LAWDESK

FAIR AND RESPONSIBLE NONBANK LENDING

TRAINING

Fair and Responsible Nonbank Lending

Course Objectives

This course will increase your awareness of fair and responsible lending principles. These principles apply to every aspect of a credit transaction, from the first phone call all the way through the collections process. Even individuals who don't directly take part in the credit decision must follow these principles.

After completing this course, you will be better prepared to:

- Distinguish between fair lending and responsible lending;
- Help prevent illegal discrimination;
- Properly handle credit applications and denials;
- Recognize and avoid unfair, deceptive, or abusive acts or practices; and
- Identify the consequences of noncompliance

Background

Fair and responsible lending is very important. Failure to lend in a fair and responsible manner can lead to significant penalties, especially when there are multiple violations.

Violation Example: A regulator imposed a penalty of $1.5 million on a lender for its violations of the Equal Credit Opportunity Act. The lender denied tax refund anticipation loans to married applicants where only one spouse applied for the loan. "Prohibited bases, like race, color, religion, national origin, age, sex, or marital status should have no effect on an individual's access to credit," said authorities. "We will vigorously enforce federal anti-discrimination law, and violators will suffer the consequences!"

Fair and Responsible Lending Laws

Let's get acquainted with how the fair and responsible lending laws all work together to help prevent illegal discrimination and unfair treatment, and to ensure access to credit for all creditworthy applicants.

Equal Credit Opportunity Act ("ECOA"): This 1974 law (implemented by Regulation B) helps to ensure access to credit for all creditworthy applicants. It prohibits discrimination in any aspect of a credit transaction. ECOA lists 9 prohibited basis factors: race, color, religion, national origin, sex, age, marital status, receipt of public assistance income, and exercise of consumer rights. It applies to consumer and commercial-purpose credit.

Federal Trade Commission Act & Dodd-Frank: Section 5 of the Act makes unfair or deceptive acts or practices illegal. Such acts or practices include any that are likely to mislead consumers and/or cause substantial harm to consumers. (Regulation AA, a 1985 regulation, applies this standard to lenders that extend credit to consumers.) The *Dodd-Frank Wall Street Reform and Consumer Protection Act* also prohibits unfair, deceptive, or abusive acts or practices.

Regulatory Guidance: Best practices emerge over time from sources such as regulatory agency guidance documents or legal actions and settlements. A wide framework of such activity protects consumers from lending abuses. As an example, regulatory guidance and examination procedures cover the topics of how lenders can avoid:

- Predatory and abusive lending;
- Unfair, deceptive, or abusive acts or practices;
- Risks of third party relationships; and
- Subprime lending risks.

State and Local Laws: Various state laws may have stricter requirements than the federal rules. For example, some states prohibit discrimination based on factors such as:

- Sexual orientation or gender identity
- Political affiliation
- Ancestral group
- Military status
- Geographic location of property

Noncompliance Consequences

Even if fair lending concerns are resolved without enforcement or legal action, they can still have severe negative effects, such as:

- Damaging the lender's reputation;
- Decreasing the value of the brand; and
- Shattering employee morale.

If regulators (i.e. FDIC or CFPB) do take enforcement action, such action can include fines and penalties. Consumers and their attorneys can bring individual or class action lawsuits. The cost of defending against such lawsuits, even if they are settled before going all the way to trial, can be enormous.

Prohibited Basis

ECOA lists specific items that cannot be considered during any aspect of a credit transaction. These items are referred to as prohibited bases. This means that in every part of the credit process – from the very first encounter with a prospective client until the time it is paid off or has to go through the collections process – you cannot consider or allow these factors to influence your thoughts or behaviors.

Each prohibited basis is listed below under ECOA. Prohibited Basis:

- Race
- Color
- Religion
- National Origin
- Sex
- Marital Status
- Age (except for ability to contract age)
- Receipt of Public Assistance Income
- Exercise of rights under the Consumer Credit Protection Act (i.e. FDCPA or FCRA)

Types of Discrimination

(1) Overt

Overt discrimination is illegal. You are practicing this type of discrimination if you express or imply a preference, based on any prohibited basis, for dealing or not dealing with applicants. This type of discrimination is sometimes informally referred to as "blatant" discrimination.

Example - A lender refuses a loan application from a woman who would like to open up a salon. The lender tells the woman that “running a business is a man’s job”.

