Compliance Insights

Your monthly compliance news roundup

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Federal Reserve to Develop Real-Time Payment and Settlement Service to Support Faster Payments

On August 5, 2019, the Federal Reserve Board (FRB) announced plans to develop a new interbank round-the-clock and real-time gross settlement service called the FedNow Service to support faster payments. With integrated clearing functionality, FedNow will involve the settlement of interbank obligations through entries in banks' master accounts at the Federal Reserve Banks. The planned service will support domestic transfers up to $25,000 with processing times expected to be seconds. Participation in FedNow, which is expected to launch in 2023 or 2024, will be limited to depository institutions that are eligible to establish a master account at the FRB.

The FRB believes that consumers living paycheck to paycheck would benefit from easier methods to pay bills and cash paychecks quickly without relying on high cost borrowing or incurring overdraft fees and penalties. The FRB's goal is to provide a national payments solution for all depository institutions, large and small.

While smaller banks and credit unions have applauded the prospect of FedNow competing with the real-time payment system currently used in the private sector, some larger institutions have been critical, raising concerns about FedNow's functionality, its effect on innovation, and data collection. The opponents of FedNow question its future interoperability with other real-time payment systems and have suggested that the 4-to-5 year launch date is too long and will hamper innovation as financial institutions take a "wait and see" approach.

In the meantime, financial institutions should consider the regulatory and operational implications of adopting FedNow or another real-time payment system. Key regulatory risks include anti-money laundering, sanctions and fraud. Heightened credit and liquidity risks will also exist as depository institutions will be required to monitor carefully transactions in

real time to cover payments within their master accounts. The FRB has not yet indicated how transaction monitoring, reporting, and blocking may work for FedNow. In addition, the FRB's supervisory role is uncertain. While the FRB does not regulate payment systems, it may increase its regulatory scrutiny over risk management systems in place to handle real-time payments.

The plans for FedNow are now open for comment. Financial institutions should review the full announcement and the FAQ document, and submit comments to have their considerations taken into account. The period to submit comments is within 90 days of August 9, 2019, as published in the Federal Register.

New Money Laundering Rules for Cryptocurrency Exchanges

In June 2019, the Financial Action Task Force (FATF) imposed further enhancements to the oversight of virtual assets (VAs), such as cryptocurrency, and virtual asset service providers (VASPs), demonstrating its continued concern about risks posed by new technologies. FATF is an inter-governmental body which sets standards, develops and promotes policies to combat money laundering and terrorist financing on an international basis.

The most notable contribution of FATF to the global anti-money laundering (AML) cause is the FATF Forty Recommendations (FATF Recommendations), a comprehensive framework of measures that countries are encouraged to implement to combat money laundering and terrorist financing. The FATF Recommendations, which were initially established in 1990, have been modified over the years to reflect evolving money laundering trends and advancements in technology.

FATF Recommendation 15 requires an assessment of the AML and countering the financing of terrorism (CFT) risks that may arise in relation to new products, business practices, and new or developing technologies. In October 2018, Recommendation 15 was amended to specifically recommend that countries regulate VASPs for AML/CFT purposes, including ensuring that such entities are licensed or registered and subject to effective systems for monitoring.

The FATF Glossary was also amended to define VAs and VASPs specifically. A VA is defined as a digital representation of value that can be digitally traded or transferred and can be used for payment or investment purposes. The term VASP generally includes individuals or entities that are involved in exchanging, transferring, safekeeping or other activities related to VAs. Importantly, VAs do not include digital representations of fiat currencies, securities, and other financial assets already covered by the FATF Recommendations.

In June 2019, FATF enhanced its October 2018 guidance by issuing an Interpretive Note to Recommendation 15 (INR 15) to clarify the prior amendments and further describe compliance responsibilities. INR 15 requires that countries apply a risk-based approach to managing the risks of VAs and VASPs, and take steps to ensure that VASPs implement the full range of AML/CFT preventive measures, such as customer due diligence, recordkeeping, suspicious transaction reporting, and sanction screening. INR 15 also requires compliance with Recommendation 16, which requires that financial institutions include originator, beneficiary, and transaction information on wire transfers and related messages, and that the information remain with the wire transfer or message throughout the payment chain.

