

# Preparing for a Fair Lending Examination

December 9, 2014



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# About Bankers Advisory

A CliftonLarsonAllen LLP Division

- A consulting firm focused on helping mortgage institutions across the United States with regulatory compliance and quality control
- Provide premium file evaluation services for mortgage credit risk and compliance assessments in the area of fair lending, state, and federal regulations

# About CliftonLarsonAllen

- A professional services firm with three distinct business lines
  - Wealth Advisory
  - Outsourcing
  - Audit, Tax, and Consulting
- 3,600 employees
- Offices coast to coast
- Serve more than 1,100 financial institutions



# Speaker Introductions

- **Marissa Aquila Blundell, J.D., VP**

Marissa is a client services director with Bankers Advisory – a CliftonLarsonAllen LLP Division. She serves as a contracts administrator and customer relationship manager. Marissa develops and implements compliance training to clients and serves on the compliance committee and co-chairs the Legislative Committee for the Massachusetts Mortgage Bankers Association. She is a graduate of Skidmore College and earned her Juris Doctor at the New England School of Law.

- **Margaret Wright, J.D., VP, Regulatory Compliance Director**

Margaret is a regulatory compliance director with Bankers Advisory – a CliftonLarsonAllen LLP Division. She manages a team of compliance consultants and oversees fair lending assessment services. She received her bachelor's from Stonehill College and Juris Doctor from Suffolk University Law School.

# Learning Objectives

- At the end of this session, you will be able to:
  - Identify the elements of a fair lending program
  - Recognize the relationship between accuracy in HMDA reporting and fair lending examination procedures
  - Outline the difference between electronic analysis using system data and reviewing completed files of closed or non-closed loans

# Enterprise-Wide Fair Lending Program

It is unlawful and a discriminatory practice for any creditor, its officers, agents or employees to discriminate in granting or fixing the terms of credit against any applicant for credit based on race, creed, color, national origin, age, sex, marital status or disability.

Fair Lending Policy and Procedures must take into consideration the institution's:

- Size
- Scope
- Business model

The fair lending goals set should be designed to be realistic and attainable.

Every person representing the institution in any capacity is responsible for ensuring that all applicants are given equal and impartial treatment in the marketing, origination, processing, approval and closing of their home mortgage loan.



# Fair Lending Regulatory Requirements

An institution's enterprise-wide fair lending program must in part ensure compliance with federal fair lending regulation, including:

- The Equal Credit Opportunity Act (ECOA)
- Fair Housing Act (FHAct)
- Fair Credit Reporting Act (FCRA)
- Home Owners Equity Protection Act (HOEPA)
- Flood Disclosure Act
- Home Mortgage Disclosure Act (HMDA)
- Real Estate Settlement Procedures Act (RESPA)
- Truth in Lending Act (TILA)
- Fair and Accurate Transactions Act (FACTA)
- The Dodd-Frank Wall Street Reform and Consumer Protection Act
- CFPB "Know Before you Owe"

# Fair Lending Risk Assessment

- *Advertising and Marketing*
- *Interviewing Procedures*
- *Processing Steps*
- *Underwriting*
- *Compensating Factors*
- *Pricing and Overages*
- *Loan Terms & Features*

# Forms of Discrimination

## **SUBTLE**

*Cancel or delayed appointment*  
*Lack of information or follow through*

## **OVERT**

*Refusal to take an application*  
*Steering toward an unsuitable loan*

## **DISPARATE IMPACT**

*When an otherwise neutral policy or  
practice burdens certain persons  
on a prohibited basis*

## **DISPARATE TREATMENT**

*Differences in treatment that are not  
fully explained by legitimate factors*

# Fair Lending: Best Practices

## *Loan Program and Marketing Review:*

- Marketing materials
- Loan programs
- Lending parameters
- Rate sheets
- Underwriting criteria
- Product description list
- Credit grading matrices
- Pricing guidelines for all loans

# Fair Lending: Best Practices

- Determine processes and authorities for any discretionary pricing options
- Review process for pricing loans and pricing strategies
- Define loan minimum and maximum criteria for each credit grade
- Assess reasonableness of credit criteria and process for adherence (cutoffs, ratios)
- Assess process for implementation of change
- Ensure pricing is consistent with consumer compliance regulations

