

K&L GATES

# Fair Lending Compliance in the Age of Disparate Impact

Melanie H. Brody  
Paul F. Hancock

September 19, 2012

[www.klgates.com](http://www.klgates.com)

## Overview

- Current Legal Standards
  - Theories of Discrimination
  - Applicability of Disparate Impact Under FHA and ECOA
  - Current Enforcement Policy
  - Application of Disparate Impact
  - Proposed HUD Rule
  - Manner of Enforcement by Federal Agencies

## Overview

- New Fair Lending Compliance Issues and Challenges:
  - Application of Disparate Impact
  - Lower Disparity Thresholds
  - CFPB Examination / Enforcement
- Considerations and Suggestions For Managing Fair Lending Risk In:
  - Loan Pricing
  - Underwriting
  - Product Placement
  - Redlining
  - Servicing / Loss Mitigation

## Theories of Discrimination

- Intentional discrimination arises where --
  - Defendant directly referenced an impermissible characteristic in denying a loan or a benefit
  - Although defendant did not outwardly consider an impermissible characteristic, the defendant's denial of a loan or benefit led to "disparate treatment" because of that characteristic
- Unintentional or "disparate-impact" discrimination
  - Although defendant did not have discriminatory animus or consider an impermissible characteristic, the application of a specific business policy or practice nonetheless had a "disparate impact" on particular groups, such as racial or ethnic minorities.

## Disparate Treatment

- What is it?
  - an intentional act of discrimination against an individual “because of their protected characteristic”
  - Whose Intent is at issue?
  - What if no individual actually discriminated, but overall statistics show disparities?
  
- Can proof of Intent arise from results of fair lending monitoring programs?
  - Government filings have been confusing but may suggest a position that continued operation with knowledge of the results is evidence of intentional discrimination.
  - On the other hand, the monitoring results may not establish that discrimination is the “but for” cause of disparities and thus may not be sufficient to establish intentional discrimination. *See Gross v. FBL Fin. Servs., Inc.*, 129 S. Ct. 2343,2345 (2009)

## Disparate Impact

- What is it?
  - the effect of differential results that arise from “practices that are facially neutral in their treatment of different groups but that in fact fall more harshly on one group than another” [\[1\]](#)

[\[1\]](#) *Smith v. City of Jackson, Miss.*, 544 U.S. 228, 239 (2005) (plurality op.)

## Is Disparate Impact Applicable Under Fair Housing Act and ECOA?

- Most lower federal courts have held that the disparate impact theory is applicable.
- Supreme Court decisions in recent years addressing the application of disparate impact under other, but similar, laws have cast doubt on the correctness of those decisions.
- Supreme Court has not yet addressed whether disparate impact is applicable under the Fair Housing Act and/or ECOA.
- The Court was poised to decide the issue under the Fair Housing Act earlier this year in *Magner v. Gallagher*, but the case was settled shortly before the scheduled oral argument.
- The Court is again considering whether to address the issue in a petition for certiorari presented in *Township of Mount Holly v. Mt. Holly Gardens Citizens in Action, Inc.*

## **Enforcement Position of Current Administration**

- The current administration has clearly articulated its view that disparate impact is applicable under both the Fair Housing Act and ECOA. The CFPB has stated its agreement with this position.
- HUD has proposed to amend the Fair Housing Act Rule to more formally adopt the disparate impact theory. The proposed Rule remains under an extended review at OMB and is not yet final.
- A change in Administrations may result in a reversal of this position.
- But, at least until a new Administration or the Supreme Court addresses the issues, lenders must be prepared to address and defend “disparate impact” legal claims.



## Enforcement Position of Current Administration

- Department of Justice:
  - Written testimony of **Assistant Attorney General Thomas Perez** from March 7, 2012 Congressional hearing:
    - “Many of the Division’s pricing cases have relied, in part, on disparate impact analysis to show a violation of law. This approach has been **unanimously accepted by the courts**, and I have made clear that, under my leadership, the Civil Rights Division is using all of the tools in our arsenal to root out discrimination and ensure a level playing field, including utilizing both disparate treatment and disparate impact analysis when supported by the facts” (emphasis added).

