

**REGULATORY ALERT**

**NATIONAL CREDIT UNION ADMINISTRATION**

**1775 DUKE STREET, ALEXANDRIA, VA 22314**

DATE: June 5, 1997 NO.: 97-RA-9

TO: All Credit Unions

Compliance Officer or Chief Executive Officer

SUBJECT: MORTGAGE LOAN PREQUALIFICATIONS: Applications or Not?

A Guide for Complying with Regulations B and C

The enclosed guide, *Mortgage Loan Prequalifications: Applications or Not?*, was produced to provide guidance to financial institutions. The guide answers questions about mortgage loan prequalification programs and compliance with the Equal Credit Opportunity Act (ECOA - Regulation B) and the Home Mortgage Disclosure Act (HMDA - Regulation C). This guide was developed by staff at the FDIC and provides guidance to FDIC-regulated institutions as well.

The guide will assist credit unions to create mortgage loan prequalification programs and services that provide good member service and comply with important components of the fair lending laws and regulations, including ECOA, HMDA, and the Fair Housing Act (FHA). The guide should also help credit unions minimize technical and substantive violations of the fair lending laws.

NCUA's mission is to promote and enforce compliance with fair lending and other consumer protection laws and regulations. Our mission is accomplished, in part, through compliance reviews during the examination process. NCUA hopes to further its mission to promote compliance by assisting financial institutions through education and guidance, such as the distribution of this guide.

Sincerely,

/S/

Norman E. D'Amours

Chairman

Attachment

**MORTGAGE LOAN PREQUALIFICATIONS:**

**Applications or Not?**

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**A Guide for Complying with Regulations B and C**

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**FOREWORD**

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The NCUA is responsible for the examination of federally chartered credit unions for compliance with fair lending laws and regulations. In addition, NCUA is responsible for the enforcement of Regulation C, the Home Mortgage

Disclosure Act (HMDA), in all state chartered credit unions. Fair lending compliance, which has a bearing on lending institutions' efforts to assist customers in obtaining residential financing, is one of the more important consumer compliance issues under the purview of the NCUA.

Questions received from lenders, examiners, community organizations and the general public indicate that there is uncertainty about how fair lending laws and regulations affect financial institutions' efforts to assist customers in obtaining mortgage credit, particularly in the area of mortgage loan prequalifications. Part of the uncertainty stems from the fact that both the Equal Credit Opportunity Act (ECOA) and Home Mortgage Disclosure Act contain sections relevant to mortgage prequalifications. Although the written regulatory guidance relative to prequalifications is relatively clear, because this information is spread among these laws, their implementing regulations and staff commentaries, it is difficult to get a concise picture of how these laws pertain to the mortgage prequalification process.

This guide pulls together these various pieces of regulatory guidance to serve as a tool for lenders and other parties involved with administering such programs. The following discussion explains how ECOA and HMDA each play a part in the mortgage prequalification process by:

- providing an overview of various prequalification programs practiced by lending institutions
- clarifying the distinction between an application and an inquiry
- discussing mortgage adverse action notices
- explaining the requirement for written applications
- providing guidance on what information needs to be recorded on the Home Mortgage Disclosure Act Loan Application Register

In addition, this guide closes with a few words on how to use the prequalification process to ensure compliance with the anti-discrimination provisions of ECOA and the Fair Housing Act.

## **PREQUALIFICATION PROGRAMS - AN OVERVIEW**

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Many mortgage lenders offer formal or informal information to prospective mortgage loan applicants prior to the submission of a written loan application. Such activities may include:

- Formal prequalification or certification programs, in which lenders apply basic underwriting standards (such as housing and debt ratios) to the prospective applicant's situation. Frequently lenders provide certificates indicating the maximum loan for which borrowers would qualify, usually subject to a satisfactory property appraisal and further verification of income, employment and credit history. Some prequalification programs even provide a preliminary evaluation of credit history.
- Home buyers' forums and seminars, in which a variety of real estate experts (lenders, real estate brokers, lawyers, appraisers, etc.) provide information about the home buying process and what may be required at each step.
- Informal or undocumented conversations between prospective applicants and lender representatives, in which potential applicants may be encouraged, counseled or coached as to their qualifications and what information they might need to provide in order to strengthen their applications.

