

# Fair Lending Risk Assessment PRIMER

## The Regulator's Perspective

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**Y**OU MAY BE ASKING YOURSELF WHY A FAIR LENDING RISK ASSESSMENT IS NEEDED, or even important as part of your bank's overall compliance risk management process. A fair lending risk assessment process provides a financial institution with a complete picture of its fair lending risk, how well it manages that risk, and the likelihood that it is complying with fair lending laws and regulations. Also, if your institution uses a risk-based approach to control and monitor compliance risk in general and fair lending risk specifically, then those risks must be identified and measured on an ongoing basis.

As regulators we understand that banking is about taking calculated risks. All financial institution managers—whether “by the seat of the pants,” in a highly sophisticated manner, or via any method in between—evaluate their financial, business, and operational risks on an ongoing basis. This process is risk-based, with resources expended appropriate to the level of risk.

Likewise, each financial institution has a different appetite for risk—a level of risk it is willing to assume. As a result, there is no “one size fits all” risk assessment process. Each financial institution must tailor its risk assessment process to meet its unique circumstances, consistent with safe and sound operating standards and ensuring compliance with applicable laws and regulations and its own ethical principles and practices.



### What Is Fair Lending Risk?

Fair lending risk is the likelihood that a financial institution's lending operations treat applicants and borrowers differently on a prohibited basis,<sup>1</sup> treat applicants in an unfair or deceptive manner, or subject applicants to predatory or abusive lending practices. It encompasses all of a financial institution's lending products—mortgage, consumer, credit card, and commercial—and all its credit-related lending activities from application to pay-off, including collection, delinquency, and foreclosure.

With this in mind, fair lending risk includes the following:

- noncompliance with the technical requirements of the Equal Credit Opportunity Act, Federal Reserve Board Regulation B, and the Fair Housing Act
- discrimination and discouragement in the lending process including the delinquency, default, and loss mitigation processes
- unfair and deceptive lending
- abusive or predatory lending

For a financial institution to have an effective fair lending risk assessment process, it must address each of these areas that are relevant to its operations and the likelihood that any of these fair lending issues may occur.

## What Is a Fair Lending Risk Assessment?

Simply stated, a fair lending risk assessment documents how a financial institution identifies, measures, controls, and monitors its lending activities to ensure that discriminatory, unfair, deceptive, abusive, and predatory acts and practices do not occur. If the institution already has a risk assessment process in place, then the fair lending risk assessment may just require verifying how well the process works and what changes may be needed to ensure continued compliance with fair lending laws and regulations, and its own policies and procedures.

Fair lending risk derives from two primary sources. The first is the inherent risk associated with the specific requirements found in relevant statutes and regulations. These include the following:

- Equal Credit Opportunity Act and the implementing regulation 12 CFR 202 (the Federal Reserve Board's Regulation B)
- Fair Housing Act
- Federal Trade Commission Act, 15 USC 45(a)(1), Section 5, which deals with unfair and deceptive acts and practices (UDAP)
- outline certain prohibited lending activities and refer to unfair and deceptive acts or practices
- relevant state fair lending and UDAP laws

The other sources of fair lending risk are policies, procedures, and practices to manage fair lending risk that do not ensure fair lending. Fair lending risk can also arise from noncompliance with policies, procedures, and practices designed to ensure fair lending. This may include financial institution procedures and practices that heighten regulatory concerns as outlined in agency advisory letters and bulletins covering unfair, deceptive, predatory, and abusive lending acts and practices.

A fair lending risk assessment should address the following four distinct components,<sup>2</sup> documenting how the institution does the following:

**A. IDENTIFIES AND MEASURES THE QUANTITY OF FAIR LENDING RISK.** Identifying risk is recognizing what risks exist or may exist with new products or business ventures. Measuring risk helps an institution determine the level of controls and monitoring needed to ensure compliance. The identification and measuring processes should be consistent with the sophistication and complexity of the institution's operations.

**B. CONTROLS AND MONITORS FAIR LENDING RISK THROUGH RISK MANAGEMENT PROCESSES.** This represents the quality of risk management the institution has in place to mitigate and manage the level of fair lending risk it is willing to assume. These systems include:

- internal controls systems
- management and staff training
- management information systems to communicate and monitor lending processes
- effective policies, procedures, and ethical standards

- internal and external audit
- appropriate and timely correction of system weaknesses, and isolated and pattern and practice exceptions and violations

**C. ASSESSES THE AGGREGATE FAIR LENDING RISK LEVEL.** The aggregate (residual) risk level is the summary of the assessment of how well the institution identifies, measures, controls, and monitors fair lending risk. Some financial institutions use the "heat map" technique or similar pictorial approach to assess overall fair lending risk.

