REDLINING UPDATE: CONFRONTING DISCRIMINATION IN LENDING AND THE COST OF NONCOMPLIANCE

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Due to an increase in investigations of alleged redlining reported by banks across the country, we wanted to raise awareness of this issue and highlight the potential repercussions from an insurance perspective. Recent enforcement proceedings should invigorate lenders to take a closer look at their current lending policies and procedures, automated underwriting systems, and business affiliations in an effort to mitigate and fully understand the financial and reputational risks of redlining exposure. Additionally, a close examination of insurance policy language is imperative.

OVERVIEW

Redlining is the unlawful practice in which lenders deny mortgages, insurance loans, and financial services to creditworthy, otherwise-eligible borrowers due to applicants' race, color, ethnicity, and/or national origin, or because the residential properties for the loans sought are located in areas with greater percentages of historically disadvantaged racial and ethnic groups.[1] Fair lending laws that prohibit redlining also preclude discrimination based upon an applicant's religion, sex, handicap, receipt of certain public funds, or familial status.

The abolishment of redlining has been an important issue for regulators since the passage of the Fair Housing Act (FHA) in 1968. Recently, the federal government has ramped up its anti-redlining enforcement efforts, which has resulted in complaints being filed against banks and other residential mortgage lenders primarily for violations of the FHA and the Equal Credit Opportunity Act (ECOA). In addition to reputational harm, redlining claims can expose institutions to significant financial losses.

Redlining claims are often not entirely covered by insurance (if covered at all). Although some financial institution management and professional liability insurance policies provide coverage for redlining claims, the coverage is largely limited to paying defense expenses. Many settlements achieved with the Department of Justice (DOJ) or federal regulators require alleged offenders to institute remedial measures — such as developing community partnerships, loan subsidies, advertising, and outreach programs — and demand that lenders pay substantial fines and monetary penalties. In those cases where insurance is triggered, the previously referenced damages are typically excluded from coverage.

Recent enforcement proceedings should invigorate lenders to take a closer look at their current lending policies and procedures, automated underwriting systems, and business affiliations in an effort to mitigate and fully understand the financial and reputational risks of redlining exposure.

HISTORY OF REDLINING

In order to prevent redlining, it is important that everyone in a lending role understand the history of the practice, how to identify it, and ways to proactively prevent it. Additional trainings or internal communications may be necessary to remind employees of their obligations under the applicable laws.

The Great Depression of the late 1920s and early 1930s was a time fraught with massive unemployment, job losses, and home foreclosures in the United States. The financial crisis led to a drastic fall in residential loans and homeownership. Congress responded by passing the National Housing Act of 1934 (NHA), which created the Federal Housing Administration. Although the NHA legislation was intended to make residential mortgages more accessible and affordable, improve housing conditions, and stem the tide of foreclosures by insuring mortgage lenders and banks against the threat of borrower default, some of the policies implemented along with the law had a lasting negative impact on certain communities of color.[2]

Many of the post-NHA underwriting guidelines were based on a 1934 dissertation by Homer Hoyt (then-Fair Housing Administration chief economist) wherein he ranked the "desirability" of people according to their race and ethnicities. Hoyt's opinions led to widespread lending discrimination against certain groups and the lasting effects still persist today.[3] Using Hoyt's theory, certain groups of people were deemed by loan underwriters to be the most detrimental to housing values and were placed in so-called "red areas" (regardless of income) that were designated on maps with red lines. In response, most banks and other mortgage lenders refused to make loans in these neighborhoods or, if they did extend credit, would only do so on an expensive basis. The discriminatory practice was colloquially called redlining and was legally permissible until the 1968 passage of the FHA (Title VIII of the Civil Rights Act of 1968 (as amended), 42 USC § 3601, et seq).[4]

Applicable laws: In general, there are two main laws, along with their implementing regulations, that prohibit redlining with regard to mortgages, student loans, business loans, and personal loans. It is these statutes and regulations that federal enforcement agencies typically rely upon to levy fines and penalties and require remedial measures. It should be noted that federal regulators may also refer cases to state attorneys general and bank regulators for investigation, and thus local and state regulations should also be reviewed.

