Equal Credit Opportunity in the 1990s: Implications for Creditors' Institutions

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By Alvin C. Harrell and Laurie A. Lucas

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1. Catch-22 for the Financial Industry

Tighter regulation of the banking industry and a recent focus on regulations intended to eliminate credit discrimination by lenders—coupled with changing expectations about the credit industry’s responsibilities in society—have created a "catch-22" environment for lenders.

While legislation such as the Financial Institutions Reform, Recovery and Enforcement Act of 1989 (FIRREA) dramatically increased the regulatory penalties and enforcement powers available to banking regulators when a bank makes bad loans,

2. FIRREA, the Crime Control Act of 1990, and FDICIA have increased the regulatory penalties and enforcement powers available to the banking regulators, providing everything from significant monetary penalties for minor reporting delays to potentially enormous civil and criminal penalties for serious violations of the Code of Ethics. The Code prohibits the regulation of banking regulators, the enforcement of law and the Code of Ethics, and the enforcement of law and the Code of Ethics.

Under these regulations, regulators have considerable discretion to recognize failures and impose remedial and penalties, even to an extent that might be after an institution’s solvent and lead to a regulatory takeover. See, generally, Lattner, Regula


8. Bus. of Am. Am. Credit, Inc. v. Federal Reserve (Soc. of Trusts) 63 U.S.L.W. 4523 (U.S. Nov. 30, 1995) (Court held that all residual classifications require analysis under the derecognition standard regardless of whether action taken by local, state or national government agency).
In addition, the "effects test" and its current manifestation under the CRA, along with its possible application under the CRA, significantly increase the stakes for lenders, as any disparate impact resulting from a creditor's evaluation of an apartment's creditworthiness on the basis of traditional underwriting criteria may result in a CRA finding regardless of the neutrality or validity of the credit criteria used in the evaluation. This result is especially troubling given that The Community Reinvestment Act (1991) restored to employers the burden of proving the business necessity of employment practices which have a disparate adverse impact on members of a protected class under the 1991 Act. If this burden of proof were applied in the lending arena, it would require creditors to bear the nearly impossible burden of proving the business necessity of factors used to determine whether an applicant is creditworthy.

While the banking regulators are legally concerned with ensuring the soundness of the deposit insurance fund, those regulators also must be concerned with the social and political environment focused on providing funding for perceived community reinvestment needs; this has created an atmosphere in which the reconciliation of these potentially conflicting concerns poses an unprecedented process for the financial industry. The federal banking regulators have responded by seeking to enhance the profitability of the national banking charter via expanded powers, banking consolidations, interstate banking and a friendly regulatory environment, as a counterbalance to the adverse financial impact of potential mandatory credit allocation measures in the 1990s. This article explores some of the implications for banking consolidation, interstate banking and the CRA regulations and the MDHA, of the "effects test" under the ECOA, the advances and proposed amendments to the Interagency CRA Joint Regulations and the Community Reinvestment Act of 1991.

II. The Community Reinvestment Act

The CRA and its implementing regulations first took effect in 1978. The CRA requires the appropriate bank regulatory agency to review and assess the record of each federally insured depository institution in meeting the credit needs of its entire community on a nondiscriminatory basis, consistent with the safe and sound operation of that institution. The Financial Institutions Reform, Recovery and FIRREA substantially amended the CRA; the 1995 CRA amendments completely replaced the existing CRA regulations. As noted elsewhere in this issue, the 1995 CRA regulations eliminate the 12 assessments factors formerly used to evaluate a financial institution, in a stated effort to shift the focus of the CRA evaluation and rating system from one centered on the process and other lending institutions in light of the recent amendments to the CRA regulations and the MDHA, the use of the "effects test" under the ECOA, the advance and proposed amendments to the Interagency CRA Joint Regulations and the Community Reinvestment Act of 1991.

The written evaluation utilizes three tests: a lending, investment and a service test, all based on the institution's record of performance in its assessment area. The 1995 CRA regulations also allow an institution the alternative of developing its own strategy for meeting its CRA obligations rather than being evaluated under the national system. The evaluation under the lending, service and investment tests is assigned a numerical score corresponding to the following chart in each of the three areas:

<table>
<thead>
<tr>
<th>Component Test Ratings</th>
<th>Lending</th>
<th>Service</th>
<th>Investment</th>
</tr>
</thead>
<tbody>
<tr>
<td>Outstanding</td>
<td>12</td>
<td>6</td>
<td>6</td>
</tr>
<tr>
<td>High Satisfactory</td>
<td>9</td>
<td>6</td>
<td>3</td>
</tr>
<tr>
<td>Satisfactory</td>
<td>6</td>
<td>3</td>
<td>3</td>
</tr>
<tr>
<td>Needs to Improve</td>
<td>3</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Substantial Non-compliance</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
</tbody>
</table>