**D. MEASURES THE AGGREGATE FAIR LENDING RISK.** For any risk assessment to be useful over time, it must be predictive. This aspect of the assessment process measures what changes may be occurring in the institution's fair lending risk profile based on current events, proposed changes, or new regulatory requirements that may impact fair lending risk in the future.

Additionally, while it may be a point-in-time assessment, fair lending risk should be monitored on a periodic basis, at a frequency that makes sense for the institution and its risk level.

## Identifying and Measuring the Quantity of Fair Lending Risk

Without identifying its fair lending risks, an institution cannot measure or manage them effectively. Risks may be evident from, among other things,

- board and management support
- policies, procedures, and lending standards and practices
- level of staff knowledge, expertise, and training
- organizational structure
- discrimination risk indicators associated with certain lending factors
- products and services offered
- distribution channels, including use of subsidiaries and third-party providers
- levels of assistance provided to applicants and borrowers
- Community Reinvestment Act assessment areas.

While this list is not all-inclusive, these factors account for most of the fair lending risk within an institution.

A board policy saying the institution will not discriminate is a good start, but it is not sufficient to ensure compliance with fair lending laws and regulations. The institution must decide the products and services it is willing to provide, create policies and procedures that address the risks associated with those products and services, and then monitor their application by lending and other associated staff to ensure that fair lending risk is adequately mitigated and managed. Checking a few boxes on a worksheet may not be enough.

The interagency Fair Lending Examination Procedures<sup>3</sup> provide in-depth guidance in describing various discrimination risk indicators an institution should consider when

identifying and measuring the quantity of fair lending risk. Briefly, these discrimination risk indicators are as follows:

- compliance program indicators
- residential lending indicators
  - overt discrimination
  - underwriting
  - steering
  - redlining
  - marketing
- consumer lending indicators
- commercial lending indicators

Additionally, to conduct a complete fair lending risk assessment, a financial institution must also consider risk indicators related to unfair, deceptive, predatory, or abusive lending practices. Refer to various agency advisories, supervisory letters, or other examination procedures for additional guidance on managing such risks.

#### *Compliance Program Risk Indicators*

The overall compliance culture within the institution is key. Some questions to ask include the following: Is it strong or weak? Are records and data, such as loan file documentation and the HMDA-LAR, accurate and reliable? Is government monitoring information complete and captured consistent with current legal requirements? If any of these or similar issues represent concerns, then fair lending risk is increased.

#### *Residential Lending Discrimination Risk Indicators*

While mortgage lending is not the only area where fair lending risk exists, it is the primary one where applicants' ethnic, racial, and sex data are gathered. As a result, fair lending risk in mortgage lending is easier to identify. On the other hand, unfair, deceptive, abusive, or predatory lending practices generally do not revolve around prohibited bases, but may impact all applicants and borrowers of any loan product.

To identify risks in mortgage lending, review lending policies, marketing materials and application forms used or to be used, agreements with third-party loan originators and servicers, and underwriting, pricing, and appraisal policies and guidelines. It is also important to understand the demographic make-up of your service areas and the distribution of applications received and originations made.

**OVERT INDICATORS:** It is hoped that any references in policies and procedures that clearly represent overt discrimination on a prohibited basis no longer exist. However, issues to look for include overt statements made by institution staff; explicit prohibited language used in application forms, marketing materials, or underwriting and pricing decisions; collecting and evaluating applicant information improperly; or improperly creating credit scoring models contrary to Regulation B requirements.

**UNDERWRITING INDICATORS:** Issues to look for include underwriting policies, procedures, and practices that may lead to disparate treatment of applicants on a prohibited basis. Indicators may include significant unexplained disparities in approval and denial rates or application processing times on a prohibited basis, and lack of clear underwriting policies that can lead to differences in granting policy exceptions, in file documentation, and in subjective interpretation of policies. Other issues to review are situations where lenders have broad discretion in

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TABLE 1	LOW	MODERATE	HIGH
	Lending policies allow little or no subjective factors (loan officer judgment, discretionary pricing, fees, etc.)	Lending policies allow some subjective factors	Lending policy allows a high level of subjective decision making
	Little or no disparity among approval/denial rates by prohibited-basis groups	Some disparities among approval/denial rates by prohibited-basis groups	Substantive disparities among approval/denial rates by prohibited-basis groups
	No conspicuous gaps in lending patterns	Explainable, conspicuous lending gaps exist	Unexplained, conspicuous lending gaps exist
	Centralized underwriting and makes own loans	Local brokers originate some loans	Decentralized underwriting and high volume of consumer loans originated by multiple statewide or nationwide brokers
	No fair lending complaints or complaints to DOJ or HUD regarding applicant discrimination or discouragement	Limited number of fair lending related complaints	Numerous fair lending related complaints

making policy exceptions or their compensation is based on the types of loans made, loan size, or volume.