First, federal enforcement agencies often accuse lenders of violating the FHA, which makes it unlawful for lenders to discriminate in their housing-related activities against any would-be borrower on the basis of the applicant's race, color, religion, national origin, sex, handicap, or familial status.

Second, federal regulators often rely upon ECOA in support of their redlining claims, as this law offers more expansive protections and is not limited to home lending. The ECOA outlaws discrimination in any aspect of a credit transaction on the basis of the applicant's race, color, religion, national origin, sex, marital status, age (capacity-based), receipt of public assistance-based income, and/or good faith exercise of any right under the Consumer Credit Protection Act.[5]

The Consumer Financial Protection Bureau's (CFPB's) Regulation B, 12 CFR Part 1002, implements the ECOA, and sets forth the lending practices and acts that are prohibited, permitted and/or required.[6] For this reason, banks may receive communications from the CFPB identifying suspected redlining practices and requesting additional information under the threat of a referral to the DOJ if a sufficient response is not provided within a delineated time frame.

Lending institutions need not approve all loan applications or make loans on identical terms. Denial of a loan absent discrimination is permissible under both the FHA and ECOA. Specifically, lenders may still deny or offer certain terms as long as they are justified on the basis of economic factors and the decisions are made without regard to any of the following:

- The applicant's race, color, religion, national origin, sex, marital status, receipt of public assistance-based income, and/or good faith exercise of any right under the Consumer Credit Protection Act
- The demographics of the residents in the neighborhood where the subject property is located

Any person or entity who is in the business of providing loans is subject to the FHA and the ECOA. It is important for anyone involved with an institution's lending operations to have a comprehensive understanding of the applicable fair lending laws and how each relates to prohibited redlining practices.

CURRENT ENFORCEMENT INITIATIVES

Redlining occurs with residential loans, student loans, business loans, car loans, and personal loans, and care should be taken to review all lending policies to assess redlining risks across all lines. Established anti-redlining and anti-discriminatory lending policies should be reviewed and given a renewed focus so as to mitigate any risks that recent aggressive and coordinated anti-redlining efforts may uncover.

Many federal agencies have their own enforcement capabilities but may also choose to coordinate efforts with each other or with the DOJ. Sometimes regulators are required to refer violations of the FHA or ECOA to the DOJ, which may result in additional fines and penalties.

It is not uncommon for redlining issues to be identified during routine compliance examinations. Post-examination investigations should be taken seriously and handled with the utmost care due to the risks of reputational harm and increased financial exposure caused by regulatory fines and penalties.

As most of the enforcement and settlements focus on housing loans, we limit our discussion here to those loans.

The DOJ: On October 19, 2023, the DOJ announced that it has secured more than $107 million in relief as a result of its Combatting Redlining Initiative since it was first launched on October 22, 2021.[7] According to the news release announcing the recovery, the "significant milestone" was reached after the Civil Rights Division's Housing and Civil Enforcement Section (in partnership with US attorneys' offices, federal financial regulatory agencies, and state attorneys general offices) secured 10 settlement agreements with banks and mortgage lending institutions in Camden, Columbus, Houston, Los Angeles, Memphis, Newark, Philadelphia, Rhode Island, Tulsa, and Wilmington.[8]

In its news release announcing its most aggressive anti-redlining effort to date, the DOJ previously indicated that its initiative is intended to do the following:

- Utilize US Attorneys' Offices as force multipliers to ensure that fair lending enforcement is informed by local expertise on housing markets and the credit needs of local communities of color.
- Expand the department's analyses of potential redlining to both depository and nondepository institutions. Nondepository lenders are not traditional banks and do not provide typical banking services, but engage in mortgage lending and now make the majority of mortgages in this country.
- Strengthen the DOJ's partnership with financial regulatory agencies to ensure the identification and referrals of fair lending violations to the DOJ.
- Increase coordination with state attorneys general on potential fair lending violations.[8]

The DOJ receives redlining violation referrals from various regulators and enforcement agencies such as the Federal Deposit Insurance Corporation (FDIC), the CFPB, and the Office of the Comptroller of the Currency (OCC). Although many of the cases are in the residential lending context, the initiative is not limited to home loans. For that reason, caution should be taken to assess practices against all lines of lending business.

