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Redlining Cases In 2015 And A New Discrimination Standard

Law360, New York (January 3, 2016, 10:03 AM ET) --

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Limited access to mortgage credit for credit-impaired and low- and moderate-income (and, therefore, disproportionately minority) borrowers has become a significant public policy challenge in the post-financial crisis era. There are many reasons for this problem. Among them are mortgage lender retreat to qualified mortgage (QM) loans out of fear of the consequences of loan default, lender aversion to use of the Federal Housing Administration (FHA) program due to the aggressive efforts of the U.S. Department of Housing and Urban Development and U.S. Department of Justice to seek to recapture (through the False Claims Act or an indemnification) insurance payments on defaulted FHA loans, and hard-nosed repurchase demands by Fannie Mae and Freddie Mac. To make matters worse, precrisis lender efforts to better serve these borrowers, even efforts arising out of initiatives of housing activists, were later attacked as “reverse redlining” and “targeting” by advocates, municipalities and even the DOJ.

In the absence of a carrot — a profitable way to serve this market — the federal agencies with responsibility for enforcing the fair-lending laws — the Consumer Financial Protection Bureau, prudential banking regulators, DOJ and HUD — are seeking to pressure lenders to make more loans to minority borrowers by using the “stick” of enforcement activity. The agencies are misapplying the disparate impact discrimination standard recently affirmed by the U.S. Supreme Court for limited use in connection with the Fair Housing Act.

Specifically, these agencies have taken the position that the failure of a lender to achieve statistical equivalence in their lending in geographies with different racial and ethnic population characteristics suggests the need for investigation to determine whether that lender is engaged in redlining discrimination. Thus, mortgage lenders are well-advised to review carefully the many recent redlining enforcement actions by the federal enforcement agencies to determine whether they are at significant risk for such an action and, if so, whether there are steps that they can take to make themselves less

vulnerable. This article describes the most recent redlining settlements and suggests the key factors that have led to this enforcement activity.

The government's use of the term "redlining" in its current wave of fair-lending enforcement, which has focused on statistics related to geographic lending patterns, is a misuse of that term. The term redlining was developed in a series of investigations focused on conduct by lenders to avoid extending credit in minority neighborhoods. Some of these early cases literally involved evidence that lending managers would draw a red line or circle on a map and direct their employees not to offer mortgage loans in certain designated areas because of their heavy minority populations. That invidious practice is very different from the situations where the government alleges redlining today, which center on allegations that a lender failed to achieve statistical equivalence in its lending penetration in minority and nonminority communities.

The recent redlining cases have relied heavily on statistical disparities in the subject lender's Home Mortgage Disclosure Act (HMDA) reportable application volume in majority minority census tracts as compared to application volume by lenders that the regulators consider to be the subject bank's "peers." The peer group analyses conducted by government analysts typically are overinclusive and fail to account for material factors such as differences in Community Reinvestment Act (CRA) assessment areas and obligations, product offerings, business models and loan delivery channels. As a result, a small business lender that primarily provides residential mortgage lending as an accommodation to its small-business customers can be compared to a bank whose business model centers predominantly on mortgage lending, as observed in several redlining settlements with community banks in St. Louis.

It also means that a prime lender with a limited product offering — possibly due to the fact that the lender has not received FHA lending authority or does not have the ability to retain any loans in portfolio — is expected to perform on par with lenders that have diverse suites of prime and subprime products as well as mortgage servicing capabilities for special-purpose loan products. For example, both of the community banks in St. Louis that recently settled redlining allegations with the DOJ offered a narrower product set focused on prime borrowers. Further, as indicated by the DOJ's 2012 settlement with Luther Burbank Savings, banks that offer mortgage products specifically designed for their high-net-worth and/or private bank customer base are also at risk of redlining allegations if they do not also provide alternative mortgage products geared toward lower-income borrowers.

Notwithstanding the obvious limitations of relying on relative loan volume in a particular geographic area without regard to differences in lender business models to establish a demonstrated intent to avoid lending to minorities or minority communities, the enforcement agencies persist in the use of superficial peer analyses as their principal evidence in bringing "redlining" discrimination cases. This misuse of statistics to advance a discrimination claim is directly inconsistent with the position taken by the U.S. Supreme Court in Texas Department of Housing and Community Affairs v. The Inclusive Communities Project Inc. ("Inclusive Communities"). In Inclusive Communities, the court upheld the availability of the disparate impact theory under the Fair Housing Act, but specifically cautioned that a statistical disparity, without an identified policy or policies allegedly causing the disparity, is insufficient to establish even a prima facie case under a disparate impact theory.

