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CFPB's Reg B Final Rule: Disparate Impact Liability Out, Discouragement Standard Narrowed, and SPCPs in the Crosshairs

SPEAKERS

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In this episode of *The Consumer Finance Podcast*, Chris Willis, Lori Sommerfield, Taylor Gess, and Lane Page discuss the CFPB's sweeping final amendments to Subpart A of Regulation B. The group unpacks the elimination of the disparate impact legal theory from ECOA, the narrowing of the discouragement standard (including what it means for targeted advertising), and the significant new limits on special purpose credit programs (SPCPs). They also explore expected litigation challenges, the continuing role of the Fair Housing Act and state laws in bringing cases under the disparate impact theory, and the practical steps lenders should be taking now to reassess fair lending testing, SPCP design, and redlining risk in light of the final rule.

Transcript

The Consumer Finance Podcast – CFPB's Reg B Final Rule: Disparate Impact Liability Out, Discouragement Standard Narrowed, and SPCPs in the Crosshairs
Host: Chris Willis
Guests: Lori Sommerfield, Taylor Gess, Lane Page
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Chris Willis (00:05):

Welcome to *The Consumer Finance Podcast*. I'm Chris Willis, the co-leader of Troutman Pepper Locke's Consumer Financial Services Regulatory Practice. And today we're gonna talk about the very exciting news out of the CFPB with the Final Reg B rulemaking having been released. But before we jump into that topic, let me remind you to visit and subscribe to our blogs, TroutmanFinancialServices.com and ConsumerFinancialServicesLawMonitor.com. And don't forget about all our other podcasts, the *FCRA Focus*, *The Crypto Exchange*, *Payments Pros*, and *Moving the Metal*, all of those are available on all popular podcast platforms. And speaking of those platforms, if you like this podcast, let us know. Leave us a review on your platform of choice and tell us how we're doing. Now, as I said, today we're gonna be talking about the recently released Final Reg B rule that was released by the CFPB. Having been proposed in November, the CFPB has now finalized the rule, and we're gonna talk all about what happened, what we thought was interesting about it, and what we think will happen next, as well as what we think the industry should do in response to this development. Joining me to talk about this are three of my colleagues, Lori

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Sommerfield, Taylor Gess, and Lane Page, all members of our Consumer Financial Services Regulatory team and all very knowledgeable about these issues. So, Lori, Taylor, Lane, thanks for being here.

Lori Sommerfield (01:22):

Great to be here, Chris.

Taylor Gess (01:23):

Yeah, thank you for having us, Chris.

Lane Page (01:25):

Thanks, Chris.

Chris Willis (01:26):

Okay, so let's just start. Taylor, let me start with you. Tell the audience, what did the CFPB do in the final rulemaking?

Taylor Gess (01:32):

Sure, Chris. So the final rule amending Reg B that was issued on April 22 largely tracks last fall's proposed rule. And just as a threshold matter, before we dig into the bones of the changes, we always like to remind people that ECOA and Reg B apply broadly to any form of credit throughout the entire credit process. So that includes advertising and marketing to application and underwriting to the granting of the credit and ongoing dealings with the creditor up through collections and termination of the credit. And as to the new Reg B rule, there are three main areas of changes. So first, the removal of disparate impact liability. Second, narrowing of the discouragement prohibition. And third, material restrictions of the special purpose credit program provisions. On that first point, so ECOA historically prohibits both disparate treatment and disparate impact discrimination on prohibited basis. When we say disparate treatment, we think of things like the creditor is treating the applicant differently based on a prohibited characteristic itself. So, like offering different interest rates based on someone's age alone or denying loans to applicants of a certain race based not on a business justification, but on the protected class status.

Taylor Gess (02:44):

But with disparate impact, we think of that as a creditor having a policy or practice that is neutral on its face but has the effect of a disproportionately negative impact on a protected group of applicants, and that the creditor's business need could be satisfied in another way that would produce less of a discriminatory effect. And this final rule removes all this effects test or disparate impact language from Reg B. And second, existing Reg B also prohibits a creditor from discouraging applicants or prospective applicants from pursuing a credit application based on a prohibited basis. And the new rule provides that the standard for what constitutes that discouragement should be that the creditor knew or should have known that its statement would discourage a protected class member from applying for the credit, that it's not enough that the applicant had a negative impression about the application

process due to the statement. And finally, the third big change relates to the special purpose credit programs. And while SPCPs are still permitted under the new rule, for-profit creditors cannot use race, color, national origin, or sex as eligibility criteria. And there are also material conditions placed on SPCPs that use the other prohibited bases, such as religion, age, marital status, or public assistance income as eligibility criteria. Including requiring evidence that without the SPCP, the specific borrower would not receive credit because of that specific characteristic. So there's some really big changes, Chris.

