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**TESTIMONY OF**  
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**OFFICE OF THE COMPTROLLER OF THE CURRENCY**  
**BEFORE THE**  
**SUBCOMMITTEE ON OVERSIGHT AND INVESTIGATIONS**  
**OF THE**  
**COMMITTEE ON FINANCIAL SERVICES**  
**OF THE**  
**U.S. HOUSE OF REPRESENTATIVES**  
**JULY 25, 2007**

Statement Required by 12 U.S.C. § 250:

The views expressed herein are those of the Office of the Comptroller of the Currency and do not necessarily represent the views of the President.

## INTRODUCTION

Chairman Watt, Ranking Member Miller, and members of the Subcommittee, I am Calvin Hagins, Director for Compliance Policy, at the Office of the Comptroller of the Currency (OCC). I am pleased to appear before you today to discuss fair lending issues, and to describe how the OCC supervises national banks to ensure compliance with the fair lending laws.<sup>1</sup>

This hearing presents a timely opportunity to discuss important issues that have been raised in the Subcommittee's letter of invitation, including the data reported by lenders under the Home Mortgage Disclosure Act (HMDA) on high cost home loans. For the third year in a row since certain high cost loan pricing data have been reported under HMDA, the data have indicated that a higher percentage of black and Hispanic borrowers have received high cost home purchase mortgages than have white or Asian borrowers.<sup>2</sup> Such results by themselves do not equate to unlawful discrimination, because HMDA data alone does not permit comparisons of borrowers who are truly similarly situated in terms of risk. Nevertheless, these results do mean that lenders and regulators need to get behind these numbers to make such comparisons to determine whether unlawful discrimination does in fact exist, especially with respect to those institutions where preliminary analysis of the HMDA data indicates elevated levels of fair lending risk.

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<sup>1</sup> In this testimony, the term "national banks" includes operating subsidiaries of national banks, because the federal fair lending laws apply to these operating subsidiaries in the same way they apply to the parent banks, and the OCC regulates operating subsidiaries for these purposes in the same way it regulates national banks.

<sup>2</sup> See Robert B. Avery, Kenneth P. Brevoort, and Glenn B. Canner, "Higher-Priced Home Lending and the 2005 HMDA Data," *Federal Reserve Bulletin*, vol. 92 (2006), at pp. A158 - 159, (FRB Report on 2005 HMDA Data) (regarding the impact of neutral borrower- and lender-related factors in reducing these reported differences.)

The OCC has long had a strong commitment to ensuring that national banks comply with fair lending laws and that consumers who seek credit from national banks are evaluated based on legitimate, nondiscriminatory factors. And, we are committed to ensuring that, for the institutions we supervise, any differences in lending patterns reflected in the HMDA data are the result of legitimate factors and not illegal discrimination. My testimony will describe the OCC's supervision and enforcement process for fair lending compliance, and the role that the HMDA data, including the relatively new loan pricing data, play in that process. We are committed to a rigorous and comprehensive program of fair lending oversight and to ongoing improvement in our activities as additional data and new analytic tools become available.

## **I. MORTGAGE LOAN PRICING CONCERNS**

The mortgage market has grown substantially more complex in recent years. Not long ago, only a limited number of mortgage products were available in the marketplace. In addition, the price (interest rate and fees) that a borrower paid for these mortgages generally was standardized, and varied primarily by loan product. For example, loans were priced based on the type and purpose of the loan, the amount and term of the loan, the loan-to-value ratio, and the collateral. Prices generally did not vary based on the creditworthiness characteristics of the borrower.<sup>3</sup>

We have a very different mortgage market today. The market has evolved in response to competition among lenders for loan volume; growth and standardization in the secondary market; better access to credit reports; advances in technology, including the use of automated underwriting and credit scoring systems; and the development of

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<sup>3</sup> FRB Report on 2005 HMDA Data at pp. A125 - 126.

risk-based pricing. These changes generally have led to less subjectivity in the loan underwriting process, greater product availability and choice, and greater choice in loan terms and prices depending on borrower risk. Lenders now offer a wide array of products and pricing structures, which has made it easier for borrowers who formerly did not meet traditional lending standards to obtain credit and purchase homes.<sup>4</sup>

Loan pricing varies, and can be influenced by a number of factors, including: borrower credit characteristics; debt-to-income ratios; cost of funds; prepayment risks; overhead costs; local market conditions and competition; the willingness and ability of the borrower to negotiate; and loan processing channels, including use of brokers. Interest rates can vary hundreds of basis points across all mortgage products, even for “prime” borrowers, depending upon the borrower’s credit circumstances and the features of the loan they choose. Price flexibility has had the positive effect of expanding access to mortgage credit and, as a result, expanding homeownership. But, it has also led to concerns about the fairness and legitimacy of pricing decisions on individual loans. The increased number of variables in the lending process also has made the task of identifying unlawful discriminatory lending practices, particularly unlawful discriminatory pricing practices, more complicated and challenging than in the past.

