FAIR LENDING/HMDA HOT TOPICS

1st ANNUAL COMMUNITY BANK EVENT/
COMPLIANCE FUNNEL
November 5th, 2019

Connie Edwards, CRCM, Shareholder
Saltmarsh, Cleaveland & Gund
Nashville Office

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Agenda

- HMDA 2018
- Fair Lending Program
- Fair Lending Review Process
- Redlining Review Process

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Fair Lending – What's it all about?

- Why is it important to discuss equal treatment and fair lending?
  - Treating all customers equally and fairly is **very important**.
  - It is illegal to treat customers differently based on a prohibited bases factor.
  - Fair lending isn't just the law, it is good business!
- Regulations with fairness (or fair lending) elements:
  - Equal Credit Opportunity Act
  - Fair Housing Act
  - Community Reinvestment Act
  - Home Mortgage Disclosure Act
  - Servicemembers Civil Relief Act
  - UDAAP

ECOA – What are Creditors Responsible for?

- Implementation: Implements the Equal Credit Opportunity Act
- Purpose: The primary purpose of the regulation is to require creditors to:
  - **Promote the availability of credit**
  - Notify applicants of action taken
  - Report credit history in the names of borrowers
  - Record Retention
  - Collect GMI
  - Provide Appraisal Reports

- Coverage: Unlike Regulation Z, which is limited to personal, family or household purpose credit, Regulation B applies to all types of credit subject to some limited exceptions in the Regulation. Generally, Regulation B applies to personal, family, household, business and agricultural purpose credit.

Elements of Regulation B/ Fair Housing Act Prohibited Basis Factors

Prohibit Discrimination on the basis of:

- Race
- Color
- Religion
- National Origin
- Sex
- Marital Status
- Age

- Public Assistance
  - ***If all or part of the applicant's income is derived from any public assistance program***
- Rights under Consumer Credit Protection Act
  - ***If the applicant has in good faith exercised any right under the Consumer Credit Protection Act***
- Fair Housing Act – same factors but adds 2 additional:
  - ***Familial Status***
  - ***Disability/Handicap Status***

HMDA Background and Purpose

HMDA DATA can be used to:

- Help determine whether institutions are meeting the housing credit needs of their communities.
- ***Identify possible discriminatory lending patterns and help enforce anti-discrimination laws.***
- Help public officials target investments to attract private investment to areas where it is needed.

The purpose of HMDA is not to prohibit certain lending activity or encourage unsound lending practices or credit allocation.

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HMDA 2018

- 2018 HMDA Data is filed - You're done, right? Wrong!
- You need to analyze it for fair lending risks/trends/strategic planning purposes!
- CFPB HMDA reporting system-fewer quality edits compared to 2017 – created issues during submission this year. (800% rate spread/$990,000,000 loan amount)
- Aggregate Data released end of August 2019 –delayed due to resubmissions. 30% rejection rate
- What are the risks w/2018 HMDA?
  - Public availability of expanded data including pricing, credit score, age, etc.
  - Very easy to obtain LAR data – available for download from FFIEC website (https://ffiec.cfpb.gov/data-browser/)
  - You have no idea who has your data – consumer groups, peers, etc.
  - Ease of putting it into a spreadsheet or a fair lending program for you to compare to peers on an expanded level – using more data
  - Expanded exams have begun – focusing on data integrity

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HMDA 2018

- Announcements from CFPB and Prudential Regulators (12/2017) on 2018 HMDA Data Examinations
  - Will we see violations for data integrity? Exam Criticism? What about resubmissions?
  - Define "material problem" – do we know?
  - Do you know the status of your data integrity? Did you scrub the data before submission?
  - Do you feel comfortable that your data is accurate to draw conclusions?
  - If not, stop, rescrub, resubmit and then begin FL review
  - Know your data!

Where is HMDA headed?

- CFPB issued a final rule on 10/10/19 that accomplished two items for HMDA reporting purposes:
    - Extended the current temporary threshold of 500 open-end lines of credit for open-end institutional and transactional coverage. For data collection years 2020 and 2021, FIs that originated fewer than 500 open-end lines of credit in either of the two preceding calendar years will not need to collect, record or report data for open-end LOCs.
    - Incorporates into Regulation C and implements the HMDA partial exemptions created by the Economic Growth, Regulatory Relief and Consumer Protection Act (EGRRCPA) and addresses certain issues related to the partial exemptions that the 2018 Rule did not address, such as how to determine whether a partial exemption applies after a merger or acquisition.
    - Bureau plans to address the proposed permanent coverage thresholds for closed-end mortgage loans and open-end LOCs in a separate final rule.

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Where is HMDA headed?

