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Best Practices for Complying with Fair Lending Laws

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Executive Summary

The fair lending laws are a set of statutory and regulatory requirements designed to protect members of the population who historically have not had fair and equal access to credit. Federal regulators have recently increased their investigations of financial institutions for possible fair lending abuses. The consequences of violating the fair lending laws can be dire, making it critically important for the boards of financial institutions to understand the laws and take steps to ensure compliance.

The topic of fair lending has become a significant priority for the federal banking agencies and the Department of Justice (DOJ) in recent years. In 2010, the federal banking agencies and the Department of Housing and Urban Development (HUD) made 49 referrals involving a possible pattern or practice of discrimination to the DOJ, more than in any of the previous 20 years. While DOJ has always pursued fair lending cases, enforcement has been particularly aggressive during the past two years since the change in administration. During that time frame through November 2011, it settled 10 cases for more than $30 million. While most of DOJ's recent settlements have been with smaller lenders, in December 2011, DOJ settled claims of discrimination in residential mortgage lending against Countrywide Financial Corporation, which was acquired by Bank of America Corporation in 2008. DOJ alleged that Countrywide discriminated against African-American and Hispanic borrowers and also on the basis of marital status. The settlement requires $335 million in compensation to be set aside for the alleged victims.

While restitution and reputational risks may be significant and affect an institution's overall safety and soundness, collateral issues can be very damaging as well. For example, evidence of discriminatory credit practices may adversely affect an institution's Community Reinvestment Act performance evaluation, which in turn can adversely affect the institution's ability to expand geographically. Accordingly, financial institutions of all sizes should adopt a proactive approach to ensuring compliance with the fair lending laws to avoid enforcement actions, reputational harm, and other negative consequences. Institutions should engage in fair lending not only because it is the law, but also because it is good business practice to avoid discrimination. This article provides an overview of the fair lending laws, best practices, the referral process, recent fair lending hot topics, and the likely impact of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) on fair lending.

Overview of the Fair Lending Laws

The fair lending laws and regulations include the Equal Credit Opportunity Act (ECOA), the Fair Housing Act, and Regulation B, which implements ECOA and was formerly issued by the Board of Governors of the Federal Reserve System, but has recently been reissued by the Bureau of Consumer Financial Protection (CFPB) without substantive changes. Under ECOA it is unlawful for a creditor to discriminate against an applicant with respect to any aspect of a credit transaction on the basis of race, color, religion, national origin, sex or marital status, or age. ECOA prohibits discrimination in "any aspect of a credit transaction," which includes, among other things, advertising and marketing, underwriting, pricing, underwriting exceptions, and loan servicing. The Fair Housing Act prohibits discrimination based upon race or color, national origin, religion, sex, familial status, or handicap. The federal banking agencies, DOJ, and the CFPB can bring fair lending actions based upon theories of disparate impact and disparate treatment, as well as overt discrimination, although the latter is rarely employed because institutions do not normally engage in overt discrimination.

Best Practices

It is becoming standard in the industry for an institution and its compliance team to conduct proactive fair lending reviews under the direction and supervision of counsel before the federal banking regulators have initiated an investigation or cited the institution for a potential fair lending violation. The current standard calls for counsel and its expert consultants to build robust computer regression models to conduct analyses of the institution's lending that are tailored to the specific institution's lending policies and practices. While it is useful as an initial step to analyze publicly available Home Mortgage Disclosure Act (HMDA) data to determine whether there are any underwriting or pricing outliers consisting of members of protected classes, such data provide relatively few explanatory variables for underwriting or pricing statistical analyses. Analysts should supplement HMDA data with numerous other types of data such as credit scores and "loan-to-value" ratios.

The purpose of a customized regression model is to determine whether there is statistical evidence to suggest that an applicant's marital status, race/ethnicity, age, or gender affected the likelihood that his or her application would be approved or denied, the likelihood that he or she would be subject to disadvantageous pricing, or the likelihood that he or she would be subject to other adverse consequences associated with applications for credit. While a review of differences in denial rates and average annual percentage rates, for example, may indicate possible disparities, a thorough analysis must control for possible legitimate explanations for differences in treatment, such as differences in credit scores or "debt-to-income" ratios.

When thorough regression analyses that substantially control for appropriate loan and borrower characteristics indicate that there are statistically significant disparities that appear to disadvantage protected classes, a more granular review of an institution's lending activity may be warranted. Through a more detailed analysis, analysts may be able to identify a particular geography (e.g. state, region, or metropolitan statistical area) or specific broker where any apparent disparities occurred.

Analysts should also supplement their analyses with matched-pair file reviews. The purpose of file reviews is to collect detailed information from individual loan files about an applicant's qualifications for credit and to compare similarly situated protected class and non-protected class applicants to determine whether the apparent disparities can be explained by legitimate, non-discriminatory factors. This review may lead to the discovery of certain attributes common to the apparently disadvantaged applicants or borrowers (other than their protected class status) that were not included in the statistical models, such as collateral-related issues or the existence of specific types of derogatory credit.