# Fair Lending: Origination

It is the responsibility of the originating lender to:

- Provide each applicant with a summary of all suitable product options that meet their home finance needs
- Ensure the applicant understands each of the eligible product options and required verifications
- Explain that qualifying guidelines and document requirements are applied uniformly to all applicants, and that all asset and income documentation must be from acceptable and verifiable sources
- Explain that collateral guidelines are applied uniformly to all applicants as long as the property meets the condition, improvements, zoning and LTV% and other requirements of the secondary market investor or insurer

# Origination Steps

## ***Loan Program: Appropriateness of Program and Eligible Alternatives***

The loan program must be appropriate to the borrower's financing needs as evidenced through the application and borrower's financial situation. Alternative programs for which the borrower is eligible should be made available.

## ***Repayment Ability***

The file should reflect the borrower's ability to repay, through the processing and underwriting steps of obtaining and reviewing credit report, paystubs, account information and asset as well as liability information.

# Origination Steps

## ***Net Tangible Benefit***

If the loan is a refinance, the program should reflect a tangible net benefit to the borrower such as a lower interest rate, lower payment or cash out of home equity.

## ***Supporting Documentation Requests***

Reasonable time must be allowed for the borrower to complete the processor and underwriter's requests for additional documentation. This is an area that in the past has been used as a barrier to take adverse action on loans where applicants have non-traditional forms of income and providing documentation became burdensome.



# Origination Steps

## *Alternative Loan Program Options*

- When an alternative loan program is offered, originators must fully document the reasons why the applicant did not qualify for the originally requested program
- The institution shall not discourage an applicant from applying for their requested loan program or discourage the applicant from continuing with the application
- Applicants should not be encouraged to apply for a higher loan amount or different loan program to benefit the loan officer in a higher compensation, faster closing or other business advantage
- Other applicant characteristics such as educational attainment, household structure, household income and level of financial sophistication are considered a basis for discrimination if considered by a loan officer in the counseling, pricing or selection of a loan program

# Monitoring Origination Standards

Production reports can be generated that are grouped by branch or loan officer and reviewed to assess the following:

- *Was application taken face-to-face, by web, mail or telephone?*
- *Was application signed and dated by all applicants?*
- *Did application include originators name, address, date and signature?*
- *Timely, correct, program information?*
- *Good Faith Estimate and 3rd party provider forms?*
- *Was loan program appropriate?*
- *Were eligible alternative options presented?*
- *Was a reasonable amount of time given to make a decision?*
- *Was a reasonable amount of time given to gather information or documents?*

# Fair Lending: Underwriting

## *Underwriting*

- Compensating factors consistently applied in accordance with the requisites of secondary market investors, mortgage insurance companies and housing partnership agencies
- Non-traditional credit sources considered for verification purposes in accordance with acceptable criteria for agency or community homebuyer programs
- Loan decisions are based on a range of factors, including without limitation: credit history, equity or down payment, stable and verifiable income and the condition and value of the collateral
- Appraisal underwriting standards are based on requisites of participating secondary market agencies and insurers
- Ability to repay analysis

# Fair Lending: Underwriting

## *Second Underwriting Review*

An institution's loan approval policy should include a review by a second underwriter or other office of the company for all denied loans

After both underwriters and officers have determined the borrower(s) cannot qualify for the requested loan program or the full range of eligible alternative options, the *Notice of Action Taken* shall be issued by the authorized employee

# Processing and Underwriting Steps

## *Processing Steps and Treatment*

Processing steps and treatment must be uniformly applied to all borrowers as outlined by lender's policies and procedures.

## *Departure from Credit Standards*

Departures from credit standards must be explained. For example, if a borrower has non-traditional sources of credit, the file should be documented with letters of reference or acceptable statements. Underwriters should explain departures from credit standards or investor guidelines wherever possible.

# Processing and Underwriting Steps

## *Compensating Factors*

Many loans may contain factors which are not apparent in the standard file documentation which can be highly favorable and reduce credit risk. All positive characteristics should be noted, documented in a memorandum, and refer to them as compensating factors when presenting a loan for approval.

