DISPARATE IMPACT’S EFFECTS ON PRICING AND COMPENSATION

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“In contrast to a disparate-treatment case, where a “plaintiff must establish that the defendant had a discriminatory intent or motive,” a plaintiff bringing a disparate-impact claim challenges practices that have a “disproportionately adverse effect on minorities” and are otherwise unjustified by a legitimate rationale.”
Understanding Decision

- *Smith v. City of Jackson* significant because Supreme Court stated that effects based discrimination theory (i.e. disparate impact) has to be clear intent of the statute.

- Consider statutory language relating to “tending to deprive” or “adversely affect” vs. FHA’s “otherwise make unavailable”
Fair Lending Litigation

• Supreme Court
  – *Texas Dept. of Housing and Community Affairs v. The Inclusive Communities Project*
  – Does the Fair Housing Act prohibit disparate impact?
  – Texas awarding subsidies for affordable housing construction more frequently in minority neighborhoods
  – Inclusive sued Texas for disparate impact of its policies
The Decision

• Antidiscrimination laws must be construed to encompass disparate impact where their text refers to the consequences of actions

• 42 USC 3604 (a) To refuse to sell or rent after the making of a bona fide offer, or to refuse to negotiate for the sale or rental of, or otherwise make unavailable or deny, a dwelling to any person because of race, color, religion, sex, familial status, or national origin.
The Decision

- Because of the language “otherwise make unavailable” the court construed that as focusing on the effects of policies as opposed to actions.
- As such Court ruled that disparate Impact applied.
- Question: Is the phrase “otherwise adversely affect” the same thing as “otherwise make unavailable”?
The Decision

- But the Court created distinctions between Disparate Impact in the employment context (Title VII) and its applicability under the FHA:
  - Cannot be based solely on the showing of statistical disparity; must have a robust causality requirement to challenged policy or practice
  - Defendants must have leeway to explain the valid interest served by their policies and thus can avoid liability if they can prove it is necessary to achieve a valid interest
Disparate Impact

- Show that a policy of the lender causes a discriminatory effect even if discriminatory intent is not present
- Plaintiff needs to identify policy and identify causal relationship to discriminatory effect
- It is up to defendant to prove it was consistent with business necessity.
## Treatment vs. Impact

**Treatment**
- Pleading stage must show inference of discriminatory intent
- Employer need only proffer nondiscriminatory reason. Not a burden of proof
- Employee’s burden to show explanation was pretext

**Impact**
- Need only show disparity and causal connection to policy
- Lender must show that the challenged policy is necessary to achieve valid interest
- Borrower must show achievable in less impactful manner
Business Necessity

• “The justification must be manifest and may not be hypothetical or speculative. Factors that may be relevant to the justification include cost and profitability. But even if a policy or practice that has a disparate impact on a prohibited basis can be justified by business necessity, it may still be found to be in violation if an alternative policy or practice could serve the same purpose with less discriminatory effect.” Federal Reserve.

• Key factor is burden of proof...
What is a valid interest

- Revenue maximization is generally not considered a valid interest.
- Valid interests often examine operating costs, enterprise risk, impositions on business required by 3rd parties. Things the business has to do to remain viable and comply with other laws and/or lawful obligations to third parties.
- Business necessity needs to be tailored to those valid interests.
Problems with Business Necessity

• Not even well defined in the courts because congress and the courts have gone back and forth

• Usually comes up in context of employment minimum eligibility which is individualized determination inapposite to residential lending on credit characteristics which is not individualized
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<td>Operational costs</td>
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Practical Implications

- More claims, new claims, everything can be challenged
- The key for lenders is to minimize and fully understand the risks by analyzing practices and procedures and undertaking regression analysis
Compensation

• Risks Not Rules
  – Different compensation with pricing margins
  – Branch margins varied within region
  – Comp plans that allow discretion and adjustments
  – The greater the number of and more frequent the adjustments and plans the bigger the risks
  – Undefined and unstructured plans are problematic
Compensation

• Review
  – Range of compensation
  – Number of plans
  – Historical changes
  – Change rationale and patterns
  – Examine by region, branch, loan officer
  – Review extremes on both ends of spectrum
  – Documentation and descriptions of plans
  – Source distinctions
Compensation

• It includes
  – Expenses and reimbursements
  – Marketing
  – Allowances
  – Averages
    • This is not to say profitability isn’t a consideration amongst other factors when applied over a number of transactions to determine viability
• Discretion
  – Can it go up or down?
  – What is extent and limitations
  – Policies, training, considerations
  – Exception approval beyond discretion
  – Exception documentation and approval process
Pricing

•Margins
  – By product
  – By region
  – By state
  – By branch
  – By loan officer
  – Beware of compounding margins
Fees

- Distinctions in fees are a bad idea unless clearly justified and even then you should avoid.
- No one understands interest rates and yield spread. Everyone understands the price of a can of soda.
- Process fees and underwriting are perceived as cost allocation and not a fee.
• Federal Reserve Board on October 22 Webinar raised concerns about target pricing to the extent it varied by LO’s who concentrated on minority areas
• Did not per se indicate it was discriminatory but rather that it could have discriminatory effects/practices depending on implementation
• Must have regression analysis, monitoring across LO’s to avoid reverse red-lining
Prevention

• Training
• Policies and procedures
• Regression analysis by branch and company-wide
• Look for patterns that cannot be explained by a legitimate rationale and look for branch-wide outliers
Prevention

- Evaluate effects of compensation plan (actual and potential) on pricing
- A branch in a high concentration minority area with substantially varied pricing from other branches
- Loan officers with higher margins that have high concentration of minority customers
• Document and define pricing exceptions
• Regression and Match Pair Analysis
• Frequency varies on size of institution; at least annually
• Review outliers and ensure proper documentation of outliers
• Determine whether to adjust policies/procedures
• Also gives insight into HMDA reporting/data integrity
Doing regression analysis

- Not based merely on HMDA data
- Depending on volume quarterly-annually
- Cost can be as little as one loan
- Need for interpretation is key
- Need for privilege is important as well as discretion
- Data integrity is critical
Fair Lending Analysis

• Regression and Match Pair Analysis
  – Use HMDA data and overlays (LTV, FICO score, etc.)
  – Regression Analysis
    • Determines whether race, ethnicity, or other prohibited basis is a significant factor in pricing or underwriting decisions
  – Match Pair Analysis
    • Protected class applications/originations are compared to similarly situated non-protected class applications/originations to see if protected class borrowers are treated similarly
What to do with Outliers?

• Provide explanation for outliers to dispute disparate impact/treatment claims
• Search for trends (geographic, branch, LO, manager level)
• Corrective actions based on trends
  – For example, adjust pricing/comp if necessary
  – Enhance exception documentation
Most Important

- Regular Regression Analysis with Interpretation and Management Involvement is critical
- Required by the CFPB pursuant to 2008 exam guide
- Fair lending is not just about pricing. It's about steering, variances, product selection, etc.
• Do an overall review of compensation and pricing practices and policies to ascertain fair lending risks
• Develop regression and testing plan based upon review
• Consider geographic dispersion and location of businesses in connection with pricing and compensation
• DO NOT TAKE SHORTCUTS
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