FAIR LENDING *Revisited*[1]

By Michael D. Waters and Cristopher Couch

In 1912, Congress investigated the cartel-like behavior among Wall Street banks to determine whether such activity had the effect of denying credit to otherwise creditworthy borrowers. During the hearings, Samuel Untermeyer, representing Congress, and J.P. Morgan famously exchanged the following words:

Mr. Untermeyer: *Is not commercial credit based primarily upon money or property?*

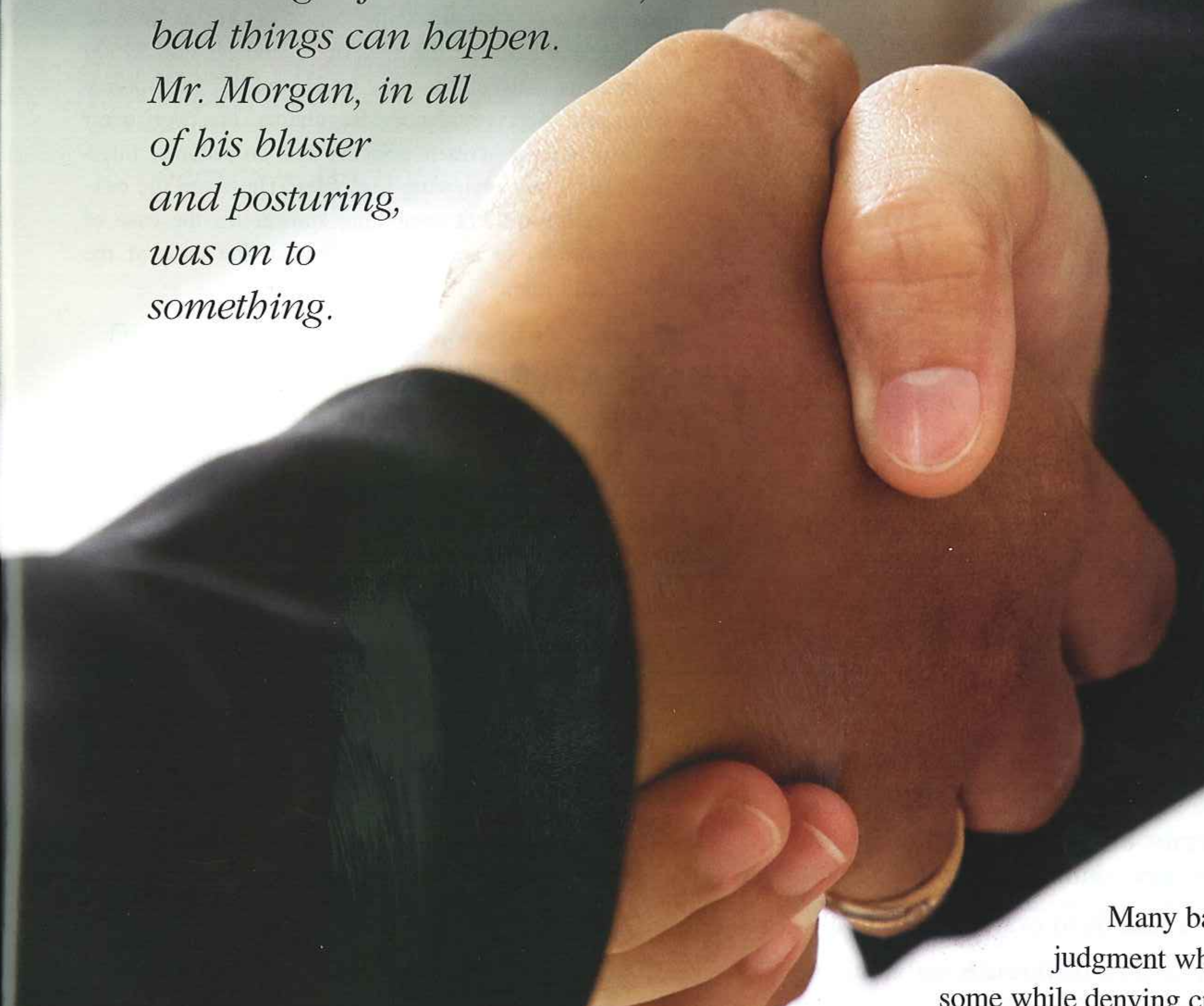
Mr. Morgan: *No sir. The first thing is character.*

Mr. Untermeyer: *Before money or property?*

Mr. Morgan: *Before money or anything else. Money cannot buy it ... Because a man I do not trust could not get money from me on all the bonds in Christendom.*

1 Much of this article is drawn from the *OCC's Handbook for Compliance, Fair Lending* (January 2010), found at http://www.occ.treas.gov/handbook/fairlep.pdf (the "OCC Handbook").

