



Compliance Corner

FEDERAL RESERVE BANK OF PHILADELPHIA

Prepared for institutions supervised by the Consumer Compliance & CRA Unit

Easing the Burden: An Alternative Fair Lending Examination Approach for “Low-Risk” Banks

by Eddie L. Valentine, Supervising Examiner

The Federal Reserve System recently adopted an alternative fair lending examination approach for banks that exhibit little discrimination risk. This new examination approach reflects the experience gained using the FFIEC fair lending examination procedures, which were distributed in January 1999.

Why Adopt an Alternative Approach?

Through experience, bank supervisors have learned that some banks have a common risk profile. Typically, these are stable community banks that are often located in suburban or rural areas where the area demographics show a very low percentage of minority residents. These banks offer standard products, and many of them are predominately commercial or agricultural lenders. In these cases, a comparative file analysis would usually focus on gender as the prohibited basis. However, in many cases there are an insufficient number of prohibited basis denials to conduct an underwriting analysis, and a terms and conditions analysis might have been conducted in the previous examination with no concerns identified. In

addition, lending policies and staff have not changed.

In such cases, there may be insufficient risk to warrant establishing any focal points for the onsite portion of the fair lending examination. The alternative procedures have been designed for situations such as this.

The alternative procedures are intended to help validate the conclusions that were drawn by examiners in the scoping process and will result in a reduction of resources being devoted to banks where the level of risk clearly is not sufficient to support extensive comparative file analysis.

Which Institutions Will Qualify?

Examiners will determine whether an institution qualifies for the alternative approach during the pre-examination scoping process. Generally, examiners will use the alternative procedures at institutions meeting the following criteria:

- The bank is a stable community bank with a very low percentage of minority residents in its

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assessment area.

- The bank offers standard products, with commercial or agricultural loans as the predominant product line.
- An insufficient number of minority group denials exist to make a meaningful comparative file analysis.
- No significant fair lending concerns were identified at the previous compliance examination.
- No significant changes have occurred in lending policies or lending staff since the prior compliance examination.

How Will the Alternative Approach Work?

The alternative procedures allow an examiner to verify whether the bank's practices are consistent with the loan policy data that was reviewed during the scoping process. If no inconsistencies were noted, the examiner would conclude the discrimination analysis without expending the significant level of resources typically associated with an extensive file review.

The success of this approach depends upon the integrity of the scoping process. Therefore, all appropriate areas of credit operations will be analyzed in the scoping process, including consumer, commercial, and agricultural lending. If no risk factors are identified during scoping, that is, the examiners believe that the institution might be a low-risk institution, the examiners will proceed with the following steps.

First, examiners will select a judgmental sample of loans for review to test how the lending criteria are actually applied. The sample will be representative of the major product lines of

the institution, and will include both denials and approvals that were processed in the preceding twelve months. The examiners will review the sample transactions to determine if they were underwritten according to the bank's articulated lending criteria. The transactions will not be compared to each other as they are in the benchmark/overlap analysis. Examiners will investigate and document any deviations in underwriting. This review will verify the actual underwriting practices of the bank and may result in the identification of risk factors.

Next, examiners will use the same sample to review the bank's pricing practices. Since denials are not priced, it may be necessary to add additional approvals to take the place of the denials in the original sample. Examiners will compare the sample's loan pricing to the bank's pricing methodology as described during the scoping process. The transactions will not be compared to each other as they are in the terms and conditions analysis. Examiners will investigate and document any pricing deviations. This review will verify the actual pricing practices and may result in the identification of risk factors.

If examiners identify no risk factors using these alternative procedures, then the low-risk conclusion drawn in the scoping process is validated. At this point, the discrimination analysis is complete. However, if risk factors are identified through either the underwriting or pricing reviews, the examiners will establish a focal point and expand the sample for that particular product line, performing a full analysis using either the bench-

mark/overlap or terms and conditions examination procedures. Sample sizes will correspond to those in the sample size tables, and will be focused on marginal applicants.

Even if examiners determine that an institution is low-risk during one fair lending examination, the scoping for the next examination will not include an automatic assumption that the bank remains low-risk. During the subsequent scoping process, examiners will make a new determination of the risk level of the bank.

Conclusion

Examiners in the Third Federal Reserve District have used the alternative fair lending examination approach on several compliance examinations conducted during the second half of 2001 and the first quarter of 2002. The approach has been well received by Third District institutions since it has achieved one of its intended purposes—reducing regulatory burden. Bank supervisors have also been pleased with the new approach since it has enabled examiner resources to be re-directed to more critical high-risk areas of compliance reviews.

