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FAIR LENDING: CURRENT ISSUES, ENFORCEMENT UPDATE, AND BEST PRACTICES FOR RISK REDUCTION

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Overview

- Fair lending is no longer limited to loan origination issues – post-closing conduct, particularly loan servicing, is the focus of current government and consumer scrutiny.
- Discrimination in loan origination is still on the government's radar, however, with settlements in ever-higher amounts.
  - American International Group subsidiaries settled charges that African American borrowers were charged higher broker fees for home mortgages than their white counterparts. *US v. AIG Federal Savings Bank*, 99-mc-09999 (D. Del., 3/4/10). DOJ's claim was based on 179,000 mortgages made from 2003-06, where AIG subsidiaries allowed "unsupervised and subjective discretion" in setting broker fees. $7.1 million settlement includes $6.1 million to compensate African American borrowers.
  - Other significant aspects: *US v. AIG Federal Savings Bank* is DOJ's first-ever case holding lenders accountable for allegedly discriminatory conduct by their affiliated brokers.
- Use of proxies (such as name and photographs) for race and ethnicity is questionable in statistics-based discriminatory lending cases – see *US v. Nara Bank*, Civ. #2:09-cv-07124-RGK-JC, September 30, 2009.

Overview

- Fair lending enforcement has migrated to loan servicing/ foreclosures/loss mitigation during the housing crisis. Foreclosures are seen as disproportionately affecting minority communities.
  - Recent studies by Community Groups bolster this perception.
- Significant public pressure exists to ensure that minority borrowers have a fair opportunity to prevent foreclosure.
- Regulators are poised to investigate and act on potential racial disparities in servicing practices.

Current DOJ Fair Lending Agenda

- DOJ's Fair Lending Task Force established January 2010.
- 38 investigations opened in 2009 by DOJ Housing Section
- Referrals alleged the following types of discrimination:
  - marital status
  - race or national origin
  - age
  - gender
- Active investigations focus on:
  - Redlining
  - Reverse Redlining
  - Retail Pricing
  - Wholesale (Broker) Pricing
  - Marketing
  - Underwriting

Factors Evaluated in Referrals to DOJ

- Referrals likely to be considered for litigation by DOJ have one or more of these characteristics:
  1. The challenged practice is serious in terms of its potential for either financial or emotional harm to members of protected classes (for example, discrimination in underwriting, pricing, or provision of lender services).
  2. The practice is not likely to cease without court action.
  3. The protected class members harmed by the practice cannot be fully compensated without court action.
  4. Damages for victims, beyond out-of-pocket losses, are necessary to deter the lender (or others) from treating the cost of detection as a cost of doing business.
  5. The agency believes the practice to be sufficiently common in the lending industry, or raises important issue, so as to require action to deter lenders.

DOJ Litigation and Settlement Principles

- Assistant Attorney General Tom Perez stated that Fair Lending cases will be litigated and settled according to several principles:
  - Settlements will require lenders to invest in the community that they harmed.
  - Settlements will promote transparency and accountability; agreements will require data collection and recordkeeping. Agreements will incorporate benchmarks to measure progress.
  - Continued use of traditional fair housing tools, such as testing, to prevent discrimination and steering.
  - Settlements will support innovative and creative solutions and require working with federal, state, and local partners to rebuild and reinvest in communities.

Key Themes in "Fair Servicing" Arena

- Skyrocketing defaults and foreclosures have drawn scrutiny of mortgage loan servicing by government agencies, legislators, consumers' groups, and private litigants.
  - Traditional enforcers (FTC, HUD, and State AGs), are being supplemented by new enforcers, *e.g.*, DOJ's Fair Lending Unit, Office of the United States Trustee, Obama Administration's Financial Fraud Enforcement Task Force.

- Key Legal and Regulatory Themes:
  - Focus on "Fair Servicing" for protected classes; and
  - Focus on unfair and deceptive servicing practices more generally, particularly regarding loans in default.

Fair Servicing: Fair Lending's New Frontier

- A new Fair Lending Unit within DOJ's Civil Rights Division is headed by Assistant Attorney General Tom Perez.
  - Conducting analyses of potential discrimination in loan modifications by examining Treasury HAMP data.
  - Partnering with other Federal agencies as well as State AGs.
  - Additional areas of focus include:
    - Access to modifications for Spanish-speaking borrowers.
    - Alignment of modification review and foreclosure processes.

