Consumer Financial Protection Bureau

1700 G Street, N.W., Washington, DC 20552

June XX, 2013

Decision memorandum for the Director

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THROUGH	Steve Antonakes
SUBJECT	Potential methodological announcements: proxy methodology and disparity tolerances

1. Proxy Methodology

RECOMMENDATION

The Bureau should ~~not~~ publish an announcement about our proxy methodology for use in the ~~near term.~~supervisory arena within the next few months, making clear that the announcement is limited to the supervisory context in order to appropriately preserve enforcement and litigation flexibility. Publishing such an announcement does have risks which could ~~endanger~~undermine our Track 2 work with auto lenders and our Track 1 ~~work with the Department of Justice.~~. On balance, however, the supervisory and transparency benefits outweigh the risks. We recommend ~~reconsidering the question of publication in six months, after further research is conducted,~~making such an announcement after further progress is made on our investigations, ~~and~~we have had an opportunity to discuss disclosure with our sister agencies, and preferably after industry publishes an anticipated white paper on proxying.

_________ Approve _________ Disapprove _________ Let's discuss

BACKGROUND ON PROXIES

The ECOA forbids creditors from inquiring about an applicant's demographic information, with very limited exceptions.[1] One important exception is the Home Mortgage Disclosure Act, which requires the collection and reporting of data on sex, race, and ethnicity by most

[1] 12 CFR § 1002.5(a), (b).

mortgage originators. But outside of mortgage lending, fair lending statistical analyses must rely on proxies to assign race, ethnicity, or sex.[2]

A proxy is a statistical method that uses available information to estimate unavailable information. For instance, a proxy might use an applicant's address to generate a probability that the applicant is of a certain race.[3] Proxies are a common statistical technique used by social scientists and economists.[4] The federal banking regulators have made clear that proxy methods may be used in fair lending exams to estimate protected characteristics where direct evidence of the protected characteristic is unavailable.[5] Courts have accepted the use of reliable proxy methods in discrimination suits for decades, while recognizing that proxies are merely estimations of protected characteristics.[6]

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[2] *See* GOV'T ACCOUNTABILITY OFC., *Race and Gender Data Are Limited for Nonmortgage Lending*, July 2008, at 3 ("In summary, we found that most studies suggest that discrimination may play a role in certain types of nonmortgage lending, but data limitations have complicated efforts by researchers and regulators to understand the extent to which possible discrimination occurs.").

[3] This ~~memo~~memorandum does not discuss how proxy-generated probabilities are used in regression modeling, although that is a separate area of methodological choice relevant to compliance management.

[4] ~~[OR is getting us these cites.]~~ *See, e.g.*, Marc N. Elliott et. al., *A New Method for Estimating Race/Ethnicity and Associated Disparities Where Administrative Records Lack Self-Reported Race/Ethnicity*, Health Services Research 43:5, Part I, Oct. 2008; *see infra* note 6 (citing cases in which proxies have been used).

[5] *See Interagency Fair Lending Examination Procedures*, at 12-13, *available at* http://www.ffiec.gov/PDF/fairlend.pdf (explaining that "[a] surrogate for a prohibited basis group may be used" in a comparative file review and providing examples of surname proxies for race/ethnicity and first name proxies for sex); *CFPB Supervision and Examination Manual*, at Procedures 19, *available at* http://files.consumerfinance.gov/f/201210_cfpb_supervision-and-examination-manual-v2.pdf (temporarily adopting the FFIEC Interagency Fair Lending Examination Procedures). We also have anecdotal evidence that other regulators use statistical proxies in their regression analyses, ~~although~~and we ~~have not yet spoken~~are currently in the process of speaking to them to confirm this and to ascertain the full variety of those methods.

