CFPB ANNOUNCES THAT IT WILL USE THE DISPARATE IMPACT "EFFECTS TEST" UNDER ECOA AND COMMITS TO FOLLOW REGULATION B IN APPLYING THAT TEST

May 1, 2012

On April 18, 2012, the Consumer Financial Protection Bureau ("CFPB" or the "Bureau") issued Bulletin 2012-04, which is intended to provide guidance regarding compliance with the fair lending requirements of the Equal Credit Opportunity Act ("ECOA"). The Bureau confirms in the Bulletin that it will use the disparate impact "effects test" in fair lending examinations and enforcement actions. The Bureau does not, however, provide details regarding the standards it will employ in implementing the effects test.

The Bureau asserts in its Bulletin that it "will continue to adhere to the fair lending principles outlined in Regulation B," the regulation implementing ECOA. Regulation B expressly incorporates the Supreme Court’s implementation of the disparate impact "effects test" when applying the concept to "a creditor’s determination of creditworthiness." The approach to disparate impact adopted by certain other agencies is inconsistent with controlling Supreme Court case law, and in particular the controlling precedent of Wards Cove Packing Co., Inc. v. Atonio. If the Bureau adopts an approach inconsistent with the approach the Supreme Court sets forth in Wards Cove, the Bureau would be acting in a manner inconsistent both with controlling Supreme Court authority and with its commitment to act in conformity with Regulation B.

The Disparate Impact Theory of Liability

Under the disparate impact theory of liability, government agencies and private plaintiffs can establish "discrimination" based solely on statistics. Liability can be established without any showing of intent to discriminate. And because a showing of intent is not required, a defendant can be found liable under the disparate impact theory even if it has taken steps intended to prevent discrimination.

By issuing the Bulletin, the CFPB joins other federal agencies that have increasingly relied on disparate impact claims to further their policy goals. The Department of Justice ("DOJ"), in particular, has made the disparate impact theory an important tool in its efforts to achieve settlements with lenders without needing to prove

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2 12 C.F.R. § 1002.6(a)
intent to discriminate. Although the availability of the disparate impact theory of liability under ECOA remains controversial, the Bulletin clearly signals the Bureau’s intention to rely on the theory in applying ECOA.

The Application of the Disparate Impact “Effects Test”

While the CFPB is clear that it will use the disparate impact “effects test” in its fair lending examinations and enforcement actions, it does not provide any detail regarding how it will implement this test. Courts and regulators have generally agreed that a burden-shifting framework is appropriate. Under the burden shifting framework, the person claiming disparate impact must first present enough evidence to make out a “prima facie case” (i.e., a case in which the evidence presented is sufficient for a judgment to be made unless the evidence is contested). If the claimant is able to make out a prima facie case, the defendant must then offer a legitimate business justification for the challenged practice. Finally, if the defendant is able to offer a legitimate business justification, the claimant must then persuade the finder of fact that other practices that reduce the disparate impact of the challenged practices also serve the company’s legitimate business interests.

While courts and regulators agree that a burden-shifting framework is generally appropriate, there has been disagreement for many years regarding the standards that should be applied in each step of this framework. This disagreement reached a head with the U.S. Supreme Court’s decision in *Wards Cove*. In *Wards Cove*, the Supreme Court articulated standards for the burden-shifting framework that the Court explained were standards the Court believed employers could actually meet and that would keep courts from being placed in a position of restructuring a company’s business practices.

If the CFPB intends to meet its commitment that it will continue to adhere to the fair lending principles outlined in Regulation B, the CFPB will apply the standards set forth in *Wards Cove* and not adopt the plainly wrong interpretation set forth in the FRB commentary. Accordingly, and consistent with *Wards Cove*, the Bureau should adopt the following standards for applying the disparate impact “effects test”:

- A prima facie case under the effects test must be based only on statistics that compare borrowers who are actually similarly-situated. This means borrowers must have similar creditworthiness characteristics, be located in similar markets, and have applied for similar products. In other words, the

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4 E.g., Thomas E. Perez, Speech to 15th Annual Community Reinvestment Act and Fair Lending Colloquium (Nov. 7, 2011), available at http://www.justice.gov/crt/opa/pr/speeches/2011/crt-speech-111107.html (“The Civil Rights Division will make use of all the tools in our arsenal to root out discrimination, including disparate impact theory if the facts support its application.”).

