

Containing Fair Lending Risk

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Mortgage lenders are facing intense scrutiny of their regulatory compliance efforts—and fair lending is at the forefront. At the same time, compliance costs are mounting more broadly and lender margins are being squeezed by market conditions. ¶ In this environment, developing cost-effective techniques to manage fair lending risk and increase operational efficiencies can mean the difference between continued life and death for a mortgage company. ¶ The Consumer Financial Protection Bureau (CFPB) has made it clear it will investigate evidence of pricing disparities to determine whether higher pricing was charged to consumers on a prohibited basis. ¶ No lenders we have known have expressed the intent to discriminate, but only the intent to make a profit. Nevertheless, good intentions are not the end of

What if you could catch a potential fair lending pricing problem before it becomes a compliance nightmare? Well, with the right technology, you can—in real time.

the story in fair lending: The CFPB, Department of Justice (DOJ) and other enforcement agencies are also concerned with disparities in results—even if they are the unintentional result of neutral profit-seeking.

With this level of scrutiny, lenders cannot afford to wait until well after loans close to find out if they have disparities. An efficient real-time control and monitoring process is needed to reduce risk.

> **Pricing discretion is not inherently bad or illegal, but it does elevate a lender's fair lending compliance risk exposure.**

Strong fair lending preventive controls, effective monitoring and comprehensive data capture are required to ensure that any pricing differences among similarly qualified borrowers can be convincingly explained based on legitimate business justifications.

To understand how modern pricing engine and loan origination system (LOS) technology can help lenders accomplish these objectives efficiently, lenders need to understand some basic fundamentals. These include the main sources of fair lending pricing risk, the data required to effectively explain pricing differences among borrowers, the aspects of the pricing process that can be automated to reduce risk, and how pricing-engine technology can support real-time monitoring.

The causes of fair lending pricing risk

As long as mortgage lenders allow some degree of discretion, negotiation or flexibility in their loan pricing, statistical disparities on a prohibited basis may occur, which can be difficult to justify.

Pricing discretion can result in fair lending risk even if loan originators are not compensated based on terms and conditions of a loan, and even if there is no intent to discriminate, regardless of who in the organization has the authority to grant discretionary pricing adjustments.

Even absent pricing discretion, the superficial appearance of statistical pricing disparities based on limited data can increase the risk of regulatory scrutiny, with all the costs that may entail. Incomplete data and documentation on pricing decisions can make it difficult or impossible for a lender to fully explain pricing differences among borrowers.

In most of the recent pricing-related fair lending settlements reached by the DOJ, the government has alleged that lender policies or practices of allowing discretionary pricing adjustments had a discriminatory "disparate impact," which resulted in minority borrowers being charged more for a mortgage loan than similarly qualified non-Hispanic white borrowers.

Under the disparate impact theory of discrimination, a lender's facially neutral policies or practices could be found to have a "discriminatory effect" if statistical analysis shows they have a disproportionate adverse impact on a prohibited basis, unless the policies or practices can be shown to have a legitimate business justification.

Many mortgage lenders find it necessary to permit some degree of discretionary pricing concessions for such purposes as meeting a competitor's rate quote, providing closing cost assistance to borrowers, rewarding customer loyalty, renegotiating a rate after rate lock, dealing with lock extensions, addressing customer service issues or operational errors, or filling mandatory loan commitments to investors.

