MAYER | BROWN

Fall 2020

FAIR LENDING NEWSLETTER

Recent Developments

Contents

Letter to Readers

Dear Reader,

Welcome to the inaugural edition of Mayer Brown's Fair Lending Newsletter. Our goal in publishing this newsletter is to provide you with a quarterly resource covering the most notable fair-lending developments of the past three months. In this edition, we cover various topics, from the current state of fair lending at federal government agencies to recent regulatory developments affecting banks and other consumer financial services companies.

It's no secret that fair lending enforcement under the leadership of CFPB Director Kathleen Kraninger (and that of her predecessor, Acting Director Mick Mulvaney) has dwindled to near non-existence. Its specialized fair lending unit has been reorganized under a division that focuses on advocacy and education. In the time since former Director Richard Cordray left the Bureau nearly three years ago, the Bureau has filed only one discrimination-related lawsuit against a mortgage lender, and one enforcement action against a mortgage lender for submitting mortgage-loan data that contained errors in the reporting of race, ethnicity and gender information. The ten other federal agencies charged with administrative enforcement of the Equal Credit Opportunity Act similarly have stalled enforcement under the current presidential administration. In stark contrast to prior years, these agencies combined have made only a handful of fair-lending referrals to the Department of Justice under the current administration. Fair Housing Act enforcement likewise is down from prior years.

COVID-19 has overshadowed just about everything in the past six months, and federal and state offices and agencies will be paying close attention to how financial institutions are serving their customers during the pandemic, particularly as consumers experience financial distress. Despite this undercurrent, however, we have seen a number of fair lending developments over the past few months. Notwithstanding the dearth of publicly announced fair-lending enforcement actions, for example, the CFPB and other federal enforcement agencies are continuing to examine supervised institutions and are citing them for fair-lending violations through the non-public supervisory process. Violations cited include allegations of so-called "redlining," such as by discouraging consumers from applying for mortgage loans based on their race and making fewer mortgage loans in predominantly minority areas than peer lenders.

One of the most notable developments of this year is the Department of Housing and Urban Development's finalization of its disparate impact rule, revising the burden-shifting framework for determining whether a given practice has an unjustified discriminatory effect in violation of the Fair Housing Act to better align with the Supreme Court's 2015 decision in *Inclusive Communities*. Reliance on the disparate-impact theory of liability was commonplace under the Obama administration, but largely avoided under the Trump administration. We can be sure that if there is a change in administration after the November election, disparate impact will make a comeback. Indeed, if Mr. Biden wins the presidency, we can expect to see a seismic shift in fair lending and fair housing priorities—not only would a new administration likely install a new CFPB Director immediately, but the Biden campaign also is pledging to end redlining and other discriminatory practices by enacting legislation to protect homeowners from abusive lenders, reverse HUD's disparate impact rule, and expand the Community Reinvestment Act to apply to non-bank mortgage and insurance companies, among other things. And even if the administration does not change, we may still see an uptick in fair lending activities, given the Bureau's recent redlining lawsuit against a non-bank lender, its issuance of a Request for Information on ten fair lending topics, and Director Kraninger's recent public statements about the Bureau's focus on ensuring that companies treat consumers fairly.

We hope you will enjoy reading the inaugural edition of our Fair Lending Newsletter and future editions to come. Please do not hesitate to contact us for any assistance.

With kind regards from the editors,

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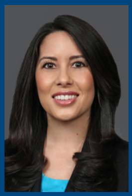

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Fair Lending Considerations in a Time of COVID-19

As the effects of the COVID-19 pandemic continue to significantly impact daily life and the US economy, government agencies have emphasized the need for lenders to continue to comply with fair lending laws. Lenders face a number of new challenges due to the pandemic, including limited access to consumer financial data, increased requests for accommodations and modifications, and various new legal and regulatory requirements and programs (*e.g.*, the Coronavirus Aid, Relief, and Economic Security Act (CARES Act)). Despite these challenges, regulators have emphasized the importance of continuing to comply with fair lending laws. Failure to do so could negatively impact actual and potential borrowers and expose financial institutions to compliance risk.

The Federal Financial Institutions Examination Council (FFIEC) is made up of the federal financial institution regulators (the Office of the Comptroller of the Currency (OCC), the Board of Governors of the Federal Reserve (Federal Reserve Board or Board), the Federal Deposit Insurance Corporation (FDIC), the National Credit Union Administration (NCUA), and the Consumer Financial Protection Bureau (CFPB or Bureau)). The FFIEC issued a statement in early August providing guidance on how financial institutions should proceed as government-mandated and voluntary loan accommodation periods begin to end. In particular, the FFIEC encouraged financial institutions to provide clear, accurate, and timely information to borrowers regarding additional accommodation options before the end of their current accommodation periods, so that institutions and borrowers have ample time to work out affordable, sustainable solutions for consumers. In addition, financial institutions should ensure their policies and procedures reflect the available accommodation options and promote consistency with fair lending laws and regulations. The FFIEC also advised financial institutions to provide appropriate training to employees regarding additional accommodation policies, as well as ensure that staff are qualified and can efficiently handle expected workloads. The FFIEC also stressed the importance of testing by internal control functions to ensure that additional accommodation options offered to borrowers are presented and processed in a fair and consistent manner and are in compliance with fair lending laws and regulations. Communications with borrowers, as well as legal documentation, should be clear, accurate, timely, and in accordance with contractual terms, policy guidelines, and applicable laws and regulations.

The CFPB similarly released a statement stressing the importance of complying with fair lending laws during the COVID-19 pandemic, particularly because the small, minority-owned, and women-owned businesses that fair lending laws are designed to protect have suffered significant negative impacts due to the pandemic. In particular, the CFPB noted several warning signs of discriminatory lending that could arise as financial institutions provide loans and debt relief under the Paycheck Protection Program established by the CARES Act:

- refusing available loans or workout options even though the borrower qualifies based on the advertised requirements;
- offering credit or workout options at higher rates or worse terms than the borrower applied for, even though the borrower

qualified for the better terms;

- discouraging borrowers from applying for credit because of a protected characteristic;
- denying credit without providing the borrower with a reason or a method to find out the reason; and
- making negative comments about protected characteristics.

Notably, although regulators have eased certain regulatory requirements during the COVID-19 pandemic and have indicated that they will take into account good-faith efforts by institutions designed to assist consumers, regulators also have re-emphasized the importance of compliance with fair lending laws during the pandemic. Accordingly, despite the numerous challenges for financial institutions during the pandemic, lenders must continue to vigilantly consider applicable fair lending risks, implications, and risk mitigation strategies.

HUD Finalizes Disparate Impact Rule

The disparate impact theory of liability arguably has been the most controversial aspect of fair lending jurisprudence in the last decade. Over Labor Day weekend, the US Department of Housing and Urban Development (HUD) finalized its revised Disparate Impact Rule (Final Rule) which, unsurprisingly, also has been the subject of significant controversy.

