October 20, 2011

Banks Blindsided by Regulators' Unfair Approach to Fair Lending Examination and Enforcement

By: Stephanie E. Kalahurka

An increasing number of community banks have become subject to harsh examination criticism, enforcement actions and even civil actions relating to apparent fair lending violations alleging discrimination in the pricing of unsecured, consumer loans. Many banks have been blindsided by these charges, largely because they were not properly informed about why certain examination information was being collected or how that information would be used. As a result, bankers have been unable to appropriately formulate responses to examination questions and lack the statistical expertise needed to fully analyze or rebut examination findings. Many more banks are now facing consent orders, civil money penalties and civil actions, often without reasonable avenues of defense or appeal. Moreover, the mere allegation of fair lending violations may result in significant reputational damage to a bank, regardless of the outcome of the investigation or proceeding.

The increased regulatory scrutiny comes as a direct result of the Administration's focused efforts to aggressively enhance the enforcement of fair lending laws. To this end, in 2010, the Department of Justice ("DOJ") publicly affirmed that fair lending enforcement was a "top priority" and created a dedicated fair lending task force within the DOJ to work closely with the bank regulatory agencies on fair lending referrals. To put its efforts into perspective, the DOJ collaborated with regulatory agencies on 49 referrals in the first year of the task force's operations, more than it had received in a single year in at least 20 years. Bankers should expect that the significant resources dedicated to the new task force, as well as the Administration's focus on fair lending, will continue to result in heightened levels of ongoing scrutiny on a range of fair lending issues.

This article is designed to help bankers recognize when their institution may be the target of a fair lending inquiry, understand the potential consequences of an alleged fair lending violation, and prevent and defend against a fair lending challenge.

How do I know if my bank is the potential target of a regulatory fair lending challenge?

The typical scenario goes something like this. During a regular compliance examination, examiners identify a sample (typically, a small sample) of unsecured consumer loans. Examiners gather data relating to the pricing of these loans and the ethnicity and/or gender of the bank's

CONTACTS

Chet A. Fenimore, Managing Partner
Direct: (512) 583-5901
cfenimore@fkhfpartners.com

Geoffrey S. Kay, Partner
Direct: (512) 583-5909
gkay@fkhfpartners.com

Lowell W. Harrison, Partner
Direct: (512) 583-5905
lharrison@fkhfpartners.com

Joseph M. Ford, Senior Partner
Direct: (512) 583-5904
jford@fkhfpartners.com

Zonnie Breckinridge, Senior Counsel
Direct: (512) 583-5911
zbreckinridge@fkhfpartners.com

Stephanie E. Kalahurka, Associate
Direct: (512) 583-5903
skalahurka@fkhfpartners.com

Derek W. McGee, Associate
Direct: (512) 583-5902
dmcgee@fkhfpartners.com

Brent Standefer, Jr., Associate
Direct: (512) 583-5906
bstandefer@fkhfpartners.com

ABOUT FKHF PARTNERS

Our firm focuses on representing banks and other financial institutions throughout the United States. We focus our practice on matters that require the attention, extensive experience, expertise and reputation of our partners. As such, we provide partner-intensive service. At all times, our clients are afforded the direct personal attention of partners having expertise and sophistication with respect to the issues. We provide legal advice on all facets of banking, corporate and regulatory law on both a state and federal level.

borrowers from a combination of file review and interviews with bank officers (although not always from the loan officers who made the subject loans). This data is sent to the regulators' statisticians in Washington, who perform a complex regression analysis to determine whether there are statistically significant differences in rates charged to minority versus non-minority borrowers sufficient to justify a finding that discrimination *may have* occurred. This process of collection and analysis takes time, and may cause a compliance examination to be held open for more than a year. When the analysis is complete, the bank is typically given a mere fifteen days to respond to the preliminary examination findings. If the bank is unable to rebut the statistical analysis, the regulators will conclude that a "pattern or practice" of discrimination has occurred.

No evidence of actual intent to discriminate is required.

Banks should understand that the finding of discrimination as a result of the regulatory inquiry may be – and is often – based solely upon the results of the statistical regression analysis, and without any direct evidence of discriminatory conduct. In light of the foregoing, bankers should be on the alert for pointed questions from examiners about the bank's consumer loan pricing practices and requests for confirmation regarding the ethnicity and/or gender of its consumer borrowers. Bankers should also be wary of compliance examinations that are held open for months awaiting the completion of statistical analysis in Washington. Banks that have significant borrowing populations among minorities (*i.e.,* banks lending in largely-Hispanic communities) have a higher risk of being subject to this type of regulatory scrutiny, although all banks are subject to the risk. In fact, we are aware of a number of fair lending inquiries in communities without significant minority ethnic populations that have focused on disparities in lending practices between males and females of the same ethnic origin.

