FEDERAL RESERVE BANK OF SAN FRANCISCO

Community Investments Vol. 9, Issue 3 The Lenders' "Other Regulator": Fair Lending Enforcement by the Department of Justice

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Over the past several years, the bank regulatory agencies have substantially expanded the effort and the expertise devoted to ensuring lender compliance with the nation's fair lending laws.[1] Concurrent with this activity, the Civil Rights Division of the U.S. Department of Justice (DOJ) has also devoted increased resources to fair lending enforcement resulting in the filing and settlement of twelve lawsuits. These lawsuits have attracted both the attention and deep concern of lenders nationwide. This article discusses the scope of enforcement powers available to the DOJ under the fair lending statutes and summarizes the cases DOJ has brought under those laws. To help lenders manage their own exposure, this article highlights those aspects of the lending process that are presently the primary focus of DOJ investigations.

DOJ's Role in Fair Lending Enforcement

Congress placed primary responsibility for enforcement of the Equal Credit Opportunity Act (ECOA) upon the banking regulatory agencies and the Federal Trade Commission which already had existing supervisory responsibilities for the various types of credit-granting entities covered by the Act. In addition, however, the ECOA provides for enforcement by the DOJ in two specific circumstances: (i) whenever an agency having administrative enforcement powers pursuant to the ECOA refers an

enforcement matter to the DOJ[2], and (ii) more broadly, whenever the Attorney General, on his or her own initiative, develops facts which support a "reason to believe that one or more creditors are engaged in a pattern or practice in violation of (the ECOA)."[3] The enforcement tool available to the Attorney General in either of the foregoing instances is the filing of a civil action in "any appropriate United States district court for such relief as may be appropriate, including actual and punitive damages and injunctive relief."[4]

DOJ's authority to file suit under the Fair Housing Act (FHAct) is similar to the "pattern or practice" basis provided under the ECOA. The relief available to the DOJ under the FHAct includes injunctive relief, monetary damages to aggrieved individuals and civil penalties of up to $100,000.

In short, the DOJ has authority to initiate its own investigations of suspected fair lending violations by lenders, both regulated and not, and to seek broad forms of monetary and other relief, without relying either on complaints from members of the public or referrals from bank regulatory agencies.

DOJ Fair Lending Cases - a Summary

Since 1992, DOJ has filed and reached settlement agreements in twelve fair lending cases in which the defendant lending institutions agreed to pay an aggregate total of approximately $24 million dollars for compensation of individual applicants or borrowers and for civil penalties. Over $10 million of this compensation went directly to persons alleged by DOJ to have been victims of discriminatory treatment. Several agreements also included the establishment of special loan funds intended to correct the effects of their alleged discrimination.

With respect to the nature of the discriminatory conduct alleged by DOJ in these twelve suits, seven were predicated primarily on claims that the defendant lenders had charged minority borrowers higher interest rates, points, fees or other loan price components than were charged to similarly

situated non-minority borrowers. In *United States v. Fleet Mortgage Corp.,* for example, a case based in large part on statistical and other information developed by the Federal Reserve Bank of Boston and Board staff, DOJ alleged a pattern or practice of discrimination as evidenced by statistically significant racial disparities in both the frequency and amounts of premium pricing, or "overages" charged on mortgage loans, coupled with an apparent absence of any credible, non-discriminatory explanations for those disparities. Fleet agreed to payments of $3.8 million in "monetary compensation" for alleged victims of discrimination, together with $200,000 to be used for public education programs regarding loan pricing and other aspects of the mortgage process.

DOJ's 1996 suit against Long Beach Mortgage Company (Long Beach) was its most controversial pricing case to date. Long Beach, an independent mortgage company, operated the "B & C" sub-prime market through both a "retail" lending operation employing its own loan officer employees and a significant "wholesale" operation involving various mortgage brokerage firms. DOJ charged that Long Beach, which authorized both its employee loan officers and its brokers at their own discretion to propose premium prices on loans, was itself liable when either a loan officer or a broker discriminated on a prohibited basis in exercising that pricing discretion. Lenders objected that the lesson of the Long Beach case was that DOJ would unfairly seek to hold them responsible for the acts of independent brokers over whose pricing behavior they had no real control. DOJ, however, took the position that, in the Long Beach case at least, the brokers were not truly independent operators from whom that lender simply purchased loans. Rather, DOJ alleged that these brokered loans (similar to loans submitted by its own employees) were routinely re-underwritten and funded by Long Beach in its own name and that Long Beach had retained the authority to approve or disapprove applicants and to set loan terms and conditions for any approved loan. Under these circumstances, DOJ regarded Long Beach as the legally responsible creditor, rather than a simple purchaser of loans. It

seems likely that DOJ will continue to bring such cases whenever they detect fact patterns indicative of substantial control by a lender over an otherwise independent broker's authority to set prices. In agreeing to the settlement, Long Beach undertook, *inter alia,* to pay $3 million to some 1,200 minority borrowers identified as victims by DOJ and to establish a $1 million fund for educating consumers on how mortgage loans are priced and the need to shop wisely for mortgage credit.