HMDA data, since being expanded in 1989 to include the race and gender of borrowers and in 2004 to include certain loan pricing information, have put into sharp focus concerns about illegal lending discrimination. Even though the data elements that

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<sup>4</sup> In contrast to their share of the mortgage market generally, national banks have not been dominant players in the subprime loan market, which generally lends to borrowers with impaired or limited credit records. Roughly one-third of the approximately \$3 trillion in total mortgages that were originated in 2006 were originated by national banks or their subsidiaries. Subprime lending by national banks and their subsidiaries in 2006, however, amounted to less than 10% of the total \$600 billion in subprime mortgage originations by all lenders.

are reported are limited, and conclusions about legal compliance cannot be drawn solely from these reports, HMDA has provided greater transparency to lending practices, most recently in the higher-cost segment of the mortgage market. As a result, the HMDA data have led to stepped-up compliance efforts by lenders, who must answer to the banking agencies, other regulators, Congress and the public, to explain why any such disparities are due to legitimate nondiscriminatory factors, and not to illegal discrimination.

## **II. THE OCC'S SUPERVISORY AND ENFORCEMENT PROCESS FOR ENSURING COMPLIANCE WITH FAIR LENDING LAWS**

Assuring fair access to credit and fair treatment of national bank customers are fundamental responsibilities of the OCC as administrator of the national banking system. The OCC comprehensively examines national banks to ensure that they are operating in compliance with applicable laws, regulations, and supervisory guidance and in a safe and sound manner.<sup>5</sup> National banks are subject to an array of laws and regulations designed to prevent illegal discrimination and ensure fair treatment of consumers.<sup>6</sup> In the fair lending area, two federal statutes protect consumers from discrimination in credit transactions: the Equal Credit Opportunity Act (ECOA) and the Fair Housing Act.

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<sup>5</sup> 12 U.S.C. § 481.

<sup>6</sup> These statutes include, in addition to the fair lending laws, the Federal Trade Commission Act's prohibition against unfair or deceptive acts or practices, 15 U.S.C. § 45; the Truth in Lending Act (which encompasses the Home Ownership and Equity Protection Act of 1994), requiring creditors to provide disclosures about terms and costs of credit and providing enhanced protections with respect to certain high cost mortgages, 15 U.S.C. § 1601 *et seq.*; the Real Estate Settlement Procedures Act, requiring advance disclosure of settlement costs in residential real estate transactions and prohibiting kickbacks or unearned fees for settlement services, 12 U.S.C. § 2601 *et seq.*; the Community Reinvestment Act, requiring the OCC to assess a national bank's record of helping to meet the credit needs of its entire community, 12 U.S.C. § 2901 *et seq.*; and the OCC's Guidelines Establishing Standards for Residential Mortgage Lending Practices, 12 C.F.R. Part 30, App. C.

ECOA and its implementing regulation prohibit discrimination against applicants for credit on the basis of race, color, religion, national origin, sex, marital status, age, receipt of public assistance income, or the exercise of rights under the Consumer Credit Protection Act.<sup>7</sup> ECOA designates the OCC as the enforcing authority with respect to national banks.<sup>8</sup>

The Fair Housing Act prohibits discrimination in making a residential real estate-related transaction available on the basis of race, color, religion, national origin, sex, familial status, or handicap.<sup>9</sup> The OCC enforces the Fair Housing Act as part of its authority to ensure national banks' compliance with applicable law.<sup>10</sup> Accordingly, the OCC examines national banks for compliance with the Fair Housing Act as well as ECOA.

#### **A. The Supervisory Process**

The OCC's fair lending supervisory and enforcement process is designed to assess and monitor the level of fair lending risk in every national bank; assess compliance with fair lending laws and regulations; obtain corrective action when significant weaknesses or deficiencies are found in a bank's policies, procedures, and controls relating to fair lending; and ensure that enforcement action is taken when warranted, including referrals to the United States Department of Justice and notifications to the United States Department of Housing and Urban Development (HUD).

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<sup>7</sup> 15 U.S.C. § 1691(a); 12 C.F.R. 202.4.

<sup>8</sup> *Id.* at § 1691c(a)(1)(A).

<sup>9</sup> 42 U.S.C. § 3605.

<sup>10</sup> *See* 12 U.S.C. § 1818.

The OCC uses a combination of analytical tools, lending information, and risk-based targeted fair lending examinations to identify and test for potential discriminatory practices. As described in greater detail below, our supervisory process entails several steps including: (1) risk assessment and screening; (2) statistical analytics and on-site examinations; and (3) enforcement and referrals.

1. *OCC Fair Lending Risk Assessments.*

The foundation of the OCC's supervisory process is the detailed, core knowledge that examiners develop and maintain about each bank's organizational structure, culture, business lines, products, services, customer base, and level of risk. In the area of fair lending, this involves an in-depth understanding of the bank's retail credit operations. The OCC's examination guidance directs examiners to consider fair lending risk as part of our supervisory process, including the nature, scope, and volume of the bank's activities, the quality of the bank's risk management systems and personnel, findings in previous risk assessments, and whether there have been recent changes in products, systems, or processes that may affect fair lending risk. Examples of factors related to fair lending that may be considered, as appropriate, in conducting risk assessments include HMDA data; types of products offered; origination channels, including reliance on third party brokers; pricing, underwriting, and compensation policies and procedures; internal controls, self-evaluations, and self-testing activities; servicing values, market environment, and profitability; loan application processes; complaint data; comments in the bank's Community Reinvestment Act (CRA) public file; and the bank's own audit results.

