U.S. Department of Justice

Civil Rights Division

Office of the Assistant Attorney General

Washington, D.C. 20035

February 21, 1995

Mr. Joe Belew
Consumer Bankers Association
1000 Wilson Boulevard
Suite 3012
Arlington, Virginia 22209-3908

Mr. Anthony Cluff
Bankers Roundtable
805 - 15th Street, N.W.
Suite 600
Washington, D.C. 20005

Mr. Samuel L. Foggie, Sr.
National Bankers Association
1802 T Street, N.W.
Washington, D.C. 20009

Mr. Ken Guenther
Independent Bankers
Association of America
One Thomas Circle
Suite 950
Washington, D.C. 20005

Mr. Warren Lasko
Mortgage Bankers Association
1125 - 15th Street, N.W.
Washington, D.C. 20005

Mr. Don Ogilvie
American Bankers Association
1120 Connecticut Avenue, N.W.
Washington, D.C. 20036

Mr. Paul A. Schosberg
America's Community Bankers
Association of America
900 - 10th Street, N.W.
Suite 400
Washington, D.C. 20006

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:

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

- o Education and voluntary compliance. 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.

- o Cooperation and coordination on policy and enforcement. 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.

- o Enforcement through litigation. 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.

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

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

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

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

Third. 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 credit-worthiness 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 credit-worthiness 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. What role does the Community Reinvestment Act play in Department of Justice enforcement of the fair lending laws?

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

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. Self-testing. 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. Self-evaluation. 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. Use in targeting lenders for investigation. 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.

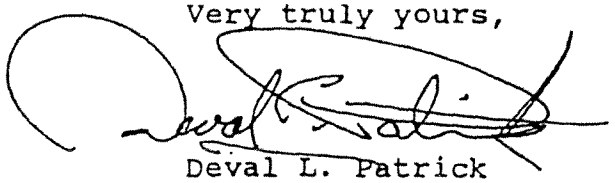
d. Testing by the bank regulatory agencies, by the Department of Justice, or by interested third parties. The Department of Justice has not yet done tests of lenders, but we are considering several possibilities, including lenders that are not HMDA reporters. You know that HUD has made grants to fair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

* * *

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