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By Bill Lewis

Mortgage lenders evaluate disparate-impact ruling

The mortgage industry seemed alarmed this past June when the U.S. Supreme Court ruled that lenders are subject to "disparate-impact" claims, but five months later those worries appear to have lessened.

In its decision, a 5-4 ruling written by Justice Anthony Kennedy, the high court held that borrowers could sue under the federal Fair Housing Act if a lender's policies resulted in a discriminatory outcome, even if there was no intent to discriminate. The decision raised fears of widespread class-action lawsuits challenging what lenders see as legitimate, nondiscriminatory reasons behind credit decisions.

But the ruling set strict standards for such lawsuits and held that lenders cannot be held liable if they show that their policies are necessary to achieve a valid goal, says Paul Hancock, a Miami lawyer who represents clients in the financial-services industry.

"Justice Kennedy's decision emphasized that there are important limitations on the use of disparate impact," Hancock says. "It can't be used to pursue demands for equal racial outcomes, or racial quotas, for example."

Downpayment levels, for instance, might have the effect of favoring nonminority borrowers, but can be justified if lenders establish that the level of risk they are assuming is in line with downpayment requirements.

If a policy results in a discriminatory outcome, lenders should be prepared to "articulate the business reasons for the policy," Hancock says. "So long as those business reasons are not arbitrary or unreasonable, courts should not reject them."

Demonstrating compliance

Mortgage companies — especially small to mid-sized lenders — are often inexperienced at demonstrating that their business practices are rational and reasonable, says Brian Koss, executive vice president of Mortgage Network Inc.

"Most of them are trying to do the right thing," Koss says. "But for many of these companies, one of the issues is that they don't know what they don't know."

Koss recommends that lenders purchase reliable software designed to measure levels of compliance with fair-housing regulations.

"The best way to do it is to find a good vendor partner who has been able to write good programming," he says. "If you have good data — your own pricing data to plug into the system — and a good compliance partner who is going to give you that ability to monitor yourself, then you're in good shape."

Although it captured the mortgage industry's attention, the June ruling came in a case that did not involve lenders or borrowers. It arose from a lawsuit filed against the state of Texas by a Dallas housing-advocacy group that argued the state's distribution of tax credits led to the concentration of affordable housing in minority neighborhoods.

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The court upheld the group's claim under the disparate-impact concept, a legal theory for challenging housing policies that is nearly as old as the 1968 Fair Housing Act itself. The Justice Department has employed the doctrine to win more than $500 million from companies accused of bias against African-American and Hispanic customers, but the June decision was the high court's first ruling on the concept.

John Taylor, president of the National Community Reinvestment Coalition (NCRC), which promotes wide access to banking and credit services, applauded the court's decision. He says the disparate-income argument is important because of the central role homeownership plays in creating wealth.

Preventing even inadvertent discrimination against members of minority groups "lends itself to those folks having more success in their life, with better education, better health care services, better transportation, safer neighborhoods, economic opportunities, access to jobs or news about potential job openings," Taylor says.

Kennedy's opinion gave lower courts a framework for disposing of frivolous, or what it called "abusive," discrimination challenges. Instead of relying only on statistical evidence of discrimination, the opinion said lawsuits must establish "robust causality" that proves a lender's actions are the cause of a discriminatory outcome. In addition, the ruling put the burden on plaintiffs to prove that there are alternative practices available to lenders that will have a less discriminatory impact and still serve the lenders' legitimate business needs.

All of those factors should be considered early in the course of litigation, Kennedy directed, at the pleading stage, when defendants submit motions to dismiss a lawsuit.

Despite the court's direction in the case, Koss says there remains a possibility that lenders that comply with existing law might, as a result, be subject to disparate-impact challenges. For instance, a policy of making only what federal law defines as qualified mortgages might result in the denial of credit to minorities at a disproportionately high rate.

"If you try to be perfect, and eliminate risk, there could be unintended consequences," Koss says.

Arriving at a definition of what is and is not an acceptable level of lending risk can be contentious. Credit scores, for instance, are universally accepted as a factor in determining creditworthiness. Banking-reform advocates, however, have challenged lenders that, for ostensibly nondiscriminatory reasons, increase Freddie Mac and Fannie Mae minimum credit-score requirements when making loans that will be guaranteed by those government-sponsored enterprises.

"When you do an overlay that essentially cuts out the 580 credit score, and raises it up to 660, you're disproportionately cutting out African-Americans and Latinos," says the NCRC's Taylor.

Enduring issue

Concern over the Supreme Court's June ruling may have dissipated, but disparate impact is unlikely to disappear as a topic of focus for the courts and lenders.

"We'll see more discussion on this issue and perhaps more litigation as to what it really means," Hancock says.

Just days after the Supreme Court issued its disparate-impact ruling, the Department of Housing and Urban Development released a years-in-the-making Rule on Affirmatively Furthering Fair Housing. It requires cities to study housing-segregation patterns, establish goals for integrating neighborhoods and to prepare a progress report every three to five years.

Housing advocates quickly praised the proposals as a step toward reducing the housing segregation that has persisted despite fair-housing laws, while Republicans in Congress denounced the rule and promised legislation and litigation to block it. ■

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