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Residential Mortgage Lending: Charting a Course Through the Regulatory Maze

*William F. Earthman**

I. Introduction

A. Scope

Considering the breadth of the topics covered in this symposium, I necessarily must define the scope of this article. I intend to address certain of the issues pertaining to the changing role of banking in the United States today from the viewpoint of the private sector of the economy, specifically commercial banking institutions. One person or institution cannot express, or represent adequately, all of the views of the entire private sector. Thus the following positions are my own; hopefully, they represent at least a portion of the views of various financial institutions.

I further caution that I do not purport to present a thorough legal analysis of all rules, regulations, and legislation applicable to the regulation of commercial banking institutions. A plethora of rules and regulations exists, and the scope of this article prevents such an analysis. As a result, I will present a brief overview of the regulatory structure applicable to commercial banking institutions and specifically address the rules, regulations, legislation, and judicial interpretations applicable to residential mortgage lending.

Finally, I will raise issues pertinent to the institution that acts in good faith to comply with the applicable rules and regulations in establishing a policy of residential mortgage lending. I leave it for lawyers on another day to develop fully all of the legal arguments relating to those issues. I do intend to emphasize by way of illustration, however, that commercial banking institutions are subject to a multitude of rules and regulations. It is often difficult to determine how these interrelate with regard to a specific issue. A banking institution cannot address accurately one particular issue without considering the applicability of all the rules and regulations to which the institution is subject.

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B. *Redlining*

One specific issue addressed by this symposium is the practice of "redlining." If what is meant by "redlining" is discrimination in residential mortgage lending, I am certainly opposed to such a practice. If, however, what is meant by "redlining" is the consideration and analysis of the effect of the surrounding neighborhood on the property which secures a particular residential mortgage loan, then there are other problems which must be addressed and focused upon. It has been stated that a lender redlines a specific geographic area located within the larger geographic area normally serviced by that lender when the lender refuses to accept any applications for loans, refuses to make any loans, or refuses to make any loans unless those loans are guaranteed by some form of public or private mortgage insurance, if the loans are to be secured by real estate in the designated areas.[1]

Allegations have been made that the practice of redlining contributes to urban decay and must be eliminated. At least one court,[2] in denying a motion for summary judgment, has ruled that redlining violates sections 3604, 3605, and 3617 of the Fair Housing Act of 1968[3] and section 2000d of the Civil Rights Act of 1964.[4] Additionally, various regulatory agencies are in the process of implementing, or have already implemented, regulations that seek, either explicitly or implicitly, to eliminate the practice of redlining.[5]

Commercial banking institutions must establish policies of residential mortgage lending that do not include the practice of redlining and at the same time provide sound investments for the institution. I intend to demonstrate that in establishing such a policy, a commercial banking institution may be confronted with problems that extend beyond the interpretation of a specific judicial decision declaring the practice of redlining to be in violation of the law. These problems arise in the determination of a policy that will comply with the judicial decision and at the same time will not jeopardize compliance by the institution with all the other rules and regulations that may be directly or indirectly applicable.

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1. *See* State of California Business and Transportation Agency, *Special Hearings on Redlining* (1975).

2. Laufman v. Oakley Bldg. & Loan Co., 408 F. Supp. 489 (S.D. Ohio 1976). For a further discussion of this case, see notes 72-74 *infra* and accompanying text.

3. 42 U.S.C. §§ 3604-05, 3617 (1970).

4. 42 U.S.C. § 2000d (1970).

5. *See, e.g.*, the Home Mortgage Disclosure Act of 1975, 12 U.S.C. § 2801 (1970), which essentially requires financial institutions to disclose what residential mortgage activities they have undertaken within specific geographic areas.

Specifically, the secondary mortgage market through various regulations[6] requires a primary lending institution, such as a bank, to analyze the effect of the surrounding neighborhood on the property which secures a particular mortgage in order for that mortgage ultimately to be sold in the secondary mortgage market. If redlining includes the analysis of the neighborhood surrounding the property securing a mortgage, a board of directors may have difficulty in structuring a policy that does not include redlining and also preserves the access of the instutution to the secondary mortgage market. Thus a dilemma and conflict arises, in structuring a policy of residential mortgage lending that will preserve access to the secondary mortgage market and will not cause the institution to redline. The statutes, rules, and regulations underlying the fiduciary obligations of officers and directors to their institutions and the residential mortgage lending practices of the institutions that I include in my discussion may not all relate *directly* to the issue of redlining. They will provide a background, however, from which I may demonstrate that accurately determining the interrelationship of these rules with the particular issue of redlining may be extremely difficult and may produce a need for clarifying potential conflicts between existing regulations and the law as it is developing with regard to redlining.

II. STRUCTURE AND REGULATION OF COMMERCIAL BANKING INSTITUTIONS

A. *Introduction*

Brief though it may be, some historical perspective is helpful to understand the plethora of rules and regulations governing today's banking system. Banking as it has existed in the United States may be separated into several historical periods. The first began with the end of the Revolutionary War and the establishment in 1782 of the Bank of North America—the first banking institution in the United States. In 1838 New York adopted the Free Banking Act after the discontinuance of the Bank of the United States as a federal institution in 1836. In 1840 the Independent Treasury System was established.

The National Banking System was developed in 1863 and in 1913 the Federal Reserve System was established. The Federal Reserve System essentially was a product of the economic panic of 1907, which induced Congress to develop a plan for a central bank-

6. *See* part IV D. *infra*.

ing system that subsequently was revised to provide for regional reserve banks.

As a result of the Great Depression in the 1930's, the Federal Deposit Insurance Corporation (FDIC) was organized on January 1, 1934. It thus became obligatory for member institutions of the Federal Reserve System to insure their deposits. The establishment of the FDIC, other than imposing additional rules and regulations, did not measurably affect the structure of banking. It did provide, however, the answer to a dilemma presented by the economic crisis of the Depression, that is, how to protect depositors. Thus the establishment of the FDIC provides an early example of the congressional tendency to react to a specific situation by issuing regulations rather than by overhauling the entire banking industry.

Today there can be no unqualified statement that regulation provides protection against all of the potential abuses or pitfalls of the banking industry. It is clear, however, that the banking industry has changed from a system of little or no governmental regulation to one of great regulation. No longer are individual banks free do do as they choose. Each banking institution is obligated to interrelate with other institutions to work as a part of an overall organic whole. No longer can "wildcat" banks be established in remote, widely isolated, and inaccessible regions of the country in the hope that the bank notes they issue will never be returned for collection. Present day banking and its regulation must be viewed as a total entity designed to serve the public interest through the private sector.

Nevertheless, it would be misleading to assert that the present day system is entirely homogeneous. Anyone slightly acquainted with the industry is aware of the existence of national banks, state banks that are members of the Federal Reserve System, non-member state banks that are insured by the FDIC, and even non-insured, non-member state banks.

B. *Bank Holding Companies*

In recent years commercial banking institutions have structured themselves, in large part, in either multi-bank or single-bank holding companies. The development of the multi-bank holding company is partly the result of restrictive branching laws imposed by several states and partly the result of a desire of the banks for diversification of the consumer services they provide. The bank holding companies generally are publicly held corporations. Thus they are subject to the scrutiny and the reporting requirements of the Securities and Exchange Commission (SEC). The officers and

directors of a bank holding company therefore assume obligations to the shareholders of the corporation, in addition to those extending to the depositors of the affiliate banks. In addition to the rules and regulations of the bank regulatory agencies,[7] the officers and directors must assure full compliance with the provisions of the Securities Act of 1933[8] and the Securities Exchange Act of 1934,[9] and the applicable rules and regulations promulgated by the SEC.

