

Fair and Responsible Banking

Session 2 Documentation Best Practices

October 6, 2015

Agenda

- Creating fair and responsible banking risk assessments.
- Using risk assessment results to drive testing and monitoring resources.
- Testing and monitoring-Ideas for enhancing your documentation.
- Management reporting.

Building a Fair and Responsible Banking Risk Assessment

Where do I start

A fair lending risk assessment is a tool to systematically evaluate an institution's fair lending risk, how well it manages that risk, and the likelihood that it is complying with fair lending laws and regulations.

Subjective vs Objective Risk Assessments

Which is better

Subjective

- Easier to complete
- Requires more judgment
- Limited by opinion, bias, lack of knowledge
- More difficult to defend
- Harder to trend

Objective

- Are generally repeatable
- Calculations can be complex and time consuming
- Easier to defend
- Enhances consistency across products and business lines

Building a Risk Assessment

What do I measure?



Building a Risk Assessment

Where are my risks?



Building a Risk Assessment

How do I measure my risk?

What is Inherent Risk

- Generally defined as the risk of violating any fair and responsible banking related rule, regulation or guidance, without taking into consideration any controls that may be in place to mitigate said risks

Likelihood x Impact = Inherent Risk

Building a Risk Assessment

How do I determine what factors to use?

Likelihood

- Exam Emphasis
- Complexity of Products
- Changes in Regulations
- Change in Transaction Volume

Impact

- Monetary Fines
- Reputational Risk
- Consumer Impact
- Enforcement Action

Building a Risk Assessment

How do I build risk scales?

Change in Transaction Volumes

- 0 - Not applicable - No transaction volume
- 1 - Transaction volume remained relatively stable from prior year (changes of less than 5%)
- 2 - Minor increase in transaction volume from prior year (5% and above, but less than 10%)
- 3 - Moderate increase in transaction volume from prior year (10% and above, but less than 50%)
- 4 - Significant increase in transaction volume from prior year (50% and greater)
- 5 - Significant increase in transaction volume from prior year (50% and greater) and significant increase planned for next year

Building a Risk Assessment

Putting it all together

| # | Direct Auto Lending Description of Risk | Regulation Impacted | Citation | Enforcement Action | Reputational Impact | Change in Transaction Volumes | Significant change in regulatory requirements | Percent of Total Score | Inherent Risk |
|--|--|---------------------|------------|--------------------|---------------------|-------------------------------|---|------------------------|---------------|
| | Weight | | | 10 | 7 | 7 | 6 | | |
| | Max score for category | | | 5 | 5 | 5 | 5 | | |
| | Max weighted score | | | 50 | 35 | 35 | 30 | 150 | |
| Fair Lending Underwriting Risks | | | | | | | | | |
| 1 | The Bank or vendor discriminates against an applicant on a prohibited basis regarding any aspect of a credit transaction. Prohibited basis means race, color, religion, national origin, sex, marital status, or age (provided that the applicant has the capacity to enter into a binding contract); the fact that all or part of the applicant's income derives from any public assistance program; or the fact that the applicant has in good faith exercised any right under the Consumer Credit Protection Act or any state law upon which an exemption has been granted by the Bureau. | ECOA | 1002.4 (a) | 4 | 5 | 1 | 2 | 63% | High |

| Risk Scale | |
|------------|--------|
| Very High | 81-100 |
| High | 61-80 |
| Medium | 41-60 |
| Low | 21-40 |
| Very Low | 0-20 |

Building a Risk Assessment

Putting it all together (another way)

| | | Impact | | | | |
|------------|----------------|---------------|------------|----------|-----------|-------------|
| | | Insignifigant | Negligible | Moderate | Extensive | Signifigant |
| Likelihood | Almost Certain | 6 | 7 | 8 | 9 | 10 |
| | Likely | 5 | 6 | 7 | 8 | 9 |
| | Possible | 4 | 5 | 6 | 7 | 8 |
| | Unlikely | 3 | 4 | 5 | 6 | 7 |
| | Rare | 2 | 3 | 4 | 5 | 6 |

| Risk Scale | |
|------------|------|
| Very High | 9-10 |
| High | 7-8 |
| Medium | 6 |
| Low | 4-5 |
| Very Low | 2-3 |

Building Risk Assessment

What types of controls are there

| Type of control | General Effectiveness | Examples |
|---------------------|-----------------------|--|
| Directive | Least Effective | Corporate Policies Procedures Pricing Guidelines Underwriting Guidelines |
| Detect or Remediate | Effective | Supervisor Reviews Exception Reporting Post Closing Reviews |
| Preventative | Most Effective | Automated Testing User Access Programmed tolerances |

