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Benjamin P. Saul, Amanda M. Raines and Ann D. Wiles on

Why Fair and Responsible Banking Risk Assessments Are Important For Non-Mortgage Business Lines

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Fair and responsible banking risk assessments – by which financial institutions identify, measure, control, and monitor their lending and, more recently, servicing activities to prevent discriminatory, unfair, deceptive, abusive, and predatory acts and practices – have long been part of the compliance function within financial institutions. To date, the literature on such assessments has focused largely on how to conduct them on mortgage business lines, but has not addressed non-mortgage operations, such as credit card, student, and automobile lending. The mortgage-centric focus of most articles results, in part, from historically greater regulatory, enforcement, and litigation scrutiny of the mortgage business. Moreover, Home Mortgage Disclosure Act ("HMDA") data, which identifies applicants in protected classes, simplifies the quantitative components of a fair and responsible banking risk assessment. Outside the mortgage context, the difficult questions of whether, and how, to conduct such risk assessments have received scant attention.

The current regulatory environment renders timely consideration of whether, and if so how, financial institutions can best assess fair and responsible banking risks in their non-mortgage business lines. This may be especially true for mono-line and non-bank institutions that historically may not have conducted such risk assessments, and for more diversified financial institutions that may have conducted these assessments with less emphasis on measuring non-mortgage risks.

Recently, regulators, the Department of Justice ("DOJ"), and state attorneys general have sharpened their focus in examinations and investigations of non-mortgage lines of business.[1] In particular, the Consumer Financial Protection Bureau ("CFPB"), which has examination and enforcement authority under the Equal Credit Opportunity Act ("ECOA") and Regulation B [2] has made clear that it will use this authority across the entire spectrum of consumer credit, especially credit card, student, and auto lending.[3]

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1 Glen Fest, *Fair Warning on Fair Lending*, AMERICAN BANKER, Aug. 1, 2010, www.americanbanker.com/magazine/120_8/fair-warning-on-fair-lending-1022774-1.html.
2 *See* Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank"), H.R. 4173, 111th Cong. § 1085 (2010).
3 *See* Press Release, Consumer Financial Protection Bureau, *Consumer Financial Protection Bureau to Pursue Discriminatory Lenders* (April 18, 2012), *available at* http://www.consumerfinance.gov/pressreleases/consumer-financial-protection-bureau-to-pursue-discriminatory-lenders/.

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In response to the heightened regulatory and enforcement scrutiny of non-mortgage consumer credit, this Emerging Issues Analysis addresses several important considerations for conducting fair and responsible banking risk assessments for non-mortgage lines of business. Although experience from mortgage risk assessments provides a useful framework, non-mortgage lines of business present special considerations, both in terms of substance and execution.

What is a Fair and Responsible Banking Risk Assessment?

A fair and responsible banking risk assessment is a process designed to provide a financial institution with an understanding of its fair and responsible banking risk, how well it manages that risk, and the likelihood that it is complying with fair and responsible banking laws and regulations.[4] Fair lending risk is the likelihood that a financial institution's lending operations may be found to treat or impact applicants and borrowers differently on a prohibited basis. It includes the potential for a finding of noncompliance with the technical requirements of certain laws and regulations, such as ECOA and Regulation B, along with discrimination and discouragement in the lending process.[5] Fair lending risk potentially encompasses all of a financial institution's lending products – mortgage, consumer, credit card, and commercial – and all its credit-related lending activities from application to closing.[6] Fair banking expands on the concepts of fair lending risk and encompasses the entire loan life cycle, including post-closing activities such as collections and servicing, and pre-application activities such as marketing and loan solicitation and origination.

Responsible banking goes beyond principles of non-discriminatory lending to examine other potentially unfair, deceptive, or abusive acts and practices ("UDAAP") by lenders. Although the precise contours of these acts and practices will be determined in part through enforcement and litigation matters, according to the CFPB Examination Manual, unfair acts or practices are those (i) that cause or are likely to cause substantial injury to consumers; (ii) in which the injuries are not reasonably avoidable by the consumers; and (iii) the injuries are not outweighed by countervailing benefits to consumers or to competition.[7] The CFPB, moreover, has defined a deceptive representation, omission, act or practice as one that (i) misleads or is likely to mislead the consumer; (ii) the

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4 Phillip R. Freer, Jr. & Calvin R. Hagins, *Fair Lending Risk Assessment Primer: the Regulator's Perspective*, ABA BANK COMPLIANCE, January/February 2008, at 6.

5 *Id*. at 7.

