MAYER • BROWN

Big Data and Non-Traditional Underwriting

Fair Lending Implications

October 19, 2016

Melanie Brody
mbrody@mayerbrown.com

Consumer Finance
MONTHLY BREAKFAST BRIEFING

Introduction

- Most credit decisions and pricing determinations are based heavily on information in credit reports generated by three national consumer reporting agencies
- Therefore, consumers who have limited or no credit history can have difficulty obtaining credit
- However, a large number of consumers are either:
  - Credit invisible, i.e., they do not have a credit report
  - Unscored, i.e., they do not have enough credit history to generate a score or their credit history is stale

Introduction

- The CFPB published a study in 2015 stating that:
  - 26 million consumers (10% of American adults) are credit invisible
  - 19 million consumers (8% of American adults) are unscored
  - African-American and Hispanic consumers are more likely to be credit invisible or unscored than white or Asian consumers
    - 15% of African-American and Hispanic consumers are credit invisible as compared to 9% of white consumers
    - 13% of African-American consumers and 12% of Hispanic consumers are unscored compared to 7% of white consumer
  - Consumers in low-income neighborhoods also are more likely to be credit invisible or unscored

MAYER·BROWN

Introduction

- Big data and non-traditional underwriting can serve as tools to make credit available to consumers who might not otherwise be eligible
- They also may allow lenders to better predict credit risk and more effectively target advertising and marketing efforts
- However, big data and non-traditional underwriting can also present fair lending risk

MAYER·BROWN

BIG DATA AND NON-TRADITIONAL UNDERWRITING

MAYER·BROWN

- Some segments of the consumer credit industry has provided for non-traditional credit for many years
  - For example, if a loan applicant does not have a credit score, Fannie Mae requires the lender to establish a non-traditional credit history for at least two non-traditional credit sources for each borrower, one of which must be housing-related (rent)
  - DU Version 10.0 provides for automated underwriting for unscored borrowers
- Big data has rapidly expanded sources of non-traditional credit data well beyond evaluations of rental payments and utility bills
- LexisNexis RiskView credit risk score is calculated using alternative data, e.g., educational history, property and asset ownership, professional licensing, evictions, recreational licenses, address instability
  - LexisNexis states that RiskView can score 86% of consumers who do not have a credit bureau score

MAYER·BROWN

- Increases in computing power have enabled massive increases in the amounts of data that can be stored, processed, and analyzed.
  - "[L]arge, diverse, complex, longitudinal, and/or distributed datasets generated from instruments, sensors, Internet transactions, email, video, click streams, and/or all other digital sources available today." ("Big Data: Seizing Opportunities, Preserving Values," Executive Office of the President, May 2014)
  - For example: web browsing history, social media presence, shopping patterns, data from fitness trackers, Facebook friends
  - Big data can involve almost anything
- Increases in computing power have also led to developments in analytics.
  - Instead of starting with a hypothesis and then carefully collecting data to validate it, collect all possible data and then look for any patterns that might emerge

MAYER • BROWN

- Using big data can create opportunities for lenders to increase business generally
- It also can help mitigate fair lending risk by expanding the ability to extend credit to minority borrowers
- On the other hand, big data can also create potential fair lending risk

MAYER • BROWN

Big Data: The Legal Framework–ECOA

- Prohibits discrimination in any aspect of a credit transaction on the basis of race/color, religion, national origin, sex, marital status, age, receipt of public assistance, and exercise of any right under the Consumer Credit Protection Act (e.g., FCRA, TILA, ECOA, FDCPA)
- Broad definition of creditor
  - Any person who, in the ordinary course of business, regularly participate in the credit decision, including setting the terms of the credit
- Also note:
  - Fair Housing Act: prohibits discrimination in residential real estate-related transactions on the basis of race/color, religion, national origin, sex, familial status, and disability

MAYER·BROWN

- State anti-discrimination laws
  - Example: California's Unruh Civil Rights Act prohibits discrimination on the basis of sex, race, color, religion, ancestry, age, disability, medical status, sexual orientation, genetic information, medical condition, citizenship, primary language and immigration status

Big Data: The Legal Framework–ECOA

- Theories of Liability:
  - Overt Discrimination
    - Explicit refusal to lend or explicit variation in terms or conditions based on a prohibited factor
  - Disparate Treatment
    - Different treatment because of a prohibited factor
    - Application of discretion is most common risk factor (but note that disparate impact theory also has been used to challenge discretionary conduct)
    - Intent not required
    - If defendant cannot show non-pretextual reason for difference in treatment, intent will be inferred

Big Data: The Legal Framework–ECOA

- Disparate Impact
  - A neutral policy or practice has a disproportionate and negative effect on a protected class
  - May be defensible if the challenged policy or practice serves a legitimate business interest
  - Challenged policy or practice may still be impermissible if the articulated business interest can be served through a less discriminatory means
- *Texas Department of Housing & Consumer Affairs v. Inclusive Communities* (135 S. Ct. 2507 (2015))
  - Disparate impact theory can be used to establish liability under the Fair Housing Act
  - But limitations on the disparate impact theory apply at the pleadings stage:
    - a plaintiff must satisfy a "robust causality" requirement by identifying a specific policy of the defendant and its link to a statistical disparity
    - policies are not contrary to the disparate impact requirement unless they are artificial, arbitrary and unnecessary barriers