Building Risk Assessment

What are some sample control effectiveness levels

Highly Effective

Effective

Moderately Effective

Somewhat Effective

Not Effective

Effectiveness
Considerations

Is it:

- Documented
- Repeatable
- Updated regularly
- How reliable is it
- When does it happen in the process
- Tested regularly
- Reported

What is my Overall Risk

How to Determine Residual Risk

Inherent Risk x Control Effectiveness = Residual Risk

| | | Residual Risk Rating | | | | |
|----------------------|-----------|------------------------------|-----------|----------------------|--------------------|---------------|
| | | Very High | High | Medium | Low | Very Low |
| Inherent Risk Rating | Very High | Medium | High | Very High | Very High | Very High |
| | High | Low | Medium | High | High | High |
| | Medium | Very Low | Low | Medium | Medium | Medium |
| | Low | Very Low | Very Low | Low | Low | Low |
| | Very Low | Very Low | Very Low | Very Low | Very Low | Very Low |
| | | Very Effective | Effective | Moderately Effective | Somewhat Effective | Not Effective |
| | | Control Effectiveness Rating | | | | |

What is my Overall Risk

How to Determine Residual Risk

| | Risks | Controls | | | | | | Risks |
|---|--|--|---|-----------------------------|---|---|----------------------|--------|
| Direct Auto Lending Product Risk | Inherent Risk | Mitigation Controls | | | | | Residual Risk | |
| # Description of Risk | Actual Inherent Risk | Directive | Detect and Remediate | Preventive | Final Control Effectiveness Rating | Comments/ Changes from prior Risk Assessments | Actual Residual Risk | |
| | | Policy, Procedure or Training in place to address risk | Manual Controls in place or Quality Control Completed Regularly | Reporting to Mgmt. in Place | Process in place at all times to control for fair lending issue | | | |
| Fair Lending Underwriting Risks | | | | | | | | |
| 1 | The Bank or vendor discriminates against an applicant on a prohibited basis regarding any aspect of a credit transaction. Prohibited basis means race, color, religion, national origin, sex, marital status, or age (provided that the applicant has the capacity to enter into a binding contract); the fact that all or part of the applicant's income derives from any public assistance program; or the fact that the applicant has in good faith exercised any right under the Consumer Credit Protection Act or any state law upon which an exemption has been granted by the Bureau. | High | Somewhat Effective | Highly Effective | Effective | None | Effective | Medium |

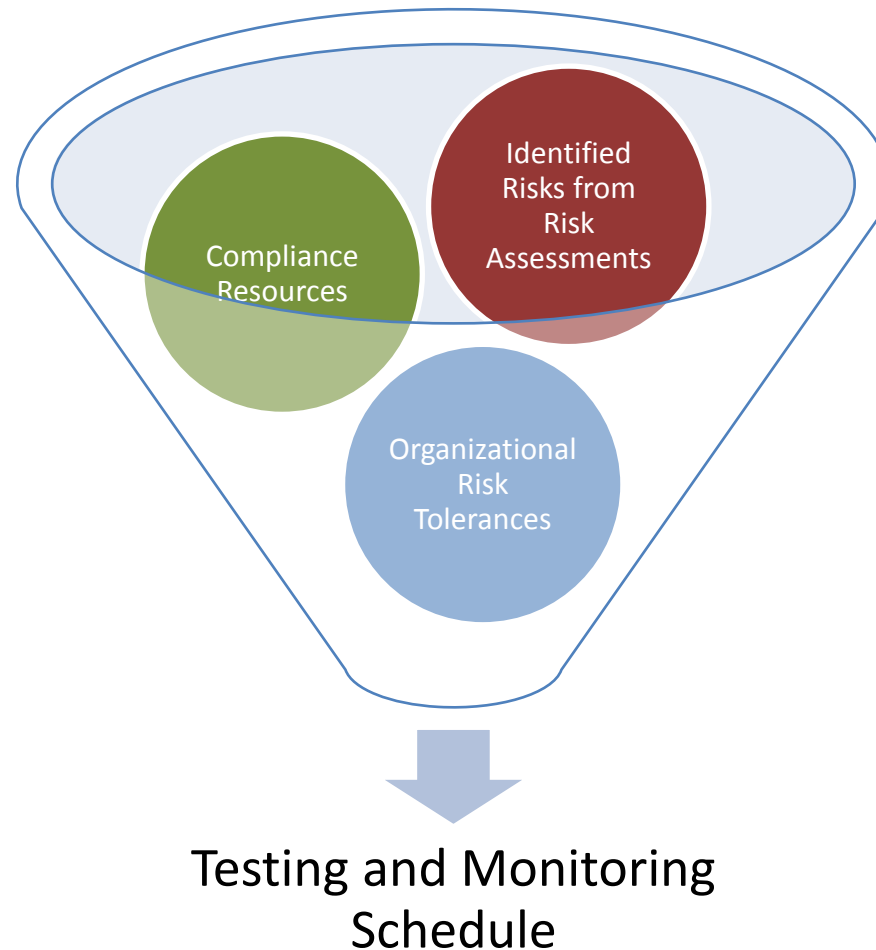
Using a Risk Assessment to drive program

What are my risk levels?



