

HUD's Disparate Impact Proposal Clarifies Fair Lending Laws

By Jeffrey Naimon and Joshua Kotin (September 27, 2019)

The U.S. Department of Housing and Urban Development last month released its long-anticipated proposal to revise its disparate impact rule under the Fair Housing Act.

Although the proposal has attracted some criticism from those who believe the proposal would make it more difficult for plaintiffs to prove discrimination claims, a closer read shows the proposal carefully aligns HUD's standards with the U.S. Supreme Court's 2015 decision on disparate impact in housing in *Texas Department of Housing and Community Affairs v. Inclusive Communities Project Inc.*[1]

In doing so, the proposal would bring clarity for mortgage lenders seeking to comply with fair lending laws, and guide examiners in applying the law consistently.

The Proposed Standard and Potential Defenses

HUD's existing disparate impact rule uses a three-pronged burden-shifting approach[2] that the Supreme Court rejected — without mentioning the current rule or the standards it set forth. Facing litigation seeking to nullify the current rule because of the important ways it differs from the Supreme Court's ruling, HUD has no choice but to make significant changes to it.

HUD's proposal describes a new five-part test for assessing disparate impact claims:

1. The challenged policy or practice is arbitrary, artificial and unnecessary to achieve a valid interest or legitimate objective.
2. There is a robust causal link between the challenged policy or practice and the disparate impact on members of the protected class. Claims relying on statistical disparities must articulate how the statistical analysis supports a claim of disparate impact by providing an appropriate comparison that shows how the policy is the actual cause of the disparity.
3. The challenged policy or practice has an adverse effect on members of a protected class.
4. The disparity that the policy or practice caused is significant.
5. The challenged policy or practice directly caused the alleged injury.

HUD's proposal also describes defenses a challenged party may offer to effectively rebut a plaintiff's allegations, and specifically outlines three ways to rebut claims using a model:

1. Provide the material factors making up the model inputs and show that the factors are not substitutes or close proxies for protected classes, and that the model is predictive of credit risk or a similar objective;
2. Demonstrate the model is produced, maintained or distributed by a recognized third



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party and is used as intended; or

3. Show the model has been subject to critical review and validation by an objective and unbiased neutral third party, and that the review determined the model was empirically derived and is a demonstrably and statistically sound algorithm that accurately predicts risk or other valid objectives, and the factors are not substitutes or proxies for protected classes.

HUD's Codification of Inclusive Communities Should Unify Regulators

Although the reasoning laid out in the Supreme Court's Inclusive Communities decision has been the law governing disparate impact cases brought under the Fair Housing Act, prudential regulators charged with administering the act and reviewing bank lending practices for potential disparate impact, have not discernably shifted their examination approach since that 2015 decision.

Fair Housing Act investigations involving underwriting and pricing practices typically start not because the regulators have identified a troubling policy or practice, but because statistical analysis shows that protected class applicants are being denied at disproportionate rates, or that protected class borrowers are paying higher prices for their mortgage loans.

Entities that cannot adequately explain these disparities are then presumed to have engaged in discrimination, even if the regulator has not identified any distinct policy or practice as causing the disparity.

This conclusory approach to assessing fair lending compliance, which is often tied to a bank's inability to provide a sufficiently compelling business justification to rebut these statistics, is widely used by regulators today — despite the fact that it is plainly tied to the old burden-shifting standard, and makes no attempt to square with Inclusive Communities.

HUD's five-part test incorporates Justice Anthony Kennedy's opinion in Inclusive Communities, providing practical guidance to regulators analyzing bank lending practices, compliance officers monitoring fair lending, and attorneys charged with advocating on their clients' behalf in fair lending examinations and investigations.

Appropriately, regulators will still be able to use statistics and newly-collected Home Mortgage Disclosure Act data to screen for lenders who are at risk of engaging in a pattern or practice in violation of the Fair Housing Act.

However, under this new test, regulators would also be required to actually identify a policy or practice creating that disparity, and show a causal link between the practice and the disparity. This new regulator responsibility is consistent with the Inclusive Communities opinion.

CFPB: You're up

HUD's proposed revision of its Fair Housing Act regulation does not apply to the Equal Credit Opportunity Act, though the two statutes are often conflated because both generally prohibit discrimination in mortgage lending against members of protected classes.

An important distinction is that there is arguably no statutory support within the ECOA for a disparate impact claim. When the Federal Reserve Board had the authority to provide

interpretations of ECOA, it took the position that ECOA supported disparate impact claims, based on legislative history it deemed relevant.[3]

At present and going forward, however, the interpretation of ECOA of primary importance to most lenders is that of the U.S. Consumer Financial Protection Bureau, which since the Dodd-Frank Act's passage has had authority to write the rules implementing ECOA and to oversee compliance with it. What the bureau will do is a live question, and a critical one for compliance officers administering fair lending programs, and wondering whether they must apply two different standards when assessing the risk of discrimination claims.

In its fall 2018 rulemaking agenda, the bureau said it was considering future rulemaking in consumer financial law, and offered as an example its reconsideration of ECOA requirements "concerning the disparate impact doctrine in light of recent Supreme Court case law and the Congressional disapproval of a prior Bureau bulletin concerning indirect auto lender compliance with ECOA and its implementing regulations." [4]

But the Bureau's spring 2019 rulemaking agenda made no mention of this initiative, and the bureau has not, under CFPB Director Kathy Kraninger, made any additional statements on its re-examination of ECOA.

Lenders will need to keep their eyes and ears open to see if the bureau follows through on its re-examination — and if it does, whether it takes an approach that is consistent with the path forward that HUD has offered.

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[1] [Texas Department of Housing and Community Affairs v. Inclusive Communities Project Inc.](#), 135 S. Ct. 2507 (2015).

[2] 24 C.F.R. § 100.500(b)(1).

[3] 12 C.F.R. 1002.6(a); Supplement I to Part 1002, Comment 1002.6(a)-2. The availability of disparate impact under ECOA has been criticized. Peter Cubita and Michelle Hartmann, *The ECOA Discrimination Proscription and Disparate Impact — Interpreting the Meaning of the Words That Actually are There*, 61 THE BUS. LAWYER 829 (2006).

[4] https://www.reginfo.gov/public/jsp/eAgenda/StaticContent/201810/Preamble_3170.html.