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In Depth

The Expectation of Exceptions in the World of Fair Lending

by Margaret Dolinger

Exception reporting is not new; all banks are required to report loan policy and loan documentation exceptions for Safety and Soundness. However, a new unwritten rule is fair lending exception tracking covering pricing and underwriting exceptions on consumer loan products. Whether it's HMDA for banks with less than or more than 500 entries, regulators want Boards and bankers to know when exceptions affect any of the prohibited bases, such as race, sex or ethnicity. For HMDA filers with more than 500 entries, tracking is even more critical – the reason being that the new HMDA dataset fields will more swiftly identify forms or patterns of disparity for bank examiners or special interest groups. As regulators show up at your bank to perform the fair lending exam, they have already reviewed HMDA LAR and will be armed with questions such as: Are loan exceptions being given to non-minorities verses protected groups?

In our fair lending reviews, we found most banks do not have a robust exception tracking monitoring process in place. We strongly recommend tracking and monitoring as a best practice. Banks need to begin capturing the exception reasons as they occur, rather than trying to piece together events that caused the exception when examiners are onsite. No one is saying that exceptions are negative but if they are made the question is, Why and how does that affect other loan transactions?

The Consumer Financial Protection Bureau (CFPB) Supervisory Highlights for Spring 2014 stated, "institutions should have policies and procedures that require, for each applicant offered an underwriting, pricing or other exception, documentation appropriate to that specific exception that is, at a minimum, sufficient to effectively monitor compliance with the exceptions policies."

On November 16, 2017, the FRB hosted the Compliance Outlook Live Interagency Fair Lending Hot Topics which included topics on the new HMDA Rules and Fair Lending. The other regulatory agencies involved in the webinar were the CFPB, DOJ, FDIC, HUD, NUCA, and OCC.

A speaker for the OCC, Vonda Eanes, Director of CRA and Fair Lending Policy stated, "All the agencies will have access to all HMDA data and despite the OCC, FDIC and FRB joint guidance prioritizing the 37 key fields, the OCC expects to leverage all the additional HMDA data fields in its lending risk analysis."

Another speaker, Katrina Blodgett, Counsel of the FRB's Fair Lending Enforcement Section of the Division of Consumer and Community Affairs, stated, "The FRB engages in risk-focused supervision and expects that an entity's Compliance Management System (CMS) provide oversight commensurate with the level of pricing discretion provided by each consumer loan program. The FRB expects that an entity clearly communicates the basis for any exceptions offered to its loan officers, including waiving, reducing or increasing fees." Ms. Blodgett encouraged Banks to use rate sheets to assist in tracking all exceptions variables and she advised that rate sheets should be reviewed as part of monthly compliance meetings.

"Tara Oxley, Chief of Fair Lending and CRA Examination at the FDIC, emphasized that fair lending monitoring programs should be conducted portfolio-wide and [especially for big banks] only limited to a branch-specific analysis where policies and procedures differ across branches. According to Oxley, an entity's review must include an analysis of its lending data and its pricing exceptions and overrides, regardless of the entity size or complexity."

In addition, the Federal Reserve's Compliance Outlook live webinar noted the pricing red flags for fair lending risk:

- The bank grants loan originators broad discretion to set interest rate and fees;
- The bank does not use rate sheets or other pricing guidelines;
- The bank does not require loan originators to clearly and consistently document pricing decisions, including exceptions; and
- The bank does not monitor for potential pricing disparities on a prohibited basis.

Red flags for underwriting have similar traits as noted above when broad discretion is granted to lenders and there is no oversight.

The FDIC has several fair lending presentations which are located on their website, where the FDIC noted fair lending concerns that may result in additional reviews by the FDIC, including:

- Disparities in pricing of credit, including fees or rates, based on a prohibited factor and were price differences are not related to pricing factors described in bank policy; and
- Disparities in loan products selection or underwriting, where there is discretion by loan officers, including where policy is unclear or where exceptions are allowed.

