

# Managing the Risk of Pricing Discretion

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**A new survey of mortgage industry practices examines the prevalence of pricing discretion in lenders' operations. Careful management of the practice is crucial to avoiding fair lending problems.**

s advisers to mortgage lenders on operations, risk management and compliance, our clients often ask us about best practices in managing the fair lending risk attached to pricing discretion. Pricing discretion goes by many names in the mortgage industry: overages and underages, premiums and shortages, secondary gain, concessions or exceptions. ¶ Whatever the label, lenders ask us how much discretion other lenders give to loan officers versus others in the organization, what are allowed justifications for pricing adjustments, how the justifications should be documented and how fair lending risk should be monitored. ¶ In this article, we use the results of a benchmarking survey we performed to answer some of these questions and to compare industry practices against what we understand to be regulatory expectations for fair lending risk management.

## What we learned

From a fair lending perspective, we believe lenders should think broadly about pricing discretion as including any judgmental adjustments to standard pricing, as listed on rate sheets or given by a pricing engine. We advise lenders to consider all categories of pricing discretion whether that takes the form of discretionary reductions or increases in interest rate or points; lender credits or fees; or rate-lock extensions, roll-downs or similar adjustments.

Our survey confirms that discretionary pricing remains an important part of doing business in the mortgage industry. Many lenders appear to find it necessary for competing effectively, accommodating customer preferences and needs, and providing good customer service.

We also found that pricing discretion is commonly exercised to help comply with certain regulatory requirements or regulation-driven business policies.

Even though the typical reasons for discretionary pricing adjustments appear to be grounded in legitimate business needs, whenever someone is empowered to vary some element of the price of credit to consumers on a judgmental, case-by-case basis, that raises a risk that borrowers with comparable qualifications and credit risk will receive different pricing outcomes.

If pricing differences tend to occur based on race, ethnicity, gender or another prohibited basis, regulatory enforcement agencies may conclude that illegal discrimination has occurred under the Fair Housing Act and Equal Credit Opportunity Act (ECOA). The Supreme Court is considering the question of whether disparate impact liability exists under the Fair Housing Act in the case of *Texas Department of Housing and Community Affairs et al., vs. The Inclusive Communities Project Inc.* Even if the court decides that disparate impact liability is not available under the Fair Housing Act, pricing discretion may still pose a fair lending disparate treatment risk under both the Fair Housing Act and the ECOA, and the Consumer Financial Protection Bureau (CFPB) has made clear its position that disparate impact is actionable under the ECOA.

For this reason, the pervasiveness of discretion needs to be matched with adequate controls to avoid potential fair lending issues or enhanced regulatory scrutiny.

Our survey covered some of the key compliance program elements cited in the CFPB's spring 2014 *Supervisory Highlights* report: policies and procedures, documentation, record retention, monitoring and senior management oversight.

The survey findings suggest the following observations regarding industry compliance programs.

**Policies and procedures:** Formal, written policies and procedures governing the exercise of discretion are typical, but are not nearly universal, and often don't cover all aspects of pricing discretion. In particular, only about half of respondents covered discretionary lender credits in their written policies.

Clear policies and procedures are fundamental to establishing controls around discretion, and the fair lending risk created



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by discretionary lender credits is conceptually no different from that created by discretionary pricing concessions.

**Range of discretion:** Only a minority of survey respondents grant any pricing discretion authority at all to loan originators or branch managers, and most of those who do impose definite and fairly low limits on that discretion.

However, a few lenders allow loan officers as much as 100 basis points of discretion and branch managers as much as 200 basis points. Only one lender in the sample reported having no limits.

Lenders that allow a wide range of discretion to front-line sales staff face a higher degree of fair lending risk that needs to be matched with appropriately diligent monitoring.

**Documentation:** The vast majority of respondents maintain some amount of documentation about discretionary pricing adjustments, but fewer capture all of the information about such adjustments as

electronic data. Without electronic data, systematic monitoring of pricing discretion is difficult or impossible.

**Monitoring:** A little more than half of respondents conduct fair lending monitoring of their discretionary pricing. Federal regulators have consistently expressed their expectation that lenders will perform appropriate monitoring of their fair lending compliance risk in discretionary pricing.

In fair lending and other enforcement actions, the Department of Justice and CFPB have cited a failure to monitor, or to act on issues identified in monitoring, as a contributory factor in alleged regulatory violations. Without monitoring, potential issues can go undetected, resulting in more serious enforcement penalties if they ultimately are detected.

**Oversight:** The CFPB has expressed its view that a lender's top-level management should be informed about fair lending risk exposures and act as one of the controls over the company's fair lending compliance risk. Our survey results suggest that fewer than half of respondent companies keep top management informed about the risk associated with discretionary pricing, and not all of those who do possess the documentation necessary to demonstrate top management awareness of this risk area to regulatory examiners.

## The key to managing pricing discretion

The CFPB's *Supervisory Highlights* report called attention to the bureau's concerns about the management of "exceptions to credit standards," which we interpret to include discretionary pricing adjustments. Notably, the CFPB explicitly acknowledged that exceptions can constitute a legitimate business practice, but cautioned that discretionary pricing practices should be complemented by an appropriate system of fair lending compliance management.

