

Home Mortgage Disclosure  
Act (HMDA) • Equality • Flexible  
Commitment • Fair Lending  
Anti-Discrimination  
Fair Housing Act • Resources

# {Closing The Gap:}

A Guide To Equal Opportunity Lending

Equal Credit Opportunity  
Act (ECOA) Regulation B  
Civil Rights Law • Reality  
Community Reinvestment Act  
Alternative Loan Products  
Marketing Strategies

Federal Reserve Bank of Boston

Underwriting Standards & Practices

## A c k n o w l e d g m e n t s

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## **Editors' Note**

A 1992 study of mortgage lending by the Federal Reserve Bank of Boston analyzed the effects of race on denial rates for blacks and Hispanics in the Boston metropolitan area.

However, around the country, members of other racial and ethnic groups may also experience credit discrimination.

For editorial purposes, it was necessary to select a single term to refer to underserved borrowers.

In this publication, the terms "minority" or "minority group" are used to refer to borrowers, including blacks and Hispanics, who are not members of the dominant culture in a particular lending area.

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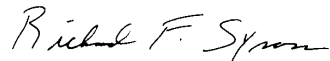
# F o r e w o r d

Fair lending is good business. Access to credit, free from considerations of race or national origin, is essential to the economic health of both lenders and borrowers.

Working together, progress has been made over the past few years since patterns of racial disparity in mortgage lending were first documented. While few people believe that purposeful discrimination is prevalent, ending those patterns has become a top priority of both public and private sector participants in the home mortgage market. But clearly, more needs to be done.

The Federal Reserve Bank of Boston wants to be helpful to lenders as they work to close the mortgage gap. For this publication, we have gathered recommendations on “best practice” from lending institutions and consumer groups. With their help, we have developed a comprehensive program for lenders who seek to ensure that all loan applicants are treated fairly and to expand their markets to reach a more diverse customer base.

I am confident that, together, we can make equal credit opportunity the reality that everybody wants.



**Richard F. Syron**  
**President and Chief Executive Officer**  
**Federal Reserve Bank of Boston**

# I n t r o d u c t i o n

Lending bias is inseparable from the broader issue of race in our society: discrimination is not unique to mortgage lending. In our nation of some 250 million people, approximately 76 percent are white, 12 percent are black, 9 percent are Hispanic, 3 percent are Asian and Pacific Islanders, and less than 1 percent are Native Americans. For the most part, we live and work separate from each other in rural areas, suburbs, and urban neighborhoods.

Cultural separation perpetuates social biases – biases that are expressed in our work and in our institutions. It is beyond the scope of this guide to analyze the complex, historical forces that have shaped race relations in the United States. For the purposes of this publication, we distinguish among three types of discrimination: overt, intentional discrimination; subtle, deliberate discrimination; and unintentional discrimination.

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Overt discrimination in mortgage lending is rarely seen today. Discrimination is more likely to be subtle, reflected in the failure to market loan products to potential minority customers and the failure of lenders to hire and promote staff from racial and ethnic minority groups. Unintentional discrimination may be observed when a lender's underwriting policies contain arbitrary or outdated criteria that effectively disqualify many urban or lower-income minority applicants.

While the banking industry is not expected to cure the nation's social and racial ills, lenders do have a specific legal responsibility to ensure that negative perceptions, attitudes, and prejudices do not systematically affect the fair and even-handed distribution of credit in our society. Fair lending must be an integral part of a financial institution's business plan.

The first step for financial institutions to take in narrowing the lending gap is to incorporate fair lending goals into their mission statements. By pledging to make fair lending a primary strategic goal of the institution, management and the board of directors set a standard for loan production staff and other employees. Management of financial institutions must establish a corporate culture in which fair lending and serving minority markets are seen to contribute to shareholder value and are rewarded.

This publication offers a program for financial institutions seeking to apply their mortgage lending standards in accordance with equal opportunity goals and to expand their activity in underserved minority markets. Banks, mortgage companies, and other lenders subject to the

Home Mortgage Disclosure Act (HMDA) are referred to as “financial institutions” or “lenders.” Specific recommendations are followed by the Federal Reserve Bank of Boston’s conclusions with respect to fair lending challenges. The recommendations are geared primarily to mortgage products but they may be modified to address small business, commercial, and consumer lending. A summary of fair lending laws is also provided.

