SIDE BY SIDE

A Guide To Fair Lending

Federal
Deposit
Insurance
Corporation

FDIC
Federal Deposit Insurance Corporation
Washington, DC 20429

Office of the Director
Division of Compliance and Consumer Affairs

FIL-36-96
June 6, 1996

FAIR LENDING GUIDE

TO: CHIEF EXECUTIVE OFFICER and COMPLIANCE OFFICER

SUBJECT: Revised Edition of *SIDE-BY-SIDE, A Guide to Fair Lending*

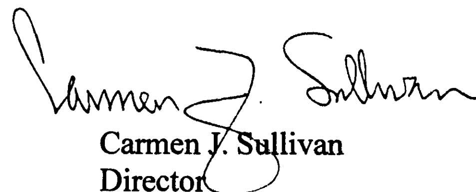
The FDIC has revised its 1994 edition of *SIDE-BY-SIDE, A Guide to Fair Lending* (see FIL-47-94). The new edition is enclosed. The guide offers suggestions on how an institution can compare its treatment of loan applicants through self-assessment. Self-assessment can help prevent and detect illegal discrimination.

The FDIC revised the guide due to the overwhelmingly positive response it received after issuing the 1994 edition. The FDIC also wishes to continue promoting self-assessments as a means of achieving fair lending goals.

The guide's only significant change is the FDIC's policy concerning an examiner's request for the results of self-testing, in which testers are used at the pre-application stage to determine differences in treatments. Under the new policy, FDIC examiners will not ask to review the self-testing results. However, if an institution voluntarily provides documentation of its self-testing efforts, the examiner will consider the results.

At the end of the guide, you will find selected references. We encourage institutions to explore these and other writings on equal credit opportunity.

If you have questions about the guide or request additional copies, please contact the Regional Office of the FDIC's Division of Compliance and Consumer Affairs shown on the attached address list.



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Enclosure

Distribution: FDIC-Supervised Banks (Commercial and Savings)

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SIDE BY SIDE

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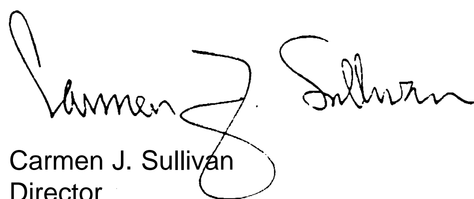
FOREWORD

The Federal Deposit Insurance Corporation recognizes the efforts undertaken by many financial institutions to improve fair lending performance. Every day our examiners and community affairs staff work with compliance officers, loan officers and others who want to ensure equal opportunity in lending. Although few lenders believe that intentional discrimination is prevalent, we know that they all share a genuine concern about the other more subtle or inadvertent forms of discrimination. People treat other people differently and differences in treatment can lead to illegal discrimination. We are also aware of the questions asked by lenders when they begin to address this concern. Does it happen here? How do we know? What can we do?

In this guide, which we first distributed in August of 1994, we provide alternative means that an institution may use to discover uneven customer service or inconsistent lending practices that may be discriminatory. This guide is not about finding discrimination, that is, violations of the fair lending laws. It's about tools that a lender can use to compare the treatment of loan applicants, identify differences and correct potential problems. Financial institutions may decide to use other methods or take a different approach to those we outline here. The process is not mandatory nor are the tools that are discussed in this guide all inclusive. A self-analysis program of detecting and preventing potentially discriminatory practices should not be undertaken to placate regulators or others. Instead, it should be used to help assure equal access to loans. We encourage institutions to employ whatever methods may work best for them to detect and prevent lending discrimination.

The Federal Deposit Insurance Corporation wants to help financial institutions seek ways to know whether discrimination occurs. We have distributed over 35,000 copies of this guide to financial institutions -- compliance officers and senior executives --, to community organizations, and to others. The guide was originally developed to provide a place to begin, take some of the mystery out of the process, and help answer some of the more basic questions. Based on the demand for the guide, we believe the procedures and processes described herein continue to be appropriate tools for financial institutions.



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INTRODUCTION

The Fair Housing Act and the Equal Credit Opportunity Act prohibit lending discrimination.[1] Although these laws have been in effect for many years, lending discrimination continues to be a cause for national concern. This guide will help lenders compare the treatment of loan applicants and identify differences that may be discriminatory. It offers suggestions on how to correct discriminatory practices and improve fair lending performance.

Part One describes how to compare the experiences of testers to determine if all persons asking about credit are provided equivalent information and encouragement. Such lending tests can be performed internally by the lender or by using an independent contractor. The information provided here on how to plan and manage a pre-application testing program will help an institution decide. Testing can help to detect discrimination or it can reassure an institution that it does not discriminate. Its focus is the point where an applicant inquires about a loan, gathers information and receives counseling or an invitation to apply. Discrimination at this important stage of the loan process occurs before it is captured on paper and often results from how one person treated another. We encourage financial institutions to take whatever steps are necessary, including some form of pre-application testing, to inspect the treatment of potential applicants. It will help to prevent illegal discrimination, improve customer service and attain lending goals.

We also encourage institutions to compare the treatment of applicants after submission of an application through a comparative analysis of loan files. Part Two of the guide suggests one method of comparative file analysis. It also provides examples of how loan product features, underwriting standards, or instances of lender assistance to borrowers can be compared to identify unequal treatment that may constitute discrimination. Disparate treatment may occur among any applicants. However, the risk of disparate treatment occurring is higher among applicants who are neither clearly qualified nor clearly unqualified for a loan as there is more room for lender discretion. The system of comparing loan files set out in this guide helps to identify and evaluate such applications.

Evaluating the results of a comparative analysis of tester experiences or actual loan applications requires identifying the different types of discrimination that may have occurred. Part Two discusses how to identify these including overt or subtle discrimination, disparate treatment, disparate impact, an

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[1] The Fair Housing Act, 42 U.S.C. § 3601 et seq., prohibits discrimination based on race or color, national origin, religion, sex, familial status, and handicap, in all aspects of residential real estate transactions, including, but not limited to: making loans to buy, build, repair or improve a dwelling; purchasing real estate loans; selling, brokering or appraising residential real estate; and selling or renting a dwelling.

The Equal Credit Opportunity Act, 15 U.S.C. § 1691 et seq., prohibits discrimination in any aspect of a consumer or commercial credit transaction based on race or color, religion, national origin, sex, marital status, age, receipt of income from any public assistance program, or the exercise, in good faith, of any right under the Consumer Credit Protection Act.

individual instance of discrimination and a pattern or practice of discrimination. Further, it suggests several corrective actions that may be appropriate to consider depending on the circumstances.

Part Three presents excerpts from other widely distributed fair lending guides that provide information useful to the comparative evaluation process. We encourage lenders to review the guides in their entirety.

As financial institutions and their legal counsel may want to evaluate all aspects of a self-assessment program, Part Four discusses what criteria will be used by the regulatory agencies in taking enforcement actions and seeking remedial measures. It further advises that the agencies must refer evidence of discrimination they may uncover to the Department of Justice or HUD even when discovered through a lender's self-testing effort. However, voluntary identification and correction of violations disclosed through a self-testing program will be a substantial mitigating factor in considering what further actions might be taken.

Finally, the closing statement of this guide is perhaps the first step that an institution should take to ensure equal treatment of loan applicants. It highlights the importance of providing multicultural awareness, race, gender and handicap sensitivity training to all levels of an institution's staff.

PART ONE: PRE-APPLICATION TESTING

Self-testing allows an institution to compare, in a controlled manner, the treatment of customers and potential customers. Testing for discrimination can help to find potential problems, or it can reassure an institution that it does not discriminate. In addition, an institution can gain insight into how its lending practices appear from the loan applicant's perspective, a valuable insight not readily available through other internal audit methods.

WHAT IS PRE-APPLICATION TESTING?

Testing is a way of measuring differences in treatment. A financial institution can use pre-application testing to uncover instances of overt or subtle discrimination[2] against individuals protected under the ECOA and the Fair Housing Act. To detect illegal discrimination, testers visit financial institutions posing as prospective loan applicants. While they do not actually complete a loan application, testers do experience the important pre-application phase of the loan process. After discussing loan possibilities, they objectively document how they were treated and the information given to them by the institution's personnel.

There are three basic types of tests: paired, multi-layered or sandwich, and complaint.

Paired Testing

A paired test consists of sending two individuals (or two couples) separately to an institution to collect detailed information about its lending practices. The testers pose as potential applicants for the same type of loan.

