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CFPB Outlines Options for Quality Control Standards for Automated Valuation Models

Options Under Consideration Include a Nondiscrimination Quality Control Factor; Focus on Algorithmic Bias Not Limited to Automated Valuation Models

SUMMARY

On February 23, 2022, the Consumer Financial Protection Bureau outlined the options it is considering in connection with the future rulemaking on quality control standards for automated valuation models (“AVMs”) required under section 1473(q) of the Dodd Frank Wall Street Reform and Consumer Protection Act (the “Dodd-Frank Act”).¹ AVMs are algorithmic computer models that apply complex mathematical formulas to property data—such as property characteristics, local market information, and price trends—drawn from various sources to estimate a home’s value. In this memorandum, we focus on the CFPB’s possible inclusion of nondiscrimination quality control criteria in a future AVM rule and its related discussion of bias in algorithmic systems. The inclusion of nondiscrimination criteria in a future AVM rule would be consistent with the federal government’s recent increased focus on discriminatory appraisal and valuation activities, including establishment of the Interagency Task Force on Property Appraisal and Valuation Equity (“PAVE”).

The CFPB’s enforcement authority under section 1473(q) extends to non-depository institution participants in the appraisal market, including real estate credit companies and mortgage loan brokers, and their subsidiaries, so a CFPB AVM rule will most likely have the greatest effect on those entities.² However, the CFPB’s outline should also be of interest to depository institutions for at least two reasons. First, it articulates the CFPB’s view that nondiscrimination laws, as they may incorporate the disparate impact theory of discrimination, apply to algorithmic systems such as AVMs. Algorithmic systems are increasingly used by depository institutions for a wide array of purposes, including not only mortgage origination and secondary market issuances, as contemplated by the AVM rule, but also a wider array of credit scoring and

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rate setting purposes, as well as credit risk management, anti-money laundering risk management and fraud risk management purposes.³ In addition, the CFPB's view may influence the views of bank regulators when evaluating the application of nondiscrimination laws to algorithmic systems. Second, the CFPB is collaborating with the federal banking regulators on a future AVM rulemaking.⁴ Accordingly, the outline may foreshadow aspects of that future rulemaking, and feedback on the outline may inform the regulators' views.⁵ Comments on the outline are requested from small entities by April 8, 2022,⁶ and from other stakeholders by May 13, 2022.

BACKGROUND

A home's value may be determined in a variety of ways, with valuations serving several purposes. When underwriting a residential mortgage, for example, lenders typically require an appraisal to estimate the home's value. An accurate estimate of the home's worth is critical in ensuring that the consumer neither ends up borrowing more than the home is worth (which may occur if the home is overvalued) nor is denied access to credit that might otherwise be available (which may occur if the home is undervalued). Increasingly, AVMs are used to estimate home values, including in connection with the mortgage appraisal process.

In section 1473(q) of the Dodd-Frank Act, Congress instructed the CFPB, the Board of Governors of the Federal Reserve System, the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the National Credit Union Administration, and the Federal Housing Finance Agency to develop regulations establishing AVM quality control standards (the "AVM Rules"). These standards must be designed to (1) ensure a high level of confidence in the estimates produced, (2) protect against the manipulation of data, (3) seek to avoid conflicts of interest, (4) require sample testing and reviews (collectively, the "First Four Factors"), and (5) account for any other such factors that the agencies tasked with developing the regulations deem appropriate.⁷ Authority to enforce the AVM Rules resides with the relevant primary federal supervisor for depository institutions and their federally regulated subsidiaries, and with the CFPB, the Federal Trade Commission, and State attorneys general for "other participants in the market for appraisals of 1-to-4 unit single family residential real estate."⁸ The CFPB and the other agencies are collaborating on the development of the AVM Rules.

Section 1473(q) defines "automated valuation model" as "any computerized model used by mortgage originators and secondary market issuers to determine the collateral worth of a mortgage secured by a consumer's principal dwelling."⁹ Much of the outline describes the ways the CFPB is considering defining the various elements of this definition. The ultimate impact of the AVM Rules on both market participants and the CFPB's goals will, of course, turn in large part on how those elements are defined. However, this memorandum focuses on what is, in our view, a particularly notable aspect of the outline: the potential imposition of nondiscrimination quality control criteria and the CFPB's related discussion of bias in algorithmic systems.

