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Mortgage Banking/Consumer Finance Commentary

Failure to Offer Loan Products on an Equal Basis to Minority Neighborhoods is Subject of New DOJ Settlement

The Department of Justice has filed its third lawsuit in three years contending that a lender has failed to offer loan products – including residential mortgages and small business loans – on an equal basis to minority neighborhoods and thereby has violated the Fair Housing Act and the Equal Credit Opportunity Act. The three lawsuits contain common factual themes and legal theories, and reveal a road map that lenders can follow to evaluate legal risk and avoid future challenges.

The most recent action, announced on October 12, 2006, is against Centier Bank. Centier is located in the Gary, Indiana area in Northwest Indiana, an area in which residential housing patterns are among the most segregated in the United States. The Department alleged that "Centier has acted to meet the credit needs, particularly with respect to residential and small business credit, of predominately white residential census tracts . . . throughout the Gary [area] and beyond, and has avoided serving the similar credit needs of majority-minority census tracts." Centier agreed to settle the claim by opening new branches in the minority areas, expanding the services offered at other facilities in the minority areas, investing $3.5 million in special financing programs for the minority areas, spending at least $875,000 for consumer financial education, and altering its advertising and promotional programs to better reach residents of the minority neighborhoods.

In 2004, the Department had filed nearly identical claims against banks in Detroit and Chicago, and the relief obtained in those actions virtually mirrors the relief obtained against the Indiana bank. In earlier years, the Department had alleged redlining in the residential mortgage arena, but the three recent lawsuits are the first to also challenge small business lending patterns pursuant to the authority of the Equal Credit Opportunity Act.

The three lawsuits reveal the types of factual issues that the Department believes to be important, as well as the legal theories employed. The end allegation in each lawsuit is that the bank has made few loans in minority residential neighborhoods. But such an allegation would not subject all lenders to legal liability. How does the Department distinguish among lenders? The requirement that lenders open "bricks and mortar" operations in minority neighborhoods is often controversial. Must a lender have a number of branches in minority neighborhoods that is comparable to the number in white neighborhoods? A careful analysis of the Department's allegations and settlement demands sheds light on these issues.

DEPOSITORY INSTITUTIONS WITH COMMUNITY REINVESTMENT ACT RESPONSIBILITIES HAVE BEEN THE TARGETS

To date, each of the lenders challenged by the Department has been a depository institution with responsibilities under the Community Reinvestment Act. Similar claims have never been brought against a non-CRA lender. This is not merely a happenstance. The Community Reinvestment Act is an important starting point for the Department's factual and legal analysis.

In Centier, the Department alleged that, for many years, the bank defined its CRA assessment area to exclude the minority neighborhoods of the metropolitan area in which it was located. The Department alleged that this assessment area failed to conform with Regulation BB, which requires that a large bank assessment area include one or more metropolitan areas or contiguous political subdivisions unless the area would be extremely large, of unusual configuration, or divided by significant geographic barriers. The Department's allegation was aided by action of the FDIC, which, in 1999, had required the bank to redraw its assessment area so as to include the minority areas. Very similar allegations were made against the banks in Detroit and Chicago. In fact, the Chicago lawsuit resulted from a referral to the Department from the Federal Reserve Board, after the Board lowered the bank's CRA rating to "Substantial Noncompliance."

It does not appear that the Department is contending that a violation of the CRA, by itself, constitutes a violation of the Fair Housing Act or the Equal Credit Opportunity Act. But, if minority residential areas are excluded from a defined assessment area when Regulation BB would seem to require the inclusion of such areas, the Department will view such action as evidence of an intention to select areas for service on the basis of race or national origin. This theory is evident in each of the three cases. It also is evident that the Department has worked in tandem with regulators in addressing the CRA issue.

Once a CRA assessment area has been defined in conformity with Regulation BB, the Department examines the bank's performance in meeting the credit needs of the entire assessment area, including the credit needs of low to moderate income neighborhoods. The particular focus of the Department is the performance of the bank in meeting the credit needs of minority residential areas.

In sum, the CRA provides the framework in which the Department's analysis is conducted. Federal law and regulation impose obligations on banks to define the areas that they will serve and then to help meet the credit needs of all portions of the defined areas. Not every violation of the CRA will constitute a violation of the Fair Housing Act or the Equal Credit Opportunity Act. But to the extent that the CRA violation arises from a failure to include geographic areas, or a failure to serve otherwise included geographic areas, in a manner that is correlated with race or national origin, the Department will view the violation also as evidence of intent to discriminate on the basis of race or national origin in violation of the Fair Housing Act and the Equal Credit Opportunity Act.

