Fair Lending

The Impact of Disparate Impact

Measuring and proving allegations of discrimination is not easy. Outright discrimination is one thing, but when discrimination is indirect, it is more difficult to recognize and measure.

As fair lending laws developed, two distinct groupings of discrimination analysis emerged: overt or intentional discrimination and unintentional discrimination. Intentional discrimination is pretty obvious and can be convincingly revealed in a variety of ways, including testing or mystery shopping.

Unintentional discrimination is a different matter. Unintentional discrimination results from policies, practices, habits or presumptions, usually without any intention to treat people differently. What is particularly challenging about unintentional discrimination is recognizing and preventing it. The fundamental question is if you don’t intend to discriminate, how do you know for sure that you are not?

This takes us to the disparate impact analysis. Also known as the effects test, the analysis looks at results in context of the market. By analyzing the demographic impact of the practice, we decide – after the fact – whether it resulted in discrimination.

In today’s environment, determining something after the fact is not good enough for those who can be put in the position of defending against a fair lending charge. Knowing before and preventing would be vastly preferable. How to do that?

The effects test actually provides a method and guide for anticipating and preventing disparate impact. It also provides you with the tools to prepare your defense in advance. The test involves three steps. The plaintiff must demonstrate that there is a disparate impact as a result of a specific business practice.

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The defendant then raises an affirmative defense of business necessity. In the third step, it is up to the plaintiff to show that there is an alternative way to meet the business purpose without the discriminatory result. By putting this process into your compliance program, you can prevent disparate impact and also have your defense ready in case anyone challenges you.

Step 1 - Business Purpose
Every change made to the organization and its services and products should have a business purpose. The simple way of putting this is that there should be a good business reason for doing what you plan to do. As is always recommended for compliance programs, the business purpose should be established at the very start of any new project or before making a change.

Having a good business reason means more than simply making a profit. Financial institutions – banks, thrifts and credit unions – are chartered to serve the convenience and needs of their markets. Even without CRA, this mandate directs chartered institutions to consider the needs and capabilities of the market they were chartered to serve.

A financial institution’s product or service should provide benefit not only to the institution but also to its customers. Predatory loans generally do not benefit the consumer. These loans were pushed out to consumers using pressure sales tactics, misrepresentations and sometimes even intentionally misleading disclosures. There was a business purpose to these loans: profit. But there was no equivalent benefit to the consumer. In fact, most of the loans actually harmed consumers.

In contrast, “plain vanilla” loan products made with sound underwriting generally do benefit the consumer. A good loan enables a consumer to make a purchase while staying within their means. A good loan also brings a profit to the lender.

In the world subject to UDAAP, the business purpose should also be vetted against UDAAP. Is the product or service designed to be fair? Is the marketing plan clear, avoiding any deception? And perhaps the most important question, will the customer benefit as much as the institution? A product without customer benefit is not likely to withstand a UDAAP challenge. One which also results in disparate impact will fall under a fair lending challenge. Products and services must do more than benefit the bank. They must also benefit the customers.

Step 2 - Business Necessity
Considering business necessity is where things get interesting. Underwriting of loans is often where the business necessity test settles. Under the new rules, underwriting has also become somewhat controversial in the realm of fair lending. When underwriting standards are tightened, highly qualified consumers are unaffected. The impact is felt by the less qualified who often represent a disproportionate number of the market’s minorities.

Given the disproportionate result of an underwriting factor such as debt ratios, how does the business purpose withstand a fair lending challenge? If underwriting is questioned, look to Regulation Z for guidance on standards that are considered necessary. If they are necessary and unfairness results, the business practice is justified.

Limiting availability of a product, such as to certain existing customers, may have a business purpose but might not be supported by business necessity. One way to test business necessity is to consider what would be the result if the limiting requirement were not imposed. Another consideration should be to determine why the institution is considering the limitation and whether there is another way to reach that purpose.

Step 3 - Market Analysis
Fair lending depends on the market your institution is chartered to serve. Knowing your market means knowing the demographics of the market. In this way, fair lending ties closely to CRA. Both programs must be based on the demographics, needs and capabilities of your market.

