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(Submitted electronically)

Robert E. Feldman, Executive Secretary
Attention: Comments
Federal Deposit Insurance Corporation
550 17th Street NW, Washington, DC 20429

Re: Comment on Request for Information on Standard Setting and Voluntary Certification for Models and Third Party Providers of Technology and Other Services, RIN 3064–ZA18 (Jul. 20, 2020)

Dear Mr. Feldman,

My name is Christopher Odinet, and I am a law professor at the University of Iowa College of Law where I teach and write about consumer finance and financial regulation. I appreciate the opportunity to comment on the Federal Deposit Insurance Corporation's (FDIC's) above captioned request for information ("RFI").[1]

In your RFI, you seek public feedback on the benefits associated with a voluntary, standards-based framework for certifying third party technology models and other technology products and services, such as those provided by financial technology (fintech) companies, for use by financial institutions that are regulated by the FDIC. A common business model that comes to mind is that used by many state-chartered industrial loan companies and some commercial banks in partnership with nonbank fintech companies for purposes of originating online loans.[2] Under this model, the marketing and loan application is handled by the fintech partner. The loan application is submitted through the fintech's website via smart phone app or website portal. The loan is then underwritten using the fintech company's proprietary model.[3] Once the application is scored, the file is passed on to the bank partner who then originates the loan. Once the loan has been funded, it is usually sold by the bank to the fintech and subsequently sold again on the capital markets (either through a wholesale

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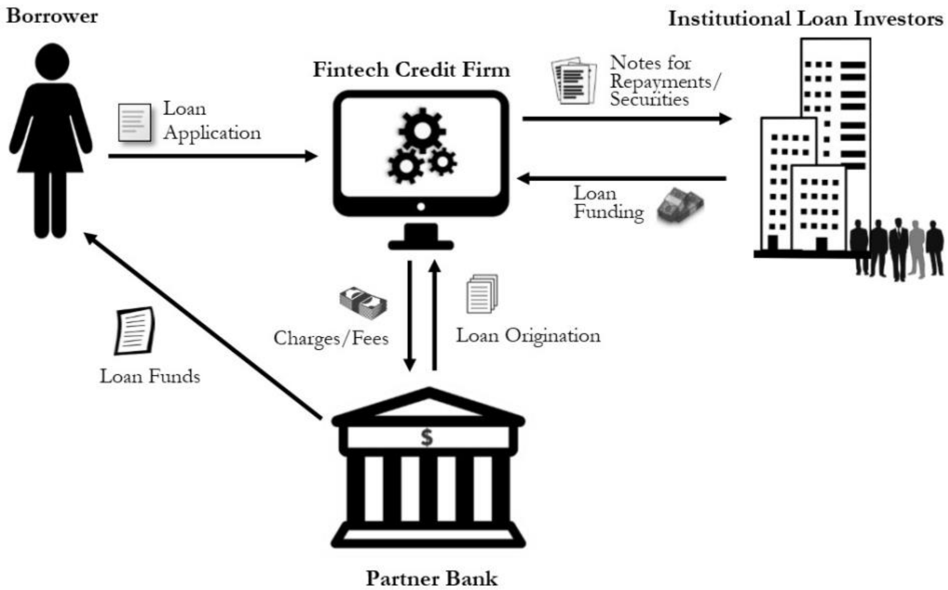
[1] FDIC, Request for Information on Standard Setting and Voluntary Certification for Models and Third-Party Providers of Technology and Other Services, RIN 3064–ZA18, 85 FED. REG. 44890 (Jul. 20, 2020), https://www.fdic.gov/news/press-releases/2020/pr20083a.pdf.

[2] For a discussion of this business model, see Christopher K. Odinet, *Consumer Bitcredit and Fintech Lending*, 69 ALA. L. REV. 781, 791 (2018).

[3] Christopher K. Odinet, *The New Data of Student Debt*, 92 S. CAL. L. REV. 1617, 1639 (2019).

buyer or through a securitization).[4] *Figure 1* below provides an overview of the so-called "bank-partnership model" of fintech lending.[5]

<u>Figure 1</u>
Fintech-Bank Partnership Model



You note in your RFI that the use of third party firms under this business model has been fraught due to the fact that "sometimes the costs and other resources associated with deploying models or technologies from third parties can be prohibitive" for the bank.[6] Also, you note that due to the complexity of the products and services that some fintechs offer, banks "may find it challenging to validate and assess such models."[7]

In hopes of remedying this problem, you suggest that the FDIC would designate a so-called standards setting organization ("SSO") that would work with stakeholders to set standards that would apply to third party technology service providers (like the fintechs described above), including in the use of these complex models. Additionally, another type of firm, so-called certification organizations ("COs"), could be called upon to assess whether these third party technology service providers and their models complied with the standards set by the SSO. It would be up to the third party technology service providers, however, as whether to submit itself and its model to this certification process.

I write primarily to raise a fair lending issue, but I would also note that I am concerned with the potential that such an SSO and COs could seriously undermine the significant responsibility that the FDIC holds in supervising the activities of banks and their third party technology service providers.[8] It is incumbent on the FDIC, acting in the interest and on behalf of the public, to examine

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[4] Christopher K. Odinet, *Securitizing Digital Debts*, 52 ARIZ. ST. L.J. 477, 500 (2020).