[6] ~~*See, e.g.*,~~ *See, e.g.*, *United States v. Union Auto Sales, Inc.*, 490 F. App'x 847, 849 (9th Cir. 2012) ("classification of 'Asians' and 'non-Asians' did not render the ECOA claim any less plausible" because "[t]he link between names and racial categorization for the purposes of both antidiscrimination law and discriminatory conduct is well-established."); *Benavidez v. City of Irving*, 638 F. Supp. 2d 709, 717 (N.D. Tex. 2009) ("The Spanish surname may be used as a proxy for Hispanic ethnicity when self-identification is not practical."); *United States v. Vill. of Port Chester*, No. 06 Civ. 15173(SCR), 2008 WL 190502, at *9 n.13 (S.D.N.Y. Jan. 17, 2008) ("Experts for both parties used the Census Bureau List of Spanish Surnames to calculate the number of Hispanic voters in a particular area . . . Neither party disputes that Spanish Surname Analysis is an accepted methodology"); *E.E.O.C. v. Autozone, Inc.*, No. 00-2923 Ma/A, 2006 WL 2524093, *1 (W.D. Tenn. Aug. 29, 2006) (finding that "it was reasonable for [the government's expert] to use census proxy data rather than the actual applicant data"); *United States v. Reyes*, 934 F. Supp. 553, 560-62 (S.D.N.Y. 1996) (accepting the use of geocoding to estimate race and noting that an expert explained that the method is "commonly used"); *United States v. Gerena*, 677 F. Supp. 1266, 1270 (D. Conn. 1987), *aff'd sub nom. United States v. Maldonado-Rivera*, 922 F.2d 934 (2d Cir. 1990) (criminal defendant's expert and federal government's expert agreed that Spanish surname analysis "is an accepted method of identifying individuals of Hispanic origin"); *I.M.A.G.E. v. Bailar*, 518 F. Supp. 800, 807 (N.D. Cal. 1981) ("many Title VII discrimination suits have relied on Spanish surnames as an identifier for evaluating adverse impact and for affecting relief"); *Guardians Ass'n of New York City Police Dep't, Inc. v. Civil Serv. Comm'n of City of New York*, 431 F. Supp. 526, 530 (S.D.N.Y. 1977) (holding that the use of three statistical methods to estimate race and national origin, including the proxy methods of surname analysis and geocoding, was "clearly trustworthy"); *Com. of Pa. v. O'Neill*, 348 F. Supp. 1084, 1086 (E.D. Pa. 1972), *aff'd in relevant part, vacated in part on other grounds*, 473 F.2d 1029 (3d Cir. 1973) (finding expert's race estimations from geocoding "reasonable"). A few courts have expressed skepticism of surname analysis where its accuracy was called into question in that particular instance. *See, e.g.*, *I.M.A.G.E.*, 518 F. Supp. at 806-07 (questioning the probative value of defendant's surname analysis because of, among other reasons, a large population of Portuguese and Filipinos residents in the area with names on the Spanish surname list). But even where courts are skeptical of surname analysis, they will consider it as evidence if its usefulness can be shown. *See, e.g.*, *Rodriguez v. Bexar Cnty.*, 385 F.3d 853, 866, n.18 (5th Cir. 2004) (expressing its opinion that Spanish surname analysis is "novel and highly problematic," but upholding the district court's consideration of it and allowing it in future cases upon a "strict showing of its probativeness").

The precise proxy methodology will differ based on the characteristic being proxied. Proxying for sex, for example, most commonly relies on a name database from the Social Security Administration, which reports counts of individuals by sex and birth year for first names occurring at least five times for a particular sex in a birth year.[7] That proxy method assigns a probability that a particular applicant is female based on the distribution of the total U.S. population across sex categories (male or female) for a given first name.

A greater variety of methods are used to proxy for race and ethnicity.[8] The most common methods use the borrower's surname, the borrower's residence (geocoding), or a combination of the two. Other methods use nonpublic information to proxy for race and ethnicity, such as data or photographs from Department of Motor Vehicle (DMV) databases or proprietary databases matching first or middle names to certain racial or ethnic groups.

Proxies using surnames are most commonly used to proxy race or ethnicity for Hispanics and Asians, based on the full count of Hispanics and Asians using those surnames published by the Census Bureau.[9] Surname analysis alone does not tend to be as effective a proxy for African-Americans, because surnames for that population are not as readily distinguished from surnames for non-Hispanic ~~White. In the fair lending context, one example of surname proxying is the OCC's recent analysis of~~ [redacted]~~k, which identified disparities in dealer markup for Hispanic borrowers.~~~~[10]~~ Whites.

A second type of race/ethnicity proxy available in fair lending analyses — referred to as geocoding — uses the demographics of the census tract in which a borrower's residence is located, and assigns probabilities about the borrower's race or ethnicity based on the demographics ~~in~~of that census tract. Depending on the methodology, a borrower may be assigned one probability (if the analysis is comparing only two groups, e.g., African Americans versus non-African Americans) or multiple probabilities (if the analysis is comparing multiple groups, e.g., African Americans, Hispanics, Asians, and Whites). ~~Based on our understanding, one example of geographical proxying was the FDIC's recent analysis of Ally Bank, which tested for disparities in dealer markup for African-American borrowers.~~ Geocoding methodologies have ~~also~~ been used, for example, in impartial jury cases to determine the racial composition of the jury pool.[11]

Over the last decade, another method of proxying race and ethnicity has been developed that integrates the surname and geographical approaches. This method was developed by health research economists at RAND,[12] and it combines the respective probabilities generated by the surname and geographical proxies. Published research on this proxy methodology

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[7] http://www.ssa.gov/oact/babynames/limits.html.

[8] *See* Kevin Fiscella and Allen M. Fremont, *Use of Geocoding and Surname Analysis to Estimate Race and Ethnicity*, HEALTH SERVICES RESEARCH 41:4, Part I (August 2006), 1483-84.

[9] http://www.census.gov/genealogy/www/data/2000surnames/index.html.

~~[10] See the August 26, 2011, letter from~~ [redacted] ~~counsel) to Patrice Alexander Ficklin, describing "significant enhancements to its fair lending modeling," including "updated proxies based on the Census 2000 list of surnames to identify Hispanic borrowers."~~

[11] *See, e.g., United States v. Reyes*, 934 F. Supp. 553, 560-62 (S.D.N.Y. 1996) (citing an expert saying that "geocoding is 'commonly used'" and deciding that "[o]nly the geocoded data from the Jury Wheel study will be considered").

[12] Marc N. Elliott et. al., *A New Method for Estimating Race/Ethnicity and Associated Disparities Where Administrative Records Lack Self-Reported Race/Ethnicity*, HEALTH SERVICES RESEARCH 43:5, Part I, Oct. 2008, at 1722.