For CRA, we look primarily at income levels. CRA directs financial institutions to serve the credit needs of their entire community including the needs of those having low or moderate-income. Fair lending takes us a step further. Income is always a factor in banking products. The consumer needs income to deposit and also needs enough income to repay loans.

Experience with CRA has shown that there is often a correlation between income levels and race or ethnicity. This raises the specter of fair lending. Given differences in income among racial and ethnic groups, there will be a related difference in account and loan qualifications. This means that some differences are inevitable and therefore acceptable. The compliance challenge is to identify differences that are not merely the result of household economics. The analysis should be able to explain any differences in impact of a product.

Fair lending, augmented by CRA, requires another consideration. It is not enough to take the easy route, design and offer products and accept the differences in impact based on income and economic resources. Both laws require financial institutions to look for ways to serve the credit needs that may not qualify for the plain vanilla products. In other words, creativity is called for. The market analysis should include consideration of alternative ways to serve all parts of the institution’s market.

Step 4 - Alternatives
Even if an analysis of the product or service and the demographics of your market do not raise concerns about discriminatory impact, it is always a good idea to consider whether there are alternative ways to reach the business purpose. Thinking this way is how creative businesses stay ahead.

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Exam Preparation

Beating the Regulators to the Punch

At ABA’s Regulatory Compliance Conference, there was a great deal of discussion about what regulators look for when they come in to examine an institution and how the industry should set priorities. While risk assessment and risk management came up in almost every session, regulators also talked about change management.

The prudential regulatory agencies – FRB, OCC and FDIC – use a risk-based examination process and begin examinations with an assessment of how effectively the institution is assessing and managing risks. Their first step is to look at the risk management process. Based on the strengths or weaknesses that they identify, they plan the focus of the rest of the examination.

Product Focused Exams

The CFPB takes a very different approach from that of the prudential regulators. While the CFPB does conduct examinations, it leans toward targeting specific concerns about consumer harm. Its primary agenda is to sniff out consumer harms and take enforcement actions. Because of this, examiners are instructed to look for the specific issues that are on the Bureau’s problem list.

CFPB examinations are targeted by product and by market. The Bureau looks across markets to identify the riskiest markets. Then the Bureau selects institutions or companies for examination. Every examination is already focused by product. Institutions already examined by the CFPB have noticed this targeting. Because the examiners are given a mission, they look harder at targeted issues and spend less time on low-priority issues than would be the case in an examination conducted by a prudential regulator.

Because of this targeted issue approach, CFPB examinations may not be comprehensive. Instead, they will look at some areas intensively and skip over others. And they often result in enforcement orders or MOUs.

Prudential regulators work very differently. Their goal is consumer protection through compliance and therefore see their role as supporting compliance to prevent violations. Prudential regulators often notify banks as concerns arise. This may be by direct contact with the institution, perhaps generated by a pattern of complaints, or through general guidance intended to alert the entire industry.

Change Management

The prudential agencies find that change management can be the weakest link in a risk management program. Change can raise risk. Change can also alter the points and processes that a risk management program should monitor. Examiners will look for any gaps in change management, particularly when the institution’s risk profile changes. To support effective change management, the process of risk management must involve thinking through every step, every decision and identifying every staff point involved. It is also critical that functions such as compliance be included throughout the entire process, from idea to product to implementation.

During preparation for and implementation of the new rules on ATR and QM, the agencies focused their attention on the risks resulting from these changes. They examined banks to be sure they were conducting effective change management – managing for the change. ATR and QM provide a good example of the thinking that must be part of change management. It was recent. It was huge, and it involved many functions in the organization.

ATR or QM?

As the new rules rolled into effect, most of the debates were about Qualified Mortgages – what were they, what were the exceptions, what was the impact of QM on fair lending and CRA programs. Fundamentally, QM is not a requirement but ATR is. QM helps the lender to pass certain tests without actually taking them, but no loan can be a QM if it is not based on the borrower’s ability to repay. As one regulator pointed out, ATR and QM are really about safety and soundness.

Third Party Vendors

In the priority of risk management, the effective management of third party vendors is considered to be a major risk. Examiners have identified situations where the institution has either failed to conduct adequate due diligence at the start of the relationship or become lax in oversight of the vendor’s performance.