Fair Servicing: Fair Lending's New Frontier

- Banking Regulators are also prioritizing fair servicing, particularly in the default context.
    - The OCC revised its Fair Lending booklet to prohibit treating borrowers differently in servicing a loan or invoking default remedies based on prohibited factors.
    - OCC and Federal Reserve Board are conducting non-public "fair servicing" reviews.
- HUD is examining HAMP data and preparing to bring joint cases with DOJ and FRB.

Fair Servicing: Fair Lending's New Frontier

- Legislators are pressuring Treasury and DOJ to publically release disaggregated HAMP modification data.
- Consumer advocacy groups shifting focus to fair servicing.
  - Recent NCRC study suggests that among HAMP-eligible borrowers 36.4% of whites received loan modification approvals in contrast to 32.3% of Hispanics and 24.3% of African Americans.*
  - Studies and reports on the foreclosure and housing crisis are likely to stimulate private litigation alleging servicers discriminated in their servicing and modification practices.

Source: National Community Reinvestment Coalition, *HAMP Mortgage Modification Survey 2010* (April 2010).

Fair Servicing: Fair Lending's New Frontier

- There are significant factual impediments to the viability of fair servicing actions, but challenges to self-policing.
  - Servicers rarely have race and ethnicity data.
  - High non-compliance by borrowers with HAMP race data collection.
  - Numerous impediments to useful and reliable statistical analysis.
  - Borrower comparisons may be difficult. *All loan applicants want a loan, but all delinquent borrowers may not want to stay in homes.*

Fair Servicing: Fair Lending's New Frontier

- Discretion is a double-edged sword in modification programs.
  - Some servicers with the most successful modification programs provide the greatest discretion for customer service and workout personnel.
  - Historically, discretion has been used against financial institutions in fair lending context.
    - If past is prologue, the greater the level of discretion, the higher the potential for race-based disparities in outcomes.
  - Regulators are signaling that discretion will be key area of fair lending compliance and enforcement focus.

Unfair and Deceptive Servicing Practices

- Regulators are challenging the sufficiency of workout procedures and other foreclosure prevention measures.

- State Attorneys General have been active with respect to investigations and related litigation.

  - Ohio AG recently sued three mortgage loan servicers asserting that loan modification practices were unfair and deceptive.

  - Connecticut AG is investigating the relationship between servicers and independent contractors.

Unfair and Deceptive Servicing Practices

- Federal Trade Commission continues to lead the charge against servicers, building on landmark consent decrees involving Fairbanks and EMC Mortgage.

- *FTC v. Countrywide Home Loans, Inc.* consent decree (June 2010) focuses on default-related fees and procedures for bankrupt borrowers.

- Key Allegations Against Countrywide:
  - Affiliates used in a "vertical integration strategy" to charge "marked up" fees to borrowers;
  - False or unsupported claims made to bankrupt borrowers regarding amounts owed and status of loans (data integrity at issue);
  - Failure to disclose fees, escrow shortages and other deficiencies that accrued while the borrower was in bankruptcy; and
  - Impermissible collection of accrued amounts after bankruptcy case closed.

Unfair and Deceptive Servicing Practices

- Largest FTC settlement in a mortgage servicing case.
  - $108 million in redress ordered.

- Settlement imposes unprecedented restrictions on default servicing:
  - Bars charging any fee for a default-related service except reasonable fees charged by a third-party for work actually performed.
  - If a service is provided by an affiliate, the fee must be within limits set by state law, investor guidelines, and market rates.
  - Borrowers must be notified if affiliates will be used, and be provided with a fee schedule.
  - Requires annual independent reviews of reasonableness of affiliates' fees.
  - Bankrupt borrowers must receive monthly notice identifying amounts currently owed, including all fees assessed during the prior month.

Unfair and Deceptive Servicing Practices

- Foreclosure and bankruptcy filings being challenged by government regulators, judges, and private litigants. Document and data integrity issues often at epicenter of disputes.
  - DOJ/Florida AG investigation of DOCX (LPS subsidiary) highlights emerging trend of document integrity issues impeding foreclosure.
  - Florida Federal judge ordered fraud hearing to probe allegations that M&T Bank changed mortgage note assignment three times for one borrower.

Fair Lending Litigation Developments

- Municipal reverse redlining lawsuits – Baltimore, Cleveland, Memphis, Birmingham.
- Option arm class actions – over 40 pending cases.
- FHA/ECOA disparate impact loan pricing and loan servicing class actions.
- Predatory lending and pricing class actions.
- Predatory servicing class actions.

State AGs in the Enforcement Arena

- State AGs seek high dollar settlements and mortgage relief.

- "Justice Outsourced" -- State AGs retain private plaintiffs' firms on contingency fee

  - Some states attempt to address budget constraints and limitations on subject matter expertise by retaining private plaintiffs' firms on a contingency fee basis, to prosecute fair lending complaints.