C. *Banking Affiliates*

A bank holding company may have as its affiliates both state and national banking institutions. A national bank is subject to regulation by the Comptroller of the Currency and the regulations issued by that office. All national banks are, in general, governed by the National Bank Act.[10] The banking laws of the state in which the national bank is operating often interface with the National Bank Act, however, and subject the national bank to state law, if federal law does not preempt specific provisions of state law. The holding company also may have as one or more of its affiliates a state bank chartered by the state in which it is operating. A state bank that is not a member of the Federal Reserve System is regulated by the FDIC, which issues applicable rules and regulations. A state bank that becomes a member of the Federal Reserve System is subject to the rules and regulations of the Federal Reserve Board (FRB). The state bank is also subject to the banking laws of the state within which it is chartered and to the rules and regulations issued by the Commissioner of Banking in that state. Moreover, the mortgage lending affiliates of a bank holding company, or the real estate department or division of a bank affiliate of the holding company, are subject to the legislation governing its residential mortgage lending activities, such as the National Housing Act,[11] the regulations promulgated by the Department of Housing and Urban Development, and other legislation applicable to those activities.

In considering any particular activity of a bank or bank holding company, one must consult or at least be aware of all of the abovementioned legislation. Good faith compliance with this legislation, including the implementing rules and regulations, often may be

7. *See* part IV *infra*.
8. 15 U.S.C. § 77a *et seq.* (1970).
9. 15 U.S.C. § 78a *et seq.* (1970).
10. 12 U.S.C. § 21 *et seq.* (1970).
11. *See* 12 U.S.C. § 1702 (1970).

difficult, since certain rules and regulations may be in conflict (or at least present a lack of clarity) when applied contemporaneously to a particular activity. Further, they may present difficult problems for the bank officer and director when, in complying, he must also consider his fiduciary obligations to the financial institution.

III. Fiduciary Obligations of Officers and Directors

A. Introduction

Directors have a general duty to insure that their corporation obeys the law and confines its activities within the limits of its corporate powers.[12] Directors may be held accountable for their corporation's *ultra vires*, or otherwise unauthorized, acts. When directors neglect their duties and the corporation suffers loss as a direct result of such a breach, the directors may be liable in damages to the corporation. Such an action may be brought by the corporation itself or by the stockholders in a derivative action for the corporation's benefit.[13] It is immaterial whether a person sought to be held liable is a director or a managing officer of the corporation. As a practical matter, an officer charged with the day-to-day management of the corporation may be subject to greater liability in particular circumstances than would be a director who has no close connection with the daily management of the corporation.[14]

Most courts hold that a director or other officer of a corporation, although not responsible for errors of judgment, is a fiduciary charged with the duty of caring for property of the corporation and managing its affairs honestly and in good faith.[15] Justice Frankfurter wrote:

> [T]o say that a man is a fiduciary only begins analysis; it gives direction to further inquiry. To whom is he a fiduciary? What obligations does he owe as a fiduciary? In what respect has he failed to discharge these obligations? And what are the consequences of his deviation from duty?[16]

The fiduciary obligation of an officer or director of a bank or a bank holding company may extend not only to shareholders of the bank holding company but also to the depositors of the individual banking affiliates of that holding company. In structuring a policy for the board of directors and for the officers of the holding company or of the individual banking affiliates, one must consider the obligations to both shareholders and depositors.

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12. Diedrick v. Helm, 217 Minn. 483, 14 N.W.2d 913 (1944).
13. W. Knepper, Liability of Corporate Officers and Directors § 1.01 (2d ed. 1973).
14. *Id.* § 1.06.
15. Neese v. Brown, 218 Tenn. 686, 405 S.W.2d 577 (1964).
16. SEC v. Chenery Corp., 318 U.S. 80, 85-86 (1943).

There has been no clear definition of what those policies should contain. On December 17, 1974, in a speech entitled *What the SEC Expects of Corporate Directors*, Ray Garrett, Chairman of the SEC, reported that the SEC had abandoned its project to issue a set of guidelines on the duties of directors. He stated:

> We have not made this decision because of any lack of concern for the desirability of directors like all citizens, knowing or at least having the means of knowing, what the law expects of them. We have simply concluded that we cannot effectively advance the cause through guidelines.

Mr. Garrett further emphasized that the SEC's views on the standard of care for directors were as follows:

> The SEC expects every corporate director to do his duty, but we are not willing to try and tell him exactly what his duty is in every situation in which he finds himself. We are, however, willing to say, indeed eager to say, that we expect directors to take seriously what the law has, in fact, long required of them. Realizing that their duty and their loyalty run to investors and not to CEO's [chief executive officers], directors must overcome the traditional and very human tendency to be compliant good guys and make the job of management more pleasant and they must take reasonable measures to protect the interest of investors. We believe that sincere and diligent effort to perform this duty is sorely needed to preserve confidence in business corporate enterprise and, if accomplished, will keep directors free from personal hazard.[17]

It is clear, however, that the law imposes certain obligations on the directors and officers of corporations in general and banks in particular in the conduct of their activities for the institutions they serve. Accordingly, a brief summary of the applicable statutes and judicial interpretations is appropriate.

B. *Officers and Directors of Bank Holding Companies*

If the bank holding company is a publicly held corporation, the general state statutes defining the obligations of the officers and directors of corporations are applicable. These statutes usually state the general proposition that the "business of the corporation shall be *managed* by a board of directors."[18] From this general directive,

17. Harris, *Directors of Industrial Companies: Special Problems*, 31 Bus. Law. 1235-36 (1976).

18. 8A Tenn. Code Ann. § 48-801 (Supp. 1975) states in part:

> The business or affairs of every corporation shall be *managed* by a board of directors, each of whom shall be of legal age. Unless otherwise provided in the charter or by-laws, directors need not he shareholders or members and need not be residents of this state. (emphasis added)

4 Del. Code Ann. tit. 8, § 14(a) (Supp. 1975) states in part:

> The business and affairs of every corporation organized under this chapter shall be *managed* by or under the direction of a board of directors, except as may be otherwise provided in this chapter or in its certificate of incorporation. (emphasis added)

See also ALI-ABA Model Bus. Corp. Act § 35 (2d ed. 1971).

a number of issues emerge. First, directors are mandated to participate in the running of the business of the corporation. It is sometimes unclear to what extent the directors must actively participate in the affairs of the corporation in order to satisfy the fiduciary obligation imposed upon them. Does the word "manage" demand or imply an active participation in the day-to-day activities of the corporation? Surely such an imposition on an outside director would seem unreasonable. It would be more reasonable to construe "manage" to mean that a board of directors selects competent management to supervise the daily activity of the corporation and then closely oversees those management operations. Directors generally may rely on management if they exercise due care and diligence in overseeing the operations.[19]

The corporate statutes often impose upon the officers and directors the additional obligation, in conducting their affairs, to exercise the care and skill of an ordinarily prudent man under similar circumstances:

> Directors and officers shall discharge the duties of their respective positions in good faith and with that degree of diligence, care and skill which ordinarily prudent men would exercise under similar circumstances in like positions.[20]

These types of statutes reasonably may be interpreted to impose upon an officer or director the duty of due care and diligence that an ordinarily prudent man acting as an officer or director of a similar institution would exercise. Thus the standard of care under such a statute becomes a relative concept, depending upon the kind of corporation, the particular circumstances, and the appropriate roles of management and the board of directors in the particular corporation. In determining the proper course of conduct for the officers and directors, consideration necessarily must be given to the size of the corporation, the kind of business it conducts, the standing committees of the board of directors, the special committees of the board of directors, the relationship between the management and the board, and other relevant circumstances.