Following is a non-exhaustive list of the regulators who generally refer cases to the DOJ (though others may also do so) and examples of some of the regulators' findings and referrals to the DOJ.

The FDIC: The FDIC's Division of Depositor and Consumer Protection conducts fair lending and residential application and loan redlining reviews during its consumer compliance examinations. As part of these fair lending risk-scoping processes, the FDIC often will first assess whether certain majority Black or Hispanic census tracts are considered to be part of a lender's reasonably expected market area (REMA). If so, the FDIC will then review Home Mortgage Disclosure Act (HMDA) data against the census tract data and REMAs to assess redlining risks and practices. The FDIC considers an area to be a majority census tract if more than 50% of the residents in that area are of that particular race or ethnicity. In the residential lending context, the FDIC will analyze the lending institution's mortgage-lending activity in the REMA and make statistical comparisons with lending activities of other banking associations in the same REMA. If the FDIC concludes that the lending institution has engaged in certain redlining activities, it may send a request to the bank to respond to the findings or may refer the matter directly to the DOJ. **Should your institution receive any communications from the FDIC or any regulatory body, it is important to notify your Gallagher broker contact immediately.**

Some typical FDIC findings may include but are not limited to the alleged failures of lenders to:

- Have mortgage loan officers (MLOs) working at branches in majority Black or Hispanic census tracts to ensure equal access for Black or Hispanic residents seeking first-lien mortgage loans
- Have branches physically located in majority Black or Hispanic census tracts for purposes of obtaining mortgages, student loans, business loans, auto loans, or personal loans
- Have specific and clearly enforced lending policies and procedures that ensure the bank provides equal access to credit to communities of color
- Ensure that automated, digital, and/or algorithmic underwriting systems are free of bias so as to prevent digital redlining
- Ensure that mortgage brokers referring loans have and enforce fair lending practices, including those focused on preventing redlining

The FDIC may also impose direct fines on the institution. **Settlements are often achieved with no admission of liability, though the terms of the settlement become public knowledge.**

The CFPB: The CFPB also enforces fair lending laws and has specific initiatives to combat redlining. It often refers violations directly to the DOJ in addition to issuing its own fines and penalties.

Whereas the FDIC mainly uncovers redlining through examinations, the CFPB performs examinations and also uncovers illegal practices in the field. In particular, the CFPB will send undercover testers to bank branches to assess how certain racial and ethnic groups are treated during the lending process. The testers are often people from Black and Hispanic communities who are instructed to inquire about mortgage and other loans.

A case that resulted in a settlement against a bank was one in which a bank employee provided information that would have restricted the Black tester to a smaller loan amount when compared to the white tester who had similar credit qualifications. The settlement included fines and requirements that the alleged offending bank develop community partnerships, commit millions of dollars in loan subsidies to Black and Hispanic communities, and engage in advertising initiatives and outreach programs to reach the affected populations.

The CFPB recently settled its first redlining case against a non-bank mortgage company after finding the alleged offender distributed emails containing racist slurs about certain ethic groups in the applicable metropolitan statistical area (MSA), avoided sending loan officers to certain MSAs on the basis of the residents' race and ethnicities, and developed and maintained marketing and advertising campaigns that excluded "majority-minority" neighborhoods.[9] Following an enforcement action, the non-bank mortgage company was required to pay a $4 million fine, spend an additional $2 million in community outreach, and invest nearly $19 million in a loan subsidy program.

The OCC: The OCC also conducts investigations into violations of the FHA and ECOA. In one case that was referred to the DOJ and resulted in a multimillion-dollar settlement, the OCC determined that the bank violated the FHA and ECOA by engaging in redlining when it avoided making loans in predominantly Black and Hispanic neighborhoods on the basis of the applicants' race and ethnicities.