- Are you already exempt from the new data points, but collected the data until May 2018? What did you do with that data?
  - **Partially Exempt HMDA Reporters – Examiners expecting you to have access to at least credit score, DTI, LTV**
- Can't predict the future –what will happen w/the new data points? ANPR issued in May 2019 revising HMDA data points with an extended comment period to 10/15/19 still needs to finalized
  - CFPB can't eliminate them all – only the data points that were added through their "discretionary authority" given by Congress as part of DFA.

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Fair Lending Program

Fair Lending CMS - what's required?

Program Governance -

- ✓ Roles and Responsibilities – Board and Management Oversight
- ✓ Fair Lending Risk Assessment

Preventive Controls –

- ✓ Policies and Procedures
- ✓ Fair Lending Training

Detective Controls –

- ✓ Robust Monitoring Program
- ✓ Audit Program
- ✓ Performance Analysis
- ✓ Complaint Management

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Fair Lending Program

- No two Fair Lending Programs will be the same-
  - different banks, demographics are different, different risks, different market share, competition, different strategies.
- Fair Lending CMS – what's the purpose?
  - *Prevention* –
    - Policies/Procedures review – looking for any overt discrimination or disparate impact statements within your policies/procedures/guidelines.
    - Fair Lending Training – At least annually
      - Consider face-to-face method of communicating risks/issues/trends/awareness where participants can ask questions of a human being for a change, instead of computer-based
      - Make sure BOD and Senior Management are also trained on FL/keep them up-to-date on the current FL risks in the industry
    - CO seat at the Table – Compliance needs to be at the table when products are being designed, CRA AA changing, strategic planning
    - Communication – BOD and Senior Management need to be aware of results and details of your FL compliance efforts

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Fair Lending Program

- Fair Lending CMS – what’s the purpose?
  - *Prevention* – (Board and Management Oversight/Training/Policies/Procedures)
    - Operational Controls – LO systems are designed to keep you in compliance.
      - ✓ Don’t allow too many hands in the admin side of your LO system (i.e. changing compliance rules in the software)
      - ✓ Be aware of issues with systems that exist out there with certain vendors - participate in user calls with your vendor. (ask about list of Encompass HMDA fields that are user-defined – scary!)
      - ✓ If using HMDA reporting software imbedded in your LO system and utilizing a separate doc prep system (DocMagic), be aware that updates made to documents in the document preparation software will not update back to your HMDA reporting system within your LO system. You will need some type of mechanism to alert you to these changes. Very manual process!

Fair Lending Program

- *Detection*
  - Robust Monitoring System –
    - ✓ Examiners are expecting that you are analyzing your data for FL purposes or you are utilizing a third-party to accomplish it
    - ✓ **Even if you are subject to partial exemption for HMDA, examiners expecting you to have access to at least credit score, DTI, LTV**
    - ✓ Even if you don't have a FL software program, it can be accomplished utilizing Excel pivot tables
    - ✓ Slice and dice your data various ways based on the new HMDA data. Filters are important and helpful – be careful to compare apples to apples
    - ✓ Important to understand your underwriting criteria and how it applies to your specific products – you will have different set of criteria for a home purchase loan vs. refinance transaction.
    - ✓ Equally important to understand your pricing methodology/rate sheet/pricing engine for mortgage shops – fixed rate vs. ARM loans, affordable housing loans, etc.
    - ✓ If you are a HMDA reporter, you <u>must</u> conduct a redlining review as part of your FL testing.

Fair Lending Program

- *Correction*
  - If you detect FL issues with policies/procedures/guidelines that are having a disproportionate impact on a prohibited group of people, you need to revise/correct/educate Sr. Mgmt. on why changes are necessary.
  - If you detect LO issues with discriminatory practices or preferences, you must deal with that immediately to lessen the consumer harm/impact.
  - If you determine that you have potential redlining issues or were criticized during last exam with MRAs, you need to put a strategic plan in place to prevent it from occurring in the future. Don't delay!
  - If your Bank was criticized for redlining through an MRA, ask me for the list of information to track for redlining purposes in preparation for your next FL examination.