2. *OCC Fair Lending Screening Process.*

While regular risk assessments allow examiners to establish a fair lending supervisory strategy for each national bank, this process is significantly augmented by the OCC's annual fair lending screening process. Through a successive series of steps and filters, starting with all of the HMDA loan information filed annually by national banks, the OCC identifies those institutions, loan products, markets, and prohibited basis categories that appear at greatest risk for discriminatory practices. Indeed, when combined with our regular risk assessments, this screening process is central to our risk-based approach to fair lending supervision because it hones in on the institutions where we conduct our most in-depth fair lending examinations (and is similar to the screening process conducted by the Federal Reserve Board.)

Starting in 2000, the OCC began using an annual screening process to enhance our regular supervisory risk assessments and to better target our examination resources to those institutions and products with the highest fair lending risk. The screening process incorporates HMDA data and other sources of information to assist examiners in identifying banks exhibiting those risks that will be scheduled for in-depth fair lending examinations. While HMDA data do not contain certain key items of information necessary for a full understanding of underwriting and pricing decisions, such as the borrower credit history, the data do provide a very important screening and risk identification tool that we use regularly in our fair lending screening and examination process.<sup>11</sup>

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<sup>11</sup> See Frequently Asked Questions About the New HMDA Data at pp. 2-3, 5-6 (Apr. 3, 2006), *available at* [www.occ.treas.gov/ftp/release/2006-44a.pdf](http://www.occ.treas.gov/ftp/release/2006-44a.pdf).

The Federal Reserve Board collects and compiles HMDA data and reviews the data for errors on behalf of the federal banking agencies. The reported information includes data on type and purpose of the loan; race, ethnicity and gender of the borrower and co-borrower; geographic location of the property; “rate spread” and HOEPA status;<sup>12</sup> and action taken on the application. For a given year, the OCC generally receives HMDA data for national banks from the Federal Reserve in June of the following year. These files contain data on approximately eight million loan applications received by national banks during the prior calendar year.

Once the OCC receives the national bank data from the Federal Reserve, OCC economists run the data through three screens that have been developed by OCC fair lending experts. These screens test for national banks that are outliers when compared to all national banks in terms of disparity ratios by race, ethnicity, and gender for: 1) denial rates; 2) the incidence of reported “rate spread loans”;<sup>13</sup> and 3) the presence of other indicators in HMDA data relating to possible differences in treatment in terms and conditions.

*a. Use of HMDA Pricing Data in OCC Screening Process.*

Loan pricing information reports are now available under HMDA for lending activity covering the years 2004, 2005, and 2006, although the agencies just received the data for 2006 lending in June of this year. Pricing disparities varied somewhat between

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<sup>12</sup> The term “rate spread” refers to the requirement in Regulation C (HMDA) that lenders report the spread between the APR on the loan and the rate of Treasury securities of comparable maturity. The requirement is triggered if the APR exceeds the Treasury security rate by 3 percentage points, for first lien loans, and by 5 percentage points, for subordinate lien loans. The term “rate spread loan” refers to a loan that meets these reporting thresholds. The term “HOEPA status” refers to the requirement in Regulation C that lenders report if a loan is subject to the Home Ownership and Equity Protection Act of 1994. See 12 C.F.R. § 203.4(a)(12) and (13).

<sup>13</sup> As noted above, lenders must report the spread between the APR on a loan and the rate on Treasury securities of comparable maturity if the spread exceeds 3 percentage points for a first lien loan and 5 percentage points for a subordinate lien loan. 12 C.F.R. § 203.4(a)(12).

2004 and 2005, but generally, data from the HMDA reports for those years indicate that black and Hispanic borrowers received a higher proportion of higher cost loans than white or other borrowers. For example, in 2005, 54.7% of black borrowers and 46.1% of Hispanic borrowers received rate spread first lien home purchase loans, as compared to 17.2% of white borrowers.<sup>14</sup>

Proportionally, higher cost loans are not as prevalent in national banks as in other categories of lenders. Nevertheless, national bank loans demonstrate similar patterns of disparity as the loans of other lenders, although the magnitude of such disparity in national banks has been lower than the aggregate totals for all lenders. Thus, for national banks in 2005, 34.3% of black borrowers and 21.6% of Hispanic borrowers received rate spread first lien home purchase loans, as compared to 8.7% of white borrowers.

The 2006 data is similar to the 2005 data. For all lenders, the 2006 data show similar disparities as in 2005 in the incidence of rate spread lending for black and Hispanic borrowers seeking first lien home purchase loans. The 2006 data also continue to show that the proportion and disparities in rate spread lending by national banks for black and Hispanic borrowers are significantly lower than the national figures.

Reasons for the disparities in the incidence of rate spread loans are not apparent from the HMDA data, and Federal Reserve Board studies indicate that the HMDA data, taken alone, may overstate the degree to which race may be a factor in pricing disparities.

The Board found that the gross mean incidence of higher price lending for black and

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<sup>14</sup> FRB Report on 2005 HMDA Data at p. A160. The incidence of rate spread loans was significantly higher for all lenders in 2005 than in 2004, due to various factors including changes in the interest rate environment. FRB Report on 2005 HMDA Data, at pp. A141-144. In 2004, the aggregate data for all lenders showed that 32.4% of black borrowers and 20.3% of Hispanic borrowers received a rate-spread first lien home purchase loan, as compared to 8.7% for white borrowers. FRB Report on 2005 HMDA Data at p. A160. For national banks, gross disparities in 2004 were lower than the figure for all lenders: 15.4% of black borrowers and 7.1% of Hispanic borrowers received rate spread first lien home loans, as compared to 3.1% of white borrowers.