These and other similar activities allow consumers to shop more effectively for a property that they can afford. Such programs can also be a key element in the penetration of low and moderate income markets and the success of first time home buyer programs.

Lenders should note, however, that prequalification services must be provided equitably to all customers and that none

of the criteria used to prequalify or advise the potential applicant may, explicitly or in effect, include illegal discriminatory factors. The Equal Credit Opportunity Act (ECOA) and Fair Housing Act (FHA) identify a number of factors that are illegal to use in evaluating a prospective applicant's qualifications:

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Race	( ECOA & FHA )
Color	( ECOA & FHA )
Religion	( ECOA & FHA )
Sex	( ECOA & FHA )
National Origin	( ECOA & FHA )
Marital Status	( ECOA )
Age (provided the applicant has the legal capacity to contract)	( ECOA )
Source of income derived from public assistance	( ECOA )
Good faith exercise of rights under the Consumer Credit Protection Act	( ECOA )
Handicap	( FHA )
Familial Status (families with dependents under age 18)	( FHA )

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Lenders, under both ECOA and FHA, have the discretion to decline oral or written applications, as long as the decision is based on legitimate underwriting standards and not one of the prohibited bases listed above. Lenders can also counsel prospective customers on possible credit or underwriting problems, even if this information discourages a customer from filing a formal application. It is important to recognize, however, that prequalification programs can generate "applications" for purposes of Regulation B, the implementing regulation for ECOA, and thus trigger notification and record keeping requirements under ECOA and HMDA. Appendix A, "Framework for Reviewing Mortgage Prequalifications for Regulations B and C Compliance," provides a simple chart that can be used as a tool to assess whether a prequalification program is in compliance.

## WHAT IS AN "APPLICATION"?

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Understanding the distinction between an "inquiry" and an "application" is important for compliance with Regulation B because several requirements apply only to applications (not inquiries). Regulation B defines a loan application as:

... an oral or written request for an extension of credit that is made in accordance with the **procedures established** by a creditor for the type of credit requested.<sup>1</sup> (Emphasis added.)

The Federal Reserve's staff interpretations of Regulation B further clarify that the phrase "procedures established":

... refers to the actual practices followed by a creditor for making credit decisions as well as its stated application procedures. For example, if a creditor's stated policy is to require all applications to be in writing on the creditor's application form, but the creditor also makes credit decisions based on oral requests, the creditor's established procedures are to accept both oral and written applications.<sup>2</sup>

In other words, in some circumstances, informal inquiries, whether verbal or in writing, must be treated as an application pursuant to Regulation B.

The next section of the interpretations describes one critical circumstance where a lender may turn an oral inquiry into an application, even if the lender's policy is to accept only written applications:

A creditor is encouraged to provide consumers with information about loan terms. However, if in giving information to the consumer the creditor also **evaluates** information about the applicant, decides to **decline** the request, and **communicates** this to the applicant, the creditor has treated the inquiry as an application and must then comply with the [adverse action] notification requirements under Section 202.9. **Whether the inquiry becomes an application depends on how the creditor responds to the applicant, not on what the applicant says or asks.**<sup>3</sup> (Emphasis added.)

When a lender verbally disqualifies a potential borrower, even on a legitimate underwriting basis, the lender, according to Regulation B, is treating an inquiry as an application. While this is allowable under Regulation B, lenders are obligated to follow certain notification and record keeping requirements of Regulation B and Regulation C, the Federal Reserve's implementing regulation for the HMDA. These notification and record keeping requirements apply only to applications and not inquiries.

Therefore, if enough information has been collected to deny a loan, and a denial has been communicated to the applicant, this interaction between a lender and prospective borrower is an "application" for the purposes of Regulation B. This is true, regardless of the amount of information collected by the lender, lender application procedures, fees paid to the lender, whether the prospective applicant has identified a specific property or loan amount, or whether the communication is written or verbal.

