

RISK

MANAGEMENT

New Challenges for Compliance Analytics

Balvinder Sangha

Ernst & Young LLP



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Subprime Mortgage Crisis in 2007

- While early to conclude that the fall-out from this market upheaval is over, key features of this event:
 - Secondary market re-priced the risk as delinquencies spiked.
 - Rate resets and payment shock coupled with softening home prices contributed to the loss of investor confidence.
 - Non-traditional mortgages the prime suspect.
 - Role of mortgage brokers under scrutiny.
 - The originate-and-sell business model of some subprime mortgage companies unraveled quickly.
 - Delinquency trends project higher future foreclosures.
- Political reaction was swift – legislation proposed for creating “suitability-type” standards, restrictions on non-traditional products, and calls for forbearance on foreclosures.
- Activists have seized this opportunity to rally against predatory and irresponsible lending.



Immediate Impact of the Crisis

- Subprime market capacity shrank considerably by 25–30%, as some lenders ceased operations, and more capacity reduction is likely.
 - New entrants to the origination market:
 - Investment banks that have traditionally focused on securitization creating vertical integration,
 - Private equity hedge funds.
- Self-imposed tightening of underwriting standards across the entire product spectrum.
- Regulatory focus on affordability driven by the Non-traditional Mortgage Guidance, 2006.
- Evolving legislative proposals and litigation that approach a “suitability-type” standard.

Fair Lending Implications

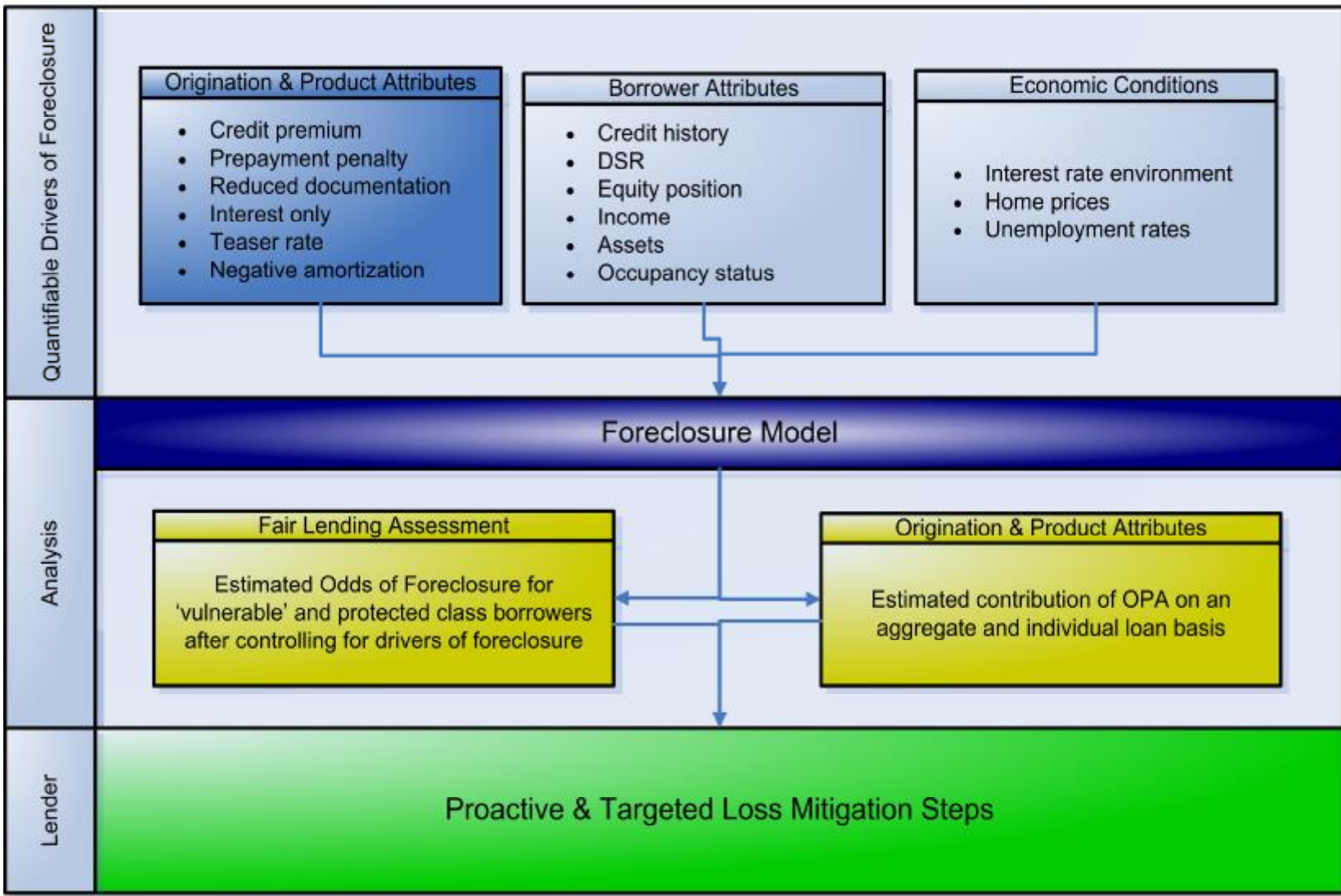
- Reduction in access to credit for the marginal borrower is likely to raise denial rate disparities for minorities causing a re-focus on underwriting disparities,
- Regulatory expectations on lender role in monitoring third-party pricing compliance to continue,
- The potential for disproportionate foreclosures of minorities will cause concerns on consistency in servicing and loss mitigation processes,
- A renewed emphasis on product placement consistency a likely fair lending issue,
- New entrants to the market introducing innovative risk models, coupled with the release of Fed study on credit scoring, will put the spotlight on disparate impact.



