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Assessing Your Institution's Fair Lending Risk

How to
identify
your
hot spots
before
you get
burned

NO MATTER WHICH compliance conference you attend, or how often, there's almost an iron-clad guarantee that you'll hear this message: "Fair lending continues to be one of the top areas of focus cited by bank regulators." While overt discrimination is (mostly) a thing of the past, indicators of disparate treatment of similarly situated applicants or disparate impacts of seemingly fair, objective credit policies can sneak up on even the most seasoned compliance manager.

It is a sign of the times that two of the most recent Department of Justice settlements for fair lending dealt not with their traditional focus on direct lenders, but with possible discriminatory actions performed by third parties on behalf of banks (see *United States v. AIG Federal Savings Bank and Wilmington Finance, Inc.*, and *United States v. Nara Bank*). Add to this the current public sentiment about industry lending practices, as well as public avowals by the U.S. Attorney General to actively and aggressively enforce fair lending in all aspects of the lending process, and the risk continues to rise. With so much focus on lending practices, the last thing you want is to be the "last one to know" when your institution has a potential fair lending problem.

For large banks, a fair lending risk assessment is not just an important and integral part of the overall compliance management program, it's also required by regulators. For small banks, while regulators have historically focused more on risk-based compliance reporting to senior management and boards of directors, a detailed fair lending risk assessment is a useful tool to fully identify and report top risks and to allocate scarce analytical resources to the areas of highest concern. To help your company identify its fair lending hot spots, we've assembled key tips on how to conduct a thorough fair lending risk assessment, regardless of the institution's size or practices.

How the company makes underwriting decisions is a key factor in determining fair lending risk. Manual underwriting introduces additional variables and unknowns that could cause problems.

Tools

The fair lending examination procedures used by the company's primary regulator are the foundation for a solid fair lending risk assessment process. Here are some places to start:

- **Interagency Fair Lending Examination Procedures** (www.ffiec.gov/PDF/FairLend.pdf), updated as of August 2009. Also check out the related appendix (www.ffiec.gov/pdf/fairappx.pdf), which includes a checklist for analyzing compliance management with regard to fair lending.
- **OCC Fair Lending Examination Procedures** (www.occ.treas.gov/handbook/fairlep.pdf), updated as of January 2010. The appendices contain a compliance management analysis checklist and an underwriter interview guide that you can refer to in developing a fair lending risk assessment approach.

Also remember that there is additional regulatory guidance on fair lending that is worth considering as you build your risk assessment process.

Questionnaires. Consider developing a questionnaire to support a consistent risk assessment process. This tool should contain a list of questions that will help you gain a baseline understanding of the business area, such as marketing, underwriting, or collections, that is scheduled for review. It is extremely important to survey and fully understand the full mix of products being offered by your business, including small volume or "specialty" product streams. Send out the questionnaire early to selected individuals in the relevant business areas to gather information on how the process works, allowing subsequent in-person interviews to focus on drilling down into areas of potentially higher risk. Above all, make sure your questionnaire is business-focused and easy to use. If the relevant business areas have associates spread across different geographic locations, consider interviewing a group consisting of representatives from each location to identify possible differences in how policies are interpreted or applied.

Scope and Schedule

A company's fair lending risk assessment approach will depend on a number of factors, including the size of the institution, the product mix offered through various business units, and the demographics of the geographic areas served. It may be appropriate to periodically perform one institution-wide fair lending risk assessment, or the company might need to perform risk assessments by product line or operational area to ensure that "hot spots" are identified properly.

A compliance manager will also need to consider the frequency of risk assessments needed and what might trigger the need to change the structure or frequency. Some product lines or operational areas with higher inherent fair lending risk factors (i.e., mortgage lending, areas with manual underwriting or unproven automated underwriting, or activities outsourced to third parties) hold the potential for more extensive or complex issues and should therefore be assessed regularly. Frequent risk assessments may also be appropriate for products or activities that carry greater regulator or public scrutiny, or where the controls and monitoring are not well

developed. A more flexible risk assessment schedule could be justified for products or activities with a lower inherent risk, or for those that have a strong control structure with effective monitoring. If the company adds a new product line or service or makes a significant change to existing products, services, or processes, this should trigger an assessment of fair lending risk to identify controls that need to be put in place. For large institutions, changes in models or scoring methodologies may also trigger a revised risk assessment.

