# Fair Lending

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# Definition and History

Depending on the entity and the laws involved —

- Equal Credit Opportunity Act (ECOA)
- Fair Housing Act (FHA)
- Home Mortgage Disclosure Act (HMDA)
- Community Reinvestment Act (CRA)

Relevant agencies may include

- DOJ
- HUD
- CFPB
- Bank regulatory agencies such as the Office of the Comptroller of the Currency, Federal Deposit Insurance Corporation (FDIC) and Federal Reserve Board.

# Examples

Some of the largest fair lending fines in history have been issued by U.S. regulators:

**1. Wells Fargo (2022) - Fine:** $3.7 billion ($1.7 billion in civil penalties + $2 billion in customer restitution). **Regulator:** CFPB

- **Issue:** Discriminatory mortgage lending practices, along with improper fees and wrongful foreclosures affecting minorities.

**2. Countrywide Financial (2011) - Fine:** $335 million. **Regulator:** DOJ

- **Issue:** Charged with systematically discriminating against Black and Hispanic borrowers by overcharging them on loans and steering them into subprime mortgages.

**3. Bank of America / Countrywide (2012) - Fine:** $1 billion. **Regulator:** DOJ

- **Issue:** "Hustle" mortgage fraud program that targeted minority borrowers with unfair lending practices.

**4. Hudson City Savings Bank (2015) - Fine:** $33 million. **Regulator:** CFPB, DOJ

- **Issue:** Redlining (failing to provide loans to Black and Hispanic communities).

**5. Trustmark National Bank (2021) - Fine:** $5 million. **Regulator:** CFPB, DOJ

- **Issue:** Redlining practices that denied loans to Black and Hispanic neighborhoods.

# Key Areas of Concern

To Summarize, Fair Lending areas of concern are:

1. Underwriting: Bias in lending decisions

2. Pricing: Bias in loan pricing

3. Redlining: Exclusion of regions/neighborhoods

4. Steering: Unfair practices, diverting borrowers to specific disadvantageous products

Historically, the focus was on Mortgages. Post Dodd-Frank, other products came into scope

- Credit Cards
- Student Loans
- Indirect Auto
- Small Business

Later even expanded to servicing – loss mitigation.

# What Are Fair Lending Models and Where Does Validation Fit In?

Bank's Underwriting various loan products

Bank's Pricing for various loan products

Bank's outcomes
Loan Approval/Denial
Loan APR
Lending Area and Products
------------------------
Fair Lending question: In these outcomes, is there discrimination? Disparate Treatment?

Compliance Dept Is Responsible for Monitoring
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Simple Stats
Models to detect Disparate Treatment: Target Group vs Control Group Testing
Matched Pair Testing
Models to detect redlining, steering

Management and Board Reporting

First Line

Validation Plays an Important Role
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Compliance Department models (in-house or vendor supplied) – if incorrect, may fail to detect issues.
Validation can identify issues and recommend remediation

Second Line

Regulators review reports – management and board reporting, validation reports

Regulators run their own analysis on Bank's data

May result in adverse findings

# Compliance Models

Fair Lending – testing for disparate treatment – is a look-back exercise.

Definitions: Target Group vs Control Group

| Target Group | Control Group |
| --- | --- |
| American Indian | Non-Hispanic Whites |
| Asian | Non-Hispanic Whites |
| African American or Black | Non-Hispanic Whites |
| Hispanic | Non-Hispanic Whites |
| Pacific Islander | Non-Hispanic Whites |
| Female | Male |
| Age 62+ | Age 18-61 |
| Low or Moderate Income Tract | Middle or Upper Income Tract |
| Minority Tract | Non-Minority Tract |

# Compliance Models

Key Questions to Answer:

- Are there discriminatory patterns in Underwriting?
    - Are minority applicants denied credit disproportionately more than majority class applications:
        - Test approval and denial rates using all the applications received past one year
        - Approval and denial rates comparison may not tell the whole story as there are “credit decisions” behind application approvals and denials.
        - Using application data build a “model” which controls for underwriting policies / variables
        - Determine if there are statistically significant differences
        - Differences are further explained through a “matched pair” testing
    - Logistic regression models with Approved/Denied status as the dependent variable
    - Explanatory variable can include Loan Type, Purpose, Owner Occupied, Lien Status, DTI, CLTV, Credit Score,
- Are there discriminatory patterns in Pricing?
    - Are minority applicants are charged more than majority class applications:
        - Test pricing using all the loans approved and approved but withdrawn within the past one year
        - Pricing comparison may not tell the whole story as there are “pricing matrices” behind originations.
        - Using application data build a “model” which controls for pricing policies / variables
        - Determine if there are statistically significant differences
        - Differences are further explained through a “matched pair” testing
    - Linear regression models with APR as the dependent variable
    - Explanatory variable can include Loan Type, Purpose, Occupancy, CLTV, Credit Score, Lock Days, Loan Type

# Compliance Models: In-house vs Vendor

- Several vendors supply fair lending models
  - Wolter Kluwer
  - Ncontracts
  - Assurity
  - SAS
- Pros
  - Banks may lack in-house expertise
  - SaaS – repeatable and cost efficient
- Cons
  - Not customized to Bank's policies and procedures
  - Limited support to explain results
  - Matched pair testing

# Conclusion – MRM Role

- Fair Lending Models Should be in the Inventory

- Risk Rating Fair Lending Models
    - Standard methodology would result in "High Risk" classification due to regulatory and reputational impacts

- Validation Frequency
    - Tricky issue
    - Testing by first line is annual – one year's worth of data is analyzed for fair lending issues
    - Should the models be validated every year?
        - Important to understand if there have been changes to the models
        - Model may not change – underlying data does change resulting in different outcomes / focal points
        - Limited annual testing

- Key Validation Steps – SR 11-7 is applied, however (validators must complete):
    - All areas of potential discrimination are covered not just underwriting
    - Replication of first line models is important
    - Be mindful about data issues
    - Ensure results are interpreted appropriately
    - Ensure focal points are reviewed further through matched pair testing
    - Ensure model documentation is accurate and complete
    - Ensure redlining and steering is analyzed/validated

# Q&A

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