BANKING & FINANCIAL SERVICES
A PERIODIC REVIEW OF SPECIAL LEGAL DEVELOPMENTS AFFECTING LENDING AND OTHER FINANCIAL INSTITUTIONS

Vol. 18 No. 13 December, 2002

INCREASED FAIR LENDING ENFORCEMENT ACTIVITY

With Lending Institutions Paying Over $1Billion in Government Fair Lending Settlements in Recent Years, the Risk of Government and Private Class-Action Litigation Has Risen Dramatically. The Authors Describe the Settlements and Suggest Litigation Avoidance Strategies for Lenders.

By Andrew L. Sandler, Benjamin B. Klubes, and Molly A. Meegan*

Over the course of the past several years, fair lending enforcement has emerged beyond Department of Justice ("DOJ") investigations concerning discriminatory treatment of minorities with respect to real estate secured loans. Today, this enforcement activity focuses on all aspects of loan transactions between lenders and consumers. Indeed, since 2000 a plethora of federal, state and local government enforcement and regulatory agencies have announced fair lending settlements with lenders aggregating to well over $1 billion in restitution and fines. These enforcement actions have involved real estate and personal loans, as well as credit card sales, credit insurance products and marketing practices. Current investigations suggest that there will be future enforcement actions involving auto and small business lending. This article describes recent trends and concludes with a general discussion of risk management techniques lenders may wish to consider in light of this enforcement onslaught.

FAIR LENDING REDEFINED

The lending industry today confronts an exponential growth in fair lending enforcement. Fair lending risk in the 1990's focused primarily on the equitable treatment of minority borrowers in the lending process. Fair lending risk today involves consideration of a myriad of issues related to fair treatment of consumers in all aspects of the lending relationship.

The most significant manifestation of this increased scope of fair lending enforcement are the recent cases where government enforcement and regulatory agencies have used federal and state unfair and deceptive trade practice statutes and a number of consumer lending statutes (e.g., Truth in Lending Act ("TILA"), Home

* *ANDREW L. SANDLER and BENJAMIN B. KLUBES are partners and MOLLY A. MEEGAN is a counsel in the Washington, D.C. office of Skadden, Arps, Slate, Meagher and Flom LLP. Mr. Sandler leads the firm's Consumer Financial Services Enforcement and Litigation practice. The authors currently represent a number of financial institutions in regulatory examinations and government investigations focused on fair lending and consumer sales practices and private class-action lawsuits. Their e-mail addresses are, asandler@skadden.com, bklubes@skadden.com, and mmeegan@skadden.com, respectively.*

ANDREW L. SANDLER and BENJAMIN B. KLUBES are both partners at BuckleySandler LLP, in the Washington, D.C. office.

Ownership and Equity Protection Act ("HOEPA"), and the Real Estate Settlement Procedures Act ("RESPA"))[1], as well as federal discrimination statutes (e.g., Fair Housing Act ("FHA"), Equal Credit Opportunity Act ("ECOA"), and the Civil Rights Act of 1866 ("Civil Rights Act"))[2], to obtain significant settlements from consumer lenders. Recent examples of this expanded reach of fair lending enforcement and the magnitude of economic costs associated with it for lenders include:

- The October 2002 settlement agreement between Household Finance Corporation ("Household" or the "Company") and at least 44 state attorneys general and banking regulators resolving allegations that Household violated state consumer protection and mortgage loan laws. As part of the settlement, Household agreed to establish a $484 million fund to provide restitution to customers affected by the Company's alleged practice of charging higher interest rates than promised and excessive prepayment penalties, as well as failure to make adequate disclosure relating to insurance premiums financed with the loans.

- The September 2002 simultaneous settlement by Citigroup Inc. of suits filed by the Federal Trade Commission ("FTC") and class action representatives alleging that Associates First Capital Corporation and its subsidiaries ("The Associates") (acquired by Citigroup in November 2000) had engaged in deceptive lending practices in violation of the Federal Trade Commission Act ("the FTC Act")[3] and state consumer protection statutes. Citigroup agreed to provide $240 million in restitution to customers affected by the Associates' alleged unfair and deceptive trade practices in connection with credit insurance and real estate loan refinancings.

