BNA's Banking Report™

May 28, 2013

CRA and Disparate Impact Now More Muddled Than Ever

FAIR LENDING

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The recent Office of the Comptroller of the Currency (OCC) decision applying disparate impact theory in finding that a group of white borrowers had been discriminated against adds a further layer of confusion to the interplay of various laws to encourage community lending and discourage discrimination. At first blush, the case would seem insignificant in view of the small size of the community bank involved (only $7 million in total assets), the limited number of borrowers entitled to restitution (around 65), and the low overall amount to be refunded (less than $100,000). As compared with the eight- and nine-figure settlements of fair lending and other cases involving mortgages that have been occurring with increased frequency, this matter shouldn't even be on the radar screen. But if it becomes a precedent that is followed in other cases involving the already complex and overlapping myriad fair lending laws and their enforcement by regulators, it could further add confusion to an area that is already too complex and confused.

The matter involves Community First Bank of Pikesville, Md., which settled OCC claims that the bank discriminated against “non-minority males and female-male couples” by failing to provide loan-related credits that the bank provided for female and minority borrowers. According to the OCC, for female and minority borrowers, the bank capped loan compensation, such as origination fees and yield spread premiums, at 2.5 percent of the loan amount, and provided a “lender credit” to those borrowers if the loan compensation exceeded the 2.5 percent target. But the bank failed to provide the lender credit for similarly situated nonminority males and female-male couples who were charged $73,000 in compensation-related fees and charges, according to the OCC.

In order to better understand the potential significance of this small case, one needs some background in the confused existing state of fair lending enforcement. Let's start with the Community Reinvestment Act (“CRA”). Though not strictly speaking a fair lending law, this Act, passed in 1977, is designed to make sure that banks serve all segments of the communities in which they are located, including low- and moderate-income neighborhoods consistent with safe and sound banking practices; and without requiring looser underwriting standards and lower pricing. However, many banks found that making these loans in many of these communities, without some underwriting and pricing concessions, was difficult to achieve. Because CRA ratings are such an important factor in regulatory consideration of bank acquisitions, and peer comparisons are a factor in determining ratings, banks made special efforts to assure that they received one of the two highest CRA ratings by adopting programs with special underwriting and pricing concessions to help generate loans that qualify for CRA credit, which in the aggregate amount to many billions of dollars. There was nothing wrong with that: it helped boost lending in these communities, a desirable social policy.

Consistent with CRA are various fair lending laws relating specifically to housing, particularly the Fair Housing Act of 1968, and other lending activities, which among other things outlaw discrimination in mortgage lending and help assure that minorities weren't being targeted to pay higher rates or meet tougher underwriting standards on mortgages than applied to similarly situated credit-worthy whites. Again, this is desirable social policy. But beginning in the mid-1990s, applying through enforcement activities the so-called theory of “disparate impact”; that is, policies that while racially neutral on their face but on the basis of hind-sighted statistical models suggested that non-whites were paying fractions of a percent of higher interest rates, banks found themselves the subject of allegations of pricing discrimination by regulators, primarily by the Civil Rights Division of the Department of Justice (“DOJ”). In other words, even if no policies were intended to charge minorities higher rates, and if reviews of mortgage applicant files did not show any evidence of overt or intentional discrimination, the limited discretion generally allowed by financial institutions to their mortgage originators to vary rates upward, combined with compensation incentives to do so, could be statistically modeled to determine whether minorities were on average paying higher rates than whites. The determination as to whether there was statistical evidence that this was the case often depended on which variables should be included in the statistical model adopted. And so some of these enforcement actions devolved into battles between regulatory mathematical experts and those hired by the banks. I was the general counsel of a large financial institution that was one of the first to be charged under the disparate impact theory. The result of whether there was any statistical analysis that indicated that minorities were on average paying higher rates than comparably situated whites came down to the inclusion or exclusion of one arcane variable among about 20. Naturally, the financial experts of the regulators and those hired by the bank disagreed as to the appropriateness of including this variable.

