

Special Analyses

- **Disproportionate Adverse Impact**
- **Pre-Application Screening**
- **Marketing**

Disproportionate Adverse Impact Violations

When all five conditions below exist, consult within your agency whether to present the situation to the lender and solicit an explanation of the lender’s business justification for the policy or criterion that appears to cause the disproportionate adverse impact. Note that condition 5 can be satisfied by **either** of two alternatives.

The contacts between examiners and lenders described in this section are information-gathering contacts within the context of the examination and are not intended to serve as the formal notices and opportunities for response that an agency’s enforcement process might provide. Also, the five conditions are not intended as authoritative statements of the legal elements of a disproportionate adverse impact proof of discrimination; they are paraphrases intended to give examiners practical guidance on situations that call for more scrutiny and on what additional information is relevant.

Note: Even if it appears likely that a policy or criterion causes a disproportionate adverse impact on a prohibited basis (condition 3), do not proceed with this analysis if the policy or criterion is obviously related to predicting creditworthiness or to some other basic aspect of prudent lending, and there appears to be no equally effective alternative for it. Examples are reliance on credit reports or use of debt-to-income ratio.

Conditions

1. A specific policy or criterion is involved.
The policy or criterion suspected of producing a disproportionate adverse impact on a prohibited basis must be clear enough that the nature of action to correct the situation can be determined.
Note: Gross HMDA denial or approval rate disparities are not appropriate for disproportionate adverse impact analysis because they typically cannot be attributed to a specific policy or criterion. Similarly, a lender’s policies of allowing employees to exercise discretion and to negotiate terms or conditions of credit can better be described as the **absence** of policies or criteria than as a situation in which a policy or criterion generates a disproportionate adverse impact. Broad discretion and vague standards raise concerns about discrimination, but examiners should focus on possible disparate **treatment**.
2. The policy or criterion on its stated terms is neutral for prohibited bases.
3. The disparity on a prohibited basis is significant.

The difference between the rate at which prohibited basis group members are harmed or excluded by the policy or criterion and the rate for control group members must be large enough that it is unlikely that it could have occurred by chance. If there is reason to suspect a significant disproportionate adverse impact may exist, consult the supervisory office, compliance manager, district counsel, and/or compliance management department, as appropriate.

4. There is a causal relationship between the policy or criterion and the adverse result.

The link between the policy or criterion and the harmful or exclusionary effect must not be speculative. It must be clear that changing or terminating the policy or criterion would reduce the disproportion in the adverse result.

5. **Either a or b:**

- a. The policy or criterion has no clear rationale, or appears to exist merely for convenience or to avoid a minimal expense, or is far removed from common sense or standard industry underwriting considerations or lending practices.

The legal doctrine of disproportionate adverse impact says that the policy or criterion that causes the impact must be justified by “business necessity” if the lender is to avoid a violation. There is very little authoritative legal interpretation of that term with regard to lending, but that should not stop examiners from making the preliminary inquiries called for in these procedures. For example, the rationale is not clear for basing credit decisions on factors such as location of residence, income level (*per se* rather than relative to debt), and accounts with a finance company. If black applicants were denied loans significantly more frequently than white ones because they failed a lender’s minimum income requirement, it would appear that the first four conditions plus 5a existed; therefore, the examiners should consult within their agency about obtaining the lender’s response, as described in the next section below.

- b. **Alternatively**, even if there is a sound justification for the policy, it appears that there may be an equally effective alternative for accomplishing the same objective with a smaller disproportionate adverse impact.

The law does not require a lender to abandon a policy or criterion that is clearly the most effective method of accomplishing a business objective. However, if an alternative that is approximately equally effective is available that would cause a less-severe impact, the policy or criterion in question will be a violation.

At any stage of the analysis of possible disproportionate adverse impact, if there appears to be such an

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alternative, and the first four conditions exist, consult within the agency how to evaluate whether the alternative would be equally effective and would cause a less-severe impact. If the conclusion is that it would, solicit a response from the lender, as described in the next section below.