This type of statutory definition of the responsibility owed by the directors and officers of a corporation represents the weight of

19. Graham v. Allis-Chalmers Mfg. Co., 41 Del. Ch. 78, 188 A.2d 125 (1963).

20. 8A TENN. CODE ANN. § 48-813 (Supp. 1975). N.Y. Bus. Corp. Law § 717 (McKinney 1963) states:

> Directors and officers shall discharge the duties of their respective positions in good faith and with that degree of diligence, care and skill which ordinary prudent men would exercise under similar circumstances in like positions.

authority in the various states.[21] It also represents a significant departure from the previously well-established case law in several jurisdictions that applied a standard requiring a corporate director to exercise the same degree of care and prudence that men prompted by self-interest generally exercised *in their own affairs.*[22]

Although the statutes speak of "managing" the affairs of the corporation and exercising the care of an ordinarily prudent man under similar circumstances, the statutes and judicial interpretations have avoided any precise definition of the affirmative responsibilities owed by directors and officers to their corporation. There have appeared, however, several general statements of the duties and obligations owed by officers and directors,[23] as well as several guidelines concerning board operations.[24] A particular board has

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21. 3A W. FLETCHER, CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS §§ 1035-38, 1063 (perm. ed. rev. repl. 1975).

22. *Id.* § 1037.

23. In Briggs v. Spaulding, 141 U.S. 132, 147 (1891), Chief Justice Fuller, referring to the degree of care required for corporate directors, stated:

> It is perhaps unnecessary to attempt to define with precision the degree of care and prudence which directors must exercise in the performance of their duties. The degree of care required depends upon the subject to which it is to be applied, and each case has to be determined in view of all the circumstances. They are not insurers of the fidelity of the agents whom they have appointed, who are not their agents but the agents of the corporation; and they cannot be held responsible for losses resulting from the wrongful acts or omissions of other directors or agents, unless the loss is a consequence of their own neglect of duty, either for failure to supervise business with attention or in neglecting to use proper care in the appointment of agents.

One author has summarized the probable ultimate meaning of the plethora of legal decisions interpreting the duties owed by officers and directors as follows:

> In determining whether directors are liable for negligent mismanagement, the courts have been prone to use fine-sounding phrases in defining the duties of directors and then proceed to decide the case without reference thereto—the rules laid down being such glittering generalities that the case could be decided either way thereunder without violating the rules. For this reason, it is almost impossible to say that there is any considerable conflict of opinion. All that can be said is that (1) the rule is stated more explicitly and as imposing greater duties to some extent in some cases than in others, and that (2) in the final analysis each case is determined upon the particular facts appearing in the case at bar. As to whether the negligence must be gross in order to be actionable, there is some apparent conflict in the authorities, more apparent than real, although it is now the general rule that want of ordinary care creates liability. Moreover, there is some conflict of opinion as to whether the degree of care is that of an ordinarily prudent man under like circumstances.

3A FLETCHER, *supra* note 21, § 1029.

24. A joint study by the National Industrial Conference Board and the American Society of Corporate Secretaries produced seven generally accepted areas of directorial responsibility:

> 1. To establish the basic objectives and broad policies of the corporation.
>
> 2. To elect corporate officers, advise them, approve their actions, and audit their performance.

considerable latitude in determining the structure of its operations and its relationship with management. Clearly, though, it is pru-

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3. To safeguard and approve changes in the corporate assets (issuance of securities, pledge of assets for loans, declaration of dividends, and conveyance of property).
4. To approve important financial decisions and actions (such as budgets, capital appropriations, officers' compensation and financial audits) and to see that proper annual and interim reports are given to stockholders.
5. To delegate special powers to others to sign contracts, open bank accounts, sign checks, issue stocks, make loans, and perform such other activities as may require the board approval.
6. To maintain, revise and enforce the corporate charter and by-laws.
7. To assume maintenance of a sound board with regular elections and filling of interim vacancies.

NATIONAL INDUSTRIAL CONFERENCE BOARD, INC.-AMERICAN SOCIETY OF CORPORATE SECRETARIES, INC., JOINT REPORT 93 (3d rev. ed. 1963).

Furthermore, the SEC has set forth four principal standards for the proper functioning of a board of directors:

1. Outside directors violate their duty to protect shareholders if their presence had *no impact whatever* on the company's operations or affairs.
2. Outside directors cannot *blindly rely* on the fact that the company employed accountants, lawyers, investment bankers, and other professionals.
3. Directors should familiarize themselves with the company's business and question management in *more than a perfunctory manner.*
4. Management must make available to outside directors *sufficient information* concerning corporate affairs to enable them *adequately to discharge* their responsibilities.

Lipton, *Opening Remarks on the Role of Directors,* 31 BUS. LAW. 1225, 1225-26 (1976); *See SEC Report of Investigation in the Matter of Stirling Homex Corporation Relating to Activities of the Board of Directors of Stirling Homex Corporation,* [Current] CCH FED. SEC. L. REP. ¶ 80,219 (1975).

Finally, in a recent article Mr. John Austin suggested a list of the following steps in structuring the organization of a national bank's board of directors:

1. Review the table of organization of management structure with the bank with emphasis on the decision-making process.
2. Conduct a periodic review of the bank's balance sheet and earning statement year to date with explanation of significant changes in the asset-liability mix and earnings performance. Significant litigation and other significant contingent liabilities should be reviewed.
3. Periodic (preferably monthly) review of new loans, bonds of credit, loan refusals and problem loans above a stated size.
4. Review of trust department operations.
5. Review national bank examination reports or state bank examination reports and other siguificant communications from regulators having jurisdiction over the bank.
6. If the bank is audited, review the audit engagement prior to the commencement of the audit and review with the auditors the financial statements.
7. Review the transactions between directors and their associates and the bank and review procedures employed when the director makes a loan to such persons.
8. Review the bank's insurance and bond coverage, bank protection and other significant programs on a periodic basis.
9. Review the bank's personnel procedures and wage and compensation programs.
10. Evaluate the management performance and study the board and management succession procedures.

Austin, *Directors of Financial Institutions: Special Problems,* 31 BUS. LAW. 1243, 1247 (1976).

dent for a board of directors to establish a policy by which the board and management interrelate and conduct the affairs of the corporation. There is little question, however, that the board is under an affirmative obligation to oversee the operations of the corporation in far more than a perfunctory manner. The obligation often may be rendered complex on the one hand, by the prescription of the Securities and Exchange Commission that the board protect the interests of the investors and on the other hand, by the growing duty of a board to render decisions and structure corporate policy in the public and community interest.