HUD's Final Rule revises the Department's previous rule on this topic to align with the Supreme Court's 2015 decision in *Texas Dept. of Housing and Community Affairs v. Inclusive Communities Project, Inc.* (*Inclusive Communities*), a landmark Fair Housing Act case. In *Inclusive Communities*, the Supreme Court held that disparate impact is a viable theory of liability under the Fair Housing Act, but that "adequate safeguards" must be implemented to protect against "abusive" disparate impact litigation and ensure that "regulated entities are able to make the practical business choices and profit-related decisions that sustain a vibrant and dynamic free-enterprise system."

The Final Rule largely tracks the proposed rule and outlines five elements that a plaintiff must demonstrate at the pleading stage in order to bring a disparate impact claim under the Fair Housing Act. Specifically, a plaintiff must sufficiently plead facts to show that:

1. The challenged policy or practice is **arbitrary, artificial, and unnecessary** to achieve a valid interest or legitimate objective such as a practical business, profit, policy consideration, or requirement of law;
2. The challenged policy or practice has a **disproportionately adverse effect** on members of a protected class;
3. There is a **robust causal link** between the challenged policy or practice and the adverse effect on members of a protected class, meaning that the specific policy or practice is the **direct cause** of the discriminatory effect;
4. The alleged disparity caused by the policy or practice is **significant**; and
5. There is a **direct relation** between the injury asserted and the injurious conduct alleged.

Under the Final Rule, a plaintiff must prove each of these elements by a preponderance of the evidence at the pleading stage. A defendant can rebut a plaintiff's allegations that the policy or practice is arbitrary, artificial, and unnecessary by producing evidence to show that the challenged policy or practice advances one or more valid interests. If a defendant is able to make that showing, then the plaintiff must prove that (i) the interest advanced by the defendant either is not valid or (ii) there is a less discriminatory policy or practice that would serve the defendant's identified interest in an equally effective manner without imposing materially greater costs on, or creating other material burdens for, the defendant.

The most significant change to the Final Rule was the removal of specific defenses to disparate impact claims for models and algorithms. This section of the proposed rule drew significant criticism from consumer advocacy groups, which argued that it improperly focused on whether a model's *inputs* included prohibited bases or proxies for prohibited bases, rather than focusing on the *outputs* of a model. HUD ultimately removed this section from the Final Rule, stating that it was premature to explicitly address defenses to claims involving models and algorithms at this time, as it expects further developments in the law in the areas of algorithms, machine learning, and artificial intelligence.

Although HUD removed the model defenses from the text of the Final Rule itself, the Rule's preamble provides some guidance regarding how defendants may justify and defend predictive models. According to HUD, a defendant can defend against a disparate impact claim based on a predictive model by showing that the model accurately assessed risk (which is a valid interest), and by demonstrating that the model is accurate by showing that it is not overly restrictive on members of a protected class. For example, if a plaintiff alleges that a lender rejects members of a protected class at higher rates than non-members, then the logical conclusion of such claim would be that members of the protected class who were approved (having been required to meet an unnecessarily restrictive standard) would default at a lower rate than individuals outside the protected class. Therefore, according to HUD, if the defendant demonstrates that a default risk assessment model leads to fewer loans being made to members of a protected class, but similar members of the protected class who did receive loans actually default more or just as often as similarly situated individuals outside the protected class, then the defendant could show that the predictive model was not overly restrictive. HUD indicates that it considers this to be an alternative to the model defenses that were laid out in the proposed rule.

Another notable aspect of the Final Rule is that it establishes a policy against the imposition of civil money penalties in administrative proceedings brought by the Department. HUD indicates that remedies in disparate impact cases should be focused on eliminating or reforming the discriminatory practice so as to eliminate disparities between persons in a particular protected class and other persons. The Final Rule provides that HUD will only seek equitable remedies in administrative proceedings involving disparate impact claims unless the defendant has been previously adjudged to have committed intentional discrimination in the last five years. Although this provision of the Final Rule does not foreclose the possibility of punitive damages in disparate impact litigation (as provided for in the Fair Housing Act), it clearly sets forth HUD's prioritization of equitable remedies in disparate impact cases.

Overall, the Final Rule arguably makes it more difficult for plaintiffs to bring disparate impact claims under the Fair Housing Act and provides defendants with enhanced safeguards for defending against such claims. HUD's Final Rule also reiterates what the Supreme Court has already declared—statistics alone are insufficient to prove a violation of the Fair Housing Act.

The Final Rule has been met with strong criticism from consumer advocacy groups and certain members of Congress. Nevertheless, it becomes effective on October 26, 2020, and will be the governing framework for evaluating disparate impact claims under the Fair Housing Act. Now that HUD has finalized its framework for evaluating disparate impact claims under the Fair Housing Act, all eyes are on the CFPB to see if it will adopt the same framework for disparate impact claims under the Equal Credit Opportunity Act (ECOA). Even though the Bureau has issued an RFI requesting feedback on the disparate impact framework under ECOA, it is unlikely that there will be any further movement from the Bureau on this issue before the November election.

CFPB Sues First Non-Bank Mortgage Lender for Alleged Redlining

Marking the first time that a federal regulator has sued a non-bank lender for alleged "redlining," the CFPB filed a lawsuit on July 15, 2020, against Townstone Financial, Inc. (Townstone), a Chicago-based mortgage lender and mortgage broker. In its lawsuit, the Bureau alleges that Townstone "red-lined" African-American neighborhoods in the Chicago area and discouraged prospective applicants from applying for mortgages on the basis of their race. The Bureau's complaint underscores what it has stated publicly—redlining is a key area of focus under CFPB's current leadership. It also serves as a reminder that even small- and medium-sized lenders are not immune from fair lending scrutiny.

In its complaint, the CFPB makes three basic allegations to support its claim that the lender met the credit needs of *non-minority* neighborhoods within the Chicago Metropolitan Statistical Area (MSA) while avoiding the credit needs of predominantly African-American neighborhoods. First, the Bureau alleges that the company's owners and senior management made disparaging remarks about African Americans, women, and predominantly African-American neighborhoods, on "The Townstone Financial Show," an AM radio show and podcast, and that these remarks served to discourage prospective African-American applicants. Second, the Bureau alleges that company failed to affirmatively market to African Americans and did not employ any African-American loan officers. Third, the CFPB's statistical analysis of Townstone's mortgage application volume allegedly revealed the company was behind its peers in capturing loan applications from majority-African-American neighborhoods. Townstone is a relatively small mortgage company, receiving an average of 740 mortgage loan applications each year during the applicable time period. The complaint asserts that, during the relevant time period, the company drew a significantly smaller proportion of mortgage-loan applications for properties in majority-African-American neighborhoods than its peer lenders did (its peer lenders allegedly received between 3.6 and 6.2 times more mortgage loan applications from majority-African-American areas in the Chicago MSA than Townstone did). Based on the totality of these circumstances (i.e., the company's statements and its acts and practices, including the small draw of applications from African-American communities as compared to lenders of comparable size), the Bureau alleges that the company redlined African-American neighborhoods in the Chicago MSA and discouraged prospective mortgage applicants on the basis of race.

