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Regulatory Alert

Regulatory Insights

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Addressing inequity

Our POV, [Algo risk: Mitigating potential bias](), discusses how developing or enhancing the appropriate compliance controls and governance frameworks around algorithms and AI models can help to mitigate differences across access, treatment, and impact while also bolstering corporate compliance and ESG initiatives.

Key points

- Public policy attention to diversity and inequity will drive regulatory attention into 2021.
- Attention to racial, social, and economic inequalities has forced all industries, including financial services, to address diversity in areas of employment and, more broadly, disparities in the fair and ethical access to, and use of, products and services.
- Within financial services, attention includes a focus on:
  - Board and executive management composition, recruiting/retention, and succession planning
  - Product/Service access and delivery (branch network, mobile/digital access, product/service offerings)
  - Investments targeted to expand economic opportunity, support ESG commitments, and address demographic disparities
  - Resolving/Reducing bias risk, especially given the expanded use of algorithms and AI.

The U.S. is involved in a broad-based discussion of racial, social, and economic equity and inclusion. Measures implemented to address the impact of COVID-19 have served to amplify the breadth and tenor of this discussion and have heightened the urgency to find resolution. Further, "ESG" has expanded into a Main Street issue as disparities related to important social factors become clearer, including: workplace safety; employee health and well-being; job security; customer engagement; community investment; and corporate leadership and innovation.

Financial services organizations are engaging in this discussion in two ways. First, they are reviewing their

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internal operations to expand awareness, promote inclusion, and implement change. Secondly, they are looking to reduce/prevent direct and indirect bias in their customer interactions by promoting programs, processes, and controls to support fair treatment, credit access, and wealth accumulation. Concerns about reducing bias risk are magnified by the increasing use of algorithms and AI models, which are being used across organizations for their power to better predict risk, recommend future courses of action, or help with market growth in underserved communities, but may also introduce bias risk.

Financial services regulators are similarly looking to address disparities within their organizations and business operations – supervision. They are actively studying potential disparate impacts of financial services policies as well as financial services organizations' compliance with laws and regulations promoting diversity, inclusion, and fairness. ESG factors, including employee health and safety, customer/investor/community support, and continuity of critical operations, are also under review.

Forward-Looking Regulatory Actions

The federal financial services regulatory agencies encourage financial institutions to actively assist customers in financial distress through prudent actions consistent with safe and sound practices, while cautioning that such efforts should adhere to consumer protection requirements, including fair lending laws, to provide the opportunity for all borrowers to benefit from these arrangements. In response to widespread attention on racial, social, and economic disparities over the past few months, these regulators have announced a variety of actions and efforts to understand the roots of disparities/inequities in the delivery of financial products and services and to implement changes. This will be an area of continued public policy and regulatory attention through 2020 and 2021; the most recent actions include the following:

National Association of Insurance Commissioners (NAIC):

- Formed a special committee to focus on Race and Insurance. The committee is charged with making recommendations by year-end 2020 to:
  - Increase diversity and inclusion among insurance regulators and the insurance industry
  - Address practices that potentially disadvantage minorities (to include sales, pricing, and underwriting)
  - Ensure ongoing engagement of the NAIC on these issues.

Federal Reserve Board (FRB):

- Reiterated its commitment to diversity and inclusion among its workforce, specifically calling out opportunities for women.
- Published, through the Federal Reserve Bank of New York (FRBNY), a five-part blog series looking at inequality in credit market access, including heterogeneity based on race, age, geography and income, and its implications for economic well-being. The series covers 1) home ownership, 2) evictions, 3) higher education and student debt outcomes, 4) effects of college tuition subsidies, and 5) Medicare and financial health.
- Published, through the FRBNY, a brief examining why Black firms have been nearly twice as likely to close in during COVID-19. The findings suggest 1) Black-owned firms are more likely to be located in COVID-19 hot spots; 2) there were gaps in the coverage of the PPP; and 3) Black firms generally were "financially disadvantaged" (e.g., weaker cash positions, weaker bank relationships, and preexisting funding gaps) at the onset of COVID-19.

Office of the Comptroller of the Currency (OCC)

- Noted in its Semi-Annual Risk Perspectives report that compliance risk is elevated across banking institutions because of the combined impact of multiple factors brought on by COVID-19, including altered operations, remotely working employees, and the swift roll-out of multiple new federal and state programs such as the Paycheck Protection Program (PPP) and forbearance programs. OCC states that, collectively, these factors increase the risk of disparate treatment and disparate impact and encouraged banks to proactively monitor and document activities to ensure fair and consistent assistance and support to applicants and borrowers.
  - OCC specifically encouraged banks providing PPP loans to document their implementation and lending decisions and to identify and track the PPP loans made to certain small business borrowers located in low- to moderate-income (LMI) areas.
  - Complaints have been lodged against the PPP alleging minority-owned and other underserved businesses have not been able to access the program funds and that some lenders prioritized large existing customers over other applicants.

Under the program, demographic data in loan and forgiveness applications is voluntary.

Securities and Exchange Commission (SEC):

— Created a Small Business Capital Formation Advisory Committee to focus on how capital markets are serving "underrepresented founders, including minorities and women," and potential regulatory solutions to "enable a more inclusive capital formation ecosystem."

Consumer Financial Protection Bureau (CFPB):

— Published a request for information (RFI) to help identify opportunities for CFPB to promote fair, equitable, and nonbiased access to credit and encourage responsible innovation that can increase access to credit for all consumers. CFPB has also published blog posts related to the RFI, covering:

— Adverse action notices when using innovative AI/machine learning models

— Special purpose credit programs to meet the credit needs of underserved communities

— Fair and equitable access to credit for minority- and women-owned businesses

— Responsibility for upholding ECOA and Regulation B through compliance examinations, enforcement actions, education outreach, and legislative authority.

Published insights from its Making Ends Meet Survey, which surveyed "adults with a credit record" about how they handle financial shortfalls and subsequent financial difficulties. The survey found "on average, African Americans were more than twice as likely as non-Hispanic whites to have difficulty paying a bill or expense and that this difference persists when controlling for income, age, gender, education, and rural status." (July 2020)

For additional information please contact Amy Matsuo, Todd Semanco, Mike Lamberth, or Yuriy Tchamourliyski.

Additional materials:
Recent KPMG Regulatory Alerts focusing on ESG risks are available here and here.

Recent Point of View, *Algo risk: Mitigating potential bias,* is also available here.

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