Example: To test for discrimination based on race, a white tester and a black tester separately visit a lending institution to ask about applying for the same type of loan. They would be provided with similar background information such as family size and employment. The black tester would generally have a slightly higher income and less debt in order to appear better qualified than his or her white counterpart. Otherwise, the individuals selected as testers should be similar in all significant respects except for the variable being tested (e.g., race, gender, familial status, etc.).

Their experiences would then be compared to determine if the individual in the protected class may have been the victim of discrimination. Importantly, in paired tests, the testers usually do not have knowledge of each other or the purpose of the test. Conducting the test in this manner helps ensure the validity of the test by minimizing the potential for bias in recording experiences.

Multi-layered Testing

Multi-layered testing or "sandwich" testing uses three testers, only one of whom is a protected class member. As with paired testing, the testers should be similar except for the variable being tested.

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[2] Overt discrimination may include, for example, outright refusal to assist an applicant or refusal to accept an application on a prohibited basis. Subtle discrimination may include, among other acts, the discouragement of an applicant based on a prohibited factor, for example, failing to give protected classes the same information or assistance as is given to other applicants.

Example: In testing for discrimination based on sex, the first tester would be male, the second tester would be female, and the third tester would be male. Marital status would be the same for all three and the female tester's qualifications would be slightly better than those of the male testers. This test structure limits non-gender variables leaving gender as the most likely basis for potential differences in treatment.

In sandwich testing, as in paired testing, the testers separately ask about similar financing requirements.

Complaint Testing

Complaint testing, unlike the sandwich or paired scenarios, uses a single tester to evaluate the experience of an actual loan applicant who believes that an illegal discriminatory event has occurred. The tester assumes characteristics similar to the complainant's and attempts to obtain information about the same loan product.

Example: The complainant is Hispanic and believes that his loan application was denied based on his national origin. A white tester would be assigned slightly worse financial and employment qualifications than those of the complainant. The complainant's experiences at the institution would be compared to the white tester's experiences to determine if there were any differences in treatment. If the tester is offered a loan or receives better treatment and more information, then the complainant may have been discriminated against on the basis of national origin.

In all three types of testing, paired, multi-layered and complaint, the testers prepare an objective, factual written account of their experiences on a standardized report form.

Self-Testing or Contract-Testing

Lending tests can be performed internally by the lending institution or by an independent contractor. The decision rests with the institution; however, it is important for each institution to weigh the advantages and disadvantages of either selection carefully.

One advantage of in-house testing is that the institution directly controls the program as it hires the testers and analyzes the results. Disadvantages are that the testing program may divert employees from other tasks, and it may be more difficult to keep the testing confidential. In addition, it may be harder to analyze the results objectively. This may be especially true if the reviewer knows the employee who was tested.

The use of an independent contractor, on the other hand, limits the use of an institution's personnel. Furthermore, objectivity and confidentiality are more easily maintained because fewer people within the institution are privy to testing program information. Disadvantages to using an independent contractor are that their methods may not suit a particular financial institution's needs, experience levels may vary, and costs may be significant. As testing expertise among contractors varies, it is important to verify a contractor's experience level, testing methodology and references. For example, a particular contractor's testing program may only deal with customer service issues and ignore testing for illegal discriminatory lending practices.

The following guide to planning, conducting and evaluating a test are provided for your financial institution's consideration in developing an internal self-testing program or in evaluating an independent contractor's program.

PLANNING THE TEST

The first step in the planning process is to select a test manager knowledgeable in fair lending and capable of supervising all activities before, during and after the test. Planning should include:

- Researching the financial institution's loan products, local demographics, HMDA data and other pertinent information
- Determining which type of test to conduct (e.g., paired, sandwich, or complaint)
- Recruiting and training the testers
- Providing testers with a "testing identity" and detailed instructions on how to complete the test

The number of tests that should be performed to determine if a financial institution may have discriminatory lending practices that are illegal will vary according to the institution's size and loan volume. For example, if testing a multi-billion dollar institution operating in a large metropolitan area, several tests for each branch may be necessary. However, if the financial institution is small or has a low lending volume, more than a few tests may be impractical. The aim is to test a representative sample of an institution's lending staff over time.

Institution size and loan volume also should determine the frequency of testing. For example, all the testing for race discrimination in a financial institution that typically has few minority loan applicants should not be performed in one week nor should the number of tests each week exceed the institution's weekly average of loan applications.

Selecting the Testers

Properly trained, almost anyone can be a tester. The tester pool should reflect the general population in terms of race, color, religion, sex, national origin, age, marital status, and disability. Potential testers may include, retired individuals, teaching professionals, or graduate students among others. For example, the Philadelphia Commission on Human Relations hired as testers recently laid-off, experienced professionals through the area unemployment office. Typically, such recruits present themselves credibly and have good interpersonal and writing skills. Intelligent, dependable individuals who communicate well and think quickly are ideal tester candidates. Hiring testers should be like hiring any good employee.

Independent testing contractors will generally already have a pool of testers. If your institution retains an independent firm, verify that the contractor's

testers are representative of the protected classes you may want to have reflected in the tests.

Training the Testers

Training is a crucial component of any testing program. The amount of time needed to train testers adequately will vary depending upon the experience level of the trainees and of the trainers. Testers should be advised that testing may be conducted even where there is no prior evidence of illegal discrimination. The following issues also should be reviewed with them:

- Court acceptance of testing versus concern about testing as entrapment
- The tester's role as an objective observer and recorder of facts, not as a judge of illegal discrimination
- The need to comply closely with testing instructions
- How to handle unexpected questions

In addition to this basic type of information and instructions on confidentiality, objectivity and accuracy, trainees also should be provided with necessary background information, a tester "identity," and instruction on completing Test Report Forms.

Providing Tester Identities

Testers should be presented with a tester identity before the test. Ideally, a tester would use his or her actual background. However, since it is unlikely that two testers will have similar enough backgrounds, fictitious identities are used for uniformity. As illustrated in Appendix A to this guide, the identities generally include information and instructions needed to complete the test; various personal and financial characteristics that the tester assumes for the test; and information about the lending institution to be tested. To maintain objectivity, however, a tester should not be provided with information about the identities of the other testers or the purpose of the test.

Items that might be included in an identity are:

- Name, Age, Marital Status, and Number of Children
- Employers, Previous Employers, Occupations/Job Titles, Years of Work Experience, and Income for the tester and, if applicable, spouse
- Current Address and Housing Information, Previous Address, Total Household Expense, and Prospective Property Information

- Loan Type and Amount, Savings and Debt Information

- Walk-in Interview or Appointment

As customer service personnel may ask why an applicant selected the particular financial institution, credible reasons for the choice and other pertinent information specific to the financial institution also should be provided to testers.

Identity information should be sufficient for testers to answer adequately most questions asked by a lender. The protected class tester's financial situation and employment record would usually be slightly better than those of the control tester. These differences should only be slight so as to suppress all socioeconomic factors except one, status in a protected class.

Identities should be varied to test for different types of illegal discrimination. For example, to test for discrimination based on receipt of public assistance income, one tester's identity should include that income source and the other tester's identity should not. Other information would generally remain the same. Individuals of the same race should be used when race discrimination is not the testing focus.

Testers should thoroughly familiarize themselves with the information contained in their identity form and consider the following questions:

- Am I uncomfortable with any of the personal characteristics?

- Have I had any prior contact with the institution to be tested or with members of the institution's staff?

- Are any of the instructions unclear?

If answers to any of the questions are yes, then a new tester should be assigned. In cases where the tester is known to institution personnel, or otherwise uncomfortable with the assignment, the test may be compromised.

CONDUCTING THE TEST

As previously stated, testers, without knowledge of each other or the testing hypothesis (e.g., testing for race, age or gender discrimination, etc.), separately visit an institution. Testers are not actually requesting a loan; therefore, they do not file a completed application. However, they do experience the first phase of the loan application process. During the test, it is important for the test manager to ensure that testers:

- Maintain confidentiality & objectivity
- Follow test instructions
- Interview using the "tester identities"
- Complete tests as scheduled
- Carefully document the test experience

Maintaining Confidentiality & Objectivity

The testing program must be kept confidential as any breach of confidentiality could invalidate the tests. Testers should not disclose their involvement in the testing program, or discuss their test experiences with anyone other than the test program manager.

Moreover, testing should be an objective process used to investigate lending practices. Among other things, testers should:

- Remember that testing a particular lending institution does not necessarily indicate that discrimination occurs there
- Refrain from making leading statements that may induce lenders to make biased comments
- Respond neutrally if a lender makes a biased statement

For example, if a loan officer asks, "Why are you looking in that neighborhood? Aren't there a lot of minorities there?" The tester should simply respond, "I'm just trying to get the best house for my money and that neighborhood is where I found it."