MAYER•BROWN

Big Data: The Legal Framework–ECOA

- HUD's 2013 disparate impact rule is arguably inconsistent with *Inclusive Communities*
- Does *Inclusive Communities* decision apply to ECOA and non-mortgage credit?
- Technical application of judicial precedent vs. regulators' interpretation

MAYER•BROWN

COMPLIANCE CHALLENGES AND STRATEGIES

MAYER·BROWN

Potential Fair Lending Concerns

- Big data raises fair lending risk in two main categories:
  1. Marketing / advertising
  2. Credit determinations
     - Underwriting (approvals/denials)
     - Product choice
     - Pricing
     - Line adjustments

MAYER·BROWN

Potential Fair Lending Concerns: Marketing

- Marketing and advertising practices -- three potential fair lending risks:
  1. Direct violation of ECOA's prohibition on "discouragement"
  2. Can serve as evidence supporting discrimination claims
  3. Impact on lending patterns
- "In most cases, a company's advertisement to a particular community for a credit offer that that is open to all to apply is unlikely, by itself, to violate ECOA, absent disparate treatment or an unjustified disparate impact in subsequent lending." *"Big Data: A Tool for Inclusion or Exclusion,"* Federal Trade Commission, January 2016.

MAYER·BROWN

Potential Fair Lending Concerns: Marketing

- Whether targeting a specific group (e.g., minority consumers) presents risk often turns on whether the product being advertised is viewed as beneficial or harmful
  - Generally, using big data to advertise and make credit available to underserved / protected class groups is viewed favorably
  - Risk of "reverse redlining" can be mitigated with product selection controls

MAYER·BROWN

Potential Fair Lending Concerns: Marketing

- Using social network or internet habits to target advertising can perpetuate a lack of access to credit for consumers who have a limited digital presence
- Consider the entire marketing strategy
- Unless marketing / advertising practices are clearly discriminatory, the primary risk arises from actual lending patterns

MAYER・BROWN

Potential Fair Lending Concerns: Credit Determinations

- Use of big data can enable institutions to make credit available to previously underserved groups
  - If big data is used to extend credit to those who otherwise would not have received credit (e.g., credit invisibles), it will be less likely to draw scrutiny than if it is used as a primary decision factor
- Reliance on big data “may exclude certain populations from the benefits society and markets have to offer” (FTC Report)
  - Data quality, including uncorrected biases, can lead to inaccurate predictions, which can lead to “erroneous” denials
  - Difference between correlation and causation

MAYER・BROWN

Potential Fair Lending Concerns: Credit Determinations

- Denials / line reductions based on shared characteristics raise fairness concerns
  - Poor credit history of customers who shopped at same places
  - Use of credit for marriage counseling, therapy or tire repair
- Even if predictive power can be established, use of certain factors may be viewed unfavorably

MAYER•BROWN

Managing Risk

- Test whether a factor has a disparate impact on one more protected class
- Test the factor's predictive power
- Consider alternatives
- Carefully document fair lending evaluations
  - Important from CMS perspective
  - Regulators may rely on your analyses rather than performing their own
- Tension between compliance and analytical teams
- Third party vendors
  - CMS / Vendor oversight
  - Reps and warranties

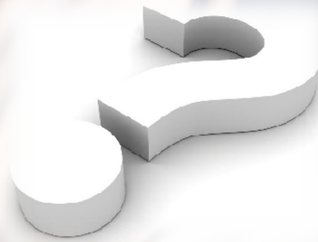
MAYER•BROWN

Fair Lending Considerations

- Big data has not changed basic fair lending concerns
  - These apply to new entrants just as they apply to traditional lenders, and new entrants need to build appropriate compliance management systems
  - Traditional lenders expanding into these areas will also need to fold the new businesses into their existing compliance management systems
- Regulatory scrutiny likely to intensify–sample headlines.
  - *"Big Data: A Report on Algorithmic Systems, Opportunity, and Civil Rights,"* Executive Office of the President, May 2016.
  - *"Consumer Finance Watchdog Plans to Supervise Marketplace Lenders," Wall Street Journal*, April 27, 2016.
  - *"Big Data: A Tool for Inclusion or Exclusion,"* Federal Trade Commission, January 2016.
  - *"How to Talk about Big Data and Lending Discrimination," American Banker*, September 10, 2015.

MAYER•BROWN

QUESTIONS



MAYER•BROWN

MAYER • BROWN

Mayer Brown is a global legal services provider comprising legal practices that are separate entities (the "Mayer Brown Practices"). The Mayer Brown Practices are: Mayer Brown LLP and Mayer Brown Europe-Brussels LLP, both limited liability partnerships established in Illinois USA; Mayer Brown International LLP, a limited liability partnership incorporated in England and Wales (authorized and regulated by the Solicitors Regulation Authority and registered in England and Wales number OC 303359); Mayer Brown, a SELAS established in France; Mayer Brown Mexico, S.C., a sociedad civil formed under the laws of the State of Durango, Mexico; Mayer Brown JSM, a Hong Kong partnership and its associated legal practices in Asia; and Tauil & Chequer Advogados, a Brazilian law partnership with which Mayer Brown is associated. Mayer Brown Consulting (Singapore) Pte. Ltd and its subsidiary, which are affiliated with Mayer Brown, provide customs and trade advisory and consultancy services, not legal services. "Mayer Brown" and the Mayer Brown logo are the trademarks of the Mayer Brown Practices in their respective jurisdictions.