



ADI Adviser

**LESSONS LEARNED:
FOURTH QUARTER 2006
FAIR LENDING SETTLEMENTS**

April 2007

INTRODUCTION

In late 2006, there were two significant fair lending settlements, one with the U.S. Department of Justice and the other with the State of New York. These cases remind us that fair lending compliance remains a central issue for lenders of all sizes and in all geographies. More importantly, each settlement suggests important lessons for lenders. One of these lessons is that fair lending laws, regulations, and examination procedures will be interpreted to apply to new home loan products and services, but that the old formula – be attentive and prepared – never goes out of style.

CENTIER BANK

Redlining Still with Us¹

In October, 2006, the U.S. Department of Justice (DOJ) announced the results of its investigation into the lending practices of Centier Bank.² That investigation led to allegations that Centier had violated both the Fair Housing Act and the Equal Credit Opportunity Act by failing to market its services to and meet the lending needs of minority neighborhoods¹ in the Gary, Indiana metropolitan area. In short, Centier was accused of “redlining”.

Although Centier Bank denied the allegations, it entered into a settlement agreement with the DOJ. For Centier, the consequences of this settlement are that, over five years, it must invest more than \$4.3 million and open new branches in minority neighborhoods it had previously not served. Further, as in similar fair lending violations,³ Centier was required to take remedial actions as redress for redlining. In addition, its violation will adversely affect Centier’s CRA rating and tarnish its reputation for several years.

Point, Counterpoint

In Centier, the DOJ made the following five assertions, grouped by actions taken and the critical result of those actions.

- Centier Bank was alleged to have –
 1. Expanded its operations and scope of business to meet the needs of predominantly white residential areas while avoiding the lending and credit needs of non-white areas;
 2. Engaged in a pattern of locating or acquiring branches outside of communities in which African-America or Hispanic residents were in the majority;
 3. Unlawfully considered race and national origin in its advertising and marketing practices by failing to advertise in minority format radio stations and newspapers; and
 4. Narrowly defined its CRA assessment area to exclude virtually all of the cities of Gary, East Chicago, and Hammond.

- As a result of these actions –
 5. Statistical analysis demonstrated that Centier Bank consistently served the credit needs of residents and owners of small businesses in majority white neighborhoods of the Gary area to a significantly greater extent than it served the needs of those located in majority minority neighborhoods.

In rebuttal, Centier Bank argued that it was not headquartered in these areas; that legal restrictions on branch banking until the 1980s and depressed, local economic conditions since then had prevented it from expanding into these areas; that the presence of well entrenched competitor banks also had been a barrier to entry in these neighborhoods; and that, although it knew it was a less productive lender in these areas than other banks, it had not intended that outcome and had never deliberately discriminated against individuals, groups, or areas based on race or national origin.

Even though this settlement occurred just over six months ago, redlining is not a new problem. It was one of the reasons for the Community Reinvestment Act, and it has always been a well known fair lending violation. The Centier Bank case reminds everyone in the lending community, however, that redlining does not have to result from intentional policies or practices, that it remains unlawful, that it will be detected, and that punishment will ensue.

COUNTRYWIDE HOME LOANS

Pricing Disparities

Two months after Centier, in December, 2006, the Office of the New York State Attorney General (OAG) used HMDA data from Countrywide Home Loans to find racial and ethnic disparities that it concluded “could support a claim under state and federal laws that prohibit discrimination in the extension of credit”.⁵ In addition to the HMDA data, the OAG reviewed Countrywide’s lending policies and procedures and conducted subpoena hearings of senior managers. Further, the OAG retained experts in statistical analysis to determine whether, after controlling for legitimate pricing factors (e.g., credit scores, outstanding debts, reserves, etc.) the pricing disparities remained.

Point, Counterpoint

The OAG found that, on average, after controlling for race-and-ethnicity-neutral factors, black and Hispanic customers paid more for loans than white customers in Countrywide's prime retail and wholesale channels. This result was due in part, the OAG concluded, to the racial and ethnic differences in the discretionary components of pricing, principally Pricing Exceptions in the retail sector and Broker Compensation in the wholesale sector.

In contrast to major lenders that are national banks,⁶ Countrywide had elected to cooperate with the OAG and contributed to the "compromise" settlement. Specifically, Countrywide agreed to –

1. Expand its ongoing monitoring of retail pricing-related discretionary decisions, including those on which the OAG focused and broker pricing practices. This monitoring was to be accomplished with existing Countrywide regression models, so long as they were determined to be reasonable by an independent consultant whom Countrywide was required to hire, or modified as necessary.
2. Compensate any black or Latino borrowers who improperly received subprime or "Alt-A" loans, when they should have received prime loans.
3. Implement a \$3 million consumer education program that included statewide seminars, conducted in English and Spanish, as required by the audience.
4. Improve disclosure about the advantages, disadvantages, and relative costs of different mortgage products and features.
5. Enhance fair lending training for loan officers.
6. Provide detailed reports to the OAG.
7. Pay \$200,000 to the State for the cost of the OAG's investigation.