Examples:

- Loan-to-Value is low
- Considerable liquid assets
- Reimbursed automobile or cost-of-living expenses from employer
- No outstanding debt
- Non-taxable income (retirement or social security)
- Excellent credit history

# Fair Lending: Best Practices

## *Use of Brokers*

- Expectations of brokers consistent with retail division expectation
- Monitoring of broker transactions to determine whether pricing or terms are in violation of federal regulation and institution policy
- Ensure loan programs and costs are consistent among ethnic and racial groups

## *Loan Originator Compensation*

- Consistent application of policy (brokers and retail)
- Compensation may not be based on prohibited factors
- Careful review of bonus or other possible forms of compensation

# Fair Lending: Best Practices

## *Consumer Complaint Resolution*

- Response within thirty days to all applicants who request orally or in writing more information regarding loan disposition
- Complaint resolution should be handled and documented by a designated employee with the full knowledge and monitoring by the compliance officer. The designated employee must respond in writing in a clear and understandable manner and provide all information as required
- In any instance where an applicant has filed a discrimination complaint with state or federal authorities, the institution must respond on a timely basis, and if appropriate, will work with its supervisory agency toward a conciliation agreement or other appropriate resolution



# Fair Lending: Self Assessment

## *Testing and Evaluations defined by the Interagency Fair Lending Examination Procedures*

### **Self Test:**

“[A] program, practice or study that is designed and specifically used to assess the institution’s compliance with fair lending laws that creates data not available or derived from loan, application or other records related to credit transactions”.

#### *Example:*

Use of a tester or “mystery shopper” to review instances of disparate treatment in the initial loan shopping period.

### **Self Evaluation:**

A process that “does not create any new data or factual information, but uses data readily available in loan or application files and other records used in credit transactions and, therefore, does not meet the self-test definition.”

#### *Example:*

Side by side file analysis, matched pair testing.

# Fair Lending: Self Assessment

## *Elements of the Fair Lending Self Assessment Evaluation*

- Comparative file review
- Utilization of the correct control and prohibited base groups
- Loan selection random or focused on marginal applicants
- Data accuracy
- Borrower treatment and institution judgment compared for differences on a prohibited basis
- Inclusion of a comparison of denied loan prohibited groups to control group approvals

# Fair Lending: Self Assessment

## *Side by Side File Review and Matched Pair Testing*

Two files having similar characteristics are matched and credit documents and methodology are given a side by side comparison to determine consistent treatment.

Disparate treatment can be measured through side by side comparisons of denied minority applicants and *marginally approved* non-minority borrowers.

A marginally approved borrower consists of file characteristics which were very close to the prohibitive basis applicant's file.

Matched pair testing may be utilized to perform benchmark comparisons among loans which were marginally denied vs. marginally approved.

# Fair Lending: Self Assessment

Self assessment to ensure compliance and adherence to policy.

Assessment for consistency and uniform standards may include reviews of:

- Loan conditions
- Nature and type of documentation requested
- Level of assistance
- Quality of service

# Fair Lending: Self Assessment

In addition to borrower treatment, disparity may be uncovered in:

- Pricing and products offered
- Timely service/closings
- Products or services offered influenced by borrower race, educational attainment, householder type and level of income

# Equal Credit Opportunity Act

ECOA prohibits lenders from discriminating against applicants on the basis of:

- Race
- Color
- Religion
- National Origin
- Gender
- Marital Status
- Age
- The receipt of public assistance
- The exercise of the borrower's rights under the Consumer Credit Protection Act.

Lenders must:

- Collect information about the applicant's race and other personal characteristics in applications for some dwelling-related loans
- Notify applicants of the action taken on their applications
- Report credit history in the names of both spouses on an account
- Provide applicants with copies of appraisal reports used in credit transactions

# Equal Credit Opportunity Act

## ECOA Notice

Lenders must provide a statement notifying borrower that ECOA prohibits discrimination based on race, color, religion, national origin, sex marital status, age, public assistance status, or exercise of right under the Consumer Protection Act.

The federal Equal Credit Opportunity Act prohibits creditors from discriminating against credit applicants on the basis of race, color, religion, national origin, sex, marital status, age (provided the applicant has the capacity to enter into a binding contract); because all or part of the applicant's income derives from any public assistance program; or because the applicant has in good faith exercised any right under the Consumer Credit Protection Act. The federal agency that administers compliance with this law concerning this creditor is:

[name and address of appropriate agency]

# ECOA: Prohibited Activities

A lender **may not** require the signature of an applicant’s spouse or other person, other than a joint applicant, on any credit instrument if the applicant qualifies under lender’s standards for creditworthiness.

