# Managing the Fair Lending Risk of Pricing Discretion

## A Survey of Mortgage Industry Practices

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As advisors to mortgage lenders on operations, risk management and compliance, clients often ask us about "best practices" in various aspects of mortgage lending. Among other things, clients ask us how other mortgage lenders approach managing the fair lending risk attached to pricing discretion: how much discretion is given to loan officers versus others in the organization, what are common justifications for pricing adjustments, how should the justifications be documented, etc. Motivated by the industry's and our own interest, we performed a benchmarking survey of clients and industry acquaintances to gather some systematic information about lender approaches to this important risk issue. In this paper, we discuss the results of the survey and the conclusions we draw from it about the current state of fair lending risk management with respect to mortgage pricing.

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## What We Learned

Our survey confirms that discretionary pricing remains pervasive in the mortgage industry, and many lenders appear to find it necessary for competing effectively in the marketplace, 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, the pervasiveness of discretion needs to be matched with adequate controls to avoid potential fair lending issues or enhanced regulatory scrutiny.

In our casual observation before the survey, many mortgage lenders have made substantial progress over the past couple of years in effectively managing pricing discretion and the associated fair lending risk. However, we have observed substantial variation in that progress across the industry, with some lenders establishing rigorous controls and documentation, and others operating with few meaningful controls. Our motivation for the survey was to gauge typical industry practices on a more systematic basis and to compare those practices against what we understand to be regulatory expectations for fair lending risk management.

Our survey covered some of the key compliance program elements cited in the Consumer Financial Protection Bureau's ("CFPB's") Spring 2014 "Supervisory Highlights" report: policies and procedures, documentation, record retention, monitoring, and senior management oversight.[1] Our survey findings suggest the following observations regarding industry compliance programs:

- **Policies & 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 one-half of respondents covered discretionary lender credits in their written policies. Clear policies and procedures are fundamental to

[1] http://files.consumerfinance.gov/f/201405_cfpb_supervisory-highlights-spring-2014.pdf

establishing controls around discretion, and the fair lending risk created 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 have 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, and one lender in the sample has no limits. Lenders who 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 lenders 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 – and the fair lending risk associated with it – is difficult or impossible.
- **Monitoring:** About 53% of respondents conduct fair lending monitoring of their discretionary pricing. Just like with fair lending compliance more broadly, 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. Absent 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 top-level management should be informed about the company's 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 one-half of respondent companies keep top management informed about the risk associated with discretionary pricing, and not all of those who do have the documentation that would be necessary to demonstrate top management awareness of this risk area to regulatory examiners.

The remainder of this paper discusses the survey and responses in detail.

## Defining "pricing discretion"

Not everyone defines "pricing discretion" the same way and the terminology surrounding pricing can vary from lender to lender. Some talk in terms of overages and underages, or premiums and shortages, or secondary gain, or concessions, or exceptions. Some of these terms are problematic when talking of pricing discretion because they may include elements of pricing which are not discretionary, or they may not include all aspects of discretionary pricing. So, to help ensure consistency of interpretations among survey respondents, we defined pricing discretion as follows:

> *For purposes of this survey, "pricing discretion" means any judgmental or discretionary adjustments to standard pricing to a borrower, as listed on rate sheets or given by a pricing engine. It includes any discretionary reductions or increases in interest rate or points, discretionary lender credits or fee waivers, and discretionary rate lock extensions, roll-downs or similar adjustments; regardless of*

- *whether it is referred to as a concession, exception, credit, waiver, overage, or underage;*
- *who in the organization grants or authorizes it;*
- *the reason for the adjustment; and*
- *whose revenue or compensation may be affected by the adjustment.*

For purposes of this survey, discretion was defined to exclude the correction of pricing errors/misquotes, Good Faith Estimate fee tolerance cures, and *bona fide* discount points.

We believe that this definition captures the key elements of discretionary price-setting that are most relevant to managing fair lending risk – namely, that someone in the lending organization is empowered to vary some element of the price of credit to the consumer on a judgmental, case-by-case basis.

This is not to say that such adjustments are inherently a fair lending compliance issue because adjustments to rates, points or fees may be supported by valid business justifications, and because they do not necessarily result in prohibited basis pricing disparities. However, any type of judgmental adjustment raises a risk that borrowers with comparable qualifications and credit risk will receive different pricing outcomes.

