Could it possibly be that, in a country where one is presumed innocent until proven guilty, a lender could be found to have discriminated on the basis of race or ethnicity, without any evidence that the lender actually intended to so discriminate? Yet this is exactly the result of the “disparate impact” and “disparate treatment” theories of liability, which are becoming more and more prevalent in the enforcement of fair lending laws.

The Department of Housing and Urban Development’s discriminatory effects rule (“Rule”) became effective on March 13, 2013, formalizing the “disparate impact” theory as a tool to establish liability under the Fair Housing Act. This article is intended to be a primer on the Rule and a discussion of ways to mitigate risk of non-compliance under the Rule.

**FAIR LENDING LAWS**

Laws and regulations considered to be “fair lending laws” include the Fair Housing Act (“FHA”) and the Equal Credit Opportunity Act (“ECOA”). The Fair Housing Act generally prohibits discrimination in all aspects of residential real estate related transactions and the ECOA generally prohibits discrimination in any aspect of a credit transaction, namely actions attendant to an extension of credit, including extension of credit to small businesses, corporations, partnerships, and trusts. Both the FHA and ECOA prohibit discrimination on the basis of race, color, religion, national origin, sex, handicap, familial status, or national origin. The ECOA additionally prohibits discrimination on the basis of age and receipt of income derived from a public assistance program. The FHA additionally prohibits discrimination on the basis of handicap. The Rule applies only to the FHA, but speculation abounds that the Consumer Financial Protection Bureau and the U.S. Department of Justice (“DOJ”) will use the Rule as guidance in enforcing the ECOA.

The Rule provides as follows: “[l]iability may be established under the Fair Housing Act based on a practice’s discriminatory effect … even if the practice was not motivated by a discriminatory intent. The practice may still be lawful if support by a legally sufficient justification …”

**Outlier data** that is suggestive of effect and those statistics will either be the DOJ’s sword or the lender’s shield.

“A practice has discriminatory effect where it actually or predictably results in a disparate impact on a group of persons or creates, increases, reinforces, or perpetuates segregated housing patterns because of race, color, religion, sex, handicap, familial status, or national origin.”

“A legally sufficient justification exists where the challenged practice: (i) is necessary to achieve one or more substantial, legitimate, nondiscriminatory interests of the respondent [lender] … and (ii) Those interests could not be served by another practice that has a less discriminatory effect.”

As one might expect, these words and phrases are fraught with nuanced meanings, which can keep teams of lawyers arguing for months on end, all of which become an expensive distraction to your core business.

**PROACTIVE EFFORTS TO MITIGATE FAIR LENDING RISK**

The DOJ is generally the “charging party”
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when bringing a fair lending claim against a respondent (lender). The DOJ “has the burden of proof to show that a challenged practice caused or predictably will cause a discriminatory effect.” If that burden is satisfied, the respondent “has the burden of proving that the challenged practice is necessary to achieve one or more substantial, legitimate, nondiscriminatory interests of the respondent or defendant.” Yet even if the respondent can satisfy its burden, the charging party can come back and try to “prevail upon proving that the substantial, legitimate, nondiscriminatory interests supporting the challenged practice could be served by another practice that has a less discriminatory effect.”

In plain terms, a lender’s defense to a fair lending claim is “all about the data,” using data points derived from the “Three L’s,” beginning with your document preparation system and loan origination system (“Loan Data Points”). Those data points include core statistics concerning the loan (i.e. loan amount, interest rate and fees charged, loan type and property address, to name just a few) and data points from the loan application (i.e. national origin, sex, marital status, among others). Additional data points may be gathered from your corporate records (“Lender Data Points”), including matching closed loans with purchased loans (and type of purchaser), loan officer and/or broker compensation amounts as a percentage of charged origination fees, individual branch loan volume as compared to the whole of the organization, borrower complaints, Home Mortgage Disclosure Act data, among others. Finally, commercially available demographic data (“Location Data Points”) is superimposed upon the Loan Data Points and Lender Data Points, all to “trend” the data and look for variance that could evidence “discriminatory effect.”

Evidence of “discriminatory effect” includes “overt” discrimination, namely a clear indication that the lender engaged in a loan practice. This is sometimes referred to the “I know it when I see it” description that is often applied to pornography. “Softer” signs of a discriminatory effect include disparities among approval/denial rates between applicants of different races, national origins, or sex (potential disparate treatment in underwriting), risk based pricing that is not objectively based or financial incentives to loan officers or brokers on loans made to protected classes of persons (potential disparate treatment in pricing). Outlier data that is suggestive of amount, interest rate and fees charged, loan type and property address, to name just a few)

Developing preemptive strategies through real time loan data review goes a long way towards spotting “trends” and “outliers.”

CONCLUSION

Defending against a fair lending claim is never a pleasant proposition – it is time consuming, costly, and frequently involves a type of publicity that is not desired.

The concerns and issues raised above are real. The largest settlement with the DOJ to date is $335 million; the second largest is $175 million. Developing preemptive strategies through real time loan data review goes a long way towards spotting “trends” and “outliers” before your organization appears on a prosecutor’s radar screen and disrupts your sleeping habits.