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Fair Lending 2012—Significant Risk Management Agenda Items

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In the first few months of 2012, lenders were cautiously optimistic that a recent Supreme Court case and a case pending before the Supreme Court would result in a victory for the financial services industry by severely limiting the use of a "disparate impact" analysis in the fair lending arena.[1] Those hopes were dashed when the pending case was withdrawn, and the Administration forcefully announced its determination to continue to use the disparate impact theory to bring governmental fair lending enforcement cases.[2]

Simultaneously (and not coincidentally), the Consumer Financial Protection Bureau (the "CFPB") not only adopted the Administration's legal position on disparate impact, but also has signaled to the consumer financial services industry it intends to significantly expand the categories of consumer financial products and services which it will review to identify possible discriminatory practices.

This Alert analyzes several of the most notable fair lending developments that occurred in the first half of 2012 from a governmental litigation and regulatory perspective. In addition, it offers our recommendations to clients and friends of the firm regarding the development of risk management practices that might be considered in light of these developments.

The Continued Viability of Disparate Impact Analysis

The recent Supreme Court case of *Wal-Mart Stores v. Dukes*, 131 S.Ct. 2541 (2011) and the grant of certiorari in the case of *Magner v. Gallagher*, Docket No. 10-1032 (2012), in combination raised the possibility that the disparate impact analysis would be rejected as a theory to prove fair housing claims.

[1] "Disparate impact" refers to the use of neutral selection criteria that nevertheless have a disproportionally adverse effect on a protected class, such as race, sex, national origin, etc. A disparate impact case is typically proved by identifying "statistically significant" data supporting the alleged discriminatory claim that cannot be eliminated by other factors indicating equal treatment of similarly situated individuals.

[2] While beyond the scope of this analysis, the Department of Justice (the "DOJ") has recently brought several fair lending cases that have relied upon disparate impact rather than arguably being provable based upon a disparate treatment theory.

The *Wal-Mart* decision rejected in the class action employment context relying upon statistical data to prove commonality for discriminatory promotional practices in which significant discretion was involved, whereas the *Magner* case raised directly the applicability of the "effects test" under the Fair Housing Act.[3]

Unfortunately, prior to the Supreme Court hearing for the *Magner* appeal, the case was withdrawn, thereupon reinstating the lower court opinion that upheld disparate impact as a viable theory to prove Fair Housing Act violations.[4] Following the withdraw of the *Manger* appeal, the DOJ indicated in various forums that it would continue to view the use of the disparate impact theory as applicable when enforcement cases were brought by the federal government (and distinguished the *Wal-Mart* case as applying to private litigants and not to "pattern and practice" cases brought by the DOJ and other government agencies).

In what many observers considered to be an unnecessary display of solidarity, on April 18, 2012, the CFPB issued a statement joining its sister agencies by indicating that it would employ the disparate impact theory as part of its examination and supervision functions of the consumer financial services industry.[5]

The CFPB, the DOJ and HUD Fair Lending Developments

In addition to endorsing the continued applicability of disparate impact, the CFPB has moved forward in the organization of its fair lending examination operations in a manner that is of concern to companies directly and indirectly under its supervision. First, the examination manuals issued by the CFPB are replete with extensive instructions by examiners to review as a priority fair lending compliance as part of the examination process. [6]

Second, and perhaps more disturbing, in its public pronouncements the CFPB has indicated that it views fair lending in a much broader context than possible discrimination based upon denials of credit pricing disparities. Rather, the CFPB has indicated that other aspects of a lender's operations would be reviewed, including discrimination arising from loan servicing practices, loan modification practices and general customer contact. (Although several of these areas of concern have been criticized in the past as possibly involving discriminatory conduct, all of these areas include discretionary conduct and hence allegations of discriminatory conduct are difficult to refute.)