All the due diligence involved in the selection of a vendor can leave management with a false sense of security. After all that work what can go wrong? Things change – in the institution and at the vendor. Examiners therefore look carefully at the ongoing management of vendors.

Management needs to understand that outsourcing does not make the risk someone else’s problem. There is still an obligation on the bank to oversee the vendor. Manage the vendor as you would your own staff. Out of sight must not be out of mind. The due diligence should also include a comparison of costs for outsourcing or doing the work within the institution. The complete cost comparison should include the costs of monitoring and auditing the vendor.

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Managing Compliance Risk:

It is all about risk and change. Risk has been the center of attention for some time, but now regulators are focusing on change as the most dangerous aspect of risk. Make sure that the risk management program anticipates and addresses change. All staff and departments that will be affected by a particular change should be represented on the change management team,

UDAAP:

Always consider UDAAP part of the equation for compliance together with any specific rules. Any product, service or other activity can fall afoul of UDAAP. Because UDAAP is in the eye of the beholder, always look at the institution’s actions and products through the eyes of a consumer. Recent cases using the “abusive” standard have raised the UDAAP bar.

Data Collection:

Get your data right. The CFPB is data driven. It is much, much more than HMDA. The Bureau’s reliance on data should come as no surprise as it is staffed with academics who use data for analysis. The CFPB’s obsession with regulation by data is spreading to other regulatory agencies as well. It is now more important than ever that data be accurate and complete. Data is also the most important element in fair lending examinations. It may be useful to apply data collection (other than Government Monitoring Information) to products other than mortgages.

Information Reporting:

Data quality includes information that you report to credit bureaus. Inaccurate data can restrict consumers’ access to credit and access to fair pricing of credit. As it reviews credit reporting concerns, the CFPB is looking closely at the accuracy of data furnished to the credit reporters. Blame for inaccuracy is likely to fall on the furnisher rather than the credit bureau.

The "Deposit Account Challenged":

Increasing attention is being given to deposit relationships and, based on information to date, the CFPB is beginning to look at the need to provide more protections for the “deposit account challenged.” Depository institutions should review policies and practices related to deposit account relationships. Speakers at the conference also recommended that careful consideration be given to any account termination or penalty. Think of it as a “second look” on the deposit side.

Vendors:

When vendors are selected – and even when making a decision to use a vendor – the right people should be at the table. This includes people managing the product, people managing the system, legal and compliance. All these areas should be part of the early decision-making and remain involved throughout the process. Neither legal nor compliance can fix problems at the last minute. And when comparing costs, compare all the costs. Managing a vendor is more than paying the vendor’s bill. The vendor must be managed – by bank staff.

IT:

Increasingly, compliance is managed through software. Because of this, compliance should regularly attend IT meetings. Developments in compliance affect IT just as developments in or changes to IT can affect the compliance program. This is particularly important when the institution is considering new systems or software.

Build Compliance Programs to Code:

Compliance should be seen as part of the business model, not as an irritating and expensive add-on. Compliance is part of the cost of doing business. The same care should be given to building and managing the compliance program as developing and managing products. In fact, compliance is part of product delivery. When it comes to compliance, build to code. Don’t take shortcuts.
August 1 or October 3?
The CFPB has proposed delaying the effective date of TRID to October 3, 2015, giving mortgage lenders more breathing room to be ready and reducing the likelihood of a temporary mortgage market shutdown on August 1 by lenders who could not meet the August 1 deadline. Thanks to some passionate lobbying by ABA and other mortgage lender trade groups, and supported by ABA’s readiness survey, the Bureau has been persuaded to issue the proposal to delay. The delay would provide an additional two months for preparation. This is still a very tight time frame. Not all vendors have delivered new systems to generate TRID disclosures. Some vendors admitted that lenders might get the new system only days before the August 1 deadline. Delivery of the system is only the beginning for compliance. The system has to be installed, tested, and corrected. It has to be tested for compatibility with other systems, such as HMDA reporting and loan operations. And then, training on how to use the system can begin – and that can take weeks. Comments supporting the delay must be sent to the Bureau no later than July 7, 2015. Earlier is even better!

Reducing Regulatory Burden
EGRPRA requires the regulatory agencies to periodically review their regulations to identify ways to reduce regulatory burden. The review for regulations including BSA and consumer protection regulations, is underway. The agencies have requested comment on ways to reduce burden or simplify the regulations under review. Comments are due not later than September 3, 2015. This is your chance!

