# Mitigating Risk of Liability for Discriminatory Lending in the Wake of *Inclusive Communities*

## INTRODUCTION

In the wake of the Great Recession, banks and other lenders have adopted stringent requirements for new loans, often requiring borrowers to make substantial down payments and refusing to lend to borrowers with low credit scores. While these measures may reduce the risk that borrowers will default, some lenders have adopted practices that disproportionately harm minority borrowers and violate long-standing federal anti-discrimination statutes. As a result, the U.S. Department of Justice ("DOJ") has been consistently and aggressively prosecuting lenders who make lending decisions on the basis of race and other characteristics protected by federal law. Indeed, in the past seven months alone, DOJ has settled five significant lawsuits alleging that a lender engaged in a pattern or practice of discriminatory lending,[1] and there is no indication that these types of enforcement actions will decline in the foreseeable future.

Generally, DOJ brings discriminatory lending claims under the Fair Housing Act ("FHA"), 42 U.S.C. §§ 3601-3619, and/or the Equal Credit Opportunity Act ("ECOA"), 15 U.S.C. §§ 1691-1691f. Administrative agencies and courts have interpreted these statutes to permit private plaintiffs and federal prosecutors to sue lenders based on allegations of both "discriminatory intent" – *i.e.*, evidence that a lender intended to discriminate against borrowers – and "discriminatory impact" – *i.e.*, evidence that a lender's practice or policy has a discriminatory effect, even where there is no evidence that a lender intended to discriminate.[2] This article examines the law governing disparate impact claims under the FHA and the ECOA, and recent DOJ enforcement actions against lending institutions.

We begin by describing the legal precedent governing disparate impact claims under the FHA, starting with a description of the U.S. Supreme Court's recent opinion in *Texas Department of Housing and Community Affairs, et al. v. The Inclusive Communities Project*, 135 S.Ct. 2507 (2015), and a discussion of *City of Los Angeles v. Wells Fargo*, No. 13 CV 9007, 2015 WL 4398858 (C.D. Cal. July 17, 2015), a recent case arising out of the Central District of California and applying the standards set forth in *Inclusive Communities*. Next, we examine the legal precedent in the Ninth Circuit governing disparate impact claims under the ECOA. We then discuss the process by which matters involving discriminatory lending are referred to DOJ for prosecution, and the factors DOJ considers in deciding whether to bring an FHA or ECOA enforcement action. Finally, we summarize five recent enforcement actions alleging lending discrimination under a theory of disparate impact. After summarizing these enforcement actions, we highlight common provisions in the settlement agreements executed in each of these actions, which we believe provide excellent guidance to lenders regarding practices they can adopt to mitigate their risk of exposure to costly and time-consuming litigation.

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1 *See* https://www.justice.gov/crt/recent-accomplishments-housing-and-civil-enforcement-section.

2 *See Ricci v. DeStefano*, 557 U.S. 557, 577 (2009) (noting that Title VII of the Civil Rights Act of 1964 prohibits both "intentional discrimination (known as 'disparate treatment') as well as, in some cases, practices that are not intended to discriminate but in fact have a disproportionately adverse effect on minorities (known as 'disparate impact')").

## FHA DISPARATE IMPACT CLAIMS

Congress enacted the FHA "to provide . . . for fair housing throughout the United States."[3] The FHA prohibits "any person or other entity whose business includes engaging in real estate-related transactions" from discriminating "against any person in making available" a real estate-related transaction or "in the terms or conditions of" a real estate-related transaction, on the basis of race.[4]

In *Inclusive Communities*, the U.S. Supreme Court considered whether disparate impact claims are cognizable under the FHA.[5] The plaintiff was a nonprofit corporation that assisted low-income families in obtaining affordable housing in Texas.[6] The plaintiff sued the Texas Department of Housing and Community Affairs ("the Department"), alleging that the Department had perpetuated segregated housing in Texas by granting federal tax credits[7] to a substantial number of developers who applied to construct low-income housing in predominantly black inner-city areas, and granting few tax credits to developers seeking to build low-income housing in white suburban communities.[8] The district court concluded that the plaintiff had established a prima facie case of discrimination under a disparate impact theory. The Fifth Circuit reversed on the merits, but held that disparate impact claims are cognizable under the FHA as a matter of law.[9]

The Supreme Court ruled that disparate impact claims are cognizable under the FHA, but articulated important limitations on such claims.[10] According to the Court, these limitations were necessary to "avoid the serious constitutional questions" that would arise if FHA disparate-impact claims were based solely on statistical disparities.[11] First, the Court made clear that disparate-impact liability is appropriate only where discriminatory practices are "artificial, arbitrary, and unnecessary,"[12] and that any governmental entity responsible for a discriminatory practice must be given an opportunity to come forward with a valid interest served by the practice.[13] Second, the Court articulated a "robust causality requirement" for disparate-impact claims predicated upon statistical disparities alone.[14] This requirement, the Court explained, puts the onus on an FHA plaintiff to identify a specific "policy

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[3] 42 U.S.C. § 3601.