~~demonstrates~~finds that, when compared against actual reported race and ethnicity data, it consistently outperforms proxies using only surname or geography in isolation.[13] For example, compared to geocoding alone, the integrated approach was found to be 74 percent more efficient in estimating individual race/ethnicity and 56 percent more efficient in estimating overall racial/ethnic composition.[14] Our Office of Research has found similar results by using self-reported race and ethnicity data from HMDA to compare the relative performance of the integrated proxy against proxies using only surname or geography. For these reasons, the Bureau is generally using the integrated proxy as the primary method in our nonmortgage analyses, though we are testing the robustness of our findings using alternative methods as well. As discussed below, our peer agencies do not use an integrated surname and geography method and, therefore, we are breaking new ground in that context.

In designing our proxy methodology, we intentionally chose a method that uses publicly available data sources so that lenders could replicate our methods in analyzing their own portfolios~~.~~ without the expenditure of funds to purchase proprietary databases. However, other methods of proxying for race or ethnicity may further improve on proxy estimates by using proprietary sources of information.[15] For instance, some companies that specialize in data proxying use nonpublic databases that match first (or even middle) names to race/ethnicity.[16] Another way of obtaining racial or ethnic data is to gather information from state DMV records, either through actual data fields collected by the state or by a visual assessment based on the borrower's driver's license photograph. The DOJ has used DMV data in isolated cases,[17] but those data are not generally available because state agencies are not always amenable to releasing ~~that data or the state may not keep~~ racial/ethnic data or may not keep such data at all. These proprietary methods ~~are likely to achieve a greater level of accuracy in~~might be more capable of identifying the race/ethnicity of particular individuals[18] but we have chosen not to use them ~~because our use of any nonpublic data compromises our~~in order to maximize the industry's ability to ~~encourage improvement of compliance management in the nonmortgage lending industry~~follow suit.

Many auto industry players, including many of the large banks, use proxies to conduct internal nonmortgage fair lending analyses. Our supervisory experience has been that gender proxies using first name and race/ethnicity proxies using surname ~~and geocoding~~(for Hispanics and Asians) and geocoding (for African Americans or "minorities" more generally) are the most common. In addition, many industry players, including dealers, use marketing

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[13] ~~*Id.* ("The Bayesian [integrated surname and geography] approach was 74 percent more efficient than geocoding alone in estimating individual race/ethnicity and 56 percent more efficient in estimating the prevalence of racial/ethnic groups, outperforming the non-Bayesian hybrid [using only surnames for Hispanics and Asians, and only geocoding for African-Americans] on both measures.")~~

[14] *See id.* at 1732. Similarly, the integrated approach outperformed a "hybrid" method using surnames to proxy for Hispanics and Asians and geography to proxy for African Americans.

[15] As discussed further below, we may use such other methods in the context of litigation to the extent they may be more precise in identifying the race/ethnicity of particular individuals.

[16] In a recent meeting with [redacted], a market research company, they explained that their method uses first, middle, and last names along with geography and information from over 100 other proprietary sources.

[17] Confirmed in May 16, 2013 meeting with DOJ. In addition, it is our understanding that DOJ has never relied solely on a statistically-based proxy of race and ethnicity, but rather has augmented its statistical proxy analysis with ~~more direct~~other types of evidence, such as drivers' license photos or lender employee assessments.

[18] Moreover, these alternative methods are not necessarily more accurate or reliable. *See, e.g., E.E.O.C. v. Kaplan Higher Learning Educ. Corp.*, No. 1:10 CV 2882, 2013 WL 322116, at *5-10 (N.D.Ohio Jan. 28, 2013) (finding the conclusions based on the judgments of "race raters," who assessed individuals' race/ethnicity based on driver's license photographs, to be unreliable and inadmissible under *Daubert*).

data about customers that is generated using proxies, although that information is often provided by third parties.

PEER APPROACHES TO PROXY METHODOLOGY

The Bureau's peer agencies (DOJ, FTC, OCC, FRB, FDIC, NCUA, HUD) have not, to date, made public announcements regarding the proxy methodology they use. We have begun a survey of these agencies to determine what methodology they use, what, if anything, they publicize about their methodology, and their reasoning for disclosing or withholding this information. Based upon our conversations with these agencies and case law review, we have determined that none of them use the integrated proxy methodology or currently publicize their methodology, though we recently learned that the FRB intends to describe its methodology in an upcoming Webinar.

Here is an agency-by-agency summary of our current understanding with respect to use and disclosure of proxies, although we are still in the process of gathering this information:

- The **DOJ** does not conduct supervisory work and in its enforcement role, conducts a case-by-case analysis of potential discrimination. Thus, DOJ does not have an overall proxy methodology. We have conferred with DOJ,[19] however, and they support a public announcement of our methodology for purposes of informing the industry of the approach we use in the supervisory context and that industry can apply in its own compliance management.

- It is our understanding that the **OCC** has not published its proxy methodology and, in any event, has only rarely used proxies for race and ethnicity in its supervisory work, even when it had ECOA jurisdiction over large national banks.

- The **FRB** uses a less complex methodology than the CFPB—specifically, a surname proxy for Hispanics and Asians and a geographic proxy for African Americans or "minorities" more generally, as opposed to our combined method, which integrates both surname and geography. As noted above, fair lending staff at the FRB have informed us that they plan to discuss publicly their proxy methodology in an upcoming webinar, scheduled for late July.

