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**Examiner Use of Home Mortgage
Disclosure Act Data to Identify Potential
Discrimination**

AUDIT REPORT

Office of Audits



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Examiner Use of Home Mortgage Disclosure Act Data to Identify Potential Discrimination

Results of Audit

Background and Purpose of Audit

The Home Mortgage Disclosure Act (HMDA) was enacted in 1975, and the Federal Reserve Board (FRB) has statutory responsibility to promulgate HMDA regulations. HMDA requires mortgage lenders to annually disclose data to the public on mortgage loan applications, originations, and purchases of home mortgage, home improvement, and refinancing loans.

The FDIC is required to assess HMDA compliance by FDIC-supervised institutions. Starting in 2004, institutions were required to include loan interest rate pricing information in HMDA data. The pricing information helps FDIC examiners in scoping fair lending examinations and detecting loan pricing disparities that may warrant further investigation.

The audit objective was to determine whether the FDIC makes appropriate use of available HMDA data to identify and assess instances of potential discrimination when examining an institution's compliance with relevant laws and regulations.

Overall, the FDIC makes appropriate use of available HMDA data during compliance examinations to identify and assess instances of potential discrimination in FDIC-supervised institutions. Specifically, we found that for the 14 institutions we reviewed, the FDIC used HMDA data to identify areas for review during examinations.

In addition, the FDIC has taken a positive step in instituting a project that requires increased attention for institutions with higher-priced loans. The FDIC has identified 47 such institutions, completing reviews of 18 institutions as of July 2006, while another 5 institutions merged or changed charters without review. Potential discriminatory practices have been identified at five institutions. The FDIC's Legal Division is in the process of assessing the results of the reviews for four of the five institutions, and the remaining institution has been given the opportunity to respond to potential discriminatory lending activities identified by the FDIC.

However, we noted that FDIC guidance could be improved in the following areas:

- examiner reporting of HMDA examination findings,
- the extent of review examiners recommend be performed by institutions when examiners identify errors in HMDA data, and
- the documentation of the lending relationships between institutions and residential mortgage brokers for HMDA reporting purposes.

Clearer guidance could reduce inconsistencies in examiner (1) reporting of errors and omissions in HMDA data and (2) handling of institutions' resubmissions of corrected HMDA data. Further, clarified guidance could provide the FDIC greater assurance that HMDA data reporting by FDIC-supervised institutions accurately reflects loan pricing disparities and that violations of fair lending laws have been identified. A greater understanding of the institution's relationships with third parties and the credit decision process would enable examiners to ensure that required disclosures are provided to the borrowers when credit decisions are made by third parties and that the institution is complying with HMDA reporting requirements.

In addition, we identified another matter warranting management attention related to examiner use of the required checklist to comprehensively document work performed in reviewing HMDA data.

Recommendations and Management Response

The report recommends that DSC (1) clarify examiner guidance related to reporting HMDA examination findings and handling institutions' review and resubmission of corrected HMDA data, (2) provide additional examiner guidance on how to document third-party residential mortgage lending relationships for HMDA reporting purposes, and (3) emphasize examiner completion of the required checklist for HMDA reviews to document work performed. The FDIC agreed or generally agreed with the recommendations and is taking responsive actions.

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DATE: September 28, 2006

MEMORANDUM TO: Sandra L. Thompson, Acting Director
Division of Supervision and Consumer Protection

FROM: Russell A. Rau [Electronically produced version; original signed by Russell A. Rau]
Assistant Inspector General for Audits

SUBJECT: *Examiner Use of Home Mortgage Disclosure Act Data to Identify Potential Discrimination* (Report No. 06-023)

This report presents the results of the Office of Inspector General's (OIG) audit of the FDIC's use of Home Mortgage Disclosure Act (HMDA) data during compliance examinations of FDIC-supervised institutions. The audit objective was to determine whether the FDIC makes appropriate use of available HMDA data to identify and assess instances of potential discrimination when examining an institution's compliance with relevant laws and regulations. The FDIC's Division of Supervision and Consumer Protection (DSC) is responsible for examining and supervising insured financial institutions to ensure they operate in a safe and sound manner and that consumers' rights are protected.

To address our objective, we assessed the FDIC's examination procedures related to the use of HMDA data during compliance examinations and examiner compliance with those procedures. Also, we reviewed the project established by the FDIC to conduct additional reviews of FDIC-supervised institutions with higher-priced loans.¹ Details on our objective, scope, and methodology are in Appendix I of this report.

We did not review examiner assessments of institutions' compliance management systems. Examiners perform these assessments to determine whether institutions have weaknesses that could result in current or future noncompliance with consumer protection laws, such as HMDA. We plan to conduct a follow-on audit of the FDIC's examination process for assessing the adequacy of institutions' compliance management systems, which include board management and oversight, policies, procedures, training, monitoring, and audits.

¹ As of 2004, lenders must disclose certain pricing information for loans with prices above designated thresholds. Loans priced above the thresholds are referred to as "higher-priced" loans.

BACKGROUND

HMDA was enacted by the Congress in 1975, and the Federal Reserve Board (FRB) has statutory responsibility to promulgate HMDA regulations.² HMDA applies to certain financial institutions, including banks, thrifts, credit unions, and other mortgage-lending institutions.³ HMDA requires mortgage lenders to annually disclose data to the public about the geographic distribution of their loan applications, originations, and purchases of home mortgage, home-improvement, and refinancing loans.⁴ HMDA grew out of public concern over credit shortages in certain urban neighborhoods. Specifically, HMDA requires lenders to report data on the ethnicity, race, gender, and income of applicants and borrowers, as well as pricing data on certain loans. HMDA also directs the Federal Financial Institutions Examination Council (FFIEC)⁵ to make summaries of the data available to the public.

In 2002, the FRB amended Regulation C, which implements HMDA, to include new loan pricing data (for detailed information, see Appendix II). Additionally, the FRB revised racial and ethnic categories to reflect recent changes to the Office of Management and Budget (OMB) racial and ethnic standards for federal statistics and administrative reporting and to conform to Census Bureau definitions.⁶ Further, lenders must ask applicants their ethnicity, race, and gender for loan applications received by telephone, mail, or the Internet. These changes allow examiners to more accurately identify and compare applicants on the basis of race and ethnicity.

Regulation C, as amended, required banks to submit the new 2004 HMDA data to the FRB by March 1, 2005, and to continue annual reporting thereafter. Specifically, institutions subject to HMDA are required to record and report interest-rate pricing information pertaining to the:

- spread between the annual percentage rate (APR) and the applicable Treasury yield if the spread is equal to or greater than 3 percentage points for originated, first-lien home mortgage, refinancing, and dwelling-secured home improvement loans;

² Federal Reserve Board Regulation C (12 Code of Federal Regulations (C.F.R.) Part 203) implements HMDA. HMDA Section 305(a), *Enforcement*, indicates that the FDIC has the authority to enforce HMDA provisions for FDIC-supervised institutions, in accordance with Section 8 of the Federal Deposit Insurance Act.

³ Banks, savings and loan associations, credit unions, and mortgage and consumer finance companies are required to report HMDA data if those institutions meet the law's criteria for coverage by HMDA. Generally, a lender may be subject to HMDA depending on: the lender's asset size, whether the lender has an office in a metropolitan statistical area (as defined by the Office of Management and Budget), and the extent of the lender's housing-related lending activity.

