Professional Perspective

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Risks & Opportunities of Regulatory Focus on Fair Lending

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In the first year of the Biden administration, the Consumer Financial Protection Bureau actively ramped up its fair lending investigations and enforcement activity. As the acting director explained, the CFPB has rededicated itself to "robust enforcement" of the nation's fair lending laws to "address issues of pervasive racial injustice and the long-term economic impacts" of the Covid-19 pandemic, with a particular focus on the impact to minority and other vulnerable populations.

The CFPB's renewed focus on fair lending and, specifically, enforcement of the Equal Credit Opportunity Act (ECOA) and Regulation B, provides an impetus for financial institutions and other entities subject to its jurisdiction to reassess their fair lending compliance programs before they find themselves the subject of a probing fair lending exam. The CFPB's renewed focus on fair lending enforcement also presents institutions with an opportunity to align business plans and their internal equity commitments with the agency's policy aims by expanding services into underbanked or otherwise underserved communities.

To ensure compliance with ECOA and Regulation B, it has always been best practice for institutions to periodically review their fair lending policies, procedures, and internal controls. Such reviews ensure that the institution's compliance regime is appropriately tailored to the credit products and services they offer, including new offerings that may have been acquired through M&A activity, as well as the latest trends in the CFPB's supervision and enforcement activity.

This article highlights non-traditional and emergent areas of fair lending risk that institutions should consider when assessing their compliance program: support for limited English proficiency (LEP) customers; lending to small, women-owned, and minority-owned businesses; and non-traditional credit models, including those reliant on artificial intelligence, machine learning, and alternative data.

Legal Background

The Dodd-Frank Act vests the CFPB with supervisory, enforcement, and rulemaking authority with respect to the Equal Credit Opportunity Act (ECOA) and the Home Mortgage Disclosure Act (HMDA).

ECOA, together with its implementing Regulation B, makes it unlawful for creditors to discriminate against applicants on the basis of race, color, religion, national origin, sex, marital status, age, and because the applicant receives public assistance, among other protected characteristics.

Unlike HMDA and its implementing Regulation C, which require only mortgage lenders to collect and report lending data to identify potential discriminatory lending patterns and enforce fair lending laws, ECOA's fair lending safeguards extend beyond mortgage lending to cover a wide array of consumer credit products. These include auto loans, credit cards, personal and other unsecured loans, and small business lending.

ECOA also covers creditors' activities before, during, and after the extension of credit and recognizes two distinct theories of liability—disparate treatment—i.e., treating applicants differently based on a prohibited characteristic—and disparate impact—i.e., employing facially neutral policies or practices that have an adverse impact on a protected class, subject to certain limitations.

Limited English Proficiency Customers

Over 67 million U.S. residents speak a language other than English in the home and, of those, more than 37% (or more than 25 million people) have limited proficiency in English. Though most LEP individuals are Spanish speakers, this potential consumer base also includes significant numbers of Chinese, Vietnamese, Korean, Tagalog, and Arabic speakers. Together, these six languages account for 80% of LEP consumers.

Consumers with limited proficiency in English traditionally have faced substantial hurdles in accessing the consumer financial services marketplace, often as a result of language-access issues. The CFPB has signaled that it views integrating LEP consumers into the marketplace to be a priority, and many institutions share the CFPB's desire to expand their products and services to this underserved consumer base.

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Among the challenges in serving the LEP population has been a lack of clarity from the CFPB and other federal regulators regarding how institutions can extend services to non-English speakers while remaining compliant with fair lending laws, UDAAP prohibitions, the Truth in Lending Act, Fair Housing Act, and other anti-discrimination regimes.

Further complicating matters, several states impose additional disclosure requirements for institutions when negotiations occur in languages other than English, including a California statute that mandates lenders provide translated versions of loan documentation when negotiations occur in any of five non-English languages. See Cal. Civ. Code § 1632.

In January 2021, the CFPB sought to encourage the industry to better serve LEP consumers by providing some much-needed clarity on how institutions can navigate these risks. The CFPB's guidance recognized the legal uncertainties that had discouraged institutions from extending services to LEP consumers historically. It emphasized that firms could enter the LEP market in a phased manner in terms of the non-English languages they support, the products and services offered to non-English speaking consumers, and the stages within the product lifecycle at which institutions provide non-English support.