- The June 28, 2000 settlements between Providian National Bank ("Providian"), the Office of the Comptroller of the Currency ("OCC"), and the State of California resolving allegations that Providian violated TILA, the FTC Act, and the false adver-

1. 15 U.S.C. §§ 1601-1666j (2002); 15 U.S.C. § 1639 (2002); 12 U.S.C. §§ 2601-2617 (2002).
2. 42 U.S.C. §§ 3601-3631 (2002); 15 U.S.C. §§ 1691-1691f (2002); 42 U.S.C. §§1981, 1982 (2002).
3. 15 U.S.C. §§ 41-58 (2002).

Standard & Poor's

A Division of The McGraw-Hill Companies

The Review of Banking & Financial Services is a periodic supplement of the *The Review of Securities & Commodities Regulation,* which is published 22 times a year by Standard & Poor's, a division of The McGraw-Hill Companies. Executive Office 55 Water Street, New York, New York 10041. Editorial Office, 299 Park Avenue 16th floor, New York, New York 10171. Subscription rates: $898 per year in U.S., Canada and Mexico; $960 elsewhere (air mail delivered). A 15% discount is available for qualified academic libraries and universities. General Editor: Michael O. Finkelstein. Associate Editor: Sarah Strauss Himmelfarb. ISSN: 1051-1741.

tising and unfair business practices laws of California by failing to adequately disclose the terms and conditions of its credit cards and ancillary products. As part of the settlements, Providian agreed to establish a $300 million restitution fund for customers affected by the practices at issue.

- The October 2000 settlement between First Alliance Mortgage Company ("FAMCO") and the FTC resolving allegations that FAMCO violated the FTC Act and TILA in connection with alleged loan packing and loan flipping. FAMCO agreed to establish a $70 million restitution fund to compensate consumers affected by the alleged unfair trade practices.

ATOMIZATION OF ENFORCEMENT

Throughout the 1990s, fair lending enforcement was largely the province of the DOJ. When bank regulatory agencies developed fair lending concerns they would refer cases to the DOJ; only occasionally would the FTC, the Department of Housing and Urban Development ("HUD"), a state attorney general or a banking agency undertake an enforcement action on its own. In contrast, since 2000, at least fifty federal, state and local enforcement agencies and bank regulators have announced significant settlements with lenders. Others are engaged in ongoing enforcement activity.

There are many reasons for this explosion in fair lending enforcement. These include the focus on a broader range of lending activities, the use of many additional statutes which are the responsibility of different enforcement authorities, the increased public focus on fair lending, especially predatory lending issues, and the exportation of fair lending enforcement expertise from agency to agency.

A related recent development is that increasingly fair lending investigations of specific lenders are being coordinated and pursued by multiple enforcement agencies. Recent examples include:

- The settlement of lawsuits brought jointly by the New York State Banking Department and New York State Attorney General and later by the FTC, DOJ and HUD against Delta Funding Corporation ("Delta") alleging that Delta violated the FTC Act, ECOA, HOEPA, and RESPA when it made loans without an adequate analysis of borrowers' ability to pay, charged African-American females higher mortgage broker fees, and paid kickbacks and unearned fees to brokers.

- The simultaneous settlement by FAMCO of separate suits filed by the FTC and a group of state attorneys general alleging violations of the FTC Act and TILA, as well as state consumer protection statutes.

- The joint settlement by Providian of allegations by the OCC and the State of California that it violated TILA, the FTC Act, and California false advertising and unfair business practices laws; and

- The multi-state settlement by Household and at least 44 state attorneys general and banking regulators resolving allegations that Household violated various state unfair and deceptive trade practices and consumer protection statutes in connection with its mortgage lending business.