## The importance of managing pricing discretion

Discretion in consumer loan pricing has been a major focus of fair lending regulatory and enforcement attention for several years. Numerous large-dollar settlements have been reached by the U.S. Department of Justice with mortgage and other lenders based on allegations that the lenders discriminated on the basis of race or ethnicity in their loan pricing. According to the government's legal theories, the lenders' policies or practices of allowing discretion to be exercised in loan pricing had a "disparate impact" on minority borrowers, which regulatory enforcement agencies consider to constitute illegal discrimination under the Fair Housing Act and Equal Credit Opportunity Act.

Concerns about the wide range of pricing discretion sometimes exercised by mortgage loan originators, and the relationship that often existed between pricing and loan originator compensation, led to the implementation of new loan originator compensation rules under Regulation Z in April 2011. Those rules do not directly restrict pricing discretion, but they do prohibit loan originators from deriving a direct monetary benefit from discretionary pricing by prohibiting the basing of compensation on the terms or conditions of a mortgage loan. Nevertheless, the combination of the loan originator compensation rule and federal enforcement activity have cause many lenders to establish tighter limits and controls around discretionary pricing.

The CFPB's Spring 2014 "Supervisory Highlights" report called attention to its concerns about the management of "exceptions to credit standards," which we interpret to include discretionary pricing adjustments, but the CFPB also explicitly acknowledged that that exceptions can constitute a legitimate business practice:

> *"CFPB examination teams have observed instances in which financial institutions lack adequate policies and procedures for managing the fair lending risk that may arise when*

> *a lender makes exceptions to its established credit standards. For example, a lender may decide not to apply certain credit standards to a borrower when there is a competing offer from another institution. Such decisions are appropriate where they are based on a legitimate justification, but it is important to maintain adequate documentation and oversight to avoid increasing fair lending risk under the Equal Credit Opportunity Act (ECOA) and its implementing regulation, Regulation B."*

The CFPB report went on to state that "A lender may promote the availability of credit by providing credit to an applicant based on a lawful exception … when exceptions practices are complemented by an appropriate system of fair lending compliance management."

The key to mitigating the fair lending risk that may arise from discretionary pricing, and other forms of discretionary decision-making in lending decisions, is to maintain a robust system for controlling, managing and monitoring the exercise of discretion. On that count, the CFPB's report notes that a strong fair lending compliance management system for exceptions often includes the following elements:

1. Policies/procedures defining the circumstances under which exceptions are allowed;
2. Documentation sufficient to explain the basis for, and the specific circumstances of, each exception;
3. Record retention;
4. Staff training;
5. Monitoring/auditing of compliance with policies & procedures;
6. Corrective action, when appropriate; and
7. Management and/or board of directors oversight of the risk associated with exceptions.

Monitoring could include specific 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.

There is no single "right" way to develop a system for effectively managing the fair lending risk associated with discretionary pricing, and the CFPB report noted that lenders may adopt different systems depending on the size and complexity of their businesses, among other factors. Nevertheless, 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.

## The Exercise of Discretion

Based on the definition we provided, 85% of survey respondents indicated that they allow some degree of pricing discretion, as shown in Table 1, though the range of discretion and who exercises it varies a fair amount. The survey results suggest that the allowance of discretion differs somewhat by type of mortgage lender. Specifically, 91% of mortgage company respondents permit some amount of discretion compared to 75% of the banks or bank affiliates in the sample.

Table 1

| Permit Discretion? | Count | Percent |
|---|---|---|
| No | 10 | 14.7% |
| Yes | 58 | 85.3% |
| Total | 68 | 100.0% |

Of the lenders who permit discretion, 98% permit pricing reductions (often referred to as concessions or underages), while 44% permit discretionary price increases (often referred to as overages or premiums), as shown in Table 2. A majority of the respondents permit only price reductions, but 42% permit both reductions and increases, and one respondent only allows price increases. We initially found the number of respondents allowing discretionary price increases to be surprising, and out of line with our own experience. Furthermore, due to the loan originator compensation rules under Regulation Z, there should be no direct incentives for loan originators to increase pricing on a discretionary basis, even though pricing upward increases the company's profits. After checking with 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 cannot rule out that some lenders in the sample increase pricing on a discretionary basis without an offsetting lender credit.

