Comments to

DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT

Regulations Division
Office of the General Counsel
451 7th Street SW, Room 10276
Washington, DC 20410

In the Matter of	**)**	
	)	
Rules and Regulations Implementing	**)**	**Docket No. FR-6111-A-01**
Fair Housing Act	**)**	
	)	

REPLY COMMENTS OF THE AMERICAN BANKERS ASSOCIATION AND STATE BANKERS ASSOCIATIONS IN SUPPORT OF REOPENING RULEMAKING REGARDING THE IMPLEMENTATION OF THE FAIR HOUSING ACT'S DISPARATE IMPACT STANDARD

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By Federal E-Rulemaking Portal

Regulations Division
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U.S. Department of Housing & Urban Development
451 7th St. SW, Room 10276
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Re: *Reconsideration of HUD's Implementation of the Fair Housing Act's Disparate Impact Standard*
Docket No. FR-6111-A-01; RIN 2529-ZA01

Ladies and Gentlemen:

This comment is submitted by the American Bankers Association (ABA)[1] and the undersigned state bankers associations (SBAs) in response to the June 20, 2018 advance notice of proposed rulemaking (ANPR)[2] of the U.S. Department of Housing and Urban Development (the Department or HUD). In the ANPR, HUD "invites public comment on possible amendments to HUD's 2013 final rule implementing the Fair Housing Act's disparate impact standard"[3] to assist HUD in "reviewing the final rule and supplement to determine what changes, if any, are appropriate following the Supreme Court's 2015 ruling in *Texas Department of Housing and Community Affairs v. Inclusive Communities Project, Inc*.,[[4]] which held that disparate-impact claims were cognizable under the Fair Housing Act and discussed standards for, and the constitutional limitations on, such claims."

I. Prequel

ABA and the SBAs vigorously support the Fair Housing Act, and the associations and their members devote substantial resources on an ongoing basis to ensure that credit decisions for all loan applicants are made without regard to race or other prohibited bases. The associations appreciate the complex issues faced by the Department in promulgating rules and enforcing the Fair Housing Act, and this comment is intended to assist HUD in ensuring that the Disparate-Impact Rule promotes a standard that is fully consistent with binding Supreme Court precedent and operates to provide guidance and clarity to entities seeking to comply with the law—the primary requirements and purposes of agency rules.

1 ABA is the voice of the nation's $17 trillion banking industry, which is composed of small, regional, and large banks that together employ more than 2 million people, safeguard $13 trillion in deposits, and extend more than $9 trillion in loans.
2 *See* 83 Fed. Reg. 28,560 (June 20, 2018).
3 *See* 78 Fed. Reg. 11,460 (Feb. 15, 2013) (Disparate-Impact Rule or Rule).
4 135 S. Ct. 2507 (2015) (*Inclusive Communities*).

ABA and the SBAs have significant concerns that the Rule adopts standards that are inconsistent with Supreme Court precedent, fails to provide necessary guidance, and is therefore outdated and ineffective. With the Supreme Court's issuance of the *Inclusive Communities* decision, the time is now ripe to reopen the Rule and effectuate necessary amendments. Application of an incorrect standard or improper enforcement of the Act would have serious negative implications for lenders and borrowers alike. Thus, the issues that this comment addresses are of great import both to the members of the ABA and SBAs, as well as to their customers.

II. Executive Summary of Comments

The Supreme Court's 2015 *Inclusive Communities* decision confirms the fundamental errors in HUD's original promulgation of the Disparate-Impact Rule in 2013. *Inclusive Communities* demonstrates the need for amendments to the Rule to (1) properly reflect the Supreme Court's binding cautionary standards, safeguards and limitations on disparate-impact liability for claims brought under the Fair Housing Act, and (2) provide appropriate and necessary guidance to the industry, including defenses and safe harbors to disparate-impact claims.

A. HUD's Error in Issuing a Rule that Rejects Supreme Court Precedent Limiting the Application of Disparate Impact is Confirmed by *Inclusive Communities*, Which Requires the Limitations HUD Rejected

To understand the Disparate-Impact Rule's flaws, it is important to understand the evolution of Supreme Court disparate-impact precedent under Title VII of the Civil Rights Act of 1964 (prohibiting discrimination in employment) and the breakpoint at which Title VII jurisprudence no longer guides interpretation of the disparate-impact standard applicable to the Fair Housing Act. Because Title VII and the Fair Housing Act contained similar prohibitory language and were designed for similar purposes, courts considering Fair Housing Act claims frequently applied the Title VII disparate-impact jurisprudence.

There is a break-point in time, however, after which Title VII jurisprudence no longer guides the interpretation of the applicable standard for disparate-impact liability under the Fair Housing Act. That breakpoint occurred in 1991 when Congress amended Title VII to abrogate—for future Title VII claims only—the disparate-impact standard articulated by the Supreme Court in *Wards Cove Packing Co. v. Atonio*, 490 U.S. 642 (1989) (*Wards Cove*). The Supreme Court has expressly held that, because Congress acted to amend only Title VII, *Wards Cove* remains binding precedent for disparate-impact claims brought under statutes other than Title VII. In promulgating the Disparate-Impact Rule and announcing the standard under the FHA, HUD erred in rejecting the standard for disparate impact described in *Wards Cove*. Obviously, HUD lacks legislative authority. Yet reaching far beyond its regulatory authority, HUD further erred by deciding to adopt the 1991 congressional amendments to Title VII as the Fair Housing Act's standard of disparate impact.

These *ab initio* errors had significant consequences. The 1991 amendments to Title VII were intended by Congress to make the disparate-impact standard for employment discrimination more plaintiff friendly and more difficult for a defendant to rebut. The 1991 amendments superseded *Wards Cove* on issues like the allocation of the burden of proof, the requirement to isolate specific practices being challenged, the constraint that disparate impact requires *significant* disparities, and the prohibition on bringing a disparate-impact claim based on statistics alone. It also imposed a greater burden on a defendant to justify a disparity and allowed a plaintiff to merely hypothesize other business practices that may have less of an impact.

In response to the first two questions posed in the ANPR, ABA and the SBAs submit that the starting point for amending the Rule is an articulation of a disparate-impact standard consistent with the Supreme Court's binding *Wards Cove* decision. Indeed, the Supreme Court's decision in *Inclusive Communities* confirms the Rule's errors through its reliance on *Wards Cove* and its articulation of the "cautionary standards," "safeguards," and "limitations" on the use of disparate impact that must be implemented and applied to claims brought under the Fair Housing Act.

Inclusive Communities expressed concern that, absent strict limits on the use of disparate impact, such claims could push potential defendants toward racial quotas, thereby raising serious constitutional concerns. The Supreme Court confirmed that claims based on statistical disparities alone must fail, and that plaintiffs must satisfy a "robust causality" requirement by linking any alleged disparity to a policy of the defendant. Only policies that are "artificial, arbitrary, and unnecessary" can be attacked with disparate-impact claims, and businesses must be given latitude to make "practical business choices and profit-related decisions." Of great significance, *Inclusive Communities* held that the remedial focus in disparate-impact cases is "elimination of the offending practice"—not on money damages or penalties. This makes sense, as the elimination of the offending practice should resolve the underlying disparity. The HUD Disparate-Impact Rule fails to recognize any of these standards, safeguards, or limitations.

B. The Rule Should be Amended to Include a Proper Definition of a Disparate-Impact Claim

In response to the third and sixth questions posed by HUD's ANPR, ABA and the SBAs suggest that Rule be amended to provide a specific definition of a disparate-impact claim of unintentional discrimination, and to provide a description of the claim's three essential elements, namely, (1) a specific, neutral policy or practice of the defendant that presents an artificial, arbitrary, and unnecessary barrier, (2) a significant, adverse and disproportionate impact, and (3) a robust causal link between the challenged policy or practice and the disproportionate impact.

Importantly, the policy or practice subject to challenge must not only be neutral on its face, but must be applied neutrally—i.e., uniformly—to all persons. Inconsistent or different application of a facially neutral policy may provide a basis for a claim of *disparate treatment,* but that is the antipathy of a claim of *disparate impact*. HUD should also carefully evaluate the impact of *Wal-*

Mart Stores, Inc. v. Dukes, 131 S. Ct. 2541 (2011), in combination with the subsequent *Inclusive Communities* decision, particularly in defining the types of business practices that can be subject to a disparate-impact challenge and the difficulties that a plaintiff faces in stating a cognizable claim. Disparate-impact plaintiffs frequently identify the practice being challenged as "*allowing discretion*" to employees. But *Dukes* observed that granting employees discretion is "a very common and presumptively reasonable way of doing business" and "is just the opposite of a uniform practice …; it is a policy *against having* uniform employment practices." 131 S. Ct. at 2554 (emphasis added) (internal quotations omitted). Thus, merging *Dukes* and *Inclusive Communities*, a disparate-impact plaintiff seeking to challenge an alleged policy of allowing discretion to employees faces an initial burden of showing that it is the type of uniform policy that can be subjected to challenge, and then faces an enhanced burden of overcoming the starting presumption that such a policy is a reasonable way of doing business and therefore not an "artificial, arbitrary, and unnecessary" barrier.

The *Inclusive Communities* lawsuit itself ended in summary judgment to the defendant when, on remand from the Supreme Court, the district court held that the non-profit's claim focused on *how* discretion was exercised by the defendant's employees—in other words, the non-profit brought a claim of *disparate treatment* and not *disparate impact*. The same limitations of *Dukes* should apply to governmental and private class action claims of a "pattern or practice" of discrimination brought under a disparate-impact theory, because such claims depend upon an impermissible assumption of commonality in decision-making.

C. The Rule Should be Amended to Articulate the "Cautionary Standards," "Safeguards" and "Limitations" Described in *Inclusive Communities*

The Disparate-Impact Rule affords scant articulation of any restrictions on the disparate-impact theory whatsoever, and should be amended and brought into accord with the Supreme Court's emphasis on limiting disparate impact. To start, the Rule must recognize that a "[r]acial imbalance … does not, without more, establish a prima facie case of disparate impact." *Inclusive Communities*, 135 S. Ct. at 2523 (quoting *Wards Cove*, 490 U.S. 642). As written, the Rule may permit the filing of frivolous lawsuits based on statistical data alone—for example, on the basis of mere differences in "denial rates" in public loan data reported by financial institutions under the federal Home Mortgage Disclosure Act ("HMDA"), 12 U.S.C. §§ 2801, *et seq*. *See* Disparate-Impact Rule Section 100.120(b)(2). In lending, generally-accepted credit assessment standards (such as the use of credit scores, down payment requirements, and debt ratios which themselves raise no inference of discrimination), may produce differential results that can be correlated with factors such as race or national origin. Congressional and regulatory reaction to the housing crisis led to more conservative underwriting which itself may be deemed to affect racial and ethnic outcomes. The broad language of the current Rule seems even to conflict with standards applied by regulatory agencies in conducting fair lending reviews. *See* Interagency Fair Lending Examination Procedures, Appendix A at 26 ("[g]ross HMDA denial or approval rate disparities are not appropriate for disproportionate adverse impact analysis because they typically cannot be attributed to a specific policy or criterion").

It is no answer to say that a lender can still prevail by meeting the "burden of proof" that the Rule (improperly) imposes, because a primary objective of lenders, as with most businesses, is to minimize the risk of ever facing a legal claim. Allegations of lending discrimination present a very serious charge, are expensive to defend, and can occasion an immediate reputational injury and business disruption. No matter how frivolous such suits may be, the threat may cause lenders to manage their end numbers, which creates another kind of risk that *Inclusive Communities* cautions against. Accordingly, the Disparate Impact Rule should be amended to provide "adequate safeguards" against the possibility of "abusive" disparate-impact claims based on nothing more than statistics by expressly stating that such claims must fail.

