BUCKLEY

Recent Developments in Fair Lending

Arkansas Community Bankers / Bankers Assurance

2019 Compliance Conference

H Joshua Kotin
Counsel, Buckley LLP

September 11, 2019

Topics for Today

- Categories of lending discrimination

- Putting the theories to work

- New realities, old legal theories

- Fair lending risk management

Categories of Lending Discrimination

Risk of Non-Compliance with Fair Lending Requirements

- Fair lending violations can result in an enforcement action and/or litigation
  - Injunctive order
  - Corrective action
  - Civil money penalties
  - Payment of damages/restitution
  - Restrictions on branching activity and acquisitions
  - Restrictions on appointment of senior executive officers and directors
  - Increased frequency of compliance examinations
  - Increase in deposit insurance premiums
  - Diminished reputation

Legal Theories of Discrimination

Type of Discrimination	Definition	Example
Overt discrimination	Direct evidence that a lender intentionally discriminated on a prohibited basis or expressed a discriminatory preference	A loan officer refuses to work with a customer because they are a protected minority
Disparate Treatment	Circumstantial evidence that a lender intentionally treated similarly situated persons differently on a prohibited basis	African American applicant is given higher APR on a personal loan than white applicant with similar credit risk profile
Disparate Impact	Evidence that a lender applied a facially neutral policy or practice uniformly to all credit applicants, but policy or practice disproportionately excludes or burdens persons on a prohibited basis	Maintaining a minimum loan amount in an underwriting guideline without providing sufficient business justification

The Disparate Treatment Test

- The applicant who sought the loan is a member of a protected class;

- The applicant qualified for a loan;

- The bank denied the application (or increased the price); and

- Similarly-situated applicants who were not in the protected classes received loans or were treated more favorably.
  - Plaintiffs may identify an inference of disparate treatment based on statistics

- Examples:
  - Less assistance overcoming application hurdles for minority applicants
  - Lower price quotes offered to applicants who appear to be sophisticated professionals

The Disparate Impact Test

Equal Credit Opportunity Act

- Plaintiff shows that a facially neutral policy has a negative, disproportionate effect on members of a protected class

- Defendant can rebut by showing a legitimate, non-discriminatory business justification for the policy

- Plaintiff must demonstrate that there is a "less discriminatory alternative" that achieves the same result

Fair Housing Act (Proposed)

- Practice is arbitrary, artificial, and unnecessary to achieve a valid interest or legitimate objective

- Robust causal link between practice and disparate impact

- Adverse effect on protected class members

- Significant disparity

- Injury directly caused by practice

BUCKLEY

Putting the Theories to Work

Brief History of "Redlining" Enforcement

- **Old School Redlining:** Institution or government entity draws actual lines on a map indicating that loans should not be made within that geography
  - No question that it constitutes intentional conduct
  - Lines are usually closely correlated with minority neighborhoods

- **Oops Redlining:** Institution "redlines" by failing to market in minority neighborhoods, failing to open branches in minority neighborhoods, drawing its CRA assessment area in ways that minimize the incorporation of minority neighborhoods
  - Intent is rarely clear – but regulators or enforcement agencies draw an inference from where the bank is (and is not) active

- **Comparative Redlining:** Regulators or enforcement agencies draw an inference of intentional conduct from a statistical analysis comparing the bank's lending to other participants – "peers" –in the same market
  - Infer intent from lower penetration rates

2019 Redlining Settlements

- DOJ settlement with Indiana-based state non-member bank over allegations of redlining in Indianapolis (June 2019)
  - Enjoins Bank from using race and other protected characteristics to
    - Make marketing and advertising decisions
    - Select sites for providing services through branches or other channels
    - Assign, train, and monitor loan officers
    - Determine geographical areas in which to solicit loan applications and generate originations
    - CAVEAT: The prohibitions do not apply where
      - Federal law permits consideration of the characteristics
      - Where consideration is for the purpose of complying with FHA or ECOA
      - Where consideration is necessary to comply with terms of the order

- Connecticut-based savings bank settles with Conn. Fair Housing Center to resolve allegations of redlining stemming from HMDA analysis and tester narratives (March 2019)

Comparative Redlining: Peer Comparisons

DOJ Redlining Settlement	Years in Scope	Average Rate at Which Peer Institutions' Application Volume Exceeded the Institution's Application Volume in Minority Tracts	Average Rate at Which Peer Institutions' Origination Volume Exceeded the Institution's Origination Volume in Minority Tracts
2019 DOJ Settlement	6-Year Period	3.5 times	2.7 times
2018 DOJ Settlement	5-Year Period	5.3 times	4.4 times
2016 DOJ Settlement	4-Year Period	3.1 times	3.0 times
2015 DOJ Settlement	6-Year Period	5.8 times	4.7 times
2013 DOJ Settlement	4-Year Period	15 – 37.5 times	N/A

Managing Redlining Risk

- Key performance indicators
  - Applications
  - Originations

- Questions to solve for:
  - What geographies should I focus on?
  - Who are my actual peers?
  - Who will the government think are my peers in their analysis?
  - Where did I come from and where am I going?