What are the potential consequences of an alleged fair lending violation?

When a "pattern or practice" of discrimination is identified, the regulators will cite a fair lending violation in the bank's compliance examination report, the bank will receive a "less than satisfactory" compliance rating, and the bank's management rating will be downgraded to a "3" rating (or lower). The bank will also receive a rating of "needs to improve" in its public Community Reinvestment Act evaluation. The regulators will also consider administrative enforcement action, which may include the imposition of civil money penalties. Finally, the matter will be referred to the DOJ, after which time the bank will typically no longer have an avenue of appeal within the applicable federal banking agency.

These consequences are only those that relate to the bank supervisory process as a result of an "apparent" fair lending violation. However, fair lending violations may also trigger a DOJ investigation and federal civil charges against the bank. DOJ investigations are time-consuming and expensive. The bank will be required to comply with voluminous document production requests in a litigation-type setting. Requests for production of loan files and pricing information going back as far as six years are not uncommon. A DOJ investigation may extend for more than a year and, depending upon its findings, the DOJ may file suit against the bank in federal court. Even if the bank is successful in its defense, the costs of that defense and the related document production will be substantial, and the bank will be subject to reputational damage.

111 Congress Avenue, Suite 820 Austin, Texas 78701 ● Tel 512.583.5900 Fax 512.583.5940 ● www.fkhfpartners.com

What is the best defense against a fair lending blindside?

The best defense against potential fair lending scrutiny can be summarized in the following important steps:

- Understand ***why*** examination information is being collected and ***how*** it is likely to be used.
- Stay involved in the regulatory process and be proactive in responding to the regulator's initial findings and regression analysis.
- Consider engaging outside statistical expertise at the earliest indication of an adverse finding.

Each of these steps is explained in more detail below.

Step 1. Understand the basis for and use of collected examination information.

As mentioned above, in the typical examination scenario, examiners will identify a sample of unsecured consumer loans and then gather data relating the pricing of these loans from a combination of file review and interviews with bank officers. Examiners may also ask bank officers to review a list of borrowers and confirm the ethnicity of those borrowers (often simply from a list of borrower surnames). From this information, the regulators' statistical experts in Washington will prepare a complex regression analysis, the results of which will determine whether the bank has *apparently* discriminated against its customers.

Because most banks typically have a logical explanation for loan pricing *other than discrimination*, it is critical that information provided to examiners for use in the regression analysis be complete, accurate and reflective of the bank's actual pricing policies. The examiner's job is simply to ask questions (typically in a "yes/no" or "check-the-box" context) and pass on the information to the statisticians for analysis. Consequently, bankers must be proactive to ensure that there is no disconnect between the bank's actual pricing practices and the practices that will be reflected by the data that is collected during the examination. The biggest problem for most banks in this situation stems from the fact that the regulators are collecting and using *quantitative* or binary data to reflect a very *qualitative* or dynamic loan pricing process.

The following example illustrates how erroneous conclusions may follow from an overly rigid and simplistic quantitative assessment of a bank's lending practices:

A compliance examiner asks a bank officer to confirm that borrower deposit relationships are a factor considered by the bank in pricing unsecured consumer loans. The officer responds, "yes," and the examiner goes on to the next question. The information provided by the examiner to the Washington statisticians lists "deposit relationships" among the various pricing factors considered by the bank. The statisticians take this information and, for the purposes of their regression analysis, incorporate a binary (yes/no) control, allowing for an increase in loan pricing when comparing a customer who has a deposit relationship at the bank to a customer who does not have a deposit relationship.

Having done this, the regulators contend that the analysis has "controlled for" deposit relationships in the bank's loan pricing. In actuality, however, the control has done nothing to

111 Congress Avenue, Suite 820 Austin, Texas 78701 ● Tel 512.583.5900 Fax 512.583.5940 ● www.fkhfpartners.com

differentiate between a borrower who has, for example, a $100 deposit relationship and a depositor who has a $100,000 deposit relationship, even though a bank officer would reasonably consider the difference in the size of the deposit relationship when pricing an unsecured consumer loan. Accordingly, all other things being equal, if the regression analysis equates a loan to a minority borrower with a $100 deposit relationship to a loan to a non-minority borrower with a $100,000 deposit relationship, the analysis will assume that any increase in pricing to the minority borrower is due to ethnicity, and not due to the size of the deposit relationship.