For example, HUD entered into a redlining settlement in May of this year, shortly before the Supreme Court issued its opinion in Inclusive Communities, in which it claimed that Associated Bank NA had failed to provide loans in neighborhoods with significant African American or Hispanic populations in six metropolitan areas in Illinois, Minnesota and Wisconsin. The Associated agreement is notable for the significant expansion of the bank's physical presence required under the agreement. Even though the

bank had already opened or begun the process of opening three branches, the agreement requires the bank to open an additional four loan production offices.

The allegations appear to have been based exclusively on the results of HUD's statistical analysis. According to the conciliation agreement, HUD's redlining allegations were based on analyses of the bank's lending in African-American and Hispanic neighborhoods that indicated Associated's market share in these neighborhoods was lower than its market share in other neighborhoods. In addition to the peer analysis results, HUD alleged that the bank's denial rate for African-American and Hispanic applicants was higher than for other applicants.

In a $33 million redlining settlement announced in September 2015, shortly after Inclusive Communities, the CFPB and DOJ alleged that Hudson City Savings Bank avoided lending to African-American and Hispanic neighborhoods in New York, New Jersey, Pennsylvania and Connecticut. The enforcement agencies cited as additional nonstatistical evidence of discrimination Hudson City's broker selection practices, noting that the bank received 80 percent of its mortgage applications from mortgage brokers but that the brokers with whom the bank worked were not located in majority African-American and Hispanic areas.

Notably, currently there is no publicly available useful data that would help a lender identify which brokers serve which neighborhoods, but the CFPB's recently adopted final rule revising Regulation C will capture and report that data. This element of the Hudson City action is a significant departure from past cases as redlining cases historically have focused on a bank's physical presence in areas and their pattern of conduct in opening and closing bank branches. The Hudson City action suggests that the enforcement agencies will now also look to lenders' relationships with third parties such as brokers and agents who sell products on behalf of, or who are referral sources for, lenders, notwithstanding the lender's lack of access to reliable information concerning the overall performance of those third parties. The agencies also alleged that Hudson City excluded African-American and Hispanic areas from its marketing strategy and credit assessment area under the CRA, a common claim in redlining enforcement actions against banks and one that conflates the CRA, a statute intended to ensure that banks meet the needs of low- and moderate-income borrowers in the communities they serve, with the federal fair-lending laws.

Redlining allegations have especially serious consequences for banks. In addition to financial penalties and reputational damage, a bank under a consent order is severely restricted in its ability to expand. From the time that a bank becomes subject to investigation by an enforcement agency through the expiration of the consent order — typically four or more years — the bank generally is subject to heightened regulatory scrutiny of any proposed branch openings or closings, as well as any proposed mergers or acquisitions. Fair-lending settlements also commonly result in a downgrade in a bank's compliance rating and CRA rating.

Notably, community banks recently have been hit the hardest by redlining allegations. Community banks — particularly those in overbanked or economically depressed metropolitan areas — have significant obstacles to penetrating the lending market in all parts of a city or MSA, and yet recent enforcement activity suggests that regulators expect these banks to allocate their scarce resources toward establishing physical presences in minority census tracts, devoting substantial marketing and advertising expenditures, and offering a diverse suite of mortgage products regardless of market demand or availability of resources. The most notable examples of such DOJ and HUD settlements have focused heavily on community banks in St. Louis, but banks in other areas have been the subject of such orders, including First United Security Bank in Thomasville, Alabama, and Community State Bank in Saginaw,

Michigan.

Given these recent redlining cases, and the many similar matters now under investigation by the federal enforcement agencies, mortgage lenders, including banks and nonbanks alike, should be prepared for increased scrutiny of strategic business decisions that could adversely impact the lender's relative statistical footprint in minority and nonminority communities. Lenders that wish to mitigate the risk of a redlining investigation should focus carefully on all aspects of their mortgage lending activity — from product development and branching to personnel and marketing strategy. In addition, lenders should consider using market penetration analysis — comparing their market penetration in all communities they serve to those of an appropriately defined peer group — to evaluate the statistical implications of their mortgage lending strategies. Lenders can then use the results of such analysis to direct their efforts to mitigate the risk of a redlining investigation.

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