(2) Disparate Treatment
Disparate treatment is another type of illegal discrimination. You are practicing this type of discrimination if you treat individual applicants differently on a prohibited basis.

Example - A lender takes extra time to help married applicants but does not offer the same courtesy to unmarried applicants.

(3) Disparate Impact
Disparate impact occurs when a seemingly neutral policy is applied uniformly to all applicants and borrowers, but creates different credit outcomes on a prohibited basis. Even if your policies seem to be neutral and applied without discriminatory intent, disparate impact may occur if protected class members receive less favorable credit outcomes.

Example - A lender has a policy of not approving auto loans under $8,000. This minimum loan amount has the effect of excluding a significant number of potential minority applicants from consideration because of their income levels.

Note - Discrimination does not have to be intentional to be illegal. Even inadvertent discrimination can lead to negative consequences.

(4) Redlining and Reverse Redlining
There are two forms of illegal disparate treatment known as redlining and reverse redlining. Remember, disparate treatment is when individual applicants are treated differently from one another on a prohibited basis.

- **Redlining**: Redlining occurs when you provide unequal access to credit, or unequal terms of credit, to specific neighborhoods because of the race, color, national origin, or other prohibited characteristics of the residents. **Example** - A lender refused to make auto loans if the vehicle will be registered in a neighborhood that is predominately Hispanic.

- **Reverse Redlining**: Reverse redlining is the practice of targeting certain borrowers or neighborhoods with less advantageous products or services based on prohibited characteristics. **Example** - A lender specifically targets minorities in poor neighborhoods with loan products that feature high-rates and high-fees.

Prevent Discrimination

(1) Overt Discrimination: To avoid overt discrimination, you should not:

- Make verbal or written statements indicating a preference on a prohibited basis.

- Establish written or unwritten polices that discriminate against customers on a prohibited basis.

- Make casual remarks that express prohibited basis preferences (even if you think such comments are only "making conversation" or "joking").

(2) Disparate Treatment: To avoid disparate treatment, you should not:

- Provide more assistance or advice, or different loan terms to some applicants over others on a prohibited basis.

(3) Disparate Impact: To avoid disparate impact, you should:

- Review policies and procedures to identify and modify any seemingly neutral policies that create different credit outcomes on a prohibited basis.

- Conduct audits to identify any potential disparate impact occurrences.

Handling Credit Applications

DO: Direct all applications through the proper lending channels to ensure that they receive the proper consideration. **Example of what to say**: "I can't tell you whether you will be approved or not. You have to complete a credit application so we can evaluate your qualifications fairly and give your application the consideration it deserves."

DON'T: Don't guess whether an applicant will or will not qualify for credit. For instance, if you tell an applicant you don't "think" they will qualify, one of the following two consequences may occur:

- The client will regard your remark as discouraging an application.
- Your comment triggers a requirement to send a denial notice.

Example of what NOT to say: "You can apply, but I doubt you'll be approved based on what you've told me so far." OR "I'm quite sure you'll qualify based on your income and credit."

Marital Status

If you receive an application for credit, you may ask about marital status if an applicant requests **secured credit**. For example, if the applicant would like to use a motor vehicle as collateral to secure the loan then you may ask about the marital status. You cannot ask about marital status if an applicant requests individual, unsecured credit **unless the applicant resides in a community property state** or is relying on property located in a community property state as a basis for repayment of the credit requested. Or, where the spouse will a permitted user or joint obligor on the account. **Correct example** - "What is your marital status," assuming the loan is secured by a motor vehicle? **Incorrect example** - "Are you divorced?"

Spousal Information

You can ask for information about a spouse (or former spouse) under the following conditions:

- The spouse will be a permitted user or joint obligor on the account (i.e. Authorized User)
- The spouse will be contractually liable on the account.
- The spouse's income is a source of repayment.
- The spouse or applicant resides in a community property state.
- The applicant is relying on alimony, child support, or separate maintenance income as a basis for obtaining the credit.

Note - You can only use the terms **married**, **unmarried** and **separated** to describe marital status. You may explain that the category unmarried includes single, divorced, and widowed persons.

You can ask applicants whether they intend to apply for credit jointly or individually. **However**, you cannot assume that the submission of a joint financial statement or other evidence of jointly held assets automatically indicates an application for joint credit.

