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Fair Lending Year in Review – 2015

Consumer Financial Services Alert

By Melanie Brody, Anjali Garg, and Olivia Kelman

2015 was an action-packed year for fair lending, including a long-anticipated Supreme Court decision on disparate-impact claims under the Fair Housing Act (“FHA”), record-breaking redlining settlements, a new round of indirect auto cases, and (in early 2016) a major setback to the National Fair Housing Alliance’s (“NFHA”) efforts to hold loan servicers and other industry players responsible for the condition of real estate owned (“REO”) property in minority communities. Here is our recap of the major fair lending highlights from 2015.

Supreme Court Rules on Disparate-Impact Claims under the Fair Housing Act

Perhaps the most significant fair lending development in 2015 was the Supreme Court’s June 25, 2015 decision upholding a plaintiff’s ability to bring a disparate-impact claim under the FHA. The Court’s decision recognizing the availability of the disparate-impact theory came as a surprise and disappointment to many industry observers. The opinion, however, also established constraints as to how the theory can be deployed, which should help alleviate concerns about potentially overzealous plaintiffs and complainants.

In *Texas Department of Housing & Community Affairs v. The Inclusive Communities Project, Inc.*,¹ Justice Kennedy, writing for the majority, identified a number of bases for the Court’s decision, including the FHA’s statutory language, appellate court jurisprudence, Congress’ 1988 amendments of the FHA, and public policy reasons.

Although recognizing disparate impact under the FHA, the Court focused much of its analysis on the “important and appropriate means of ensuring that disparate-impact is properly limited.” The Court emphasized that the limitations on the disparate-impact legal theory apply “at the pleading stage” because “prompt resolution of these cases is important.” Relying on *Wards Cove Packing Co. v. Atonio*,² a Title VII employment-law matter, the Court described the “robust causality requirement” a plaintiff must satisfy in a disparate-impact case by identifying a specific policy of the defendant and its link to a statistical disparity. *Inclusive Communities* held that “[g]overnmental or private policies are not contrary to the disparate-impact requirement unless they are artificial, arbitrary, and unnecessary barriers” and noted that businesses should be able to make “practical business choices and profit-related decisions.” Indeed, federal district courts have already begun to apply *Inclusive Communities* to weed out meritless disparate-impact claims.

For plaintiffs, defendants, regulators, and business actors alike, *Inclusive Communities’* guidance as to the contours of a proper disparate-impact claim was a long time coming; in the years leading up to the decision, the Court twice before granted certiorari to resolve the question. Just days before the Court granted certiorari to review the question for the first

¹ 135 S. Ct. 2507 (2015).

² 490 U.S. 642 (1989).

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time in 2012, the petitioners dismissed their appeal,³ causing the House of Representatives to investigate the circumstances of the dismissal.⁴ In 2013, the Court again granted certiorari to hear the question, but the petitioners again abandoned their appeal.⁵

Although *Inclusive Communities* has resolved the question of whether disparate-impact is cognizable under the FHA, an issue still remains as to whether the 2013 disparate-impact rule promulgated by the U.S. Department of Housing and Urban Development (“HUD”) conforms to the limitations of *Inclusive Communities*.⁶ The American Insurance Association challenged the legality of the HUD rule, and the case is currently pending in the U.S. District Court for the District of Columbia.⁷ Although the initial complaint challenged the availability of disparate-impact claims under the FHA, the Association filed a motion for leave to amend its complaint to assert a claim that the HUD rule is inconsistent with the limitations of *Inclusive Communities*. That motion, which was opposed by HUD, is fully briefed and awaiting the district court’s resolution.

In the coming year, the lending industry should pay close attention to developments in the *American Insurance Association* case, as well as focusing on how the regulators apply the disparate-impact theory in examinations and enforcement and how courts apply the theory in litigation.