Co-Signer Alert
The CFPB has issued a report on the difficulties that co-signers of student loans encounter when attempting to be released from the obligation. The study focuses on difficulties that cosigners faced when asking to be removed. There is scant information about the contractual obligations the co-signer undertook.

Comments supporting the delay of TRID are due to the CFPB no later than July 7. Get your comments in as early as possible, supported with any details about delays from vendors and training needs. Suggest delaying the effective date of January 1, 2016 to make changes compatible with HMDA reporting.

Comments on OCC’s proposal to renew its existing consumer complaint form are due to OCC by July 10, 2015. Comments are open for suggestions on ways to improve the form and to reduce burden.

Watch for the CFPB’s publications of narrative portion of consumer complaints it receives. Stay on top of any complaints against your institution and be ready for any bad press.

Good News! The CFPB has proposed delaying the implementation date for TRID, moving it to October 1, 2015. Not enough mortgage lenders could be ready in time.

August 10 is the effective date for the joint agency rule requiring state regulation for any non-federally regulated Appraisal Management Company (AMC) in order to provide appraisal management services for federally-related transactions.

Comments offering suggestions for regulatory burden reduction are due to the bank regulatory agencies by September 3.

The Federal Reserve expects to issue final amendments on several aspects of the proposal to revise Regulation CC “soon.”

The CFPB expects to release a final rule amending Regulation CC, Expedited Funds Availability in June 2015, in conjunction with the Federal Reserve’s final rule.

The CFPB expects to release a final rule amending Regulation C, HMDA, in July 2015. This proposal will contain the major changes directed by the Dodd-Frank Act.

The prudential regulatory agencies may be making proposals based on their review of regulations to reduce regulatory burdens.
How to Protect Consumers

Compliance in the form of consumer protection laws has existed for nearly half a century. Consumers still experience financial harms and financial institutions experience regulatory burden. In this half century of consumer protection, we don’t seem to have found the right balance between consumer and financial institution.

Managing the consumer financial protection regulations fell first to the prudential regulators. They were charged with issuing regulations, interpreting the laws, examining for compliance and taking enforcement action when needed.

These same agencies were also responsible for the safety and soundness of the institutions they regulated. The responsibility for safety and soundness necessarily influenced how the prudential agencies approached consumer protection regulations. Consumer protection through compliance with the laws was approached in a literal manner. Do what the law says or face enforcement actions.

In the age of risk management, non-compliance with consumer protection laws became a form of risk to reputation and bottom line. As the prudential regulators saw it, a safe and sound institution was one that was prudently managed and in compliance with all applicable laws, including consumer protection laws.

Using a compliance-with-the-law approach, the regulators wrote laws designed to carry out the specific tasks and prohibitions contained in the consumer protection laws. The result was highly technical regulations tied to the law rather than to the activity. Examinations were institution by institution, regulation by regulation.

Enter the Consumer Financial Protection Bureau with a mandate to protect consumers and no responsibility for safety and soundness. As the consumer protection regulations moved from the prudential regulators to the CFPB, the focus changed. Protecting consumers became the sole consideration. The Bureau’s approach to regulations is based on providing the consumer the information and protections they need.

Regulations such as Regulation Z are designed to impose consumer protections. Unfortunately, the CFPB staff has not paid careful attention to some of the details laid out in the statutes. Their new regulations focus on consumer protections but give light attention to legal requirements that are considered less important to consumer protection.

An equally dramatic change is the change in focus from prudential regulators attention to each regulation to the CFPB’s focus on market and products. With the focus on market-wide issues and specific products that tend to cause consumer harm, the Bureau enforces by finding a target and bringing one or two grandiose enforcement actions rather than working with each institution to achieve compliance.

These two approaches are dramatically different. Congress has judged the prudential agency approach to be inadequate. The CFPB’s approach leaves the targeted institutions breathless and others – who may or may not be in compliance – unscathed.

Which system is better? It isn’t hard to figure out. All we have to do is look at which players in the consumer finance market treated customers fairly and which did not. Depository institutions know the answer to that. Institutions that are examined regularly for compliance with all laws are motivated to achieve a high level of compliance. And whether the focus is simply technical to do what the laws required, the result is protected consumers.

