K&L GATES

The Resurgence of Redlining: The Hudson City Savings Bank Settlement and How to Manage Redlining Risk

Melanie Brody, Partner (202.778.9203, Melanie.Brody@klgates.com)
Paul Hancock, Partner (305.539.3378, Paul.Hancock@klgates.com)
Anjali Garg, Associate (202.778.9442, Anjali.Garg@klgates.com)
Olivia Kelman, Associate (305.539.3382, Olivia.Kelman@klgates.com)

Background

BACKGROUND

- Redlining in the fair lending context refers to the practice of **denying financial services**—usually residential mortgage loans—to residents of certain geographic areas based on the racial or ethnic makeups of those areas:
  - "[D]eclaring black areas off-limits for mortgage lending [is] a practice otherwise known as redlining." Press Release, U.S. Department of Justice, "Justice Department Obtains Unprecedented Settlement from D.C. Area Bank [i.e., Chevy Chase] for Allegedly Failing to Service Predominantly Black Areas," (Aug. 22, 1994).

- Historically, red lines were allegedly drawn on maps to indicate neighborhoods in which companies would refuse to do business.

BACKGROUND

- Although the Supreme Court has recognized the application of disparate impact under the Fair Housing Act, the legal theory is not necessarily applicable to all types of claims:
  - "[The Fair Housing Act] covers a variety of practices … . Some practices lend themselves to the disparate impact method, others not." *Village of Bellwood v. Dwivedi*, 895 F.2d 1521, 1533 (7th Cir. 1990).
  - *Dwivedi* held that proof of intent (i.e., disparate treatment) was necessary to show a "steering" violation of the Fair Housing Act.
  - Under that same logic, intent would be required to prove a redlining violation.
- Federal enforcement agencies seem to suggest that redlining could be pursued under a disparate impact theory, although they often merge the concepts in pleadings.

BACKGROUND

- Currently, the term “redlining” is applied much more broadly:
  - The term usually refers to when a lender is statistically shown to have made a smaller proportion of its loans in predominately minority census tracts as compared to non-minority census tracts within the same Metropolitan Statistical Area (“MSA”), as compared to its peer lenders.
  - Now the focus is on whether the lender lends “equally” in minority and non-minority geographies.
- To date, redlining enforcement has focused exclusively on depository institutions due to their Community Reinvestment Act obligations.
- Has the assessment area been drawn in a fair and nondiscriminatory manner?
  - DOJ has frequently contended that a lender’s assessment area should be larger.
- Has the lender properly served minority areas of the assessment area?

BACKGROUND, CONT.

- The CFPB now conducts redlining examinations and investigations on non-depository institutions and has indicated that it expects such institutions to monitor their lending for potential redlining risk.

- CFPB Annual Fair Lending Report (April 28, 2015):
  - “The Bureau had a number of ongoing investigations and authorized lawsuits against institutions that are focused on fair lending. In particular, the Bureau focused its efforts on addressing redlining. . . At the end of 2014, the Bureau had several open investigations of potential redlining.”

- The CFPB has also suggested that it may evaluate non-mortgage products for potential redlining.

Recent Redlining Settlements

RECENT SETTLEMENTS

- Three recent redlining settlements illustrate the resurgence of redlining enforcement:
  - *United States Department of Housing and Urban Development v. Associated Bank, N.A.*, Complaint No. 00-12-003-8 (May 26, 2015)
    - Chicago, IL; Milwaukee, WI; Lake-County-Kenosha County, IL-WI areas
    - HUD-initiated complaint
  - *Consumer Financial Protection Bureau and United States v. Hudson City Savings Bank, F.S.B.* (D.N.J.) (Sept. 24, 2015)
    - NY/NJ MSA; Camden MSA; and Bridgeport, CT MSA
    - CFPB referral
  - *United States v. Eagle Bank and Trust Company of Missouri*, 4:15-cv-01492 (E.D. Mo.) (Sept. 29, 2015)
    - St. Louis, MO metropolitan area
    - FDIC referral