## Enforcement Position of Consumer Financial Protection Bureau

- Consumer Financial Protection Bureau:
  - Bulletin 2012-04
    - Expressly takes the position that disparate impact is actionable under the Equal Credit Opportunity Act and Regulation B
    - Not clear from the Bulletin whether the Bureau intends to follow *Wards Cove* in defining the scope of disparate impact liability or the previous language in the Federal Reserve Board Official Staff Commentary to Regulation B
  - Regulation B
    - When the Bureau reissued Regulation B under its transferred authority to administer the Equal Credit Opportunity Act, the Bureau moved the language discussing disparate impact from a footnote into the text of the Regulation

## The *Manner* of Applying Disparate Impact is an Equally Important Issue

- Where does the theory come from?
  - “[P]ractices . . . neutral on their face, and even neutral in terms of intent” cannot be maintained if they result in discrimination. *Griggs v. Duke Power Co.*, 401 U.S. 424 (1971).
  - For years after *Griggs*, disparate impact cases involved challenges to **objective** criteria:
    - *Dothard v. Rawlinson*, 433 U.S. 321 (1977) (requirement that police officers be taller than 5’ 2” and weigh more than 120 lbs. “would exclude 41.13% of the female population while excluding less than 1% of the male population)

## ***Manner of Applying Disparate Impact***

- In *Watson v. Fort Worth Bank & Trust*, 487 U.S. 977 (1988), the Supreme Court noted for the first time that “disparate impact analysis is no less applicable to **subjective** . . . criteria than to objective” practices.
- *Watson* narrowed in important respects by *Wal-Mart Stores, Inc. v. Dukes*, 131 S. Ct. 2541 (2011):
  - Most significant civil rights decision in many years
  - Sex discrimination in employment based on disparate impact allegations
  - The plaintiffs challenged the alleged disparate impact of Wal-Mart supervisors’ **discretionary decision making** authority, relying upon *Watson*
    - Allowing discretion by hundreds of local supervisors is “just the opposite of a uniform . . . practice”
    - No glue holding decisions together to answer the question: “Why was I disfavored?”
    - Discretion is “presumptively reasonable”

## **Wards Cove Decision Provides the Supreme Court Currently Applicable Guidance**

- In *Watson in Wards Cove Packing Co. v. Atonio*, 490 U.S. 642, 656 (1989), an employment discrimination case, the Court articulated this standard:
  - “**Especially** in cases where an employer combines **subjective criteria** with the use of more rigid standardized rules or tests, the plaintiff is in our view responsible for isolating and identifying the specific employment practices that are allegedly responsible for any observed statistical disparities.”
  - Further, the burden of persuasion remains with the plaintiff. The defendant need only produce evidence of a **business justification** or **business consideration** that serves the legitimate goals of the defendant.
- The controversial *Wards Cove* holding led to the 1991 Amendments to Title VII.
  - But there have been **no** comparable amendments to the Fair Housing Act or the Equal Credit Opportunity Act.

## Summary of “Disparate Impact” Application Under *Wards Cove*”

- A plaintiff must:
  1. Identify the **specific policy or practice** of the defendant;
  2. Establish a **disparate impact** through the use of statistical evidence; and
  3. Prove the existence of a **causal link** between the identified policy and the disparate impact.
- Once the plaintiff establishes a prima facie case, the defendant may articulate a **legitimate business justification** for the challenged policy.
- If the defendant articulates a business justification, the plaintiff must rebut the justification by showing that the defendant’s business goal may still be achieved through a **less discriminatory alternative**.

## The Proposed HUD Rule Would Apply a Standard that Differs from *Wards Cove*

- Proposed rule shifts burden of proof to defendant to show “necessary and manifest relationship” that “cannot be served by another practice that has a less discriminatory effect”
  - Both the shifting of the burden and the heightened standard are contrary to *Wards Cove*
  - under the proposed rule simply by showing that a less discriminatory alternative “could” serve the defendant’s business interest
  - *Wards Cove* required that any alternative must not only be “equally effective as” the chosen practice but also must have been known to and rejected by the defendant; it cannot merely be a post-hoc creation by the plaintiff