If you have any questions regarding the alternative fair lending approach, please contact Supervising Examiner Eddie L. Valentine (eddie.valentine@phil.frb.org) at (215) 574-3436 or Connie Wallgren, Consumer Compliance/CRA Examinations Unit Manager (connie.wallgren@phil.frb.org) at (215) 574-6217. ■

HUD Clarifies Policy on Lender Payments to Mortgage Brokers

On October 18, 2001, the Department of Housing and Urban Development (HUD) issued RESPA Statement of Policy 2001-1 (SOP 2001-1), *Clarification Regarding Lender Payments to Mortgage Brokers*. SOP 2001-1 clarified Statement of Policy 1999-1, which sets forth HUD's position on the legality of lender payments to mortgage brokers in connection with federally related mortgage loans. HUD issued Statement of Policy 2001-1 to eliminate ambiguities concerning its position on yield spread premiums and overcharges by settlement service providers. The new policy became effective immediately.

SOP 2001-1 reiterates HUD's position that yield spread premiums are not *per se* legal or illegal and clarifies the test for the legal-

ity of such payments set forth in the 1999 Statement of Policy. HUD also reiterated its longstanding position that it may violate Section 8(b) and HUD's implementing regulations if:

- Two or more persons split a fee for settlement services, any portion of which is unearned;
- One settlement service provider marks-up the cost of the services performed or goods provided by another settlement service provider without providing additional actual, necessary, and distinct services, goods, or facilities to justify the additional charge; or
- One settlement service provider charges the consumer a fee where no, nominal, or duplicative work is done, or the

fee is in excess of the reasonable value of goods or facilities provided or the services actually performed.

SOP 2001-1 also reiterates the importance of disclosure so that borrowers can choose the best loan for themselves, and it describes disclosures that HUD considers best practices.

Links to HUD's RESPA Statements of Policy are available on HUD's web site at www.hud.gov:80/offices/hsg/sfh/res/resapol.cfm. ■

Just in Time for Hurricane Season

The Federal Emergency Management Agency (FEMA) has updated its book, *Answers to Questions About the National Flood Insurance Program*. According to FEMA, the most recent edition includes information about several program changes. For example, a new section has been added on FEMA's Repetitive Loss Properties Strategy and any discussion of the discontinued 3-year term policies for flood insurance has been removed. The new edition updates web site addresses and the addresses and telephone numbers of FEMA's regional offices. Copies of the brochure can be downloaded from FEMA's web site at www.fema.gov/nfip/qanda.htm.

Unfair or Deceptive Acts: Section 5 of the Federal Trade Commission Act Applies to Banks

On May 30, the Federal Reserve Board released a letter from Chairman Alan Greenspan to Rep. John J. LaFalce confirming the application to banks of the prohibition contained in section 5 of the Federal Trade Commission Act against unfair or deceptive acts or practices.

For the press release and full text of the letter, visit the Board of Governor's web site at <www.federalreserve.gov/boarddocs/press/bcreg/2002/20020530/default.htm>.



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Excerpt from Chairman Greenspan's Letter

"The Board believes that the FTC Act's general prohibition against unfair or deceptive acts or practices applies to banks as a matter of law. By its terms, the prohibition does not exclude banks, and thus the banking agencies may use their authority under section 8 of the Federal Deposit Insurance Act (FDI Act) to enforce compliance with the prohibition. The fact that banks are excluded from the FTC's authority to enforce this prohibition merely reflects Congress' preference that the banking agencies—not the FTC—are the appropriate enforcing authorities for

banks. Moreover, the fact that the Board may issue rules prohibiting specific practices and the banking agencies may enforce these Board rules does not negate the fact that the general prohibition in the FTC Act applies to banks and that the banking agencies have authority under the FDI Act to enforce any law, including that statutory prohibition. This is fully consistent with 1975 amendments to the FTC Act establishing consumer complaint processes at the banking agencies and requiring the agencies to take appropriate action on complaints about unfair or deceptive practices by banks."

Additional Consumer Information on Privacy

The Federal Reserve has released a new publication for consumers, *Privacy Choices for Your Personal Financial Information*. This guide provides information about the choices consumers face as a result of the privacy provisions of the Gramm-Leach-Bliley Act of 1999, and helps consumers make informed choices about whether to allow their personal financial

information to be shared with other organizations.

Financial institution staff who answer consumer questions about the privacy notices might find this guidance helpful. The brochure can be downloaded in pdf format from the Board of Governor's web site at <www.federalreserve.gov/pubs/privacy>.