Navigating Fair Lending Risks in Bank M&A Transactions

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BANK MERGER & ACQUISITION (M&A) ACTIVITY has declined in recent years, but motivated buyers and sellers continue to identify M&A opportunities to advance their business objectives. M&A transactions can serve as effective strategies for growth, efficiency, and market expansion, but they can also elevate risks to the combined bank post-merger.

When evaluating M&A opportunities, banks on both sides of the transaction must be aware of increased regulatory scrutiny of fair lending practices and should take a proactive approach to assessing fair lending risk in the due diligence phase. Careful consideration of the fair lending risk profile of the acquiring bank, target bank and combined entity can help both parties understand potential hurdles to regulatory approval. Once those concerns are identified, the banks can take steps to mitigate the combined bank's post-transaction compliance risks and proactively develop a narrative that addresses regulatory or public interest concerns. This article explores key fair lending considerations for bank M&A transactions.

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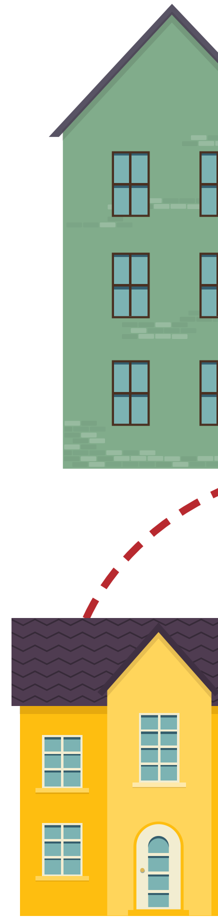

Increased regulatory scrutiny of fair lending compliance

In recent years, the federal government has specifically prioritized advancing the goal of racial equity through enforcement of fair lending laws—a trend with important ramifications for banks considering M&A opportunities. Fair lending laws, including the Equal Credit Opportunity Act (ECOA) and the Fair Housing Act, prohibit discrimination in all aspects of credit transactions. Beyond fair lending laws, several other federal statutes also promote fair lending goals. The Community Reinvestment Act (CRA) seeks to affirmatively encourage banks to help meet the credit needs of the entire community served by the institution and ratings take into account lending discrimination; the Home Mortgage Disclosure Act (HMDA) seeks to prevent lending discrimination and redlining by requiring the collection and public disclosure of certain demographic information about mortgage loan applicants; and the Consumer Financial Protection Act prohibits unfair, deceptive or abusive acts and practices.

The Biden Administration issued a stern policy directive in 2021: "The Federal Government has a critical role to play in overcoming and redressing th[e] history of discrimination and in protecting against other forms of discrimination by applying and enforcing Federal civil rights and fair housing laws."[1] Carrying the torch, federal banking regulators and the Consumer Financial Protection Bureau (CFPB) responded with increased levels of supervisory, investigative, and enforcement activity targeted to perceived fair lending concerns.

In 2022, the CFPB initiated 32 fair lending examinations or targeted reviews, representing a 146 percent increase in such activities since 2020.[2] This elevated focus continued in 2023, with the CFPB initiating 28 fair lending examinations or targeted reviews.[3]

In tandem with the increased supervisory focus, citations issued by the federal banking agencies and the CFPB for violations of ECOA and Regulation B dramatically increased, with 81 institutions cited in 2020,[4] 198 institutions cited in 2021,[5] 174 institutions cited in 2022,[6] and 189 institutions cited in 2023.[7] These citations addressed a broad scope of practices, including alleged violations relating to lending discrimination, adverse action notices, insufficient record retention, impermissibly inquiring about prohibited characteristics, and failing to follow rules concerning use of information.