Every banker can relate to this sentiment. Knowledge of the character of one's borrower leads to one's trust in repayment. Character is king. As we've all learned from the recent credit crisis, when lending gets too far removed from knowledge of one's borrower, bad things can happen. Mr. Morgan, in all of his bluster and posturing, was on to something.



Congress, however, was on to something, too. Many bankers use subjective judgment when granting credit to some while denying credit to others. In the face of empirical evidence that some of this subjective judgment raised public policy issues, Congress passed the Fair Housing Act in 1968 and the Equal Credit Opportunity Act in 1974. The two Acts together are commonly referred to as the "Fair Lending Laws," and generally make it illegal to discriminate against applicants for credit on the basis of race, color, religion, national origin, sex or marital status or age. In the language of the Fair Lending Laws, these are "Prohibited Bases" or "Prohibited Factors." At their most basic, the Fair Lending Laws forbid using Prohibited Factors as a proxy for character, and require bankers to evaluate borrowers neutrally and without prejudice.

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Today, most bankers appreciate that the Fair Lending Laws generally require a Prohibited Factor-blind approach to the granting of credit, which includes the marketing, underwriting, scoring and approval of credit products. As an increasing number of regulatory actions indicate, however, many bankers may not appreciate the process by which regulators evaluate their compliance with Fair Lending Laws and, thus, may not understand how even good faith decisions can lead to inadvertent violations.

First, it should be noted that race and nationality get special attention under the Fair Lending Laws, as does residential lending. Discrimination based on race and nationality are viewed as particularly troublesome, and home-ownership particularly prized, so the regulators give them heightened scrutiny. As a result, many, if not most, Fair Lending examinations have race, nationality or residential lending as a focal point.

Next, it is important to understand that "discrimination" occurs not only when one thing is disfavored, but also when another thing is favored. As a result, each of the following, when based on a Prohibited Factor, constitutes a violation of the Fair Lending Laws according to the OCC Handbook:

- **Failure to provide information or services**, or the provision of different information or services regarding any aspect of the lending process, including credit availability, application procedures, or lending standards;
- **Discouragement or selective encouragement of applicants** in inquiries about or applications for credit;
- **Refusal to extend credit or the use of different standards** in determining whether to extend credit;
- **Variance of the terms of credit offered**, including the amount, interest rate, duration, or type of loan;
- **Use of different standards** to evaluate collateral;
- **Treatment of borrowers differently** in servicing loans or invoking default remedies; or
- **Use of different standards for pooling or packaging a loan** in the secondary market.

Similarly, expressing a preference based on a Prohibited Factor — whether or not the bank acts on that preference – constitutes a violation. For example, where a loan representative advises a potential applicant, "We don't usually make loans to [a particular category or group of borrowers]," the bank has violated the Fair Lending Laws. The statement serves to discourage the potential applicant from applying, *regardless of whether the bank treats applications from that category or group of borrowers differently* and, thus, the statement constitutes a violation.

Finally, it is also important to understand that violations may occur inadvertently. As the OCC Handbook makes clear, regulators may find disparate treatment based on a Prohibited Factor (i.e., a Fair Lending Violation) based on overt evidence, but they may also find them based on comparative evidence or through evidence of a disparate impact.

