Managing Risk – Are You Fair and Responsible?

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Managing fair lending risk has become one of the more critical and subjective areas of compliance risk management in today's regulatory environment. Assessing risk is becoming more complex … are you fair AND responsible? How do you define unfair, deceptive, and abusive? Do your lending policies, procedures, processes, and practices reflect a "culture of compliance" throughout your organization? Does your control environment adequately limit risk? Does your fair and responsible lending program provide answers to current regulatory risks? Is your fair lending story well documented?

Regulatory examination focus has continued to evolve with each new enforcement action, issuance of new rules, and reinterpretation of existing rules. Emphasis is not only driven by actual harm to consumers, but also by the "potential for harm". Discrimination risk exists whenever a lender has a business practice that permits borrowers to be treated more favorably or less favorably on a prohibited basis OR if the results of analysis indicate that a prohibited basis group has been disadvantaged in some way.

Responsible lending generally refers to the motive in how a borrower may or may not be treated. Does a business practice actually have the appearance of being unfair, deceptive, or abusive? Or, does the consumer's perception raise this level of risk? The best approach is to ensure that borrower communication and the delivery of credit services are fair, understood, transparent, and appropriate to the needs of the borrower.

So, as we struggle to address all potential fair and responsible lending risk, it's important to remember that not everything has changed. Discrimination risk

must continue to be assessed throughout the credit life cycle –including but not limited to levels of assistance, product selection, marketing, credit underwriting, pricing, fees, appraisal practices, collections, loss mitigation, and foreclosure. The key is in understanding the difference between disparate treatment and disparate impact.

- Disparate treatment - Treating applicants or borrowers differently on a prohibited basis that cannot be explained by other factors which 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 - Generally refers to 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 controversial and complex claim of discrimination. Lenders with strong internal controls and monitoring programs will have an expectation that consistency is the key to limiting risk. Regulators will focus not only on policies, but also on the impact of those policies. Identifying disparate impact risk requires a deep understanding of business practices in order to effectively define what types of analysis are required.

It is equally important to consider the "people" risk – employees and applicants. Training should be job specific for employees and should include a customer service "sensitivity" component. Managing borrower risk is more complicated. Perception of treatment and application outcome can result in customer complaints. Customer complaints are getting more focus and should receive a high level of attention from senior management for resolution.

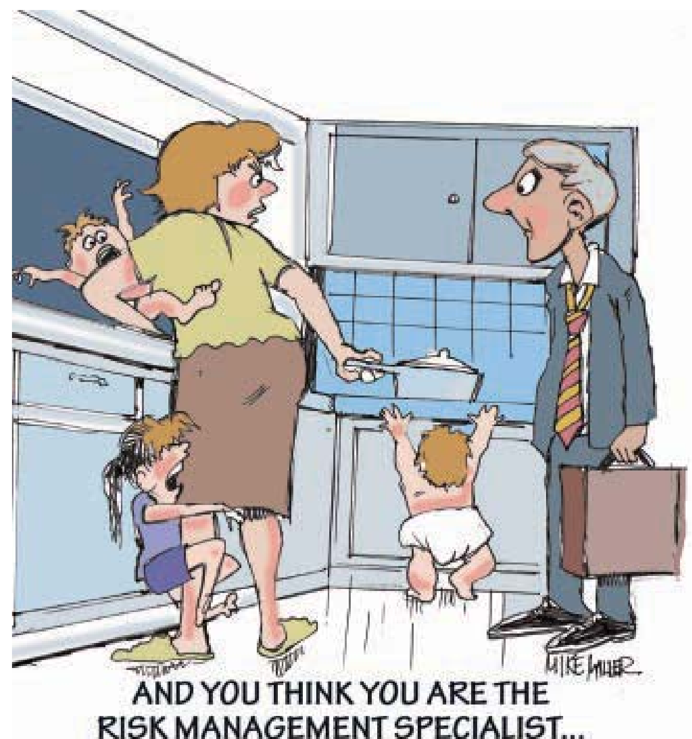
Risk Management

Identifying risks includes defining inherent 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 is no "one-size-fits-all" solution or standard assessment process. Business practices determine the approach and focus of evaluating risk and should addresses both process and performance risk - what is intended and what actually happens.

Process Risk

Process reviews are qualitative in nature and are intended to "tell the fair and responsible lending story", providing answers to questions before they are asked. This type of assessment defines how things work, addressing the "compliance culture". An effective fair lending program includes:

- Board / Senior Management Oversight – The Board of Directors and senior management teams ⊳



need to understand fair and responsible lending risk. Communication is the key – meetings should include updates on enforcement activity, internal and external reviews, and other industry focused information.

- Compliance / Fair Lending Management – An effective compliance management system will include a fair and responsible lending program. Responsibilities should be clearly defined to ensure that all employees understand risk associated in individual roles in the lending process.

- Internal Controls – Preventive and detective controls are necessary to effectively manage risk and should include policies, procedures, training, monitoring, testing, and risk assessments.

- Marketing – Marketing and advertising efforts should be designed to reflect the population characteristics, as well as reach all areas of the communities served. Social media generates unique challenges in managing marketing risk.

- Credit Process – Access to credit, credit risk management, cost of credit, account management, and loan servicing are obviously key areas of risk which require on-going oversight and risk assessment.

Performance Risk

Performance risk is generally identified through a statistical evaluation of performance, not policies – not an evaluation of what is meant to happen, but what actually occurs. Disparities in levels of assistance, underwriting, application fall out rates, or pricing, as well as steering or redlining issues will require additional research. Comparative file reviews or matched pair testing should additionally provide a framework for identifying and evaluating areas of risk not easily identified in other processes.

Wrap Up

The only "simple" truth is that fair and responsible lending risk will continue to evolve and expand with each new or revised regulation and enforcement action. Lenders have to look back and forward at the same time - identifying what has happened in the past and what is expected to happen in the future. Compliance professionals will be identifying, measuring, controlling, monitoring, and managing risk – while looking ahead and preparing, instead of waiting and reacting.

Loretta is a regulatory compliance and risk management executive with over 30 years of experience in the financial services industry. Her most significant area of focus is fair and responsible lending risk management, including compliance management system and program development, qualitative and quantitative risk assessments, data quality management, process mapping, and staff training. Loretta can be reached at: lkirkwood@crosscheckcompliance.com.

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