Financial Services & Products ADVISORY ▪

OCTOBER 10, 2023

Affirmative Action in Lending: The Implications of the *Harvard* Decision on Financial Institutions

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Early this summer, the U.S. Supreme Court's ruling in *Students for Fair Admissions v. President and Fellow of Harvard College* effectively ended race-conscious admission programs at colleges and universities across the country. Specifically, the Supreme Court held that decisions made "on the basis of race" do nothing more than further "stereotypes that treat individuals as the product of their race, evaluating their thoughts and efforts—their very worth as citizens—according to a criterion barred to the Government by history and the Constitution."

In particular, the Supreme Court reasoned that "when a university admits students 'on the basis of race, it engages in the offensive and demeaning assumption that [students] of a particular race, because of their race, think alike.'" Such stereotyping purportedly only causes "continued hurt and injury," contrary as it is to the "core purpose" of the Equal Protection Clause. Ultimately, the Supreme Court reminded us that "ameliorating societal discrimination does not constitute a compelling interest that justifies race-based state action."

In the context of lending, federal regulatory agencies expect and encourage financial institutions to explicitly consider race in their lending activities. While the Community Reinvestment Act has required banks to affirmatively consider the needs of low-to-moderate-income neighborhoods, regulatory enforcement actions over the last few years have required both bank and nonbank mortgage lenders to explicitly consider an applicant's protected characteristics such as race and ethnicity—conduct plainly prohibited by fair lending laws.

Could the impact of the Supreme Court holding extend beyond education to lending and housing? Will the *Harvard* decision serve to undercut federal regulators' legal theories for demonstrating redlining and present a challenge for special purpose credit programs that explicitly consider race or other protected characteristics?

Fair Lending Laws Prohibit Consideration of Race

The Equal Credit Opportunity Act (ECOA) prohibits a creditor from discriminating against any applicant, in any aspect of a credit transaction, on the basis of race, color, religion, national origin, sex or marital status, or age (provided the applicant has the capacity to contract). Similarly, the Fair Housing Act prohibits discrimination against any person in making available a residential real-estate-related transaction, or in the terms or conditions of such a transaction, because of race, color, religion, sex, handicap, familial status, or national origin.

In March 2022, the Consumer Financial Protection Bureau (CFPB) went as far as to update its Examination Manual to provide that unfair, deceptive, or abusive acts and practices (UDAAPs) "include discrimination" and signaled that the CFPB will examine whether companies are adequately "testing for" discrimination in their advertising, pricing, and other activities. When challenged by various trade organizations, the U.S. District Court for the Eastern District of Texas ruled that the CFPB's update exceeded the agency's authority under the Dodd–Frank Act. This decision is limited, however, and enjoins the CFPB from pursuing its theory against those financial institutions that are members of the trade association plaintiffs. It is also unclear if the verdict will be appealed by the CFPB.

Despite federal prohibitions, regulators such as the CFPB and the U.S. Department of Justice (DOJ) expect, and at times even require, lenders to affirmatively target their marketing and lending efforts to certain borrowers and communities based on race and/or ethnicity.

Race-Based Decisions Are Encouraged and Even Required by Regulators

CFPB examiners often ask lenders to describe their affirmative, specialized efforts to target their lending to minority communities. If there have been no such explicit efforts by the institution, the CFPB penalizes these lenders for not explicitly considering race in their marketing and lending decisions. For example, in the CFPB's redlining complaint against Townstone Financial, the CFPB alleged that "Townstone made no effort to market directly to African-Americans during the relevant period," and that "Townstone has not specifically targeted any marketing toward African-Americans."

What's more, if enforcement culminates in a consent order, the CFPB and DOJ effectively impose race-based action by requiring lenders to fund loan subsidies or discounts that will be offered exclusively to consumers based on the predominant race or ethnicity of their neighborhood. In the CFPB/DOJ settlement with nonbank Trident Mortgage, the lender was required to set aside over $18 million toward offering residents of majority-minority neighborhoods "home mortgage loans on a more affordable basis than otherwise available."

