Fair banking

Modernization of fair and unbiased lending practices for financial institutions

Fair and unbiased lending practices

The current outlook for fair and unbiased lending is driven by increased regulatory scrutiny with the mission of using enforcement to drive customer and market transformations.

From the Consumer Financial Protection Bureau (CFPB) signaling its intent to increase supervision around fair lending laws and regulations such as Unfair, Deceptive, or Abusive Acts or Practices (UDAAP) to the Community Reinvestment Act (CRA) and Section 1071 of the Dodd-Frank Act, financial institutions (FIs) and their fair-lending practices will be in the regulatory spotlight for years to come. For example, the proposed modernization of the CRA will encourage banks to meet the needs of people more broadly in low- and moderate-income communities. Meanwhile, modifications to Section 1071 of Dodd Frank affecting the Equal Credit Opportunity Act (ECOA) will require FIs to collect and submit specific data regarding credit applications from women-owned, minority-owned and small businesses.

The evolution of fairness and inclusion

Although fairness and inclusion were once seen as a compliance requirement, they have now evolved to become a holistic issue spanning the entire lending lifecycle, which includes front-end access to products and services in an unbiased, equitable manner, as well as enabling an equitable end result. Accordingly, FIs benefit not only by promoting fairness and inclusion but also by having the opportunity to manage change in a cost-effective manner to facilitate attainable growth – in addition to finding a balance in expanding inclusion to credit products.

Additional benefits of integrating fair and responsible banking principles include increased customer satisfaction, a reduction in regulatory penalties and fines, brand elevation in the eyes of consumers, and the creation of new revenue streams by expanding markets[1] and profiles with a specific focus on audiences that credit unions have traditionally dominated and FinTechs and nonbanks have tapped into.

> “FIs benefit not only by promoting fairness and inclusion but also by having the opportunity to manage change in a cost-effective manner to facilitate attainable growth — in addition to finding a balance in expanding inclusion to credit products.

[1] "Latino-Owned Businesses May Be the U.S. Economy's Best Bet," *JPMorgan Chase & Co website*, undated, accessed September 2023 at https://www.jpmorganchase.com/news-stories/latino-owned-businesses.

Responding to the challenges and opportunities

In response to increased regulatory scrutiny, evolving fair-lending standards and emerging opportunities, the banking industry has taken several courses of action. These include enhancing risk assessments and measures to better evaluate fairness and controls, reviewing and/or updating discretionary procedures across the entire product sales and servicing lifecycle, examining decision-making models for potential disparate impact, and eliminating fees where controls cannot demonstrate prevention of disparate outcomes.

The industry is also turning to data modeling by performing assessments using proxy data and model refinement such as:

- Examining refined proxy data analytics and modeling for increased accuracy and insights, stronger vendor oversight and monitoring, and rigorous fair-lending control testing
- Reassessing disparate impact analysis that considers the complexity of algorithms and bias-vs.-accuracy trade-offs
- Developing tighter policies, practices, procedures and control over integrity and security of the data and models
- Identifying community advisory committees/credit counseling groups while conducting discrimination studies

