The Consumer Finance Podcast: Uncovering Disparities: The CFPB's Small Business Lending Study
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Guests: Lori Sommerfield and Joseph Reilly
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Chris Willis:

Welcome to *The Consumer Finance Podcast*. I'm Chris Willis, the Co-Leader of Troutman Pepper's Consumer Financial Services Regulatory practice. Today, we're going to be talking about a study that the CFPB recently released on what it believes to be differential treatment of black and white small business owners seeking small business loans.

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Now, as I said, today, we're going to be talking about a recent study that the CFPB released in which it sent in essentially mystery shoppers into various unnamed small business lenders' physical locations in a couple of states, and found that they believe that black applicants for small business loans were treated differently than white small business owners seeking loans. The CFPB published this study as an indication of what it believes may be occurring in the small business lending market and used the study to bolster its position for the need for the 1071 Small Business Data Collection Rule.

Now, I'm joined to talk about this study by two of my colleagues who are perfectly suited to discuss this and tell us all about it. Those are Lori Sommerfield and Joe Reilly. They're both my partners in our consumer financial services group, and they both have a high degree of concentration in fair lending and small business lending issues. So, Lori, Joe, thanks for joining us on the podcast today.

Lori Sommerfield:

Happy to be here, Chris.

Joseph Reilly:

Yes. Thank you, Chris.

Chris Willis:

Well, let's drive right into it. I've sort of given a little bit of a summary of what the CFPB did and what they found. But let's start to get into a little bit more details. Lori, do you mind telling the audience a little bit more about the methodology that the CFPB used for this study?

Lori Sommerfield:

Sure, Chris. Let me begin my comments by stating that mystery shopping or secret shopping has been around for decades, but it's primarily been used in mortgage lending under the Fair Housing Act. We've seen HUD, for example, conduct mystery shopping, and even some mortgage lenders do so on their own. But usage in the small business lending context is basically a new frontier, so I think this makes it unusual. Now, in terms of the methodology, the CFPB used match pair testing consisting of one black, and one white tester, and they trained individuals to pose as small business owners seeking credit.

The study involved 100 in-person test visits to 25 bank branches located in Fairfax County, Virginia, and 25 branches in Nassau County, New York. Now, the CFPB used 23 different financial institutions over the course of several months in 2023. That was a year ago. Bank branches were selected at random from a set of large banks that offer in-person small business loans and services. So, going back to the test itself, the testers presented themselves based on a pre-developed small business profile. They went into these branches inquiring about available business financing options. Each visit was audio recorded, presumably secretly, and then, afterwards, each participant completed a survey that documented their experience.

The study looked at four different aspects of the pre-application or loan inquiry process. First, encouragement or discouragement for applying for a loan. The study found that black participants consistently reported feeling less encouraged to apply for a loan compared to their white tester counterparts. Secondly, the study looked at information provided about requested loan products and potential steering of bank representatives to other types of products. The study found that bank representatives were equally likely to discuss their requested business credit products with both the black and white testers, but they were significantly more likely to discuss non-requested products with black testers. The CFPB found that the difference was fairly large, with bank representatives discussing non-requested products with about three in five of the black testers, but fewer than two in five of the white testers.

The third aspect of the study looked at the overall quality of treatment or customer service that the tester received. White testers subjectively reported receiving higher levels of customer service than black testers did. But there were no statistically significant differences in the actual objective index measure of the observed customer service behaviors by the bank representatives. Finally, the study looked at the amount of business and credit information that was requested, and the CFPB didn't find any statistically significant differences there.

Chris Willis:

Okay. Thanks, Lori. You mentioned that testing like this has been sort of a staple under the Fair Housing Act for years. I think, not only have certain government agencies done it, but my recollection is, some of these fair housing centers have done testing over the years, not just for mortgage lending, but also for real estate agents, and real estate developments, and rental properties, and things like that. So, testing like this, this sort of mystery shopper testing, has a very long history under the Fair Housing Act.

Joe, I want to turn to you now. The CFPB study makes this sound extremely precise and scientific, but it's not necessarily so. So, there are some potential avenues for criticism of trying to prove a claim of differential treatment or discouragement or something like that through an exercise like this. Would you mind talking to the audience about that?