Using risk assessment results to drive testing and monitoring resources

How to prioritize Reviews and Monitoring



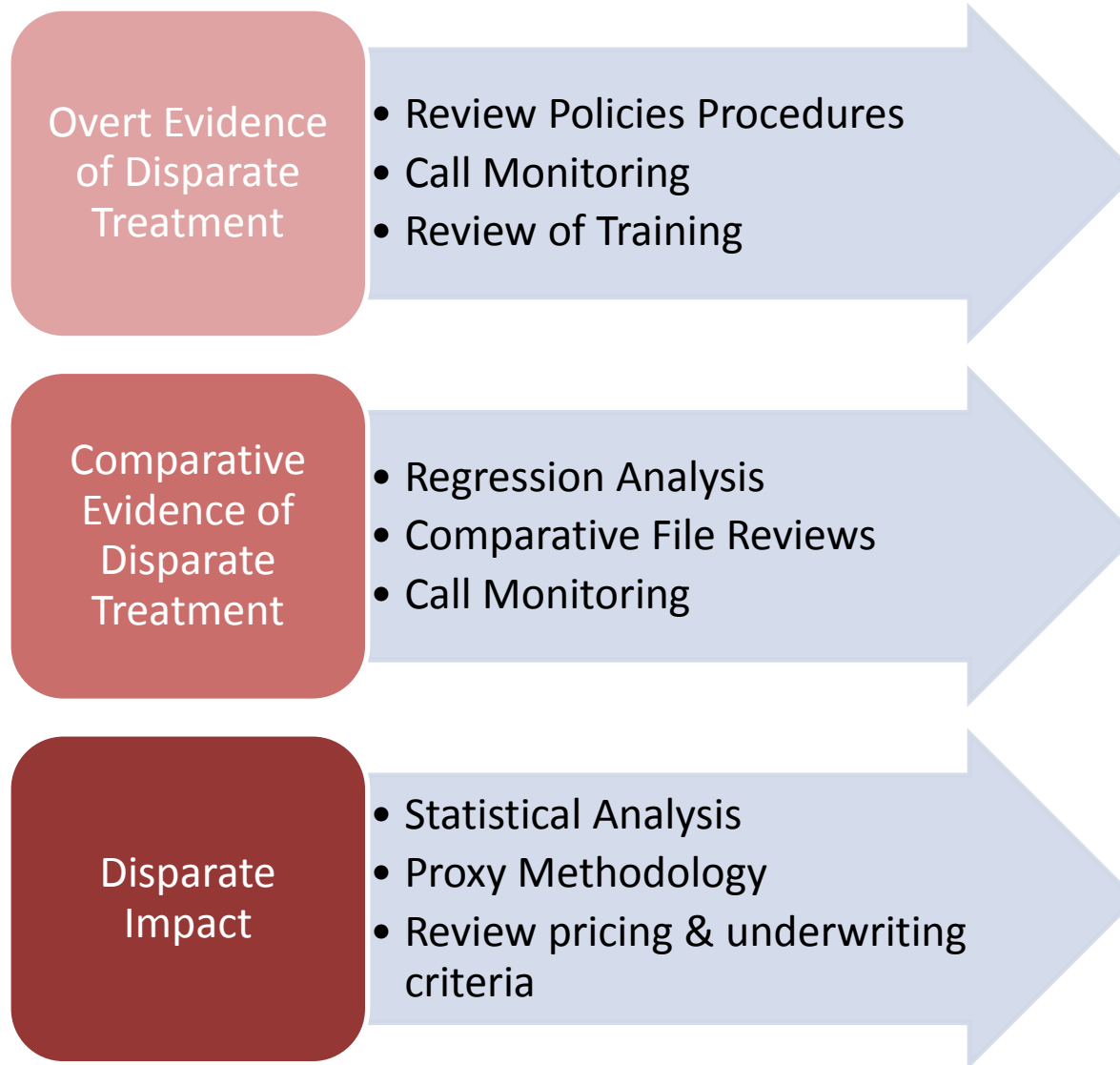
Using risk assessment results to drive testing and monitoring resources