## Proposed HUD Rule

- Mortgage industry trade associations filed a comment letter opposing the rule
  - Explained that the proposed rule failed to recognize that disparate impact liability was **inconsistent with the plain language** of the Fair Housing Act
  - Explained that the allocation of burdens and standards of proof was **inconsistent with Supreme Court precedent**
  - Cautioned that the proposed rule risked the creation of a **quota** system
  - Noted that recent legislation, including the Dodd-Frank Act, obligated lenders to comply with **more stringent requirements** that might themselves have a disparate impact on minority groups



## Current *Manner* of Enforcement of Federal Agencies

- The Department of Justice and HUD appear to be implementing the standard of the proposed HUD Rule even though it is not final and seemingly conflicts with Supreme Court precedent
- Virtually all disparate impact claims have involved challenges to “subjective” rather than “objective” business policies and practices, most commonly affording “discretion” to employees in performing job duties
  - The agencies rely on the authority of *Watson* and contend that the *Wal-Mart* decision is not applicable to government claims.
- The recent Department of Justice lawsuit against Luther Burbank Savings appears to be the Administration first traditional application of disparate impact to challenge an “objective” rather than a “subjective” lending practice. The Department claimed that the bank’s “implementing and maintaining a \$400,000 minimum loan amount policy in its wholesale lending channel . . . resulted in discrimination on the basis of race and national origin.”

## Fair Lending Compliance Issues and Challenges

- Aggressive Use of Disparate Impact Theory
  - Any statistical disparity across borrower groups may present risk, regardless of whether there are differences in treatment
  - Business justification defense may work in court, but can be a tough sell with government agencies
  - DOJ treats the granting of discretion as a “policy” that can be the basis for a disparate impact claim
    - Provides a basis for holding a lender responsible for differences in wholesale lending outcomes (e.g., cross-broker pricing differences)

## **Fair Lending Compliance Issues and Challenges**

- Pricing Disparity Tolerances Are Much Lower
  - In the past, very small statistical differences, although statistically significant, were not treated as ‘violations’ if they were not economically meaningful
  - Agencies making DOJ referrals, requiring remediation, on very small differences
  - Appear to be moving toward a zero-tolerance standard

## Fair Lending Compliance Issues and Challenges

- CFPB Fair Lending Examinations
  - Conducting fair lending examinations of non-mortgage credit products, *e.g.*, small business loans, payday loans
  - Expectations are sometimes vague and/or still emerging, resulting in uncertainty
  - Examiners have uneven fair lending experience
  - Participation of enforcement lawyers in exam process
  - Tight timing demands
  - Demands for privileged compliance monitoring material

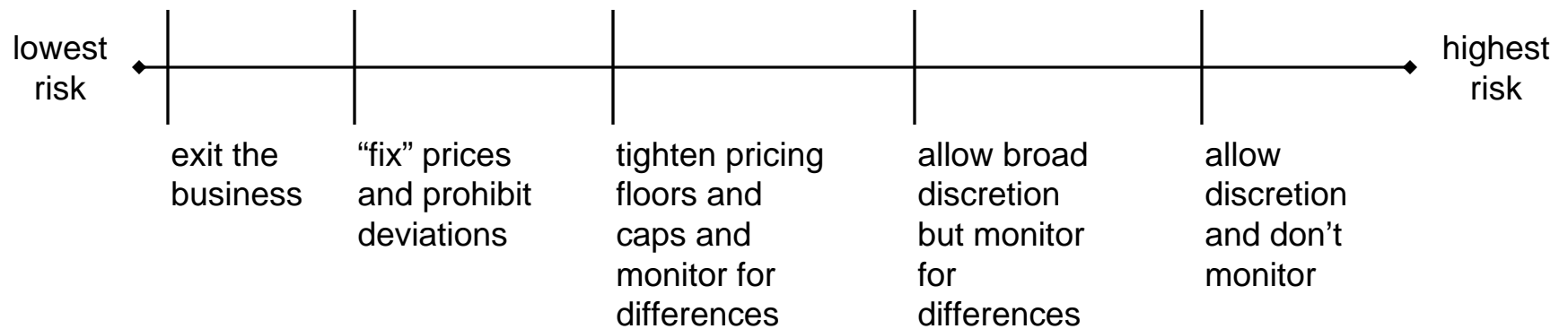
## Key Fair Lending Focal Points

- Pricing
- Underwriting
- Product Placement
- Redlining
- Servicing / loss mitigation