**PRICING INDICATORS:** The most significant pricing-related factor that increases fair lending risk is the discretion lenders or third-party originators have in setting price. Other factors include lender compensation tied to loan pricing, risk-based pricing systems that are not risk-based, and price quotations that are inconsistent with prices actually charged.

Additionally, there are other terms and conditions that can have a discriminatory impact or raise predatory or abusive lending concerns. These may include loan terms, collateral or co-signer requirements, significant rate or pricing factors not related to risk or cost, deceptive or incomplete disclosure of key requirements, or making loans on collateral value rather than the applicant's ability to repay.

**STEERING INDICATORS:** Steering occurs when an applicant is directed to a less favorable or more costly loan product. This most often occurs when an institution offers similar products through more than one delivery channel, such as mortgage lending and consumer lending departments with similar products priced differently. Steering can also occur when the institution offers prime and nonprime products through different origination channels—retail lenders, subsidiaries, and third-party brokers.

Practices that increase fair lending risk include one-way referrals; significant differences in the proportion of ethnic, minority, or gender applicants between different channels; and loan officers having broad discretion in promoting or deciding loan products.

**REDLINING INDICATORS:** Redlining occurs when an institution's policies or practices create different levels of credit access or provide different credit terms on a prohibited basis based in part on where an applicant resides within the service area. For example, redlining may exist when lending patterns have unexplainable conspicuous gaps in low- and moderate-income or predominately minority neighborhoods within an institution's service area. Indicators may

include significant differences in the proportion of loans originated, applications received, approval and denial rates, or any other lending pattern between ethnic and minority neighborhoods and nonminority neighborhoods. Consumer or community group complaints may also indicate that redlining exists.

**MARKETING INDICATORS:** Marketing and advertising can increase fair lending risk when

- targeting only specific segments of an institution's assessment area
- excluding minority or low- and moderate- income areas
- using pre-screened lists that exclude potential applicants or geographic areas on a prohibited basis
- noting that the number of minority loan applications received is significantly below their representation in the total service area population

**CONSUMER LOAN INDICATORS:** The fair lending risks associated with consumer lending are basically the same as those identified for mortgage lending. However, because government monitoring information is not collected for general consumer lending, determining whether disparities exist and the level of risk that exists is more challenging. The institution needs to decide how best to identify and measure this risk based on its unique circumstances and product mix.

**COMMERCIAL LENDING INDICATORS:** If your institution does a large volume of small-business lending, your review of fair lending risk should focus on the relevant indicators mentioned above for underwriting, pricing, redlining, and marketing.

After you have identified all the relevant fair lending risks associated with your institution's lending programs, you must decide whether they represent low, medium, or high risks or some similar designation. In making this determination, you should also consider the likelihood that any of these risks may occur. Part of this decision will focus on the actual inherent risk in the indicators your institution

TABLE 2

STRONG	MODERATE	WEAK
Decision making is centralized, with ongoing monitoring. Underwriting standards and override procedures are clear and followed.	Staff generally adheres to underwriting standards and override procedures.	Decision making is decentralized, without monitoring of discretionary pricing, use of overrides, or policy exceptions.
Fair lending considerations are incorporated into all areas of the bank, i.e., rollout of new products, advertising, changes in forms, disclosures, etc.	Fair lending considerations are sometimes overlooked and aren't incorporated into all bank areas. Management effects corrective action when necessary.	Fair lending considerations are not incorporated in numerous bank areas. Management does not effect corrective action.
Policies and procedures are adequate to ensure compliance.	Policies and procedures are generally adequate but certain weaknesses exist.	Policies and procedures do not provide sufficient guidance or ensure compliance.
When deficiencies are identified, management promptly implements meaningful corrective action.	Management is responsive when deficiencies are identified in the normal course of business or second review.	Errors and deficiencies are not self-identified. Management may respond only when violations are cited.
Appropriate fair lending compliance controls and systems (e.g., quality control functions, compliance audits, and self-assessments) identify compliance problems and assess performance.	No significant shortcomings are evident in fair lending compliance controls or systems (e.g., quality control functions, compliance reviews, compliance audits, and self-assessments). The probability of serious future violation or noncompliance is within acceptable risk tolerances.	Significant shortcomings are evident in fair lending compliance controls or systems (e.g., quality control functions, compliance reviews, compliance audits, and self-assessments). The probability of serious future violation or noncompliance is NOT within acceptable risk tolerances.

faces, and the management processes you have established to mitigate and manage those risk indicators.