[5] Christopher K. Odinet, *Predatory Fintech and the Politics of Banking*, IOWA L. REV. (forthcoming 2021), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3677283.

[6] 85 FED. REG. 44891.

[7] *Id.*

[8] 12 U.S.C. §§ 1464(d)(7), 1867(c)(1); 12 U.S.C. § 1867(c)(1) ("whenever a depository institution that is regularly examined by an appropriate Federal banking agency . . . causes to be performed for itself, by contract or otherwise, any

and properly supervise the depository institutions under its regulatory purview.[9] Off-loading regulatory supervision to third party firms, which are highly suspectable to industry capture,[10] works against the proper fulfillment of this responsibility. It makes supervising the use of complex technologies by the bank sector—already quite a challenging task—even more opaque and could eventually allow a culture to grow at the FDIC that encourages the out-sourcing of all meaningful regulatory duties that intersect with high level technology products and services.[11] Instead, the FDIC should aim to build up its own resources and expertise so that this kind of important supervision can be conducted in-house by trained banking officials that hold the public trust.[12]

As to the fair lending issue, I am concerned that this proposal, taken together with a recent proposal by the U.S. Department of Housing and Urban Development ("HUD"), could significantly weaken enforcement of the Fair Housing Act ("FHA") under the disparate impact analysis. In August 2019, HUD issued a proposed rule ("HUD Rule") titled "HUD's Implementation of the Fair Housing Act's Disparate Impact Standard."[13] The HUD Rule seeks to make changes to the way courts interpret the disparate impact theory under the FHA. The Supreme Court explained the three step burden-shifting framework for disparate impact claims under the FHA in the 2015 case of *Texas Department of Housing and Community Affairs v. Inclusive Communities Project, Inc.*[14] In that case, the court held that the first step is for the plaintiff to make out a prima facie case by alleging facts or producing statistical data that show the defendant's specific policy or practice caused a discriminatory effect on a legally protected class of persons.[15] Then, the burden of proof shifts to the defendant to show that, despite the plaintiff's allegations, the policy or practice so used served a valid interest such that the use of this policy or practice was necessary to achieve one or more substantial, legitimate, and nondiscriminatory interests.[16] Finally, the plaintiff can still prevail if he or she is able to show in the final step that the defendant still could have achieved the valid interest through the use of an alternative method that would have had less of a disparate impact.[17]

The HUD Rule, however, seeks to create a number of safe harbors to assist defendants in meeting the burden established in the second step of the analysis. Meeting this burden means that the plaintiff fails to establish a prime facie case, and the case is dismissed at the onset. These proposed

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services authorized under this chapter, whether on or off its premises . . . such performance shall be subject to regulation and examination by such agency to the same extent as if such services were being performed by the depository institution itself on its own premises."); *see also* 12 U.S.C. § 1464 (d)(7).

9 FFIEC, Risk Management of Outsourced Technology Services, n.2 (Nov. 28, 2000), https://www.ffiec.gov/PDF/pr112800_guidance.pdf; *see also* Federal Reserve, Guidance on Managing Outsourcing Risk 2 (Dec. 5, 2013) ("'service providers' is broadly defined to include all entities that have entered into a contractual relationship with a financial institution to provide business functions or activities.").

10 Benjamin P. Edwards, *The Dark Side of Self-Regulation*, 85 U. CIN. L. REV. 573 (2017) (analyzing the myriad problems with the industry-led regulation of securities brokers and dealers by the Financial Industry Regulatory Authority (FINRA)).

11 FFIEC, Outsourcing Technology Services Booklet (last visited July 7, 2020), https://ithandbook.ffiec.gov/it-booklets/outsourcing-technology-services/introduction.aspx#cite-text-0-0; FFIEC, Supervision of Technology Service Providers (TSP) Booklet 1 (Oct. 2012), https://ithandbook.ffiec.gov/media/274876/ffiec_itbooklet_supervisionoftechnologyserviceproviders.pdf.

12 For a discussion of the FDIC and its culture during times of financial crisis, see SHELIA BAIR, BULL BY THE HORNS: FIGHTING TO SAVE MAIN STREET FROM WALL STREET AND WALL STREET FROM ITSELF (2012).

13 HUD, HUD's Implementation of the Fair Housing Act's Disparate Impact Standard, RIN 2529-AA98, 84 FED. REG. 42854 (Aug. 19, 2020), https://www.govinfo.gov/content/pkg/FR-2019-08-19/pdf/2019-17542.pdf.

14 135 S. Ct. 2507 (2015).

15 *Id.* at 2514.

16 *Id.* at 2515-22.