Lenders, and also their regulators, must look for ways to eliminate the unjustified lending disparities that have been documented. To ensure fair lending, those of us responsible for providing credit should regularly ask ourselves questions such as the following:

1. When we hire, do we promote a cultural diversity that is reflective of the communities we serve?
2. When hiring lending staff, do our interviewers take into account possible racial prejudices of job applicants?
3. Do we train all of our staff in the area of equal lending?
4. Do we have any mechanisms through which unfair lending practices, policies, or procedures may be detected? If so, are we able to determine the effectiveness of these mechanisms?
5. Do we inform all potential borrowers, regardless of their race or ethnicity or the location of the property, about all of our lending programs so they may decide which best fit their needs?
6. Do we deliberately steer minority mortgage applicants to federally insured programs because we assume that minorities are less creditworthy?
7. Do we have mortgage lending practices that include location of property as a risk factor?
8. Does our mortgage pre-qualifying procedure tend to encourage or discourage minority applicants?
9. Do we offer homebuyer education programs for potential applicants who are unfamiliar with the mortgage lending process?
10. Do we regularly review our advertising to see if the choice of illustrations or models suggests a customer preference based on race?
11. Are we as assertive in attracting minority loan applicants as we are in attracting white applicants?
12. Are we familiar with the practices of the real estate and mortgage brokers and appraisers with whom we do business?
13. Do we encourage the brokers and appraisers with whom we do business to be constructively active in minority communities?
14. All things being equal, do white and minority credit applicants have the same chance of getting a loan from this financial institution?



## Recommendations

The recommendations that follow were gathered from a variety of sources, including mortgage lenders, bankers' associations, credit counseling agencies, fair housing organizations, and social research groups. All of these organizations agree that an effective strategy for equal opportunity in lending must be driven by economic, social, and legal incentives. They also believe that each institution must develop its own strategy, based on local market dynamics, and that this strategy must be comprehensive, flexible, and integrated into daily business operations. Finally, each organization stressed the importance of having the Board of Directors take an active role in guiding the development, implementation, and monitoring of an equal opportunity lending strategy.

The recommendations are organized to address three distinct levels within a financial institution, the Board of Directors, Management, and Loan Production Staff. The Board of Directors refers to the governing body of a financial institution. The term can also refer to the Board of a holding company that owns the financial institution. Management refers to the people responsible for the decision-making and supervision necessary to carry out the objectives of the financial institution. The term encompasses both senior management and other levels of management staff. Loan Production Staff refers to loan originators, interviewers, underwriters, and loan processors. The term can also refer to any staff member who is involved in the loan process, including tellers and customer service representatives.

These recommendations are intended as guidelines. As with any business strategy, each institution must define for itself what is appropriate, effective, and feasible. Some of the recommendations focus on working with lower-income consumers, first-time homebuyers, urban residents, or applicants unfamiliar with conventional financial practices. It should be recognized, however, that many minority borrowers do not possess these characteristics.

"The regulatory issues in the 1990s will not be limited to safety and soundness, but will increasingly emphasize fairness: whether or not banks are fulfilling the needs of their communities."

**Lawrence B. Lindsey**  
**Member**

**Board of Governors**  
**of the Federal**  
**Reserve System**  
**Address to the**  
**California Bankers**  
**Association**  
**May 11, 1992**

Staff training is a crucial component of a financial institution's efforts to combat possible discriminatory lending practices. All employees involved in the loan process should be familiar with the federal laws that protect prospective borrowers from biased treatment, as well as applicable state laws. Training should address such laws and regulations as the Equal Credit Opportunity Act (Regulation B), the Fair Housing Act, the Home Mortgage Disclosure Act (Regulation C), and the Community Reinvestment Act. In addition to a regular training program on compliance with laws, financial institutions should ensure that employees have been trained on how they are expected to treat customers, since poor customer service can be perceived as discrimination. Lenders may also wish to consider training designed to encourage employees to accept and appreciate racial and ethnic diversity.

The Board of Directors should adopt a policy that provides all employees with regular, ongoing training on laws and regulations that protect prospective borrowers from biased treatment. A conscientious Board will recognize the potential liability associated with noncompliance with these laws and regulations, as well as the business opportunities that may be lost. In addition, the Board may wish to provide for diversity training. The Board itself should participate in training programs and it should require management to report regularly on the programs' effectiveness.

### Did You Know?

Failure to comply with the Equal Credit Opportunity Act or Regulation B can subject a financial institution to civil liability for actual and punitive damages in individual or class actions. Liability for punitive damages can be as much as \$10,000 in individual actions and the lesser of \$500,000 or 1 percent of the creditor's net worth in class actions.

**Regulation B  
Equal Credit  
Opportunity  
12 CFR  
202.14(b)**

Management should develop training programs that address all aspects of the lending process. For example, a key concern among regulators and the minority community is that potential minority customers may be discouraged from applying for mortgage loans. Accordingly, training should include a section on understanding and preventing unlawful pre-screening. (See the section on Testing Fairness in Lending Practices.) Training should also cover the consequences of noncompliance with the laws and regulations that protect prospective borrowers from biased treatment. Diversity training can help build a multicultural work force, as well as help employees understand their attitudes about different cultures. Management should regularly evaluate the effectiveness of training programs; this evaluation should include input from the loan production staff.