The Household situation is particularly noteworthy in demonstrating that the state attorneys general apparently are exporting the joint investigation and settlement approach they adopted with respect to the tobacco industry to the consumer lending context.

NON-REAL ESTATE SECURED LENDING

At the same time that fair lending review has been expanded significantly beyond the concept of preventing discrimination against protected class members, the enforcement agencies have made their way from the practices of real estate secured lenders to those of credit card lenders. Indeed, some of the most significant recent cases have focused on credit card lending issues.

FIDELITY FEDERAL BANK

Most recently, in July 2002 the DOJ entered into a settlement agreement with Fidelity Federal Bank ("Fidelity"), a federal savings bank in California that was involved in a short-lived foray into the credit card lending business in the late 1990's.[4] Pursuant to the settlement, Fidelity agreed to establish a $1.6 million restitution fund to compensate consumers who applied for credit to one of four third-party service providers that issued credit cards funded by Fidelity. The practices at issue included the use of underwriting criteria that referenced protected classes, policies encouraging all members of a household to sign a credit application, and training materials that directed marketing personnel to confirm that potential consumers could read and understand marketing materials published in English. Fidelity also agreed to ensure that all future applicants for credit cards issued by Fidelity were not subject to ECOA violations by, among other things, establishing the underwriting standards for credit financed by the bank and ensuring appropriate collection activities on the accounts, as well as monitoring all training materials, credit application forms, and adverse action notice statements issued directly by Fidelity or indirectly by third-party service providers in connection with Fidelity credit card programs.

FIRST NATIONAL BANK OF MARIN

On December 3, 2001, the OCC again entered into a consent order with a credit card lender, First National Bank of Marin, to settle allegations that the bank had engaged in unfair and deceptive trade practices in marketing a secured credit card to non-prime customers.[5] The practices at issue involved levying a charge against the credit account when first issued that was close to the available credit limit on the account. That charge had to be paid by a customer in order to establish a secured savings pool against which the customer could charge in the future. In the settlement, First National Bank of Marin agreed to establish a $4 million restitution fund to refund application and other fees charged to consumers who received a credit card with less than $50 in available credit and to clearly and conspicuously disclose the cost and operation of credit cards issued in the future.

DIRECT MERCHANTS

On May 3, 2001, Direct Merchants Credit Card Bank, N.A.("Direct Merchants"), a marketer of credit cards to non-prime customers, entered into a consent order with the OCC to settle allegations that the bank had treated credit card customers unfairly by advertising credit cards with particular terms but then "downselling" roughly 50% of applicants to cards with less favorable terms.[6] Direct Merchants agreed to establish a $3.2 million redress fund to compensate customers affected by the practice, and agreed to clearly and conspicuously disclose the possibility that a customer may be downsold to a less favorable account in its marketing materials.

PROVIDIAN

On June 28, 2000, Providian entered into consent decrees with the OCC and the State of California and agreed to deposit at least $300 million into a fund to compensate credit card customers affected by Providian's alleged failure to disclose the terms, conditions, and/or limitations on its credit cards and ancillary products.[7] The Providian settlement focused on the sale of credit protection, insurance and other ancillary products with a credit card, and reflected the view of the OCC that such products often do not have real economic value to a consumer and are sold in a deceptive manner. It also set forth a myriad of marketing requirements that Providian must comply with in the future, all designed to ensure "clear and conspicuous" disclosure of the terms, conditions, and material limitations on credit and ancillary products offered by the bank.