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FL Review Planning Process

- Develop your FL Risk Profile – have you completed a FL Risk Assessment that encompasses the whole institution?
  - Identify your inherent risks - examples
    - Highly diverse population in your trade area (marketing risk)
    - Presence of racially or ethnically designated geographies in trade area or wherever you are lending. Higher risk geographies can impact exam focus (redlining risk)
    - Multiple lending channels that offer similar credit products, including pricing risk in same geography/different channels (steering risk)
    - Discretion in lending processes (underwriting and pricing risk)
- If not, stop and complete the FL Risk Assessment

FL Review Planning Process

- Once you know your inherent risks, then you can identify the lending products for scoping.
  - Largest volume and highest risk product(s)
  - HMDA Reporter – Recommend looking at Portfolio Mortgage Lending – largest volume other than secondary/biggest risk area/greatest opportunity for discretion.
- FRB/FDIC scoping priority
  - HMDA
  - Consumer Secured and Unsecured/Student Lending (if applicable)
  - Commercial Lending (small business emphasis)
- Select loan product for review – most commonly used by examiners – FDIC, FRB for HMDA/FL redlining purposes
  - Home Purchase loans, Conventional, Owner Occupied, 1st Lien, Site Built, 1 unit

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FL Review Scoping Process

- FL Risk Factors to be reviewed for Residential Lending – Underwriting, Pricing, Redlining (if in an MSA), Steering, Levels of Assistance, including average days from application to action and Marketing FL risk factors, if redlining risk is found.
- Consumer Secured/Unsecured/Student Lending/Indirect Auto Lending – Focus of review should be on underwriting and pricing, including geographical analysis of pricing risk. BISG Proxy analysis is still being used by examiners, even though it was considered unreliable and isn't being used by CFPB any longer.
- Caveat – consideration will be given to business model – if you have a high volume of manufactured housing, investment property, reverse mortgages or open-end LOCs, Examiners will include in FL exam scope.

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FL Review Planning Process

- Once you have done your scoping, identify risk factors, risk controls and residual risk based on the FFIEC Interagency FL Procedures-
  - ✓ Residential Mortgage Lending – need to address FL risk factors – U1, U2, U3, U9, P1, P2, P3, P4, P5, P6, P7 (if applicable), S1, S2, S4, S5, S5, S6, S7, S8 (if applicable), R1, R2, R3, R4, R8, R9
  - ✓ Consumer Secured/Unsecured/Student Lending/Indirect Auto Lending - need to address FL risk factors – U1, U2, U3, U4, U5, U6, U7, P1, P2, P3, P4

  https://www.ffiec.gov/pdf/fairlend.pdf

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FL Review Process

✓ Pull from a validated HMDA LAR-File to import into your FL software

- Extract the following – put in a separate file for analysis later if needed
  - HELOCs
  - Business/commercial
  - Interest-only feature
  - Balloon payment feature
  - Construction/permanent
  - Manufactured homes
  - Non-owner occupied and investment homes
  - Secondary market loans (if applicable)
  - ARM loans
  - Fixed rate loans

- Run HMDA Exception report within your software – determine if you have any validity or syntactical edits.
  - Any geocoding issues – re-geocode those that didn't upon import
  - Resolve any geocoding issues – must be correct for valid redlining analysis
  - You should've already scrubbed your HMDA data and re-filed if more than 3 key field errors after the 3/1/19 submission date.

UW FL Review Process

- Pay attention to your filtering process – some issues can occur during the filtering process. Sometimes, you don't have all the information you need for an adverse action file (i.e. filtered based on 6-AUS system.
- Underwriting Test – compare originated control group files to denied target group files.
- Conduct Matched Pair Testing - where your underwriting and pricing knowledge will be most needed
  - Tips --Never include non-Hispanic when designating white male – issue because of disaggregated race/ethnicity categories.
    - *Do not use joint race (the joint category is one borrower is white and the other borrower is a single minority race) with the 2018 HMDA data per CFPB.*
    - *Most commonly used by FRB/FDIC –white male only, no co-applicant originated for CG and black female only, no co-applicant declined.*
    - *Make sure you select same product for comparative analysis.*
    - *Per FRB, never compare joint borrowers with single borrowers!*
    - *If you are testing for ethnicity, you would make the control group – non-Hispanic and the target group Hispanic*
    - Also need to consider age ...based on your demographic profile, added field (calculated) for >62
- After you've completed the matched pair testing, it's time to review the actual files that make up the matched pairs to verify their match.

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UW Matched Pair Testing

- FL Software allows you to set tolerance settings for matched pair testing—not to identify marginal transactions, but "better situated" targets
  - o Credit Score, DTI, LTV
    - o Applicant CS >-10
    - o DTI <5.00
    - o LTV <5.00
- o For your MP testing, cast your net wide and narrow as you go.
- During comparative file analysis -
  - Review entire file, including all lender notes, any overrides, underwriter notes, etc.
  - Review entire denial, including AA Notice, credit report, application, underwriting transmittal, if applicable, appraisal, etc.