[4] 42 U.S.C. § 3605(5).

[5] 135 S.Ct. at 2513.

[6] *Id.* at 2514.

[7] Pursuant to 26 U.S.C. § 42, the federal government provides low-incoming housing tax credits that are distributed to developers through designated state agencies. States distributing such credits must develop selection criteria for awarding the credits. § 42(m)(1).

[8] *Id.*

[9] *Id.* at 2515.

[10] *Id.* at 2521.

[11] *Id.* at 2522.

[12] *Id.*

[13] *Id.*

[14] *Id.*

or policies" that caused the statistical disparity.[15] The Court said that the robust causality requirement also would mitigate the risk that governmental or private entities would use numerical quotas in lending *to avoid* disparate impact liability.[16]

Third, the Court emphasized that lower courts must closely scrutinize disparate impact claims at the pleading stage, examining "with care" whether a plaintiff has successfully established a prima facie case of discrimination.[17] Such exacting scrutiny, the Court said, would preclude a plaintiff from advancing beyond the pleading stage, where she merely points to "a one-time decision" by the defendant, rather than a policy that has a disparate impact on a protected party.[18] Finally, the Court emphasized the importance of "prompt resolution" of disparate impact claims, making clear that lower courts should, where appropriate, quickly dispose of meritless disparate-impact claims at the pleading stage of litigation.[19]

**FHA Disparate Impact Claims in the Ninth Circuit After *Inclusive Communities*: *City of Los Angeles v. Wells Fargo***

In *Wells Fargo*, applying the standards set forth in *Inclusive Communities*, a district court in the Ninth Circuit granted summary judgment in favor of Wells Fargo in an FHA lending discrimination lawsuit. The plaintiff, City of Los Angeles (hereinafter "the City"), alleged that Wells Fargo had engaged in a pattern and practice of "reverse redlining" by extending home mortgage loans to minority borrowers in minority neighborhoods on "predatory" terms.[20] The complaint cited eight types of allegedly discriminatory practices, two of which the court addressed in granting the defendant's motion for summary judgment.[21] The first practice involved the issuance of 27 "high-cost loans" to minority borrowers, which the plaintiff defined as loans that carried a high cost for the borrower due to the rate spread.[22] The rate spread for these loans allegedly was 1.5% for first-lien loans and 3.5% for subordinate lien loans.[23]

The second practice involved the issuance of United States Federal Housing Authority ("USFHA") loans. USFHA loans require a minimal down payment (3.5% of the home purchase price) and provide low closing costs, full amortization and no prepayment penalties, and are available to borrowers with low credit scores.[24] The drawback of a USFHA loan is that the borrower must pay a

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15 *Id.* at 2523.

16 *Id.*

17 *Id.*

18 *Id.*

19 *Id.* at 2523.

20 2015 WL 4398858, at *1.

21 The parties agreed that only two of the allegedly discriminatory practices occurred during the statute of limitations period.

22 2015 WL 4398858, at *2.

23 *Id.*

24 *Id.*

mortgage insurance premium ("MIP"), which can be 1.75% of the value of the loan, and the borrower cannot cancel the MIP until she pays 22% of the principal of the loan.[25] The borrower of a conventional loan, on the other hand, could cancel the MIP after 20% of the principal was paid.[26] The plaintiffs alleged that the defendants issued more USFHA loans to minority borrowers in areas predominantly populated by minorities, and that borrowers who had received USFHA loans paid more for their loans than borrowers who were issued conventional loans.

With respect to the 27 "high-cost" loans, the court held that the City had failed to put forth the evidence necessary to demonstrate that such loans had a "significantly adverse" effect on minorities.[27] In particular, the court emphasized that the City's own expert had determined that the disparity between the likelihood that a racial minority would receive a high-cost loan and the likelihood that a non-Hispanic white borrower would receive a high-cost loan was "not statistically significant," and that even disparities among racial groups were "negligible."[28]

The court also ruled that even if the City could point to a statistically significant disparity, the City had failed to put forth evidence of a Wells Fargo policy that gave rise to such disparity.[29] Specifically, the court observed that the City did not take issue with any of Wells Fargo's policies, but instead claimed that the bank's *failure to implement an appropriate policy* caused the allegedly discriminatory practices. Citing the Supreme Court's admonition in *Inclusive Communities* that disparate impact claims should not force private parties to "adopt racial quotas," the Court stated that the City's request that Wells Fargo "monitor relevant data," and then issue loans on the basis of race to "correct the disproportionate issuance" of high-cost loans to minority borrowers, would cause the kind of racial discrimination the Supreme Court expressly cautioned against in *Inclusive Communities*.[30]