- Other factors for consideration
  - Loan policies and procedures
  - Assessment area
  - Branching
  - Marketing and outreach

Fair Lending Risk in Pricing

- Large national bank fined $25 million for alleged FHA violations and directed to remediate $24 million to impacted customers (Mar. 2019)
  - Bank developed program where applicants with "qualifying banking relationship" seeking an eligible mortgage could receive closing credit or rate reduction
  - OCC alleged ineffective risk management and internal controls resulted in certain borrowers not receiving the benefit for which they were eligible

- Small bank required to remediate $1.2 million for alleged FHA violations (Nov. 2015)
  - Bank utilized "Target Pricing" whereby loan officers were assigned a "minimum base price" they were expected to achieve on each loan
  - DOJ claimed protected class borrowers were served disproportionately by loan officers with higher MBPs than those serving white borrowers
  - DOJ claims protected class borrowers had their loans marked up to a greater extent above the MBP than loans to white borrowers

Fair Lending Risk in Underwriting

- Areas of focus in underwriting
  - Denial disparities
  - Failure to properly qualify income in special circumstances
    - Maternity leave
    - Disability
  - Failure to consider public assistance income
  - Innovative modeling of credit risk
  - Judgmental underwriting

- Drivers of risk in underwriting
  - Failure to clearly articulate underwriting guidelines
  - Failure to train staff on key areas of regulatory focus
  - Inconsistent application of guidelines

New Realities, Old Legal Theories

Limited English Proficiency

- **The Limited English Proficiency conundrum**
  - CFPB & HUD encouraging financial institutions to provide more services in non-English language
  - 65 million people in US speak language other than English at home
    - 2 in 5 of those people are LEP
  - Voluntary collection associated with mortgage URLA
  - Factors to consider in determining which LEP services to offer
    - Census Bureau data on prevalence of non-English languages in footprint
    - Communications/activities that most significantly impact consumers
- **Fair Lending/UDAAP tug of war**
  - Marketing materials v. origination process
  - Intake v. account management
  - Inclusion v. targeting
  - Cultural sensitivity
  - Translation capabilities
  - CMS (training, monitoring, etc.)

Digital Marketing

- Sophisticated digital marketing can bring great benefits
  - Consumers are increasingly engaging online and within their apps
  - Cost-effective
  - Better customer experience when presented with products and services they actually desire
- Sophisticated digital marketing requires good risk management
  - (Digital) Redlining risk
  - Third party oversight
  - Model governance

Case Study: Social Media Investigations

- Focus of complaints relates to targeting or excluding certain groups
  - Disability-related interests: "assistance dog," "mobility scooter," "deaf culture"
  - Familial status interests: "child care," "parenting," adds to users with children of certain age
  - National origin interests: "Latin America," "Hispanic National Bar Association"
- Advertisers could also draw a red line around majority-minority zip codes to avoid showing ads to these users

BUCKLEY

Fair Lending Risk Management

Key Elements of a Fair Lending Program

- **Strong management**
  - Tone at the top
    - Board Fair and Responsible Servicing Policy
  - Committee structure
    - Expectation is that fair lending issues are discussed at senior levels of organization
  - Defined roles and accountability
    - Formal program document establishes responsibilities for business, compliance, and audit

- **Qualitative risk assessment**
  - Formal review of fair lending controls—at least annually
  - Corrective action plans stem from findings

Key Elements of a Fair Lending Program

- **Preventive controls**
  - Business unit policies and procedures
  - Integrate Fair Lending Officer in business processes to identify and mitigate fair lending risk
  - Change management process
  - Management of exceptions
  - Training
- **Detective controls**
  - Analytics program
  - Complaint management

Fair Lending Analytics

- Key testing areas
  - Underwriting
  - Pricing
  - Exceptions
  - Redlining

- Typical regression analysis approach
  - Data validation
  - Model/control specification
  - Regression
  - File/outlier review

H. Joshua Kotin

Counsel
(312) 924-9855
jkotin@buckleyfirm.com