Consumer Finance Monitor (Season 3, Episode 4): Redlining Claims: What is the Current Risk?

Speakers: Chris Willis and Rich Andreano

Chris Willis:

Welcome to the Consumer Finance Monitor podcast, where we explore important new developments in the world of consumer financial services and what they mean for your business, your customers, and the industry. I'm your host, Chris Willis, and I'm the Practice Group Leader of Ballard Spahr Consumer Financial Services Litigation Group, and I'll be moderating today's program. For those of you who want even more information, don't forget about our blog, consumerfinancemonitor.com. We've hosted that blog since 2011 so there's a lot of relevant industry content there.

Chris Willis:

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Chris Willis:

Now, today I'm joined by my partner, Rich Andreano, who's one of the heads of our Mortgage Banking Group and who is a leading expert on fair lending issues. And that's a good thing because today we're going to be talking about one of the most visible fair lending issues that's out there, and that is the subject of redlining. First, Rich, welcome to the podcast.

Rich Andreano:

Thank you, Chris. Glad to be here.

Chris Willis:

So we're going to talk today about lining, which there's always a lot of news about with respect to various enforcement actions on, but maybe you could start off by just giving the audience a brief description of what is redlining.

Rich Andreano:

Sure. And basically it refers to the practice that goes back several years where historically involving typically banks but more modernly also involving non-banks, where in a particular area, particularly a metro area, there would be a conscious effort not to seek applications from or make loans in certain parts of the area that were typically high-minority areas. And the term redlining comes from what they would literally do is take a map of the area and draw a red line around the areas in which they did not want to lend, so the loan officers knew not to seek applications in that area.

Chris Willis:

Now, when we think of a lot of consumer protection issues, violations of various consumer protection statutes, we tend to get really focused on the CFPB as the primary enforcer of those statutes. But when it comes to mortgage redlining, is it just the CFPB or are there other regulators that have expressed an interest historically or currently in redlining?

Rich Andreano:

Yes, there's actually a number of regulators. Primarily it's been federal but we're now also seeing state interest. The federal banking regulators, FDIC and Comptroller will look at their various banks they supervise for redlining, HUD who still

enforces the Fair Housing Act will look at redlining and a lot of the settlements recently have the Department of Justice. So there are many federal agencies here that look at this issue and it continues to be an important issue. And I know folks believe with the current administration that the federal government isn't focusing on fair lending but that's really not the case. In fact, there have been recent settlements involving the Department of Justice on redlining issues.

Chris Willis:

And in fact I think we've also been aware of the fact that on the supervisory front, both the CFPB and the federal banking regulators are just in the current year doing examinations that are specifically geared towards redlining. So I think you're right that there's no reason to believe that the different administration has brought about less focus on redlining.

Rich Andreano:

Exactly. We've been involved in both investigations and examinations involving the Bureau during the current administration, so you just don't know about these if the results are positive for the client and it doesn't result in enforcement action, but the Bureau is looking very intently at redlining.

Chris Willis:

Yep. And so, let's get a little deeper into how the Bureau or the OCC or the FDIC, HUD, or the Department of Justice might evaluate a set of facts for potential redlining. And there's sort of a recipe that past enforcement efforts seem to have followed to make a claim of redlining against banks that do mortgage lending. What is the recipe, Rich?

Rich Andreano:

Yeah, generally we've seen a fairly consistent approach recently. And with a bank, the starting point often is the analysis of the Community Reinvestment Act assessment area. The banks have to delineate what their assessment area is, and often what the regulators will look for is, is the shape of the area perhaps a horseshoe, a donut, or sometimes even a crescent. Where it appears that what the bank is trying to do is specify areas of a metropolitan area and exclude from its assessment area high-minority areas. So the thought is it shows a visual, almost conscious attempt to focus lending efforts and branch activity in majority-white areas and exclude high-minority areas. So that's often one of the first things they will look at.