⁴ Information about each application or loan and about each applicant or borrower is reported on a loan-by-loan, application-by-application basis on a lender's loan application register (LAR).

⁵ The FFIEC, established in March 1979, is a formal interagency body empowered to prescribe uniform principles, standards, and report forms for the federal examination of financial institutions by the FRB, the FDIC, National Credit Union Administration (NCUA), Office of the Comptroller of the Currency, and Office of Thrift Supervision and to make recommendations to promote uniformity in the supervision of financial institutions.

⁶ According to the OMB *Federal Register* Notice entitled, *Revisions to the Standards for the Classification of Federal Data on Race and Ethnicity*, there are five minimum categories for data on race: American Indian or Alaska Native, Asian, Black or African American, Native Hawaiian or Other Pacific Islander, and White. Also, there are two categories for data on ethnicity--Hispanic or Latino and Not Hispanic or Latino.

- spread between the APR and applicable Treasury yield if the spread is equal to or greater than 5 percentage points for originated, subordinate-lien home mortgage, refinancing, and dwelling-secured home improvement loans; and
- loans that exceed the Home Ownership and Equity Protection Act (HOEPA) triggers for each originated or purchased loan.⁷

The addition of rate spread and HOEPA information to the HMDA data provides examiners with additional tools to scope and focus the fair lending portion of compliance examinations. HOEPA imposes restrictions on certain loan features, including balloon payments and prepayment penalties, and requires improved disclosures for customers. Identifying these loans helps examiners detect abusive practices that have accompanied some of these loans in the past.

The FDIC is responsible for evaluating FDIC-supervised financial institutions' compliance with federal consumer protection laws and regulations.⁸ Two federal statutes specifically prohibit discrimination in lending: the Fair Housing Act (FHA), enacted by Title VIII of the Civil Rights Act of 1968; and the Equal Credit Opportunity Act of 1974 (ECOA).⁹ Examiners use HMDA data to assist in evaluating institution compliance with the anti-discrimination laws and other consumer protection laws in order to determine the scope of the fair lending portion of a compliance examination and select loan applications for the purposes of comparison of treatment by the lending institution.

FRB Analysis of the New HMDA Data

In September 2005, the FRB published its first study of the new expanded HMDA data entitled, *New Information Reported under HMDA and Its Application in Fair Lending Enforcement* (Study). The FRB Study confirmed a commonly held belief about mortgage prices: “Traditionally underserved minority groups were more likely than other populations to pay higher prices for mortgages.” Specifically, the differences in patterns across racial and ethnic groups were significant, and it was clear that most minority groups were much more likely to get higher-priced loans than Whites. The Study reported that a much higher share of mortgages

⁷ Congress enacted the HOEPA in response to evidence of abusive mortgage lending, particularly lending that involves excessive interest rates and fees. HOEPA identifies a class of high-cost mortgage loans and requires that consumers who enter into these transactions be provided with additional disclosures intended to facilitate comparison with other loan products. HOEPA also restricts the use of certain loan terms associated with abusive lending and authorizes the FRB to issue regulations that prohibit specific types of mortgage lending practices found to be abusive.

⁸ As part of the compliance examination process, the FDIC reviews the information and disclosures that are provided to consumers by FDIC-supervised institutions in accordance with consumer protection laws and regulations. Also, DSC considers an institution's compliance with fair lending, privacy, and other consumer protection laws and its performance under the Community Reinvestment Act (CRA) when reviewing an institution's application for entry into or expansion within the insured depository institution system.

⁹ The FHA prohibits discrimination in various phases of housing and makes it unlawful for any lender involved in residential real-estate-related transactions to discriminate against any persons in making those transactions available, or in the terms and conditions of those transactions, because of race, color, religion, national origin, gender, familial status, or handicap. The ECOA prohibits discrimination in any aspect of a credit transaction on the basis of race, color, religion, national origin, gender, marital status, age, receipt of income from a public assistance program, and the good faith exercise of any right under the Consumer Credit Protection Act of 1968.

were higher priced for Black and Hispanics than for non-Hispanic Whites or Asians and that much racial and ethnic disparity in higher-priced lending was a result of the choice of lending institutions. Blacks and, to a lesser extent, Hispanics were much more likely than Whites to apply to institutions that typically originated higher-priced mortgages to applicants of all races and ethnicities.

The new collection and reporting requirements provide an improved starting point for identifying potential discriminatory practices. However, the FRB cautioned that even with the new data, it is important to note that analysis of the HMDA data alone cannot identify discriminatory lending practices. For example, the HMDA data, while providing some red-flag indicators of potential discrimination, do not include information on the creditworthiness of borrowers or other pricing factors (such as loan-to-value ratios or credit scores) that a bank may use in pricing loans.

According to the FRB, institution-specific analyses are essential in determining whether loan-pricing differences, in fact, reflect discriminatory treatment of minority groups. Examining an institution for which loan pricing differences (based on race, ethnicity, or gender) are statistically significant and for which purely objective pricing factors (such as loan-to-value ratios or credit scores) cannot explain pricing differences, requires a review of loan files; discussions with management or loan personnel about possible reasons for the differences; evidence to support explanations provided by management or loan personnel for pricing differences; interviews with customers, where necessary, regarding their experiences with the lender; and a careful vetting of an institution's policies, procedures, and actual practices.

FDIC Analysis of the New HMDA Data

According to the FDIC's Division of Insurance and Research (DIR), the new HMDA information on loan interest-rate pricing will help policymakers assess concerns about mortgage pricing from both a fair lending and consumer protection perspective. The 2,817 FDIC-supervised institutions that reported 2004 HMDA data account for 31.8 percent of the 8,853 institutions and mortgage companies reporting these data. DIR's analysis of the 2004 HMDA pricing data showed that these FDIC-supervised institutions:

- accounted for 8.6 percent of loan originations (1.3 million of the total 15.0 million reported loans) in the 2004 HMDA data, and
- reported 222,000 loans with rate spreads above the HMDA price-reporting threshold; these "high-rate" loans comprised about 17 percent of the 1.3 million loans.¹⁰

It is DSC's opinion that the expanded HMDA data collection and reporting requirements provide examiners more readily available data for initial analysis, which should improve the efficiency and quality of the scoping process for the fair lending portion of the compliance examination and subsequently enhance the examiners' ability to identify loan-pricing concerns that warrant further investigation.

¹⁰ Technically, high-rate loans totaled 18.3 percent of loans, net of those excluded, because some HMDA data included loan applications prior to 2004.

The new HMDA pricing information has been of significant interest to many public and private groups, including consumer groups, community groups, federal regulators, and congressional committees. The federal regulatory agencies also use the data in conjunction with CRA performance evaluations.

RESULTS OF AUDIT

The FDIC makes appropriate use of available HMDA data during compliance examinations to identify and assess instances of potential discrimination in FDIC-supervised institutions. Examiners are following prescribed procedures for analyzing HMDA data during regularly-scheduled compliance examinations. Specifically, we found that examiners verified and used the HMDA data to identify areas for review during examinations.