The Rule must also be amended to clarify the important obligation of courts and regulators to carefully scrutinize disparate-impact claims at the pleading stage of a litigation, or the scoping stage of an examination, to weed out meritless claims. Under *Inclusive Communities* a "plaintiff who fails to allege facts at the pleading stage … cannot make out a prima facie case of disparate impact" and such claims require "prompt" dismissal. Likewise, these standards need to be applied by the federal supervisory and enforcement agencies, including HUD and DOJ. All agencies must pledge adherence to the "cautionary standards" expressed by the Court. The Rule contains no instruction regarding the gatekeeping role of courts and agencies presiding over disparate-impact claims at the pleading stage.

D. The Rule Should be Amended to Properly Reflect the "Robust Causality" Requirement, Burden-of-Proof Standards, Appropriate Remedies, and Proximate-Cause Requirements in Disparate-Impact Lawsuits.

In response to the fourth question posed by HUD's ANPR, *Inclusive Communities* and *Wards Cove* leave no room for doubt that a disparate-impact plaintiff must meet a standard of "robust causality" to proceed with claims brought under the Fair Housing Act. Yet the Rule makes no attempt to articulate any causal standard. HUD should amend the Rule to reflect the causality standard for stating a prima facie case under *Inclusive Communities* and *Wards Cove*.

As noted earlier, the Rule does not properly describe the allocation of burdens of proof and production required by Supreme Court precedent. The plaintiff bears the burden of *persuasion* (i.e. proof) throughout the litigation, even though a defendant might face a burden of *production* at the justification stage to explain the reasons for the business practice that is challenged. The Supreme Court holds that the business interest must be "legitimate," meaning "valid," but the Court expressly disclaimed any requirement that a defendant establish its policy was "essential" or "indispensable." The Rule must recognize the legitimacy and validity of a profit motive. And a plaintiff cannot rely on a hypothetical business practice without demonstrating (1) alternative practice ***would*** (and not simply ***could***) serve the defendant's legitimate business interests in an equally effective manner, and (2) that the suggested practice was known to and rejected by the defendant. This burden is rigorous because courts are not equipped to dictate business practices. Yet, ignoring judicial precedent, the Rule adopts a standard that appears to permit liability if the plaintiff merely speculates that a hypothetical alternative practice ***might*** have a lesser impact.

The Rule should also be amended to articulate the types of remedies available in disparate-impact lawsuits. *Inclusive Communities* holds that the "remedial focus" in disparate-impact cases is "elimination of the offending practice," not compensatory damages, punitive damages, or civil penalties. At a minimum, the Rule should reflect that claims for punitive damages and civil money penalties cannot be awarded as a remedy for a disparate-impact violation.

The Rule should be amended to acknowledge the Supreme Court's recent Fair Housing Act decision in *City of Miami v. Bank of America*, 137S.Ct. 1296 (2017), which requires plausible allegations and proof that any injury claimed by the plaintiff is the direct, proximate cause of the defendant's challenged business practice. To the extent that independent actions of independent parties caused or contributed to the plaintiff's alleged injury, the disparate-impact claim must be dismissed for failure to meet the Fair Housing Act's direct proximate causation requirement.

E. The Rule Should be Amended to Provide Guidance to the Industry—Including Defenses and Safe Harbors

In response to the fifth and sixth questions presented in HUD's ANPR, the Rule provides virtually no guidance to aid in compliance with the law, which is the overarching purpose of any regulation, and instead merely states that issues must be decided on a "case-by-case" basis. That is wrong: Guidance—including defenses and safe harbors—is essential. Suggestions for amending the Disparate-Impact Rule to provide necessary guidance include the following:

- The Rule should be amended to recognize the right of lenders to pursue a profit motive and to adopt credit-worthiness standards in accordance with the lender's assessment of and tolerance for risk;

- The Rule should be amended to acknowledge that disparities caused by the policies of third parties (such as the government, government agencies, investors, or independent businesses), can provide a valid defense to disparate-impact liability;

- The Rule should be amended to clarify that adherence to governmental or government-sponsored standards, policies, or programs should not create disparate impact liability, and the Rule should create an exemption for lending and servicing practices that are undertaken in compliance with governmental or government-sponsored policies or programs; and

- The Rule should be amended to state that the use of a variable in an automated model should present no disparate impact concern if the variable is predictive of credit risk and the variable does not serve as a substitute or proxy for a prohibited characteristic.

III. <u>Discussion</u>

A. Relevant Background Regarding the Rule's Adoption of an Incorrect and Improper Standard for Disparate Impact Under the Fair Housing Act

1. *HUD was bound to adopt a Fair Housing Act standard for disparate impact consistent with Supreme Court precedent*

Section 815 of the Fair Housing Act authorizes HUD to "make rules … to carry out this subchapter" after "giv[ing] public notice and opportunity for comment." 42 U.S.C. § 3614a. HUD's rulemaking authority is limited to defining the application of the Fair Housing Act in a manner consistent with judicial precedent. *See Chevron, U.S.A., Inc. v. Natural Res. Def. Council, Inc.*, 467 U.S. 837, 865 n.9 (1984) ("The judiciary is the final authority on issues of statutory construction and must reject administrative constructions which are contrary to clear congressional intent."). It is beyond question that HUD has no authority to alter the judicial interpretation of a statute as Congress might choose to do. *Olmstead v. L.C. ex rel. Zimring*, 527 U.S. 581, 624 n.3 (1999) ("highlight[ing] principle that a departure from the traditional understanding of discrimination requires congressional action"); *Maislin Indus., U.S., Inc. v. Primary Steel, Inc.*, 497 U.S.116, 131, 134-35 (1990); *Chicago & So. Air Lines, Inc. v. Waterman Steamship Corp.*, 333 U.S. 103, 113-14 (1948).

In this regard, HUD was not operating on a clean slate in 2013 when it promulgated the Rule and articulated the standard of disparate impact under the Fair Housing Act. Significant Supreme Court precedent existed to both direct HUD and limit the reach of its rulemaking, precedent arising largely from the Supreme Court's *Wards Cove* decision interpreting the standards of disparate-impact claims in the Title VII employment context. Supreme Court decisions rendered on claims brought under Title VII, including *Wards Cove*, generally serve as precedent for claims brought under Title VIII in the housing context for several reasons. The basic prohibitory language of Title VII (before its amendment by Congress in 1991) was similar to that of the Fair Housing Act, and the two statutes serve similar purposes, with Title VII designed to eradicate discrimination in employment and the Fair Housing Act designed to eradicate discrimination in housing. In such circumstances, courts have recognized "a strong indication that the two statutes should be interpreted *pari passu*"—i.e., in the same way. *Northcross v. Board of Educ. of Memphis City Schs.*, 412 U.S. 427, 428 (1973) (per curiam); *see also Smith v. City of Jackson, Miss.*, 544 U.S. 228, 233-34 (2005). HUD itself recognized this concept in devising the Disparate-Impact Rule, agreeing that "courts have drawn the analogy between Title VII and the Fair Housing Act in interpreting the Act." Disparate-Impact Rule, 78 Fed. Reg. at 11,466. In addition, HUD cited federal circuit court decisions standing for the proposition that "[c]laims under Title VII and the [Fair Housing Act] generally should receive similar treatment." *Id.* at 11,462 n.35.

There is a break-point in time, however, after which Title VII jurisprudence no longer guides the interpretation of the applicable standard for disparate-impact liability under the Fair Housing Act. The break-point occurred when Congress passed the Civil Rights Act of 1991, which, in pertinent part, displaced the *Wards Cove* disparate-impact standard for future disparate-impact claims brought under Title VII. *See* 42 U.S.C. §§ 2000e-2(k)(1)(A)-(B); *Smith*, 544 U.S. at 240 ("One of the purposes of th[e] amendment [to Title VII] was to modify the Court's holding in *Wards Cove* …, a case in which we narrowly construed the employer's exposure to liability on a disparate-impact theory"). Significantly, however, Congress took no similar action to amend the Fair Housing Act (or any other antidiscrimination law) to displace the *Wards Cove* standard.

Thus, prior to 1991, it certainly was both appropriate and common to look to judicial interpretations of Title VII to guide the Fair Housing Act standard for disparate-impact claims. But after Congress's 1991 amendments to Title VII, it constitutes an error to do so because Title VII is now governed by a congressionally-enacted standard that is not applicable to other laws prohibiting discrimination. Removing any doubt, the Supreme Court has squarely required the continued application of *Wards Cove* to disparate-impact claims arising under statutes other than Title VII. *See Gross v. FBL Fin. Servs., Inc.*, 557 U.S. 167, 174 (2009) ("[w]e cannot ignore Congress' decision to amend Title VII's relevant provisions but not make similar changes to the [Age Discrimination in Employment Act ('ADEA')]. When Congress amends one statutory provision but not another, it is presumed to have acted intentionally"); *Smith* ("While the relevant 1991 amendments expanded the coverage of Title VII, they did not amend the ADEA or speak to the subject of age discrimination. Hence, *Wards Cove's* pre-1991 interpretation of Title VII's identical language remains applicable to the ADEA").

In the absence of a congressional action similar to the 1991 amendments to Title VII, it must be presumed that Congress intended *Wards Cove* would continue to supply the disparate-impact standard under the Fair Housing Act. *See Gross*, 557 U.S. at 174; *Chevron*, 467 U.S. at 865 n.9. Thus, HUD was bound by *Wards Cove* when promulgating the Disparate-Impact Rule, and it constituted error for HUD to apply the 1991 Title VII amendments to disparate-impact claims under the Fair Housing Act.

2. *HUD impermissibly rejected binding Supreme Court precedent and improperly announced Congress's 1991 amendments to Title VII as the standard for disparate impact under the Fair Housing Act*

When it finalized the Rule, HUD explicitly—and wrongly—rejected the Supreme Court's *Wards Cove* decision as supplying the governing standard for Fair Housing Act disparate-impact claims, stating that "HUD does not agree … that Wards Cove even governs Fair Housing Act claims."

Disparate-Impact Rule, 78 Fed. Reg. at 11,473. HUD provided no explanation for this action and cited no authority permitting a departure from binding Supreme Court precedent through administrative rulemaking, but simply referenced the "*Wards Cove* case" as "superseded."

Rather than *Wards Cove*, HUD chose the "Title VII discriminatory effects standard codified by Congress in 1991" as the standard to govern disparate-impact claims under the Fair Housing Act. Disparate-Impact Rule, 78 Fed. Reg. at 11,474. HUD made no attempt to articulate any authority for its adoption of the congressionally-enacted 1991 Title VII amendments in the Fair Housing Act context. The reason is obvious: No such authority exists. HUD lacks authority to overrule Supreme Court precedent and adopt a standard for the Fair Housing Act that required an act of Congress to achieve in the context of Title VII. HUD simply has no power to emulate Congress and overrule Supreme Court statutory interpretations with which it may disagree.

Even assuming, solely for the sake of argument, that HUD had the authority to reject the *Wards Cove* standard and to promulgate in the housing-discrimination realm what it took an act of Congress to achieve in the employment-discrimination realm, the Disparate-Impact Rule exceeds HUD's authority for a separate but interrelated reason. Although HUD purports to adopt the "Title VII discriminatory effects standard codified by Congress in 1991," HUD did not adopt the entirety of the standard Congress enacted for Title VII. Disparate-Impact Rule, 78 Fed. Reg. at 11,474. For instance, under the 1991 Title VII standard, employment-discrimination plaintiffs must establish intent—not merely discriminatory effect—to state a claim for money damages. *See* 42 U.S.C. §§ 1981a(1), 1981a(2) (prohibiting compensatory and punitive damages in Title VII disparate-impact cases). Yet, in promulgating the Rule, HUD selectively rejected the provisions of the 1991 standard that precluded disparate-impact plaintiffs from obtaining money damages under Title VII (either compensatory or punitive) and set no limits on the use of disparate impact to obtain money damages under the Fair Housing Act.

