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INVESTIGATING CLAIMS OF DISCRIMINATION IN HOUSING FINANCE

STEPHEN M. DANE*

INTRODUCTION

For decades, allegations have been made that the mortgage lending industry discriminates against minorities, women, and other protected groups. In the past, public and private efforts to enforce mortgage lending discrimination laws have been minimal.¹ Now, however, private litigation against mortgage lenders is on the rise, and federal, state, and local enforcement agencies have begun to pay serious attention to charges of discrimination by mortgage lenders.²

As a consequence, those charged with the responsibility of investigating and enforcing fair housing and civil rights laws find themselves in a new arena, scrutinizing the business practices of an industry with which they have had little prior contact. Public and private fair housing investigators are familiar with the traditional factfinding and information-gathering techniques used in the investigation of fair housing claims generally, such as refusals to rent and steering. However, the investigation of a mortgage lending discrimination claim usually involves different techniques and data sources.

This Article is written for the fair housing or civil rights investigator who is new to the mortgage lending field. Its focus is pragmatic, not scholarly, although some references have been provided for those interested in further study. It walks the reader, step by step, through the investigation of a claim of discrimination in mortgage lending.

Part I suggests some areas of preliminary study for those

* Cooper, Straub, Walinski & Cramer, Toledo, Ohio. An earlier version of this Article was prepared for The National Fair Housing Alliance and appears in its *Mortgage Lending Investigation Manual*. It is reprinted here with the permission of The National Fair Housing Alliance.

1. See generally Stephen M. Dane, *Federal Enforcement of the Fair Lending, Equal Credit Opportunity, and Community Reinvestment Laws in the 1980s*, in REPORT OF THE CITIZENS' COMMISSION ON CIVIL RIGHTS, ONE NATION, INDIVISIBLE: THE CIVIL RIGHTS CHALLENGE FOR THE 1990S 252-55 (1989).

2. Stephen M. Dane, *Eliminating the Labrynth: A Proposal to Simplify Federal Mortgage Lending Discrimination Laws*, 26 U. MICH. J.L. REF. 527, 531 n.13 (1993).

who are unfamiliar with the fundamental principles at play here. Part II sets forth a series of pre-investigation questions that will help focus most routine investigations. Part III lists several sources of information. Part IV discusses issues that often arise during the conciliation and settlement process. Part V provides a short discussion of concerns unique to the investigation of claims of discrimination in the appraisal process.

I. STEP ONE: BECOME AN EXPERT

Trying to investigate a claim of mortgage lending discrimination without knowing certain fundamental principles is like walking through a mine field without a map. The investigator must develop some expertise and knowledge in several areas before any intelligent factfinding or focusing of the investigation can begin. This section suggests several general areas of preliminary study.

First, one must understand the structure, operation, and regulation of the housing finance industry. Get a grasp of who the principal players are in the residential mortgage loan origination industry and in the secondary market. Obtain an understanding of the role each of the various support industries, such as appraisers and credit reporting agencies, play in the mortgage loan decision-making process.³

Second, one should become familiar with the history of mortgage lending discrimination in this country. Knowing what policies and practices have been used by the lending industry in the past will help illuminate the legitimacy of present day decisions that may operate to discriminate against minorities, residents in minority neighborhoods, women, and other protected groups. Fortunately, a number of helpful articles exist on this topic.⁴

The investigator must also become familiar with mortgage loan processing and underwriting guidelines. Most problems with mortgage loan applications that result in charges of discrimination occur during the processing and underwriting stages. The investigator must determine whether the act or decision of the