Hispanic borrowers declines substantially when the data are adjusted by applying just a few borrower-related factors, such as income, loan amount, and property location, and by controlling for the lender used. These basic factors account for a substantial portion of the gap between black and Hispanic borrowers and white borrowers in the incidence of rate spread lending reflected in the 2004 and 2005 HMDA data.<sup>15</sup> However, while a larger percentage of black and Hispanic borrowers received rate spread loans than white and Asian borrowers, analysis of the HMDA data indicates that the average rates they pay on those rate spread loans are about the same as the rates paid by white and Asian borrowers that receive such loans.<sup>16</sup>

The OCC uses HMDA data in our fair lending screening process, and, in particular, we incorporate HMDA pricing data in our screens to identify and select banks for fair lending examinations based on risk. With respect to rate spread loans reported in those years, OCC economists and examiners test for differences in rate spread incidences between the prohibited basis groups and the control group. Our examiners follow up on any disparities, and conduct examinations of banks targeted for examination based on this screening process, as well as our risk assessments. This is the process we used for our screens for 2004 and 2005 data, and we are following a similar process with respect to the 2006 HMDA pricing information.

*b. Other Screens.*

In addition to these three screens, the OCC uses two other screens that rely on HMDA data and Census Bureau data to assess application patterns in metropolitan

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<sup>15</sup> FRB Report on 2005 HMDA Data, at p. A160. For first-lien home purchase loans, the report indicates that these factors account for all but 10 percentage points of the gap between black and white borrowers in 2005, and 7 percentage points in 2004.

<sup>16</sup> FRB Report on 2005 HMDA Data, at p. A159.

statistical areas. We also incorporate the results of pricing screens that the Federal Reserve Board performs. While there can be substantial overlap between the Federal Reserve's results and the results we obtain, there is not complete overlap because the screening parameters we use are not identical, and any additional banks flagged by the Federal Reserve's screens are included in our list of institutions to receive further scrutiny.

Finally, our annual screening lists contain two random sample components. First, the entire population of national banks is randomly sampled to develop a list of banks that will receive in-depth fair lending examinations. Our random sampling ensures that each national bank faces the possibility of an in-depth examination in any given year, even if the bank does not report HMDA data and even though it has not triggered our risk-based screening criteria. The OCC also randomly samples OCC-supervised credit card banks to develop a separate list of those institutions that will receive fair lending examinations.

The OCC periodically reviews and modifies its screening process to enhance its effectiveness, and to incorporate new sources of risk information as they become available. For example, credit scores have been proven to be predictive of loan performance, and are used routinely by mortgage lenders, but are not reflected in HMDA data. Therefore, the OCC and the other Federal Financial Institution Examination Council (FFIEC)<sup>17</sup> member agencies are in the process of purchasing an external database that will provide us the additional capability of mapping credit scores by census

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<sup>17</sup> The federal banking agency members of the FFIEC include the OCC, the Federal Reserve Board, the Federal Deposit Insurance Corporation, the Office of Thrift Supervision, and the National Credit Union Administration.

tract. This data should help in our general assessment of fair lending risks in particular geographies.

After we have developed preliminary screening lists, the lists are sent to examiners of the banks identified on the list for review.<sup>18</sup> The banks that appear on the final screening lists receive an in-depth, on-site fair lending examination.

### 3. *OCC Fair Lending Examinations.*

The OCC's fair lending supervisory process is a multi-step process for assessing a national bank's compliance with fair lending laws. Ultimately, these steps are designed to lead to a determination of whether or not there is a reason to believe that a bank has engaged in unlawful discrimination that would require a referral to the Department of Justice or HUD, or enforcement action by the OCC. After we identify banks that appear to exhibit the highest fair lending risk through our fair lending risk assessment and screening steps, the next step is the fair lending examination itself.

Our fair lending examinations use interagency fair lending examination procedures and additional OCC-developed analytical tools to evaluate the credit decisions made by a bank to help us determine whether different outcomes in lending decisions are the result of unlawful discrimination. Our examiners rely on the comprehensive and detailed examination guidance contained in fair lending examination procedures, which were developed with the other FFIEC agencies.<sup>19</sup> These procedures contain detailed guidance for assessing risks of unlawful behavior involving overt discrimination,

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<sup>18</sup> In a small number of instances, banks may be added to, or removed from, the list based on recommendations by examiners concerning the level of fair lending risk.

<sup>19</sup> Comptroller's Handbook, *Fair Lending Examination Procedures* (Apr. 2006) (*Examination Procedures*), available at <http://www.occ.treas.gov/handbook/fairlep.pdf>. The OCC's *Examination Procedures* incorporate the Interagency Fair Lending Examination Procedures, as well as OCC-specific supplemental material.

underwriting and pricing discrimination, steering, and discriminatory redlining and marketing.<sup>20</sup>

Today, it is rare for our examiners to encounter overt evidence of unlawful discrimination, such as a written lending policy that treats applicants differently on a prohibited basis.<sup>21</sup> Instead, what we may see is information indicating different lending outcomes for individuals or groups. Our supervisory approach is then to evaluate the factors a bank relies on to explain their credit decisions, and to reach our own conclusions about whether these factors are legitimate, business-related, and nondiscriminatory, and that they do in fact explain the outcomes. If disparities remain that cannot be attributed to these legitimate factors, then examiners preliminarily conclude that there is reason to believe that the disparities are the result of unlawful discrimination, and we then move to the enforcement and referral process described below.