As with most disputes with government agencies, the playing field was hardly level. Facing the possibility of a significant pending acquisition being delayed or even denied over potential violations of fair lending laws, the bank settled for what was then the highest penalty DOJ had obtained to date. (The $4 million settlement now looks pretty paltry compared with amounts paid recently to settle these matters.)

Expanding, Complicating the Banks' Burden

Matters became even more complicated when the regulators decided that the banks were responsible not only for average statistical variances in mortgage pricing by their own employees, but also by brokers from whom they purchased mortgages, thereby requiring banks to police these brokers' incentive compensation programs by applying the same statistical models to determine whether these purchased loans indicated that minorities, on average, were paying higher rates than non-minority borrowers. As a result, many banks set up their own expensive compliance programs and infrastructure to statistically compare after the fact the rates paid by minorities and whites on self-originated and purchased loans. Giving the originators limited pricing discretion that compensated them for higher rate loans, which the lenders maintained was crucial in hiring and keeping the best personnel – which is not in of itself forbidden by any law – was still allowed by many lenders, as long as the average paid by minorities and whites was statistically similar. Many critics of the industry complained that the lenders were crying wolf when they defended the practice on grounds relating to employing the best personnel, but much of the industry argued that these long-standing practices were essential and were willing to live with after-the-fact statistical analysis, whereby originators whose rates charged to minorities seemed higher on average were in some way penalized.

With these new policies in place, enforcement activity tended to decline. But the financial crisis of 2008, resulting in the passage of the Dodd-Frank Act, which included the creation of a new agency exclusively dedicated to consumer protection (the Consumer Finance Protection Bureau or “CFPB”), combined with the fact that poorly underwritten higher-priced mortgages were in large measure responsible for the creation of the crisis, resulted in renewed interest in the topic of compliance with fair housing laws in the origination of mortgages by a swath of government agencies, including the new CFPB, banking regulators and the DOJ. What followed was a series of high-profile, extremely large settlements by a number of banks of allegations of discrimination in the pricing of mortgage loans based on disparate impact grounds.

The interesting thing is that the banks were hopeful that the whole theory of disparate impact might well be overturned by the Supreme Court in a case that it was to hear last term involving disparate impact in certain housing laws. The betting was that the conservative Court would throw out the theory completely. Unfortunately for the banks, the case ultimately was withdrawn before it was heard by the Court. This only served to embolden the regulators to continue to enforce discrimination cases in the lending area utilizing disparate impact analysis.

Then came the recent enforcement action by the OCC against a small institution for instituting programs offering concessions in mortgage pricing for unmarried women and minorities; in other words, so-called “reverse discrimination.” This decision collides with the fact that banks have been careful in pricing to make sure that there was no discrimination against minorities; but in fact, many have offered pricing concessions to minorities in order to obtain favorable CRA ratings. In many respects, the whole subject has taken on many of the attributes of the validity of affirmative action policies in college admissions, a matter that the Supreme Court is scheduled to review again this term.

The purpose of this article is not to criticize any given program to encourage fair lending and availability of credit to all constituencies; but the latest enforcement action by the OCC does create a mine field for financial institutions where they face the risk of being “damned if they do and damned if they don't.” The layering on top of this of myriad new regulations issued under Dodd-Frank on a variety of mortgage lending practices will only add to the quagmire. The regulators that enforce these laws (the CFPB, OCC, DOJ, etc.), who seem to be operating in tandem (as opposed to many cases where different federal agencies seem to be acting at cross purposes) need to come up with a clear-cut statement that will provide direction to lenders as to how to design programs that are well-intended attempts to help various minority groups, and to achieve favorable CRA ratings, without running afoul of fair lending laws, rather than by utilizing the enforcement mechanism on a case-by-case basis, which frequently produces inconsistent rulings that often seem difficult or even impossible to follow.

For More Information

The OCC consentorder can be viewed at http://op.bna.com/bar.nsf/r?Open=jtin-97r2gu.