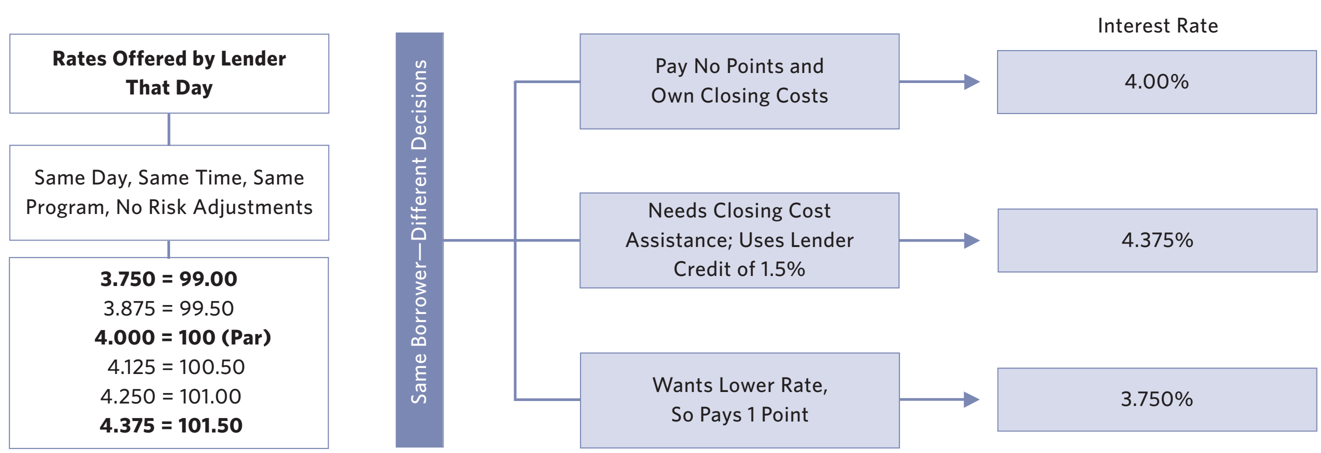
In addition, pricing premiums (overages) can occur as a result of granting the borrower the lowest available rate that does not require the borrower to pay discount points. In such situations, there may be room for discretion in using the premium revenue to grant credits to cover the borrower's closing costs.

Pricing discretion is not inherently bad or illegal, but it does elevate a lender's fair lending compliance risk exposure. If the exercise of discretion has the effect of favoring one protected demographic group over another, whether that result was intentional or not, enforcement agencies might view it as illegal discrimination.

Even putting aside the effects of discretion, statistical pricing disparities can arise if a lender's branches or originators have different pricing levels or fees and sell into the same markets. Similarly, disparities can arise if branches or originators

FIGURE 1

VARIOUS INTEREST RATES ARE POSSIBLE FOR ANY GIVEN BORROWER



SOURCE: Tammy Butler, Master CMB

serving markets with high minority concentrations tend to have higher pricing levels or fees than branches or originators serving markets with low minority concentrations.

In addition, the role of borrower choices should be acknowledged in creating the appearance of pricing disparities. Figure 1 provides a simple illustration. Various interest rates are available to any given borrower for any given loan program, at any given point in time, depending upon his or her needs and preferences.

The role of borrower choices should be acknowledged in creating the appearance of pricing disparities.

The fact that similar borrowers selected different rates on this basis does not mean that they were treated differently in a sense that should be relevant to fair lending compliance. Nevertheless, such differences in borrower choices can create the appearance of pricing disparities if they happen to be correlated with a prohibited basis, and are not captured in data and accounted for in a fair lending analysis.

Even the passage of time can create the appearance of pricing differences among similarly situated borrowers: One loan may be locked at noon and another may be locked at 2 p.m. or the next day, after the market shifted. Both the level of rates and specific risk adjustments can change over time.

Other factors consistently cited in recent fair lending settlements as contributing to alleged pricing discrimination have included a lack of: 1) clear policies and controls governing the exercise of discretion, 2) documented business rationale for discretionary pricing adjustments, or 3) effective fair lending monitoring and corrective action.

These issues can be exacerbated by a lack of complete and accurate data that is required to examine and explain pricing disparities, which may appear in the incomplete set of loan data often relied upon by regulatory examiners.

Controlling fair lending compliance risk in the face of these complexities and market realities can be costly and cumbersome unless technology tools are exploited to automate the necessary preventive controls.