As to the USFHA loans, the court held that there was no evidence that the issuance of USFHA loans to minority borrowers adversely affected them.[31] In reaching this conclusion, the court observed that USFHA loans imposed higher costs on borrowers, because, in effect, the federal government had passed the insurance cost of the loans to risky borrowers in the form of an MIP.[32] In other words, the court explained that the federal government had assumed the financial risk of lending to individuals who ordinarily would be unable to obtain a home loan from Wells Fargo, by essentially guaranteeing the loan in the event of default. In exchange for this guarantee, the government required borrowers of USFHA loans to pay the MIP, which is essentially the insurance cost of the loan. The court found that this arrangement – which made loans available to individuals who otherwise could

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[25] *Id.*

[26] *Id.*

[27] *Id.*, at *7.

[28] *Id.*

[29] *Id.*, at *8.

[30] *Id.*

[31] *Id.*, at *11.

[32] *Id.*, at *10.

not afford them – did not amount to discrimination on the basis of race.[33] The court also referenced various statements by federal officials, including statements from the White House and the Secretary of Housing and Urban Development ("HUD"), touting the merits of the USFHA loan program and the opportunities it created for minorities to own a home.[34] In light of these additional benefits, the court found that the USFHA loans did not adversely affect minorities.

*City of Los Angeles* is currently on appeal to the Ninth Circuit. Although the district court's analysis regarding USFHA loans seems to be on solid footing, the Ninth Circuit could very well take a different approach to the high-cost loan issue. While the district court concluded that the lack of a specific policy causing a statistical disparity did not give rise to a colorable disparate impact claim, lenders should not presume that, under other circumstances, the absence of a policy could not produce a disparate impact. Indeed, in many cases, a policy of nonfeasance may in and of itself be the proximate cause of a substantial statistical disparity between the types of loans issued to minority and non-minority borrowers. For example, a lender who obtains data revealing a substantial statistical disparity between loans issued to minority borrowers and non-minority borrowers, but nonetheless chooses to ignore the data and proceed with the status quo, may very well have implemented a "practice" that perpetuates lending discrimination.

Although *City of Los Angeles* is currently under review by the Ninth Circuit, it provides an excellent example of the rigor with which courts will examine disparate impact claims brought by private litigants in the aftermath of *Inclusive Communities*. The district court in *City of Los Angeles* clearly took to heart the Supreme Court's instruction to examine disparate-impact claims "with care" at the pleading stage, and to dispose of meritless claims. Whether plaintiffs bringing disparate impact claims in the Ninth Circuit in the future will have difficulty advancing such claims beyond the pleading stage remains to be seen.[35]

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[33] *Id.*

[34] *Id.*

[35] Given the limited number of FHA cases resolved on the pleadings (or at summary judgment) since *Inclusive Communities* was decided, no clear pattern has emerged suggesting that the "robust causality requirement" set forth in *Inclusive Communities* has changed the likelihood that FHA disparate-impact claims will survive the pleading stage of litigation. While some courts have disposed of disparate impact lawsuits on the pleadings based on the "robust causality requirement," *see City of Miami v. Bank of America Corp. et al.*, 2016 WL 1072488 (S.D. Fl. Mar. 17, 2016) (granting defendant's motion to dismiss the second amended complaint in FHA disparate-impact action alleging Bank of America engaged in policy or practice of "steering minority borrowers in Miami into 'predatory' mortgage loans"); *Ellis v. City of Minneapolis*, 2015 WL 5009341 (D. Minn. Aug. 24, 2015) (granting defendant's motion to dismiss FHA disparate-impact lawsuit under causation standard set forth in *Inclusive Communities*), others have not, *see County of Cook v. HSBC North Am. Holdings, Inc.*, 2015 WL 5678575 (N.D. Ill. Sept. 30, 2015) (denying defendant's motion to dismiss FHA claim alleging disparate-impact theory of liability, based on plaintiff's allegation that "pricing policies Defendants designed increased the costs for loans made to minority borrowers, thereby reducing their home equity, and caused a 'downward spiral' of mortgage delinquencies and failures amongst minority borrowers"); *Long Island Housing Servs., Inc. v. Fair Housing Justice Center, Inc.*, 2015 WL 7756122 (E.D.N.Y. Sept. 1, 2015) (denying defendant's motion to dismiss in FHA disparate-impact lawsuit based on "specific allegations" in the amended complaint that "[d]espite allegedly being aware of the potential for disparate impact, the Agency apparently insisted during negotiations that Maestro apply the age requirements and residency preference system established by the allegedly discriminatory ordinance.").