## Managing Pricing Risk

- Mortgage:
  - Loan originator compensation rules mitigated, but did not eliminate, pricing risk for residential mortgage lenders
  - Underages still are an issue
  - Cross-broker compensation differences are still an issue
- Non-mortgage:
  - Significant range of risk across different products
  - Risk largely depends on **level of discretion**

# Managing Pricing Risk - Discretionary Pricing Risk Spectrum



## Managing Pricing Risk

- If pricing is fixed by rule and no exceptions are permitted, consider:
  - Evaluating whether pricing factors raise potential disparate impact concerns
  - Auditing to ensure pricing rules are followed
  - Possibly performing statistical testing to ensure even outcomes across borrower groups



## Managing Pricing Risk

- If pricing discretion is permitted, consider:
  - Narrowing discretion as much as possible
  - Providing comprehensive fair lending training to employees with pricing discretion
  - Requiring reasons for deviations from par and document reasons (*e.g.*, copy of competing offer)
  - Capturing reasons for deviations from par electronically

## Managing Pricing Risk

- If pricing discretion is permitted, consider (continued):
  - Monitoring for pricing differences
    - Work with business, experienced analysts and compliance counsel to structure testing
      - Issues include price metrics to be tested, proper data segmentation, frequency of testing, geographies tested and scope of drill-downs
    - Develop corrective action plan including potentially issuing refunds
  - Wholesale mortgage pricing remains a difficult challenge
    - Consider monitoring closely and consider narrowing discretion if differences persist

## Managing Underwriting Risk

- Underwriting disparities have reemerged in recent years as a fair lending enforcement and examination topic
- Level of risk is related to (i) factors used to make credit decisions, and (ii) degree to which the creditor permits exceptions / judgmental decisions
- Lenders should consider performing a qualitative review of their underwriting criteria to identify potentially problematic factors
  - CFPB has signaled a focus on less discriminatory alternatives

## Managing Underwriting Risk

- Statistical testing / monitoring
  - Evaluate degree of discretion allowed in the underwriting process in determining frequency and scope of monitoring
  - Consider testing overall outcomes and exceptions, if allowed
- Because enforcement cases are largely driven by statistics, lenders should consider capturing exception reasons electronically
- Lenders that decline to make non-QM mortgages may have to defend denial disparities

## Managing Product Placement Risk

- Past cases have involved ‘steering’ of minority borrowers into subprime loan products
- Using the disparate impact theory, DOJ has sought to hold wholesale lenders responsible for product placement outcomes, even though third party mortgage brokers handled product selection discussions with borrowers
- Future product placement issues could include FHA vs. non-FHA, fixed vs. ARM
- Lenders should ensure their compensation and other practices do not incentivize sales personnel to push “less desirable” products

## Managing Product Placement Risk

- Depending on the lender's product options, underwriting process and sales/marketing practices, product placement monitoring may be advisable
- File reviews often reveal reasons for product selections that are not explained by electronic data
  - Not always practical, especially when volume is high and time is tight
  - Consider collecting additional data that may explain product selection

## Managing Redlining Risk

- No universally accepted definition of “redlining” and no universally-accepted method for evaluating redlining risk
  - Tom Perez, U.S. DOJ AAG for Civil Rights, has described redlining as “[t]he practice where a red line is literally drawn around certain elements of the city that are predominantly minority and lending does not occur there”
  - Tom Perez also described redlining as the practice of not offering prime-rate loans in minority areas
  - Actual enforcement has been much more extreme

## **Managing Redlining Risk**

- To evaluate redlining risk, depository institutions should evaluate their CRA assessment areas to ensure that they are drawn in a non-discriminatory manner
- Assuming the assessment area is fairly drawn (or the lender is not subject to the CRA), the next step is to evaluate the volume and distribution of applications and loans between minority and non-minority areas
- Possible approaches for evaluating this include:



## Managing Redlining Risk

1. “Proportionate distribution” approach: compares the percentage of a lender’s total originations in minority communities to its peers’ percentages
  - This approach has been used in enforcement
  - Difficult to manage to this standard because peer data is not available until after the fact
  - “Peer” definition is important, but there is no universally accepted meaning
  - Questions include whether:
    - FHA lenders should be compared to non-FHA lenders
    - Niche lenders (*e.g.*, lenders that focus on jumbo loans) should be compared to non-niche lenders

## Managing Redlining Risk

2. “OCC” Approach: evaluates a lender’s applications and originations in minority vs. non-minority areas, taking into account census tract economic characteristics
  3. Overall Volume Approach: examines the total number of applications received from, and loans funded in, minority areas
- Decisions regarding which approach(es) to use, how to define peers, and how to define “minority areas” and “non-minority areas” are case-specific

## **Managing Servicing / Loss Mitigation Risk**

- ECOA and FHA extend to post-closing activity, but until relatively recently, servicing and loss mitigation received little attention
- DOJ, CFPB and others have indicated that fair servicing now is an area of focus
- Issues include:
  - Home retention vs. foreclosure, deed in lieu, etc.
  - Modification terms and timelines
  - REO upkeep in minority vs. non-minority areas
- Challenges include:
  - Defining what is a “good” outcome
  - Analyzing a complex, non-uniform process
  - Handling data limitations

## Presenters



**Melanie H. Brody**

Partner  
Washington, D.C.  
p. +1.202.778.9203  
melanie.brody@klgates.com

Ms. Brody concentrates on federal and state regulatory compliance and enforcement matters, primarily for financial services providers. She represents banks, mortgage lenders and consumer finance companies on a variety of issues, including fair lending, privacy, and information security. She also handles matters involving compliance with the Fair Credit Reporting Act, Home Mortgage Disclosure Act, Fair Debt Collection Practices Act and Real Estate Settlement Procedures Act.



**Paul F. Hancock**

Partner  
Miami  
p. +1. 305.539.3378  
paul.hancock@klgates.com

Mr. Hancock focuses his practice on litigation and defense of federal and state government investigations. A primary focus has been the financial services industry, where he has represented the nation's largest financial institutions as well as other industry members, large and small, facing governmental or private claims. Mr. Hancock has a long background in federal and state law enforcement prior to entering private practice. He served in the Civil Rights Division of the U.S. Department of Justice (DOJ) for more than twenty years.

## Introducing our Blog

For news and developments related to consumer financial products and services, please visit our blog at [www.consumerfinancialserviceswatch.com](http://www.consumerfinancialserviceswatch.com) and subscribe to receive updates.

PUBLISHED BY  
**K&L GATES**

Home  
About  
Contact

### Subscribe to Blog Updates

 Subscribe to this blog via RSS  
 Subscribe to this blog by email

### Subscribe to Consumer Financial Services Alerts

Subscribe to receive client alerts

### Topics

Bureau of Consumer Financial Protection (CFPB)  
Other Federal Agencies & GSEs  
Litigation & Enforcement Actions  
UDAAP  
Privacy & Information Security  
Fair Lending/Anti-Discrimination  
Servicemember Protections  
Preemption & Federalism  
Mortgage Lending  
Mortgage Servicing  
Credit Cards  
Debt Collection



Search 

## Is It Illegal Under Federal Law to Opt Out Of Jurisdictions Exercising Eminent Domain?

By K&L Gates on September 11th, 2012  
Posted in Mortgage Servicing

By [Laurence E. Platt](#)

Is a refusal to make or buy residential mortgage loans from jurisdictions that seize loans through eminent domain a federal crime or a reasoned response to excessive government intervention? That's the question that people are asking today in light of the comments of Lt. Governor of California Gavin Newsom. Yesterday, he asked the U.S. Department of Justice to investigate and prosecute those in the industry who advocate staying away from jurisdictions exercising eminent domain. Did he expect the industry instead to send thank you notes?

Continue Reading

 Tweet  Like

 Comments

TAGS: California Lieutenant Governor, eminent domain, foreclosure, Gavin Newsom, loan modification, mortgage loans, principal writedown, San Bernardino

## Servicemembers' Civil Relief Act Protections Extended

By K&L Gates on August 27th, 2012  
Posted in Mortgage Servicing, Servicemember Protections