Countrywide also agreed to engage in self-testing and comparative file reviews to meet several of these requirements. For example, the OAG required both of these analytical methods to determine whether loan officers (and, presumably, brokers as well) are continuing to provide the required enhanced

explanations of product costs and features, to determine products being offered and prices quoted, and to assist in investigating identified disparities.

THE RELEVANCE OF FAIR LENDING COMPLIANCE

Fair lending enforcement has been a regulatory priority for more than 15 years. During that time, much progress has been made as most lenders have increased awareness of fair lending, upgraded their compliance programs, and changed business procedures. Some lenders have taken on the mantle of leadership.

As these two cases indicate, however, constant attention is required. Centier involved redlining, which is one of the oldest types of fair lending violations. Countrywide involved pricing disparities, another fair lending issue that is not new.⁷ Countrywide did point to fair lending issues that appear likely to be more important in coming years. One example is product placement, which is in response to the conclusion that some borrowers were sold subprime or Alt-A products carrying higher costs but were likely qualified for prime products. Another example is increased disclosure requirements.

Indeed, at this writing⁸ the U.S. Congress, both the Senate and the House banking committees, are holding hearings and formulating legislation that could add new dimensions to fair lending compliance. For example, the chairman of the House Committee on Financial Services, Barney Frank, is considering legislation that, among other things, will impose "suitability" requirements on lenders. Under these requirements, lenders will collect more information from applicants, compare that information to available products, and match the applicant to the product. Some will argue that this is what many lenders already do, and they would be correct. However, because of several bad actors, all lenders' diligence in this regard will be reviewed and tested. Inevitably, some unwary or unprepared lenders will be cited for failures on these new regulatory dimensions.

LESSONS LEARNED

In the short-term, two messages can be taken from Centier and Countrywide. First, fair lending must

remain a primary compliance concern. While Bank Secrecy Act and Anti-Money Laundering get the most attention today, followed closely by information security and privacy, these and other compliance matters add to the importance of compliance instead of pushing off or subordinating fair lending the compliance agenda.

Second, as new lending products and methods are devised, interpretation of fair lending laws and regulations will expand to ensure that core policy objectives are served. When they occur, redlining, pricing disparities and other well known fair lending violations will be detected, but so will new forms of fair lending violation. One might even argue that the expanded application of these laws is accelerating relative to the pace of the industry. The potential actions in the Congress could create new tools for regulators but however soon those tool are devised, the debate will certainly create pressure for expedited attention to lenders who are making loans to borrowers who do not understand what they are buying, who cannot afford them, and whose costs are higher than they should be.

If these are the two messages, what are the answers? Not surprisingly, the answers are already known – although perhaps not always practiced:

- Build and maintain a comprehensive fair lending compliance program that is risk-based;
- Ensure that that program includes both regular self-testing and self-evaluation;
- Focus timely attention on compliance weaknesses;
- Conduct regular risk assessments to determine whether there has been a change in the risk profile and, if so, how the compliance program needs to adapt; and
- Create and manage cross-functional fair lending teams that bring together expertise in compliance policy, data analysis, underwriting, secondary markets, product development, and sales.

The old formula still applies: be attentive and prepared.

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¹ For a summary of fair lending enforcement cases from the 1990's onward, focusing on bank and mortgage companies, please see ADI's website (www.adiconsulting.com) for a fair lending timeline.

² U.S. v Centier Bank

(<http://www.usdoj.gov/crt/housing/documents/centiersettle.htm>)

³ In this article, "minority neighborhoods" are defined as census tracts in which the majority of the population is white, non-Hispanic.

⁴ See U.S. v Albank

(<http://www.usdoj.gov/crt/housing/documents/albankcomp.htm>) and

U.S. v Chevy Chase Bank

(<http://www.usdoj.gov/crt/housing/documents/chevychasesettle.htm>)

⁵ See In the Matter of: Countrywide Home Loans, Inc.; Attorney General of the State of New York, Civil Rights Bureau; December 5, 2006.

⁶ HSBC, JP Morgan Chase and Wells Fargo are cited in the OAG's press release as lenders who sided with the Office of the Comptroller of the Currency in arguing that states are pre-empted by federal banking law from enforcing fair lending laws.

⁷ U.S. v Fleet Mortgage Corp.

(<http://www.usdoj.gov/crt/housing/documents/fleetsettle.htm>) and

U.S. v Long Beach

(<http://www.usdoj.gov/crt/housing/documents/longbeachsettle.htm>)

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