Secondary Marketing Strategies for Fair Lending and Compliance

Identifying & Controlling the Risk

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Agenda

- Recent fair lending enforcement focus
- Some things that increase fair lending risk in pricing
- What you can do to control fair lending risk
Recent U.S. Government Fair Lending Settlements

- Cases alleging disparate impact in the pricing of consumer loans resulting from the exercise of pricing discretion (see handout for details)

<table>
<thead>
<tr>
<th>Case</th>
<th>Settlement Amount</th>
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<tbody>
<tr>
<td>U.S. v. Countrywide Financial Corporation (2012)</td>
<td>$335 million</td>
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<tr>
<td>U.S. v. PrimeLending (2011)</td>
<td>$2 million</td>
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<tr>
<td>FTC v. Gateway Funding (2009)</td>
<td>$2 million (deferred)</td>
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<td>FTC v. Golden Empire Mortgage (2010)</td>
<td>$1.5 million</td>
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<td>U.S. v. Texas Champion Bank (2013)</td>
<td>$700,000</td>
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<td>U.S. v. C&amp;F Mortgage Corp. (2011)</td>
<td>$140,000</td>
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<td>U.S. v. Nixon State Bank (2011)</td>
<td>$100,000</td>
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- Most relate to conduct prior to the 2011 loan originator compensation rules, but similar issues persist under the new regime
Common threads in settlements

• Broad discretion allegedly resulted in “disparate impact”

• “Subjective and unguided pricing adjustments … not based on a borrower’s objective credit characteristics”

• Lack of clear policies and/or controls governing exercise of discretion

• Little or no documentation of business rationale for discretionary pricing adjustments

• Financial incentives for loan originators to charge higher rates or fees, or to steer borrowers to higher-cost products

• Lack of effective fair lending monitoring or corrective action

• Liability extending to multiple years in the past

• Liability for actions of third-party originators
CFPB: The “new cop on the beat”

- Key focus is “risk to consumers” -- “the potential for consumers to suffer economic loss or other legally-cognizable injury as a result of a violation of Federal consumer financial law.”

- “The CFPB will focus on risk to consumers when it evaluates the policies and practices of a financial institution. We expect that institutions will offer consumer financial products and services in accordance with Federal consumer financial law and will maintain **effective systems that focus on an institution’s ability to detect, prevent, and correct practices that present a significant risk of violating the law and causing consumer harm.”** -- CFPB Supervision Manual

- In exam reports and enforcement orders, CFPB has ordered lenders to implement a “Compliance Management System”
Some things that increase fair lending risk in pricing

• Unclear policies/procedures and inconsistent execution
• Concessions that are granted less often to one protected class group than another (whatever the reason)
• Branches with different pricing levels that sell into the same market
• Higher pricing levels or fees in markets with high minority concentrations
• Overlays to investor pricing not supported by a demonstrable business justification/need
• Pricing criteria/LLPAs that are not customary
• Lack of monitoring
• Failure to take action based on monitoring
Controlling fair lending risk in pricing: preventive measures

• Consistency, discipline and documentation are key

• Clear fair lending policy statement

• Clear operational policies and procedures designed to avoid discrimination, regularly reviewed, and reinforced by regular training

• Manage pricing discretion as you would exceptions
  • Defined limits on discretion
  • Tiered authority for approving discretionary adjustments
  • Document business reasons for discretionary adjustments (e.g., concessions, waivers, lock renegotiations … anything subject to negotiation) – preferably as data
  • Involve Compliance in the process

• Document rate reductions provided in exchange for discount points
Controlling fair lending risk in pricing: *preventive measures*

- System controls to enforce policies and procedures, and limit errors
- Pre-funding review or system controls to prevent funding of loans that do not comply with policy
- Consider refunds if non-compliant loans fund inadvertently
- Maintain documentation and/or data supporting the pricing for each loan and options offered to the consumer
  - Rate sheet in loan file, or
  - Data in LOS or pricing engine
- Develop and document analytical support showing the business justifications for pricing strategy decisions
Controlling fair lending risk in pricing: preventive measures

- Involve compliance/legal specialists in significant decisions about pricing strategy
- Capture data needed to monitor and justify pricing
  - Credit and program attributes that affect the rate/price
  - Relevant measure(s) of discretionary pricing
  - Historical pricing available on alternative products
- Accountability mechanisms
  - Monitor and enforce adherence to the rules (which means you must have the data to support the monitoring)
  - Scorecard linked to fair lending metrics, possibly tied to compensation
  - Defined path for corrective/disciplinary action
- Document your controls, monitoring and overall compliance program
- Reporting to board/executive management
Controlling fair lending risk in pricing: 

**detective measures**

- Establish a statistical fair lending monitoring program
  - Monitor pricing outcomes regularly in relation to race, ethnicity & gender
    - Regression analysis and outlier review
    - Examine rate/APR and overage/underage
    - Frequency and size of concessions/exceptions
    - Broker compensation (including cross-broker differences, and lender- vs. borrower-paid), aggregate and by broker
    - Differences in profit margins across products
    - Aggregate plus by market, channel, region/division, branch and originator
  - Corrective action
    - Restrict discretion for branches/LOs that are generating disparities
    - Adjust policies and procedures as necessary
    - Consider possible refunds in the event of “unjustified” disparities
Controlling fair lending risk in pricing: 
detective measures

• Audit to ensure that policies and procedures are being followed
• Pay attention to consumer complaints
• Evaluate whether pricing factors raise potential disparate impact concerns
• Evaluate whether pricing levels can be adjusted to reduce the need for concessions
• Evaluate whether fees are justifiable (UDAAP risk)
  • Note: UDAAP enforcement is being used as an alternative route for fair lending enforcement
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