

Know Your Customer, but Don't Use What You Know to Discriminate

Grace Powers

Countrywide Financial Corporation

November 28, 2007 / San Diego, CA

Knowing Your Customer - What is Authentication?

- Authentication is the process used to confirm an individual's identity as a party to a transaction.
- Importance of authentication for electronic transactions
 - » Promotes legal enforceability;
 - » Builds consumers' trust in electronic agreements and transactions;
 - » Reduces fraud;
 - » Inhibits identity theft; and
 - » Assists in compliance with applicable laws.

- Passed in the wake of the 9/11 to deter and punish terrorists in the US and abroad. Act includes:
 - » Enhanced investigative tools for law enforcement;
 - » New immigration laws; and
 - » New and more rigorous anti-money laundering laws.
- To combat money-laundering, Section 326 requires financial institutions to:
 - » Verify the identity of any person seeking to open an account;
 - » Maintain records of the information used to verify the person's identity; and
 - » Consult government lists of known or suspected terrorists or terrorist organizations.
- Regulations implementing Section 326 requires certain financial institutions, such as banks and thrifts, to adopt written customer identification programs ("CIPs") which are approved by the institutions Board of Director's and incorporated into the institution's anti-money laundering compliance program under the Bank Secrecy Act.

- Information Gathering - Prior to opening a new account with a covered customer, financial institution must obtain at a minimum from individuals:
 - » Name;
 - » Date of birth;
 - » Residential or work address; and either
 - Tax identification number for US citizens; or
 - For non-US citizens, a TIN, passport number and country of issuance, alien id card number, any government-issued document number and country of issuance that evidences nationality or residence and bears a photo.

- Identity Verification
 - » Use risk based procedures - Must be able to form a “reasonable belief” that the institution knows the identity of each new customer.
 - Can use a third party to perform id verification services, but institution needs to ensure that the third party uses the same level of authentication the institution would use.
 - » Verify within reasonable time after account opening.
 - » Must describe when institution will use documentary and/or non-documentary methods.
- Financial institutions must provide adequate notice to customers that they are requesting information to verify customers’ identities.

- Applies to both retail and commercial customers
- Technology-neutral
- Focuses on risks and risk management techniques associated with the Internet delivery channel, but principles useful to all forms of electronic banking activities.
- Guidance focuses on four issues:
 - » Risk Assessment
 - Single-factor authentication may be inadequate for high-risk transactions involving access to customer information or the movement of funds to parties.
 - » Account Origination and Customer Verification
 - Use reliable alternate methods to paper verification.
 - » Monitoring and Reporting
 - Audit to assist in detection of fraud, money laundering, compromised passwords, or other unauthorized activities.
 - » Customer Awareness
 - Key defense against fraud and identity theft.

- Fair Housing Act
- Equal Credit Opportunity Act (ECOA) / Regulation B
- Home Mortgage Disclosure Act (HMDA) / Regulation C

- Enacted in 1968, the Fair Housing Act (42 U.S.C. § 3601 *et seq.*) (“FHA”) makes it unlawful for any person or other entity whose business includes engaging in residential real-estate related transactions to discriminate against any person in making available such a transaction, or in the terms or conditions of such a transaction because of:
 - » Race;
 - » Color;
 - » Religion;
 - » Sex;
 - » Handicap;
 - » Familial status; or
 - » National origin.
- Residential real-estate related transactions include, but are not limited to:
 - » Making loans to buy, build, repair, or improve a dwelling;
 - » Purchasing real estate loans;
 - » Selling, brokering, or appraising residential real estate; or
 - » Selling or renting a dwelling.
- HUD’s implementing regulations for FHA are found at 24 C.F.R. 100 *et seq.*

- Enacted in 1974, ECOA (15 U.S.C. § 1691 *et seq.*) makes it unlawful for any creditor to discriminate against any applicant based on:
 - » Race or color;
 - » Religion
 - » National origin;
 - » Sex;
 - » Marital status;
 - » Age;
 - » Receipt of public assistance income; and
 - » Exercise of any right under the Consumer Credit Practices Act (e.g., TILA, ECOA, etc.)
- The implementing regulations for ECOA are found in the Federal Reserve Board's Regulation B (12 CFR § 202 *et seq.*).