The problem of incomplete data

When screening lenders for potential fair lending issues, regulators and consumer advocates have traditionally used the publicly available Home Mortgage Disclosure Act (HMDA) data, which contains only a few of the numerous loan and borrower characteristics that are central to pricing decisions.

In their fair lending examinations, the CFPB and other regulatory agencies also request a limited number of pricing-related data elements (e.g., credit score, loan-to-value [LTV] ratio and loan program, as well as the interest rate and annual percentage rate, among other things). However, even the expanded "HMDA Plus" data set lacks all of the data elements required to fully explain why different borrowers received different pricing.

Essentially, there are two categories of data that need to be captured systematically and incorporated into fair lending analysis:

- ***Standard pricing variables*** include all of the borrower risk and loan program characteristics that determine the interest rate, and the rate adjustment associated with each. Capturing these is the easier part of the problem, because a pricing engine must incorporate all of them in order to price correctly.
- ***Discretionary pricing variables*** include all of the factors that are subject to choice by the borrower or the lender. Examples include whether the borrower needs a lender credit, chooses to buy down the interest rate or chooses a par (zero points) rate; plus discretionary pricing concessions or credits. Historically, these factors have not been captured systematically in data or documentation by many lenders.

When a lender's fair lending compliance is evaluated based on a limited data set that lacks all of these elements, there is a good chance that some prohibited basis pricing disparities will be found even if the lender has not engaged in illegal discrimination.

Automating fair lending preventive controls

There are several aspects of the mortgage pricing process that can be reduced to rules and procedures within pricing engines or origination systems to control fair lending risk.

Pricing engines and origination systems can help a lender to:

- lock down pricing;
- enforce limits on discretionary adjustments;
- enforce approval authorities for granting concessions or exceptions;
- limit the potential for errors; and
- provide the data and documentation needed to both monitor fair lending risk and respond effectively to regulatory inquiries.

The following describe how these pricing engine capabilities help to control fair lending compliance risk.

Eliminate errors and inconsistencies: Consistency is at the core of fair lending—ensuring that each borrower receives the correct pricing, based on their qualifications, loan parameters and other relevant business considerations. Inadvertently undercharging some borrowers and overcharging others can result in inconsistent pricing on a prohibited basis.

When the pricing process is not automated end to end, errors can arise both when rates are locked and as loans are repriced or relocked due to changing circumstances prior to closing. Pricing engines eliminate the need for paper rate sheets, manual pricing calculations and manually checking and rechecking for adherence to pricing policies and regulations each time a change occurs. Automation ensures that no loan-level pricing adjustments are missed or incorrectly applied and any available pricing premiums are handled consistently with the lender's pricing policies.

Enforce pricing policies: Policies governing pricing discretion and other elements of pricing only work effectively if controls exist to enforce them and monitoring is performed to ensure compliance.

Workflow built into a pricing engine can be used to flag lock requests that exceed an originator's or branch manager's authority, force the input of appropriate justifications for concessions or exceptions and automatically route the request to the appropriate manager or executive for approval.

System workflow also can generate a "data trail" that can be used to monitor and report on discretionary pricing, helping to ensure that the cumulative frequencies and amounts of concessions or exceptions stay within established tolerances.

Comply with anti-steering regulations: Automation allows the loan originator to be presented systematically with the set of viable loan program and pricing options available for each borrower's situation. This both creates efficiencies for the originator and reduces reliance on the originator's ability to identify all possible options for each borrower.

It also helps to avoid situations in which latent biases may cause an originator to steer borrowers to particular products—either on a prohibited basis or simply to enhance profits. Data on the options available or considered, and the rationale for the ultimate product selected, can be stored in the pricing engine or origination system and can be produced as needed to defend against potential steering concerns.

