Recent Developments in Fair Lending

Arkansas Community Bankers / Bankers Assurance
2019 Compliance Conference

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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

<table>
<thead>
<tr>
<th>Type of Discrimination</th>
<th>Definition</th>
<th>Example</th>
</tr>
</thead>
<tbody>
<tr>
<td>Overt discrimination</td>
<td>Direct evidence that a lender intentionally discriminated on a prohibited basis or expressed a discriminatory preference</td>
<td>A loan officer refuses to work with a customer because they are a protected minority</td>
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<tr>
<td>Disparate Treatment</td>
<td>Circumstantial evidence that a lender intentionally treated similarly situated persons differently on a prohibited basis</td>
<td>African American applicant is given higher APR on a personal loan than white applicant with similar credit risk profile</td>
</tr>
<tr>
<td>Disparate Impact</td>
<td>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</td>
<td>Maintaining a minimum loan amount in an underwriting guideline without providing sufficient business justification</td>
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</tbody>
</table>
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
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

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