STATISTICAL ALLEGATIONS

Associated Bank	Hudson City	Eagle Bank
"**Compared to other lenders**, [Associated Bank's] lending in majority-minority census tracts was lower than in other neighborhoods, and the difference was statistically significant."	"Analysis of Hudson City's mortgage applications…**as compared to its peers** showed disparities in lending to majority-Black-and-Hispanic neighborhoods between Hudson City and its peers. These disparities are statistically significant and show that there were applicants seeking mortgage loans in majority-Black-and-Hispanic areas in these MSAs."	"Statistical analyses of the [Bank's] residential real estate-related loan applications and originations for each year from 2006 to 2012, show that the defendant served the credit needs of the residents of majority-white census tracts in the Missouri portion of the St. Louis MSA to a significantly greater extent than it served the residential real estate-related credit needs of the residents of majority-black census tracts. During that time, there were statistically significant disparities with respect the defendant's residential real estate lending activity **when compared with similar lenders**."

STATISTICAL ALLEGATIONS, CONT.

Hudson City: Peer Example	Eagle Bank: Peer Example
0.1% of loan applications came from high-Black-and-Hispanic areas in the Camden MSA compared to 4.4% for the Bank's peers (44 times as many).	1.9% of loan applications were related to residential properties located in majority-Black census tracts in the St. Louis MSA. During the same time period, comparable lenders generated 11.1% of their applications from majority-Black Census tracts (five times as many).

QUALITATIVE ALLEGATIONS

Hudson City	Eagle Bank
Branch and broker locations: • Branches located outside of majority-Black-and-Hispanic areas • Accepted mortgage loan applications outside of and not in proximity to majority-Black-and-Hispanic areas • None of the Bank's 7 retail loan officers are Black or Hispanic or can speak Spanish • Heavily concentrated broker network outside of majority-Black-and-Hispanic areas (94.5% of top 50 brokers)	Locations: • All 12 of the Bank's full-service branches in the St. Louis area are located in majority-white census tracts • Of the 17 bank offices, 14 are in census tracts with a minority population of less than 10%; one limited-service facility is in a census with a minority population of 10 to less than 20%; and one full-service and one limited-service facility are in census tracts with a minority population of 20 to less than 50%
Exclusion of majority-Black-and-Hispanic neighborhoods from CRA assessment areas	Exclusion of majority-Black census tracts from CRA assessment areas
Exclusion of majority-Black-and-Hispanic neighborhoods from the Bank's limited marketing efforts	Failure to market mortgage lending services to Black borrowers or in majority-Black census tracts

QUALITATIVE ALLEGATIONS, CONT.

Hudson City	Eagle Bank
Failure to monitor for redlining despite the CFPB’s 2012 recommendation to do so	N/A
Failure to hire sufficient staff to ensure compliance with its fair lending obligations	N/A

SETTLEMENTS: FINANCIAL TERMS

Associated Bank	Hudson City	Eagle Bank
No civil money penalty	$5.5 million civil money penalty to the CFPB	No civil money penalty
$9.54 million in subsidies for qualified loan applicants in certain majority-minority census tracts	$25 million in loan subsidies to qualified applicants in majority-Black-and-Hispanic neighborhoods (up to $18,750 per individual applicant)	$800,000 in loan subsidies for home mortgage or small business loans (up to $20,000)
Originate, fund, or purchase $190.8 million in mortgage loans in certain majority-minority census tracts	N/A	N/A
$3 million in affordable home repair grants	N/A	N/A
N/A	$750,000 on community development partnership programs	N/A

SETTLEMENTS: FINANCIAL TERMS CONT.

Associated Bank	Hudson City	Eagle Bank
$1.4 million in affirmative marketing and outreach	$200,000 per year on targeted advertising and outreach, including at least two print media, radio advertisements on two radio stations, point of distribution materials, and direct mailings directed to African American and Hispanic consumers and quarterly outreach programs	$25,000 per year on targeted advertising and marketing, including one print media, two radio stations, point of distribution materials, and direct mailings targeted toward majority-African-American census tracts and quarterly outreach programs
$1.35 million for CRA training and education	$100,000 per year on consumer financial education programs	$18,750 per year on consumer financial education and credit repair programs (including HUD-approved financial education counselors, special purpose checking accounts, or debt forgiveness)