5 E.g., Peter N. Cubita & Michelle Hartmann, *The ECOA Discrimination Proscription and Disparate Impact—Interpreting the Meaning of the Words That Actually Are There*, 61 BUS. LAW. 829 (2006). A discussion of whether ECOA permits the use of the disparate impact theory is beyond the scope of this paper.

analysis must not compare borrowers to the general population of members of the prohibited basis group.\(^7\)

- A bank must be able to defend against statistical disparities by pointing to a **legitimate business justification**. While this justification should not be insubstantial, the Bureau should not require that such a justification be “necessary,” “essential,” or “indispensable” to the bank’s business to pass muster. The Supreme Court has already explained that such a “degree of scrutiny would be almost impossible for most [companies] to meet . . . .”\(^8\)

- A less discriminatory alternative must be **equally effective** as the bank’s chosen procedures in achieving the bank’s legitimate business goals. Additionally, for a less discriminatory alternative to be considered, it must have previously been brought to the bank’s attention. This is critical for lenders as there are myriad combinations of underwriting and pricing factors that can be used. It is impossible for a bank to test each combination to determine the one that results in the lowest statistical disparities.\(^9\)

A departure from these standards would effectively be a departure from the principles promulgated in Regulation B and would be inconsistent with controlling Supreme Court precedent. Such a departure would also be directly inconsistent with the Bureau’s commitment in its Bulletin to follow the principles enunciated in Regulation B.

When *Wards Cove* was criticized as not being tough enough on employers, Congress passed the Civil Rights Act of 1991, which amended Title VII to codify different standards for the burden-shifting framework. The 1991 amendments did not, however, amend any federal civil rights law other than Title VII. Although some lower courts and federal regulators wrongly assumed that the changes to Title VII resulted in changes to the burden-shifting framework that applies to other civil rights laws, the Supreme Court has since clarified in *Smith v. City of Jackson* that the *Wards Cove* standards continue to apply to civil rights laws other than Title VII.\(^10\) And as recently as 2011, the Supreme Court continued to cite *Wards Cove* as viable precedent.\(^11\)

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\(^7\) *Wards Cove*, 490 U.S. at 651; cf. *Hazelwood Sch. Dist. v. United States*, 433 U.S. 299, 308 (1977) (“a proper comparison was between the racial composition of Hazelwood’s teaching staff and the racial composition of the qualified public school teacher population in the relevant labor market”) (emphasis added).

\(^8\) *Wards Cove*, 490 U.S. at 659.

\(^9\) 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 *id.* 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 (citing *Furnco Constr. Corp. v. Waters*, 438 U.S. 567, 578 (1978)).

\(^10\) *Smith v. City of Jackson*, 544 U.S. 228, 240 (2005) (“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.”). Similarly, because the Civil Rights Act of 1991 did not
This Supreme Court clarification has important implications for Regulation B, because the Federal Reserve Board (“FRB”)—the agency that promulgated Regulation B—is one of the agencies that has misapplied to ECOA the 1991 amendments to Title VII. Following the 1991 amendments, the FRB amended its official commentary to Regulation B to apply to ECOA the new burden-shifting framework for employment cases set forth by Congress in the 1991 amendments. Notwithstanding the subsequent Supreme Court ruling in *City of Jackson* making clear that this was a misapplication of the 1991 amendments, the FRB has not revised this commentary. The commentary is now plainly inconsistent with Supreme Court jurisprudence. This failure by the FRB to revise its Regulation B commentary—or the CFPB to revise it when adopting it—is particularly troubling because the commentary expressly acknowledged that the area of disparate impact is “an evolving area of law,” and that the burden-shifting framework is a “judicial doctrine” that evolves as the Court issues subsequent opinions. Because Regulation B incorporates the evolving judicial doctrine of disparate impact, Regulation B properly must be viewed as incorporating the controlling law governing disparate impact—which, in the case of ECOA, is the Supreme Court’s decision in *Wards Cove*.

The Bureau Should Avoid Misusing Statistics as Have Certain Other Agencies

In addition to concerns about the standards the CFPB may adopt in implementing the disparate impact effects test, there are additional concerns that the Bureau may follow certain other agencies in misusing statistics in applying the disparate impact concept to lending in pursuing its fair lending agenda.