NONDISCRIMINATION QUALITY CONTROL FACTOR

In the outline, the CFPB acknowledges the potential advantages presented by AVMs, including the potential to reduce some types of discrimination—e.g., overt or intentional discrimination. At the same time, the CFPB expresses concerns that algorithmic systems generally, including AVMs, present risk of discriminatory bias. According to the outline, AVMs may reflect bias in their design and function or through the use of biased data.¹⁰ In the CFPB’s view, these biases may be hard to identify and address, including because algorithms may be highly complex and not easily understood or audited. In addition, the CFPB cautions that algorithmic systems, including AVMs, may replicate historical patterns of discrimination or introduce new forms of discrimination because of the way a model is designed, implemented, and used—e.g., if a model systematically over- or under-values properties in neighborhoods of color.¹¹ As an example, the CFPB points to an algorithm used for determining hospital care that allocated Black patients less care than similarly situated White patients.¹² According to the CFPB, this bias occurred because the algorithm used historical data about health costs as a proxy for health needs, but did not take into account that unequal access to care meant that less money had been spent caring for Black patients than for White patients.¹³

The outline states unequivocally that “algorithmic systems such as AVMs are subject to federal nondiscrimination laws, including the Equal Credit Opportunity Act (ECOA) and the Fair Housing Act (FHA).”¹⁴ According to the CFPB, ECOA’s bar on discrimination extends to an AVM that uses a prohibited basis or proxy for a prohibited basis as an input in the model; it also extends to the use of an AVM that has an adverse impact on members of a protected class absent a legitimate business need or where that need could be reasonably achieved through alternative means that are less disparate in their impact.¹⁵ The CFPB indicates that the former could constitute evidence of disparate treatment in violation of ECOA, while the latter could constitute evidence of disparate impact in violation of ECOA. Because algorithmic systems are subject to federal nondiscrimination laws, “[i]t is critical for AVM model risk to be mitigated with proper fair lending controls and governance.”¹⁶

With a view toward mitigating potential fair lending risks the CFPB believes are presented by AVMs, and relying on its authority under section 1473(q) to establish AVM quality control standards designed to “account for any other such factor” that it deems appropriate, the CFPB is considering including an “AVM nondiscrimination quality control factor.” Under this factor, referred to in the outline as the “Fifth Factor,” entities would be required to adopt policies and procedures specifically designed to mitigate fair lending risk in the use of AVMs—an obligation that the CFPB states would be independent of the preexisting (and continuing) obligation to comply with federal nondiscrimination requirements, including ECOA and the FHA.¹⁷ According to the outline, the CFPB views this requirement as consistent with current fair lending guidance.¹⁸

The CFPB is considering two alternative compliance approaches that it may propose if it does decide to specify a nondiscrimination quality control factor. First, the CFPB is considering an approach that would

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afford entities the flexibility to design the relevant fair lending policies, practices, and control systems in a manner that is tailored to their business models.¹⁹ Under this first compliance approach, controls would need to be commensurate with an institution's risk exposures, size, and business activities, and the extent and complexity of its use of AVMs.²⁰ Second, the CFPB is considering whether to propose prescriptive requirements for the nondiscrimination quality control factor.²¹ According to the outline, these requirements might address risks that lending decisions based on AVM outputs generate unlawful disparities by, for example, specifying methods of AVM development and providing AVM use cases.

As an alternative to adopting nondiscrimination quality control requirements, the CFPB is considering whether compliance with applicable nondiscrimination laws with respect to AVMs is already encompassed within the First Four Factors; namely, the factors requiring a high level of confidence in the estimates produced by AVMs, protection against the manipulation of data, and random sample testing and reviews.²²

IMPLICATIONS

Several recent studies have concluded that Black- and/or Latino-owned homes are often valued at levels substantially lower than comparable White-owned homes.²³ The Biden administration has established as a priority the elimination of appraisal bias. Shortly after President Biden's inauguration, he issued a memorandum outlining the continued legacies of residential segregation and discrimination, including the undervaluation of properties owned by families of color, and announced an administration policy to eliminate racial bias and other forms of discrimination in all stages of home-buying.²⁴ In furtherance of that policy, in June 2021, the administration launched the PAVE Interagency Task Force, "a first-of-its-kind interagency effort to address inequity in home appraisals."²⁵ In July 2021, the CFPB announced that it had prioritized resources to focus on the role of racial bias in home appraisals.²⁶ The administration's efforts coincided with a widely publicized incident in which the California home of a Black couple, Tenisha Tate-Austin and Paul Austin, was appraised for 50 percent less when presented as owned by the couple than when presented as owned by a White friend.²⁷ The Austins subsequently filed suit against the appraiser and, in February 2022, the U.S. Department of Justice filed a statement of interest in the matter confirming that combatting bias in appraisals is a high priority across the federal government.²⁸ Also in February 2022, the CFPB announced that it had "joined senior staff from across the federal government to submit a joint letter to [the Appraisal Foundation, which sets standards for appraisers,] emphasizing that federal prohibitions against discrimination under the [FHA and ECOA] extend to appraisals."²⁹