And in the more recent DOJ settlement with Washington Trust, the consent order required the lender to subsidize only those mortgage loans made to "qualified applicants," defined in the settlement as consumers who either reside, or apply for a mortgage for a residential property located, in a majority-Black and Hispanic census tract. Such subsidies are a common feature of recent redlining settlements, which have been occurring with increased frequency since the DOJ announced its Combating Redlining Initiative in October 2021.

Not only do the CFPB and DOJ encourage, and in certain cases, even require, race-based lending in potential contravention of fair lending laws, but federal regulators also expect some degree of race-based hiring by lenders. This expectation is based on the stereotypical assumption that lenders need racial and ethnic minorities in their consumer-facing workforce to attract racial and ethnic minority loan applicants. In the *Townstone* complaint, for example, the CFPB chastised the lender for failing to "employ an African-American loan officer during the relevant period, even though it was aware that hiring a loan officer from a particular racial or ethnic group could increase the number of applications from members of that racial or ethnic group." Ultimately, all the recent redlining consent orders announced by the CFPB and DOJ impose at least some race-based requirement, which would seem to run afoul of fair lending laws and Supreme Court precedent.

Racial Quota-Based Metrics Used by Regulators

Further, when assessing whether a lender may have engaged in redlining against a particular racial or ethnic group, the CFPB and DOJ, as a matter of course, employ quota-based metrics to evaluate the "rates" or "percentages" of a lender's activity in majority-minority geographic areas, specifically majority-minority census tracts (MMCTs). Then the regulators compare such rates or percentages of the lender's loan applications or originations in MMCTs to those of other lenders. For example, in its complaint against Lakeland Bank, the DOJ focused on the alleged "disparity between the *rate* of applications generated by Lakeland and the *rate* generated by its peer lenders from majority-Black and Hispanic areas." The agency criticized the bank's "shortfalls in applications from individuals identifying as Black or Hispanic compared to the local demographics and aggregate HMDA averages."

Undoubtedly, this approach utilizes nothing more than a quota-based metric, which the Supreme Court in *Harvard* squarely rejected. Indeed, the Supreme Court reasoned that race-based programs amount to little more than determining how "the breakdown of the [incoming] class compares to the prior year in terms of racial identities," or comparing the racial makeup of the incoming class to the general population, to see whether some proportional goal or benchmark has been reached.

While the goal of meaningful representation and diversity is commendable, the Supreme Court emphasized that "outright racial balancing and quota systems remain patently unconstitutional." And such a focus on racial quotas means that lenders could attempt to minimize or even eliminate their fair lending risk simply by decreasing their lending in majority-non-Hispanic-White neighborhoods—without ever increasing their loan applications or originations in majority-minority neighborhoods. Of course, this frustrates the essential purpose of ECOA and other fair lending laws.

Potential Constitutional Scrutiny of Race-Based Lending Efforts

If race-based state action, including the use of racial quotas, violates the Equal Protection Clause, it is possible that the race-based lending measures recently encouraged and even required by federal regulators may be constitutionally problematic. In addition to racially targeted loan subsidies and racially motivated loan officer hiring, regulators continue to encourage lenders to implement special purpose credit programs (SPCPs) to meet the credit needs of specific racial or ethnic groups. As the CFPB noted in its advisory opinion, "[b]y permitting the consideration of a prohibited basis such as race, national origin, or sex in connection with a special purpose credit program, Congress protected a broad array of programs 'specifically designed to prefer members of economically disadvantaged classes' and 'to increase access to the credit market by persons previously foreclosed from it.'"

While SPCPs are explicitly permitted by the language of ECOA and its implementing regulation, Regulation B, as an exception to the statute's mandate against considering a credit applicant's protected characteristics, it is uncertain whether these provisions, if challenged, would survive constitutional scrutiny by the current Supreme Court.

Takeaways for Lenders

For the time being, lenders that offer SPCPs based on a protected characteristic should ensure that their written plans continue to meet the requirements of Section 1002.8(a)(3). As always, the justifications for lending decisions that could disproportionately affect consumers based on their race, ethnicity, or other protected characteristic should be well documented and justified by legitimate business needs. And if faced with a fair lending investigation or potential enforcement action, lenders should consider presenting to regulators any alternate data findings or conclusions that demonstrate the institution's record of lending in MMCTs rather than focusing on the rates or percentages of other lenders in the geographic area.

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