Dodd-Frank at Five Years: Implications for Consumers and the Economy

By Todd J. Zywicki

Introduction

Enacted into law in July 2010, the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) was animated in large part by the belief that a primary source of financial instability was an inadequate consumer financial protection regime at the federal level. Dodd-Frank sought to address those perceived deficiencies both by substantive legislation (for example, by banning binding arbitration provisions in mortgages) and by creating the Consumer Financial Protection Bureau (CFPB) within the Federeal Reserve and vesting that new super-bureaucracy with vast rule-making, litigation, and supervisory powers over all consumer credit products and services.

Five years after Dodd-Frank's passage, what is the record of the law and the regulations it has spawned? Higher prices and reduced choice for consumers and little to increase consumer financial protection.

Yet while this sorry result for US consumers is tragic, it is hardly surprising. The failure of Dodd-Frank's regulatory agenda to promote the interests of consumers was built in from the beginning.[1] The CFPB, for instance, is vested with extraordinarily broad powers to regulate virtually every consumer credit product in the United States under the vague charge to prevent "unfair, deceptive, and abusive" terms and practices. At the same time, this vast power is vested in an agency with an unprecedented lack of democratic accountability. Under the statute, the president can nominate the director, but once confirmed the director can be removed only "for cause."[2] Furthermore, the CFPB is outside Congress's appropriations power, and is authorized to spend hundreds of millions of taxpayer dollars every year with no accountability to the US people.

Given this extreme lack of democratic accountability, the CFPB has done what all bureaucracies tend to do: it has constantly expanded its power, promoted its own bureaucratic interests at the expense of the public, and trampled under foot other public policies, such as consumer choice and financial innovation.

The impact on US families and the economy from the actions of this unaccountable super-regulator has been disastrous:

- By imposing a regulatory regime that substitutes the judgment of bureaucrats for consumer decisions, Dodd-Frank has raised prices and cut off access to mortgages, credit cards, and bank accounts, harming millions of US families that use credit to improve their lives and depressing economic growth.[3]
- By stripping consumers of mainstream financial products such as mortgages, credit cards, and bank accounts, Dodd-Frank has driven the most vulnerable Americans into the arms of check cashers, pawn shops, and payday lenders, increasing their reliance on those products for which sharp practices are most feared.
- The crushing regulatory compliance cost burden and destruction of community banks' traditional relationship lending model has accelerated consolidation of the retail banking system, making big banks even bigger and further eliminating competition and choices for consumers.
- The CFPB has launched a massive data-mining program that collects data on hundreds of millions of consumer credit cards, mortgages, bank accounts, and other products, an appetite for consumer information that far exceeds any reasonable regulatory purpose. Not only do these data-mining operations impose costs on banks and their customers, the operations' scale creates unprecedented threats to privacy and risks to personal information security.
- Because many small, independent, kitchen-table businesses use products such as personal credit cards, home equity loans, and auto title loans in financing their businesses, the CFPB's powers reach into all of these small businesses as well. Little wonder then for

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the first time in US history more businesses are being destroyed than new businesses being started.[4]

After five years, has Dodd-Frank made US families better off? No. Instead, the overall impact of Dodd-Frank has been to slow our economic recovery, raise prices, reduce choice, and eliminate access to the financial mainstream for US families. And low-income Americans have been hit the hardest.

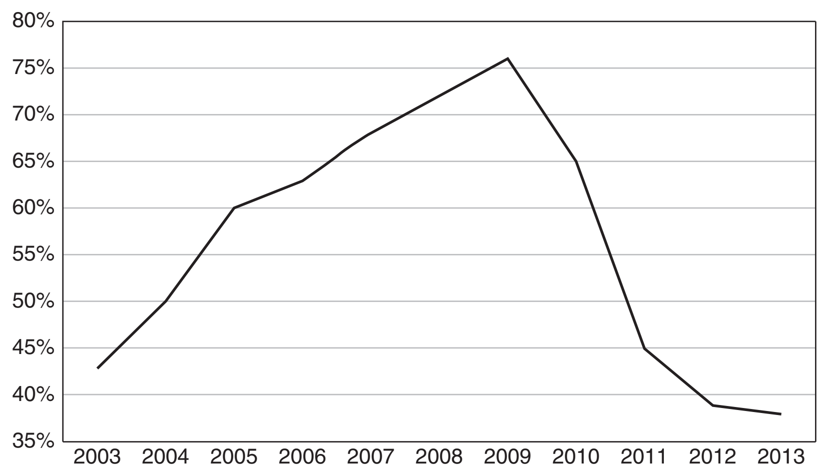
Bank Accounts and the End of Free Checking for Millions

The years 2001 to 2009 saw one of the most important pro-consumer innovations in the history of retail consumer financial services: the rapid spread of near-universal consumer access to free checking.[5] It is estimated that during that period, consumer access to free checking accounts increased from under 10 percent of all bank accounts to 76 percent. In the years since Dodd-Frank, however, the number has collapsed to half of that amount—38 percent, as shown in Figure 1.[6]

Not only are more consumers forced to pay fees to maintain their checking accounts, but those (and other) fees also have soared. Fees are twice as high on average as before Dodd-Frank was enacted, as shown in Figure 2.[7]

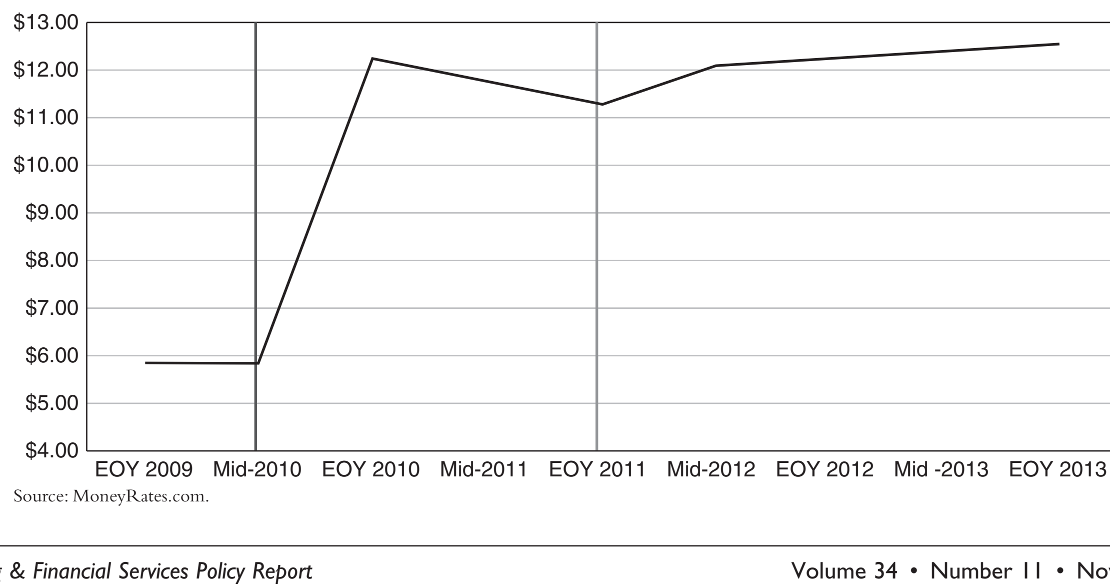
Figure 2 shows trends in the amounts of monthly maintenance fees for non-free checking accounts since 2009. The first bar (marked mid-2010) marks the

Figure 1: Banks Offering Free Checking from 2003 to 2013



Source: Bankrate.com.

Figure 2: Monthly Maintenance Fee (Non-Free Checking)



Source: MoneyRates.com.

date on which Dodd-Frank was passed in July 2010, including the Durbin Amendment. Moreover, the passage of the Durbin Amendment with its "hard cap" price controls on permissible interchange fees was completely unexpected. The Durbin Amendment was a last-minute floor amendment to Dodd-Frank and had never been seriously considered previously in any committee prior to being proposed and adopted on the floor. As a result, there was no anticipatory increase in bank fees prior to July 2010, as would have been the case had the enactment of the Durbin Amendment been expected.

The second bar (marked EOY 2011) captures the date at which the Federal Reserve's rule-making went into effect (October 2011). As can be seen, there was a second jump in average bank fees around the period that the Durbin Amendment went into effect.

Moreover, this decline in access to free checking and increase in bank fees has taken place *only* at those banks subject to the Durbin Amendment: larger banks with more than $10 billion in assets.[8] In contrast to the dramatic reduction in free checking at large banks, there is no sign of a reduction in access to free checking or increased fees at banks that are not subject to the Durbin Amendment's price controls. In fact, there is some evidence that free checking might have actually increased slightly at exempt banks. This suggests that the loss of access to free checking and higher bank fees is the result of the Durbin Amendment, a factor unique to larger banks, and not general economic conditions or heightened regulation generally.

Most troubling, however, is that low-income and other vulnerable populations have been most adversely impacted by Dodd-Frank's destruction of access to free checking: according to the FDIC, the number of unbanked consumers increased by 1 million between 2009 and 2011 and the number of underbanked consumers increased still faster.[9] Although economic recovery has reversed some of those losses for lower-income consumers, the impact of Dodd-Frank has put bank accounts—once the first rung on the ladder of financial inclusion—out of the reach of millions of young and lower-income Americans, forcing them to rely on alternative financial services such as check cashers and pawn shops.

Credit Cards

Consumers have also suffered a loss of access to credit cards in the post-crisis era, not only because of Dodd-Frank but also because of the impact of the Credit Card Accountability Responsibility and Disclosure Act—and once again, low-income consumers have suffered the most. According to the CFPB's own estimates, the period between July 2008 and December 2012 saw the closure of 275 million credit card accounts and elimination of $1.7 trillion in credit card line of credit.[10] Overall, the CFPB found a significant decline in the percentage of households that had cards, from 76 percent to 71 percent. But even this figure understates the disproportionate impact on low-income consumers. According to Federal Reserve Board economists Glenn Canner and Gregory Elliehausen, the percentage of households in the lowest quintile of credit scores with credit cards fell from 65 percent in 2008 to 54 percent in 2010.[11] Loss of access to credit cards has forced those consumers into great reliance on higher-cost products such as payday loans and overdraft protection.[12]

Mortgages

The CFPB's "qualified mortgage" (QM) and "ability to repay" rules have dramatically slowed the recovery of the housing market, and fears of government liability have caused even large lenders to lend cautiously, especially to riskier borrowers. As Janet Yellen, the chair of the Board of Governors of the Federal Reserve System, has noted, "Banks, at this point, are reluctant to lend to borrowers with lower FICO [credit] scores."[13] Despite the heavy regulatory burden imposed by the CFPB's mortgage rules, however, the rules are silent with respect to one of the most important risk factors for mortgage foreclosures—the reduction or elimination of minimum down payment requirements.[14] Nor do the rules address state antideficiency laws or cash-out refinancing by homeowners, both of which have been shown to have materially contributed to the foreclosure crisis.[15] In fact, Section 1414(g) of Dodd-Frank Dodd-Frank actually mandates new disclosures before a consumer loses his or her antideficiency law protection, a provision that will increase defaults and foreclosures in the event of a future downturn in housing prices. Other provisions of Dodd-Frank, including new regulations on mortgage servicing companies and new substantive regulations on foreclosure processes under Dodd-Frank Section 1413, will also increase the cost and length of the mortgage foreclosure process, which also has been shown to lead to increased defaults and foreclosures.

Moreover, while the increased cost and risk associated with making mortgages has led many banks to exit the mortgage market,[16] non-bank lenders (typically less-regulated than banks) have filled the market demand, increasing their share of mortgage lending from 10 percent in 2009 to 43 percent in 2015.[17] Ironically, one consequence of Dodd-Frank and the CFPB's aggressive regulation and litigation against banks has been to drive consumers toward a variety of lenders with less regulatory scrutiny.[18]

At the same time, there is little evidence that Dodd-Frank and the regulations promulgated pursuant to it will actually accomplish their goal of improving underwriting and reducing foreclosures. Peter Wallison, former general counsel of the Department of the Treasury, estimated that had the QM rules applied in the period leading up the financial crisis, the default rate on QM-conforming mortgages would have still been 23 percent.[19] Summarizing the assembled conclusions of several studies, economist Mark Calabria concluded that the proposed restrictions on debt-to-income ratios in the QM and QRM (Qualified Residential Mortgages) rules "appear to have very modest impacts on projected defaults."[20] Requiring lower loan-to-value ratios (such as by requiring larger down payments or restricting cash-out refinancing), by contrast, would have substantially reduced defaults and foreclosures during the financial crisis;[21] however, the final mortgage rules eliminated any minimum down payment requirements for QM and QRM mortgages, thus eliminating one of the reforms that would have had the most significant effect on foreclosures.

