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Commercial Financial Services Brief: Equal Credit Opportunity Act — A Primer on Disparate Impact, Part One

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What is fair? In the area of credit, it would seem to mean being treated equally. Thus, for example, the Federal Equal Credit Opportunity Act (ECOA) states that it is unlawful for a creditor to discriminate against an applicant with respect to any aspect of a credit transaction on the basis of color, race, religion, sex, national origin, marital status, and several other bases. How that discrimination is determined is the subject of various philosophical approaches.

Overt discrimination has long been recognized to be covered by the Act. This type of discrimination, known as disparate treatment, consists of intentional discriminatory treatment of one or more specific individuals for one of the prohibited reasons (e.g., intentionally charging a female a higher rate of interest than that charged to a male). But is that the only test for discrimination?

For some time the U.S. government has also been pursuing a more subtle (and controversial) type of discrimination known as disparate impact. For example, disparate impact might be found in a statistical analysis that shows over the course of a number of credit transactions, female borrowers pay higher interest rates than male borrowers. Thus, even though a single loan may not appear to be discriminatory, discrimination may be found over a large number of loans on a statistical basis. The government has used disparate impact analysis in various contexts but with the exception of ECOA the federal banking regulators have not explicitly applied this test until recently.

Recently the Consumer Financial Protection Bureau (CFPB) issued guidance on fair lending compliance for indirect auto lenders (those lenders that take assignment of dealer retail installment contracts). The guidance targets the practice of auto dealers marking up the lender's risk-based buy rate and receiving compensation based on the increased revenue from the "excess" interest rate. The CFPB determined that these lenders are "creditors" under the Equal Credit Opportunity Act in that they permit the dealer markup and compensate the dealers on that basis. As creditors, if some credit applicants are charged more than other credit applicants similarly situated on a prohibited basis, such as race, there is a violation of the Act.

The CFPB asserts in its guidance that the practice of allowing auto dealers to set a rate higher than the buy rate creates a significant risk that pricing disparities on a prohibited basis, such as race and national origin, will occur in violation of the Act. The bulletin does not cite any evidence that intentional discrimination actually exists. Nonetheless, it "suggests" steps "to ensure that the indirect lender is operating in compliance." Such steps may include: (1) imposing controls on dealer markup and compensation policies, or otherwise revising them, and monitoring and addressing the effects of those policies to eliminate unexplained pricing disparities on prohibited bases (this may be easier said than done as the law generally prohibits a creditor inquiring about the race, color, religion, national origin, or sex of an applicant, with limited exceptions); or (2) eliminating dealer discretion to mark up buy rates and compensating dealers using another mechanism, such as a flat fee per transaction. To the extent the mark up is one method lenders use to compensate dealers for the value they add by originating loans and finding financing sources, a flat fee should work and clearly would be nondiscriminatory, but it could result in a disincentive to use a particular lender whose rate would be overall comparatively higher (unless most lenders used this method). However, some lenders have chosen to go this route.

The guidance goes on to also promote adopting a robust fair lending compliance management program as an important tool for limiting fair lending risk in indirect auto lending. Such a program might include: (1) an up-to-date fair lending policy statement; (2) regular fair lending training for all employees involved in credit transactions, as well as for officers and Board members; (3) ongoing monitoring for compliance with fair lending policies and procedures and periodic review for potential violations; and (4) regular analysis of data for potential disparities on a prohibited basis in various aspects of the credit transaction, including underwriting. Also suggested are: (1) prompt corrective action when unexplained disparities are found on a prohibited basis (the law sets up a procedure for self-testing and self-correction); and (2) promptly remunerating affected consumers.

It could be suggested that even though the CFPB statement is a "guidance," that it creates a risk that a lender that does not implement the CFPB's suggestions may well face administrative enforcement. Of course, the practical observation is that large institutions with assets of more than $10 billion and their affiliates are most at risk as they are subject to CFPB's supervisory authority. However, others are subject to CFPB's enforcement authority, and when the CFPB adopts a rule extending its supervisory authority to "larger participants," then nonbank lenders may find themselves in the same boat as the $10 billion or more class.

It is important to note that this approach does not depend on the actual intent of a lender but is based on the effects of a lender's actions that result in disparate impact-including when a measure with a lesser disparate impact could be used with acceptable results. The "effects test" is not limited to CFPB enforcement of the Equal Credit Opportunity Act. In a future communication we will talk about further applications of this test.

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