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Identifying and Addressing Redlining Risk

April 2024

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On President Joe Biden's first day in office, he signed Executive Order 13985, *Advancing Racial Equity and Support for Underserved Communities Through the Federal Government*.[1] Soon after, the Department of Justice (DOJ) announced its goal to ramp up its scrutiny by "making far more robust use of our [DOJ's] fair lending authorities."[2]

The department launched its "Initiative to Combat Redlining" in October 2021, resulting in an increased regulatory focus on "redlining," which occurs when a bank 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."[3] Since launching the initiative, the DOJ has announced 10 redlining settlements with banks and mortgage lenders and more than 24 pending redlining investigations. ICBA is also aware of examiners significantly increasing their investigation of potential fair lending and redlining violations during exams.

ICBA created this guide to help raise awareness of fair lending and redlining scrutiny. It will first provide a high-level overview of the types of discrimination claims that a bank can face. It will then move on to a more detailed treatment of redlining and what your bank can do to protect itself from redlining violations.

Disparate Impact, Disparate Treatment, and Redlining

The fair lending laws — which include the Fair Housing Act[4] and the Equal Credit Opportunity Act[5] — prohibit banks from discriminating against any applicant with regard to any aspect of a credit transaction on the basis of race, color, religion, national origin, sex, marital status, or age.

Banks have an ongoing duty to monitor their business practices to identify and mitigate fair lending risk. Because discrimination claims can arise even in cases where the bank has no discriminatory intent or where banks are unaware that discrimination is taking place, maintaining an effective fair lending compliance program is crucial.

Generally, illegal discriminatory conduct falls into two broad categories — *disparate impact* and *disparate treatment*.

1 The White House, "Executive Order On Advancing Racial Equity and Support for Underserved Communities Through the Federal Government," EO 13985 (Jan. 20, 2021) available at: https://www.whitehouse.gov/briefing-room/presidential-actions/2021/01/20/executive-order-advancing-racial-equity-and-support-for-underserved-communities-through-the-federal-government/

2 Katy O'Donnell, *PoliticoPro*, "Garland launches housing discrimination crackdown," (Oct. 22, 2021), available at: https://subscriber.politicopro.com/article/2021/10/22/garland-launches-housing-discrimination-crackdown-1392005.

3 Office of the Comptroller of the Currency, Federal Deposit Insurance Corporation, Federal Reserve Board, Office of Thrift Supervision, National Credit Union Administration, "Interagency Fair Lending Examination Procedures" (Aug. 2009), pg. 29-30, available at: https://www.ffiec.gov/pdf/fairlend.pdf.

4 42 U.S.C. §§ 3601–3619

5 15 U.S.C. §§ 1691–1691f

Disparate impact

A bank may violate the fair lending laws by creating a disparate impact when a neutral policy or practice results in disproportionate burdens on or illegally excludes a protected class. For example, if a bank has a policy not to extend home mortgage loans for less than $100,000, that neutral policy could be shown to disproportionately exclude minority applicants due to lower housing prices in the neighborhoods where they live. Even though the aforementioned policy makes no mention of race and is applied to all races equally, it may still amount to illegal discrimination under a disparate impact theory if it creates a discriminatory effect.

However, the fact that a policy or practice creates a disparity on a prohibited basis is not enough, on its own, to justify liability under a disparate impact theory. A neutral policy or practice that creates a disparate impact may be permissible if it is justified by a business necessity. However, even policies and practices justified by a business necessity may be illegal if an alternative policy or practice could serve the same business purpose with less discriminatory effect.

Disparate treatment

Disparate treatment occurs when a loan applicant or prospective applicant is treated differently on the basis of a prohibited characteristic. Disparate treatment may be proved by overt evidence that a lender explicitly considered prohibited factors or, more commonly, through comparative evidence that a lender treated similarly situated customers differently in ways that are not explained by legitimate non-discriminatory factors.

