

Disparate Impact Considerations for Private Education Loans

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Fair Lending Framework

- ECOA & Regulation B:
 - Regulation B §1002.4 prohibits discrimination on a prohibited basis.
 - Prohibited basis means race, color, religion, national origin, sex, marital status, or age.
 - Discrimination can be either as a result of disparate treatment or disparate impact.
 - Disparate treatment is the treatment of applicants differently based on one of the prohibited factors.

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Disparate Impact

- Discrimination that occurs when a lender applies a practice uniformly to all applicants, but the practice has a discriminatory effect on a prohibited basis that is not justified by a business necessity.
- Found in Regulation B, not in ECOA.
- Derived from employment law.
- Comment 2 to Regulation B §1002.6 states that Congressional intent was to include in effects tests for ECOA.

Disparate Impact and the CFPB

- Disparate Impact is the law, notwithstanding ongoing controversy
- CFPB Bulletin 2013-02: Guidance to indirect auto lenders stating that they are responsible for unlawful, discriminatory pricing; dealer participation arrangements create a significant risk of fair lending violations
- The assignee is the person being held responsible for the discrimination; the assignee is the only party subject to CFPB

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Disparate Impact

- Auto finance is the source of the current controversy
 - Dealer offers the consumer's application to several sales finance companies
 - Dealer has discretion to increase (or decrease) the "buy rate"
 - Dealer participates in any interest in excess of the buy rate
 - Dealer sometimes negotiates the rate with the consumer
 - No transparency to the consumer

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Ally Consent Order

- Pattern or practice of discrimination on the basis of race and national origin based on the dealer mark-up of the interest rate
- Ally did not admit allegations, said it did not believe that there is measurable discrimination by dealers, no court decision
- Ally agreed to pay a civil penalty, compensation, monitor dealer participation and take appropriate corrective action if the monitoring reveals discriminatory effects of the dealer participation

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Disparate Impact

- Auto finance industry response has been to consider alternative dealer compensation methods:
 - Flat or fixed compensation based on amount financed or per deal
 - Tightly-limited scenarios for dealer discretion; meeting competition option
 - Monitoring of dealer discretion scenarios

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Disparate Impact

- The auto finance enforcement actions show the CFPB's willingness to enforce fair lending when:
 - the covered person does not directly or personally interact with the consumer; and
 - The covered person does not directly determine the interest rate
- The CFPB's methodology used in these enforcement actions is highly controversial and could be used in other settings

Disparate Impact

- The CFPB's methodology is based on the use of proxies for race and ethnicity
- The CFPB published its methodology in October 2014 in a highly technical statistical analysis

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Bayesian Improved Surname Geocoding (BISG)

- Assigns a race or ethnicity to a consumer based on address and surname
- Each surname is given a racial/ethnic distribution
- Calculates a probability that a specific surname is indicative of a specific group

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BISG Criticisms

- Proxies are not necessarily adjusted to reflect consumer preferences by group
- BISG overstates minority variances due to interaction between names and census tract populations

BISG Criticisms

- Difficult to assess consumer harm with BISG
- BISG does not provide useful information for identifying and compensating consumers
- In auto finance context, there are many other dealer-specific factors that BISG does not recognize

CFPB Response

- CFPB declined to meet with industry to address criticisms
- Not clear if:
 - CFPB agrees or why it doesn't
 - How CFPB accounts for variations within an industry
 - CFPB would agree with evidence that suggests that legitimate business factors eliminate discriminatory pricing

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Implications for Education Finance

- No pricing discretion similar to that exercised by auto dealers
- FAO role in product access?
- CFPB's prior concern about the use of CDR as loan qualification or loan pricing factor
- Lack of direct interaction with consumer is not a bar to testing for or alleging disparate impact
- Same statistical methods used by CFPB with respect to auto finance would apply to any type of loan portfolio

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The Use of CDRs in PEL Underwriting

- CFPB 8/29/2012 report noted that most lenders use CDRs to either determine school eligibility or to set loan pricing
- Most lenders using CDRs use it to determine school eligibility at usually between 8-12%
- CFPB also noted that racial and ethnic minority borrowers are disproportionately concentrated in schools with higher CDRs.

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CFPB's View of CDRs

- CDRs weren't designed for use in PEL underwriting
- Potential disparate impact concern at least at a threshold level
- CFPB December 2012 Fair Lending Report also noted that the use of CDRs at very low levels is a fair lending concern:
 - reduced credit access
 - increased costs

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CFPB's View of CDRs

- CFPB PEL Examination Manual looks at the use of CDRs, business justification for that use and whether there is any analysis to support its business justification

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NCUA and CDRs

- NCUA Supervisory Letter No. 13-13 (December 2013) addressed a number of issues concerning PELs
- NCUA identified credit risk as a risk factor in offering PELs
- NCUA said CDRs were a useful analytical tool for risk assessment and monitoring

Use of CDRs – A Summary

- Possible Fair Lending issue
- Possible regulatory conflict
- Possible business justification
- Possible change to the law

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Disparate Impact Litigation

- Actual litigation arises under the FHA, not ECOA
- But both statutes lack language that has been interpreted in other contexts that prohibits disparate impact as well as disparate treatment: “refuse”, “make”, “deny”, “discriminate”

Disparate Impact Litigation

- Regulation B includes disparate impact based on Congressional record
- HUD regulation (2011) includes disparate impact
- HUD regulation was invalidated in 2013 by DC district court

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Supreme Court Status

- Three cases have been brought since 2011
- *Texas Department of Housing* case was argued in January 2015; decision by June 30
- Decision could go many ways; including decision on constitutional grounds
- FHA case effect on ECOA is not immediate or clear

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Questions?

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