SETTLEMENTS: PROSPECTIVE RELIEF

Associated Bank	Hudson City	Eagle Bank
Open four loan production offices in certain majority-minority census tracts within 30 months of the Agreement	Open or acquire two new full-service branches within majority-Black-and-Hispanic neighborhoods in retail-oriented spaces in visible locations within 18 and 30 months, respectively	Open two new branches within 18 months (one already scheduled to open at the end of 2015)
Fair lending training	Fair lending training	Fair lending training
Second-level review policy for denied applications	N/A	N/A
Financial education programs	Sponsor a minimum of 12 financial education events per year	Sponsor a minimum of 12 financial education events per year

K&L GATES

SETTLEMENTS: PROSPECTIVE RELIEF

Hudson City	Eagle Bank
Compliance plan, including policies and procedures to select and oversee brokers to address redlining risk and **statistical monitoring** for redlining risk including peer analysis of applications and originations from majority-Black-and-Hispanic neighborhoods	N/A
Revise CRA assessment areas to include specified locations	Modify CRA assessment area to include specified locations (already completed in 2013)
Credit needs assessment of majority-Black-and-Hispanic neighborhoods	Credit needs assessment of majority-African-American census tracts
Hire or designate a full-time Director of Community Lending	Designate a full-time Director of Community Development
Ensure that existing branches in majority-Black-and-Hispanic neighborhoods accept mortgage loan applications	N/A

K&L GATES

SETTLEMENTS: PROSPECTIVE RELIEF

Hudson City	Eagle Bank
Ensure that at least 8% (or three) loan officers are assigned to serve branches and loan production offices in majority-Black-and-Hispanic neighborhoods	N/A
	Develop a community development partnership program to provide credit, financial, homeownership, small business, and/or foreclosure prevention services to the residents of majority-African-American census tracts

Recommendations

EVALUATING REDLINING RISK

- Using recent settlements as a guide, lenders should consider evaluating their redlining risk using both qualitative and statistical metrics.
- Qualitative metrics could include:
  - CRA assessment area
  - Branch locations
  - Geographic focus of advertising and marketing efforts
  - Communities served by brokers
  - Racial/ethnic diversity in sales force

REDLINING MONITORING

- Goal of redlining testing is to identify geographies in which the Target Lender may be viewed as underserving residents of majority minority census tracts, as compared to its "peer" lenders.
- Unlike other types of fair lending testing (e.g., underwriting and pricing), there is neither a commonly-accepted analytical approach nor a generally-accepted standard for concluding whether a particular lender's activity presents legal risk.
- Therefore, lenders should consider using redlining testing results as a tool for identifying geographies in which they might consider prioritizing minority-area lending outreach efforts, as opposed to a basis for concluding whether they have violated the Fair Housing Act and/or Equal Credit Opportunity Act.

REDLINING MONITORING, CONT.

- To perform redlining testing, statisticians use Home Mortgage Disclosure Act ("HMDA") data to compare the Target Lender's loan application and origination activity to that of its peer lenders.
- HMDA data becomes publicly available in September or October of the calendar year following the year in which the lending activity occurred.
- 2014 HMDA data has been released.
- Statisticians therefore can perform redlining testing on a Target Lender's 2014 lending activity, as compared to its peers' 2014 lending activity.

REDLINING MONITORING, CONT.

- There are numerous analytical approaches for performing redlining tests—there is no “gold standard.” Two commonly used ones are:
  - Comparative (proportional) distribution: compares the Target Lender to peer lenders in the overall market, based on the percentage distribution of each lender’s loans between high-minority (>=75% minority) and low-minority (<=25% minority) census tracts.
  - Market share: compares the Target Lender’s market shares in high-minority and low-minority census tracts as compared to its peer lenders’ market shares.
- But lenders also may want to consider loan volume distribution, which compares the Target Lender’s loan application and/or origination **unit volumes** in majority-minority neighborhoods with that of other peer lenders in majority-minority neighborhoods.

REDLINING MONITORING, CONT.