In some instances, the distinction between an inquiry and a denied application can be unclear. In recognition of lenders' confusion about Regulation B and prequalification programs, the Federal Reserve's staff interpretations specifically state that:

Whether a creditor must provide a notice of action taken for a prequalification or preapproval request depends on the creditor's response to the request. For instance, a creditor may treat the request as an inquiry if the creditor provides general information such as loan terms and the maximum amount a consumer could borrow under various loan programs, explaining the process the consumer must follow to submit a mortgage application and the information the creditor will analyze in reaching a credit decision. On the other hand, a creditor has treated a request as an application, and is subject to the adverse action notice requirement of section 202.9 if, after evaluating information, the creditor decides that it will not approve the request and communicates that decision to the consumer. For example, if in reviewing a request for prequalification, a creditor tells the consumer that it would not approve an application for a mortgage because of a bankruptcy in the consumer's record, the creditor has denied an application for credit.<sup>4</sup>

The staff interpretations provide some examples of situations in which only an inquiry has taken place. It is an inquiry:

... when a consumer calls to ask about loan terms and an employee explains the creditor's basic loan terms, such as interest rates, loan-to-value ratio and debt-to-income ratio.<sup>5</sup>

Even if the lender collects information from a customer, an inquiry may still not be an application. The staff interpretations also clarify that it is not an application:

... when a consumer asks about terms for a loan to purchase a home and tells the loan officer her income and intended down-payment, but the loan officer only explains the creditor's loan-to-value policy and other basic lending policies, without telling the consumer whether she qualifies for the loan.<sup>6</sup>

Communication with a prospective applicant could still qualify as an inquiry if the lender and prospective applicant determine that the applicant's debt and housing ratios exceed the lender's standards, but the lender points out the compensating factors that could be taken into account that might allow a loan to be approved. In contrast, if the lender fails to point out the bank's discretion to consider positive compensating factors, leaving the prospective applicant with the impression that the lender would not approve the loan, then such communication would have turned an inquiry into a denied application.

In these examples, the determining factor in classifying a particular interaction with a prospective applicant as an inquiry or an application is the communication of a denial by the lender to the applicant. The denial does not have to

be explicit in nature and can be construed as any communication that would lead a reasonable person to conclude that an application would receive negative consideration.

In contrast to declined applications, as long as prospective applicants are being encouraged to proceed, lenders have reasonable discretion in defining what constitutes an application. The Regulation B staff interpretations indicate that "a creditor has the latitude under the regulation to establish its own application process and to decide the type and amount of information it will require from credit applicants."<sup>7</sup> For example, within the flexibility provided by Regulation B, some lenders might consider prequalification certificates to constitute an application, while others might require a borrower to have a contract to purchase a property and file a formal written application in order to generate an application.

## **WHEN IS AN ADVERSE ACTION NOTICE REQUIRED?**

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ECOA requires the creation of a paper trail for all inquiries, including prequalifications, that meet the Regulation B definition of an "application". Specifically, for all applications, whether written or verbal, Regulation B provides that:

... a creditor shall notify an applicant of action taken within:

1. 30 days after receiving a completed application concerning the creditor's approval of, counteroffer to, or adverse action on the application;
1. 30 days after taking adverse action on an incomplete application, unless notice is provided in accordance with paragraph (c) of section 202.9;
1. 30 days after taking adverse action on an existing account; or
1. 90 days after notifying the applicant of a counteroffer if the applicant does not expressly accept the credit offered.<sup>8</sup>

Such notices:

... shall be in writing and shall contain: a statement of the action taken; the name and address of the creditor; a statement of the provisions of section 701(a) of the act; the name and address of the federal agency that administers compliance with respect to the creditor; and either:

1. A statement of specific reasons for the action taken; or
1. A disclosure of the applicant's right to a statement of specific reasons within 30 days, if the statement is requested within 60 days of the creditors notification.<sup>9</sup>

These provisions affect mortgage prequalifications because, in situations where a prequalification meets the regulation B definition of an "application," a creditor will need to provide a written adverse action notice. This is true regardless of where the applicant is in the prequalification process or how much (or little) information has been collected by the lender.