Public enforcement actions by the federal banking agencies and the CFPB to address ECOA and Regulation B violations have also increased. The CFPB brought two enforcement actions in 2021, with the first asserting violations related to adverse action notifications and the second alleging redlining.[8] 2022 saw three ECOA enforcement actions, one by the CFPB and two by the Federal Trade Commission (FTC), challenging redlining and discriminatory auto lending.[9] In 2023, the CFPB, Federal Deposit Insurance Corporation (FDIC), and FTC brought four enforcement actions.[10] The CFPB's actions challenged discrimination in credit card lending and discriminatory targeting of consumers for predatory loans, the FDIC's action challenged a bank's fair lending compliance program, and the FTC's action alleged discrimination in auto loan pricing.[11]

Agencies are required to make referrals to the Department of Justice (DOJ) when there is a reason to believe that an institution has engaged in a pattern or practice of discrimination. The amount of evidence required to satisfy the "reason to believe" standard has fluctuated over time, though reports on fair lending referrals to the DOJ have shown a spike in referrals in recent years. In 2021, the DOJ received seven fair lending referrals: two each from the CFPB, the FDIC, and the National Credit Union Administration (NCUA); and one from the Federal Reserve Board (FRB).[12] The DOJ received 24 fair lending referrals in 2022: 12 from the FDIC, five each from the CFPB and the NCUA, and one each from the FRB and the Office of the Comptroller of the Currency (OCC).[13] And in 2023, the DOJ received 33 fair lending referrals from the CFPB (18 referrals), FDIC (seven referrals), NCUA (six referrals), FRB (one referral), and OCC (one referral).[14]

The DOJ has prioritized investigations and enforcement actions to redress redlining, an unlawful practice where lenders deny or avoid providing mortgages or other credit services to neighborhoods based on the race or national origin of the residents of those neighborhoods. In October 2021, the DOJ announced its Combating Redlining Initiative, representing "the department's most aggressive and coordinated effort to address redlining."[15] Since then, redlining investigations and enforcement actions have increased considerably, with the DOJ publicly stating that it has two dozen open redlining investigations and announcing 11 redlining settlements.

Increased regulatory scrutiny of fair lending translates into heightened levels of risk for all banks and, given the unique risks inherent to new bank combinations, indicates that banks should take a proactive approach to assessing fair lending risk in the due diligence phase of an M&A transaction. Two critical focus areas for pre-transaction diligence are redlining and fair lending compliance programs.

M&A redlining risk considerations

Redlining risk is a key area for banks to assess prior to consummating an M&A deal. The DOJ has provided unequivocal notice that it will pursue redlining claims against banks as successors in interest where the challenged activity was conducted by entities that the surviving bank merged with or acquired. Relatedly, one lesson learned from recent redlining settlements is that regulators will no longer provide a post-acquisition grace period to a merged entity: from legal inception, newly-combined banks are expected to provide credit services in minority areas of their markets at levels similar to other lenders operating in those markets. In fact, the DOJ has sued multiple banks for allegedly redlining markets that they had only recently entered because of M&A activity—in one case, the DOJ's complaint asserted that the period of the alleged redlining began in the *same year* that the acquisition occurred.

When contemplating an acquisition of a bank that operates in a new market, the acquiring bank should carefully evaluate the

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target bank's existing redlining risk profile in that new market. As part of due diligence on any new markets, the acquiring bank should consider performing several statistical peer analyses comparing the percentages of applications and originations in majority-minority census tracts with those of other "peer" lenders operating in the market. The government generally selects peers by applying a filter for other lenders with 50 to 200 percent of the HMDA volume of the bank at issue. Because statistical peer comparisons are a primary method used by regulators, enforcement agencies and consumer advocacy groups to scope potential redlining examinations, investigations and lawsuits, a baseline grasp of both banks' lending performance in minority communities is particularly important if the combined bank will continue to operate in the market being assessed.

In addition, the DOJ continues to look to facts regarding a bank's physical presence in minority communities, particularly if the bank's minority-area lending activity falls significantly below that of peers. Accordingly, the acquiring bank should also review the target bank's branch and loan production office (LPO) locations and take into consideration its own branch and LPO network to assess how the combined networks would serve minority areas. Recent redlining lawsuits make clear that banks will not receive a pass simply because locations were acquired from another institution that itself made the branching decisions. If a target bank has room for improvement in minority-area lending and branches are predominantly located in non-minority areas, the acquiring bank should consider diving deeper and conducting further diligence to understand the existing strategy for penetrating minority communities.