*a. Setting the Focus and Scope of the Examination.*

Prior to beginning an examination, our examiners first develop one or more “focal points” for the examination. A “focal point” encompasses the loan product, market, decision center, time frame, and prohibited basis and control group to be analyzed.<sup>22</sup> The development of focal points assists our examiners in concentrating resources on the areas of highest risk. In addition, given the tremendous diversity in mortgage products and payment options available today, it is critical that our focus is on treatment of similarly situated borrowers within the same product types, and our focal point selections helps us

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<sup>20</sup> *Id.* at pp. 23-29.

<sup>21</sup> For example, the OCC has found explicit policies to treat applicants differently based on age or marital status, such as a policy that required younger applicants to have a co-signer, and a policy in which the bank would evaluate information about the income and employment of a co-applicant spouse, but not comparable information about a non-spouse co-applicant.

<sup>22</sup> *Examination Procedures* at p. 10.

to do that. For example, home improvement loans would not be grouped together with home purchase loans for analysis. The screening lists described above help identify focal points for our examiners, especially for banks in the midsize and community bank program. Focal points recommended through the screening process, however, can be modified if the circumstances warrant, and our examiners consider HMDA data and other relevant information in finalizing focal points for their fair lending examinations.

Once focal points are selected, examiners determine the examination intensity. The intensity of the examination refers to the breadth and depth of the analysis that will be conducted with respect to the loan products that have been selected for evaluation, and it identifies discrimination risk factors for the products to be evaluated based on information about the bank's risk profile, its compliance risk management procedures and controls, its lending policies, and audits.<sup>23</sup> Examiners also may consider the bank's own self-evaluations in setting the intensity of the examination.<sup>24</sup>

Examiners conduct an underwriter interview to document the underwriting criteria the bank uses, how they are applied, whether changes have been made during the time frame being reviewed, and the degree of discretion that is exercised in lending and pricing decisions.<sup>25</sup> This information is used when examiners conduct transaction testing and file reviews to ensure that the bank complied with its stated policies. If statistical modeling is used in the examination, a thorough review of bank policies assists in ensuring that the model encompasses key variables used in underwriting or pricing decisions by the bank. Examiners also review policies and procedures to ensure that no overtly unlawful discriminatory factors are used in evaluating applicants.

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<sup>23</sup> *Examination Procedures* at pp. 12-13, pp. 33-34 & App. A.

<sup>24</sup> *See Examination Procedures* at App. H.

<sup>25</sup> *Id.* at p. 36 & App. J.

*b. Use of Statistical Analysis.*

For banks that have a large volume of applications, as well as a variety of loan product types, OCC economists may develop a statistical model to compare information from large numbers of files and to test for potential unlawful discrimination. The statistical model is an automated comparative file review of all applications or originations in a given population, such as all files relating to a particular loan product. As explained in more detail below, an important advantage of statistical modeling is that it can compare a large number of files simultaneously over all the relevant factors -- something that is very difficult to do with human judgment alone. Thus, the use of statistical tools in fair lending examinations enables the OCC to conduct comprehensive, risk-based examinations, and the methodologies we use are consistent with principles and methods generally accepted by the federal courts and consistent with the approach taken by the Department of Justice in fair lending litigation.

Examiners first review the bank's underwriting and pricing policies, and then work with quantitative experts to construct a statistical model to test for potential disparate treatment. As part of this process, the OCC receives a large amount of information from the bank that is not contained in the HMDA data and which may explain variations in underwriting and pricing decisions by race and ethnicity. For example, underwriting policy information can include cutoffs or threshold values for certain key variables, like debt-to-income ratios. For pricing examinations, examiners request from the bank information such as rate sheets, policies on "overages" and "underages,"<sup>26</sup> and exceptions to pricing policies. OCC economists often model the

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<sup>26</sup> An "overage" occurs when a lender permits a loan officer or broker to impose a higher number of points or a higher interest rate on a loan than the lender's target price for the loan product. The "overage," or the

underwriting and pricing decisions using commonly accepted statistical techniques such as logistic regression (in the case of underwriting) or linear regression (in the case of pricing).<sup>27</sup> As underwriting and pricing decisions can vary by bank, channel, and product, the exact model specifications also can vary bank to bank, and exam to exam. Once the model is developed, we focus on the magnitude and significance of the estimated disparities between prohibited basis groups and a control group, using standard statistical tests.<sup>28</sup> These techniques help to identify particular applications or originations that appear to be outliers or to identify applicants who appear to be similarly situated, but who experienced different outcomes. The corresponding loan files then can provide examiners with a better starting point for comparison than that which could be achieved through random selection.

*c. Comparative File Reviews.*

In mid-size and community banks, which have smaller volumes and less diversity in loan types, after setting the examination focus and scope, the next stage of a fair lending examination is typically a comparative file review, rather than the use of statistical analysis.<sup>29</sup> Examiners review files to compare denied versus approved applicants who are similarly situated, or to compare the terms and conditions offered to

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difference between the actual price on a loan and the target price, typically is shared between the lender and the loan officer or broker as a means of increasing compensation. An “underage” occurs when the actual loan price is lower than the lender’s target price.