Other Income & Accounts

When applying for credit, it is important that you understand the applicant's financial situation. All income and debts should be accounted for, but you must ensure that you are asking the right questions. You can ask the applicant if they have any other accounts on which they are liable.

You can also ask applicants if they have additional sources of income such as alimony, child support and separate maintenance payments. However, you must state that applicants need not reveal such income unless they want it considered in granting the credit. **Correct example** - "Do you have any additional income you would like considered in the credit request?"

Dependents

During the application process, you can inquire about the number and ages of the applicant's dependents. You may also inquire about the financial obligations related to the dependents. You may never ask non-financial or personal questions regarding the applicant's birth control practices or intentions for having or raising children. **Correct example** - "How many dependents do you have, and what are their ages?" **Incorrect example** - "Do you intend to have (or have more) children?"

Residency Status

You can ask about an applicant's immigration and permanent residence status. If you elect to inquire about such status, you must uniformly ask ALL applicants about it. You cannot base your decision to ask about residency status on any prohibited basis such as race or national origin. **Correct example** - "What is your immigration or citizenship status?"

Evaluating Credit Requests

The ECOA permits a lender to consider any information received as long as the information is not used to discriminate against an applicant on a prohibited basis. When evaluating credit requests, you must be aware of what you CAN or CAN'T consider with regard to customer information.

- **Childbearing**: You can't assume that certain applicants are more likely to have or raise children – events which may reduce future income. **Cannot Consider Example** - Whether certain applicants are more likely to have or raise children – events which may reduce future income.

- **Income**: You can't discount or exclude from consideration part-time wages, annuities, pensions or other retirement benefits. However, you may consider the likelihood that the income will continue at certain levels or for certain time periods. You can't discount alimony, child support and separate maintenance payments. If the applicant chooses to have such income considered, you must treat it the same as ordinary income. **Can Consider Example** - You can consider the likelihood or duration that any income, including alimony, child support and maintenance, will continue.

- **Age**: You can't treat the age of an elderly applicant (defined as age 62 or over) as a negative factor in judging creditworthiness. You can't deny credit or terminate a loan when, due to the applicant's age, credit-related insurance is unavailable. You can consider age to favor elderly applicants. You can consider age to verify that an applicant is old enough to enter into a contract. **Can Consider Example** - The applicant's age to verify that he or she is old enough to enter into a contract. **Cannot Consider Example** - The age of an elderly applicant (defined as age 62 or over) as a negative factor in judging creditworthiness.

- **Spousal Signatures**: You can require a signature from the applicant's spouse (or another person) on any instrument necessary to create or perfect the security interest in the loan collateral (Example: a motor vehicle title). You can't require that an applicant's spouse sign a promissory note or obligation if the spouse is not a co-borrower.

- **Cosigners**: You can require a cosigner if an applicant is not individually creditworthy. You can't require that a cosigner be the applicant's spouse. The cosigner may be any eligible creditworthy person of the applicant's choosing.

Risk Factors

(1) Loan Pricing

Discretionary loan pricing, which may lead to inconsistent loan pricing, may result in allegations of disparate treatment or disparate impact. A best practice to avoid pricing problems is to ensure that pricing relates to legitimate credit factors, as opposed to other borrower characteristics.

- **Disparate Treatment -** Several lenders have been accused of charging protected class borrowers higher loan prices than non-protected class members. Lenders whose policies permit overages and markups are often the subject of such allegations. The difference in pricing was identifiable even when controlling for legitimate considerations, such as credit scores.

- **Disparate Impact -** Disparate impact is a possibility when lenders negotiate rates with applicants. Applicants who are unaware that they can negotiate prices and/or have limited knowledge about financing may rely on company employees to guide them through the lending process. Applicants who remain under-informed may agree to higher loan rates than those negotiated by more savvy applicants. If a less sophisticated applicant also falls into a prohibited basis category, disparate impact may occur.

To prevent allegations of discriminatory loan pricing, consider incorporating the following best practices:

- If pricing is negotiable, tell applicants up front. By doing so, you allow all applicants (as opposed to only those who are financially sophisticated) an opportunity to bargain.
- Even if you negotiate with borrowers, pricing should still relate to legitimate credit factors, such as credit scores and repayment histories.
- Do not offer higher pricing solely to profit from an applicant's lack of knowledge.
- Be cautious of financial incentives accompanied by broad pricing discretion, such as through the use of overages, underage and yield spread premiums.
- Establish caps on markups, or use a flat fee that all personnel can apply.