The FRB and DOJ have used the disparate impact theory in a manner inconsistent with recent Supreme Court precedent. Specifically, their assertion that the use of discretion is a neutral policy subject to disparate impact analysis is plainly inconsistent with the Supreme Court’s opinion in *Wal-Mart Stores, Inc. v. Dukes*. In *Dukes*, the Court explained that a policy of allowing employees to exercise discretion is not a uniform practice as is generally required for disparate impact analysis, but is rather a

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11 *Wal-Mart Stores, Inc. v. Dukes*, 131 S. Ct. 2541, 2555 (2011) (citing *Wards Cove*); see also id. at 2565 (Ginsburg, J., dissenting) (citing *Wards Cove*).
15 Id. at 2554.
policy against having a uniform practice. Courts have held that this analysis also applies to programs that allow loan officers discretion in pricing. Because individual loan officers may exercise discretion in very different ways, it is not appropriate to group these decisions together into a statistical disparate impact analysis.

Moreover, for an analysis of lending practices to be consistent with controlling precedent, as well as long-standing historical practice by the agencies, the analysis must be based on a regression analysis. When a claim of “discrimination” is based solely on statistics, a regression analysis is essential to ensure that the statistical analysis compares borrowers who are similarly situated. And, as Dukes makes clear, discretion is “a very common and presumptively reasonable way of doing business—one that . . . ‘should itself raise no inference of discriminatory conduct’ . . . .” Accordingly, any statistical analysis that effectively prohibits the exercise of discretion is contrary to Supreme Court precedent.

A Cautionary Note

As the CFPB considers how best to meet its commitment to adhere to Regulation B and the Supreme Court precedent it incorporates, it should be careful not to follow the highly political and legally deficient approach recently taken by HUD in a recent proposed rulemaking superficially intended to influence the Supreme Court’s consideration of applicability of the disparate impact standard to Fair Housing Act cases in the then pending Magner case. HUD’s proposed disparate impact standard deviates from the Supreme Court’s Wards Cove mandate in many material ways. For example, HUD’s proposed rule would provide that a “legally sufficient justification” exists only “where the challenged housing practice: (1) [h]as a necessary and manifest relationship to one or more legitimate, nondiscriminatory interests of the [respondent or defendant] . . . and (2) those interests cannot be served by another practice that has a less discriminatory effect.”

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16 Id. at 2555; accord Watson v. Fort Worth Bank & Trust, 487 U.S. 977, 994 (1988).
18 Dukes, 131 S.Ct. at 2554; accord Watson, 487 U.S. at 990.
19 Implementation of the Fair Housing Act’s Discriminatory Effects Standard, 76 Fed. Reg. 70921 (proposed Nov. 16, 2011). The Supreme Court granted certiorari in Magner v. Gallagher on November 7, 2011, just 9 days before HUD’s proposed rulemaking was published in the Federal Register. After briefing in the U.S. Supreme Court had been completed, and shortly before oral argument was scheduled to be heard, the City of St. Paul, Minnesota—the petitioner in the Magner case—withdraw its appeal. City Officials explained that while it was confident the City would have prevailed in its appeal—and that the Supreme Court would have ruled that the Fair Housing Act does not permit disparate impact claims—such a ruling “would undercut important and necessary civil rights cases throughout the nation.” http://www.stpaul.gov/index.aspx?NID=4874.
20 Proposed 24 C.F.R. § 100.500(b).
HUD’s proposed standard would be significantly more onerous for banks to satisfy than the Supreme Court’s *Wards Cove* standard discussed above and has been criticized by numerous parties, including the ABA, which have urged HUD through the rulemaking process to align its approach to *Wards Cove*. Given the approach HUD has advocated in its proposed rule, and the similar approaches other agencies have adopted, there is cause for concern that the CFPB will chart a similar course. But the CFPB’s commitment to adhere to Regulation B provides some basis for hope that the experienced fair lending lawyers at the Bureau will adopt the more workable standards discussed above. If the CFPB follows HUD’s lead and deviates from controlling Supreme Court precedent, banks will face very serious difficulties in defending even small disparities based on well-established practices from claims of disparate impact liability. The Bureau’s choice in approach will be a significant test of the credibility of its fair lending examination and enforcement program.

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* Updated May 9, 2012.