Again, this is the first public redlining action against a non-bank mortgage lender by any federal regulator.[1] Although the complaint outlines certain factual allegations related to the potential discouragement of prospective applicants in connection with certain marketing statements, redlining is fundamentally about the refusal to do business in majority-minority geographies. And because most redlining cases ultimately settle, there is very little case law precedent to offer any insight as to how a court may rule on this matter. For these reasons, it is unclear whether the CFPB's allegations about the company's marketing and employment practices, coupled with its statistical allegations, will be sufficient to prove a redlining claim in a court of law.

For a more detailed discussion of the key takeaways from this lawsuit, you can read our full Legal Update here or listen to our podcast here.

1 It is also the CFPB's first redlining case under the Trump administration, although the CFPB has only brought two other public redlining cases in its history, and those cases were joint efforts that involved the Department of Justice. *CFPB v. Hudson City Savings Bank, F.S.B.*, Case No. 2:15-cv-07056 (D. N.J. Sept. 24, 2015); *CFPB v. BancorpSouth Bank*, Complaint, Case No. 1:16-cv-118-GHD-DAS (N. D. Miss. June 29, 2016).

Supervisory Examinations Reveal ECOA and Regulation B Concerns

As we've noted throughout this newsletter, redlining remains a focal point for regulators. The CFPB's single discrimination-related enforcement action of the year is a redlining-based lawsuit. And its latest edition of *Supervisory Highlights* documents that examiners have observed intentional redlining of majority-minority neighborhoods (i.e., >50% minority) in two MSAs by engaging in practices that discourage people from applying for credit.

The Bureau alleges that these lenders used marketing materials that would discourage reasonable persons on a prohibited basis from coming to them for mortgage loans, including by publishing ads that prominently featured a white model and distributing marketing materials that featured "almost exclusively" white models. At open houses, the lender provided marketing materials that included headshots of its loan officers where almost all the materials showed professionals who appeared to be white. These marketing claims, coupled with statistical analyses showing that the lenders received significantly fewer applications from majority-minority neighborhoods and high-minority neighborhoods (>80% minority) than their peers, prompted the Bureau to determine that the lenders' redlining was intentional. Rather than initiating public enforcement actions, however, the Bureau apparently accepted the lenders' practice changes as sufficient to address its concerns. In response to the exam findings, lenders implemented outreach and marketing programs to increase their visibility in majority-minority census tracts in the relevant MSAs and made other improvements to their compliance management systems. These findings echo some of the allegations made by the Bureau in its recent redlining lawsuit against Townstone and reinforce the Bureau's focus on potential redlining (by both banks and non-banks) and discouragement in marketing and advertising.

Another exam finding reportedly involved one or more lenders' failure to consider public assistance income. ECOA prohibits discrimination against a credit applicant because any of their income derives from a public assistance program, such as social security income or food stamps. While a creditor may consider the amount and probable continuance of such income, it may not *automatically* discount or exclude such income from consideration. At least one lender examined by the CFPB allegedly improperly excluded unemployment benefits and certain other types of public income from income calculations without considering the applicant's actual circumstances when evaluating loss mitigation applications, even though it did not have written policies directing the practice. The lender provided financial remuneration and mortgage modifications to any affected borrowers, updated its policies and procedures, and enhanced its training to ensure that all types of public assistance income are considered in evaluating loss mitigation applications. Lenders may consider reviewing their policies and practices regarding treatment of public assistance income to ensure they are in compliance with regulatory expectations.

These exam findings reveal that the Bureau's fair lending exams are focused largely on potential disparate treatment, rather than disparate impact, violations. Further, as Director Kraninger has stated publicly, the Bureau's preference is to resolve issues identified through the exam process using non-public supervisory mechanisms, instead of through public enforcement actions.

CRA Developments

The OCC announced a final rule on May 20, 2020, overhauling its Community Reinvestment Act (CRA) regulations. The CRA requires insured depository institutions to participate in investment, lending, and service activities that help meet the credit needs of their communities, with an emphasis on low- and moderate-income communities and small businesses and farms.

The OCC's move to go its own way on CRA updates is unprecedented in terms of CRA regulations, which the OCC, FDIC, and Federal Reserve Board have historically issued jointly. For the first time, banks will be subject to different CRA regulatory schemes, not only depending on the size and purpose of the bank, but also depending on the bank's prudential regulator. Exacerbating the issue, the Federal Reserve Board issued an advance notice of proposed rulemaking on September 21, 2020, and it will accept comments on the proposal for 120 days following publication in the Federal Register (at the time of printing, the notice had not yet been published in the Federal Register). Although the Federal Reserve Board's stated goals of transparency and certainty are similar to those of the OCC, the Board's proposed CRA framework would differ from the OCC's framework in myriad ways, from how banks' performance is evaluated to whether or not new data collection requirements are imposed. And the FDIC, which just last year was seemingly in alignment with the OCC, has not joined either agency but instead could follow suit with its own, third CRA framework.

Differences between the CRA regulatory schemes and how they are implemented are likely to cause confusion and increase uncertainty for banks attempting to comply with the CRA, as well as for other CRA stakeholders, such as those seeking funding and support. Critics of the OCC's new regulatory scheme, including the Federal Reserve Board, have expressed concerns that the framework's emphasis on the dollar amount of qualifying activities will reduce banks' incentive to invest in low- and moderate-income communities and other markets important to the CRA's purpose of addressing unequal access to credit. Community groups likewise are opposed to the rule. And the Biden campaign has pledged to make major changes should Mr. Biden win the presidential election—among other things, he promises to expand the CRA to apply to non-bank mortgage and insurance companies. Notwithstanding these inevitable challenges, the OCC's new rule became effective on October 1, 2020. The deadline for compliance with the rule varies depending on the regulatory provision and type of institution, with some requirements not taking effect until 2024.

For a full discussion on the OCC's new CRA regulations, please see our Legal Update.

CFPB Finally Makes Progress on Implementing Small Business Lending Data Collection Requirements

On September 15, 2020, the CFPB published a detailed outline of proposed options it is considering to implement a rule under Section 1071 of the Dodd Frank Act. Ten years ago, Section 1071 amended ECOA to require financial institutions to collect and report information concerning credit applications made by women- or minority-owned businesses and by small businesses. Although the CFPB was tasked with drafting rules to implement Section 1071, it did not take significant steps to meet that obligation until 2017, when it reported on some preliminary research, and then later in November 2019, when it held an information-gathering symposium.