Rich Andreano:

Also that goes along with that is where are the branch locations? And if there were a few or none in a high-minority areas then they will also look at, does the lending seem to be centered around the branch locations? Because obviously if the lending centers are around branch locations and fewer or no branches are placed in high-minority areas, that's another signal to the government that the bank is intentionally trying not to lend in those areas.

Rich Andreano:

Then what they'll also do is, what are the marketing efforts? What marketing has the bank engaged in and to what extent was the marketing targeted to high-minority areas. And often you'll find that in these cases where they've moved forward the marketing was focused on areas outside of the high-minority areas.

Rich Andreano:

Finally, what they do and this is somewhat controversial because the regulator decides who are your peer lending institutions, which is often debatable where the institution often disagrees who's included as its peers. But what they'll look at is the amount of applications that the bank under examination receives from high-minority areas and compare that rate to the peer institutions. Often what you'll find is by several multiples the peer institutions receive a higher percentage of applications from high-minority areas. Similarly, they'll look at actual loans made. And again, often the peer institutions by several multiples will have a much higher percentage of loans made in high-minority areas. That has been fairly consistent.

Rich Andreano:

Another factor they look in general are what does your staff look like, particularly your loan originators? Does your staff reflect the ethnicity and race of the areas in which you lend? That is a particularly important thing because that projects your image to the public because often loan officers appear in ads or on the website and to the regulator it signals who you're willing to deal with. So those are consistent factors that we see and they're often cited in complaints brought by the agencies for redlining.

Chris Willis:

Yeah. And in addition to those, that normal set of factors that you went through, we have on isolated occasions seen other things. So for example, in the BankcorpSouth case, there was an allegation in that complaint about a recording of loan officers talking in a meeting and having discussions in which they made statements that seem to indicate an attempt intent to redline. So that's not a normal element that we see in most cases but when that sort of direct evidence is available to the government they'll obviously look at it as well.

Rich Andreano:

That is an important factor because what it raises is one thing the government often relies on today, which is the whistleblower. And clearly there was a whistleblower in there, and one thing that case pointed out is all of your employees are carrying around these things, smartphones, which are capable of recording long conversations. And that's something in terms of policies in general, just not in fair lending but overall companies need to think about.

Chris Willis:

Yeah, I think that's a very important point for our audience to hear. Now, you just went through the historical set of factors that we've seen in complaints alleging redlining over the years against banks. And as far as I know every redlining enforcement action that's ever actually been brought, has been brought against a bank. But in your comments earlier in the show, Rich, you mentioned both banks and non-banks, what's going on with respect to non-banks and redlining?

Rich Andreano:

Yes. We know in fact the Bureau is looking both in the examination context and in the investigation context at redlining involving non-banks. And the big issue for the industry here is where is the guidance? Non-banks and banks are completely different animals so if the Bureau believes redlining applies to a non-bank, where is the guidance for the industry to follow in knowing at least what the Bureau's concerns are so they can adjust their practices or perhaps engage the Bureau on whether those concerns are valid?

Rich Andreano:

What we have seen is the Bureau tends to apply the approach used with banks, which is focusing on the branch networks, taking the Community Reinvestment Act approach. But there are big factors here where non-banks differ. First non-banks are not subject to the Community Reinvestment Act so they don't have an affirmative legal obligation to serve all areas of communities in particular to focus on low and moderate income areas. That's a big legal distinction.

Rich Andreano:

Second, branch networks really aren't how non-banks typically deliver their services. Often the branches are simply where the loan officers happen to live, or where a branch that the non-bank acquired happen to be located, and those offices can lend frankly throughout the nation. Usually it's just the limit of where the branch and where the loan officers are licensed and they don't necessarily focus only on the narrow area where the branch is located. So we think there is a disconnect in using the branch focus when doing a redlining analysis of a non-bank.