  - The use of private plaintiffs' firms has been expanded to representation in investigations.

  - Retention on a contingency fee basis is not permitted under the laws of many states and raises due process concerns.

Is Government Being Provoked to Sue?

- GAO Report tacitly encourages additional agencies to refer fair lending cases: "Since 2005, OTS, the Federal Reserve, and FDIC have referred more than 100 lenders to DOJ for further investigations of potential fair lending violations, as required by ECOA, while OCC made one referral and NCUA none."

- GAO Report downplays government success in settling discrimination cases: "Enforcement agencies have settled relatively few (eight) fair lending cases since 2005. Agencies identified several enforcement challenges, including the complexity of fair lending cases, difficulties in recruiting and retaining staff, and the constraints of ECOA's 2-year statute of limitations."

Source: "Fair Lending: Data Limitations and the Fragmented U.S. Financial Regulatory Structure Challenge Federal Oversight and Enforcement Efforts," GAO-09-704, July 15, 2009; online at http://www.gao.gov/products/GAO-09-704.

Of 31 fair lending referrals in 2009, 21 were from the Federal Deposit Insurance Corporation (FDIC); 6 from the Federal Reserve Board (FRB), and 4 from the Office of Thrift Supervision (OTS). Source: "Fair and Responsible Lending Regulatory and Enforcement Update," by Andy Sandler, Consumer Bankers Association, CBA Live 2010, June 2010.

Is Government Being Provoked to Sue?

- Provocative Statements and Statistics Lead to Additional Enforcement Efforts

  - "There are at least 4 million fair housing violations in our country ever year."
  - "Fair Housing enforcement at HUD is failing."
  - "Fair Housing enforcement at The Department of Justice is weak."

Source: The Future of Fair Housing, Report of the National Commission on Fair Housing and Equal Opportunity (December 2008), online at http://www.lawyerscommittee.org/admin/fair_housing/documents/files/0005.pdf

Data Weaknesses Add to Uncertainty

- Difficulty of identifying/isolating discriminatory conduct is "built in" to the data analyzed in fair lending cases
  - HMDA data (for mortgage lending) do not include information on borrower credit profiles
  - Non-mortgage lenders are not required to report the race, ethnicity, and sex of borrowers
- GAO Conclusion: Without additional data, agencies' and regulators' capacity to identify potential lending discrimination is limited.

Source: "Fair Lending: Data Limitations and the Fragmented U.S. Financial Regulatory Structure Challenge Federal Oversight and Enforcement Efforts," GAO-09-704, July 15, 2009; online at http://www.gao.gov/products/GAO-09-704

GAO Recommendations on Fair Lending Enforcement

- GAO Recommendations to Congress (July 2009):
  - Authorize collection of additional data, *e.g.*, credit scores, LTV and DTI ratios for mortgage loans, and race, ethnicity and sex for non-mortgage loans.
  - Extend the statute of limitations for ECOA violations.
  - Ensure that fair lending laws are comprehensive and consistently applied, and that oversight is efficient and effective.
  - Addressing gaps and inconsistencies in oversight of independent mortgage brokers and nonbank subsidiaries.
  - Addressing inconsistent fair lending oversight by depository institution regulators.
  - Multi-agency collaboration to identify approaches for better assessing the potential risk for discrimination during the pre-application phase of mortgage lending, *e.g.,* use of testers, surveys of borrowers and applicants.

Risk Mitigation Strategies

- Prioritize procedural and compliance training.
- Establish ceilings on broker fees.
- Supervise performance of loan originators with subjective or discretionary authority.
- Second reviews of loan fees prior to funding.
- Carefully craft loss mitigation policies, emphasis on consistent and full documentation of exceptions.
- Privileged self-assessments of workout data.
  - Examine outcomes by race, national origin, and other prohibited bases.
  - Analysis should include range of workout possibilities.
  - Examine issues such outcome frequency, terms, and speed.
- Monitor workout practices, including consumer complaints and litigation. Adjust accordingly.
- Make robust data integrity checks central in boarding.
- Conduct thorough due diligence and compliance review of third-party service providers.
- Implement comprehensive internal procedures for monitoring legal and regulatory compliance.

Short Term Predictions for Fair Lending Enforcement

- Increased use of consent orders by bank regulators.
- More DOJ consent decrees.
- More actions claiming discrimination in credit card and auto lending.
- Proliferation of State AG fair lending enforcement actions.
- Denial disparity rates return as major issue.

For Further Information

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