- The **FDIC**, like the FRB, uses a less complex methodology than the CFPB, including only surnames (for Hispanics and, more recently, Asians), with no geographic component. The FDIC economists with whom we spoke indicated that they supported a public announcement of our methodology.

- **HUD's** fair lending authority under the Fair Housing Act is limited to mortgage lending, for which the availability of HMDA data generally obviates the need to proxy.

BENEFITS AND RISKS OF PUBLISHING OUR METHODOLOGY

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[19] DOJ's Civil Rights Division is concurrently conducting investigations into indirect auto lending with us.

Several institutions and industry groups have asked the Bureau to publish the methodology it uses for proxying in its auto lending analyses. ~~A published proxy methodology will enhance their~~We recommend publishing the proxy methodology we use in our supervisory work and that industry can apply to its own compliance management, while making clear that we make determinations of discrimination on a case-by-case basis and that all available enforcement and litigation tools remain open and are not bound by the announcement. This will enhance responsible lenders' ability to conduct self-analyses on their own portfolios, allowing them to identify and address issues before a CFPB exam or investigation commences, while maintaining the flexibility to tailor our proxy methodology in specific enforcement matters, particularly in litigation.

~~Our~~Because our sister regulatory ~~or~~and enforcement agencies have ~~chosen~~ not ~~to~~yet publicly ~~announce~~announced the methodologies they use in ~~their~~ fair lending analyses~~. We consider here the merits and risks of publication, and~~ , we recommend ~~against it in the short term.~~continuing our inter-agency discussions on this topic and making our disclosure within the next few months.[20]

Benefits

The primary benefit of publishing information about proxy methodologies is that it will improve ~~compliance in nonmortgage lending.~~ the ability of lenders to assess compliance in nonmortgage lending. A published proxy methodology will enhance lenders' ability to conduct self-analyses on their own portfolios, allowing them to identify and address issues before a CFPB exam or investigation commences. Some lenders may be ready to adopt a proxy method for their compliance management program if it can be translated into actionable steps. Many small financial institutions cannot afford to hire economists or consultants to create a compliance management system that uses proxies, so a simple explanation from our agency might encourage industry adoption outside the (generally large) institutions that now use it.[21] Other lenders that already use proxies may be willing to alter their methods if they are shown the advantages of a new method. An announcement would potentially precipitate adoption of the integrated proxy method, simply because that method would carry the imprimatur of our agency. ~~This creates a win-win outcome. Lenders benefit by~~All of this will benefit both lenders and the Bureau. Lenders benefit by using the information gleaned from the proxy to target their finite compliance resources to the areas of greatest fair lending risk, thus better protecting themselves from potential claims of discrimination. The Bureau benefits by inducing voluntary compliance activity and potential corrective action by the industry.

~~As some lenders roll out dealer monitoring programs in response to our March bulletin, it is possible that even some auto *dealers* may use our proxy method to conduct analyses of their~~

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[20] The FRB does not conduct public enforcement activities and, therefore, does not have the same concerns that we do that such a disclosure could restrict our ability to apply a different, potentially more precise, proxy methodology in an enforcement matter or litigation. However, the fact that the FRB plans to share the methodology it uses in conduct examinations is a strong argument in favor of our doing the same.

[21] As some lenders roll out dealer monitoring programs in response to our bulletin, it is possible that some auto *dealers* may use our proxy method to conduct analyses of their own portfolios, further enhancing overall ECOA compliance. While the Bureau's ECOA authority generally does not extend to dealers (with certain exceptions), better compliance at the dealer level should improve outcomes at the lender level where we do have authority.

~~own portfolios. Many dealers and small financial institutions cannot afford to hire economists or consultants to create a compliance management system that uses proxies, so a simple explanation from our agency might encourage industry adoption outside the (generally large) institutions that now use it. The information gained from the proxy could be used by companies to target their finite compliance resources to the areas of greatest fair lending risk.~~

Another related benefit of publishing our methodology is that it fulfills our ~~desire to be transparent~~goals of transparency with financial institutions. Transparency is a value, but it also fulfills many objectives. Publication would relieve some uncertainty about how we assign race and ethnicity. In light of our bulletin urging indirect auto lenders to adopt compliance management systems that necessarily rely on proxying, publication would also provide additional information as to how to implement our guidance and respond to industry concerns about the lack of specifics with respect to what the Bureau is expecting. It would also encourage dialogue about proxy methodologies and might potentially spur further methodological enhancements ~~in~~to proxying. Because proxies are the only viable means of conducting statistical fair lending analyses in nonmortgage lending, if executed appropriately, a publication could prompt supportive messages from other agencies, consumer and civil rights advocates, and academics.

Finally, we have already informed several institutions in PARR letters that we are using a proxy methodology that combines both surname and geocoding, including citations to the academic literature discussing this methodology. These institutions are thus aware of our approach, and publication would provide that information to the rest of the industry.

