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Using Self-Evaluations To Streamline The Fair Lending Examination

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In 1999, the Federal Reserve began examining banks for fair lending compliance utilizing the risk-based fair lending examination procedures approved by the Federal Financial Institution Examination Council (FFIEC). These procedures provide clear guidance to financial institutions about the methods used to examine for compliance with federal fair lending laws and regulations, as well as how an examination can be streamlined if an institution's compliance program meets certain criteria. This article will address the proactive measures a financial institution can implement to streamline its fair lending examination.

Financial institutions can perform their own fair lending self-evaluation.

If a financial institution's self-evaluation is performed in accordance with regulatory guidelines, it can substitute for a large portion of the examiners' fair lending analysis. Fair lending self-evaluations consist of comparative analyses of loan applicants for disparate treatment in both underwriting and terms and conditions offered. Unlike self-tests using credit shoppers, self-evaluations are not protected from disclosure. There is no penalty for not sharing the outcome of a self-evaluation; however, financial institutions lose the opportunity for a streamlined fair lending examination by declining to inform examiners of the results.

> Regulators expect all financial institutions to perform some form of self-evaluation.

Why would a financial institution perform a self-evaluation?

Most importantly, as noted in the Fair Lending Interagency Policy Statement, regulators expect all financial institutions, regardless of size, to perform some form of self-evaluation. However, even without this requirement, institutions would derive benefits from performing self-evaluations. For example, the self-evaluation will reveal whether fair lending training and procedures are effective. It may also uncover areas of weakness or potential violations prior to the onset of an examination. Finally, if examiners can use the results of the self-evaluation as evidence of fair lending compliance, they will use a significantly reduced on-site scope and the sample size of files reviewed will be decreased significantly.

Who is responsible for performing self-evaluations?

Responsibility to perform self-evaluations can rest with the compliance unit, internal audit, or an external consultant, whether under contract or under the auspices of the financial institution's legal counsel. Naturally, institutions could also use any combination of the aforementioned sources.

How will the examiners determine if the self-evaluation meets regulatory guidelines?

Examiners will look at three areas when determining if the self-evaluation meets regulatory guidelines: the scope and timing, the methodology, and the accuracy of the data.

Scope and Timing

Examiners will analyze the scope and timing of the institution's self-evaluation by posing two questions:

- Did the self-evaluation cover transactions occurring no longer than two years prior to the current examination date?

- Did the self-evaluation cover the same focal points (high-risk products, markets, or prohibited basis groups) selected for the planned examination?

If the answer to either of these questions is "no," then the self-evaluation cannot serve to eliminate examination steps. However, examiners will still analyze the self-evaluation methodology and communicate any concerns or recommendations for improvement to management.

Methodology

In order for an institution's self-evaluation to be used as a reliable measure of fair lending compliance, the methodology employed by the financial institution's analysts should be very similar to that outlined in the fair lending examination procedures.

- Examiners will expect to see a comparative file analysis in which treatment of a particular prohibited basis group of applicants is measured and compared to a control group. The comparative analysis for denials and approvals should, as outlined in the examination procedures, focus on the underwriting criteria that resulted in denials of prohibited basis applicants, and determine if the control group applicants were required to meet the same standard.

- Examiners will also evaluate the definition of prohibited bases and control groups to determine if the method of identification was accurate and consistent with fair lending laws.

- Examiners will review the sample selection process to ascertain if it is similar to techniques outlined in the fair lending examination procedures. For disparate treatment in underwriting, the selection process should focus on marginal applicants. The analysis should also focus on one product; for example, a mortgage applicant cannot be compared to a credit card applicant.

Examiners will review the sample selection process to ascertain if it is similar to techniques outlined in the fair lending examination procedures.

- The number of files sampled and reviewed should roughly correspond with the sampling guidance in the procedures. In cases where examiners determine that the institution's sample size is too small, they may still be able to use the institution's data and pull additional files to bring the sample size up to an acceptable level.

Accuracy of Data

The procedures require that examiners sample 10 percent of the denied and approved transactions reviewed in the self-evaluation to verify that relevant information was accurately collected. The examiners will be looking for data used by the underwriters to make the credit decision, as well as details of the assistance provided to the applicant by the underwriter or loan processor during the application process.

The loan file data collected should be similar to the data that would be collected by examiners if they were doing the analysis. This would include basic credit underwriting information such as debt-to-income ratios, length of employment, credit history, loan-to-value ratio, number of trade lines, etc. The examiners will also determine whether all of the credit variables and quality of assistance factors were collected in a systematic and accurate manner.

What happens to the conclusions drawn from the self-evaluation?

If examiners find that the self-evaluation was performed accurately and the conclusions are well supported, they will incorporate the results into the examination report. The report will indicate that the findings are based on verified data from the institution's self-evaluation.

If problems are found with the way that data is collected or important variables are omitted, the examiners cannot rely on the self-evaluation to streamline the examination. However, if some portions of the institution's self-evaluation methodology are deemed reliable, examiners may still be able to use the data gathered by the institution and incorporate it into their analysis. For example, if the self-evaluation compared applicants without taking into account the reasons for denial, the examiner could still use the credit data culled from the files, but would have to perform the comparisons focusing on the reasons for denial.

Where can the specific procedures for streamlining the fair lending examination be found?

The entire process for performing a self-evaluation and streamlining a fair lending examination is in the appendix to the fair lending procedures. The procedures and the appendix are attached to the January 5, 1999 FFIEC press release, and can be viewed at <www.ffiec.gov/pr010599.htm>.

If you have any questions regarding fair lending self-evaluations, please contact Connie Wallgren, Consumer Compliance Examinations Manager at (215) 574-6217 or Eddie L. Valentine, Supervising Examiner at (215) 574-3436. ■