Chris Willis (04:16):

And particularly with regard to the discouragement piece, Taylor, there were two things that struck me. One is the CFPB explains that there was a mismatch between the words that were in Regulation B that only prohibited sort of words or statements or something like that that discouraged an applicant, whereas the official commentary had more broad language about the creditor's practices or acts or something like that. And so they seem to be bringing it back, obviously, just to the sort of statements kind of basis. And then I think the other thing is how many times the CFPB went out of its way to say that targeted advertising directed at one group is not discouragement of people who don't receive the ad. That seemed to be a very central theme to what they were wanting to do on discouragement to me.

Taylor Gess (05:03):

Yeah, Chris, I definitely agree.

Chris Willis (05:05):

So the rulemaking release, Lane, was 170-something pages of interesting reading. I know I read it with a lot of interest, and you did too. Tell the audience about some of the nuggets that we pulled out of the commentary associated with the CFPB's analysis and discussion of comments and the reasoning for the final rule.

Lane Page (05:25):

Sure. There was a lot of commentary, so I might miss something, but I will try to cover what caught my eye and I think caught yours as well. Disparate impact probably is the shortest topic here because it's a pretty straightforward revision. I think the main takeaway in the commentary for the disparate impact revisions is that while disparate impact is no longer a prohibited thing under ECOA, disparate treatment still is. And that includes facially neutral criteria that are also used as proxies for prohibited basis characteristics. So if there are neutral criteria that act as proxies for prohibited characteristics, and if they're intentionally designed or applied in that way, they are still prohibited. So disparate impact, don't need to worry about it, but you still need to be looking out for any facially neutral criteria that could act as a proxy. Another thing I would note is that currently lenders are often performing model analysis to identify disparate impact, and several commenters raised concerns about whether they would still be permitted to perform these analyses based on the removal of disparate impact. And while the commentary does not state outright that these are permissible, it does not state that they're not permissible and says that's something that the creditors are going to have to assess based on their compliance with other laws and state laws. So while it doesn't outright approve of these analyses, it does suggest that lenders are still able to perform them.

Chris Willis (06:54):

Though I think the CFPB did still warn creditors at some point in the rulemaking release that sort of an explicit racial balancing of a model to equalize adverse impact ratios or something like that would still be viewed as illegal in their view, that that would be disparate treatment in their consideration.

Lane Page (07:12):

Right. And I think there's a good balance there between testing to see how your model is performing and then reacting to it. So reacting to it and making adjustments based on what you see, that's where you have to be careful and make sure you're staying away from any balancing or anything that could really be seen as disparate treatment. Now moving on to discouragement. As you noted, Chris, the big thing that the CFPB has made clear is that encouragement is not discouragement. So encouraging one group by using targeted advertising or advertising in a particular neighborhood does not constitute discouragement of a group that did not receive that advertising. And the big thing here with discouragement revisions overall, is focusing on the intent of the creditors versus how someone might interpret a creditor's action. So as noted with the targeted advertising, that doesn't constitute discouragement. Another important part about this is the focus on words and advertisements versus actions. So words, oral or written words, constitute actionable conduct. But what is not actionable are business decisions, such as branch locations, where you're advertising, or where you're engaging with the community through open houses or other events. So that really opens up a lot of conduct that creditors were likely worried about before, particularly with branch locations and advertisement locations, where creditors worried that if you did not have a branch in this neighborhood, it could be seen as discouraging applicants in that neighborhood from applying for credit.

Chris Willis (09:00):

Yeah, and all of that was really born out of the redlining enforcement experience that we've reported upon so many times in the blog and on this podcast, where branch location and selective advertising were frequently used as pieces of evidence in DOJ redlining cases brought under the Combatting Redlining Initiative in the last administration.

Lane Page (09:19):

And I think that is going to be crucial in how lenders are evaluating their advertising and location decisions. And then I think the last big point that I took from the commentary on discouragement is the CFPB really harping on the difference between potentially controversial statements, including political statements, and statements that are objectively discouraging. So just because a creditor makes a statement that a potential applicant might disagree with does not mean it's discouraging that applicant.

Chris Willis (09:54):

Yeah. And in that vein, the CFPB repeatedly referenced the Townstone case, and it was very, very evident how strong the disagreement is between the CFPB's current leadership and the legal theories that were espoused in the complaint in that case.