<sup>27</sup> In general, a regression analysis seeks to explain the relationship between an outcome (e.g., a pricing or underwriting decision) and variables that may explain that outcome (e.g., credit score, debt-to-income ratio, or loan-to-value ratio). A “linear regression” typically is used in situations, such as in reviewing loan pricing decisions, where there may be a range of potential values (e.g., many possible APRs), whereas a “logistic regression” is better suited to an analysis of situations where the outcome can be only one of two values (e.g., an approval or denial of a loan application).

<sup>28</sup> In determining the level of confidence of statistical significance that would support a finding of discrimination in a particular matter, the OCC would evaluate the overall facts and circumstances and would consult judicial precedent developed under the civil rights laws. As appropriate, the OCC would also consult with the Department of Justice’s fair lending enforcement staff.

<sup>29</sup> In addition to a review of loan files, our examinations may also focus on the use of and the variables contained in credit scoring models. *Examination Procedures* at App. B.

such applicants. The fair lending examination procedures provide guidance on how to determine sample sizes and the types of files to compare.<sup>30</sup> For underwriting analyses, examiners are to place special emphasis on identification of marginal applicants. A “marginal applicant” is one who is neither clearly qualified nor clearly unqualified.<sup>31</sup> The review of loan files for marginal applicants assists examiners in determining whether similarly situated borrowers were treated differently and the reasons for different outcomes.

*d. Examination Conclusions.*

For all banks, when potential unlawful discriminatory results are found, examiners present their findings to bank management for an explanation. If the bank’s explanation is inadequate to rebut preliminary examination findings, the findings are documented, and decisions are made on what OCC supervisory or enforcement action should be taken and on whether the matter must or should be referred to the Department of Justice or HUD.<sup>32</sup> This process is discussed in more detail below. Additionally, even if no violation is found, where specific practices or a lack of adequate controls expose the bank to unacceptable risk that a fair lending violation could occur, the OCC will direct bank management to modify its practices or policies to address that risk. Significant problems can be addressed in a variety of ways, including as examination findings and conclusions, or as “Matters Requiring Attention” (MRAs) directed to bank management and boards of directors, in written reports of examination and other written supervisory communications.

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<sup>30</sup> *Id.* at pp. 16-17, 37-52 & App. D.

<sup>31</sup> *Examination Procedures* at pp. 40-43 & App. E.

<sup>32</sup> *Examination Procedures*, at pp. 66-68 & App. C.

## **B. The Enforcement Process**

### *1. Referral and Notification Provisions.*

ECOA requires the OCC to refer matters to the Department of Justice “whenever the agency has reason to believe that 1 or more creditors has engaged in a pattern or practice of discouraging or denying applications for credit” in violation of ECOA’s nondiscrimination provisions.<sup>33</sup> In cases not involving a pattern or practice of violations, the OCC has discretion to make a referral to the Department of Justice when it has reason to believe that discrimination has occurred or when it is unable to obtain compliance with the ECOA’s provisions.<sup>34</sup> ECOA also requires the OCC to notify HUD when there is a reason to believe that a creditor has violated ECOA and the Fair Housing Act, but the matter is not referred to the Department of Justice.<sup>35</sup> Further, Executive Order 12892 requires each executive agency to forward to HUD information suggesting a violation of the Fair Housing Act. The information also must be forwarded to the Department of Justice if it indicates a possible pattern or practice of discrimination in violation of the Fair Housing Act.<sup>36</sup> Finally, a 1991 Memorandum of Understanding between HUD and the federal banking agency members of the FFIEC requires the agencies to notify HUD of complaints that appear to allege a violation of the Fair Housing Act.

Generally, banks are provided with a letter containing preliminary findings of discrimination and are given an opportunity to respond in writing. If, after the response is considered, the supervisory office continues to believe that violations of the ECOA or

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<sup>33</sup> 15 U.S.C. § 1691e(g).

<sup>34</sup> *Id.*

<sup>35</sup> *Id.* at § 1691e(k).

<sup>36</sup> Executive Order 12892, Leadership and Coordination of Fair Housing in Federal Programs: Affirmatively Furthering Fair Housing § 2-204 (Jan. 17, 1994), *reprinted in* 42 U.S.C.A. § 3608 note (West 1994).

the Fair Housing Act occurred, final determinations are made regarding violations and referrals and notifications to the Department of Justice and HUD.

2. *OCC Fair Lending Enforcement and Referrals.*

a. *In General.*

Since 1993, we have made referrals to the Department of Justice and/or notified HUD of 38 matters under the referral and notification provisions of ECOA. Additionally, pursuant to the 1991 Memorandum of Understanding, the OCC has forwarded to HUD 91 complaints of discrimination filed with our Customer Assistance Group since the fourth quarter of 2002.

Several of our referrals to the Department of Justice have involved allegations of unlawful discriminatory pricing. Indeed, one of our most important enforcement actions, involving discriminatory overages in mortgage lending, was settled well before amendments to HMDA rules made pricing data publicly available.