Although the new mortgage rules were expected to have little impact on reducing defaults, they have had a large impact on reducing mortgage lending, especially in the subprime market.[22] In substantial part, the imposition of reams of bureaucratic red-tape and paperwork has made it more of a hassle for consumers to apply for and receive a mortgage.[23] For example, the "average large bank underwriter could process about 165 loans per month in 2005 but can only do about 33 today."[24] According to Realtytrac, by 2013 the US mortgage market had recovered to the extent that mortgage originations had increased to more than 2.5 million per quarter, exceeding $600 billion in mortgages originated. Following the rolling out of the QM proposal in 2013, however, mortgage originations collapsed to less than 1.5 million per quarter (and less than $400 billion in amount) and have remained well below the pre-QM levels since (see Figure 3).[25]

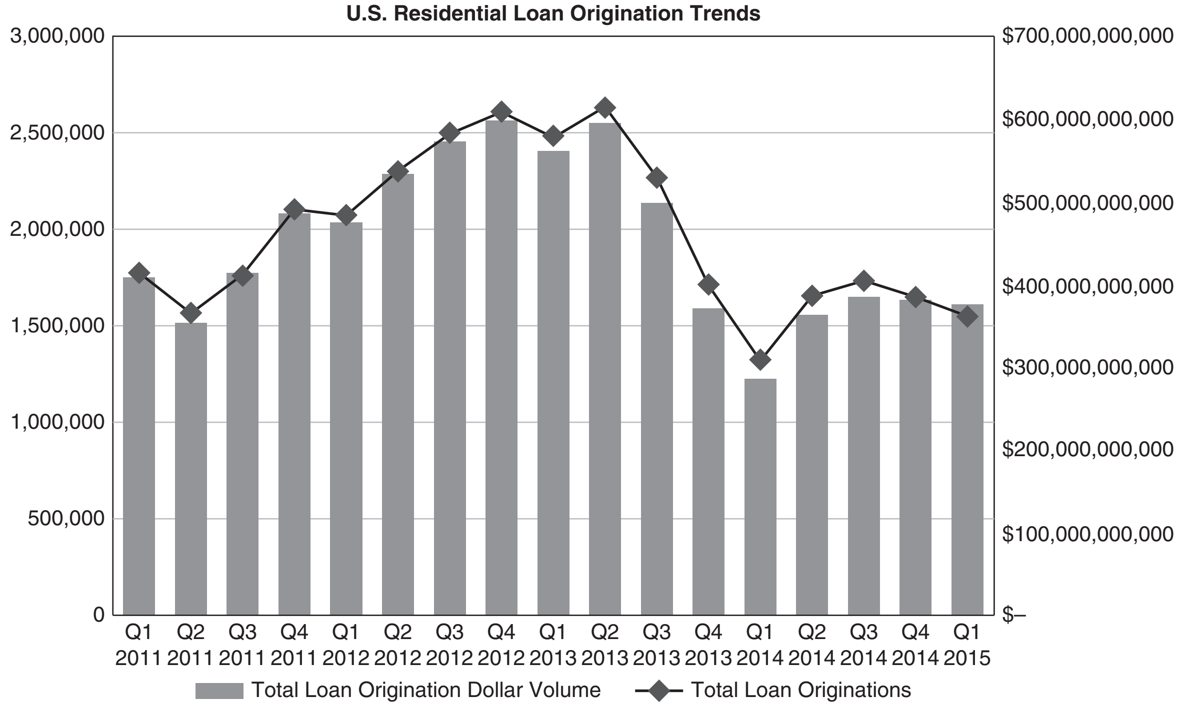
The CFPB's regulatory costs have fallen particularly heavily on smaller and community banks. For example, a study by the Mercatus Center at George Mason University found that 71 percent of small banks stated that the CFPB has affected their business activities.[26] Sixty-four percent of small banks reported that they were making changes to their mortgage offerings because of Dodd-Frank, and 15 percent said that they had either exited or were considering exiting residential mortgage markets entirely. Nearly 60 percent of small banks reported that the CFPB or the qualified mortgage rule had a "significant negative impact" on their mortgage operations. Nearly 60 percent said that the CFPB has had a significant negative effect on bank earnings, and more than 60 percent said that changes in mortgage regulations had had a significant negative effect on bank earnings.

Moreover, by imposing a one-size-fits-all mechanical underwriting system for mortgages, the QM rule has deprived community banks of their one competitive advantage against megabanks: their intimate familiarity with their customers and their ability to engage in relationship lending with their customers. As a result of these myriad factors, it is not surprising that according to a study by researchers at Harvard University's John F. Kennedy School of Government, community banks are shrinking at twice the rate since Dodd-Frank's enactment than before, while larger banks have grown in size.[27]

In addition to leading to reduced competition and choice in mortgage markets, this decline in the competitiveness of community banks is also reflected in a reduction in small business lending, as community banks provide a disproportionate share of small-business lending in the economy.[28] According to the summary of one report by Goldman Sachs:

> While there is some added subtlety to the results of our analysis, we find in general that low-income consumers and small

Figure 3: Mortgage Origination Volume



Source: Realtytrac.com.

businesses—which generally have fewer or less effective alternatives to bank credit—have paid the largest price for increased bank regulation. For example, for a near-minimum wage worker who has maintained some access to bank credit (and it is important to note that many have not in the wake of the financial crisis), the added annual interest expenses associated with a typical level of debt would be roughly equivalent to one week's wages. For small and mid-sized businesses the damage from increased bank regulation is even greater: their funding costs have increased 175 basis points (bp) more than those of their larger peers, when measured against the pre-crisis period. That funding cost differential is enough to seriously damage the ability of smaller firms to compete with their larger competitors. This fact has become all too evident in the economic statistics and is already changing the shape of American business, as small and mid-sized firms, the historic engines of US job creation, shrink and sometimes disappear, displaced by large corporations.[29]

Data Mining

One particularly alarming example of the CFPB's bureaucratic hubris—and subordination of the interests of US consumers to its own narrow bureaucratic agenda—is the agency's extraordinary data mining program of US families' financial accounts. Currently, the CFPB collects and monitors information for some 600 million US credit card accounts, "22 million mortgages, 5.5 million student loans, two million bank accounts with overdraft fees, and hundreds of thousands of auto sales, credit scores, and deposit advance loans."[30] Yet even this vacuuming up of our financial information is not enough. The CFPB wants to enlarge its portfolio to 95 percent of all credit card accounts—almost 1 billion accounts in total.

Is it necessary for the CFPB to snoop so deeply into our bank accounts and credit card statements in order to further its regulatory agenda? Of course not. In fact, George Mason University economist Thomas Stratman has estimated that the number of credit card accounts for which the CFPB wants to collect consumer information is some 70,000 times greater than is necessary for the agency to execute its regulatory mission.[31]

But the costs of CFPB's demand for information do not fall solely on the banks that must provide it. Although the CFPB claims that this data is anonymous, every bit of information increases the risk to consumers of identity theft and other misuse of their information. In fact, testifying before this committee last year, CFPB director Richard Cordray admitted that the information the CFPB collects is not 100 percent secure and could be hacked.[32] Moreover, according to a recent article in *Science*, using only three months of anonymous credit card data, the researchers were able to reidentify 90 percent of individuals, with women being more readily reidentifiable than men.[33]

While the unnecessary acquisition and retention of troves of Americans' information is troubling enough in itself, it is especially worrisome in light of repeated rebukes of the CFPB's faulty data security systems.[34] Following massive data security breaches and compromising of personal information by the Internal Revenue Service and Office of Personnel Management, it is inexplicable that the CFPB continues to insist on vacuuming up excessive amounts of consumer data without considering the privacy threat to consumers.

Bureaucratic Overreach

Finally, despite Dodd-Frank's broad grant of authority to the CFPB to regulate every consumer credit product in the United States, even that broad reach has proven insufficiently expansive for the agency. For example, Dodd-Frank expressly prohibits the CFPB from regulating loans made by auto dealers—yet through the rubric of enforcing fair-lending laws the CFPB has essentially deputized banks and other indirect auto lenders as *de facto* arms of the federal government. Moreover, recognizing that the information necessary to implement such a scheme simply does not exist, the CFPB has instead turned to a scientifically dubious methodology (Bayesian Improved Surname Geocoding) to try to impute the alleged race of each loan applicant.[35] The CFPB has also given itself authority to regulate third-party sellers of cell phone apps[36] and for-profit colleges, and it has even required a land developer to improve the condition of the roads in a housing development.[37]

Scholars of the regulatory process have long understood that agency imperialism is a predictable tendency of bureaucracies, as they seek to enlarge their power and influence over policy. Given the absence of meaningful internal or external institutional controls on the CFPB, it is hardly surprising that the CFPB has aggressively sought to expand its reach into all of these areas, from telecommunications services to the provision of higher education.

Looking back on the last five years, it is disappointing that Dodd-Frank squandered the historic opportunity presented by the financial crisis to create a modern and coherent consumer protection regime—one that would not only protect consumers from sharp practices but also promote competition, innovation, and consumer choice. Even worse, Dodd-Frank imposed a regime that instead has led to higher prices, less innovation, and less choice in consumer credit products, while doing little to improve consumer protection. By taking away preferred choices for consumers, such as mortgages, bank accounts, and credit cards, Dodd-Frank and other laws have increased consumer dependence on less preferred products like payday loans, pawn shops, and check cashers. Most tragic of all, low-income and younger consumers—who already had the fewest choices—are those who have suffered the most from Dodd-Frank's regulatory onslaught.

Notes

1. Todd J. Zywicki, "The Consumer Financial Protection Bureau: Savior or Menace?," 81 *George Washington L. Rev.* 856 (2013).
2. *But see* Statement of Barney Frank, "Hearing Before the Subcommittee on Oversight and Investigations of the Committee on Financial Services, U.S. House of Representatives, (Feb. 15, 2012) at p. 8 ("Just a couple of points—first of all, this notion that the director cannot be removed is fanciful. It says in the statute that, yes, the director is appointed for a 5-year term, but can be removed by the president for insufficiency, neglect of duty, or malfeasance. No one doubts that if a change in administration comes, and the new president disagrees with the existing director, he or she can be removed. And proving that you were not inefficient, the burden of proof being on you, would be overwhelming.").
3. *See* Thomas A. Durkin, Gregory Elliehausen, Michael E. Staten, and Todd J. Zywicki, *Consumer Credit and the American Economy* (Oxford, 2014).
4. *See* Ian Hathaway and Robert E. Litan, "Declining Business Dynamism in the United States: A Look at the States and Metros," *Brookings Institution Economics Studies* (May 2014), *http://www.brookings.edu/~/media/research/files/papers/2014/05/declining%20business%20dynamism%20litan/declining_business_dynamism_hathaway_litan.pdf,* last accessed Oct. 31, 2015.

5. Todd J. Zywicki, Geoffrey A. Manne, and Julian Morris, "Price Controls on Payment Card Interchange Fees: The U.S. Experience" (June 4, 2014), available in *http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2446080*, last accessed Oct. 31, 2015.
6. *Id.* at 6, Figure 1.
7. *Id.* at 8, Figure 4. Mid-2010, of course, is when Dodd-Frank was passed into law. EOY 2011 marks the period at which regulations from the Federal Reserve System (Federal Reserve) regulations implementing the "Durbin Amendment" to Dodd-Frank became effective.
8. *Id.* at 10–13.
9. Federal Deposit Insurance Corporation, 2011 *FDIC National Survey of Unbanked and Underbanked Households* 10 (Sept. 2012), available at *http://www.fdic.gov/householdsurvey/2012_unbankedreport.pdf*, last accessed Oct. 31, 2015;
10. Consumer Financial Protection Bureau, *CARD Act Report: A Review of the Impact of the CARD Act on the Consumer Credit Market* 56 (Oct. 1, 2013).
11. Glenn B. Canner and Gregory Elliehausen, "Consumer Experiences with Credit Cards" at 10 Table 2, *Federal Reserve Bulletin* (Dec 2013), online at *http://www.federalreserve.gov/pubs/bulletin/2013/pdf/consumer-experiences-with-credit-cards-201312.pdf*, last accessed Oct. 31, 2015. By contrast, for highest-quintile households, card holding fell only one percentage point (from 91 percent to 90 percent of households).
12. *See* Robert L. Clarke and Todd J. Zywicki, "Payday Lending, Bank Overdraft Protection, and Fair Competition at the Consumer Financial Protection Bureau," 33 *Review of Banking and Financial Law* 235 (2013–14).
13. For example, Janet Yellen, chair of the Board of Governors of the Federal Reserve System, has stated, "Banks, at this point, are reluctant to lend to borrowers with lower FICO [credit] scores. They mention in meetings with us consistently their concerns about put-back risk, and I think they are—it is difficult for any homeowner who doesn't have pristine credit these days to get a mortgage. I think that is one of the factors that is causing the housing recovery to be slow. And of course, you know, there were a lot of practices in connection with mortgage lending that really needed to be changed, we don't want to go back to those days, but it is important to clarify—for us to work to clarify the rules around mortgage lending to create an environment of greater certainty for lenders to be willing to extend mortgage credit." Federal Reserve Board, *Transcript of Chairman Yellen's Press Conference* at p. 12 (June 18, 2014).
14. *See* Zywicki, *supra* n.1, at 913.
15. *See* Todd J. Zywicki and Joseph Adamson, "The Law and Economics of Subprime Lending," 80 *University of Colorado L. Rev.* 1 (2009) (summarizing studies).
16. *See supra* n.13.
17. *See* Diana Olick, "How Dodd-Frank Changed Housing, for Good and Bad," *CNBC.com* (Jul. 16, 2015), available in *http://www.cnbc.com/2015/07/16/how-dodd-frank-changed-housing-for-good-and-bad.html*, last accessed Oct. 31, 2015.
18. Let me emphasize that I am *not* implying that just because non-bank lenders are less lightly regulated and supervised that one should infer that they are engaging in malfeasance. But for the architects of Dodd-Frank it is hard to see how this would be considered a desirable effect of the law and regulation.
19. Peter Wallison, *Hidden in Plain Sight: What Really Caused the World's Worst Financial Crisis and Why it Could Happen Again* (2015).
20. Testimony of Mark A. Calabria, Ph.D., Director, Financial Regulation Studies, Cato Institute Before the Committee on Financial Services United States House of Representatives Hearing titled "The Dodd-Frank Act Five Years Later: Are We More Stable?" (July 9, 2015) at 13; *see also id.* at 13 n.16 ("The presence of a DTI in excess of 41 percent increases the probability of default by 0.25, 0.08, and 0.59 for fixed rate, long-term ARM and Hybrid ARM, respectively. Accordingly to GAO's analysis, reducing the prevalence of mortgages with a DTI in excess of 41 will have barely notice effects (although statistically significant in all cases)" (citing United States Government Accountability Office. 2010. "Nonprime Mortgages: Analysis of Loan Performance, Factors Associated with Defaults, and Data Sources." Report to Congress, GAO-10-805 (Aug. 2010).
21. Calabria Testimony, *supra* n.17, at 13–14 ("For fixed rate non-prime purchase loans, moving from a LTV of 100 to under 80 percent reduces projected default probabilities by over 3 percentage points. For hybrid non-prime ARMs, the reduction in projected default probabilities is just over 6 percentage points. Coupled with full documentation and a LTV under 80 percent, one could eliminate over 70 percent of the standardized default risk among hybrid non-prime ARMs. Academic studies have arrived at similar conclusions when examining the drivers of default among subprime mortgages.").
22. *Id.*
23. *See* Olick, *supra* n.17.
24. *Id.*
25. Realtytrac, "U.S. Residential Loan Originations Increase 17 percent in Q1 From a Year Ago Despite 6 Percent Drop From Previous Quarter" (May 14, 2015), available in *http://www.realtytrac.com/news/realtytrac-reports/q1-2015-u-s-residential-loan-origination-report/*, last accessed Oct. 31, 2015.
26. Hester Peirce, Ian Robinson, and Thomas Stratmann, "How Are Small Banks Fairing Under Dodd-Frank?," Mercatus Center Working Paper No. 14-05 (Feb. 2014).
27. Marshall Lux and Robert Greene, "The State and Fate of Community Banking," Harvard Kennedy School M-RCBG Associate Working Paper No. 37 (2015), available in *http://www.hks.harvard.edu/centers/mrcbg/publications/awp/awp37*, last accessed Oct. 31, 2015.
28. Goldman Sachs, "The Two-Speed Economy" (Apr. 2015), available in *http://www.goldmansachs.com/our-thinking/public-policy/regulatory-reform/2-speed-economy-report.pdf*, last accessed Oct. 31, 2015.
29. Goldman Sachs, "Who Pays for Bank Regulation?" at 2–3 (June 2014); *http://www.goldmansachs.com/our-thinking/public-policy/regulatory-reform/who-pays-for-bank-regulation-pdf.pdf*, last accessed Oct. 31, 2015.