The Interagency Fair Lending Exam Procedures on page 20 says an exam procedure compares approved and denied applications and includes the identification of marginal files to note the following:

- The extent of any assistance, including both affirmative aid and waivers or partial waivers of credit policy provisions or requirements, that appears to have been provided to marginal-approved control group applicants which established them to overcome one or more credit deficiencies, such as excessive debt-to-income ratio; and
- The extent to which marginal-denied target group applicants with similar deficiencies were, or were not, provided similar affirmative aid, waivers or other forms of assistance

In addition, page 9 of the Procedures identifies several risk factors specific to pricing and underwriting:

PRICING

Risk Factor	Risk Description
P2	Presence of broad discretion in loan pricing (including interest rate, fees and points) such as through overages, underages or yield spread premiums. Such discretion may be present even when institutions provide rate sheets and fee schedules if loan officers or brokers are permitted to deviate from those rate and fees without clear and object criteria.
P4	Disparities among prices being quoted or charges to applicants who differ as to their monitored prohibited basis characteristics.

UNDERWRITING

Risk Factor	Risk Description
U5	Lack of clear guidance on making exceptions to underwriting criteria, including credit adoring overrides.
U6	Lack of clear file documentation regarding reasons for any exceptions to normal underwriting standards, including credit scoring overrides.

Lastly, TCA recommends that banks go to their regulatory agency exam manual for consumer compliance, search on the topic of exceptions and note how the examiners will review the bank on tracking and monitoring on pricing and underwriting exceptions for fair lending. The common theme among the agencies is how effective is the bank's monitoring for exceptions to ensure there is no form of disparate treatment to prohibited basis groups. Remember, you don't know what you don't know – a potential red flag!

So, knowing what the regulatory agencies' expectations are regarding exception monitoring, which HMDA dataset fields will receive extra attention by the regulatory agencies for underwriting when a comparative analysis is conducted based off borrower characteristics and location. They are:

- Loan to value
- Credit score
- Debt to income
- Income

The examiners will also heavily focus on the pricing HMDA dataset fields when a comparative analysis is conducted based off borrower characteristics and location, such as:

- Interest rate
- Introductory rate
- Total loan costs
- Origination fees
- Discount
- Lender credit

Regulators and special interest groups can now view the big-volume HMDA bank's data for underwriting and pricing to identify outliers that can be potential forms of disparities to prohibited basis groups. In addition, know that your regulatory agency will have already reviewed your submitted HMDA data and will identify the outliers. As they question management about the lending outliers, they will ask about your exception monitoring program to determine whether the bank identified the same outliers. How will your bank answer these questions?

So, what does this mean to a bank, if the regulatory fair lending exam procedures note the analysis for applied exceptions? How easy is it now for outliers to be identified by examiners by reviewing a bank's HMDA LAR to avail information through analysis that a pattern of disparity exists? If discretion is allowed by lenders and underwriters by the bank, then the regulatory agencies expect a report to record the data to assist with monitoring and trending for identification of disparate treatment patterns.

Therefore, it is imperative for a bank to have in its fair lending risk assessment a risk factor for exceptions, pricing and underwriting, with a control process in place to mitigate the exception risks.

As a banker, you may say, where do we start? A bank needs to determine whether exceptions are allowed – if yes, then there should be another level of approval process noted in the bank's lending policy along with the process to record, monitor and report to management. In the development of an exception report or enhancements to an existing exception report, the following information should be included:

Pricing Exceptions Report Fields	Underwriting Exceptions Report Fields
Loan Number	Loan Number
Borrower	Borrower
GMI	GMI
Minority Borrower Y/N	Minority Borrower Y/N
Geocoding	Geocoding
Minority Tract Y/N	Minority Tract Y/N
Loan Program	Loan Program
Note Date	Note Date
Pricing on Rate Sheet or Pricing engine	Credit Score Exception
Pricing Granted	Loan to Value Exception
Fee waivers	Deb to Income Exception
Lender credit	Other Exception
Loan Officer	Loan Officer
Approver of Exception	Approver of Exception
Approval Date	Approval Date
Comment on Justification for exception	Comment on Justification for exception

Banks are encouraged by the regulatory agencies to have a robust monitoring program regarding exceptions as part of their Compliance Management System.

If your bank does not have a robust fair lending exception tracking report to assist with monitoring and reporting to senior management, contact TCA to learn A Better Way for fair lending assistance at info@tcaregs.com.