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## A legal update from Dechert LLP

### U.S. Department of Justice Turns Spotlight on Disparate Impact Discrimination Claims

Fair lending is back with a giant thud!

In addition to the regulatory burdens imposed by the Dodd-Frank Act, financial institutions must now adjust to the potential of a new round of discrimination claims that are likely to be based on the effects that statistics suggest, rather than an actual intent to discriminate.<sup>1</sup>

Most recently, this was underscored by the U.S. Department of Justice's (DOJ) settlement this month with Luther Burbank Savings (Burbank) to resolve discrimination claims under the FHA and ECOA. The DOJ alleged that Burbank's general \$400,000 minimum loan amount for single family mortgage loans had a disparate impact on African-American and Hispanic borrowers that was not justified by business necessity or legitimate business considerations. As demonstrated in this case, the reluctance of institutions to litigate with the DOJ in these types of cases allows broad de facto discrimination liability principles to be established by the DOJ through settlements, rather than as a result of a fully developed case ruled on by a court.

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<sup>1</sup> There has been growing controversy as to whether disparate impact is a basis for liability under the Fair Housing Act (FHA) and the Equal Credit Opportunity Act (ECOA). Disparate impact does not involve any showing of discriminatory treatment. In contrast, discriminatory treatment claims, which are routinely pursued by the DOJ, include claims that similarly situated minority applicants are treated less favorably than minority applicants in regard to lending decisions as to loan approval or denial or interest rates. Disparate treatment claims also involve claims that geographic service area decisions are correlated to minority status.

This enforcement policy is made all the more treacherous to navigate with (i) financial institutions under pressure from regulators to strictly underwrite loans and (ii) pending qualified mortgage and risk retention regulations, which will tend to standardize mortgage lending products.

#### Disparate Impact Liability Theory

Federal regulators have taken the position that liability under the ECOA and FHA may be based on a finding of impermissible disparate impact.<sup>2</sup> For example, the commentary to Regulation B, which implements the ECOA, states that:

The act and regulation may prohibit a creditor practice that is discriminatory in effect because it has a disproportionately negative impact on a prohibited basis, even though the creditor has no intent to discriminate and the practice appears neutral on its face, unless the creditor practice meets a legitimate business need that cannot be achieved as well by means that are less disparate in their impact.<sup>3</sup>

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<sup>2</sup> For a detailed discussion of the issues related to the use of disparate impact discrimination theory in the context of the FHA and ECOA, see Vartanian, Ledig, Babitz, Browning and Pitzer, *The Fair Lending Guide*, §§ 4.01, 6.02.

<sup>3</sup> 12 C.F.R. pt. 1002, Supp. I, § 1002.6, ¶16(a)-2.

As part of the Clinton Administration's fair lending initiative, in 1994, an Interagency Task Force on Fair Lending, which included the DOJ, the Federal Trade Commission, the Department of Housing and Urban Development (HUD) and federal financial regulatory agencies issued a Policy Statement on Discrimination in Lending (Interagency Policy Statement). The Interagency Policy Statement provided the following example of the principle of discriminatory impact:

A lender's policy is not to extend loans for single family residences for less than \$60,000. This policy has been in effect for ten years. This minimum loan amount policy is shown to disproportionately exclude potential minority applicants from consideration because of their income levels or the value of homes in the areas where they live. The lender will be required to justify the "business necessity" for the policy.<sup>4</sup>

Since the 1990's, the DOJ has pursued many fair lending claims which are generally handled through the filing of a complaint and a proposed order containing the terms of a settlement negotiated between the DOJ and the lender. These cases have focused on disparate treatment allegations.

In 1997, the DOJ did settle a case involving disparate impact claims.<sup>5</sup> In that case the DOJ alleged, among other things, that Nationwide Mutual Insurance Company's policy that a home could not be insured if it was above a certain age or below a certain value, violated the FHA. The DOJ alleged that company's policies were not necessitated by consideration of risk, profit, or any other legitimate race-neutral business consideration. It further asserted that alternative methods are available which would accomplish the business objectives that form the ostensible rationale for the challenged practices without the substantial and disproportionate burden on residents of minority neighborhoods. In the settlement, the company agreed to end the challenged policies.

Recently, attention has turned to disparate impact claims. In November 2011, HUD proposed amendments to its FHA regulations that would provide that liability may be established based on a practice's

<sup>4</sup> 59 Fed. Reg. 18266, 18269 (Apr. 15, 1994).

<sup>5</sup> See DOJ Press Release, Nationwide Insurance Company reaches \$13 million settlement with Justice Department, March 10, 1997.

discriminatory effect that is not supported by a legally sufficient justification.<sup>6</sup> The Consumer Financial Protection Bureau (Bureau), which assumed responsibility for ECOA and its implementing rules under Regulation B under the Dodd-Frank Act, issued a bulletin reaffirming that the doctrine of disparate impact remains applicable as the Bureau exercises its supervision and enforcement authority to enforce compliance under ECOA and Regulation B.<sup>7</sup>

During the Supreme Court's last term, the Court agreed to hear an appeal by the City of Saint Paul which would have challenged the use of disparate impact under the FHA in connection with a challenge by landlords to the city's housing code enforcement practices. The City then asked the Supreme Court to dismiss the case. The City explained its action by stating that national civil rights organizations and legal scholars believe that if the City prevails before the Supreme Court, such a result could completely eliminate disparate impact civil rights enforcement, including the FHA and the ECOA.<sup>8</sup> The case was dismissed on February 10, 2012.