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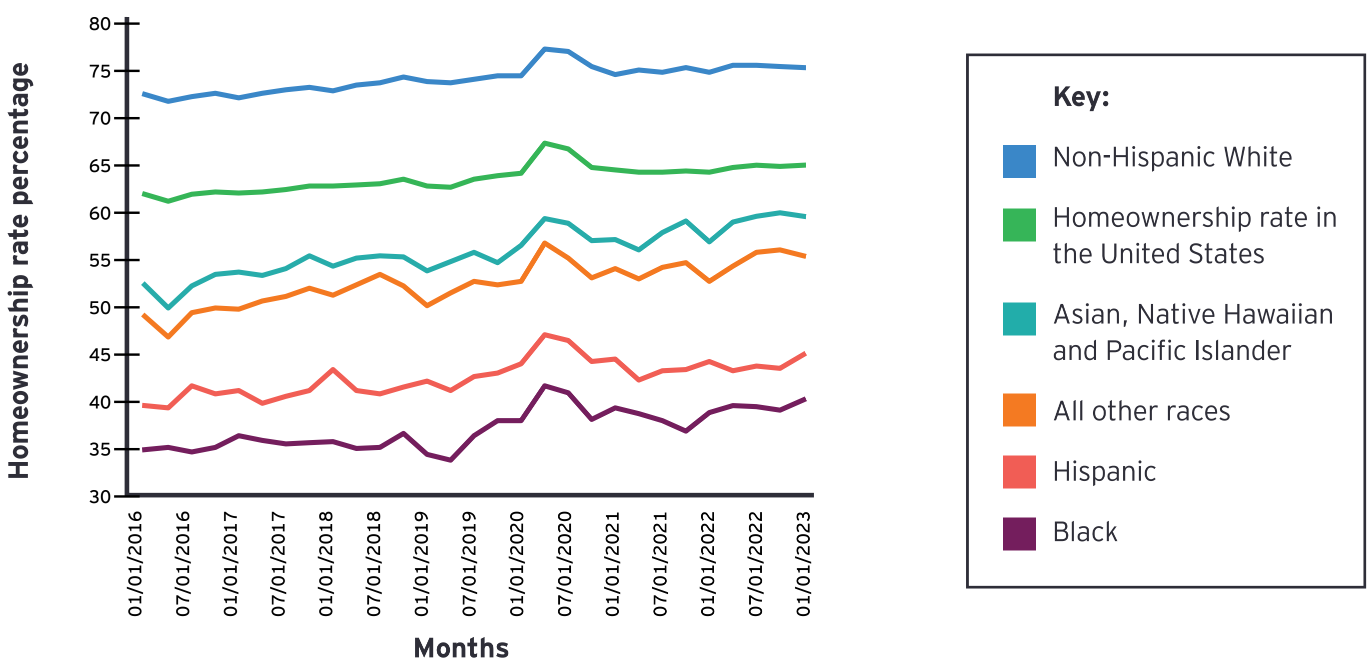
> As an example, a large global bank determined that improving access to the housing credit 20 years ago may have resulted in additional 770,000 Black homeowners.[2]

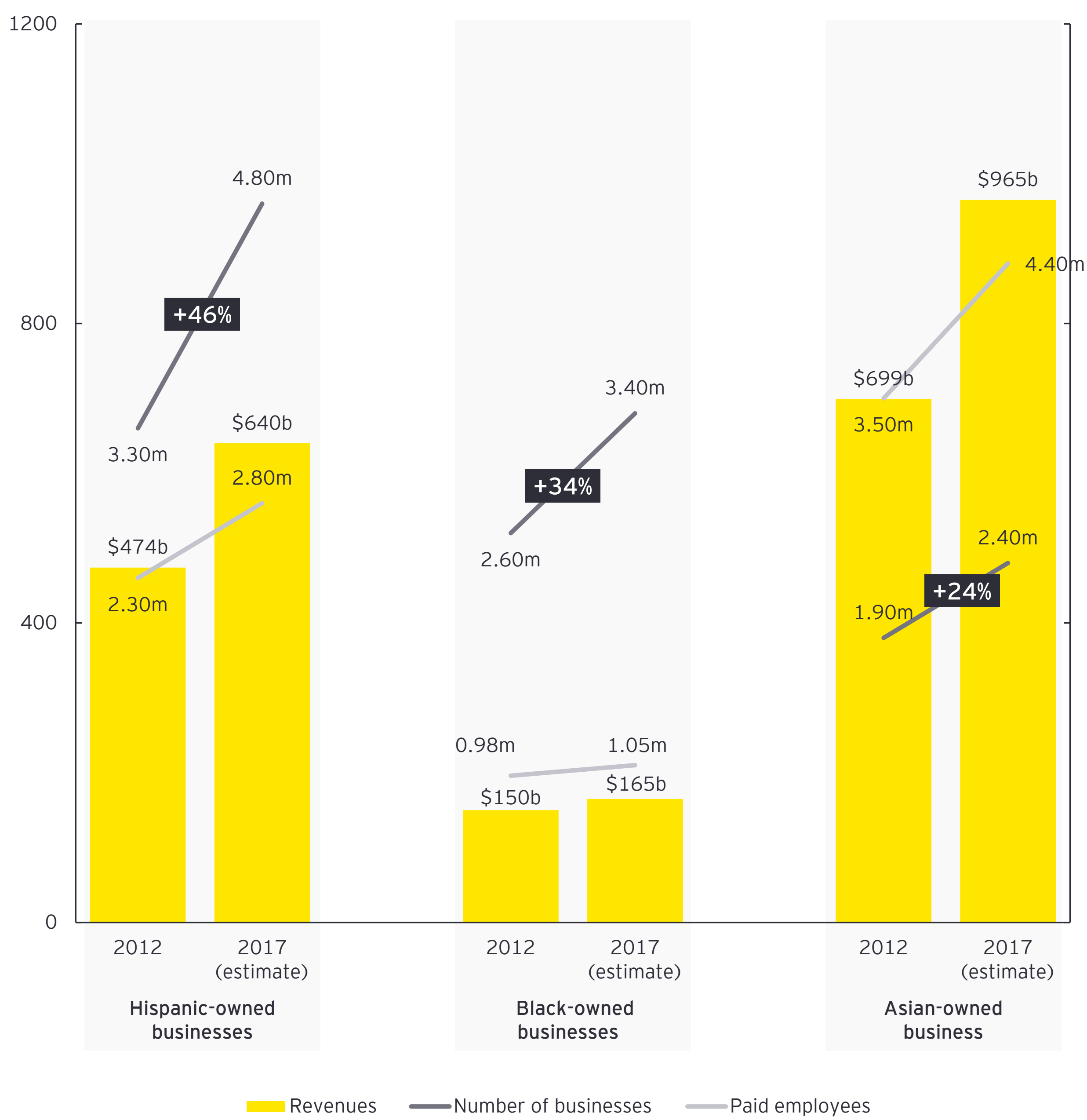
Homeownership by race in the US since 2016