Lenders **may not** request information about a co-applicant’s alimony, child support or separate maintenance unless the income is a basis for repayment.

## Guarantees:

- Personal—lender **may not** require personal guarantees on a prohibited basis
- Spousal—lender **may not** require the signature of a guarantor’s spouse

<b>Uniform Residential Loan Applic</b>				
<p>This application is designed to be completed by the Applicant(s) with the Lender’s assistance. Applicants should complete this form as “Borrower” or “Co-Borrower” as applicable. Co-Borrower information must also be provided (and the appropriate box checked) when <input checked="" type="checkbox"/> the income of assets of</p> <p>If this is an application for joint credit, Borrower and Co-Borrower each agree that we intend to apply</p>				
_____		_____		
Borrower		Co-Borrower		
I. TYPE OF MORTGAGE AND TERMS OF LOAN				
<b>Mortgage</b>	<input type="checkbox"/> VA	<input type="checkbox"/> Conventional	<input type="checkbox"/> Other	Agency Case Number
<b>Applied for:</b>	<input type="checkbox"/> FHA	<input type="checkbox"/> USDA/Rural		
Amount	Interest Rate	No. of Months	<b>Amortization</b>	<input type="checkbox"/>
\$	%		<b>Type:</b>	<input type="checkbox"/>

Note the opening statement:  
*“completed with the lender’s assistance”*



# ECOA: Prohibited Practices

*“A creditor shall not make any oral or written statement, in advertising or otherwise, to applicants or prospective applicants that would discourage on a prohibited basis a reasonable person from making or pursuing an application.”*

Prohibited Practices at origination include:

- Failing or refusing to provide to any person, because of race, color, religion, sex, handicap, familial status, or national origin information regarding:
  - Availability of loans or other financial assistance
  - Application requirements
  - Procedures or standards for review and approval of loans or financial assistance
  
- Providing information on basis of race, color, religion, sex, handicap, familial status, or national origin, which deviates from information provided to others.

# ECOA: Adverse Action

## **Adverse Action is:**

- Suggesting an applicant should not apply in response to any statement by the application
- Adverse action occurs as soon as the borrower is discouraged, a complete or signed application is not required.

## **Written Notification of Action Taken is required:**

- 30 days after the credit decision date, including decision to not proceed based on incompleteness
- 30 days after the date the application is received or completion date as determined by Lender's own policies and procedures
- 30 days after taking adverse action on an existing account
- 90 days after notifying the applicant of a counteroffer if the applicant does not expressly accept or use the credit offered

# ECOA: Adverse Action Notice

## Adverse Action Notice Content

- Name and Address of Creditor
- Action Taken and Date
- Reasons for action taken or a notification that reasons will be provided to borrower upon borrower request
- If decision was based on credit score the credit score information must be included regardless of any other reason.

# ECOA: Adverse Action Notice

- The credit score notice must include:
  - The numerical score used
  - The range of possible scores under the model used
  - Key factors that adversely affected the credit score
  - The date on which the score was created
  - The name of the person or entity that provided the score
  - Joint Applicants
    - If the credit score of one borrower is the reason for denial, the credit score notice may only be provided to that borrower alone
    - Two Notice of Action forms will be needed in this scenario

# Fair Housing Act (FHAct)

The prohibition of discrimination in sale, rental, or advertising of dwellings by race, color, religion, sex, handicap, familial status, and national origin

The Fair Housing Act applies to:

- Residential real estate-related transactions
- The sale, rental, or advertising of dwellings
- The provision of brokerage services

# Fair Housing Act (FHAct)

## *Availability of Loans*

### **Prohibited Practices include:**

- Failing or refusing to provide to any person, because of race, color, religion, sex, handicap, familial status, or national origin information regarding:
  - Availability of loans or other financial assistance
  - Application requirements
  - Procedures or standards for review and approval of loans or financial assistance
  
- Providing information , on basis of race, color, religion, sex, handicap, familial status, or national origin, which deviates from information provided to others

# Fair Housing Act (FHAct)

## *Loan Terms and Conditions*

### **Unlawful conduct includes:**

- Using different policies, practices, or procedures in evaluating or in determining the creditworthiness of any person on the basis of race, color, religion, sex, handicap, familial status, or national origin
- Determining the type of loan or other financial assistance to be provided with respect to a dwelling, or fixing the amount, interest rate, duration or other terms for a loan or other financial assistance for a dwelling or which is secured by a residential real estate, because of race, color, religion, sex, handicap, familial status, or national origin.