By engaging counsel to set up a monitoring process that seeks to identify disparities before the regulators do, an institution can enhance its policies and practices to narrow or eliminate any such disparities. The explanatory power of statistical analyses depends greatly upon the quality of data retained by a financial institution. During the course of the monitoring process, counsel should review an institution's lending policies and practices and make recommendations for clarifying and enhancing them as appropriate to promote consistency in their application by the institution's personnel. Counsel may also have suggestions for ways to improve the institution's data quality. In addition, institutions should engage counsel to review new products in the development stage to avoid possible fair lending risks.

An institution should regularly review and enhance its fair lending training programs. For example, risks of possible unlawful discriminatory treatment often arise in the context of underwriter or loan officer discretion. Institutions should identify which aspects of the underwriting or pricing decision-making process involve discretion in order to limit or monitor and audit such discretion, as appropriate. As a result, institutions may identify areas in which they should enhance training to minimize the potential for disparate treatment based upon discretionary differences among underwriters and loan officers. In addition, to avoid allegations of redlining, institutions should pay close attention to the areas in which they are lending and compare their geographical lending profile to that of other lenders of the same size, or compare their profile to other institutions that make loans of a similar type or volume.

If an institution has not taken appropriate proactive steps such as those discussed above, at the first hint of an allegation of unlawful discriminatory practices, an institution should immediately retain counsel and expert analysts, if it has not already done so, to create regression models customized to the policies and practices of the institution. The analyses should be performed at the direction and under the supervision of counsel, the intention of which is to establish the attorney/client relationship and to be able to claim

attorney work product privileges. Counsel should assist with investigating the factual issues under dispute, develop legal arguments, and write advocacy submissions to the agency or agencies alleging unlawful discrimination.

Referrals

ECOA requires the federal banking agencies to refer matters to DOJ whenever an agency has a "reason to believe" that one or more creditors has engaged in a "pattern or practice" of discouraging or denying applications for credit in violation of ECOA. Additionally, ECOA requires the federal banking agencies to notify HUD whenever there is reason to believe that both ECOA and the Fair Housing Act have been violated and the suspected practices have not been referred to DOJ. In our experience, the agencies have take the position that two or more violations constitutes a "pattern or practice." Once DOJ receives a referral, it may make information requests or request to interview employees. If DOJ decides to bring an action it may file an action in federal district court or it may propose that the institution consent to an order, which would be filed in a federal district court and would have to be approved by a federal district judge. In either case, an institution would remain under the jurisdiction of the federal district court until the requirements of the order are satisfied or the matter is terminated by an order of the court. Institutions rarely choose to litigate with DOJ because of the prolonged nature of such proceedings, the expense and uncertainty of litigation, and reputational risks and other non-quantifiable factors.

Hot Topics

Recent enforcement actions and presentations by the regulators have highlighted certain fair lending topics with respect to which institutions should be particularly vigilant. Recently alleged discriminatory practices include, among other things, the following: discrimination in the underwriting or pricing of loans; steering minority borrowers into less favorable loans; discrimination on the basis of marital status, gender, or age; redlining through the failure to provide equal lending services to minority neigh-

borhoods; reverse redlining through predatory lending targeted at minority neighborhoods; and discrimination in loan modifications and servicing.

Fair Lending Post Dodd-Frank

The Dodd-Frank Act created the CFPB and specifically defined the term "fair lending" to mean "fair, equitable, and nondiscriminatory access to credit for consumers." It remains to be seen how this standard will be applied to institutions that are subject to supervision by the CFPB. In all certainty, it will mean changes to the way institutions deliver their lending services. The Dodd-Frank Act charges the CFPB with responsibility for implementing and enforcing the federal consumer financial laws, which include certain enumerated consumer laws, with respect to insured depository institutions with assets in excess of $10 billion, as well as loan servicers and certain other non-depository institutions. Notably, while ECOA is among the enumerated consumer laws, the Fair Housing Act is not. Like the federal banking agencies, the CFPB has a wide range of enforcement powers and is required to refer cases involving a "pattern or practice" of discriminatory lending to DOJ. Smaller institutions, while not subject to the direct supervision and regulation of the CFPB, will nonetheless be affected indirectly because of the broad consumer protection rulemaking authority it has. While it remains to be seen what the CFPB's priorities will be, the CFPB's Supervision and Examination Manual includes detailed examination procedures for mortgage servicing, which is an indication that the agency plans to devote a great deal of attention to that area.

Conclusion

Institutions should seek to identify disparities in their lending practices for possible fair lending violations in advance of fair lending examinations. Through statistical analyses an institution and its counsel may be able to explain apparent disparities and demonstrate that they do not represent acts of unlawful discrimination. This can go a long way in preparing for examinations, avoiding future problems, and doing the right thing.