FAIRNESS IN LENDING

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About the Author

Leonard S. Rubinowitz is an Associate of the Woodstock Institute. The Woodstock Institute is a non-profit organization which conducts research, training and education for the public, private, and voluntary sectors about ways to ameliorate disparities in the availability of capital and credit.

Leonard is also an Associate Professor of Law and Urban Affairs at Northwestern University. He received his B.A. Degree from the University of Wisconsin at Madison in 1965 where he majored in history, and his L.L.B. from Yale Law School three years later. Prior to his coming to Northwestern he served as Special Assistant to the Regional Administrator of HUD Region V. In his capacity as a Field Associate of the Brookings Institution since 1975, he has analyzed Housing Assistance Plans from the Chicago metropolitan area for a study that is being conducted by that institution. He is the author of Low Income Housing: Suburban Strategies (Ballinger Publishing Company, 1974), and numerous law review articles having to do with housing and urban affairs. He was part of a team that conducted research and strategy identification for the Illinois Governor's Commission on Mortgage Practices in 1974, and is the co-editor of a set of working papers used by the Commission entitled "Mortgage Lending Practices in Older Urban Neighborhoods" (Center for Urban Affairs, Northwestern University, 1975).

FAIRNESS IN LENDING

Summary

This is the fourth of a series of papers analyzing publicly initiated reinvestment strategies.

Like many other states, Missouri passed a fair housing statute in the early 1970's. Section 3 of that law, which was approved June 22, 1972, is entitled "Prohibited acts of lending agencies." It provides that no financial institution doing business in the state shall deny or otherwise discriminate by altering the terms of "a loan or other financial assistance because of race, color, religion or national origin" of the borrower.

In the last three years, several states have had bills introduced in and/or passed by their legislatures which go beyond outlawing discrimination by lenders on the basis of the characteristics of the borrower to include a prohibition against arbitrary denial of a loan on the basis of <u>neighborhood</u> characteristics. Sponsors of these bills have argued that they are necessary to supplement earlier fairness in lending statutes since a refusal by a lender to make loans in certain older or racially changing neighborhoods may have the effect of discriminating against minorities without actually violating earlier fair housing statutes.

This paper reviews recent statutory and regulatory fairness in lending initiatives which prohibit loan denial on the basis of group <u>or</u> neighborhood characteristics.

FAIRNESS IN LENDING

The Fairness in Lending provisions prohibit lending institutions from discriminating in making loans. These requirements may focus on discrimination because of the location of the property involved. Such prohibitions may be enacted at the federal, state or local level, through legislative action or adoption of regulations by administrative agencies. The prohibitions may relate to home improvement or rehabilitation loans as well as mortgages. The prohibitions may cover rejections of such loans as well as variations in the terms and conditions of the loans based on the location of the house. The provision may prohibit varying the down payments, interest rates, mortgage terms, or discount or other service charges based on location.

The purpose of the fairness in lending requirements is to "give every applicant an equal opportunity to obtain a loan, by evaluating the applicant's credit worthiness on an individual basis, without referring to the presumed characteristics of a group or neighborhood."[1]

Fairness in lending provisions can be adopted through statute at the federal, state or local level. In addition, administrative agencies may be able to adopt such regulations if their enabling statutes are sufficiently broad to permit them to do so. The requirements generally apply to state and/or federally chartered financial institutions. In some cases they apply to only a specific type of financial institution. This may happen because the requirements are imposed through the regulations of a regulatory agency whose jurisdiction is limited to one type of financial institution, such as savings and loan associations.

If the requirements are adopted by statute, the role of the federal or state agency involved may be to enforce the fairness in lending provisions. In other instances the administrative agencies may promulgate the regulations initially as well as enforce them.

Fairness in lending requirements incorporate a variety of enforcement mechanisms. The federal or state regulatory agency may take the initiative to initiate fairness in lending regulations based on its analysis of information available from disclosure information provided by the lending institutions or other forms of monitoring, such as the regular examination procedure. Alternatively, enforcement may depend on individuals who feel themselves to be victims of discrimination by lending institutions filing complaints. These may be administrative complaints filed with the regulatory agency or suits filed in court by the individual who alleges discrimination.

The first agency to adopt fairness in lending regulations was the Federal Home Loan Bank Board (FHLBB), which regulates federally chartered savings and loan associations. Pursuant to the 1968 Civil Rights Act -- the Federal Fair Housing Law --

the FHLBB adopted nondiscrimination in lending regulations in 1972.[2] These regulations state that "fair housing and equal opportunity in home financing is a policy of the United States."[3] They prohibit discrimination based on "race, color, duration, application procedure, collection or enforcement procedures, or other terms or conditions of housing related loans."[4]

The regulations indicate that the refusal to make a loan in a particular area because of the age of the homes or the income level in the neighborhood may be in violation of these regulations prohibiting discrimination. They do that because a lending institution's refusal to lend in a particular area "solely because of the age of the homes or the income level in a neighborhood may be discriminatory in effect since minority group persons are more likely to purchase used housing and to live in low income neighborhoods."[5]

The first state statute which prohibited geographical discrimination is the Illinois Fairness in Lending Act of 1975.[6] The statute purports to apply to <u>all</u> banks, credit unions, insurance companies, mortgage banking companies and savings and loan associations which operate or have a place of business in the State of Illinois. This includes federally chartered as well as state chartered institutions.