The Bureau did not prescribe a one-size-fits-all approach. Instead, it outlined a set of compliance principles and guidelines for institutions to consider when expanding access to LEP customers. While the Bureau's decision to provide industry participants a degree of flexibility in how they roll out LEP services is encouraging and prudent, the absence of prescriptive guidelines means that financial institutions that answer the Bureau's call to better support LEP consumers still face considerable fair lending risk.

As institutions revisit their fair lending compliance programs in advance of potential scrutiny by the Biden CFPB, identifying and ensuring that adequate controls for the risks attendant in serving, or not serving, LEP customers should be front of mind. Even with the CFPB's latest guidance, the existing legal framework requires institutions to consider a careful balance between consumer preference and need, operational capability, and fair lending obligations.

For instance, in deciding whether to expand non-English services to LEP customers, what products and services will be offered, and in what non-English languages, institutions must be sure they are clearly and concurrently documenting those decisions. While it is permissible under ECOA and Regulation B for lenders to consider information regarding LEP consumers' language preference and the likelihood that such LEP consumers will use particular products or services, poor controls open the door to such factors being construed as proxies for national origin.

The CFPB's recent guidance likewise defers to institutions to decide which consumer-facing activities or communications in the product lifecycle should be provided in non-English languages based on their subjective determination of whether such activities will "significantly impact consumers." At minimum, however, if a lender provides any support to consumers in a language other than English, including in branches, they should provide LEP consumers with clear and timely disclosures in that language describing the extent and limits of the in-language services provided throughout the entire product lifecycle.

Finally, while institutions' fair lending programs already should include outcome testing to monitor for potential disparities among protected classes, enhanced monitoring of consumer communications—including marketing materials, customer service scripts, and in-branch communications—to non-English speakers is critical as institutions expand services to LEP consumers. It similarly is critical that institutions keep apprised of developments at the state level, as various jurisdictions, including California, Texas, Oregon, and others, impose additional obligations on institutions in their interactions with non-English speaking consumers.

Small Business Lending

After nearly a decade of inaction, the CFPB issued a notice of proposed rulemaking under Section 1071 of the Dodd-Frank Act on Sept. 1, 2021. Enacted to help facilitate fair lending enforcement with respect to small business lending, among other purposes, Section 1071 and the CFPB's forthcoming rulemaking impose HMDA-like reporting obligations for small business lenders.

The new rule requires covered financial institutions to collect and report annually to the CFPB information regarding the race, sex, and ethnicity of the principal owners of businesses that submit credit applications, as well as information generated by the institution in considering applications—e.g., the application date, method, and action taken by the

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institution—and information about the applications themselves—e.g., the amount of credit applied for, purpose of the loan, information about the nature of applicants' businesses—among other information.

These new obligations will equip the CFPB with statistical information that can be used in fair lending examinations and enforcement actions related to small business lending, complementing the government's other efforts to ensure fair lending and promote community development.

In parallel, the CFPB has been actively monitoring institutions' fair lending compliance with respect to the Paycheck Protection Program (PPP), which was a temporary small business lending program created by the Coronavirus Aid, Relief, and Economic Security Act (CARES Act).

The CFPB's examiners already have identified potential fair lending issues in their prioritized assessments of PPP lenders, as discussed in a recent Supervisory Highlights release. Specifically, the CFPB indicated that lenders' decisions to restrict PPP loans to existing customers may have had a disproportionate impact on minority borrowers and could run afoul of ECOA and Regulation B.

Given the CFPB's focus on small business lending within PPP and the Bureau's issuance of a proposed rule implementing Section 1071, institutions' reviews of their fair lending compliance programs should be sure to account for fair lending compliance in their small business lending portfolio. Such focus is essential for firms that facilitated PPP loans. Once equipped with additional loan-level data collected pursuant to Section 1071, small business lenders can expect the CFPB to adopt similarly aggressive supervisory and enforcement postures in this space as it does in other areas of consumer finance, including home and auto lending.