Besides pricing, the other predominant focus of the loan decision process reflected in DOJ's lawsuits is on loan processing and underwriting. The earliest of the twelve fair lending cases summarized here, *United States v. Decatur Federal S&L,* filed in September, 1992, alleged that the lender had applied stricter underwriting criteria to minority applicants than to others. In June, 1995, DOJ settled a case against Northern Trust Company in Chicago, where the principal allegation was that the lender's loan personnel had not provided African American applicants with the same *level of assistance* in overcoming credit problems or meeting other qualification criteria, as were accorded white applicants. As more recent cases demonstrate, discriminatory disparities in levels of assistance to applicants, together with pricing discrimination, become a central element in DOJ's fair lending focus.

Important Lessons From DOJ Investigations

It is the rare loan applicant whose qualifications as a borrower match perfectly all of the underwriting standards of the typical lending institution. The vast majority of applicants will have some flaw in their credit history, or perhaps a loan to value or debt to income ratio that exceeds FNMA's or the lender's own guidelines, or a shortage of cash needed to pay closing costs. Loan officers, processors and underwriters are called upon constantly to assist at least some of these applicants to overcome one or more such imperfections and thereby qualify for a loan. Fair lending laws require that these everyday acts of assistance be provided on a consistent basis to all applicants and without regard to race, gender, age or other prohibited basis.

Moreover, it is the lack of such consistency, perhaps reflected initially in HMDA data showing disparities in loan approval rates for white applicants compared to minorities, that both bank examiners and DOJ investigators regard as a significant "red flag", calling for more intensive scrutiny. The allegations against a relatively small New Mexico lender set forth in the complaint filed earlier this year by the DOJ in *United States v. First National Bank of Dona Ana County* are compellingly instructive about the kinds of issues to which every lender must pay close attention on an on-going basis. That complaint alleged, in abbreviated part, as follows:

- First National provided loan officers with vague, non-specific processing and underwriting guidelines and instructions such that loan officers were left with *de facto* authority to establish their own minimum standards;
- No official at First National reviewed decisions by loan officers to ensure that all persons were treated fairly;
- First National failed to adequately train its loan officers and other employees regarding fair lending obligations;
- Loan files revealed that in processing applications, loan officers made greater efforts to obtain information from non-minority applicants to demonstrate their eligibility than was expended on behalf of minority applicants, including failures to make comparable efforts (a) to allow minorities to explain adverse credit report items; (b) to verify credit sources listed on minority loan applications; and (c) to elicit from minority applicants possible "offsetting" qualifications that might compensate for deficiencies;
- Loan files also revealed that loan officers applied more stringent, less flexible underwriting standards on minority loan applications than on applications from similarly situated white applicants.

As these allegations demonstrate, *consistency* is the most important principle behind any effective fair lending compliance program. This includes

consistency of behavior in the level of assistance given to applicants, as well as consistency in the making of exceptions to established bank underwriting guidelines or other policies. Perhaps even more difficult is ensuring consistency on the part of those who exercise discretion when pricing loans to applicants. It is widely understood that most of us hold certain stereotypes, often subconscious, about people we perceive as "different." In the lending context, these perceptions may be about differences in susceptibility to being overcharged, perhaps even as to their relative "worthiness" as borrowers. To the extent that these stereotypes are related to race, to gender or to some other basis that is prohibited under the fair lending laws, only an on-going insistence by a lender's managers on fair and consistent treatment of all applicants, supported through training and self-evaluation, will provide an adequate assurance that such stereotypes do not become part of the loan making or pricing decision.

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[1] *These are (a) the Equal Credit Opportunity Act (15 U.S.C. 1691a, et seq), which prohibits discrimination against an applicant by any creditor, with respect to any aspect of a credit transaction, on the basis of, inter alia, race, color, religion, national origin, sex, marital status, or age and (b) the Fair Housing Act (42 U.S.C. 3601 et seq.), which, inter alia, makes it unlawful to discriminate in any lending-related activity affecting residential real estate on the basis of race, color, religion, sex, handicap, familial status, or*

national origin. Obviously, in housing-related cases, there is substantial overlap in coverage between the two acts.

[2] *Under Section 706(g) of ECOA, the bank regulatory agencies, including the National Credit Union Administration, are required to make such referrals whenever they have "reason to believe that 1 or more creditors has engaged in a pattern or practice of discouraging or denying applications for credit in violation of (this Act)." (Referrals to the DOJ under certain other circumstances are permissive, rather than mandatory.)*

[3] *ECOA, Section 706(h).*

[4] *It bears noting that the limitation of $10,000 on punitive damage awards to individual private claimants provided for in Section 706(b) of the Act is not applicable to cases brought by DOJ.*