Regulatory Oversight* x *The Consumer Finance Podcast – New Jersey's Big Bet on Disparate Impact: What the AG's New Rules Mean for Lenders and AI
Host: Chris Willis
Guests: Lori Sommerfield and Matthew Berns
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Chris Willis (00:05):

Welcome to this special crossover edition of *The Consumer Finance Podcast* and *Regulatory Oversight*. I'm Chris Willis, the co-leader of Troutman Pepper Locke's Consumer Financial Services Regulatory Group. And today we're going to be talking about an area of great interest to our clients, and that is a new set of disparate impact regulations that were just finalized by the New Jersey Attorney General's Office.

(00:28):

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 of our other podcasts, we have the *FCRA Focus* all about credit reporting, the *Crypto Exchange*, all about digital assets, *Moving the Metal*, which is our auto finance podcast, and *Payments Pros*, which of course is our podcast about the payments industry. All of those are available on all popular podcast platforms.

(00:57):

And speaking of those platforms, if you like this podcast, let us know. Leave us a review on your podcast platform of choice and let us know how we're doing.

(01:05):

Now, as I said, today we're going to be talking about disparate impact. And it seems like a funny topic to be talking about because the federal regulators, pursuant to President Trump's executive order, are doing their best to eliminate or remove disparate impact from as many areas under federal law as possible.

(01:23):

But federal law is not the only potential source of disparate impact as we were recently reminded by this rulemaking in New Jersey, which we're going to spend today's episode talking about. Joining me to talk about that are two of my colleagues. First, Lori Sommerfield, who's a partner in our Consumer Financial Services group and a regular on the podcast. So Lori, great to have you back. And we also have a new colleague, Matt Berns, who is joining us from our Regulatory Investigations, Strategy and Enforcement practice group, or RISE, who we very frequently collaborate with in the consumer financial services world. Matt not only is a colleague of ours in that practice group, but also has the distinction of having served for a number of years in the New Jersey Attorney General's Office, in a number of leadership roles in the front office, including overseeing the Division of Civil Rights, which is the part of the AG's office who did the rulemaking we're going to be talking about today. So Matt, welcome to the podcast and thanks for being on today.

Matt Berns (02:16):

Thanks, Chris.

Lori Sommerfield (02:16):

And Chris, great to be with you.

Chris Willis (02:18):

Thank you both for being here. So let's jump into what's happened in New Jersey. And so Matt, let me start with you. Can you give our audience a high-level overview of the new rules that the New Jersey Attorney General's Office just finalized related to disparate impact under New Jersey state law?

Matt Berns (02:35):

Sure, Chris. What these rules do is first affirm that disparate impact is a viable theory of liability under New Jersey's Law Against Discrimination (or LAD, as we call it), which is the country's oldest state civil rights law and one of its broadest, both in terms of the number of protected classes and the subject matters to which it applies.

(02:54):

New Jersey's AG describes these rules as the most comprehensive state-level disparate impact regulations in the country. And I think that's fair because the second thing these rules do is explain how the disparate impact standard applies in all of the different subject matter areas covered by the LAD. Those are employment, housing, places of public accommodation, contracting, and probably of greatest interest for your listeners, financial lending.

(03:20):

Third, for each of these subject matter areas, DCR's rules identify examples of the kinds of policies or practices that may result in disparate impact discrimination, and explain how DCR would evaluate disparate impact claims in each of those examples.

(03:34):

I think these examples provide helpful guidance for understanding how DCR might approach disparate impact claims in different contexts. But more importantly, they shed some light on the types of practices that this particular regulator views as concerning, that they might want to discourage, and that they might prioritize for enforcement.

(03:52):

The fourth thing the rules do is lay out the standards for determining whether a policy or practice has an unlawful disparate impact—who has the burden of proof and so forth—and the types of evidence that DCR might consider in reaching that conclusion.

(04:09):

I should add that while the rules are comprehensive, their impact remains to be seen. The New Jersey AG and DCR take the position that the rules codify and clarify existing law, but do not create any additional liabilities for covered entities. Whether that's true is debatable. But their position at least suggests that the rules are more like guidance regarding existing obligations than new regulatory requirements.

Chris Willis (04:33):

Okay. So let's talk about the substance of what's in the regulation. And you mentioned that it has sort of a general statement of the standard for proving disparate impact. And then specific discussions in specific use cases. And I want to talk about both of those with you.

(04:50):

When I read the sort of general formulation for disparate impact that's contained in the New Jersey rules, Matt, I felt like it was pretty strongly reminiscent of the traditional standard as we understand it under most federal laws that have disparate impact, the three-part burden shifting test, with business justification being a defense.

(05:14):

But there was one thing that caught my attention as I read this general provision and the commentary surrounding it from the DCR, and that is with respect to business justification, you'll sometimes see statements in federal regulators' interpretations of disparate impact that say, if you have a business justification for a challenged practice and you're looking at a less discriminatory alternative, it only counts as a less discriminatory alternative if it achieves the business purpose as well as the original challenged business practice. And in fact, there's guidance, for example, from the federal banking regulators that would say that about the Equal Credit Opportunity Act.