Joseph Reilly:

Sure, Chris. The study only involved two counties and testing by a limited number of testers. But the real flaw is that the testers very likely knew or suspected the purpose of the study, which does present a real opportunity for what's called experimenter bias in the reporting of the conversations they had with bank employees. In fact, the CFPB even felt it necessary to bury a caveat in their press release that says, "Given the design and scope of this pilot research, these findings should not be generalized to the broader small business lending market." There were flaws and limitations.

Last though, I do want to say that just because there were flaws in this study, of course, doesn't mean there was no differential treatment. It just means we can't really rely on this study as evidence that there was differential treatment.

Chris Willis:

Yeah, understood. That experimenter bias is probably familiar to a lot of listeners when they hear about medical research studies, where people are doing some sort of drug testing and some people are given a placebo, and some are given the actual drug. The actual experimenters who are administering the drug are not told which they are administering to prevent exactly the kind of experimenter bias that you mentioned, right?

Joseph Reilly:

That's a great analogy to drug testing.

Chris Willis:

Yes. Thanks a lot, Joe. Lori, let's talk about what the purpose of this study was. I really want to have you address it in two dimensions. One, what did the CFPB say in its press release and in the study itself its purposes were? Then, what do we think the actual real purpose might have been if it's different to or in addition to the stated purpose?

Lori Sommerfield:

Sure, Chris. In terms of the CFPB's stated goals, the press release from the Bureau stated that the study illustrates the need for comprehensive lending data to uncover potential discrimination in small business lending. As you know, that's sort of been their focal point in issuing the Section 1071 final rule. They suspect and believe that potential discrimination exists out there in small business lending.

Interestingly, I was at a fair lending conference recently, and two CFPB employees who are responsible for helping manage and implement the Section 1071 final rule made a remark about this study because it had just come out. And they stated that the study was actually issued for research purposes only and to share those learnings with the public, rather than for enforcement purposes. So, that's what they're stating publicly is the purpose.

But I think in terms of the actual aim or the goal of the study, I'd like to make a few comments about that and you're welcome to weigh in on this, as well as Joe. This study isn't really dependent on Section 1071 data because it's not even available yet. Regulators could do this type of testing to determine whether pre-application discouragement exists without it. And we know this can be done today under the existing fair lending laws. However, once the 1071 data is collected and reported, we know that the CFPB, state regulators, and consumer advocacy groups will begin analyzing it for evidence of discrimination, as we discussed earlier in this podcast. It's likely that the CFPB is making its first shot across the bow foreshadowing that discrimination may be found in small business lending data. And then, that supervisory and enforcement actions could result.

I also think it's somewhat suspicious in terms of the timing of the release of the study because it was just released after the presidential election. But as I noted in describing the methodology, it was conducted about a year ago. So, I think our guess is that the Bureau intended that study to serve as a blueprint for state regulators, state AGs, and consumer advocacy groups to conduct similar testing and bring claims under ECOA. Again, potentially without the need for Section 1071 data.

Chris Willis:

Right, because speaking of 1071 data, even once that data is available, it's not going to show the kind of thing that the CFPB was going after in this study, would it?

Lori Sommerfield:

That's correct, Chris, it would not.

Chris Willis:

Right, because you don't report anything until you have an application and none of these people submitted an application.

Lori Sommerfield:

Correct. So, this is all focused on pre-application conduct by lenders.

Chris Willis:

Yes. I'll throw in one more potential motivation for the Bureau. I think the Bureau also wanted industry to worry about this kind of mystery shopper testing and to be aware that it should do this sort of testing for itself to control these perceived risks of differential treatment that the CFPB believes to exist. We'll talk more about that later, but I believe that's likely in the CFPB's mind as well.

Lori Sommerfield:

I agree, Chris. Good point.

Chris Willis:

Joe, Lori mentioned 1071 and the public at least tie in, although not very strong logically tie in between this study and 1071. It reminds me that I think our listeners probably would appreciate an update on where the 1071 rule stands in terms of what's the status of the litigation, etc. You're very involved in that, representing one of the trade associations in the litigation. Would you mind bringing everybody up to speed on where everything stands with the litigation?

