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# Mortgage Banking/Consumer Finance Commentary

## Loan Eligibility Criteria Subject to Disparate Impact Attack

Using loan size or property type as eligibility criteria for making or purchasing residential mortgage loans may raise significant fair lending issues based on a recent Conciliation Agreement ("Agreement") announced by HUD. The Agreement, reached in September, resolves a complaint filed by the National Community Reinvestment Coalition (NCRC) against SouthStar Funding ("SouthStar"). NCRC alleged that SouthStar was discriminating on the basis of race and national origin in violation of the Fair Housing Act by refusing to make mortgage loans on row homes in Baltimore and/or row homes valued at less than $100,000.00 nationally. The Agreement provides that SouthStar will cease using these criteria as an absolute bar to the making of a loan, and will pay $500,000.00 to NCRC. Worthy of note is that the Agreement appears to include the application of a "disparate impact" analysis to a complaint alleging discrimination in lending on the basis of race and national origin. The analysis upon which the Agreement is based impacts not only loan originators, but also secondary market investors who establish underwriting standards and other purchase criteria for residential mortgage loans.

### "DISPARATE TREATMENT" AS COMPARED TO "DISPARATE IMPACT"

Complaints of lending discrimination most frequently are reviewed under a "disparate treatment" legal theory. That is, the issue presented is whether the complainant was treated differently than a similarly qualified applicant on account of her race, national origin or other prohibited factor. For example, disparate treatment may be established by proof that a Hispanic applicant was denied financing to purchase a row home when an identically qualified White applicant was approved for financing for the row home and the lender is unable to offer a nondiscriminatory reason for the difference in treatment. "Disparate treatment" constitutes intentional discrimination. Difficult issues often arise in the actual application of the "disparate treatment" legal standard, but it generally is accepted that this legal theory is appropriate for evaluating complaints of unlawful discrimination in the lending process.

The NCRC complaint did not allege that applicants for loans to purchase a row home were treated differently on account of race or ethnicity; they simply alleged that no one, regardless of race or ethnicity, would be eligible to receive a loan. The complaint thus raised the much more controversial issue of the propriety of applying a "disparate impact" legal theory to claims of lending discrimination.

This legal theory arises from the field of employment litigation and assumes that a defendant has uniformly applied a neutral criterion to all applicants, that is, there is no "disparate treatment." If the uniformly applied, neutral criterion disproportionately impacts a group protected by civil rights laws, the defendant is required to demonstrate that the criterion is justified by a business necessity to avoid a finding of legal liability. Even if business necessity is established, a violation may exist if it is demonstrated that the business consideration can be satisfied by a criterion that has a less severe impact on protected groups. Unlike "disparate treatment," intent is not a necessary element of proof in "disparate impact" cases.

The "disparate impact" theory might be applied in employment litigation, for example, to a fire department that requires that all firefighters be at least six feet tall. This criterion for employment, although neutral and uniformly applied, would disproportionately impact females, and, thus, if the employer is unable to demonstrate that it is necessary to be six feet tall to be an effective firefighter, the employment criterion would constitute illegal discrimination on the basis of gender.

## "DISPARATE IMPACT" AS APPLIED TO CLAIMS OF LENDING DISCRIMINATION

The "disparate impact" legal theory, however, does not easily migrate from employment to lending. Lenders utilize a host of criteria that have differing impacts on groups protected by the Fair Housing Act and the Equal Credit Opportunity Act. Down payment requirements, for example, likely have a greater impact on Black and Hispanic borrowers than White borrowers inasmuch as the racial and ethnic households do not have the same level of wealth as White households. Perhaps it could be demonstrated that debt ratio standards disqualify a significantly greater percentage of minority applicants than White applicants. Does such an "impact" require lenders to demonstrate that the criteria, which are time-honored and customary, are driven by a business necessity? Would a lender be required to evaluate whether its business reasons for debt ratios could still be met if the ratios were raised to higher levels and therefore, perhaps, more minorities could be qualified? These are the types of issues that have greatly concerned the lending industry, and the issues remain largely unresolved.

To start, the question of whether the "disparate impact" theory is applicable to **any** claim under the Fair Housing Act is not free of doubt. The Reagan Administration expressed the view that only intentional discrimination is prohibited by the Fair Housing Act, even though federal courts of appeal had uniformly held to the contrary. The Clinton Administration differed and contended that a Fair Housing Act violation could be established utilizing a "disparate impact" analysis. The view of the current Administration is unclear. The issue has not yet been addressed by the United States Supreme Court, and the Court may well differ with the present lower court interpretations if an appropriate case, in which the issue has been preserved, reaches that level. Unless and until that happens, however, it can be expected that federal courts will continue to apply "disparate impact" under the Fair Housing Act. It is more certain that a "disparate impact" theory is appropriate under the Equal Credit Opportunity Act, since the theory is described in the implementing regulation, Regulation B.

## PREVIOUS GUIDANCE FROM FEDERAL AGENCIES

In this backdrop, federal officials—even in Administrations supporting application of "disparate impact"—have been cautious in describing how it might be applied in the lending context. For example, the "Policy Statement" of the federal "Interagency Task Force on Fair Lending" that was released during the Clinton Administration expressed the view that "disparate impact" is applicable to claims of lending discrimination, "[a]lthough the precise contours of the law on disparate impact as it applies to lending discrimination are under development." There have been few, if any, developments since that time.