## **MUST AN APPLICATION BE IN WRITING?**

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Regulation B requires that institutions maintain files documenting written applications for mortgages on dwellings occupied as a primary residence. Regulation B provides that:

... a creditor shall take written applications for the types of credit covered by section 202.13(a) but need not take written applications for other types of credit.<sup>10</sup>

Credit applications covered by Section 202.13(a) include those:

... primarily for the purchase or refinancing of a dwelling occupied or to be occupied by the applicant as a principal residence, where the extension of credit will be secured by the dwelling.<sup>11</sup>

This section also requires lenders to request information regarding:

1. race or national origin, using the categories American Indian or Alaskan Native; Asian or Pacific Islander; Black; White; Hispanic; or Other (Specify);
1. sex;
1. marital status, using the categories Married, Unmarried and Separated; and
1. age.<sup>12</sup>

Regulation B does not, however, require that the applicant complete a written application. Rather, the responsibility rests with the lender. Even if the applicant does not fill out a written application, the lender can complete an application on behalf of the applicant to comply with Regulation B. The Regulation B staff interpretations state that:

The requirement of written applications for certain types of dwelling-related loans is intended to assist the federal supervisory agencies in monitoring compliance with the ECOA and the Fair Housing Act. **The creditor may complete the application on behalf of an applicant and need not require the applicant to sign the application.**<sup>13</sup> (Emphasis added.)

Thus, lenders who have declined oral applications (e.g., prequalifications) must create an "application" to comply with Regulation B.

## **MUST A PREQUALIFICATION BE REPORTED FOR REGULATION C (HMDA) COMPLIANCE?**

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Most mortgage lenders with an office or branch in a Metropolitan Statistical Area and assets in excess of \$28,000,000, are subject to HMDA and Regulation C. Covered lenders are required to collect and maintain a list, the Loan Application Register (LAR), containing information about home purchase, refinance and home improvement loans. Covered lenders are expected to track, among other data, the disposition of each loan application, including denials.

Applications on the LAR are reported in one of several action categories, including originated, approved but not accepted, denied, withdrawn, and file closed for incompleteness. These action categories reflect a final action on an application. Because prequalifications are preliminary in nature, they may not exactly fit into any of these stated action categories. This classification problem can result in incorrect reporting of prequalification data and can distort HMDA data analysis.

In recognition of the problem, the Federal Reserve Board has determined that for 1994, 1995, 1996, and 1997 HMDA data collection, institutions may elect to not report prequalification requests on the LAR. The Federal Reserve staff commentary published on December 11, 1995, states that:

Board interpretations that appear in the official staff commentary to Regulation B (Equal Credit Opportunity, 12 CFR Part 202, Supplement 1) are generally applicable to the definition of an application under Regulation C. **However, under regulation C, the definition of an application does not include prequalification requests.**<sup>14</sup> (Emphasis added.)

It is essential to remember, however, that the exemption from HMDA reporting requirements does not extend to Regulation B requirements regarding adverse actions or written applications. The Regulation C staff commentary notes that:

... Regulation C does not require an institution to report prequalification requests on the HMDA-LAR, even though

these requests may constitute applications under Regulation B.15

Lenders, however, should be careful in using this prequalification exemption, especially in situations that constitute a denial under Regulation B. In many cases, a denial under a prequalification program is based on the credit history of the applicant and may be issued prior to the selection of a specific property or loan amount. Since information on property location and loan amount are necessary to complete the LAR, or analyze the resulting HMDA reports, it would be appropriate to treat this as an exemption. In contrast, denials where the lender knows the property location and loan amount can be included on the LAR.

Lenders should be alert that this exemption may be temporary. The staff commentary notes that "The Board may consider amending Regulation C at a later date to address whether (and how) institutions should report some or all prequalification (or preapproval) requests."<sup>16</sup> At the earliest, such provisions could take effect for the collection of 1998 HMDA data.