Lane Page (10:10):

Right. They were bothered by the Townstone case, as they showed us when they really revamped or, I guess, reduced the enforcement action against Townstone or the settlement agreement. And now they are still bothered by it, making that clear to the industry.

Lori Sommerfield (10:25):

I think the Townstone case is the whole impetus for narrowing the discouragement provision in Reg B, personally.

Lane Page (10:31):

Yeah, it certainly reads that way when you look at the commentary. And then moving on to special purpose credit programs. This is, I would say, by far the most impactful of the revisions to Reg B, and we'll talk about that in a minute about how lenders should react. But there was some interesting commentary regarding this as well. I think the biggest takeaway I have is that while programs using race, color, national origin, and sex as eligibility criteria are illegal, lenders are still allowed to use programs that target specific geographies or income levels for CRA or other purposes. So having a program that focuses on majority-minority and low-to-moderate income census tracts are still okay. And in response to some comments about whether these types of programs would violate ECOA, the CFPB explicitly made clear that lenders do not need to worry about disparate impact violations because that's no longer relevant under ECOA.

Chris Willis (11:30):

Yeah. And embedded in that, I think is an interesting premise, which is targeting a lending program at majority-minority census tracts is seemingly, in the CFPB's view now, not a proxy for race, for example, that it should be analyzed solely as a disparate impact matter, not treatment. And of course, since there's no disparate impact anymore, everything is okay. I think that embedded premise is also a very interesting one.

Lane Page (11:56):

I agree it's interesting, and I don't necessarily know how much I agree with it. I think that you could probably find some analyses that could conclude that that is a proxy. But we know how this current CFPB will react to that. It's a question of whether other regulators would agree with that. And I think my last comment about the commentary would be that the commentary suggests that lenders are still allowed to use special purpose credit programs that are part of a settlement agreement or consent order, which is notable because there are many such agreements, particularly with respect to redlining, that require special purpose credit programs that exclusively use these prohibited bases that we're no longer allowed to use under Reg B. I think this is notable. Obviously, it's notable because lenders do not have to worry as much about violating the law while also violating a legal agreement. But we expect that in the future, these will no longer be included in settlement agreements.

Chris Willis (12:54):

Maybe not. But there is one important distinction to draw on the settlement agreement front, Lane, and I think it is

that if it's a settlement agreement with a government regulator, you can do it. I don't think the logic of the CFPB's discussion in the rulemaking release would apply to a settlement between private parties in a redlining case.

Lane Page (13:11):

Unless it had been entered with a court to some degree. But I think it would be a very fact-specific scenario.

Chris Willis (13:18):

Sure. If a court orders it, I think that would probably also fall. They're citing a provision in Reg B that says you can follow the law, and the law is, included in that is court orders, administrative orders, things like that. And so, yes, if a court were to order it. But if you just entered into a settlement agreement with someone without a court ordering it, I don't think it would be covered.

Lane Page (13:26):

Right.

Chris Willis (13:33):

And therefore protected.

Lane Page (13:40):

That leaves you in a very sticky situation where, you could be subject to violating that or violating the new Reg B.

Chris Willis (13:47):

That's right. So, Lori, let me turn to you now. I mean, I think what we got with the final rule was kind of what we expected to get, and that is the rule is finalized essentially as proposed. So we've been knowing that this was happening. What do we think will happen next? Because surely this isn't the last chapter of this particular novella.

Lori Sommerfield (14:08):

Certainly not. And the next step is certainly litigation. I think the sheer amount of real estate that the Bureau uses in the preamble to support and defend the final rule indicates that the CFPB is anticipating legal challenges. And we clearly expect that several consumer advocacy groups, as well as state attorneys general, are going to file lawsuits contesting key elements of the final rule very soon. Those lawsuits are clearly going to focus on removal of the effects test from Reg B, narrowing the discouragement standard, and significantly restricting the use of SPCPs by creditors. And the lawsuits may contest each of those elements or all of them. I think it's possible we could see a preliminary injunction issued by a court even before the effective date of July 21. But litigation is certainly going to tie up the final rule for a period of time, if not years. And, Chris, I think, as you and the audience know, the U.S. Supreme Court has previously held in the Inclusive Communities case that the disparate impact theory is cognizable under the Fair Housing Act. That case was decided back in 2015. But circuit court law is

relatively unsettled on the topic of whether disparate impact claims can be brought under ECOA. And the Supreme Court has never directly addressed that topic. So this could be the pivotal case that finally makes it to the Supreme Court for decision on that issue. And the CFPB likely has motivation to try to accelerate the course of any Reg B final rule litigation to attempt to get a decision before the current administration ends. And conversely, consumer advocacy groups and state AGs would probably want to either delay or slow down the litigation so that the case couldn't make it to the Supreme Court by the end of this administration. So it's going to be really interesting to see how this plays out.