Our first referral to the Department of Justice resulting in a public consent decree and consent order involved allegations of race discrimination in the pricing of unsecured home improvement loans. This was the first settlement obtained by a federal banking agency to remedy race discrimination in lending. The bank was required to establish a \$750,000 compensation fund, implement a customer assistance program to provide information about the bank's products and how to qualify for these products, and implement a matched pair testing program.<sup>37</sup>

Two subsequent cases also involved discrimination in loan pricing. In a 1995 case, the OCC found that a lender was charging higher overages on mortgage loans to

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<sup>37</sup> *U.S. v. First National Bank of Vicksburg*, Consent Decree (S.D. Miss. 1994), available at <http://www.usdoj.gov/crt/housing/documents/vicksburgsettle.htm>.

black borrowers than to similarly-situated white borrowers. The Department of Justice entered a settlement agreement with the lender requiring the lender to cap overages, implement a monitoring and compliance system to ensure uniform pricing, and establish a compensation fund of \$420,000.<sup>38</sup> In another case originating with an OCC examination, the Department of Justice filed suit claiming that the bank's Native American customers were charged higher interest rates on consumer loans than other customers who were similarly situated. To settle the lawsuit, the bank agreed to (1) create a \$175,000 compensation fund; (2) set aside \$100,000 to defray certain loan fees for applicants residing in the reservation the bank served; (3) conduct a money management education program for residents of the reservation; and (4) take affirmative steps to increase the pool of qualified Native American applicants for positions at the bank.<sup>39</sup>

A later case involved the OCC's use of statistical techniques to find racial discrimination in the bank's handling of home improvement loan applications. The OCC's analysis concluded that, after controlling for neutral factors, black applicants were at least three times as likely to be rejected for home improvement loans because of the manner in which the bank implemented overrides of its credit scoring system. The Department of Justice's settlement agreement with the bank required a \$3 million compensation fund for aggrieved applicants, as well as monitoring and review of underwriting decisions.<sup>40</sup>

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<sup>38</sup> *U.S. v. Huntington Mortgage Co.*, Settlement Agreement (N.D. Ohio 1995), available at <http://www.usdoj.gov/crt/housing/documents/huntingtonsettle.htm>.

<sup>39</sup> *U.S. v. First National Bank of Gordon, Nebraska*, Consent Order (W.D.S.D. 1997), available at <http://www.usdoj.gov/crt/housing/documents/gordonsettle.htm>.

<sup>40</sup> *U.S. v. Deposit Guaranty National Bank*, Settlement Agreement (S.D. Miss. 1999), available at <http://www.usdoj.gov/crt/housing/documents/dgnbsettle.htm>.

The Department of Justice's first public consent decree involving discrimination in credit card lending also originated as an OCC referral. In that case, we found that Spanish speaking applicants were subjected to stricter underwriting standards than English speaking applicants, and that Spanish speaking cardholders were excluded from credit promotions. The bank's settlement included an agreement to establish a \$1.5 million compensation fund for aggrieved individuals.<sup>41</sup>

Other OCC referrals to the Department of Justice have concerned violations involving age and marital status discrimination. In a number of such instances, after such a referral, the Department of Justice has declined to take action and has requested that the OCC resolve the matter and provide consumer redress through our own supervisory and enforcement procedures. Depending on the violation, the number of and harm to potential victims, remedial action voluntarily undertaken, and other factors,<sup>42</sup> these cases have been resolved through (1) supervisory action; (2) informal, nonpublic supervisory agreements; or (3) formal, public consent orders. One such example involved evidence of discrimination against non-Asian applicants for mortgage loans. The OCC resolved the case with a consent order that required the bank to pay a civil money penalty and to establish a \$400,000 settlement fund to compensate affected applicants.<sup>43</sup>

*b. Recent Trends.*

The number of instances in which we have found illegal discrimination has declined in recent years. While lending markets have become more complex, and we

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<sup>41</sup> *U.S. v. Associates National Bank*, Settlement Agreement (D. Del. 2001), available at <http://www.usdoj.gov/crt/housing/documents/assocsettle.htm>.

<sup>42</sup> See 1994 Interagency Fair Lending Policy Statement, 59 Fed. Reg. at p. 18,272 (discussion of factors federal banking agencies will consider in determining appropriate enforcement sanctions and remedial measures).

<sup>43</sup> *In the Matter of: First Central Bank, N.A., Cerritos, California*, Stipulation and Consent Order (Feb. 2, 1999), available at <http://www.occ.treas.gov/ftp/release/99-23a.txt>.

have many challenges to address with the recent collection of HMDA pricing data, we would hope for, and expect, a decline in unlawful lending discrimination in national banks given our supervisory oversight, the fair lending enforcement actions taken by the OCC described above, and the significant steps taken by national banks to monitor and improve their fair lending compliance since that time. Indeed, OCC enforcement actions have sent a strong signal to national banks that their compliance with fair lending laws will be scrutinized and that noncompliance will be subject to enforcement action. In addition, in response to our supervisory and enforcement regime, national banks have adopted a number of measures designed to improve their fair lending compliance. Many banks now use second review programs, testing, and self evaluations to monitor and reduce racial disparities in loan transactions. To mitigate fair lending compliance risks relating to third party brokers, banks have both imposed caps on overall compensation a broker may be paid and limited broker discretion in loan underwriting and pricing decisions, and banks also monitor broker loan channels for pricing disparities. Finally, some banks have developed special procedures to address the risk of inappropriate and potentially unlawful steering, for example, by reviewing applications submitted through a subprime lending channel to determine whether the applicant can qualify for better terms in the prime channel. Concerns about reputation risk and loss of customers, combined with the knowledge that the OCC will scrutinize banks that display elevated levels of fair lending risk and take action where appropriate, act as a powerful incentive to banks to ensure that their lending processes are free of illegal discrimination.