Table 2

| Type of Discretion | Count | Percent |
|---|---|---|
| Both increases & reductions | 22 | 42.3% |
| Price reductions only | 29 | 55.8% |
| Price increases only | 1 | 1.9% |
| Subtotal: Permit reductions | 51 | 98.1% |
| Subtotal: Permit increases | 23 | 44.2% |
| Total | 52 | 100.0% |

Not surprisingly, the most common reason for allowing discretionary price reductions is meeting a competing offer, which is permitted by 94% of the lenders responding to this question, as shown in Table 3. 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). Only three lenders reported that they do not allow price reductions to meet competition, but they do allow reductions for other reasons: either due to post-lock renegotiation, to address customer service issues or operational errors, or to avoid triggering "high cost" loan requirements under the Home Ownership and Equity Protection Act.

In addition, one lender indicated that a pricing concession may be given to ensure that the loan meets the requirements of a "Qualified Mortgage."[2]

Table 3

| Reason for Discretionary Reduction | Count | Percent |
|---|---|---|
| Meet competitive offer | 49 | 94.2% |
| Renegotiation after rate lock | 40 | 76.9% |
| Address customer service issue or operational error | 39 | 75.0% |
| Needed to avoid High Cost Loan | 36 | 69.2% |
| Change in loan parameters after lock | 34 | 65.4% |
| Borrower needed closing cost assistance | 30 | 57.7% |
| Reward customer relationship/loyalty | 23 | 44.2% |
| Needed to meet Net Tangible Benefit test | 22 | 42.3% |
| Compensating risk factors justify lower pricing | 9 | 17.3% |

Another area in which discretionary pricing can arise is in providing lender credits to the borrower to cover closing costs. Since the 2011 loan origination compensation rules went into effect, we have found that many lenders have adopted a pricing policy that requires the loan originator to select the lowest available note rate that does not require the borrower to pay discount points (i.e., that does not result in a loan price below par). In some cases, that approach to pricing 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 increments of one-eighth of a percentage point, there is not always a rate available that yields exactly a 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 and/or to reduce the principal balance (to the extent that is possible given the requirements investors, government-sponsored enterprises and regulations); some keep it as extra revenue for the company; and some allow discretion over how much is credited to the borrower. Among our survey respondents, 44% reported that they allow discretion in whether to credit any premium revenue to the borrower, and 56% do not allow discretion.

We also inquired about who within the lender's organization has some degree of authority to exercise discretion in pricing, and how much latitude staff in different positions have. As shown in Table 4, we found that some degree of discretionary pricing authority resides with the secondary markets department for 80% of the lenders, and a slightly smaller percentage vest some pricing authority in a company executive. Only 40% of respondents allow branch managers some authority for pricing discretion, and only one-third give such authority to loan officers.

[2] "Qualified mortgages," are defined under 12 CFR Part 1026.

Table 4

| Has Pricing Discretion Authority | Count | Percent | Median Limit on Adjustments (basis points) |
|---|---|---|---|
| Loan Officer | 15 | 33.3% | 25.0 |
| Branch Manager | 18 | 40.0% | 45.0 |
| Secondary Markets Department | 36 | 80.0% | 75.0 |
| Compliance or Fair Lending Officer | 14 | 31.1% | 62.5 |
| Company, Region or Division Executive | 34 | 75.6% | 100.0 |

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

Not surprisingly, the Secondary Markets Department typically has a wider range of pricing discretion (a median of 75 basis points) than loan officers or branch managers and company executives have even wider discretion (a median of 100 basis points), with two respondents indicating that executives have no specific limits on their pricing discretion.

Not all of the respondents specify their limits on pricing discretion in terms of basis points of the loan amount, however. One respondent stated that limits were denominated in terms of a percentage of target profit per loan. Another lender specifies limits in terms of margin: that is, the branch manager has discretion up to 100% of the branch margin, the Secondary Markets Department has discretion up to 100% of the company margin, and the executive in charge of production has full discretion to make any adjustment he or she deems necessary. Another lender indicated that loan officers have discretion only over how much of a pricing premium to credit to the borrower to cover closing costs.

Survey respondents varied in terms of the role that their compliance or fair lending officer plays in approving discretionary pricing adjustments. The range of scenarios that trigger a compliance approval among survey respondents included the following:

- All adjustments from standard pricing.
- Anything besides a competitive situation or a rate renegotiation.
- Underages greater than 25 basis points.

- Anything outside of two note rates above or below par (from the schedule of available note rates).[3]
- Requests for discretion outside of policy limits.
- Concessions used to cure a fee limitation (e.g., a Good Faith Estimate tolerance cure or avoiding a Higher Priced Mortgage Loan).

