

ADI Adviser

## **THE SELF-TESTING PRIVILEGE for FAIR LENDING COMPLIANCE**

The Congress and federal regulators want lenders to improve compliance with fair lending laws. One way to accomplish this goal is to encourage lenders to conduct self-tests of their compliance performance and to correct the deficiencies they uncover. This had been a challenge because self-tests generate new information, and lenders ran the risk that the results of these self-tests would later be used against them by regulators or private litigants.

The most important step in meeting this challenge was to create a legal privilege for self-testing. This privilege is limited, but many large and small lenders have found the limits very workable. The new privilege can be lost, but lenders can maintain it through careful compliance effort.

In the final analysis, the privilege provides a solid foundation for lenders to conduct self-testing for fair lending compliance. It is built from the series of consent decrees and policies that have been evolving for more than twelve years. The self-testing privilege was designed to give lenders an incentive to get the information they need in order to correct conditions that

foster lending discrimination or actual discriminatory behavior by employees.

This article discusses the privilege for self-testing conducted for fair lending compliance under the Equal Credit Opportunity Act (ECOA), Reg B, and the Fair Housing Act (FHAct). The privilege was established through new rules from the Board of Governors of the Federal Reserve System (the Fed) and the Department of Housing and Urban Development (HUD), and the rules went into effect on January 30, 1998. These rules are the result of extensive commentary and debate that occurred during most of 1997. The intention is for both rules to be substantially similar, with the only differences being due to independent requirements of the two governing statutes.

## THE RULES

Both the Fed's and HUD's rules state that, if a lender or lender *voluntarily* conducts or authorizes a third party to conduct a *self-test*, the report or results of the self-test are *privileged*, provided that the lender has taken or is taking *appropriate corrective action* to address any *likely violations* identified by the self-test." (Emphasis added)

### What is a "Self-Test"?

A "self-test" is defined, under both rules as, "Any program, practice or study that:

1. Is designed and used specifically to determine the extent or effectiveness of a lender's compliance; and,
2. Creates data or factual information that is not available and cannot be derived from loan or application files or other records related to credit transactions."

The first part of this definition narrows the scope of self-test to efforts (i.e., programs, practices, or studies) that are designed and used specifically for compliance with the ECOA or Reg B and with the FHAct. In order to meet the definition of a "self-test," the efforts must have fair lending compliance as their primary objective, which could be demonstrated, if necessary, throughout the planning and implementation of the self-test. In addition,

self-tests must produce data or factual information that is new. In other words, the data from a self-test is not contained in and cannot be derived from loan or application files or any other existing records. Self-tests must meet both of these requirements in order to obtain the privilege.

### Examples of "Self-Tests"

Both rules cite pre-application, matched-pair testing and surveys of customers as examples of compliance programs, practices, or studies that meet the definition of "self-test." Under both of these kinds of programs, the lender's undertaking, whether done by staff or by a third party, meets the conditions for a self-test –

- Designed for fair lending compliance purposes, and
- Creates new data or factual information.

In the pre-application testing context, the testers pose as customers seeking credit, and the new information they create is the record of their experience. In the post-application or survey context, the customers being surveyed are those who recently applied for credit, and the new information created is their responses to questions about their experience between the time of their initial inquiry and final disposition of their application.

### Examples of Compliance Efforts that are Not "Self-Tests"

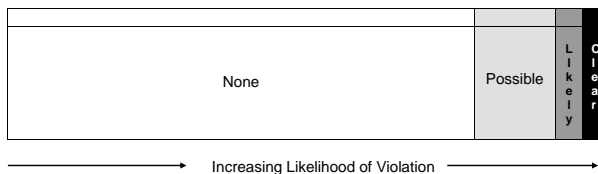
Analysis of loan origination or other system data, comparative file reviews, and other audits that are based on existing files, meet the first part of the definition of "self-test" but they fail on the second part. A file review is designed to determine the extent of lender compliance with fair lending laws and regulations, but it does not produce any new data or factual information. The results of a file review provide additional insight from the files, but this insight is derived from data and factual information already in the loan and application files. The OCC refers to these compliance efforts as self-evaluations to distinguish them from self-tests.

Some efforts have been made to create multi-purpose projects. These projects would result in both fair lending compliance and other types of data. Unless carefully

designed, these multi-purpose projects will also fail to meet the definition of “self-test” and therefore will not be privileged.<sup>1</sup> In contrast to comparative file reviews which fail the second part of the test, these multi-purpose programs are at risk of failure on the first part of the definition of self-test – i.e., they might not stand scrutiny for having fair lending compliance as their primary purpose.

For example, some lenders have asked third parties who conduct their service quality mystery shops to report results based on whether the shopper is a member of a protected class (e.g., racial minority, female, etc.). This kind of effort would not be privileged because the shopping program was designed primarily to obtain service quality information and not to determine the extent of fair lending compliance. On the other hand, a program that is designed and used specifically to create information for fair lending compliance purposes qualifies for the privilege, even though its by-product is service quality information. Therefore, a self-testing program that is designed to test compliance with fair lending laws could also produce, as a secondary output or by-product, information that would be useful for understanding service quality, adherence to sales practices, the effectiveness of sales or operational training, efficiency, or another non-compliance objective.