If the lender makes an ambiguous statement, the tester should ask questions to get a clearer understanding of what the lender means. For example, if the lender says, "You wouldn't want to buy a house in that neighborhood because your children will not be comfortable at the neighborhood school," the tester may ask questions to find out why the lender thinks the tester's children would not be comfortable at the school.

Most importantly, testers collect facts. Testers should not:

- Make subjective judgements about the person(s) who served them

- Offer opinions concerning their treatment

- Make leading statements about specific protected classes

Testers do not decide if there may have been illegal discrimination or disparate treatment. The test program manager makes that determination based on factual reports submitted by control testers, protected class testers or a complaint tester, depending on the type of test.

Following Test Instructions

Testing is a controlled process. Therefore, testers should avoid deviating from the instructions given them by the test manager, as this too may invalidate test results. If a tester has any questions concerning a particular testing situation, the tester should contact the test manager.

In instances where a telephone call was made to an institution before a site visit, the tester should review the telephone narrative to refresh his or her memory about the information that may have been exchanged. Testers should use common sense to determine suitable testing attire; however, dressing conservatively is usually a good rule to follow. Also, testers should not wear badges or buttons that suggest personal, political or social beliefs.

Interviewing Techniques

Testers should act interested and enthusiastic about obtaining a loan. When testing for discrimination in mortgage lending, testers will usually portray themselves as first-time home buyers so it is plausible that they may not know a great deal about the mortgage lending process; however, some familarity with basic lending terms, such as provided in Appendix B, is advisable.

Testing identities are designed by the test supervisor to specifically control for a variety of discriminatory practices. Deviation from the assigned identity may invalidate the test results. Therefore, it is imperative that testers carefully follow their identity instructions.

Testers should let the loan officer solicit information from them concerning their loan needs and personal qualifications. However, if by the end of the site visit, a loan officer has not been informative, a tester may ask, for example:

- Do you think I will qualify for the loan?

- What type of loan do you recommend based on my qualifications?

- How long is the application process?

- What else do I need to provide you with before submitting my application?

Scheduling the Test

Typically, paired tests should be completed on the same day, preferably within a few hours of each other. However, as previously mentioned, the financial institution's size and loan volume will ultimately determine when tests are scheduled. For example, if a financial institution makes only a few loans per month, test scheduling should be flexible enough to permit an acceptable comparison without raising suspicion.

Documenting the Test

It is natural for persons seeking a loan to take notes during a conversation with a loan officer or other institution personnel. Often, the information given to potential loan applicants is substantial and requires note-taking. However, testers should be careful. The lender may become uncomfortable or suspicious if the tester appears to be writing every word the lender says. Testers should collect materials such as the loan officer's business card or loan information pamphlets. Any written notes and materials should accompany the completed test report sent to the test manager.

Testers should make objective observations of their surroundings during a site visit. Everything from desk nameplates to equal opportunity or fair housing signs posted on walls should be noted and recorded on the report forms at the conclusion of the test.

Furthermore, testers should complete the test as scheduled and contact the test manager if any problems occur. Report forms should be completed immediately after each test while facts are still fresh in the tester's memory. Testers also should promptly deliver their test reports and materials obtained during the site visit to the test manager.

EVALUATING THE TEST

After completing the test, several critical steps are necessary to determine whether illegal discrimination has occurred during the test and what corrective measures should be considered. These include:

- Debriefing the testers
- Completing all test forms
- Analyzing each test carefully
- Writing a report on the results of the test
- Recommending corrective action

Debriefing the Testers

Testers should contact the test manager after a site visit is completed or telephone interaction. This contact allows the test manager to debrief the tester and gives the tester an opportunity to describe any problems that may have arisen during the site visit.

Debriefings will confirm that a test was performed and enable the supervisor to elicit information about the visit. Questions may include the loan representative's name, the interest rate quoted, the amount of time spent with the loan representative or other questions to clarify what the tester reports.

Completing a Report

Nearly every test will require some type of report form. Report forms are used to record information exchanged between the tester and the loan representative during the site visit. Reports usually contain two sections. The first section contains specific questions soliciting information such as whether an appointment was made, the time the visit began and ended, how long the tester waited for an interview, and which loan products were discussed.

Appendix C provides a listing of examples of other questions that may be included in the first section of a testing report.

The second section of a testing report would usually provide space for a tester's narrative, or a comprehensive description of the site visit. The narrative is particularly important because it can be used to validate the tester's responses to the specific questions in the first part of the report. The narrative should begin with the tester first contacting the lending institution, whether

by telephone or in person, and should conclude with the tester leaving the institution. The narrative should include verbatim statements by the loan officer to the tester, where possible, as well as other information received during the test. As the narrative is one of the most important aspects of a report, it should avoid subjective or ambiguous comments.

In addition to the test "report form," there may be other reports for the tester to complete. The most common are:

- Telephone Contact Report: This type of form may be used to record any telephone calls made to a lending institution. Most telephone calls are made before a site visit to the institution. Information from this type of call would generally include:

  - Name of the staff person
  - Purpose of the call
  - Whether the tester asked about any specific programs or products
  - Whether the person informed the tester of a specific program or product
  - Date of the call
  - Whether the staff person requested specific personal financial information or information about the property such as its location or price
  - A narrative description of the conversation

- Follow-Up Report: This type of report may be used to record any post-test attempts by loan staff to contact a tester. Testers should record who made the contact, the type of contact (e.g., mail or telephone), whether a specific product or program was discussed, the date and time of the contact, and a narrative description of the conversation or nature of the contact.

Analyzing the Results

The test manager has sole responsibility for collecting the reports, analyzing the data, and determining whether an institution may have engaged in discriminatory practices. The test results will either show that corrective measures should be considered by the lender or that the institution is serving its clients well and in a manner consistent with the fair lending laws.

The manager analyzes the tester reports to determine if the Equal Credit Opportunity Act or the Fair Housing Act appear to have been violated. Comparing the reports side-by-side will help in identifying inconsistent statements by personnel of the lending institution. For example, report forms

should be examined to see if the lender offered different terms or conditions concerning loan products, interest rates, application fees, loan terms, or provided different information regarding the availability of loans in certain neighborhoods.

Particular attention should be paid to service questions such as: How long did the tester wait for an interview? How was the tester greeted? Where was the tester interviewed? Although differences in the responses to these questions may not necessarily indicate illegal discrimination, different answers may reveal areas where customer service can be improved.

Following the test manager's initial evaluation, another qualified person should analyze the test results. The second analysis provides an internal control against any possible bias of the test manager and may either verify or contradict the manager's initial findings. The second review person should evaluate the reports without knowing the outcome of the first evaluation.

A summary report of both analyses should be completed. If any differences in treatment are discovered, it is important that legal counsel be notified to help determine if any fair lending laws were violated.

Addressing Lender Concerns

Any discussion of pre-application testing would be incomplete without addressing some of the concerns that relate to the use of testers. Some people claim that testing is illegal because testers deliberately set out to look for discrimination, or they criticize testing because they say it is entrapment. If appropriate procedures are followed, testing is not illegal, nor is it entrapment.

At least since 1973, Federal courts have approved using testers to investigate and prove allegations of housing discrimination. To quote one judge: "It would be difficult indeed to prove discrimination in housing without this means of gathering information." Hamilton v. Miller, 477 F.2d 908, 910 n.1 (10th Cir. 1973). Even though testers mislead commercial landlords and lenders, such deception is viewed by the courts as a relatively small price to pay to detect and prevent discrimination.

The criticism that testing is entrapment is insupportable because the defense of having been induced by the government to engage in an illegal act is available only in criminal actions, not under civil discrimination statutes, and where the government has allegedly induced the activity. In the present situation, the FDIC is advocating that institutions test themselves to discover civil violations of law. Therefore, no matter how objectionable testing may seem to some, it is not a defense to a civil charge of discrimination.

Admittedly, some people are suspicious and critical of testing. They may not realize that testing is both a means to discover possible discrimination, and a

protection for law-abiding lenders because it may provide evidence that an institution is not violating the discrimination laws. For example, testing may show that a complaint was unfounded because there is no evidence of discrimination or because a borrower has misinterpreted a lender's practices.

In the latter case, testing may enhance internal controls by bringing to light a practice that might be confusing or offensive to some borrowers. Corrective steps may then be taken.