ACTUAL LOAN APPLICATIONS AND ORIGINATIONS MAY BE THE MOST IMPORTANT FACTORS

While the CRA might provide the framework for the analysis in that it imposes a legal obligation to offer credit services in defined areas, the most important issue is the extent of lending activity in the minority areas. Thus, in each case, the Department has examined the volume of loan applications received from the minority areas of the total geography that the bank is, or should be, serving. In each of the cases, the Department concluded that the lender received few applications from the minority areas and originated few loans in those areas. For example, in Centier the Department alleged that the bank made only 248 loans in the minority area over a five year period, and further alleged that peer lenders were making many more loans in these same residential areas.

The Department likes to present its allegations using maps as demonstrative aids. The maps, attached as exhibits to the complaints, depict the geographic area in which the bank operates and are color-coded to reveal minority residential concentrations. The location of the property that is the subject of each loan application or origination is depicted by a dot. The density of the dots in white residential areas as compared to minority residential areas reveals the point that the Department is seeking to establish. Similar maps have been used in each case. An example of a map appended to the Centier complaint is attached hereto.

The allegations regarding loan applications and originations from minority areas may be the most crucial allegations of the Department's complaints. If the banks had been receiving applications and originating loans in the minority areas in closer proportion to the minority neighborhood share of the total assessment area, it would be much more difficult for the Department to allege redlining, even against banks that were experiencing CRA difficulties with their regulators.

However, the Department does not rest its charge solely on the loan origination data. Rather, in each lawsuit, the Department has alleged that other components of the bank's operations evidence an intent not to serve minority residential areas.

THE SIGNIFICANCE OF BRANCHING ACTIVITIES

Perhaps the most controversial of the Department's allegations in these cases has been the challenge to branching activities and the remedial requirement to open "bricks and mortar" branches in minority neighborhoods. Many would argue that such a requirement is an unnecessary, unwarranted and costly intrusion into a bank's operation.

The Department seems to be of the view, however, that, in these three cases, branching was a method chosen by the banks to attract customers and market their loan products. In Centier, the Department alleged that "a major component of the Bank's expansion has been the construction or acquisition of additional branch offices, which are designed both to better serve existing customers and to attract new customers for Centier's services and products." The Department further contended that the Indiana bank only opened branches in minority residential areas when it was pressured to do so by its regulator, the FDIC. Additionally, it was contended that the bank utilized in-store supermarket branches in minority neighborhoods and that such branches did not offer the full range of banking services as did other branches.

Once again, the Indiana complaint mirrors the allegations of the earlier lawsuits. In the Detroit case, the Department alleged that the bank "declined to open branches in the City of Detroit . . . so as to avoid serving that community." In Chicago, the Department alleged that "the Bank continued its race and national origin-based pattern of adding or acquiring new branches to serve only white communities." In addition, in Chicago the Department alleged that the bank implemented a practice of using full-service ATMs (deposit taking and cash dispensing) in white residential areas while using only cash dispensing ATMs in minority areas.

OTHER MARKETING EVALUATED BY THE DEPARTMENT

In each of the cases, the Department has challenged the marketing practices of the banks and presented allegations that marketing was directed to the white community. In Chicago, for example, the Department alleged that the bank "solicited credit transactions through a variety of discriminatory means, including, but not limited to, the use of mortgage brokers serving white communities in the Chicago region." In both Chicago and Indiana, the Department criticized the banks' focus of radio and print advertising on "general audiences" and a failure to utilize minority format outlets.

ACTIONS EXPECTED IN THE FUTURE

Three lawsuits in three years with nearly identical factual and legal allegations certainly confirm the Department of Justice's focus on redlining. While other issues, such as loan pricing, are know to be the subject of the Department's fair lending inquiries, there is no reason to expect a letup on the redlining focus.

It can also reasonably be expected that depository institutions with responsibilities under the Community Reinvestment Act will continue to be the primary targets. The CRA defines the legal obligations of the banks, and a failure to meet those obligations in a manner that is correlated with race or ethnicity, in large part, is the basis for the Department's allegations of redlining. Regulators likely will continue to play an important role in the events leading to such lawsuits.