# Fair Housing Act (FHAct)

## *Purchasing Loans*

### **Unlawful conduct includes:**

- Purchasing loans or other debts or securities which relate to, or which are secured by dwellings in certain communities or neighborhoods but not in others because of the race, color, religion, sex, handicap, familial status, or national origin of persons in such neighborhoods or communities
- Pooling or packaging loans or other debts or securities which relate to, or which are secured by, dwellings differently because of race, color, religion, sex, handicap, familial status, or national origin
- Imposing or using different terms or conditions on the marketing or sale of securities issued on the basis of loans or other debts or securities which relate to, or which are secured by, dwellings because of race, color, religion, sex, handicap, familial status, or national origin



# Fair Housing Act (FHAct)

## *Selling, Brokering and Appraising*

It is unlawful for lender, any third party service providers, any person or entity whose business includes selling, brokering, or appraising residential real property to discriminate against any person in the services provided.

Such unlawful practices include, but are not limited to:

- Using an appraisal of residential real property in connection with the sale, rental, or financing of any dwelling where the person knows or reasonably should know that the appraisal improperly takes into consideration race, color, religion, sex, handicap, familial status, or national origin

# Home Mortgage Disclosure Act

The Home Mortgage Disclosure Act was enacted by Congress in order to allow the public to monitor the lending activity of a financial institution to determine whether the credit needs of their local communities were being served.

All banks, savings & loan institutions, credit unions, mortgage lenders and consumer finance companies must submit a Loan Application Register (LAR) under the Home Mortgage Disclosure Act. The LAR includes information on both originated and non-originated loans, including loans which have been denied, withdrawn, approved not accepted and closed for incompleteness.

## HMDA in Fair Lending:

- Review of the LAR to determine whether financial institutions are serving their communal housing needs
- Regulators examine the LAR information to determine patterns and trends that might indicate covert or overt discriminatory practices.

# HMDA LAR Reporting

## *HMDA LAR Data Integrity*

A regulator performing a fair lending examination must “verify the integrity of the data” being utilized for their review

The HMDA LAR may be used as a form of data verification by a comparison of the HMDA LAR information against the loan information found in the actual loan file

In anticipation of this, an institution should perform an occasional HMDA scrub

If a fair lending examiner finds too many errors, they may require the data be corrected before they are able to complete the full examination

# HMDA Pre-Approval Program

If the loan or application was for a home purchase and your institution has a **covered preapproval program** then the transaction is reported on your LAR

- **a covered preapproval program:** is a program in which the financial institution, after a comprehensive analysis of the credit worthiness of the applicant issues a written commitment (subject to only limited conditions) to the applicant valid for a designated period of time to extend a home purchase loan up to a specified amount

# HMDA Pre-Approval with Conditions

Pre-approval considered approved by lender if commitment letter issued resulting from institution's pre-approval program:

The written commitment may not be subject to conditions other than:

- Conditions that require the identification of a suitable property;
- Conditions that require that no material change has occurred in the applicant's financial condition or creditworthiness prior to closing; and
- Limited conditions that are not related to the financial condition or creditworthiness of the applicant that the lender ordinarily attaches to a traditional home mortgage application (such as certification of a clear termite inspection).

# Fair Lending Examination

## *Interagency Fair Lending Examination Procedures*

The determination of the focal points is where the fair lending examination process begins.

The examination focal points will be determined by the examiner based on a review of a lender's loan products (with a focus on special programs specifically targeted to assist underserved areas), markets, demographics and volume of lending for each loan product offered.

In review of the lender's documentation in determination of the scope, the examiner will be looking for overt indicators of discrimination: disparate treatment in underwriting, pricing, steering, marketing and discriminatory redlining.

# Fair Lending Examination

The examiner's review of the institution's compliance management system for purposes of examination scope will take note of the following risk factors:

- The strength of lender's overall compliance record,
- The completeness of CRA, ECOA and HMDA monitoring information records,
- Data and recordkeeping issues which result in unreliable information,
- Previous examinations uncovered fair lending problems,
- The overall compliance program compared to other similar institutions,
- The regularity of updates to the compliance program to incorporate regulation changes,
- Strength of fair lending training available and required for employees.