Correcting Discriminatory Practices

How to correct discriminatory practices that may be discovered is addressed at the conclusion of Part Two on page 26; and Part Four outlines on page 36 what criteria will be employed by the financial institution regulatory agencies in taking enforcement actions or seeking remedial measures when discrimination is discovered.

It also should be noted that if an institution finds a pattern or practice violation through its own self-testing effort, and a federal regulatory agency becomes aware of it, the agency is required under the Equal Credit Opportunity Act, to refer the matter to the Department of Justice whether or not corrective action has been taken. To address lenders' concerns about possible referrals and to encourage the use of self-testing, several agencies, including the FDIC, have agreed not to require or request any information about a lender's self-testing program, except in cases where the agency has independently determined that a lender has unlawfully discriminated and the lender uses the results of self-tests to defend itself against the charge. Even the Department of Justice has announced that, as a general matter, it will not use evidence created by self-testing against the lender that undertook the self-testing, and will not request a lender's self-testing results to form a basis for determining whether to file a pattern or practice complaint. If a lender relies on the results of self-testing to defend itself against a Department of Justice charge of discrimination, the Department will expect the information to be disclosed. To that end, if a fair lending suit is authorized and litigation actually commences following unsuccessful settlement efforts, the Department has reserved the right to seek discovery at that time.

Financial institutions should check with their primary regulatory agency to determine the current position of the agency, or other agencies, on whether, or under what circumstances, it would ever seek the results of the institution's self-testing activity. However, it can only benefit an institution to discover and correct possibly discriminatory practices before an applicant is harmed or a federal regulatory agency learns of them.

A testing program can help an institution assess its compliance with fair lending laws. How useful it will be is up to the institution. Testing should not be done to placate regulators and community groups. Instead, testing should be undertaken to facilitate an institution's ongoing evaluation of its lending policies and procedures in an effort to guarantee equal access to loans.

PART TWO: A COMPARATIVE ANALYSIS OF LOAN FILES

Differences in treatment of applicants that may constitute a violation of fair lending laws can be detected through the comparative analysis of a sample of loan files. The sample should include a target group of applicants from a protected group most at risk of discrimination on a prohibited basis. These should be compared against a control group of others not at risk. It is necessary to inspect and compare individual loan files for both accepted and rejected applicants to determine differences in the actual treatment of applicants and possible illegal discrimination.

The following guidelines present a step-by-step approach to a comparative analysis of loan files. The focus here is on residential mortgage loans because residential mortgage loan applications provide most of the monitoring information necessary to test for illegal discrimination. However, the procedures also can be used to analyze other types of loan applications, such as consumer loans, to the extent that information contained in the applications would allow.[1] The basic steps suggested provide some examples of how loan product features, underwriting standards, or instances of lender assistance to borrowers can be compared to discern differences in treatment. The more detailed the loan file comparison becomes, the better one will be able to test for discrimination and judge an institution's fair lending performance.

[1] Regulation B, Equal Credit Opportunity (12 CFR 202.5), generally prohibits the collection of information on the race, color, sex and national origin of loan applicants except for certain residential loans as defined in 12 CFR 202.13 or as otherwise allowed in 12 CFR 202.5(b).

PLANNING THE ANALYSIS

The first phase of a comparative analysis of loan application files involves planning and preparation. Steps in this process include:

- Selecting a target group from a prohibited basis category to test for differential treatment that may be discriminatory
- Selecting a control group of applicants from a different group not likely to experience illegal discrimination
- Creating a sample of approved and denied applications of the appropriate size from each group

Selecting the Target Group

First, decide which group from a prohibited basis category to test. The selection process should begin with a review of the demographics of the institution's community, an analysis of the institution's HMDA data, and discussions with community representatives, including minority real estate brokers and small business owners who can provide insight into the credit needs of minority communities. An "hypothesis" can then be formed about which types of applicants might be discriminated against, in which loan products, and on what prohibited bases.

Focus on groups in each prohibited basis category that have traditionally been disadvantaged and are most at risk of illegal discrimination. For example, when testing for gender discrimination, target women applicants; or when testing for discrimination based on race or national origin, separately target Black, Native American, Asian, or Hispanic applicants. Be careful not to group Non-White applicants as a "minority target group"; rather, compare each ethnic or racial group individually to White applicants. The loan product to consider might be the institution's most popular product in the community or a product line with a high number of denials to minority or other protected class applicants.

Selecting the Control Group

The control group should be a sample of applicants who seem least likely to have experienced discrimination on a prohibited basis. This group will usually be white males or white couples but may vary depending on local situations. Compare the treatment of applicants in the target group against this group to determine if the target group received less favorable treatment.

Creating the Sample

It is important that all applications in the sample be drawn from the same time period to avoid any mitigating effect that changes in product features, underwriting standards or lending personnel would likely have on the test. For institutions subject to the Home Mortgage Disclosure Act (HMDA) the sample can be selected from entries on the institution's HMDA Loan Application Register (LAR).

Include only approved applications in the control group sample[2], as this will provide evidence of the actual standards and practices used to approve loans.

For the target group sample, the population should include rejected, approved and withdrawn applications. These should be compared against applications in the control group to identify common factors that would upon evaluation indicate disparate or less favorable treatment. Include approved applications and withdrawn applications from members of the target group, in addition to rejected applications, because these may also evidence disparate treatment. For example, members of protected groups may have been approved for loans but on more onerous terms, or applicants from protected groups may have been encouraged to withdraw applications.

Where there are several branches or decision centers, the office locations may affect the type of applicant likely to be attracted to them. For example, if testing for race or ethnic origin discrimination, applications from a branch in an integrated or minority area should be included in the sample with applications from a branch in a predominantly white area to assure an adequate comparison of the treatment of minority and white applicants.

Determining the Sample Size

Unless the total number of rejected and withdrawn application files is unusually large, all such files should be included in the target group sample. All rejected and withdrawn applicants of the targeted protected group should be presented on a sample spreadsheet. Once the target group sample is selected, you can calculate the size of the control group. Generally, the control group sample should be at least as large as the target group sample; but if the target group is small, the control group may need to be significantly larger (e.g., four times the size or more) to ensure that there is an adequate basis for comparison.

The size of the sample will vary depending on the size of the institution, volume of loans, and the number of offices. If there is an insufficient loan volume from which to draw a valid sample, the period covered by the sample should be expanded.

[2] Initially, the control group sample should consist only of approved applications as the primary purpose of the comparison is to identify similarly situated target group applicants who were treated less favorably. If any are identified, a next step may be to compare them against a sample of denied applications from the control group to determine if similarly situated control group applicants may have been denied on a different prohibited basis.

COMPARING THE FILES

Several basic steps can facilitate an orderly analysis of the sample of applications created. These include:

- Placing the sample on a spreadsheet and developing a list of comparative factors
- Identifying any exceptions to institution lending policy or practices
- Comparing applications from the target group and the control group to determine differences in treatment of the applicants

Creating a Comparison Spreadsheet

After creating the sample of loan applications, place them on a spreadsheet. Appendix D to this guide contains an example of one such spreadsheet - "Mortgage Lending Decision Analysis (MLDA) Worksheet." Using a spreadsheet will help to determine if the reasons for an applicant's denial are consistent with the institution's lending policies and practices and whether policies and practices are consistently applied without regard to any prohibited bases. Appendix D lists additional items that a lender might include on the spreadsheet to more adequately determine unfavorable treatment of target group applicants. Other factors can be added as a lender may deem necessary. In particular, a lender may want to include such items as assistance in completing an application or cross-selling more suitable loan products or other services. These and other factors could indicate whether the quality of assistance offered to target applicants and control applicants differ in any way.

Identifying Exceptions to Policy or Standard Practice

Review all applicant profiles to identify any exceptions to loan policies for each item on the sample spreadsheet such as minimum and maximum mortgage loan amounts, analytical ratios and other decision factors used by the institution. In addition, any exceptions made to articulated policy standards or common practices regarding the nature and length of employment, credit history, underwriting and appraisal standards, or any other loan decision criteria should be identified. It also should be determined whether there is any pattern to the exceptions such that the exceptions may have become a standard practice or policy. The likely effect this may have on protected groups should be evaluated.

Identifying Unequal Treatment

The control group should be compared with the target group to establish equal or different treatment in the terms and conditions of loans (e.g., the length of

the amortization periods, interest rates, special fees, or higher fees on smaller loans) and the quality of assistance offered to an applicant.