As we have [previously discussed](), once Section 1071 is implemented, certain financial institutions will be required to collect information regarding the race, sex, and ethnicity of the principal owners of small businesses and women- and minority-owned businesses and submit this information to the CFPB, similar to what is currently required by the Home Mortgage Disclosure Act for mortgage loans. The CFPB's outline proposes several potential options for developing the small business lending data collection rule and is a precursor to any future proposed rulemaking. At this stage, the CFPB is seeking feedback on the direction of the rule. Feedback and comments on the scope of the rule can be sent to 2020-SBREFA-1071@cfpb.gov until December 14, 2020. The CFPB is also seeking feedback on the potential impacts on small business entities and has requested submission of such feedback by November 9, 2020.

Below, we summarize the key aspects of the Bureau's outline and its proposals regarding the scope of the rule.

WHO WOULD BE REQUIRED TO COLLECT INFORMATION UNDER THE RULE?

The Bureau is proposing to apply the data collection and reporting requirements to all entities that meet the statutory definition of "financial institution" under Section 1071: "any partnership, company, corporation, association (incorporated or unincorporated), trust, estate, cooperative organization, or other entity that engages in any financial activity." Under this proposed definition, the requirements would apply to a variety of entities that engage in small business lending, including depository institutions, online lenders/platform lenders, community development financial institutions, lenders involved in equipment and vehicle financing, commercial finance companies, governmental lending entities, and non-profit, non-depository lenders.

WHO WOULD BE EXEMPT FROM THE COLLECTION AND REPORTING REQUIREMENTS?

The Bureau is considering proposals, in light of Section 1071's statutory purposes, to exempt certain entities from the collection and reporting requirements based on size-based and/or activity-based thresholds. The Bureau is concerned that the smallest financial institutions, or those with the lowest volume of small business lending, might reduce or cease their small business lending activity because of the fixed costs of compliance with an eventual 1071 rule, which could be contrary to the community development purpose of Section 1071 and could also be contrary to one of the general purposes of the Bureau, to facilitate access to credit.

Specifically, the Bureau is considering whether depository institutions with assets under a given threshold should be exempt from collecting and reporting. The Bureau is considering setting this threshold at either $100 million or $200 million in assets. In addition, the Bureau is considering whether to require financial institutions to collect and report data only if they exceed either a specified number or dollar value of small business loans originated in a specified period. The Bureau is considering setting these thresholds at: (1) at least 25 loans or $2.5 million; (2) at least 50 loans or $5 million; or (3) at least 100 loans or $10 million. The Bureau is also considering whether to use these two tests together to determine coverage under its future 1071 rule.

WHOSE INFORMATION WOULD A FINANCIAL INSTITUTION BE REQUIRED TO COLLECT?

Although the language in Section 1071 suggests that the Bureau could require financial institutions to collect information from *all* small businesses and women- and minority-owned businesses, the Bureau is considering requiring data collection only for applicants that meet the Bureau's definition of a small business. Under the proposed approach, financial institutions would not be required to collect and report data for women-owned and minority-owned businesses that are not "small," but would be required to identify women-owned and minority-owned businesses within the pool of small business applicants. The Bureau is considering this simplified standard because it is concerned that a requirement to collect and report 1071 data on applications for women-owned and minority-owned businesses that are not small businesses could affect all aspects of financial institutions' commercial lending operations while resulting in limited information beyond what would already be collected and reported about women-owned and minority-owned small businesses. In addition, the Bureau acknowledges that financing for large businesses can be much more varied and complex than the products used for small business lending.

As for the definition of a "small business" under the rule, Section 1071 requires the CFPB to either use the Small Business Administration's (SBA) size standards or to request SBA approval for a size standard specific to the rule. Generally, the SBA classifies business size using North American Industry Classification System (NAICS) codes, which take into consideration each business's specific industry, annual receipts, and number of employees. For purposes of its 1071 rule, the Bureau is considering adopting a simplified size standard in order to assist both financial institutions and applicants seeking to quickly understand whether a business is "small." By adopting a simplified standard, the CFPB would not require financial institutions to determine the appropriate six-digit NAICS code, and then the relevant size standard based on that NAICS code, for each applicant. Rather, the Bureau is considering three alternative approaches for a simpler size standard: (1) defining a small business as one that earns either $1 million or less or $5 million or less in gross annual revenue in the prior year; (2) defining a small business as one that employees 500 people or less for the manufacturing and wholesale industries, or as one that makes $8 million or less in gross annual revenue for all other industries; or (3) using an applicant's gross annual revenue or number of employees based on a modified version of the size standards in NAICS code categories.

WHAT TYPES OF CREDIT AND APPLICATIONS FOR CREDIT WOULD BE COVERED?

The Bureau is considering proposing that covered products under its 1071 rule include term loans, lines of credit, and business credit cards. In contrast, the Bureau is considering proposing that the following products be excluded from coverage under any 1071 rule: consumer-designated credit, most leases, factoring, trade credit, and merchant cash advances. Notably, the Bureau is considering proposing that factoring arrangements (i.e., purchases of accounts receivable) not be a covered product under Section 1071 because they are generally not considered subject to ECOA or Regulation B. The Bureau is also considering proposing that merchant cash advances, which usually involve a cash advance to a merchant in exchange for a promise to repay a percentage of future revenues, not be a covered product because including them may add additional complexity or reporting burdens given the unique structure of the transactions.

The Bureau is also considering clarifying circumstances that would not be reportable under Section 1071, even if certain of these circumstances are considered an "application" under Regulation B, including: (1) inquiries/prequalifications; (2) reevaluation, extension, and renewal requests, except requests for additional credit amounts; and (3) solicitations and firm offers of credit.

WHAT DATA POINTS WILL FINANCIAL INSTITUTIONS HAVE TO COLLECT?

Section 1071 directs the Bureau to require financial institutions to collection certain mandatory data points. Specifically, each financial institution must compile, maintain a record of, and report to the Bureau the following information provided by any credit applicant: (1) whether the applicant is a women-owned, minority-owned, and/or small business, (2) the application/loan number, (3) the application date, (4) the loan/credit type, (5) the loan/credit purpose, (6) the credit amount/limit applied for, (7) the credit amount/limit approved, (8) the type of action taken, (9) the action taken date, (10) the census tract of the applicant's principal place of business, (11) the applicant's gross annual revenue, and (12) the race, sex, and ethnicity of the applicant's principal owners.

In addition, Section 1071 gives the Bureau the authority to require financial institutions to collect and report "any additional data that the Bureau determines would aid in fulfilling the purposes of [Section 1071]." The Bureau is considering requiring the reporting of the following "discretionary data points": (1) pricing of both originated credit and credit that is approved but not accepted; (2) the applicant's time in business; (3) the applicant's NAICS code; and (4) the applicant's number of employees.

More specific information on each proposed data point, including a description and data elements to be collected, can be found at Appendix D to the outline.