The institution's component test ratings are then tabulated, and a composite assigned rating is made based on the following scale:

Points: Composite Assigned Rating
20 - 19 Outstanding
11 - 10 Satisfactory
05 - 04 Needs to Improve
00 - 04 Substantial Non-compliance


The institution's rating and a statement describing the basis for the rating are then made available to the public. Initially the CRA was relatively benign, but the force of the CRA has changed in two significant ways. First, the 1995 CRA regulations modify the evaluative criteria used by regulators when assigning a particular financial institution a CRA rating. It is not clear, however, that the new criteria are any less subjective than the old system, and if anything, they are more complex than ever. Second, the CRA ratings are now released to the public in a written evaluation by the appropriate supervisory agency. These changes will increase the pressure on banking institutions to increase community lending and investment activities, and consequently will increase the discretion of the banking regulators to scrutinize bank management policies as part of the examination process.

III. The Home Mortgage Disclosure Act

As with the CRA, FIRREA amended the MDHA; the 1995 CRA regulations also affected the MDHA regulations. MDHA is primarily a disclosure statute which requires a financial institution to compile and report data on mortgage lending within an institution's Metropolitan Statistical Area (MSA). FIRREA broadens the scope of data reporting required under MDHA.

Specifically, FIRREA amended MDHA's requirements by (1) extending the scope of the term "depositary institution" to include any "lending institution," (2) requiring data on "completed applications" in addition to loans actually made by the institution, and (3) requiring that this "data" include information involving mortgagee or mortgage applicant "groups" according to census tract, income level, racial characteristics, and gender. These new requirements likely will result in substantial new reporting costs for all depository institutions. The new MDHA disclosures are required to be filed with the appropriate state or Federal regulator on or before the following dates:

1. 6 months from the effective date of the new regulations
2. 1 year from the date of the notice
3. 2 years from the date of the notice


The reporting requirements now in place under MDHA, in conjunction with the ECOA and Regulation B, facilitate proportionate allocations of credit based on racial or ethnic characteristics or other politically sensitive criteria, quite aside from the CRA. Experience with the equal employment laws lends support to this ruling and the related findings and conclusions.

A. Background of the ECOA

The CRA was enacted in 1974, as part of the Consumer Credit Protection Act (1968), to deal with discrimination based on sex and race in the consumer credit market. Under the provisions of the amended Act, it is unlawful for any "creditor" to discriminate against any "applicant" with respect to any aspect of a credit transaction on the basis of race, color, religion, national origin, age, sex or marital status, thus as long as the applicant has the capacity to contract, because all or part of the applicant's income derives from any public assistance program, or because the applicant has in good faith exercised any right under the Consumer Credit Protection Act. Implementing regulations also were promulgated by the Board of Governors of the Federal Reserve System to enforce the ECOA. The Act is reviewed annually, and is subject to legislative change each year. The ECOA applies to private creditors as well as regulated institutions.

banking institutions; the former may be even more exposed than the latter, as they lack the paternalistic protections of banking regulators with safety and soundness responsibilities and a possible inclination to protect their charges.

The ECOA deals with all phases of a credit transaction, including the application and loan process as well as ongoing activities under the ECOA, and also must perform certain affirmative obligations, 36 related largely to the ECOA's notification requirements. 37 If a creditor fails to comply with the ECOA's affirmative obligations, regardless of a lack of specific intent to do so, liability will result. 38

The ECOA provides for administrative enforcement as well as civil liability. 39 Most litigation under the ECOA has been initiated by administrative agencies. Depending upon the powers available to the administrative agency involved in the dispute, however, the results of administrative enforcement (i.e., an action brought by the Consumer Credit Protection Committee for the creditor private litigation, since the ECOA allows the agencies to enforce compliance to the extent of any authority conferred on the agency by other law. This authority is in addition to the powers prescribed under the ECOA. 40

Though private civil litigation was intended to be the primary means of enforcing the Act, there has been little, if any, evidence that the death of private enforcement is related to problems in obtaining the data needed to prove that discrimination might have occurred. 41 FIRESA and the 1995 CRA revisions have amended the HMDA, however, to require the collection by creditors of the type of data that would be helpful to the plaintiff in a disparate impact or disparate treatment case. 42 In addition, the proposed amendments to the ECOA would eliminate the prohibition relating to the collection of data monitoring on an applicant's race, color, sex, religion, or national origin, although the use of such data in the evaluation procedure would continue to be prohibited. Data collection would be voluntary, and if the applicant refused to supply the data, the creditor would not be able to require it; nor would the creditor be allowed to visibly gather the data. 43 The possible implications for the credit industry in light of these changes, especially given the incorporation of the effects test not in the ECOA, are many.