Loan Production Staff should attend staff training programs and provide management with feedback on the quality of both internal and external training programs.

## Hiring and Promotion Practices

Hiring and promotion practices that foster racial and ethnic diversity can help a financial institution gain a competitive edge in cultivating business in underserved markets. A staff that encompasses a variety of viewpoints and experiences can create an environment in which minority applicants feel welcome, strengthen ties to minority communities, and design policies and products that more effectively meet the needs of minority customers. Moreover, by explicitly encouraging employees and directors to participate in community development activities, institutions demonstrate their commitment to serving minority communities to both staff members and the public.

The Board of Directors should review the institution's record, in both policy and practice, on hiring and promoting minorities and should direct management to make any necessary changes to the institution's policies. The racial and ethnic diversity among management and the Board must be included in this examination. The Board may wish to develop a policy to encourage community development activity by employees, and to seek out ways in which Board members can participate as well.

Management should take steps to ensure that racial and ethnic diversity extends throughout the institution – and is not confined to branches located in minority communities. Recruitment programs that target members of the minority communities served by the institution may be desirable. Management should also review promotion practices to ensure that no real or perceived biases limit the advancement of minorities; this review process should include input from the loan production staff. Management should encourage employee participation in community development activities that develop employees' skills and also bring minority customers into the bank. Such activities include involvement with local community development organizations, attendance at seminars and conferences, and participation in credit counseling and homebuyer programs.

Loan Production Staff should share with management their insights into how hiring and promotion practices might be altered to encourage greater diversity. Minority staff members may be able to assist in recruiting. Staff should explore opportunities for community development activity and should consider participation in in-house community service programs or institutional partnerships with intermediaries that offer credit counseling or homebuyer education.

### Did You Know?

U.S. Census data predict that by the year 2000 minorities will make up nearly 30 percent of the country's population, and that minorities may well form the nation's majority by the year 2050.

**U.S. Bureau of the Census  
Population Projections of the U.S. by Age, Sex, Race, and Hispanic Origin: 1992 to 2050**

## Compensation Structure

The compensation structure for loan production staff should not discourage them from working with lower-income or financially unsophisticated applicants. If staff are compensated according to a pay structure based simply on the number and size of loans closed, they will be reluctant to work with applicants who require more time and assistance or who are requesting relatively small loans.

The Board of Directors should ensure that the compensation structure does not penalize loan production staff for working with applicants who are lower-income or unfamiliar with the lending process. For an institution to effectively target underserved markets, the pay structure must reward loan production staff for spending time with these applicants and for participating in buyer education programs and other activities that build ties with these markets.

Management should determine whether the existing compensation structure discourages loan production staff from working with applicants who are seeking smaller mortgages or who are unfamiliar with conventional lending practices. Surveying the loan production staff may help define the needs of these borrowers. The nature of the assistance needed – allowing additional time to work through the application, providing information on the homebuying process, or gathering resources targeted for first-time and lower-income homebuyers – will suggest where adjustments to the pay structure for loan production staff may be appropriate or where alternative approaches to servicing these customers may be necessary.

Loan Production Staff should review their own practices to determine whether the existing compensation structure or other policies limit their ability to effectively serve applicants who are lower-income or unfamiliar with the lending process. They should alert management to policies that they perceive as encouraging or discouraging them from working with these applicants.

## Underwriting Standards and Practices

Even the most determined lending institution will have difficulty cultivating business from minority customers if its underwriting standards contain arbitrary or unreasonable measures of creditworthiness. Consistency in evaluating loan applications is also critical to ensuring fair treatment. Since many mortgage applicants who are approved do not meet every underwriting guideline, lending policies should have mechanisms that define and monitor the use of compensating factors to ensure that they are applied consistently, without regard to race or ethnicity.

The Board of Directors should establish a policy to detect and eliminate biases in underwriting standards and practices. As part of this policy, management should be directed to review existing underwriting standards and practices to ensure that they are valid predictors of risk. Special care should be taken to ensure that standards are appropriate to the economic culture of urban, lower-income, and nontraditional consumers. The Board should require management to define acceptable compensating factors and to monitor their use by loan production staff.

The Board may also wish to establish a written policy on equal opportunity lending, in which its underwriting guidelines are explained. This policy can describe the institution's commitment to the community and to minority and lower-income consumers and explain how its products can meet homebuyers' needs.

Management should review both underwriting standards and practices. (See also the sections on Second Review Policies and Testing Fairness in Lending Practices.)

### Underwriting Standards

#### *Property Standards and Minimum Loan Amounts.*

These standards should be checked for arbitrary rules as to the age, location, condition, or size of the property. Such standards could negatively affect applicants who wish to purchase two- to four-family homes, older properties, or homes in less expensive areas.

