DLP:PFH:ACR:jg
DJ 188-12C-8

JUN 12 1996

Re: Proposed Lawsuit Against
Long Beach Mortgage Company

Deval L. Patrick
Assistant Attorney General
Civil Rights Division

Paul F. Hancock
Chief, Housing and Civil
Enforcement Section
Civil Rights Division

As you requested, we have continued to consider whether our lawsuit against the Long Beach Mortgage Company should be limited to the "retail" aspects of its operations or whether we should address the company's entire operation, i.e., both "retail" and "wholesale" lending. We continue to believe that unlawful discriminatory purpose has infected the company's entire operation, and, after review, our Appellate Section has stated its agreement with the legal theory we would advance. Our negotiations with Long Beach's lawyers have not been successful, as the company refuses to take any action to prevent discrimination in the "wholesale" portion of its business.

As you know, Long Beach makes, or originates, mortgage loans through its own employees as well as through independent brokers. Our investigation has demonstrated that pricing has been based on prohibited factors, and, as a result, African Americans, Hispanics, women and older persons [hereinafter referred to as "minorities"] have, on average, paid a significantly higher price for loans.[1] This is not a matter of all minorities paying a hidden fractional point more than others for their loans. For the most part, this case involves a smaller, but substantial, group that paid far above the norm. Long Beach knew or should have known of the price disparities in its wholesale loan portfolio, where the total broker charges ranged from one-half percent to more than 12% of the amount borrowed. Throughout the

---

[1] The lender's base prices are well above those of the standard market, because it lends to homeowners with impaired credit. It allows its loan officers and its brokers to charge borrowers prices that are above the base prices, the former to earn incentive compensation and the latter to earn a fee for their service. We are not challenging the base pricing mechanism nor the surcharge practice. We are alleging discrimination in the amounts charged above the base prices.

period covered by our Complaint, the lender maintained a computerized database in which it recorded the price of every loan; it also recorded the race, ethnicity, sex, and age of every borrower and co-borrower and, for wholesale loans, the name of the broker. The discriminatory pricing was as evident in loans brought to the company by employees as it was in wholesale loans. Long Beach cannot deny its responsibility for its employees' pricing of loans. Yet, for neither type of loan did the company have in place procedures to ensure that the pricing of loans was not based on prohibited factors.[2]

The economic impact of this discrimination was severe. Twelve percent of the loan amount to obtain a loan of $100,000 amounts to $12,000 in out-of-pocket expenses. For wholesale loans, we estimate that the total out-of-pocket expenses for the victims of discriminatory pricing during the period January 1992 through June 1994 was more than $3.8 million.[3] By far the most heavily damaged group consisted of 136 African American females over the age of 55, whose average out-of-pocket loss was almost $2,400 apiece.

Our recommendation to include "wholesale" lending would take us into new fair lending waters. But the waters are not uncharted. The legal theory which we propose to advance is straightforward: A lender is legally responsible for unlawful discrimination in the loans that it makes. The language of the applicable statutes support us. Section 805 of the Fair Housing Act prohibits discrimination in the "making" of mortgage loans; and the Equal Credit Opportunity Act includes within the definition of covered "creditor" any company that "regularly extends, renews, or continues credit."[4]

---

[2] Long Beach also knew the geographic distribution of both sets of loans, which largely overlapped because its brokers constantly worked the same areas its loan officers did. The lender routinely plotted (on separate retail and wholesale maps) the ZIP Code for each loan it made. For example, its map of wholesale loans in Los Angeles from mid-1992 to mid-1993 shows the highest volume in South Central (right in the middle of Rep. Maxine Waters' District).

[3] This is an average of $670 each for an estimated 5,708 victims who obtained wholesale loans and paid more than the average paid by younger white males.

[4] The straightforward definition of "creditor" in the ECOA is reiterated in Regulation B, 12 C.F.R. § 202.2(l). Regulation B, however, adds a caveat that Long Beach may attempt to apply to this case: "A person is not a creditor regarding any violation of the act or this regulation committed by another creditor unless

(continued...)

The fact that the allegedly discriminatory loans were made by Long Beach is important. Brokers are permitted to take applications, but are not permitted to commit Long Beach. Long Beach's contract with the brokers specifically states that Long Beach "may, in its sole discretion, decide whether or not to make a loan to an applicant and may determine the terms and conditions of any such loan." (1992 contract, paragraph 15.) Thus, our claim would not reach the more difficult question of the liability of a secondary market purchaser for loans that may be discriminatory in origination. All of the loans are Long Beach loans (underwritten, funded, closed in its name, and serviced), and it will be difficult for the company to contend -- contrary to its own contract with brokers -- that it is not responsible for the terms and conditions of those loans.

