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Interagency Fair Lending Guidance: A First Step, but in the Right Direction?

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Five federal regulators, with HUD noticeably absent, issued the first interagency guidance on the much-debated intersection of fair lending enforcement and the Ability-to-Repay and Qualified Mortgage Standards Rule taking effect in January 2014. In an Interagency Statement issued on October 22, 2013, the Consumer Financial Protection Bureau, Office of the Comptroller of the Currency, Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation and the National Credit Union Administration responded to industry concerns about whether the decision to offer only "Qualified Mortgages" (QMs) will put lenders at risk for fair lending claims. The agencies advised that they "do not *anticipate* that a creditor's decision to offer only qualified mortgages would, *absent other factors*, elevate a supervised institution's fair lending risk" under the Equal Credit Opportunity Act (ECOA). They stopped short of providing any definitive guidance, let alone making any guarantees. Generally, the Interagency Statement provides some limited comfort for lenders who plan to issue QMs, but the guidance is incomplete.

THE REGULATORY BACKDROP

The Dodd-Frank Act charged the Consumer Financial Protection Bureau (CFPB) with rewriting mortgage lending rules, including the creation of a new Ability-to-Repay Rule. The Rule generally requires lenders to make a reasonable, good-faith determination that a consumer has the ability to repay a mortgage loan before extending the loan.[1] And it creates a presumption of compliance for certain QMs, which may have a debt-to-income ratio limit of no greater than 43% and are subject to various restrictions on loan features perceived as more risky, like interest-only terms, prepayment fees, extended amortization, "points and fees" in excess of 3% and balloon payments. In the CFPB's words, the Rule "provides a shield against litigation by borrowers who default or mortgage-backed securities holders if loans hit some elevated requirements."[2]

The strictures surrounding QMs are reminiscent of former Congressman Frank's "plain vanilla" mortgage rule, surfaced in the early stages of the Dodd-Frank Act debate. There are widespread concerns that choosing to offer only relatively low-priced mortgage loans with "standard" terms will result in low to moderate income borrowers being shut out of the mortgage market. To the extent this results in a disproportionate negative impact on product choice for minority (non-white) borrowers, fair lending risks arise.

[1] For more detail, see our client alerts on the Ability-To-Repay Rule here and here.

[2] CFPB Press Release, "Federal Regulators Provide Guidance on Qualified Mortgage Fair Lending Risks" (Oct. 22, 2013), available here.

Regulators broadly interpret ECOA and the Fair Housing Act (FHA) to apply to any lending policy that has an adverse impact on a protected class of borrowers, regardless of any discriminatory intent by the lender. The CFPB interprets ECOA to prohibit any "practice that . . . has a disproportionately negative impact on a prohibited basis . . . unless the creditor practice meets a legitimate business need that *cannot reasonably be achieved as well* by means that are less disparate in their impact."[3] And the Department of Housing and Urban Development (HUD) recently issued an aggressive disparate impact rule that requires a defendant to show that "the challenged practice is *necessary* to achieve one or more substantial, legitimate, nondiscriminatory interests" and that the defendant could meet that interest with some other, theoretical practice "that has a less discriminatory effect."[4] The CFPB, HUD, OCC and other regulators have been consciously and vocally ramping up fair lending enforcement even as the CFPB has been working on tightening lending requirements.[5]

AGENCY RESPONSE

The Interagency Statement responds that they "do not *anticipate* that a creditor's decision to offer only Qualified Mortgages would, *absent other factors*, elevate a supervised institution's fair lending risk." The agencies took care to add, though, that "[i]ndividual cases will be evaluated on their own merits," and "[c]reditors should continue to evaluate fair lending risk as they would for other types of product selections, including by carefully monitoring their policies and practices and implementing effective compliance management systems."

In the Statement, the agencies liken the current situation to that in 2008, when many creditors decided to stop offering higher-priced mortgage loans after the adoption of various rules regulating those loans. They added, "We are unaware of any ECOA or Regulation B challenges to those decisions."

