FAIR SERVICING:

REGULATORS WATCH FOR DISCRIMINATION BY SERVICERS

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"Fair lending requirements apply throughout the life of the loan!"[1]

Federal regulators delivered that message in October 2013, reminding loan servicers that they are subject to fair lending liability and must manage their fair lending risks. The regulators' message concerning "fair servicing" risk has been repeated recently, reflected in settlement provisions that require loan modifications to be implemented in ways that avoid geographical disparities or discrimination against protected classes. For example, the Consumer Financial Protection Bureau (CFPB) included such provisions in the recent consent order it entered into with Ocwen, a large non-bank servicer. Specifically, the consent order resolved claims related to Ocwen's loss mitigation and foreclosure practices, but it left open the possibility of claims for discrimination. Along with other recent consent orders and regulatory pronouncements, the Ocwen settlement terms indicate regulators are scrutinizing fair servicing issues.

Concerns about fair servicing can arise across asset classes—including mortgage loans, personal loans, student loans, credit cards, and even business loans. Given the heightened regulatory attention to this issue, servicers should develop or enhance proactive risk mitigants, including preventative and detective controls.

Fair Servicing Concerns Arise in Many Situations

Servicers interact with borrowers in varied ways over the lifetime of loans, giving rise to multiple areas of fair servicing risk. A mortgage servicer could face regulatory scrutiny or legal liability, for example, if borrowers in a protected class receive loan modifications at a statistically lower rate than other borrowers, or if there are differences in the mitigation options or the fees assessed to certain borrowers. Although a recent Federal Reserve Bank study found no evidence of disparities in the rates at which minority borrowers get modifications[2], no servicer wants their loan modification practices singled out as an exception.

Mortgage servicers are not the only ones potentially at risk, because there are many situations where servicing actions involve credit decisions that could disproportionately impact protected classes. For instance, when credit card

1 *2013 Interagency Fair Lending Hot Topics,* Non-Discrimination Working Group of the Financial Fraud Enforcement Task Force (Oct. 24, 2013), available at http://www.philadelphiafed.org/bank-resources/publications/consumer-compliance-outlook/outlook-live/2013/102413.pdf at 40.

2 Collin & Reid, *Who Receives a Mortgage Modification?*, Federal Reserve Bank of San Francisco (Dec. 2010).

companies decide to raise or lower existing customers' credit lines, it might disproportionately impact certain groups. A credit card servicer's customer retention efforts might focus on certain geographic areas or persons with a certain income or simply be a matter of discretion, each methodology should be tested for possible impact on protected classes. If loan servicers proceed more quickly to foreclosure or repossession or other measures in certain neighborhoods or with certain types of borrowers, collection efforts could adversely affect protected classes. Servicers who market ancillary products to their current customers, such as debt suspension or identity theft protection, may also be at risk if their marketing targets certain demographics.

But determining the existence of fair servicing problems can be difficult because servicers often have no data about race and other protected characteristics. Even with such data, it may not be evident when discrimination is occurring. That's because not all borrowers have the same goals (are not similarly situated). With delinquent mortgage loans, some borrowers may want a loan modification, while others want to conduct a short sale, to provide a deed in lieu of foreclosure, or to receive cash in exchange for the property. And, some may be okay walking away from the property. So, for example, data indicating that a protected group of borrowers has received loan modifications at a lower rate than a control group of borrowers may not accurately portray whether or not loan modification discrimination is occurring. Likewise, discrepancies regarding foreclosure or repossession might be indicative of fair servicing problems, or might not be—some borrowers may be happy to give up collateral rather than continuing to attempt to repay a loan. These ambiguities can make it difficult to assess fair servicing risk.

The Prohibition on Discrimination

Servicers should be proactive in detecting and preventing discrimination. Fair servicing risks arise because fair lending liability does not end once a loan is originated.

The CFPB is not the only regulator looking at fair servicing issues.