In addition, the FDIC has instituted the HMDA Pricing Data Outlier Project, which uses the new HMDA data and requires additional analyses and expanded reviews of institutions identified as having higher-priced loans. As of July 2006, the FDIC had identified five institutions engaged in potential discriminatory practices. The HMDA Pricing Data Outlier Project, explained in detail in the following section of the report, is an expanded and positive use of the HMDA data by DSC (see **FDIC Project to Assess Institutions Identified as Having Higher-Priced Loans**).

However, we found that the FDIC could improve compliance examination guidance related to HMDA. The guidance does not specifically address how examiners should report errors and omissions in HMDA data and does not clearly articulate the time period for which banks should be required to review HMDA-reportable loans after examiners have identified errors in the HMDA data. Clearer guidance could reduce inconsistencies in examiner (1) reporting of errors and omissions in HMDA data and (2) handling of institutions' resubmissions of corrected HMDA data. Further, clarifying guidance could provide the FDIC more assurance that HMDA data reporting by FDIC-supervised institutions accurately reflects loan pricing disparities and that violations of fair lending laws have been identified (see **Compliance Examination Guidance**).

Additionally, for our sample of 14 institutions, we noted that examiner workpapers did not fully explain the bank's relationships with brokers, investors, and correspondents (third parties) or which entity was responsible for making final credit decisions on loan applications. A greater understanding of the institution's relationships with third parties and the credit decision process would enable examiners to ensure that required disclosures are provided to the borrowers when credit decisions are made by third parties and that the institution is complying with HMDA reporting requirements (see **Documentation of Third-Party Credit Relationships and Examination Work Performed**).

In addition, we identified another matter warranting management attention related to examiner completion of the required checklist to document work performed in reviewing HMDA data (see **Other Matter Warranting Management Attention**).

FDIC PROJECT TO ASSESS INSTITUTIONS IDENTIFIED AS HAVING HIGHER-PRICED LOANS

The FDIC has instituted a project to annually identify HMDA-reporting institutions with higher-priced loans. The FDIC refers to such institutions as “outliers,” which have the largest pricing disparities for a given loan product and for a given racial, ethnic, or gender minority group. The FDIC has identified 47 FDIC-supervised institutions as HMDA outliers. In early 2005, DSC:

- Issued examiner guidance in Transmittal 05-006 entitled, *Considering the New Home Mortgage Disclosure Act (HMDA) Pricing Information when Conducting Fair Lending Examinations of Institutions Subject to HMDA*, dated March 2, 2005.
- Developed screening criteria to identify the outliers upon receipt of the HMDA data from the FRB (additional information is available in Appendix III).
- Submitted the outlier project as a proposed 2006 Corporate Performance Objective.

The FDIC established the HMDA Pricing Data Outlier Project as a 2006 Corporate Performance Objective with the goal of starting all of the onsite reviews of HMDA outliers by the end of 2006; however, not all of the onsite reviews will be completed in 2006. Institutions whose data show unusual loan pricing disparities for minorities or women will be subject to accelerated reviews (if not already scheduled for compliance examinations in 2006) and increased scrutiny to assess potential discriminatory or other illegal credit practices. Both DSC and DIR are involved in the outlier project and have a memorandum of agreement that captures the focus of the project and the commitment by each division.

As of July 25, 2006, reviews for 23 of the 47 outliers had been resolved. For 18 of the 23 outliers, the FDIC has completed the reviews, and no violations were found; the other 5 outliers had merged or changed charters without FDIC review.¹¹ Nine reviews were in progress as of the time of our audit field work, and the remaining 15 reviews will be initiated by the end of 2006. Table 1 below summarizes the status of the outlier reviews.

Table 1: FDIC-Supervised 2004 HMDA Reporters Identified as Outliers

Total Outliers by Region	Resolved Reviews*	Reviews in Progress	Reviews Scheduled for 3 rd Quarter 2006	Reviews Scheduled for 4 th Quarter 2006
Atlanta (16)	8	2	2	4
Dallas (20)	7	4	4	5
Kansas City (1)	1	0	0	0
Chicago (6)	4	2	0	0
New York (4)	3	1	0	0
Totals: (47)	23	9	6	9

* Includes five reviews not performed due to mergers or charter changes.

¹¹ According to DSC, the FDIC outlier list contains only preliminary scoping information – not evidence of violations. However, when an institution on the list changes its charter, the FDIC will offer its preliminary information to the federal regulator with enforcement jurisdiction.

Reviews of HMDA Outlier Banks

The FDIC’s outlier project includes a supervisory and examination strategy to identify institutions that pose a significant risk for discriminatory or abusive lending practices as follows:

- Regional and field offices review the outlier list and identify institutions that pose less risk because recent examinations indicate that loan pricing policies are standardized, based on risk, and applied uniformly with little or no discretion.
- The remaining institutions that pose more risk complete a questionnaire, providing explanations for pricing disparities and pricing policies and practices.
- Regional and field offices prioritize the institutions that require visitations and fair lending examinations, focusing on higher-priced loans.
- DSC plans a schedule of visitations and examinations for these institutions.

In addition, DIR provides ongoing analytical assistance to DSC examiners in processing HMDA data related to higher-priced loans if the examiners need more in-depth analyses of the data. This is done at the request of the DSC Headquarters Senior Fair Lending Specialist.

According to DSC management, although HMDA data do not include creditworthiness, underwriting, or evaluation criteria and other information necessary to conclusively identify abusive or discriminatory lending, the data are sufficient to indicate whether further review is required. To date, it appears likely that five of the nine reviews in progress may result in discrimination findings for the outlier institutions. For four of those five institutions, the FDIC’s Legal Division is preparing a legal opinion based on the results of the reviews, and the remaining institution has been notified of its review results and given the opportunity to respond to the potential discriminatory lending activities identified by the FDIC. Table 2 below summarizes the types of disparities identified by HMDA outlier screening of the 47 institutions with potential discriminatory practices.

Table 2: Types of Disparities and Potential Discrimination Identified by FDIC HMDA Outlier Review Project

FDIC Regional Office (Number Of Institutions)	Type of HMDA Data Disparity *			Institutions with Potential Discriminatory Practices
	Disparities in Average Rate Spread	Disparities in Incidence of Higher- Priced Loans	Disparities in Incidence of HOEPA Loans	
Atlanta (16)	8	9	4	2
Dallas (20)	5	14	4	3
Kansas City (1)	0	1	1	0
Chicago (6)	1	3	0	0
New York (4)	0	4	1	0
Total: 47	14	31	10	5

* Some institutions are cited in multiple categories.

According to a DSC official, it is doubtful that the issues identified at the five institutions would have been identified without the new expanded HMDA data and the outlier screening techniques.

COMPLIANCE EXAMINATION GUIDANCE

We found that the FDIC could improve compliance examination guidance related to HMDA. The guidance does not specifically address how examiners should report errors and omissions in HMDA data and does not clearly articulate the extent to which financial institutions need to review and correct data in order to resubmit it to the FRB. Clearer guidance could reduce inconsistencies in examiner (1) reporting of errors and omissions in HMDA data and (2) handling of institutions' resubmissions of corrected HMDA data. Further, clarified guidance could provide the FDIC greater assurance that HMDA data reporting by FDIC-supervised institutions accurately reflects loan pricing disparities and that violations of fair lending laws have been identified.

