Keeping Fintech Fair: Thinking about Fair Lending and UDAP Risks

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Keeping Fintech Fair

- Benefits, Opportunities, and Risks of Fintech
- Fair Lending Laws
- Unfair or Deceptive Acts or Practices (UDAP) Laws
- The Importance of Proactive Consumer Compliance
- Focus on Alternative Data
    - Big Data
    - Questions to ask early in the process

*Companion article: Keeping Fintech Fair: Thinking About Fair Lending and UDAP Risks

Benefits, Opportunities, and Risks of Fintech

- Benefits:
  - More efficient and accurate credit decisions for consumers and small businesses at lower cost
  - Potential to leverage more granular data about consumers' finances and small businesses' operations to increase accuracy of credit risk predictions
  - Convenience
  - New products to help consumers manage financial lives

Benefits, Opportunities, and Risks of Fintech *(continued)*

- Opportunities: 26 million Americans are credit invisible and 19.4 million do not have sufficient credit data to be scored

  - Potential to responsibly underwrite and offer credit to consumers with little to no traditional credit history (e.g., thin file consumers and the credit invisible)

Benefits, Opportunities, and Risks of Fintech *(continued)*

- Risks: Fintech is not immune to consumer protection risks that face brick-and-mortar financial services. Some risks, such as redlining and steering, may be amplified; other risks may be mitigated.

- Consumer protection risks can include:
  - Fair Lending
  - UDAP
  - Fair Credit Reporting Act (FCRA)*
  - Privacy and Cybersecurity risks*

  * These items are outside the scope of this presentation

Fair Lending Laws

- Fair Housing Act & Equal Credit Opportunity Act (ECOA): Mortgages
- ECOA: Non-Mortgage Credit, including
  - Auto Loans
  - Unsecured Loans
  - Student Loans
- Fair Housing Act:
  - Sale/Rental of Dwellings
  - Appraisals
  - Homeowners Insurance

Fair Lending Laws *(continued)*

- Protected factors under ECOA and FHA:
  - Race, Color, National Origin, Sex, Religion

  In addition, under ECOA
  - Marital Status
  - Age
  - Receipt of Public Assistance
  - Exercise of Rights under Consumer Credit Protection Act
- Under the Fair Housing Act
  - Familial Status
  - Handicap

Fair Lending Laws *(continued)*

- Laws broadly prohibit two kinds of discrimination
  - Disparate Treatment: lender treats a consumer differently because of a protected characteristic
    - Ranges from overt discrimination to subtle differences in treatment
    - Does not need to be motivated by prejudice or conscious intent to discriminate
    - Risks can arise where bank employees have broad discretion to set interest rates and fees

Fair Lending Laws *(continued)*

- Laws broadly prohibit two kinds of discrimination *(cont.)*
  - Disparate Impact: lender's policy or practice has a disproportionately negative impact on a prohibited basis
    - Policy or practice may violate the law unless it meets a legitimate business necessity that cannot reasonably be achieved by a means with less impact on protected classes
    - Business necessity factors could include cost and profitability

Unfair or Deceptive Acts or Practices

- Federal Trade Commission act prohibits unfair or deceptive acts or practices (UDAP)
- Dodd-Frank Act prohibits unfair, deceptive, or abusive acts or practices (UDAAP)
- Deception: Representations, omissions, or practices that are likely to mislead a consumer acting reasonably under the circumstances and are material
- Unfair: Acts or practices that cause or are likely to cause substantial injury to consumers that they cannot reasonably avoid and are not outweighed by countervailing benefits to consumers or competition

Deception

- In financial services, deception often involves mispresenting the terms or costs of financial products or services
- Examples of deception from past Federal Reserve, FDIC, and FTC actions include
  - Failure to provide information about fees
  - Misrepresentation of the amount of credit available in a product
  - Gathering personal information for purported loan applications, but using the information for other purposes including sales to third parties and fraudulently debiting accounts

Unfairness

- Practices in financial services can also be unfair
  - For example, in an FTC action a website operator gathered extensive personal information from consumers for purported payday loan applications. Consumers believed that they were applying for loans, but the operator sold their application information, including Social Security numbers and bank account information, to companies that fraudulently debited their bank accounts.
  - The FTC's complaint alleged that this practice was unfair

Proactive Consumer Compliance

- Integrate consumer protection considerations into early phases of business development

- Compliance colleagues are key partners in development of fintech products

- Both Fair Lending and UDAP analysis depend on specific facts and circumstances

- This presentation offers general questions to help guide thinking early in the business development process when considering new or alternative data

Big Data

- Big Data generally refers to the analysis of large, complex data sets that are collected over time from different sources
  - Analytic developments like machine learning can open new approaches to data modeling
  - Potential to underwrite more consumers with greater efficiency and accuracy and at lower cost
- Potential concerns about fairness and accuracy
  - Predictions can result in bias toward some consumers
  - Information flow may be restricted based on perceived characteristics of recipient
  - Exclusion of real or virtual communities from opportunities