If a bank and its target bank have overlapping markets, M&A due diligence should incorporate an analysis of the combined bank's potential redlining risk profile in those markets. The target and acquiring banks in an M&A transaction may each have low levels of redlining risk when the banks are analyzed separately but, when combined, the surviving institution may confront elevated levels of risk. The combined bank may have a drastically different peer list and statistical minority-area lending results in the market post-transaction than either of the involved banks had before the combination. Similarly, redlining risk may be elevated if the surviving bank emerges from the M&A transaction with a series of branch and LPO locations that exclude majority-minority census tracts by forming a combined shape around minority areas.

A separate but related fair lending risk that accompanies the new physical footprint created by an M&A transaction is the new CRA assessment area established by the resultant bank. Acquiring banks have historically adopted the assessment area of the target bank and appended it to their existing assessment area. This practice has been adopted with tacit approval by regulators. Adopting this approach carries the risk of creating a combined assessment area that creates a "donut" or "crescent" shape around majority-minority census tracts that did not exist prior to the acquisition—a circumstance that would increase fair lending risk and create tension with the CRA's assessment area delineation requirements. Performing a basic pre-acquisition CRA assessment area evaluation can help the acquiring bank delineate an assessment area for the combined entity that aligns with fair lending and CRA obligations.

By conducting sufficient due diligence to understand the redlining risk being acquired along with the target bank's physical locations and assessment

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areas, the combined bank will be empowered to begin developing a targeted action plan for managing post-transaction redlining risk in new markets and existing markets.

M&A fair lending compliance program diligence

A second top-line item to review in the diligence phase of an M&A transaction is the sufficiency of the target bank's fair lending compliance programs. A bank's overall fair lending compliance program encompasses policies, procedures, processes, monitoring and testing programs, and a compliance audit function to ensure compliance with fair lending laws. When evaluating a bank's fair lending compliance program, regulators generally focus on two primary components. First, examiners consider the sufficiency of Board and management oversight, including the commitment to compliance, third-party oversight, change management, comprehension and management of risk, and self-identification and corrective action. Second, examiners consider the compliance program itself, including policies, training, monitoring, and consumer complaint processes.

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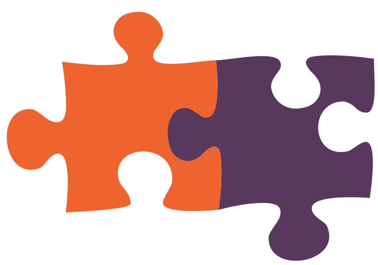
Failing to maintain an adequate fair lending compliance program is a pervasive theme in public enforcement actions challenging a broad range of fair lending violations, including discriminatory redlining, pricing, underwriting, marketing, and modeling, that arise in a variety of product contexts, including mortgages, credit cards, auto loans, consumer loans, and more. Agencies have cited failures to elevate risk to Boards and management, to maintain procedures for fair lending monitoring, to change policies causing discriminatory impacts, and to take meaningful steps to address identified risks. To remedy perceived fair lending compliance program failures, regulators often require banks to overhaul and rebuild their programs—requirements that involve significant hard costs.



Even where an acquiring bank's post-transaction plan involves applying its fair lending compliance program to the acquired institution, an extinguished bank's deficient fair lending compliance program can create risk for the combined bank. As noted, federal agencies will pursue actions against a combined bank for the acquired bank's fair lending violations. Additionally, federal courts have permitted private plaintiffs to bring fair lending lawsuits challenging the pre-acquisition practices of an acquired bank under theories of "successor liability," and such lawsuits are costly and burdensome to defend.

At a minimum, pre-transaction diligence should include reviewing the target bank's fair lending policy and program, practices relating to Board and management oversight of the program and risk reporting, the scope and cadence of fair lending monitoring and risk assessment activities, consumer complaint management practices, and processes relating to corrective action and remediation. Such reviews can be undertaken by requesting documents, by having conversations with key officials responsible for fair lending compliance, or a combination of both strategies.