Another consideration in developing a fair lending risk assessment approach is determining the scope of the review. Take a look at the lending products the institution offers, and don't stop with consumer lending. The Equal Credit Opportunity Act's discrimination provisions apply to consumer, small business, and commercial lending alike, and apply to all points in the customer relationship, from discussing an application through collection efforts or termination of an account. Likewise, the Fair Housing Act applies to any lending activity on residential real estate, regardless of whether the borrower is an individual, a small business, or a commercial entity. Mortgage lending may well be the highest-risk area, but other third-party relationships (e.g., auto dealerships that refer credit applications or closed deals to your institution) can also be a concern. Any area of lending where third parties are involved should receive additional scrutiny. What you don't know about what a third party is doing can hurt your institution, as shown by the recent DOJ settlements.

How the company makes underwriting decisions is a key factor in determining fair lending risk. Manual underwriting introduces additional variables and unknowns that could cause problems. The types of information available to underwriters while making their lending decisions can increase your fair lending risk. Automated underwriting is generally less risky, but only when the parameters of the system are prohibited basis-neutral. If there are undetected biases in an automated system, the impact could be a more far-reaching risk than the manual decisioning process. While an automated decisioning program considers only a defined set of data points and always in exactly the same way, it doesn't ensure that the decisions won't have disparate impacts.

Identifying Fair Lending "Hot Spots"

When performing fair lending risk assessments, the objective should be to ask comprehensive questions whose answers will reveal items for further analysis. This should include the following areas/aspects of the lending process:

- **Marketing:** How does the bank's marketing message get people interested enough to apply for a product? Does the company's marketing take advantage of media beyond the local newspaper or radio station? Do the images used in ads reflect the demographics of the community and encourage all potential applicants to apply? If the marketing does not cover the entire community that your company serves, or if some of the marketing is by referral or through personal connections in the community (this tends to happen more with small business or commercial lending), investigate to

make sure that there is neither preferential treatment nor discouragement on any of the prohibited bases. Look out for any practices that seem to target certain applicants or geographic areas with different products or services based on prohibited characteristics, as this may constitute potential redlining.

- **Underwriting and decline decisions:** If underwriting is done manually, or if an automated decision can be reviewed and overturned by a lender, assess the guidance in place for making these decisions and the amount of flexibility the underwriters have in making the loan decision. How much documentation is kept to support such decisions? Is this data collected and reviewed at the program level? Is there a decline review process, and are such reviews performed by someone other than a first-level underwriter? Under what circumstances can someone override the underwriter's decision, who has the authority to do so, and how is justification for that decision documented? Are overrides tracked?
- **Pricing:** How are the prices (including fees) for lending products established? Is there any flexibility in pricing, and if so, how much, and what criteria determine when a higher or lower price can be set for a given product? Are there "floor" and "ceiling" rates that cannot be exceeded? Is there monitoring for adherence to pricing rules? Pricing can be just as sensitive an area as the underwriting decision itself. Make sure there is adequate record retention of pricing data to provide an audit trail to assess lending data at a point in the future.
- **Credit policies:** Take a look at the company's credit policies. Do

they avoid considering any of the prohibited bases, or anything that could be construed as a proxy for a prohibited basis? Who sets credit policies, and what sort of review do those policies go through (i.e., compliance or legal review) before being implemented? Can exceptions be made to an established credit policy, and if so, who has the authority to make that decision, and how is it documented? Could the policy, when followed consistently, produce disparate impacts? Are policy exceptions collected, tracked, and analyzed for potential patterns or problems?

- **Customer service:** If there is any judgment involved in customer service activities such as waiving late payment fees, there should be clearly documented criteria to determine when and under what circumstances fees can be waived.
- **Collections/recoveries:** When reviewing collections and recoveries processes, consider who handles these processes. Does your institution manage these internally, or are they outsourced to a third party? Are there fair and objective guidelines in place for determining how and when to offer a settlement, and for how much? What about for hardship programs? Who sets these guidelines, and how are they reviewed for compliance? Remember to look at any processes for management review and override of the first-level decision, as well as general monitoring for policy adherence.
- **Loss mitigation and foreclosures:** As with collections and recoveries, consider who handles these activities, what policies or guidelines are in place for deciding when and whether to offer a workout package (loan modification, debt forgiveness, short

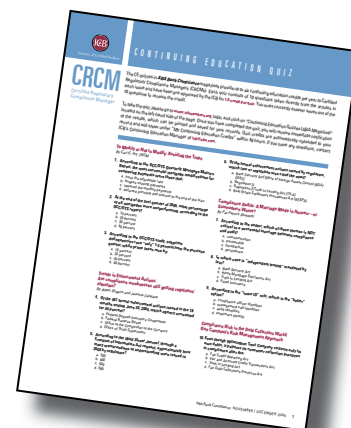


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Don't forget your company's regulator, who can be an invaluable resource in providing input to design a fair lending program that meets the institution's needs.

sale, deed in lieu of foreclosure, etc.) or proceed with foreclosure, who is responsible for making these decisions, and whether effective monitoring is in place to measure policy adherence.