3. One well-written, easy-to-read resource is MARSHALL DENNIS, *RESIDENTIAL MORTGAGE LENDING* (3d ed. 1992).

4. Calvin Bradford has extensively documented the history of mortgage lending discrimination on the basis of race, both in the conventional market and the government-backed loan market. See Calvin Bradford, *The History of Discrimination in the Mortgage Lending Industry*, in *MORTGAGE LENDING INVESTIGATION MANUAL* Ch. 1 (National Fair Housing Alliance 1992); Calvin Bradford, *An Analysis of Underwriting and Appraisal Practices and Their Impact on Credit Availability*, 3 *REAL EST. ISSUES* 1 (1978); Calvin Bradford, *Financing Home Ownership: The Federal Role in Neighborhood Decline*, 14 *URB. AFF. Q.* 313 (1979); Calvin Bradford, *Report on the Role of the Veterans Administration in Causing Rapid and Massive Racial Resegregation*, 1-23 (1984).

lender comports with acceptable practices or whether some deviations from normal underwriting or processing procedures have occurred. Knowing and understanding basic processing and underwriting principles will aid in focusing the investigation at an early stage.⁵

One significant part of the underwriting process, which is also important in its own right, is the appraisal of real estate. The investigator must therefore become familiar with appraisal practices and principles in order to make an adequate determination whether inappropriate appraisal or underwriting practices have occurred.⁶

Finally, a working knowledge of the laws and regulations relating to mortgage lenders is critical. Prohibitory laws, such as the Fair Housing Act⁷ and the Equal Credit Opportunity Act,⁸ are well-known. But many other federal laws impose recording and reporting requirements on lenders that may be useful in the collection of data.⁹

II. STEP TWO: IDENTIFY THE FOCUS OF THE INVESTIGATION

The investigator with a good grasp of the mortgage lending industry and its procedures will quickly focus the investigation to the critical area. Neglecting to focus the investigation at an early stage will inevitably result in an enormous waste of time and resources reviewing matters that may not be relevant to the claim of discrimination that was lodged. This section suggests some preliminary questions each investigator should ask before embarking on the data collection process.

For example, *who* should be investigated? That is, who was responsible for the adverse decision or treatment? It is not always the mortgage loan originator, the company to which the applicant applied, that has made a decision adverse to the applicant. The

5. The National Fair Housing Alliance has published a Manual that provides an overview of generally acceptable loan processing procedures and underwriting guidelines. See NATIONAL FAIR HOUSING ALLIANCE, MORTGAGE LENDING INVESTIGATION MANUAL (1992). One may also want to take courses at a local university or attend seminars and training programs sponsored by lenders or their trade organizations. More advanced training can be obtained by attending seminars sponsored by the Federal National Mortgage Association (Fannie Mae).

6. See National Fair Housing Alliance, *supra* note 5, for a source which offers a relevant discussion. Several issues that commonly arise in the lending discrimination field are discussed in a workbook published by the Federal National Mortgage Association (Fannie Mae) entitled *Focus: Appraisal Guide* (1988). A resource useful to understanding the Uniform Residential Appraisal Report is AMERICAN REALTY FORMS, *Guide to the Uniform Residential Appraisal Report (URAR)*.

7. 42 U.S.C. §§ 3601-3619 (1988).

8. 15 U.S.C. § 1691 (1988).

9. These various laws and regulations are summarized in Dane, *supra* note 2.

negative decision could have been made by a secondary market buyer of the loan with whom the loan originator has a business relationship and who reviewed the loan for purposes of approval or denial. A private mortgage insurer may have refused to issue insurance even though the loan originator was willing to approve the loan application. An appraisal conducted by an independent appraiser may be the source of the decision to turn down or modify a mortgage loan request. The loan itself may have been approved but the applicant may have been unable to procure homeowner's insurance on the property. Identifying whose actions should be subject to investigation is critical and should be done early in the investigation process.

What *type* of discrimination is alleged to have occurred? Does it appear that the adverse decision was the consequence of the characteristics of the applicant (e.g., race, sex, age, etc.), or instead, was it based on property characteristics or the location of the property in a particular neighborhood? For example, an investigator faced with a situation in which an African-American applicant has been turned down, on the basis of poor credit, for a mortgage loan to buy property located in a white suburb will probably not want to spend a lot of time developing a case of redlining. There could very well be situations, however, in which the type of discrimination possibly occurring is not clear and that both forms of discrimination, applicant and neighborhood, should be investigated.