C. *Officers and Directors of Banks*

The National Bank Act mandates that "[t]he affairs of each association shall be managed by not less than five (5) directors. . . ."[25] The Act further provides that:

> Each director, when appointed or elected, shall take an oath that he will, so far as the duty devolves on him, diligently and honestly administer the affairs of such association, and will not knowingly violate or willingly permit to be violated any of the provisions [of the Act] . . . .[26]

The Federal Reserve Act[27] contains a similar provision forbidding the "knowing" violation of that Act where the regulations promulgated by the FRB are applicable to the directors of state banks that are members of the Federal Reserve System. That Act states in pertinent part:

> If the directors or officers of any member bank shall knowingly violate or permit any of the agents, officers, or directors of any member bank to violate any of the provisions of sections 375, 375a, and 376 of this title or regulations of the board made under authority thereof . . . every director and officer participating in or assenting to such violation shall be held liable in his personal and individual capacity for all damages which the member bank, its shareholders, or any other persons shall have sustained in consequence of such violation.[28]

The Tennessee banking laws contain similar provisions concerning the directors of state banks. They provide in pertinent part that:

> The affairs of a state bank shall be *managed* by a board of directors which shall exercise its powers and be responsible for the discharge of its duties.[29]

25. 12 U.S.C. § 71 (1970).
26. 12 U.S.C. § 73 (1970).
27. 38 Stat. 251 (1913) (codified in scattered sections of 12, 15, 28, 31 U.S.C.).
28. 12 U.S.C. § 503 (1970).
29. 8 TENN. CODE ANN. § 45-226 (Supp. 1975).

The statutes further set forth a mandate for the board of a bank to review periodically lending and investment transactions.[30]

There is essentially little difference between the general standards and obligations imposed by state statutes upon the officers and directors of corporations and those imposed upon the officers and directors of a national or state bank. The applicable statutes generally provide that the institution shall be *managed* by a board of directors. Certain distinctions, however, should be noted.

First, the directors of national banks and the directors of state member banks of the Federal Reserve System may not *knowingly* allow the violation of the applicable laws pertaining to their respective institutions. Banks are heavily regulated, and it would be fairly easy for directors knowingly to commit an act that unknowingly is a violation of one of the many rules or regulations applicable to state and national banks. Case law, however, generally indicates that absent a showing of an intent to violate the law or a gross refusal to investigate or take action that would amount to an intentional act, bank directors will not be subjected to statutory liability even though they violate the law.[31]

Secondly, bank directors generally must take particular note of the comments concerning their institutions made by regulatory officials as a result of bank examinations.[32] The directors must take action to cure adverse circumstances noted by the examining officials or run the risk of exposing themselves to criticism and perhaps personal liability imposed by the courts for not properly fulfilling their obligations of due care and diligence to the institution in a particular situation.

Thirdly, banks may be considered quasi-public institutions entrusted with the funds of the public and subject to a multitude of state and federal regulations. Accordingly, the directors and officers of banking institutions may be obligated to conform to a higher standard of management responsibility than are their nonbanking counterparts.[33] Generally, however, such a higher standard will not be imposed upon bank officers and directors since the courts, pursuant to the applicable statutes, will determine each case according to the particular facts and impose the standard of an ordinarily

30. 8 TENN. CODE ANN. § 45-227 (Supp. 1975).

31. Hoehn v. Crews, 144 F.2d 665 (10th Cir.), *cert. denied*, 323 U.S. 773 (1944).

32. *See* Austin, *supra* note 24.

33. Gadd v. Pearson, 351 F. Supp. 895 (M.D. Fla. 1972); Allied Freightways v. Cholfin, 325 Mass. 630, 91 N.E. 2d 765 (1950); Broderick v. Marcus, 152 Misc. 413, 272 N.Y.S. 455 (Sup. Ct. 1934).

prudent man acting in similar circumstances. Finally, the conduct of a director may be measured by the custom and usage of other banks.[34]

IV. Laws and Regulations Pertaining to Residential Mortgage Lending

A. *Introduction*

The basic authority permitting national banks to make real estate loans is found in the Federal Reserve Act, in which such a loan is described as follows:

> A loan secured by real estate within the meaning of this section shall be in the form of an obligation or obligations secured by mortgage, trust deed, or other instrument upon real estate, which shall constitute a first lien on real estate in fee simple or, under such rules and regulations as may be prescribed by the Comptroller of the Currency on a leasehold . . . . [35]

For state banks the authority to make such loans is found in the various state statutes, some of which provide that state banks are authorized to make loans and extend credit upon the same terms as the national banks in the state:

> Notwithstanding any provision to the contrary . . . state hanks shall have the power to make loans upon the same terms as loans are authorized and credit extended by national banks in this state . . . . [36]

Additional authority for the lending of money by state chartered institutions declares that:

> Any state bank may lend money and discount or purchase evidences of indebtedness and any agreement for the payment of money.[37]

From this rather broad underlying statutory language, which provides the basis for the lending of funds secured by real estate, banks must begin to chart their courses through a most comprehensive system of regulation.

In addition to the general provisions of the Federal Reserve Act and the underlying regulations promulgated to implement the Act, the regulations of the FDIC, the appropriate state or national enabling legislation, the Bank Holding Company Act and its amendments,[38] and the various SEC rules and regulations, banks are also subject to numerous regulations that directly concern the lending of

34. FDIC v. Boone, 361 F. Supp. 133 (W.D. Okla. 1972); *see* Austin, *supra* note 24.
35. 12 U.S.C. § 371 (1970).
36. 8 Tenn. Code Ann. § 45-435 (Supp. 1975).
37. 8 Tenn. Code Ann. § 45-428 (Supp. 1975).
38. 12 U.S.C. §§ 1841-48 (1970).

money—including the Consumer Credit Protection Act,[39] the Real Estate Settlement Procedures Act,[40] the Interstate Land Sales Full Disclosure Act,[41] the Fair Housing Act,[42] and the Home Mortgage Disclosure Act of 1975.[43] All of these statutes are vitally important to a bank in considering its real estate portfolio, with greater or lesser emphasis placed on any one or more of the statutes depending on the kind of transactions involved.

B. Real Estate Settlement Procedures Act

The Secretary of Housing and Urban Development issued Regulation X[44] pursuant to the Real Estate Settlement Procedures Act which required certain advance disclosures to be provided by a Lender to each person borrowing money to finance the purchase of certain residential real estate. Basically, the real estate in question comprised one-to-four-family dwellings and the Regulation referred to the lending taking place regarding these dwellings as "Home Mortgages." The information required to be furnished was most comprehensive and pertained primarily to costs, fees, expenses to be encountered at the closing of the transaction, in addition to the cost basis of the seller in relation to the purchase price paid by the buyer-borrower. Elaborate schedules of advance disclosure were promulgated, and the overall impact of the Act and the regulations was to revolutionize the entire residential real estate industry.

The procedures established resulted from a finding by Congress that abuses existed in the real estate industry[45] that could be prevented by disclosure prior to the time of closing. Congress chose "Federal Lenders"[46] as the appropriate entity to make the

39. 15 U.S.C. §§ 1601-81t (1970).

40. 12 U.S.C.A. §§ 2601, 2602-04, 2607, 2609, 2616, 2617 (Supp. I, 1976).

41. 15 U.S.C. §§ 1701-20 (1970).

42. 42 U.S.C. §§ 3601-19, 3631 (1970).

43. 12 U.S.C.A. §§ 2801-09 (Supp. I, 1976).

44. 40 Fed. Reg. 22,448 (1975).

45. 12 U.S.C. § 2601 (Supp. IV, 1974).