V. Inapplicability of the Effects Test in Credit Transactions

A review of the applicable Supreme Court cases 44 suggests that the effects test is likely to be inappropriate under the ECOA. 45 Creditors also felt that any inclusion in the commentary of the rule of evidence, laid down in the Griggs and Allegheny cases, should refer as well to the later Supreme Court decision in Washington v. Davis. 46

In Washington v. Davis, the Supreme Court held that, under the due process clause of the Fifth Amendment of the United States Constitution, a racially neutral qualification for employment of police officers set by the District of Columbia was valid, making clear that the policies of Griggs and Allegheny cases. 47

References to the effects test were also incorporated into the Commentary and also in a footnote to Regulation B 48 where they remain to this day; the recent amendment to the Commentary also adopted the burdens of proof for employment cases that were certified in the 1995 Act. 49 There is no apparent statutory basis for these references.

Creditor's and their counsel's object of concern was that a new amendment to the ECOA was beyond the statute and regulation and might tend to stimulate frivolous private lawsuits. There were concerns that the making of a claim of discrimination based upon the "effects" of a credit decision would bring into question the entire range of credit decisions and the results in examination of all of the applications received by a creditor over an extended period to identify the possible significant
course of race, sex, or any other prescribed basis as a factor attributable to each and every transaction in the creditor's files. 50 Creditors also felt that any inclusion in the commentary of the rule of evidence, laid down in the Griggs and Allegheny cases, should refer as well to the later Supreme Court decision in Washington v. Davis. 51

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In addition, the Griggs and Allegheny cases were carefully distinguished from the cases of general applicability that were considered by the Supreme Court to determine whether the Civil Rights Act of 1964 46. Clearly, Title VII would be inapplicable in a credit transaction.

B. The ECOA As a Credit Allocation Device

Many concerns focus on the ECOA, which is potentially broader and even more potent than the amended CRA. 41 In other words, it could be argued that "discrimination" violates not only the CRA, but the ECOA as well. 42

The effects test was developed by the courts in response to federal statutory requirements in the area of employment law. There are, however, so many differences between creditworthiness and job qualifications that it is virtually infeasible to compare the two or to gauge the relationship to the legal issues involved. Allocation of too few available jobs is too many people is fundamentally different from the problems involved in extending credit. For example, job qualifications (at least for those paying average wages) are fairly simple to demonstrate and are the same for each identical position. Not so with standards of creditworthiness, which vary from debtor to debtor, from creditor to creditor, from time to time, between types of credit, and may depend on terms and collateral, legitimate differences in assessments of probable risk, predictions about the future, and the size of the loan or credit extended as well as the time at which and for which it is extended. A credit decision is less subject to a decision involving in the stock market. The determination of a simple or uniform standard for individual creditworthiness that would fit a wide spectrum of creditors, borrowers, collateral, types of credit and economic circumstances would be a complex and impossible task which cannot be compared to the relative simplicity of determining whether an applicant is capable of performing a routine job (as was the case in Griggs).

The rate of charge also differentiates creditworthiness standards from employment standards. Within narrow limits, employers generally pay the same wages for the same work. 50 In credit transactions, however, rates of charge may vary from state to state, creditor to creditor, or borrower to borrower, and even transaction to transaction, depending on a wide array of legal, economic, and sometimes unquantifiable factors, generally relating to individual perceptions relating to inherent uncertainties about the future and the assessment of credit risks.

Moreover, "protected categories" under the ECOA are much broader than those covered by employment statutes. For example, marital status, age, receipt of public assistance and good faith exercise of Consumer Credit Protection Act rights are excluded from the ECOA but not from Title VII, again making these two acts difficult to compare.

Finally, under an effects test applied to all phases of a credit transaction, evidence of disproportionate impact (even if possible to obtain) should not be regarded as evidence of a violation of the Act. Under the ECOA, an affirmative obligation to consider the ECOA is to consider each individual application on the basis of his or her own creditworthiness and not on the basis of any assumptions about the characteristics of
VI. The Civil Rights Act of 1991 and the Ward's Cove Decision

Efforts to convince the FRB that the effects test is inappropriate for credit transactions and that it should be deleted from Regulation B and the Commentary, however, have been unavailing. The Civil Rights Act of 1991, therefore, also should be added to the industry's list of concerns as it effectively overruled the Supreme Court's rating in Ward's Cove Packing Company, Inc. v. Frank Attnell in employment cases.