*Obligation Ratios.* Special consideration could be given to applicants with relatively high obligation ratios who have demonstrated an ability to cover high housing expenses in the past. Many lower-income households are accustomed to allocating a large percentage of their income toward rent. While it is important to ensure that the borrower is not assuming an unreasonable level of debt, it should be noted that the secondary market is willing to consider ratios above the standard 28/36.

“Underwriting guidelines, along with the interpretation and application of the guidelines, were created based on historical data that primarily reflect nonminority mortgage loan participants and therefore may be unintentionally racially biased.”  
**HMDA Task Force Report  
Mortgage Bankers Association of America  
September, 1992**

*Down Payment and Closing Costs.* Accumulating enough savings to cover the various costs associated with a mortgage loan is often a significant barrier to homeownership by lower-income applicants. Lenders may wish to allow gifts, grants, or loans from relatives, nonprofit organizations, or municipal agencies to cover part of these costs. Cash-on-hand could also be an acceptable means of payment if borrowers can document its source and demonstrate that they normally pay their bills in cash.

*Credit History.* Policies regarding applicants with no credit history or problem credit history should be reviewed. Lack of credit history should not be seen as a negative factor. Certain cultures encourage people to “pay as you go” and avoid debt. Willingness to pay debt promptly can be determined through review of utility, rent, telephone, insurance, and medical bill payments. In reviewing past credit problems, lenders should be willing to consider extenuating circumstances. For lower-income applicants in particular, unforeseen expenses can have a disproportionate effect on an otherwise positive credit record. In these instances, paying off past bad debts or establishing a regular repayment schedule with creditors may demonstrate a willingness and ability to resolve debts.

Successful participation in credit counseling or buyer education programs is another way that applicants can demonstrate an ability to manage their debts responsibly. (See the section on Buyer Education.)

*Property Appraisal/Neighborhood Analysis.* Terms like “desirable area,” “homogeneous neighborhood,” and “remaining economic life” are highly subjective and allow room for racial bias and bias against urban areas. The same holds true when lenders evaluate properties based on their market appeal or compatibility with the rest of the neighborhood. (See the section on Third Party Involvement in the Loan Process.) It should be noted that the Federal Home Loan Mortgage Corporation (Freddie Mac) has stated that neighborhoods undergoing revitalization should be assessed on their potential as well as their existing condition. Also, the Federal National Mortgage Association (Fannie Mae) will accept block-by-block underwriting analyses in urban neighborhoods being rehabilitated.

*Employment History.* It is important to distinguish between length of employment and employment stability. Many lower-income people work in sectors of the economy where job changes are frequent. Lenders should focus on the applicant’s ability to maintain or increase his or her income level, and not solely on the length of stay in a particular job.

*Sources of Income.* In addition to primary employment income, Fannie Mae and Freddie Mac will accept the following as valid income sources: overtime and part-time work, second jobs (including seasonal work), retirement and Social Security income, alimony, child support, Veterans Administration (VA) benefits, welfare payments, and unemployment benefits.

### ***Underwriting Practices***

Review and monitoring of the mortgage origination and underwriting process will help determine whether the institution is treating all potential and actual applicants fairly, and whether it is communicating its lending policies clearly to the public.

To ensure fair treatment, it is important that the lending institution document its policies and practices regarding acceptable compensating factors. If an institution permits flexibility in applying underwriting standards, it must do so consistently. Management should consider developing a checklist for loan production staff to ensure that all allowable compensating factors are requested of the borrower (such as explanations of late debt payments or a demonstrated ability to carry high housing costs). The checklist will also make loan production staff aware of the institution's commitment to serving borrowers who may not meet traditional underwriting standards.

One way to help ensure that compensating factors are applied consistently among racial and ethnic groups is to document and monitor their use. Debt-to-income ratios and credit history are two areas in which lenders frequently allow for compensating factors.

Informed borrowers are more likely to ask loan production staff about ways to enhance their applications. Thus, another way to encourage consistent treatment is by clearly communicating the institution's lending policies and underwriting standards to the public. The lender's commitment to the community and to minority and lower-income consumers can be described in mortgage-related documents, including marketing materials, pre-qualification worksheets, and applications. These documents could also explain the institution's credit evaluation and underwriting criteria.

*Loan Production Staff* must review their practices to ensure that they use compensating factors consistently. If a formal checklist does not exist, loan production staff should have a mental checklist of compensating factors that they should request from borrowers. Loan production staff can also draw on their experience with minority applicants, particularly lower-income or first-time homebuyers, to help determine how the institution can improve its loan products. They may wish to note which compensating factors they frequently record during the application process. They can also inform management of any vague or unclear wording in loan application documents that could present a stumbling block for first-time mortgage loan applicants.