Joe Reilly:

Oh, certainly, Chris. So, what is pending now is an Administrative Procedure Act challenge to the 1071 rule. That challenge was rejected at the district court level late just this past summer. So, the trade association we represent along with the ABA and other trades are now appealing that decision to the Fifth Circuit. Just yesterday, we filed our merits brief on appeal. The Fifth Circuit, having been told that the compliance date for this role for the larger lenders is July, the Fifth Circuit has agreed to expedite this appeal. So, it will hear oral argument on February 3rd and I think we can look to a decision perhaps in April, give or take.

But our advice to all clients has been to just continue your path toward coming into compliance in July. If there's a nice surprise from the litigation, we'll take it. But anything coming out of the litigation is much more likely to simply limit the scope of the rule, rather than invalidate the rule as a whole. So, it's good to keep on marching toward compliance.

Chris Willis:

Okay. Thanks a lot, Joe. I definitely agree with that assessment as well. Well, let's talk about another practical issue, which is, in light of the CFPB study, the mystery shopper study that we've been talking about throughout the podcast. What is your, Lori and Joe's view, on what steps lenders, small business lenders, particularly those with physical locations where loans are originated, should be doing in light of the fact of this study coming out?

Lori Sommerfield:

Well, Chris, I'll take a first shot at that. I think to your point about the fact that the CFPB may have issued this study to basically make small business lenders concerned about this type of discouragement that's outside of the scope of Section 1071. Small business lenders with a retail presence might wish to consider doing similar mystery shopping themselves, which would be covered, we believe, under ECOA's self-testing provision, that's found in Section 1002.15 of Regulation B.

Under that self-testing privilege, a self -test is basically any type of test that's designed to determine the extent or the effectiveness of a creditor's compliance with ECOA, and creates data or factual information that's not available or cannot be derived from loan application files or other records that relate to credit transactions. Clearly, this type of in-person pre-application inquiry would fall within the scope of that. But the important thing to note that in order to conduct this testing, first of all, you should consult with legal counsel to conduct it under attorney-client privilege. But then, if you find any issues, you also are required to take corrective action in order to avail yourself of the privilege.

Chris Willis:

What exactly is the privilege? Because self-testing doesn't come up very frequently, and I bet, a lot of our listeners don't really understand the scope of the self-testing privilege under ECOA. Do you mind addressing that?

Lori Sommerfield:

Sure, Chris. The ECOA self-testing privilege allows small business lenders to independently withhold the test results from their regulator. This would apply not only in the exam context, but in a supervisory context as well.

Chris Willis:

Thanks, Lori. That's really important for listeners to know, because there aren't that many situations that qualify as a self-test under ECOA. Like your normal statistical fair lending analysis of loan applications or decisions isn't covered, but this definitely is, and that's why a lot of people don't know about it. It's critical to note that the results of the self-test could be withheld both in examinations and in enforcement investigations against any governmental entity. So, it's a really powerful privilege where it applies.

But you spoke about one of the conditions of the privilege being the necessity to take corrective action. So, if you don't mind, talk about what that might look like. If a lender did its own mystery shopping self-testing and found some sort of differential treatment at the branch employee level, what kind of corrective action would be called for under those circumstances?

Lori Sommerfield:

Well, I think that a small business lender would want to reexamine its training for branch personnel to make sure that they are adequately trained in fair lending concepts. Also, small business lenders should review their policies and procedures for providing information about loans or products to consumers to ensure they are providing a consistent level of service.

Chris Willis:

Makes sense. Well, Lori and Joe, this has been a very interesting conversation. I especially want to underline something that you both said earlier for our listeners, and that is, we believe that the release of this study is designed to be both a blueprint and a call to action for state regulators and for consumer advocacy groups to perform similar tests themselves and to take action against small business lenders, even without any 1071 data being available, because that won't be available to the public until the end of 2026, probably.

It is a real risk out there that we've known about for a long time in mortgage lending and real estate under the Fair Housing Act, but which now seems to be coming to visit us in the small business lending world. So, Lori and Joe, thank you very much for your insights on this. Joe also, for the update on what's going on with 1071. Of course, thank you to our audience for listening to today's episode as well.

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