CRA Insights

CRA Charles River Associates

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Fair lending considerations when tightening credit requirements in response to the COVID-19 crisis

Key takeaways

During the COVID-19 crisis, many financial institutions have responded to anticipated higher delinquency rates by tightening their lending criteria to reduce credit risk in their portfolios. When making changes that decrease access to credit, financial institutions should consider the fair lending risks associated with their new policies, and in particular:

1. Consider if the new policy may have unintended differential outcomes across protected classes,
2. Consider whether alternative policies might achieve the same reduction in credit risk while having smaller differential impacts across protected classes,
3. Document the business justification for the new policy and why that policy was chosen over alternatives that were considered, and
4. Establish a timeline to reassess the policy and its justification.

Background

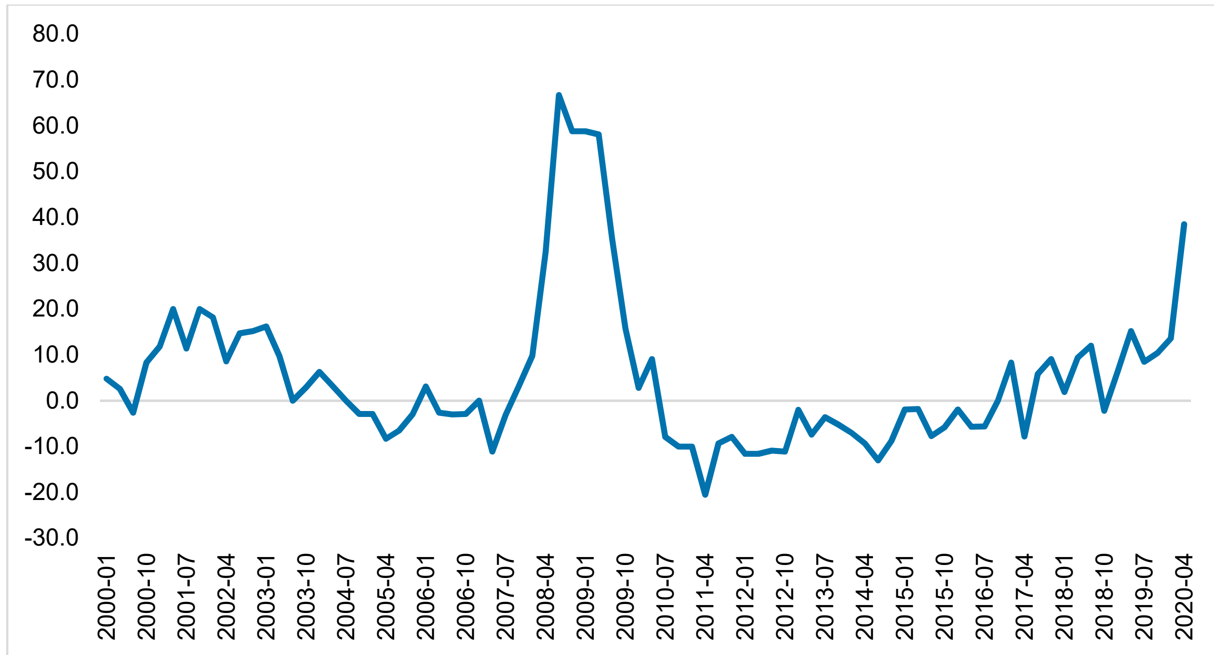
The COVID-19 pandemic raises new challenges for financial institutions. These include quickly rolling out new lending programs like the Paycheck Protection Program and enhancing forbearance procedures and options for consumers, while transitioning to working remotely. As lenders across the spectrum of products (mortgages, autos, and credit cards) experience increasing delinquency rates, several lenders have begun to adjust credit criteria to protect and enhance the safety and soundness of the financial institution.[1]

The Federal Reserve regularly surveys financial institutions to ask if that institution is tightening or loosening credit standards. The results of the survey for credit card lending, from January 2000 to April

[1] See, for example, "Credit cards start cutting limits for people facing tough times," *American Banker*, April 23, 2020, https://www.americanbanker.com/articles/credit-cards-start-cutting-limits-for-people-facing-tough-times and Diana Olick, "Here's why it's suddenly much harder to get a mortgage, or even refinance," CNBC, April 13, 2020, https://www.cnbc.com/2020/04/13/coronavirus-why-its-suddenly-much-harder-to-get-a-mortgage-or-even-refinance.html.

