ***Supervisory Policy on Predatory Lending***, issued by the FDIC in January 2007, addresses the increasing number of abuses in the subprime lending market and calls for more responsible lending. This can be found at: http://www.fdic.gov/news/news/financial/2007/fil07006a.html

Freddie Mac Subprime Lending Standards

The GSE announced in February 2007 that it will no longer buy 2/28 and 3/27 mortgage products that are not underwritten at the fully indexed and amortizing rate and/or lack sufficient documentation

Legislative Actions

Congressional hearings have been ongoing throughout 2007 and early 2008 on nontraditional and subprime mortgage lending and the causes and consequences of the turmoil in the mortgage market.

HR 3915, introduced by Representatives Brad Miller (D-NC), Mel Watt (D-NC) and Barney Frank (D-MA), called "The Mortgage Reform and Anti-Predatory Lending Act of 2007," was approved by the U.S House of Representatives in November 2007. Intended to combat abuses in the mortgage lending market and to provide protections for mortgage consumers and investors, the bill prohibits "steering" borrowers to higher priced loan products if they can qualify for a lower priced, more favorable loan; establishes a new system for licensing and registration of mortgage originators, including brokers and bank loan officers; requires, as a minimum underwriting standard for mortgage loans, that the borrower must have a reasonable ability to repay; attaches limited liability to secondary market securitizers of home mortgage loans that do not meet these new standards; expands consumer protections for "high cost home loans" under HOEPA; and includes protections for renters of foreclosed homes. Similar legislation is now (April 2008) pending in the Senate.

Local Actions

In January 2008, the Mayor and City Council of Baltimore filed suit in the U.S. District Court for the District of Maryland, Baltimore Division, against Wells Fargo Bank, N.A. and Wells Fargo Financial Leasing, Inc., claiming that "reverse redlining" that targeted Baltimore's underserved and vulnerable, primarily African-American, neighborhoods has resulted in a foreclosure crisis and substantial and irreparable damage to the neighborhoods and to the City of Baltimore. The suit is brought under the Fair Housing Act; the Complaint for Declaratory and Injunctive Relief and Damages is found at:
http://www.aba.com/aba/documents/GeneralCounsel/BankingDocket/Baltimore.pdf

APPENDIX B

Quality of Assistance Questionnaire

The purpose of the following questions is to determine the points in the residential mortgage lending process at which the quality of assistance provided by a loan officer may be unequal. These questions can be particularly effective when used during a file review.

Initiative

- Does the business unit have an affirmative residential mortgage loan program for low and moderate-income applicants? For realtors that cater to such applicants? For mortgage brokers that cater to such applicants?
- Does the loan officer give a face-to-face interview to all similarly situated minority and non-minority applicants? If not, explain why.
- Does the loan officer initiate telephone and/or written contacts about the status of the application with non-minority applicants but leave such contacts to be initiated by similarly situated minority applicants? If yes, explain.
- Does the loan officer provide encouragement to non-minority applicants about the process and likely success of the application but fail to do so for similarly situated minority applicants? If yes, explain.
- Does the loan officer take the initiative to obtain needed information (e.g., contact third parties) or deal with problems (e.g., securing access for the appraiser) for a non-minority applicant but leave the burden to obtain information or deal with problems on similarly situated minority applicants? If yes, explain.

Flexibility and Creativity

- Does the loan officer give creative suggestions (e.g., gift letters, using cash to pay down debts) to help qualify non-minority applicants but fail to do so for similarly situated minority applicants? If yes, explain.
- Does the loan officer use terms such as 'investment worthiness' when evaluating a non-minority applicant (suggesting flexibility) but use terms such as 'requirements' and 'standards' when a evaluating similarly situated minority applicants (suggesting a rigid approach)? If yes, explain.
- Does the business unit grant exceptions to Fannie Mae's debt-to-income ratio requirements to non-minority applicants but not to similarly situated minority applicants? If yes, explain.
- Does the loan officer ask for alternative proof of payment histories (e.g., records of cash payments) from non-minority applicants without credit histories, but fail to do so for similarly situated minority applicants? If yes, explain.
- Does the loan officer raise immaterial procedural matters with a minority applicant but ignore such matters with similarly situated non-minority applicants? If yes, explain.

Dealing with Obstacles

- Does the loan officer ask for information from a non-minority applicant to identify possible 'compensating factors' that would qualify such applicant despite high ratios or other defects, but fail to ask for such information from a similarly situated minority applicant? Examples of 'compensating factors' include: ability to accumulate reserves or devote a greater portion of income to basic needs; housing expenses are increased only marginally as a result of the home purchase; applicant's compensation is not included in the 'effective income' that directly affects the applicant's ability to pay; and the probability of increased earnings. If yes, explain.