AT WHAT POINT IN THE APPLICATION PROCESS WILL THE DATA BE COLLECTED?

The Bureau is considering not specifying a particular time period during the application process when financial institutions must collect 1071 data from applicants. The Bureau indicates that it is disinclined to specify a time period for collecting 1071 data from applicants, as it is concerned that doing so could be disruptive to financial institutions' existing processes.

WHEN WOULD FINANCIAL INSTITUTIONS BE REQUIRED TO REPORT THE DATA?

The Bureau is considering proposing that financial institutions collect data under the 1071 rule on a calendar-year basis, and submit the information to the Bureau by a specified time after the end of each calendar year. In addition, the Bureau is considering proposing that financial institutions retain the data for at least three years after submission to the Bureau.

HOW LONG WILL FINANCIAL INSTITUTIONS HAVE TO COMPLY WITH THE NEW RULE?

The Bureau is considering proposing that financial institutions have two calendar years for implementation following the Bureau's issuance of its eventual 1071 rule. Further, the Bureau intends to provide guidance in the form of plain language compliance guides and aids; technical specifications and documentation; and by conducting meetings with stakeholders to discuss the rule and implementation issues in order to assist financial institutions with efficient and effective implementation.

WHAT WILL THE CFPB DO WITH THE DATA?

Congress enacted Section 1071 for the purpose of facilitating enforcement of fair lending laws and enabling communities, governmental entities, and creditors to identify business and community development needs and opportunities for women-owned, minority-owned, and small businesses. In particular, the data will help the Bureau enforce ECOA's prohibition on discriminating against an applicant, including business applicants, on the basis of race, sex, ethnicity, and other prohibited bases in any aspect of a credit transaction. The Bureau believes that data collected under the 1071 rule will also be helpful in fulfilling Congress's purposes in enacting section 1071 by identifying potential fair lending concerns regarding small businesses, including women-owned and minority-owned small businesses, as well as the needs and opportunities for both business and community development.

WHAT IS THE FUTURE OF SMALL BUSINESS LENDING REGULATION?

The Bureau's recent progress on the 1071 rule is part of a larger trend of increased momentum to regulate small business lending. For example, earlier this year the SBA promulgated regulations implementing the Small Business 7(a) Lending Oversight Reform Act of 2018. With regard to the 1071 rule, the CFPB was forced to move forward with implementation in order to comply with a settlement agreement the Bureau reached in a lawsuit alleging that the Bureau violated the Administrative Procedure Act by failing to timely promulgate the 1071 rule. Under the terms of the agreement, the Bureau was required to publish the outline of proposals for the 1071 rule by September 15, 2020. The agreement also requires the Bureau to establish a Small Business Advocacy Review Panel by October 15, 2020, and submit status reports on its progress on the rule every 90 days.

CFPB Seeks Public Input on Key ECOA Issues

Through a request for information (RFI) released on July 28, 2020, the CFPB is seeking public input on opportunities for the Bureau to clarify Regulation B in a way that prevents credit discrimination and promotes credit access and innovation. The Bureau has requested feedback on a diverse set of topics, though the request is not limited to the below topics. Commenters are encouraged to address any other aspects of ensuring fair access to credit and promoting innovation in their submissions.

Specifically, the ECOA RFI seeks feedback on whether and how the Bureau:

1. Should provide additional clarity regarding its approach to disparate impact analysis;
2. Can address regulatory uncertainty with respect to serving limited English proficiency populations;
3. Should clarify the Special Purpose Credit Program provisions in Regulation B to facilitate the use of such programs;
4. Can provide additional guidance regarding affirmative advertising to disadvantaged groups;
5. Can support small business lending, particularly to minority- and women-owned businesses;
6. Can or should, in interpreting ECOA, look to the Supreme Court's recent ruling in *Bostock v. Clayton County* that the prohibition against sex discrimination under Title VII applies to discrimination on the basis of sexual orientation and gender identity;
7. Should provide additional guidance on whether state laws are preempted by ECOA and/or Regulation B, as well as examples of potential conflicts or intersections between state laws and regulations and ECOA and/or Regulation B;
8. Should clarify ECOA's restrictions on the use of public assistance income, including whether and how creditors can ascertain the probability that public assistance income will continue in making underwriting decisions;
9. Should provide more regulatory clarity to help facilitate innovation in a way that increases access to credit for consumers and communities in the context of AI/ ML; and
10. Should clarify adverse action notice requirements regarding providing a statement of the specific reasons for the adverse action.

These all are areas that have been subject to regulatory uncertainty in recent years, particularly as financial services products and services evolve and institutions seek new ways to reach traditionally underserved populations.

Arguably, the most controversial topic in the RFI is the Bureau's request for feedback on the appropriate framework for assessing disparate impact claims under ECOA. HUD's Disparate Impact Rule—finalized earlier this month—has been the subject of significant controversy, with consumer advocacy groups arguing that it goes beyond the Supreme Court's 2015 *Inclusive Communities* decision and that the heightened pleading standards may extinguish the viability of disparate impact claims in the future. If the CFPB outlines a framework for assessing disparate impact claims under ECOA that is different from the framework outlined in HUD's Final Rule, this could lead to significant uncertainty for the mortgage industry, because mortgage lenders are subject to both ECOA and the Fair Housing Act.

If you are interested in submitting comments in response to the Bureau's ECOA RFI, the deadline for submissions is December 1, 2020.

DOJ Announces Two Fair Lending Settlements in July

On July 23, 2020, the US Department of Justice (DOJ) and the U.S. Attorney's Office for the Eastern District of New York entered into a settlement agreement with a national bank to resolve allegations that the bank had engaged in a pattern or practice of discrimination based on disability in violation of the Fair Housing Act.

According to the complaint, the bank's written policies in place prior to 2016 were discriminatory because they prohibited mortgage and home equity lending to adult applicants who were represented by legal guardians or conservators, even if a court had granted the guardian or conservator legal authority to take out a mortgage loan on the specific property at issue on behalf of the individual. According to the DOJ, all adults who were denied loans under these policies had a disability and, in some cases, the bank allegedly knew about applicants' disabilities because it was informed of them through guardians or conservators or through documents submitted to the bank as part of the application process. The DOJ alleged that the bank also failed to make reasonable accommodations to allow these applicants to apply for loans, such as by denying requests from applicants who asked it to accept court-ordered guardianship or conservatorship paperwork in lieu of power of attorney documents. The bank denies that it discriminated against persons with disabilities and asserts that the policies at issue were implemented after the financial crisis for the purpose of protecting at-risk applicants from financial exploitation. The bank also asserts that, during the time period at issue, it did make some mortgage loans to applicants with disabilities who had legal guardians or conservatorships.

Under the settlement, the bank agreed to pay $4,000 for each otherwise eligible applicant who was denied a loan under the historic guardian and conservator policies, amounting to an expected $300,000.