The Equal Credit Opportunity Act (ECOA) makes it unlawful for any creditor "with respect to any aspect of a credit transaction" to discriminate based on race, color, religion, national origin, age, sex, or marital status. A lender also can't discriminate because any part of the applicant's income derives from a public assistance program or because a consumer exercises their rights under the Consumer Credit Protection Act.[3] The CFPB describes the "broad reach of the statute's prohibition" as "cover[ing] creditor activities before, during, and after the extension of credit," including the alteration or termination of credit and collection procedures.[4]

Evidence of the intent to discriminate is not required to be enforced as a violation of ECOA. Courts and regulators understand the statute to prohibit both intentional discriminatory treatment and practices that cause a disparate impact. With disparate impact liability, a creditor can be liable if its neutral business practice causes a disproportionately negative impact to a protected group, even without any intent to discriminate. Not all disparities are enforced as violations of the law, however. A disparate impact is allowed if it is justified by "a legitimate business need that cannot reasonably be achieved by means that are less disparate in their impact," as phrased by the CFPB.[5] Because of disparate impact liability, servicers should be watchful for conduct that causes a discriminatory effect, just as they must be vigilant against intentionally discriminatory conduct.

Regulators are Focused on Fair Servicing

Regulators are monitoring fair servicing issues. The reminder that "Fair lending requirements apply throughout

2 Collin & Reid, *Who Receives a Mortgage Modification?*, Federal Reserve Bank of San Francisco (Dec. 2010).
3 15 U.S.C. § 1691.
4 CFBP Supervision and Examination Manual v.2 (Oct. 2012) ("CFPB Manual") at ECOA 1-2.
5 12 CFR Part 1002 Supp. I § 1002.6(a)-2.

Discretionary decisions are a "red flag" that indicate fair servicing risk.

the life of the loan!" was one example of a regulatory "heads up" that attention will be given in this area during examinations. The Interagency Fair Lending Examination Procedures provide another example: regulators examining compliance programs look at what anti-discrimination training is provided with respect to offering loan modifications, imposing late charges or other fees, and initiating collection or foreclosure.[6]

The CFPB is also paying attention, which is not surprising for an agency that views "equitable access to credit" as an important part of its mission.[7] The CFPB examination procedures for mortgage servicers notes that servicers "who participate in a credit decision about whether to approve a mortgage loan modification" are subject to ECOA.[8] CFPB examiners are directed to review a sample of servicing records of consumers who are delinquent or at imminent risk of default; in that review, examiners are instructed to "be mindful of activities that may indicate disparate treatment of consumers in violation of the ECOA."[9]

One way that examiners look for discrimination is to assess how loans are serviced for borrowers with limited English proficiency. Do customer servicing personnel working with those borrowers have the same training and authority as other customer service personnel? If they have less authority to grant to loan modifications, the CFPB might interpret that as evidence of disparate treatment discrimination based on national origin.

In looking for instances of disparate impact, CFPB examiners analyze data concerning loss mitigation workouts, loan modifications, and the rate and timing of foreclosures. The examination manual lists several examples of how examiners might identify a disparate impact:

> "analysis of the distribution of protected class members in the pool of delinquent borrowers versus the distribution of protected class members receiving a range of loss mitigation outcomes, including reinstatement, repayment plan, forbearance, loan modification, short sale, deed-in-lieu, and foreclosure;"

> "analysis of processing times and loan modification attributes including interest rate, principal, and monthly payment reductions for protected class members when compared to non-protected class members;" and

5 12 CFR Part 1002 Supp. I § 1002.6(a)-2.

6 Interagency Fair Lending Examination Procedures, Appendix at 3 (Aug. 4, 2009), *available at* http://www.federalreserve.gov/boarddocs/caletters/2009/0906/09-06_attachment.pdf.

7 *Addressing credit discrimination*, Consumer Financial Protection Bureau (Dec. 14, 2011), *available at* http://www.consumerfinance.gov/blog/addressing-credit-discrimination.

8 CFPB Examination Procedures, Mortgage Servicing (Jan. 2014) at 3.

9 *Id.* at 17.

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"analysis of the representation of protected classes in the group of seriously delinquent borrowers versus their representation among borrowers who lose their homes to foreclosure."[10]

The CFPB also looks at "loss mitigation policies or procedures that contain factors that could have disproportionately negative, unjustified impact on a credit decision on a prohibited basis."[11] One example, specifically noted by the CFPB, is outreach efforts that vary by geography, which may negatively impact minority neighborhoods.

CFPB examiners also look at the potential disparate impact of ancillary products that servicers market based upon demographics. The CFPB Examination Manual states that examiners should determine "…whether each such optional product or service is offered and provided in a manner consistent with ECOA. Targeted marketing of these products on the basis of race, for example, may indicate an increased risk of potential ECOA violations and require further inquiry."[12]

The CFPB is not the only regulator looking at fair servicing issues. Just like the CFPB's consent order with Ocwen, several 2013 consent orders with the Office of Comptroller of the Currency and the Federal Reserve Bank require that servicers engaging in loan modification and foreclosure prevention actions cannot disfavor specific geographic areas or low or moderate income borrowers, and otherwise cannot discriminate against protected classes.