Risks

There are risks to publishing our proxy methodology in the current environment. First, publicizing our methodology prematurely opens it up to attack. News reports are already labeling it as racial profiling and junk science, and these aspersions may increase if we reveal greater specificity. Of course, those attacks may also continue regardless, and publishing our methodology may actually provide us with ammunition to counter such charges. As noted above, however, other proxy methods that rely on proprietary data may be more precise than ours, and we could open ourselves up to criticism of our proxy methodology. We understand that a prominent industry law firm will soon be publishing a white paper criticizing the integrated method of proxying and possibly criticizing proxying more generally. Also, we recently received a letter from several Democrats on the House Financial Services Committee asking for details on our methods, and would expect further requests (and perhaps even a Congressional hearing) to explain any announcement about methodology. ~~There are serious risks to publishing our proxy methodology in the current environment. First, our Track 2 work is focused on moving indirect auto lenders towards a nondiscretionary form of dealer compensation, but an announcement on proxy methodology might suggest that lenders should instead eliminate the fair lending risk via a more robust compliance management system. There is evidence that one large auto lender has expressed interest in Track 2 because it believes our bulletin was in fact suggesting elimination of discretionary markup, and an announcement on proxy methodology would dispel that impression.~~

We believe it preferable to assess the white paper and its impact on our methodology prior to a public announcement so as not to get caught flat-footed by vocal criticism. If we publish our method in detail, moreover, we risk encouraging yet more questions on more complicated, fact specific subjects, such as our regression modeling.

Second, a methods announcement ~~would~~could also endanger our Track 1 work by ~~providing fodder to defendants to show how our methods are inferior to other proprietary proxies and by~~ tying us to methods that we may prefer to use only for ~~supervisory purposes~~conducting examinations, rather than litigation. To lessen this risk, any such announcement should make clear that it is limited to the approach we take in conducting examinations, that we may use other approaches in enforcement matters and potential litigation as the particular facts of the case warrant, and that all available tools remain at our disposal, including developing or utilizing more advanced proxy methodologies as they may evolve down the road. Proxying remains an evolving area ~~of economies~~in statistical methods and we expect that conversations with other federal agencies and experts may further inform our thinking. For example, we have reason to believe that our proxy is less ~~accurate~~precise in identifying the race/ethnicity of particular individuals than some proprietary proxy methods that use nonpublic data. ~~The litigation risk is particularly acute here because we are working with the DOJ jointly on our nonbank investigations, and the DOJ may not agree with our proxying approach. Moreover, if~~If we publish a certain method and then feel compelled to use it in litigation, a defendant could potentially request all the deliberation behind that method through discovery~~. If we choose not to publish, we will~~ and it may not be ~~more likely to consult an outside expert~~protected by the Deliberative Process privilege. We could also be disadvantaged in litigation by the fact that the agency took a public position on the "correct" methodology for ~~litigation purposes and our internal methodological deliberations will not be discoverable.~~this type of analysis, calling into question any alternative approaches that we may want to apply in the future.

~~A third risk of publishing our proxy methodology in the short term is that it risks~~Third, our Track 2 work is focused on encouraging lenders to consider carefully the relative costs and benefits of the options outlined by the bulletin for addressing fair lending risk and on assisting indirect auto lenders that desire to adopt nondiscretionary forms of dealer compensation. An announcement on proxy methodology at this time may interfere with this effort. Publishing our methodology may suggest that we are not neutral as to the outcome (and are pro-CMS), while our bulletin was neutral as to how to solve the problem. Such an announcement will generate significant public discussion, and the discussion likely will be centered on only one of the options from the bulletin, namely the implementation of robust CMS, and will not address the other option, namely the adoption of nondiscretionary compensation systems. This focus on CMS may cause lenders to believe erroneously that the Bureau prefers the CMS solution, especially as it is a commonly used solution in this space. The focus on CMS also may discourage lenders from considering the costs and benefits of both options; because much of the discussion likely will jump directly to questions of how to implement a CMS, lenders may gloss over the root question of whether a CMS solution is the best solution for them in this context. For example, one lender has expressed interest in Track 2 because it believes that – after careful consideration of the issues raised by the bulletin – a nondiscretionary compensation system is a better method for addressing the risk. That lender, however, also has expressed concern that other lenders appear not to be considering the issues raised by the bulletin as carefully and may not be weighing the relative costs and benefits of the options suggested. A public announcement on proxy methodology without a concomitant discussion of other possible solutions may convince those lenders not to engage in a careful consideration of options other than robust CMS.

Finally, publishing our proxy methodology in the short term highlights potential conflicts with our sister regulatory institutions. Those agencies do not currently publish their methodologies~~ and~~, although the FRB has informed us that they ~~may~~intend to do so during a webinar in July,[22] and, as noted, its methodology differs from ours.[23] We are continuing our discussions with our sister agencies, who use ~~different~~related but not identical proxy methods ~~from~~to those we use or would publish. Our publication might implicitly suggest that other methods are inferior, and it is our understanding that some fair lending enforcement agencies have been using other proxy methods for many years. Even though we have no authority to decide methodologies for other regulators, a court might reasonably inquire why such methods would differ between federal regulators enforcing the same fair lending laws. We plan to continue to engage with other regulatory and enforcement agencies over the next few months to better understand their research methods~~ and why they have chosen not to publish them~~.