OPEN ISSUES

The Interagency Statement responds only to the very first part of the industry's wider concerns about fair lending enforcement after the Ability-to-Repay Rule takes effect in 2014. The Statement implies that the decision to issue only QMs may constitute a "legitimate business need" under the ECOA, but stops short of saying so. Instead, it states vaguely that "creditors *may* have a legitimate business need to fine-tune their product offerings over the next few years in response" to the Ability-to-Pay Rule and other Dodd-Frank Act regulations. This might provide some comfort that, at least for now, a decision to offer only QMs in 2014 is arguably in response to a legitimate business need. But in any event, even a legitimate business need can be overridden by an agency determination that the need can "reasonably be achieved as well" by some other practice that the agency decides that it prefers.

More broadly, the Interagency Statement is limited to "guidance" about "some general principles that will guide supervisory and enforcement activities." That may be helpful for working with the agencies at the next exam, and it may even be persuasive to a court considering a fair lending challenge. But it does not limit the ability of private plaintiffs or other regulators like HUD to bring claims under the FHA or any other state or federal statute, or even do anything to bind the issuing agencies. The agencies could have issued official staff commentary stating that,

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[3] 12 C.F.R. pt. 1002, Supp. I, § 1002.6, ¶ 6(a)-2.

[4] 24 C.F.R. 100, available on the HUD website.

[5] See, for example, CFPB Bulletin 2012-04 and our client alerts on CFPB enforcement actions regarding HMDA violations and indirect auto lending, the new HUD disparate impact rule, and recent disparate impact litigation in the Supreme Court.

in their view, the decision to issue only QMs consistent with the Ability-to-Pay Rule is in response to a legitimate business need and will not in and of itself subject a lender to liability under the ECOA, but they chose not to do that.

Even assuming the agencies mean to say that they “anticipate” abstaining from bringing fair lending claims on the basis of a creditor’s decision to issue only QMs, that is of limited comfort because that is not how disparate impact fair lending claims are commonly initiated. In practice, with the popularity of disparate impact, government agencies or private plaintiffs point to rough data that appear to show that a protected class of borrowers, on average, has statistically significant adverse outcomes. Then, particular practices are attacked. The alleged “practice,” for example, may be a grant of impermissible “discretion” to loan originators. Under the disparate impact burden-shifting analysis, defendants must prove that the identified practice is “necessary” to achieve a legitimate interest, while the existence of an alternative that merely “serves” the interest in a less discriminatory way may result in liability for discrimination. This lack of symmetry increases the risk of second-guessing and 20-20 hindsight in disparate impact cases.

A real issue, then, is whether a lender’s decision to issue QMs could impact its fair lending data by, among other things, increasing denial rates for protected classes of borrowers who are on average statistically less likely to meet the QM requirements. The lender would then be obligated to prove that the disparity is due to its policy of not making loans other than QMs and not, for example, because of an overly broad grant of discretion to its loan officers or the alleged failure to adequately serve minority communities through its advertising or branch locations. The Interagency Statement seems to leave open this possibility, noting that “other factors” may still “elevate a supervised institution’s fair lending risk.”

Moreover, the guidance, such as it is, is limited to the ECOA. Fair lending enforcement and litigation takes many forms, including under the FHA and state and federal UDAP / UDAAP laws. HUD did not join the Interagency Statement, and has issued its own aggressive interpretation of the disparate impact doctrine under the FHA.[6] In the Interagency Statement, the agencies advised that they “believe the same principles described [in the Statement] apply in supervising institutions for compliance with the . . . FHA,” but again, that is not binding on any court or on HUD.

CONCLUSION

Any guidance on the implementation of the Ability-to-Repay Rule and fair lending enforcement is welcome. But, fair lending enforcement and litigation may still pose serious concerns even for lenders issuing only QMs. The lesson from the Interagency Statement may be that lenders electing to make only QM loans should continue to carefully evaluate and monitor fair lending risk, through HMDA data analysis and other prudent measures within a robust compliance management system.

[6] For more information, please our client alert here.

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