3. ***The Disparate-Impact Rule (i.e., the standard of the 1991 congressional amendments to Title VII) is a substantial departure from* Wards Cove**

Some had perceived the *Wards Cove* disparate-impact standard as too rigorous for plaintiffs, and the purpose of Congress in amending Title VII in 1991 was to create a less rigorous standard for disparate-impact claims brought under that statute. *See Smith*, 544 U.S. at 240 ("One of the purposes of th[e] amendment [to Title VII] was to modify the Court's holding in *Wards Cove* …, a case in which we narrowly construed the employer's exposure to liability on a disparate-impact theory."). Given that Congress specifically designed the 1991 amendments to alter the *Wards Cove* disparate-impact standard for future claims under Title VII, and given that HUD adopted the standard of the 1991 Title VII amendments as the Fair Housing Act's disparate-impact standard, it comes as no surprise that the Disparate-Impact Rule diverges widely from *Wards Cove*. In particular, the Rule departs from *Wards Cove* in at least five significant ways:

- ***First***, *Wards Cove* requires a plaintiff to "demonstrate that it is the application of a specific or particular employment practice that has created the disparate impact under attack," 490 U.S. at 657, but HUD permits a plaintiff "to challenge the decision-making process as a whole," Rule, 78 Fed. Reg. at 11,469. On this point, ABA and the SBAs recommend amendments to the Rule *infra* at Section III.C.1.

- ***Second***, *Wards Cove* requires that "each challenged practice has a significantly disparate impact," 490 U.S. at 657, but HUD made a "decision not to codify a significance requirement," Rule, 78 Fed. Reg. at 11,468. On this point, ABA and the SBAs recommend amendments to the Rule *infra* at Section III.C.1.

- ***Third***, *Wards Cove* requires that the "ultimate burden of proving that discrimination against a protected group has been caused by a specific employment practice remains with the plaintiff at all times." 490 U.S. at 659. At the justification stage the defendant "carries the burden of producing evidence of a business justification for his employment practices" (i.e., the burden of production), but the Supreme Court made it clear that the "burden of persuasion, however, remains with the disparate impact plaintiff. . . . The persuasion burden here must remain with the plaintiff, for it is he who must prove that it is because of such individual's race, color etc. that he was denied a desired employment opportunity." *Id.* Yet, HUD "formalizes a burden-shifting test," that improperly places the burden of proof on the defendant. Rule, 78 Fed. Reg. at 11,460. On this point, ABA and the SBAs recommend amendments to the Rule *infra* at Section III.C.4.

- ***Fourth***, *Wards Cove* specifies "there is no requirement that the challenged practice be 'essential' or 'indispensable' to the employer's business for it to pass muster," 490 U.S. at 659, but HUD requires the "defendant to prove that the challenged practice is necessary to achieve one or more of its substantial, legitimate, nondiscriminatory interests," Rule, 78 Fed. Reg. at 11,460. On this point, ABA and the SBAs recommend amendments to the Rule *infra* at Section III.C.4.

- ***Fifth***, *Wards Cove* requires that "any alternative practices … must be equally effective … in achieving [] legitimate [] goals," 490 U.S. at 661, but "HUD does not believe … the less discriminatory alternative must be 'equally effective,' or 'at least as effective,' in serving the respondent's or defendant's interests," Rule, 78 Fed. Reg. at 11,473. On this point, ABA and the SBAs recommend amendments to the Rule *infra* at Section III.C.4.

4. **Inclusive Communities** ***Confirms HUD's Errors in Rejecting*** **Wards Cove** ***and Adopting a Standard that Required an Act of Congress to Achieve for Title VII***

Two years after the Rule was promulgated, the Supreme Court decided *Inclusive Communities* and announced the binding limitations on disparate-impact liability under the Fair Housing Act.

Although the Rule predates *Inclusive Communities*, the decision confirms HUD erred in rejecting *Wards Cove* and adopting the standard of the 1991 congressional amendments to Title VII.

Significantly, the Supreme Court continued to rely on *Wards Cove* in the Fair Housing Act context in its *Inclusive Communities* decision, noting only that *Wards Cove* was "superseded by statute on other grounds"—i.e., superseded by the 1991 amendments for claims arising under Title VII. *Inclusive Communities*, 135 S. Ct. at 2523. In fact, *Inclusive Communities* cites with approval the approach to a disparate-impact claim set forth in *Wards Cove*, thus confirming that HUD was wrong in taking the position that "HUD does not agree … that *Wards Cove* even governs Fair Housing Act claims." Disparate-Impact Rule, 78 Fed. Reg. at 11,473. As discussed in greater detail in Section III.B below, further confirming HUD's error, the Supreme Court not only reiterates the same concerns in *Inclusive Communities* as it previously did in *Wards Cove*, but it elaborates even further on those concerns and the driving rationale.

B. The Supreme Court's 2015 *Inclusive Communities* Decision Requires "Cautionary Standards," "Safeguards," and "Limitations" on Disparate Impact that are Absent from the HUD Rule and Render it Outdated

In its 2015 *Inclusive Communities* decision, the Supreme Court held that the Fair Housing Act "imposes a command with respect to disparate-impact liability." 135 S. Ct. at 2524. With respect to this "command," *Inclusive Communities* found it "important and appropriate" to describe at length the "cautionary standards," "safeguards," and "limitations" on disparate impact liability that must be followed. *Id.* at 2523-2524. Because the Disparate-Impact Rule either rejects or contains no discussion of necessary limitations on the use of disparate impact for claims under the Fair Housing Act, the Rule stands in tension with the standard affirmed by the Supreme Court and is now outdated.

In particular, the Supreme Court focused on the harmful and unconstitutional consequences flowing from an overbroad application of disparate impact—including the possible invidious consideration of race or national origin in decision-making through racial quotas. *See id.* at 2523 (quoting *Wards Cove*, 490 U.S. at 653). *Inclusive Communities* stresses the necessity of "adequate safeguards" on disparate impact to avoid the "danger that potential defendants may adopt racial quotas—a circumstance that itself raises serious constitutional concerns." *Id.* at 2523. The Supreme Court thus cautioned against the "serious constitutional questions that might arise under the FHA, for instance, if such [disparate impact] liability were imposed based solely on a showing of a statistical disparity." *Id.* at 2522.

Thus, relying on the *Wards Cove* standard, *Inclusive Communities* held that a "disparate-impact claim that relies on a statistical disparity must fail if the plaintiff cannot point to a defendant's policy or policies causing that disparity" and that the application of a "robust causality requirement ensures that racial imbalance does not, without more, establish a prima facie case of disparate impact" under the Fair Housing Act. *Id*. (alterations and quotation marks omitted) (quoting *Wards Cove*, 490 U.S. at 653). If a plaintiff "cannot show a causal connection between the [defendant's] policy and a disparate impact—for instance, because federal law substantially limits the [defendant's] discretion—that should result in dismissal of the case." *Id.* at 2524.

The Supreme Court further highlighted that "[d]isparate-impact liability mandates the 'removal of artificial, arbitrary, and unnecessary barriers," not the "displacement" of "valid governmental and private priorities." *Id.* at 2522, 2524. Thus, "disparate-impact liability must be limited so … regulated entities are able to make the practical business choices and profit-related decisions that sustain a vibrant and dynamic free-enterprise system." *Id.* at 2519. This means that "[e]ntrepreneurs must be given latitude to consider market factors." *Id.* at 2524.

Inclusive Communities also instructed that "[c]ourts must [] examine with care whether a plaintiff has made out a prima facie case of disparate impact" because "prompt resolution of these cases is important." *Id.* at 2523. The Supreme Court emphasized that a "plaintiff who fails to allege facts at the pleading stage … cannot make out a prima facie case of disparate impact." Staunch gatekeeping of disparate-impact claims is important because, "[w]ithout adequate safeguards at the prima facie stage, disparate-impact liability might cause race to be used and considered in a pervasive way and would almost inexorably lead governmental or private entities to use numerical quotas, and serious constitutional questions then could arise." *Id.*

Finally, *Inclusive Communities* directs that "[r]emedial orders in disparate-impact cases should concentrate on the elimination of the offending practice that arbitrarily operates to discriminate on the basis of race." *Id.* at 2524. Thus, "even when courts do find liability under a disparate-impact theory," remedial measures should be "design[ed] to eliminate racial disparities through race-neutral means." *Id.*

In contrast to *Inclusive Communities*, however, the Rule describes no meaningful limits on the use of disparate impact and certainly not the type of limits that the Supreme Court has mandated. Accordingly, the Rule is out-of-step with Supreme Court precedent.

C. ABA's Proposed Amendments to the Disparate-Impact Rule

1. *The Disparate-Impact Rule should be amended to include a proper definition of a disparate-impact claim*

The ABA and SBAs provide the comments below in response to the third and sixth questions presented by HUD in the ANPR.[5] By failing to include a proper "definition" of disparate impact,

[5] The following is the third question presented by HUD's ANPR: "Does the Disparate Impact[] Rule's definition of 'discriminatory effect' in 24 CFR 100.500(a) in conjunction with the burden of proof for stating a prima facie case in 24 CFR 100.500(c) strike the proper balance in encouraging legal action for legitimate disparate-impact cases while avoiding unmeritorious claims?" The following is the sixth question presented by HUD's ANPR: "Are there revisions to

the Rule fails to "strike the proper balance in encouraging legal action for legitimate disparate-impact cases while avoiding unmeritorious claims." *See* ANPR at 28,561. Further, because the Rule lacks a proper definition of disparate impact, it fails to provide necessary clarity regarding the distinction between claims of disparate impact (i.e., unintentional discrimination) on the one hand and claims of disparate treatment (i.e., intentional discrimination) on the other. The Rule should be amended to include a proper definition of disparate impact not only to provide clarity to regulated entities seeking to comply with the law, but also to promote "heartland" uses of the theory and to discourage "abusive" claims. *Inclusive Communities*, 135 S. Ct. at 2522, 2524.

A disparate-impact claim of unintentional discrimination has three essential elements: (1) a specific, neutral policy or practice of the defendant that presents an artificial, arbitrary, and unnecessary barrier, (2) a significant, adverse and disproportionate impact on a protected class, and (3) a robust causal link between the challenged policy or practice and the disproportionate impact.[6] The Rule should be amended to include this definition and explain each element.

The starting point of a claim of disparate impact is the identification of a specific, facially-neutral policy or practice of the defendant that presents an artificial, arbitrary and unnecessary barrier to housing. *See Wards Cove*, 490 U.S. at 657 (plaintiff must isolate "***specific or particular … practice*** that has created the disparate impact"); Interagency Fair Lending Examination Procedures, Appendix A at 26, 28 (examiners review a "***specific neutral policy or criterion***" and "the policy or criterion suspected of producing a disproportionate adverse impact on a prohibited basis should be clear enough that the nature of action to correct the situation can be determined"). Unless a plaintiff or claimant identifies a proper policy or practice ***of the defendant*** that is subject to challenge, a disparate-impact claim cannot leave the starting gate. *See Inclusive Communities*, 135 S. Ct. at 2514 ("[i]f a statistical discrepancy is caused by factors other than ***the defendant's policy***, a plaintiff cannot establish a prima facie case" (emphasis added)). For example, the Ninth Circuit Court of Appeals rejected disparate-impact claims premised on a theory that the defendant lenders "failed to adequately monitor [their] loans for disparities," concluding that a failure-to-adequately-monitor "is not a policy at all." *City of Los Angeles v. Wells Fargo & Co.*, 2017 WL 2304375 (9th Cir. May 26, 2017); *City of Los Angeles v. Bank of Am. Corp.*, 2017 WL 2323441 (9th Cir. May 26, 2017).