The complaint against the bank also alleged that the bank's branches were "concentrated in majority-white neighborhoods, that the bank's loan officers did not serve the credit needs of majority-Black and -Hispanic neighborhoods, that [the bank's] outreach and marketing avoided those neighborhoods, and that [the bank's] internal fair-lending policies and procedures were inadequate to ensure that the bank provided equal access to credit to communities of color."[10]

In another case the OCC referred to the DOJ, the OCC asserted that the bank failed to provide equal access to residents seeking first-lien mortgage loans in majority-minority (predominantly Black) census tracts and Hispanic neighborhoods in a certain urban area.[11] Similar to the FDIC, the OCC in this case analyzed mortgage-lending activity in the REMA and made statistical comparisons with lending activity of other banking institutions in the same area. The OCC also compared the number of branches to the number of MLOs and found there were fewer MLOs in the predominantly Black and Hispanic neighborhoods, thus signaling what the OCC felt was the bank's unwillingness to lend to these communities.

Without admitting or denying liability, the alleged offending bank agreed to pay millions of dollars in civil penalties. The bank was also required to invest in a loan subsidy fund to increase credit opportunities for current and future residents of predominantly Black and Hispanic neighborhoods, to dedicate at least four MLOs or community lending specialists to these neighborhoods, and open a loan production office in a majority Black and Hispanic neighborhood of the city. In addition, the OCC required the bank to devote hundreds of thousands of dollars to developing community partnerships to provide services to residents of majority Black and Hispanic neighborhoods that increase access to residential mortgage credit, as well as devote at least several hundred thousand dollars per year to advertising, outreach, consumer financial education, and credit repair initiatives in and around the particular city.[12] In this case, the bank established a fair lending oversight committee and designated a community lending manager to oversee the efforts and work in close consultation with the bank's leadership.[13]

OTHER CONSIDERATIONS — ASSESSING RELATIONSHIPS WITH REFERRING BROKERS

Many banks have agreements with mortgage brokers who refer loan applications to them. In at least one recent enforcement action, a regulator sought to hold the bank liable for its referring broker's suspected redlining practices.

Specifically, in this case, the bank's board of directors received a letter from a regional director of the FDIC entitled "Preliminary Findings of Fair Lending Review — Residential Application and Loan Redlining Review," which set forth the FDIC's initial findings and opinion that some of the bank's residential lending and marketing practices constituted redlining in violation of the ECOA and the FHA. With regard to the bank's own marketing and outreach practices, the FDIC took issue with the bank's decision to not conduct any marketing for residential loan products or have any of its loan officers solicit loans of this type for a several-year period in the particular REMA. In this regard, the FDIC noted that the majority of home loan originations came as referrals from several mortgage brokers who worked with mostly white and Asian communities, and who themselves also conducted no marketing or outreach in majority Black or Hispanic communities.

The FDIC determined that, since the bank ultimately made the underwriting decisions on the loan referrals, the bank was legally responsible for ensuring equal access to credit through marketing and outreach in the majority Black census tracts (MBTs) and majority Hispanic census tracts (MHTs) in the REMA despite not being the originators of the loans. Thus, the FDIC sought to hold the bank responsible for the inactions of its referring brokers. Given this seemingly expanded scope of liability, lenders are encouraged to engage in fair lending practices discussions with anyone from whom they receive loan referrals.

POTENTIAL INSURANCE COVERAGE FOR REDLINING CLAIMS

Coverage for redlining claims may be available but is often limited to defense expenses. An insured may logically assume that a policy that responds to discrimination claims would cover a redlining claim. However, insurers have historically deemed redlining to be a lending act. Thus in cases where coverage exists and there is no specific redlining exclusion, a redlining claim would be covered under the lending liability insuring agreement of a financial institution's management and/or professional liability insurance policy.