Cryptocurrency has become an established component of the global financial system. Although the legal and regulatory obligations associated with this emerging technology are still developing, the new FATF guidance is a significant step. Regulators and other government authorities are paying more attention to this sector and this focus will likely remain. Entities involved in VAs, directly or indirectly, must learn to accept and adapt to the evolving regulatory landscape to help ensure their future viability.

HUD Proposes Disparate Impact Rule

On August 16, 2019, the Department of Housing and Urban Development (HUD) published a proposed rule amending its current disparate impact rule (2013 Disparate Impact Rule) to reflect and align with its interpretation of the Supreme Court's 2015 ruling in *Texas Department of Housing and Community Affairs v. Inclusive Communities Project, Inc.* The proposed rule, if implemented, would establish new standards for plaintiffs attempting to establish a *prima facie* disparate impact claim.

Title VIII of the Civil Rights Act of 1968 (Fair Housing Act or the Act), as amended, prohibits discrimination in the sale, rental, or financing of dwellings and in other housing-related activities on the basis of race, color, religion, sex, disability, familial status, or national origin. Pursuant to its congressional authority, HUD established a disparate impact rule in 2013 to address, and create liability for, practices that have a discriminatory effect. Under the 2013 Disparate Impact Rule, HUD established a 3-part "burden-shifting framework" consisting of the following elements:

- First, the plaintiff must prove that the practice at issue caused or predictably will cause a discriminatory effect. A practice has a "discriminatory effect" when it actually or predictably results in a disparate impact on a group of persons or creates, increases, reinforces, or perpetuates segregated housing patterns because of race, color, religion, sex, handicap, familial status, or national origin.

- If the plaintiff establishes a discriminatory effect, the defendant has the burden of proving that the challenged practice is necessary to achieve a substantial, legitimate, non-discriminatory interest. Such interests must be supported by evidence and cannot be hypothetical or speculative.
- If the defendant meets the burden of establishing a substantial, legitimate, non-discriminatory interest, the plaintiff may still prevail by proving that the challenged practice could be served by another practice that has a less discriminatory effect.

The proposed rule maintains the burden-shifting framework while imposing more specific standards for establishing a *prima facie* case. The rule requires that a plaintiff's allegation plead facts supporting the following five elements:

- That the challenged policy or practice is arbitrary, artificial, and unnecessary to achieve a valid interest or legitimate objective.
- That there is a robust causal link between the challenged policy or practice and a disparate impact on members of a protected class.
- That the alleged disparity caused by the policy or practice has an adverse effect on members of a protected class.
- That the alleged disparity caused by the policy or practice is significant.
- That there is a direct link between the disparate impact and the complaining party's alleged injury.

The proposal provides that a defendant may rebut a claim of disparate impact at the pleading stage by showing that a plaintiff's allegations do not support a *prima facie* case through one of the following three methods:

- The defendant may show that its discretion is materially limited by a third party—such as through a federal, state or local law—or a binding or controlling court, arbitral, regulatory, administrative order, or administrative requirement.
- In instances where the defendant's offending policy or practice relies on a proprietary algorithmic model, a defendant has three options. First, the defendant can identify the inputs used by the model, demonstrate that these factors are not proxies for protected classes under the FHA and show how the model is a valid predictor of risk or other valid objectives. Second, the defendant

may also show that the challenged model is produced, maintained, or distributed by a recognized third party that determines industry standards, that the inputs and methods are not determined by the defendant, and the defendant is using the model as intended. Third, the defendant may show that the model has been subjected to critical review and has been validated by an objective third party that has found the model to be statistically sound and to accurately predict risk or other valid objectives without relying in any material part on factors that are substitutes or close proxies for protected classes under the FHA.

- The defendant may also simply demonstrate that the plaintiff has failed to allege sufficient facts to establish a prima facia case.