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the Disparate-Impact Rule that could add to the clarity, reduce uncertainty, decrease regulatory burden, or otherwise assist the regulated entities and other members of the public in determining what is lawful?"

[6] To "give examiners practical guidance" in conducting fair lending examinations, the federal financial institutions regulators provide "conditions" that should "exist" for "disproportionate adverse impact," including (1) "a specific policy or criterion is involved," (2) "the policy or criterion on its stated terms is neutral for prohibited bases," (3) the "policy or criterion falls disproportionately on applicants or borrowers in a prohibited basis group," and (4) "there is a causal relationship between the policy or criterion and the adverse result." Interagency Fair Lending Examination Procedures, Appendix A at 26.

Additionally, the policy or practice subject to challenge must not only be neutral on its face, but must be applied neutrally—i.e., uniformly—to all persons. *See* Letter from Deval L. Patrick, Assistant Attorney General, U.S. Department of Justice, Civil Rights Division, to Don Ogilvie, American Bankers Association, *et al.*, re: Department of Justice Fair Lending Enforcement Program (Feb. 21, 1995) (*hereinafter* "DOJ Fair Lending Enforcement Position Statement") at 4 ("we will look first to see whether the standards are facially neutral and whether they are in fact applied neutrally in all cases" because the "premise that the practices in question have been applied neutrally to all" is one of the "essential conditions for disparate impact analysis"); *see also* Interagency Fair Lending Examination Procedures at iv (a "disparate impact" claim involves a defendant that "applies a racially or otherwise neutral policy or practice equally to all credit applicants").[7] This foundational aspect of a disparate-impact claim has long presented confusion; more than 20 years ago the DOJ observed that "lenders sometimes believe that neutral practices are having only a disparate impact, when in fact the lender's employees have been applying them differentially, resulting in disparate treatment." DOJ Fair Lending Enforcement Position Statement at 3. Recently, confronted with the same confused claim, the Eight Circuit Court of Appeals applied *Inclusive Communities* and rejected an argument that the different application of a neutral policy could support a disparate-impact claim, holding that "[i]nconsistent application of housing standards, of course, may be the basis for a disparate treatment claim under the FHA," but "an FHA disparate-impact claim may not be used … merely because housing standards are inconsistently applied." *Ellis v. City of Minneapolis*, 860 F.3d 1106, 1112 & n.3 (8th Cir. 2017).

To eliminate this persistent confusion regarding the starting definition of a disparate-impact claim and policies subject to disparate impact challenge, the HUD Rule should be amended to clarify that there is no such thing as a disparate-impact claim based on a policy that is disparately applied—i.e., differently applied—to protected groups and non-protected groups. Rather, the concept of a disparate-impact claim is that the challenged policy or practice is applied in the same manner to all consumers—i.e., consumers are treated the same—but the policy then has an unintended and disproportionate impact on certain groups.

Another way confusion has arisen involves challenges to so-called "policies" of allowing employee discretion. As the federal judiciary has concluded, Fair Housing Act challenges to a policy of discretion must fail in the great bulk of instances. Although the Supreme Court has allowed such disparate-impact claims to proceed "in appropriate cases," *Watson v. Fort Worth Bank & Trust*, 487 U.S. 977, 990-91 (1988), pursuit of such claims under a disparate-impact theory was severely restricted by the Supreme Court's decision in *Wal-Mart Stores, Inc. v. Dukes*, 131 S. Ct. 2541 (2011).

[7] For the Department's convenience, a copy of the 1995 DOJ Fair Lending Enforcement Position Statement is enclosed as Exhibit A.

In *Dukes*, the Supreme Court observed that granting employees discretion is "a very common and presumptively reasonable way of doing business—one that we have said should itself raise no inference of discriminatory conduct"—and rejected the application of the disparate-impact theory to a company-wide policy of discretion. 131 S. Ct. at 2554-55. *Dukes* held that the challenged "'policy' of *allowing discretion* … is just the opposite of a uniform practice …; it is a policy *against having* uniform employment practices." 131 S. Ct. at 2554 (emphasis added) (internal quotations omitted). This language, applied together with the instructions of *Inclusive Communities,* places a burden on a plaintiff to demonstrate that the allocation of discretion to employees is the type of practice that can be challenged under disparate impact. Then the plaintiff faces a burden to overcome the presumption that allowing discretion to employees is a reasonable way of doing business, and therefore is not an "artificial, arbitrary, and unnecessary" barrier.

Also, where hundreds or thousands of persons independently exercise discretion in carrying out their job duties, there can be no presumption of "commonality" of decision making, which is the subject of a disparate-impact approach. *Id*. Moreover, *Dukes* resulted in the dismissal of multiple Fair Housing Act class actions alleging disparate-impact claims challenging an alleged policy of discretion in loan-pricing decisions. *See, e.g., Rodriguez v. Nat. City Bank,* 726 F. 3d 372, 384-386 (3rd Cir. 2013) (FHA case, applying *Dukes*, holding "the exercise of broad discretion by an untold number of unique decision-makers in the making of thousands upon thousands of individual decisions undermines the attempt to claim, on the basis of statistics alone, that the decisions are bound together by a common discriminatory mode"); *see also* Order Denying Pls.' Mot. for Class Cert., *In re Wells Fargo Residential Mortgage Lending Discrimination*, M:08-md-01930 (N.D. Cal. Sept. 6, 2011), ECF No. 401. The same limitations of *Dukes* should apply to governmental and private class action claims of a "pattern or practice" of discrimination brought under a disparate impact theory, since such claims depend upon an erroneous assumption of commonality in decision-making. *See, e.g., Teamsters v. United States*, 431 U.S. 324, 358 (1977) ("In a pattern-or-practice case, the plaintiff tries to establish … that … discrimination was the company's standard operating procedure, the regular rather than the unusual practice").

Further, *Inclusive Communities* casts serious doubt on the Disparate-Impact Rule's pronouncement that the Supreme Court's decision in *Dukes* has no application to disparate-impact claims under the Fair Housing Act. After *Inclusive Communities* was remanded by the Supreme Court to the district court for further consistent proceedings, consistent with *Dukes*, the district court found that "[w]here a plaintiff establishes that a subjective policy, such as the use of discretion, has been used to achieve a racial disparity, the plaintiff has shown disparate treatment"—not disparate impact. *Inclusive Communities Project, Inc. v. Texas Dep't of Hous. & Cmty. Affairs*, 2016 WL 4494322, at *7 (N.D. Tex. Aug. 26, 2016). Accordingly, the district court entered summary judgment for the defendant, holding that the *Inclusive Communities* plaintiff's "is actually complaining about disparate treatment, not disparate impact." *Id*.

The Disparate-Impact Rule suggests no limitations on the use of disparate impact to challenge the common and nondiscriminatory business practice of allowing employees some discretion in performing their duties. It is true that policies of allowing discretion could be misused to result in discrimination—i.e., by treating consumers differently because of race in exercising discretion. In such instances, however, it is not the policy of allowing discretion that leads to rogue results, but rather it is some act of intentional discrimination. ABA agrees that discretion should never serve as a pretext to discriminate, but allowing discretion cannot be defined as a practice that can be challenged under a disparate-impact theory. HUD, at minimum, should amend the Rule to clarify that a plaintiff cannot establish disparate-impact liability by challenging the ***exercise*** of discretion.

The second element of a proper disparate-impact claim is a significant adverse and disproportionate impact on a protected group. The Rule should make two important points regarding this element. First, disparate impact requires a significant—i.e., substantial and meaningful—impact on a protected group. *See Wards Cove*, 490 U.S. at 657 (requiring a "showing that each challenged practice has a ***significantly*** disparate impact" (emphasis added)); *Washington v. Davis*, 426 U.S. 229, 246–47 (1976) (disparate-impact challenge to "practices disqualifying ***substantially*** disproportionate numbers of black" applicants (emphasis added)). Even beyond statistical significance, the disparity must have practical, real-world significance. *See City of Los Angeles v. Wells Fargo & Co.*, 2015 WL 4398858 (C.D. Cal. July 17, 2015), *aff'd*, 2017 WL 2304375 (9th Cir. May 26, 2017) (rejecting disparate-impact claim because "[t]he difference between 0.0033 percent and 0.0008 percent does not create a genuine dispute such that a jury must decide this issue" because "the evidentiary disparities are negligible. The [plaintiff] must provide evidence of a ***significantly*** disproportionate effect on minorities, and comparing thousandths of a percentage fails to meet the minimum threshold of *Inclusive Communities*" (emphasis in original)). Second, the question of whether a particular outcome is "adverse" to a protected group may sometimes have an easy answer, but in many circumstances the answer is not always clear. *Inclusive Communities* cautions against challenging policies in circumstances where, "from the standpoint of determining advantage or disadvantage to racial minorities," it "seems difficult to say as a general matter" that one outcome "is discriminatory, or vice versa." 135 S. Ct. at 2523.

The third element is a "robust" causal connection between the identified policy and the disparity. ABA references, without repeating, its discussion on this topic, *infra*, at Section III.C.3.

2. *The Disparate-Impact Rule should be amended to articulate the cautionary standards, safeguards, and limitations recognized by the Supreme Court in* Wards Cove *and expanded upon in* Inclusive Communities

Inclusive Communities confirms that many "cautionary standards," "safeguards," and "limitations" are necessary and vital to the proper enforcement of disparate-impact claims brought under the Fair Housing Act. Indeed, after recognizing the applicability of disparate impact, the Supreme Court's articulation of the limitations on disparate-impact claims, and the rationale for those limitations, constitute a major portion of the *Inclusive Communities* decision. In contrast to *Inclusive Communities*, however, the Disparate-Impact Rule affords scant articulation of any restrictions on the disparate-impact theory whatsoever. The Rule should be amended and brought into accord with the Supreme Court's emphasis on properly limiting the application of disparate impact. Beyond amending the Rule to expressly include the Supreme Court's language regarding "cautionary standards," "safeguards," and "limitations," the ABA and SBAs recommend two amendments to capture the essence of the decision.

First, *Inclusive Communities* holds that a "[r]acial imbalance … does not, without more, establish a prima facie case of disparate impact." 135 S. Ct. at 2523 (quoting *Wards Cove*, 490 U.S. 642). In other words, the Supreme Court has made clear that a disparate-impact claim cannot proceed on a statistical disparity alone, and the reason is that such a requirement "protects defendants from being held liable for racial disparities they did not create." *Id.* at 2523. The Rule's failure to include a prohibition on disparate-impact claims based on statistics alone can have and has had severe consequences for participants in the lending industry.

As written, the Rule may permit the filing of frivolous lawsuits based on statistical data alone—for example, on the basis of mere differences in "denial rates" in public loan data reported by financial institutions under the federal Home Mortgage Disclosure Act ("HMDA"), 12 U.S.C. §§ 2801, *et seq*. Disparate-Impact Rule, Section 100.120(b)(2). In lending, generally-accepted credit assessment standards, which themselves raise no inference of discrimination, may produce differential results that can be correlated with factors such as race or national origin. For instance, it is commonplace and accepted for lenders to consider applicants' credit scores as an important indicator of credit risk, because such a score is highly predictive of risk and costs relatively little to obtain. At the same time, the Federal Reserve Board has found that the "[d]ifferences in credit scores among racial or ethnic groups … are particularly large," with 52.6% of African-Americans in the sample appearing in the lowest two score deciles, as compared to 16.3% of non-Hispanic whites. *See* Board of Governors of Fed. Reserve Sys., Report to the Congress on Credit Scoring and Its Effects on the Availability and Affordability of Credit, at 80 (Aug. 2007).