Rich Andreano:

Another big factor is banks have a lot more resources than non-banks. In particular, a bank and hold a loan in portfolio, whereas a non-bank mostly could only make a loan that it sells. This limits the ability for non-banks to offer products that are tailored to low and moderate income individuals. And what we have found is it appears the Bureau hasn't fully appreciated that difference when doing a redlining analysis.

Chris Willis:

Do you think it's fair to say based on our experience, Rich, where we've seen the Bureau doing exploration of redlining through both examinations and investigations, do you think it's fair to say that they appear to be looking for an example of a case in which to apply redlining principles to a non-bank?

Rich Andreano:

Indeed. We think they are looking for the perfect example to bring forward and just haven't found it yet. But there are things we think that non-banks should look at to decrease the potential for the Bureau to select them for redlining. One is in fact just how are you portrayed to the public? And the way most companies, non-banks are portrayed today is the website. And look at the website because we know of one case where we think what was a factor in triggering an investigation is the company had its loan officers on the website and pictures of the loan officers, and almost all of them were white males and that was a factor of the Bureau noted in its investigation that was of concern.

Rich Andreano:

So it look at how you're portrayed, look at your staff. And if your staff is not diverse we suggest focusing on diversity for a variety of reasons, but one of them is in fact because that's what the Bureau seems to look at initially, because it's very easy to scan websites of lenders. And they also look at, frankly, the HMDA data where you're lending in a given area. Again, we think they're applying a bank analysis where a bank really has an obligation to serve all areas where it's located and non-banks don't have that legal obligation so we think there is a disconnect there. But it's probably worth having your lending patterns compared with the lending patterns of similarly sized non-banks in your area just to see if you perhaps stand out as having a lower volume of applications and loans. And-

Chris Willis:

Yeah, that makes a lot of sense. And certainly, I would underline the point of the Bureau has the ability, obviously it has access to all the HMDA data for everybody who reports it, and it has the ability to conduct highly-automated analysis that will look for apparent exclusion of high-minority areas from a particular lender's portfolio, either of applications or originations as you mentioned, and so that's a radar you don't want to be a blip on. And so the exact analysis that you just recommended for non-banks is I think one of the most important ways that they can serve to assess their own risk under this area and to help keep themselves off the radar that they don't want to be on.

Rich Andreano:

Yes, absolutely.

Chris Willis:

Thus far we've really been talking about what I would think about as classical redlining, that is physical redlining in a particular metro area as applied to mortgage lending. And that is of course the enforcement experience that we've had. We've only ever had redlining cases in that context, banks, mortgage lending in a particular metro area. But there's a potential for the redlining theory to grow with technology and in particular, I'm talking about this concept of digital redlining. And so I think the audience would be really interested to hear, Rich, your views on what is the possibility and what would it look like to have a digital redlining theory? What would it involve and what would a regulator look at?

Rich Andreano:

Sure. And this is the classic case that we seeing that as technology evolves it allows us to do things but sometimes we have to question whether we should do those things particularly without safeguards. And this is one of the areas because with the combination of data that technology allows us to analyze more quickly, you can really segment consumers and start selecting them by various factors which can include either directly or indirectly prohibited characteristics such as race or gender or age.

Rich Andreano:

And we have seen that in the context of, although it's by no means limited to this, the Facebook-targeted advertising platform that has attracted the attention of regulators and private plaintiffs. We think the first settlement in this area was back in 2018 where the Washington State attorney general, yes, a state attorney general not the federal government, settled a claim that Facebook engaged in unfair and deceptive practices through the targeted marketing platform. And the allegation was that it allowed users of the platform to decide who would receive an ad based on various prohibited characteristics. And that was not limited to credit advertisements, it was a broader advertising basis. That was really we think one of the first settlements in the area.