## 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 recommendations noted above suggest that lenders should have some sort of documentation that identifies, at the very least, 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 that 76% of survey respondents have a written policy or procedure governing the exercise of pricing discretion. However, only 53% 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 that 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 that they document something about their discretionary pricing adjustments: either the existence of an adjustment, the amount of the adjustment, the reason for the adjustment or the approval of the adjustment, or some combination of these, as shown in Table 5. However only about 77% of respondents indicated that they document all of these things.

Table 5

| What is Documented? | Count | Percent |
|---|---|---|
| Presence of an adjustment | 40 | 88.9% |
| Amount of the adjustment | 42 | 93.3% |
| Reason/justification for the adjustment | 44 | 97.8% |
| Approval of the adjustment | 37 | 82.2% |
| All of the above | 35 | 77.8% |

Respondents varied in terms of where they store information about pricing discretion. To facilitate 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%) 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% record the amount of a pricing adjustment as data, 69% record the reason for the adjustment as data, and 58% record the approval as data.

[3] For example, if rates are specified in one-eighth increments, the range of permitted discretion would be plus or minus 0.250%.

Only three of the 45 respondents to this question (7%) indicated that they store such information only in paper or imaged loan files.

The loan origination system is the most common computer system repository (73% of respondents), followed by a pricing engine or other secondary markets system (40%). Eight of the respondents (18%) maintain a stand-alone log or spreadsheet of discretionary pricing adjustments, and four (9%) use such a log or spreadsheet as their only form of documentation.

Even though 89% store some amount of discretionary pricing adjustment information in a data format, not all of those lenders regularly monitor the frequency and amounts of pricing adjustments: overall 80% said that they conduct some form of regular monitoring of pricing discretion. And, of those who perform regular monitoring, about two-thirds perform fair lending monitoring that specifically examines differences in discretionary pricing adjustments based on race, ethnicity or gender. Therefore, overall only about 53% of respondents (two-thirds of 80%) monitor their discretionary pricing for fair lending risk.

Finally, we found that only 23% 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 customer or loan officer 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 their 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. However, we found that fewer than one-half (48%) of the respondents regularly have pricing discretion reports or logs reviewed by a senior executive or a management committee (e.g., compliance committee, management committee or board of directors). Of those that do have such a management review process, 86% document that review in some way (e.g., in meeting minutes).

## Concluding Comments

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 mortgage lenders need to improve in order to effectively manage their fair lending pricing risk and to meet regulatory expectations regarding compliance risk management.

## About the Survey

CRA and Garrett McAuley solicited 177 mortgage lenders for the survey, with responses collected using an internet-based survey instrument. A total of 68 lenders responded to all or part of the survey. The institutions surveyed included both depository and non-depository institutions. Because the lender sample was drawn from our lists of clients and industry acquaintances, it cannot be considered an entirely random and representative sample of the mortgage industry. In particular, non-depositories are overrepresented relative to depositories in terms of both their numbers and their shares of mortgage loan originations. Nevertheless, we believe that the sample contains a sufficient diversity of lender types and sizes to be an informative and useful view into current industry practices, particularly for non-depository lenders.

The composition of the respondent population is shown in Table 6 for the respondents who provided this information. Survey respondents who provided information about their size had monthly loan origination volume ranging from a low of $1 million to a high of $15 billion, with a median of $50 million.

Table 6

| Entity Type | Count | Percent |
|---|---|---|
| Bank or Bank Affiliate | 12 | 17.6% |
| Credit Union | 1 | 1.5% |
| Mortgage Company | 29 | 42.6% |
| Information Not Provided | 26 | 38.2% |
| Total | 68 | 100.0% |

Retail and consumer direct lenders were most heavily represented in the sample, as shown in Table 7, but the sample also included some wholesale and correspondent lenders, as well as multi-channel lenders.

Table 7

| Channels | Count | Percent |
|---|---|---|
| Correspondent Only | 3 | 4.4% |
| Retail/Consumer Direct Only | 25 | 36.8% |
| Retail/Consumer Direct & Correspondent | 5 | 7.4% |
| Retail/Consumer Direct & Wholesale | 3 | 4.4% |
| Retail/Consumer Direct, Wholesale & Correspondent | 5 | 7.4% |
| Wholesale & Correspondent | 1 | 1.5% |
| Information Not Provided | 26 | 38.2% |
| Total | 68 | 100.0% |

## About the Authors

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