On July 2, 2020, the DOJ entered into a settlement with a used car dealership to resolve allegations that the dealership had engaged in a pattern or practice of discrimination in credit transactions based on race in violation of ECOA. The DOJ filed its lawsuit in 2019 after its Fair Housing Testing Program – in which individual testers pose as prospective car buyers – allegedly found that the dealership offered more favorable financing terms to white testers as compared to African-American testers. Specifically, the dealership allegedly offered white testers the option to fund down payments in two installments. Contrastingly, the dealer allegedly required African-American testers to provide a larger down payment and quoted African-American testers higher biweekly payment amounts on "Buy Here, Pay Here" retail installment contracts more often than white testers.

Under the consent order, the dealership was required to develop and implement employee training and a written policy to ensure compliance with ECOA. This included developing non-discriminatory and standardized procedures for collecting application and financial information and determining terms and conditions. Notably, the DOJ did not impose any civil money penalties or require any consumer remediation as part of the settlement.

The DOJ's Civil Rights Division has been relatively quiet on fair lending issues over the last four years, and instead has focused much of its efforts on prosecuting unlawful treatment of servicemembers under the Servicemembers Civil Relief Act.

CFPB Encourages Use of Special Purpose Credit Programs

In July 2020, the CFPB published a blog post reminding creditors of the availability of special purpose credit programs (SPCPs) under ECOA and Regulation B and encouraging their use. In its blog, the Bureau pointedly reminded creditors that they can legally use affirmative advertising to meet the credit needs of underserved communities by developing SPCPs. This message is consistent with the Bureau's previous proclamations that it takes a favorable view of conscientious efforts to develop SPCPs to promote extensions of credit to any class of persons who would otherwise be denied credit or would receive it on less favorable terms.

What exactly is an SPCP? An SPCP is a tool lenders can use to target underserved communities for special lending programs without running afoul of ECOA and Regulation B's anti-discrimination prohibitions. Generally, ECOA and Regulation B make it unlawful for creditors to discriminate against applicants for credit on the basis of race, color, religion, national origin, sex, marital status, age (provided that the applicant has the capacity to enter into a binding contract), receipt of public assistance income, or the good faith exercise of any right under the Consumer Credit Protection Act. In general, lenders may not treat similarly situated applicants for credit differently on the basis of a prohibited characteristic, such as race or national origin, or consider such characteristic in evaluating applicants for credit. Unlawful disparate treatment discrimination can arise if a creditor treats applicants differently—whether less favorably or more favorably—based on a prohibited characteristic.

Notwithstanding this general prohibition against the consideration of prohibited bases in connection with a credit transaction, ECOA and Regulation B permit lenders to provide "special purpose credit" to meet special social needs or for the benefit of economically disadvantaged persons. Under an SPCP, a creditor is permitted to request information about an otherwise-prohibited characteristic—such as race or national origin—and consider such characteristic in determining an applicant's eligibility under the program without violating ECOA. Three types of credit programs qualify as SPCPs:

1. A credit program expressly authorized by federal or state law to benefit an economically disadvantaged class of persons;
2. A credit program offered by a 501(c) not-for-profit organization for the benefit of its members or for the benefit of an economically disadvantaged class of persons; and
3. A credit program offered by a for-profit organization, or in which such an organization participates to meet special social needs, if it meets certain requirements, including a written plan and a demonstration of social need.

To qualify as an SPCP, a for-profit lender must have a written plan that identifies the class of persons the program is designed to benefit and that sets forth the lender's procedures and standards for extending credit under the program. For a program to qualify, its purpose must be to extend credit to a class of persons who, under the lender's customary standards of creditworthiness, probably would not receive such credit or would receive it on less favorable terms than are ordinarily available to other applicants applying to the lender for a similar type and amount of credit.

Despite the Bureau's encouragement, some lenders are hesitant to implement SPCPs because the Bureau and other regulators refuse to pre-determine whether individual programs qualify for SPCP status, instead leaving it up to the creditor to make decisions regarding the status of its program and whether it constitutes an SPCP under the limited regulatory guidance available. But creditors have an opportunity now to make suggestions to the Bureau. As part of its recent RFI on ECOA issues, the Bureau has asked for input on whether it should address potential regulatory uncertainty regarding the use of SPCPs, including clarifying the SPCP provisions of Regulation B.

In the meantime, creditors interested in setting up an SPCP should consult with legal counsel to ensure that the program is structured to conform to the parameters outlined in Regulation B.

Democratic Senators Raise Concerns about Use of Educational Data In Credit Underwriting

On February 13, 2020, Democratic Senators Cory Booker, Sherrod Brown, Kamala Harris, Bob Menendez, and Elizabeth Warren sent letters to five lenders and two data service providers regarding their use of educational data (i.e., a range of variables tied to a consumer's postsecondary education, such as school attended and college major) in credit underwriting decisions. Specifically, the Senators raised concerns about whether the use of such data could have a disparate impact on borrowers of color.

ECOA and Regulation B prohibit discrimination on a prohibited basis in any aspect of a credit transaction. That includes disparate impact—i.e., instances where a facially neutral policy causes a disproportionate negative impact on a protected class that is not the result of a legitimate business justification.

The Senators' letter appears to be in reaction to a report issued by the Student Borrower Protection Center (SBPC), a special interest group founded by the CFPB's former student loan ombudsman. That report alleged that the use of education data in private student loan underwriting and pricing could have a disparate impact on minority borrowers. The report describes two case studies of student lenders and suggests that borrowers at Historically Black Colleges and Universities (HBCUs), Hispanic-Serving Institutions (HSIs), and community colleges are charged more in interest and fees than similarly-situated borrowers at traditional four-year universities. Specifically, the report alleges that a graduate of Howard University (an HBCU) would be charged approximately $3,500 more over the life of a five-year loan than a similarly situated graduate of New York University (NYU). The report also alleges that a graduate of the University of New Mexico – Las Cruces (UNM-LC)(an HSI) would be charged approximately $1,750 more than the NYU graduate over the same loan period. This statistic is allegedly based on a hypothetical 24-year old New York City resident with a bachelor's degree in computer science who works as a salaried financial analyst making $50,000 per year with $5,000 in savings, where the hypothetical applicant applied for a $30,000 student loan refinancing product. The report's methodology appears to be flawed for several reasons, including that the alleged pricing differences were based on averaging an APR range, rather than the actual interest rate quoted or charged to any particular borrower, and that the report did not analyze whether a degree from NYU confers better career prospects in the school's home market, New York City, than either Howard University or UNM-LC. The SBPC alleges that its findings are indicative of "educational redlining," but the use of this term is arguably inflammatory and inaccurate because "redlining" involves the intentional refusal to do business or provide credit in majority-minority geographies, rather than the types of pricing differences that are alleged in the report.