ASSOCIATES NATIONAL BANK

On March 29, 1999, Associates National Bank ("ANB") entered into a settlement with the DOJ in which it agreed to establish a $1.5 million trust fund to compensate Span-

4. *See* Settlement Agreement, *United States v. Fidelity Federal Bank*, No. 1-02-03906-NG (E.D.N.Y. July 8, 2002), *available at* http://www.usdoj.gov/crt/housing/documents/fidelitysettle.htm (visited Nov. 10, 2002). The Fidelity Federal Bank settlement marks the first time that a credit card lender has been held responsible for the actions of third party contractual partners with which it did business.
5. See Consent Order, In re: First National Bank of Marin Las Vegas, OCC No. 2001-97 (December 3, 2001), available at http://www.occ.treas.gov/ftp/eas/ea2001-97.pdf (visited Nov. 10, 2002).
6. *See* Consent Order, *In re: Direct Merchants Credit Card Bank, N.A.*, OCC No. 2001-24 (May 3, 2001), *available at* http://www.occ.treas.gov/ftp/eas/ea2001-24.pdf (visited Nov. 10, 2002).
7. *See* Consent Order, *In re: Providian National Bank*, OCC No. 2000-53 (June 28, 2000), *available at* http://www.occ.treas.gov/ftp/release/2000-49b.pdf (visited Nov. 10, 2002).

ish-language applicants for a credit card offered by the bank.[8] ANB had offered a Spanish-language credit card to Hispanic applicants that, due to an inadvertent computer programming error, did not have terms and conditions that matched those of its non-Spanish-language credit cards, and did not include them in all marketing campaigns.

AUTO LENDING

In addition to the focus on credit card lenders, the DOJ, FTC, and bank regulators also have turned their sights to alleged discriminatory and/or predatory practices of auto lenders following the lead of class-action lawyers. It has been publicly reported that the DOJ and FTC undertook a multiyear investigation of the captive finance companies affiliated with Chrysler Financial Company L.L.C., Ford Motor Credit Company, and General Motors Acceptance Corporation, although no lawsuit or settlement followed. Class-action lawyers have been more aggressive, filing a series of actions against the captive finance companies and banks that provide automobile financing. The DOJ got back into this area by filing an amicus brief in support of the plaintiffs in a private class action lawsuit against Nissan Motor Acceptance Corp.[9] The DOJ brief argues that ECOA imposes on creditors a non-delegable duty not to discriminate in the provision of credit that renders a lender strictly liable for ECOA violations by third parties. See Amicus Brief at 3-5. According to the government, a lender cannot immunize itself from liability under ECOA by delegating aspects of the credit transaction to third parties and thereafter disclaim responsibility for the discriminatory acts of those third parties which occurred in credit transactions approved and funded by the lender.

8. *See* Settlement Agreement, *United States v. Associates National Bank*, No. 99-196-SLR (D. Del. March 29, 1999), *available at* http://www.usdoj.gov/crt/housing/documents/assocsettle.htm (visited Nov. 10, 2002).
9. *See* Amicus Brief, *Cason v. Nissan Motor Acceptance Corp.*, No. 3-98-0223 (M.D. Tenn. July 31, 2000), *available at* http://www/usdoj.gov/crt/housing/ documents/nissan1.htm (visited Nov. 10, 2002). In that suit, the plaintiff class alleges that Nissan set a minimum risk-based annual percentage rate ("APR") at which it would fund particular loans. However, the lender also instituted a policy that permitted the dealer, at its discretion, to increase the risk-based APR offered to a costumer up to a certain percentage. The plaintiff class asserts that the dealer's ability to set loan terms in a discretionary manner led to discrimination against African-American consumers in violation of ECOA. The court recently certified the class as to claims for injunctive or declaratory relief only.

Rather, the DOJ argued, liability for the third party's discriminatory practices attaches to the lender irrespective of the lender's knowledge of or control over the acts of its affiliate.

LITIGATION AVOIDANCE STRATEGIES FOR LENDERS

This more aggressive fair lending enforcement activity coupled with increased private class action litigation addressing protected class and predatory lending issues has made fair lending among the most significant risk management issues for the consumer lending industry. We recommend consideration of proactive business and marketing strategies designed to diminish fair lending risk. These include:

- *Clear and Conspicuous Disclosure.* This has become the definitive standard for lenders with respect to marketing and sales tactics. Fees and points charged to consumers in connection with a loan, especially if such charges are included in the principal balance, must be clearly disclosed and explained to the customer. To the extent a lender seeks to sell ancillary products such as credit insurance or fee-based products, the lender's written solicitation materials and telemarketing scripts should be clear as to the terms of such offers, including whether such ancillary products must be purchased to obtain the credit product itself. In addition, careful consideration should be given to the terms pursuant to which consumers who purchase such products should be permitted to cancel the purchase and a disclosure of the cancellation options.