## ECOA DISPARATE IMPACT CLAIMS

Congress enacted the ECOA to eliminate discrimination in credit transactions.[36] The ECOA makes it unlawful for a creditor "to discriminate against any applicant, with respect to any aspect of a credit transaction . . . on the basis of race, color, religion, national origin, sex or marital status, or age."[37]

As noted above, *Inclusive Communities* made clear that disparate impact claims are cognizable under the FHA. However, *Inclusive Communities* says nothing about whether such claims are cognizable under the ECOA. Few federal courts have addressed the issue in depth, and those who have done so, including the Ninth Circuit, have generally concluded that disparate impact claims are cognizable under the ECOA.[38]

In *Miller v. American Express Co.*, 688 F.2d 1235 (1982), the Ninth Circuit considered whether American Express's policy of automatically cancelling a supplementary cardholder's credit-card account after the death of the basic cardholder constituted discrimination on the basis of marital status, in violation of the ECOA, and whether a plaintiff alleging a claim under the ECOA must show discriminatory intent or discriminatory effect to prove an ECOA violation.[39] The court held that American Express's decision to cancel the plaintiff's supplementary credit card without an assessment of her creditworthiness amounted to discrimination on the basis of marital status.[40] In reaching this conclusion, the court noted that a plaintiff did not need to prove intent to discriminate in order to state a cognizable claim under the ECOA, because "discrimination in credit transactions is more likely to be of the unintentional, rather than the intentional, variety."[41] The court went on to say that the history of the ECOA referred "by analogy to the disparate treatment and adverse impact tests for discrimination which are used in employment discrimination cases under Title VII."[42] Upon examining the legislative history of the ECOA, the Ninth Circuit held that a plaintiff could establish a violation of the ECOA with evidence of "the *effects of a creditor's practices*," "the creditor's motives" or the creditor's "conduct in individual transactions."[43]

There are good reasons to doubt whether *Miller* was correctly decided, and whether, if confronted

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36 *Treadway v. Gateway Chevrolet Oldsmobile Inc.*, 362 F.3d 971, 975 (7th Cir. 2004).

37 15 U.S.C. § 1691(a)(1).

38 *See Golden v. City of Columbus*, 404 F.3d 950, 963 n.11 (6th Cir. 2005) (noting that "[n]either the Supreme Court nor this Court have previously decided whether disparate impact claims are permissible under ECOA. However it appears they are"); *Ramirez v. GreenPoint Mortg. Funding, Inc.*, 633 F.Supp.2d 922, 927 (N.D.C.A. 2008) (holding that disparate impact claims are cognizable under FHA and ECOA); *Zamudio v. HSBC N. Am. Holdings Inc.,* No. 07 C 4315, 2008 WL 517138, at *2 (N.D.Ill. Feb. 20, 2008) (same); *Beaulialice v. Fed. Home Loan Mortg. Corp.*, No. 8:04-CV-2316-T-24-EAJ, 2007 WL 744646, at *4 (M.D.Fla. Mar. 6, 2007) (same); *Powell v. American Gen. Finance, Inc.*, 310 F.Supp.2d 481 (N.D.N.Y. 2004) ("The ECOA provides for a private cause of action based on disparate impact or disparate treatment").

39 *Id.* at 1237.

40 *Id.*

41 *Id.* at 1239.

42 *Id.* at 1239-40.

43 *Id.* at 1240 (emphasis added).

with another opportunity to consider whether disparate impact claims are cognizable under the ECOA the Ninth Circuit will rule as it did in *Miller*.[44] Nevertheless, *Miller* is well-established law in the Ninth Circuit, and thus plaintiffs in the Ninth Circuit may continue to bring ECOA lawsuits based on a disparate-impact theory of liability.

## DOJ PROSECUTIONS AND AGENCY ENFORCEMENT ACTIONS

The aforementioned cases discuss the standards governing disparate-impact claims in the context of lawsuits brought by private litigants under the FHA and the ECOA. This section addresses enforcement actions brought by the federal administrative agencies and DOJ, with particular emphasis on DOJ discriminatory lending actions.