Reporting Results of Reviews of HMDA Data

DSC guidance could be improved in relation to examiner reporting of errors and omissions in HMDA data for the period covered by the examination. Specifically, current FDIC compliance examination guidance does not specifically address how errors and omissions of current year HMDA data¹² should be presented in the examination report. Corporate-wide guidance could reduce inconsistent compliance reporting by examiners and ensure violations are being reported when appropriate. In addition, the FDIC could have greater assurance that negative trends or new problems with institution processes for compiling and recording HMDA data are reported.

For 9 of the 14 institutions in our sample, examiners found HMDA errors or omissions during the compliance examinations. For eight of those nine institutions, examiners explained the nature of their findings in the compliance examination reports. However, for the remaining institution, the examination report did not include a summary of findings on the institution's current year HMDA data.¹³

During the examination of the institution in question, the DSC examiner found that the institution had omitted 68 applications from its 2005 HMDA data, which had not yet been submitted to the FRB. The institution's current year HMDA data included only 17 applications that had resulted in loans and did not include those 68 applications that had been either withdrawn or denied. The examiner discussed the 68 omissions in the data with bank management, who agreed to correct the error. In addition, the examiner made a recommendation in the compliance examination report that the bank record all secondary market applications withdrawn or denied in the 2005 HMDA data. However, the examination report did not specifically discuss the 68 loan applications that had been omitted from the bank's HMDA data.

¹² Current year HMDA data are data that have not yet been submitted to the FRB.

¹³ While one of eight institution examinations is not a high noncompliance rate, we consider the materiality of the failure to report all withdrawn or denied applications and the related regional policy to be significant.

Prior to the examination of this institution, the responsible regional office (RO) conducting the examination contacted DSC-Washington for clarification regarding when errors and omissions should be mentioned in the compliance examination report and was informed that the Regional Director could make that determination. As a result, the RO adopted a policy that it would not report findings on errors or omissions in HMDA data if the errors or omissions are found in current year data, prior to submission to the FRB by the bank. The RO guidance issued on August 9, 2004, entitled, *Compliance Update*, addresses current year violations of the HMDA data requirements as follows:

If errors or omissions are detected in CY [current year] HMDA application data, **do not cite a violation in the compliance report.** Section 203.6(b) of FRB Regulation C provides that bona fide errors are not violations if the error was unintentional, occurred despite the maintenance of procedures reasonably adapted to preclude such violations, and provided the bank corrects and completes the information prior to the submission of the loan application register to its regulatory agency. **Comments relating to CY HMDA data errors or omissions can be included on the Examiner's Comments and Conclusions pages at the discretion of the examiner.** (Emphasis added.)

According to RO management, the regional policy was influenced by the fact that two other federal banking agencies in the region do not cite current-year HMDA data compilation and recording errors as violations in their examination compliance reports because FRB Regulation C allows financial institutions the opportunity to correct the data before the March 1 reporting deadline of the following year.

The RO guidance is partially consistent with Regulation C requirements in that errors and omissions in current year HMDA are not considered violations in some circumstances, including when the mistakes are corrected before submission of the HMDA data to the FRB. However, neither the RO policy nor DSC guidance defines how current year HMDA data examination findings should be discussed in the examination report, which can lead to inconsistencies in examiner reporting of such cases. As a result, negative trends or new problems with institution processes for compiling and recording HMDA data might go unreported.

Additionally, the FDIC's *Compliance Examination Manual* notes that "current calendar year HMDA data recording errors may also be violations of FDIC Rules and Regulations Part 338.8: *Fair Housing*."¹⁴ An examiner's decision to omit current year HMDA data errors and omissions from the compliance examination report could, therefore, lead to other violations not being reported.

To ensure consistency in examiner reporting of errors and omissions and consideration of possible related violations, the FDIC *Compliance Examination Manual* should be revised to address errors or omissions in HMDA data that warrant reporting by examiners.

¹⁴ FDIC Rules and Regulations, *Fair Housing*: Section 338.8, *Compilation of loan data in register format*, states, "Banks and other lenders required to file a Home Mortgage Disclosure Act loan application register (LAR) with the Federal Deposit Insurance Corporation shall maintain, update and report such LAR in accordance with Regulation C of the Board of Governors of the Federal Reserve System."

Reviews of HMDA Data for Resubmissions to the FRB

DSC examination guidance does not clearly articulate the time period for which banks should be required to review HMDA-reportable loans after examiners have identified errors in the HMDA data. Examiners found inaccurate data for 9 of the 14 banks we reviewed. However, examiner recommendations to review and resubmit corrected data were inconsistent as illustrated below:

- In three cases, the bank was required to review all HMDA data for the period covered by the examination before resubmitting the data to the FRB.
- In four cases, the bank was not required to review the HMDA data for the period or resubmit corrected data to the FRB.

For the remaining two cases, one institution was cited with a significant violation because the bank was not consistently requesting required HMDA data. The institution was required to develop written procedures and implement additional training. In the second instance, the institution had failed to collect and report any 2004 HMDA data and was, therefore, required to collect and report this data. Neither of the institutions was required to resubmit HMDA data.

Part III of the *Compliance Examination Manual*, dated July 1999, entitled, *HMDA Disclosure and Reporting*, directs examiners to determine errors that occurred during the previous reporting period and, if errors did occur, the steps the financial institution took to correct and/or prevent such future errors. The manual also states that “the institution should review 1-3 years of HMDA-LAR data to correct significant inaccuracies.”

Verification of accuracy is critical because HMDA data errors may also be violations of FDIC Rules and Regulations, Section 338.8, *Fair Housing*. The manual states that errors in the data columns entitled, *Race, Gender, Income, Type of Action Taken, and Census Tract* would significantly affect the examiner’s decision that the bank should resubmit the data. However, the manual does not define “significant inaccuracies” nor explain the 1-3 year period of HMDA data the financial institution should review in order to correct inaccuracies.

Conclusion

DSC examination guidance could be improved in relation to examiner reporting of errors or omissions in HMDA data. Separate regional office policies regarding when HMDA data errors and omissions are reported in compliance examinations or the time period of financial institution review of HMDA data in order to correct inaccuracies could result in examination inconsistencies nationwide. An institution’s failure to provide accurate HMDA data may distort bank data disclosed to the public, interfering with the public’s evaluation of an institution’s performance and resulting in serious consequences to the public perception of the banking and mortgage lending industries and the distribution of public-sector investments. Revising guidance to address examination reporting of errors or omissions will assist examiners in identifying institutions with possible discriminatory lending patterns or that may be violating fair lending laws. Guidance should be further revised to define “significant inaccuracies” and to specify the extent to which financial institutions need to review the data in order to resubmit it to the FRB.

Recommendation

We recommend the Director, DSC:

- (1) Revise the *Compliance Examination Manual* guidance to specify when and how errors and omissions of current year HMDA data should be reported in compliance examination reports, define significant inaccuracies, and identify the extent of financial institution review of HMDA data in order to resubmit corrected HMDA data to the FRB.

DOCUMENTATION OF THIRD-PARTY CREDIT RELATIONSHIPS AND EXAMINATION WORK PERFORMED

Examiner workpapers did not always document the bank's relationships with brokers, investors, and correspondents¹⁵ or which entity was responsible for making final credit decisions on loan applications. Fair lending review procedures require examiners to document the credit decision-making process of institutions during the scoping stage of the review, which would include the entity that makes the credit decision when the bank has entered into relationships with brokers, investors, or correspondents (hereafter referred to as third parties). In general, the entity making the credit decision is required to report the HMDA data. When a HMDA-reporting institution makes a credit decision for a loan through a third party, the institution rather than the third party reports the loan for HMDA purposes. A greater understanding of the institution's relationships with third parties and the credit decision process would enable examiners to ensure that required disclosures are provided to the borrowers when credit decisions are made by third parties and that the institution is complying with HMDA-reporting requirements.