Servicers Can Detect and Prevent Fair Servicing Problems

With proactive strategies and tools, servicers can mitigate their fair servicing risk. Detecting disparities often begins with looking at the available data. Relevant data will not always exist, but the regulation implementing ECOA allows privileged self-tests, which servicers can use to collect certain demographic data to monitor compliance with ECOA.[13] Self-testing should be conducted under the direction of legal counsel to help ensure attorney-client privilege protection is available to the extent possible.

Even when servicers lack data about ethnicity or other protected characteristics, they can use proxies to assess whether fair servicing exposure might exist. Employing census tract or surname proxies (or the Bayesian Improved Surname Geocoding proxy, known as BISG, which uses both census tracts and surname data), servicers can identify the likely race or ethnicity of borrowers. Although these proxies are far from perfect, regulators often use them as the basis for identifying possible demographic disparities for further investigation.

Data may not be meaningful by itself, but it can be a starting point to determine whether or not borrowers in protected classes are disproportionately affected by certain credit decisions. Analyzing data is becoming increasingly important because there is an emerging regulatory expectation that servicers will check for fair servicing problems by analyzing their data. Of course, conducting such analysis carries the risk of potential disclosure of arguably unfavorable results to regulators upon request. But regulators are beginning to analyze servicer data themselves and may be able to reach the same conclusions. For that reason,

10 *Id.* at 18-19.
11 CFPB Examination Procedures, ECOA (July 2013) at 11.
12 CFPB Examination Procedures, Mortgage Servicing (Jan. 2014) at 7.
13 12 CFR §§ 202.5(b)(1) & 202.15.

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servicers may benefit from conducting their own analysis of data so that they can be proactive about identifying and remedying potential fair servicing problems before they magnify and before there are negative regulatory or enforcement consequences. When the data reveal disparities, statistical analysis can highlight areas for further inquiry. A regression analysis may also be appropriate to determine the likelihood that race or another protected characteristic caused a disparity.

If a disparity is identified, that, in and of itself, does not necessarily indicate that a servicer violated ECOA; there may be legitimate reasons for the disparity. Those reasons can be fleshed out with a comparative file review of similar borrowers who received different results, which can pinpoint the reasons for dissimilar treatment. If there are no similarly situated borrowers to conduct a comparative file review, a transactional review of affected borrowers' files can identify whether a legitimate basis existed for the servicer's decisions. By determining whether identified potential disparities have legitimate causes, servicers can recognize and rectify issues that might otherwise give rise to fair servicing litigation or regulatory actions.

Aside from the detective control of monitoring data, servicers can also take preventative steps to limit fair servicing risks. Because ECOA's prohibition on illegal discrimination extends beyond lenders, servicers should provide anti-discrimination training for employees (including third-party service providers) who handle loan modifications and other decisions that might cause exposure. Discretionary decisions are a "red flag" that indicate fair servicing risk. So, training employees to ensure that decisions are not based on borrowers' race, gender, national origin, or other protected characteristics is the first line of defense against fair servicing liability.

Guiding employees to make non-discriminatory decisions based on business needs is also important. Effective and neutral policies and procedures are key. If employees have discretion to do things like grant loan modifications, there should be adequate internal procedures, controls, and monitoring to ensure they understand the parameters undergirding that discretion and, in turn, are exercising such discretion properly and in as uniform a way as possible.

One helpful method of avoiding inequitable treatment is for procedures to set forth timeframes to process loan modification requests (or other decisions involving borrowers), so that issues involving some borrowers do not languish, while others are processed quickly.

Delineating (by policy) acceptable exceptions to guide the application of discretion is also strongly encouraged. If there are policy exceptions, they should also be clear, and should be governed by adequate process and controls. Exceptions should be documented and monitored. Robust documentation in the files helps support decision-making, if it is questioned, and helps ensure that servicers are making decisions that do not discriminate. ■

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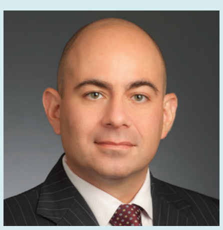

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