Examples of Unlawful Discrimination under FHA and ECOA

- Examples of unlawful discrimination based on a prohibited factor under FHA and/or ECOA:
 - » Failing to provide information or services or providing different information or services regarding any aspect of the lending process, including credit availability, application procedures, or lending standards;
 - » Discouraging or selectively encouraging applicants with respect to inquiries about or applications for credit;
 - » Refusing to extend credit or using different standards in determining whether to extend credit;
 - » Varying the terms of credit offered, including the amount, interest rate, duration, or type of loan;
 - » Using different standards to evaluate collateral;
 - » Treating a borrower differently in servicing a loan or invoking default remedies; or
 - » Using different standards for pooling or packaging a loan in the secondary market.
- Lenders may not express, orally or in writing, a preference based on prohibited factors or indicate that it will treat applicants differently on a prohibited basis.
- FHA requires reasonable accommodations for a person with disabilities.

- Existence of illegal disparate treatment may be established either by statements revealing that a lender explicitly considered prohibited factors (overt evidence) or by differences in treatment that are not fully explained by legitimate nondiscriminatory factors (comparative evidence).
- **Overt evidence:** Lender openly discriminates on a prohibited basis.
 - » Exception: Special purpose credit programs.
- **Comparative evidence:** Lender treats an applicant differently based on a prohibited factor.
 - » Does not require showing that treatment was motivated by prejudice or conscious intent to discriminate; only that there is no credible, nondiscriminatory reason to explain difference in treatment.
 - » Look at similarly situated applicants.
- **Redlining:** Lender provides unequal access to credit or terms of credit, because of a prohibited characteristic of the residents of the area in which the applicant resides or will reside or in which the real property to be mortgaged is located.

- Disparate impact: When a lender applies a racially or otherwise neutral policy or practice equally to all credit applicants, but the policy or practice disproportionately excludes or burdens certain persons on a prohibited basis.
 - » What is the effect of the lender's policy or practice?
 - » Is the policy or practice justified by "business necessity"?
 - Is there an alternative policy or practice that could serve the same business necessity with less discriminatory effect?
 - » Evidence of discriminatory intent is not necessary to establish that lender's policy or practice is disparate impact discrimination.

- Enacted in 1975, HMDA (12 USC § 2801 *et seq.*) requires certain depository and non-depository for-profit financial institutions to collect, report, and disclose data about originations (including applications that do not result in originations), purchases and refinancings of home purchase and home improvement loans.
- Regulatory agencies use such data to:
 - » Help determine whether financial institutions are serving the housing credit needs of their communities;
 - » Aid government officials in distributing federal funds so as to attract private investment to areas where it is needed; and
 - » To assist in identifying possible discriminatory lending patterns.
- HMDA is implemented by the Federal Reserve Board's Regulation C (12 CFR 203 *et seq.*).

- Annual reporting: Financial institutions must submit the required data on a HMDA Loan Application Register (LAR) to their respective regulatory agencies by March 1st following the calendar year to which the loan data relates and must make a modified LAR available to the public upon request.
- Loan information data collected:
 - » Loan information
 - » Loan number;
 - » Application date;
 - » Loan type;
 - » Request for pre-approval;
 - » Loan amount;
 - » Lien position;
 - » HOEPA status; and
 - » Rate spread.

- Applicant information:
 - » Race or national origin, sex and income of applicant or borrower.
 - Required to report on face-to-face applications, but applicant not required to provide information.
- Property information:
 - » Location of property by metropolitan statistical area (MSA), state, county, and census tract; and
 - » Property type and occupancy status.
- Action taken, date of action taken, denial reasons and purchaser type.

- Automated underwriting: Useful to prevent pricing differences between protected and unprotected classes.
- Loan Origination Systems (LOS): Useful for HMDA reporting if designed to collect HMDA required information.
- HMDA reporting software: Very important that the data inputs from the LOS or other sources are accurately mapped to the reporting software.
 - » HMDA data useful to determine whether there are pricing differences between protected and unprotected classes that need further investigation to ensure that such differences can be explained through non-discriminatory factors, such as credit history.

Thank you!

Grace Powers

1st VP, Sr. Legal Counsel

Countrywide Financial Corporation

Grace_Powers@Countrywide.com