Redlining

Redlining is a type of disparate treatment in which a bank provides unequal access to credit or unequal terms of credit based on a prohibited characteristic to the residents of an area in which the credit seekers reside or will reside or in which a residential property to be mortgaged is located. For example, avoiding providing home loans and other mortgage services in majority-Black and -Hispanic neighborhoods would constitute redlining.

Understanding Your Market

To avoid inadvertently committing redlining, it is important to understand the demographics of the market your bank serves. Regulators evaluate a bank's redlining risk inside its Reasonably Expected Market Area (REMA). The Federal Financial Institutions Examination Council (FFIEC) Interagency Fair Lending Examination Procedures define an institution's fair lending REMA as the "areas where the institution actually marketed and provided credit and where it could reasonably be expected to have marketed and provided credit."[6]

Your bank's Community Reinvestment Act (CRA) assessment area is a useful starting point to begin thinking about your bank's fair lending REMA. **However, REMAs may extend beyond your CRA assessment areas if your bank markets and provides credit outside your assessment area.** Additionally, ICBA is aware of a general preference by regulators to use "whole geographies" — e.g. whole counties or whole Metropolitan Statistical Areas (MSAs) — as opposed to partial counties. Unlike CRA, which permits banks to define their own assessment area, REMAs are defined by

6 *Supra* note 3 at p. 32.

examiners. If your examiner defines a REMA more broadly than your CRA assessment area, you should consider discussing the matter with them and providing evidence that you cannot reasonably serve areas outside of your CRA assessment area.

Use of Partial Counties

CRA regulations have historically permitted banks to delineate partial counties as assessment areas so long as they could demonstrate that their assessment area reflected the portion of the geography that the bank could reasonably be expected to serve and did not reflect illegal discrimination or arbitrarily exclude low- and moderate-income census tracts.[7] The new CRA rule will continue to permit partial county assessment areas for small and intermediate banks but will require whole county assessment areas for "large" banks (those over $2 billion in assets).

Because regulators will generally prefer whole geographies, banks that believe they should only be evaluated in a certain portion of a county should be prepared to demonstrate that they cannot reasonably be expected to serve the entire area. Evidence that a partial county is more appropriate as an assessment area or fair lending REMA might include showing that the bank does not make loans in parts of the county outside of its assessment area, that it does not market there, and that it has no branch presence outside of its assessment area.

If your bank plans to define an assessment area as a partial county, you should continue to use whole census tracts. Furthermore, ensuring that you are not arbitrarily excluding majority-minority census tracts or tracts that are low- and moderate-income is important. If you choose to define an assessment area that does exclude these tracts, you must be able to demonstrate that it would not be reasonable for the bank to serve those areas due to the lack of proximity to physical branches and balance sheet capacity.

To argue that your REMA should only extend as far as your CRA assessment area and not to full counties or MSAs, you should be prepared to demonstrate that you do not market outside of your CRA assessment area and that you do not make a substantial number of loans in the tracts you believe should be excluded from your REMA. FFIEC has a mapping tool that allows you to view the demographics of every census tract and whether they are low- and moderate-income.[8]

Redlining Analysis

When evaluating whether a bank has committed redlining in a REMA, examiners will look for evidence of both traditional redlining — where 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 — and "reverse redlining" — where an institution targets certain borrowers or areas with less advantageous products or services based on prohibited characteristics. Using these two theories, examiners will determine whether:

7 12 CFR 228.41(d); 12 CFR 228.41(e).
8 FFIEC, Geocoding Information, available at: https://www.ffiec.gov/cra/geocode.htm.

- an institution fails or refuses to extend credit in certain areas;
- an institution targets certain borrowers or certain areas with less advantageous products;
- an institution makes loans in such an area but at a restricted level or upon less-favorable terms or conditions as compared to contrasting areas; or
- an institution omits or excludes such an area from efforts to market residential loans or solicit customers for residential credit.[9]

First, examiners will look for **overt evidence** of redlining — specifically whether any written or oral policy of the bank suggests that the institution links the racial or national origin character of an area with any aspect of access to or terms of credit. This evidence might include specific reference to a prohibited group, but it does not necessarily have to. For example, a bank policy that says, "We do not lend in Chinatown" and a policy that says, "We do not lend north of 10th Street," if the majority of the population north of 10th Street is Asian American, could both constitute overt evidence redlining. Overt evidence of redlining is rare, but it is a good idea to ensure that your bank's policies do not contain any language that would treat a certain neighborhood differently based on the race of the residents of that neighborhood.