Terms and Conditions. Each key ratio should be compared for target applicants and control applicants to discern individual differences in treatment and possible patterns. Specific geographic areas should be reviewed for differential treatment as this may indicate "redlining." When comparing target group applicants to control group applicants, it is not necessary for all the applicant characteristics to be similar. The focus should be on similar "flaws" in applicant characteristics that may have resulted in the denial of a target group applicant but not a control group applicant. For example, if target group applicants appear to be denied credit based on debt-to-income ratios that exceed the institution's normal underwriting standards, you should look for approved control group applicants with debt-to-income ratios similar to those of denied applicants. Other inconsistencies may include:

- Minority applicants denied due to debt service ratios and non-minority applicants approved with identical debt service ratios

- Applicants from minority neighborhoods or with a handicap offered a shorter term than other applicants

- Interest rate inconsistencies that were not based on valid lending criteria

- Lower loan-to-value ratios that predominate for loans secured by property in minority neighborhoods

Quality of Assistance. It is important to remember that the risk of disparate treatment is higher in the treatment of applicants who are either "marginally" qualified or "marginally" unqualified. Here there is more room for lender discretion and "valid" reasons for denying loans to minority applicants may not have been applied in the cases of non-minority applicants with similar characteristics. In addition, offsetting reasons for approving a loan to a marginally qualified non-minority applicant could involve information the lender may usually fail to consider for minority applicants. For example, the lender may request an explanation for derogatory credit report information from a white applicant but fail to do so for a minority applicant, whose qualifications otherwise fall within the institution's underwriting guidelines, with derogatory credit information.

A pattern of inconsistencies should raise questions that require a review of lending policies and discussions with loan staff. For example, if "insufficient income" is cited often as the reason for denial of applicants from a prohibited basis group, one might ask for the institution's definition of income; whether all of an applicant's income is considered; whether the loan policies are too restrictive; or whether more restrictive practices exist in the market area.

Another example would involve whether there is a possible pattern of "underappraisals" for members of the target group. On the spreadsheet include a

category for “Loan-to-Selling Price Ratio” to help determine if the loan-to-price ratio is consistently less than the loan-to-value ratios for members of the target group or for properties in some of the institution’s lending areas. These ratios can indicate possible under-appraisals, which may be a problem for protected groups. An institution should then reconsider its appraisal review process and discuss the problem with staff or fee appraisers.

In addition, foreclosure files, collection files, and institution owned real estate files should be reviewed individually or, if there is a large enough number, a sample may be reviewed.

Exceptions found in the sample review process should be discussed with loan department personnel to establish any additional information that may have a bearing on a particular application’s decision. Each file where an inconsistency is present should be reviewed to determine whether any practices have a discriminatory effect on minorities, women, or other protected groups. If no reasonable explanation for the inconsistencies can be determined, then a violation may exist. Where denials or more restrictive terms correlate with particular census tracts or neighborhoods and, again, no reasonable explanation for the inconsistencies can be determined, then unlawful redlining also may be a possibility.

EVALUATING THE RESULTS

After each target group loan file has been reviewed and compared for different treatment, a determination must be made about whether the differing treatment constitutes a violation of law. Substantive as well as technical violations should be identified in addition to different types of discrimination. It also should be determined whether any violations constitute a pattern or practice of discrimination.

Identifying Technical and Substantive Violations

Unlawful discriminatory practices range from the overt to the very subtle. The motivations behind such practices range from prejudice to simple ignorance of the law. Violations generally fall into two categories: technical and substantive. Within the category of technical violations, some may be procedural, such as not having the Equal Housing Lender poster on display. However, technical violations, especially of a repetitive nature, can be indicators that possible substantive violations may also exist. Substantive violations involve actual discrimination on a prohibited basis, either disparate treatment or disparate impact.

Identifying Types of Lending Discrimination

When evaluating the results of the analysis, look for any evidence of overt discrimination, as well as evidence of disparate treatment and disparate impact.

Evidence of overt discrimination exists when a lender openly and blatantly discriminates on a prohibited basis.

Disparate treatment occurs when a lender treats an applicant differently based on one of the prohibited bases. Disparate treatment ranges from overt discrimination to more subtle differences in treatment. As discussed earlier, disparate treatment may more likely occur in the treatment of applicants who are neither clearly well-qualified nor clearly unqualified for a loan. Even when there is an apparently valid explanation for a particular difference in treatment, further investigation may indicate disparate treatment.

Disparate impact occurs when a policy or practice applied equally to all applicants has a disproportionate adverse impact on applicants in a protected group. However, identifying the existence of a possible disparate impact is only the first step in finding lending discrimination. The next step is to determine whether the policy or practice is justified by a "business necessity." For example, a lender's policy, in effect for several years, does not permit mortgage loans for less than $60,000. If this minimum loan amount is shown to disproportionately exclude potential minority applicants from consideration because of their income levels or the value of the houses in certain areas in

which they live, the lender will be required to justify the "business necessity" for the policy. The justification may not be hypothetical or speculative. Yet, factors that may be relevant to the justification could include, for example, cost and profitability.

Even if a policy or practice that has a disparate impact on a prohibited basis can be justified by "business necessity," it may still be found to be discriminatory if an alternative policy or practice could serve the same purpose with less discriminatory effect. However, where the policy or practice is justified by "business necessity" and there is no less discriminatory alternative, a violation of the Fair Housing Act or the ECOA may not exist.

Identifying a Pattern or Practice

It is important to identify both individual violations and possible patterns of violations. Isolated, unrelated or accidental occurrences will not constitute a pattern or practice of discrimination. However, repeated, intentional, regular, usual, deliberate or institutionalized practices will almost always constitute a pattern or practice.

In determining whether a pattern or practice exists certain factors should be considered, including whether the conduct appears to be grounded in either written or unwritten policy or an established practice; whether there is evidence of similar conduct to more than one applicant; whether the conduct is within an institution's control and the relationship of the number of instances of the conduct to total lending activity. Depending on the circumstances, violations that may involve only a small percentage of an institution's total lending activity could constitute a pattern or practice.

The evaluation should focus on detecting the presence of both individual instance and systemic violations, and should evaluate internal controls present within the institution to prevent and detect discrimination. Lenders should review any articulated standards or lending policies for possible violations and to detect:

Purposeful discrimination. This includes both overt and the less obvious types of discrimination such as disparate treatment when strict standards are used to reject applicants on a prohibited basis, but more flexible standards are applied selectively to others;

Disparate impact. This includes a policy or practice that may be applied equally to all credit applicants, but the policy or practice has a disproportionate adverse impact on applicants from a group protected against discrimination; and

Unduly subjective standards. This includes no standards or non-specific standards. Such subjectivity can lead unintentionally to allowing prohibited factors

to influence an institution's decision-making process. Historic customs concerning race, gender or handicap discrimination, for example, may continue to be practiced until clear and direct policies ensuring nondiscrimination are in place.

Correcting Discriminatory Practices

If an institution discovers practices that may be discriminatory, it should determine the cause and consider taking appropriate corrective actions including, but not necessarily limited to:

- Identifying applicants whose applications were processed inappropriately and, with legal counsel's advice: offering to extend credit if applicants were denied improperly and compensating them for any damages, both out-of-pocket and compensatory, and notifying them of their legal rights

- Correcting any institutional policies or procedures that may have contributed to the discrimination

- Identifying, training or disciplining the employees involved

- Considering development of community outreach programs or changes in marketing strategy or loan products to better serve minority segments of the market area

- Improving audit and oversight systems to ensure there is no recurrence of the discrimination

PART THREE: OTHER GUIDES TO FAIR LENDING

Many useful guides to detecting and preventing illegal lending discrimination have been developed in recent years by the regulatory agencies and others. With the passage of time, some may have been put aside, overlooked, or forgotten. Included in this section are excerpts from several that outline how lenders can evaluate and improve fair lending performance.

How to Evaluate and Improve Fair Lending Performance

Home Mortgage Lending and Equal Treatment, A Guide for Financial Institutions, published by the FFIEC in November, 1991, highlights some lending standards and practices that may on the basis of race, sex, handicap, or certain other factors adversely affect the ability of credit applicants to obtain home mortgages. A summary is provided here that alerts lenders to less obvious forms of discrimination discussed in the previous sections of this guide and suggests ways to avoid them.

Closing the Gap - A Guide to Equal Opportunity Lending, a publication of the Federal Reserve Bank of Boston released in April, 1993, presents a comprehensive approach that financial institutions can take to address possible discrimination in lending and improve fair lending performance. It emphasizes participation and involvement at all levels of lender operations. While the focus is on mortgage lending, most of the recommendations apply to other lending areas, including consumer, commercial and small business lending. A fair lending check list from Closing the Gap is highlighted here to assist lenders in evaluating performance.