- Does the loan officer give ‘proactive assistance’ to non-minority applicants but fail to give such assistance to similarly situated minority applicants? If yes, explain.
- Does the loan officer tell non-minority applicants about problems early in the application process, but tell minority applicants about such problems only after the loan application is in jeopardy? If yes, explain.
- Does the loan officer clearly explain to non-minority applicants that certain problems will terminate the application process, but fail to make such danger clear to a minority applicant? If yes, explain.
- Does the loan officer and/or underwriter look for the general pattern of account payment in non-minority applicants’ credit histories but emphasize isolated unsatisfactory or slow payment of accounts for similarly situated minority applicants? If yes, explain.

Discretion

- Does the loan officer and/or underwriter characterize income from a particular source (e.g., overtime or part-time work, public assistance, child support, alimony) to be ‘expected to continue’ for a non-minority applicant, but deem similar sources of income to be temporary or unstable for a similarly situated minority applicant? If yes, explain.
- Does the loan officer and/or underwriter characterize certain obligations as ‘recurring charges’ for a minority applicant, but deem similar charges to be temporary or irregular charges for similarly situated non-minority applicants? If yes, explain.
- Does the loan officer and/or underwriter consider the average monthly or annual income for a non-minority applicant but focus on the low-income periods for a similarly situated applicant? If yes, explain.
- Does the loan officer and/or underwriter count projected rental income from the property if located in a higher income neighborhood (or neighborhood inhabited primarily by non-minorities), but discount projected rental income from a property located in a in a low-to moderate-income neighborhood (or neighborhood inhabited primarily by minorities)? If yes, explain.
- Does the loan officer and/or underwriter interpret liberally for a non-minority applicant the restrictions on who may provide a gift to cover closing costs, but interpret such restriction narrowly for similarly situated minority applicants?
- Does the loan officer and/or underwriter help a non-minority applicant qualify for an advantageous loan-to-value by interpreting co-borrower and ‘identity of interest’ restrictions liberally, but interpret such restrictions narrowly for similarly situated minority applicants? If yes, explain.
- Does the loan officer and/or underwriter inquire about or consider projected income (e.g., return to work of a household member, promotion, etc.) for a non-minority applicant, but fail to inquire about or consider such income for a similarly situated minority applicant? If yes, explain.
- Does the loan officer provide guidance to a non-minority applicant about utilizing ‘sweat equity’ provisions, but fail to provide such guidance to a similarly situated minority applicant? If yes, explain.
- Does the loan officer an/or underwriter characterize job changes resulting in increased income as indicating stable income for a non-minority applicant, but characterize such job changes as negative for similarly situated minority applicants (without considering the increased income)? If yes, explain.

Credit History

- Does the loan officer solicit an explanation of derogatory information for a non-minority applicant, but fails to do so for a minority applicant? If yes, explain.

- Does the loan officer and/or underwriter seriously consider an explanation of derogatory information from a non-minority applicant (e.g., does the loan officer and/or underwriter verify the information or reconsider the application), but fail to do so for a minority applicant? If yes, explain.
- Does the loan officer ask a non-minority applicant whether credit problems (including bankruptcy) resulted from factors beyond the applicant's control, but fail to do so for minority applicants? If yes, explain.
- Does the loan officer ask a minority applicant to account for recent inquiries shown on the credit report, but fail to do so for a similarly situated minority applicant? If yes, explain.
- After an application is rejected for bad credit, does the loan officer tell a non-minority applicant how to contact the credit reporting agency, but fail to do so for a minority applicant? If yes, explain.

Appraisals

- Does the appraiser make unusual value adjustments, without persuasive explanation, in low- to moderate-income neighborhoods (or neighborhoods inhabited primarily by minorities), but make no or modest adjustments in higher income neighborhoods (or neighborhoods inhabited primarily by non-minorities)? If yes, explain.
- Does the loan officer and/or underwriter reduce the loan-to-value ratio because of declining value concerns for properties located in a low-to moderate-income neighborhoods (or neighborhoods inhabited primarily by minorities), but fail to do so for properties located in higher income neighborhoods (or neighborhoods inhabited primarily by non-minorities)? Each appraisal should already contain a section addressing declining value concerns. If yes, explain.
- Does the appraiser rate a higher income neighborhood (or a neighborhood inhabited primarily by non-minorities) based on comparisons with competing areas, but rate a low-to moderate-income neighborhood (or a neighborhood inhabited primarily by minorities) without such comparisons and without accounting for relative advantages (e.g., proximity to employment center). If yes, explain.
- Does the underwriter accept the appraisers opinion that properties in low- to moderate-income neighborhoods (or neighborhoods inhabited primarily by minorities) are functionally obsolete or unmarketable based on specific observed features (e.g., room layout), but rely on the actual success or failure of such properties in higher income neighborhoods (or neighborhoods inhabited primarily by non-minorities)? If yes, explain.
- Does the appraiser and/or underwriter characterize discount points, buy-downs, and similar terms as 'customary' for comparables for properties located in higher income neighborhoods (or neighborhoods inhabited primarily by non-minorities) with the result that there is no reduction in the value of such comparables? If yes, does the appraiser and/or underwriter consider such terms to be concessions for comparables for properties located in low- to moderate-income neighborhoods (or neighborhoods inhabited primarily by minorities) with the result that there is a reduction in the value of such comparables? If yes, explain.
- Does the underwriter rely on the lesser of the 'market value' or 'sales comparison' appraised values for property in a low-to moderate-income neighborhood (or a neighborhood inhabited primarily by minorities), but rely on the appraiser's reconciliation of the two values for a valuation of property in a higher income neighborhood (or a neighborhood inhabited primarily by non-minorities)? If yes, explain.