6 *Id*.

7 Consumer Financial Protection Bureau, Supervision and Examination Manual – Version 1.0: Consumer Laws and Regulations: Unfair, Deceptive, or Abusive Acts or Practices (UDAAP) 2 (2011).

consumer's interpretation of the representation, omission, act or practice is reasonable under the circumstances; and (iii) the misleading representation, omission, act or practice is material.[8] Finally, the CFPB defines abusive acts or practices as those that (i) materially interfere with the ability of a consumer to understand a term or condition of a consumer financial product or service or (ii) take unreasonable advantage of (a) a lack of understanding on the part of the consumer of the material risks, costs, or conditions of the product or service; (b) the inability of the consumer to protect his or her interests in selecting or using a consumer financial product or service; or (c) the reasonable reliance by the consumer on a covered person to act in the interests of the consumer.[9]

An Increasing Focus on Non-Mortgage Business Lines

Non-mortgage fair and responsible banking risk assessments have become increasingly relevant. As an initial matter, fair "lending" examinations have both intensified and evolved from traditional areas of regulatory focus, such as judgmental underwriting and discretionary pricing, to include all aspects of the credit life cycle—*i.e.*, servicing and collections. As examinations have intensified generally, so too has the intensity with which examiners now analyze issues related to non-mortgage credit. Adverse findings and concomitant downgrades in compliance and management ratings have been the twin results of broader, more intense compliance examinations.

In addition to increased scrutiny of the full credit life cycle, regulators are scrutinizing an expanded range of consumer credit offerings. For example, credit cards have become an area of significant regulatory attention. The CFPB, in particular, has focused on credit cards, already issuing a report on its collection of credit card complaint data and unveiling an online database tracking credit card complaints.[10] Indeed, the CFPB's Consumer Response Office complaint system began with a singular focus on credit cards "because of [their] wide use, and because credit card problems have been historically among the highest kinds of consumer grievances,"[11] virtually assuring the Bureau's continued focus in this area.

8 *Id*. at 5.
9 *Id*. at 9.
10 Consumer Financial Protection Bureau, Consumer Response: Interim report on CFPB's credit card complaint data (Nov. 30, 2011), *available at* http://www.consumerfinance.gov/reports/consumer-response-interim-report-on-cfpbs-credit-card-complaint-data/; Evan Weinberger, *Banks Fear CFPB Credit Card Database Will Give Them Bad Rap*, LAW 360, June 19, 2012.
11 *Id.*

In the area of student lending, Congress and the press have raised significant concerns about whether private lenders have made "suitable" loans to student borrowers.[12] The CFPB and Department of Education, moreover, are currently conducting a comprehensive private student lending study mandated by Dodd-Frank,[13] for which they have sought broad information, including underwriting, servicing, and modification criteria.[14] In addition, the CFPB recently began accepting consumer complaints about private student loans, adding to its existing complaint process for personal loans, automobile loans, and credit cards. The online complaint submission form asks: "Do you believe the issue involves discrimination?"[15]

Finally, there have been increased fair lending and enforcement actions by federal and state regulators, including the establishment of a Fair Lending Unit within the Civil Rights Division of the DOJ.[16] This unit addresses "more subtle forms of discrimination," including lenders and brokers who have denied minorities access to credit. The DOJ has openly defended its enforcement practices, asserting that the absence of effective consumer protections and meaningful federal enforcement has not only resulted in discrimination but also contributed to the economic crisis.[17]

Further complicating matters for the industry is that the DOJ, prudential regulators, and CFPB have all reiterated their reliance on disparate impact theories of liability as a critical component of their examination and enforcement toolkits. Indeed, Tom Perez, Assistant Attorney General for the Civil Rights Division, has stated that the "Fair Lending Unit will use every tool in [its] arsenal, including but not limited to disparate impact theory."[18] In addition, the CFBP has recently announced that it plans to follow the DOJ's lead in pursuing fair lending violations based on disparate impact.[19]