Creating a calendar

| | | | | | | | Week Starting | | 29 | 5 | 12 | 19 | 26 | 2 | 9 | 16 | 23 | 2 | 9 | 16 | 23 |
|------------------------|----------------------------|-------------------|-----------|-----------|-------------------|-----------|---|------------|-----------|---|----|----------|----|---|-------|----|----|---|---|----|----|
| Frequency | Review | Planning | Testing | Reporting | Corrective Action | Total | Manager | Employee 1 | January | | | February | | | March | | | | | | |
| Quarterly | HMDA Validation | 2 | 10 | 5 | 1 | 18 | 8 | 10 | | ■ | ■ | | | | | | | | | | |
| Lending Testing | | | | | | | | | | | | | | | | | | | | | |
| Y4 | Direct Auto Lending Review | 10 | 10 | 10 | 5 | 35 | 15 | 20 | | | | | | | | | | | | | |
| Y3 | Credit Card Underwriting | 10 | 10 | 10 | 5 | 35 | 14 | 21 | | | | | | | | | | | | | |
| Monitoring | | | | | | | | | | | | | | | | | | | | | |
| Quarterly | 1st Mtg Pricing Exceptions | | 2 | 1 | | 3 | 3 | | | | | | | | | | | | | | |
| On-Going | Complaints | | 2 | 1 | | 3 | 3 | | | | | | | | | | | | | | |
| | | Total Days | 22 | 34 | 27 | 11 | 94 | 43 | 51 | | | | | | | | | | | | |
| New in 2015 | | | | | | | | | | | | | | | | | | | | | |
| | | | | | | | Completed | √ | | | | | | | | | | | | | |
| | | | | | | | In progress | — | | | | | | | | | | | | | |
| | | | | | | | Planned | ▲ | | | | | | | | | | | | | |
| | | | | | | | Management Final Review and Action Plan | ■ | | | | | | | | | | | | | |
| | | | | | | | Update to Board of Directors | + | | | | | | | | | | | | | |
| | | | | | | | Announcement memo issued (Actual) | • | | | | | | | | | | | | | |
| | | | | | | | Critical Info Requested | ▲ | | | | | | | | | | | | | |
| | | | | | | | Critical Information Received | ■ | | | | | | | | | | | | | |
| | | | | | | | File Review (Anticipated) | + | | | | | | | | | | | | | |
| | | | | | | | Fieldwork completed (Actual) | • | | | | | | | | | | | | | |
| | | | | | | | Report - Initial findings Issued (Actual) | ▲ | | | | | | | | | | | | | |
| | | | | | | | Report - Final Issued (Actual) | ■ | | | | | | | | | | | | | |

Documentation of Testing and Monitoring

What should I test for and how can I document?



Documentation of Testing and Monitoring

What should a review consist of?

Planning

- Announcement Memo / Kick off meeting
- Review risk assessment – Identify key changes
- Review policies and procedures
- Review previous testing (Compliance, Internal Audit, Exams)
- Review Exam Manuals
- Determine scope of the review
- Document planning process

Testing

- Identify key controls
- Determine sample methodology
- Determine type of testing
 - Test of controls
 - Transactional Testing
- Create review templates (work papers)
- Perform testing
- Document work papers

Documentation of Testing and Monitoring

What should a review consist of?

Validate Findings / Determine Corrective Action

- Engage business partners / SMEs to validate initial findings
- Determine appropriate corrective action, including for example:
 - Process/System changes
 - Manual workaround to prevent recurrence until systems are updated
 - Remediation to impacted customers
- Determine an appropriate timeline to complete corrective action

Reporting

- Executive summary
- Overall rating (Acceptable, Needs Improvement, Deficient)
- Observations
- Corrective action plans with business owner and due date

Follow-up

- Track and report open issues until they are resolved
- Ensure past due issues are appropriately escalated
- Document resolutions and conduct follow-up to confirm corrective action was effective
- Update Risk Assessments based on action plans

Management Reporting

Who should receive fair and responsible banking updates

Bank Board or Sub-Committee

- High level overview of Annual Risk Assessments
- Overview of Review Findings
- Status of Corrective Action

Management

- Detailed Review Reports
- Marketing Analysis
- Fair and Responsible Banking monitoring trending

Compliance Department

- All review and monitoring documentation
- List of final findings and action plans and remediation efforts
- Review calendar

Testing and monitoring

Post mortem: What are ideas for enhancing your documentation

Updating testing and monitoring documentation

- Planning Documents
- Review Work papers
- Procedures

Updating Trending Graphs

- Exception Levels
- Complaints
- Volumes

Repurpose Reporting and Guidance

- Complete and document data validation efforts- **Regulatory hot topic**
- Leverage regulatory and internal resources-Don't re-create the wheel
- Monitor Industry trends to enhance internal program

Update your risk assessment

- Update Risk Assessments at least annually or more frequently based on size on complexity of your organization
- Update documentation as regulations and guidance change
- Have business units complete self assessments

Documentation

What is enough?