## Alternative Loan Products

Lenders should be aware of the programs available to reduce the costs and risks of lending to customers who do not meet conventional underwriting standards. Lenders can participate in loan programs offered by federal, state, and local agencies, or develop products to serve these customers in cooperation with public and private nonprofit organizations.

The Board of Directors should direct management to explore the various public programs designed for borrowers with special needs. The Board may also wish to encourage management to work with the public sector to develop products that assist lower-income borrowers by using public money to reduce interest rates, provide down payment assistance, or otherwise reduce the cost of the mortgage. The Board should also encourage management to work with special secondary mortgage market programs designed for lower-income homebuyers.

Management should seek out federal and state mortgage programs targeted to first-time or lower-income homebuyers. State and local agencies may offer soft second mortgages, down payment assistance, and other enhancements that can help an otherwise creditworthy applicant qualify for a conventional first mortgage. Management should also be aware of the special programs for lower-income homebuyers offered through Fannie Mae and Freddie Mac. Finally, in order to ensure that these alternative loan products are used effectively, loan production staff must be trained in both the mechanics and the appropriate use of such products.

Loan Production Staff should be aware of all the alternative loan products their institution offers to applicants who do not meet conventional underwriting guidelines. They should be familiar with the guidelines of any government-sponsored mortgage loan programs that the institution offers, as well as any public programs that would help qualify an applicant for a conventional loan (such as soft second mortgage and down payment assistance programs). They should also be familiar with the criteria of special secondary mortgage market programs for lower-income homebuyers. If they do not believe they have received sufficient training in the mechanics or applicability of such programs, they should relay their concerns to management.

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“We will pursue every avenue – mortgage lenders, community groups, builders and developers, housing finance agencies, mortgage insurers, and federal, state, and local governments – to find partners that will help us fulfill our corporate objective of providing viable financial products and services that will increase the availability and affordability of housing for low-, moderate-, and middle-income Americans.”

**Federal National Mortgage Association Lender Letter January 24, 1992 (Source: Public Information Office)**

## Second Review Policies

A prompt and impartial second review of all rejected applications can help ensure fairness in the lending decision and prevent the loss of business opportunities. Denied applications should be compared with applications that did not meet the institution's stated loan policy but were approved based on compensating factors. Including these approved applications in the second review process can help ensure that compensating factors are handled fairly and consistently among different racial and ethnic groups. Financial institutions may also wish to organize and participate in multi-bank mortgage review boards. These boards review applications that do not meet the underwriting criteria of a particular institution but may qualify under another lender's guidelines.

Financial institutions should also review and analyze withdrawn applications to ensure that these applicants have not been unfairly counseled to withdraw.

The Board of Directors should adopt second review policies and require that management report the results to the Board.

Management should implement and monitor second review policies. Particular attention should be directed to verifying that the loan production staff is aware of all underwriting guidelines and consistently applies compensating factors. Management should participate in the second review process to ensure impartiality and should report its results to the Board. This process may lead to changes in the institution's underwriting policies. (See also the section on Underwriting Standards and Practices.)

"We see evidence that there are a significant number of prospective home buyers in this country whose only barrier to achieving their dream of home ownership is not their economic status, but their racial status."  
**James A. Johnson**  
**Chairman**  
**Federal National Mortgage Association**  
**Wall Street Journal**  
**November 30, 1992**

Loan Production Staff should record exceptions to underwriting standards based on allowable compensating factors. In addition, loan production staff may find that their experience with minority applicants indicates that the institution's stated loan policy should be modified to incorporate some of the allowable compensating factors. Frequently recorded compensating factors should be communicated to management for a review by the Board of Directors.

## Marketing Strategies

An effective marketing strategy can establish a lender as a familiar face in minority communities and can provide the institution with information concerning local credit and service needs. In designing an effective strategy, mortgage lenders, particularly banks and thrifts, must address several issues. First, many minority neighborhoods lack access to basic banking services; it may be difficult to convince residents of these communities that an institution can meet their needs without having an office nearby. Second, consumers who have little interaction with banks and thrifts may best be reached through institutions with which they *are* familiar, such as community service agencies and religious institutions. Regular contact with these organizations can also provide lenders with valuable information that may help with marketing and product development. Third, marketing materials must reflect the racial and ethnic composition of the targeted communities.

For financial institutions that conduct their mortgage lending through a mortgage company subsidiary, referral practices must not be allowed to provide opportunities for illegal pre-screening. (See the discussion on the pre-application stage in the section on Testing Fairness in Lending Practices.)

The Board of Directors should ensure that the institution's marketing strategy includes all minority communities in its service area and reflects the racial and ethnic composition of its customer base. The Board may find it necessary to direct management to undertake a thorough review of existing marketing efforts, to determine their effectiveness and to focus on developing ties with established institutions in minority communities. The Board should require management to report regularly on the manner and effectiveness of their advertising campaigns.