Obtaining the lender's response

If the first four conditions plus either 5a or 5b appear to exist, consult within your agency about whether and how to inform the lender of the situation and solicit the lender's business justification. The communication with the lender should explain:

- The specific neutral policy or criterion that appears to cause a disproportionate adverse impact.
- How the examiners learned about the policy.
- How widely the examiners understand it to be implemented.
- How strictly they understand it to be applied.
- The prohibited basis on which the impact occurs.
- The magnitude of the impact.
- The nature of the injury to individuals.
- The data from which the impact was computed.

The communication should state that no violation exists if the policy or criterion is used because of business necessity *and* there is no alternative that would accomplish the lender's objective with a smaller disproportionate adverse impact. It should inform the lender that cost and profitability are factors the agency will consider in evaluating the lender's business necessity. It should ask the lender to describe any alternatives it considered before adopting the policy or criterion at issue.

Evaluating and following up on the response

The analyses of "business necessity" and "less discriminatory alternative" tend to converge because of the close relationship of the questions of what purpose the policy or criterion serves and whether it is the most effective means to accomplish that purpose.

Evaluate whether the lender's response persuasively contradicts the existence of the significant disparity or establishes a business justification. Consult the supervisory office, compliance manager, district counsel, and/or compliance management department, as appropriate.

Discriminatory pre-application screening

Obtain an explanation for any:

- Withdrawals by applicants in prohibited basis groups without documentation of customer intent to withdraw;
- Denials of applicants in prohibited basis groups without any documentation whether qualified; or
- On a prohibited basis, selectively quoting *strongly unfavorable* terms (for example, high fees or down payment requirements) to prospective applicants, or quoting *strongly unfavorable* terms to all prospective applicants but waiving such terms for control group applicants. (Evidence of this might be found in withdrawn or incomplete files.)

If the lender cannot explain the situations, examiners should consider obtaining authorization to contact the customers to verify the lender's description of the transactions. Information from the customer may help determine whether a violation occurred.

In some instances, such as possible "prescreening" of applicants by lender personnel, the results of the procedures discussed so far, including interviews with customers, may be inconclusive in determining whether a violation has occurred. In those cases, examiners should, if authorized by their agency, consult with management regarding the possible use of "testers" who would pose as apparently similarly situated applicants, differing only as to race or other applicable prohibited basis characteristic, to determine and compare how the lender treats them in the application process.

Possible discriminatory marketing

1. Obtain full documentation of the nature and extent, together with management's explanation, of any:
 - Prohibited basis limitations stated in advertisements;
 - Code words in advertisements that convey prohibited limitations; or
 - Advertising patterns or practices that a reasonable person would believe indicate prohibited basis customers are less desirable.
2. Obtain full documentation as to the nature and extent, together with management's explanation, for any situation in which the lender, despite the availability of other options in the market:
 - Advertises only in media serving nonminority areas of the market;
 - Markets through brokers or other agents that the lender knows, or could reasonably be expected to know, to serve only one racial or ethnic group in the market; or
 - Utilizes mailing or other distribution lists or other marketing techniques for pre-screened or other offerings of residential loan products* that:

- Explicitly exclude groups of prospective borrowers on a prohibited basis; or
- Exclude geographies (e.g., census tracts, ZIP codes, etc.) within the institution's marketing area that have demonstrably higher percentages of minority group residents than does the remainder of the marketing area, but which have income and other credit-related characteristics similar to the geographies that were targeted for marketing.

**Note:* Pre-screened solicitation of potential applicants on a prohibited basis does not violate

ECOA. Such solicitations are, however, covered by the FHAct. Consequently, analyses of this form of potential marketing discrimination should be limited to residential loan products subject to coverage under the FHAct.

3. Evaluate management's response particularly with regard to the credibility of any nondiscriminatory reasons offered as explanations for any of the foregoing practices. Refer to **Evaluating Responses to Evidence of Disparate Treatment** elsewhere in the **Appendix** for guidance.