Documentation Requirements for Third-Party Credit Relationships

The FFIEC *Interagency Fair Lending Examination Procedures*, revised August 19, 2004, states that examiners should focus the compliance examination based on: an understanding of the credit operations of the institution, the risk that discriminatory conduct may occur in each area of those operations, and the feasibility of developing a reliable record of an institution's performance and fair lending compliance in each area of those operations. In addition, the FFIEC guidance requires examiners to determine how the financial institution ensures that the home mortgage disclosure information is properly compiled and disclosed. Examiners must make this determination for the institution and any third parties responsible for the credit decision.

The FFIEC publication entitled, *A Guide to HMDA Reporting: Getting It Right!*, states that when an institution subject to HMDA requirements makes a loan through a third party such as a broker, the institution, rather than the third party, reports the loan. HMDA data on loan applications that do not result in loan originations must also be reported by the entity that makes

¹⁵ For the purpose of HMDA reporting, a financial institution that processes a loan application and arranges for another institution or investor to acquire the loan at settlement is acting as a "broker." An institution that acquires a loan from a broker at or after closing is acting as an "investor." "Correspondents" are companies that usually close and fund loans in their own name and subsequently sell them to a lender.

the credit decision. Further, the FFIEC guide contains, *Appendix D: Official Staff Commentary on Regulation C*, which explains that a broker may or may not make a credit decision on an application (and thus the broker may or may not have reporting responsibilities) as follows:

- If the broker makes a credit decision, it reports that loan; if the broker does not make a credit decision, it does not report the loan.
- If an investor (an institution) reviews an application and makes a credit decision prior to closing the loan, the institution reports the loan.
- If the investor (institution) does not review the application prior to closing, the institution reports only the loans that it purchases; it does not report the loans it does not purchase.
- If an institution makes a credit decision on an application prior to closing the loan, the institution reports that loan, regardless of who closes it.

The *Compliance Examination Manual, Part III, Understanding Credit Operations*, states that before evaluating the potential for discriminatory conduct, the examiner should review sufficient information about the institution and its market to understand the credit operations of the institution and the representation of prohibited basis group residents¹⁶ within the markets where the institution does business. According to the manual, relevant background information includes the institution's organization of its credit decision-making process, including identification of the delegation of separate lending authorities and the extent to which discretion in pricing or setting credit terms and conditions is delegated to various levels of managers, employees, or independent brokers or dealers. Further, where an institution has multiple underwriting or loan processing centers or subsidiaries, each with fully independent credit-granting authority, the examiner should consider evaluating each center and/or subsidiary separately, provided a sufficient number of loans exists to support a meaningful analysis.

Examination Workpaper Documentation of Third-Party Relationships

DSC examiners did not always fully document in the workpapers the banks' mortgage lending relationships with third parties. Our review of examination workpapers for the 14 institutions in our sample showed that 8 institutions had a relationship with a third party in the origination of residential mortgage loans. However, as illustrated in the following examples, examination workpapers for these institutions did not fully explain the banker-third party relationship.

- The workpapers for one institution indicated that a majority of the loans were "handled by a third-party mortgage group." No further details were provided, and the examiner's report of examination stated that the institution did not report the loans in its HMDA data.
- One institution designated one branch to perform residential lending as a broker for the institution. We could not determine from the workpapers where the final credit decisions were made. Further, the loans were not included in the institution's HMDA data.
- One institution that was acting as a broker was not making the credit decision. The institution correctly did not include the loans in its HMDA data, but the workpapers did not document the broker-lender relationship of the institution.

¹⁶ The FHA defines prohibited basis as race, color, religion, national origin, gender, familial status, and handicap.

In the current residential real estate market, 68 percent of loans involve brokers.¹⁷ According to the Mortgage Bankers Association, over the last 10 to 15 years, new breeds of broker-lender relationships and subsequent transactions have presented a number of legal issues that could affect financial institutions. As a result, it is important for examiners to fully understand which entity is making the credit decision and how it is being made in order to adequately assess whether an institution is reporting all HMDA-reportable loans, monitoring the activities of brokers and correspondents that make loans on behalf of the institutions, and providing full disclosure to applicants regarding the terms and conditions of their loans.

Conclusion

Compliance examination guidance states that an examiner should review relevant background information to understand the credit operations of an institution, including its third-party relationships involving credit decisions. Documentation of these relationships in the examination workpapers helps to ensure that required disclosures are provided to the borrowers when credit decisions are made by third parties and that additional reporting or resubmission of HMDA data is required when the bank acts as the broker and makes the credit decision.

Recommendation

We recommend the Director, DSC:

- (2) Provide additional examination guidance on how to determine and document third-party residential mortgage lending relationships for HMDA-reporting purposes.

OTHER MATTER WARRANTING MANAGEMENT ATTENTION

Documentation of Examination Work Performed

During the course of our review, we observed that examiners are not fully documenting HMDA-related examination work. For the 14 banks we reviewed, we found only 1 instance in which the examiners used the required checklist format to document the review of HMDA data. For the remaining 13 banks, evidence in workpapers was difficult for us to locate in order to conclude that examiners had reviewed procedures, training, and controls for HMDA reporting in reference to the banks' compliance management system.

DSC Transmittal No. 2004-015 entitled, *Revised Interagency Examination Procedures for the Home Mortgage Disclosure Act*, dated May 3, 2004, contains a checklist of examination procedures that address an institution's HMDA policies and procedures, processes for the collection and compilation of loan data, and disclosure and reporting requirements. Specifically, the transmittal states:

¹⁷ According to the Mortgage Bankers Association publication *NewsLink*, dated May 20, 2005, in the modern residential real-estate market, 68 percent of loans involve brokers.

. . . If HMDA and Regulation C are applicable, then the following examination procedures should be performed separately for the depository institution and any of its majority-owned mortgage subsidiaries. A separate checklist should be completed for each institution subject to HMDA and Regulation C.

Consistent and comprehensive documentation of HMDA compliance is essential in identifying red flags in HMDA data and provides evidence that allows examiners to support potential fair-lending violations. DSC needs to remind examiners to use the required checklist when performing HMDA data reviews to ensure accurate and meaningful examinations of financial institution compliance with consumer protection laws and regulations.

Recommendation

We recommend the Director, DSC:

(3) Emphasize that examiners should complete the required checklist for HMDA data reviews.

CORPORATION COMMENTS AND OIG EVALUATION

On September 27, 2006, the Acting Director, DSC, provided a written response to the draft report. The response is presented in its entirety in Appendix IV of this report. DSC concurred with all three recommendations.

Regarding recommendation 1, DSC stated that existing guidance on how to treat errors and omissions of current year HMDA data is sufficient. However, DSC agreed that clarifying the guidance would be beneficial. As a result, DSC will revise existing guidance by June 30, 2007, to more clearly explain when it is appropriate to (1) discuss current year HMDA data examination findings in the examination report and (2) resubmit corrected HMDA data to the FRB.