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12 *See* Sue Shellenbarger, *Student Loans Drive Grads to Delay Marriage, Children*, WALL ST. J., Apr. 18, 2012, http://online.wsj.com/article/SBB0001424052702304818404577350030559887086.html.
13 H.R. 4173 § 1077.
14 *Id*.; *see also* Request for Info. Regarding Private Educ. Loans and Private Educ'l Lenders, 76 Fed. Reg. 222 (Nov. 17, 2011).
15 *File a Student Loan Complaint*, CONSUMER FINANCIAL PROTECTION BUREAU, http://www.consumerfinance.gov/complaint/app/studentloan/ask (last visited Mar. 23, 2012).
16 Tracy Russo, *Fair Lending*, THE JUSTICE BLOG (Sept. 1, 2011), http://blogs.justice.gov/main/archives/1537.
17 Tracy Russo, *It is Right to Fight Discrimination in Lending*, THE JUSTICE BLOG (Sept. 6, 2011), http://blogs.justice.gov/main/archives/1542.
18 Channing Turner, *Perez Calls for Reining in 'Wild Wild West' in Lending,* MAIN JUSTICE (June 23, 2010), http://www.mainjustice.com/2010/06/23/perez-calls-for-reining-in-wild-wild-west-in-lending.
19 Shahien Nasiripour, *US to Use Statistics to Probe Lending Claims,* FIN. TIMES, Apr. 19, 2012, http://www.ft.com/intl/cms/s/0/54ce1cf0-8977-11e1-85b6-00144feab49a.html#axzz1yGVbv4A4; Meg Handley, *Cordray, Consumer Bureau Target Discriminatory Lending,* CHI. TRIB., Apr. 19, 2012, http://articles.chicagotribune.com/2012-04-19/news/sns-201204191107usnewsusnwr201204180418lendersapr19_1_lending-practices-equal-credit-opportunity-act-cfpb.

Disparate impact occurs "when a lender applies a racially or otherwise neutral policy or practice equally to all credit applicants, but the policy or practice disproportionately excludes or burdens certain persons on a prohibited basis."[20] Because this theory of liability may be viewed by regulators and enforcement agencies as applying more easily to model-driven business lines, such as credit card and student lending, than disparate treatment theories, the risk of exposure outside the mortgage context is increased. Given HUD's proposed rules for disparate impact cases,[21] the DOJ's and CFPB's statements regarding their use of the disparate impact theory, and the relatively recent voluntary dismissal of *Magner v. Gallagher,*[22] a case challenging the viability of disparate impact theory under the Fair Housing Act that had been pending before the Supreme Court, regulators and enforcement agencies will continue to emphasize disparate impact theory.[23]

Fair And Responsible Banking Risks in the Mortgage Arena Apply To Non-Mortgage Product Risk Assessments

Many of the potential areas of fair and responsible banking risk in the mortgage context apply equally to non-mortgage lines of business. Indeed, many fair lending examination manuals identify numerous potential areas of fair lending risk for mortgage lending and simply refer to these same areas when discussing fair lending risks for consumer and commercial loans. Therefore, when conducting non-mortgage risk assessments, a financial institution can, and should, draw upon principles and practices for conducting mortgage assessments.

At a basic level, these principles and practices include examination of policies and procedures, discussion and observation of actual practices with personnel, assessment of training and monitoring, analyzing of consumer complaints, and examination of data where available. Additional more specific areas of fair and responsible banking risk that apply equally to mortgage and non-mortgage lines of business are identified below.

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20 Fed. Fin. Insts. Examination Council ("FFIEC"), Interagency Fair Lending Examination Procedures iv (2009).
21 24 CFR pt. 100. In June 2012, New Jersey Representative Scott Garrett offered an amendment to a spending bill that would stop HUD from enforcing discrimination based on the disparate impact theory. *See* Amendment to H.R. 5972.
22 *Magner v. Gallagher*, 132 S. Ct. 548 (2011).
23 On June 11, 2012, the Township of Mount Holly New Jersey filed a certiorari petition requesting the Supreme Court to hear a case challenging whether the disparate impact theory is recognized under the Fair Housing Act. *See Township of Mount Holly, New Jersey v. Mt. Holly Gardens Citizens in Action, Inc.*, No. 11-1507 (U.S.).

Use of Discretion

In general, one of the first steps in any fair and responsible banking risk assessment involves evaluating the amount of discretion, if any, used in the underwriting and pricing of loan products. Typically, the greater the amount of discretion, the more risk a lender faces.

One example of potential fair lending concern is the ability of credit analysts or loan officers to override automated credit models. For example, in 2000, the DOJ sued Deposit Guarantee National Bank for violating the Fair Housing Act by allowing its branch loan officers to override automated underwriting decisions which resulted in minority applicants being three times more likely to be rejected than similarly situated white applicants.[24] The DOJ has cautioned that "lenders must be careful in allowing overrides. Where disproportionate numbers of white applicants are approved for credit despite a failing credit score or disproportionate numbers of minorities are denied credit even with a passing credit score, there is a concern that discrimination may be at work."[25] This concern could apply to any non-mortgage line of business that relies upon automated credit models but permits low-side or high-side overrides.

