



Rethinking Fair Lending

February 24, 2023



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Agenda

1. Fair Lending in Flux: *Townstone Financial*, UDAAP, and the changing boundaries of anti-discrimination law
2. Into the mid-21st Century: Artificial Intelligence, Machine Learning, and the Application of New Technologies to an Aging Legal Infrastructure
3. Expanding Fair Lending Risk through Third Party Partners
4. Fair Lending and its Application to Alternative Finance Products



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Level Setting: The Plain Language of ECOA

It is unlawful “for any creditor to discriminate against any applicant on the basis of sex or marital status with respect to any aspect of a credit transaction.”

ECOA specifically defined “applicant” to mean “any person who applies to a creditor directly for an extension, renewal, or continuation of credit, or applies to a creditor indirectly by use of an existing credit plan for an amount exceeding a previously established credit limit.”

15 U.S.C. § 1691 (emphasis added).



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What is an “Applicant”

ECOA defines “[a]pplicant” as a person who “applies” for credit: “The term ‘applicant’ means any person who applies to a creditor directly for an extension, renewal, or continuation of credit, or applies to a creditor indirectly by use of an existing credit plan for an amount exceeding a previously established credit limit.”

ECOA uses the word “debtor” to refer to the customer after they have entered into a credit transaction. “The term ‘credit’ means the right granted by a creditor to a debtor to defer payment of debt or to incur debts and defer its payment or to purchase property or services and defer payment therefor.”



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What is an “Applicant”

Regulation B defines “applicant” as “any person who requests or who has received an extension of credit from a creditor, and includes any person who is or may become contractually liable regarding an extension of credit. For purposes of § 1002.7(d), the term includes guarantors, sureties, endorsers, and similar parties.”

12 CFR § 1002.2(e) (emphasis added)



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Advisory Opinion on Coverage of Fair Lending Laws

“[I]nterpretive rule[]” released under CFPB’s Advisory Opinion policy “to resolve regulatory uncertainty,” meaning uncertainty with respect to regulatory or statutory provisions.

The advisory opinion purportedly “clarif[ies]” that “ECOA protects people from discrimination in all aspects of a credit arrangement.”



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Advisory Opinion on Coverage of Fair Lending Laws

ECOA “bars lenders from discriminating against customers after they have received a loan, not just during the application process.”

Citing Regulation B’s “expansive” definition of “credit transaction,” the ECOA advisory opinion declares: “the Bureau interprets aspects of the credit transactions enumerated in Regulation B as including and encompassing the servicing of that credit, debt collection, loss mitigation, payment plans, settlements, co-signer release, and certain other services provided to existing accountholders.”



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Townstone Financial

- July 2020 Complaint
 - Townstone alleged to have violated protections under ECOA based on Reg. B language that prohibits discouraging applications for credit on a prohibited basis.
 - First ever CFPB redlining complaint against a non-bank mortgage lender.
 - Redlining complaints: no effort to market to African Americans, no targeted marketing in relevant MSA, few total applications compared to peer lenders.
 - *Townstone Financial Show* – radio show and podcast used to generate mortgage loan applications (400 episodes).
 - *5 broadcasts made alleged racist comments to discourage prospective applicants.*



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Townstone Financial

- Question Raised: Does redlining violate ECOA?
ECOA focuses on the treatment of *applicants*
Conduct alleged here concerns *prospective applicants*
- Why important to CFPB?
DOJ, HUD have authority to make Fair Housing Act claims
Not the CFPB
- Critical Argument:
Reg. B provides: A creditor shall not make any oral or written statement, in advertising or otherwise, to applicants or prospective applicants that would discourage on a prohibited basis a reasonable person from making or pursuing an application. 12 C.F.R. § 1002.4(b).



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Townstone Financial

- Townstone's Motion to Dismiss

Argument that CFPB attempted to expand reach of ECOA beyond statutory language through its implementing regulation (Reg. B). ECOA does not regulate behavior relating to prospective applicants that have not yet applied for an extension of credit.

Statutory Language:

It shall be unlawful for any creditor to discriminate against any applicant, with respect to any aspect of a credit transaction—on the basis of race, color, religion, national origin, sex or marital status, or age (provided the applicant has the capacity to contract). 15 U.S.C. § 1691(a).

“Applicant” means “any person who applies to a creditor directly for an extension, renewal, or continuation of credit, or applies to a creditor indirectly by use of an existing credit plan for an amount exceeding a previously established credit limit.” 15 U.S.C. § 1691a(b).