Pricing FL Review Process

- Pricing Test – compare originated control group files to originated target group files.
- For HMDA Reporters, remember to look at rate spread differentials >15 bps
- If there are any pricing differences found by geography, you must have a business justification.
- Run all pricing reports by MSA and your peers within that MSA – analyze different geographies due to demographic characteristics (i.e. Memphis vs. Omaha – very different)
- If you have non-MSA areas as part of your CRA AA -- do not combine w/MSA areas

Definition of Redlining

Redlining = A form of illegal discrimination in which an institution provides unequal access to credit, or unequal terms of credit, because of the race, color, national origin, or other prohibited characteristic(s) of the ***residents of the area*** in which the credit seeker resides or will reside or in which the ***residential property to be mortgaged is located***

FRB's Abbreviated Definition – Unequal access to credit to residents or neighborhoods on a prohibited basis

Reverse redlining = the practice of **targeting** certain borrowers or areas with **less advantageous products or services** based on prohibited characteristics

Redlining

County Code	Tract Code	Tract Income Level	Distressed or Under -served Tract	Tract Median Family Income %	2019 FFIEC Est. MSA/MD non-MSA/MD Median Family Income	2019 Est. Tract Median Family Income	2015 Tract Median Family Income	Tract Population	Tract Minority %	Minorit y Populat ion	Owner Occupied Units	1- to 4- Family Units
103	0201.01	Moderate	No	50.81	$66,900	$33,992	$29,939	4885	80.96	3955	988	1965
103	0201.05	Upper	No	153.58	$66,900	$102,745	$90,486	5102	22.70	1158	1359	1293

- High Minority Census Tract (HMCT) - census tract with a minority population of 80% or more
- Majority Minority Census Tract (MMCT) - census tract with a minority population of 50% or more
- Recent settlements focused on specific minorities, e.g., majority Black, majority Hispanic tracts – check the demographics of your CRA AA and know which minorities to focus on.

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Redlining Risk Factors

- Based on the 2009 Interagency Fair Lending Examination Procedures, examiners generally review the following risk factors for redlining:
  - Lending Disparities
  - Branching
  - Marketing and Outreach
  - Assessment Area(s)
  - Overt Statements and Complaints

Lending Disparities

Indicator of Risk:

- A statistically significant disparity between a lender's mortgage applications and originations in majority-minority neighborhoods compared with the adjusted aggregate of similar lenders
    - "Adjusted aggregate" is typically defined as lenders with lending activity that is between 50 and 200 percent of the lender's volume within the market, but maybe adjusted further based on the lender's business model.
- Existence of lending disparities based on comparison with an adjusted aggregate indicates the ability of a lender to provide access to credit in a particular market.
- *"Mapping is a powerful tool to assessing redlining risk."*

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Lending Disparities

As part of your Risk Assessment, lenders can:

- *Map* applications and originations
- *Monitoring your lending activity* against lenders in your AA or market area that have lending activity between 50-200% of your lending volume
  - If you adjust volume thresholds or you include/exclude certain lenders from analysis based on your business model, document your rationale

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Branching

Indicator of Risk

- By geography: Lender does not locate branches or LPOs within majority-minority neighborhoods
- By products and services:
  - *No mortgage loan officers available in branches/LPOs located in majority-minority neighborhoods*
  - *Hours of services at branches/LPOs are more limited in majority-minority neighborhoods*
  - *Focus of branches/LPOs in majority-minority neighborhoods is on deposits, not credit products*
  - *Branches or LPOs in majority-minority neighborhoods do not offer the same loan products as those offered in nonminority neighborhoods.*

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Branching

As part of risk assessment and the institution's strategic planning process, lenders should consider developing a branching strategy:

- Assesses fair lending risk when adding or closing branches and LPOs
- Assesses fair lending risk when adding or closing branches and LPOs based on mergers or acquisitions
  - Document reasons why and retain them for the next FL examination
- Periodically evaluate the services and products offered in branches and LPOs located in majority-minority neighborhoods to determine if there are differences that would raise the fair lending risk

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Marketing and Outreach

Indicator of Risk:

- Exclusionary traditional marketing and outreach: The lender's print and in-person marketing and outreach activities exclude majority-minority neighborhoods.
- Exclusionary internet-based marketing and outreach: The lender's digital marketing and outreach activities exclude majority-minority communities, as well as minority applicants.
  - Third-party actions by vendors in the area of internet-based marketing and outreach can raise additional risks for lenders to manage.

