Eight Steps to the Risk Assessment of Loan Production
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The Consumer Financial Protection Bureau (Bureau) urges the importance of risk assessments. Indeed, its own risk assessment process is designed to evaluate on a consistent basis the extent of risk to consumers arising from the activities of a particular supervised entity and to identify the sources of that risk. In this article, I will provide a set of guidelines to assess certain risks associated with loan production.

"Risk to consumers" is a key phrase used by the Bureau for the purpose of assessing risk. That is, risk assessments must be directed at determining the potential for consumers to suffer economic loss or other legally-cognizable injury as a result of a violation of federal consumer financial law.[1]

In order to determine the risk to consumers, a proper Risk Assessment should consider the interaction of two broad sets of factors:

1. The inherent risks in a particular line of business or the entity as a whole, and
2. The quality of controls implemented by the entity to manage and mitigate those risks.

A Risk Assessment is actually undertaken by the Bureau during its supervision planning process to set priorities and focus examination and supervision activities.

Inherent risks include factors that increase the potential for unfair, deceptive or abusive acts or practices (UDAAP), for discrimination (i.e., fair lending), or for violations of other Federal consumer financial laws. It also includes factors that increase the compliance management challenges of a business and thereby increase the risk of such violations.

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With regards to the quality of risk controls, various factors are considered, including those factors relating to both managing and mitigating specific, inherent risks as well as the strength of an entity's overall system of compliance management.

The following eight steps can help a residential mortgage lender and originator to conduct risk assessments of individual lines of loan production.[2] The risk assessment is not a determination of whether a violation of law exists; however, it is foundational in disclosing strengths and weaknesses in the loan flow process.[3]

Eight Steps to Assessing the Risks in Loan Production

1. Assess the level of retail and/or wholesale originated (broker or correspondent) mortgage loans relative to overall production. Significant increases or a disproportionate percentage can present the originator with substantial credit, pricing, recourse, and liquidity risk.

2. Assess the volume of nonconforming, subprime, Alt-A, or nontraditional mortgage loans originated by the originator and by the industry. The company should have a robust mortgage origination process (i.e., processing and underwriting) and several funding options to avoid potential liquidity issues. Rapid increases in such loans may signal a significant buildup of credit, operational, and compliance risks within the company and across the system.

3. Review the company's strategy to originate for the portfolio versus originating for sale, and determine the extent to which mortgage loans originated for sale are transferred to the portfolio. Portfolio increases beyond strategic plans may be representative of systemic or staffing issues in the origination process. Significant variations in standards used to underwrite loans for sale versus loans for the portfolio may be cause for concern.

4. Determine whether the originator has high or an increasing level of policy exceptions. The pressure to acquire assets and achieve revenue targets may be driving the company to ignore characteristics that have been proven to cause higher levels of default and repurchase requests.

5. Determine whether the company is loosening underwriting standards without other compensating factors and adequate funding sources. Excessive underwriting flexibility without investor or senior management approval is likely to prove harmful to the company at different levels.

6. Determine whether the originator has a high level of missing documents on closed loans. High volumes and poorly defined pre-funding review processes can lead to high levels of rejections or repurchase requests.

7. Review the number and nature of QC, audit, and consumer compliance findings. Originators should ensure that consumers have clear and balanced information about the menu of products being offered by the company. Failure to do so may be in violation of federal and state laws and regulations.

8. Determine whether the company has sufficient policies, procedures, and staff to comply with requirements related to the origination of mortgage loans set forth in federal law (including RESPA (Regulations X) and TILA (Regulation Z), state law, and investor requirements. The company should pay particular attention to the assessment of consumers' ability to repay the loan, appraisal requirements, loan originator registration and licensing obligations, loan originator compensation limitations, and disclosure requirements.

The foregoing eight factors bear on inherent risk and relevant risk controls involving loan production.

The Bureau's Examiners will conduct their own risk assessment and rate each relevant factor (i.e., low, moderate, or high inherent risk; strong, adequate, or weak risk controls and mitigation), and they will comment briefly on the basis for each rating and the issues to consider during the examination. These factors involving loan production, and other facets of a company (i.e., management and supervision, internal and external audits, information technology, secondary marketing, servicing, mortgage servicing asset, and so forth), factor into the ratings, taken as a whole, which result in a Risk Summary.

The Risk Summary is the Bureau's conclusion about whether the overall risk to consumers is low, moderate, or high. Furthermore, the Risk Summary also includes a judgment about the expected change in the overall risk (decreasing, increasing, or stable/unchanged), and when that direction last changed. Finally, the Risk Summary is then included in the Examination Report issued by the Bureau.

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[1] Supervision and Examination Manual, *Consumer Risk Assessment*, V.2 (October 2012), Consumer Financial Protection Bureau

[2] Assessments of individual lines of business in large complex entities may be considered together to reach conclusions about the entity as a whole.

[3] Mortgage Banking, *Examination Procedures*, pp 92-93, Office of the Comptroller of the Currency, February 2014