(05:53):

But New Jersey made a point of saying, "We considered saying this in our rule, but we didn't." Which raises the idea that a less discriminatory alternative may be less effective in achieving the business purpose than the challenged practice is and therefore may result in liability. I found that kind of worrisome. Do you have any views on that, Matt?

Matt Berns (06:17):

Yeah, that is an interesting point, Chris. And I think we'll need to see how that plays out because there was a fair bit of debate about exactly what DCR intended on that point among the commenters.

(06:29):

Another area where DCR appears to be departing from the standards that our listeners might be familiar with is in the burden shifting framework that applies, particularly in the context of housing and housing financial discrimination. As people probably know, there's a three-step framework that applies to determine whether a policy or practice that has a disproportionately negative effect on a protected class actually amounts to disparate impact discrimination. At one of those steps under federal law, the complainant bears the burden of showing that there's a less discriminatory alternative to the challenged practice or policy that would achieve the same goal. And that is the standard that DCR adopts here in every context other than housing and housing financial assistance.

(07:17):

But in the context of housing and housing financial assistance, DCR says that the respondent or defendant bears the burden at this step so that the person accused of disparate impact discrimination must show that there is no less discriminatory alternative. DCR says that applying this standard for housing discrimination is consistent with state intermediate appellate court precedent and justified by policy considerations, including the parties' unequal access to information and legal representation and the fact that housing is a basic right.

Chris Willis (07:46):

Got it. So I would just point out that from a practical standpoint, this was what the CFPB was doing under the Equal Credit Opportunity Act in supervision in a series of exams that were going on in 2024 and in certain public statements made by the Bureau, including a supervisory highlights put out the day before President Trump was inaugurated in which they essentially, not a legal matter, but as a practical matter, put the burden on lenders to essentially prove that there wasn't a less discriminatory alternative to their underwriting models. So I think New Jersey is in some company there with respect to that issue.

(08:21):

But Matt, let's dive into the sort of specific use cases that the New Jersey regulation discusses. Because I think you're right, that's a very interesting thing, and shed some light on how the AG's Office may choose to apply and prioritize the law from an enforcement standpoint going forward. Can you just give our listeners a flavor for some of the examples of the specific provisions and examples that New Jersey brings up in those sections of the regulation that you referenced?

Matt Berns (08:50):

Sure, Chris. So one example is that DCR talks about the consideration of credit history in the housing context. And the rule explains that consideration of credit history may have a disproportionate impact on the basis of race because of the racial wealth gap. And then goes on to say that policies or practices that involve individualized consideration of people's credit histories are less likely to result in unlawful disparate impact discrimination than policies that set bright lines that automatically exclude people based on certain numerical thresholds. That's just one example.

(09:34):

DCR has examples like that throughout the entirety of the regs in its discussion of employment discrimination, housing discrimination, discrimination in the context of places of public accommodation and so forth.

Chris Willis (09:48):

And I think you may have mentioned this before, Matt, but who's subject to these new rules? And who's subject to the LAD, the Law Against Discrimination in New Jersey?

Matt Berns (09:57):

Sure. The short answer is that these new rules apply to anyone who's subject to the LAD. And the rules are far-reaching because the LAD itself is far-reaching. However, the rules are not intended to apply to anyone who is not already regulated by the statute.

(10:10):

The rules define who is a covered entity, and that definition includes any employer, labor organization, employment agency, housing provider, real estate broker, agent, or salesperson, lending institution, place of public accommodation, or other person who is already required to comply with the LAD. Some of the categories that I just mentioned might overlap. A bank, for example, might be regulated under the LAD as an employer, as a lending institution, and as a place of public accommodation. And as we talked about, different legal standards might apply to disparate impact claims in the bank's employment practices versus its mortgage origination practices.

Chris Willis (10:48):

Got it. So Lori, let me get you involved in this conversation. And one of the things that I noticed in the regulation in the section dealing with employment discrimination is that there's a discussion of disparate impact arising from the use of artificial intelligence and other automated decision-making tools, which are very near and dear to our hearts as lawyers for the consumer lending industry. And so what I wanted to ask, Lori, is do you think those rules have anything to teach us as lenders' lawyers about how New Jersey might approach the use of automated decision-making or AI in other areas like loan underwriting algorithms?

Lori Sommerfield (11:30):

Yes, I do, Chris. Although the rule itself only addresses AI and automated decision-making tools in an employment context, the DCR was crystal clear in its responses to public comments that the rules apply to the use of automated decision-making tools by covered entities in all contexts that are covered by the LAD, so not just the employment context.

(11:51):

So for example, if a lending institution, which is defined as a covered entity, uses an algorithm to inform its underwriting practices, then they need to be mindful of potential disparate impact on protected class applicants. Just like an employer would be wary of using job application screening tools that could have a disparate impact on job applicants.

(12:13):

But I think one of the big takeaways is that companies that use AI or automated decision-making tools supplied by third parties can't avoid liability simply by saying that they've outsourced their decision making to a software vendor. Regulators in New Jersey are going to want to know whether the user of that software took reasonable steps to ensure that that product complies with the New Jersey law and likely will also want to know whether the product was tested to evaluate potential disparate impact.