It is true that brokers negotiate the price of proposed loans that they present to Long Beach for underwriting, and we do not dispute that Long Beach may not be able to exercise the same range or methods of control over brokers as it does over its own employees. This concern, however, should not determine the outcome. The facts do not support a defense that the discrimination results from Long Beach's inability to control the action of brokers. Pricing discrimination is evident from both the "retail" and the "wholesale" loans, thus supporting a claim the such discrimination is company policy, rather than a mere inability to control brokers. As noted previously, the contract with brokers does control their actions to a significant extent, and Long Beach is under no obligation to accept loans from brokers who propose terms that are contrary to company policy. Rather, the facts show that the loan terms proposed by the brokers have <u>not</u> been contrary to the company policy.

While the company has averted its eyes in reviewing proposed prices that might contribute to the overall pattern of discrimination against minorities, the company continues to state a willingness to recognize and defer to other pricing laws, such

---

[4](...continued)
the person knew or had reasonable notice of the act, policy, or practice that constituted the violation before becoming involved in the credit transaction." <u>Id</u>. This language does not affect our ability to bring a suit against Long Beach for its wholesale loans for two reasons: (1) if the brokers illegally discriminated, Long Beach knew or had reasonable notice of the practices of the brokers that constituted the illegal discrimination, and hence, is liable within the express language of Regulation B; and (2) our legal theory is based on the action of Long Beach and not the action of the brokers -- we are not attempting to hold Long Beach liable for a "violation of the act .... committed by another creditor," and, hence, the above-referenced caveat is not applicable.

as state usury laws. It is difficult to understand why the company thinks it may be liable if the price of a loan violates usury law, but not liable if the same loan violates fair lending laws.

This would be our first case involving "wholesale" lending, but the fact pattern is quite similar to factual situations that have supported other decisions to litigate. Most brokers who submit proposed loans to Long Beach present very few loans each year, and often the brokers deal only with one minority group, e.g., when their business operation is located in an African American residential neighborhood.[5] Thus, individual brokers may not be discriminating since there is no one whom they are treating more favorably than their minority customers. However, if the brokers are proposing to Long Beach that the company extend the loan on terms that include a higher price than the company charges white applicants, Long Beach itself is engaging in discrimination by extending the loan on those terms.

In United States v. Huntington Mortgage Co., C.A. No. 1:95-CV-2211 (N.D. Ohio, October 18, 1995), we considered a similar fact pattern. One African American employee of Huntington concentrated her efforts in African American neighborhoods and charged a loan price that was higher that other company employees, who worked in predominately white neighborhoods, charged. Although no individual employee was treating his or her customers differently on the basis of race or other prohibitive factor, the total loan originations by the company revealed racially discriminatory pricing. African Americans recipients of loans originated by Huntington, on the average, paid higher prices than similarly qualified whites, and that company-wide pricing difference was the basis of our claim of a legal violation. Although the loan officer working in African American neighborhoods was an employee, we do not believe that our recommendation to prosecute would have been any different if the loan officer proposed the loans as a broker.

In other pricing discrimination cases, such as United States v. Fleet Mortgage Corp., C.A. No. 96-2278 (E.D.N.Y. May 7, 1996), we have not considered it relevant whether an individual employee treated his or her customers differently on account of race or national origin; as in the Long Beach matter we have evaluated the aggregate of loans made by the company. Again, the only difference is that in previous pricing cases the loan terms, including price, were proposed by an employee, while in the case

---

[5] Even the brokers that submitted between four and 50 loans to Long Beach over a two-year period had few white borrowers who were not members of protected groups, making broker-by-broker comparisons impossible.

under consideration the loan terms, including price, were proposed by a broker.[6]

Long Beach argues to us that it lacks the legal power to control the loan terms proposed by brokers, but in reality the company's concern is that it believes that it lacks the practical power to control the terms in loans presented by brokers. The contract the company executes with brokers contradicts the claim that the company lacks legal power to control the terms of loans presented by brokers. Regarding practical power, the company argues that it would lose business if it did not accept the high prices proposed by brokers; these brokers would merely present the same terms to another lender and the asserted abandonment would ruin the business of Long Beach.[7]

Defendants in the Huntington and Fleet cases presented virtually identical arguments. They contended that overages were necessary to attract loan officers with high levels of productivity, and argued that if unlimited overages were not allowed, the high volume loan officers would quit and work for a lender that allowed unlimited overages. After negotiations, however, these other defendants agreed that they could offer employee incentives by allowing overages, but at the same time monitor implementation to ensure that the aggregate of loans made by the company did not result in the pricing differences that would implicate fair lending laws.