The key to mitigating the fair lending risk from discretionary pricing is to maintain a robust system for controlling, managing and monitoring the exercise of discretion.

The CFPB's report noted that a strong fair lending compliance

management system for exceptions often includes the following elements:

- policies/procedures defining the circumstances under which exceptions are allowed;
- documentation sufficient to explain the basis for, and the specific circumstances of, each exception;
- record retention;
- staff training;
- monitoring/auditing of compliance with policies and procedures;
- corrective action, when appropriate; and
- management and/or board of directors oversight of the risk associated with exceptions.

Monitoring includes statistical testing for fair lending risk associated with pricing discretion, such as by monitoring differences in the incidence and sizes of discretionary pricing adjustments based on race, ethnicity and gender. It is clear that the CFPB and other financial regulators expect lenders of all types and sizes to have some means to effectively manage and monitor the risk.

### How do lenders manage pricing discretion?

Pricing discretion remains quite common in the mortgage industry—85 percent of survey respondents indicated that they allow some degree of pricing discretion, with discretion being somewhat more common at mortgage companies (91 percent) than at banks or bank affiliates (75 percent).

Of the lenders that permit discretion, 98 percent permit pricing reductions (often referred to as concessions or under-ages), while 44 percent permit discretionary price increases (often referred to as overages or premiums), as shown in Figure 1.

A majority of the respondents permit only price reductions, but 42 percent permit both reductions and increases, and one respondent only allows price increases.

Based on follow-up information from some respondents, it appears that the discretionary price increases refer mainly to situations in which the rate is increased in order to allow the lender to pay some or all of the borrower's closing costs. However, we understand that some lenders in the sample allow increases in pricing on a discretionary basis without an offsetting lender credit.

Not surprisingly, the most common reason for allowing discretionary price reductions is meeting a competing offer, which is permitted by 94 percent of the respondents who allow discretionary pricing (see Figure 2).

The next two most common reasons for discretionary price reductions—reported by about three-quarters of the respondents—were post-lock renegotiation and addressing customer service issues or operational errors (e.g., processing delays or other service issues).

Another area in which discretionary pricing can arise is in providing lender credits to the borrower to cover closing costs. We have observed that many lenders have a policy that requires selecting the lowest available note rate that does not require the borrower to pay discount points. In some cases, that approach can result in an above-par loan price (premium revenue to the lender), even when there is no discretion in setting the interest rate.

For example, given that interest rates are specified in in-

crements of one-eighth of a percentage point, there is not always a rate available that yields exactly a zero-point or par loan price. We have found in our consulting work that lenders vary in terms of how they handle that premium—some give it to the borrower as a lender credit toward closing costs or to reduce the principal balance (if that is possible given the requirements of investors, government-sponsored enterprises and regulations); some keep it as extra revenue; and some allow discretion over how much is credited to the borrower.

Among our survey respondents, 44 percent reported that they allow discretion in whether to credit any premium revenue to the borrower.

We also inquired about how much latitude staff in different positions are given to make discretionary pricing adjustments. We found that some degree of discretionary pricing authority resides with the secondary markets department for 80 percent of the respondents, and a slightly smaller percentage vest some pricing authority in a company executive (see Figure 3).

Only 40 percent of respondents allow branch managers some authority for pricing discretion, and only one-third give such authority to loan officers.

As one would expect, limits on the amount of pricing discretion tend to increase with a staff member's level and scope of authority. Loan officers typically have authority to

**FIGURE 1**

#### TYPE OF DISCRETION PERMITTED BY LENDERS

Type of Discretion Permitted	Percent
Both increases and reductions	42.3%
Price reductions only	55.8%
Price increases only	1.9%
Subtotal: Permit reductions	98.1%
Subtotal: Permit increases	44.2%
Total	100.0%

SOURCE: Charles River Associates and Garrett, McAuley & Co. survey

**FIGURE 2**

#### MOST COMMON REASONS FOR ALLOWING DISCRETIONARY PRICE REDUCTIONS

Reason for Discretionary Reduction	Percent
Meet competitive offer	94.2%
Renegotiation after rate lock	76.9%
Address customer service issue or operational error	75.0%
Needed to avoid high-cost loan	69.2%
Change in loan parameters after lock	65.4%
Borrower needed closing-cost assistance	57.7%
Reward customer relationship/loyalty	44.2%
Needed to meet net tangible benefit (NTB) test	42.3%
Compensating risk factors justify lower pricing	17.3%

SOURCE: Charles River Associates and Garrett, McAuley & Co. survey

vary pricing by only 25 basis points without additional approval, but a few respondents reported that loan officers are given authority to vary pricing by as much as 50 or 100 basis points. Only one lender in the sample indicated that loan officers have no specific limits on their pricing discretion.

Twenty-five basis points was also the most common limit for branch managers, but the median is 45 basis points and the range goes as high as 200 basis points. Again, only one lender indicated that branch managers have no specific limit on their pricing discretion.