## **OTHER CONSIDERATIONS**

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The primary purpose of this guide is to help institutions understand and comply with the various intertwined notification and record keeping requirements of Regulations B and C. However, no guide dealing with these two regulations would be complete without a few suggestions on also complying with the anti-discrimination provisions of ECOA and the FHA.

Lenders offer a wide variety of programs and services to assist prospective applicants in selecting and qualifying for various mortgage loan options. ECOA, HMDA and FHA and their implementing regulations should all be considered in designing and managing prequalification programs and services. In particular, lenders should be aware that prequalifications are subject to ECOA and FHA prohibitions from making oral or written statements that would discourage an applicant from pursuing an application based on any of the prohibited bases.

As a precautionary measure and management tool, lenders may want to consider monitoring adverse action notices and application files to prevent, detect, monitor, and correct illegal discrimination. The time between the initial contact with the prospective borrower and the submission of a formal written application (the stage where prequalifications occur) is a stage where discrimination, intentional or not, is difficult to monitor, detect and prevent. Monitoring adverse action notices is one effective technique for encouraging and monitoring compliance with fair lending requirements during this period. Such monitoring programs are a sound business practice and can be part of a financial institution's audit and control systems.

Many institutions have developed second review programs in which applications that are likely to be denied are reviewed to ensure that all possible avenues for approval have been explored prior to formal denial. Prequalification "rejections" should be candidates for any internal audit program that takes a second look at rejected applications. Every institution should make sure that those verbal and prequalification denials are given the same consideration as more formal applications.

Finally, the monitoring of prequalification decisions can be a powerful training tool to remind originators and underwriters of the importance of carefully considering all alternatives and compensating factors before turning away a prospective applicant. This reminder can help to guard against inadvertent or intentional discrimination. It can also help make sure that no institution is unnecessarily turning away good business.

## **ENDNOTES**

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1. 12 C.F.R. § 202.5(f)

2. *Federal Reserve Board Regulation B Official Staff Interpretations*, 12 C.F.R. § 202.2(f), Supp. I, comment 2.

3. *Ibid.*, comment 3.

4. Ibid., comment 5.
5. Ibid., comment 4.
6. Ibid.
7. Ibid., comment 1
8. 12 C.F.R. § 202.9(a)(1).
9. 12 C.F.R. § 202.9(a)(2).
10. 12 C.F.R. § 202.5(e).
11. 12 C.F.R. § 202.13(a).
12. Ibid.
13. *Regulation B Official Staff Interpretations*, 12 C.F.R. § 202.5(e), Supp. I, comment 1.
14. *Federal Reserve Board Regulation C Official Staff Commentary*, 12 C.F.R. § 203.2(b), comment 1.
15. Ibid., comment 2.
16. Ibid., "Section-by-Section Analysis", 12 C.F.R. § 203.2(b).

## APPENDIX A

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### FRAMEWORK FOR REVIEWING MORTGAGE LOAN PREQUALIFICATIONS FOR COMPLIANCE WITH REGULATIONS B AND C

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STEP	DESCRIPTION	YES	NO
1	The lender conducts a mortgage prequalification program	Go to Step 2	Stop
2	Have prospective applicants been discouraged from applying, or actually denied, as defined by section 202.2(f) of Regulation B prior to the submission of a formal written application?	(1) Assess how the lender controls and monitors the process to ensure that no factors prohibited by the Fair Housing Act or ECOA are used to deny or discourage applicants.  (2) Assess whether written adverse action notices are provided for denials as required by section 202.9 of Regulation B.  (3) Go to step 3	Go to step 3
3	Does the prequalification program include mortgages on primary residences of the applicants subject to 202.13 documentation?	Lenders who have declined oral applications (e.g. prequalifications) must create a written "application" as required by section 202.5(e) of Regulation B.  (1) Assess whether written applications are being created as required.	Stop

(2) Assess whether the government monitoring information is collected as required by section 202.13 of Regulation B.

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