### The Referral Process

Under the ECOA and the FHA, bank regulatory agencies must refer matters to the DOJ for investigation and prosecution if they have reason to believe that a lender has engaged in a pattern or practice of discrimination. Under the ECOA, the referring agency is the Federal Trade Commission ("FTC"); under the FHA, the referring agency is HUD. Upon receiving a referral, DOJ determines whether to investigate the matter or leave it to the administrative agency for enforcement. In making this determination, DOJ considers a number of factors. Generally, DOJ will not investigate and prosecute a matter if:

- The practice has ceased and there is little chance that it will be repeated;
- The violation may have been accidental or arose from ignorance of the law's more technical requirements, such as spousal signature violations and minor price breaks for certain age groups not entitled to preferential treatment; and
- There either were few potential victims or *de minimis* harm to any potential victims.[45]

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[44] As least one author has correctly noted that the statutory language the Supreme Court relied on in *Inclusive Communities* in holding that disparate impact claims are cognizable under the FHA is absent from the ECOA. Epstein, Are Disparate Impact Claims Legally Cognizable Under ECOA?, *available at* http://www.law360.com/articles/703661/are-disparate-impact-claims-legally-cognizable-under-ecoa. Specifically, this author notes that the FHA expressly makes it unlawful for a person to "*otherwise make unavailable* or deny, a dwelling to any person because of race . . . ." 42 U.S.C. § 3604 (emphasis added). The Court in *Inclusive Communities* held that the term "otherwise make unavailable" suggested that the law prohibited "the consequences of an action rather than the actor's intent." 135 S.Ct. at 2518. By contrast, the author referenced above argues, the ECOA does not use the word "otherwise" in describing activities prohibited by the statute, but instead makes it unlawful for a creditor to "discriminate against any applicant" on the basis of race. 15 U.S.C. § 1691(a). The D.C. Circuit has also suggested that disparate-impact claims are not cognizable under the ECOA in *Garcia v. Johanns*, 444 F.3d 625, 633 (D.C. Cir. 2006), stating:

> Both Title VII and the Age Discrimination in Employment Act (ADEA) prohibit actions that "otherwise adversely effect" a protected individual. *See* 42 U.S.C. § 2000e-2(a)(2); 29 U.S.C. § 623(a)(2). The Supreme Court has held that this language gives rise to a cause of action for disparate impact discrimination under Title VII and the ADEA. *See Smith v. City of Jackson*, 544 U.S. 228, 125 S.Ct. 1536, 1540, 161 L.E.D.2d (2005) (ADEA); *Griggs v. Duke Power Co.*, 401 U.S. 424, 432, 91 S.Ct. 849, 28 L.Ed.2d 158 (1971) (Title VII). ECOA contains no such language.

[45] *See* https://www.justice.gov/sites/default/files/crt/legacy/2015/04/13/ecoareport2013.pdf.

DOJ will generally take on matters that have the following characteristics:

- The practice is serious in terms of its potential for either financial or emotional harm to members of protected classes (for example, discrimination in underwriting, pricing, or provision of lender services);
- The practice is not likely to cease without court action;
- The protected class members harmed by the practice cannot be fully compensated without court action;
- Damages for victims, beyond out-of-pocket losses, are necessary to deter the lender (or others like it) from treating the cost of detection as a cost of doing business; or
- The agency believes the practice to be sufficiently common in the lending industry, or raises an important issue, so as to require action to deter lenders.[46]

While this guidance is helpful in assessing the likelihood that DOJ will assume responsibility for the investigation and prosecution of a matter, it does not, of course, provide meaningful guidance regarding the types of practices which, in DOJ's estimation, amount to a violation of the FHA and the ECOA. In the following section, we examine recent DOJ enforcement actions to ascertain the kinds of lending practices DOJ considers to be suspect, and the preventative measures that lenders can take to avoid investigation and prosecution.

**Recent Enforcement Actions**

Between October 2015 and the present, DOJ has settled five enforcement actions alleging that a given lender's policy or practice had a disparate impact on racial minorities under the FHA or ECOA.

In United States v. Toyota Motor Credit Co., 16 CV 725 (C.D. Cal. 2016) (Civ. No. 16-725), DOJ alleged that between January 1, 2011 and February 2, 2016, Toyota Motor Credit Company ("Toyota"), the financing arm of Toyota Motor Corporation, discriminated against thousands of African-American and Asian and/or Pacific Islanders who obtained financing through Toyota to purchase automobiles. The complaint alleged that Toyota employed a policy of permitting dealers to mark up the interest rates on consumer loans, which resulted in African-American consumers paying an average of over $200 more in interest for their automobile loans than whites, and Asian and/or Pacific Islander consumers paying an average of over $100 more in interest for their automobile loans than whites, and that Toyota failed to implement adequate compliance monitoring to prevent this discrimination.[47] Based on these allegations, the government charged Toyota with violating the ECOA, 15 U.S.C. § 1691a(1). The parties submitted a joint consent order to the district court on February 2, 2016 proposing to resolve all of the government's claims.

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[46] *Id.*

[47] Compl. ¶¶ 21, 22.