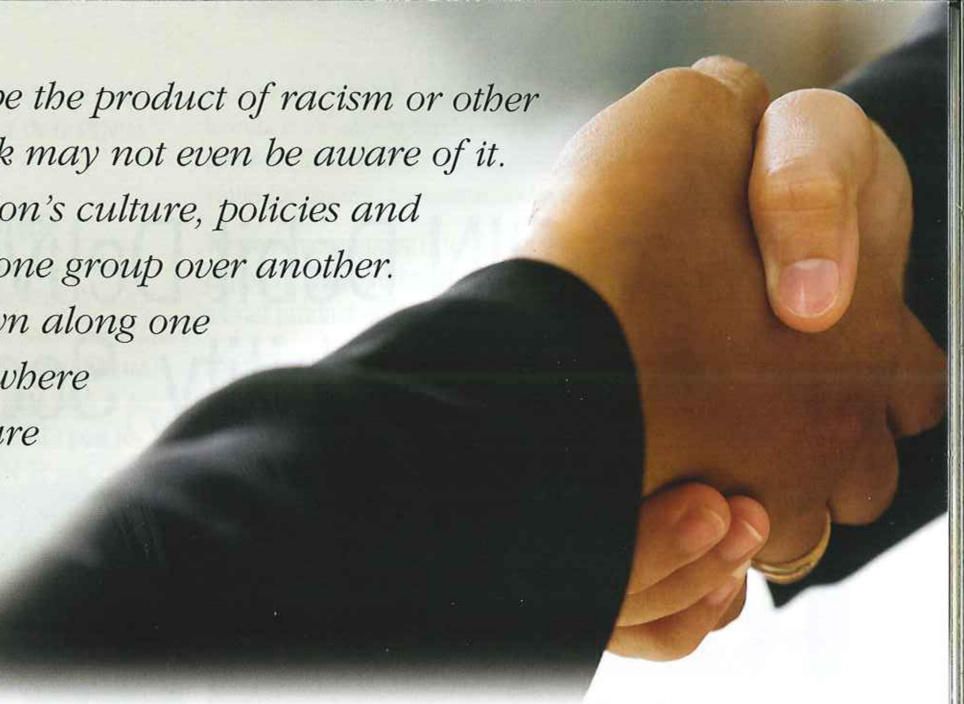
OVERT EVIDENCE

Overt evidence of disparate treatment lies in oral or written actions or policies. For instance, the oral statement above would constitute overt evidence of disparate treatment. Similarly, if a bank has a policy of "automatically" granting $1500 lines of credit to applicants between the ages of 21 and 30, and $2500 lines to applicants between the ages of 31 and 40, such policy would constitute overt evidence. Regulators discover overt evidence by reviewing written policies and procedures, interviewing personnel and reviewing loan files. These are the easy cases, and generally reflect something sinister (in the case of the comment above) or something naïve (in the case of the "automatic" credit line).

COMPARATIVE EVIDENCE

Comparative evidence of disparate treatment is identified within a bank's applications and lending statistics by comparing the bank's treatment of statistically similar applicants and borrowers. This evidence does not require any showing that the treatment was motivated by prejudice or even a conscious intention to discriminate. As the OCC Handbook states:

> *Discrimination may not be the product of racism or other prejudices, and the bank may not even be aware of it. Nonetheless, the institution's culture, policies and location may inadvertently favor one group over another. Where such favoritism breaks down along one or more Prohibited Factors, even where innocent, the Fair Lending Laws are implicated and the institution should take care to evaluate its operations and options.*



Disparate treatment may more likely occur in the treatment of applicants who are neither clearly well qualified nor clearly unqualified. Discrimination may more readily affect applicants in this middle group for two reasons. First, if the applications are "close cases," there is more room and need for bank discretion. Second, whether or not an applicant qualifies may depend on the level of assistance the bank provides the applicant in completing an application. The bank may, for example, propose solutions to credit or other problems regarding an application, identify compensating factors, and provide encouragement to the applicant. Banks are under no obligation to provide such assistance, but to the extent they do, the assistance must be provided in a nondiscriminatory way.

A violation premised upon comparative evidence may, in some cases, be troubling, as no intent is required. That is, it does not require any showing that the treatment was motivated by prejudice or even consciousness; the disparate treatment is alone sufficient. However, when comparative evidence reveals an "apparent" violation, the bank is permitted to rebut the claim by showing that the applicants or borrowers were treated differently not because of a Prohibited Factor, but because of something else. As a result, "apparent" should not be equated with "final."

DISPARATE IMPACT

Examiners may also find disparate treatment where a bank has a neutral policy, equally applied, but the policy itself disproportionately burdens a person or group based on a Prohibited Factor. In such a case, the policy will be found to have a "disparate impact" in violation of Fair Lending Laws. For example, if a bank has a policy not to make residential loans for less than $250,000, this policy — even if evenly applied — may have the effect of disproportionately burdening minority borrowers because of income levels or the value of houses in the areas in which they live.

As with comparative evidence, however, a finding of disparate impact does not necessarily equate to a Fair Lending violation. The institution has the right to show that the policy or practice is justified by an actual (as opposed to hypothetical) "business necessity," such as cost or profitability. However, the bank's position may be rebutted by the examiner's showing that a less burdensome or discriminatory alternative exists which would serve the same business purpose.

The OCC Handbook acknowledges that discrimination based on comparative evidence or disparate impact present the harder cases. The discrimination may not be the product of racism or other prejudices, and the bank may not even be aware of it. Nonetheless, the institution's culture, policies and location may inadvertently favor one group over another. Where such favoritism breaks down along one or more Prohibited Factors, even where innocent, the Fair Lending Laws are implicated and the institution should take care to evaluate its operations and options.

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