The Board may wish to establish a written policy on equal opportunity lending that explains the institution's commitment to the community and to minority and lower-income customers. This can be included in all marketing materials.

The Board should also see that the institution's Home Mortgage Disclosure Act (HMDA) data are used fully and effectively. Management should be required to report the volume, location, and composition of loan applications received, and the disposition of those applications. The Board should be informed of inexplicably low numbers of applications from minorities or high percentages of denials issued to minority applicants.

### Did You Know?

The Fair Housing Act prohibits advertisements or published material, related to the sale of a dwelling, that suggest a preference based on race, color, sex, or national origin.

**Ragin v. New York Times**  
**923 F.2d 995**  
**(2nd. Cir. 1991)**  
**and 42 U.S.C.**  
**3604(c)**

Management should ensure that any policy statements regarding the institution's commitment to its local community, and to minority and lower-income customers, are included in all marketing materials. Marketing plans should be reviewed to ensure that they are effective in reaching minorities and reflect the racial and ethnic composition of the service area. This may mean using local newspapers, electronic media, and foreign language advertisements; advertising through informal channels such as religious institutions and community service agencies; and encouraging feedback from community groups on product awareness and suitability. Call programs should also be reviewed to ensure that brokers and realtors who operate in minority neighborhoods are included. Consideration should be given to the development of homebuyer education seminars; these can be held in-house or in conjunction with community organizations or local government. (See the section on Buyer Education.)

Surveys of customers and the community-at-large can provide information on whether the institution is perceived to be giving quality service. For example, an institution might survey loan applicants to find out why they chose to apply to the institution, whether they understood the institution's underwriting standards, whether their questions were satisfactorily answered, and whether they felt they were treated properly.

Management should also review HMDA data regularly, monitoring the volume, location, and composition of loan applications received, and the disposition of those applications. If the number of applications received from minorities seems disproportionately low, the cause should be determined. If denial rates are relatively high for minority applicants, management should be able to explain the disparity.

Loan Production Staff should call regularly on brokers, realtors, community development agencies, community service providers, and community and political leaders. They should encourage feedback and suggestions for improvements to the institution's formal and informal methods of marketing and relay this information to management. They should participate when possible in programs that build awareness of their institution and enhance its image in the minority community.

## Buyer Education

Providing counseling and education on homeownership is a significant and effective way for lenders to familiarize themselves with the needs of minority customers, particularly first-time homebuyers. This service can be provided in many ways, including in-house programs and publications as well as joint sponsorship of educational programs with local community service providers and government agencies. Helping to educate consumers will make the lender's job easier overall; homebuyers will be more knowledgeable and better prepared when applying for a loan.

Lenders should also be aware of existing credit counseling services that can help consumers who have problem credit histories to develop responsible budgets and feasible repayment plans.

The Board of Directors should encourage management to explore ways of providing buyer education. This can be accomplished through direct in-house services, such as buyer education seminars, open houses, and publications, or in conjunction with community or public agencies that have established homebuyer counseling programs. If no such programs exist in the community, the Board should consider working with other lenders either to establish a buyer education program or to provide financial resources so that a local community service agency can set up a program. The Board should require management to report regularly on the effectiveness of these programs.

Management should establish relationships with existing homebuyer education and counseling programs, in both the private and public sectors. Management should also encourage participation by loan production staff in community-based homebuyer education programs. Further, it might consider offering special incentives to graduates of these programs who qualify for a loan, such as waived application fees or reduced closing costs.

Loan Production Staff should participate in education programs to assist first-time homebuyers. These programs typically cover the entire homebuying process, from working with realtors to understanding the responsibilities of homeownership. Loan production staff can educate and inform potential homebuyers by explaining the mortgage financing process in a setting where people are likely to be freer with their questions. Further, lenders can develop a better understanding of the concerns or misperceptions of first-time homebuyers, particularly minorities.

"The great myth that may exist among bankers is that their customers have some way of knowing their bank's credit standards and other credit decision criteria."  
**Lawrence B. Lindsey**  
**Member**  
**Board of Governors**  
**of the Federal**  
**Reserve System**  
**Address to the**  
**Community**  
**Reinvestment**  
**Conference**  
**Santa Monica, CA**  
**September 21, 1992**

## Third Party Involvement in the Loan Process

A financial institution that is committed to fair lending and to expanding its markets to a more diverse customer base should work with appraisers, private mortgage insurance companies, real estate brokers, mortgage brokers, and other third parties in the loan process who are also committed to these goals.

Institutions that sell loans to the secondary market should be fully aware of the efforts of Fannie Mae and Freddie Mac to modify their guidelines to address the needs of borrowers who are lower-income, live in urban areas, or do not have extensive credit histories.