~~Finally, publicizing our methodology in the short term opens our methodology up to attack and further questions. News reports are already labeling it as racial profiling and junk science, and these aspersions may increase if we reveal greater specificity (although those attacks may also continue regardless). We understand that a prominent industry law firm will soon be publishing a white paper criticizing the integrated method of proxying and possibly criticizing proxying more generally. Also, we recently received a letter from several Democrats on the House Financial Services Committee asking for details on our methods, and would expect further requests (and perhaps even a Congressional hearing) to explain any announcement about methodology. Moreover, the more detail we provide, the more questions we may receive about more complicated subjects such as our regression modeling.~~

CONCLUSION

In light of these risks, we recommend ~~against~~ publication ~~in~~within the ~~short term. Instead, we recommend reconsidering the possibility of publication in six~~next few months.~~[24]~~ ~~Publishing anything about methodology before exhausting~~, preferably after we have completed our ~~Track 2 options would likely decrease the likelihood of a multi-lender settlement eliminating discretionary markup. Moreover, we should be careful not to jeopardize our Track 1 enforcement actions before knowing whether they will proceed to active litigation, potentially jointly with the DOJ. In the meanwhile, we will discuss methodological issues~~discussions with our sister ~~regulatory~~ agencies~~,~~ to fully understand

[22] An FRB announcement, however, does not carry the same risk for that agency as a similar announcement would for us. The FRB does not entertain enforcement actions and, instead, refers them to the DOJ, which has a "clean" review of the matter and is not bound by FRB's prior actions. We could, from a public perception viewpoint, be seen as bound by our own prior announcement. At the same time, the very fact that the FRB announces its methodology publicly will likely put additional pressure on us to do the same.

[23] As discussed above, the FRB uses a less complex methodology (surname for Hispanics and Asians and geography for African Americans, as opposed to our combined method), while the FDIC uses only surnames with no geographic component. In other words, the FRB and FDIC use the same underlying Census data as we do, but in different ways, in order to proxy for race and ethnicity.

~~[24] If we decide to publish something on proxy methods in the nearer term, we could mitigate some of the risks by publishing an endorsement of proxying generally that provided specificity about various methods but did not espouse any one in particular. We understand from the OCC that smaller banks would appreciate guidance on the legality under ECOA of proxying; this more limited announcement would address this concern. Such an announcement would still endanger our Track 2 work and might prompt further questions and pressure about which proxy we prefer.~~

differences in our methods and ~~learn more about industry counterarguments from~~preferably after we have had a chance to review the anticipated industry white paper. -When making such an announcement, we can mitigate some of the risks described above by: (1) simultaneously reminding lenders about other (non-CMS) options for managing the fair lending risk created by dealer markup; (2) clarifying that the announcement applies exclusively to our supervisory work, thus fully reserving enforcement/litigation flexibility; and (3) emphasizing the importance of proxying more generally and the multitude of possible approaches to it, even as we publish details about our current method. [25]

[25] We understand from the OCC that smaller banks would appreciate guidance on the legality under ECOA of proxying, and a general endorsement of proxying would address this concern.

2. Disparity Tolerances

RECOMMENDATION

The Bureau should not announce the degree of disparities in dealer markup that we would consider "materially insignificant." Publication of our "tolerances" entails serious risks to our auto finance initiative, our ongoing enforcement matters, and to our fair lending work more generally.

__________ Approve __________ Disapprove __________ Let's discuss

INTRODUCTION

Industry has asked whether the Bureau will publicly state its tolerances for disparities — that is, its standard for material insignificance. We have a number of concerns about doing so, and recommend against it.

The Bureau and indirect auto lenders have a common interest in ensuring that our fair lending compliance efforts are focused on the areas of highest risk. Both have recognized that small disparities, while statistically significant at the 95% confidence level, may be deemed "materially insignificant," and therefore within an acceptable tolerance.[26] The concept of material insignificance recognizes at least two factors. First, statistical models may never be perfect, and small disparities may be reflective of "noise" in the data or failure to account for all relevant explanatory factors rather than actual discrimination. Second, even if small disparities may properly be described as discrimination, the Bureau's resources necessary to eliminate them may outweigh the benefit to consumers.

BACKGROUND ON FAIR LENDING TOLERANCES

A "tolerance" is a threshold, often expressed in basis points when one's focus is pricing, below which disparities would be deemed materially insignificant, and therefore not subject to supervisory or enforcement action. No federal regulator or enforcement agency has chosen to announce its tolerances for fair lending disparities. However, lenders routinely use tolerances in designing their compliance management programs in order to focus scarce compliance resources on the areas of greatest risk. For example, in response to the March compliance bulletin on auto finance, some lenders have designed "dealer watch lists" that monitor certain dealers if the disparities in a dealer's portfolio rise above a certain number of basis points.[27]

Importantly, tolerances vary based on a number of relevant factors. These factors include the product type, the nature of the activity under consideration, and the nature of the data

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[26] We use this concept for policy, not legal, purposes, and would argue against its use as a legal standard. However, as noted below, publication of tolerances, risks the perceived adoption of such a legal standard.
[27] Tolerances for such programs range from 10 to 25 basis points, but those tolerances are for dealer-level, not lender-level, disparities.

itself. Because of these distinctions, any announcement would need to recognize that a tolerance in auto dealer markup would not necessarily apply to other practices or products.

Tolerances vary by loan product because features such as the loan term or loan amount may dramatically impact the magnitude of consumer harm represented by a particular number of basis points of disparity. For example, a mortgage loan is usually larger and is held for a longer term than an auto loan, and so similar basis point disparities in APR may create many more dollars of harm in mortgage lending than auto lending.