Another area of potential fair lending concern equally applicable to mortgage and non-mortgage lines of business is pricing discretion. In 2005, the Federal Reserve noted that discretionary pricing may constitute a fair lending violation, and numerous discretionary pricing cases have been filed by private actors and governmental entities throughout the years.[26] This is an area in which there appears to be a greater amount of attention paid to non-mortgage lines of business recently than in the past. The Attorney General's recent Annual Report to Congress states that in 2011, the Civil Rights Division "received a notable number of pricing discrimination referrals involving non-mortgage loans."[27] Among those referrals are (i) three referrals from the FDIC involving unsecured consumer loan pricing discrimination; (ii) one referral from the FDIC involving student loan pricing discrimination; (iii) one referral from the Federal Reserve

24 *United States v. Deposit Guar. Nat'l Bank*, PUBLIC ACCESS TO COURT ELECTRONIC RECORDS (June 21, 2012), https://ecf.mssd.uscourts.gov/cgi-bin/DktRpt.pl?66939446398306-L_452_0-1.

25 Robert G. Schwemm & Jeffrey L. Taren, *Discretionary Pricing, Mortgage Discrimination, and the Fair Housing Act*, 45 HARV. C.R.-C.L. L. REV. 375, 391 n.100 (2010) (*quoting* U.S. Dep't of Justice, Civil Rights Div., Fair-Lending Enforcement Program (2001).

26 Robert B. Avery et al., *Higher-Priced Home Lending and the 2005 HMDA Data*, 84 FED. RESERVE BULLETIN A123, A128-29 (2006) (noting that discretionary pricing has been identified as a "risk factor" by federal regulators charged with determining whether lenders are engaged in illegal price discrimination); *see e.g.*, *Smith v. Chrysler Fin. Co.*, No. Civ.A. 00-6003(DMC), 2003 WL 328719 (D. N.J. Jan. 15, 2003); *Ramirez v. GreenPoint Mortg. Funding, Inc.*, 663 F. Supp. 2d 922 (N.D. Cal. 2008).

27 *The Att'y Gen.'s 2011 Annual Report to Congress Pursuant to the Equal Credit Opportunity Act Amendments of 1976* at 15, DEP'T OF JUSTICE, www.justice.gov/crt/about/documents/ecoareport2011.pdf (last visited June 20, 2012).

Board involving automobile loan pricing discrimination; and (iv) two referrals (one from the FDIC and one from the OTS) involving pricing discrimination in consumer loans based on sex.[28] The DOJ in 2011 also settled a pricing discrimination case involving unsecured credit loans,[29] which was the first case of its kind by the Department in more than 10 years.[30]

Use of Attributes in Credit Models

Another area of potential fair lending risk that has been identified in the mortgage context but also applies to non-mortgage lines of business are the attributes used in automated credit models. The Interagency Fair Lending Examination Procedures related to Considering Automated Underwriting and Credit Scoring instructs examiners to identify and obtain "[a]ll variables scored by each product's scorecard(s) and the values that each variable may take."[31] These attributes should be evaluated to determine if automated credit models are based on factors that unfairly impact protected classes.[32] Although numerous factors could cause fair lending risk, two attributes to consider are the use of age cutoffs or geography in lending practices.

As to the use of age cutoffs, Regulation B "expressly requires the initial validation and periodic revalidation of a credit scoring system that considers age."[33] A credit scoring system can consider age in the following manner: (i) the system can be split into different scorecards depending on the age of the applicant and/or (ii) age may be directly scored as a variable.[34] Credit scoring systems that consider age in either of

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28 *Id*.

29 *Id*. at 4-5 (discussing *United States v. Nixon State Bank*, No. SA-11-CV-488, 2011 WL 2550751 (W.D. Tex. filed June 17, 2011), ECF No. 3.

30 Of note, the Supreme Court's recent decision in *Wal-Mart v. Dukes* could be read to limit lender's exposure in discretionary pricing cases. *See* Benjamin P. Saul, Elizabeth E. McGinn, & Kristopher Knabe, *Fair Lending Class Actions Following Wal-Mart v. Dukes,* BLOOMBERG LAW REPORTS BANKING AND FINANCE (Nov. 30, 2011), *available at* http://www.buckleysandler.com/uploads/36/doc/bloomberg_wal-mart-v-dukes_saul-mcginn-knabe.pdf.