The Board of Directors should adopt a policy that requires the financial institution to advise all third parties involved in the loan process of its commitment to equal opportunity lending. The Board can also adopt a policy that encourages any third party associated with the lending process to receive training on federal laws that protect prospective borrowers from biased treatment. The lender can invite third parties to attend training sessions conducted by the lender.

### Did You Know?

A HUD study estimates that 59 percent of black homebuyers and 56 percent of Hispanic homebuyers experience some form of discrimination in their encounters with real estate agents. Discrimination occurs in the areas of information given on housing availability, contributions to completing the transaction (including assistance in obtaining financing), and steering toward particular neighborhoods.

**Housing Discrimination Study: Synthesis**  
**U.S. Department of Housing and Urban Development**  
**Office of Policy Development and Research**  
**August, 1991**

Management should ensure that all third parties with which it works are aware of the institution's equal opportunity lending policies. It may be desirable to invite third parties to attend in-house training programs on consumer credit protection laws.

Management should be aware that Fannie Mae and Freddie Mac have issued statements to the effect that they understand urban areas require different appraisal methods. Accordingly, it may be advantageous to use the services of appraisers with experience in conducting appraisals in minority and lower-income neighborhoods. Management should consider having all appraisal reports that would cause an application to be denied reviewed by another experienced appraiser. This can help protect the financial institution as well, as it may be held liable if an appraisal is found to be discriminatory.

Management should be aware of any differences in standards used by private mortgage insurance companies. If a private mortgage insurance company refuses to issue insurance on a particular loan, the financial institution may wish to have another reputable company review the application.

Lenders should question any differences that arise from the review process and consider the results when determining which private mortgage insurance companies they use. In addition, financial institutions may wish to work with private mortgage insurance companies that have demonstrated a commitment to minority and lower-income applicants.

Management should ensure that their loan production staff works with reputable real estate brokers and mortgage brokers who operate in minority neighborhoods. The institution's community contacts can be a useful source of information about brokers active in these communities.

Loan Production Staff should be aware of the practices of third parties associated with the financial institution. For example, members of the loan production staff whose service area includes minority communities should inform management of any mortgage or real estate brokers who do not refer minorities to the financial institution. Loan production staff should be familiar with the amendment to the Equal Credit Opportunity Act that requires a financial institution to provide a copy of the appraisal to an applicant who makes a timely request. Reviewing and responding to complaints about appraisals can alert loan production staff to problems. The loan production staff should relay any concerns about appraisal practices to management.

## Testing Fairness in Lending Practices

Institutions should systematically review loan files to ensure that underwriting standards have been applied consistently to applicants of different races. A large financial institution with significant loan volume may be able to use statistical analysis to determine if race or ethnicity has affected lending decisions.

Lenders can test for discrimination in the pre-application stage by using shoppers. Testing by use of paired individuals who assume similar characteristics other than race can assist financial institutions in determining whether discrimination occurs in the pre-application stage. Of particular interest should be whether the institution is engaging in illegal pre-screening by discouraging prospective borrowers from applying for a mortgage. Testing can also allow a financial institution to determine if loan production staff spend less time explaining the institution's products to minority applicants; if white applicants receive more coaching than minorities; or if loan personnel direct minorities to particular products, such as Federal Housing Administration-insured loans, or to other mortgage lenders. Of particular interest to a parent holding company will be the process by which subsidiary banks refer potential borrowers to subsidiary mortgage companies.

The Board of Directors should direct management or an audit committee to develop procedures for the systematic review of loan files to determine if underwriting standards are being applied consistently to applicants of different races. The Board can work with management to determine the feasibility of using shoppers to test for discrimination in the pre-application stage.

Management or an audit committee should establish procedures to systematically review loan files to determine if loan standards are being applied consistently to applicants of different races. A comprehensive mortgage loan checklist completed by the loan production staff can confirm that each member of the staff has followed the same procedure for each applicant and solicited all the information necessary to make the loan decision. (See the section on Underwriting Standards and Practices.) This monitoring mechanism can help the institution identify any discrepancies in practices. Management should report to the Board of Directors periodically regarding the ongoing review. In addition, management can work with the Board of Directors to determine the feasibility of using shoppers.

Loan Production Staff should be conscious of how they treat prospective borrowers of all races and ethnic groups in all aspects of the lending process. Loan production staff should pay particular attention to staff training that focuses on illegal pre-screening and steering.