Document pricing decisions: Workflow steps can be built into an origination system or pricing engine to guide the originator through various process and compliance checklists, and to prompt the originator or other staff to input explanations for pricing decisions or changes along the way. If concerns about statistical pricing disparities should arise later, such documentation can help to justify the pricing of each loan to regulatory examiners without having to undertake extensive manual reviews.

Retain complete and accurate data: Fair lending statistical analyses are often hampered by incomplete or inaccurate data. However, data-input controls and validation checks can be automated to reduce errors in data capture, which otherwise could lead to pricing errors and an inability to explain pricing disparities on a statistical basis. Pricing engine systems also can store every data element and every pricing adjustment that went into pricing each loan. Furthermore, as the cost of data storage has declined, it has become possible to store data on all available programs and pricing that were available at any point of time in the past, which can help in defending against claims of improper steering.

Demonstrate controls to regulatory examiners: Aside from helping to enforce and monitor compliance, an automated system of pricing controls can provide the means to easily demonstrate the lender's management controls to examiners, who are interested in understanding the workings of a lender's compliance management system.

Further, pricing engine technology can facilitate real-time monitoring for potential pricing disparities, and serve as the basis for an early-warning system that flags transactions that may contribute to pricing disparities.

What if potential fair lending risk issues could be detected and corrected in real time, before loans closed?

What does real-time fair lending monitoring look like?

Standard after-the-fact monitoring based on complex statistical regression models—though still a necessity—is subject to inherent limitations. Even with a complete data set, it may not be possible for a regression model to fully account for all of the relevant factors that would explain pricing differences across a diverse pool of loans originated over a period of months or a year.

But what if potential fair lending risk issues could be detected and corrected in real time, before loans closed?

A real-time loan-by-loan monitoring and control process can help to anticipate and mitigate potential issues. A real-time monitoring system can be a first step in signaling a potential pricing issue, even though it may not be sufficient to determine whether issues may arise after aggregation of loans over time.

Real-time monitoring starts with the recognition that, if we know all the variables that affected the rate each borrower received, then theoretically we can use those variables and the actual price adjustments in a pricing engine, plus a lot of mathematics, to convert every borrower's rate to a comparable "apples-to-apples" basis. In other words, produce a basis of comparison for loans as if they all had the same characteristics and loan parameters, and were priced at the same point in time.

Among other things, the rate can be adjusted for the effects of different credit profiles (e.g., taking out the effects of different credit scores, LTVs, occupancy status, etc.) and of borrower choices or preferences (e.g., the desire or need to receive credits toward closing costs in exchange for a higher rate, or the willingness to pay discount points to lower the rate).

After all borrowers' rates have been equalized or normalized in this way, any differences that remain would reflect only rate or points choices not dictated by normal rate-price dependencies and risk-based pricing adjustments as they are defined in the pricing guidelines for each loan product—including the effects of pricing discretion.

These differences can become the basis for real-time monitoring as lock requests come into the system, and for identifying any pricing outliers that could create fair lending risk.

When outliers are reviewed on a timely basis, then justified, documented and corrected as appropriate—or if they do not occur in the first place—there is a much greater chance that any statistical disparities that may appear in the aggregated loan data will be justifiable based on sound business reasons.

A model for the future, today

The current regulatory and business climate demands that mortgage lenders place greater reliance than ever on upfront fair lending preventive controls, rather than waiting to identify fair lending issues only after they have occurred. The sort of pricing control process described in this article can reduce the potential for unjustified, and unjustifiable, pricing differences among borrowers and can increase operational efficiency.

Real-time monitoring will not eliminate the need for the kinds of after-the-fact compliance monitoring and reporting expected by regulators, but it will allow the lender to detect potential issues early enough that it can be dealt with before they grow into serious compliance issues.

The technology already exists for this sort of real-time control and monitoring of fair lending pricing risk. Pricing engines have most, if not all, of the necessary data to flag potential pricing anomalies. This can lead to a much more controlled environment with reduced compliance risk. **MB**

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