31 FFIEC, Interagency Fair Lending Examination Procedures Appendix II Considering Automated Underwriting and Credit Scoring (2009).

32 Comptroller's Handbook on Credit Card Lending states that "[m]anagement should ensure that the bank's scorecards do not have the effect of discrimination." Comptroller of the Currency, Credit Card Lending Comptroller's Handbook 13 (1998). Also, putative class action complaints alleging violation of fair lending laws based on the use of automated underwriting and credit scoring systems have survived motions to dismiss. *See e.g.*, *Zamudio v. HSBC North Am. Holdings Inc.*, No. 07C4315, 2008 WL 517138, at *1-2 (N.D. Ill. Feb. 20, 2008) (denying motion to dismiss FHA/ECOA-based complaint alleging that mortgage lender's automated underwriting and credit scoring systems discriminated against minorities due to "discriminatory assumptions . . . embedded in the statistical formulas used to analyze credit information and ultimately form underwriting decisions.").

33 FFIEC, Interagency Fair Lending Examination Procedures Appendix II Considering Automated Underwriting and Credit Scoring, Section E (2009).

34 *Id*. Age-split scorecards involve a credit scoring system that is spit into only two scorecards. If one scorecard covers a wide age range that encompasses applicants 62 or older, the system is treated as considering, but not scoring, age. Typically, the younger scorecard in an age-split system is used for applicants under a specific age between 25 and 30. These systems de-emphasize factors such as the number of trade lines and the length of employment and increase the negative weight of any

these two manners must be empirically derived and demonstrably and statistically sound.[35]

The use of geographic identifiers, if any, also should be evaluated. Although state-level distinctions have proven to be less problematic, when an institution moves toward the use of more granular geographic identifiers such as zip codes or metropolitan statistical areas ("MSAs"), potential fair lending implications increase. For example, the CFPB ECOA Examination Program notes that examiners should "pay special close attention" to whether the "creditor's underwriting or pricing guidelines contain any unusual criteria that could have a possibly negative disparate impact on a protected class" such as underwriting or pricing models that use ZIP codes.[36] The FDIC Compliance Examination Manual contains similar direction to its examiners, but the FDIC also recognizes that segmentation by geographic location can be an important tool in addressing credit risk.[37]

Marketing

Marketing also should be evaluated in any fair and responsible banking risk assessment. While marketing activities themselves are not extensions of credit under ECOA and Regulation B,[38] they may raise fair lending concerns. In particular, institutions should evaluate the use of non-credit bureau attributes or protected class status, such as gender, age, and of course, race, in marketing its products.[39]

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derogatory information on the credit report. These systems do not raise the issue of assigning a negative factor or value to the age of an elderly applicant. If a scorecard scores age directly, in addition to being empirically derived and demonstrably and statistically sound, the credit must ensure that the age of an elderly applicant is not assigned a negative factor or value. A negative factor or value means utilizing a factor, value, or weight that is less favorable than the credit's experience warrants or is less favorable than the factor, value, or weight assigned to the most favored age group below the age of 62. *Id*.

35 *Id*.

36 Consumer Financial Protection Bureau, Supervision and Examination Manual – Version 1.0: ECOA Examination Procedures: Section A (2011). The FDIC Compliance Examination Manual explicitly directs examiners to "[e]xamine institution policies . . . that provide for different processing or underwriting requirements based on geographic identifiers . . . to assure that they do not treat protected group applicants differently then other similarly situated applicants." FDIC, The FDIC Compliance Examination Manual IV-2.10 (2011).

37 FDIC, Credit Card Activities Manual Chapter V (2007).

38 "*Extend credit* and *extension of credit* mean the granting of credit in any form (including, but not limited to, credit granted in addition to any existing credit or credit limit; credit granted pursuant to an open-end credit plan; the refinancing or other renewal of credit, including the issuance of a new credit card in place of an expiring credit card or in substitution for an existing credit card; the consolidation of two or more obligations; or the continuance of existing credit without any special effort to collect at or after maturity)." 12 C.F.R. § 202.2(q)..

39 ECOA permits creditors to refuse to extend credit to applicants under the age of 18 because those applicants do not have "the capacity to contract." 12 U.S.C. § 1691(a). Although there is no specific upper age cutoff for marketing efforts, regulators have issued guidance warning of the dangers of targeting "vulnerable" consumers, including the elderly. *See, e.g.,* FDIC Financial Institution Letter 26-2004 (Mar. 11, 2004) ("Banks should take particular care in marketing credit and other products and services to the elderly, the financially vulnerable, and customers who are not financially sophisticated."). Also, lenders have been subject to enforcement orders based on allegations of unfair or deceptive practices in connection with products targeted to the elderly.