46. A "federal lender" is (1) a lending institution, the deposits or accounts of which are insured by the Federal Savings and Loan Insurance Corporation (FSLIC), the Federal Deposit Insurance Corporation (FDIC) or any other agency of the Federal Government, or (2) a lending institution which is regulated by the Federal Home Loan Bank Board or any other agency of the Federal Government, or (3) a "creditor," as defined in section 103(f), [of the Consumer Credit Protection Act, 15 U.S.C. § 1603(f) (1970)] who makes or made new investments in residential real estate loans aggregating more than $1,000,000 in either the calendar year in which the Date of Settlement of the Federally Related Mortgage Loan in question occurs or the calendar year prior thereto. . . . Section 103(f) defines "creditor" as follows:

> (f) The term "creditor" refers only to creditors who regularly extend, or arrange for the extension of, credit for which the payment of a finance charge is required, whether

disclosures but additionally required all lenders to make the required disclosures when the loan was in any any federally related.[47] Penalties were imposed upon lenders who violated provisions of the Act by failing to provide the required disclosure[48] similar to those individuals or entities who directly violated the proscribed activities contained in the legislation.[49] Thus a Bank, as a federally related lender, was required to overhaul its closing practices to conform to the Act.

In reaction to the Act and the regulations, the residential real estate industry, including buyers-borrowers, sellers, lenders, and real estate brokers, arose almost en masse in consternation at the lengthy delays that were encountered as a result of the requirements of the Act. Little by little, the Department of Housing and Urban Development removed the most criticized provisions, until finally Congress removed all provisions regarding advance disclosure.[50] Presently, lenders are required only to provide the buyer-borrower with an approved closing statement (HUD 1 Form) as soon as practicable *following* the closing.[51] The advance disclosure provisions soon will be reinstituted, but perhaps with regulations that may make the Act more practicable.

C. *Home Mortgage Disclosure Act of 1975*

In another area, Congress recently has enacted the Home Mortgage Disclosure Act of 1975[52] after determining that the actions of some lending institutions contributed to the decline of certain urban geographic areas due to the failure of such institutions to provide

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in connection with loans, sales of property or services, or otherwise. The provisions of this title apply to any such creditor, irrespective of his or its status as a natural person or any type of organization.

41 Fed. Reg. 1672 (1976).

47. A federally related loan is (i) one made by a federal lender, *or* (ii) is made in whole or in part, or insured, guaranteed, supplemented, or assisted in any way, by the Secretary or any other officer or agency of the Federal Government, or (iii) is made in connection with a housing or urban development program administered by the Secretary or other agency of the Federal Government, *or* is intended to be sold by the originating lender to the Federal National Mortgage Association (FNMA), the Government National Mortgage Association (GNMA), or the Federal Home Loan Mortgage Corporation (FHLMC), or to a financial institution which intends to sell the mortgage to FHLMC. 41 Fed. Reg. 1672 (1976).

Note that GNMA's authority to purchase mortgages includes broad authority under 12 U.S.C. § 1720(a) (1970) "to purchase such types, classes, or categories of home mortgages" as the President shall determine to carry out the purposes of 12 U.S.C. § 301(b) (1970).

48. Act of Dec. 22, 1974, Pub. L. No. 93-533, § 7, 88 Stat. 1726 (repealed 1976).

49. 12 U.S.C. § 2607 (Supp. IV, 1974).

50. Act of Jan. 2, 1976, Pub. L. No. 94-205, 89 Stat. 1157.

51. 12 U.S.C. § 2603 (Supp. IV, 1974); 41 Fed. Reg. 1672 (1976).

52. 12 U.S.C.A. § 2801 (Supp. I, 1976).

adequate home financing to qualified applicants on reasonable terms and conditions. The Act seeks to accumulate data to determine whether depository institutions are adequately serving the needs of their communities and to assist in the determination of particular geographic areas that may require special assistance.

The FRB, which is intended to implement the Act, promulgated Regulation C[53] and distributed it to members of the Federal Reserve System on March 26, 1976. The Regulation provides that depository institutions having ten million dollars ($10,000,000.00) or more in assets with offices in principal metropolitan areas ("standard metropolitan statistical areas"—SMSA's) are required to make available information regarding the number and dollar amount of loans, with reference to census tracts where possible, and if not, then by zip code designation. The entities required to comply with the Regulation are commercial banks, savings banks, savings and loan associations, building and loan associations, homestead associations (including cooperative banks), and credit unions of the appropriate size that make federally related mortgage loans as determined by the Board of Governors of the Federal Reserve System.

Information to be disclosed would include the following:

1. Loans on one to four family residences and on family residences of more than four units;
2. Loans on individual units of cooperative condominiums; and,
3. Secured and unsecured home improvement loans.

Construction lending is not contemplated to be included within the framework of those loans to be disclosed. Subordinate loans, as well as primary loans, would be included in the disclosure requirement. Additionally, the affected lending institutions will be required to itemize those loans insured by the Federal Housing Administration (FHA) and those guaranteed by the Veterans Administration (VA). Further, the number and dollar amount of mortgages made to borrowers who do not reside on property secured by the mortgages must be disclosed.

The apparent intention of the Regulation is to collect statistical data for the federal government and to make lenders individually aware of precisely where they are lending their funds. The basic tools for reporting the data is a "census tract" as determined on the basis of the 1970 census. Such a tract comprises a small geographical territory containing 4,000 inhabitants into which counties in

53. 41 Fed. Reg. 13,619 (1976).

SMSA's have been divided for purposes of statistical analysis. Since 1970 many of the SMSA's have been modified and others have been added. Thus it appears that some confusion may arise, but the Act and the Regulation allow, at least to a limited extent, the use of zip codes as an alternative means of identification, particularly for that period of time prior to July 1, 1976.[54]

State chartered institutions that are already subject to mortgage disclosure laws similar to the federal requirement will be exempt from the reporting requirements of the Act.[55] Since the scope of the exemption is yet to be determined, however, the impact on all lending institutions will be immediate. Institutions must obtain the appropriate exemptions or comply with the Act and the Regulations. Each institution unable to obtain an exemption will be required by the Regulation to supply the required data for each SMSA in which it has a home office or a branch office for each fiscal year beginning with its last full fiscal year ending prior to July 1, 1976.

Any institution subject to the disclosure requirements of the Act will be required to make available to the public at its home or branch offices, subject to certain further regulations, the information required by the Act.[56] The institution must mail, at a reasonable cost, a copy of the loan disclosure statement to anyone requesting the information and must maintain files that are essentially open to public inspection.

D. *The Secondary Mortgage Market*

Two principal types of lending are contemplated in the residential real estate financing market. The first of these is known as "direct lending." It is primarily used by banks (both commercial and savings), building and loan associations, federal and state savings and loan associations, and certain other private mortgage companies. These entities make direct loans to the buyer-borrower and handle the bulk of real estate closings. In turn, these lenders look to the "secondary mortgage market" as an outlet for the sale, or

54. The Board has proposed that institutions be allowed to disclose information pertaining to loans made prior to July 1, 1976, by zip code rather than by census tract. *Id.* at 13,621. The chief sponsor of the Act, Congressman Fernand J. St. Germain (D-R.I.), has urged the Board to require retrospective as well as prospective information to be broken down by census tract rather than by zip code since the more specific census tract information is more useful in analyzing redlining patterns. *See* letter from Congressman St. Germain to Arthur F. Burns, March 31, 1976 (on file with *Vanderbilt Law Review*).

55. 12 U.S.C.A. § 2805 (Supp. I, 1976).

56. 12 U.S.C.A. § 2803(a)(1) (Supp. I, 1976).

discounting, of the mortgages that they place in their books.