Down-payment requirements also impact various protected groups differently. This result is reflected in examining census data on household wealth, because wealth (versus income) is the primary source for a down payment. The Federal Reserve Board economists reported that, "[i]n 2016, white families had the highest level of both median and mean family wealth: $171,000 and $933,700, respectively," while "Black and Hispanic families have considerably less wealth than white families. Black families' median and mean net worth is less than 15 percent that of white families, at $17,600 and $138,200, respectively. Hispanic families' median and mean net worth was $20,700 and $191,200, respectively." *See* Board of Governors of Fed. Reserve Sys., *Recent Trends in Wealth-Holding by Race and Ethnicity: Evidence from the Survey of Consumer Finances* (Sept. 27, 2017). Debt-to-income and loan-to-value requirements can also have a differential impact among various protected groups. These are simple examples of basic elements of assessing credit risk, and yet differences in their impacts should not trigger legal claims under the Rule's disparate-impact approach.

And, in making two relatively new types of residential mortgage loans—namely, Qualified Mortgages ("QMs") and Qualified Residential Mortgages ("QRMs")—created pursuant to the Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010) ("Dodd-Frank Act") and certain of its implementing regulations, lenders may engage in more conservative underwriting to avoid ability-to-repay liability (in connection with QM loans) or risk-retention requirements (in connection with QRM loans). *See* Dodd-Frank Act §§ 941, 1412. These safety-and-soundness considerations in underwriting are endorsed by federal law and regulation as an important measure to prevent a repeat of the housing market crisis and Great Recession, but at the same time, these prudent underwriting requirements may restrict the availability of loans to groups with weaker credit profiles or less wealth or income and, correspondingly, to individuals who are members of particular protected classes.

Under the Rule as written, differentials observed in data may prompt disparate-impact lawsuits or investigations—even though socio-economic differences among different groups most often explain the disparities in outcome. Again, the Supreme Court has made clear that HMDA data or other statistical disparities alone are not indicative of illegal discrimination and do not give rise to disparate-impact claims. *See Inclusive Communities*, 135 S. Ct. at 2523; *Dukes*, 131 S. Ct. 2541, 2555-56 (2011) (criticizing reliance on mere statistical disparity between members of two different groups as basis for bringing Title VII claims).[8] And the federal financial institutions regulators have provided direction to their fair lending examiners consistent with the Supreme Court's prohibition. *See* Interagency Fair Lending Examination Procedures, Appendix A at 26 ("[g]ross HMDA denial or approval rate disparities are not appropriate for disproportionate adverse impact analysis because they typically cannot be attributed to a specific policy or criterion").

Of course, a primary objective of most lenders, as with most businesses, is to minimize the risk of ever facing a legal challenge. A lawsuit alleging lending discrimination is a very serious charge and can occasion an immediate reputational injury and business disruption caused by the need to defend such accusations. The allegation of a statistical impact is newsworthy even if there is no reasonable inference that it is caused by the challenged business. Moreover, defending

[8] *Dukes* refused to permit a disparate-impact claim purporting to challenge a so-called "policy" of allowing employees discretion, and as discussed in Section III.C.1 above, challenges to a policy of discretion must fail in the great bulk of instances. A common flaw of purported disparate-impact claims that attack "policies" of discretion is that they improperly rely on nothing more than statistical disparities. Indeed, this was true of the claim the Supreme Court rejected in *Dukes*: the plaintiffs offered no evidence other than a statistical disparity to support assertions that the defendant should be held liable under a disparate impact theory for allowing employees "discretion."

allegations of disparate impact is typically very expensive. No matter how frivolous such suits may be, the threat may cause lenders to manage their end numbers, which creates another kind of risk that *Inclusive Communities* cautions against, namely, that "disparate-impact liability might cause race to be used and considered in a pervasive way and 'would almost inexorably lead' governmental or private entities to use 'numerical quotas,' and serious constitutional questions then could arise." 135 S. Ct. at 2523.

At bottom, *Inclusive Communities* is clear that a lender cannot be held liable for statistical disparities that may result from promotion of the federal government's policy of safety and soundness in underwriting. Accordingly, the Disparate-Impact Rule should be amended to provide "adequate safeguards" against the possibility of "abusive" disparate-impact claims based on nothing more than statistics by expressly stating that such claims must fail.

Second, the Rule should be amended to clarify the important role of courts and regulators to carefully scrutinize disparate-impact claims at the pleading stage of a litigation, or the scoping stage of an examination, in order to weed out meritless disparate-impact claims. *Inclusive Communities* emphasizes that, "at the pleading stage," courts "must [] examine with care whether a plaintiff has made out a prima facie case of disparate impact." 135 S. Ct. at 2523. In order to "protect potential defendants against abusive disparate-impact claims," the Supreme Court stresses that "prompt resolution of these cases is important." *Id*. Thus, under *Inclusive Communities* a "plaintiff who fails to allege facts at the pleading stage … cannot make out a prima facie case of disparate impact" and such claims should be promptly dismissed. Likewise, these standards need to be applied by the federal supervisory and enforcement agencies, including HUD and DOJ. All agencies must pledge adherence to the "cautionary standards" expressed by the Court. The Rule must be amended because it contains no instruction regarding the gatekeeping role of courts and agencies presiding over disparate-impact claims at the pleading stage.

3. *The Disparate-Impact Rule should be amended to adopt the Supreme Court's "robust causality standard"*

The ABA and SBAs provide the comments below in response to the fourth question presented by HUD in the ANPR.[9] The Disparate-Impact Rule makes no attempt to articulate any causal standard for disparate-impact claims, much less a causal standard that is consistent with the Supreme Court's decisions in *Inclusive Communities* and *Wards Cove*. The Supreme Court's *Inclusive Communities* and *Wards Cove* decisions leaves no room for doubt or discussion that a

[9] The following is the fourth question presented by HUD's ANPR: "Should the Disparate Impact Rule be amended to clarify the causality standard for stating a prima facie case under *Inclusive Communities* and other Supreme Court rulings?"

disparate-impact plaintiff must meet a standard of "***robust causality***"[10] to proceed with a claim under the Fair Housing Act. *Inclusive Communities*, 135 S. Ct. at 2523.

In particular, the Supreme Court directs that "a disparate-impact claim that relies on a statistical disparity must fail if the plaintiff cannot point to a defendant's policy or policies causing that disparity" and explains that this "robust causality requirement" is "necessary" to "protect[] defendants from being held liable for racial disparities they did not create." *Inclusive Communities*, 135 S. Ct. at 2523; *see also id.* at 2514 ("[i]f a statistical discrepancy is caused by factors other than ***the defendant's policy***, a plaintiff cannot establish a prima facie case" (emphasis added)). The *Inclusive Communities* "robust causality" standard is entirely consistent with the Supreme Court's prior ruling in *Wards Cove*. There, the Supreme Court upheld a "specific causation requirement," whereby a plaintiff must "show[] that each challenged practice has a significantly disparate impact on [] opportunities for whites and nonwhites," and explained that "[t]o hold otherwise would result in [defendants] being potentially liable for the myriad of innocent causes that may lead to statistical imbalances." *Wards Cove*, 490 U.S. at 658.

Absent application of the "robust causality" standard, lenders may choose to exit products entirely due to the risk of being held liable for disparate impacts they did not create, but rather were created by socio-economic differences or by policies of the government or government-sponsored entities. To bring its rulemaking into line with binding Supreme Court authority, HUD should amend the Rule to reflect the "causality standard for stating a prima facie case under *Inclusive Communities*" and *Wards Cove*. ANPR at 28,561.

4. ***The Disparate-Impact Rule should be amended to adopt the Supreme Court's burden of proof standard***

The ABA and SBAs provide the comments below in response to the first and second questions presented by HUD in the ANPR.[11] Because the Disparate-Impact Rule improperly rejected the Supreme Court's *Wards Cove* standard in favor of Congress's 1991 standard for Title VII (*see supra* at Section III.A), the Rule incorrectly assigns and articulates the burden and standard of proof that must be applied to Fair Housing Act claims.[12] Thus, the Rule not only fails to

[10] Webster's Third New International Dictionary defines "robust" as "having or showing vigor, strength, or firmness" and "strongly formed or constructed." Defs. 2 and 3 (1981) (definition 1 refers to "vigorous health").

[11] The following is the first question presented by HUD's ANPR: "Does the Disparate Impact Rule's burden of proof standard for each of the three steps of its burden-shifting framework clearly assign burdens of production and burdens of persuasion, and are such burdens appropriately assigned?" The following is the second question presented by HUD's ANPR: "Are the second and third steps of the Disparate Impact Rule's burden-shifting framework sufficient to ensure that only challenged practices that are artificial, arbitrary, and unnecessary barriers result in disparate impact liability?"

[12] The *Inclusive Communities* petitioners sought certiorari on two questions, namely, "1. Are disparate-impact claims cognizable under the Fair Housing Act? 2. If disparate-impact claims are

"appropriately" and properly "assign burdens of production and persuasion, but it also fails to ensure that "only challenged practices that are artificial, arbitrary, and unnecessary barriers result in disparate impact liability." *See* HUD ANPR at 28,561.

In particular, several aspects of the Disparate-Impact Rule regarding the burden and standards of proof contravene the Supreme Court's jurisprudence, namely (1) the shifting of the burden of proof to the defendant, (2) the requirement that a defendant articulate a policy which "has a necessary and manifest relationship to one or more of the housing provider's legitimate, nondiscriminatory interests," and (3) the requirement that a plaintiff only establish that a less-discriminatory alternative could serve the defendant's business interests. The Rule should be amended to correct these errors and bring the Rule into conformity with governing law.

First, the Rule contravenes Supreme Court precedent by shifting the burden of proof to the defendant. Under *Wards Cove*, "the ultimate burden of proving that discrimination against a protected group has been caused by a specific [] practice remains with the plaintiff ***at all times***." *Wards Cove*, 490 U.S. at 659 (emphasis in original). Although, once a plaintiff establishes all elements of a prima facie case of disparate impact, the defendant "carries the burden of producing evidence of a business justification for [the] practice," the Supreme Court expressly held that any "suggest[ion] that the persuasion burden should shift to [the defendant] once [the plaintiff] established a prima facie case of disparate impact" is "erroneous." *Id.* In rejecting any attempt to "shift" the "ultimate burden" of proving discrimination, the Supreme Court emphasized that the "rule conforms with the usual method for allocating persuasion and production burdens in federal courts." *Id.* The Rule must therefore be amended to reflect that the plaintiff bears the burden-of-proof at all stages of a disparate-impact action.

Second, under *Wards Cove*, if the plaintiff makes a prima facie showing of disparate impact, the defendant can justify the challenged policy by articulating a legitimate business goal that the policy serves. 490 U.S. at 658-59 ("at the justification stage of … a disparate-impact case, the dispositive issue is whether a challenged practice serves, in a significant way, the legitimate employment goals of the employer"). Consistent with *Wards Cove*, *Inclusive Communities* states that "[a]n important an appropriate means of ensuring that disparate-impact liability is properly limited is to give housing authorities and private developers leeway to state and explain the ***valid interest*** served by their policies." 135 S. Ct. at 2522 (emphasis added). The business interest

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cognizable under the Fair Housing Act, what are the standards and burdens of proof." Pet. for a Writ of Cert., *Texas Dept. of Hous. & Comm. Affairs v. The Inclusive Communities Project, Inc.*, No. 13-1371 (U.S. May 13, 2014). Although the Supreme Court declined to grant certiorari on the second question regarding the burdens of proof for disparate-impact claims, *see* Opinion, *Texas Dept. of Hous. & Comm. Affairs v. The Inclusive Communities Project, Inc.*, No. 13-1371 (U.S. Oct. 2, 2014) ("Petition for writ of certiorari to the United States Court of Appeals for the Fifth Circuit granted limited to Question 1 presented by the petition"), the Supreme Court's *Inclusive Communities* decision cited with approval *Wards Cove*, which articulates burdens and (as discussed in Section III.A above) applies to Fair Housing Act claims.

must be "legitimate," meaning "valid," but the Supreme Court expressly disclaimed any requirement that the defendant establish that its policy was "essential" or "indispensable." By seemingly requiring more, the Rule fails to ensure that the only policies subject to challenge are those that are artificial, arbitrary, and unnecessary barriers as required by *Inclusive Communities*.