Chris Willis (15:57):

Yeah, it will be interesting, but there is almost three years for the litigation to play out. And so the consumer advocates, I don't think, want this rule to be in effect for three years and then challenge it. Their best win would be to get a preliminary injunction and then have the rule stayed and then not have the Supreme Court decide the case until June of 2029 or something. That's a long way away. And the fact of getting a preliminary injunction would, of course, make the case immediately appealable. And so they're in a little bit of a tough spot, I think, in terms of the delay that they would naturally want to try to engender in the litigation.

Lori Sommerfield (16:33):

For sure. And the legal strategy here is going to be really critical for consumer advocates and state AGs to try to continue to pause or delay the litigation.

Chris Willis (16:43):

You know, and the other thing about what will happen next, I mean, just leaving aside ECOA altogether, ECOA is one really important piece in the fair lending puzzle. But there's other pieces to the puzzle too. You mentioned the Fair Housing Act, Lori, and there's state laws too. So what do we think will happen with respect to those laws while this is playing out?

Lori Sommerfield (17:05):

Well, state laws are going to continue to be in effect as well as the federal Fair Housing Act. So creditors are going to continue to have to comply with those laws because disparate impact is still cognizable under the Fair Housing Act as well as state laws. So, for example, there's several states like New York, New Jersey, California, Massachusetts, that all have state anti-discrimination laws that allow claims under the disparate impact theory, as well as government actors, state government actors. So I think that this is not a get out of jail free card just because the CFPB has decided to claim that disparate impact claims can't be brought under ECOA or Reg B anymore.

Chris Willis (17:43):

Yeah. And I wonder actually whether those state law actors might try to increase the level of activity – enforcement or other activity – that they have under either the state laws or the Fair Housing Act, which they can bring claims under the Fair Housing Act just like everybody else, in an effort to try to prevent any of what they would perceive

as backsliding on disparate impact while this rule is working its way through the courts.

Lori Sommerfield (18:06):

I would anticipate that. And we've seen state AGs especially stepping up to the plate and beginning to enforce their own fair lending laws, and issue regulations that more strongly underpin the disparate impact theory, like the state of New Jersey. So I would expect to see more activity along those lines over the next two and a half years.

Chris Willis (18:26):

So we've painted a picture of what's going to happen next in the wake of this rule being finalized. So let's just end with a practical point. If you're a lender in the industry, what should you do in reaction to this rule being finalized?

Lori Sommerfield (18:40):

Well, I'll take that question, Chris, to start with, and then I welcome input from both Lane and Taylor. I think that creditors need to plan for two potential scenarios. First, the final rule becoming effective on July 21, just as the CFPB planned. And second, the rule either being enjoined or perhaps even vacated by a court at some level. But nonetheless, the industry is going to have to take steps to begin complying with the final rule over the next 90 days. So, of course, industry participants should review the final rule in some detail to make sure that their fair lending risk management programs align with it. But I think the two key compliance measures that financial institutions and consumer finance companies need to focus on are, first of all, this concept of disparate impact and what they do in terms of their monitoring and testing programs. So as we've been discussing, even though the disparate impact theory has been eliminated by the CFPB's rulemaking at this point, the theory is still going to be enforced under the Fair Housing Act as well as state fair lending laws, as we just discussed, Chris.

Lori Sommerfield (19:46):

So from a compliance perspective, that means that creditors are going to have to shift from ECOA-based disparate impact testing to placing more emphasis on disparate treatment as well as proxy discrimination analyses, which Lane mentioned earlier in our podcast. Mortgage lenders still have disparate impact liability under the Fair Housing Act and state law analogs, so they're going to need to continue to focus their disparate impact monitoring and testing on compliance with those laws. And second, any creditors that have special purpose credit programs need to evaluate them right away to either align with the new restrictions in Reg B or consider whether to terminate them altogether. For creditors that have race, color, national origin, or sex-based mortgage-based lending SPCPs, it's going to be especially important to redesign them to comply with the contours of the Reg B final rule. For example, as Lane mentioned earlier, if transitioning to using properties that are located in LMI neighborhoods or majority-minority census tracts, or take steps to just simply wind them down if it's not possible to redesign them. Those are the two issues I think I would focus on from a compliance perspective if I were a creditor.