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Townstone Financial

▪ N.D. Illinois – Feb. 3, 2023

CFPB responded by arguing that the discouragement provision in Reg. B “is authorized by and necessary to the ECOA.”

Court applied *Chevron* two-step framework.

First Step: Whether Congress has spoken to the precise question at issue?

Here: when analyzing ECOA’s language, Congress spoke directly and unambiguously in using the term “applicant” in the manner it was used.

As a result: ECOA only prohibits discrimination against applicants, not prospective applicants.

The “CFPB cannot regulate outside the bounds of the ECOA, and the ECOA clearly marks its boundary with the term ‘applicant.’”



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Townstone Financial

▪ What’s next from a procedural perspective?

CFPB will likely appeal to Seventh Circuit.

Court could affirm. Court could also reverse, but would be a difficult case for CFPB to win in SCOTUS given current makeup.

• Key Questions / Implications

- How can the CFPB achieve its goals?
- What sources of law can the CFPB, or the Biden Administration, utilize?



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UDAAP Exam Manual

An act or practice is **unfair** when:

- (1) It causes or is likely to cause substantial injury to consumers;
- (2) The injury is not reasonably avoidable by consumers; and
- (3) The injury is not outweighed by countervailing benefits to consumer or to competition.



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UDAAP Exam Manual

March 16th Press Release and Exam Manual Update

Press Release: CFPB will “expand its anti-discrimination efforts to combat discriminatory practices across the board in consumer finance.” Specifically, CFPB will use its **unfairness authority** to bring discrimination claims *where ECOA does not govern, in addition to the cases where ECOA does, in fact, govern.*

Example: Denial of access to a bank account on a prohibited basis (*e.g.*, religion or race).



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UDAAP Exam Manual

March 16th Press Release and Exam Manual Update

UDAAP Exam Manual Update:

Now reflects that discrimination can be unfair in cases where ECOA does not apply (or, even where it does apply). *UDAAP Exam Manual* p. 10.

CFPB examiners will require supervised companies to show their processes for assessing risks and discriminatory outcomes, including documentation of customer demographics and the impact of products and fees on different demographic groups. *UDAAP Exam Manual* p. 12.

- CFPB examiners should ask for documentation regarding use of models, algorithms, and decision-making processes used in connection with products and services. *UDAAP Exam Manual* p. 12.
- CFPB examiners will review whether internal controls are adequate to prevent UDAAPs by reviewing whether the entity has established policies and procedures to (1) “review, test, and monitor any decision-making processes it uses for potential UDAAP concerns, including discrimination” and (2) “mitigate potential UDAAP concerns arising from the use of its decision-making processes, including discrimination.” *UDAAP Exam Manual* p. 14.



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UDAAP as Gap Filler

Non-Credit Areas

- Deposit Accounts
- Savings Accounts
- Payments
- Purchase / Sale Financing Arrangements (Factoring, MCA, etc.)
- Some BNPL Products
- Etc.

Categories that are not Protected under ECOA

- Limited English Proficiency (LEP)
- Geographic Area
- Disability
- Veteran Status
- Familial Status (Beyond Marriage Status)
- Etc.



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UDAAP as Gap Filler

Coverage under ECOA

- **Application:** Credit Products
- **Types of Prohibited Discrimination:**
 - Overt
 - Disparate Treatment
 - Disparate Impact
- **Basis for Discrimination:** Limited by ECOA's list of protected categories.

Coverage under UDAAP

- **Application:** Credit and non-Credit Products
- **Types of Prohibited Discrimination:**
 - Overt
 - Disparate Treatment
 - Disparate Impact
- **Basis for Discrimination:** Apparently unlimited.



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UDAAP as Gap Filler

Targeting non-credit products

“[D]enying access to a checking account because the individual is of a particular race could be an unfair practice even in those instances where ECOA may not apply.”

“[N]ot allowing African-American consumers to open deposit accounts, or subjecting African-American consumers to different requirements to open deposit accounts, may be an unfair practice even in those instances when ECOA does not apply to this type of transaction.”

Targeting classes that are not protected under ECOA

The CFPB might identify disparities in loans made to individuals with limited English proficiency, and utilize UDAAP as a legal theory.

Targeting products with data deficiencies

Auto Lending
Unsecured
Non-Dwelling Secured Loans



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Other Sources of Law / Sources of Risk

- Fair Housing Act
- State Fair Lending / Human Rights Law
- DOJ and State Enforcement Agencies
- Others?