---

[6] Long Beach argues that because so many brokers present loans to the company each year, and because we have no proof that the individual brokers treat their customers differently on a prohibitive basis, there can be no legal liability for the end product of pricing discrimination. This contention, which we challenge in the text above, is one end of the spectrum of defenses to pricing discrimination. At the other end are cases like United States v. Security State Bank of Pecos, Texas, C.A. No. SA-95-CA-0996, (W.D.Tex. October 18, 1995), where the defendant argued that only one person was involved in determining the price of loans and that that person was acting contrary to the bank's policy; therefore, it was argued, we could not establish a pattern or practice of discrimination against the bank. In all cases of pricing discrimination, however, we have focused our review on the loans made by the institution, rather than on the actions of individuals in isolation.

[7] This is the same form of argument made in the mid-1960's by restaurants and motels to excuse non-compliance with the public accommodations law and by school districts defending "freedom-of-choice" desegregation plans. Further, this Long Beach argument is highly exaggerated. The vast majority of it's wholesale brokers did not present it with out-of-line broker fees.

It is relevant to consider the impact of our recommendation on the lending industry. As noted, our efforts to ensure racial fairness in the use of overages has not caused the catastrophes that were predicted by some. Since Long Beach lawyers have informed the industry about our proposed action against the company, a number of industry representatives have contacted us to discuss the issues.[8] Most were misled by Long Beach's counsel into believing that we were about to challenge more "indirect" lending, such as occurs when a bank buys loan papers from a automobile dealer. As we discussed lender liability for loans that it makes, we learned that most members of the regulated industry are concerned about the terms of loans that may be presented by brokers; we were told that such lenders would refuse to accept a loan if the proposed price was as far out-of-line as Long Beach's. On June 4, 1996, while in New Orleans for a compliance conference sponsored by the American Bankers Association, I spoke with Barry Leeds, who heads a private company providing compliance services to banks and other lenders. In the course of conversation, he told me that an increasing part of his business has come from lenders that want to ensure that brokers with whom they are dealing are not creating compliance problems for the lenders. Mr. Leeds said his company is using testing as well as consumer interviews to report to lenders regarding the treatment afforded to consumers by brokers.

Today, Kay R. Kinney, the Executive Vice President of the National Association of Mortgage Brokers (NAMB), visited me to discuss compliance with fair lending laws by mortgage brokers. Mortgage brokers have not had trade associations comparable to those for depository institutions, but the staff of NAMB recently has increased in size in an effort to better represent the broker segment of the industry. Ms. Kinney said that NAMB is attempting to improve the "image" of mortgage brokers and also is making efforts to ensure compliance with fair lending laws by members of the organization. She stated the industry's opposition to any action designed to eliminate the use of brokers or to control the prices that they charge. But she also said that lenders can easily separate the "good" brokers from the "bad" brokers, and that the organization has urged lenders to refuse to do business with those mortgage brokers who, for example, are not pricing loans in a fair manner. She cited an example of one lender who had dropped 175 brokers from its approved list out of concern that the brokers might present compliance problems for the lender.

---

[8] We met, for example, with representatives of the Mortgage Bankers Association. Also, former Associate Attorney General Wayne Budd met with us on behalf of a consortium of large mortgage lenders that do a substantial amount of wholesale lending.

We do not suggest that the industry would agree with our decision to include "wholesale" originations in fair lending reviews, but the pricing discrimination at issue seems to be more of a problem in the sub-prime market, which is for the most part unregulated. These lenders concentrate on financing for persons who might not qualify for the terms offered by the front-line of the industry. They charge a higher price in part because the loans they make are more risky, but also likely because their business operations have never been regulated or subjected to fair lending scrutiny in a manner similar to the front-line industry. This is the segment of the industry that would be most effected by our recommendation; it also is the segment of the industry that may be most deserving of our attention. It is informative that even the trade association (NAMB) that represents members of this portion of the industry has suggested remedial actions that carry far beyond the action that Long Beach has been willing to take.

