# How to Identify and Address Fair Lending Red Flags

Regardless of the administration or regulatory environment, all lenders should strive to avoid fair lending risk.

When evaluating fair lending risk, does your institution overlook any areas? Where does your focus lie? Too often, lenders focus on the mountain ahead (their overall risk management strategy) but fail to address the pebble in their shoes (commonly overlooked red flags). Too often, these pebbles can become boulders and, if not mitigated, become more significant issues that affect the entire institution.

With that in mind, here are eight common red flags that could indicate potential fair lending risks and actionable strategies to address them.

1. **Discretion or Exceptions in Underwriting and Pricing**

While flexibility in lending can be beneficial, it's vital to check the compliance boxes. To do this, establish clear guidelines for decision-making. Monitor the frequency of exceptions to identify trends that may warrant policy reassessment. Additionally, document the reasons for each exception, including triggers and compensating factors, as this helps balance flexibility and discipline.

A robust approval process requiring necessary signatures should be implemented, alongside thorough documentation of exceptions and their justifications. Finally, conducting regular comparative reviews with the compliance team ensures that similarly situated individuals are treated equitably.

Your institution can manage exceptions while fostering accountability by staying vigilant in the underwriting and pricing process.

2. **Lack of Clear Standards for Product Referrals**

Steering—or deliberately guiding applicants toward or away from certain loan products or lending channels on a prohibited basis—can raise compliance risks. The FDIC notes that steering risk arises when there are unclear or inconsistently applied standards for referring loan applicants to specific channels, classifying them as "prime" or "sub-prime" borrowers, and determining which alternative loan products to offer based on their status.

To mitigate steering risk, create and enforce clear, objective, and consistent standards for product referrals at your institution. Regular training and review sessions should be conducted to ensure all team members understand these guidelines and implement them consistently.

### 3. Overlooked Audit Findings

Findings from exams and audits are crucial indicators of where improvements are needed. They highlight weaknesses or challenges, but often lenders don't address known issues, leading to significant problems down the road, including penalties and reputational loss.

To effectively manage findings, establish a process for tracking and addressing them promptly. Regular reporting to the board can help keep everyone informed and accountable for remediation activities.

### 4. Infrequent Complaints

No complaints, no problems, right? Think again.

An absence of complaints indicates you don't have a proper consumer complaint resolution process. After all, consumer complaints are a part of doing business, and when utilized properly, they don't only identify potential risks—they can improve processes.

A consumer complaint program should include established policies and procedures, specialized staff training, and ongoing monitoring to identify trends and prevent recurrence of issues. When your institution receives a complaint, evaluate it for potential violations by assessing the root cause, severity, duration, and pervasiveness of the harm caused.

### 5. Incentivizing Noncompliance

Do your compensation structures encourage behaviors that could compromise fair lending principles? The consequences of incentivizing noncompliance can be significant, as Wells Fargo learned a few years ago when the institution agreed to pay a $3 billion settlement for consistently pressuring employees to meet unrealistic sales goals, leading to millions of unauthorized accounts and misuse of customer information.

Wells Fargo's problems were caused by a lack of compliance culture. An important part of a strong compliance culture is a properly managed compensation policy, documented and defined plans for those policies, and continued monitoring. This process is especially important for loan originator compensation, as it's a key source of fair lending risk.

### 6. Weak Compliance Management

A comprehensive fair lending compliance management program is non-negotiable.

Ensure your program includes board oversight, regular risk assessments, documented policies, training, independent reviews, self-testing, and robust complaint management. The right compliance management solution can streamline many tasks, saving your team valuable time and resources.

7. **Failure to Analyze Loan Data**

Your data tells a story, but if you fail to analyze it regularly, you miss strategic opportunities to improve your lending practices and risk compliance problems.

Start by analyzing your loan data against census and peer data, particularly your HMDA loan application and origination data. Ensure your peers are appropriately defined, as being in the same market doesn't guarantee similarity in product mix.

When reviewing the data, consider how it aligns with census data and market HMDA lending and whether it suggests under-servicing protected groups or specific income areas. After your analysis, share findings with senior management and create an action plan to manage risk and address disparities.

Document all decisions and business reasons for transparency with regulators. Remember, regardless of the current administration and regulatory environment, your institution can be criticized in the future for failing to manage fair lending risk now.

8. **Ignoring Risk Indicators**

Stay proactive by integrating risk indicators into your overall compliance strategy. Risk indicators for lenders include a high percentage of first-payment default loans, a high rate of customer complaints, or a higher-than-usual fraud rate.

Regularly monitor industry trends and regulatory updates that could influence your lending practices. Being informed will help you adapt quickly and address potential risks before they escalate.

By acknowledging these red flags and implementing effective strategies to mitigate them, lenders can enhance their fair lending practices, foster a culture of compliance, and ultimately serve their communities better. Remember, proactive management of fair lending risk is not just about compliance; it’s about building trust and maintaining a strong reputation in the market.