For recommendation 2, DSC stated that examiners are very familiar with the reporting requirements that relate to third-party residential mortgage lending relationships and agreed that it is important to properly identify and document these relationships in the workpapers. As a result, DSC will review existing guidance and, where necessary, issue revised guidance by June 30, 2007.

For recommendation 3, DSC agreed that examiners are required to use the HMDA checklist to document HMDA-related examination data reviews and will remind examiners to use the checklist for those reviews within the framework of the FDIC's refocused compliance examination procedures. This message will be reiterated to supervisory staff by year-end 2006.

Appendix V contains a summary of management's response to the recommendations. Management's planned actions are responsive to the recommendations. The recommendations are resolved but will remain open until we have determined that the agreed-to corrective actions have been completed and are effective.

OBJECTIVE, SCOPE, AND METHODOLOGY

Objective

The audit objective was to determine whether the FDIC makes appropriate use of available HMDA data to identify and assess instances of potential discrimination when examining an institution's compliance with relevant laws and regulations.

We performed our audit at the FDIC's Washington headquarters office and two DSC regional offices from January through July 2006 in accordance with generally accepted government auditing standards.

Scope and Methodology

The scope of the audit included an assessment of the FDIC's policies and procedures related to how HMDA data should be used during the fair lending portion of compliance examinations, as well as examiner compliance with those policies and procedures. We also reviewed the FDIC's efforts to review and assess compliance in institutions identified as having higher-priced loans.

Specifically, we reviewed:

- Regulations and legislative updates, including the HMDA of 1975, Regulation C (12 C.F.R. Part 203), and various transmittals, directives, and guidelines issued by the FDIC.
- The FDIC's *Compliance Examination Manual*, dated July 31, 1999, and revised April 19, 2006.
- DSC Regional Directors Memorandum 2005-006, *Considering the New Home Mortgage Disclosure Act (HMDA) Pricing Information when Conducting Fair Lending Examinations of Institutions Subject to HMDA*, dated March 2, 2005.
- DSC Regional Directors Memorandum 2004-015, *Revised Interagency Examination Procedures for HMDA*, dated May 3, 2004.
- FFIEC publication sent to institutions annually entitled, *A Guide to HMDA Reporting – Getting It Right!*, effective January 1, 2004.
- FFIEC *Interagency Fair Lending Examination Procedures*, dated August 19, 2004.
- *Interagency Expanded Guidance for Subprime Lending Programs*, dated January 31, 2001.
- FRB Bulletin, Summer 2005, article entitled, *New Information Reported under HMDA and Its Application in Fair Lending Enforcement*.
- DIR's *Description of FDIC Screens for HMDA Pricing Data*, dated July 12, 2006.
- Examination documentation and reports for a judgment sample of 14 HMDA-reporting banks in the FDIC Atlanta and Dallas regional offices.
- DSC and DIR analyses and examination documentation for seven FDIC-supervised HMDA outlier institutions.

In addition, we interviewed:

- an FFIEC representative to obtain information related to the roles of the FFIEC and other agencies in the processing of HMDA data.

- DSC and DIR officials in headquarters and staff in two FDIC regional offices.

Compliance With Pertinent Laws and Regulations

The audit addressed HMDA provisions, which are implemented by the FRB's Regulation C. Regulation C generally requires that institutions report the following data:

- Each application or loan, including the application date received; the action taken and the date of that action; the loan amount; the loan type and purpose; if the loan is sold, the type of purchaser; and for certain loans, some pricing information.
- Each applicant or borrower, including national origin or race, gender, and annual income.
- Each property, including occupancy status, location, and lien status.

As of 2004, Regulation C requires that lenders disclose pricing information (interest rates and fees) for loans with prices above designated thresholds. Loans priced above the thresholds are referred to as "higher-priced" loans.

Our audit reviewed FDIC examiners' assessments of HMDA compliance by FDIC-supervised institutions that are HMDA-reporting institutions. Appendix III contains additional details on HMDA requirements.

Computer-based Data, Performance Measures, Fraud and Illegal Acts, and Internal Controls

Validity and Reliability of Data from Computer-based Systems. We determined through interviews and information available on the DSC Website that DSC's System of Uniform Reporting of Compliance and CRA Exams (SOURCE) system is the primary tool to track and document compliance examinations of FDIC-supervised institutions. During the audit, we conducted limited testing on SOURCE data to determine its accuracy as it relates to tracking HMDA-reporting institutions, and we found inaccuracies in the data fields that identify those institutions. We brought these inaccuracies to DSC's attention. For the purposes of this audit, we did not rely on the SOURCE system data. Our assessment centered on interviews of DSC and DIR staff and reviews of regional office bank files, examination reports, and examination workpapers.

Performance Measures. We reviewed the FDIC's annual performance plan and strategic plan to determine whether the Corporation (1) has established quantifiable performance measures and (2) developed and analyzed data to assess program, project, or function performance related to its efforts to identify discriminatory lending in FDIC-supervised institutions. In fulfilling its primary supervisory responsibilities, the FDIC pursues two strategic goals: FDIC-supervised institutions are safe and sound; and consumers' rights are protected, and FDIC-supervised institutions invest in their communities. The second strategic goal directly relates to how the FDIC promotes institution compliance with consumer protection and fair lending laws.

The FDIC has begun a supervisory and examination strategy to identify those institutions, identified as having higher-priced loans, that pose a significant risk for discriminatory or abusive

lending practices. This strategy has been incorporated into a 2006 Corporate Performance Objective, which is included under the section entitled, *Sound Policy*, and states, “The Performance Objective is to promote sound policies regarding consumer safeguards, education, and choice in the areas of access to the financial mainstream, fairness in the delivery of products and services, and privacy and data security.” The action to address this objective is to complete the HMDA Pricing Data Outlier Project approved by the Corporate Policy Committee as follows:

- DSC regional offices will complete reviews of questionnaire data and submit recommendations for adjustments to the list of outlier institutions and revised examination schedules.
- The DSC-Washington office will issue revised lists of outlier institutions and consolidated examination schedules.
- Regional offices will submit quarterly progress reports during the year.
- Regional offices will submit final progress reports, with all necessary examinations initiated by December 29, 2006.

Fraud and Illegal Acts. The objective of this audit did not lend itself to specific steps for providing reasonable assurance of detecting fraud or illegal acts. However, we were alert to the potential for such activity, and we did not identify any illegal acts or abuse or potential areas susceptible to illegal acts or abuse.

Internal Controls. We identified DSC’s internal controls related to the risk-focused examination process for compliance examinations and systems used for measuring, monitoring, and reporting program performance. Also, we reviewed the results of DSC Internal Control Reviews related to compliance examinations. In addition, we determined that DSC conducts internal control reviews under its *Regional Office Review Program*, which is organized into three categories: Examination and Supervision, Management, and Administration. Each review covers a 24-month period or the period since the last regional review, whichever is less. We reviewed this information to gain an understanding of the applicable control environment. Additionally, we reviewed and assessed internal controls applicable to examiners’ use of HMDA data. Our testing identified several control deficiencies that are addressed in the previous sections of this report.