Big Data *(continued)*

- The source of data can affect the outcome
  - If a dataset does not include sufficient diversity, the resulting output may be inaccurate
  - Data may reflect historical biases, such as employment demographics, and perpetuate them
- Thus, the fact that an algorithm is data-driven does not ensure that it is fair or objective

Questions to Guide the Process to Evaluate New Data Uses for Credit Access

- What is the basis for considering the data?
  - Is there a nexus with creditworthiness?
  - Are the data accurate, reliable, and representative of all consumers?
  - Will the predictive relationship be ephemeral or stable over time?
- How are you using the data?
  - Are you using the data for the purpose for which they have been validated?
  - Do consumers know how you are using the data?
  - Are you using data about consumers to determine what content they are shown?
  - Which consumers are evaluated with the data?
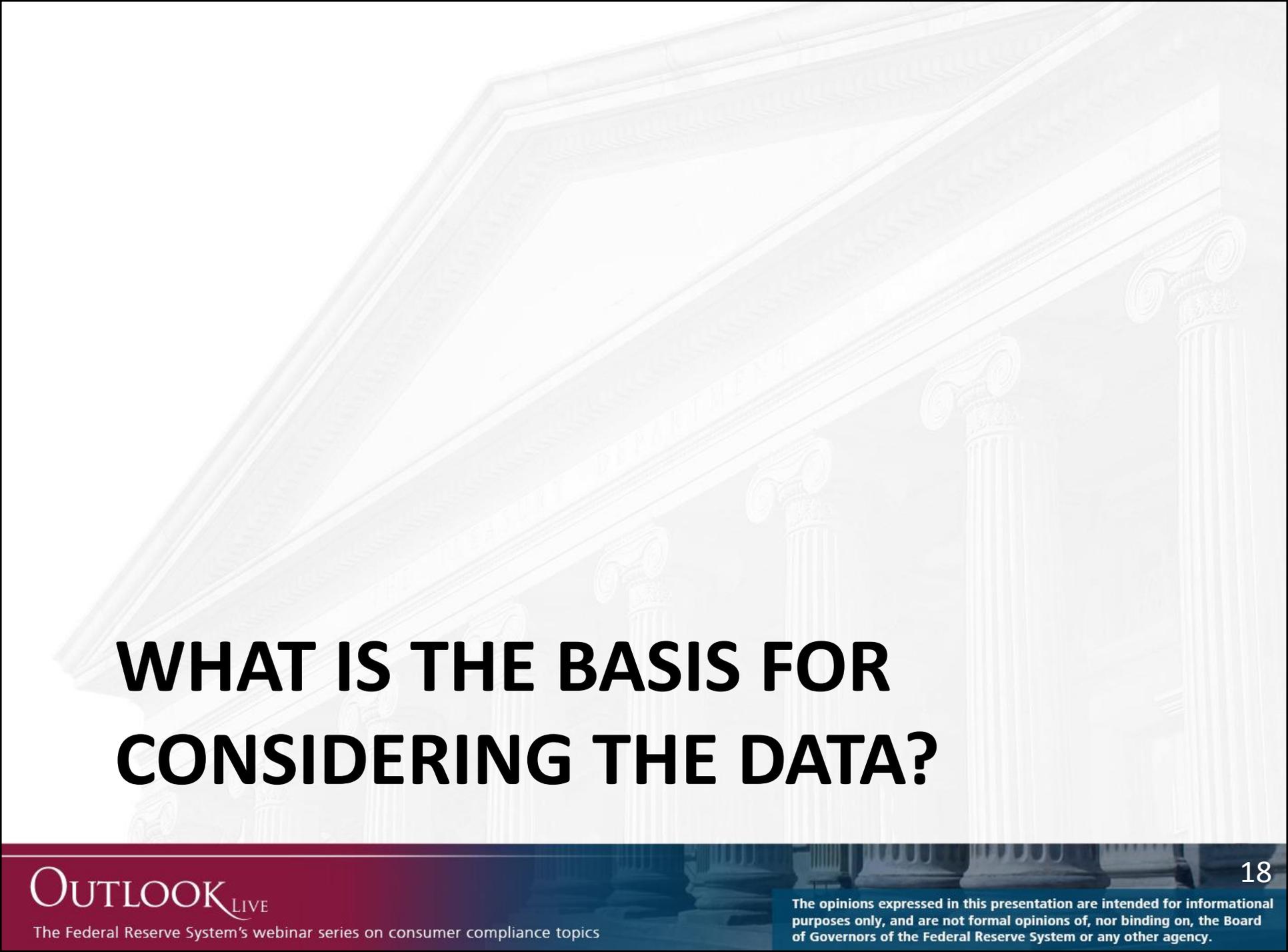
WHAT IS THE BASIS FOR CONSIDERING THE DATA?

Is there a nexus with creditworthiness?