Though it may be premature to begin preparing outcome testing regimes to account for the loan-level demographic information that will be collected pursuant to the CFPB's small business data collection rule—the notice of proposed rulemaking contemplates a compliance date 18 months after publication of the final rule—institutions would be wise to ensure that their current proxy-based statistical testing programs extend to their small business and PPP portfolios.

Banks and non-bank lenders also should include small business lending policies and procedures in their periodic reviews, ensure that any manual underwriting overrides for small business loans are examined and subject to clear written guidance, and assess the extent to which small business loans are being marketed and made accessible to LEP business owners.

Non-Traditional Credit Models

According to the CFPB, 45 million Americans face barriers to accessing affordable credit that is underwritten using traditional credit models. Approximately 26 million Americans are considered "credit invisible," meaning they have no credit history with a nationwide credit reporting agency, and an additional 19 million have "unscorable" credit histories under commercially available credit scoring models, such as FICO.

The CFPB also recognizes that communities of color, particularly Black and Hispanic consumers, are disproportionately more likely to be impacted by this phenomenon during the underwriting process. And, even when minority consumers have available credit histories, studies have shown that traditional credit scoring models may be inherently discriminatory.

Institutions looking to expand access to credit in traditionally underserved communities may consider incorporating alternative data sources into their credit decisioning models. In 2017, the CFPB undertook to better understand the prevalence and nature of such approaches then in use or being contemplated in the industry.

Of particular interest, the CFPB requested information on the extent to which institutions were relying on non-traditional data sources, such as trends or patterns in traditional loan repayment data, payment information related to non-loan products that require regular payments—e.g., rent, insurance, utilities—cashflow data and information about borrower's other assets, data indicative of a borrower's stability—e.g., the frequency with which a borrower changes addresses, phone numbers, email addresses—data about a borrower's educational or vocational background, behavioral data about the borrower—e.g., internet browsing behavior, devices used, and products purchased—and data about borrowers' friends and associates, including information gleaned from social media.

Evolving alongside these alternative inputs are non-traditional modeling techniques and technologies, such as artificial intelligence, machine learning, and advanced algorithms, which likewise were a subject of the CFPB's 2017 request for information. Whether developed internally or by third parties, including data brokers, these technologies can enable

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institutions to more efficiently identify patterns or trends in large volumes of data that may be predictive of an applicant's or customer's creditworthiness, allowing institutions to extend affordable credit to consumers who may have been deemed too risky under traditional models.

The CFPB acknowledged that while the use of alternative data and decisioning technology may expand access to credit, they also present fair lending risks. For instance, even if information traditionally not included in a borrower's credit reporting file is accurate, which itself is an area of risk, alternative data may inadvertently serve as proxies for protected classes under ECOA.

Likewise, while advanced credit modeling algorithms, and even artificial intelligence or machine learning, may reduce costs to lenders, expedite credit decisions, and mitigate the fair lending risks traditionally associated with manual underwriting, they also carry the risk of disparate impact in credit outcomes since they can perpetuate discrimination inherent in the underlying data.

These risks are a subject of ongoing study by the CFPB. In 2017 and 2020, the CFPB issued no-action letters to Upstart Network, Inc., a company that has incorporated alternative data and machine learning techniques into its underwriting model. The NALs require Upstart to provide access and insights to the CFPB on its use of alternative data and advanced decisioning technology, which will enable the CFPB to better assess whether and how such technologies can expand access to credit for traditionally underserved populations and whether they give rise to potential disproportionate impacts.

To adequately control for these risks, a necessary first step is for fair lending compliance officers to understand whether and to what extent alternative data and non-traditional modeling are being used in connection with the extension of credit. Only by understanding each input used in credit underwriting and scrutinizing their accuracy—as well as the third-party data brokers from whom alternative data may be sourced—can institutions fairly assess whether alternative data may serve as a proxy for a protected class.

Fair lending officers should also ensure that they understand how those systems function and that the development and operation of such systems are adequately documented. The best way to ensure such systems are developed to control fair lending risk is to ensure that compliance personnel are involved in their development from the outset.

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