Among other prohibitions, Section 4 states that "no financial institution, in contemplation of any loan to any person, may: (a) deny or vary the terms of a loan on the basis that a specific parcel of real estate offered as security is located in a specific goegraphical area."[7] The statute specifies several examples of what it means to vary the terms of a loan. These include, but are not limited to, the following practices: "1) Requiring a greater than average down payment than is usual for the particular type of a loan involved. 2) Requiring a shorter period of amortization than is usual for the particular type of loan involved. 3) Charging a higher interest rate than is usual for the particular type of loan involved. 4) An underappraisal of real estate or other items of property offered as security."[8] The statute permits financial institutions to continue sound underwriting practices in contemplation of a loan. The institution may still consider the creditworthiness of the borrower, the market value of the real estate, and the need to diversify the financial institution's portfolio.

The statute provides for enforcement through court action. Any person who has been aggrieved as a result of a violation of the geographical discrimination provision "may bring an action in the Circuit Court of the County in which the particular financial institution involved is located."[9] The statute provides that the court, on finding that the financial institution has committed such a violation, may award actual damages and, in its discretion, award court costs to the aggrieved party. The statute also contains a severability clause.[10]

If one portion of the statute or application thereof is found to be unconstitutional or invalid, that would not invalidate the remainder of the statute. For example, if the court found that the statute could not apply constitutionally to federally chartered lending institutions, it would continue to apply to the other institutions specified in the statute.

In Wisconsin, the Commissioner of Savings and Loan adopted a fairness in lending regulation.[11] This regulation became effective on April 1, 1975. It applies to state-chartered savings and loan associations. The regulation prohibits discrimination by location of the security property as follows: "no association may deny or vary terms of a written loan application on the grounds that a specific parcel of real estate proposed as security for a mortgage loan is located within a given geographic area."[12]

The regulation permits the Commissioner to take into account business judgments which are made to achieve genuine business needs such as diversification of the association's portfolio and compliance with state or federal law or regulations of any state or federal agency. The regulation also provides an <u>incentive</u> for savings and loan associations to provide the applicant with a written explanation for a modification of the usual terms. The regulations establish a presumption of discrimination if a loan is rejected or if the terms contained are other than those originally applied for, if the reason is not indicated to the applicant in writing.[13]

The regulation also requires that associations maintain a fairness in lending notice for free distribution to the public in a conspicuous place in each of their offices.[14] The form and content of the notice are to be approved by the Commissioner. Unlike the Illinois statute, the Wisconsin regulation does not have specific enforcement procedures for violations of fairness in lending provisions. The Commissioner's general procedures are utilized. A consumer who believes himself or herself to be aggrieved may complain to the Commissioner's Office. In addition, the regular examination procedure may reveal violations of the fairness in lending regulation. There does not appear to be any additional element in the examination procedure designed specifically for this purpose.

The most extensive fairness in lending regulation adopted to date was adopted by the California Secretary of Business and Transportation. This department regulates state chartered savings and loan associations in California. The regulations are extensive not only in the detail of the definitions of fairness in lending, but also in the monitoring and disclosure which are provided to assist in enforcement of the regulation.

Initially the California regulation prohibited consideration of neighborhood factors completely; but later the agency revised the rules to permit locational considerations under certain narrowly defined conditions. These regulations flatly prohibit consideration of racial or ethnic characteristics of the neighborhood and permit only limited use of other locational characteristics such as socio-economic change.[15]

In addition to the states which have already adopted fairness in lending requirements, a number of other states are actively considering such an approach. In the January, 1977, session of the Connecticut General Assembly, a bill was proposed to prohibit discrimination mortgage lending. The essence of the bill, which passed and becomes effective on October 1, 1977, is suggested by the following:

> No financial institution shall discriminate, on a basis that is arbitrary or unsupported by a reasonable analysis of the lending risks associated with the applicant for a given loan or the condition of the property to secure it, in the granting, withholding, extending, modifying, or renewing, or in the fixing of the rates, terms, conditions, or provisions of any mortgage loan or home improvement loan on real property located in the municipality in which a financial institution has a home or branch office, or in any municipality contiguous to such municipality, solely because such property is located in a specific neighborhood or geographical area, provided, however, that it shall not be a violation of this section if the mortgage loan or home improvement loan is made pursuant to a specific public or private program, the purpose of which is to increase the availability of mortgage loans or home improvement loans within a specific neighborhood or geographical area in which such investment capital has generally been denied."[16]

The bill would apply to any commercial bank, savings and loan association or credit union which makes home improvement loans or mortgage loans. It authorizes the Commissioner of banks to make such investigations as he deems necessary, granting him or her the power to hold hearings, and issue subpoenas to compel the attendance of witnesses and the production of documents.[17]

If the Commissioner finds a violation, he is to order the institution to cease its unlawful practices. The bill also provides that continued violations after such a cease and desist order make the institution liable to a penalty of $ 5,000 for each offense, to be recovered with costs by the state in any court in the state.[18]

In addition, an applicant who has been discriminated against is provided with the alternative remedy of bringing a private action in court.[19] On a finding of a violation, the court may award damages, reasonable attorney fees, and court costs.