Lending acts or lending services wrongful acts are typically defined in a financial institution's management and/or professional liability policy to mean "any acts, errors, or omissions in connection with the rendering or failure to render services involving or relating to an extension of credit; an agreement or refusal to extend credit, the collection, restructuring, repossession, or foreclosure of any extension of credit; or servicing of any loan, lease, or extension of credit." In the usual redlining discrimination claim, the OCC, FDIC, CFPB, or DOJ will allege violations of the ECOA or FHA. Because the alleged wrongful acts relate to an extension of credit, insurers have traditionally deemed them to be "lending acts or lending services wrongful acts."

In general, coverage for redlining claims under the lending liability insuring agreement is largely limited to paying defense expenses, as most of the other damages are excluded from the definition of loss or are subject to a policy exclusion. Loss is generally defined to include defense expenses and other amounts the insured becomes legally obligated to pay on account of a claim made against it for lending services wrongful acts to which coverage applies.

Most insurers exclude fines and penalties from the definition of loss on the basis that coverage for those damages is void against public policy. Statutory fines or penalties are considered to be penal — rather than remedial — and are therefore generally deemed to be uninsurable with very few exceptions. In some states, courts have held that a state's policy of freedom of contract outweighs a competing public policy to disallow coverage for fines or penalties, which is why some insureds may have a policy endorsement allowing some coverage for fines and penalties. Even though this is infrequent, fines and penalties for "lending acts" are rarely covered.

The typical definition of "loss" would also exclude remedial and/or injunctive relief such as developing community partnerships, committing to provide loan subsidies, investing in marketing and advertising, and fostering outreach programs. The policy may also exclude coverage for intentional or willful violations of the law and/or the gain of illegal profits.

Each case is fact-specific and the adjuster will need to assess covered damages as they are presented. On that basis, we may see an adjuster reserve the carrier's rights as to the definition of "loss," meaning he will agree to consider each item of damages submitted by the bank on a case-by-case basis.

As each policy's form differs and endorsements can change defined terms, it is important to review your specific insurance policy to determine the exact definitions. Gallagher's Financial Institutions practice works with banks every day to assist in the mitigation of risk. Please contact us to help you determine which policy may apply to a hypothetical redlining claim.

About the authors

Sarah Gurka
Senior Claims Advocate
Financial Institutions
Advocacy Leader
NRC Specialty
(610) 548 5265
sarah_gurka@ajg.com

Sarah joined Gallagher in August 2022 as a senior claims advocate. She has more than 15 years of combined experience in communications, law, and insurance, with a specific focus on financial lines.

Sarah is an attorney who practiced law for eight years before she started her insurance career as an employment practices liability claims adjuster at one of the world's largest insurers. She has worked for several national and international carriers in individual contributor and management roles, handling and overseeing insurance claims involving employment practices liability, management liability, professional liability, cyber, commercial crime, transactional risk, and fiduciary liability. She has mediated and settled hundreds of claims throughout the country, the majority of which involved complex fact patterns and insurance coverage issues.

Throughout the course of her career, Sarah has evaluated claims for a wide array of financial institutions, including commercial banks, investment banks, brokerage firms, mortgage companies, ratings agencies, financial exchanges, crypto exchanges, and credit unions.

Eileen Yuen
Managing Director
Financial Institutions
(973) 921 8283
eileen_yuen@ajg.com

Eileen is the managing director leading Gallagher's Financial Institutions practice, providing niche expertise to Gallagher's clients and branch offices across the US. Eileen is responsible for developing the national strategic direction of the practice, cultivating organic growth, leading the creation of financial institutions-related knowledge content, and identifying and unifying Gallagher resources. Additionally, she manages the program design, marketing, and ongoing risk management services tailored to a book of business that includes both publicly traded and privately held community, regional, national, and global banks; hedge funds; trust companies; investment advisors; wealth management firms; insurance companies; etc. Previously, Eileen served as a vice president at Willis, and spent nearly a decade with Marsh and McLennan. Currently, she is an active member of various state bankers associations, the advisory council for banks at Travelers Insurance, and the advisory council for the American Bankers Association Insurance Services Program, as well as a corporate partner of the American Bankers Association.

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