Redlining

One of the many consequences of the 2008 financial crisis was an across-the-board tightening of consumer finance lending criteria, particularly in the residential mortgage space. Tighter underwriting obviously reduces the risk of default, but also limits access to credit. Consumers who lack significant financial assets and have credit history blemishes are particularly hard hit. As a result, regulators have become increasingly concerned that minority communities (among others) are being harmed by a lack of access to credit. This concern has prompted a renewed focus on redlining practices, with regulators opening numerous redlining investigations against banks and other lending institutions.

In 2015, the federal government settled three cases involving allegations of so-called “redlining.” Historically, the term redlining referred to the practice of denying financial services to residents of certain geographic areas based on the racial or ethnic makeups of those areas. The 2015 enforcement actions were based on alleged quantitative evidence showing statistical disparities in lending activity across minority versus non-minority census tracts, and qualitative allegations relating to branch locations and advertising practices. These settlements require the banks to pay large sums to fund loan subsidies and grant programs and also require the banks to open new branches in majority-minority census tracts, engage in financial education, and implement fair lending training.

In May 2015, HUD entered into a record-breaking settlement with a Midwest bank to resolve allegations of “disparate treatment redlining.” HUD claimed that, as compared to other

³ See Stip. to Dismiss Writ of Certiorari, *Magner v. Gallagher* (Feb. 14, 2012) (No. 10-1032).

⁴ See Press Release, U.S. House of Representatives Comm. on the Judiciary, Members Probe Justice Dep’t on Lawsuit Quid Pro Quo Arrangement (Sept. 27, 2012).

⁵ See Stip. to Dismiss Writ of Certiorari, *Township of Mount Holly v. Mt. Holly Gardens Citizens in Action, Inc.* (Nov. 15, 2013) (No. 11-1507).

⁶ See Implementation of the Fair Housing Act’s Discriminatory Effects Standard, 78 Fed. Reg. 11460, 11469 (Feb. 15, 2013).

⁷ See *American Ins. Ass’n v. U.S. Dept. of Hous. & Urban Dev.*, No. 1:13-00966 (D.D.C.).

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lenders, the bank's lending in majority-minority census tracts was lower than in other neighborhoods. In addition to funding nearly \$10 million in various loan subsidies, marketing, and training programs, the settlement required the bank to originate, fund, or purchase \$190.8 million in mortgage loans in certain majority-minority census tracts. The bank was also ordered to open four loan production offices in certain majority-minority census tracts, implement fair lending training, implement a second-level review policy for denied applications, and provide financial education programs.

In September 2015, the Consumer Financial Protection Bureau ("CFPB") and the Department of Justice ("DOJ") entered into a consent order with a savings bank. The complaint alleged that the savings bank engaged in redlining through its (1) location of branches and loan officers, (2) exclusion of African American and Hispanic census tracts from its Community Reinvestment Act ("CRA") assessment area, (3) use of brokers outside of majority African American and Hispanic neighborhoods, (4) marketing directed at neighborhoods with relatively few minority residents, and (5) exclusion of residents from majority-minority counties from discounted home improvement loans for borrowers with low to moderate incomes. The consent order requires the savings bank to pay a \$5 million civil money penalty to the CFPB and \$25 million in loan subsidies to consumers. The savings bank was also ordered to engage in a variety of remedial measures, including improved advertising, consumer education, expanded branch locations and CRA assessment areas, community partnerships, a credit needs assessment, training, and hiring.

Also in September 2015, DOJ entered into a redlining consent order with another Midwest bank. DOJ alleged that the bank engaged in redlining through (1) location of branches and loan officers, (2) exclusion of majority-African American census tracts from its CRA assessment area, and (3) failure to market mortgage lending services to African American borrowers or in majority-African American census tracts. The bank was ordered to pay nearly \$1 million in loan subsidies, advertising, and consumer financial education and credit repair programs. The bank must also expand branch locations and CRA assessment areas, implement fair lending training and financial education programs, and perform a credit needs assessment.

It is likely that there will be more redlining enforcement in 2016. Although it is becoming clear that regulators expect institutions to monitor their lending activity for potential redlining risk, a uniform standard for identifying violations has not yet emerged. Lenders therefore should consider performing redlining testing, but be sure to interpret the results with particular care.