30. Newt Gingrich, "A Government Snoop That Puts the TSA to Shame," *Wall Street J.* (July 1, 2015).

31. *See* Letter of Professor Thomas Stratman to Congressman Scott Garrett (Jan. 23, 2014), available in *http://mercatus.org/sites/default/files/StratmannCFPBStatisticMethods.pdf*, last accessed Oct. 31, 2015.

32. *See* Richard Pollock, "Federal Consumer Bureau Data-Mining Hundreds of Millions of Consumer Credit Card Accounts, Mortgages," *Washington Examiner* (Jan. 29, 2014), available in *http://www.washingtonexaminer.com/consumer-bureau-data-mining-hundreds-of-millions-of-consumer-credit-card-accounts-mortgages/article/2543039*, last accessed Oct. 31, 2015.

33. Yves-Alexandre de Montjoye, Laura Radaelli, Vivek Kumar Singh, and Alex "Sandy" Pentland, "Unique in the Shopping Mall: On the Reidentifiability of Credit Card Metadata," 347 *Science* No. 6221 536–39 (Jan. 30, 2015).

34. *See* Government Accountability Office, *Consumer Financial Protection Bureau: Some Privacy and Security Procedures for Data Collections Should Continue Being Enhanced* (Sept. 2014); Board of Governors of the Federal Reserve System, Consumer Financial Protection Bureau, Office of Inspector General, *Security Control Review of the CFPB's Cloud Computing–Based General Support System*, 2014-IT-C-010 (Washington, D.C.: July 17, 2014).

35. *See* Arthur P. Baines and Marsha J. Courchane, *Fair Lending: Implications for the Indirect Auto Finance Market*, Charles River Associates (Nov. 19, 2014), *http://www.crai.com/sites/default/files/publications/Fair-Lending-Implications-for-the-Indirect-Auto-Finance-Market.pdf*, last accessed Oct. 31, 2015.

36. *Consumer Financial Protection Bureau v. Sprint Corp.*, Civil Action 14-9931 (Dec. 1, 2014), available in *http://files.consumerfinance.gov/f/201412_cfpb_cfpb-v-sprint-complaint.pdf*, last accessed Oct. 31, 2015.

37. *In the Matter of International Land Consultants, Inc., et al.*, Administrative Proceeding File No. 2015-CFPB-0010 (May 1, 2015) (consent order), available in *http://files.consumerfinance.gov/f/201505_cfpb_consent-order-international-land-consultants.pdf*, last accessed Oct. 31, 2015.

What Is the Future of Fair Lending Following *Inclusive Communities*?

By John L. Ropiequet

The US Supreme Court issued its much anticipated decision on whether the disparate impact theory is a valid basis for Fair Housing Act (FHA)[1] cases at the end of June in *Texas Department of Housing and Community Affairs v. Inclusive Communities Project, Inc.*[2] The Court ruled, by a five to four majority, that disparate impact is a viable FHA theory, but it put significant restrictions on how such cases should be prosecuted. The Court cautioned that "mere statistical evidence," which had formed the basis for all previous federal fair lending enforcement actions,[3] was not sufficient proof for a disparate impact case.[4] The majority further stated that "[a] robust causality requirement" was necessary to guard against abuse of the disparate impact theory.

As discussed in a previous article,[5] fair-lending class action litigation seems to have disappeared as a result of the Supreme Court's decision in *Wal-Mart Stores, Inc. v. Dukes,*[6] which presented seemingly insurmountable evidentiary obstacles to maintaining disparate impact class action cases that are based on allowing pricing discretion to decision-makers. However, federal enforcement actions against mortgage lenders proceeded apace, with defiant statements from the regulators,[7] despite the apparent setback for the disparate impact theory posed by the *Dukes* decision. More recently, as also discussed in a previous article,[8] auto finance has become a significant focus of attention for the Consumer Financial Protection Bureau (CFPB). The CFPB has pushed the envelope beyond where it was in earlier mortgage-lending enforcement actions because the auto finance cases impose vicarious liability for the discretionary pricing decisions of completely independent parties rather than decisions by the defendants' own employees and agents.

Inclusive Communities was decided under unusual circumstances, representing the third time that the Supreme Court granted *certiorari* on the issue of whether disparate impact cases can be brought under the FHA. The Court had granted *certiorari* on the same question in two other cases, both of which settled shortly before they were set for oral argument.[9] Moreover, the US Circuit Courts of Appeals had been unanimous in finding that the FHA did allow disparate impact cases, with only one of the 12 circuits not ruling on the issue.[10] The grants of *certiorari* despite the lack of a circuit split, combined with a district court decision against the disparate impact theory in the one circuit that had not ruled on the question that invalidated the US Department of Housing and Urban Renewal's (HUD) Disparate-Impact Rule,[11] only heightened the drama.

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Inclusive *Communities* in the Lower Courts

Unlike the typical FHA fair lending case that challenges the mortgage-lending practices of a private lender, *Inclusive Communities* involved actions by a state agency that was responsible for allocating federal tax credits. The defendant Texas Department of Housing and Community Affairs (Department) administered the federal Low Income Housing Tax Credits program in Texas.[12] Under the program, 9 percent credits are distributed to developers of low-income housing projects, and the credits can be sold to finance construction.[13] The Department awards the limited amount of available credits to competing developers based on a complicated set of selection criteria under which a point system prioritizes the criteria, subject to approval, rejection, or modification by the Texas Governor.[14]

The plaintiff, Inclusive Communities Project, Inc., is a nonprofit organization that promotes integration in the Dallas area, assisting low-income residents in finding affordable housing in "predominantly Caucasian, suburban neighborhoods."[15] It sued the Department for "disproportionately approving tax credit units in minority-concentrated neighborhoods and disproportionately disapproving tax credit units in predominantly Caucasian neighborhoods, thereby creating a concentration of the units in minority areas, a lack of units in other areas, and maintaining and perpetuating segregated housing patterns."[16]

The trial court found that the plaintiff made a *prima facie* showing of both intentional discrimination and disparate impact at the summary judgment stage, but found at trial that the plaintiff failed to meet its burden of establishing intentional discrimination.[17] With respect to the disparate impact claim, the trial court applied the burden-shifting formula adopted by the US Court of Appeals for the Second Circuit.[18] This formula required the Department to justify its actions with a compelling governmental interest and prove that there were no less discriminatory alternatives.[19] The trial court found that, assuming the Department's interests were legitimate, it nevertheless failed to prove "that there were no less discriminatory alternatives to the challenged allocations."[20]

On appeal to the US Court of Appeals for the Fifth Circuit, the court reached only one issue: whether the trial court had applied the proper burden-shifting formula for proof of an FHA disparate impact claim.[21] The Fifth Circuit noted that different US Courts of Appeals had applied different formulas for burden-shifting, but that after the trial court issued its decision, HUD issued its Disparate-Impact Rule, which included a burden-shifting standard.[22] Finding that the Disparate-Impact Rule "standards are in accordance with disparate impact principles and precedent" in federal case law, the Fifth Circuit adopted the Rule's burden-shifting approach and remanded the case to the trial court to consider its decision in light of the Disparate-Impact Rule.[23]

A concurring opinion observed that on remand, the trial court "should reconsider the State's forceful argument that the appellees did not prove a facially neutral practice that caused the observed disparity" in the allocation of tax credits.[24] It noted earlier case law, including the US Supreme Court's decision in *Smith v. City of Jackson*,[25] that required more than "statistical evidence of disparity alone" to establish a *prima facie* case, and that "[a] plaintiff must specifically identify the facially neutral policy that caused the disparity."[26] As the concurrence stated, "Put more bluntly, if the appellees' framing of disparate impact analysis is correct, then the NBA is *prima facie* liable for disparate impact in the hiring of basketball players."[27]

The concurring opinion further noted that the Department's policies and practices for awarding tax credit grants "are anything but simple," because federal and state statutes "require satisfaction of numerous criteria to ensure the integrity, financial viability, and effectiveness of the projects."[28] In particular, one object of the tax credit statute "is to advantage projects located in low income census tracts or subject to a community revitalization plan," and that "[i]n essence, the appellees are seeking a larger share of the fixed pool of tax credits at the expense of other low-income people who might prefer a community revitalization."[29]

The U.S. Supreme Court's Decision

As it did in two earlier cases, *Gallaher v. Magner*[30] and *Mt. Holly Gardens Citizens in Action, Inc. v. Township of Mount Holly*,[31] the US Supreme Court granted *certiorari* in *Inclusive Communities* to review the following question: "Are disparate impact claims cognizable under the Fair Housing Act?"[32] Justice Kennedy, writing for the five-Justice majority, held that disparate-impact claims are cognizable but, prominently referring to the issues addressed in the concurring opinion to the Fifth Circuit's decision, noted important restrictions on use of the disparate impact theory.

> The *Inclusive Communities* majority opinion began with these observations: [33]
>
> In a concurring opinion, Judge Jones stated that on remand the District Court should re-examine whether the ICP had made out a *prima facie* case of disparate impact. She suggested the District Court incorrectly relied on bare statistical evidence without engaging in any analysis about causation. She further observed that, if the federal law providing for the distribution of low-income housing tax credits ties the Department's hands to such an extent that it lacks a meaningful choice, then there is no disparate-impact liability.
>
> The opinion then stated that the issue before the Supreme Court was whether "under a proper interpretation of the FHA, housing decisions with a disparate impact are prohibited."[34] The majority's analysis relied on several factors that provided evidence of a congressional intent that Section 804(a) and Section 805(a) of the FHA[35] supported disparate-impact claims. The majority found that

the key phrase "otherwise make unavailable" in Section 804(a) "refers to the consequences of an action rather than the actor's intent" based upon its earlier analyses of other antidiscrimination provisions in employment laws.[36] This "results-oriented language" was similar to the provisions of Section 703(a)(2) in Title VII of the Civil Rights Act of 1984[37] as construed in *Griggs v. Duke Power Co.*[38] and Section 4(a) of the Age Discrimination in Employment Act of 1967 (ADEA)[39] as discussed in *Smith v. City of Jackson*.[40]

Based on this, the *Inclusive Communities* majority found:[41]

> Together, *Griggs* holds and the plurality in *Smith* instructs that anti-discrimination laws must be construed to encompass disparate-impact claims when their text refers to the consequences of actions and not just to the mindset of actors, and where that interpretation is consistent with statutory purpose. These cases also teach that disparate-impact liability must be limited so employers and other regulated entities are able to make the practical business choices and profit-related decisions that sustain a vibrant and dynamic free-enterprise system. And before rejecting a business justification—or, in the case of a governmental entity, an analogous public interest—a court must determine that a plaintiff has shown that there is "an available alternative … practice that has less disparate impact and serves the [entity's] legitimate needs."

