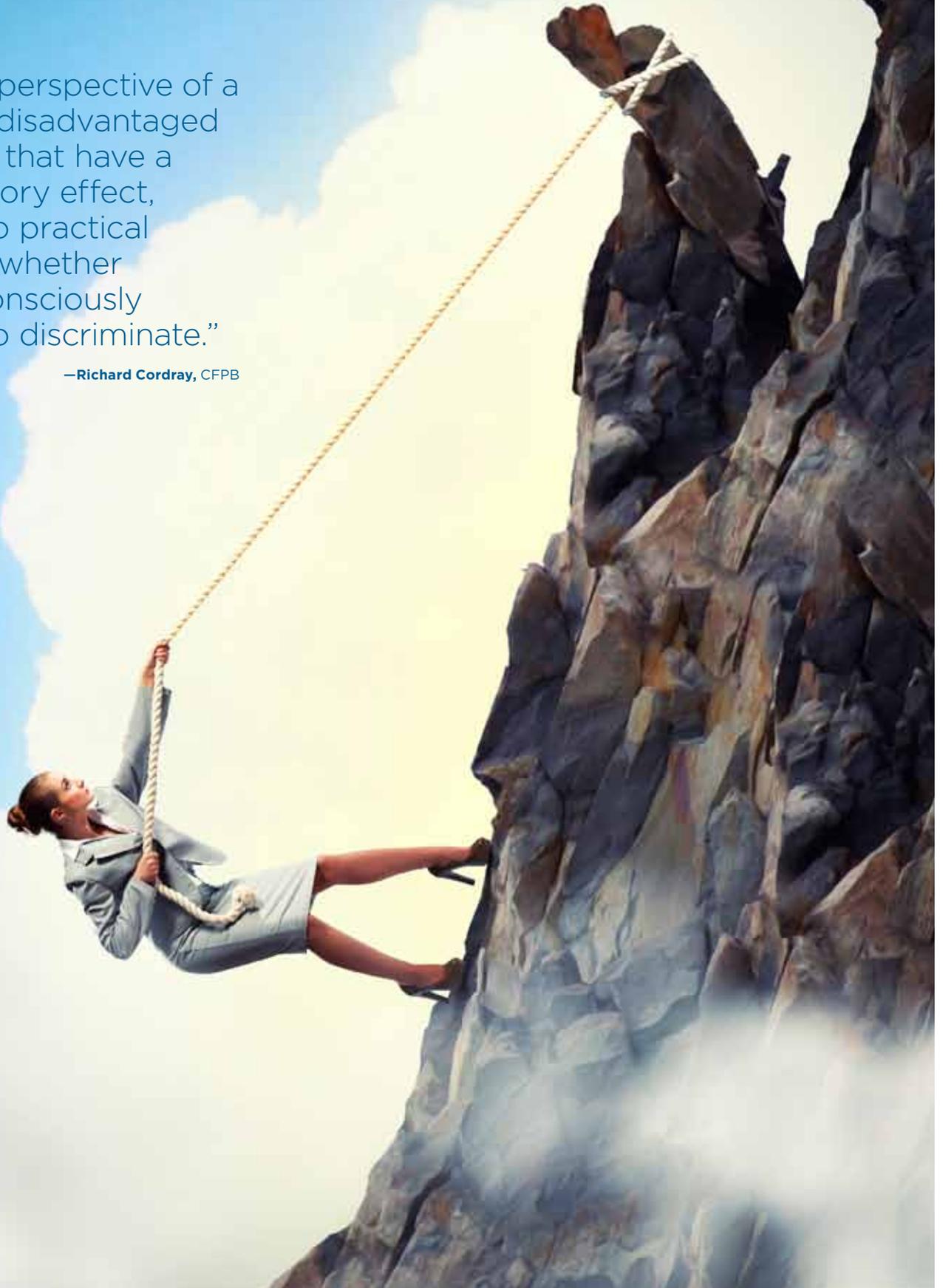




“From the perspective of a consumer disadvantaged by policies that have a discriminatory effect, it makes no practical difference whether a lender consciously intended to discriminate.”

