Consumer Financial Protection Bureau

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Information memorandum for the Director

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THROUGH	Steve Antonakes
SUBJECT	Information Memo: disparity tolerances

SUMMARY

Industry has asked whether the Bureau will publicly state its tolerances for disparities—that is, the degree of disparities in fair lending analyses that we would consider "materially insignificant." Publication of "tolerances," however, entails serious risks to our auto finance initiative, our ongoing enforcement matters, and our fair lending work more generally.

INTRODUCTION

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. 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.

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 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. 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 likely use lower tolerances in supervisory matters, but these tolerances are not public. 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 (Prime Lending). 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 TOLERANCES

Benefits

The rationale for publishing tolerances is that such information would help lenders design their own compliance management systems. This transparency would allow 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 might benefit because publishing our tolerances would potentially induce more self-analysis by industry actors, thereby encouraging voluntary compliance. However, it would be hard to define one set of tolerance thresholds that applies equally in all circumstances.

Transparency brings other benefits, such as encouraging healthy debate about the appropriate level of dealer markup tolerances and discussion about the variety of potential tolerances, and how certain tolerances should be expressed.

Risks

Maintaining the status quo regarding tolerances in the industry has several advantages. First, and quite simply, it would allow us to assess the facts and circumstances of each case and make a determination with the benefit of tangible details. 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. While an announcement could make clear that tolerances are just one of the criteria we consider, 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.

Publicizing a tolerance carries with it the disadvantage that it supports imposing a heightened legal standard for showing disparate impact in future enforcement actions. Some courts require a showing that disparities are not only statistically significant but also practically significant or substantial, while other courts reject any requirement beyond that of statistical significance. 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 cumulative evidence of discrimination is compelling. Any public announcement of tolerances would be identifying tolerances as a matter of *policy*, while potential defendants could easily twist such an announcement by claiming that it represents the Bureau's adoption of a *legal* requirement that disparities be substantial to demonstrate actionable discrimination.

Publication of tolerances could also fuel the industry's attack on disparate impact by suggesting that there can be a *per se* level of discrimination rather than the thoughtful, multi-step process required in order to assess disparate impact. The industry has focused its critique of the Bureau's reliance on disparate impact on our failure to announce specific tolerances that would trigger liability. But this very question oversimplifies the disparate impact doctrine into a game of "gotcha" that looks only at numerical *ex post facto* effects by ignoring critical steps in the disparate impact analysis. Under the law, a creditor may be responsible for a facially neutral policy or practice that is applied equally, if that policy or practice has a disproportionate adverse effect on a prohibited basis, *unless the policy is justified by a legitimate business need* that cannot reasonably be achieved as well by means that are less disparate in their impact. Thus, even if a policy has a disparate impact, there is no violation when there is a legitimate business need and no less discriminatory alternative for the policy. In practice, if responsible lenders proceed thoughtfully by adopting policies that are supported by legitimate business need, they are unlikely to be subject to a successful disparate impact challenge. Such thoughtful analysis underlies countless credit-related policies and practices, most obviously in the development of credit risk models and underwriting guidelines used throughout the industry. However, purely discretionary policies may be far harder to justify by business need. It is this lack of business need—and not merely the disparate effect that such policies commonly have—that underlies the fair lending risk inherent in such policies. Publishing tolerances thus risks feeding the industry's attempt to take focus away from the lack of business need for dealer markup.

Publicizing tolerances also may 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 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. Worse yet, the publication of our tolerances 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 among federal regulators enforcing the same fair lending laws.

Publishing tolerances also could appear 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 may have in the past.

Industry, on the other hand, would 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 disaggregating 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." For an average auto loan of $26,000 over 60 months, 5 basis points of disparity creates approximately $0.60 of consumer harm each month, or approximately $36 over the life of the loan. Yet the harm affects many consumers individually 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

Based on the above discussion, the costs outweigh the benefits of publishing a tolerance for disparities in the context of dealer markup (or, indeed, any other context).

Information Memo Clearance Sheet

Document:	Subject/Title	Information Memo: disparity tolerances				
Owner:	Name	Patrice Ficklin	Office	Fair Lending	Tel. Ext.	[redacted]
Approved:	Name of Associate or Assistant Director			Steve Antonakes		

Legal Division		Name of clearer	Christine Ladd	Date	June 28, 2013
Office	Research	Name of clearer	Bryce Stephens	Date	July 8, 2013
Office	Supervision	Name of clearer	Calvin Hagins	Date	June 27, 2013
Office	Enforcement	Name of clearer	Craig Cowie	Date	June 26, 2013
Office	ILL Markets	Name of clearer	Rick Hackett	Date	June 7, 2013
Office		Name of clearer		Date	