Is the problem presented a procedural one or an underwriting one? In other words, did the allegedly discriminatory behavior occur in the manner in which the application was processed (such as pre-screening or the imposition of more onerous documentation requirements)? Or was a decision made on the merits of the application itself, an underwriting decision, which might make an investigation of processing irrelevant?

Should the investigation be a treatment or an effects investigation? Does it appear as though the lender is treating applicants differently by, for example, inconsistently applying legitimate underwriting guidelines? Or is it the legitimacy of the underwriting guidelines themselves, consistently applied, that may be at issue? An effects investigation would focus on facially neutral underwriting criteria that, even if consistently applied to all applicants, may have an adverse impact on a protected category, such as women or residents of minority neighborhoods. It would therefore involve a different investigatory focus and the development of different facts than would an investigation of a lender who was applying legitimate underwriting guidelines inconsistently on a prohibited basis.

Suggesting that the investigation be focused in one or more of the particular areas discussed above does not mean that a com-

prehensive, full-scale investigation of all aspects of a particular lender's business operations should not be reviewed. There may be a lender whose reputation or lending decisions are so bad that a full-scale review of all aspects of its lending behavior is warranted. In the usual case, however, the investigator, whether public or private, will have limited resources and will be conducting an investigation in response to a particular complaint. The most efficient way to proceed is to narrow the focus of the investigation at the outset.

Additionally, it may be important for some investigators, such as private fair housing groups, to make an early assessment of whether there is a possible violation of the law. Much of the data gathering, discussed in the next section, can be successfully performed only with the use of subpoena power and judicial discovery procedures. Private fair housing groups may refer questionable complaints immediately to HUD or the Department of Justice. These complaints are typically accompanied with a list of specific inquiries to direct to the respondent institution.

III. STEP THREE: GATHER INFORMATION

Once the investigator has developed a preliminary focus, the data collection process may begin. Information relevant to an allegation of mortgage lending discrimination can come from a wide variety of sources. The most common sources are discussed in this section.

A. From the Complainant

As is true for investigating more traditional fair housing claims, counsel must interview the plaintiff applicant and record the exact sequence of significant events. In a mortgage lending investigation, counsel must establish the fundamental qualifications of the complainant (i.e., income-to-debt ratios, credit, etc.), review any written notice requirements for adverse action under the Equal Credit Opportunity Act (ECOA),¹⁰ determine the location of the property, and record the entire history of contact with the lender. Additionally, counsel should question the complainant about economic losses and other potential damages suffered.

B. From the Institution

The lender itself can be a source of a significant amount of relevant information. If the lender is a depository institution, its underwriting guidelines must be available for inspection and

10. 15 U.S.C. § 1691(d) (1988); 12 C.F.R. § 202.9 (1993).

review by the public.¹¹ Non-depository institutions may voluntarily supply copies of their underwriting guidelines. The investigator will want to review the underwriting guidelines to determine whether the adverse decision is consistent with those guidelines and/or to analyze the legitimacy of the operative guideline.

For example, is the particular underwriting guideline that led to the adverse action a holdover from past discriminatory practices that a lender has never bothered to remove? Regardless of its origin, does the operative underwriting guideline have a discriminatory effect? One lender had a policy that prohibited maximum financing if any "functional obsolescence" was noted on the appraisal. This guideline, if consistently applied, would have precluded maximum financing of virtually all older, central city (and therefore, minority) properties in one midwestern city, because older properties are more likely to have some "functional obsolescence" noted on their appraisals than are newer-built homes.