Table 1 is illustrative of how you might measure the quantity of each fair lending risk indicator present in your institution.<sup>4</sup>

### Controlling and Monitoring Fair Lending Risk Through Risk Management Processes

Now that you have identified and measured the inherent fair lending risk, you must then assess how well your institution's risk management system controls and monitors that risk. To be effective, any risk management process must start with the board of directors and flow through senior management to the staff level. However, the purpose of risk management is not to eliminate all risk, but to manage it appropriately, consistent with an institution's established risk tolerance and safe and sound operations.

As with any risk area within your institution, managing the fair lending risk covers four key areas:<sup>5</sup>

- **POLICIES** established by the board and senior management. These should reflect the board and senior management's commitment to ensuring fair lending compliance. Policies can be formal or informal but must be communicated to bank staff and monitored to ensure they are followed.

- **PROCESSES** include the programs, procedures, standards, and practices that management and staff follow to ensure compliance with fair lending laws and regulations, and the institution's own policies and standards. While there is some overlap with control systems, processes are generally designed to prevent errors and violations.

- **PERSONNEL** administer or participate in the various lending activities and programs offered by the institution. These staff should be qualified to handle their assigned tasks, be trained in the various fair lending laws

and regulations, and understand the institution's fair lending policies and objectives.

- **CONTROL SYSTEMS** provide institution management with the tools and information systems to control and monitor fair lending compliance and to resolve identified weaknesses. These systems should include detective controls, appropriate management information systems, quality or compliance reviews, audit, and various other activities such as self-testing or self-evaluation of specific product lines, regression analysis and statistical modeling, or comparative file reviews.

These aspects of an institution's risk management process are what control and monitor fair lending compliance. They will be applied differently in each institution depending on size, organizational structure, complexity of product offerings, and the number and types of product delivery channels.

Rather than trying to identify various controls and monitoring processes that an institution may have in place, we are again providing a chart of how you might designate the quality of your fair lending risk management process<sup>6</sup> (See Table 2).

### To Wrap It Up

After you have documented the manner in which your institution identifies, measures, controls, and monitors fair lending risk, you can determine the aggregate or residual risk. You should also be able to decide whether that risk is stable, increasing, or decreasing. At this point, you have the information in hand to document an adequate fair lending compliance process, or to indicate that changes are needed to bring your institution's process to an adequate level.

Additionally important, over the years we have seen financial institutions' fair lending practices referred to the Departments of Justice and Housing and Urban Development. We have also seen these departments

initiate their own investigations into discriminatory and other unfair lending practices. In these cases, discriminatory or deceptive practices have been made public, large financial settlements and civil money penalties have been paid, reputations have been damaged, and financial institutions have been required to implement sound fair lending compliance risk processes to prevent such practices from happening again.

Lastly, while we regulators expect you to have risk assessment processes for fair lending, the process is yours, not ours. What you do should meet your needs, be documented and defensible, and satisfy your responsibility to comply with lending laws and regulations. BC

#### ABOUT THE AUTHORS

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#### Endnotes

<sup>1</sup>The prohibited bases under ECOA are race, color, religion, national origin, sex, marital status, age, receipt of public assistance income, or the exercise of any right under the Consumer Credit Protection Act. The prohibited bases under the FHA are race, color, religion, sex, handicap, familial status, or national origin.

<sup>2</sup>See the Supervision by Risk section, pages 24-27, of the Bank Supervision Process, Comptroller's Handbook, September 2007, available at [www.occ.treas.gov/handbook/ss.htm](http://www.occ.treas.gov/handbook/ss.htm).

<sup>3</sup>See Part I, pages 14-32, of the Fair Lending Examination Procedures, Comptroller Handbook, April 2006, available at [www.occ.treas.gov/handbook/compliance.htm](http://www.occ.treas.gov/handbook/compliance.htm), accessed October 20, 2006. This information is also available in each of the other Federal financial institution agencies' fair lending examination procedures.

<sup>4</sup>See page 172 of Community Bank Supervision—Appendixes, Comptroller's Handbook, March 2005, available at [www.occ.treas.gov/handbook/ss.htm](http://www.occ.treas.gov/handbook/ss.htm).

<sup>5</sup>See the Supervision by Risk section, pages 24-27, of the Bank Supervision Process, Comptroller's Handbook, September 2007, available at [www.occ.treas.gov/handbook/ss.htm](http://www.occ.treas.gov/handbook/ss.htm).

<sup>6</sup>See page 173 of Community Bank Supervision—Appendixes, Comptroller's Handbook, March 2005, available at [www.occ.treas.gov/handbook/ss.htm](http://www.occ.treas.gov/handbook/ss.htm).