—Richard Cordray, CFPB





Assessing the Risk of Mortgage Servicing

Sure, the industry is rife with risks, but having a fair and responsible lending program in place can help lessen their likelihood.

By Loretta Kirkwood, Managing Director, CrossCheck Compliance

Fair and responsible lending risk management has rapidly become one of the most critical areas of compliance management in today's lending environment. The risks are not new. The concept is not new.

Regulatory focus, oversight, and enforcement activity, however, is shifting and evolving with each pronouncement by the Consumer Financial Protection Bureau (CFPB) and quite possibly with each completed regulatory examination. During the course of the past 18 months, lenders have been overwhelmed with new rules to implement, as well as guidance and reinterpretation of existing rules—all with the underlying intent of protecting consumers from financial harm.

As expected and predicted, the residential foreclosure and declining market issues in recent years have directed attention to the potential for discrimination in mortgage servicing and loss mitigation. The underlying reasons for this shift in focus may be subject to debate, but the importance of developing a fair and responsible lending risk management program for

mortgage servicing is not. The good news is that there is no need to start from scratch. The same risks associated with the loan origination process apply to mortgage servicing and loss mitigation.

Mortgage servicing practices specifically identified by the CFPB and prudential regulators as “higher-risk areas” include servicing transfers, payment processing, and loss mitigation. Much of the focus has been centered on “unfair” business practices associated with incomplete or incorrect disclosures, inadequate documentation management, and generally disorganized processes throughout the mortgage servicing life cycle. The continuing theme is that a weak or inadequate compliance management system increases fair and responsible lending risk in all aspects of the lending process, including loan servicing and loss mitigation.

The importance of protecting mortgage borrowers, especially those who are delinquent or facing foreclosure, is evident in the CFPB's recent guidance. This combined with increased regulatory oversight, community focus, and tightening credit standards underscores the need to develop an effective fair and responsible lending program for mortgage servicing activities.

Fair and Responsible

Fair lending in general is considered to be a “simple” concept, one whose core principles are to be consistent and fair. From a regulatory standpoint, risk of discrimination exists wherever a lender or servicer has a business practice that permits borrowers to be treated either more favorably or less favorably on a prohibited basis, or if the results of analysis of patterns in lending or servicing “indicate” that a prohibited basis group has been disadvantaged in some way. The simplicity ends when you consider the impact of a borrower's perception of the servicing process. Does the borrower view collection,

loss mitigation, and foreclosure practices to be fair? In all things, perception overrides logic and creates risk. The complexity of servicing practices creates significant challenges in developing an effective internal control environment. Consideration has to be given to the borrower's understanding of the process, his or her particular individual circumstances, and desired outcome. Not all borrowers “want” or “need” to be rescued.

Discrimination claims can be generated from indications of disparate treatment or disparate impact and do not necessarily require evidence of harm to the borrower. The mere potential for harm is enough to warrant regulatory action.

Responsible lending is another element of fair lending and generally refers to the motive for treatment of the borrower. Does a business practice either in truth or concept have the appearance of being unfair, deceptive, or abusive? The focus is on ensuring that borrower communication and the delivery of credit services are fair, understood, transparent, and appropriate to the needs of the borrower.



Understanding the difference between treatment and impact is an important step in developing an effective fair and responsible lending risk management process. Every step in the credit process should be evaluated for either risk—including but not limited to levels of assistance, product selection, marketing, credit underwriting, pricing, fees, appraisal practices, collections, loss mitigation, and foreclosure.

- *Disparate treatment* refers to a difference in treatment of applicants or borrowers on a prohibited basis that cannot be explained by other factors and may result from unfair, deceptive, or abusive lending practices. The risk of disparate treatment exists throughout the credit life cycle and is often the result of broad discretion, case-by-case exceptions, and limited or no quantifiable justification for variances to policy or credit standards.