The majority thus found that the FHA's "otherwise make unavailable" language was "equivalent in function and purpose" to the "otherwise adversely affect" language in Title VII and the ADEA, noting "they serve as catchall phrases looking at consequences not intent."[42] In addition, the majority found that language similar to that in Section 805(a) of the FHA had been construed "to include disparate-impact liability."[43]

The majority ruling found further evidence that disparate impact was intended to be encompassed in the FHA because the statute was amended in 1988 after nine US Courts of Appeals "had concluded the Fair Housing Act encompassed disparate-impact claims."[44] This constituted "convincing support for the conclusion that Congress accepted and ratified the unanimous holdings of the Courts of Appeals finding disparate-impact liability," because "[w]hen it amended the FHA, Congress was aware of this unanimous precedent."[45] The majority also found that, in addition to making no change to the FHA in light of the case law precedent, the 1988 amendments, which added exemptions from FHA liability, "assume the existence of disparate-impact claims," which was additional evidence that Congress intended to allow such claims under the FHA.[46]

The *Inclusive Commun*ities majority observed that the FHA's "central purpose" was served by recognizing disparate-impact liability because it "plays a role in uncovering discriminatory intent" by allowing "plaintiffs to counteract unconscious prejudices and disguised *animus* that escapes easy classification as disparate treatment."[47] However, the opinion went on to state that "disparate-impact liability has always been properly limited in key respects that avoid the serious constitutional questions that might arise under the FHA, for instance, if such liability were imposed based solely on a showing of statistical disparity."[48] The opinion cautioned against taking a view of disparate-impact liability which "may be seen simply as an attempt to second-guess which of two reasonable approaches the housing authority should follow in the sound exercise of its discretion in allocating tax credits for low-income housing."[49] Instead, courts must "give housing authorities and private developers leeway to state and explain the valid interests served by their policies."[50]

The *Inclusive Communities* majority ruling urged that trial courts dealing with disparate-impact cases take a realistic view of the facts to avoid the paradox of "impos[ing] onerous costs on actors who encourage revitalizing dilapidated housing in our Nation's cities merely because some other priority might seem preferable."[51] Citing its earlier decision in *Wards Cove Packing Co. v. Atonio*,[52] also cited in the Fifth Circuit concurrence,[53] the opinion stated:[54]

> [A] disparate-impact claim that relies on a statistical disparity must fail if the plaintiff cannot point to a defendant's policy or policies causing that disparity. A robust causality requirement ensures that "[r]acial imbalance … does not, without more,

establish a prima facie case of disparate impact" and thus protects defendants from being held liable for racial disparities they did not create.

The opinion further cautioned that without the safeguard of a robust causality requirement, "disparate-impact liability might cause race to be used and considered in a pervasive way and 'would almost inextricably lead' governmental or private entities to use 'numerical quotas', and serious Constitutional questions then could arise."[55]

The majority opinion observed, as did the Fifth Circuit concurrence, that if the plaintiff could not show "a causal connection between the Department's policies in a disparate-impact—for instance, because federal law substantially limits the Department's discretion—that should result in dismissal of this case."[56] The opinion also took note of the "well-stated principal dissenting opinion" by Justice Alito when it stated that "[t]he limitations on disparate-impact liability discussed here are also necessary to protect potential defendants against abusive disparate-impact claims."[57] It observed that any remedial orders entered in a disparate-impact case "must be consistent with the Constitution" and must "concentrate on the elimination of the offending practice that 'arbitrar[ily] … operate[s] invidiously to discriminate on the basis of rac[e].'"[58]

The *Inclusive Communities* Dissent

Justice Alito, writing for four dissenting Justices, took a very different view of the cognizability of fair-lending claims under the FHA.[59] Instead of looking for "evidence" of what Congress intended, the dissent looked squarely at the language of the statute to determine whether the words actually used in the statute showed that disparate impact as well as disparate treatment was prohibited by the FHA. The dissent concluded that it was not.

The dissent observed that both Section 804(a) and Section 805(a) of the FHA used the key phrase "because of" in connecting prohibited acts to race, color, national origin, or other protected categories.[60] To the dissenters, "because of" clearly meant the same thing as "by reason of" or "on account of."[61] Thus, "the terms [after] the 'because of' clauses in the FHA supply the prohibited motivations for the intentional acts … that the Act makes unlawful."[62] The dissent noted that "intent makes all the difference" wherever the term "because of" is used, for example in the criminal penalties in the FHA and in other statutes.[63] With respect to the argument that the phrase "make unavailable" in Section 804(a) indicated that disparate impact was included as well as disparate treatment, the dissent stated that "all of the phrases that precede the 'make unavailable' language unmistakably describe *intentional* deprivations of equal treatment, not merely actions that happen to have a disparate effect."[64]

The dissent found that its position was confirmed by the fact that "[t]he very 'concept of disparate-impact liability … was quite novel'" when the FHA was enacted, so that it was "anachronistic to think that the Congress authorized disparate-impact claims in 1968 but packaged that striking innovation so imperceptibly in the FHA's text."[65] In addition, the 1988 amendments to the FHA did not modify the meaning of the language in Section 804(a) and Section 805(a), leading the dissenters to conclude that "Congress has done nothing since 1968 to change the meaning of the FHA prohibitions at issue in this case."[66]

The dissent also stated that it was improper to find, as the majority did, that "Congress implicitly ratified disparate impact in 1988" because of the previous decisions in the US Courts of Appeals that had allowed disparate impact claims.[67] For one thing, the contemporaneous position of the United States before the Supreme Court in the Second Circuit case that provided the burden-shifting formula used by the *Inclusive Communities* trial court was that the FHA did not support disparate impact claims.[68] Furthermore, congressional opinion on the subject of disparate impact liability at the time that the amendments were adopted was not unanimous and the amendments "have all the hallmarks of compromise among these factions."[69] The fact that HUD's Disparate-Impact Rule was now in effect also carried no weight with the dissenters because, in their view, the FHA was "not ambiguous" because it "prohibits only disparate treatment, not disparate impact," and "an agency can never 'rewrite clear statutory terms to suit its own sense of how the statute should operate.'"[70]

The dissent also found no support for disparate impact liability in *Griggs* or *Smith*. It noted that *Griggs* did not even discuss Section 703(a)(2) of Title VII in terms of disparate impact claims but instead looked at Title VII's "objective" to remove barriers to equal employment opportunity.[71] The dissent stated that the "text-free reasoning" in *Griggs* "undoubtedly led to the pattern of Court of Appeals decisions in FHA cases upon which the majority now relies" where courts "often made little effort to ground their decisions in the statutory text."[72]

Turning to the decision in *Smith* where the Supreme Court did "grapple with the text of the provision at issue," the dissent observed that the Supreme Court "unanimously agreed that the first of these provisions, § 4(a)(1), does not authorize disparate-impact claims," and that a majority of the Court would allow disparate-impact claims under Section 4(a)(2).[73] Because the language of Section 804(a) and Section 805(a) "resemble[s] § 4(a)(1) of the ADEA, which the *Smith* Court unanimously agreed does not encompass disparate-impact liability," the dissent found that *Smith* provided no basis to support disparate impact liability under the FHA.[74] Likewise, the dissent found that upon close examination, the statute discussed in *Board of Education v. Harris*,[75] cited by the majority in support of disparate impact liability under section 805(a) of the FHA, provided no support for the majority's conclusion.[76]

The dissent began with the observation that the decision by the US Court of Appeals for the Eighth Circuit in *Gallagher v. Magner*,[77] the first case in which the Supreme Court granted *certiorari* to review disparate impact liability under the FHA which was settled before oral argument was heard,[78] "could be used to attack St. Paul, Minnesota's efforts to combat 'rodent infestation' and other violations of the City's housing code."[79] The dissent concluded with the statement that, "[a]s *Magner* shows, when disparate impact is on the table, even a city's good-faith attempt to remedy deplorable housing conditions can be branded 'discriminatory.'"[80] With respect to the facts in *Inclusive Communities*, the Court noted that "one respondent has sued the Department for not allocating enough credits to higher income areas" while "*another* respondent argues that giving credits to wealthy neighborhoods violates 'the moral imperative to improve the substandard and inadequate affordable housing in many of our inner cities.'"[81] The majority's treatment of disparate impact claims under the FHA led to a conundrum: [82]

> No matter what the Department decides, one of these respondents will be able to bring a disparate-impact case, and if the Department opts to compromise by dividing the credits, both respondents might be able to sue. Congress surely did not mean to put local governments in such a position.

The dissent therefore concluded that "disparate impact can be dangerous," and that "privileging purpose over text also creates constitutional uncertainty," a result that "[w]e should avoid."[83]

Subsequent Fair Lending Case Developments

Inclusive Communities has been applied in only one reported case so far and has been referred to in three other cases, but without consideration of its application to fair lending litigation. The case in which *Inclusive Communities* was applied, *City of Los Angeles v. Wells Fargo & Co.*,[84] involved claims by the city that it had suffered injury as a result of Wells Fargo's discriminatory lending practices, which targeted minority borrowers with expensive mortgage loans that resulted in foreclosures that damaged the city.[85] This case was part of a wave of similar cases filed by local governments that began in Atlanta, Georgia, in 2012[86] and has spread to other areas.[87] The *Wells Fargo* case was one of four cases filed by the city against major mortgage lenders that made similar fair lending claims under the FHA and the Equal Credit Opportunity Act (ECOA).[88]

The *Wells Fargo* court issued an opinion in 2014 that denied a motion to dismiss the complaint for failure to state a claim.[89] However, the court granted Wells Fargo's summary judgment motion less than a month after the *Inclusive Communities* decision was handed down by the Supreme Court. Taking seriously the *Inclusive Communities* Court's admonition that trial courts examine disparate impact allegations "with care," the *Wells Fargo* court took a close look at the evidence that supported the city's claims.[90]

The city's disparate impact claims related to the bank's lending practices with respect to two of its mortgage products, high-cost loans and loans made under the US Federal Housing Authority (USFHA) program.[91] With respect to high-cost loans, the court found a lack of quantitative evidence to support the city's claim. Out of 4,260 loans to minority borrowers, only 27 were high-cost, and only 12 of those loans were for owner-occupied homes, to which the FHA applies.[92] Five of the 12 went to African-American borrowers and seven went to Hispanic borrowers, while only four similar loans were issued to white borrowers.[93] Although the city asserted that these numbers were "statistically significant," the court disagreed, finding that "[t]he City's only evidence to prove that statistical adverse effect is the blistering statistical comparison of '0.0033% likelihood' to '0.0008% likelihood,'" which its own expert found unconvincing.[94]

The *Wells Fargo* court found that the *Inclusive Communities* decision "precludes the City's statistical disparity evidence from creating a genuine issue regarding a *prima facie* case."[95] In addition, it found that the city failed to identify a "policy or policies that caused the disparity," as required by *Inclusive Communities*.[96] The city argued that the bank "failed to appropriately monitor relevant data to identify and correct the disproportionate issuance of High-Cost loans to minority borrowers," but the court found that this was a lack of a policy rather than a policy and was "essentially advocating for racial quotas."[97] The court found that this was exactly the sort of result that *Inclusive Communities* held would raise "serious constitutional concerns" and that "Wells Fargo cannot constitutionally issue high-cost loans based on a racial quota system."[98]

As to the USFHA loans, the *Wells Fargo* court found additional problems. Under the USFHA program, borrowers with poor credit could obtain mortgage loans with down payments as low as 3.5 percent of the purchase price, compared with conventional loans that required an excellent credit rating plus a 20 percent down payment.[99] The program also required that borrowers purchase mortgage insurance, resulting in higher costs than conventional mortgage loans.[100] The court found that, contrary to the city's claims, the higher cost USFHA loans offered to minority borrowers did not create a disproportionately adverse effect on them when all of the costs and benefits of the program were considered, because the program allowed the bank to "issue what would otherwise be a high-risk loan because the federal government is the guarantor of the loan and assumes the risk of default."[101]

The court further took note of statements by HUD and President Obama lauding the USFHA loan program for enabling minority borrowers to buy homes, and even a resolution by the city that encouraged borrowers to seek such loans.[102] Moreover, with respect to the city's claims that the bank's policies created an "artificial, arbitrary, and unnecessary barrier" to be removed by means of its disparate impact case, the court found that "[t]he only decision Wells Fargo made was to participate in this federally created and sanctioned lending program."[103] The court therefore found that:[104]

> If any disparate impact results from USFHA loans, it is a result of federal policy and not Wells Fargo policy. Furthermore, the federal government is clearly unconcerned by the large number of minority families seeking USFHA loans as HUD boasts about these statistics on an annual basis.

Furthermore, the *Wells Fargo* court found that holding the bank liable for participating in "a program explicitly designed to give minority borrowers access to affordable loans" would violate the command of *Inclusive Communities* that "defendants are not 'held liable for racial disparities they did not create.'"[105]

The court closed its discussion by noting that the city's disparate impact lawsuit was supposed "to hold Wells Fargo accountable for its role in the subprime mortgage crisis of the last decade," and that "[t]he City insinuated that it would vindicate the rights of the oppressed minority homeowner through this suit."[106] It found that the city's arguments against USFHA loans, made in order to bring some of the bank's conduct within the applicable two-year statute of limitations, were "disheartening."[107] The court stated:[108]

> USFHA loans help low-income families overcome those barriers [to homeownership]. Minority borrowers with poor credit and little money for a down payment can put their family in a home through a USFHA loan. The City apparently does not care about barriers to minority homeownership or the benefits USFHA loans provide to low-income Angelinos. The City was willing to end the program specifically designed to help minority borrowers in exchange for a few thousand dollars in the City coffer. The City is not a champion of minority rights as it declared in the Complaint.

The City of Miami filed similar suits against the same four major mortgage lenders at the same time that Los Angeles filed its suits.[109] Unlike the Los Angeles case against Wells Fargo, however, three of the Miami cases were dismissed on motions for failure to state a claim on the ground that the city had failed to establish standing to sue under the FHA.[110] On appeal from these decisions, the US Court of Appeals for the Eleventh Circuit issued three opinions on September 1, 2015, that reversed the dismissal orders.[111]

The Eleventh Circuit issued its lengthiest opinion in *City of Miami v. Bank of America, N.A.*,[112] and adopted the reasoning in that decision in the two other cases.[113] Most of the court's *Bank of America* decision dealt with the city's standing to sue under the FHA, finding that it had both Article III standing[114] and statutory standing.[115] The *Bank of America* court also found that the city had sufficiently alleged proximate causation[116] and that its allegations were sufficient to invoke the continuing violation doctrine for limitations purposes.[117]

At the end of its discussion on standing and the other elements necessary to state a claim, the *Bank of America* court observed that "while this appeal was pending, the Supreme Court handed down a decision that may materially affect the resolution of this case" after remand.[118] It noted that the *Inclusive Communities* Court held that disparate impact claims are cognizable under the FHA and that the Supreme Court also made some pronouncements "in *dicta*."[119] These pronouncements included:[120]

- Avoiding serious constitutional issues;
- Protecting defendants "from abusive disparate-impact claims";
- Allowing defendants to explain the interests served by their policies;
- The "robust causality requirement"; and
- The requirement that disparate impact claims "must be aimed at 'removing artificial, arbitrary, and unnecessary barriers' rather than 'displac[ing] valid governmental and private priorities.'"