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Into the mid-21st Century: Artificial Intelligence, Machine Learning, and the Application of New Technologies to an Aging Legal Infrastructure



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Consumer Financial Protection Bureau Outlines Options To Prevent Algorithmic Bias In Home Valuations

Standards will help protect homebuyers and owners during the valuation process

FEB 23, 2022

Washington, D.C. - The Consumer Financial Protection Bureau (CFPB) today outlined options to ensure that computer models used to help determine home valuations are accurate and fair. The options will now be reviewed to determine their potential impact on small businesses.

"It is tempting to think that machines crunching numbers can take bias out of the equation, but they can't," said CFPB Director Rohit Chopra. "This initiative is one of many steps we are taking to ensure that in-person and algorithmic appraisals are fairer and more accurate."



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Into the mid-21st Century: Artificial Intelligence, Machine Learning, and the Application of New Technologies to an Aging Legal Infrastructure



Consumer Education ▾ Rules & Policy ▾ Enforcement ▾ Compliance ▾ Data & R

[Consumer Financial Protection Circulars](#)

CONSUMER FINANCIAL PROTECTION CIRCULAR

Consumer Financial Protection Circular 2022-03

Adverse action notification requirements in connection with credit decisions based on complex algorithms

Question presented

When creditors make credit decisions based on complex algorithms that prevent creditors from accurately identifying the specific reasons for denying credit or taking other adverse actions, do these creditors need to comply with the Equal Credit Opportunity Act's requirement to provide a statement of specific reasons to applicants against whom adverse action is taken?

Response

Yes. ECOA and Regulation B require creditors to provide statements of specific reasons to applicants against whom adverse action is taken. Some creditors may make credit decisions based on certain complex algorithms, sometimes referred to as uninterpretable or "black-box" models, that make it difficult—if not impossible—to accurately identify the specific reasons for denying credit or taking other adverse actions.¹ The adverse action notice requirements of ECOA and Regulation B, however, apply equally to all credit decisions, regardless of the technology used to make them. Thus, ECOA and Regulation B do not permit creditors to use complex algorithms when doing so means they cannot provide the specific and accurate reasons for adverse actions.



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Algorithms and Fair Lending: Special Challenges

- Does your input data violate ECOA?
- Can your input data be used as a proxy for a protected class?
- How does your algorithm operate?
- How can you determine whether good inputs result in discriminatory output?
- Are you systematically auditing your underwriting decisions?
- What about third party vendors?
- What about UDAAP?



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Working with Third Parties

- Third Party Vendors and the Regulatory Landscape
 - CFPB Has Authority to Enforce Consumer Protection Law with regard to Vendors
 - CFPB is Flexing its “Dormant Authority” to examine non-bank Financial Institutions
- “Given the rapid growth of consumer offerings by nonbanks, the CFPB is now utilizing a dormant authority to hold nonbanks to the same standards that banks are held to,” said CFPB Director Rohit Chopra. “This authority gives us critical agility to move as quickly as the market, allowing us to conduct examinations of financial companies posing risks to consumers and stop harm before it spreads.”
- CFPB can examine if it has “reasonable cause to determine [that the activity poses] risk to consumers.”



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Working with Third Parties

Third Party Vendors and the Regulatory Landscape

CFPB Bulletin 2016-02

“[T]he mere fact that a supervised bank or nonbank enters into a business relationship with a service provider does not absolve the supervised bank or nonbank of responsibility for complying with consumer Federal consumer financial service law to avoid consumer harm.”

CFPB Expects that lenders will have an effective risk management process.



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Third Parties and UDAAP

- The revised UDAAP Exam Manual expects covered entities to “monitor[] the activities of employees and third-party contractors, marketing sales personnel, vendors, and service providers to ensure they do not engage in unfair, deceptive, or abusive acts or practices with respect to consumer interactions.”
- Entities should “ensure[] that employees and third parties who market or promote products or services are adequately trained so that they do not engage in unfair, deceptive, or abusive acts or practices, including discrimination.”
- Entities should have “a process to take prompt corrective action if the decision-making processes it uses produce deficiencies or discriminatory results.”



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Risk/Reward Balance in Vendor Relationships

Tolerable: Is your entire vendor suite consistent with your company’s risk tolerance?

Manageable: Do you have processes and procedures in place designed to manage enterprise risk?

Reasonable: Are your vendor management risk controls reasonably consistent with industry expectations?



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Fair Lending and Alternative Credit Products

- BNPL?
- MCA / Factoring?
- Dodd-Frank 1071