Foreclosure Analysis

- Ensuring consistency in the loss mitigation process which involves fact-specific and one-on-one negotiations.
 - High-level assessment of trends in the loss mitigation data
 - Multinomial (accounting for multiple outcomes) approaches to quantify the likely outcomes.
- Aligning forbearance strategy with litigation risk exposure.

Foreclosure Analysis



Product Placement Analysis

- New twist to the steering analysis beyond prime and subprime designation.
- The recent congressional hearings as well as some settlements have intensified the pressure to ensure that customers are not being steered to higher cost add-ons – NINA, SISA, etc.
- A very tough standard to implement since consumer preferences and needs are difficult to analyze. Some approaches used by lenders:
 - A customer segmentation analysis by transaction attributes may be useful to identify anomalies.
 - A quantitative model approach may also be used to predict the likely product placement based on transaction attributes, and identify borrowers that deviate from the expectation.



Disparate Impact Analysis

- Steps in evaluating disparate impact are:
 - Identify the variable(s) with highest adverse impact
 - Evaluate whether the variable(s) can be justified by business necessity, and also
 - Evaluate whether the business necessity can be achieved with an alternative variable(s) with less disparate impact.
- Potential for disparate impact is not limited to scoring models and could involve rate sheets, pricing policies, and other tools related to credit extension.
- Since business necessity is an ambiguous concept, quantify the business benefit/loss relative to the alternative standards.

- The current environment has heightened the risk of predatory lending concerns in addition to fair lending allegations, with a particular emphasis on:
 - Concern of potentially unjustifiable foreclosures is very high due to political sensitivity of the issue, resulting in calls for forbearance, suitability standards, lender liability, and intensified regulatory scrutiny.
 - Broker compensation and actions will continue to receive regulatory attention,
 - Potential disparate impact will become an issue as the industry re-examines risk in the post-meltdown subprime mortgage market dominated by vertically integrated companies
- Compliance analytics need to evolve to keep pace with the emerging consumer protection issues.

Quantitative Economics and Statistics

Balvinder.Sangha@ey.com

(202) 327-8373



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www.ey.com

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