In respect to the CFPB's fair lending enforcement authority, it should be noted that its authority might be viewed as being co-equal with the authority given to the DOJ. For example, the CFPB has direct examination and supervision authority over the 111 largest depository institutions and their holding companies, virtually all mortgage-related entities, pay-day lenders and for-profit educational lenders—including the ability to initiate administrative or civil litigation for alleged ECOA or Fair Lending Act violations. In light of the relative paucity of fair lending claims handled by the DOJ in the past several years, it is likely that the CFPB may assume the mantle of the primary enforcer of fair lending for the federal government.

In regard to the DOJ and its fair lending enforcement approach, the current leadership of the DOJ has taken an enforcement posture that relies to a greater degree on a disparate impact analysis rather than a

[3] 42 U.S.C. §§ 3601*et seq.*

[4] Although somewhat convoluted procedurally, *Magner* appears to have been dismissed because proponents of disparate impact feared that the Supreme Court would use the case to invalidate the use of disparate impact not only in regard to Fair Housing Act cases, but also for cases brought under the Equal Credit Opportunity Act, 15 USC § 1691*et seq.* (the "ECOA").

[5] CFPB Bulletin 2012-04 (Fair Lending) (April 18, 2012).

[6] The CFPB's examination manual containing its ECOA and fair lending examination procedures can be found at http://www.consumerfinance.gov/wp-content/themes/cfpb_theme/images/supervision_examination_manual_11211.pdf.

disparate treatment analysis (*e.g.*, overt or intentional discriminatory behavior), covering a wide range of lending practices, including pricing, redlining and reverse redlining.[7] Of particular notoriety has been the focus the DOJ has placed on geographic lending patterns and the relationship between fair lending and a depository institution's Community Reinvestment Act ("CRA") delineated communities, with criticism being directed to banks whose CRA communities allegedly fail to incorporate minority majority geographies.[8]

Finally, and not to be excluded, HUD issued a proposed regulatory interpretation that would adopt as a formal regulation the use of disparate impact as a theory that might be utilized to prove violations of the Fair Housing Act. (As of the date of this Alert, it appears that HUD's proposed regulation is under final review by the Office of Management and Budget.)[9]

The Dodd-Frank Act—Changes Yet to Come

In addition to responding to what has become an increasingly aggressive enforcement environment, changes made to various provisions of the federal consumer protection laws will increase the risk of fair lending violations by increasing the data required to be reported by lenders—and thereby facilitating the analysis of a variety of fair lending claims based upon a disparate impact analysis. These statutory amendments will be implemented in the next few months by amendments to the implementing federal consumer laws to be issued by the CFPB.

Perhaps most significantly, the Home Mortgage Disclosure Act ("HMDA")[10] was amended by Section 1094 of the Dodd-Frank Act to require that mortgage lenders report the following additional transaction-specific mortgage factors as to mortgage loan applications and loans actually originated:

- Age
- Total points and fees
- The APR for a loan and the "benchmark rate" for all loans
- Prepayment penalties
- The value of the real property security
- The introductory or teaser rate for a loan
- The amortization terms
- The loan term
- The channel through which the loan was originated
- The loan originator's identifier under the S.A.F.E. Act
- A universal loan identifier (assigned to a particular loan)
- The real property parcel number for the real property security
- The borrower's credit score(s)

[7] Assistant Attorney General Thomas E. Perez Testimony Before the Senate Judiciary Committee at Hearing on Fair Lending, Washington, D.C., (March 7, 2012).

[8] *See, United States v. Midwest Bankcentre*, Civ. Action No. 4:11 CV 1086 FRB (June 28, 2011).

[9] 76 *Fed. Reg.* 70,921 (Nov. 16, 2011).

[10] 12 U.S.C. 2801 *et seq.*

The CFPB will likely issue proposed amendments to HMDA's implementing Regulation C[11] in sufficient time to commence reporting the new data elements by January 1, 2013.

Section 1097 of the Dodd-Frank Act amends the 2009 Omnibus Appropriations Act to specifically direct the CFPB to adopt rules to prevent unfair, deceptive or abusive practices for all aspects of the mortgage process. (The CFPB has indicated that it views so-called "UDAAP violations" as being closely associated and overlapping with lending discrimination.) Several commentators have expressed the view that this provision may enable the CFPB to bring fair lending actions even in instances in which proving discriminatory conduct may be difficult due to the lack of statistical data to support a disparate impact claim.