Suggested Lending Activities. In a public announcement on May 27, 1993, the federal financial institutions supervisory agencies jointly communicated to lenders eleven activities suggested as a means to improve fair lending performance. We include them in this section.

The FDIC Compliance Examination Manual and the examination procedures and guidelines in use by other regulatory agencies are a useful source of information to assist financial institutions in developing self-assessment programs. Excerpts presented here from the FDIC Fair Housing Examination Procedures expand upon the discussion in the previous section on policies, procedures and subjective lending criteria that may raise questions of disparate impact discrimination.

We encourage financial institutions to contact the agencies cited for copies of the source documents in their entirety.

Home Mortgage Lending and Equal Treatment
A Guide for Financial Institutions

Published by:
Federal Financial Institutions Examination Council
1776 G Street, NW, Suite 850B,
Washington, DC 20006

The FDIC distributed a camera-ready copy of this brochure in a letter to financial institutions on March 16, 1992 (FIL-19-92). It presents examples of lender requirements that may have a discriminatory effect on minority applicants and offers several recommendations. While the principles outlined apply to all forms of discrimination, the guide focuses on discrimination based on race in several areas of the lending process. The following is a summary of several of its recommendations:

Loan Origination Process

To assure that lending personnel are applying standards appropriately, lenders should:

- Reassess property standards and minimum loan amounts that may not consider neighborhood differences in minority areas
- Investigate credit practices for possible pre-screening when disproportionate low application levels are found for particular groups
- Develop a simple "equal opportunity in lending" policy statement and periodically discuss it with staff
- Print detailed information about mortgage loan terms and qualifications and make it easily available to loan officers and the general public. Information about steps applicants can take to help them qualify, such as monetary gifts from others to meet a downpayment, can be made available. Discrimination is less likely to occur if information regarding qualifications, rules, common exceptions, and helpful hints is clearly spelled out in writing, made available in the lobby, and explained to all applicants.

Appraisal Process

If appraised values appear to play a substantial role in rejections or reductions of loan amounts in minority areas, lenders should:

- Determine that appraisers have recently received effective fair housing training and subscribe to current fair housing standards of the Appraisal foundation or other organizations

- Be alert to two appraisal practices most likely to cause equal opportunity problems:

First, *in the cost approach to value,* racial bias may be reflected in unsupported adjustments for "functional and economic obsolescence." Lenders should not assume that large adjustments are appropriate just because a home or neighborhood is over a certain age.

Second, *in the comparable sales approach,* racial bias may cause the appraiser to select comparables or make adjustments that are inappropriate.

Marketing Process

Lenders also should be sensitive to potential discriminatory effects of their marketing practices, in particular:

- Where lender strategies fail to include contact with minority realtors and other realtors serving predominately minority areas, there is almost always a low level of minority applicants

- Similarly, lender advertising can have dramatic effects on the way minority borrowers view lenders. Failure to advertise in media directed to minority areas, or in media known to appeal to minorities, can limit the ability of an institution to attract minority applicants.

Private Mortgage Insurance

In addition to reviewing and revising their own standards and practices lenders can also attempt to influence the standards of private mortgage insurers. Lenders should:

- Carefully review rejections of loans submitted to private mortgage insurance companies

- Select companies that may be more receptive to ideas for changes

CLOSING THE GAP

Published by:
Federal Reserve Bank of Boston
P. O. Box 2076
Boston, MA 02106 (617) 973-3459

Recognizing that fair lending is good business "Closing the Gap" states that lenders, and their regulators, should look for ways to eliminate the unjustified lending disparities that have been documented over the years. A series of questions from it are included here to assist lenders in evaluating fair lending performance.

1. When hiring, do you seek cultural diversity which reflects the demographics of your community?

2. When hiring lending staff, do you take into account possible racial, religious or other prejudices of job applicants?

3. Do you train all staff in the area of fair lending?

4. Do you have any mechanisms through which unfair lending practices, policies, or procedures may be detected? If so, are you able to determine the effectiveness of those mechanisms?

5. Do you inform all potential borrowers, regardless of their race or ethnic background or the location of the property, about all of your lending programs so they may decide which best fits their needs?

6. Do you deliberately steer minority applicants to federally insured programs because you assume that minorities are less credit-worthy?

7. Do you have mortgage lending practices that include location of property as a risk factor?

8. Does your mortgage pre-qualifying procedure tend to encourage or discourage minority applicants?

9. Do you offer home-buyer education programs for potential applicants who are unfamiliar with the mortgage lending process?

10. Do you regularly review your advertising to see if the choice of illustrations or models suggests a customer preference based on race?

11. Are you as assertive in attracting minority applicants as you are in attracting non-minority applicants?

12. Are you familiar with the practices of the real estate and mortgage brokers with whom you do business?

13. Do you encourage the brokers and appraisers with whom you do business to be constructively active in minority communities?

14. All things being equal, do non-minority and minority credit applicants have the same chance of getting a loan from this financial institution?

FDIC COMPLIANCE EXAMINATION MANUAL

Available by Subscription from the FDIC
Fair Housing Section

In the previous section of this guide, A Comparative Analysis of Residential Loan Applications, we stressed the importance of reviewing loan policies and procedures for any disparate impact implications, i.e., where policies and practices may appear neutral on their face but have the net effect of a disparate impact on a protected group. If an adverse effect or impact on a prohibited bases group is shown, it is the responsibility of the institution to justify the particular policy or practice by a "business necessity." Some policies or practices that may raise disparate impact questions include, but are not limited to, the following excerpted from the "FDIC Compliance Examination Manual":

- A requirement that the property securing a mortgage loan must not exceed a particular age, or appraisal practices that establish unrealistically low values for older properties
- Restricting mortgage lending to loans for certain types of properties, such as single family homes, properties having no more than two floors, those with large lots, garages, or with large square footage requirements
- A policy of not making loans on properties in certain locations or appraisal practices that arbitrarily discount the value of a property because of its location
- A policy of making mortgage loans only to applicants who have previously owned a home
- Establishing highly restrictive downpayment or income requirements, e.g., requiring a 25 percent downpayment or setting a very low (such as 20 percent) maximum monthly mortgage payment to income ratio
- Setting high minimum mortgage loan amounts that effectively exclude low-income borrowers or low maximum loan amounts that limit the financial institution's participation in the mortgage market
- Arbitrarily excluding FHA or VA mortgage loans

In addition, general and not specific subjective lending criteria may raise effects test or disparate impact questions. Examples of subjective lending criteria that may lead to possible unlawful discrimination include:

- The property should be in a "stable" or "rising" area, should be "well-maintained" and have an "attractive appearance" or "good curb appeal"

- The neighborhood should be “desirable”; there should be “homogeneity of residents and structures”; or the neighborhood should reflect “satisfactory pride of ownership”

- Applicants must not be of “questionable” character; must have an “excellent” credit rating; or must have “adequate” longevity on the job

Such subjective criteria may allow lending personnel to arrive at differing interpretations. Also, they may have the effect of discouraging creditworthy applicants.

SUGGESTED LENDING ACTIVITIES

Press Release, May 27, 1993
Federal Deposit Insurance Corporation
Federal Reserve Board
Comptroller of the Currency
Office of Thrift Supervision

On May 27, 1993, the federal financial institutions supervisory agencies jointly communicated their deep concerns about lending discrimination in a letter to the chief executive officers of financial institutions. The letter urged special attention to the following 11 activities suggested to improve fair lending performance:

- Using an internal review system for consumer, mortgage and small business loan applications that would otherwise be denied
- Enhanced employee training that engenders greater sensitivity by financial institution management, and employees, to racial and cultural differences in our society
- Training of loan application processors to assure that any assistance provided to applicants in how to qualify for credit is provided consistently to all loan applicants
- Efforts to ensure that all persons asking about credit are provided equivalent information and encouragement
- Affirmative marketing and call programs designed to assure minority consumers, realtors, and business owners that credit is available on an equitable basis; marketing may involve sustained advertising programs covering publications and electronic media that are targeted to minority audiences
- Ongoing outreach programs that provide the institution with useful information about the minority community, its resources, credit needs and business opportunities
- Participation on multi-lender Mortgage Review Boards that provide second reviews of applications by participating lenders
- Participation in public or private subsidy or guarantee programs that would provide financing on an affordable basis in targeted neighborhoods and communities
- Use of commissions or other monetary or nonmonetary incentives for loan officers to seek and make safe and sound consumer and small business loans in minority communities

PART FOUR: ENFORCEMENT ACTIONS AND REMEDIAL MEASURES

In order for financial institutions and their legal counsel to evaluate any self-assessment program adequately, it is important to know how the regulatory agencies will respond to illegal discrimination.