- Some data have an obvious link to creditworthiness, while others are less obvious
  - In small business lending, some creditors are developing underwriting models based on financial and business records
    - Same types of data used in traditional underwriting
    - Derived in a different way, through analyzing thousands of transactions
  - Similarly, analyzing cash flow or bank account data to understand income and debt-to-income is related to traditional underwriting
- The more speculative the nexus with creditworthiness, the higher the fair lending risk

Nexus to Creditworthiness *(continued)*

- If data are correlated with race or other prohibited bases, careful analysis is critical
  - For example, where an applicant went to school or level of education
  - CFPB's recent no-action letter conditioned on extensive fair lending testing and data reporting

Nexus to Creditworthiness *(continued)*

- Careful analysis especially important where data may not only be correlated with prohibited bases, but may reflect effects of historical discrimination such as redlining or segregation
  - Whether a consumer's online social network includes people with poor credit histories can raise concerns about discrimination against those living in disadvantaged areas
- Some data that may not appear correlated with race or national origin alone may be highly correlated with prohibited characteristics when evaluated in conjunction with other fields

Are the data accurate, reliable, and representative of all consumers?

- For example, concerns have been raised about the accuracy and reliability of medical debt data

  - Federal Reserve and FTC studies found widespread errors in public record data, much of which is related to medical debt

  - CFPB complaint data have underscored continuing concern from consumers

  - In response, FICO and VantageScore modified their scoring models to limit the weight placed on medical debt

Are the data accurate, reliable, and representative of all consumers?
(continued)

- Data sets may not be representative. For example, data used for behavioral modeling, such as browsing and social media data, may be skewed toward certain populations.

- Alternative data has promise for credit-invisible consumers if the data sources are accurate, representative, and predictive

Will the predictive relationship be ephemeral or stable over time?

- Consider whether the predictive potential of the data is likely to be stable over time, or ephemeral

- For example, if a model uses online data from social media sites such as Yelp and Facebook, what happens to the reliability of the data as consumers' online habits evolve?

HOW ARE YOU USING THE DATA?

Are you using the data for the purpose for which they have been validated?

- Data can be used for marketing, fraud detection, underwriting, pricing, debt collection, and many other uses

- Validating a data field for one use does not mean it's appropriate for another use
  - For example, fraud detection data may not be suitable for underwriting or pricing decisions

- Fair lending risks could include steering, underwriting, pricing, or redlining

Do consumers know how you are using the data?

- The use of alternative data could raise questions of fairness and transparency

- ECOA, Regulation B, and the Fair Credit Reporting Act (FCRA) require that consumers denied credit be provided adverse action notices specifying the top factors used to make that decision

  – Lenders and consumers may not know what specific information is used by alternative credit scoring systems, how data impact scores, and what consumers can do to improve scores

Do consumers know how you are using the data? *(continued)*

- Behavioral data may raise particular concerns
  - In one matter, the FTC alleged the lender failed to disclose that consumers' credit limits could be reduced for using the card for transactions such as paying for marriage counseling, therapy, or tire-repair services
  - Commenters have reported to the FTC that credit card companies have lowered consumers' credit limits based on the payment history of other consumers that shopped at the same store

Do consumers know how you are using the data? *(continued)*

- UDAP issues could arise if a firm misrepresents how consumer data will be used. For example, in an FTC matter mentioned earlier, the FTC alleged a website asked consumers for personal information to match them to lenders; instead, the FTC claimed the firm simply sold the consumers' data

Are you using data about consumers to determine what content they are shown?

- Target marketing and advertising may have benefits and risks
  - Can make it easier and less expensive to reach consumers, including underserved consumers
  - But can amplify risks of steering or digital redlining when information is curated based on detailed data about consumers, including habits, preferences, financial patterns, and where they live

Are you using data about consumers to determine what content they are shown?
(continued)

- DOJ and CFPB enforcement action against a lender that excluded consumers with a Spanish-language preference from credit card promotions, even where the consumer met the promotion's qualifications

- News media have also reported on this concern
  - Facebook categorized users by racial affinities, and a news organization was able to purchase an ad about housing and exclude minority racial affinities from the audience
  - A bank used predictive analytics to determine what credit card offers, including subprime offers, to show a consumer
  - Consumers were offered different prices for merchandise and service depending on where they lived

Which consumers are evaluated with the data?

- Alternative data fields may expand access to traditionally underserved consumers, but some consumers can be negatively impacted
  - Advocates have expressed concern about utility payment data penalizing low-income consumers, particularly in cold weather states where consumers may fall behind on utility bills in winter but catch up during lower-cost months
- Applying algorithms only to consumers who would otherwise be denied based on traditional criteria could help ensure that algorithms expand access to credit
- [Recent Community Reinvestment Act (CRA) guidance](#) includes use of alternative credit histories as an example of an innovative or flexible lending practice

Conclusion

- Fintech may increase convenience and speed and expand responsible and fair access to credit

- It would be a lost opportunity if instead of expanding financial inclusion opportunities, fintech resulted in the calcification of existing inequities or digital redlining

- It is up to all of us – regulators, enforcement agencies, industry, and advocates – to ensure that fintech promotes a fair and transparent financial marketplace and the potential benefits are realized and shared by as many consumers as possible

QUESTIONS?

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