Section 1071 of the Dodd-Frank Act amends the ECOA (which applies to *both* consumer and commercial lenders) by imposing data-gathering and reporting obligations for small business loans for women-owned or minority-owned businesses. Among other data elements that will become reportable, lenders will be required to report whether the applicant is a women-owned or minority-owned entity, including:

- Information regarding the individual application
- The loan purpose
- The amount of credit requested
- The credit decision
- The census tract in which the business is located
- Financial information regarding the business
- The race, sex and ethnicity of the principal owners of the business

In addition, the ECOA amendments make clear that other related or desirable information may also be required as determined by the CFPB in regulations to be issued.[12] (Because data on these elements may not have been systematically collected by lenders in the past, an institution's ability to prospectively analyze this loan information may be hampered.)

Fair Lending Compliance and Risk Management Considerations

The scope of the challenges presented by the above-described fair lending changes are of concern to a broad range of financial intermediaries—both consumer and commercial entities. More importantly, from a risk manager's perspective it should be recognized that the time and expense related to disproving and defending against a governmental allegation of discriminatory lending far out weighs the resources devoted to a well-designed compliance program.

In the case of commercial lenders, the primary focus will likely be on implementing the new reporting scheme for small business lending to be determined by the CFPB. In that regard, it is likely that the reporting requirements will be in many respects similar to the reporting currently required by HMDA and Regulation C.

[11] 12 C.F.R. § 203.1 *et seq.*

[12] On April 11, 2011, the General Counsel of the CFPB issued an opinion that clarified that the above-described ECOA amendments would not become effective until the CFPB issued implementing amendments to Regulation B, 12 C.F. R. § 202.1 *et seq.* (As of the date of this Alert, the CFPB has not indicated the date by which proposed amendments to Regulation B would be issued for public comment.)

In that regard, however, it is important to note that the touchstone of the federal fair lending enforcement programs is the availability of data enabling governmental agencies to identify statistical anomalies that may indicate discriminatory lending activity. Accordingly, it is likely that commercial lenders will soon have to conduct internal ECOA small business lending reviews similar to those conducted each year upon the publication of the HMDA data to determine whether a lender's small business lending results warrants further investigation.

In the case of consumer financial lenders, the immediate necessity of developing an enhanced risk management program to monitor exposure to the expanded range of fair lending allegations is far more pronounced. In that regard, we note the following:

First, even though the amendments to HMDA and Regulation C have not yet been adopted by the CFPB, a review of the new data points in conjunction with a lender's current internal fair lending analysis might be appropriate. Because the emphasis in such a review is to determine whether possible disparate impact concerns might be resolved by increasing degrees of statistical analysis (including loan level file reviews such as matched-pair analyses), determining possible exposures may be appropriate.

Second, even though the CFPB has taken the position that it is entitled to see attorney-client privileged information, the use of the attorney-client privilege to prevent disclosure of sensitive fair lending analytical data remains advisable. Though beyond the scope of this Alert, it is by no means clear whether the CFPB in fact has the authority to demand to review attorney-client privileged materials—and in the context of a fair lending investigation, objecting to granting the CFPB access to sensitive data must be considered.

Finally, even though it appears that the Administration as a whole has taken an aggressive approach to fair lending, the central role being taken by the CFPB may present some benefits to lenders. Specifically, lenders who have been required to address fair lending allegations before the DOJ and the federal banking agencies have often been confronted by an ever-changing set of statistical standards that are the basis of investigations. Because financial intermediaries operate best when clear compliance guidelines are available, if the CFPB plays a central role in future fair lending enforcement it may be able to identify reliable rules by which lenders may be able to analyze and evaluate their fair lending performance.

Please note that many of the legal concerns in this Alert have been summarized for the sake of brevity, and may require consultation with legal counsel to assist in developing an appropriate risk compliance program.

If you have questions, please contact the Pillsbury attorney with whom you regularly work or the author:

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