A simple example illustrates the complicated position in which the standard of the Rule would place those subject to it. The decision to charge a certain amount of rent might be related to maintaining a certain profit margin, which *Inclusive Communities* recognizes as a valid business interest. 135 S. Ct. at 2519. Such commonplace and lawful decisions, approved by the Supreme Court, are not recognized by the Disparate Impact Rule.

Third, having articulated a legitimate business goal, the defendant should prevail under *Wards Cove* unless the plaintiff can prove "that 'other tests or selection devices, without a similarly undesirable racial effect, ***would*** also serve the ... legitimate [business] interest[s]'" in an equally effective manner. *Id*. at 660 (emphasis added). Under *Wards Cove*, the plaintiff cannot prevail by merely showing that a less discriminatory alternative ***could*** serve the defendant's business interest. *Inclusive Communities* reiterates this standard, holding that "before rejecting a business justification … a court must determine that a plaintiff has ***shown*** that ***there is*** an available alternative practice ***that has*** less disparate impact and ***serves*** the entity's legitimate needs." 135 S. Ct. at 2518 (internal alternations and quotations omitted.) Ignoring *Wards Cove*, the Rule adopts standard that appears to allow for liability if the plaintiff merely offers an alternative that ***might*** have a lesser impact.

Moreover, the standard in the Rule suggests that the plaintiff can offer a hypothetical alternative about which a defendant may not have any knowledge or capacity for implementing. This too is contrary to *Wards Cove*. The Court stated that any alternative must not only be "equally effective as" the chosen practice but also must have been known to and rejected by the defendant; it cannot merely be a post-hoc creation of the plaintiff. *See* 490 U.S. at 660-61. This is a logical extension of the Court's recognition that "[c]ourts are generally less competent than [businesses] to restructure business practices." *Id.* at 661. Once again, this is fully consistent with *Inclusive Communities*, which holds that a plaintiff must "***show***[] that ***there is*** an available alternative practice ***that has*** less disparate impact and ***serves*** the [defendant's] legitimate needs." 135 S. Ct. at 2518 (internal alternations and quotations omitted)(emphasis added).

5. *The Disparate-Impact Rule should be amended to include discussion of appropriate remedies in disparate-impact cases*

Inclusive Communities emphasizes that "[r]emedial orders in disparate-impact cases should concentrate on the elimination of the offending practice that arbitrarily operates to discriminate on the basis of race." 135 S. Ct. at 2524. Of course, there is nothing new about this remedial focus on "elimination of the offending practice" in cases of proven disparate impact—more than 20 years ago the DOJ described its policy position on this topic in a manner entirely consistent with *Inclusive Communities*, stating that "unlike our approach in disparate treatment cases, in instances of disparate impact our emphasis will typically be on reform of the unlawful practice, rather than on penalties." DOJ Fair Lending Enforcement Position Statement at 4. Yet HUD refused to include such a limitation in the Rule and provided no guidance to limit the availability of compensatory damages, punitive damages, or civil penalties in disparate-impact cases.

At a minimum, because civil penalties and punitive damages are intended to punish and deter bad conduct, and because disparate-impact claims require no evidence of intentional misconduct, the Rule should be amended to preclude awards of civil penalties and punitive damages in disparate-impact cases. As the United States Supreme Court has held, "[t]he purpose of punitive damages is to punish the defendant for his willful or malicious conduct and to deter others from similar behavior," *Memphis Cmty. Sch. Dist. v. Stachura*, 477 U.S. 299, 307 n.9 (1986), and "all civil penalties have some deterrent effect," *Hudson v. United States*, 522 U.S. 93, 102 (1997) (addressing civil penalties in context of federal banking statutes). Of course, the nature and circumstances of a disparate-impact violation, and the complete lack of willfulness associated with the violation, by definition, are such that the defendant had no intent to discriminate. Culpability arises from the unintended effects of a race-neutral policy or practice, not the defendant's purposeful treatment of individuals in a discriminatory manner. Thus, under the circumstances presented by a pure disparate-impact violation, the goals of punishment and deterrence cannot be served by an award of punitive damages or civil penalties because the defendant had no intention to violate the Fair Housing Act in the first place.

Additionally, Fair Housing Act jurisprudence demonstrates that civil money penalties and punitive damages should not be awarded in disparate-impact cases. For example, the legislative history of the 1988 amendments confirms that that civil penalties "are not automatic in every case"—courts should focus on "the nature and circumstances of the violation" and "the goal of deterrence" in awarding civil penalties. House Comm. On the Judiciary, Fair Housing Amendments Act of 1988, H.R. REP. No. 711, 100th Cong., 2d Sess. 18, reprinted in 1988 U.S.C.C.A.N. 2173, 2201. Also, appellate courts have determined that a Fair Housing Act civil penalty "is especially appropriate when a defendant is found to have intentionally discriminated," *Smith & Lee Associates, Inc. v. City of Taylor, Mich.*, 102 F.3d 781, 798 (6th Cir. 1996), and have reversed civil money penalty awards lacking the appropriate focus on serving the goal of deterring future discriminatory conduct, *see, e.g., Morgan v. Sec'y of Hous. & Urban Dev.*, 985 F.2d 1451 (10th Cir. 1993).[13] Similarly, appellate courts upholding awards of

[13] And district courts routinely apply an intent standard in awarding civil money penalties under the Fair Housing Act. *See, e.g., United States v. Vill. of Marshall, Wis.*, 787 F. Supp. 880, 881 (W.D. Wis. 1991) ("The Court further finds and concludes that ***the defendant did not intentionally discriminate*** against [plaintiff] and acted in good faith when reaching its decision to deny [plaintiff's] request for a statutory exception. There is ***no evidence of intentional misconduct*** on the part of Village officials, but instead efforts were made to cooperate fully with [plaintiff]. ***This is not a case which suggests civil penalties be awarded***." (emphasis added)).

"punitive damages" under the Fair Housing Act have focused on whether the "record contains ample evidence of intentional disregard of the [plaintiff's] rights." *Phillips v. Hunter Trails Cmty. Ass'n*, 685 F.2d 184, 190-91 (7th Cir. 1982) (determining that the plaintiff's claim involved "discriminatory intent, not of facially neutral actions that harmed blacks more than whites," and refusing to overturn award of punitive damages because "the willfulness of the [defendant's] conduct is appropriately weighed").

Finally, while the Rule's approach to disparate impact is supposedly patterned upon the standard for employment discrimination as set forth in the 1991 amendments to Title VII, Congress determined that the disparate-impact standard is applicable ***only*** in lawsuits that ***do not*** seek monetary relief. *See* 42 U.S.C. §§ 1981a(1), 1981a(2) (prohibiting compensatory and punitive damages in Title VII disparate-impact cases); *Kolstad v. Am. Dental Ass'n*, 527 U.S. 526, 533 (1999) (following the 1991 Congressional amendments, Title VII "limits compensatory and punitive damages awards, however, to cases of 'intentional discrimination'—that is, cases that do not rely on the 'disparate impact' theory of discrimination"). Yet, the Department refused to impose a similar limitation on disparate-impact claims under the Fair Housing Act. Thus, the Rule not only expanded the use of disparate impact far beyond Title VII—which statute supposedly was the guidepost for HUD's approach—but it also selectively ignored important limitations on disparate-impact liability established by Congress's 1991 standard.

6. *The Disparate-Impact Rule should be amended to provide guidance to regulated entities seeking to comply with the law, including defenses and safe harbors*

The ABA and SBAs provide the comments below in response to the fifth and sixth questions presented by HUD in the ANPR.[14] An overarching goal of any agency rule is to inform entities that must comply with a statute of the obligations and expectations of the federal agency with the authority to enforce the statute. Despite these objectives for rulemaking, the Rule provides virtually no guidance on factors to consider in the context of compliance or litigation, and no defenses or safe harbors whatsoever. Instead, the Rule maintains that each situation needs to be decided on a "case-by-case" basis. 78 Fed. Reg. at 11,471. But a fundamental purpose of a rule is to provide meaningful guidance that minimizes the number of decisions that must be made on a case-by-case basis. Businesses that are subject to the Act, as well as those involved in its enforcement, would benefit significantly from a thoughtful and reasoned rule that contains

[14] The following is the fifth question presented by HUD's ANPR: "Should the Disparate Impact Rule provide defenses or safe harbors to claims of disparate impact liability (such as, for example, when another federal statute substantially limits a defendant's discretion or another federal statute requires adherence to state statutes)?" The following is the sixth question presented by HUD's ANPR: "Are there revisions to the Disparate Impact Rule that could add to the clarity, reduce uncertainty, decrease regulatory burden, or otherwise assist the regulated entities and other members of the public in determining what is lawful?"

meaningful guidance, and thereby promotes voluntary compliance, avoids frivolous or unnecessary claims, and provides certainty and clarity regarding the application of the law.

In fact, *Inclusive Communities* makes clear that disparate-impact claims under the Fair Housing Act must not put regulated entities "in a double bind of liability." 135 S. Ct. at 2523. Thus, in addition to its improper adoption of an outdated disparate-impact standard that is out-of-step with binding Supreme Court precedent, the Rule is fatally flawed and ineffective because it fails to provide real-world guidance—including defenses and safe harbors—to regulated entities seeking to comply with the law. *See* ANPR at 28,561. To be consistent with this directive, the Rule should be amended to provide the guidance suggested by ABA and the SBAs below.

First, the Rule should recognize the right of lenders to pursue a profit motive and to adopt credit-worthiness standards in accordance with the lender's assessment of and tolerance for risk. *Inclusive Communities* confirms that "disparate impact liability must be limited so … regulated entities are able to make practical business choices and profited-related decisions that sustain a vibrant and dynamic free-enterprise system" and "[e]ntrepreneurs must be given latitude to consider market factors." 135 S. Ct. at 2523; *see also* DOJ Fair Lending Enforcement Position Statement at 4 ("we would not condemn any facially neutral policy or practice the absence of which would demonstrably jeopardize the safety or soundness of any financial institution" and "we do not expect lenders to adopt any particular credit-worthiness requirements"). Consistent with *Inclusive Communities*, recognition of profit and credit-risk motivations as valid and legitimate concerns is critical to a properly-functioning Disparate-Impact Rule.

Second, contrary to the Rule, *Inclusive Communities* holds that the policies of third parties can provide a valid defense to a disparate-impact claim. The Supreme Court held that "if the [plaintiff] cannot show a causal connection between the [defendant's] policy and a disparate impact—for instance, because federal law substantially limits the Department's discretion—that should result in dismissal of th[e] case." 135 S. Ct. at 2524; *see also Meyer v. Holley*, 537 U.S. 280, 286-89 (2003) (limiting vicarious liability under the Fair Housing Act to traditional agency relationships).

As written, however, the Rule creates liability for entities complying with contractual obligations set by third parties, including the federal government. For instance, a loan servicer applying loss-mitigation criteria set by the party that owns the loan (very commonly not the servicer) or by Treasury may face liability under the Rule for purported disparate impact caused by the criteria. As another example, the purpose and design of several Dodd-Frank Act revisions to ability-to-repay and underwriting standards is to improve safety and soundness by causing fewer loans to be made to borrowers with weaker credit profiles, and to increase the cost of loans to those borrowers if they are made.