The entities comprising the secondary market are important in this discussion principally because of the impact on the primary lenders of regulations pertaining to these entities. The primary lenders who are interested in the potential sale of their mortgage loans must follow closely the requirements of the secondary mortgage market. The advantage to the primary lenders in "selling" their mortgages is that they are able in almost every instance to maintain a servicing contract with those institutions comprising the secondary market, and at the same time, reacquire the funds received from the sold mortgage loans for additional investments in real estate, which will, in turn, be subsequently sold. With each sale, the servicing account of the primary lender is maintained as a source of income. This procedure provides a benefit not only to the institution, but it also benefits the residential real estate market by increasing the funds potentially available for loans.

Traditionally, the secondary market was composed of insurance companies, savings banks, and several "quasi-governmental" entities. Under the present economic conditions, the impact of the quasi-governmental entities has been enormous because they have been almost the exclusive market for residential real estate loans. This phenomenon is due at least in part to the success other members of the traditional secondary mortgage market have enjoyed by investing their funds in commercial paper and the like, perhaps avoiding the complexities of real estate lending.

(1) Federal Home Loan Mortgage Corporation

One of the several quasi-governmental agencies involved with any bank or residential real estate lender is the Federal Home Loan Mortgage Corporation (FHLMC), a private agency created by the enactment of the Emergency Home Finance Act of 1970.[57] To help alleviate the lack of "end financing," FHLMC was established to purchase mortgages from financing institutions that were members of the Federal Home Loan Bank System, and it subsequently was authorized to purchase mortgages from all financial institutions, which had deposits or accounts insured by an agency of the United States Government.[58]

The *Sellers' Guides* published by FHLMC set forth the following:

57. 12 U.S.C. §§ 1451-59 (1970).
58. 12 U.S.C. § 1454 (1970).

> The fundamental objective of FHLMC's programs is to establish and enhance markets for mortgages in order to provide an adequate and stable supply of funds for housing on the best possible terms. . . .[59]

Under the terms of the *Sellers' Guides*, provision is made that conventional loans, loans insured by the Federal Housing Administration, or loans guaranteed by the Veterans Administration may be sold to FHLMC.

As with all other regulations to which a bank is subject, FHLMC imposes numerous additional requirements to safeguard the quality of the loans acquired under its conventional loan programs. The seller of any mortgage is required to warrant that it has complied with all provisions of equal opportunity in housing.[60] In the case of a breach by the seller, the warranty allows FHLMC, in addition to any other remedies, to require the seller-bank to repurchase any mortgages found not to comply with all the warranties.

While many of the requirements are relatively standard, all tend to require the seller to establish a "quality product" for sale. No summary of the various mortgage requirements for conventional loans (i.e. loans other than FHA or VA guaranteed loans) would be adequate except to point out that they stress the generation of mortgages with satisfactory loan-to-value ratios and require a certain minimal cash equity.[61]

Mortgage insurance, insuring the lender against default by the borrower, is required on all FHLMC conventional mortgage loans that have a loan-to-value ratio in excess of eighty percent. This requirement of private mortgage insurance imposes the additional requirements of the private mortgage insurance industry on the seller-bank.

In defining an acceptable "term" for a mortgage, it is stated that the original term may not exceed a period of thirty years, "or such lesser term as is appropriate, given the character, age, and *location of the mortgage premises*."[62] Thus tacit recoguition is made that some locations are less desirable than others, and that in such instances appropriate modifications may be made to the terms of any loan made for property located therein. The Residential Loan Application required for FHLMC is most comprehensive with regard to the mortgaged premises.

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59. Federal Home Loan Mortgage Corporation, *Sellers' Guides*, Forward, 2 CCH FED. BANKING L. REP. ¶ 11,687 (1976).

60. FHLMC *Sellers' Guide*, Conventional Mortgages § 1.402, 2 CCH FED. BANKING L. REP. ¶ 25,324 (1976).

61. *Id.* § 3.201(a), 2 CCH FED. BANKING L. REP. ¶ 25,324 (1976).

62. *Id.* § 3.201(i), 2 CCH FED. BANKING L. REP. ¶ 25,328 (1976) (emphasis added).

(2) The Federal National Mortgage Association and the Government National Mortgage Association

Two additional entities having a major impact on residential mortgage lending are the Federal National Mortgage Association (FNMA) and the Government National Mortgage Association (GNMA). The role of these organizations in residential housing is momentous. While FNMA is privately owned, and GNMA is a corporate instrumentality of the federal government within the Department of Housing and Urban Development, both were created by acts of Congress. The National Housing Act of 1934, as amended, created the original Federal National Mortgage Association.[63] In 1968, pursuant to the enacting legislation, the original Federal National Mortgage Association was divided into GNMA, which remained within the government's sphere, and FNMA, which became a private corporation.[64] FNMA holds the largest residential mortgage portfolio in the world.

FNMA's function involves principally the acquisition of mortgages from various lending institutions with money borrowed from the private sector at the then current market rates. When market funds are scarce, FNMA makes its major purchases and expands its role in the mortgage community. When investment funds are abundant, FNMA sells its mortgages to private investors at the relatively higher yields obtained during the high interest rate periods. It operates strictly on the system of paying for mortgages on the basis of supply and demand.

On a weekly basis FNMA reviews the demand for mortgage funds and determines the amount of money that it will make available for the upcoming week. Mortgage sellers, including banks, bid for that money by enumerating their mortgage requirements and the price, or discount, they are prepared to take to obtain such financing. The overall demand for mortgage funding is determined by the bidding process in which the sellers determine the amount of discount that they are willing to take. The "discount" is the percentage points by which the face amount of the note secured by the mortgage is reduced to bring the fixed rate instruments into a competitive position in the money market.

The commitments that are obtained from FNMA need not necessarily be exercised and may, in fact, provide a cushion against which the seller may make residential mortgage loans during the

63. 12 U.S.C. § 1716 (1970).
64. 12 U.S.C. § 1716b (1970).

commitment period. The only requirement is that depending upon the length of the commitment and other variable factors, the seller is required to pay a fee ranging anywhere from one-half to one percent for short range commitments to somewhat higher figures for long term commitments. FNMA, in conjunction with GNMA, is now authorized to purchase conventional mortgages as well as FHA insured and VA guaranteed mortgages.

As with FHLMC, detailed *Sellers' Guides* have been published to inform all eligible sellers of the general requirements and regulations. In those regulations, potential sellers are reminded "of their obligations under the Federal Fair Housing Law, . . ." and ". . . [t]o assure the carrying out of the goal of equal opportunity, FNMA will require sellers to maintain appropriate records for a minimum of one year, whether involving mortgages submitted to FNMA for purchase or not, . . . in order to determine that the sellers' loan production to minorities is consistent with the goal of equal treatment."[65]

The conventional selling contract supplement of FNMA refers to the necessary evaluations of the "neighborhood" for use in appraising the premises being considered for a mortgage. It states that nothing is intended to prevent the appraiser from

> considering the social and economic characteristics of the neighborhood to the extent that they are presently, or are likely to, affect the value of the subject property. However, the appraiser is to report detrimental neighborhood conditions in factual specific terms by giving the addresses of the affected properties and an exact description of the nature of the conditions involved in each case.[66]

It is the intent of FNMA to require an individual analysis on a premises-by-premises basis, rather than to allow the broad sweeping generalizations that could adversely affect the making of loans to the entire neighborhood.