17 *Id.* at 2518.

safe harbors specifically deal with the defendant's use of algorithmic models. I raise concerns specifically with respect to two of these provisions.[18]

The first safe harbor provides that a defendant will have defeated the plaintiff's showing of a prima facie case of discriminatory effect in the use of a model "such as a risk assessment algorithm" if the defendant:

> Shows that the challenged model is produced, maintained, or distributed by a recognized third party that determines industry standards, the inputs and methods within the model are not determined by the defendant, and the defendant is using the model as intended by the third party[19]

The second safe harbor provides the same protection in the same context if the defendant:

> Shows that the model has been subjected to critical review and has been validated by an objective and unbiased neutral third party that has analyzed the challenged model and found that the model was empirically derived and is a demonstrably and statistically sound algorithm that accurately predicts risk or other valid objectives, and that none of the factors used in the algorithm rely in any material part on factors that are substitutes or close proxies for protected classes under the Fair Housing Act[20]

I am concerned that the FDIC's use of SSOs and COs, in conjunction with the HUD Rule, will seriously weaken the disparate impact cause of action, which is a powerful tool in fighting discrimination in the housing market.

To illustrate my concerns, allow me to provide a simple example using the business model described in *Figure 1* above. Suppose that a financial technology firm has created a risk assessment algorithm that will be used in consumer loan or small business underwriting. Indeed, these types of credit scoring programs are already being deployed in the market today.[21] Next, let us assume that this fintech company enters into a partnership agreement with an FDIC-regulated bank for use in loan underwriting. At this time, the FDIC has approved an SSO to set standards for the use of these kinds of algorithms and, indeed, the fintech has submitted itself and its algorithm to a designated CO for evaluation. The CO grants the certification. Next, the fintech and the bank deploy the model in making a host of residential mortgage loans. However, the model preferences white borrowers over borrowers of color based on a range of alternative data points. Or perhaps the model preferences men over

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[18] 84 FED. REG. 42862.

[19] *Id.*

[20] *Id.*

[21] *See* Odinet, *Predatory Fintech*, *supra* note 5 (describing several partnerships and drawing from 10-K annual reports on file with the Securities and Exchange Committee detailing the machine learning and alternative data used in these underwriting programs).

women borrowers. Some empirical studies[22] and news media stories[23] have already revealed instances of such discrimination using sophisticated algorithmic underwriting. An aggrieved borrower would file suit against the bank for originating these loans under the theory that they constitute FHA disparate impact violations.

However, taking into account the HUD Rule and the use of the SSOs and the COs, the bank could have a powerful shield against liability. First, the bank could simply argue, using the second safe harbor, that the challenged model has been "validated by an objective and unbiased neutral third party" that has determined it meets the applicable fair lending laws.[24] Indeed, the SSO and the CO could easily meet this definition and standard as broadly articulated in the HUD Rule. Having been so blessed by the FDIC's third party standards and certification process, the plaintiff's otherwise valid claim would be defeated.

I am also worried about an instance where the SSO becomes the party that produces, maintains, or distributes the model to banks for their use in furnishing financial products and services. This would meet the first safe harbor that protects the defendant when the "recognized third party that determines industry standards."[25] In such a case, the bank could simply say that it does not determine the "inputs and methods [used in] the model" and that the bank is merely "using the model as intended by the third party."[26]

I hope you will take these concerns into account as you consider implanting the proposals set forth in your RFI. Creating a regulatory environment that eases the cost of innovation is only desirable if strong consumer protection laws, such as those dealing with fair lending, can still be vigorously enforcement. I am concerned that your proposal, in concert with the HUD Rule, will weaken an important part of policing fair housing violations in the United States at just the moment when individuals may need its protection the most.

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[22] Devin G. Pope & Justin R. Sydnor, *What's in a Picture? Evidence of Discrimination from Prosper.com*, 46 J. HUM. RESOURCES 53, 53 (2011) ("[B]lacks . . . are 25 to 35 percent less likely to receive funding than those of whites with similar credit profiles. . . . [L]enders making such loans earn a lower net return compared to loans made to whites with similar credit profiles because blacks have higher relative default rates."); Robert Bartlett et al., *Consumer-Lending Discrimination in the Fintech Era* 5 (UC Berkeley Pub. Law Research Paper, 2019), https://faculty.haas.berkeley.edu/morse/research/papers/discrim.pdf ("In aggregate, our findings suggest that from 2009 to 2015, lenders rejected 0.74 to 1.3 million Latinx and African-American applications that would have been accepted except for discrimination. FinTech lenders, on the other hand, do not discriminate at all in the decision to reject or accept a minority loan application in our sample.").

[23] Taylor Telford, *Apple Card Algorithm Sparks Gender Bias Allegations Against Goldman Sachs*, WASH. POST (Nov. 11, 2019, at 9:44 am CST), https://www.washingtonpost.com/business/2019/11/11/apple-card-algorithm-sparks-gender-bias-allegations-against-goldman-sachs/; Chris Arnold, *Graduates of Historically Black Colleges May Be Paying More For Loans: Watchdog Group*, NPR MORNING EDITION (Feb. 5, 2020), https://www.npr.org/2020/02/05/802904167/watchdog-group-minority-college-graduates-may-pay-higher-interest-rates.

[24] *Id.*

[25] *Id.*

[26] *Id.*

Thank you for considering my view on this RFI. I welcome the opportunity to discuss these issues further.

Sincerely,

[redacted]

Christopher K. Odinet
Professor of Law