The lending institution will also have application files. Certainly the complainant's application file will be relevant, as will the files of all similarly situated applicants. "Similarly situated" applicants are those whose applications possess the same general characteristics as the complainant's, with the only significant difference being race, sex, or some other protected characteristic. The investigator will be looking for the consistency of the complainant's treatment with similarly situated applicants and/or the consistency of the application of a particular underwriting guideline.

For example, if a single female complainant has been rejected for a mortgage loan because of poor credit, the investigator will want to review approved loan files to determine if any single males with similar poor credit histories were approved by the lender. Ideally, and if resources permit, the investigator will want to conduct a statistical analysis of a random sample of the lender's loan files. The major restriction on any review of application files, however, is that they are unavailable for review without a subpoena or voluntary disclosure by the lender. If the case goes to litigation, an attorney for the plaintiff may seek the assistance of a local fair housing organization to assist in collecting and reviewing loan application data.

The lender's Home Mortgage Disclosure Act Mortgage Loan Disclosure Statements (HMDA Data)¹² should be obtained and analyzed. Such statements, if not available from the lender, can be obtained from a central repository of the Federal Reserve Bank

11. 12 C.F.R. § 528.2(a) (1993).

12. 12 U.S.C. §§ 2801-2810 (1988).

operating in the state. These statements are prepared by the Federal Financial Institutions Examination Council (FFIEC) and can be used to analyze a particular lender's patterns based on location or applicant characteristics.

Lenders subject to the Community Reinvestment Act (CRA)¹³ are required to publish a CRA statement and maintain a CRA file for the submitted public comments concerning the institution's lending performance.¹⁴ Few CRA public comment files will contain any useful information, but they should at least be reviewed to see if the institution has received any complaints in the past about its lending behavior. Complainants should eventually submit letters to the institution's CRA file regardless of the outcome of any formal investigation. The lender's CRA statement usually offers more helpful information, for it may provide a clue as to what efforts the lender is making to do business or not to do business in minority communities and minority neighborhoods.

The CRA statement may also disclose clues about the institution's marketing program. For example, does the lender target any minority communities for its loan products? Does it use minority media? Does the CRA statement suggest a focus by the institution on white, upper income, suburban business? The CRA statement will also disclose the availability of the lender's facilities. Does the lender maintain a fair number of branch offices in minority neighborhoods? Does it have different office hours or does it provide different services depending upon the location of its branches?

Many lending institutions are required to maintain Loan Application Registers (LAR). National banks, federally chartered savings associations, and state banks or saving associations insured by the FDIC all must maintain LARs.¹⁵ If the investigator can gain access to the LARs, they may reveal a pattern of treatment based on a prohibited characteristic or on a prohibited location. Many lenders will also have significant data stored in computers. Its usefulness will depend upon the type of information stored, which may not include such significant characteristics as race, sex, income, credit, the reason for denial, loan-to-value ratios, location, etc., and probably will demand expert technical assistance to analyze and interpret. Additionally, some smaller institutions still use loan committees to make decisions on residential loan applications, and consequently possess loan committee minutes. Counsel should review these minutes. Unfortunately, whether the information is in computer format or in printed minutes, counsel will most likely need to obtain a subpoena in order

13. 12 U.S.C. §§ 2901-2905 (1988).

14. 12 C.F.R. §§ 25.4, 228.4, 345.4, 563.4(e) (1993).

15. 12 C.F.R. §§ 27.4, 528.6, 338.4(a)(2)(iii).

to access it.

C. From the Underwriters

If possible, the investigator should interview the underwriter or decisionmaker who made the critical decision under investigation. Of particular importance will be the following factors: the level of experience and training the underwriter has had; the assumptions about the loan application that were made by the decisionmaker, and why those assumptions were made; and what judgments were made, and why. The investigator should ask for proof of the *written* basis for any judgment or rationale, such as the institution's own underwriting guidelines, Fannie Mae or Freddie Mac underwriting guidelines, or other written bases. During such an interview, the investigator should be attentive to the existence of unfounded prejudices (e.g., assumed high risk of low-income people or single parent households).