Assessments also should review the use of any third-party marketing data or product such as household segmentation models that use non-bureau attributes, or place potential customers into different categories based on attributes that could be seen as proxies for protected class status. This is particularly important where marketing activities encourage customers to apply for different products with different pricing or features. For example, if applicants could be underwritten using different criteria based on application channel, marketing models that direct borrowers to certain channels may increase fair lending risks if they result in similarly situated applicants being treated differently.[40]

While linkage between fair lending and marketing practices is a newer issue, marketing activities have long presented UDAAP risks. For example, in 2004, the Federal Trade Commission ("FTC") sued a mortgage broker who advertised mortgage refinance loans at "3.5% fixed payment 30-year loan" or 3.5% fixed payment for 30 years, implying that the offer was for a 30-year loan with a 3.5% fixed interest rate.[41] Instead, the FTC claimed that the broker did not offer any such type of loan but instead offered adjustable rate mortgages with an option to pay various amounts, including a negative amortization option.[42] Recent settlements involving allegations of unfair or deceptive advertising have included advertising associated with ancillary products such as the marketing of cash back features on credit cards.[43]

Particular Considerations Related To Non-Mortgage Lines of Business

Beyond these general principles, there are several additional risks specific to non-mortgage products that should be considered when conducting fair and responsible banking risk assessments.

Credit Cards

When conducting a fair and responsible banking risk assessment of credit cards, at least three particular risks should be considered. The first relates to any discretion

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See, e.g., Wachovia Bank, N.A., No. 2008-028, AA-EC-08-12, 2008 WL 7087238 (OCC Apr. 24, 2008) and *Wachovia Bank, N.A.*, No. 2008-027, AA-EC-08-13, 2008 WL 7087237 (OCC Apr. 24, 2008) ($150 million in restitution and $10 million fine in connection with Wachovia's role in processing payments for unscrupulous telemarketers who targeted the elderly).

40 FFIEC, Interagency Fair Lending Examination Procedures Appendix VII Special Analyses: Section C Possible Discriminatory Marketing (2009).

41 Press Release, Federal Trade Commission, *FTC: Mortgage Broker's Deceptive Claims Tricked Consumers Looking for a Good Rate* (June 2, 2004), *available at* http://www.ftc.gov/opa/2004/06/chasefinancial.shtm.

42 *Id*.

43 *Advanta Bank Corp.*, FDIC-08-259b, FDIC-08-403k, 2009 WL 2477705 (FDIC June 30, 2009), *available at* http://www.fdic.gov/bank/individual/enforcement/2009-06-21.pdf.

available in setting or adjusting credit lines. Given the scrutiny of discretion in underwriting and pricing as discussed above, it is extremely likely that discretion in other aspects of credit also will receive significant attention.

The second area is evaluating the fair and responsible banking impact, if any, of complying with the independent ability to pay requirement under the Federal Reserve Board's ("FRB") Regulation Z. This new requirements means that credit card issuers may no longer request and consider "household" or "spousal" income when evaluating an individual consumer's ability to pay unless the spouses are joint applicants on the account or the spouse applying alone lives in a community property state.[44] During the comment period on this rule, the credit and retail industries claimed that married women not working outside their homes were the most likely to be negatively impacted by this requirement.[45] Although the FRB has stated that a card issuer would not violate Regulation B by complying with this independent ability to pay requirement,[46] it remains to be seen whether other regulators and private plaintiffs will nevertheless bring disparate impact claims.

Finally, an assessment should be conducted regarding any ancillary products, such as debt protection or identity protection-type products offered by the credit card company. This assessment should include a review of the marketing, sales, and servicing of these products, the accuracy of product disclosures related to costs, benefits, refund policies, and other material terms. The Government Accountability Office ("GAO") has stated that, although there are few consumer complaints regarding these products, they carry a substantial cost and can be difficult for consumers to understand. Prudential regulators, state attorneys general, the CFPB and private plaintiff firms have begun scrutinizing these products with some settlements already reached.[47] In July 2012, Capital One Bank, (USA) N.A. entered into consent agreements with the CFPB and OCC in which it agreed to pay $210 million to settle alleged violations of deceptive marketing, sales, and operational practices related to its ancillary products.[48]

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44 Sara Emley, *The New "Independent Ability to Pay" Requirement of Open-End Credit Under the Federal Reserve Board's Reg Z,*" BLOOMBERG LAW REPORTS BANKING & FINANCE (June 1, 2011), *available at* http://www.buckleysandler.com/uploads/36/doc/Bloomberg_Emley_Independent-Ability-to-Pay.pdf.