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"We strongly recommend that lenders develop an internal program to test for discrimination in mortgage lending at both the prequalification and application stages."  
**HMDA Task Force Report**  
**Mortgage Bankers Association of America**  
**September, 1992**

## C o n c l u s i o n s

Discrimination based on race, color, religion, age, gender, or national origin is unlawful, insidious, and harmful. It is harmful to the individual, to society, and to the marketplace. Discrimination prevents the financial market from operating effectively and efficiently by disregarding or discounting information about minorities that should be used to make credit decisions. As we move to a more competitive world economy, we cannot afford inefficiency based on bias and misinformation.

This publication has outlined a comprehensive approach that financial institutions can use to combat possible discrimination in lending. While the focus has been on mortgage lending, most of the recommendations apply to other lending areas, including consumer, commercial, and small business lending. The approach emphasizes participation and involvement at all levels of bank operation.

Lenders at smaller institutions may ask: All this is fine, but what resources do we have to conduct such a program? Even with limited resources, small institutions can incorporate elements of the program into their business plans. Whether your institution is large or small, you may want to consider the following steps to getting started on an anti-discrimination program.

First, approach your state trade association. It may already be organizing efforts to share the costs of conducting training and of setting up mortgage review programs or other anti-discrimination programs. It may also know of resources to help your institution individually. If your association is not yet active, your institution can be a catalyst to get it to respond to this pressing need. Next, contact the American Bankers Association, the Mortgage Bankers Association, the National Bankers Association, or the Independent Bankers Association. They have programs to assist their member institutions in dealing with this issue. Finally, talk to fellow lenders. They are likely to be facing the same problems, and resources can be shared among institutions to implement the recommendations in this booklet. Remember that most of these recommendations focus on working within and building upon the existing structure of your institution. The “solution” is not to adopt quick-fix programs that are tangential to your daily business operations, but to modify established policies and develop new procedures so you can better reach underserved markets.

Much work remains to be done in eliminating discrimination from the marketplace. To the extent that individual financial institutions adopt the program outlined in this brochure, it will benefit the institution and its community, and contribute to a more effective, efficient, competitive, and just economy.

### **Home Mortgage Disclosure Act (Regulation C)**

Enacted by Congress in 1975 and amended during the period from 1988 to 1991, the Home Mortgage Disclosure Act (HMDA) is intended to provide the public with loan data that can be used to determine whether financial institutions are serving the housing credit needs of their communities, to assist public officials in distributing public sector investments, and to assist in identifying possible discriminatory lending patterns. Financial institutions are required by Regulation C, which implements HMDA, to report data regarding loan applications, as well as information concerning their loan originations and purchases. HMDA requires most lenders to report the race, sex, and income of mortgage applicants and borrowers.

### **Equal Credit Opportunity Act (Regulation B)**

The Equal Credit Opportunity Act (ECOA) was enacted in 1974 to promote the availability of credit to all creditworthy applicants without regard to race, color, religion, national origin, sex, marital status, age, receipt of public assistance funds, or the exercise of any right under the Consumer Credit Protection Act. Regulation B, issued under the ECOA, prohibits creditor practices that discriminate on the basis of any of these factors.

The federal agencies that regulate financial institutions have authority to enforce Regulation B administratively. Civil suits for unlawful credit discrimination may be brought within two years of the date of the occurrence of the alleged violation. Damages include actual damages and punitive damages of up to \$10,000 in individual actions. Punitive damages are limited to the lesser of \$500,000 or 1 percent of the creditor's net worth in class actions.

### **Fair Housing Act**

A 1968 civil rights law, the Fair Housing Act prohibits discrimination in the sale or rental of a dwelling on the basis of race, color, religion, handicap, sex, familial status, or national origin. Under the Fair Housing Act, it is unlawful for any person who engages in the business of making or purchasing residential real estate loans, or in the selling, brokering, or appraising of residential real property, to discriminate on the basis of the factors listed above.

Enforcement of the Fair Housing Act may be obtained administratively through the U.S. Department of Housing and Urban Development, or by civil action commenced within two years of the alleged discriminatory housing practice.

### **Community Reinvestment Act**

The Community Reinvestment Act (CRA) was enacted in 1977 to require each federal financial supervisory agency to encourage financial institutions to help meet the credit needs of their delineated communities, including low- and moderate-income neighborhoods within those communities, consistent with safe and sound banking practices. Each of the four supervisory agencies (the Board of Governors of the Federal Reserve System, the Comptroller of the Currency, the Federal Deposit Insurance Corporation, and the Office of Thrift Supervision) has issued regulations to implement the CRA. The CRA regulations of each agency require the board of directors of each institution to adopt, and at least annually review, a CRA statement. The statement must include a map depicting the area served by the institution, a list of all types of loans the institution is prepared to extend within its community, and a copy of its CRA Notice. In addition, an institution must maintain a public file containing its most recent CRA evaluation, any CRA statements in effect for the most recent two-year period, and any written comments received on its CRA performance for the same period.

**If you have any comments or questions  
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