The *Bank of America* court stated that on remand, "[a]ny newly pled complaint must take into account the evolving law on disparate impact in the FHA context," something the court could not "pass judgment on" in the absence of an amended complaint.[121]

Subsequent Enforcement Developments

Neither the CFPB nor the US Department of Justice (DOJ) has brought an enforcement action against a mortgage lender for a violation of the FHA since *Inclusive Communities* was decided. Indeed, only one such enforcement action has been brought since the end of 2013,[122] possibly because the agencies were waiting to see how the Supreme Court ruled on the question of whether disparate impact claims are cognizable under the FHA in *Inclusive Communities*. However, following the *Inclusive Communities* ruling, two enforcement actions were brought against auto finance companies pursuant to the CFPB's and the DOJ's authority under the antidiscrimination provisions of the ECOA[123] and Regulation B.[124]

The first action, against American Honda Finance Corporation (AHFC), filed two weeks after the *Inclusive Communities* decision was issued, alleged that African-American, Hispanic, and Asian/Pacific Islander automobile buyers whose purchases were financed by AHFC paid 36 basis points, 28 basis points, and 25 basis points more, respectively, than similarly situated white purchasers.[125] No evidence of discrimination was alleged other than these statistical disparities, which were alleged to be "statistically significant" and "based on race and not based on creditworthiness or other objective criteria related to borrower risk."[126] The only AHFC policy identified was its "policy and practice of allowing dealers to markup a consumer's interest rate above Honda's established buy rate and then compensating dealers from that increased interest revenue."[127] In addition, it was alleged that AHFC "has not monitored whether discrimination occurred across its portfolio of loans through charging markups."[128] Under its consent orders with the CFPB and the DOJ, AHFC agreed to pay $24 million in restitution to affected consumers, but without a civil fine.[129] It also agreed to change its interest rate markup policy under one of three options set forth in the consent orders,[130] including a flat rate system that would eliminate any discretion to auto dealers in marking up the buy rate.[131]

The CFPB and the DOJ brought a similar enforcement action against Fifth Third Bank in September 2015 based on automobile purchase contracts that were financed by the bank.[132] Allegedly, African-American and Hispanic purchasers were charged 35 and 36 basis points, respectively, more than similarly situated white purchasers.[133] Again, the disparities were alleged to be "significantly significant" and "based on national origin and not based on creditworthiness or other objective criteria related to borrower risk."[134] The only bank policy identified was its "policy and practice of allowing dealers to markup a consumer's interest rate above Fifth Third's established buy rate and then compensating dealers from that increased interest revenue," without "timely and adequate action to address markup disparities that Fifth Third had identified across its portfolio of retail installment contracts."[135] In addition, the bank allegedly "has not at all times monitored whether discrimination occurred in its portfolio of loans through charging markups."[136] Fifth Third agreed to pay $18 million in restitution to affected consumers, without a civil fine,[137] and it agreed to follow the same three options for changing its interest rate markup policy as AHFC.[138]

Conclusion

At this point, the courts are only beginning to grapple with what the cautionary language in *Inclusive Communities* means and how it should be applied. The CFPB and the DOJ, on the other hand, are continuing to bring enforcement actions that seem to rely on a view of the disparate impact theory that does not take into account the *Inclusive Communities* Court's cautionary pronouncements. Specifically, mere statistical evidence appears to continue to be sufficient for the CFPB and the DOJ to pursue enforcement actions. And, the absence of a policy of the target, rather than policies of the other parties that it does business with, that proximately causes a disparate impact also seems to present no barrier to fair-lending enforcement actions, so far.

However, unless targets of fair-lending enforcement actions decide that the CFPB's statistical evidence and failure to identify policies that cause a disparate impact are no longer sufficient to provide a viable basis for such actions against them under the *Inclusive Communities* decision, and they therefore resist the CFPB's terms for proposed consent orders, the limitations imposed on governmental action by the decision will not be tested in court. To date, no major target has ever publicly challenged a fair-lending enforcement in court. Three smaller targets have moved to dismiss fair-lending enforcement actions by the DOJ and the Federal Trade Commission, but all of the cases eventually resulted in consent orders, likely with harsher terms than otherwise could have been negotiated.[139]

In addition, it remains to be determined whether the ruling in *Inclusive Communities*, including the cautions about the use of statistical evidence and a robust causation requirement, applies to actions under the ECOA, which, unlike the FHA, governs all forms of lending, not just mortgage lending. This issue, likewise, is unlikely to be tested in court unless an enforcement target subject only to the ECOA, like an auto finance company, decides to resist the proffered terms of a consent order.

Because all of the pending fair-lending cases brought by local governments involve mortgage lending practices that are subject to the fair-lending provisions of the FHA, those cases are unlikely to turn on differences between the provisions of the ECOA and the FHA with respect to what is required to prove a violation. Instead, the mortgage lenders that are the targets in these cases, like Wells Fargo in the Los Angeles case, will most likely seek to prevail at the summary judgment stage, based on application of the *Inclusive Communities* strictures to the evidence adduced by the plaintiff local governmental entities.

Notes

1. Pub. L. No. 90-284, tit.VIII, 82 Stat. 73, 81–89 (1968) (codified as amended at 42 U.S.C. §§ 3601-3631 (2012)).
2. 135 S. Ct. 2507 (2015).
3. *See* John L. Ropiequet, Christopher S. Naveja & L. Jean Noonan, "Fair Lending Developments: A Continuation and a New Beginning," 70 *Bus. Law*. 625, 626–29 (2015) [hereinafter Fair Lending 2015] (discussing fair lending enforcement settlements based on statistical disparities); John L. Ropiequet, Christopher S. Naveja & L. Jean Noonan, "Fair Lending Developments: Enforcement Intensifies, Class Actions Diminish," 68 *Bus. Law*. 637, 637–42 (2013) [hereinafter Fair Lending 2013] (same).
4. *Inclusive Communities*, *supra* n.2 at 2523.
5. *See* John L. Ropiequet & Christopher S. Naveja, "A Curious Dichotomy: Fair Lending Litigation and Enforcement Actions Following *Wal-Mart Stores, Inc. v. Dukes*," 32 *Banking & Fin. Serv. Policy Rep*. 1 (January 2013) [hereinafter Curious Dichotomy].
6. 131 S. Ct. 2541 (2011).
7. *See* Curious Dichotomy, *supra* n.5, at 7–8.
8. *See* John L. Ropiequet, "The CFPB's Proposed Larger Participant Rule for Non-Bank Auto Lenders," 34 *Banking & Fin. Serv. Policy Rep*. 1 (March 2015).
9. *See* John L. Ropiequet, "Is the Invalidation of HUD's Disparate-Impact Rule a Harbinger or a Footnote?", 34 *Banking & Fin. Serv. Policy Rep*. 12, 16 (April 2015) [hereinafter Harbinger]. *See also* John L. Ropiequet, Christopher S. Naveja & L. Jean Noonan, "Fair Lending Developments: Is Disparate Impact Here to Stay?", 69 *Bus. Law*. 609, 611–13 (2014).

10. *See* Harbinger, *supra* n.9, at 12 & n.4.

11. *See id*. at 13–14.

12. *Inclusive Cmtys. Project, Inc. v. Tex. Dep't of Hous. & Cmty. Affairs*, 747 F.3d 275, 277 (5th Cir. 2014), *aff'd*, 135 S. Ct. 2507 (2015). *See* 26 U.S.C. § 42 (2012).

13. *Inclusive Cmtys*., *supra,* n.12, 747 F.3d *at* 277.

14. *Id*. at 277–78.

15. *Id*. at 277.

16. *Id*. at 278.

17. *Id*. at 279.

18. *Id*. at 280 (citing *Huntington Branch, NAACP v. Town of Huntington*, 844 F.2d 926, 939 (2d Cir.), *aff'd*, 488 U.S. 15 (1988)).

19. *Id*.

20. *Id*.

21. *Id*.

22. *Id*. at 281–82.

23. *Id*. at 282–83

24. *Id*. at 283.

25. 544 U.S. 228, 241 (2005).

26. *Inclusive Cmtys*., *supra,* n.12, 747 F.3d at 283.

27. *Id*. at 284.

28. *Id*.

29. *Id*.

30. 619 F.3d 823 (8th Cir. 2010), *cert. granted*, 132 S. Ct. 548 (2011) & *cert. dismissed*, 132 S. Ct. 1306 (2012). *See* Question Presented, *Magner v. Gallagher*, No. 10-1032 (U.S. Nov. 11, 2011), available at *http://www.supremecourt.gov/qp/10-01032qp.pdf,* last accessed Oct. 30, 2015.

31. 658 F.3d 375 (3d Cir. 2011), *cert. granted*, 133 S. Ct. 2824 (2013) & *cert. dismissed*, 134 S. Ct. 636 (2013). *See* Question Presented, *Twp. of Mt. Holly v. Mt. Holly Citizens in Action, Inc.*, No. 11-1507 (U.S. June 17, 2013), available at *http://www.supremecourt.gov/qp/11-01507qp.pdf,* last accessed Oct. 30, 2015.

32. *See* Question Presented, *Tex. Dep't of Hous. & Cmty. Affairs v. Inclusive Cmtys. Project*, Inc., No. 13-1371 (U.S. Oct. 2, 2014), available at *http://www.supremecourt.gov/qp/13-01371qp.pdf,* last accessed Oct. 30, 2015 .

33. *Inclusive Cmtys*., *supra,* n.12, 135 S. Ct. at 2515.

34. *Id*. at 2516.

35. 42 U.S.C. §§ 3604(a), 3605(a) (2012).

36. *Inclusive Cmtys*., *supra,* n.12, 135 S. Ct. at 2518.

37. 42 U.S.C. § 2000e-2(a)(2) (2012).

38. 401 U.S. 424 (1971).

39. 29 U.S.C. § 623(a) (2012).

40. 544 U.S.C 228 (2005). *See Inclusive Cmtys*., *supra,* n.12, 135 S. Ct. at 2516–18.

41. *Id*. at 2518 (citing *Ricci v. DeStefano*, 557 U.S. 557, 578 (2009)).

42. *Id*. at 2519.

43. *Id*. at 2518–19 (citing *Bd. of Educ. v. Harris*, 444 U.S. 130, 140–41 (1979)).

44. *Id*. at 2519 (citing *Huntington Branch, NAACP v. Town of Huntington,* 844 F.2d 926, 935–36 (2d Cir. 1988); *Resident Advisory Bd. v. Rizzo,* 564 F.2d 126, 146 (3d Cir. 1977); *Smith v. Clarkton,* 682 F.2d 1055, 1065 (4th Cir. 1982); *Hanson v. Veterans Admin.,* 800 F.2d 1381, 1386 (5th Cir. 1986); *Arthur v. Toledo,* 782 F.2d 565, 574–75 (6th 1986); *Metro. Hous. Dev. Corp. v. Vill. of Arlington Heights,* 558 F.2d 1283, 1290 (7th 1977); *United States v. Black Jack,* 508 F.2d 1179, 1184–85 (8th 1974); *Halet v. Wend Inv. Co.,* 672 F.2d 1305, 1311 (9th 1982); *United States v. Marengo Cty. Comm'n,* 731 F.2d 1546, 1559 n.20 (11th 1984).

45. *Id*. at 2520.

46. *Id*.

47. *Id*. at 2521–22.

48. *Id*. at 2522.

49. *Id*.

50. *Id*.

51. *Id*. at 2523.

52. 490 U.S. 642, 653 (1989).

53. *Inclusive Cmtys*., *supra,* n.12, 747 F.3d at 284 (concurring opinion).

54. *Inclusive Cmtys*., *supra,* n.12, 135 S. Ct. at 2523.

55. *Id*.

56. *Id*. at 2524 (citing *Inclusive Cmtys*., *supra,* n.12, 747 F.3d at 283–84 (concurring opinion)).

57. *Id*.

58. *Id*.

59. Justice Thomas, who joined in Justice Alito's dissent, wrote a separate dissent in which he stated his view that *Griggs* improperly interpreted Title VII as allowing disparate impact claims and therefore did not provide a proper basis for interpreting the FHA as allowing such claims. *Id*. at 2526–32.

60. *Id*. at 2533.

61. *Id*. at 2534 (citing *Univ. of Tex. Sw. Med. Center v. Nasser*, 133 S. Ct. 2517, 2527, 2530 (2013).

62. *Id*. (citing *Am. Ins. Ass'n. v. Dep't of Hous. & Urban Dev.*, 74 F. Supp. 3d 30, 40 n. 20 (D.D.C. 2014)).

63. *Id*. (citing 42 U.S.C. § 3631(a); 18 U.S.C. § 249).

64. *Id*. at 2536 (citing *Am. Ins. Ass'n*., *supra* n.62, at 40).

65. *Id*. at 2537 (citing *Smith v. City of Jackson*, 544 U.S. 228, 258 (2005) (O'Connor, J., concurring)).

66. *Id*.

67. *Id*.

68. *Id*. at 2538–39 (citing Brief for the United States as *Amicus Curiae*, *Town of Huntington v. Huntington Branch, NAACP*, No. 87-1961, at 15). *See supra* n.18 and accompanying text.