45 *Id*. at 2.

46 76 Fed. Reg. at 22976 (Apr. 25, 2011).

47 Victoria Finkle and Jeff Horwitz, *Consumer Bureau Threatens Banks' Credit Card Protection Profits,* AMERICAN BANKER, Feb. 6, 2012, http://www.americanbanker.com/issues/177_25/payment-protection-discover-cfpb-fdic-credit-cards-1046366-1.html.

48 *In the Matter of Capital One Bank, (USA) N.A.*, File No. 2012-CFPB-0001 (CFPB July 16, 2012); *In the Matter of Capital One Bank (USA,) N.A.*, 2012-153 (OCC July 17, 2012).

Student Lending

Student lending presents unique fair and responsible banking issues. Given the challenges unique to underwriting student loans – *i.e.*, the primary applicant typically has little or no income or credit history – nearly all private education lenders have begun using some combination of non-bureau, "school-based" attributes in their credit score models to predict repayment ability. These school-based attributes can include college, major, grade point average, school type (*e.g.*, for-profit versus not-for-profit school, or two-year versus four year degree programs), student grade level, cohort default rate,[49] and standardized test scores. As with any other non-credit bureau attribute, use of school-based attributes could create fair lending risk under disparate impact theory depending upon what they are and how they are weighted. In the past few years, cohort default rate, a neutral metric that the U.S. Department of Education itself uses to determine a school's eligibility to receive Title VII funds, has drawn scrutiny from Congress and the CFPB.[50]

Automobile Lending

Indirect automobile lending brings with it unique fair and responsible banking risk considerations. In indirect automobile lending, financial institutions develop loan programs by establishing relationships with automobile dealers. The financial institutions define the type of borrower and loan they will accept, and the automobile dealers gather credit information from prospective vehicle buyers, complete loan applications, and typically forward the collected information to the bank electronically for underwriting and approval.[51]

One area of indirect automobile lending that has come under intense scrutiny is the allowance of dealer mark-ups or overages in pricing. As a result of agreements in several class action settlements, the industry tends to cap overages at 2.5%.[52] However, with increased regulatory focus in this area, it is unlikely that lenders can simply rely on such a cap to avoid potential liability. For example, in addition to the

49 Cohort default rate is defined as “the percentage of those current and former students who enter repayments . . . [and] default before the end of the second fiscal year following the fiscal year in which the students entered repayment.” 20 U.S.C. § 1085(m).

50 The CFPB and Department of Education study required under Dodd-Frank includes questions related to cohort default rate. *See* H.R. 4173 § 1077(b)(6).

51 FDIC, FDIC Supervisory Insights: The Changing Landscape of Indirect Automobile Lending (2005), *available at* http://www.fdic.gov/regulations/examinations/supervisory/insights/sisum05/article04_auto_lending.html.

52 Mark A. Cohen, *Imperfect Competition in Auto Lending: Subjective Markup, Racial Disparity, and Class Action Litigation* (Vanderbilt Univ. Law Sch. Law and Econ. Working Paper No. 07-01), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=951827.

numerous private putative class actions on this issue,[53] in 2009 the DOJ filed a consent order resolving claims against Nara Bank, alleging that the bank violated ECOA by charging non-Asian customers higher overages than similarly-situated Asian customers.[54] It also appears that the CFPB is investigating indirect auto lending, either for rulemaking or enforcement purposes.[55] Any risk assessment, therefore, should review any variability in pricing by dealers, including whether there is adequate training and monitoring in place.

Next Steps

Before beginning a risk assessment of non-mortgage operations, a lender should consider carefully whether an assessment is advisable and how it should be conducted. Although there is no one-size-fits-all answer to the question of whether conducting a risk assessment makes sense for every financial institution, our experience generally suggests that a financial institution benefits in the long run by knowing its risks. Indeed, conducting an assessment not only helps the institution identify problems, but also provides the institution with a roadmap to solve those problems. Assessments simultaneously demonstrate to regulators that the institution is proactive where compliance and fair and responsible banking are concerned.