[2] Dedrick Asante-Muhammad, Jamie Buell, and Joshua Devine, "60% Black Homeownership: A Radical Goal For Black Wealth Development," National Community Reinvestment Coalition, March 2, 2021, https://ncrc.org/60-black-homeownership-a-radical-goal-for-black-wealth-development

By using census tracking data and evaluating internal data populations, banks can make an impact with the unbanked, the underbanked and other segments of the underserved population, improving their customers' financial wellbeing while opening new market opportunities for growth. Regional banks have also committed to expanding and investing in opportunities to advance minority business development and increase minority homeownership rates.[3]

Number of minority-owned US businesses growing rapidly



[3] "A Message from John Turner on Regions' Commitment to Racial Equity: President and CEO of Regions Financial Corp. discusses our work to address racial injustice and inequality," *Regions Bank*, June 18, 2020, https://doingmoretoday.com/a-message-from-john-turner-on-regions-commitment-to-racial-equity/

Source: U.S. Census Bureau, Survey of Business Owners 2012. 2017 estimate based on percentage increase from 2007 to 2012.

Bank leading practices

Forward-thinking banks are taking the following four steps to address fair and unbiased lending:

1. Engaging in core platform modernization and changes to processes, data and analytics capabilities to drive beyond regulation compliance and target untapped markets
2. Performing assessments using proxy data to understand coverage/gaps of underrepresented "areas" (limitations on reliability), considering potential business changes (marketing, branch/sales strategy) based on anticipated data outcomes, and evaluating whether small-business-focused special purpose credit programs can provide insights
3. Performing exercises to assess future ratings under updated CRA parameters and reviewing lending data to assess how well products serve low- to moderate-income (LMI) communities, rethinking banking presence in LMI areas (e.g., branch strategy) and growing a more diverse online banking base
4. Prioritizing equality-focused actions and anticipating/proactively acting ahead of key regulatory decisions to allow improved consumer offerings and overall industry growth opportunities

The balance between extending credit while avoiding default

But how can banks find a balance in expanding inclusion to credit products while carefully managing risk? The answer lies in managing how credit is extended. By starting at the top of the lending funnel, banks can extend or improve their marketing and lead generation to unfocused consumers and segments by using data analytics to examine and understand the focused groups to determine how they can be positioned to win with them and by evaluating to see if they are generating sustainable leads or ones that will fail later (costing money). Better credit decisioning and risk parameter tools such as FICO10T or Vantagescore models can also be employed to increase loan conversion and lower the cost of originations.

In addition, as the industry moves toward a more holistic servicing model with increased customer engagement and product bundles, customers who may not be able to buy a home or a car today can start on their path to financial independence by building credit through other bank offerings. Through partnerships with credit counseling agencies, credit unions and other groups, banks can access and serve segments of the disenfranchised population and take on more of a financial advisory role with these customers throughout their financial lifecycle. Using this methodology would enable banks to replace independent transaction-based services – where the client journey normally ends with a "denied/rejected" status – with building a relationship with and having a customer for life.

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Conclusion

Financial institutions that are reactive to broader changes in fair banking will be behind the curve compared with institutions that are preparing to make enhancements to their compliance procedures, lending models and data analytics capabilities. Being unprepared will result in a potential negative reputational impact, with heightened risks and fines, while banks that proactively address pending and future challenges will be able to meet their regulatory burden, enhance their reputation, and support social responsibility and inclusion, while increasing customer satisfaction and growth.

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