69. *Inclusive Cmtys.*, *supra,* n.12, 135 S. Ct. at 2540–41.

70. *Id*. at 2543 (citing *Utility Air Regulatory Grp. v. U.S. Envtl. Prot. Agency*, 134 S. Ct. 2427, 2446 (2014)).

71. *Id.* at 2544.

72. *Id.* (citing *United States v. Black Jack*, 508 F.2d 1179, 1184 (8th Cir. 1974)).

73. *Id.* at 2545.

74. *Id.* at 2546.

75. 444 U.S. 130, 132–33 (1979).

76. *Inclusive Cmtys.*, *supra,* n.12, 135 S. Ct. at 2548.

77. 619 F.3d 823 (8th Cir. 2010), *cert. granted*, 132 S. Ct. 548 (2011), & *cert. dismissed*, 132 S. Ct. 1306 (2012).

78. Justice Thomas's dissent noted Assistant Attorney General Perez's "secret deal with the petitioners" in *Gallagher* "to prevent this Court from answering the question" presented in that case. *Inclusive Cmtys.*, *supra,* n.12, 135 S. Ct. at 2529 n.4.

79. *Id.* at 2532 (citing *Gallagher*, *supra,* n.77, at 830).

80. *Id.* at 2548 (citing *Gallagher*, *supra,* n.77, at 834).

81. *Id.* (citing Reply Brief for Respondent Frazier Revitalization Inc., at 1).

82. *Id.* at 2549.

83. *Id.* at 2550–51.

84. No. 2:13-cv-9007-ODW-RZx, 2015 WL 4398859 (C.D. Cal. July 17, 2015), *app. docketed*, No. 15-56157 (9th Cir. July 29, 2015).

85. *Id.* at *1.

86. *See* Complaint, *DeKalb Cty. v. HSBC N. Am. Holdings, Inc.,* No. 1:12-cv-03640-SCJ (N.D. Ga. Oct. 12, 2012). *See* Fair Lending 2015, *supra* n.3, at 631–33.

87. *See, e.g.*, *Complaint, Cty. of Cook v. HSBC N. Am. Holdings, Inc.,* No. 1:14-cv-2031 (N.D. Ill. Mar. 21, 2014).

88. *See* Complaint, *City of Los Angeles v. Citigroup, Inc.,* No. 2:13-cv-9009-ODW-RZx (C.D. Cal. Dec. 5, 2013); Complaint, *City of Los Angeles v. Bank of Am. Corp.,* No. 2:13-cv-9046-PA-AGR (C.D. Cal. Dec. 5, 2013); Complaint, *City of Los Angeles v. JP Morgan Chase & Co.,* No. 2:14-cv-4168-ODW-RZx (C.D. Cal. May 30, 2014).

89. *City of Los Angeles v. Wells Fargo & Co.,* No. 2:13-cv-9007-ODW-RZx, 2014 U.S. Dist. LEXIS 72818 (C.D. Cal. May 28, 2014). *See* Fair Lending 2015, *supra* n.3, at 633–34.

90. *Wells Fargo*, 2015 WL 4398858, at *6.

91. *Id.* at *2.

92. *Id.* at *7.

93. *Id.*

94. *Id.*

95. *Id.*

96. *Id.* at *8.

97. *Id.*

98. *Id.*

99. *Id.* at *9.

100. *Id.* at *2.

101. *Id.* at *10.

102. *Id.* at *10–11.

103. *Id.* at *12.

104. *Id.* at *13.

105. *Id.*

106. *Id.*

107. *Id.*

108. *Id.* at *14.

109. *See* Complaint, *City of Miami v. Bank of Am. Corp.,* No. 1:13-cv-24506 (S.D. Fla. Dec. 13, 2013); Complaint, *City of Miami v. Wells Fargo & Co.,* No. 1:13-cv-24508 (S.D. Fla. Dec. 13, 2013); Complaint, *City of Miami v. Citigroup, Inc.,* No. 1:13-cv-24510 (S.D. Fla. Dec. 13, 2013); Complaint, *City of Miami v. JP Morgan Chase & Co.,* No. 1:14-cv-22205 (S.D. Fla. June 13, 2014).

110. *City of Miami v. Bank of Am. Corp.*, No. 1:13-cv-24506, 2014 U.S. Dist. LEXIS 95445 (S.D. Fla. July 8, 2014), *rev'd*, 2015 U.S. App. LEXIS 15444 (Sept. 1, 2015); *City of Miami v. Wells Fargo & Co.,* No. 1:13-cv-24508, 2014 U.S. Dist. LEXIS 95445 (July 8, 2014), *rev'd*, 2015 U.S. App. LEXIS 15443 (Sept. 1, 2015); *City of Miami v. Citigroup, Inc.,* No. 1:13-cv-24510, 2014 U.S. Dist. LEXIS 95445 (July 8, 2014), *rev'd*, 2015 U.S. App. LEXIS 15442 (Sept. 1, 2015).

111. *City of Miami v. Bank of Am. Corp.,* No. 14-14543, 2015 U.S. App. LEXIS 15444 (Sept. 1, 2015); *City of Miami v. Citigroup, Inc.,* No. 14-14706, 2015 U.S. App. LEXIS 15442 (Sept. 1, 2015); *City of Miami v. Wells Fargo & Co.,* No. 14-14544, 2015 U.S. App. LEXIS 15443 (Sept. 1, 2015).

112. *Bank of Am.*, 2015 U.S. App. LEXIS 15444, at *3 n.1.

113. *Citigroup*, 2015 U.S. App. LEXIS 15442, at *3; *Wells Fargo*, 2015 U.S. App. LEXIS 15443, at *3.

114. *Bank of Am.*, 2015 U.S. App. LEXIS 15444, at *24.

115. *Id.* at *38.

116. *Id.* at *52.

117. *Id.* at *58 (citing *City of Los Angeles v. Bank of Am. Corp.,* 2014 U.S. Dist. LEXIS 161164, at *7 (C.D. Cal. Nov. 14, 2014); *City of Los Angeles v. JP Morgan Chase & Co.,* 24 F. Supp. 3d 940, 952 (2014)).

118. *Id.* at *60.

119. *Id.* at *61.

120. *Id.* at *61–62.

121. *Id.* at *62.

122. *See* Complaint, *United States v. Provident Funding Assoc., L.P.,* No. 3:15-cv-02373 (N.D. Cal. May 28, 2015), available at *http://files.consumerfinance.gov/f/201505_cfpb_complaint-provident-funding-associates.pdf,* last accessed Oct. 30, 2015.

123. Pub. L. No. 93-495, tit.V, 88 Stat. 1500, 1521–25 (1974) (codified as amended at 15 U.S.C. §§ 1691-1691f (2012)).

124. 12 C.F.R. pt. 1002 (2015).

125. Complaint at 5–6, *United States v. Am. Honda Fin. Corp.,* No. 2:15-cv-05264 (C.D. Cal. July 14, 2015), available at *http://www.justice.gov/opa/file/629806/download,* last accessed Oct. 30, 2015.

126. *Id.*

127. *Id.* at 6.

128. *Id*.

129. Consent Order 10, *United States v. Am. Honda Fin. Corp.,* No. 2:15-cv-05264 (C.D. Cal. July 14, 2015) [hereinafter Honda DOJ Consent Order], available at *http://www.justice.gov/opa/file/629811/download,* last accessed Oct. 30, 2015; Consent Order at 16, *In re Am. Honda Fin. Corp.,* No. 2015-CFPB-0014 (July 14, 2015) [hereinafter Honda CFPB Consent Order], available at *http://files.consumerfinance.gov/f/201507_cfpb_consent-order_honda.pdf,* last accessed Oct. 30, 2015.

130. Honda DOJ Consent Order, *supra* n.129, at 4–9; Honda CFPB Consent Order, *supra* n.129, at 10–15.

131. Honda DOJ Consent Order, *supra* n.129, at 9; Honda CFPB Consent Order, *supra* n.129, at 14–15.

132. *See* Complaint, *United States v. Fifth Third Bank*, No. 1:15-cv-00626-MRB (S.D. Ohio Sept. 28, 2015), available at *http://www.justice.gov/opa/file/778601/download,* last accessed Oct. 30, 2015.

133. *Id*. at 5–6.

134. *Id*. at 6.

135. *Id*.

136. *Id*. at 7.

137. Consent Order at 12, *United States v. Fifth Third Bank*, No. 1:15-cv-00626-MRB (S.D. Ohio Sept. 28, 2015) [hereinafter Fifth Third DOJ Consent Order], available at *http://www.justice.gov/opa/file/778606/download,* last accessed Oct. 30, 2015; Consent Order at 15–16, *In re Fifth Third Bank*, No. 2015-CFPB-0024 (Sept. 28, 2015) [hereinafter Fifth Third CFPB Consent Order], available at *http://files.consumerfinance.gov/f/201509_cfpb_consent-order-fifth-third-bank.pdf,* last accessed Oct. 30, 2015.

138. Fifth Third DOJ Consent Order, *supra* n.137, at 5–10; Fifth Third CFPB Consent Order, *supra* n.137, at 9–14.

139. A lengthy DOJ enforcement case asserting that an auto dealership discriminated against non-Asian credit buyers resulted in a consent order after the case was dismissed by the trial court and the dismissal was reversed on appeal. *See United States v. Nara Bank,* No. 2:09-cv-7124-RGK-JC, 2010 U.S. Dist. LEXIS 78918 (C.D. Cal. May 28, 2010), *rev'd sub nom*. *United States v. Union Auto Sales, Inc.,* 490 F.App'x 847 (9th Cir. 2012); Consent Decree, *United States v. Nara Bank,* No. 2:09-cv-7124-RGK-JC (C.D. Cal. Sept. 4, 2013), available at *http://www.justice.gov/crt/about/hce/documents/unionautosales_settle.pdf,* last accessed Oct. 30, 2015. *See also* Fair Lending 2015, *supra* n.3, at 629. The defendant in another DOJ enforcement case entered into a consent order before its motion to dismiss was ruled on. *See* Consent Order, *United States v. GFI Mortg. Bankers, Inc.,* 12-CV-2502-KBF (S.D.N.Y. Aug. 27, 2012), available at *http://www.justice.gov/crt/about/hce/documents/gfisettle.pdf,* last accessed Oct. 30, 2015. *See also* Fair Lending 2013, *supra* n.3, at 639–40. An FTC enforcement case also resulted in a settlement without reaching a court decision on a motion to dismiss. *See* Stipulated Final Judgment and Order, *FTC v. Golden Empire Mortg., Inc.,* No. CV09-3227 CAS (HSx) (N.D. Cal. Sept. 20, 2010), available at *https://www.ftc.gov/sites/default/files/documents/cases/2010/09/100920gemstip.pdf,* last accessed Oct. 30, 2015. *See also* John L. Ropiequet, Christopher S. Naveja & L. Jean Noonan, "Fair Lending Developments: The End of Discretionary Pricing?", 65 *Bus. Law*. 571, 579 (2010).

THE MONITOR

The Monitor is an agenda of matters of interest to the financial services industry. The Monitor includes: (1) regulatory and related matters on which comment periods are open; (2) important regulatory initiatives that are still pending and under active consideration; (3) recent regulatory matters of continued urgency to the financial services community; and (4) cases pending before the US Supreme Court and other federal and state courts. All cases are listed by subject. Unless otherwise noted, this issue of The Monitor covers developments during the period September 20, 2015, through October 20, 2015.

BANK REGULATION

CFPB Wants More HMDA Data from Smaller Number of Lenders

The Consumer Financial Protection Bureau (CFPB) has amended Reg. C—Home Mortgage Disclosure (12 CFR Part 1003) to reduce the number of lenders that must file reports but require more data to be collected and reported. According to the bureau, the amendments will reduce the number of banks and credit unions that must file Home Mortgage Disclosure Act (HMDA) reports by about 22 percent, but will require those that must report to collect up to 48 data points for each loan or application. The amendments also are intended to make it easier for institutions to file reports by making data collection consistent with established industry standards.

The version of the final rule published on the CFPB's Web site runs a lengthy 797 pages. In an effort to explain the amendments, the bureau has provided a summary of the rule and a separate summary of the data points that must be collected. The CFPB also has provided an implementation timeline for the amendments that shows no changes for 2016. Compliance will be phased in beginning Jan. 1, 2017, and full compliance will be required with reports to be filed in 2020.

HMDA requires lenders to collect and report information on home loan applications, originations, and purchases. The information is published and can be used for several regulatory purposes, including identifying potential home loan discrimination. According to the bureau, the Dodd-Frank Act expanded the information that is to be collected in an effort to make available information about practices that were seen as having contributed to the mortgage crisis, such as adjustable-rate loans and loans with nonamortization features. A proposal to implement the changes was announced in July 2014.

Covered institutions

The rule amendments retain and expand existing exemptions for smaller financial institutions. The bureau says that a new reporting threshold will exclude small depository institution lenders with low loan volumes. Institutions that originated fewer than 25 closed-end loans or 100 open-end loans during the two previous calendar years will be exempt from reporting obligations.

According to the bureau, these lenders are involved in such a small number of loans that exempting them will not affect the usefulness of the total HMDA data that is collected.

The rule retains existing asset-size, location, loan activity, and "federally-related" tests for which institutions are covered. Beginning in 2018, bank, thrift, and credit unions lenders will be covered if they meet all four tests and the loan-volume threshold, while nonbank lenders will be covered if they meet only the location and loan-volume threshold, the bureau's summary says. All lenders will be subject to the same loan-volume threshold after the amendments take effect.

Covered transactions

The definition of the types of transactions that are covered by the HMDA rule is being changed to what the CFPB calls a "dwelling-secured standard," as opposed to the current "purpose-based test," for consumer-purpose loans and applications. For business-purpose loans, the rule will use both a dwelling-secured test and purpose-based test.