That is not to say that nonbank lenders – without CRA responsibilities – are completely off the radar screen. But such a challenge against a lender without CRA responsibilities would require an alternative legal analysis. Such lenders do not start with an obligation to serve any particular community, and thus the mere fact that they do not operate in minority neighborhoods does not indicate that their actions are illegal. It is safe to assume that the Department believes that cases of this type require proof of intentional discrimination, and markedly different elements of proof likely would have to be utilized against the non-CRA lender.

The Department has previously expressed the view that non-CRA lenders retain the right to focus on certain "niche" markets without running afoul of fair lending laws, so long as the lenders do not adopt their "niche" markets under circumstances from which a discriminatory purpose could fairly be inferred, and so long as they serve their "niche" markets in a nondiscriminatory manner. If such lenders are to be challenged, the proof may well include more evidence of overt discrimination – that might reveal discriminatory intent – than the actions that have been filed to date.

There also is no sign that the Department will back away from its demands that banks open branches in minority neighborhoods in factual situations similar to those presented in the three recent cases. At the same time, the lawsuits do not appear to reflect a view that all CRA institutions risk fair lending challenge if they do not have a minimum number of branches in minority neighborhoods. Again, the important issue is whether the bank is properly serving the credit needs of minority neighborhoods, not the number of branches in the minority neighborhoods.

It is theoretically possible that a bank could be challenged for redlining even if it had a large number of branches in minority neighborhoods but was refusing to make home mortgage loans or small business loans in minority areas. Similarly, a bank with no branches in minority neighborhoods may still fairly meet the home mortgage needs and small business credit needs of minority areas by operating from a central location. Other CRA issues may arise with the regulators, but the role of the Department of Justice in enforcing the Fair Housing Act and the Equal Credit Opportunity Act is not implicated so long as the institution's credit programs are fairly available in minority neighborhoods.

ACTIONS TO REDUCE RISK

A fair lending compliance program presents many difficult challenges to lenders. Compared to complex issues such as possible discrimination in loan pricing, it is significantly easier to avoid redlining claims.

Obviously, lenders with CRA responsibilities should pay particular heed. It is advisable to review assessment area boundaries, even without prodding from regulators, to ensure that they are drawn in conformity with Regulation BB. Red flags should arise if only certain areas of a city, county, or metropolitan area are excluded from the assessment area and such excluded areas are inhabited primarily by minorities.

When a lender is confident that its CRA assessment area is drawn in a racially and ethnically fair manner, it can examine its loan applications and originations by geographical areas within the assessment area. Fair lending software is readily available to join HMDA data with Census data and produce maps that are the same product that the Department of Justice believes to be so important in its actions. Just as the maps can be used to tell a negative story, they can be used to tell a positive story. The map provides a snapshot of a lender's performance.

Data regarding applications and originations in minority areas can be compared to the performance of peers, as revealed by HMDA reports, and thereby help a lender evaluate its own performance. In the event that a lender concludes that it is not servicing the areas to the extent that might be reasonably expected, it can look for the cause.

Branching may play a role, particularly for those lenders who offer their credit products primarily through branch locations. But it may not be necessary to jump to a conclusion that additional branches are needed simply because performance is not at an acceptable level. Other devices might be considered, such as outreach to real estate personnel serving the minority areas or targeted print or radio advertising.

A lender may find it more effective to open an office specializing in mortgage loans or business credit than to open a full-service branch. This is not to minimize the importance of branching from a regulatory or fair lending perspective, but rather to emphasize that there are alternative methods of addressing specific issues. Regulators and the Department of Justice likely would look favorably on lenders who conduct this type of risk assessment and use it as a guide to improve their enforcement program.

Finally, non-CRA lenders should not lose sight of the redlining issue. While they have not been the target to date, it is foreseeable that they could be in the future. Continued analysis of higher-priced lending already has raised concerns regarding the geographic areas served by lenders and the prices charged to minority consumers as compared to the prices charged to non-minority consumers. No enforcement actions have yet been filed but it is reasonable to expect that such actions may include challenges to marketing programs. Just as banks conduct analyses of their branching programs, non-CRA lenders might conduct an analysis of their office locations and marketing programs to evaluate whether they might face a claim of illegal redlining.

If you have any questions about this Alert, please contact Paul F. Hancock (305.539.3378 / phancock@klng.com) or any member of K&LNG's Mortgage Banking/Consumer Finance Group.

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