**Policies, procedures, documentation and monitoring**

Policies, procedures, documentation and data are important components of a comprehensive compliance risk management system for pricing discretion. The CFPB’s spring 2014 *Supervisory Highlights* report suggest that lenders should have some sort of documentation that identifies when pricing exceptions were granted, the amount of the exception, the reason or justification for the exception, and whether the exception was approved in accordance with the lender’s policies.

We found 76 percent of survey respondents have a written policy or procedure governing pricing discretion. However, only 53 percent have a policy or procedure that specifically addresses whether and to what extent any pricing premiums should be credited to the borrower.

This result suggests not all lenders may be thinking about pricing discretion in broad, comprehensive terms when defining their pricing policies.

All of the respondents who provided information about their documentation practices indicated they document something about their discretionary pricing adjustments—either the existence of an adjustment (89 percent), the amount of the adjustment (93 percent), the reason for the adjustment (98 percent), the approval of the adjustment (82 percent) or some combination of these. However, only about 77 percent of

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respondents indicated they document all of these things.

To perform statistical monitoring and reporting about pricing discretion, it is useful to have at least some information stored in an electronic format. The vast majority of the respondents (89 percent) stated that they store such information in one or more computer systems as electronic data (instead of or in addition to loan files).

Overall, about 87 percent record the amount of a pricing adjustment as data, 69 percent record the reason for the adjustment as data and 58 percent record the approval as data. Only 7 percent of respondents indicated that they store such information only in paper or imaged loan files.

Even though 89 percent store some amount of discretionary pricing information in data form, not all of those lenders regularly monitor the frequency and amounts of pricing adjustments. Overall, 80 percent said they conduct some form of regular monitoring of pricing discretion. However,

only about 53 percent of respondents specifically monitor their discretionary pricing for fair lending risk.

Finally, we found that only 23 percent of respondents keep a record of the requests for pricing concessions that were not granted.

Such information can be relevant for assessing fair lending risk, because it can allow a lender to assess whether an imbalance in the granting of pricing concessions based on race, ethnicity or gender may be attributable to a difference in the frequency of requests, or a difference in request approval rates across demographic groups.

From a business profitability perspective, a record of concession requests that were not granted, together with information about whether the loans were ultimately originated, can help to gauge the extent to which concessions are actually necessary in order to compete effectively.

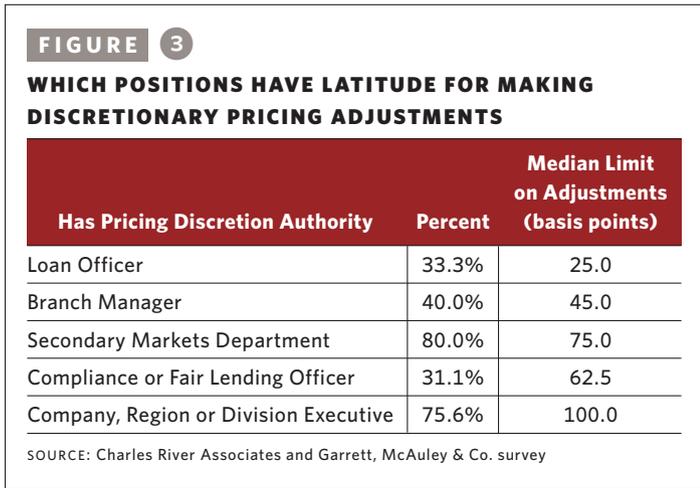
**Management reporting**

The CFPB’s recommendations for managing fair lending risk associated with pricing discretion (and its recommendations regarding compliance management more broadly) include some level of involvement on the part of executive management and/or the board of directors in monitoring the company’s compliance with exception policies and procedures.

Yet we found fewer than half (48 percent) of the respondents regularly have pricing discretion reports or logs reviewed by a senior executive, a management committee or the board of directors. Of those that have a management review process, 86 percent document that review in some way (e.g., in meeting minutes).

**The ultimate takeaway and survey details**

The survey results indicate that pricing discretion remains an important part of doing business in the mortgage market. While discretionary pricing is not inherently bad—and actually may be a necessary part of remaining competitive



and satisfying customers—it also presents significant regulatory compliance risk.

Ensuring fair treatment of consumers requires maintaining appropriate control systems and monitoring. Our survey identified several areas in which some mortgage lenders need to improve in order to effectively manage their fair lending pricing risk and to meet regulatory expectations regarding compliance risk management.

As for how the survey was conducted, Charles River Associates and Garrett, McAuley & Co. solicited 177 mortgage lenders for the survey, and 68 lenders responded to all or part of the survey.

Because the lender sample was drawn from our clients and industry acquaintances, it cannot be considered a random and representative sample of the mortgage industry. In particular, non-depositories are overrepresented relative to depositories. Nevertheless, we believe that the sample contains a sufficient diversity of lender types and sizes to provide a useful view into current industry practices.

Survey respondents who provided information about their size had monthly loan origination volume ranging from \$1 million to \$15 billion, with a median of \$50 million.

Retail and consumer-direct lenders were most heavily represented in the sample, but the sample also included some wholesale and correspondent lenders, as well as multi-channel lenders. Additional details about the survey are available from the authors. **MB**

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