- Testing:
  - Testing is usually performed only on MSAs in which the Target Lender has a certain minimum volume of loans (e.g., the lender made at least 100 loans in the year being reviewed).
  - At a minimum, define peer lenders as those lenders that had an origination volume in the applicable market with 50%—200% of the target lender's lending volume.
- The testing features described above are "conservative," meaning that we did not use testing methods (e.g., more granularly defining peers) that may improve the overall results.
- For example, if the Target Lender does not make FHA loans, it may be appropriate to exclude lenders with a large percentage of FHA loans from the peer list.

REDLINING MONITORING, CONT.

- Sample Results:
  - The following chart presents hypothetical results for a Hypothetical MSA.
  - In the Hypothetical MSA:
    - Target Lender made a total of 500 loans. 20% of them were in high-minority tracts and15% of these loans were in low-minority census tracts.
    - The ratio of Target Lender's high-minority share to low-minority share is 1.33 (20/15 = 1.33).
    - In comparison, all of Target Lender's peer lenders combined made a total of 50,000 loans. 15% of these loans were in high-minority census tracts, and 19% of them were in low-minority tracts.
    - The ratio of all peer lenders high-minority share to low-minority share is 0.79 (15/19 = 0.79).
    - This means the target lender had 1.33 times as much lending in high-minority tracts as in low-minority tracts, whereas its peers had only 0.79 times as much lending in high-minority tracts as in low-minority tracts.
    - In other words, Target Lender out-performed its peers in its rate of lending in high-minority tracts.

Defending Redlining Claims

DEFENDING REDLINING CLAIMS

- Does redlining require proof of intentional discrimination? Can proof of a disparate impact establish liability for redlining?
- "Redlining" by definition envisions intentional discrimination, but enforcement agencies appear to contend that redlining claims can be brought under a disparate-impact legal theory.
- The definition of redlining has evolved, and at present, it appears the government's focus is on equality of outcomes between minority and non-minority communities.
- The government's approach to redlining claims:
  - The initial focus is on whether an institution has fairly drawn its assessment area.
  - The question becomes whether the institution is meeting the credit needs of all segments of the community that it serves.

K&L GATES

DEFENDING REDLINING CLAIMS

- An institution facing a redlining claim should defend its assessment area.

- Data necessary to perform a redlining analysis is not complex, but careful thought is required in order to select the appropriate data, peers, and analytical methodology to provide a fair evaluation of a lender’s performance.

- The Community Reinvestment Act does not always impose an obligation that requires an institution to serve the entire MSA in which it operates.

DEFENDING REDLINING CLAIMS

- Institutions should carefully examine the “peer” question, and should consider how their “peers” can appropriately be defined.
  - For example, community banks might appropriately be compared to other community banks.

- Carefully consider the products offered by other lenders in selecting peers:
  - Compare performance by product, if appropriate.

- Peer review is necessarily a rear-view mirror analysis because HMDA data is not made available until the following year.

DEFENDING REDLINING CLAIMS

- Can "niche" lenders be liable for redlining?
  - Non-FHA lenders arguably should be compared to other non-FHA lenders.

- "Provided the lender did not adopt its 'niche' under circumstances from which a discriminatory purpose could fairly be inferred, and that the lender's 'niche' marketing is consistently applied, I would not generally expect the Department [of Justice] to prosecute on the basis of such 'niche' lending practices." Letter from Deval L. Patrick, Assistant Attorney General, U.S. Dept. of Justice, "Department of Justice Fair Lending Enforcement Program," (Feb. 21, 1994).
  - Query whether the current administration would agree with these views.

DEFENDING REDLINING CLAIMS

- Institutions should consider alternate methods of performing redlining analyses:
  - Consider performing a loan volume distribution analysis.
  - Consider performing an analysis segmented by product.

- Consider segmenting a redlining analysis to more accurately answer the question of whether an institution is helping to meet the credit needs of all communities in its assessment area.

K&L GATES

DEFENDING REDLINING CLAIMS

- Federal agencies have pushed the concept of “redlining” far beyond its original limits.
- In many respects, “redlining” claims have simply become a demand for racial and ethnic quotas.
- Under a proportional distribution analysis, a large percentage of lenders always are subject to claims of alleged “redlining.”
  - Approximately half of lenders will necessarily perform worse than the average.
  - Query whether a court would accept this approach.
- At some point, industry members may need to challenge the government’s approach.

K&L GATES