Because overt evidence is uncommon, most of the redlining exam will focus on **comparative evidence**. Examiners will look for comparative evidence of redlining using the six-step process outlined below:

1. **Identify minority areas.** Identify and delineate any areas within the institution's CRA assessment area and reasonably expected market area for residential products that have a racial or national origin character.
2. **Exclusion of minority areas.** Determine whether any minority area identified in Step 1 appears to be excluded, under-served, selectively excluded from marketing efforts, or otherwise less favorably treated in any way by the institution.
3. **Comparison to non-minority areas.** Identify and delineate any areas within the institution's CRA assessment area and reasonably expected market area for residential products that are non-minority in character and that the institution appears to treat more favorably.
4. **Adjacent minority areas.** Identify the location of any minority areas located just outside the institution's CRA assessment area and market area for residential products, such that the institution may be purposely avoiding such areas.
5. **Credible and reasonable.** Obtain the institution's explanation for the apparent difference in treatment between the areas and evaluate whether it is credible and reasonable.
6. **Supporting evidence.** Obtain and evaluate other information that may support or contradict interpreting identified disparities to be the result of intentional illegal discrimination.[10]

9 *Supra* note 3 at p. 30.
10 *Supra* note 3 at p. 38.

Majority-Minority Areas

The redlining analysis begins by asking examiners to identify any "areas within the institution's CRA assessment area and reasonably expected market area for residential products that have a racial or national origin character." In general, examiners will look to analyze racial and national origin concentrations in quartiles (such as 0 to <=25%, >25% to <= 50%, >50% to <= 75%, and >75%) or based on majority concentration (0 to <=50%, and >50%). Census tracts that have a minority population of greater than 50% are known as "majority-minority census tracts" and are a useful starting point for redlining analysis because they will often be considered areas that have a racial or national origin character.

Examiners may compare the percentage of a bank's home mortgage loans, collected pursuant to the Home Mortgage Disclosure Act (HMDA), in majority-minority census tracts to the percentage of home mortgage loans originated by other HMDA filers. If your bank originates a relatively small percentage of loans in majority-minority census tracts, it may be considered comparative evidence of redlining because it could indicate that you avoid lending in those tracts.

While examining your bank's lending in majority-minority tracts is a good place to begin the analysis, you should not stop there. Examiners are instructed to "bear in mind that it is illegal for the institution to consider a prohibited factor in any way" and that "[f]or example, an area or neighborhood may only have a minority population of 20%, but if the area's concentration appears related to lending practices, it would be appropriate to use that area's level of concentration in the analysis."[11]

That means that redlining may occur even outside of a majority-minority tract and even in a REMA that has no majority-minority census tracts. Banks should carefully examine the demographics of their communities and scrutinize their lending in areas that are majority-Black, majority-Hispanic, majority-Asian, or that have a concentration of any racial group that is less than a majority but still significant. **Any area that has a plausible "racial or national origin character" may give rise to a redlining claim if comparative analysis indicates that it is being treated differently by the bank.**

The FDIC recommends that "Banks can also benefit from conducting a visual analysis by plotting information on a map. This could include plotting both loan application and origination data."[12] A visual analysis may make it easier to spot any "donut holes," or areas with few loans and applications in the bank's REMA. If these areas of low activity have a racial or national origin character, a redlining violation may occur. If a bank finds that it has a relatively low number of loans and applications from such areas, it should consider if it has policies or practices that lead to this disparity and whether it can implement any changes to increase lending volume in those areas.