- **Incentive programs:** If the institution offers incentives to associates or third parties for acquiring new clients, taking applications, underwriting loans, servicing loans, or collecting on delinquent accounts, look closely at how the incentive programs are structured. Are there incentives for offering one product over another, which could increase the risk of illegal steering? Are incentives based solely on volume, or do they take into consideration adherence to policies and procedures, including compliance with regulatory requirements?
- **Policies and procedures:** Are there formalized policies and procedures in place that address fair lending requirements? Who is accountable for these policies and procedures? How often are they reviewed and renewed, and who approves them for adequate coverage of fair lending requirements prior to implementation?
- **Portfolio monitoring:** Does the institution perform portfolio monitoring on current accounts on any kind of regular basis? Are there decisions made about whether to suspend or reduce home equity lines of credit, small business loans, or commercial loans, even if they are not past due? If so, how are these decisions made, and are the criteria reviewed by the compliance department before they are implemented?
- **Training:** Who receives fair lending training, and how is it structured? Is it general awareness training (i.e., computer-based training modules), or in-depth classroom training, or a combination of both? How often is training offered—upon hire, annually, or on some other schedule? Is training participation mandatory or optional? Is training completion tracked, and mandatory training requirements enforced? Is there any testing to assess the level of participants' understanding of fair lending when training has been completed? When issues are identified, are the impacted staff groups provided with targeted training in order to prevent recurrence?
- **Quality assurance/monitoring:** How does the company monitor marketing, customer service, underwriting, and collections activities for compliance with applicable regulatory requirements? Who performs this review, and how is it done (e.g., call monitoring, mystery shopping, or management review of loan documentation)? How often is monitoring performed, who sees the results, and what actions are taken to remediate any issues? How does the company handle possible fair lending violations identified in the course of such monitoring?
- **Complaints:** Does the company monitor customer complaints for any allegations that could relate to fair lending? If so, how are such complaints investigated, and how are any identified issues resolved?

After the Assessment

As with any other risk assessment process, the fair lending risk assessment should be designed to identify any weaknesses that point to possible problem areas. To prioritize these weaknesses, you may rank risks on a simple scale of "low," "moderate," or "high," or you might use a more sophisticated model that quantifies

the risk based on likelihood and impact. When the assessment is complete, how you address the risks you identified is critical. To make the most of the risk assessment, be sure to follow it up:

- Determine what changes need to be made to address the identified weaknesses in your fair lending program. Corrective action proposals may include more written guidelines for business processes, new or updated training, or ongoing monitoring that will allow you to detect potential noncompliance more quickly.
- Meet with business area management to discuss the findings, explain where their highest risks are, put their fair lending risk in context with the rest of the institution, and obtain agreement on follow-up activities. This should include identifying the people who will be responsible for doing the work and assigning deadlines for each corrective action item.
- Actively monitor the progress of the remediation activities. The real purpose of the risk assessment is to make sure that the institution is appropriately managing the identified risks, and that job isn't done until all identified corrective action is complete.

In addition to the above, consult the company's legal counsel for advice on performing ongoing data monitoring for fair lending compliance, and whether you should reference data monitoring results (which will likely be attorney-client privileged) in your fair lending risk assessment. It is also critical that legal counsel be involved in determining how best to address any fair lending concerns that arise during risk assessments or monitoring. Work with the company's auditors (whether internal or external) to schedule fair lending reviews on an appropriate frequency, and to make sure those reviews provide sufficient coverage to help assess the effectiveness of the overall fair lending program. Also, don't forget your company's regulator, who can be an invaluable resource in providing input to design a fair lending program that meets the institution's needs.

Finally, remember that your company is not alone. Every institution, regardless of size, faces the same challenges in assessing fair lending risk. Compliance managers should take advantage of opportunities to discuss different approaches with fellow compliance professionals. Developing and instituting fair lending risk assessment best practices will help your institution identify its fair lending hot spots—before it gets burned. ■

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