On July 18, 2012, American Bankers Association President Frank Keating wrote to Federal Reserve Board Chairman Ben Bernanke asserting that disparate impact theory is not supported by the terms of the FHA and the ECOA. The letter requested that government agencies stand down from applying the disparate impact approach to fair lending enforcement and return to the objective of protecting borrowers from intentional prohibited-basis discrimination to assure that similarly situated individuals are treated similarly. The letter took the position that persisting in asserting the disparate impact doctrine will adversely impact credit availability and create undue supervisory risk and burden.

## The Burbank Settlement

In this environment, the DOJ's Burbank disparate impact action is likely to further spur controversy in this area. In its complaint, the DOJ alleged that Burbank had enforced a minimum loan amount policy (generally

<sup>6</sup> 76 Fed. Reg. 70921 (Nov. 16, 2011).

<sup>7</sup> Bureau Bulletin 2012-04, Apr. 18, 2012.

<sup>8</sup> See Press Release, City of Saint Paul seeks to dismiss United States Supreme Court case *Magner vs. Gallagher*, Feb. 10, 2012.

\$400,000) for its wholesale single family residential mortgage program conducted through a network of mortgage brokers, which constituted almost all of the institution's single family residential lending activity, between 2006 and 2011.<sup>9</sup> The DOJ alleged that this policy had a disparate impact on the basis of race and national origin and violated the FHA and ECOA.

The DOJ's disparate impact allegation was based on a comparison of Burbank's lending activity in light of its minimum loan policy to lending activity by other comparable lenders operating in the same markets. The DOJ alleged that during 2006 to 2010 Burbank originated only 5% of its single family residential mortgage loans in majority-minority census tracts, while other lenders which made a similar volume of single family loans, originated 42% of their loans in majority-minority census tracts. It also alleged that overall only 6% of Burbank's single family loans during 2006 to 2010 were made to African-American or Hispanic borrowers, while other lenders that made a similar volume of loans as Burbank made 32% of their single family loans to African-American or Hispanic borrowers.

The DOJ alleged that Burbank maintained its minimum loan policy in spite of its knowledge that its low level of lending to African-American and Hispanic borrowers and in majority-minority census tracts was attributable to its minimum loan amount policy.

The complaint did not make redlining allegations against Burbank as it has done in a number of prior fair lending actions. In that regard, however, the complaint does contain a footnote stating that separate statistical analyses of Burbank's applications demonstrate a statistically significant failure to generate applications from African-Americans and Hispanics and majority-minority census tract applicants at a level equal to its peer lenders.

The complaint states that since June 2011, Burbank has operated with a \$20,000 minimum loan policy for single family loans that has not produced adverse consequences to its lending business. The complaint asserts that the \$400,000 minimum loan amount policy was not justified by necessity or legitimate business considerations. In that regard, an editorial in the Wall Street Journal stated that during the period that the DOJ examined only 11 of Burbank's 629 loans

<sup>9</sup> Burbank's primary focus is on multi-family lending.

outstanding — 1.75% — went into default.<sup>10</sup> In a contested matter, a court would examine a lender's business justification for a policy that had a disparate impact. The Interagency Policy Statement stated that the factors that may be relevant to the business necessity test could include cost and profitability.<sup>11</sup>

The proposed settlement provides that during the term of the agreement Burbank will not increase its minimum loan amounts for wholesale or retail single family lending without prior notice to the DOJ. Burbank will also be required to spend \$900,000 on partnerships with community development organizations, advertising and outreach and consumer education. It also would be required to make available a minimum of \$1.1 million in a special financing program designed to increase residential mortgage credit that it extends to qualified borrowers seeking loans of \$400,000 or less, which may be in the form of preferential interest rates, closing cost assistance or other assistance.

## Implications

The impact of this case seems fairly clear:

- While DOJ fair lending settlements do not create binding precedent, they have played a major role over the past two decades in shaping the operations of lending institutions.
- The Burbank case will likely give greater impetus to examination and enforcement efforts by federal regulators, including the Bureau and the DOJ, to pursue disparate impact fair lending claims.
- Institutions will need to carefully evaluate the business justification for lending policies that may have a disparate impact and consider whether there are acceptable alternatives to the policies in question.
- The government may have a tool to affirmatively define lending programs rather than just restricting what they cannot do.

This case also puts a greater focus on the impact of the Bureau's forthcoming ability-to-repay regulations with

<sup>10</sup> *A Fine for Doing Good*, Wall Street Journal, Sept. 17 at A18.

<sup>11</sup> 59 Fed. Reg. at 18269.

the Qualified Mortgage standard<sup>12</sup> and on the terms of the interagency Qualified Residential Mortgage exception to the Dodd-Frank Act's section 941 risk retention requirements.<sup>13</sup> These pending rules will have a critical impact on lending institutions' underwriting standards and the shape of mortgage markets in this country. To the extent that tightened loan policies and

<sup>12</sup> *DechertOnPoint* "U.S. Consumer Financial Protection Bureau in the Process of Restructuring Regulation of the Residential Mortgage Market: Qualified Mortgage Rule Emerges as Critical Issue"; *DechertOnPoint* "Federal Reserve's Proposed Rule to Implement the Ability-to-Repay Requirements for Residential Mortgage Loans and its Impact on Lenders and RMBS Investors".

<sup>13</sup> *DechertOnPoint* "Risk Retention Proposal for Residential Mortgages Comes into Focus"; *DechertOnPoint* "Risk Retention and Residential Mortgages: Legislation, Regulation and Economics".

standardized mortgage products restrict access to credit in a manner that disproportionately affects minority borrowers, they could trigger challenges by regulators and the DOJ under disparate impact principles.

These developments will spur interest in Supreme Court review of the application of disparate impact theory to FHA and ECOA claims.



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