On the other hand, institutions must understand that if an assessment results in a report or other written work product, it is highly likely that such documents will be requested by and provided to the prudential regulator as well as the CFPB.[56] This result remains likely even if – as should always be the case – the risk assessment is conducted under

53 *See e.g.*, *Coleman v. GMAC*, 220 F.R.D. 64 (M.D. Tenn. 2004); *Cason v. Nissan Mortgage Acceptance Corp.*, 212 F.R.D. 518 (M.D. Tenn. 2002).

54 *United States v. Nara Bank*, No. CV 09-7124 RGK (JCx), 2010 WL 2766992 (C.D. Cal. May 28, 2009). Although Nara Bank entered into a consent decree, one of the automobile dealers moved to dismiss the complaint against it, which the district court granted. The district court granted the motion to dismiss finding that the DOJ's disparate impact claim was implausible because (i) the classification of Asians and non-Asians was vague and ambiguous at best and (ii) the DOJ's statistical allegations were unpersuasive. *See id*. at *3. The DOJ has appealed this decision to the Ninth Circuit Court of Appeals. *See United States v. Union Auto Sales, Inc.*, No. 10-56177 (9th Cir.). For further discussion of the case, see Andrew L. Sandler & Liana R. Prieto, LexisNexis Emerging Issues Analysis, *U.S. v. NARA Bank: In 2010's First Litigated Fair Lending Case, DOJ Fails to State a Plausible Claim That Auto Dealers Discriminated Against 'Non Asians*,' 2010 Emerging Issues 5218 (July 23, 2010).

55 Jeff Horwitz, *Banks Fear Becoming Collateral Damage in CFPB-Car Dealer Proxy Fight*, AMERICAN BANKER, June 11, 2012, http://www.americanbanker.com/issues/177_112/CFPB-auto-lending-discrimination-enforcement-actions-1050054-1.html.

56 12 U.S.C. § 1828(x) provides privilege protections for information disclosed to banking agencies and supervisors, however it is unclear whether that protection extends to the CFPB. The CFPB itself has taken the position that no waiver of privilege occurs as the result of disclosure to the Bureau. In addition, the House passed H.R. 4014 on March 29, 2012, which would amend Section 1828(x) to explicitly extend the privilege protections to the CFPB. The bill has not yet passed the Senate. On June 28, 2012, the CFPB issued 12 C.F.R. part 1070, subpart D, which states that the submission by any person of any information to the CFPB in the course of the CFPB's supervisory or regulatory process will not waive or otherwise affect any privilege such person may claim with respect to the information. *See* 12 C.F.R. Part 1070.47(c). The rule became effective 30 days after publication.

the attorney-client and all other applicable privileges. Thus, any risk assessment report could highlight issues for regulators on which they could then focus.

If it is decided that a risk assessment will be conducted, it should not go forward until the scope of what should be examined, how that examination will be conducted, and the type of information and work product are defined. Consideration of these questions at the outset will help keep the assessment focused and efficient and is more likely to provide the institution with results that are useful for evaluating and improving performance.

Another consideration to address up front is whether any sort of statistical analysis should be conducted in connection with the risk assessment. Unlike in the mortgage context in which HMDA data typically is readily available, most non-mortgage lenders do not capture the race, gender, or other protected class information of credit applicants. Instead, they must rely on geocoding or other proxies for this information. While proxies can be reasonable tools for internal compliance testing, they have significant limitations that limit the robustness of any analysis.[57] These limitations may give rise to imprecise results, including false positives, and as a result, careful consideration should be given to whether and how to utilize them in conjunction with any assessment. Members of the assessment team, financial institution management, or legal counsel who are knowledgeable about both statistical methods and current legal theories and regulatory enforcement involving disparate impact claims would be especially helpful in reaching a decision on the use of statistical analysis in the risk assessment.

Given the current regulatory environment in which examiners expect to see robust, comprehensive compliance programs, financial institutions are well-advised to give serious consideration to undertaking privileged self-assessments of their fair and responsible banking risks – especially those in non-mortgage lines of business. The time to fix the roof is when the sun is shining.

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57 *See, e.g.*, GAO, GAO-08-698, Fair Lending: Race and Gender Data Are Limited for Nonmortgage Lending 17-18 (2008) ("[absent racial data,] regulators may rely on time consuming and *possibly unreliable techniques* to assess lenders' compliance with fair lending laws" that "have potential for error"); Wansu Chen et al., Limitations and potential uses of census-based data on ethnicity in a diverse community, 14 Annals of Epidemiology 339, 342 (2004).

Benjamin P. Saul, Amanda M. Raines and Ann D. Wiles on

Why Fair and Responsible Banking Risk Assessments Are Important For Non-Mortgage Business Lines

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