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BANKTHINK

Home Lenders' Fair-Lending Dilemma

By Thomas P. Vartanian and Robert H. Ledig

New mortgage and fair-lending priorities are creating hard choices for lenders.

They will need to design mortgage underwriting standards that balance the financial risks of lending to customers who fall outside the new safe harbor mortgage rules with those that may adversely affect protected classes of customers under fair-lending laws. It is an unfair choice that will cloud the development of mortgage markets, and ultimately, the availability of mortgage credit.

Next January, the mortgage ability-to-repay and qualified mortgage rules recently issued by the Consumer Financial Protection Bureau, will take effect. The ability-to-pay rule will provide non-QM borrowers and their attorneys with a new arsenal of suitability and foreclosure defenses, which may erode the value of a mortgage loan. Lenders' inclination to make non-QM loans will also be influenced by the market's willingness to buy such loans or provide financing secured by them.

Loans that meet the requirements for a QM safe harbor, which include a maximum 43% debt-to-income ratio, will be presumed to meet the ability-to-pay requirements. In contrast, non-QM loans will not benefit from such a presumption. So a lender that does not satisfy the rule's ability-to-repay requirements may be subject to borrower claims for damages and, in a foreclosure action, new defenses which may delay foreclosure. These rules will discourage lenders from lending to borrowers who can easily sue them if they default, or where there is any likelihood of foreclosure.

The challenges posed by these rules are complicated by the fact that they do not establish clear guidance for lenders to objectively determine when a loan satisfies the ability-to-repay requirement. While not quite the standard for pornography, in the litigation world that will be created by these rules, the bureau, plaintiffs and judges have great leeway to argue that they know unsuitable lending when they see it.

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Dodd-Frank strongly encourages lenders to make QM loans to protect the interests of borrowers and lenders. At the same time, however, various federal agencies may stand ready to bring fair-lending charges if a disproportionate number of borrower declinations fall among protected classes of people who are unable to qualify for a QM loan. Those agencies focus on the use of the "disparate impact" theory of discrimination as a basis for proving a violation of the Fair Housing Act or the Equal Credit Opportunity Act. Under this theory, the government or a private party may challenge a "facially neutral" lending policy of a lender – such as one that seeks to make only QM loans – as discriminatory if the application of the policy has a discriminatory effect, even if the lender has no intent to discriminate.

To rebut such a charge of discrimination, the lender would have to demonstrate that the underwriting standards it used served a legitimate business need that could not have been achieved as well by using alternative underwriting standards that would have had less of a discriminatory impact.

To date, fair-lending actions by the Department of Justice have focused on allegations of disparate "treatment," where discretion results in significantly different treatment of similarly qualified borrowers. In September, however, the DOJ announced a rare disparate impact claim where the department alleged that an institution's general $400,000 minimum loan amount was not justified by legitimate business considerations. For its part, the bureau, which has assumed responsibility for the Equal Credit Opportunity Act, has issued a bulletin reaffirming that disparate impact theory will be applied as it exercises its authority under the law.

If these developments were not enough of a challenge, the Department of Housing and Urban Development just issued a rule that codifies disparate impact liability under the Fair Housing Act. HUD's action is notable in light of potential Supreme Court consideration during the current term of whether disparate impact may serve as a basis for liability under this law. In public comments on the proposed version of the rule, industry members asked for guidance on what level of impact would be considered to be disproportionate. In its final rule, HUD declined to provide such guidance, leaving the test of a discriminatory effect to each fact-specific inquiry. It also rejected the need for safe harbors or exemptions for lending policies, including the use of credit scores or compliance with the QM rule, as neither appropriate nor necessary.

Lenders want and need to comply with the law, but without clear and consistent guidance in this area, they appear to be facing a Catch-22 of regulatory and litigation challenges. Congress and the bureau are strongly encouraging lenders to make QM loans based on the view that they best serve the interests of borrowers and lenders. Yet, to the extent that a lender decides to limit its lending to QM safe harbor loans, federal regulators have to date provided no assurance that they will not pursue a fair-lending claim for using such a facially neutral policy. Lenders deserve clear guidance on federal regulators' views on this critical issue, and clarity is imperative to allow credit markets to work efficiently and effectively.

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