Auto Lending

2015 proved to be an active year for fair lending enforcement in the auto finance market. Regulators took their first action against a buy-here-pay-here used-car dealership, entered into consent orders with multiple indirect auto lenders, and finalized a rule enabling the CFPB to supervise larger participants in the non-bank auto finance market.⁸

In February 2015, DOJ settled its first discrimination case against a buy-here-pay-here used-car dealership. DOJ and the North Carolina Attorney General alleged that the dealership

⁸ See Melanie Brody, Anjali Garg, Christa Bieker, K&L Gates LLP, *Time for a Tune-up: CFPB Finalizes Rule to Supervise Nonbank Auto Finance Companies and Issues Auto Finance Examination Procedures* (June 24, 2015), available at <http://www.klgates.com/time-for-a-tune-up-cfpb-finalizes-rule-to-supervise-nonbank-auto-finance-companies-and-issues-auto-finance-examination-procedures-06-24-2015/>.

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engaged in “reverse redlining” by allegedly targeting African American borrowers for used car loans using unfair and predatory terms. The parties must establish a \$225,000 settlement fund for affected borrowers. The consent decree also requires the defendants to establish certain written policies and procedures regarding collecting customer financial information, account maintenance, and data retention; improve disclosures; limit monthly payments to no more than 25 percent of a borrower’s total documented monthly net income; limit annual percentage rate to 5 percent below North Carolina’s allowable limit and reduce that rate by at least 3% for certain credit-worthy applicants; ensure sales prices are “competitive,” as defined in the settlement, with other local dealers; follow state and federal law regarding servicing, repossessions, and account closures; post and provide non-discrimination notices; and provide annual training to employees.

In May 2015, the DOJ reached a settlement with an FDIC-regulated bank that makes indirect motorcycle loans for discriminatory pricing. DOJ alleged that the bank allowed dealers to mark up interest rates on motorcycle loans in a manner that was not based on the borrower’s creditworthiness or other objective criteria, resulting in certain minority borrowers paying an average of over \$200 more during the term of the loan. The consent order requires the bank to limit or eliminate the pricing discretion it gives to motorcycle dealers and pay \$395,000 in compensation to those affected by the past practices.

In July 2015, the CFPB and DOJ entered into a joint settlement with an indirect auto lender to resolve discriminatory pricing allegations. The CFPB alleged that dealers charged minority borrowers between 25 and 35 basis points more than similarly situated non-Hispanic white borrowers, which would have caused the same minority borrowers to pay between \$150 and \$250 more than white borrowers over the terms of their loans. The lender was ordered to pay \$24 million in restitution and reduce or eliminate dealer discretion in pricing.

Finally, in September 2015, the CFPB and DOJ entered into a consent order with an indirect auto lending bank to resolve discriminatory pricing allegations. The agencies alleged that the bank allowed dealers to charge minority borrowers higher interest rates of up to 2.5 percentage points above the buy rate in violation of the Equal Credit Opportunity Act. In addition to paying \$18 million in consumer relief, the consent order requires the bank to reduce permissible dealer markups to 100–125 basis points depending on the loan term, and to either (i) allow exceptions to markups if properly documented and monitored or (ii) disallow dealer participation discretion altogether.

Auto finance is clearly a priority for the CFPB and DOJ, and auto lenders should consider evaluating their fair lending compliance efforts to ensure they are positioned to identify areas of risk.

Municipality Lawsuits

Beginning in late 2012, municipalities and other local government entities began filing lawsuits under the FHA against some of the largest banks in the country. The suits allege that the origination of so-called “predatory” loans to minority borrowers caused the borrowers to default, the loans to be foreclosed, property values to decrease, and the plaintiffs to suffer damages in the form of lost property-tax revenues and increased municipal-services expenditures. These lawsuits continue to be litigated in federal district and circuit courts located in Florida, Georgia, California, and Illinois, as well as in California state courts.