In the past, regulators have raised fair lending concerns when certain aggregated or non-individualized factors are used in assessing the creditworthiness of an individual applicant. For example, regulators including the CFPB and the FDIC have criticized the use of cohort default rate (a measure of the rate at which students at a given institution default on their student loans) in certain circumstances. In light of the SBPC's report and citing to past criticism from regulators, the Senators asked the lenders and data service providers for information about their use of educational data and the potential disparate impact such use could have on minority borrowers.

Within a few weeks of receiving the letter, each company provided responses to the Senators' questions. Five months later and with election season fast approaching, Senators Sherrod Brown, Elizabeth Warren, and Kamala Harris wrote to the CFPB with their findings, recommendations, and the companies' responses. The Senators expressed particular concerns about lenders use of the school an applicant attended and the use of an applicant's anticipated income for their major or program in determining creditworthiness.

The findings and recommendations attached to the Senators' letter also ask the CFPB take various immediate actions, including the following:

- Send a supervisory information request to all supervised entities to discuss the prevalence of the above underwriting practices.
- Conduct fair lending investigations of all supervised entities, including private student lenders that rely upon educational criteria in underwriting or credit decision-making.
- Issue guidelines on recommended fair lending compliance management systems for all lenders.
- Encourage creditors, including private student lenders, to conduct voluntary self-tests to determine the extent or effectiveness of their compliance with ECOA and Regulation B.

The CFPB does not yet appear to have made public statements regarding the use of educational data in credit underwriting in response to the Senators' letter. If there is a change in administration come November, it will be interesting to see whether the Bureau focuses on the use of educational data in credit underwriting, especially in light of Senator Harris' apparent interest in this area.

Fair Lending and Immigration Status

Over the summer, a large bank settled with a class of immigrant plaintiffs who sued the bank for denying their applications for consumer and small business loans and credit cards because they were not permanent residents of the United States.

The plaintiffs were covered by the government's Deferred Action for Childhood Arrivals (DACA) policy, which allows certain people who came to the United States as children and meet a variety of guidelines provided by the US Citizenship and Immigration Services to remain the United States temporarily. Individuals who meet those guidelines may request consideration of "deferred action" for a period of two years, renewable upon good behavior. Deferred action refers to prosecutorial discretion to defer removal actions against an individual for a specified period of time, but it does not provide lawful immigrant status. DACA recipients are also eligible for work authorization while subject to deferred action.

In their action against the bank, the DACA recipients alleged that the bank denied their applications for credit because they were not US citizens or lawful permanent residents and that doing so violated 42 U.S.C. § 1981 (Section 1981), ECOA, and California's Unruh Civil Rights Act (Unruh Act).

Section 1981 provides "all persons within the jurisdiction of the United States…the same right…to make and enforce contracts…as is enjoyed by white citizens…" In other words, it prohibits discrimination based on alienage in the making and enforcement of contracts. Plaintiffs alleged that the bank violated this provision when it distinguished between citizens and non-citizens in credit underwriting. This claim survived a motion to dismiss arguing that Section 1981 is preempted by ECOA.

ECOA prohibits discrimination on a prohibited basis in any aspect of a credit transaction. Although the law does not allow creditors to refuse to grant credit because an applicant comes from a particular country, it does allow creditors to take into account an applicant's immigration status or status as a permanent resident of the United States. For example, a creditor *may* consider an applicant's immigration status and differentiate between non-citizens who are longtime residents with permanent resident status and non-citizens who are temporarily in this country on student visas. The Official Interpretations to Regulation B explicitly state that a denial of credit on the ground that an applicant is not a United States citizen is not *per se* discrimination based on national origin. Plaintiffs initially alleged that the bank discriminated against them on the basis of their national origin, but those claims were eventually dismissed.

Conversely, California's Unruh Act prohibits business establishments from arbitrarily discriminating on a prohibited basis, including on the basis of citizenship, primary language, or immigration status. This arguably conflicts with the provisions of Regulation B, which explicitly permit creditors to consider an applicant's immigration status, as it could have a bearing on creditors' ability to obtain repayment. Plaintiffs allege that the bank violated this provision when it required credit applicants to be a US citizen or permanent resident with a citizen co-signer.

The bank agreed to pay up to $20 million as part of the settlement. Up to $13.73 million will be provided to DACA recipients who tried to apply for credit from the bank but were denied. The bank has also agreed to change its policies to lend to DACA recipients on the same terms and conditions as U.S. citizens, so long as there is an appropriate product. For example, the Federal Housing Administration (FHA) does not permit lenders to make FHA-insured mortgage loans to DACA recipients.

Since the case settled and there is no binding precedent, the perceived conflict between Regulation B and the Unruh Act's treatment of immigration status remains unresolved. Lenders making loans in California should consult with counsel on how to handle these issues to mitigate potential regulatory and litigation risk.

OCC Launches Project REACh Initiative to Reduce Racial Disparities

On July 10, 2020, the OCC announced the launch of a new effort to promote access to credit and capital for underserved populations. The Roundtable for Economic Access and Change, dubbed Project REACh, will bring together leaders from the banking industry, civil rights organizations, business, and technology to identify and reduce barriers to full, equal, and fair participation in the nation's economy. Project REACh will focus on policy and structural changes that can help more people participate, increase access to credit and capital and expand financial inclusion, and reduce barriers to affordable homeownership. For example, noting that 50 million Americans have no credit score, the OCC wants the roundtable participants to consider potential alternatives to credit scores that could promote entry to financial services. Project REACh's national projects will be focused on inclusion for credit invisibles, revitalization of minority depository institutions, and affordable housing. Local approaches will focus on developing regional solutions. The OCC hosted the first roundtable meeting on July 10, to begin identifying projects the group will undertake.

Adverse Actions Based on AI/ML Underwriting Models

In July 2020, the CFPB published a blog post highlighting the existing regulatory flexibilities for complying with adverse action notice requirements in Regulation B when creditors use complex artificial intelligence (AI) and machine learning (ML) models for credit underwriting. The CFPB acknowledged that AI and ML create some challenges for a creditor in determining and documenting its reason for denying an application for credit, but pointed to existing official commentary, which allows for some flexibility in how creditors explain decisions to applicants.

Regulation B requires a creditor to disclose to a loan applicant its principal reasons for denying an application, and those reasons must relate to and accurately describe the factors actually considered or scored. Under the Official Interpretations to Regulation B, however, creditors do not have to describe how or why a disclosed factor adversely affected an application, and, for credit scoring systems, creditors do not need to disclose how the factor relates to creditworthiness. These interpretations provide creditors some latitude when issuing adverse action notices based on the results of AI models where the variables that are implicated in the denial and the key reasons for the denial are known, but the mode may rely on non-intuitive relationships. The Bureau also noted that ECOA and Regulation B do not require use of any particular list of reasons for denial, thus providing creditors with some ability to develop their own list of reasons when denying credit based on alternative data sources and complex models.