(2) Steering

Consumers have diverse lending needs and when lenders offer a variety of products and features, they are helping meet those credit needs. However, wider arrays of product offerings may create fair lending risk. The difference between guiding a consumer towards a specific product or feature and illegally steering is based on whether you do so on a prohibited basis, rather than based on an applicant's needs or other legitimate factors. It is not necessary to demonstrate financial harm to a group that has been steered. It is enough to demonstrate that you took action on a prohibited basis, regardless of the ultimate financial outcome. You must never consider any prohibited basis when directing a consumer to a product.

- **Example 1** - Your company offers nontraditional loan products or products with potentially onerous terms, such as prepayment penalties. You direct all female applicants to products that

contain prepayment penalties because you feel that female applicants tend to change their minds more frequently and refinance or payoff their loans sooner than male applicants. This is illegal steering based on sex.

- **Example 2** - Your company offers different lending products based on credit risk levels. You automatically recommend a higher-risk product, to all Hispanic mortgage applicants because you feel that Hispanics typically do not qualify for conventional loans. This is illegal steering based on national origin.

- **Example 3** - Your company offers prime and sub-prime products through different channels. You advise all Asian applicants to sub-prime products, as you feel that these applicants earn less income than other applicants. This is illegal steering based on race.

(3) Broker & Other Third Party Activity

Your company may be found in violation if it participates in transactions in which it knew or should have known that third parties such as brokers were engaged in illegal discrimination.

- **Example 1** - Your company purchases loans from 1st Financial Brokers. 1st Financial Brokers only makes loans to applicants living in middle to upper income census tracts. It automatically denies all applicants living in low- to moderate-income census tracts. Your institution discovers this, but it continues to purchase these loans because it feels that they are low-risk. 1st Financial Brokers is conducting illegal disparate treatment, by redlining and because your company knows about this activity, it may be held liable for the broker's actions.

Best Practices

To help avoid fair lending violations, you and your company may choose to implement these best practices.

- **Policies & Procedures** - Incorporating fair lending principles into your company's lending policies and procedures will help your company remain in compliance. Reviewing these policies and procedures will enhance your understanding of the rules and alert you to controls your company has put in place.

- **Controls** - Putting controls in place, such as caps on pricing, exception handling processes, and automating underwriting standards, will help you avoid fair lending violations.

- **Monitoring** - Having qualified individuals monitor and review your company's loan data on a regular basis can help identify any potential fair lending problems before they get out of hand or the examiners find them.

- **Training** - Attending regular training with real-world scenarios will assist you in applying the fair lending principles to your everyday work.

Notifications

It's also important that you comply with the notification requirements of ECOA. You must inform consumers of the action taken on their applications **within 30 days** from the time you **receive a completed application**. Basically, ECOA prescribes a 30-day timeframe for decisioning an application and then communicating to applicants whether a loan request was approved or denied. If denied, the lender must deliver an adverse action notice to inform the applicant of the action taken and reasons for denial. Credit outcomes fall into 3 categories.

- **Approval** - If the loan is approved exactly as submitted, you can communicate this verbally or in writing.

- **Denial** - If you deny the loan, you must send a written adverse action notice. Loan modifications are also subject to the adverse action rules.

- **Counteroffer** - If you do not make the loan on the terms and conditions requested, but are willing to extend credit on different terms, you must notify the applicant of your counteroffer. If the applicant refuses the counteroffer, you must treat this as a denial.

If you need more information to make your credit decision, you must, **within 30 days**:

- Inform the applicant that you require additional information;
- Give a reasonable time to respond;
- Advise the applicant that unless he or she responds, no further consideration will be given to the application.
- Items you consider "incomplete" must be within the applicant's control to provide.

For example, you can consider an application incomplete if the applicant has not given you income information. You can't consider an application incomplete just because you haven't yet pulled the applicant's credit report.

Record Retention

The ECOA requires you to retain ALL evidence of compliance with its consumer protection provisions for **25 months** from the application date. There are other federal laws, as well as some state laws, that may require longer record retention periods.