If we decline to challenge the "wholesale" portion of the pricing differences in the Long Beach litigation, the result may be that similarly situated minorities will enjoy differing protections depending upon whether they first contacted a broker or an employee. For example, if two minority families received Long Beach loans with prices substantially higher than the terms provided to white consumers, both families may be entitled to relief, one family may be entitled to relief, or neither family may be entitled to relief.

Also, a failure to prosecute here will leave a wide hole in our enforcement program. Long Beach presents the most "direct" of the "indirect" lending situations. As noted repeatedly, Long Beach reserves the right to set the terms and conditions of all loans and makes the loan in its own name. If we cannot bring an action here, it seems logical that we could not challenge "table funding" situations, where the "indirect" lender agrees to immediately purchase a loan made in the name of another company. Even more beyond our reach would be the finance companies of the Big Three automobile manufactures whose policies we have been investigating. Those companies purchase loans whose terms are, in most instances, set by auto dealers. Although our auto lending investigation remains at an early stage, we are examining the liability of the finance companies for pricing differences in the loans that they purchase.

We also are working with the Department of Veterans Affairs to consider whether veterans have been subjected to discriminatory treatment on a prohibited basis in obtaining VA home mortgages. A preliminary review of the data provided by the VA seems to confirm that African American borrowers at a number of companies are paying substantially higher prices for loans than are white borrowers. At this stage we have incomplete information regarding the extent to which brokers have played a

role in the origination of those loans. However, we know that 84% of all VA loans nationwide are made through mortgage companies, and we have identified several large-volume VA lenders that are known to obtain substantial numbers of loans from brokers.

A majority of the home mortgage loans made in the United States each year are made by non-bank lenders using brokers. We repeatedly have voiced an intention to subject the non-bank lenders to the same degree of fair lending scrutiny as banks receive, and such a enforcement policy received wide-spread publicity when restated by the Attorney General during her May 20, 1996, speech to bankers at the national conference held in Boston.[9]

We do not believe that the remedy to be sought against Long Beach needs to be complex. The out-of-line broker charges are not difficult to identify. Just as we have allowed the continued use of overages, with monitoring to ensure compliance, a similar remedy can be tailored to ensure that loans presented by brokers do not cause the lender to be liable for pricing discrimination. It is not necessary to seek parity in pricing of "retail" loans and "wholesale" loans, since a broker has a legitimate claim to just compensation, and such compensation may differ -- again for legitimate reasons -- from the compensation paid to employees. At the same time, it will be necessary for Long Beach to reject pricing terms proposed by brokers that are out-of-line with the non-discriminatory pricing policies which we would require the company to adopt. Such action is consistent with the steps already being taken by the front-line lenders.

The only "justifiable" business concern that Long Beach can have to such a remedy is that it will loose a significant portion of its business to less reputable lenders who will not object to extending credit pursuant to the high prices of the brokers. We believe that we can address this issue, however, by ensuring the industry that this enforcement effort will extend beyond Long Beach. Our lawsuits involving overages have already caused wide-spread change in the industry without the consequences predicted

---

[9] One questioner at the conference noted that banks are subject to regulatory review by many agencies and asked how we would provide the same level of scrutiny to nonbank lenders. In response, the Attorney General stated that we would convene a meeting with all segments of the industry to discuss compliance. We have been researching to determine who should be invited to such a meeting, since it goes beyond the type of lending that we have addressed thus far. For example, many credit card issuers have contacted us to determine there responsibilities under fair lending laws. We are coordinating with the FTC and with HUD in making the preliminary plans for such a meeting.

by the defendants in our lawsuits. The industry-wide meeting that the Attorney General suggested will be a good vehicle for describing our enforcement policy to the unregulated lenders. And perhaps a letter addressing the issue, patterned upon you February 21, 1995, letter to the industry, could be used to further elucidate our policies.

Our negotiations with the Long Beach lawyers have reached impasse on several issues, but by far the most serious issue is our proposal to include the company's "wholesale" operation within our claim. Resolution of this issue may require contested litigation. We recognize that the resolution is not free of doubt, but given the seeming validity of our position, the egregiousness of the facts presented, and the importance of the issue to our overall enforcement program, we believe it appropriate to submit the issue to the courts for resolution.

For these reasons, we recommend that you authorize us to file the complaint promptly.

Approve:_____

Disapprove:_____

Comments:

cc: Records Hancock Ross T.File