In apparent recognition of concerns expressed by the lending industry, the Policy Statement says:

> Lenders will not have to justify every requirement and practice every time that they face a compliance examination. The agencies recognize the relevance to credit decisions of factors related to the adequacy of the borrower's income to carry the loan, the likely continuation of that income, the adequacy of collateral to secure the loan, the borrower's past performance in paying obligations, the availability of funds to close, and the existence of adequate reserves. While lenders should think critically about whether widespread, familiar requirements and practices have an unjustifiable disparate impact, they should look carefully at requirements that are more stringent than customary. Lenders should also stay informed of developments in underwriting and portfolio performance evaluation so that they are well positioned to consider all options by which their business objectives can be achieved.

The agencies offered only two examples of the types of lending practices that might be challenged under the "disparate impact" theory, one of which is strikingly similar to the issue addressed in the NCRC/SouthStar Agreement, particularly given the rise in housing prices since the date of the Policy Statement. The Policy Statement says:

> **Example**: A lender's policy is not to extend loans for single family residences for less than $60,000.00. This policy has been in effect for ten years. This minimum loan amount policy is shown to disproportionately exclude potential minority applicants from consideration because of their income levels or the value of the houses in the areas in which they live. The lender will be required to justify the "business necessity" for the policy.

A lender may contend that the "business necessity" is the need to make a profit; with lender's fees based on a percentage of the loan amount, loans below a certain dollar amount simply are not profitable. In response, the government agency, or private plaintiff, might argue that a lender could charge an additional fee as necessary to ensure a profit, but the applicant should not be precluded from receiving a loan.

## CAN ADDITIONAL "DISPARATE IMPACT" CLAIMS BE EXPECTED?

Inasmuch as the NCRC/SouthStar dispute was resolved by conciliation it is inappropriate to view the Agreement as a reflection of this Administration's position on whether a showing of intent is required to establish a violation of the Fair Housing Act. Staff at HUD have long argued for the application of "disparate impact" and frequently employ the method of analysis in conducting investigations. The issue rarely rises to the top, however, primarily because the factual circumstances underlying Fair Housing Act claims almost always center on "disparate treatment."

At the same time, if the federal agencies are to pursue a "disparate impact" claim, it most likely will be based on factual circumstances similar to the above example from the Policy Statement. A minimum loan amount is a likely target as is a policy of refusing to make loans on a certain type of house, such as a row house. It appears unlikely that the agencies will challenge, under "disparate impact," customary and time-honored underwriting principles, but will look for aberrational criteria that, as the Policy Statement cautioned, "are more stringent than customary." The greater the impact on homeownership opportunities in minority communities, the more likely that the agencies will conclude that the use of "disparate impact" is appropriate.

Although it can be expected that the federal agencies will proceed cautiously in applying "disparate impact" such caution will not be applied in private litigation. Advocacy groups have strongly argued for an application of the "disparate impact" test under the Fair Housing Act, and they frequently seek application of the test even when the facts point toward "disparate treatment." They have enjoyed some success in the federal judicial system. Advocacy groups may challenge customary lending criteria that, to this point, have remained unchallenged, and they most certainly would seek application of the "disparate impact" legal standard in any such litigation. State attorneys general have also indicated a propensity to employ a "disparate impact" analysis more readily than federal enforcement officials.

## IMPACT ON THE SECONDARY MARKET

NCRC's challenge was directed only at SouthStar but the remedy provides that SouthStar "will notify . . . secondary market investors with whom it conducts business that it has discontinued its prohibition against lending on row homes under $100,000.00 in value and row homes in Baltimore." The Fair Housing Act specifically prohibits discrimination in "the making or **purchasing**" of residential mortgage loans. (Emphasis added.) Although the instant challenge was not brought pursuant to the Equal Credit Opportunity Act ("ECOA"), the Federal Trade Commission has interpreted ECOA's prohibitions on discrimination to reach "a potential purchaser of the obligation who influences the credit decision by indicating whether or not it will purchase the obligation if the transaction is consummated." In 1997, the Department of Justice invoked both of these statutes in an action against a New York federally chartered thrift institution alleging that the thrift

implemented discriminatory loan purchase criteria by excluding certain minority residential areas from eligibility. To the extent that the secondary market, in establishing the standards that are implemented by the lenders, requires standards that might have a "disparate impact," they may find themselves the target of government agencies or advocacy groups.

## PREVENTIVE ACTIONS FOR LENDERS TO CONSIDER

This settlement should not be viewed as the start of an avalanche of new fair lending litigation, but it demonstrates the importance of a well-rounded compliance program. Fair lending claims, for the most part, will continue to focus on "disparate treatment" and a compliance program should be so guided. But "disparate impact" should not be ignored. Aberrational policies should be scrutinized carefully, and it is advisable to review underwriting engines and pricing policies at least periodically to evaluate the impact on protected groups and to consider whether the impact can be minimized by alternative criteria that achieve the same business purpose. Such actions can minimize the risk of legal challenge, even from the most extreme groups.

This Agreement also demonstrates the importance of fair lending considerations to secondary market purchasers of loans. Since the date of the Policy Statement, the role of the secondary market has continued to expand and such entities often establish detailed standards regarding loans that are eligible for purchase. Loan purchasers should have compliance programs that, in many respects, mirror the programs of compliant loan originators.

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