This is only one example of how a seemingly innocuous and altogether truthful response to a compliance examiner's question (*i.e.*, "are deposit relationships a factor considered in loan pricing?") can result in a flawed statistical analysis that may have dire regulatory and reputational consequences for the bank. The results of a regression analysis are only as accurate as its underlying data inputs. With this in mind, bankers should ensure that information - especially information relating to the factors considered by loan officers in pricing consumer loans - is accurately and completely conveyed to examiners, and further, that the examiners are accurately and completely conveying that information to the analysts who will be preparing any regression models.

Step 2. Stay involved and be proactive during and after the regulatory examination.

A bank's ability to respond to and defend alleged fair lending violations diminishes the further along the regulators go in the investigation/enforcement process. Moreover, once the regulators have made a referral to the DOJ, the bank will typically no longer have an avenue of appeal within the applicable federal banking agency and some form of enforcement action will become virtually unavoidable.

As we have emphasized, it is important to understand the process and be aware of what is going on from the beginning. Bankers should stay in regular communication with examiners during and after the compliance examination and inquire as to the progress of the examination and the status of any findings. Generally, a bank will have several months between the time that examiners collect information and the results of the regression analysis are finalized. During this period, bank management should proactively follow-up with examiners, requesting status updates as to the progress and results of the regression analysis. It is also common for examiners to contact the bank periodically during this analysis period, requesting confirmation of certain information or following up on questions posed by the statisticians. The bank should use any such request as an opportunity to ask for a status update and, as with the initial information request, the bank should make sure that it fully understands how the information that it is providing will be used so that it may respond in a manner that will accurately reflect the bank's actual loan pricing practices.

Step 3. Consider bringing in outside expertise at the earliest indication of adverse findings

The regression models used by the regulators to evidence fair lending violations are complex and are prepared by statistical experts. Most banks don't have the in-house statistical expertise to fully analyze the regulators' regression models or to create their own, competing analysis. Accordingly, at the first indication of an adverse finding, bank management should consider consulting with experienced

111 Congress Avenue, Suite 820 Austin, Texas 78701 ● Tel 512.583.5900 Fax 512.583.5940 ● www.fkhfpartners.com

statistical experts to assist the bank in identifying any potential flaws or disparities in the regulators' regression analysis and in heading off adverse examination findings.

In the unfortunate event that the bank receives a formal, written notice of adverse findings (typically permitting the bank a mere fifteen days to respond), *immediate* consultation with statistical experts and regulatory counsel becomes imperative. This "15-day letter" almost always signals the bank's last meaningful chance to request more time or to respond before the regulators' findings become "final," triggering the significant and costly consequences discussed above. In our experience, the regulators have been willing to provide extensions of the 15-day response period and to consider competing regression analysis at this stage. Any successful response, however, must be carefully targeted to address the quantitative data included in, and the results of, the regulators' regression model.

What can I do, even before a compliance examination, to proactively prevent fair lending criticism?

All banks should take steps to review the effectiveness of their compliance management control systems as those controls relate to fair lending. In particular, formal policies and procedures addressing consumer loan pricing should be in place and reviewed regularly. Banks should adopt a uniform pricing matrix for unsecured consumer loans. This matrix can permit variations in pricing, but those variations should be based upon legitimate and measurable pricing factors such as credit scores or existing loan or deposit relationships with the bank. Any variations or exceptions from the pricing matrix should be infrequent and should be approved by committee to ensure that those exceptions are being made consistently. For example, one loan officer should not make a 2% pricing exception based upon a specific factor while another loan officer makes a 1% exception based upon the same factor. All exceptions should be thoroughly documented. Finally, all consumer loan officers should receive regular and documented training on the bank's compliance management systems, the Equal Credit Opportunity Act and the related Federal Reserve Regulation B.

Careful adherence to the above recommendations may not ensure that justice is served in every case, but it will discourage the regulators from misapplying an exceedingly blunt enforcement instrument at the expense of your bank and its good reputation.

111 Congress Avenue, Suite 820 Austin, Texas 78701 ● Tel 512.583.5900 Fax 512.583.5940 ● www.fkhfpartners.com