Adherence to governmental or government-sponsored standards, policies, or programs should not create disparate-impact liability. Rather, the Rule should create an exemption for lending and servicing practices that are undertaken in compliance with governmental or government-sponsored policies or programs. The Rule must recognize the ability of lenders to promote safety and soundness considerations in underwriting—such considerations promote the policies of the federal government, and the Rule should expressly exempt lenders from liability for any statistical disparity that might result. Alternatively, the Rule could afford a safe-harbor defense of a presumption of non-discrimination for the conduct of a lender or servicer taken in compliance with governmental standards, such as QM rules or other similar statutes and regulations or government-sponsored requirements. Regardless of its form, whether an exemption or a safe-harbor provision, the critical element of such a revision to the Proposed Rule is to ensure that the rule does not create a Catch-22 double-bind of liability for lenders or servicers who are otherwise complying with government rules or assisting in effectuating the government's residential housing policies.

Third, in *City of Miami v. Bank of America Corp.*, the Supreme Court recently held that a plaintiff must satisfy a "requirement" of pleading and proving "direct" proximate causation to state a "claim" under the Fair Housing Act. 137 S. Ct. 1296, 1305-06 (2017). Without allegations (at the pleading stage) and proof (at the summary judgment stage) sufficient to meet the proximate cause directness requirement, a plaintiff lacks a cause of action under the statute altogether. *See id.* To establish "direct" proximate cause, the plaintiff must generally show that the asserted injuries do not extend "beyond the first step" in the causal chain that begins with the defendant's challenged conduct. *Id.* at 1306. In providing direction to lower courts presiding over Fair Housing Act claims, *City of Miami* referenced settled "directness principles" established in the Supreme Court's prior precedent, *id.* at 1305, including the principle that a plaintiff cannot establish direct proximate cause where the alleged harm "may have been produced by independent factors," *Associated Gen. Contractors v. Cal. State Council of Carpenters*, 459 U.S. 519, 542 (1983), or where a "theory of liability" rests on "separate actions by separate parties," *Hemi Grp., LLC v. City of New York*, 559 U.S. 1, 2-3 (2010). Indeed, the Supreme Court noted that: "[t]he housing market is interconnected with economic social life. A violation of the [Fair Housing Act] may, therefore, be expected to cause ripples of harm to flow far beyond the defendant's misconduct. Nothing in the statute suggests that Congress intended to provide a remedy wherever those ripples travel." *City of Miami*, 137 S. Ct. at 1306 (citations and quotations omitted). Thus, consistent with this binding Supreme Court precedent, HUD should amend the Rule to provide that disparate-impact claims brought under the Fair Housing Act—like all claims brought under the Act—must satisfy the requirement of direct proximate cause.

The Supreme Court's proximate cause ruling highlights a significant and fatal flaw in a type of disparate-impact claim that has been improperly been brought against members of the ABA and SBAs. In particular, lenders have been forced to defend purported "disparate impact" claims of "pricing discrimination" that challenge the lender's so-called "policy" of allowing discretion to independent third-party businesses (such as mortgage brokers) to set fees that are charged to customers. As discussed above, such claims have always improperly distorted the disparate-impact legal theory, as challenges to policies of discretion have always been improper (*see supra* at Section III.C.1), but the *City of Miami* decision confirms that any attempt to bring a similar claim must be dismissed: a lender cannot be held liable under the Fair Housing Act for a disparate impact where the independent actions of independent third parties break the proximate causal chain. The Rule should be amended to clarify that allegations challenging a lender's policy of allowing third-party businesses to set the fees charged to customers cannot support a disparate-impact claim.

Fourth, many lenders are moving to automated pricing and underwriting systems. Use of a variable in an automated model should present no disparate-impact concern if the variable is predictive of credit risk and the variable does not serve as a substitute or proxy for a prohibited characteristic. *See* Board of Governors of the Federal Reserve System, "Report to Congress on Credit Scoring and Its Effects on the Availability and Affordability of Credit" (Aug. 2007) ("[u]nder court and regulatory agency interpretations, the test for disparate impact requires that a practice both have a disproportionate effect on a protected population and lack a sufficient business justification. An empirically derived, demonstrably and statistically sound credit-scoring model is likely to have a sufficient business rationale for the characteristics that constitute the model"); Interagency Fair Lending Examination Procedures, Appendix A at 26 (directing examiners evaluating disparate impact risk to consider "if the policy or criterion is obviously related to predicting creditworthiness and is used in a way that is commensurate with its relationship to creditworthiness," and "examples are reliance on credit reports or use of debt-to-income ratio in a way that appears consistent with industry standards and with a prudent evaluation of credit risk").

The issues faced by lenders are far more complex in that the many elements related to credit risk assessment are usually layered in complex models or algorithms often developed by third parties. For example, as noted above, the government-sponsored enterprises Fannie Mae and Freddie Mac require lenders to evaluate credit risk pursuant to automated underwriting systems containing models proprietary to those entities. Under the Rule as written, lenders may face liability for credit decisions based on automated underwriting systems that the government-sponsored enterprises Fannie Mae and Freddie Mac require lenders to use and that contain credit-risk algorithms which lenders have no ability to alter. The sum total of the elements in the model might have the same differential impact as the application of single assessment elements such as credit score and ability to make a down payment, yet lenders are not in a position to "justify" each element of the model much less the relationships among all the variables.

Fifth and finally, Section 100.500(a) of the Rule states that a "practice has a discriminatory effect where it actually or predictably . . . creates, increases, reinforces, or perpetuates segregated housing patterns." While this language might have application, for example, to local government entities with zoning authority, application of this language to lenders would have severely detrimental consequences in the residential mortgage lending context. In particular, a mortgage lender plays no role in a prospective borrower's decision of where to live—prospective borrowers submit applications to mortgage lenders for financing only after completing the home-seeking process and selecting the neighborhood and home in which they desire to live. Thus, a mortgage lender should not be held liable for the effects on "housing patterns" that might arise from a prospective borrower's choice of housing. A lender's consideration of the borrower's race, or the racial composition of the area in which the borrower desires to live, in connection with evaluating an application for home financing would itself violate the Fair Housing Act. Simply put, it would be invidious, impermissible discrimination for a lender to deny a loan application of a white borrower seeking to purchase a home in a majority-white census tract on grounds that approving the loan might "perpetuate[] segregated housing patterns." The language of Section 100.500(a) should be removed from the Rule, but if it remains, HUD must create a safe harbor for lenders who properly consider applications for financing without regard to race or the racial composition of the area in which the home is located, regardless of the impact on "segregated housing patterns."

IV. Conclusion

In the most authoritative opinion concerning unintentional discrimination standards in the Fair Housing Act context, the Supreme Court has ruled it necessary to observe strict limitations on the use of the disparate-impact theory. The Supreme Court articulated these limitations in the *Inclusive Communities* case to avoid injecting improper considerations of race into decision-making and to address other important constitutional concerns implicated by recognition of the theory. These concerns were neither recognized nor acknowledged by HUD in the crafting of its 2013 Rule. HUD must therefore act to amend its Disparate-Impact Rule to meet the binding standards defined by the Supreme Court in its *Inclusive Communities* decision.

At the same time, there is a clear opportunity for the Department to provide actual guidance on the application of disparate impact under the Fair Housing Act. Businesses that are subject to the Act, as well as those institutions involved in its enforcement, would benefit significantly from a thoughtful and reasoned Rule that contains meaningful guidance.

We urge the Department to act to fix the legally erroneous and outdated standards for disparate-impact liability in its Rule. The flawed Rule poses serious negative implications for banks and their ability to properly serve American communities. ABA and a representative group of SBAs would welcome the opportunity to meet with the Department to discuss the issues raised in this comment letter.

Sincerely,

American Bankers Association
Alabama Bankers Association
Alaska Bankers Association
Arizona Bankers Association
Arkansas Bankers Association
California Bankers Association
Colorado Bankers Association
Connecticut Bankers Association
Delaware Bankers Association
Florida Bankers Association

Georgia Bankers Association
Hawaii Bankers Association
Idaho Bankers Association
Illinois Bankers Association
Illinois League of Financial Institutions
Indiana Bankers Association
Iowa Bankers Association
Kansas Bankers Association
Kentucky Bankers Association
Louisiana Bankers Association
Maine Bankers Association
Maryland Bankers Association
Massachusetts Bankers Association
Michigan Bankers Association
Minnesota Bankers Association
Mississippi Bankers Association
Missouri Bankers Association
Montana Bankers Association
Nebraska Bankers Association
Nevada Bankers Association
New Hampshire Bankers Association
New Jersey Bankers Association
New Mexico Bankers Association
New York Bankers Association
North Carolina Bankers Association
North Dakota Bankers Association
Ohio Bankers League
Oklahoma Bankers Association
Oregon Bankers Association
Pennsylvania Bankers Association
Puerto Rico Bankers Association
Rhode Island Bankers Association
South Carolina Bankers Association
South Dakota Bankers Association
Tennessee Bankers Association
Texas Bankers Association
Utah Bankers Association
Vermont Bankers Association
Virginia Bankers Association
Washington Bankers Association
West Virginia Bankers Association
Wisconsin Bankers Association
Wyoming Bankers Association

EXHIBIT “A”

U.S. Department of Justice

Civil Rights Division

Office of the Assistant Attorney General

Washington, D.C. 20035

February 21, 1995

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Re: Department of Justice Fair Lending Enforcement Program

Gentlemen:

I am writing to answer the series of questions on lending discrimination that you posed to us following our meeting of October 12, 1994. Since there was considerable overlap between the list of questions asked by the banking associations in their joint letter of October 31 and by the Mortgage Bankers Association in its November 8 letter, I will share this entire response with each of the organizations. I ask that you forgive our delay in responding. We have used the time to develop as much consensus of view and approach as possible with the other relevant regulatory and enforcement agencies.

Before I answer your specific questions, I want to restate a few general principles:

<u>First</u>. The Department of Justice fair lending enforcement program will continue to emphasize these three components:

- <u>Education and voluntary compliance</u>. This includes meetings, conferences and seminars with bankers and brokers, their legal counsel, and their professional associations; it also includes meetings with community and civil rights groups.

- <u>Cooperation and coordination on policy and enforcement</u>. This includes not only the work of the Interagency Task Force on Lending Discrimination but also assistance to agency examiners and investigators, to United States Attorneys, and to interested state Attorneys General and other state and local enforcement agencies.

- <u>Enforcement through litigation</u>. The litigation will continue to include matters the regulatory agencies refer to us as well as matters we develop through our original investigations, particularly concerning unregulated lenders. We are working with the various regulators to assure that each regulator is following appropriate practices and procedures in conducting fair lending examinations; once that is established, our expectation would be that DOJ litigation against regulated lenders would focus on patterns and practices of discrimination referred to us by a regulatory agency.

<u>Second</u>. We will concentrate our enforcement efforts on the three aspects of lending discrimination we believe are causing the greatest harm to potential borrowers:

- Loan denials based on unlawful discrimination in processing and underwriting of loan applications.

- Differential cost of credit based on unlawful discrimination rather than individual applicant creditworthiness.

- Limitations on access to credit which operate to discriminate unlawfully.

<u>Third</u>. We reaffirm our commitment to consider a lender's initiative in undertaking self-evaluation and effective self-correction and elimination of the unlawful conduct in advance of a DOJ investigation, together with cooperation in remedying past violations, as a basis

for seeking only compensatory (and not punitive) damages.

Fourth. We continue to think that lenders can and should exercise discretion in evaluating an individual's application for credit -- as opposed to adopting a mechanistic scoring system for all purposes. We stress our strong belief, based on what we have learned through our enforcement efforts to date, that lenders should be certain that their employees do not exercise that discretion in a manner that discriminates unlawfully.

Fifth. We encourage self-testing. In addition to the steps outlined in response to your specific questions, we are considering legislative measures to extend a form of privilege or protection to a lender's self-testing results.

In responding to your specific questions, I have attempted to describe the intended enforcement program of the Department of Justice, rather than provide you with a set of legal opinions. I think this is the proper approach. Our goal as a law enforcement agency is to bring an end to unlawful lending discrimination. I ask that you in the lending industry join with us in taking positive steps to make any necessary changes in lending practices quickly and voluntarily.