Loans or credit lines for commercial purposes are not covered by the amended rule unless they are for home purchase, home improvement, or refinancing purposes. Home improvement loans that are not secured by a dwelling are excluded from the rule's coverage, as are agricultural-purpose loans.

The treatment of preapproval requests also is being changed. Covered institutions will be required to report information on home purchase loan preapproval requests that are approved but not accepted. Requests for preapprovals of open-end lines of credit, reverse mortgages, and purchase loans to be secured by multifamily residences will not be reportable covered transactions.

Data points

The summary of reportable data provided by the bureau shows that the amendments require lenders to collect and report 25 new data points and that 12 existing data points are being modified. The CFPB's notice says that the total 48 data points can be separated into four categories:

- Information about applicants, borrowers, and underwriting, including age, credit score, debt-to-income ratio, and automated underwriting system results;
- Information about the property securing the loan, such as construction method and property value, as well as additional information about manufactured and multifamily housing;
- Information about the loan's features, such as additional pricing information, loan term, interest rate, introductory rate period, nonamortizing features, and the type of loan; and
- Unique identifiers, such as a universal loan identifier, property address, loan originator identifier, and a legal entity identifier for the financial institution.

Additionally, lenders that collect information about applicants' ethnicity, race, or gender based on visual observation or surname must disclose that they do so. If ethnicity and race information is provided by the applicant or borrower, the financial institution must permit that applicant or borrower to self-identify using disaggregated ethnic and racial categories.

Reporting burden

According to the bureau, it will be easier for covered institutions to file reports because many of the data points to be collected are the same as or similar to data that institutions already collect for processing, underwriting, pricing, or secondary-market sale purposes. The data points also "align with well-established industry data standards." This consistency will reduce the reporting burden and also provide better quality, more useful data, the CFPB believes.

The CFPB will eliminate the loan/application register (HMDA-LAR) using a two-step process. Institutions will be required to submit LARs electronically in 2018. Beginning in 2019, they will be required to use a new online submission tool and revised submission procedures.

Beginning in 2020, lenders that reported at least 60,000 originated loans and applications in the preceding year will be required to file quarterly reports.

The amendments will relieve lenders of the obligation to provide a disclosure statement or modified LAR on request. Instead, they will be permitted simply to refer the requestor to the CFPB's Web site.

The CFPB notice will be in an upcoming issue of the *Report*.

CFPB to Ban No-Class-Action Arbitration Clauses?

Taking another step closer to regulating mandatory pre-dispute arbitration clauses, the Consumer Financial Protection Bureau (CFPB) has released an outline of the proposals under consideration. Although the bureau's proposals would not entirely ban arbitration clauses, the proposals would ban arbitration clauses that block class action lawsuits in consumer contracts. The proposed ban would apply to most consumer financial products, including credit cards, checking and deposit accounts, prepaid cards, money transfer services, certain auto loans, auto title loans, small dollar or payday loans, private student loans, and installment loans.

Arbitration study

In March, the bureau released the results of its arbitration study, in which it concluded that arbitration clauses restrict consumers' relief for disputes with financial service providers by limiting class actions. The bureau found that few consumers individually seek relief through arbitration or the federal courts, while millions of consumers are eligible for relief each year through class action settlements. According to the CFPB's study, from 2008 to 2012, approximately 6.8 million consumers received $220 million in payments from class action settlements per year.

However, the bureau's study also found that most arbitration agreements can be used to move class lawsuits from court to arbitration, where class proceedings are typically prohibited under the arbitration agreement. Companies often successfully use arbitration agreements in consumer financial class litigation cases filed in court to block access to any form of class proceeding for those claims.

Proposed rulemaking

To address these concerns, the bureau is considering a proposed rule that would require any arbitration agreement included in a contract for a consumer financial product or service offered by a covered entity to expressly provide that the arbitration agreement is inapplicable to class action cases unless and until class certification is denied or the class claims are dismissed. The requirement would apply to arbitration agreements entered into at least 180 days from the effective date of any regulation.

The bureau is also considering a requirement that covered entities that use arbitration agreements submit initial claim filings and written awards in consumer finance arbitration proceedings to the bureau. The bureau is also considering whether to publish the claims or awards to its Web site, making them available to the public. This would permit the bureau (and the public, if the bureau chose to publish them) to monitor arbitrations and identify arbitration trends and potentially problematic business practices that harm consumers.

Covered companies

According to the bureau, the proposed ban would apply to companies that provide financial products or services for consumer purposes, as defined in the Dodd-Frank Act. The bureau provided an extensive list of companies that may be affected, including, but not limited to: depository institutions, credit unions, credit card issuers, certain auto and auto title lenders, payday lenders, private student lenders, loan originators that are not creditors, remittance transfer providers, currency exchanges, issuers of general-purpose reloadable prepaid cards, virtual currency providers, credit repair organizations, debt settlement firms, providers of credit monitoring services, and debt buyers. The bureau is also considering whether to cover additional consumer financial products and services, such as payment processing.

The bureau is considering excluding from its proposed regulation products or services that are in any of the following categories:

(1) Already subject to arbitration rules issued by the Securities and Exchange Commission or the Commodity Futures Trading Commission;
(2) Provided by persons when not regularly engaged in business activity, such as an individual who may loan money to a friend;
(3) Provided by the federal government;
(4) Provided by state, local, and tribal governments and government entities to persons in their jurisdiction, or to persons outside their jurisdiction if it is not credit subject to the Truth in Lending Act or Reg. Z—Truth in Lending (12 CFR Part 1026); or
(5) Credit extended by a business for a consumer's purchase of the business's nonfinancial goods or services when covered by Section 1027(a)(2)(B)(ii) of the Dodd-Frank Act (12 U.S.C. §5517(a)(2)(B)(ii)).

Alternatives Considered

The bureau considered prohibiting arbitration agreements entirely, which would ban arbitration of individual claims, or requiring safeguards to ensure fairness. The bureau rejected those alternatives because the evidence to date "is inconclusive due in part to the low number of claims resolved in arbitration." The bureau also rejected an alternative that would have allowed companies to require class arbitration for consumer finance claims because the bureau "was not confident that class arbitration is a reliable setting for aggregated resolution of consumer finance claims."

Volcker FAQs Address Market Making Compliance, Certification

The Federal Reserve Board has updated its Frequently Asked Questions (FAQs) regarding the application of Section 13 to the Bank Holding Company (BHC) Act, commonly referred to as the Volcker Rule, and regulations adopted by the Fed, Office of the Comptroller of the Currency, Federal Deposit Insurance Corporation, Securities and Exchange Commission, and Commodity Futures Trading Commission. The Fed noted that while the FAQs apply to banking entities for which the Fed has jurisdiction under Section 13 of the BHC Act, they have been developed by staff of all five agencies.

In FAQ No. 17, the agencies' staff was asked whether a banking entity's compliance program for market-making-related activities may include objective factors on which a trading desk may reasonably rely to determine whether a security is issued by a covered fund. The staff was further asked whether a market maker meets its compliance program requirements by making use of a shared utility or third-party service provider that uses objective factors to identify whether a security is issued by a covered fund.

Objective Factors

At the outset of their analysis the agencies' staff noted that a bank relying on the market-making exemption to the Volcker Rule must have a reasonably designed compliance program for a trading desk involved in the market-making activity. As for the design of the compliance program, the staff added that the trading desk may include "objective factors" on which the trading desk may reasonably rely to determine whether a security is issued by a covered fund. For purposes of the Volcker Rule, "objective factors" are considered to be factual criteria that can be used to reliably identify whether an issuer or a particular type of issuer is a covered fund.

As to the issue of relying on objective factors to determine whether a security is issued by a covered fund, the staff concluded that an objective factor would be whether securities of the issuer were offered in transactions registered under the Securities Act. On the other hand, the staff cautioned that it would not be reasonable for a trading desk to rely solely on either or both the name of the issuer or the title of the issuer's securities. They noted that these factors alone would not convey sufficient information about the issuer for a trading desk reasonably to determine whether a security is issued by a covered fund.

Shared Utility/Service Providers

In responding to whether a banking entity can make use of a shared utility or third-party service provider that uses objective factors to identify whether an issuer or a particular type of issuer is a covered fund, the agencies' staff stated that the shared utility or third-party service provider must be subject to independent testing and audit requirements applicable to the banking entity's compliance program. The staff also noted that if the shared utility or third-party service provider is not effective in identifying whether a security is issued by a covered fund, then the banking entity must promptly update its compliance program to remedy any defect issues and, as necessary, take action under Volcker Rule implementing regulations, such as terminating an activity or investment.

CEO Certification

New FAQ No. 18 discusses the timing of when a banking entity is required to submit the annual CEO certification for prime brokerage transactions. The FAQ also discusses the timing issue as to legacy-covered funds.

Although the Volcker Rule regulations generally place certain limitations on a banking entity's relationships with a covered fund, the regulations allow the banking entity to enter into any prime brokerage transaction with any covered fund in which a covered fund managed, sponsored, or advised by such banking entity, or an affiliate, has taken an ownership interest. These prime brokerage transactions are permissible, so long as the conditions enumerated in the final rule are satisfied, which includes an annual written CEO certification. For purposes of the Volcker Rule regulations, a "prime brokerage transaction" means any transaction that would be a covered transaction, as defined in Section 23A(b)(7) of the Federal Reserve Act that is provided in connection with custody, clearance and settlement, securities borrowing or lending services, trade execution, financing, or data, operational, and administrative support.

To fulfill the certification requirement, a CEO should submit the first certification after the end of the conformance period but no later than March 31, 2016. A banking entity can provide the required annual certification in writing at any time prior to the March 31 deadline to the relevant agency.

The timing of the CEO certification for legacy funds—covered funds sponsored or owned by a banking entity prior to Dec. 31, 2013—must be submitted by March 31 following the end of the relevant conformance period. Since the conformance period currently ends on July 21, 2016, the CEO certification must be submitted by March 31, 2017. However, the Fed has signaled its intentions to further extend the conformance period until July 31, 2017. Therefore, it is conceivable the CEO certification could be submitted by March 31, 2018.

CFPB Studies Private Student Loan Servicers

The Consumer Financial Protection Bureau (CFPB) has released its annual report on student loan complaints.

The bureau said that it is taking a closer look at problems with loan servicers reported by certain borrowers. The CFPB said in a blog post based on the report that the bureau is quite concerned about repayment problems experienced by borrowers with older federal student loans made by banks and other private lenders.

The bureau explains in the post that most federal student loans were made by private lenders until 2010, the year that the Federal Family Education Loan program (FFELP) ended. These were the most common student loans, and, according to the CFPB, borrowers with this type of loan still make up nearly a third of all student loan borrowers, owing more than $370 billion in debt as of June 30, 2015.

The CFPB noted that there are "many unanswered questions" about how "these borrowers fare over time." Part of the problem is the lack of public information about the performance of federal loans made by private lenders. The bureau said the report calls for better information about the entire student loan market, including more information on delinquencies, defaults, and how well borrowers in income-driven repayment plans do over time.

Report background. The 2015 Annual Report of the CFPB Loan Ombudsman details analysis from a voluntary request sent by the CFPB's Student Loan Ombudsman to certain market participants, asking for data about loans originated under FFELP and held by private investors. The report also describes certain limitations of this data, noting that it may not be representative of all borrowers with FFELP loans and differences in loan maturity, portfolio composition, and availability of certain benefits may contribute to these results.

This year's report analyzes complaints submitted by consumers from Oct. 1, 2014, through Sept. 30, 2015. According to the report, during this period the bureau handled approximately 6,400 private student loan complaints, an increase of approximately 23 percent compared to that of the previous year. The CFPB also handled 2,300 debt collection complaints related to private and federal student loans.

Loans in Default

The report states that outstanding federal student loans made by private lenders may have a higher concentration of borrowers in default or delinquency than the student loan market at-large. The CFPB estimated that more than 25 percent of student loan borrowers are delinquent or in default market-wide. At least 30 percent of borrowers with FFELP loans—more than 5 million in total—are behind on their loans or are already in default.

Servicing and Debt Collection

Borrowers with both private and federal student loans continue to submit complaints describing servicing and debt collection practices that create barriers to enrolling in alternative repayment plans, including income-driven repayment plans for borrowers with federal loans. Private student lenders are expanding proprietary modification offerings for troubled borrowers, according to the report. Private student loan borrowers report that they encounter servicing problems, including lack of access to timely and accurate information on availability or eligibility criteria to enroll in alternative repayment programs.

Repayment Options

Many debt collection complaints from borrowers with federal student loans describe how borrowers attempt to avoid default during a period of financial hardship, but have difficulty finding information about repayment options, including income-driven repayment plans. Borrowers have the right under federal law to enroll in an income-driven repayment plan, but some borrowers report that they did not know they were eligible. The CFPB also received complaints that borrowers who apply for an income-driven repayment plan are held up by paperwork processing delays, receive inconsistent instructions from servicers, or experience difficulty enrolling in these programs.

According to the report, economic and other incentives for student loan servicers may encourage servicing practices that contribute to borrower distress, particularly for federal student loans originated by private lenders under FFELP.

Fed Replaces Pre-Merger, Pre-Conversion Exam Waiver Rules

The Federal Reserve Board has updated its guidance on the circumstances under which a federal reserve bank may, after consulting with the Fed's staff, waive a consumer compliance or safety and soundness examination of a financial institution that wants to become a Federal Reserve System state member bank. The guidance also applies when a bank that is not a state member bank is merging with a state member bank if a state member bank will be the surviving entity after the merger. Prior guidance from 2011 has been rescinded.