§ 202.15 Incentives for self-testing and self-correction.

(a) *General rules*—

(1) *Voluntary self-testing and correction.* The report or results of the self-test that a creditor voluntarily conducts (or authorizes) are privileged as provided in this section. Data collection required by law or by any governmental authority is not a voluntary self-test.

(2) *Corrective action required.* The privilege in this section applies only if the creditor has taken or is taking appropriate corrective action.

(3) *Other privileges.* The privilege created by this section does not preclude the assertion of any other privilege that may also apply.

(b) *Self-test defined*—

(1) *Definition.* A self-test is any program, practice, or study that:

(i) Is designed and used specifically to determine the extent or effectiveness of a creditor's compliance with the Act or this regulation; and

(ii) Creates data or factual information that is not available and cannot be derived from loan or application files or other records related to credit transactions.

(2) *Types of information privileged.* The privilege under this section applies to the report or results of the self-test, data or factual information created by the self-test, and any analysis, opinions, and conclusions pertaining to the self-test report or results. The privilege covers workpapers or draft documents as well as final documents.

(3) *Types of information not privileged.* The privilege under this section does not apply to:

(i) Information about whether a creditor conducted a self-test, the methodology used or the scope of the self-test, the time period covered by the self-test, or the dates it was conducted; or {{4-30-03 p.7224}}

(ii) Loan and application files or other business records related to credit transactions, and information derived from such files and records, even if the information has been aggregated, summarized, or reorganized to facilitate analysis.

(c) *Appropriate corrective action*—

(1) *General requirement.* For the privilege in this section to apply, appropriate corrective action is required when the self-test shows that it is more likely than not that a violation occurred, even though no violation has been formally adjudicated.

(2) *Determining the scope of appropriate corrective action.* A creditor must take corrective action that is reasonably likely to remedy the cause and effect of a likely violation by:

(i) Identifying the policies or practices that are the likely cause of the violation; and

(ii) Assessing the extent and scope of any violation.

(3) *Types of relief.* Appropriate corrective action may include both prospective and remedial relief, except that to establish a privilege under this section:

(i) A creditor is not required to provide remedial relief to a tester used in a self-test;

(ii) A creditor is only required to provide remedial relief to an applicant identified by the self-test as one whose rights were more likely than not violated; and

(iii) A creditor is not required to provide remedial relief to a particular applicant if the statute of limitations applicable to the violation expired before the creditor obtained the results of the self-test or the applicant is otherwise ineligible for such relief.

(4) *No admission of violation.* Taking corrective action is not an admission that a violation occurred.

(d) *Scope of privilege—*

(1) *General rule.* The report or results of a privileged self-test may not be obtained or used:

(i) By a government agency in any examination or investigation relating to compliance with the Act or this regulation; or

(ii) By a government agency or an applicant (including a prospective applicant who alleges a violation of § 202.4(b)) in any proceeding or civil action in which a violation of the Act or this regulation is alleged.

(2) *Loss of privilege.* The report or results of a self-test are not privileged under paragraph (d)(1) of this section if the creditor or a person with lawful access to the report or results:

(i) Voluntarily discloses any part of the report or results, or any other information privileged under this section, to an applicant or government agency or to the public;

(ii) Discloses any part of the report or results, or any other information privileged under this section, as a defense to charges that the creditor has violated the Act or regulation; or

(iii) Fails or is unable to produce written or recorded information about the self-test that is required to be retained under § 202.12(b)(6) when the information is needed to determine whether the privilege applies. This paragraph does not limit any other penalty or remedy that may be available for a violation of § 202.12.

(3) *Limited use of privileged information.* Notwithstanding paragraph (d)(1) of this section, the self-test report or results and any other information privileged under this section may be obtained and used by an applicant or government agency solely to determine a penalty or remedy after a violation of the Act or this regulation has been adjudicated or admitted. Disclosures for this limited purpose may be used only for the particular proceeding in which the adjudication or admission was made. Information disclosed under this paragraph (d)(3) remains privileged under paragraph (d)(1) of this section.

[Codified to 12 C.F.R. § 202.15]