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Marketing and Outreach

As part of risk assessment, lenders can (and should):

- *Monitor marketing and outreach activities* to ensure that those activities are reaching the entire AA or credit market area, including any predominantly minority neighborhoods
- *Review use of all criteria or filters in internet-based marketing and outreach activities to determine fair lending risk*
- Manage third-party risks by:
  - *Understanding whether the advertising platform utilizes algorithms or filters that could exclude majority-minority communities or minority applicants.* If present, lender should review such practices for fair lending risk.
  - *Requesting reports from vendors and partners indicating the reach of the lender's marketing and outreach activities.*

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Overt Statements and Complaints

- OCC's Definition of Complaint – "Written expression of dissatisfaction"
- Examiners Review of Complaints includes:
  - *Identifying type and number across all products (including foreclosure and servicing complaints), business lines, and channels*
  - *Determine whether issues* from prior findings are *resolved or unresolved*
  - *Identify focal points for fair lending examinations based on indications of disparate treatment or redlining*
- Examiners recommend using complaint data as an early warning tracker for emerging issues and trends
- Recommendation would be to make this review a focused, separate review either annually or more frequently if residual risk warrants

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Assessment Area(s)

CRA Assessment Area is determined by the institution

- includes whole geographies where an institution has its main office and branches and deposit-taking ATMs
- may not extend substantially outside of these
- consists of one metropolitan statistical area (MSA); metropolitan divisions; census tracts; or one or more contiguous political subdivisions, such as counties, cities, or towns
- risk is arbitrarily excluding low- or moderate-income geographies from your AA

Redlining - REMA

FFIEC defines a REMA as *"an expected market area where the institution **actually marketed and provided credit** and where it **could reasonably be expected to have marketed and provided credit**"…*

> *…based on institution's distribution of applications and loans as well as its marketing and outreach efforts (10/16 FDIC Banker Call)*

- REMAs do not always coincide with CRA assessment areas
- REMA is not defined in fair lending laws
- REMA would not be written in report of examination unless there was a redlining issue

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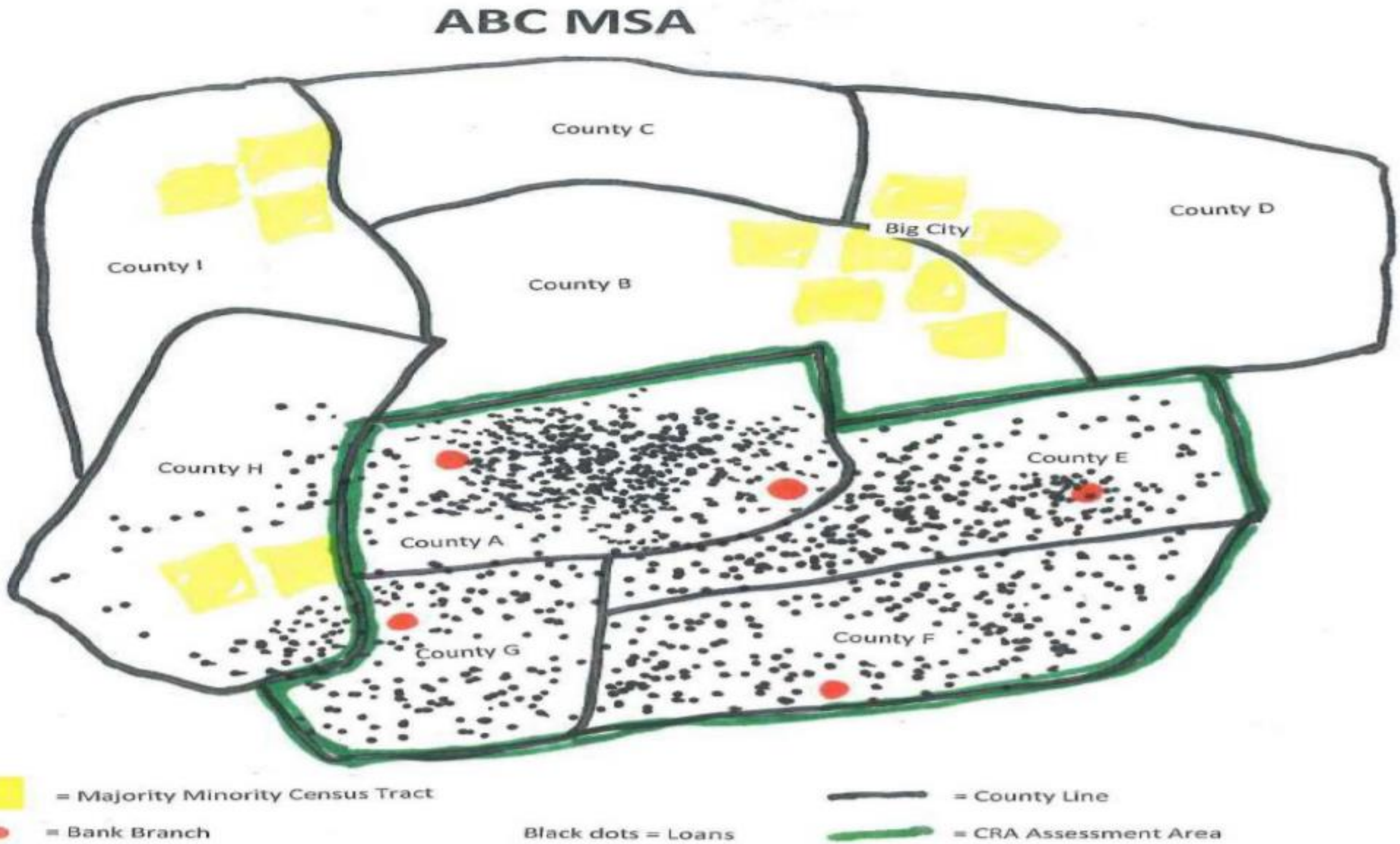
This is from the FDIC Atlanta's 10/16 Call. The AA is in green; the REMA would add County H