And those other guys? They still aren’t complying. It can be cheaper to get caught and pay a fine than to comply.
**Question:** As I am completing comparison between the “old and new” mortgage disclosures, I do not happen to see the “Required Deposit” disclosure optional language or the flood insurance notice that was available or provided in the past. Am I missing it? It does not seem to appear within the “Other Consideration” options of disclosures within the guides and I was just wondering if you could confirm not addressed or lead me to the section where noted.

**Answer:** When it comes to the CFPB’s new mortgage disclosure forms, what you see is what you get. Some Truth in Lending information simply is not on the forms. Presumably the CFPB did not think the information was relevant for mortgage transactions. Required deposit disclosures are usually triggered by consumer loans rather than mortgages. However, such a situation could occur and the question would be whether the disclosure would be required even though omitted from the CFPB’s form.

The problem is whether using the form as the Bureau has designed it will fully comply with the Truth in Lending Act. It is pretty obvious that the CFPB started with RESPA and then added in what parts of TILA they considered necessary. The regulation as written by the CFPB appears to say that use of this form complies with Regulation Z. However, that doesn’t necessarily speak to the Truth in Lending Act. Flood, of course, is not one of the CFPB’s regulations so they don’t address flood issues at all.

What to do? You could type it in the form, although that is something the Bureau appears to frown on. Or you could provide a separate notice with that information. If the loan is rescindable, a separate old-TILA disclosure would resolve any issues about whether material disclosures were provided.

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**Answer:** You are absolutely right that a risk assessment should be done. In fact, the best approach would have been to conduct a risk assessment before considering the purchase. At that stage, the risk question would be whether the bank should even get into the title agency business. On one level this is a pure business risk assessment. The other risks to consider involve lending regulations and other compliance considerations.

The biggest risk the bank should consider comes from RESPA. There are two fundamental issues: pricing and referrals. Pricing must be based on the market. Whether considering RESPA, TILA or UDAAP, the first thing any investigator looks at is the price of the service. This is considered in the context of the overall market pricing. Any pricing above the going rates in the rest of the market will be a red flag.

**Question:** Our bank is considering purchasing a small title agency. While casual talks have been ongoing for a period of time, things are at the point where this is a serious consideration and a risk assessment needs to be done. I imagine this should mirror what we would do for any new product the bank would offer; however I am at a bit of a loss related to requirements that may be specific to the Title Agency. Any words of advice would be greatly appreciated.

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**Question:** Referrals become the most difficult risk to manage. First, any referral to a title company that is part of the holding company triggers an affiliated business disclosure which explains to the consumer that the two entities are related. And because the title company would be an affiliate, you cannot require the consumer to use that particular title company. You may include it on the list of settlement service providers with the GFE (soon to be Loan Estimate) but must also disclose that the company is an affiliate.

After RESPA issues are resolved, take a hard look from all directions at any aspect that could raise UDAAP concerns. The very fact that two settlement service providers are connected seems to be a red flag to UDAAP hunters.

These compliance issues may seem easily managed with good procedures and training. But your management should be aware that one slip-up can have serious consequences. In considering the compliance risks, you should start with an analysis of the business plan. How will referrals be made? Will the title company provide services for other lenders? Will there be any dual employees? How will pricing be set? Think through the function of making a mortgage loan and consider what could go wrong.

**Question:** What happens to HMDA reporting when we start using the new Loan Estimate and Loan Closing disclosures?

**Answer:** In theory, nothing happens because the same information should be reported. The challenge is making sure that the HMDA reporting system works with both the old and the new disclosure systems. It might be a good idea to run a complete HMDA report before switching to the new disclosures.

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Reserve Maintenance Manual Updated

P U R P O S E:
To keep your compliance, audit, and legal officers and staff up-to-date on regulatory and compliance issues and industry related techniques;
To provide guidance for implementing and managing your compliance program;
To increase your awareness and understanding of compliance developments;
To provide you with information that will be useful in communicating compliance information to bank staff; and,
To assemble all of the above in a readable, understandable, usable format that can be photocopied and distributed in-house by each subscriber.

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