2020, are summarized in Figure 1.[2] While there has been a gradual increase in tightened standards since 2014, the survey shows substantial tightening with the advent of COVID-19. While levels have not reached those observed during the Great Recession, we have not seen the full response to COVID-19 as of the survey's April 3, 2020 end date. The rapid COVID-19 response, and the uncertainty about its duration, suggests that financial institutions may face challenges assessing the risks associated with credit tightening.

Figure 1: Net percentage of domestic banks tightening standards on consumer loans, credit cards, percent, quarterly, not seasonally adjusted



Mitigating fair lending risks

Any consideration of tightened credit standards or modifications to credit product offerings should weigh the fair lending implications of such decisions. Facially neutral policies that restrict access to credit may present a fair lending risk if they result in differential outcomes for those in classes protected by the Equal Credit Opportunity Act (ECOA) or the Fair Housing Act (FHA), if there are less discriminatory alternatives available, or if those policies do not have a sufficient business justification. Financial institutions are having to act quickly, with heavily burdened staff, and may not have the resources in the present environment to perform the full suite of analyses they would normally perform when considering a policy change.

Financial institutions can increase credit standards by:

1. Increasing income and employment verification requirements,
2. Increasing minimum credit scores, income, or asset requirements,

[2] Board of Governors of the Federal Reserve System (US), Net Percentage of Domestic Banks Tightening Standards on Consumer Loans, Credit Cards [DRTSCLCC], retrieved from FRED, Federal Reserve Bank of St. Louis; https://fred.stlouisfed.org/series/DRTSCLCC, May 4, 2020. Respondent banks received the most recent survey on March 23, 2020, and responses were due by April 3, 2020.

3. Adjusting the market footprint, and
4. Limiting product offerings or reducing credit lines.

Each option may reduce credit risk by making credit more difficult to access for different consumer populations. In addition, financial institutions must consider the potential differential impact of such policies on those in protected classes, such as race, ethnicity, gender, or age. In doing so, financial institutions should consider all alternatives available to achieve their credit risk goal and document the justification for the chosen policy. To the extent possible, that justification should include both quantitative and qualitative reviews of the policy choices.

It is also important to establish a timeline for reassessing the policy change. Policies now seen as justified due to the impacts of the COVID-19 pandemic may no longer be seen as justified six months or a year from now. As the business justification for a policy that has a differential impact on protected classes fades, the fair lending risk associated with that policy increases. By establishing a timeline to review the policy change, financial institutions can make sure they do not have unnecessary restrictions on the access to credit that creates an unjustifiable disparate impact on a protected class.

About the Financial Economics Practice at CRA

Our consultants provide economic and financial analysis and advice to financial institutions, financial regulators, and counsel representing financial institutions. Our experts are skilled in quantitative modeling and econometrics, particularly as applied to issues in credit and compliance risk in consumer lending markets. We provide fair lending analyses of underwriting, pricing, and servicing practices for use in litigation and regulatory investigations. We also provide ongoing statistical monitoring of fair lending risk, including monitoring required under the terms of consent orders with federal government agencies.

Contact

Arthur Baines
VP & Co-Practice Leader
+1-202-662-7838
abaines@crai.com

Marsha Courchane
VP & Co-Practice Leader
+1-202-662-3804
mcourchane@crai.com

Adam Gailey
Principal
+1-202-662-3879
agailey@crai.com

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