Given this focus on addressing discriminatory home appraisal and valuation activities, the CFPB's potential specification of a nondiscrimination quality control factor for AVMs is not surprising. This increased focus on valuations and related matters should prompt banks and other entities involved in home mortgage origination to consider taking a fresh look at and, if needed, modifying their fair lending risk assessment processes to ensure they encompass non-discriminatory home appraisal and valuation activities, including AVMs, whether conducted in-house, by an affiliate, or by a third-party provider. If a bank's processes

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identify unaddressed fair lending risks involving AVMs, appropriate mitigating controls should be implemented.

The CFPB's outline is a preliminary step aimed at informing the CFPB's AVM rulemaking efforts. All potentially affected entities will have the opportunity to comment once the AVM Rules are proposed. The CFPB is coordinating with the other specified agencies on the anticipated AVM Rules, and the CFPB's outline may foreshadow matters those agencies are also considering. The CFPB has invited small entities to provide feedback by April 8, 2022, and other stakeholders by May 13, 2022. Beyond AVMs, the outline's attention to potential bias in algorithms more generally is consistent with a long-standing priority of CFPB Director Rohit Chopra.³⁰ Indeed, within days of confirmation, Director Chopra indicated that algorithmic bias would be a CFPB priority.³¹ Subsequently, the CFPB voiced concerns in its strategic plan "about the racial equity impacts from increased usage of data and algorithms in making decisions about people in financial markets"³² and encouraged tech workers who have knowledge of algorithmic bias to report it to the CFPB.³³

Larger banks typically employ algorithmic systems for a wide array of purposes, many of which are wholly unrelated to home appraisals or valuations. For this reason, the CFPB's statement in the outline that algorithmic systems *in general* are subject to federal nondiscrimination laws is also notable—even more so when coupled with the CFPB's further indication that the disparate impact theory of discrimination extends to such systems. We expect algorithmic bias to continue to be a focus of the CFPB in the coming months, including in examinations. Moreover, we anticipate the CFPB will be on the lookout to bring enforcement actions showcasing this priority. Accordingly, entities the CFPB supervises or that utilize services offered by such entities should consider taking a fresh look at their fair lending risk assessment processes to ensure they encompass any algorithmic systems the entity directly or indirectly employs that may implicate federal nondiscrimination laws. Again, if processes identify unaddressed fair lending risks, appropriate mitigating controls should be implemented.

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ENDNOTES

- 1 Public Law 111-203, 124 Stat. 1376 (2010), section 1473(q), 124 Stat. 2198 (codified at 12 U.S.C. § 3354).
- 2 Outline at 3, 28-29. According to the CFPB, small entities likely to be directly affected and within the purview of the CFPB’s enforcement authority include real estate credit companies, secondary market financing companies, mortgage loan brokers, mortgage loan servicers, and other non-depository companies related to credit intermediation, and the vast majority of these entities are small.
- 3 See, e.g., Financial Stability Board, Artificial intelligence and machine learning in financial services: Market developments and financial stability implications (Nov. 2017), *available at* <https://www.fsb.org/wp-content/uploads/P011117.pdf>; KPMG, Algorithmic bias and financial services: A report prepared for Finastra International (March 2021), *available at* https://www.finastra.com/sites/default/files/documents/2021/03/market-insight_algorithmic-bias-financial-services.pdf.
- 4 The CFPB has identified “several categories of small depository institutions whose use of AVMs may be directly affected,” even though they are not subject to the CFPB’s enforcement authority, “including commercial banking institutions, savings institutions, credit unions, and other depository institutions related to credit intermediation with assets of \$600 million or less.” The CFPB estimates these small depository institutions constitute approximately 83 percent of depository institutions. Outline at 4 and n.122. The Federal Housing Finance Agency must also issue regulations under the same Dodd-Frank Act provision. 12 U.S.C. § 3354(b).
- 5 Although the CFPB is collaborating with regulators on an AVM rulemaking, the proposals reflected in the outline “should not be construed to represent the views or recommendations of the other agencies[.]” Outline at 4.
- 6 Whenever the CFPB is considering proposing a rule that might have a significant economic impact on a substantial number of small entities, the Regulatory Flexibility Act, as amended by section 1100G of the Dodd-Frank Act, requires the CFPB (but not the other agencies) to convene a Small Business Review Panel to collect advice and recommendations from small entities that are likely to be subject to the rule. See 5 U.S.C. § 609(b), as amended by section 1100G of the Dodd-Frank Act. The CFPB published the outline with a view toward satisfying this requirement.
- 7 Dodd-Frank Act section 1473(q), 124 Stat. 2198 (codified at 12 U.S.C. § 3354).
- 8 12 U.S.C. § 3354(c).
- 9 12 U.S.C. § 3354(d).
- 10 Outline at 24.
- 11 *Id.*
- 12 *Id.*
- 13 *Id.*
- 14 Outline at 23. According to the outline, AVMs may also be subject to state and local nondiscrimination laws. Outline at note 92.
- 15 Outline at 23.
- 16 *Id.*
- 17 Outline at 24.