If a pattern or practice violation is identified through an institution's own self-assessment effort, and a federal regulatory agency becomes aware of it, the agency is required under the Equal Credit Opportunity Act to refer the matter to the Department of Justice whether or not corrective actions have been taken. As noted in Part One, in order to address lenders' concerns about possible referrals and to encourage self-assessments, several agencies including the FDIC and the Department of Justice, have agreed to seek self-testing results only when a lender uses self-testing to defend itself against a charge of discriminatory activity brought by the agency through an independent determination. While this policy has not been expanded by most agencies to apply to other methods of self-assessment, self-discovery and correction of possibly discriminatory practices before an applicant is harmed or a federal regulatory agency learns of them can only benefit an institution. Voluntary identification and correction of violations disclosed through a self-testing program will be a substantial mitigating factor in evaluating what actions should be taken.

It is also important to consider what criteria will be employed by the federal banking regulatory agencies in taking enforcement actions or seeking remedial measures when discrimination is discovered. These criteria are outlined below in an excerpt from the Policy Statement on Discrimination in Lending issued by the Interagency Task Force on Fair Lending.

Policy Statement on Discrimination in Lending

Issued by:
Interagency Task Force on Fair Lending
Provided to FDIC supervised institutions as FIL 29-94, dated April 29, 1994.
Published in the Federal Register 59 FR 18266, dated April 15, 1994.

The Policy Statement on Discrimination in Lending was released in March of 1994 by the Interagency Task Force on Fair Lending. It was issued jointly by the Federal Deposit Insurance Corporation, U. S. Department of Housing and Urban Development, U. S. Department of Justice, Office of the Comptroller of the Currency, Office of Thrift Supervision, Board of Governors of the Federal Reserve System, Federal Housing Finance Board, Federal Trade Commission, National Credit Union Administration, and Office of Federal Housing Enterprise Oversight.

The policy statement was issued to provide guidance about what the agencies consider in determining if lending discrimination exists. The policy statement discusses what constitutes lending discrimination under the Equal Credit Opportunity Act and the Fair Housing Act, answers questions about how the agencies will respond to lending discrimination, and outlines what steps lenders might take to prevent discriminatory practices.

In a series of questions and answers it also explores what criteria will be employed by the federal banking regulatory agencies in taking enforcement actions or seeking remedial measures when discrimination is discovered. In addition to any referrals to the Department of Justice or HUD that may be required, the federal banking agencies are authorized to use the full range of their enforcement authority under 12 U.S.C. 1818 to address discriminatory lending practices. This includes authority to seek:

- Enforcement actions that may require both prospective and retrospective relief

- Civil Money Penalties (CMPs) in varying amounts against the financial institution or any institution-affiliated party (IAP) within the meaning of 12 U.S.C 1818(u), depending, among other things, on the nature of the violation and the degree of culpability

In addition to the above actions, the federal banking agencies also may take removal and prohibition actions against any IAP where statutory requirements for such actions are met.

The federal banking agencies will make determinations about the appropriateness of any potential enforcement action after giving full consideration to a variety of factors. In making these determinations, the banking agencies will consider:

- The number and duration of violations identified

- The nature of the evidence of discrimination (i.e., overt discrimination, disparate treatment or disparate impact)

- Whether the discrimination was limited to a particular office or unit of the financial institution or was more pervasive in nature

- The presence and effectiveness of any anti-discrimination policies

- Any history of discriminatory conduct

- Any corrective measures implemented or proposed by the financial institution

The severity of the federal banking agencies' enforcement response will depend on the egregiousness of the financial institution's conduct. Voluntary identification and correction of violations disclosed through a self-testing program will be a substantial mitigating factor in considering whether to initiate enforcement action. In addition, the federal banking agencies may consider whether an institution has provided victims of discrimination with all the relief available to them under applicable civil rights laws.

The federal banking agencies may seek both prospective and retrospective relief for fair lending violations.

Prospective relief may include requiring the financial institution to:

- Adopt corrective policies and procedures and correct any financial institution policies or procedures that may have contributed to the discrimination

- Train financial institution employees involved

- Establish community outreach programs and change marketing strategy or loan products to better serve all sectors of the financial institution's service area

- Improve internal audit controls and oversight systems in order to ensure there is no recurrence of discrimination

- Monitor compliance and provide periodic reports to the primary federal regulator

Retrospective relief may include:

- Identifying customers who may have been subject to discrimination and offering to extend credit if the customers were improperly denied

- Requiring the financial institution to make payments to injured parties

Restitution: This may include out-of-pocket expenses incurred as a result of the violation to make the victim of discrimination whole, such as: fees or expenses in connection with the application; the difference between any greater fees or expenses of another loan granted elsewhere after denial by the discriminating lender; and, when loans were granted on disparate terms, appropriate modification of those terms and refunds of any greater amounts paid.

- Requiring the financial institution to pay Civil Money Penalties (CMPs)

The banking agencies have the authority to assess CMPs against financial institutions or individuals for violating fair lending laws or regulations. Each agency has the authority to assess CMPs of up to $5,000 per day for any violation of law, rule or regulation. Penalties of up to $25,000 per day are also permitted, but only if the violations represent a pattern of misconduct, cause more than minimal loss to the financial institution, or result in the gain or benefit to the party involved. CMPs are paid to the U.S. Treasury and therefore do not compensate victims of discrimination.

- Other Affirmative Action

The federal banking agencies also have the authority to require a financial institution to take affirmative action to correct or remedy any conditions resulting from a pattern or practice. The banking agencies will determine whether such affirmative action is appropriate in a given case and, if such action is appropriate, the type of remedy to order.

CONCLUSION

A FINAL WORD

The closing recommendation of this guide is perhaps the first step that an institution should take to ensure equal treatment of loan applicants. Stereotyping others can lead to often unintentional differences in treatment which, in turn, may lead to illegal discrimination. Although prohibited lending discrimination may be unintentional, it is, nevertheless, against the law. Multicultural awareness, race, gender, and handicap sensitivity training should be provided to all levels of a financial institution's personnel. It can give them insight into how they may stereotype others who are different and, perhaps, treat them less favorably. An ounce of prevention is worth a pound of cure. As a first step, taken with the others proposed in this guide, it can help to prevent illegal lending discrimination.

APPENDIX A: TESTER IDENTITY

Personal Information:

Name: ______________________________
Race: __________ Age: __________ Sex: __________

Current
Address: ______________________________

Marital Status: ______________ How Long: __________
Spouse's Name: ______________ Age: __________

Number of Children: ______________
Names/Ages: ______________________________

Years at Current Address: ______________________________
Rent Amount: ______________________________

Previous Address: ______________________________
Years at Previous Address: ______________________________
Rent Amount: ______________________________

Employment Information:

Employer: ______________________________
Occupation: ______________________________
Address of Employer: ______________________________
____
Length of Employment: ______________________________
Monthly Gross Income: ______________________________
Annual Gross Income ______________________________
Monthly Net Income: ______________________________

Previous Employer: ______________________________
Occupation: ______________________________
Length of Employment: ______________________________
Monthly Gross Income: ______________________________
Annual Gross Income: ______________________________
Monthly Net Income: ______________________________

Spouse's Employer: ______________________________
Occupation: ______________________________
Length of Employment: ______________________________
Monthly Gross Income: ______________________________
Annual Gross Income: ______________________________
Monthly Net Income: ______________________________

Spouse's Previous Employer: ______________________________
Occupation: ______________________________
Length of Employment: ______________________________
Monthly Gross Income: ______________________________
Annual Gross Income: ______________________________
Monthly Net Income: ______________________________

Total Annual Household Income: ______________
Gross: ______________
Net: ______________

Credit Information:

Charge Card(s):	Balance	Monthly Payment
(1)		
(2)		
(3)		

Loan(s):	Balance	Monthly Payment
(1)		
(2)		
(3)		

Other Financial Information:

Savings: ______________________________

Amount: ______________________________

Checking: ______________________________

Amount: ______________________________

Other: ______________________________

Housing Information:

Neighborhood/House Location ______________________________

Address: ______________________________

Size/# Bedrooms: ______________________________

Style: ______________________________

Age: __________ CAC: __________ Garage Type: __________ Taxes: __________

Sales Price: ______________________________

Closing Date: ______________________________

Down payment: ______________________________

Source: ______________________________

Other closing costs: ______________________________

Source: ______________________________

Information about the Financial Institution:

Name: ______________________________

Address: ______________________________

Phone: ______________________________

Hours: ______________________________

How you found this office: ______________________________

Miscellaneous:

Other
Instructions: ____
____
____
____
____
____
____

APPENDIX B: LENDING GLOSSARY FOR TESTERS

The Lending Glossary is used to familiarize testers with various lending terms that are useful to know prior to a lending institution site visit.