Taylor Gess (20:58):

Lori, I totally agree. I would just add on the Fair Housing Act front, I think a lot of times people hear Fair Housing Act and they say, “I’m not a mortgage lender, so that doesn’t apply to me.” And we have a lot of creditors that are active in the home improvement finance space. That’s really been a growing area of point-of-sale finance lately. And so for those folks to also think about how the Fair Housing Act impacts their business, I think is also really important.

Lori Sommerfield (21:26):

That’s a really good point, Taylor. Thanks for raising that.

Lane Page (21:28):

Lori, I also agree with you, particularly on the special purpose credit programs. I think that to me poses the biggest danger right now. It’s publicly-available information, so the biggest and easiest target for the federal government to go after. And we’ve already seen HUD is investigating a Washington state special purpose credit program based on the characteristics that they use. And I would be surprised if once this rule becomes effective, if it becomes effective, if the CFPB does not do something similar.

Lori Sommerfield (21:59):

I agree with you, Lane. I definitely see that coming. And I think that special purpose credit programs pose great risk to creditors if they’re not designed to align with the new Reg B final rule.

Chris Willis (22:09):

And honestly, I’m not sure that that danger is in 90 days in the future. I think that danger is today. And I think, frankly, when the new administration came in, there were a number of moves early on to disfavor special purpose credit programs, like asking Fannie and Freddie to exit all of the ones that they were parties to, that happened a year ago. And then the withdrawal of the HUD guidance that stated that even though there’s nothing in the Fair Housing Act about it, that nevertheless it’s okay under the Fair Housing Act to have special purpose credit programs. That guidance was, I think it was formally withdrawn after being ghosted off the HUD website for a while, is my recollection of that. So I think the manifestations of danger of a race-based mortgage special purpose credit program have been with us for a good part of a year now. And I think honestly the industry’s already reacted to that, and the rulemaking is just one more ringing of that bell that you already know a lot about, I think.

Lori Sommerfield (23:04):

And Chris, I think withdrawal of the interagency guidance encouraging special purpose credit programs is going to be the next tree to fall.

Chris Willis (23:11):

Oh, sure. Yeah, absolutely. I agree with that. And honestly, the biggest problem with that is for mortgage lenders who will worry about the resumption of a focus on redlining in a future Democratic administration if it manifests

itself in a way similar to what we saw during the Biden administration, where it was purely a statistical inquiry about whether you were below the average of your peers in MMCTs in whatever city it happened to be. And so there was a great desire by mortgage lenders to essentially acquire more market share in MMCTs via the use of what I consider to be ever more generous special purpose credit programs. They'd have to really think about whether or not they can do those now. But if they don't do them, what is their exposure to redlining in a backward-looking inquiry under a future Democratic administration? I think it's actually a really tough spot for mortgage originators right now.

Lane Page (24:03):

I think also depending on how lenders react to the discouragement changes, if they begin advertising in very particular neighborhoods or begin only having branch locations in particular neighborhoods, then that could really have an impact on future redlining enforcement actions if redlining is revived, which is probably going to happen at some point, depending on how far the look-back is.

Chris Willis (24:28):

Yeah, I agree with that. The location of advertising and branch location have always been two of the critical factors that the Department of Justice used in all of its redlining complaints. Look at every single one. They all emphasize that point, or almost every single one. And so you'd have to be quite brave to say, "Oh, I'm just gonna advertise in white neighborhoods now for my mortgage lending product." That seems not a super safe thing to do, even though the CFPB has said it's okay.

Lane Page (24:53):

I have a feeling a Democratic administration is not going to care very much for what the current CFPB has to say.

Chris Willis (25:01):

Yes, I think your prediction there is most astute. So Taylor, Lane, Lori, thanks very much for joining me for a discussion of this important issue. We'll of course be watching to see what happens in terms of litigation and next steps here, and of course we'll be bringing the news to you and our commentary on it both via our blogs and via this podcast. So thank you all for being with me today, and thanks to our audience for listening as well. As I told you at the beginning of the show, we'd really like it if you would visit and subscribe to our blogs, TroutmanFinancialServices.com and ConsumerFinancialServicesLawMonitor.com. And while you're at it, why not visit us on the web at troutman.com. We have a great Consumer Financial Services email list that you can add yourself to and get copies of the alerts and advisories that we send out from time to time, as well as invitations to our occasional industry-only webinars. And of course, be on the lookout on your podcast feed for a great new episode of this show coming every Thursday afternoon. Thank you all for listening.

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