Impact of fair lending compliance on M&A applications

Bank regulators expressly consider fair lending compliance when evaluating M&A applications, and historical non-compliance can have a direct impact on the approval process. The OCC's M&A application review asks: "Do any of the combining banks present concerns relating to unfair, deceptive, or abusive acts or practices (UDAP/UDAAP), fair lending, or other discriminatory or illegal practices?"[16] The FRB similarly reviews the record of compliance and considers "[e]nforcement actions, and/or any identified fair lending or other consumer protection-related referrals or investigations pending by federal or state agencies or authorities."[17] The FDIC also considers any "outstanding formal or informal enforcement action related to fair lending or compliance performance" and "actions related to discrimination or other illegal credit practices impacting CRA performance."[18]

Significantly, bank CRA ratings, compliance ratings and management ratings can be downgraded because of fair lending violations, and such downgrades may restrict a bank's ability to engage in expansionary M&A activities. Rating downgrades also result in the loss of expedited processing of M&A applications.

Bank regulators are not alone in scrutinizing fair lending issues associated with potential M&A deals—advocacy organizations and other members of the public may independently raise fair lending concerns in an effort to block proposed bank combinations. Certain bank M&A applications require the issuance of a notice informing the public of the right to comment on or protest the filing during the relevant comment period. Underscoring potential reputational risks, applications that receive public comments expressing CRA, fair lending, or consumer compliance concerns are made publicly available.

When comments are filed on a M&A application, the banking agencies typically publish each comment without change and the comments, including supporting material, are part of the public record. Advocacy organizations and the public may also request a hearing to voice their fair lending concerns. Public comments can slow the pace of progress toward regulatory approval of a transaction and can even halt such efforts altogether. In many cases, public comments result in conditions placed on the acquiring bank to make commitments to address fair lending concerns raised in the comments.

Given the direct impact of fair lending on M&A applications, banks considering M&A opportunities on more extended timelines should ramp up fair lending compliance programs to avoid future barriers to implementing strategic plans.

Suggestions for mitigating fair lending risk in M&A transactions

Due diligence

Banks entering M&A negotiations should conduct sufficient due diligence to assess the fair lending practices of the target institution, including:

- Researching public sources—including CRA Performance Evaluations, public enforcement actions or private litigation, and the CFPB's consumer complaint database—to identify any publicly-available history of fair lending claims.

- Evaluating the target bank's fair lending compliance program, including the fair lending policy, Board and management oversight of the program and risk reporting, the scope and cadence of fair lending monitoring and risk assessments, consumer complaint management practices, and processes relating to corrective action and remediation.
- Analyzing HMDA data to help measure the redlining risk of the target bank in new markets and to estimate the projected risk of the combined institution in existing markets.
- Analyzing branch and LPO locations and CRA assessment area delineations in new and existing markets to help evaluate redlining risk.

Integration planning

Effective integration planning is crucial to harmonizing the lending practices of the merging institutions, including:

- Developing plans with concrete timelines for contemplated post-transaction actions to minimize fair lending risks identified in due diligence.
- Implementing comprehensive fair lending training programs for the combined bank's employees.
- Ensuring that systems and data management tools are compatible and capable of supporting fair lending compliance post-merger.

Post-closing

Post-M&A, banks should be prepared to take action to mitigate heightened fair lending risks inherent to bank combinations, including:

- Reporting to the Board and senior management on the newly-combined bank's fair lending risk profile.
- Executing on plans to address fair lending weaknesses identified in due diligence.
- Documenting the fair lending impact of any contemplated exits from markets, discontinuations or reductions of products or services, and closures of locations.

Conclusion

In the context of bank M&As, fair lending risk considerations are critical to ensuring a smooth transition, maintaining compliance, and mitigating the risk of facing claims post-transaction. By conducting pre-transaction fair lending due diligence, planning for effective integration, and implementing improvement plans post-closing, banks can successfully traverse the complexities of fair lending risk in M&A deals. ■

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ENDNOTES

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ABA RESOURCES

ABA Training: Fair Lending
aba.com/training-events/online-training/fair-lending

ABA Guide
Bank Mergers & Acquisitions: A Self-Assessment Guide
https://www.aba.com/news-research/analysis-guides/bank-mergers-acquisitions-a-self-assessment-guide

Also see "Lessons Learned from Redlining Examinations and the Initiative to Combat Redlining" in the July-August 2024 issue.