ENDNOTES (CONTINUED)

- 18 *Id.*
- 19 *Id.*
- 20 *Id.*
- 21 *Id.*
- 22 *Id.*
- 23 See, e.g., Perry, Rothwell and Harshbarger, The Devaluation of Assets in Black Neighborhoods, *Brookings Metropolitan Policy Program*, November 2018, available at <https://www.brookings.edu/research/devaluation-of-assets-in-black-neighborhoods/>; Howell and Korver-Glenn, The Increasing Effect of Neighborhood Racial Composition on Housing Values, 1980-2015, *Social Problems*, Vol. 68, Issue 4, pp. 1051-1071 (Nov. 2021), available at <https://academic.oup.com/socpro/article/68/4/1051/5900507?guestAccessKey=3f763018-8869-4fd9-ba21-987daa73e324&login=false>; Williamson and Palim, Appraising the Appraisal, Fannie Mae (Feb. 2022), available at <https://www.fanniemae.com/media/42541/display>; and Racion and Ethnic Valuation Gaps In Home Purchase Appraisals, Freddie Mac (Sept. 20, 2021), available at <https://www.freddiemac.com/research/insight/20210920-home-appraisals>.
- 24 Memorandum of Jan. 26, 2021, Redressing Our Nation's and the Federal Government's history of Discriminatory Housing Practices and Policies, 86 Fed. Reg. 7487 (Jan. 29, 2021).
- 25 Fact Sheet: Biden-Harris Administration Announces new Actions to Build Black Wealth and Narrow the Racial Wealth Gap (June 1, 2021), available at <https://www.whitehouse.gov/briefing-room/statements-releases/2021/06/01/fact-sheet-biden-harris-administration-announces-new-actions-to-build-black-wealth-and-narrow-the-racial-wealth-gap/>.
- 26 CFPB Prioritizing Resources Against Racial Bias in Home Appraisals (July 2, 2021), available at <https://www.consumerfinance.gov/about-us/blog/cfpb-prioritizing-resources-against-racial-bias-home-appraisals/>.
- 27 See, e.g., ABC News 7, Black California couple lowballed by \$500K in home appraisal, believe race was a factor (Feb. 12, 2021), available at <https://abc7news.com/black-homeowner-problems-sf-bay-area-housing-discrimination-minority-homeownership-anti-black-policy/10331076/>.
- 28 See Statement of Interest of the United States, *Tenisha Tate-Austin, et Al. v. Janette C. Miller, et al.*, 21-cv-09319 (filed Feb. 14, 2022).
- 29 CFPB, Appraisal discrimination is illegal under federal law (Feb. 4, 2022), available at <https://www.consumerfinance.gov/about-us/blog/appraisal-discrimination-illegal-under-federal-law/>.
- 30 See, e.g., Prepared Remarks of Federal Trade Commissioner Rohit Chopra, Silicon Flatirons Conference (Feb. 10, 2019), available at https://www.ftc.gov/system/files/documents/public_statements/1453633/remarks_of_commissioner_chopra_at_silicon_flatirons.pdf.
- 31 Remarks of Director Rohit Chopra at a Joint DOJ, CFPB, and OCC Press Conference on the Trustmark National Bank Enforcement Action (Oct. 22, 2021), available at <https://www.consumerfinance.gov/about-us/newsroom/remarks-of-director-rohit-chopra-at-a-joint-doj-cfpb-and-occ-press-conference-on-the-trustmark-national-bank-enforcement-action/>.
- 32 CFPB Strategic Plan, FY 2022 – 2026, p. 7, available at https://files.consumerfinance.gov/f/documents/cfpb_strategic-plan_fy2022-fy2026.pdf.
- 33 CFPB calls tech workers to action (Dec. 15, 2021), available at <https://www.consumerfinance.gov/about-us/blog/cfpb-calls-tech-workers-to-action/>.

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