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Key Fair Lending Insights From DOJ 'Redlining' Deal

By **Melanie Brody** (August 1, 2019, 1:11 PM EDT)

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Last month, the U.S. Department of Justice settled redlining claims[1] against First Merchants Bank, an Indiana-based bank regulated by the Federal Deposit Insurance Corporation. The First Merchants settlement[2] is the first redlining matter initiated[3] and settled under the Trump administration, and it contains useful insights for institutions seeking to evaluate their own redlining risk. This article summarizes the case and the key compliance takeaways.

Background and Allegations

Investigation Was DOJ-Initiated

Although many DOJ fair lending investigations arise out of referrals from a prudential regulator or the Consumer Financial Protection Bureau,[4] the First Merchants settlement documents do not mention an underlying regulatory investigation. Thus, it appears that the DOJ initiated the matter of its own accord. This suggests that even though the pace of fair lending enforcement has slowed considerably since President Barack Obama left office,[5] the DOJ has not completely abandoned the issue and is, in fact, willing to proactively open its own fair lending cases.

Factual Allegations

As is the case with all redlining matters, the DOJ's case against First Merchants consisted of a combination of factual claims and statistical allegations. According to the complaint, First Merchants adopted policies and procedures that were "intended to deny residents in majority-Black census tracts equal access to, or discourage them from applying for, real estate-related credit." Specifically, the DOJ claimed that First Merchants:

- Largely excluded majority-black census tracts from its Community Reinvestment Act assessment area, while including "overwhelmingly white counties," thus creating a horseshoe-shaped assessment area that "carved out the urban core" of Indianapolis-Marion County;[6]

- Failed to maintain any branches in majority-black areas of Indianapolis-Marion County despite growth and expansion into white areas in recent years;

- Failed to employ any residential mortgage loan officers with any presence in majority-black census tracts until more than a year after the DOJ initiated its redlining investigation;

- Failed to “meaningfully advertise” in majority-black areas of Indianapolis-Marion County and intentionally focused its residential mortgage loan marketing (consisting of direct mail, billboards, and online and digital advertisements) in white suburban counties; and

- Implemented a mortgage lending policy that expressed a preference for “existing or potential customers” in its “branch footprint,” which is based in majority-white areas.

Statistical Allegations

The DOJ alleged that the foregoing conduct discouraged prospective applicants in “majority-black neighborhoods” from seeking loans from First Merchants and resulted in the bank making a smaller percentage of loans in those neighborhoods compared to other lenders. The DOJ presented a series of statistical comparisons to support these claims.

The DOJ’s statistical analyses focused on the bank’s application and origination volumes in the Indianapolis-Carmel-Anderson, Indiana metropolitan statistical area as compared to the application and origination volumes of its peer institutions.[7] Specifically, the DOJ claimed that between 2011 and 2017, First Merchants’ peers received applications from majority-black census tracts within the Indianapolis MSA at three and a half times the rate of the bank. Interestingly, the DOJ also claimed that within majority-black census tracts, First Merchants received a majority of its applications — 69 percent — from white applicants, compared to its peers, which in the same census tracts received only 36 percent of their applications from white applicants.

The DOJ further claimed that First Merchants underperformed its peers in loan originations within majority-black census tracts in the Indianapolis MSA. Specifically, the DOJ claimed that between 2011 and 2017, First Merchants’ peers originated residential mortgage loans in majority-black census tracts at more than two and a half times the rate of the bank.

Summary of Settlement Terms

Among other things, the settlement agreement and agreed order between the DOJ and First Merchants requires the bank to:

- Refrain from discriminating on the basis of race in violation of the Equal Credit Opportunity Act or the Fair Housing Act;

- Engage a consultant to assess the bank’s fair lending risk management program, and revise the bank’s policies, procedures, monitoring and training to ensure compliance with fair lending laws as they apply to marketing and making available products in majority-black census tracts;

- Maintain a fair lending monitoring program, including statistical analysis of mortgage underwriting, pricing and redlining risk;

- Conduct fair lending training;

- Conduct a community credit needs assessment focused on majority-black census tracts in Indianapolis-Marion County;

- Designate a full-time director of community lending and development to oversee development of the bank’s lending in majority-black areas;

- Serve all counties in its CRA assessment area, including Indianapolis-Marion County, and notify the DOJ of any proposed changes to its assessment area;
- Open one new, full-service branch in a majority-black census tract in Indianapolis-Marion County as well as a loan production office in Indianapolis-Marion County that is centrally located to multiple majority-black census tracts and accessible to residents of those census tracts by public transportation;
- Spend $500,000 on advertising, community outreach, consumer financial education and credit repair counseling; and
- Invest at least $1.12 million in a loan subsidy fund to increase the amount of home mortgage credit it extends to residents of majority-black census tracts in Indianapolis-Marion County.