If possible, other underwriters employed by the institution should also be interviewed. The investigator will want to uncover their attitudes or practices, whether they have received any instructions from management that are not contained in written underwriting or processing guidelines, and whether the rationale or guideline used by the decisionmaker was legitimate and consistent with institution policy.

D. From Others Associated with the Institution

Many large lending institutions have designated CRA officers. Counsel should interview these officers. Additionally, other employees of the institution who are not necessarily underwriters or decisionmakers may also have relevant information and therefore should be sought out. Finally, counsel should locate and interview former employees, underwriters, or loan officers of the institution under investigation, for they can be the source of much information.

E. From Third Party Sources

In an ironic twist for most fair housing advocates, a significant source of useful information in the investigation of mortgage lending discrimination claims is real estate agents. Such agents, more than any other observers of the financing industry, are aware of lending institutions' reputations and practices, and may know of other instances of possible discriminatory treatment. Minority agents, or those who do a significant amount of business in minority neighborhoods, often can identify which lending institutions seem to be avoiding minority applicants or minority neighborhoods.

Other lenders may also be helpful in collecting information about the institution subject to the investigation. They may be able to comment on the legitimacy of the decision under investigation, and provide an assessment of the target institution's reputation in the lending community. Some fair housing advocates request trusted local lenders to review a particular lending discrimination claim, and procure an informal opinion that may assist in focusing further investigation.

Community or neighborhood groups, particularly those involved in neighborhood reinvestment or revitalization, are useful sources of information. They may be aware of an institution's reputation in the community or other instances of possible discriminatory conduct. Additionally, counsel should interview any independent appraisers. The investigator should look for any special instructions given to appraisers from the institution pertaining to location or suggested estimates of value. Appraisers may also be able to identify any unique problems with certain neighborhoods (e.g., a lender who frequently disputes the appraiser's estimate of value in certain locations).

F. From Regulatory Agencies

Federal and state regulatory agencies periodically evaluate lending institutions subject to their jurisdiction. Federal financial regulatory agencies, for example, conduct Community Reinvestment Act compliance reviews on a periodic basis. Some of these agencies perform statistical analyses of the regulated institution's loan files during the agency examinations. The reports, evaluations, and studies generated by these agencies may contain information helpful to the investigator. Some reports, such as CRA evaluations, are available to the public for review.

G. Testing

Testing can be a useful investigatory tool in the mortgage lending context. Testing may be particularly appropriate where the focus of the investigation is the lender's alleged pre-screening or treatment of inquirers. Comprehensive testing of an institution's underwriting decision is much more difficult. For additional information, one should consult a fair housing organization that is experienced in testing lending claims.

IV. STEP FOUR: CONCILIATION AND SETTLEMENT

After all the facts have been gathered, the investigator must determine whether there is evidence of a violation of the applicable civil rights laws. Assuming that such a determination is made, a number of remedial options are available, including the filing of administrative charges or the initiation of litigation in court. Re-

ardless of the option chosen, at some point, the parties will begin negotiating a way to resolve the claim. This section identifies the most frequently negotiated settlement terms.

Remedies for the aggrieved individual could include a mortgage loan under the original terms and conditions for which application was made; a mortgage loan at or below market rates, or under the most favorable terms and conditions available; monetary damages, including any economic loss caused by the grievant having to obtain a mortgage loan at another institution under less favorable terms (e.g., higher closing costs, higher interest rate, etc.); a refund of any loan application or processing fees that the applicant had to pay to the institution; and any other standard remedies normally associated with civil rights claims (such as attorney's fees, litigation expenses, damages for mental distress, loss of civil rights, etc.).