The CFPB appears to be trying to allay some concerns regarding the adoption of AI and ML by addressing potential regulatory uncertainties. Although this desire for innovation is helpful, as a practical matter, these regulatory flexibilities do not necessarily help creditors actually determine the principal reasons for the denial when using a complex model. Accordingly, through its recent ECOA RFI, the CFPB is also interested in understanding how creditors are determining the principal reasons for a denial, and how best to convey those reasons to consumers. The CFPB also encourages institutions to use its regulatory sandbox, trial disclosure program, and no action letter process to explore creative ways of informing consumers of the reasons for denial when using complex AI and ML models.

Emerging Fair Lending Issues – Digital Advertising and Models

Regulators, including HUD and the CFPB, have become increasingly focused on discrimination risks related to digital advertising. Recently, HUD has investigated digital advertisers and advertising platforms that restrict who sees housing- or mortgage-related ads based on their personal characteristics such as race or gender (prohibited bases under fair lending/housing laws) or based on a proxy for a prohibited basis (*e.g.*, geography, social media activity). HUD also has worked with online advertisers to enhance their policies and practices related to the Fair Housing Act and has encouraged online advertising platforms to take steps to eliminate unlawful discrimination and align their advertising practices with applicable anti-discrimination requirements. In a warning to others engaged in digital advertising, HUD has indicated that it will continue to review online advertising platforms to ensure that people are not being denied housing or lending opportunities that are advertised online based on any prohibited characteristic or proxy for a prohibited characteristic. Discouragement on a prohibited basis in connection with advertising also has been a focal point for the CFPB, as evidenced by the allegations in its recent redlining lawsuit and the latest edition of *Supervisory Highlights*.

Another area of emerging fair lending risk is the use of models. Last year, the CFPB updated its ECOA Baseline Exam Procedures to include a module on Fair Lending Risks Related to Models. Examiners are directed to review a company's fair lending risks and controls related to the use of models in credit decisioning, and to address the following questions:

- Does the entity track the expected usage of each model; the types and sources of data used by each model; and whether the model was developed internally or by a third-party?
- Does the entity conduct any fair lending related review or testing of models?
- Does the entity evaluate the validity or performance of its models by prohibited basis group?
- If the entity employs third party models in the credit process, have the models been reviewed or tested by the entity or third party for fair lending risk?
- Does the entity have policies and procedures governing model use, including when it may be appropriate to make overrides/exceptions to a model decision?
- When adverse action is taken on the basis of one or more credit scoring models, what methodology is used to select the reasons why the adverse action was taken?

As the use of models becomes more commonplace for both credit and non-credit activities, institutions should examine their model governance process and fair lending compliance management systems to ensure that they are in compliance with regulatory expectations.

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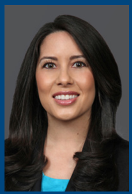

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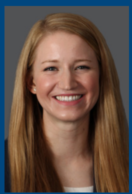

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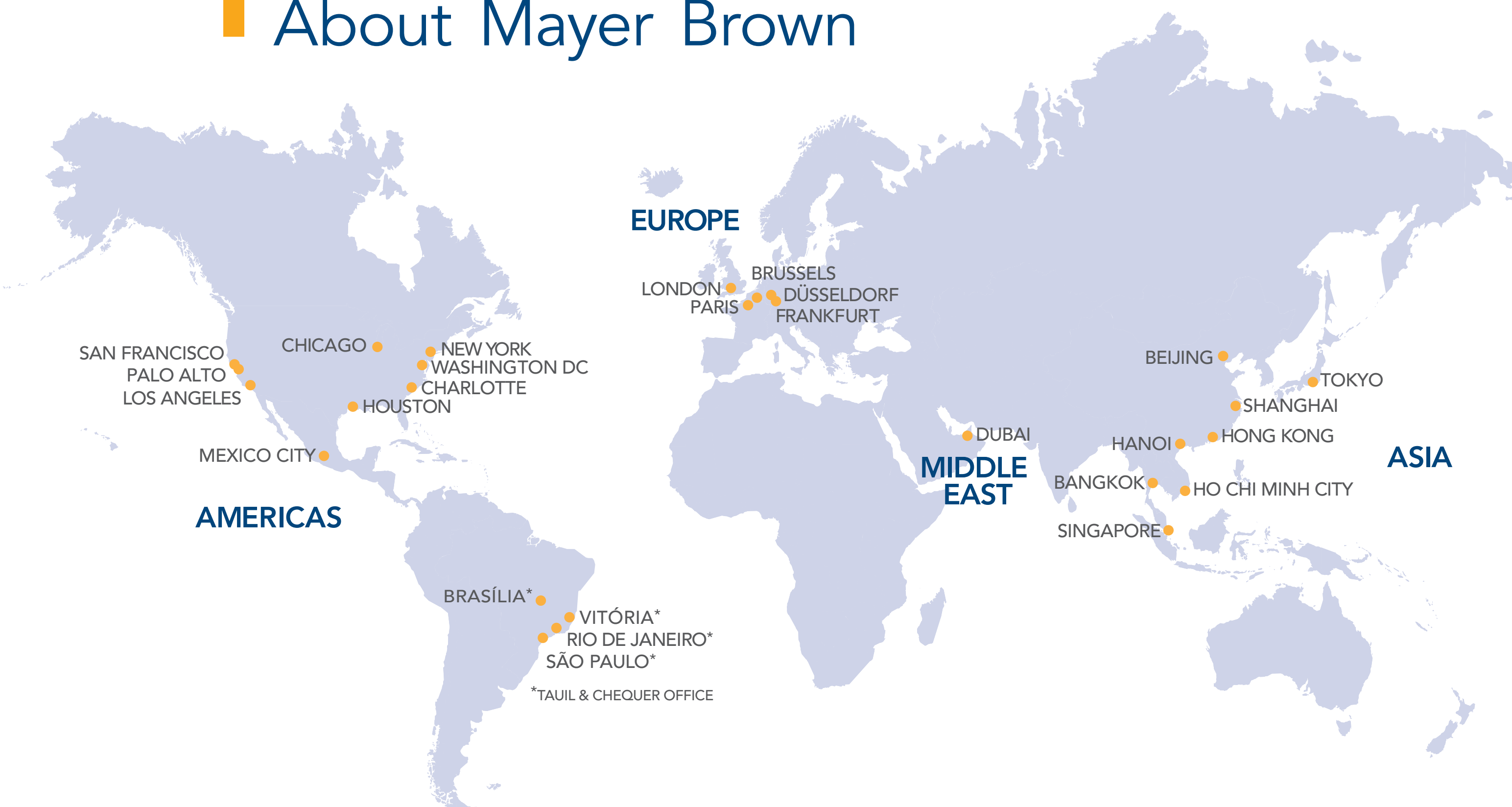

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