Redlining – Analyzing Peers

- FRB and FDIC use the following numbers to compare your bank's lending numbers to a similar situated HMDA group and demographics:
  - Typically 50 to 200% of your bank's HMDA and lending volume
  - Tell the examiners who you believe are your peers and document your rationale.
  - This data can be pulled either through most FL software programs or through the FFIEC website and calculated without FL software.
  - FFIEC HMDA Flat Files Data for Similar Situated HMDA group through 2016: https://www.ffiec.gov/hmda/hmdaflat.htm For years 2017, 2018 and forward, you will need to use this link https://ffiec.cfpb.gov/data-browser/ You can filter data by geography levels (nationwide, state & MSA/MD) and then you can select two variables like loan type, purpose, etc. - many to choose from-
  - Keep in mind that your lending volume changes annually and your peers' data will change each year as well

Excellent Article on the effect of peer selection: ABA Compliance Magazine "How to Assess Redlining Risk by Analyzing Peers" http://magazines.aba.com/bcmag/november_december_2017?pg=28#pg28

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DOJ’s Redlining Investigative Focus

- Investigations (and the regulatory agencies’ exams) often focus on four categories of evidence to assess the bank’s efforts to serve minority areas:
  - CRA Assessment Area(s)
  - Branch Locations
  - Marketing/Advertising
  - Statistical Analyses – applications and originations

Recent DOJ Settlement/ DOJ vs. First Merchants Bank

- Department of Justice (DOJ) filed Complaint on June 13, 2019, alleging that First Merchants Bank, (headquartered in Muncie, IN) engaged in unlawful redlining of majority-Black areas of Indianapolis-Marion County, along with disparate impact.
- DOJ and First Merchants Bank settled on August 9, 2019
- No CMPs similiar to KleinBank settlement.