A task force established by the Governor of Michigan proposed that Michigan enact legislation which would prevent lenders from considering the "location of property offered as collateral, racial or ethnic characteristics or trends in surrounding neighborhoods, age of the structure or surrounding structures; lenders shall not establish minimum mortgage amounts as a condition for approval of a loan application."[20]

The task force also proposed that lenders be prohibited from using any appraisal or underwriting standards which do not have a demonstrable economic basis and which tend to have a discriminatory effect.[21] The lender would bear the burden of proving that the standards which have a discriminatory effect are used as a matter of business necessity. The approach used by the Governor's task force in Michigan would essentially prohibit specific appraisal and underwriting practices as well as the use of neighborhood or locational criteria. In addition, the task force recommended monitoring by the state for compliance with these standards.

Even before the task force came out with its recommendation, Michigan had legislation pending (HB 5776, and HB5773/5774/5775) which would prohibit consideration of "geographical risks" or "neighborhood factors" which "in view of the institution may affect the present or future residential real estate value in the community."[22]

States with fairness in lending provisions have received only a small number of complaints regarding violations of these requirements.[23] Generally, financial institutions conclude that this indicates there was no redlining in the first place. Others argue that legislation or regulations are not sufficiently comprehensive, and that disclosure legislation or regulations and other measures are necessary along with the fairness in lending requirements for them to be effective. In addition, some suggest that any enforcement mechanism which depends on citizen complaints is likely to be ineffective, because of the cost and the time involved in filing and following through with such a complaint.

Traditionally, after-the-fact examinations of financial institutions by federal and state regulators have been used to determine an institution's compliance with statutes and regulations. Given the fact that the number of statutory and regulatory fairness in lending requirements at both the federal and state levels have increased sharply since the FHLBB issued its regulations in 1972, determining the extent of compliance by various institutions has become more difficult both for regulators and for financial institution managers.

This would suggest that states contemplating the passage or strengthening of fairness in lending statutes or regulations use their regulatory agencies regular or special examination processes to insure compliance, rather than relying on consumer complaints to call attention to violations. Not only does this procedure better protect consumers, but in the long run it would seem to insure that no individual institution will be singled out as a target for allegations regarding non-compliance.

The philosophy of having government define parameters of achievement for financial institutions, in assuring equal access to credit, rather than legislating categories of action, is reflected in the "Foreward" of the recently issued U. S. Office of the Comptroller of the Currency's Handbook for Consumer Examinations as evidenced by the following:

> Compliance with consumer protection legislation is a prerequisite to successful banking and a bank is acting in its own best interest by serving the public fairly and within the scope of the law.[24]

FOOTNOTES

[1] Wisconsin Administrative Code, Chapter S-L 27.01 Purpose.

[2] 37 C.F.R. 8436, April 27, 1972, Part 528.

[3] 37 C.F.R. 8436, April 27, 1972, 531.8(a).

[4] Ibid.

[5] 37 C.F.R. 8436, April 27, 1972, 531.8(c)(6).

[6] Illinois Public Act 79-634, Fairness In Lending, August 28, 1975.

[7] Ibid., Sec. 4

[8] op. cit., Sec. 2(c), (1) -(4).

[9] Illinois Public Act 79-634, Sec. 6.

[10] Illinois Public Act 79-634, Sec. 7.

[11] Wisconsin Administrative Code, S-L 27, Fairness In Lending.

[12] S-L 27.05(2).

[13] S-L 27.09.

[14] S-L 27.11

[15] Subchapter 23, Chapter 2, Title 10, California Administrative Code - "Fair Lending;" Subchapter 24, Chapter 2,

Title 10, California Administrative Code - "Guidelines Relating to Fair Lending."

[16] Act to Prohibit Discrimination in Mortgage Lending, Connecticut Public Act 77-153, Section 3.

[17] Connecticut Public Act 77-153, Sec. 8.

[18] Connecticut Public Act 77-153, Sec. 9.

[19] Connecticut Public Act 77-153, Sec. 7.

[20] State of Michigan, Final Report of the Governor's Task Force on Redlining, December, 1976, Appendix A "Recommendations," 3), a).

[21] Ibid.

[22] Final Report of Governor's Task Force, p. 9.

[23] Final Report of Governor's Task Force, P. 10.

[24] Comptroller's Handbook for Consumer Examinations, Office of the Comptroller of the Currency, Administrator of National Banks, Washington, D. C., p. 1.