BY DANIELLA CASSERES, ATTORNEY, OFFIT KURMAN

Credit Union Fair Lending Risk in Mortgage Lending

Is your credit union involved in mortgage lending? If so, a recent Supreme Court decision will likely impact the fairness of your loan practices and policies. Regular monitoring of your disparate impact risk could safeguard you against costly claims. Learn more about the importance of statistical analysis for your CU's neutrality.

A recent U.S. Supreme Court decision has paved the way for increased regulatory compliance risk in the mortgage lending space. Although fair lending has long been a concern for banks and credit unions, the Supreme Court's June 2015 decision, which confirmed that disparate impact is prohibited by the Fair Housing Act, may increase the number of fair lending claims against mortgage lenders. In Texas Department of Housing and Community Affairs v. The Inclusive Communities Project, Inc., a majority in the Supreme Court held that the Texas Department violated the Fair Housing Act by awarding tax credits for low-income housing developments in predominantly minority neighborhoods. The Inclusive Communities Project, a non-profit group, sued the Texas Department because its allocation of tax credits disproportionately affected minority neighborhoods as opposed to Caucasian neighborhoods.

The Supreme Court's recent interpretation of disparate impact as it relates to the Fair Housing Act is important because it permits fair lending claims absent a pleading of discriminatory intent. To bring a disparate impact claim, a plaintiff need only claim that a lender's policy disproportionately impacts a protected class of borrowers based on race, color, religion, sex, familial status or national origin. A lender may implement otherwise lawful policies and activities; however, if its policies inadvertently affect a protected class of borrowers disproportionately, then the lender is subject to risk of violating the Fair Housing Act. Moreover, to overcome a disparate impact claim, a lender must prove that its policy, which affects protected classes, is necessary to conduct its business. However, it is unclear what the Court would deem a business necessity in the housing context and to what extent lenders will have discretion in determining what is necessary to operate their business.

Because disparate impact claims are easy to bring and difficult to defend, credit unions with mortgage lending operations must regularly monitor their disparate impact risk. A statistical analysis will help a credit union determine whether its otherwise neutral lending policies inadvertently cause disparate impact to protected classes. Particularly for credit unions with lending profiles spanning various cities, states and regions, it

is difficult to identify the disproportionate impact of pricing or underwriting decisions across various mortgage products and populations without statistical regression modeling. A fair lending regression model will analyze an institution's HMDA data and certain overlays, such as product type and loan-to-value-ratios, to determine whether pricing or underwriting decisions are impacted by protected class designations at a statistically significant level. A fair lending analysis will produce outlier loans that should be reviewed to determine whether the underwriting or pricing decisions on those loans were based on business necessity. Such analysis will also identify any trends with particular loan officers, branches or regions. Companies exhibiting disparate impact may then prospectively determine if they should change internal policies, such as adjusting branch margins in pricing or loan originator compensation, to control for the disproportionate effect to protected class borrowers.

Fair lending issues are sometimes associated with loan originator compensation strategies because loan originator compensation is often linked to pricing margins. However, credit unions must carefully structure their loan officers' compensation so that compensation for transactions is not impacted by loan pricing. The Truth in Lending Act's ("TILA's") loan originator compensation rules prohibit compensation based on terms of loans, such as price. Non-compliance with loan originator compensation rules has led to a number of recent regulatory enforcement actions.

Most recently, in June 2015, the Consumer Financial Protection Bureau issued two enforcement actions for violations of TILA's loan originator compensation rules. One of these actions resulted in $19 million in redress and civil penalties. Lenders were fined for improperly paying their loan officers based on profits and terms of loans, both of which are

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prohibited under TILA's loan originator compensation rules. In one case, the lender allowed its loan officers to vary their compensation based on pricing concessions and paid bonuses based on loan profits. The rules define a transaction term as any right or obligation of the parties to a credit transaction. Pricing concessions affect the borrower's obligation to pay the mortgage lender on a credit transaction and are thus terms of loans. TILA prohibits compensation based on terms of loans, which could incentivize loan originators to offer mortgage terms that lead to higher compensation but may not be in the best interest of the borrower. Furthermore, should a loan originator make a costly error that leads to a pricing concession, a lender is prohibited from reducing the loan originator's compensation on that transaction except under very limited circumstances. The loan originator compensation rules permit a reduction in loan originator compensation only when there is an unforeseen increase in settlement cost to the consumer and when the reduction in compensation would reduce the increased cost to the consumer. It is often difficult to argue that loan originator error is unforeseen.

For the same reason that pricing should not affect loan originator compensation, payments based on profits are also generally impermissible. Compensation based on profits is considered payment based on terms of loans because the compensation is based on the terms of multiple transactions. Nevertheless, the loan originator compensation rules provide an exception wherein a lender can pay its originators a bonus of up to 10 percent of the originator's compensation for the applicable bonus period. Despite this exemption, credit unions must carefully structure profitability bonuses so that payments do not run afoul of the rule's prohibition on payments based on terms of loans.

As credit unions revisit their policies in light of fair lending risks, it is important to also consider the interplay of various regulations governing residential mortgage lending such as loan originator compensation rules. That is because federal agencies have indicated that they will consistently and aggressively enforce the regulations promulgated under the Dodd-Frank Wall Street Reform and Consumer Protection Act. Internal controls, including implementing compliant policies and ongoing compliance monitoring, will be essential as the regulatory environment enhances a credit union's lending risk. Credit unions should devise controls to mitigate the risk of violating fair lending laws by carefully considering business necessity in their compensation, pricing and underwriting decisions and by frequently monitoring and evaluating risk trends.

Daniella Casseres is an attorney with the Offit Kurman law firm. Her legal practice focuses on laws and regulations governing mortgage lenders, mortgage brokers, financial institutions and consumer finance companies. She regularly advises clients on state and federal compliance laws and regulations including fair lending, advertising, licensing, privacy, TILA, RESPA, FHA, FCRA and BSA requirements. She can be reached at dcasseres@offitkurman.com or (703) 745-1811.