Summary of Prior Audit Coverage

To date, there have been no OIG audits conducted that relate specifically to HMDA. However, on March 26, 2002, the OIG issued Audit Report No. 02-009, *The Division of Compliance and Consumer Affairs' Risk-Scoping Process for Fair Lending Examinations*. The objective of the audit was to assess: (1) the adequacy of the FFIEC Interagency Fair Lending Examination Procedures for the FDIC's pre-examination planning for fair lending examinations of small banks, (2) the FDIC's implementation of the FFIEC interagency procedures as they relate to identifying fair lending risks during the offsite pre-examination planning phase of the fair lending reviews, and (3) the related management controls.

We found that examiners generally followed the FFIEC interagency procedures when risk-scoping the fair lending portion of 15 compliance examinations in our review. We did not find instances of examiners expanding the scope of their reviews unnecessarily or limiting the scope without justification. However, FFIEC interagency fair lending procedures did not provide examiners with adequate guidance for conducting reviews of small banks, non-HMDA-reporting banks, or commercial loan products. In addition, our review determined that: (a) due to the lack of available monitoring and demographic data, examiners were often unable to apply risk-scoping procedures to determine the potential for discrimination for many of the prohibited bases covered by the Fair Housing Act and the Equal Credit Opportunity Act and (b) controls over the fair lending risk-scoping process were generally effective, but documentation requirements needed to be improved.

We recommended clarifying and reinforcing requirements that examiners adequately document the scope of the work performed, including transaction testing and spot checks of the reliability of the institutions' compliance review functions, during the onsite portion of compliance examinations. Management's proposed actions were sufficient to resolve each recommendation.

HOME MORTGAGE DISCLOSURE ACT OF 1975

The Home Mortgage Disclosure Act (HMDA) is implemented by the FRB's Regulation C. According to Section 302(a) of HMDA, the Congress found that some depository institutions had sometimes contributed to the decline of certain geographic areas by their failure to meet their chartering responsibilities to provide adequate home financing to qualified applicants on reasonable terms and conditions. According to the FRB, the purpose of HMDA is:

. . . to provide the citizens and public officials of the United States with sufficient information to enable them to determine whether depository institutions are filling their obligations to serve the housing needs of the communities and neighborhoods in which they are located and to assist public officials in their determination of the distribution of public sector investments in a manner designed to improve the private investment environment.

HMDA regulations require depository and certain for-profit, nondepository institutions (such as mortgage companies and other lenders) to collect, report, and disclose data about originations and purchases of home mortgage, home equity, and home improvement loans. Institutions must also report data about applications that do not result in originations.

In 2002, the FRB made a number of important changes to the disclosure requirements that substantially increased the types and amount of information made available through HMDA reporting. The 2002 revisions to Regulation C were intended to improve the quality, consistency, and utility of the data reported under HMDA. The revisions were also intended to ease regulatory burden, primarily by clarifying and simplifying parts of the regulation. According to the FRB, the new requirements:

- expanded coverage to more nondepository lenders;
- streamlined the definitions of refinancing¹⁸ and home improvement loans;
- revised the definition of application to include certain requests for pre-approvals;
- mandated for the first time the collection of data on lien status, property code (site-built or manufactured homes), loan pricing, and HOEPA status;
- incorporated changes to the rules on collecting and reporting information on race and ethnicity to conform to guidance issued in 1997 by OMB;¹⁹
- required lenders to request the race, ethnicity, and gender of prospective borrowers who apply by mail, Internet, or telephone; and
- revised the categories that identify the type of institution to which loans are sold.

The most important change to Regulation C is the requirement that lenders disclose pricing (interest rates and fees) for loans with prices above designated thresholds. Loans priced above the thresholds are referred to as higher-priced loans. During 2004, for the first time, lenders were required to start collecting information for higher-priced loans by the income level of the

¹⁸ The new rules define a refinancing as a secured home loan that satisfies and replaces another secured home loan by the same borrower. The reporting of home equity lines of credit (extended for any purpose) is voluntary.

¹⁹ *Revisions to the Standards for the Classification of Federal Data on Race and Ethnicity*, *Federal Register*, vol. 62 (October 30) pp. 58782-90.

census tract in which the property was located and by borrower characteristics (income, race, ethnicity, and gender). A higher-priced, first-lien loan has an interest rate of 300 basis points or more above the yield for a Treasury security of comparable term. A junior lien loan is higher-priced if it has an interest rate that is 500 basis points or more above the yield for a comparable Treasury instrument.

The new loan price data are intended to advance enforcement of consumer protection and anti-discrimination laws and improve mortgage market efficiency. Loan pricing data and other HMDA data can be used by the agencies and others as a screening tool to identify aspects of the higher-priced mortgage market that warrant a closer look to determine whether there is abuse or discrimination. Also, lenders, community groups, government agencies, and others can use the data to identify opportunities for private or public investment.

The FFIEC, acting on behalf of the federal regulatory agencies, has contracted with the FRB to compile the reported information and prepare individual disclosure statements for each institution and for each metropolitan statistical area. Disclosure and aggregate reports provide detailed tables of data on individual loans and applications. In addition, the FFIEC also makes available the characteristics of each census tract represented in the tables. For 2004, disclosure statements for 8,853 HMDA-reporting lenders were prepared as follows:

- 3,946 disclosure statements were for commercial banks;
- 1,017 disclosure statements were for savings institutions;
- 2,030 disclosure statements were for credit unions; and
- 1,860 disclosure statements were for mortgage companies.

The 25 largest organizations, reporting the largest number of applications, accounted for 55 percent of the applications in the 2004 data.

FDIC OUTLIER SCREENING CRITERIA

The FRB provides a list of outliers for each federal banking regulator and has modified its statistical analysis system for fair lending examinations to incorporate the new information available in the expanded HMDA data.²⁰ Additionally, the FDIC has established specific screening criteria for HMDA data reported by FDIC-supervised institutions. The FDIC's screening assesses disparities in pricing rates for specific loan products and denial rates for specific racial/ethnic groups. According to DSC, the screening criteria differ from those of the FRB for several reasons, including but not limited to, the fact that the FRB combines data for Blacks and Hispanics, while the FDIC separates data on race, and differences exist in methodologies and definitions.

The FDIC's screening evaluates pricing/denial rates for each racial group separately, assessing disparities measured relative to pricing/denial rates evident for Non-Hispanic Whites. Additionally, the FDIC's screening assesses disparities in pricing and denial rates for a given loan product using the following measures:

- Incidence of higher-priced loans: The difference between the percentage of the target group for which rate-spread information is reported and the percentage of the control group for which rate-spread information is reported.
- Average rate-spread: The difference between the average rate spread on higher-priced loans reported for the target group and the average rate spread on higher-priced loans reported for the control group.
- Incidence of HOEPA Loans: The difference between the percentage of loans to the target group and the percentage of the loans to the control group that are flagged as HOEPA loans.
- Denial Rates: The ratio of the target group denial rate to the control group denial rate.

The specific loan product categories the FDIC's screening process analyzes are:

- owner-occupied, first lien: 1-4 family; home mortgage, home improvement, refinance, and manufactured housing loans;
- owner-occupied, second lien: home mortgage, purchase, home improvement, and refinance loans; and
- owner-occupied, unsecured: 1-4 family and manufactured housing, home purchase, home improvement, and refinance loans.