A. Disparate Impact Generally

Your letters raise issues about the possible disparate impact of lender policies and practices. The banking associations asked about adoption of high creditworthiness standards, the mortgage bankers asked about "niche" lending, and both asked about loan officer compensation policies. You should consider the Joint Policy Statement on Lending Discrimination that the Joint Task Force adopted last spring as the general context for my answers.

My answers are based on the assumption that the essential conditions for disparate impact analysis have been met, including the premise that the practices in question have been applied neutrally to all. Our experience to date teaches us that lenders sometimes believe that neutral practices are having only a disparate impact, when in fact the lender's employees have been applying them differentially, resulting in disparate treatment, such as when employees have been more helpful to some applicants than others in obtaining clarifying or compensating information. This occurs most often in two areas: explanations for negative credit history and minimizing of debt ratios (which in turn means maximizing countable income and minimizing countable debts).

When and if we encounter apparent disparate impact that is of serious consequence to those protected by the fair lending laws, we will look first to see whether the standards are facially neutral and whether they are in fact applied neutrally in all cases. If so, we will proceed to a disparate impact analysis, which includes whether there is a business necessity for the apparently neutral standard or practice. Unlike our approach in disparate treatment cases, in instances of disparate impact our emphasis will typically be on reform of the unlawful practice, rather than on penalties.

B. The Specific Questions:

1. With respect to the adoption of "strict or high creditworthiness standards in accordance with [the lender's] assessment of and tolerance for risk," what weight does the Department attach to the requirements of bank safety and soundness?

Once the prerequisites for a disparate impact analysis have been met, safety and soundness, as well as other factors that affect the viability of the institution, will be central factors in any inquiry into the "business necessity" of the standards in question. The weight we would attach to any of these considerations would depend on the circumstances, including the soundness of the factual underpinnings of "business necessity," the significance of the impact, etc. These determinations must be made on a case-by-case basis.

Generally, we foresee no action on a disparate impact claim unless the impact is significant and there is no business necessity for the offending policy or practice. Of course, we would not condemn any facially neutral policy or practice the absence of which would demonstrably jeopardize the safety or soundness of any financial institution.

We do not expect lenders to adopt any particular creditworthiness requirements. Our experience has been with lenders whose general standards are either those of the secondary mortgage market or lower. We do not know the extent to which lenders have adopted standards that are actually higher than the secondary market. Clearly, there are lenders who specialize in "jumbo" loans and others who hold themselves out to be "niche" lenders, as discussed below, but our present belief is that they constitute a small portion of the market. My advice to such lenders is: Be consistent, within reason and common sense. We will view it as intentional discrimination if they discourage or exclude minority borrowers by announcing specialized standards yet regularly make exceptions for whites who apply despite their not meeting the announced standards.

2. "If marketing decisions based on [economic characteristics of borrowers] result . . . in lending patterns that are concentrated in areas with predominantly white residents, does DOJ consider such 'niche' lending business decisions worthy of prosecution?"

This multi-layered question was posed by the mortgage bankers. I will answer it in terms of its implicit assumption that the lender has no statutory responsibility to serve all the members of the community in which it does business.

Provided the lender did not adopt its "niche" under circumstances from which a discriminatory purpose could fairly be inferred, and that the lender's "niche" marketing is consistently applied, I would not generally expect the Department to prosecute on the basis of such "niche" lending practices.

One thing we would look at closely is the type and geographical area of the "niche," and whether the lender has an alternative marketing strategy aimed at a broader market and makes exceptions that belie its claim of a narrowly defined market. Depending on the circumstances, a facially neutral practice which results in a metropolitan-wide disparate impact based on race must be evaluated in light of the lender's business necessity. While the facts might sustain a technical violation, only practices of sufficient consequence would normally merit prosecution.

I assume in the question posed by the mortgage bankers that this lender would service any qualified borrower from the neighborhoods it purports to serve and would behave consistently in response to all loan requests that came from elsewhere. As we have said before, lenders must select their markets, provide services within those markets, and treat loan applicants in a manner that is free of discrimination.

3. a. What is the importance of a lender's "compensation plans for loan officers with respect to the products/services that they sell to the public" for purposes of Department of Justice enforcement?

   b. "To what extent must lenders either recruit or hire a certain number of minority loan officers or other lending employees in order to comply with the Fair Housing and Equal Credit Opportunity Act?"

Neither the Fair Housing Act nor the Equal Credit Opportunity Act require lenders to compensate employees in a particular manner or to hire a certain number of minority employees. (Title VII of the Civil Rights Act of 1964, of course, prohibits discrimination in employment on the basis, *inter alia*, of race or national origin.) Issues related to compensation programs and diversity of workforce have arisen in some of our lawsuits that have challenged racial discrimination in the underwriting or marketing of loan products. We view these issues primarily in the context of remedy, however, not liability. Generally, if a lender is fairly marketing its services to all segments of its service area and otherwise not engaging in discrimination, we would have no occasion to even examine payment structures.

At the same time, lenders might consider adjusting payment structures if they are failing to properly serve all segments of the service area. Similarly, many lenders have recognized that a diverse workforce might make it easier to achieve the goal of fair lending. In the absence of a diverse workforce we have encountered examples where neighborhoods are ignored simply because no employee is familiar with the neighborhood, where loan officers may not be as comfortable in dealing with minority applicants, or where appraisers lack experience in appraising properties in certain areas. This is not to say that lenders must hire minority employees to deal with minority applicants or that minority appraisers must appraise properties in minority neighborhoods; but a diverse work team that is properly trained can contribute to the elimination of some of the problems that we have identified.

The question regarding compensation programs might also encompass the issue of "overages." Some of the bank regulators and the Department of Housing and Urban Development have issued guidance to lenders on the issue of overages. The Department of Justice's position is consistent with theirs: The overages system is not, in and of itself, unlawful, but it is unlawful to charge persons higher interest rates on the basis of race. This is not to suggest that mathematical precision is required between the rates charged loan recipients grouped by racial category. Lenders that choose to compensate their loan officers or other employees by allowing them to charge different prices to similarly qualified applicants for the same loan product do not necessarily violate the fair lending laws when the results are not the same for all groups. But, the Department of Justice will take a very close look to find out how differing results came about. The larger the difference, the harder we will look.

4. Is it the intention of the Department of Justice "to spend its time and resources investigating and prosecuting lenders" on the theory that "second look" programs devoted entirely to the review of rejected minority applicants constitute discrimination against rejected white applicants?

Our view of a minority-only second review system is as expressed in the Joint Policy Statement on Lending Discrimination. I do not foresee a need for litigation over this issue.

Further, we do not think that second-review programs should be either a substitute for the decision-making of front-line employees or necessarily a permanent fixture for the lender. It is our hope that such programs will be used by lenders as an interim management tool -- to instruct front-line employees how to process and underwrite loans in a thorough and fair manner and to teach middle-management supervisors to insure that this is the case so that there will no longer be a need for a second review.

5. "Can one instance of lending discrimination warrant a referral from the banking agencies to the Department?"

Rarely. An isolated instance is normally referred to HUD or to a state or local enforcement agency -- and may possibly lead to a suit by an individual. If HUD "charges" the complaint, and either party "elects" to have the matter resolved in federal court rather than by administrative proceedings, we are required under current law to file suit on behalf of the complainant. In the event that a lender discovers such an incident, my advice is that the lender treat it as a serious problem and resolve it quickly.

At the Department of Justice, we expect to focus on patterns and practices of lending discrimination, which would normally rest on more than one instance. The only "one-instance" pattern or practice would be an act that provided direct evidence of discrimination, such as an overt statement of discriminatory policy (which we would treat as an admission). I think it is important that lenders understand that the limitations on our resources will dictate that many pattern or practice charges will be handled by the agencies through administrative enforcement.

6. "What are the parameters of a 'pattern or practice' that merit referral?"

Technically, the 1991 amendment of the Equal Credit Opportunity Act requires the agencies to refer a matter to us any time they have reason to believe a lender has engaged in a pattern or practice of discrimination. We have informed the agencies that we will return for administrative enforcement most if not all the referrals that do not meet the priorities I described above. We have already returned some referrals, and we are working with the agencies on procedures for identifying returnable matters before they are formally referred, in order to enable the agencies to resolve them more quickly.

7. <u>What role does the Community Reinvestment Act play in Department of Justice enforcement of the fair lending laws</u>?

The responsibility for enforcing the CRA belongs to the regulatory agencies. If we determine that a lender (whether or not it is subject to CRA requirements) has deliberately conducted its business in such a way as to avoid lending to persons protected by the fair lending laws, we will consider that evidence of a pattern or practice of lending discrimination. CRA performance may be relevant; but, in our view, it is not dispositive.

8. <u>To what extent will the Department of Justice use information gathered through lenders' "self-testing" as evidence in filing a complaint</u>?

We draw a distinction between "self-testing" and other forms of self-assessment that lenders may conduct ("self-evaluation"). "Self-testing" refers to the practice of arranging for "testers" or "shoppers" to pose as lender clients to ascertain how the lender's employees would treat clients. What distinguishes self-testing from other forms of self-assessment is that it generates information that would not otherwise normally be available to the lender (or others) in the normal course of business. In contrast, "self-evaluation" is based on data maintained by the lender (such as Home Mortgage Disclosure Act statistics, CRA MAPS, loan files, policy manuals, training materials, and audit reports), and therefore could be replicated by outside investigators.

a. <u>Self-testing</u>. As a general matter, the Department of Justice will not use evidence created by self-testing against the lender that undertook the self-testing, and will not request a lender's self-testing results to form a basis for determining whether to file a pattern and practice complaint.

In the absence of legislative protection, which we are currently considering, I would be most comfortable with this in those cases where the lender took appropriate steps to protect self-testing information as attorney work product or material protected by the attorney-client privilege.

I do want to be clear, however, that if the Department independently determines that a lender has unlawfully discriminated and a lender relies on the results of self-testing to defend itself against the charge, we will expect the self-testing information to be disclosed. To that end, if a fair lending suit is authorized and litigation actually commences following unsuccessful settlement efforts, we reserve the right to seek discovery of self-testing at that time.

b. <u>Self-evaluation</u>. The extent to which we will use evidence generated by self-evaluation will vary on a case-by-case basis. Assuming no issues of privilege, which I will omit in this discussion, in considering remedies we would look favorably on whether the lender's self-evaluation was followed promptly with effective steps to correct any discriminatory practices found.

c. <u>Use in targeting lenders for investigation</u>. Lenders need not be concerned that engaging in either self-testing or self-evaluation will increase the likelihood that they will be investigated by the Department of Justice. Such assessments are consistent with full compliance with the law. We expect lenders to engage in this kind of monitoring and to deal with problems they discover rather than to avoid learning about such problems.

d. <u>Testing by the bank regulatory agencies, by the Department of Justice, or by interested third parties</u>. The Department of Justice has not yet done tests of lenders, but we are considering several possibilities, including lenders that are not HMDA reporters. You know that HUD has made grants to fair housing groups for such testing.

Any of these forms of testing that we believe are reliable and produce results that are indicative of a pattern or practice of lending discrimination may form the basis for a Department of Justice lawsuit.

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I appreciate this opportunity to spell out the Department of Justice's position on a number of fair lending enforcement issues. I hope that my answers to your questions will be helpful to you and your member lenders. Once you have had a chance to consider these, I invite you to come in again and talk over any additional clarifications you believe are necessary. Please contact my confidential assistant, Denise Jones, when you are ready.

Very truly yours,

Deval L. Patrick
Assistant Attorney General

cc: The Assistant Secretary of the Treasury
The Comptroller of the Currency
The Assistant Secretary for Fair Housing,
Department of Housing and Urban Development
The Acting Director of the Office of Thrift Supervision