Tolerances may also differ based on the activity under consideration. Fair lending analyses typically examine multiple aspects of the credit transaction, including underwriting decisions (denials), pricing (both APR and fees), steering, redlining, and more. Reasonable tolerances will likely vary for each aspect. For example, APR tolerances are typically lower than fee tolerances because discriminatory APR pricing has a greater impact over time. Put differently, a large upfront fee disparity might appear small if rolled into the APR, which amortizes that difference over the life of the loan.

Moreover, tolerances also may be expressed in different ways. For example, underwriting decisions are often reflected in odds ratios (e.g., African American borrowers were denied at 1.8 times the rate of non-Hispanic White borrowers), while redlining may be reflected by comparing one institution's rate of lending in minority areas with that of its peers, which can be reflected in both absolute differences (e.g., the share of Lender A's originations that occur in minority neighborhoods is 10 percentage points lower than its peers') and relative differences (e.g., Lender A is only 1/5 as likely as its peers to make loans in minority neighborhoods). Fee tolerances can be expressed in dollar amounts or as a percentage of the loan amount.

Tolerances also depend on the nature of the data itself. In auto lending, for example, dealers and lenders do not collect information on race or gender, so we proxy for those characteristics. Our proxy methodology, although better than other commonly used methods, necessarily introduces skepticism about the precision of our results, and this may counsel in favor of increasing our tolerances in auto lending relative to mortgage lending, where race and ethnicity are reported for most loans. Additional data considerations or evidence of intentional discrimination might be specific to a particular lender and might change our assessment of the appropriate tolerance. In short, our tolerances will depend on the circumstances of each case, or at the very least on a multitude of factors, which makes it very difficult to specify a single threshold for all cases.

PEER APPROACHES TO TOLERANCES

The Bureau's peer agencies (DOJ, FTC, OCC, FRB, FDIC, NCUA, HUD) make case-by-case assessments of whether to pursue supervisory or enforcement activity in response to statistical disparities. ~~Just as we noted above with respect to proxy methodology, we~~We are not aware of any agency publicly announcing its tolerances; rather, over time they tend to develop a reputation for leniency or stringency.

Through an examination of enforcement actions from the DOJ, one can glean unstated tolerances for certain types of cases. These numbers should be viewed as informal *enforcement* tolerances~~.~~; thus, they reflect fact patterns that are appropriate for public enforcement, including potential litigation. The supervisory agencies that refer cases to DOJ ~~almost certainly~~likely use lower tolerances in supervisory matters, but these tolerances are not public.[28] In referring a matter to the DOJ, the supervisory agencies have made a determination that they have reason to believe that an entity has engaged in a pattern or practice of lending discrimination; such referrals, therefore, often do not involve fact patterns that are appropriate for public enforcement.

Over the last few decades, the lowest disparities used in a DOJ case were pricing disparities reflected through APR, ranging from 5-14 basis points ([redacted]). The lowest pricing disparities reflected through retail fee markups involved disparities of 13-28 basis points, but that case also had much higher broker yield spread premium disparities (up to 107 basis points) in wholesale pricing ([redacted]). Another mortgage pricing case had retail fee markup disparities of 19-26 basis points and broker yield spread premium disparities of 16-66 basis points in wholesale pricing [redacted]. The lower end of markup pricing disparities in two other cases ([redacted] was 20 basis points. We can infer from these cases that DOJ deems mortgage pricing disparities of 5 basis points to be actionable when reflected through APR and deems mortgage pricing disparities of approximately 20 basis points to be actionable when reflected through markup. However, the facts and circumstances of each case may well have influenced DOJ's decision to pursue each case.

BENEFITS AND RISKS OF PUBLISHING OUR TOLERANCES

Benefits

The rationale for publishing our tolerances is that such information would help lenders design their own compliance management systems. This transparency allows lenders to focus on the areas of greatest fair lending risk and not expend scarce compliance resources on eliminating negligible disparities that do not pose considerable risk of consumer harm. A concrete tolerance figure could help compliance officers design internal analyses and monitoring programs that correspond to the Bureau's stated tolerances. Lenders would benefit from the greater certainty they would have about where to focus their compliance efforts and when they might expect concern from the Bureau in examinations. The Bureau itself would benefit because publishing our tolerances would potentially induce more self-analysis by industry actors, thereby encouraging voluntary compliance. However, each institution is different and each set of facts are different. It would be hard to explain one set of disclosed tolerance thresholds and then apply it equally to all institutions.

Transparency brings other benefits. By being forthright about our tolerances, publication might encourage healthy debate about the appropriate level of dealer markup tolerances. An announcement might also spark discussion about the variety of potential tolerances, and how certain tolerances should be expressed.

Risks

~~The approach of our peer agencies, which have declined~~Declining to publish our tolerances~~,~~ has several advantages. First, and quite simply, it ~~allows these agencies~~would allow us to

[28] For example, in December 2011 the FDIC referred [redacted] to the DOJ based on disparities of 7.9–8.6 basis points between Asian and non-Hispanic White borrowers. The DOJ deferred the matter for administrative enforcement.

assess the facts and circumstances of each case and make a determination with the benefit of tangible details.[29] We do not typically rely on statistical findings alone in determining whether discrimination has occurred. At the very least, we confirm the results of statistical analyses with file reviews and other data and information, such as complaints, policies and procedures, or interviews with lender personnel. For instance, an entity might have relatively low disparities, but the regulator might have evidence from a whistleblower to accompany the statistical evidence. Another hypothetical is a lender that specializes in high-value lending, such that small disparities still yield thousands of dollars in consumer harm for each loan. Yet another example is when an APR model fits the data extremely well—meaning that we believe we have accounted for most if not all factors that might legitimately explain the disparities—a lower tolerance may be appropriate. In short, a rule of thumb does not suit all fingers, and a public commitment to a certain tolerance makes it difficult to make exceptions where warranted. An announcement could make clear that our tolerances are just one of the criteria we consider, but each such qualification weakens the transparency value of publication and, in any event, may be too fine a distinction for an occasion on which we seek corrective action for disparities less than our published tolerance.