²⁰ The statistical analysis system uses HMDA data as a screen to identify those institutions and their specific products that warrant closer review for fair-lending concerns. The FRB has shared the screening procedures with other federal financial banking agencies so that, if they wish, they may integrate them into their supervisory programs. Additionally, the FRB is responding to agency requests for additional, more detailed analysis of the individual institutions that may be of concern to the agencies.

Using 2004 HMDA data, DIR developed screening tools, based on DSC's criteria, which analyzed pricing disparities for specific mortgage products and racial ethnic groups. Two screening tools focus on the analysis of disparities in the incidence of higher-priced loans and in the average spread on higher-priced loans for minorities compared to non-Hispanic Whites:

- The macro-screen²¹ analyzes HMDA data for all FDIC HMDA-reporting institutions, ranking disparities and identifying the outliers. DIR used macro-screens to rank FDIC-supervised institutions in terms of the pricing disparities evident for minorities in the 2004 HMDA data and provided DSC with the rankings.
- The micro-screen²² analyzes the HMDA data for one bank only and runs statistical tests on observed pricing disparities.

HMDA Pricing Data Review Procedures

DSC Transmittal 05-006, *Considering the New Home Mortgage Disclosure Act (HMDA) Pricing Information when Conducting Fair Lending Examinations of Institutions Subject to HMDA* (March 2, 2005), provides guidance on how the new pricing information available in the 2004 HMDA data are to be considered when conducting fair lending reviews of financial institutions, that is, HMDA reporters, that make certain higher-priced loans. This guidance requires examiners to consider the new HMDA pricing data during each compliance examination. Pricing analyses are triggered only when a rate spread or HOEPA loan is reported on the banks' HMDA data.

According to Transmittal 05-006, when pricing-related information is reported, it should be reviewed in the scoping stage of the examination, and the results of this review should be explained in the scoping section of the Fair Lending Memorandum. Where the scoping analysis identifies a risk of discrimination, a comparative file analysis should be conducted to determine the reason for the pricing differences. A comparative pricing analysis in a fair lending review typically involves a statistical analysis of all pricing decisions for a credit product made by the institution for a specified period. According to the Transmittal, this analysis is conducted most efficiently when regional staff, DSC Washington fair lending staff, and statistical experts in DIR (who conduct the pricing-related statistical analysis) coordinate their efforts. The Transmittal also states that significant disparities in either the frequencies or amounts of pricing-related data do not, in and of themselves, indicate a high risk of pricing discrimination and that examiners should determine how the institution prices each loan product in which significant disparities exist.

The new HMDA information allows for a better understanding of lending activity in the higher-priced segment of the home-loan market, which is now a substantial part of the market. The

²¹ The "macro" screening technique for higher-priced loans uses the HMDA data file for FDIC-supervised institutions and ranks the institutions in terms of pricing disparities observed for specific loan products and specific protected groups (racial/ethnic groups and females). These rankings are used to generate lists of "high-risk" institutions from a fair-lending examination perspective.

²² The "micro" screening tool for higher-priced loans uses LAR data for an individual bank to analyze the pricing data at the bank level and perform simple statistical tests on observed pricing disparities. The output of the micro screens can be used to help examiners decide whether to expand the scope of an ongoing fair lending examination.

growth of this market segment, while affording some consumers greater access to credit, has been accompanied by concerns about abusive lending practices.

CORPORATION COMMENTS



Federal Deposit Insurance Corporation

550 17th Street, NW, Washington, DC 20429

Division of Supervision and Consumer Protection

September 27, 2006

MEMORANDUM TO: Stephen M. Beard
Deputy Assistant Inspector General for Audits

FROM: Sandra L. Thompson, *SLT*
Acting Director
Division of Supervision and Consumer Protection

SUBJECT: Response to Draft Report Entitled:
Examiner Use of Home Mortgage Disclosure Act Data to Identify Potential Discrimination
(Assignment Number 2006-011)

The Division of Supervision and Consumer Protection ("DSC") appreciates the opportunity to respond to the Office of the Inspector General's ("OIG") draft report, *Examiner Use of Home Mortgage Disclosure Act ("HMDA") Data to Identify Potential Discrimination*. We agree with the overall assessment that DSC makes appropriate use of available HMDA data during compliance examinations to assess instances of potential discrimination in FDIC-supervised institutions. We also appreciate your observation that the FDIC has proactively initiated the HMDA Pricing Data Outlier Project, which encompasses a supervisory and examination strategy to identify and evaluate institutions that may pose enhanced risk for discriminatory or abusive lending practices.

The report contains three recommendations to clarify and reinforce examination guidance related to HMDA. It states:

1. *We recommend that the Director, DSC, revise the Compliance Examination Manual guidance to specify when and how errors and omissions of current year HMDA data should be reported in compliance examination reports, define significant inaccuracies, and identify the extent of financial institution review of HMDA data in order to resubmit corrected HMDA data to the Federal Reserve Board ("FRB").*

DSC RESPONSE:

DSC generally agrees with the recommendation. While we believe that we have sufficient guidance on how errors and omissions of current year HMDA data should be treated, we also agree that clarifying existing guidance would be beneficial. Consequently, we will revise existing guidance to more clearly explain when it is appropriate to discuss current year HMDA data examination findings in the

examination report, and when it is appropriate to resubmit corrected HMDA data to the FRB. We will issue new guidance in this area by June 30, 2007.

2. *Provide additional examination guidance on how to determine and document third-party residential mortgage lending relationships for HMDA reporting purposes.*

DSC RESPONSE:

DSC generally agrees with the recommendation. While we believe that our examiners are very familiar with the reporting requirements that relate to third party residential mortgage lending relationships, we agree that it is important to properly identify and document these relationships in the work papers. We will review existing guidance and, where necessary, issue revised guidance to examiners by June 30, 2007.

3. *Emphasize that examiners should complete the required checklist for HMDA data reviews.*

DSC RESPONSE:

DSC agrees with the recommendation. We agree that examiners are to use the required checklist for HMDA data reviews. We will remind examiners to use the checklist for HMDA data reviews within the framework of FDIC's refocused compliance examination procedures. We will reiterate this message to supervisory staff by year-end 2006.

MANAGEMENT RESPONSE TO RECOMMENDATIONS

This table presents the management response on the recommendations in our report and the status of the recommendations as of the date of report issuance.

Rec. Number	Corrective Action: Taken or Planned/Status	Expected Completion Date	Monetary Benefits	Resolved: ^a Yes or No	Open or Closed ^b
1	DSC will revise existing guidance to more clearly explain when it is appropriate to (1) discuss current year HMDA data examination findings in the examination report and (2) resubmit corrected HMDA data to the FRB.	June 30, 2007	None	Yes	Open
2	DSC will review existing guidance related to identifying and documenting third-party residential mortgage lending relationships and, where necessary, issue revised guidance.	June 30, 2007	None	Yes	Open
3	DSC will remind examiners to use the checklist for HMDA data reviews within the framework of the FDIC's refocused compliance examination procedures.	Year-end 2006	None	Yes	Open

^a Resolved – (1) Management concurs with the recommendation, and the planned corrective action is consistent with the recommendation.
(2) Management does not concur with the recommendation, but planned alternative action is acceptable to the OIG.
(3) Management agrees to the OIG monetary benefits, or a different amount, or no (\$0) amount. Monetary benefits are considered resolved as long as management provides an amount.

^b Once the OIG determines that the agreed-upon corrective actions have been completed and are effective, the recommendation can be closed.