- *Disparate impact* is generally the result of unintended consequences. A disparate impact claim of discrimination occurs when statistical analysis reveals that a prohibited basis group appears to have been disadvantaged by a business policy or practice that is facially neutral and applied consistently to all borrowers.

Disparate impact is the more complex discrimination claim and the most controversial. The U.S. Supreme Court is scheduled to hear the a housing case, *Mount Holly v. Mount Holly Gardens Citizens in Action*, which many speculate will reverse the disparate impact standard in fair lending cases.

The CFPB and HUD continue to declare their commitment to disparate impact enforcement. Shaun Donovan, Department of Housing and Urban Development (HUD) secretary, stated, "As we've learned over the years, housing discrimination comes in many forms.

Discrimination doesn't have to be intentional in order to have a damaging effect." The CFPB's director, Richard Cordray, has vowed to "pursue discrimination in consumer financial markets based on disparate impact as well as disparate treatment. From the perspective of a consumer disadvantaged by policies that have a discriminatory effect,

ent risk, establishing standards and controls for limiting risk, and developing appropriate corrective action plans when risk levels are outside of acceptable tolerances.

The principles of fair and responsible lending risk management normally associated with loan origination apply equally to mortgage servicing and include

Process Risk

Process risk assessments are a qualitative approach to evaluating a servicer's inherent risk, effectiveness of the compliance management system, fair lending program, and control environment, as well as defining any residual risk. Process reviews are intended to "tell the fair and

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Regardless of whether the disparate impact standard is upheld, the possibility of discrimination claims in mortgage servicing is a very real risk. Mortgage servicers should begin developing and implementing fair and responsible lending risk management programs and internal controls that will withstand scrutiny of the regulators.

Risk Management

The business of mortgage servicing is substantially about limiting risk and maintaining profitability. Every aspect of the credit process from application to payoff involves defining, accepting, and managing risk. Fair and responsible lending risks should be managed and evaluated in the same way as any other financial risk. Basic steps include identifying inher-

ent risk, establishing standards and controls for limiting risk, and developing appropriate corrective action plans when risk levels are outside of acceptable tolerances.

While there is a significant amount of fair lending information and guidance available from industry associations, law firms, and consulting firms, there are no "one-size-fits-all" solution assessment process. Every lender or mortgage servicer has business practices that create unique risk in processes and performance, including what is intended and what actually happens.

Recent fair and responsible lending enforcement actions and litigation provide a framework of "best practices" for identifying, managing, and limiting fair and responsible lending risk. Fair lending settlements in general provide valuable guidance that applies to all aspects of the credit process, including mortgage servicing and loss mitigation. Effective risk management addresses process risk, as well as performance risk.

responsible lending story" and provide answers to questions before they are asked.

Developing a fair lending program that documents and defines how things "work" is an important first step in evaluating process risk. The key components of a fair lending program are defined as follows:

- *Board/Senior Management Oversight* – Does the board and/or senior management team understand fair and responsible lending risk? To what extent does the board and/or senior management provide oversight of fair and responsible lending risk management? How frequently is information and results of risk assessments, monitoring, and testing presented to the management team?
- *Compliance/Fair Lending Management* – What policies and procedures are in place to



communicate the commitment to fair and responsible lending? What is the organizational hierarchy for compliance management? What authority is granted to the compliance officer and fair lending officer? How are management and individual compliance responsibilities defined, communicated, and monitored? Are policies and procedures established to address compliance risk within business functions and practices?