Marketing and Outreach

Banks should review their marketing materials to ensure areas with a racial or national origin character are not excluded. In particular, banks should ensure that any type of targeted marketing, whether digital or using physical mail, does not exclude

11 *Supra* note 3 at p. 40.
12 FDIC, "Identifying and Mitigating Potential Redlining Risks," available at: https://www.fdic.gov/resources/bankers/fair-lending/documents/fdic-redlining-fair-lending-resources-page.pdf.

majority-minority areas because this could lead to a redlining violation. Banks should also ensure that their advertising content is designed to attract a wide range of applicants and does not appear to exclude certain racial or national groups.

If a bank notices that it is not doing sufficient lending in majority-minority areas, it may be appropriate to affirmatively market to those areas to increase loan volume. However, banks should be careful that they do not disproportionately lend in such areas with less favorable terms or target customers in majority-minority areas with higher interest rate products, which would be considered "reverse redlining."

Banks looking to proactively increase lending in majority-minority areas may consider creating a Special Purpose Credit Program (SPCP).[13] An SPCP allows a bank to target an economically disadvantaged class of persons and to "extend credit to a class of persons who, under the organization's customary standards of creditworthiness, probably would not receive such credit or would receive it on less favorable terms than are ordinarily available to other applicants applying to the organization for a similar type and amount of credit."[14] Normally, treating a class of persons differently based on a prohibited characteristic would be prohibited as disparate treatment, but it may be permissible using an SPCP designed to mitigate the economic disadvantage of some groups. Whether an SPCP is appropriate depends on a bank's individual circumstances. Banks should seek legal advice to assess the risks and opportunities associated with creating such a program.

Conclusion

Banks have an ongoing duty to monitor their business practices to identify and mitigate fair lending risk, including the risk of redlining. Redlining does not require overt evidence that a bank is treating an area differently on the basis of a prohibited characteristic. It may be proven by comparative evidence that a bank receives fewer applications or makes fewer loans in areas that have a racial character.

Banks must understand their market, both the extent of the area they can reasonably serve and whether there are minority areas that they are lending in at a relatively low rate compared to their peers. If such areas are identified, banks should be proactive and create a strategy to increase lending in these areas before it leads to a redlining violation.

13 12 CFR 1002.8.
14 12 CFR 1002.8(a)(3)(ii).

Additional Resources

ICBA has made available several resources that can aid in fair lending compliance. These resources include ICBA's Online Individual Course on fair lending, which provides an overview of fair lending laws, the types of lending discrimination, and the policies and procedures your bank needs to ensure compliance with the laws.

ICBA also offers a model fair lending policy, which establishes bank policies for ensuring fair lending laws are followed when taking loan applications, conducting telephone inquiries, advertising, and creating credit evaluation standards.

Banks should also familiarize themselves with the interagency fair lending exam procedures, which contain detailed descriptions of the exam process and provide insight into how examiners identify potential fair lending violations.

Banks may also consider using companies like Azimuth, a participant in ICBA ThinkTECH Accelerator that provides dashboards that show banks neighborhoods that have high and comparatively low approval rates, which may be helpful in identifying and correcting disparities.

Finally, banks may also consider using other third-party software like ICBA Preferred Service Provider WoltersKluwer's Fair Lending Wiz, which can be used to conduct fair lending risk assessments and statistical regression analysis to spot potential disparate impact violations.

ICBA

About ICBA

As local and trusted sources of credit, America's community banks leverage their relationship-based business model and innovative offerings to channel deposits into the neighborhoods they serve, creating jobs, fostering economic prosperity, and fueling their customers' financial goals and dreams.

With nearly 50,000 locations nationwide, community banks employ nearly 700,000 Americans and are the only physical banking presence in one in three U.S. counties.

Holding $5.8 trillion in assets, $4.8 trillion in deposits, and $3.8 trillion in loans to consumers, small businesses and the agricultural community, community banks channel local deposits into the Main Streets and neighborhoods they serve, spurring job creation, fostering innovation and fueling their customers' dreams in communities throughout America.

For more information, visit ICBA's website at www.icba.org.

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