GNMA, which possesses powers derived generally from the Government National Mortgage Association charter,[67] is financed both by the United States Treasury and private capital. It is authorized, among other functions, to provide special assistance at the direction of the executive branch of government for the financing of selected types of marketable residential mortgages originating under special housing programs. It is also directed to provide financing for residential mortgages as a means of retarding or stopping

65. FNMA Conventional Selling Contract Supp. § 103, 2 CCH FED. BANKING L. REP. ¶ 25,504 (1975).

66. FNMA Conventional Selling Contract Supp. Part VIII (1976).

67. *See* 12 U.S.C. § 1716b (1970).

declining mortgage lending and home building activities that threaten materially the stability of a high level national economy.

E. Federal Housing Administration

The Federal Housing Administration was created by the National Housing Act of 1934, the administration of which was transferred to the Department of Housing and Urban Development in 1965.[68] The FHA is not a lender nor does it construct housing, but it implements numerous insurance programs established in the National Housing Act, which are intended to make mortgage funds available in various strategic categories and to help stabilize the mortgage market.

The procedures that are followed with regard to mortgages involving individual homes, or with regard to project mortgages in which FHA will either insure construction advances or insure the mortgage upon completion, are quite similar. Initially, an approved lending institution may apply as a mortgagee for mortgage insurance. Such an application must comply with the requirements sufficiently to allow the FHA to determine the eligibility of the loan from three standpoints: the terms of the loan itself, including the interest rate and mortgage amount; the property in question; and the proposed borrower's eligibility and his ability to pay the proposed mortgage debt.

Thereafter, there is an examination of the proposed transaction from both the technical aspect of the project and from the standpoint of underwriting considerations that exist for any mortgage loan. If an application is accepted, a commitment then is issued setting forth the terms and conditions under which the proposed mortgage will be insured. To the mortgagee, this commitment represents a binding contract between itself and the FHA, and upon the satisfaction of the terms and conditions of such commitment, a final endorsement will be issued. The mortgagee thereafter is in a position to sell the insured mortgage loan much more easily in the secondary mortgage market. This general view of a most complex transaction naturally does not give sufficient consideration to the time, efforts, and detail required by individual transactions.

The FHA actively works to prohibit discrimination in any housing activities involving it or any participants in its insurance programs.[69] If complaints are made against a particular mortgagee, a

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68. 12 U.S.C. § 1702 (1970).

69. 24 C.F.R. § 200.315 (1975) provides that:

No person, firm, or other entity receiving the benefits of Federal Housing Adminis-

hearing is instituted first on an informal level and then as a full hearing before a representative of the Commissioner. In the case of a finding of discrimination involving lending practices, the lender may have its status as an approved mortgagee withdrawn.

F. Veterans Administration

The Veterans Administration[70] is an independent entity in the executive branch of the Government. Among its other purposes, the VA administers the issuance of guarantees for loans made to veterans for the purchase of homes and other real estate.

Briefly stated, any lending institution that is examined and supervised by an agency of the United States or of any state or territory is included as a permitted lender with regard to loans made to eligible veterans. Detailed regulations governing such guarantees, (similar to FHA insured loans) exist; from the mortgage lenders' standpoint the greatest attribute of such a guarantee is that it permits greater access to the secondary mortgage market.

G. Private Mortgage Insurance

Reference has been made previously to the role that private mortgage insurance plays in the development of a policy or "pattern" for residential loans by a bank. As an example, the Mortgage Guaranty Insurance Corporation, one of the country's major private insurers of mortgages, sets forth in its guide pertaining to underwriting policies:

> Neighborhood characteristics are important in establishing the marketability of a property, particularly where high loan-to-value ratio lending is desired.
>
> For loans on existing construction, the neighborhood should be characterized as having a broad appeal and good marketability as shown by prompt sales and low vacancy rates.
>
> The emphasis in appraising property for high-ratio lending should be placed on the residential characteristics of the neighborhood, [and the] compatability of the subject property with surrounding structures . . . .[71]

The existence and availability of private mortgage insurance is a prerequisite in practically all situations of conventional residential mortgage financing (i.e. non-FHA-VA) when the loan-to-value ratio

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tration mortgage insurance or doing business with the Federal Housing Administration shall engage in a "discriminatory practice" as such term is defined. . . .

24 C.F.R. § 2000.310 (1975) defines discriminatory practice to mean "any discrimination because of race, color, creed, or national origin in lending practices. . . ."

70. 38 U.S.C. § 201 (1970).

71. Mortgage Guaranty Insurance Corporation Operating Manual § 301.00 (1973).

exceeds eighty percent. Thus, due to the requirements of the secondary mortgage lenders, the extensive rules and regulations governing the issuance of private mortgage insurance become germane. With this brief review of the regulations imposed upon the banking industry by both the government and the private sector, one can begin to appreciate the situation faced by a banking institution in making loans that comply with such regulations, and that are also fundamentally sound investments.

V. Problems for the Institution Attempting to Establish a Good Faith Policy Concerning Residential Mortgage Lending

A financial institution may have various problems in establishing a policy that will comply with all necessary rules and regulations with regard to residential mortgage lending, will provide sound investments for the institution, and will successfully withstand attacks of alleged redlining. A number of specific problems arise in determining a residential mortgage lending policy.

First, there is no clear definition of what activities constitute redlining. Although for the purposes of the discussion in this article I have acknowledged a description of redlining, a precise definition has not been established authoritatively. Thus the question still remains: what specific activities constitute redlining and expose an institution to liability for a violation of the law? The seminal case dealing directly with redlining, *Laufman v. Oakley*,[72] essentially sets forth two basic principles in its denial of a motion for summary judgment by the defendant. First, the court held that the practice of redlining violated sections 3604, 3605, and 3617 of the Fair Housing Act of 1968 and section 2000d of the Civil Rights Act of 1964.[73] Secondly, the court adopted the position stated by the General Counsel for the Federal Home Loan Bank Board (FHLBB) in its amicus brief that opposition to redlining and support of the plaintiffs was not an attempt to establish a policy of forcing financial institutions to invest in "declining neighborhoods."[74] The court,

72. 408 F. Supp. 489 (S.D. Ohio 1976).

73. *Id.* at 491.

74. The text of the court's opinion contains the following language:

MR. SHORE: . . . The Board has determined in its regulations that the racial composition of a neighborhood is not a legitimate rationale of criteria and neither is it a business-like criteria for the making of a loan. If a neighborhood in fact is declining, if property can't be sold, for whatever reason, regardless of the racial criteria, why, that's a legitimate business judgment."

The foregoing statement constitutes, we believe, a completely satisfactory statement of the relevant FHLBB regulations and policies which we also believe are fully supported by the law. *Id.* at 501.

however, did not give a precise definition of the proscribed activity deemed redlining. Even assuming that an institution intends not to discriminate in its residential mortgage lending activities, it may nevertheless engage in practices that conceivably could be held to constitute redlining. For example, if an institution has not intended to discriminate but has not extended loans in a particular geographic area in which other institutions may be redlining, that institution may still be subject to attacks for redlining. This may occur merely because, in its determination not to accept particular loan applications, a lending institution has not invested in a particular area for sound economic reasons, and not for the purpose of discrimination.

Secondly, if an institution is attempting to make a good faith determination whether an investment in a particular area is a sound one, the *Laufman* case provides little guidance. Although that case seemed to recognize that a sound business reason for not investing in a particular area may be that the area is a declining neighborhood, the court gave no clear guidelines as to what considerations an institution may use in order to make that determination.