In United States v. Sage Bank, (D.Mass. 2015) (Civ. No. 15-13969), the government alleged that between January 2011 and May 2014, Sage Bank originated approximately 550 loans to African-American and Hispanic borrowers at higher prices than the loans originated to non-Hispanic white borrowers, and made these lending decisions based on the borrowers' race or national origin, rather than creditworthiness.[48] In particular, the complaint alleged that Sage Bank had employed a policy whereby each of its loan officers was assigned a "minimum base price" ("MBP"), which represented the minimum price that the loan officer was expected to receive for each loan the officer originated.[49] Loan officers were then given broad discretion to mark up the price of each loan based on subjective factors unrelated to a borrower's creditworthiness.[50] As a result of this policy, the government alleged that the average loan issued to an African-American borrower cost approximately $2,452 more than the average loan issued to a white borrower for the same amount of money borrowed.[51] Similarly, the government alleged that the average loan issued to a Hispanic borrower cost the borrower approximately $1,438 more than the average loan issued to a white borrower for the same amount of money borrowed.[52] As a result of this conduct, the government charged Sage Bank with violating the FHA, 42 U.S.C. §§ 3605(a) and 3604(b), and the ECOA, 15 U.S.C. § 1691(a)(1). The parties submitted a joint consent order to the district court on December 1, 2015, proposing to resolve all of the government's claims.

In United States v. Eagle Bank & Trust Co., (E.D. Mo. 2015) (Civ. No. 15-1492), the government alleged that, in expanding the scope of its lending operations in Missouri, Eagle Bank and Trust Company of Missouri ("Eagle Bank") took the steps necessary to meet the credit needs of borrowers in the market for residential real-estate loans in the areas of St. Louis predominately occupied by whites, but neglected to serve the residential real-estate credit needs of borrowers located in areas predominantly populated by blacks.[53] For example, although blacks made up approximately 19% of the total population of St. Louis in 2000, the government alleged that, from 2006 to 2012, only 1.9% of the single-family residential loan applications in St. Louis generated by Eagle Bank were for residential properties located in areas primarily occupied by blacks.[54] The complaint also alleged that Eagle Bank had failed to establish branch offices in areas primarily occupied by blacks, but instead established branch offices in locations in areas occupied primarily by whites.[55] For example, the government alleged that, from 1988 to 2015, Eagle Bank had opened 11 full-service branches in areas predominantly occupied by whites, and no full-service branches in areas predominantly occupied by blacks.[56] The complaint also alleged that Eagle Bank discouraged lending to minority borrowers by

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[48] Compl. ¶ 2.

[49] *Id.* ¶ 3.

[50] *Id.*

[51] *Id.* ¶ 4.

[52] *Id.*

[53] Compl. ¶ 11.

[54] *Id.* ¶¶ 10, 20.

[55] *Id.* ¶ 13.

[56] According to the Complaint, at present, all twelve of Eagle Bank's full-service branches in the St. Louis area are located in areas predominately occupied by Whites. *Id.*

excluding areas primarily occupied by blacks from its reported Community Reinvestment Act assessment area.[57] Based on these allegations, the government charged Eagle Bank with violations of the FHA, 42 U.S.C. §§ 3605(a), 3604(a), and 3604(b), and the ECOA, 15 U.S.C. § 1691(a)(1).

In United States v. Hudson City Savings Bank, F.S.B. (D.N.J. 2015) (Civ. No. 15-7056), the government alleged that Hudson City Savings Bank, F.S.B. (“Hudson City”) had engaged in a pattern or practice of redlining by conducting its lending business in a manner that discouraged applicants in predominantly black and Hispanic neighborhoods in the New York/North New Jersey, Philadelphia, and Wilmington areas from obtaining mortgage loans.[58] Specifically, the complaint alleged that Hudson City had discouraged minorities from applying for credit by, among other things: (a) “placing its branches and loan officers principally outside of majority-black-and-Hispanic neighborhoods”; (b) “excluding many majority-black-and-Hispanic neighborhoods from its Community Reinvestment Act assessment area and one of its low-to-moderate income loan programs”; (c) “selecting mortgage brokers that are mostly located outside of, and do not effectively serve, majority-black-and-Hispanic neighborhoods”; and (d) “focusing its limited marketing in neighborhoods with relatively few black and Hispanic residents.”[59] As a result of these allegedly discriminatory practices, the government charged Hudson City with violating both the FHA, 42 U.S.C. §§ 3605(a), 3604(a) and 3604(b), and the ECOA, 15 U.S.C. § 1691(a)(1).

In United States v. Fifth Third Bank, (S.D. Oh. 2015) (Civ. No. 15-626), DOJ alleged that Fifth Third Bank (“Fifth Third”), a depository institution, discriminated against thousands of African-American and Hispanic borrowers nationwide by employing a practice of allowing dealers to mark up interest rates on car loans based on factors unrelated to a prospective borrower’s creditworthiness, and failing to adequately monitor its lending practices to prevent race-based discrimination.[60] The government alleged that, as a result of Fifth Third’s dealer markup and compensation policies, the average African-American and Hispanic borrower was required to pay over $200 more per loan than other borrowers.[61] Based on these allegations, the government charged Fifth Third Bank with violating the ECOA, 15 U.S.C. § 1691a(1).