# Fair Lending Examination

## *Use of Institution's Self Assessment Evaluations*

The self assessments must not have occurred longer than two years prior to the exam and must have covered the same “product, prohibited basis, decision center and stage of the lending process” as the regulator’s fair lending examination.

The self-evaluations sampling sizes must cover the same amount as the fair lending examiner would request to review in order to be used to streamline the examination.

If disparate treatment is uncovered under the self-assessment, the fair lending examiner will also take this information into consideration, determining if the explanations and responses were adequate.



# Fair Lending Examination

## *Documentation requests: Compliance program*

- Organization charts identifying compliance, HMDA or CRA responsibilities, including job descriptions
- Lists of pending fair lending litigation or administrative proceedings
- Results of self-evaluations or self-tests
- Any written or printed statements describing fair lending policies and/or procedures
- Training materials related to fair lending issues including records of attendance
- Records detailing policy exceptions or overrides, exception reporting and monitoring processes
- Demographic information prepared or used by institution
- Any fair lending complaints received and responses thereto

# Fair Lending Examination

## *Documentation requests: Lending Policies and Loan Volume*

- Internal underwriting guidelines
- Description of any credit scoring system in current use or in use during the exam period
- Pricing policies for each loan product
- A description of each form of compensation plan for all lending personnel and managers
- Advertising copies for all loan products and internet website addresses
- The most recent HMDA/LAR, including unreported data if available and any existing registers for each non-HMDA loan product
- A description of any application or loan level databases maintained, including a description of all data fields within the database or that can be linked at loan level
- Forms used in the application and credit evaluation process
- Lists of service providers

# Fair Lending Examination

## *Examination Format*

- An underwriting comparison of denied and approved loan files, between prohibited group applicants denied loans and control group approved loans.
- A comparative file review, statistical analysis or combination of both for pricing or terms and conditions disparities between groups.
- A review of whether applicants were steered toward certain products based on a prohibited basis rather than the applicant's needs, even if no actual financial harm resulted.

# Examination Format

- Comparative redlining file analysis to determine whether the lender is excluding certain geographic areas based on racial or demographic characteristics
- A review of lender's marketing practices
- Review of any customized credit scoring model, the use in the underwriting system of a standard credit bureau credit score, adverse action decisions based on credit scores alone and the determination of disparate treatment in the application of credit scoring programs.
- Documentation of any instances of overt discrimination uncovered through comparative file review and the scope determination process. Instances of overt discrimination may be either written or unwritten.

# Discriminatory Practice Uncovered

## *Appearance of Disparate Impact resulting from a Fair Lending Examination*

Is there a legally sufficient justification?

The Interagency Fair Lending Examination Procedures Appendix outlines examples of common lender justifications concerning comparative disparate treatment:

- “The institution’s personnel were unaware of the prohibited basis identity of the applicant”
- “The different in treatment was justified by differences in the applicants (applicants not similarly situated)”
- “The different results stemmed from an inadvertent error”
- “The apparent disparate treatment on a prohibited basis is a misleading portion of a larger pattern of random inconsistencies” (where similarly situated)
- “Loan terms and conditions” where “risks and costs are legitimate considerations in setting prices and other terms and conditions of loan products.”

# Discriminatory Practice Uncovered

*The FDIC provides the following steps that may be taken if an institution uncovers a discriminatory practice or practice resulting in disparate treatment on a prohibited basis:*

- Identification of applicants whose applications were processed inappropriately and, with legal counsel's advice: offering to extend credit if applicants were denied improperly and compensating them for any damages, both out-of-pocket and compensatory, and notifying them of their legal rights
- Correcting any institutional policies or procedures that may have contributed to the discrimination
- Identifying, training or disciplining the employees involved
- Considering development of community outreach programs or changes in marketing strategy or loan products to better serve minority segments of the market area
- Improving audit and oversight systems to ensure there is no recurrence of the discrimination



## Questions?

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## Bankers Advisory

A CliftonLarsonAllen LLP Division

375 Concord Avenue, Suite 101

Belmont MA 02478

T 617-489-2008 F 617-489-2208



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