Thirdly, it is not clear whether an institution has an affirmative obligation to make investments that may promote the community welfare but also may create greater risks for the institution with no greater profits. The Federal Reserve Board has issued an interpretation of its Regulation Y,[75] which essentially sets forth a statement that the Board encourages, or at least allows as a financially related activity, an institution to make investments in projects that promote the community welfare. Specifically cited in the interpretation as qualifying are low- and middle-income housing projects. Does that interpretation set forth, either expressly or implicitly, a mandate by the Federal Reserve Board for financial institutions to establish affirmative policies and to make such investments?

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75. The interpretation includes the following:

> Under § 225.4(a)(7) of Regulation Y, a bank holding company may . . . engage in ". . . projects designed primarily to promote community welfare, such as the economic rehabilitation and development of low-income areas." . . . [T]he Board intends . . . to enable bank holding companies to take an active role in the quest for solutions to the nation's social problems.
>
> . . .
>
> Within the category of permissible investments under § 225.4(a)(7) are investments in projects to construct or rehabilitate multi-family low- or moderate-income housing with respect to which a mortgage is insured under sections 221(d)(3), 221(d)(4), or 236 of the National Housing Act (12 U.S.C. 1701) and . . . "other state, local, or federally assisted projects."

12 C.F.R. § 225.127 (1976).

If such a mandate exists, the directors and officers of the institution may often find themselves in a potential conflict with their fiduciary obligations to the institution. A loan officer or other authorized representative of the institution, probably may make any mortgage loan initially without breaching his fiduciary obligation to the institution if such loans are made in good faith and comply with the established policies of the institution. If, however, such loans are made and are subsequently criticized or classified as substandard by regulatory officials in their examinations of the institution, significant problems may arise. For example, if in the public interest, there is a necessity for extensions or renewals on such loans, the directors and officers authorizing such extensions or renewals may have conflicts with their fiduciary obligations. Traditionally, the duties of due care and diligence may be violated if such extensions or renewals are made on loans which have been criticized by the examiners. How much latitude do officers and directors have in such situations? Moreover, the ability of the individual loan officers to foreclose on those properties, if necessary in the interest of the institution, may be limited because in such situations the community image of the institution making foreclosures may be severely damaged.

Fourthly, in a press release that announced regulations implementing the Home Mortgage Disclosure Act, the FRB noted that the Act and regulations specify that nothing in them is meant to encourage unsound lending practices or the allocation of credit.[76] The general purpose of the Act and the regulations is to require disclosure of the geographic areas in which an institution has made residential mortgage loans. Is there a tacit recognition by the FRB that a potential problem may exist in that an institution may be obligated to make loans in all geographic areas to protect itself against attacks of redlining, and as a result may engage in unsound lending practices? What constitutes unsound lending practices if redlining is defined to include the evaluation of the effect of the surrounding neighborhood on the property securing a loan? Is a practice that prohibits such an evaluation and thus may preclude access to the secondary mortgage market an unsound lending practice?

Fifthly, a number of institutions have developed pools in various cities of the United States in order to invest in geographic areas of those cities which otherwise may not constitute desirable areas

76. FRB Press Release (March 26, 1976).

for investment.[77] Does such a practice establish a custom or usage in the industry obliging other commercial lending institutions to establish similar policies? If one determines that such an obligation exists, one must ask to what extent should the institution make such investments? There is little question that a corporation may make a limited number of charitable contributions. However, are such investments in community welfare projects charitable contributions? In reality, they may constitute long-term loans that provide a higher risk to the institution with a lower rate of return and that may subject banks to criticism by regulatory officials. Although it may be argued that such practices constitute a means of insulating the institution from exposure to charges of redlining, the question remains concerning the extent to which such investments prudently may be made to avoid such attacks.

Sixthly, in implementing a residential mortgage lending policy, officers and directors may undertake activities that conceivably could have a materially adverse effect on the institution. For example, the impact of such activities on the secondary mortgage market must be carefully considered. Every financial institution must depend in some part on the secondary mortgage market, and therefore must comply with regulations that preserve its access to that market in making initial loans. The ability to extend long-term residential mortgage loans with a fixed interest rate and subsequently to sell those loans in the secondary mortgage market has several advantages. For example, the funds generated from the sales can be committed once again to the residential mortgage market, thereby increasing the number of residential mortgage loans made. Further, the practice provides and allows a better utilization of the bank's available capital. If such access to the secondary mortgage market is jeopardized, significant problems for the institution may arise. In complying with the rules and regulations to preserve the access to that market, however, the institution also may conduct activities that subject it to allegations of redlining. For example, in making the initial loan, the institution must provide a representation setting forth an evaluation of the neighborhood in which a loan is made. Does such an evaluation of the overall neighborhood comprise an activity that could subject the institution to attack for redlining? Similarly, regulations in the secondary mortgage market dictate the term of the loan based on the age of the property or the dwelling involved. This also may be a questionable practice in light of the concept of redlining.

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77. *The Redlining Scare Eases City Mortgages*, BUS. WEEK, April 26, 1976, at 36.

Furthermore, the regulations applicable to the secondary mortgage market also may have very specific repurchase provisions. Generally, if there has been any violation of the regulations, the institution may be forced to repurchase those mortgages. Suffice it to say that forced repurchase by an institution of many of its loans sold in the secondary mortgage market may be materially detrimental to the institution, if it violated numerous regulations in the implementation of a policy to avoid attacks of redlining.

Finally, with regard to the fiduciary obligations of officers and directors, the directors should set forth a general policy concerning residential mortgage lending and oversee the implementation of that policy by management. The question arises in structuring such a policy whether the directors of the institution owe a duty *solely* to the depositors of and investors in that institution. Is there a further duty to the community from which the institution draws its depositors and to the welfare of that community? Specifically, is the directors' duty solely to provide a good return to investors or is there a further public duty owed to the community in which the institution is operating?

VI. Possible Solutions to the Problem of Redlining and Conclusion

The practice of redlining has been attacked for a number of reasons. Two of the most obvious criticisms are that redlining contemplates discrimination in the lending process and that it provides a catalyst for urban decay. The solution that is most desirable, and that must be attained, is one that eliminates redlining and leads to an elimination of urban decay.

One possible solution is the filing of individual class actions against lending institutions. Such actions may provide remedies for specific situations; however, the scope of such remedies is limited. Individual class action attacks may eliminate redlining in the specific geographic areas in question. This solution is not far-reaching, however, since the problem may be eliminated only in those particular areas.

A more comprehensive solution would be provided if the various regulatory agencies issued regulations specifically defining the activities that constitute redlining. Furthermore, such regulations could set forth specific guidelines that would define those activities not comprising redlining and that would preserve the access of lending institutions to the secondary mortgage market.

The secondary mortgage market must recognize the problem of

redlining and the potential problems faced by commercial institutions in complying with the specific regulations of that market and with the law pertaining to redlining. Essentially, one may derive a far-ranging solution to the problem if such guidelines are set forth in a clearly defined regulation, or set of regulations, which coordinate with the many regulations already in existence.

The activity of redlining must be eliminated. The burden of finding a means for its elimination, however, must not rest solely with the financial institutions. The numerous rules and regulations and laws to which officers and directors are subjected in conducting the affairs of lending institutions create a quandary in which it is difficult to establish, in good faith, a viable policy of residential mortgage lending that does not subject the institution to attacks for redlining.