Assuming the case is not resolved at the pleadings stage, the Proposed rule also defines the burden of proof for both parties to the action.

Undoubtedly, the additional burdens proposed will prove a significant hurdle for many plaintiffs seeking to bring forward a complaint under the Fair Housing Act. HUD, however, is not the only agency with fair housing, discrimination, and disparate impact in its sights. In the preamble to its Fall 2018 Rulemaking Agenda, the Consumer Financial Protection Bureau (CFPB) noted that it "*is reexamining the requirements of the Equal Credit Opportunity Act concerning the disparate impact doctrine."* While this statement affords the CFPB flexibility to move in a number of directions with relation to disparate impact under ECOA, it is not likely that it will act adverse to HUD in relation to the topic.

The public comment period is open through October 18, 2019.

California-Based Bank Settles Redlining Allegations and Lessons Learned for Financial Services Institutions

On July 29, 2019, the U.S. Department of Housing and Urban Development (HUD) approved a settlement between the California Reinvestment Coalition (CRC) and a California-based banking institution. The settlement resolves redlining allegations under the Fair Housing Act (FHA) brought against the bank in February 2017. The redlining allegations state that the bank's branch locations, marketing, and origination of mortgages discriminated against residents of majority-minority neighborhoods within the bank's Community Reinvestment Act (CRA) assessment area.

Redlining is a term used for an illegal practice where residents of an area or neighborhood are not granted the same access to credit by a particular financial institution as residents of

other areas on the basis of race, color, or for some other prohibited reason. Redlining has been a significant focus for the past several years and there are many instances where community groups such as the CRC have alerted regulatory agencies to perceived discriminatory practices. In this case, the bank denied that it violated the FHA or engaged in any discrimination on the basis of race, national origin, or other prohibited factor but entered into a conciliation agreement with the CRC to obtain administrative closure of the matter. Under the terms of the conciliation agreement, the bank has committed to:

- Opening or acquiring a full-service branch within the its CRA assessment area in a census tract that has a majority-minority and low-to-moderate-income population.
- Originating $100 million in home loans to borrowers in majority-minority census tracts within the CRA assessment area.
- Making available loans that can be used for home improvement, refinancing, or home purchase that specify no minimum loan amount.
- Refrain from denying residential loans solely on the ground that the applicant has a tax identification number rather than a social security number and to ensure a second-level review process for all denied residential loan applications.
- Making available $5 million for an affordable home mortgage program to provide discounts or subsidies on home loans to borrowers in majority-minority census tracts within its CRA assessment area.
- Offering FHA-insured mortgages and other mortgage loan products at all branches and including such mortgage products in all marketing materials at all branches.
- Allocating $1 million in grants to non-profit organizations that provide community services and benefits such as financial literacy and education programs, credit counselling, community revitalization, and similar programs within the bank’s assessment area.
- Dedicating $1.3 million towards advertising and community outreach to consumers in majority-minority census tracts within the assessment area.
- Providing and promoting a language translation service for residential mortgage originations and providing print mortgage marketing materials in all branches in both English and Spanish;

- Requiring employees with residential mortgage lending duties to attend two hours of fair lending training annually.
- Donating $100,000 to the CRC.

An allegation of redlining can present significant costs and complications for a financial institution, even if not proven. As such, it is a risk that should be carefully managed. The traditional visual analysis of a bank's market area which contains loan application data along with demographic information such as minority population percentages is a good place to start. However, an appropriate evaluation of the data also requires consideration of other variables such as branch location and peer-lending data.

Redlining enforcement activities are likely to continue as fair lending risks evolve, the overall marketplace shifts, and consumer credit needs and access to credit changes. Financial services institutions should revisit their overall fair lending programs, beginning with their risk assessment, and ensure their self-testing or monitoring of their lending products include a standard redlining review, as well as a documented root cause analysis. Institutions that truly understand their redlining risk will be best positioned to go to market, meet the credit needs of their communities, and improve their overall profitability.

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