There are many systemic or institutional remedies available in the residential mortgage lending context. The terms of a settlement or conciliation proposal can include:

- Eliminating offensive underwriting guidelines, practices, or procedures;
- Establishing affirmative underwriting guidelines (using some of the better Fannie Mae and Freddie Mac underwriting guidelines as guides);
- Training underwriters on fair lending laws and civil rights generally;
- Remedying prior identifiable discriminatory loan decisions. For example, the institution may be required to notify other rejected applicants and offer them the option of resubmitting their application or waiving the application fee the next time they apply; the institution may be required to contact approved applicants who may have been refused more favorable terms and conditions on a prohibited basis and offer them the option of refinancing their loans without charge under the original terms and conditions requested or more favorable terms;
- Initiating affirmative marketing efforts, including increasing in marketing efforts in minority media, minority neighborhoods, or to potential minority applicants; also by increasing loan activity in targeted neighborhoods or to targeted applicants by, for example, setting aside a designated pool of money for increased penetration into such markets;
- Monitoring the lender by an appropriate fair housing or monitoring agency, including periodic meetings with the lender, periodic reviews, audits, or studies of the lender's loan activity; and including statistical analyses of the lender's loan decisions by an independent contractor reporting to the investigative or monitoring agency;
- Distributing a fair lending brochure to all rejected and withdrawn applicants, or applicants whose original loan terms were rejected, that would include a statement of the applicants' rights and reme-

dies;

—Establishing a policy of making appraisal reports available for inspection and copying to all applicants, especially those that are rejected, withdrawn, or approved under different terms and conditions; and

—Notifying all employees, underwriters, and referral agencies of any steps described above that are being taken by the lender.

V. APPRAISAL INVESTIGATION ISSUES

Counsel should specifically investigate discriminatory appraisal practices in much the same manner as described above, but with a few additional twists which are identified in this section.

First of all, one should note that an allegation of appraisal discrimination usually involves a location or neighborhood discrimination problem. Although it is possible that an appraiser will perform a discriminatory appraisal because of the race, sex, or disability of the applicant, most investigations focus upon the racial or ethnic makeup of the neighborhood within which the property is located.

To begin, the investigator will certainly want to evaluate the accuracy and completeness of the appraisal. Are all of the facts contained on the appraisal form true? Does the appraisal contain all relevant facts, or is important information missing? What comments were made about the neighborhood? Were they accurate? Were they complete? Did the appraisal mention only negative information about the neighborhood and ignore any mention of positive developments or characteristics about the neighborhood? Additionally, the investigator will want to check the consistency of the appraisal at issue with legitimate appraisal principles. Counsel may consult Fannie Mae and Freddie Mac guidelines in the absence of an easy-to-use appraisal guide or assistance from a helpful appraiser.

If possible, the investigator will want to review other appraisals performed by the same appraiser or appraisal company (a) in the same neighborhood, and (b) in comparable, white neighborhoods. The purpose of such a review is to look for any difference in analysis of value that can be explained only by the difference in the racial composition of the neighborhoods.

Moreover, the investigator should review any "standard" file maintained by the appraiser regarding the subject neighborhood. This will verify the accuracy and completeness of the information contained on the appraisal, and enable counsel to verify the consistency of such a file with similar files maintained on comparable, white neighborhoods.

If possible, the investigator should interview the appraiser. The appraiser should be asked what assumptions and data the

appraiser relied upon in forming conclusions. The interviewer must be attentive to any hidden prejudices or assumptions that may not be explicitly reflected on the appraisal (e.g., "that neighborhood will not get any better").

Finally, the investigator may also want to interview former employees, associates of the appraiser, other lending institutions, or real estate agents familiar with the applicable neighborhood.

CONCLUSION

Claims of mortgage lending discrimination will no doubt increase as the public becomes more aware of the issue and consumers become more educated about the mortgage lending process. Private fair housing agencies and public, state, and local civil rights enforcement units will need to develop a trained workforce, capable of investigating such claims competently. The suggestions contained in this Article may assist in developing such an expertise.