In the case of a charter conversion, the bank ordinarily must satisfy nine separate criteria before a federal reserve bank can waive the otherwise-required pre-membership examination. Additional considerations apply in the case of a merger. The guidance adds that a safety and soundness examination can be waived if it would not furnish information that would be useful in the Fed's consideration of the charter conversion or merger, even if some of the criteria are not met.

Charter conversion waivers

Five of the nine criteria are set by Reg. H—Membership of State Banking Institutions in the Federal Reserve System (12 CFR Part 208). These require the bank to:

AU: Please explain what this means. First reference.

- be well-capitalized;
- have a composite CAMELS rating of "1" or "2";
- have a Community Reinvestment Act (CRA) rating of "outstanding" or "satisfactory";
- have a consumer compliance rating of "1" or "2"; and
- Have no major unresolved supervisory issues with either its current primary regulator or the Consumer Financial Protection Bureau.

Four additional safety and soundness criteria must be met:

- The bank's CAMELS management component must be either "1" or "2."
- The "close date" of the most recent full-scope safety-and-soundness examination must be less than nine months from the date of the membership application.
- There may not have been any material changes to the bank's business model since the most recent report of examination, and there may be no material changes planned for the next four quarters.
- The annual growth in total assets shown by the most recent Call Report must have been less than 25 percent, and planned growth over the next year also must be less than 25 percent.

Merger waivers

In the case of a merger that will leave a state member bank as the surviving entity, a waiver may be granted if the state member bank will meet all of the criteria on both an existing basis and a pro-forma basis after the merger. However, the guidance adds that other factors could require an examination, such as a change in the member bank's senior leadership or strategy, less-than-satisfactory ratings having been given to the bank with which the member bank is merging, or business lines or products new to the member bank resulting from the merger.

Consumer Compliance Examinations

Before deciding whether to waive a consumer compliance examination, the federal reserve bank staff members are to look at the bank's recent consumer compliance examinations, reviews, and risk assessments from the bank's current regulator as well as information from the CFPB, the guidance says. An examination should not be waived if the bank has a less-than-satisfactory consumer compliance rating.

Moreover, an examination might be called for even if the rating is "1" or "2," the guidance says. If the information from other agencies reveals significant weaknesses, an examination targeted on the area of concern should be considered.

A low CRA rating also would be relevant even though the CRA does not apply directly to Federal Reserve System membership, the guidance warns. This is because a poor CRA rating "presumably would reflect unfavorably on the abilities of management." A CRA performance review might then be needed.

Examination Scope

A pre-merger or pre-membership examination can be targeted on areas of identified weaknesses, according to the guidance. No report of examination is required, but the examination results should be documented as part of the application process. For larger institutions, the federal reserve bank staff is expected to rely on information generated by the continuous monitoring process to the extent possible.

COURT DEVELOPMENTS

High Court Won't Review Punitive Award against Quicken Loans

The US Supreme Court has denied a request by Quicken Loans that it review a $2.17 million punitive damages award upheld by the Supreme Court of Appeals of West Virginia in subprime loan litigation brought by a borrower. In its petition, Quicken Loans argued that the West Virginia Supreme Court should not have allowed the borrower's attorney's fees and costs, totaling $596,200, to have been included in the punitive-to-compensatory damages ratio that the state court deemed to be in accord with West Virginia law and not excessive. According to Quicken Loans, the inclusion of attorney's fees and costs as part of the compensatory damages calculation of the ratio violated the lender's substantive due-process rights protected by the Fourteenth Amendment (see *Quicken Loans Inc. v. Brown*, W. Va. Sup. Ct., March, 25, 2015.)

Homeowners Seek Review of Mortgage Rescission Rejection

Homeowners who tried to rescind a mortgage loan transaction based on a claimed incorrect finance charge disclosure have asked the Supreme Court whether a rescission notice delivered before foreclosure proceedings began was adequate to allow them to invoke a tighter disclosure requirement that applies after a foreclosure is initiated. The US Court of Appeals for the Eighth Circuit decided that rescission was not available because the finance charge was close *Beukes v. GMAC Mortgage, LLC*, Fed. Banking L. Rep.).

Tolerance for Error

When a consumer refinances a mortgage, the finance charge generally is treated as having been disclosed accurately if the amount disclosed does not vary from the correct amount by "more than an amount equal to one-half of one percent of the total amount of credit extended" (15 U.S.C. §1605(f)(2)(A)). That would have allowed a difference of $1,235 in this case, the Eighth Circuit said.

A more consumer-friendly error tolerance is applied when homeowners exercise their rescission rights after a foreclosure proceeding has been started. In that case, a disclosure is treated as accurate if the disclosed charge "does not vary from the actual finance charge by more than $35 or is greater than the amount required to be disclosed" (15 U.S.C. §1635(i)(2)).

Claim on Appeal

The homeowners said the disclosed finance charge understated the actual charge by more than $900, which would have been close enough to satisfy the pre-foreclosure tolerance but not the post-foreclosure tolerance. Their petition for *certiorari* asks the Court whether they should have been required to provide a second rescission notice, after foreclosure proceedings began, in order to avail themselves of the post-foreclosure error tolerance.

The Eighth Circuit did not address whether the initial notice could in some sense "carry over" into the foreclosure proceedings, saying only that "The Beukeses did not timely attempt to exercise any expanded right to rescind arising from §1635(i)(2) that might have been available after the initiation of foreclosure proceedings in March 2010."

The petition was filed in *Beukes v. GMAC Mortgage, LLC*, No. 15-368.

Identity Theft Claims Distinct from Furnisher Duties not Preempted

Claims under a New York law that provides private civil remedies for identity theft victims are not necessarily preempted by the Fair Credit Reporting Act (FCRA), the US Court of Appeals for the Second Circuit has decided. As long as the claims do not concern FCRA-imposed responsibilities of persons who furnish information to consumer reporting agencies, they survive preemption.

The consumer complained that Chase employees had opened new accounts in the names of fictitious companies, using her name as signatory, and also had appropriated her dormant checking account in furtherance of a Medicare fraud scheme. The scheme resulted in frequent overdrafts, closed accounts, and, much worse, the eventual arrest and prosecution of the consumer for engaging in a money laundering conspiracy.

After the consumer was acquitted of money laundering, she sued Chase under a New York anti-identity theft law that allows suits by victims if the identity theft resulted in the transmission to a consumer reporting agency of information that otherwise would not have been provided. She claimed that the overdrafts, closed accounts, arrest, and prosecution generated adverse reports to consumer reporting agencies that passed the information along to various banks, and that JP Morgan was responsible for its employees' actions.

Trial Court Dismissal

Chase argued that the state law claims were preempted by the FCRA, and the district court judge agreed. although the act generally seeks not to preempt state laws, it does explicitly preempt state laws in specific areas. One exception to the preservation of state laws preempts laws "with respect to any subject matter regulated under … Section 1681s-2 of this title, relating to the responsibilities of persons who furnish information to consumer reporting agencies" (15 U.S.C. §1681t(b)).

The district court judge decided that the consumer's state law claims fell under that description and thus were preempted. However, the appellate court disagreed, determining that the consumer's claims could be interpreted in a way that rescued them from preemption.

FCRA Provisions

FCRA Section 1681s (15 U.S.C. §1681s-2) imposes specific responsibilities on persons who transmit information to consumer reporting agencies, including not furnishing information known to be false and having procedures to respond to identity theft claims. Looking in detail at the preemption language of 15 U.S.C. §1681t(b), the appellate court decided that the act allowed preemption only of state laws that were "with respect to" information furnisher duties imposed by 15 U.S.C. §1681s-2. Further, "with respect to" meant "concerning"—in other words, only state laws that concern information furnisher duties under 15 U.S.C. §1681s-2 are preempted.

Interpretation of Consumer's Claims

When the complaint was interpreted in the light most favorable to the consumer, it raised claims that did not concern Chase's duties as an information furnisher, the court decided. The complaint most reasonably should be construed as alleging that Chase was liable under a theory of *respondeat superior* for the identity theft perpetrated by its employees. If the employees' identity theft resulted in the forbidden transmission of information to consumer reporting agencies, Chase then might be liable under the New York law.

Stated more clearly, the consumer's complaint could be interpreted as claiming that Chase was liable for the employees' identity theft, not that the bank was liable for reporting adverse information about the consumer. That claim under the state law would not be preempted by the FCRA.

However, if the consumer attempted to argue that Chase was liable for furnishing false information, that claim would be preempted, the court warned.

Galper v. JP Morgan Chase Bank, N.A. (2nd Cir.)

TILA Says Land Trust Has Right to Rescind Mortgage Transaction

A land trust used by a homeowner to hold title to her home was a consumer under the Truth in Lending Act (TILA) and Reg. Z—Truth in Lending (12 CFR Part 1026), the Illinois Supreme Court has determined. This means the trust should have been given TILA-required disclosures when a reverse mortgage was granted on the home and had a three-year right to rescind the loan transaction when those disclosures were not given, the court said.

According to the court, the homeowner and the land trust entered into a reverse mortgage transaction in 2009. The mortgage identified the trust as the borrower and mortgagor, although both the trust and homeowner signed the note. The mortgage included a clause making clear the trust had no liability to repay the note and providing that foreclosure was the creditor's only collection avenue. Because the loan transaction was a reverse mortgage, the loan became due on the homeowner's death or if she failed to use the home as her principal residence for a year.

According to the opinion, TILA-required disclosures, including a description of her right to rescind the transaction, were given to the homeowner. A set of disclosures was prepared for the trust, but it was not delivered.

The homeowner died less than a year later, and the creditor soon filed a foreclosure suit against the trust, the court continued. The trust responded by notifying the creditor that it was exercising its right to rescind the transaction and, when the creditor did not respond, the trust filed a counterclaim in the foreclosure suit. The counterclaim asserted that the trust had not been given TILA-required disclosures and demanded rescission, damages for the TILA violations, and damages for the refusal to rescind the transaction.

Trial Court Dismissal

The trial court judge dismissed the counterclaim. Shortly thereafter, the trust paid the creditor the full amount due on the note and transferred the property to an unidentified third party. The creditor then dismissed the foreclosure complaint, but the trust appealed the dismissal of the counterclaim.

Appellate Court Proceedings

The appellate court concluded that the rescission demand was timely but that the trust could not rescind the transaction because it was not an obligor. Under TILA and Reg. Z, only obligors have rescission rights, the court said. The mortgage made clear that the trust had no duties under the loan or mortgage, and the trust received no benefit from the transaction, so it was not an obligor. Under those circumstances, only the homeowner could rescind the transaction, the appellate court decided.

The trust had forfeited any claim for damages by not raising those claims on appeal, the court continued. It also suggested that such claims might have been untimely.

The trust appealed the ruling to the state Supreme Court.

Obligors Only?

The court first noted a discrepancy between TILA and Reg. Z—TILA, which says that an obligor has the right to rescind a mortgage transaction (12 U.S.C. §1635(a)), while Reg. Z says that "each consumer" whose interest will be subject to the mortgage has a right to rescind (12 CFR 1026.23(2)). Moreover, the staff comments (12 CFR 1026.23) say that "consumer" includes "any natural person" whose interest in the home will be affected, even a person who is not obligated to repay the loan.

As a result, the right to rescind was not restricted to obligors, according to the court. Reg. Z and the staff comments have been in existence since 1968, and if Congress disagreed with the regulation it could have amended TILA, in the court's opinion. Certainly Congress could have acted when it moved TILA enforcement authority from the Federal Reserve Board to the Consumer Financial Protection Bureau.

Effect of Reverse Mortgage

The decision was influenced by the fact that the case involved a reverse mortgage. A reverse mortgage is to be repaid only by a sale of the property, the court pointed out. Nobody is personally liable, meaning there is no obligor under the ordinary meaning of the word. That would mean lenders had no duty to provide disclosures to anyone, and no one would have a right to rescind, a conclusion that clearly was contrary to TILA and Reg. Z.

Land trust's interest

Under Illinois law, the trust held the legal title to the property for the benefit of the homeowner, the court then observed. The homeowner's real property ownership interest was converted to a personal property interest in the trust. The comments to 12 CFR 1026.2(a) say that consumer credit extended to a land trust is considered to be credit extended to a natural person, the court added.

If property is in a land trust, the trust holds the ownership; in fact, because the beneficiary holds only a personal property interest in the trust, the trust is the only person who holds an interest in the real property. Thus, it is the trust's interest that is subject to the mortgage, the court reasoned.

If credit to a land trust is considered to be credit to a natural person, and the land trust's interest is subject to the mortgage, then the trust was entitled to receive the TILA-required disclosures, the court decided. Also, if the disclosures were not given, the trust was entitled to the three-year right to rescind the transaction.

Effect of Property Sale

The court also rejected the creditor's argument that the trust's transfer of the property extinguished the right to rescind. Both TILA and Reg. Z say the right to rescind expires on the sale of the property, but that refers to the *exercise* of the right as opposed to the *enforcement* of the right. The trust exercised the right by notifying the creditor of the rescission demand long before it acquired and then transferred the home.

If a transfer of the property ended the ability to enforce the right to rescind, the trust would lose not only the ability to rescind but also the ability to recover damages for the creditor's wrongful failure to rescind, the court pointed out.

Statutory Damages

The trust also wanted statutory damages for the creditor's failures to provide required disclosures required by TILA and to rescind the transaction on demand. The appellate court had decided that these claims had not been preserved for appeal. The appellate court was wrong, the court said.

The trial court judge dismissed the counterclaim because he decided the trust could not describe a viable claim, meaning he never addressed the issue of statutory damages, the court pointed out. There was no order about the damages claim from which the trust could have appealed, so there was no need to preserve the issue.

The appellate court's belief that the claims could be untimely was wrong as well, the court said. The claim for statutory damages was filed well within the one-year statute of limitations. [*Financial Freedom Acquisition LLC v. Standard Bank and Trust* (Ill. Sup. Ct.)]