Key Compliance Takeaways

Although every enforcement action and resulting settlement is based on unique facts and circumstances, there are several lessons that residential mortgage lending institutions can learn from the First Merchants case.

First, even though fair lending enforcement appears to have been deprioritized since President Donald Trump took office, it has not disappeared. Redlining in particular remains a focal point,[8] and, of course, if a Democrat wins the next presidential election, redlining and other fair lending issues will reemerge as enforcement priorities.

Second, although redlining investigations involve an evaluation of both statistics and facts about the lender's efforts to either seek or avoid extending credit in minority areas, it is often the statistics that trigger the start of an inquiry. Agencies with fair lending enforcement authority use screening software that enables them to identify institutions that are underperforming their peers in minority area lending. Thus, even though statistics should not be used as the sole indicator of redlining risk, they do serve as an important tool for understanding areas of potential risk as well as a gauge for whether an institution is likely to be targeted for an investigation.

While it's very important to avoid using statistical findings from one case as binding compliance thresholds or clear markers of a violation, they can provide benchmarks for assessing risk. In the First Merchants case, the DOJ claimed that the bank's peers received applications from majority-black census tracts at three and a half times the rate of the bank and made loans in majority-black census tracts at two and a half times the rate of the bank. Lenders that underperform their peers at higher rates than First Merchants did may be more likely to face a potential redlining inquiry.[9]

In addition to statistical performance, lenders should consider whether their business practices raise potential redlining concerns or, on the other hand, could be used to defend inferences made from unfavorable statistical findings. For depository institutions, a CRA assessment area that gerrymanders around minority communities can be a red flag. Locating branch offices in racially and ethnically diverse locations as opposed to in exclusively white areas can serve as evidence that a lender desires to serve minority communities.

Similarly, ensuring that advertising and marketing efforts reach minority area residents can counteract claims that a lender is seeking to avoid lending in such areas. Finally, implementing a strong compliance program, including monitoring and effective training, can help demonstrate a lender's commitment to fair lending.

Redlining can be a complicated issue, and every institution has a unique set of circumstances that influence whether it may be at risk. Nevertheless, lenders can use the First Merchants settlement as a tool for evaluating their own compliance situation and whether they are a likely target for a redlining inquiry.

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[1] A copy of the complaint can be found here: https://www.justice.gov/opa/press-release/file/1173131/download.

[2] A copy of the settlement can be found here: https://www.justice.gov/opa/press-release/file/1173146/download

[3] In May 2018, the Trump administration's DOJ settled a redlining complaint against Minnesota-based Klein Bank that President Obama's Attorney General Loretta Lynch had filed just one week before President Trump's Jan. 20, 2017 inauguration.

[4] According to the complaint, First Merchants has $9 billion in assets, making it too small to be supervised by the CFPB, which only has supervisory authority over depository institutions with assets of more than $10 billion.

[5] For example, according to its most recent Fair Lending Report to Congress, during 2018, the CFPB did not bring any fair lending enforcement actions or refer any fair lending matters to the DOJ.

[6] The complaint states that in 2016, First Merchants added Indianapolis-Marion County to its assessment area, thus addressing the exclusion of majority-black census tracts.

[7] For purposes of these comparisons, the DOJ defined peer institutions as other financial intuitions that received between 50 percent and 200 percent of the bank's annual volume of mortgage applications in the Indianapolis MSA. This definition is intended to limit the institutions against which First Merchants was compared to those that had a reasonably comparable volume of mortgage lending activity. Although in some cases it may be appropriate to further refine a lender's peer group for purposes of analyzing redlining risk, e.g., by comparing predominantly conventional lenders to other predominantly conventional lenders (versus lenders that make a material volume of government-insured or -guaranteed loans), in this case, it appears that the DOJ focused its peer definition exclusively on application volume.

[8] The CFPB's June 2019 Annual Fair Lending Report also specifically indicates that "[r]edlining continues to be a priority for the Bureau in both mortgage lending and small business lending."

[9] It's also worth noting that in addition to reviewing relative volumes of activity in majority-minority census tracts, the DOJ also looked at the percentage of applications from black versus white consumers within majority-black census tracts.