Rich Andreano:

But to me, I had been concerned about it beforehand because in fact I recall a situation where I was called by the counsel and compliance staff of a... This was a non-bank lender. And they had digital advertising technology that allowed them to be highly-selective based on various traits of consumers. So they walked me through a potential plan of the non-bank to engage in advertising and at the end they asked what did I think, and my reaction was I thought it would just be much simpler and efficient to post ads that said, "Minorities need not apply."

Rich Andreano:

And I waited for the challenge and I didn't get a challenge. I got, "We were hoping you would say that, Rich." Because they similarly were concerned by the plan of the business people to engage in this targeted type of advertising and it wasn't using Facebook platform, it was a different type of platform that they had available to them. And to me really signaled that we had moved into a new era where this is very much a concern where we have so much data available on consumers and the ability to really micromanage who receives an advertisement, that you have to be very careful.

Rich Andreano:

So if any of your companies are thinking of engaging in this with any platform, you really need to drill down and figure out what is going on, what factors are being considered and are any of those factors directly prohibited characteristic or closely related so it would serve as a proxy for a prohibited characteristic? So it's a concern and I think we're going to see a lot of movement in this area. And in fact, in addition to the Washington State Attorney general we know HUD has first filed a complaint and now has filed an actual charge of discrimination against Facebook based on the targeted advertising platform. One private lawsuit has settled and a new lawsuit just in end of October was filed against Facebook. This is based on the California unrest Civil Rights Act.

Rich Andreano:

We're seeing claims both under federal law Fair Housing Act in particular which HUD's bringing, and here are California Civil Rights Act and the Washington State attorney general took an unfair and deceptive practice approach. It's a concern, but it's also a concern for the advertisers because the New York State Department of Financial Services over the summer announced that it was going to look at advertisers, probably Facebook too, but clearly advertisers that it regulates and that of course includes mortgage lenders. So this is a new area and I think it's an area that's going to draw a lot of attention from both federal and state regulators, as well as private plaintiffs.

Chris Willis:

Yeah, and I think you're clearly correct about that. And I think the advice you gave which I'd like to underline here of making sure that the attributes used in targeting advertising don't directly use protected characteristics or anything that's a close proxy for it is probably the best formulation we can use right now, and in fact that's the language in the HUD charge that you mentioned. I don't think there's any possibility of taking some of the traditional elements of redlining like peer analysis, for example, and applying it to non-mortgage lenders because there wouldn't be any peer data to show. So I'm very focused on the characteristics in the model issue that you highlighted. Would you agree with that?

Rich Andreano:

I think so. And this is an area where one concern to us is, do we have a situation where the government is enforcing first rather than providing guidance first? Clearly an area of concern and we think it's one that would be right for the Bureau to take the lead and to actually provide some guidance in this area, that we have this new technology, it offers a lot of things to do that can target but how do we target in an appropriate way? And important here, Regulation B does have a concept that a creditor can affirmatively solicit or encourage members of traditionally-disadvantaged groups to apply for credit, especially groups that might not normally seek credit from their particular creditor.

Rich Andreano:

So you have this Regulation B concept that you can try to encourage disadvantaged groups by specifically targeting them. We'd like the Bureau to fill in the blanks more on exactly what we can and can't do here, because I think there are some benefits through targeted advertising to in fact reach underserved groups, but we need some guidance here. And unfortunately it looks like regulators are leading with a stick and not with a carrot.

Chris Willis:

Yeah, I think you're right about that and we'll certainly have to follow this as it unfolds. Rich, thank you very much for sharing your insights and expertise on today's podcast. And thanks for our listeners for tuning in. Make sure to visit our website ballardspahr.com, or you can subscribe to our show in Apple Podcasts, Google Play, Spotify, or your favorite podcast platform. And don't forget to check out our blog, consumerfinancemonitor.com for daily insights into the financial services industry, and our Mortgage Banking Update for insight specific to mortgage banking. If you have any questions or suggestions for our show, please email us at podcast@ballardspahr.com, and stay tuned each Thursday for a great new episode. Thanks for listening.