- *Internal Controls* – What policies, procedures, training, monitoring, testing, and assessment practices exist to limit fair and responsible lending risk? What process is in place to ensure accuracy and timeliness of disclosures, notices, and other communication with the consumer? How do you ensure that more or less favorable treatment does not occur? What efforts are made to monitor and test the consistency and fairness in customer outreach, levels of assistance, and loss mitigation efforts? What levels of monitoring and testing are preformed related to the technical requirements of fair lending laws and regulations?
- *Collections, Loss Mitigation, and Foreclosure* – What efforts are made to monitor and evaluate credit risk in the existing portfolio? What triggers are in place for collection efforts, loan modification options, and foreclosure action? What efforts are made to ensure the consumer understands their options? What documentation is required for different loss mitigation efforts?
- *Performance Analytics* – What efforts are made to analyze the outcome of various loss mitigation options? How are disparities in levels of assistance, underwriting, and pricing evaluated? What efforts are made to evaluate potential risk associated with steering and redlining? What, if any, proxy methodologies are used in performance analysis? What comparators and/or tolerances are established for disparity analysis and comparative file reviews?

Performance Risk

The performance risk assessment is a statistical evaluation of performance, not policies—not an evaluation of what is meant to happen, but what actually occurs. Disparities in any aspect of collections, loss mitigation, or foreclosure require additional research, as well as potential comparative file reviews.

The assessment of performance risk can be somewhat blurred in mortgage servicing due to the nature of loss mitigation practices. Developing an effective system of data capture for analysis is the key to ensuring an accurate and complete review of collection practices, loss mitigation efforts, and foreclosure processes. New mortgage servicing rules and guidance issued by the CFPB provide a framework for “what” information should be reviewed. The challenge is in modifying existing systems or developing new ones to capture sufficient information in order to perform disparity analysis.

There is also the underlying issue of how you determine the best outcome for the delinquent borrower. How do you define what is most beneficial to the customer? How much consideration is given to the customer’s needs and desired outcome? What documentation is required to substantiate different outcomes driven by customer intent?

Consider the following areas of risk when establishing policies, internal controls, and performance analytics:

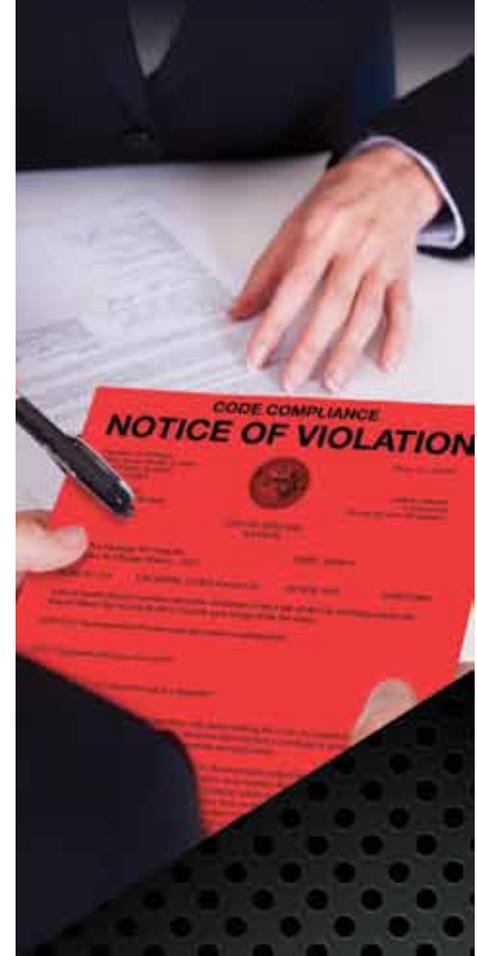
Area	Description
Practice Risk	Collection triggers Loan documentation Processing times Third-party actions
Default Servicing Outcome Disparities	Loan modification Short sale Foreclosure
Option Disparities	Reduced rates Term extensions Reductions in principal
Exception Disparities	Policy exceptions Fee waivers

The “simple” truth is that fair and responsible lending risk will continue to evolve and expand into new areas of the credit life cycle. Mortgage servicers should be identifying, measuring, controlling, monitoring, and managing that risk—looking ahead and preparing, instead of waiting and reacting.

Whether you perform risk assessments internally or choose to outsource the process to ensure independence, fair lending process and performance reviews need to be a component of your compliance management system. **M**

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