Several clear patterns emerge from these enforcement actions. First, with respect to automobile loans, DOJ closely scrutinizes policies that confer broad discretion to loan officers to determine interest rates, and tie loan officer compensation to the total revenue generated by the loans issued by an officer (including the interest accrued on each loan). Investigators clearly believe that these prac-

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[57] Congress enacted the Community Reinvestment Act of 1977 (“CRA”) for the purpose of encouraging financial institutions to “help meet the credit needs of the local communities in which they are chartered.” 12 U.S.C. § 2901(b). Pursuant to the regulations implementing the CRA, promulgated by the Office of the Comptroller of the Currency (“OCC”), banks are required to “delineate one or more assessment areas within which the OCC evaluates the bank’s record of helping to meet the credit needs of its community.” 12 C.F.R. § 25.41(a). Thus, the Act essentially requires each financial institution to identify the geographic area(s) that make up “its community.” By identifying the geographic boundaries of “its community,” each bank delineates areas where it will “help meet the credit needs” of the populace. The designation of an assessment area is vital to a bank’s overall CRA assessment, because, by eliminating areas predominantly populated by lower-income earning minorities, a bank can avoid a poor overall CRA assessment score.

[58] Compl. ¶ 4.

[59] *Id.* ¶ 5.

[60] Compl. ¶ 1.

[61] *Id.* ¶ 3.

tices, coupled with substantial disparities between the interest rates charged to minority borrowers and white borrowers, gives rise to an inference of unlawful discrimination.

Second, federal prosecutors seem to target financial institutions that do not offer, solicit and market their lending products to borrowers who reside in geographic areas predominantly occupied by other minorities. Third, federal prosecutors consider significant statistical disparities between the number of loan applications generated for minority borrowers and the number of loan applications generated for white borrowers to be a sign of discriminatory lending.

Finally, federal prosecutors often take the position that a practice of nonfeasance – failing to take corrective action in the face of information clearly revealing unlawful discrimination – in and of itself can be a form of discriminatory lending.

## BEST PRACTICES

Based on these enforcement trends, and our review of recently executed consent orders in discriminatory lending prosecutions, we believe that lenders should consider adopting the following practices to ensure that they comply with their FHA and ECOA obligations and minimize the risk of exposure to costly investigation and prosecution.

### Statistical Analysis of Redlining Risk

First, lenders should consider collecting and analyzing data regarding the loan applications and originations they execute in neighborhoods primarily occupied by low-income earning minorities. In collecting this information, lenders should examine (a) whether they issue a substantially disproportionate number of loans to whites, and (b) whether the interest rates associated with the loans they issue to minority borrowers are higher than the rates associated with the loans they issue to whites.[62] While, as explained above, statistical disparities alone are insufficient to prove disparate treatment under *Inclusive Communities*, such evidence appears to at least serve as a "starting point" for DOJ discriminatory lending investigations. Thus, lenders should, at minimum, compile and analyze this kind of data to determine whether remedial action is necessary to reduce their risk of exposure to prosecution.

### Inclusion of Full-Service Lending Offices in Areas Predominantly Occupied By Racial Minorities

Community banks should assess whether they have an adequate number of branch offices located in geographic areas predominantly populated by minorities.[63] Bank loan officers should also consider

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62 Lending institutions should be careful, however, to avoid adopting racial quotas to remedy the lending disparities revealed by the aforementioned statistical analysis. While it is unlikely that an enforcement agency will target banks that use racial quotas that benefit minorities for the purpose of remedying past discrimination, compliance officers should be mindful of the Supreme Court's guidance in *Inclusive Communities* that judicial orders designed to remedy past discrimination should be race neutral, because "[r]emedial orders that impose racial targets or quotas" may "raise difficult constitutional questions." 135 S.Ct. at 2512.

63 Recent consent orders commonly contain provisions requiring banks to open branch offices in these areas, and ensure that these offices offer the full spectrum of banking and lending services. For example, the settlement agreement in *Hudson City* specifically required the bank to "open or acquire two new full-service branches located within majority-Black-and-Hispanic neighborhoods" in the certain areas within New York, Connecticut and Philadelphia areas. Similarly,

advertising and marketing their banking and lending services to minorities who reside in areas predominately occupied by minorities. Marketing to these borrowers may include: (a) the distribution of printed advertising materials describing the bank's full panoply of lending products; (b) radio advertisements aired on stations that serve minority audiences; (c) the distribution of written brochures and materials to geographic areas predominantly occupied by minorities; and (d) direct mailings to individuals residing in areas predominantly occupied by minorities. All such materials should clearly convey that a bank is an equal opportunity lender, and make clear that minorities are welcome to apply for and receive access to all of the bank's services.