Referral numbers alone can also be misleading, because the OCC also has available a variety of supervisory mechanisms to address problematic practices or

weaknesses in controls before such issues lead to potential violations. As previously described, the fair lending supervisory process entails a number of steps, in ascending order of consequence, including our assessment and screening processes to identify banks exhibiting higher fair lending risks, fair lending examinations of those banks, corrective actions to address deficiencies, and finally, where necessary, enforcement actions to address violations of law or deficiencies in bank controls. Formal enforcement actions involving referrals to the Department of Justice generally should be necessary only if the preceding measures have failed to ensure compliance with the fair lending laws. Our goal is to stanch fair lending risk through comprehensive and escalating supervision -- before it develops into illegal practices requiring referrals and enforcement.

When the OCC finds practices or weaknesses that could expose the bank to an unacceptable risk that a fair lending violation could occur, for example, we direct bank management to modify its practices or policies to address that risk. Significant problems can be addressed in a variety of ways, including through findings and conclusions, or as MRAs of bank management and boards of directors, in written reports of examination. To assist institutions in strengthening fair lending controls, our examiners also may provide supervisory recommendations. These may be contained in examination reports, or in other communications to the institution. These elements of the OCC supervisory process help to prevent bank practices from reaching the point where enforcement action or referrals to the Department of Justice are warranted.

To illustrate, OCC examiners have issued nearly 200 MRAs relating to ECOA and HMDA compliance since 2002. Some of these MRAs concerned practices and weaknesses in internal controls that could present fair lending risk. Other MRAs

concerned controls on discretionary pricing, improving documentation of credit decisions, improving and expanding self-monitoring activities, and improving controls relating to brokered loans. Additionally, during this timeframe, the OCC has taken supervisory actions to address violations of HMDA reporting requirements and provisions of ECOA relating to issues such as collection of government monitoring information and adverse action notices. This careful attention to reporting, information collection, and notice obligations further enhances compliance with the fair lending laws by national banks.

3. *New OCC Supervisory Initiatives.*

Notwithstanding past OCC supervisory action and enforcement, we recognize the new challenges we face with the increased complexity of the mortgage lending market, the increased use of brokers, and the surge in the use of subprime and other higher priced lending products for less creditworthy borrowers. It has become more difficult to make a determination whether pricing variations are the result of legitimate nondiscriminatory factors or unlawful discrimination – and we need to adjust and make refinements to our approach to address this challenge.

Although the HMDA pricing data plainly help in this regard, we remain in a relatively early stage of analysis. Because of the time lag in releasing “scrubbed” pricing data, we are still in only the second year of using the results for fair lending supervision, having just recently received the data for the third year, 2006. Thus far, our targeted and focused examinations resulting from the analysis of this data have resulted in no referrals of pattern and practice violations to the Department of Justice: we have found that pricing disparities between classes of borrowers have been explained satisfactorily by

differences in borrower creditworthiness and other legitimate factors used by the bank to underwrite the loans and to set prices.

These early determinations are by no means the end of the story, however. We want to make sure that we are doing everything we can to investigate disparities in lending practices, including by refining our fair lending supervisory techniques as we go forward and by targeting emerging risks. In particular, certain practices, such as “steering” applicants to particular products to the exclusion of others and the ability of brokers to price loans, may be contributing to fair lending risks and deserve closer scrutiny.<sup>44</sup>

Therefore, we are taking specific actions to review and improve our fair lending supervision program. In particular, the Comptroller has directed the examiners of our banks with large mortgage operations to establish the following as supervisory objectives for the next fair lending examinations of their banks:

- A targeted review of bank controls and oversight procedures over brokers to address the risks of unlawful pricing disparities in this channel; and
- A targeted review of bank controls and procedures to ensure that applicants are not unlawfully “steered” to high cost loan products.

In addition, we have initiated a review through the FFIEC of the interagency fair lending examination procedures to evaluate whether the procedures need to be refined, based on

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<sup>44</sup> The Federal Reserve Board found a much lower incidence of higher-priced lending by lenders in their CRA assessment areas than by the same lenders when they make loans outside of their assessment areas. Although the Board explained that the HMDA data do not contain sufficient information to draw any firm conclusions on this point, it noted that loans extended to borrowers outside an institution’s assessment area “may be more likely to come through mortgage brokers.” FRB Report on 2005 HMDA Data, at pp. A157-158.

our first two years of experience, to better analyze the factors underlying disparities in loan pricing.

## **CONCLUSION**

In conclusion, this hearing is an important opportunity to examine the fair lending implications of the continued disparities in HMDA reports, and to review how the federal banking and enforcement agencies are following up on these concerns. At the OCC, we are committed to ensuring that the institutions we supervise are not engaged in unlawful discriminatory practices. Moreover, we continue to review and enhance our fair lending supervisory procedures to ensure that they are as effective as possible in detecting unlawful lending discrimination.

I appreciate the opportunity to present the OCC's views on these issues and will be pleased to answer any questions that you might have.