- *"Know Thy Business Partner".* To the extent a financial institution uses brokers, dealers or other third parties to market its products, a lender is well advised to conduct adequate due diligence prior to establishing that relationship. The timing of due diligence is important. If a lender can weed out problematic partners before establishing a third party relationship, the lender directly benefits. The less oversight necessary to ensure that one's brokers and dealers are not acting in a discriminatory or predatory manner after the relationship is established, the less likely a lender will find itself charged with responsibility for the behavior of a broker or dealer on the ground that the broker or dealer is an agent of the lender.

- *Price Caps.* Lenders can take action to protect themselves from fair lending scrutiny based on third party behavior by employing the use of appropriate price caps as well. The limitation on price charged or profit earned by a third-party will help protect a financial institution that will ultimately place a loan on its own books.

- *Reducing Negotiated Pricing Discretion in Favor of Risk-Based Pricing.* A lender can protect itself from unfair pricing allegations in several ways. For example, if a lender uses a risk-based pricing matrix, that matrix should be applied to all customers, regardless of the marketing channel by which the customer arrives at the lender. If the same objective pricing criteria are used for all customers, the lender is protected from claims of unfair or discriminatory pricing. A financial institution should institute limits on pricing discretion by its employees to specific and documented exceptions. An appropriate second review process should be used to examine any exceptions granted to the pricing matrix.

- *Limiting Refinance Fees.* Financial institutions engaged in refinancing of loans can limit or eliminate points and fees on "old money" subject to refinancing in order to protect themselves from allegations that they are engaged in loan flipping. For example, if a customer refinances a loan within a short time, a lender may limit fees and points to that portion of the loan which represents new borrowing only. Similarly, standards for loan approvals that require real "benefits" to a consumer may be established, including, for example, lower interest rates, lower monthly payments, and significant additional funds availability. Lastly, a lender may want to consider limiting the frequency with which it will permit refinancing of loans. A financial institution engaged in home equity refinancing and using property appraisers should have set standards for selecting these appraisers or an approved appraiser list. Moreover, the appraiser should be selected for a particular property by someone other than the responsible loan officer.

- *Minimum Debt-to-Income Ratios.* Equity stripping continues to be a frequent allegation made against targeted financial institutions. Lenders can decide not to offer asset-based lending products. If such products are offered, the evolving best practice standard is the requirement that consumers granted a loan have a debt to income ratio of 50% or less. Lenders also should carefully scrutinize "no document" or "low document" lending programs to determine whether they allow sufficient analysis of ability to repay.

- *Prepayment Penalty Limitations and Options.* Adequate disclosure of prepayment penalties should be made. Lenders should also consider providing the customer with the option of a loan without prepayment fees at a higher rate. Finally, consideration should be given to limiting prepayment penalties to finite periods needed to recoup amortized lending expenses, usually two to three years.

- *Advertising Accuracy and Clarity.* Advertising for both secured and unsecured loan products should be geared toward clear and conspicuous disclosure. The use of hypothetical comparisons of customers' current monthly debt payments to payments with a lender's debt consolidation loans should accurately represent potential lesser payments and disclose key relevant information about the loan, such as origination fees and closing costs. Advertising should be roughly equivalent in all markets to avoid charges that a bank is engaged in redlining or reverse redlining.

CONCLUSION

Fair lending enforcement activity has exploded and the direct and indirect economic cost of such activity to consumer lenders has skyrocketed. Fair lending risk management therefore must be a significant priority for entities engaged in all types of consumer lending activity. ■