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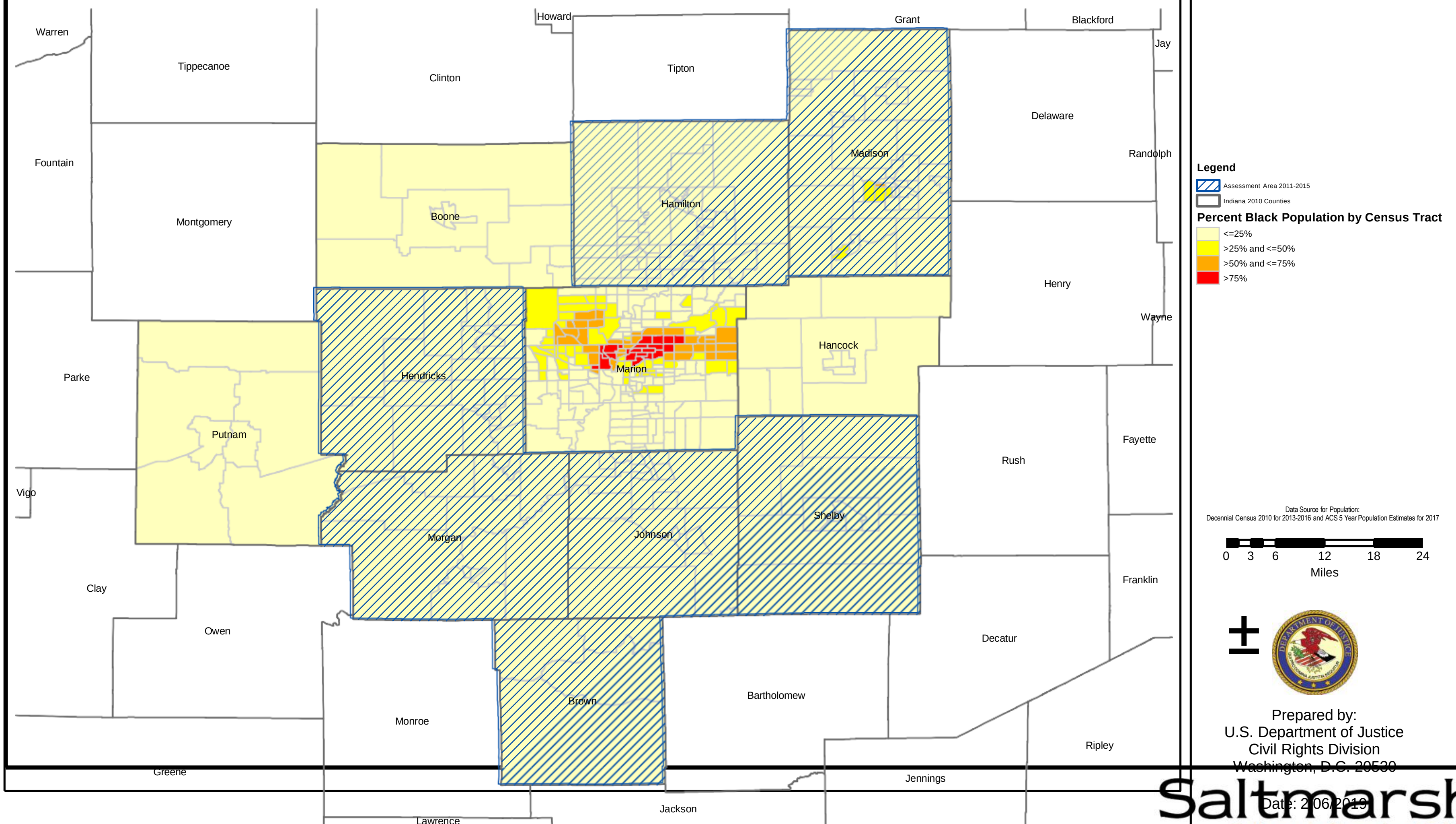
FMB CRA Assessment Area

- ✓Indianapolis MSA
- ✓Until 2016, FMB excluded 98% of majority-Black CTs in the MSA – took only 2% of the majority-Black CTs
- ✓Bank's AA was horseshoe-shaped
- ✓Bank employees referred to the shape as the 'Indy donut"
- ✓In 2016, FMB added Indianapolis-Marion County to its assessment area to "address the horseshoe shape.

First Merchants Bank Assessment Areas 2011-2015
Indianapolis MSA



FMB Branching

- ✓FMB currently has 34 branches in Indianapolis MSA
- ✓All branches located in majority-White suburban tracts.
- ✓FMB never acquired or built a branch in a majority-Black tracts.