Another disadvantage to publicizing a tolerance is that it ~~may impair our~~supports imposing a heightened legal standard to showing disparate impact in future enforcement actions. Any public announcement of tolerances would be identifying tolerances as a matter of *policy*, but potential defendants could easily twist such an announcement as being the Bureau's adoption of a *legal* requirement that disparities be substantial to demonstrate actionable discrimination. Although some courts require a showing that disparities be not only statistically significant but also practically significant or substantial, other courts reject any requirement beyond that of statistical significance.[30] Defendants could point to an announcement of the Bureau's tolerances to be an adoption of this substantiality or practical significance legal standard. This could create an additional legal hurdle for the Bureau's proving discrimination, potentially precluding claims with small disparities even when the evidence of discrimination is compelling.

A public announcement may also impair our future enforcement actions because it could be used by a defendant to weaken a case with disparities close to or below our publicized

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[30] *Compare Waisome v. Port Auth. of New York & New Jersey*, 948 F.2d 1370, 1376 (2d Cir. 1991) (finding that "though the disparity was found to be statistically significant, it was of limited magnitude" and citing sources explaining the difference between statistical and practical significance), *with Stagi v. Nat'l R.R. Passenger Corp.*, 391 F. App'x 133, 140 (3d Cir. 2010) ("As "practical" significance has not been adopted by our Court, and no other Court of Appeals requires a showing of practical significance, we decline to require such a showing as part of a plaintiff's prima facie case."). Statistical significance is mathematical and normally corresponds to the 95% confidence level — that is, when the probability of a particular finding being the result of random variation is less than 5%. Statistical significance is more easily obtained as the number of observations analyzed increases. Material significance, in contrast, is subjective and depends upon a judgment of whether a given amount of statistically proven difference matters for practical purposes. We note that both of these cases imposing a requirement of practical significance were employment promotion cases and we believe we might have a more compelling argument in the lending context against imposing such a standard given the harm to many consumers. Statistical significance is mathematical and normally corresponds to the 95% confidence level — that is, when the probability of a particular finding being the result of random variation is less than 5%. Statistical significance is more easily obtained as the number of observations analyzed increases. Material significance, in contrast, is subjective and depends upon a judgment of whether a given amount of statistically proven difference matters for practical purposes.

tolerance. This risk is particularly acute given that tolerances in APR disparities are lower than tolerances in fee disparities, and because such distinctions require a nuanced understanding of the methods involved, the higher tolerances could easily be used to undermine the lower.[31] Worse yet, if we publicize our tolerances, that information could be used to weaken the cases of our sister regulators as well, or make the Bureau appear weak on fair lending. Even though we have no authority to decide tolerances for other regulators, a court might reasonably inquire why such tolerances would differ between federal regulators enforcing the same fair lending laws.

Another risk of publishing tolerances is that it appears to signal that the CFPB permits some modicum of discrimination, although this risk may be mitigated by careful wording. Nonetheless, the headline risk for the Bureau could impair our relationship with the public, and the consumers with whom we hope to build trust, who may not fully comprehend the methodological reasons behind tolerating disparities that are statistically, but not materially, significant. Publishing an amount of "acceptable discrimination" also creates the risk that lenders will manage to that tolerance, and loosen their current policies to allow greater disparities than they had in the past.

Industry, on the other hand, will undoubtedly criticize our tolerances for being unreasonably low. Further, there is the risk that industry will focus on the number and not on a more thorough evaluation of overall fair lending risk. News reports have already sought to minimize the potential harm in dealer markup by spreading the harm over dozens of monthly payments. If we publish a tolerance of 5 basis points, for example, we should expect a common refrain to be that we are worried about disparities amounting to less than "a dollar a month per consumer~~,"[32] even though~~." For an average auto loan of $26,000 loan over 60 months, 5 basis points of disparity creates approximately $0.60 of consumer harm each month. Yet the harm affects many consumers and totals tens of millions of dollars across the market. This kind of news coverage not only risks diminishing our efforts, but also impairs our trust with American consumers and their political representatives.

CONCLUSION

Because of the foregoing risks, our recommendation is that we not publish a tolerance for disparities in the context of dealer markup (or, indeed, any other context).

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[31] This risk is not merely hypothetical. We currently have an enforcement action based on APR disparities of less than 10 basis points. However, the average harm in that matter exceeds $600 per loan.

~~[32] For an average auto loan of $26,000 loan over 60 months, 5 basis points of disparity creates approximately $0.60 of consumer harm each month.~~

Decision Memo Clearance Sheet

Document: Subject/Title ____________________

Owner: Name __________ Office __________ Tel. Ext. ______

Approved: Name of Associate or Assistant Director ____________

Pre-Cleared:

Legal Division		Name of clearer		Date	
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