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Both the plaintiffs and the defendants in these cases enjoyed significant victories in 2015. To start, two federal district courts in California granted summary judgments on the merits to two large banks on all disparate-treatment and disparate-impact claims filed by the City of Los Angeles. Applying the Supreme Court's *Inclusive Communities* decision, one of the federal courts rejected the challenge to FHA loans holding that the loans benefitted minority borrowers and that "compliance with federal programs and procedures cannot mean that [the bank] created an artificial, arbitrary, or unnecessary barrier" to support a disparate-impact claim. The Court also found that evidence of a disparity that compares thousandths of a percentage is negligible and fails to meet the minimum threshold of *Inclusive Communities*. Because the City of Los Angeles failed to prove any foreclosures of loans originated in the FHA's two-year limitations period, another federal court held that the City of Los Angeles lacked an Article III injury, and thus, the case was time barred. Additionally, a federal district court in Illinois found that Cook County lacked statutory standing because its claims fell outside the FHA's zone of interests, and the court granted the bank's motion to dismiss without prejudice.

On the other hand, the Eleventh Circuit Court of Appeals reversed a Florida district court's order granting the defendants' motions to dismiss with prejudice the complaints filed by the City of Miami and remanded the cases to the district court for further proceedings. The Eleventh Circuit held that the FHA's grant of standing to any "aggrieved person" extends as broadly as is permissible under Article III, and thus the City of Miami alleged statutory standing to sue. The Eleventh Circuit also held that the City of Miami adequately pled proximate cause. Although agreeing that the City of Miami's original complaint was time-barred on its face, the Eleventh Circuit determined the City of Miami should get another chance to try to plead a timely claim. Perhaps emboldened by the Eleventh Circuit's decision, a new lawsuit was filed in the wake of the ruling by the City of Oakland.

Because the municipality lawsuits remain in active litigation, it is difficult to predict how they may or may not impact the industry on a prospective basis. Lenders should keep abreast of developments in these cases, particularly any holdings that characterize certain loan products or product features as "predatory."

NFHA's Administrative REO Complaints

In 2015, NFHA continued its largely unsuccessful crusade to hold mortgage loan servicers, investors, and other institutions responsible for diminishing property values in minority communities. Beginning in 2012, NFHA filed a series of administrative complaints with HUD against several institutions alleging that their REO maintenance practices violated the FHA and harmed minority communities by contributing to deteriorating property values, among other matters.⁹

In a nutshell, NFHA's theory is that post-foreclosure, servicers, investors, property maintenance vendors, and others maintained and marketed REO property in minority communities at a lower standard than in non-minority communities. According to NFHA, the alleged difference in REO maintenance standards destabilizes communities of color, creates health and safety hazards, adds to blight, and burdens local governments.

⁹ See National Fair Housing Alliance, *REO Complaints and Press Releases*, available at <http://www.nationalfairhousing.org/REO/tabid/4265/Default.aspx>.

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Aside from one early settlement, NFHA has yet to achieve any success with these claims, and recently suffered a major setback. In January 2016, HUD issued a no cause determination regarding NFHA's REO maintenance claims against a major institution and dismissed the complaint. Among other matters, the HUD determination stated that NFHA failed to demonstrate a pattern or practice of discrimination, the photographic evidence offered by NFHA failed to prove discrimination, and that an analysis of property preservation expenditures showed no disparities in preservation efforts. NFHA's counsel has stated that NFHA will seek reconsideration of HUD's decision.

Although the NFHA REO maintenance complaints have not gained any traction to date, REO maintenance is nevertheless an important issue, particularly for distressed communities and the institutions that are responsible for managing and marketing foreclosed properties. Such institutions should closely review HUD's no cause determination, and might consider evaluating their practices to identify areas of potential concern.

2015 proved to be an exciting year for fair lending, with a major Supreme Court decision, lawsuits and complaints raising new theories of discrimination, and creative enforcement by the CFPB, HUD and DOJ. We look forward to following, and keeping you informed about, fair lending developments during 2016.

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