(12:41):

And I think another takeaway, Chris, is that state regulators are clearly very interested in issues surrounding these new advanced technologies and likely are going to be focused on how their enforcement tools can be used to address them going forward. And I think New Jersey has made that focus pretty explicit by announcing a new civil rights and technology initiative that seeks to address the risks of discrimination that can stem from the use of AI and these other types of advanced technologies.

Chris Willis (13:09):

Got it. And so given that, and also given Matt's statements about the section on housing and the shade that it throws on the use of credit scores, I mean, if you read that section, it says, "Well, we all know ... " I'm paraphrasing, of course, "we all know credit scores are biased against certain groups in the United States, and that's not fair." So it's going to be a disparate impact problem to use them in tenant screening, for example. That's what that section, as I read it, says. I don't love the criticism of credit scores that are very widely used in the consumer lending industry, and sometimes with hard cutoffs. I mean, there's many lenders that have standards that say, "I only make loans to people who have a commercially available credit score above X threshold. And if you're below that threshold, you're declined." And I think it remains to be seen whether that thinking pollutes the New Jersey AG's view on consumer lending.

(14:06):

But Lori, talk to the audience a little bit about what you think in general the significance to lenders is from these New Jersey regulations, despite the fact that there's not a specific section about lending in the regulations themselves.

Lori Sommerfield (14:19):

Well, I think, Chris, I'd like to first address that question in the context of what's happening at the federal level. So as the audience knows, over the past year, the Trump administration has basically disavowed use of the disparate impact theory for liability. And it began back in April of 2025 when Executive Order 14281 was issued. That executive order is titled “Restoring Equality of Opportunity and Meritocracy,” and that executive order called disparate impact theories of liability unconstitutional under the Equal Protection Clause. And it directed federal agencies and even the states to eliminate use of that theory to the maximum extent possible.

(15:02):

Since then, we've seen agencies across the federal government roll back those types of rules and policies that embrace disparate impact theory, and we've seen them drop enforcement actions that rely on disparate impact liability. But many states are ignoring that directive.

(15:18):

So the federal context here is what makes New Jersey's adoption of a disparate impact rule so noteworthy because it reflects the fact that state regulators remain highly committed to use of the disparate impact theory despite what's going on at the federal level. So I wanted to just set that as sort of the foundation here.

(15:36):

But importantly, I think New Jersey's new disparate impact rules underscore for lenders that their lending practices may still face disparate impact scrutiny by New Jersey and other states, despite what's going on at the federal level. State-chartered banks and non-bank lenders likely, in my view, face greater risk for non-compliance because of federal preemption for nationally chartered banks. And we haven't seen that much activity by state AGs in the past going after national banks for alleged violations of state fair lending laws.

(16:08):

But I think it also seems significant that the DCR has adopted specific rules for applying disparate impact in a variety of contexts, but lending was given very little attention in the rule, as you pointed out, Chris. So we'll just have to be watching to see how that plays out and advising the audience of any developments in that area, particularly around the use of credit scores.

Chris Willis (16:30):

Yeah. And we'll also sort of see if the Trump administration makes good on its threat in the executive order to sort of turn the Attorney General loose on any state that has a disparate impact law to allege that it is a violation of the Equal Protection Clause. As you mentioned, Lori, this would be an opportunity for the administration to do that. Let's see if that threat is made good or not because New Jersey has certainly thrown down the gauntlet to the administration, in my feeling, by finalizing this regulation.

Lori Sommerfield (17:00):

Exactly, Chris. And it's a very bold action by New Jersey.

Chris Willis (17:04):

Yeah. And Matt made the point earlier in the call that the New Jersey AG's Office said this is the most comprehensive state regulation on disparate impact. I'm sure that's true because as far as I know it's the only one so far. There are other states that could follow suit.

(17:21):

And one that I'm thinking of in particular is New York. I mean, the New York Department of Financial Services has explicitly taken the position that the New York fair lending law, Executive Law 296A, does carry disparate impact liability. It has said that in enforcement cases. Now, those were settlements, those weren't litigated cases, but still you have the state regulator sort of responsible for that law making that assertion. And they could do a rulemaking just like the New Jersey AG's Office did. So it'll be interesting to see if they follow suit in that regard.

(17:49):

Matt, do you have any final comments to share with the audience before we wrap things up?

Matt Berns (17:53):

I don't have anything else to add, Chris, but really appreciate the opportunity to join you for today's podcast.

Chris Willis (17:58):

Okay. Well, very much appreciate you being on and bringing your expertise and background from your years in the New Jersey Attorney General's Office to benefit the audience in terms of your insights. And Lori, as always, thanks for being on as well.

(18:10):

And of course, thanks to our audience for listening to today's episode as well. As I said at the top of the show, don't forget to 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 and add yourself to our Consumer Financial Services and RISE email lists. That way we can send you copies of the alerts and advisories that we send out from time to time, as well as invitations to our industry only webinars that we hold periodically. And of course, stay tuned for a great new episode of this podcast every Thursday afternoon. Thank you all for listening.