**Reported CRA Assessment Areas**

Community banks should ensure that their CRA reports to regulatory agencies contain a fair and accurate assessment of the precise geographic boundaries of the communities they serve, and do not eliminate any portions of the community predominantly occupied by low-income earning minorities. Banks should also carefully examine past CRA disclosures to ensure that they do not intentionally or unintentionally exclude areas primarily populated by minorities, and in the event that such disclosures exclude areas heavily populated by minorities, banks should take appropriate corrective action.

**Loan Officer Discretion and Financial Incentives**

Lenders should consider compensating loan officers based on the amount of credit they extend to borrowers, instead of the total value of the loans they issue, plus interest. This type of compensation system will mitigate the risk that loan officers will make lending decisions based on factors that bear no relation to a prospective borrower's creditworthiness. Lenders should also consider lowering the ceiling on the amount of interest that a loan officer may charge to a borrower for a home loan without obtaining approval from a higher authority within the lending institution.[64] Implementing this type of policy will ensure that lending institutions have more centralized control over the type of lending decisions that are particularly susceptible to bias.

**ECOA and FHA Training Programs**

Lenders should conduct appropriate ECOA and FHA training. Such training should be mandatory for all management officials, loan officers, and employees who exercise significant decision-making authority in determining whether to issue a loan to a prospective borrower and the interest rate that will accompany the loan. Compliance training should cover, at minimum, a lender's obligations under the ECOA and FHA, and should include mandatory testing to ensure proficiency.

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the settlement agreement in *Eagle Bank and Trust Co.* requires the bank to open a "full-service branch at 4100 Lindell Boulevard, St. Louis, Missouri 63108."

[64] For example, the consent orders in *Toyota Motor Credit Corp.* and *Fifth Third Bank* both contained provisions capping the interest rates set by automobile dealerships to 1.25% or 1%. Specifically, the *Toyota Motor Credit Corp.* consent order provided that Toyota could choose one of three options in implementing a dealer compensation policy. Each of the options included a provision which stated that Toyota would limit each dealer's discretion in setting the rate of interest on an automobile loan to "one hundred and twenty-five (125) basis points for retail installment contracts with terms of sixty (60) months or less, and one hundred (100) basis points for retail installment contracts with terms greater than sixty (60) months."

**Community Outreach Partnerships**

Lending institutions should consider partnering with community-based organizations that assist financially distressed borrowers in areas predominantly occupied by minorities. By partnering with community-based organizations, banks will enhance their ability to: (1) help minority borrowers obtain loans by educating them on basic financial planning issues such as repairing credit; (2) market and issue loans to prospective minority borrowers; (3) increase their physical presence in geographic areas predominantly populated by minorities, and (4) promote the stabilization of housing markets in areas primarily occupied by minorities. Additionally, these partnerships provide an excellent opportunity for lenders to serve the members of the communities within which they do business through other charitable means.

**Compliance Officers**

All of the compliance measures set forth above require extensive planning, coordination, oversight and monitoring. As such, lenders should consider appointing an existing officer, or hiring an officer, to manage the lender's efforts to ensure compliance with the ECOA and the FHA.

## CONCLUSION

In recent years, many of the lending practices adopted by financial institutions have triggered investigations and prosecutions by DOJ for violations of the ECOA and FHA. As explained, the area of law governing these enforcement actions is rapidly developing. Therefore, lending institutions should stay abreast of the prosecutorial priorities of federal agencies charged with enforcing federal discriminatory lending laws, and the body of case law interpreting these laws. By staying informed of these developments, and adopting the policies necessary to mitigate the risk of discriminatory lending, lenders may avoid the costly and time-consuming process of defending against lending discrimination lawsuits.

**About Carlsmith Ball**

Carlsmith Ball LLP is one of the largest law firms in the Pacific region with offices in Honolulu, Hilo, Kona, Maui, and Los Angeles. Our attorneys are recognized as leaders in the industry, named to the 2015 Hawaii Super Lawyers list and ranked among "America's Leading Lawyers for Business" by Chamber and Partners USA. For more than 150 years, Carlsmith Ball has provided clients innovative and results-oriented representation in sophisticated commercial and financial transactions and in complex arbitration and litigation matters. For more information about the firm, please visit www.carlsmith.com.

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This information is not intended as legal advice. Readers should seek specific legal advice before acting with regard to the subjects mentioned herein. Please direct any questions regarding the issues discussed herein to any Carlsmith Ball LLP attorney.

**Author(s)**

Kenji Price, Esq.
808.523.2500
kprice@carlsmith.com