Term	Definition
Adjustable (or Variable) Rate Mortgage (ARM)	A mortgage on which the rate is subject to periodic adjustment. The method, frequency, and basis for the change are disclosed to the borrower. ARM rates are usually tied to some widely published market rate of interest or index.
Amortized Mortgage Loan	A mortgage loan that provides for regular repayments at stated intervals, usually monthly, quarterly, or semiannually, to reduce the principal and to cover interest as it comes due.
Application Fee	A charge by financial institutions to cover the initial costs of processing a loan request and checking credit.
Appraisal	An independent estimate of the fair market value of real estate. An appraisal fee is part of the closing costs for a loan.
Closing Costs	The costs to a borrower of closing a mortgage loan. These usually include an origination fee, title search and insurance, attorneys fees, survey fee, home inspection fee, and prepaid items such as taxes and insurance escrow payments.
Conventional Loan	A mortgage loan that is not insured by the Federal Housing Administration or guaranteed by the Veterans Administration or Farmers Home Administration.
Debt-to-Income Ratio	The ratio of the borrower's monthly debt to monthly income, using either net or gross income levels, expressed as a percentage. An acceptable ratio may differ according to the loan product or available down payment.
Down Payment	An amount equal to the difference between the purchase price of a house and the down payment. Conventional loans usually require a down payment of 5%-20%; federally insured loans often require less than 5%.

Earnest Money	A portion of a down payment delivered to a seller or an escrow agent by the purchaser of real estate, along with a purchase offer, as evidence of good faith in negotiating the purchase of the property. The purchaser forfeits the earnest money if the sale is not consummated through the fault of the purchaser.
Federal National Mortgage Corporation ("Fannie Mae")	A corporation chartered by Congress that purchases and sells conventional and federally insured residential mortgages.
Federally Insured Loans	Loans insured against default by the Federal Housing or Veterans Administration.
Federal Home Loan Mortgage Corporation ("Freddie Mac")	A corporation authorized by Congress to purchase conventional mortgages from depository institutions and HUD approved mortgage bankers.
Fixed-Rate Mortgage	A mortgage with a constant rate of interest over the life of the loan.
Hazard Insurance	Insurance covering physical damage to property by natural causes, vandalism, and other causes.
Loan Origination Fee	The amount the lender charges for handling the initial application and the processing of a loan.
Loan-to-Value Ratio	The ratio between the amount of a loan and the appraised value of property securing the loan, expressed as a percentage of the appraised value.
Point	A prepaid finance charge imposed by the lender at closing to increase its yield beyond the stated mortgage interest rate. A point equals one percent of the loan amount.
Private Mortgage Insurance	Insurance written by a private company protecting the mortgage lender against loss from a default by the borrower. Premiums are paid by the borrower. Often referred to as "PMI."
Survey	A measurement of land showing its location with reference to known points, its dimensions, and the location and dimensions of any improvements. Surveys are often required by lending institutions to show that the lot on which a house is located has not been encroached upon by another structure.
Title	Legal evidence of ownership of real or personal property.

Title Insurance — Insurance for lenders and/or borrowers against financial loss resulting from claims arising out of defects in the title to real property which may not have been discovered during the title search. The cost of the policy is based on the loan amount, and it often paid by the buyer.

Title Search — A review of public records to disclose past and current facts about the ownership of real property.

APPENDIX C: TESTING REPORT FORM

SAMPLE QUESTIONS

1. Tester's Name, Address and Phone Number
2. Name and Address of the Lending Institution or Branch of the Lending Institution
3. Date of test
4. Was an appointment made?
5. If an appointment was made, with whom?
6. Time visit began
7. Time visit ended
8. When you entered the office, did you?
   a. Talk to a secretary, receptionist or teller who referred you to a manager or officer.
   b. Talk to a secretary, receptionist or teller who referred you to someone else.
   c. Talk to a secretary, receptionist or teller who then interviewed you.
   d. Talk to a manager or officer who then interviewed you.
   e. Talk to a manager or officer who referred you to someone else.
9. How long did you wait for interview?
10. Where did you wait?
11. Name of person who interviewed you
    -Individual's race and gender
12. Where was your interview?
13. How long was your interview?
14. Did the interviewer (Circle all that apply):
    a. Introduce him/herself to you.
    b. Offer a business card.
    c. Ask your name.
    d. Shake your hand.
    e. Smile at initial contact.
    f. Look you in the eye at initial contact.
    g. Ask you to be seated.
    h. Offer you any coffee or other refreshment.
15. Did you receive a business card or other written information?
    If yes, describe and attach to form.
16. Description of each person spoken to/contacted, including name, title, age, sex, race, and a physical description:
17. What types of loans did the lender discuss with you? (Circle all that apply)
    a. Conventional
    b. Fixed
    c. ARM
    d. FHA
    e. VA
    f. Other (Describe) ____

18. What are the qualifying ratios at this bank?
    Housing to income: ____________________
    Debt to income: ____________________
    Based on gross or net? ____________________
19. What did the lender say were your ratios?
    Housing to income: ____________________
    Debt to income: ____________________
20. Is there an application fee?
    If yes, how much? ____________________
    Is it refundable? ____________________
21. According to lender were you qualified for a loan?
    If yes, what type(s)? ____________________
    What interest rate? ____________________
    If no, why not? ____________________
22. For the types of financing recommended by the lender, provide loan type, loan amount, loan length, interest rate, points, application fee, down payment, monthly payments, closing costs, and any other costs.
23. What, if anything, did the lender say about the lending process, including the estimated length of processing time?
24. What percent down payment did you say you were going to make?
25. Was that sufficient?
26. If not, what is required to get the loan?
    Private Mortgage Insurance (PMI) ____________________
    Second Mortgage ____________________
    Other ____________________
27. If PMI is required, what are the costs?
    At closing ____________________
    Monthly ____________________
28. Did the lender discuss financing PMI?
29. Were you offered an application?
30. Did the lender discuss closing costs with you?
31. Did the lender provide a good faith estimate?
32. Did the lender tell you to look for financing elsewhere?
    If yes, where?
33. What else did the lender say you needed to do to apply for the loan?
34. Did the lender ask the location of the house?
35. Did the lender make any comments about the community where the property is located?
    If yes, what was said?
36. Did the lender make any statements about race, color, ethnicity, religion, sex, age, marital status or handicap?
    If yes, what was said?
37. Did the lender record any information you provided?
38. Did the lender make a note of how to contact you?
39. Did the lender explain the next steps to take to proceed with the application?
    If yes, explain

APPENDIX D: MORTGAGE LENDING DECISION ANALYSIS WORKSHEET

Loan Type:

Purchase:
Refinance:
HI:
Construction:

# of Applicants

Accepted:
Rejected:

KEY—RACE
W=White
B=Black
H=Hispanic
A=Asian
I=Native American
O=Other
KEY—MARITAL STATUS
M=Married
U=Unmarried
S=Separated

(Continued on next page)

Applicant	Loan Officer	Census Tract (N'Hood)	Loan Amount		Loan to Value Ratio	Loan to Price Ratio	Monthly Debt to Income Ratio
			Requested	Granted			
Examples:							
#124	#07	101	200M	200M	80	75	34
#265	#07	109	100M		97	90	30

Housing Pmt to Income Ratio	PMI Y/N	Mtg. Duration (Mos)	Int. Rate	Points	Race (Use Key)	Marital Status (Use Key)	Sex M/F	Action Taken	Reasons for Rejection
29	N	360	8	1	W	S	F	Approved	Appraised Value
28	Y	300	8	2	B	S	M	Denied	

Note: Other categories such as "Quality of Assistance" factors also may be included. For example: Derogatory Credit Reporting Explanations; Cross-selling a More Suitable Loan Product; Appraiser Contacts; Consultations With Other Loan Officers; Requests for Additional Information; and other Evidence of Applicant Counselling; etc.

ACKNOWLEDGEMENT AND SELECTED REFERENCES

ACKNOWLEDGEMENT

Some of the ideas, processes and procedures included here have previously been presented at seminars and workshops or in other manuals, guidelines or publications. We are truly grateful to the individuals who have developed this wealth of information and to those who have provided counsel and assistance in completing this document.

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