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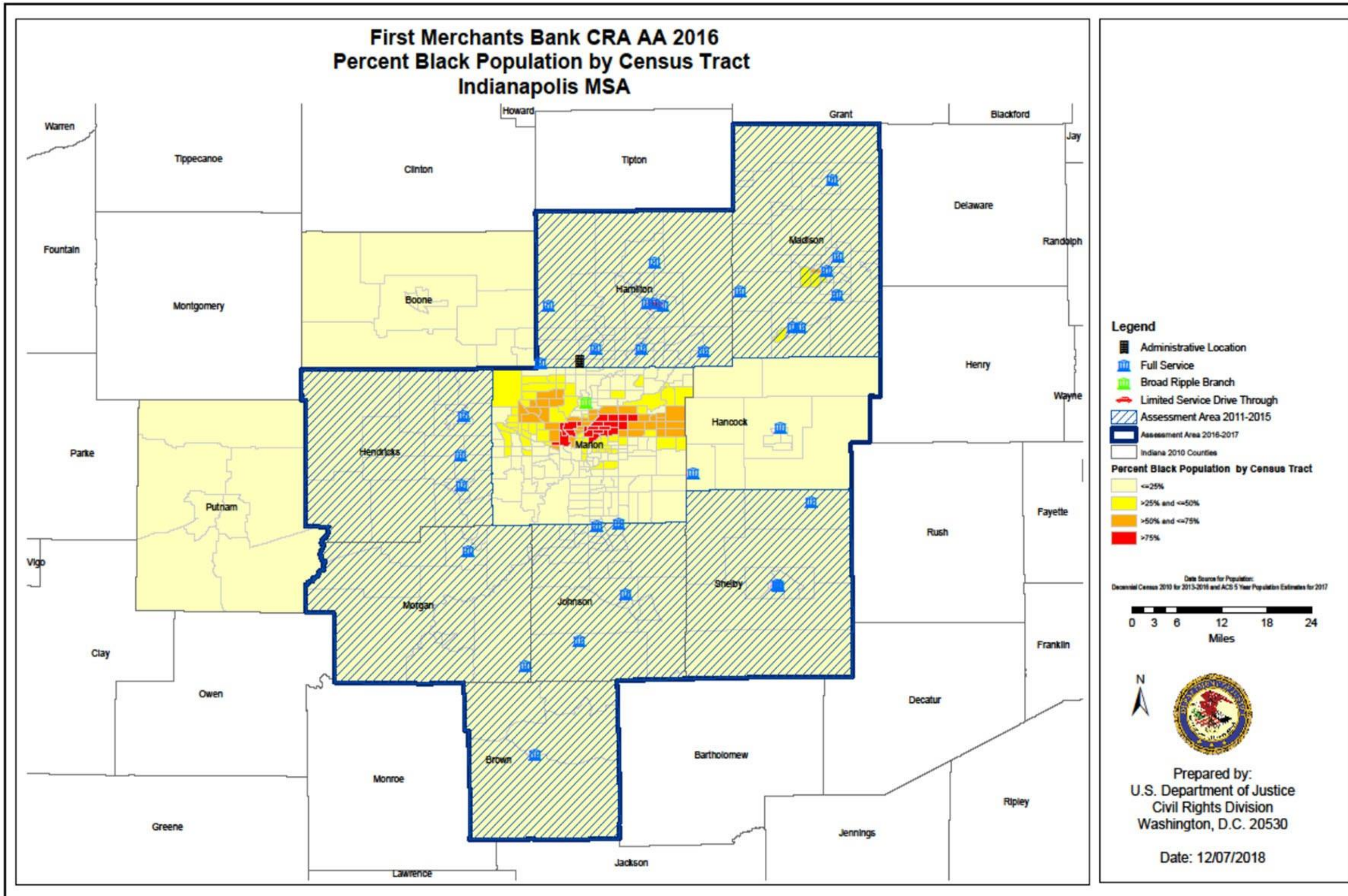

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FMB Marketing/Advertising

- ✓FMB marketing was limited to majority-White areas
- ✓Some of their marketing campaigns were explicitly limited to the “Indy donut”, meaning the outlying suburban areas
- ✓In marketing campaigns prior to 2017, FMB excluded every tract in Indianapolis
- ✓In marketing campaigns starting in 2017, FMB excluded majority-Black areas, while including majority-White areas in Indianapolis-Marion County

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FMB Statistical Analyses

- ✓FMB severely underperformed its peers in majority-Black areas in generating mortgage loan applications, and originating loans
    - FMB – 2011-2017 – 1.71% majority-Black tracts
    - Peers – 2011-2017 – 4.64% majority-Black tracts
- ✓FMB's applications from majority-Black tracts were from predominately White applicants
- ✓By contrast, peer banks' applications from majority-Black tracts were predominately from Black applicants
    - FMB – Less than 2% of their applications came from majority-Black tracts
    - Peers – Received 6.15% of their applications from majority-Black tracts
    - Peers received 3x more applications than FMB from majority-Black tracts

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FMB Settlement Terms

- Terms include:
  - $1.12 million in a loan subsidy fund targeted at Black neighborhoods
  - $500,000 toward advertising, community outreach credit repair and education
  - One branch and one LPO officer to serve predominately Black neighborhoods in Indianapolis
  - Must add a director of community lending and development

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Recent Redlining Guidance

1. 2019 Fair Lending Interagency Outlook Live Webinar, 10/1/19
2. CFPB Fair Lending Report issued June 2019 (corrected 09/19)
3. FRB Consumer Compliance Supervision Bulletin, July 2018
4. CFPB Supervisory Highlights Issue 13, Fall 2016
5. Outlook Live 2016 Interagency Fair Lending Hot Topics, 10/4/16
6. FDIC Atlanta Region Regulatory Conference Call, 10/27/16 “Reasonably Expected Market Area, Trade Area, and Assessment Area: Where Do they Fit under CRA and Fair Lending?” Including “Determining the Reasonable Expected Market Area for Redlining Analysis” by Gary Clayton.
7. FDIC Regional Regulatory Conference Calls “Are you at Risk for Redlining? Understanding your Reasonably Expected Market Area (REMA) and CRA Assessment Area” San Francisco, 3/14/18; New York 3/30/17

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Questions??

Contact Information:

Connie Edwards, CRCM, Shareholder

Saltmarsh, Cleaveland & Gund

2 Maryland Farms Way, Ste 132

Brentwood, TN 37027

Phone #: (615) 661-0885

Cell #: (615) 500-5257

Connie.Edwards@saltmarshcpa.com

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