Ward's Cove involved Alaskan salmon fishing in which had a predominantly white work force in skilled jobs and a predominantly non-white work force in unskilled jobs that paid less. The U.S. Court of Appeals for the Ninth Circuit held that this statistical imbalance created a prima facie case of discrimination against the companies under Title VII of the Civil Rights Act of 1964. The Supreme Court disagreed. Its opinion stated:

The lower court's theory at the very least would mean that any employer who had a segment of his work force that was for some reason 'racially' imbalanced, could adopt it into court and forced to engage in the expensive and time-consuming task of defending the 'business necessity' of the methods used to select the other members of his work force. The only practicable option for many employers will be to adopt racial quotas...this is a result that Congress expressly rejected in drafting Title VII.19

The court held that the proper comparison was between the proportion of a racial group in the work force and the proportion of qualified members of that group in the pool available to the employer. The Supreme Court also held that the plaintiff must specifically identify the employment practice alleged to be responsible for the disparity. Once that has been done, the employer must produce evidence of a business justification for those practices, but the ultimate burden of persuading the court that discrimination exists remains with the plaintiff.

Ward's Cove did not change the laws prohibiting discrimination in employment (or credit), but it did drastically change the burden of proof required to make a case of unlawful discrimination in employment (and, indirectly, in credit) cases. In essence, the Supreme Court held that discrimination in Title VII cases must be proved rather than assumed.20 This holding would have directly undermined the viability of the "effects test" in the context of credit transactions. The Civil Rights Act of 1991, however, reversed this decision restricting to the employer the burden of proving the business necessity of employment practices having a disparate adverse impact. However, the effects of this legislation on the consumer finance industry are unclear.

The FRB conceded, in its explanation of the 1976 revision of Regulation B (dated December 29, 1976), that "[i]f a judicial doctrine the effects test is not well suited to regulatory implementation. In addition, it is, of course, subject to change if it is examined as applied by the Courts."21

The effect of the 1991 Act legislation which overruled Ward's Cove, the FRB's statement of the continued reference to the effects test in Regulation B and the ECOA Commentary, the 1995 CRA revisions, HMDA, and proposed revisions to Regulation B all pose potential problem areas for the consumer 'finance industry.

VII. Implications for Creditors in the 1990s

Two dramatically divergent trends are apparent from this analysis. The U.S. Supreme Court in Ward's Cove had been moving toward a literal construction of federal law22 and away from the creative use of judicial power to fashion new means of remedying social ills. These pronouncements would weigh heavily against efforts to allocate credit under the guise of an ECOA "effects test." At the same time, however, Congress, with the passage of FRRREA and The Civil Rights Act of 1991, the banking regulators with the 1995 CRA revisions, and the Clinton Administration with its activist Justice Department enforcement actions, have become increasingly responsive to certain political pressures to ameliorate problems in urban and inner city areas by using the resources of the financial system. The accommodation between these trends illustrates a basic, unresolved socio-political issue relating to the extent to which the public has a legal entitlement to allocate private credit. Like it or not, the credit industry is at the center of this storm. The direction of the prevailing political wind will significantly affect the nature of our financial system in the 1990s. For lenders, their attorneys, and their customers, no issue is of greater significance.

19. 42 U.S.C. 2000e-2 a (1976). It is also worth noting that the Supreme Court in 1976 rejected an equal employment opportunity commission charge in which a black applicant was denied employment as a bakery worker because a store manager who was in charge of employment had a personal bias against blacks. See, for example, Remmers v. United States, 343 U.S. 227 (1952), and 42 U.S.C. 2000e-2(a) (1976).
23. See ECOA, 12 U.S.C. 2901 et seq., which was introduced to level employees in Fair Credit and Employment.

MEMORIAL ESTABLISHED FOR JIM WALTER'S CHILDREN

In June 1995, shortly before he was to address fair-lending issues at a program sponsored by the Conference in Dallas, Texas, Governing Committee member James Walter was killed in a tragic auto accident near his home in Portland, Oregon. A scholarship fund has been established for the benefit of his minor children. Contributions should be sent to:

Walters Children's Scholarship Fund
U.S. Bank of Oregon
1901 NE 42nd Avenue
P.O. Box 13325
Portland, Oregon 97223
Account No.: 0096738841