Figure 1: Where Appropriate Corrective Action May Be Necessary



### What Are Likely Violations?

The second issue raised by the self-testing privilege language is that of the “likely violation.” When a “likely violation” is discovered through self-testing, “appropriate corrective action” is required, even though no violation has been formally adjudicated.” A “likely violation” is a

<sup>1</sup> Please see Official Staff Interpretations on amendments to Regulation B, Section 202.15(b)(1)(i).

violation that is considered more likely than not to have occurred. Figure 1 illustrates our experience that the vast majority of interactions between customers and bankers do not create likely violations of fair lending laws.

Relating the self-testing privilege to “likely violations” has several purposes. First, it provides the context for self-testing. Self-testing is a serious undertaking, with compliance as its primary purpose. Second, “likely violations” provides the subject matter for “appropriate corrective action.” It is these kinds of violations that must be addressed in order to maintain the self-testing privilege – not hair-splitting distinctions or vague ideas about differences in treatment, on the one hand, but also not only formally adjudicated violations, on the other.

### What Does Appropriate Corrective Action Mean?

The next critical issue is the definition of “appropriate corrective action.” As a condition for maintaining the privilege, a lender must take “appropriate corrective action” for any likely violations it uncovers during the self-test. “Appropriate corrective action” is defined as action that is “reasonably likely to remedy the cause and effect of a likely violation by –

- Identifying policies or practices that are the likely cause,
- Assessing the extent and scope of any violation.”

The relief can be remedial or prospective, depending on the circumstances. However, the relief should be made available in a timely way. A dilatory process of self-testing, identifying likely violations, and providing appropriate corrective action, would create a risk of losing the privilege.

The concept of “appropriate corrective action” evolved from the consent decrees and investigations by the U.S. Department of Justice (DOJ). All of the relevant consent decrees have acknowledged the corrective actions taken or to be taken by the lender whose policies or practices were at issue in DOJ’s complaints. Further, DOJ officials have indicated that they have not pursued, in some instances, lenders that had already initiated steps to address whatever possible fair lending violations they

discovered through self-testing, file reviews, investigations of complaints, etc. What constitutes “appropriate corrective action” will be determined on a case-by-case basis.

Through the privilege language, these kinds of mitigating factors are being converted into a requirement for lenders, by making them a condition to maintaining the privilege for a self-test. There are understandable concerns about how regulators will interpret “appropriate corrective action,” but it seems reasonable to expect that a body of examples of such action will build from the existing base and relieve much of this concern. Table 1 shows the early stages of this body of examples.

### A Self-Test Must Be Voluntary

To be covered by the self-testing privilege, the lender must undertake the self-test voluntarily. This requirement supports the underlying reason for these rules, namely, the desire to encourage lenders to conduct self-tests as a way of furthering compliance with fair lending laws.

If the self-test were required by a regulatory or enforcement agency, it would be conducted because that agency had reason to believe that violations of fair lending laws had occurred. The testing in these situations would be designed to obtain additional information on and insight into, the nature and extent of these possible violations or the effectiveness of corrective steps related to past allegations or violations. A self-test conducted in these conditions is not voluntary.

### The Scope of the Privilege

Finally – perhaps one of the most important questions – What protection does the privilege give a lender? As the language of the self-testing privilege states, “the report or results of a privileged self-test may not be obtained or used:

- By a government agency in any examination or investigation relating to compliance with the [ECOA (Reg B) or the FHAct]; or
- By a government agency or an applicant (including a prospective applicant who alleges a violation of

Section 202.5(a) in any proceedings or civil action in which a violation of [ECOA (Reg B) or the FHAct] is alleged.

**Table 1: Examples of Appropriate Corrective Action**

#### From the Interagency Policy Statement

- Identifying customers whose applications may have been inappropriately processed, offering to extend credit if they were improperly denied; and compensating them for any damages, both out-of-pocket and compensatory; and notifying them of their legal rights;
- Correcting any institutional policies or procedures that may have contributed to the discrimination;
- Identifying, and then training and/or disciplining, the employees involved;
- Considering the need for community outreach programs and/or changes in marketing strategy or loan products to better serve minority segments of the lender’s market; and
- Improving audit and oversight systems in order to ensure there is no recurrence of the discrimination.

#### From Recent Consent Decrees

- Albank: Make \$55 million in discounted loan available in area where alleged redlining occurred; conduct targeted advertising; contribute at least \$700,000 to home ownership counseling programs; provide fair lending education for employees; and take steps to ensure that brokers comply with fair lending laws.
- Long Beach: Pay \$3 million to 1,200 borrowers who were allegedly the victims of discrimination; provide fair lending training to employees; offer fair lending training to brokers; inform brokers of its fair lending policies; periodically review its broker lending operations to ensure compliance; and spend \$1 million on consumer education program.
- Chevy Chase: Invest \$11 million over five years in designated African-American neighborhoods, with at least \$7 million used to subsidize special mortgage programs in African-American census tracts; open two additional mortgage offices and open a branch in majority African-American neighborhoods; and target advertising and community outreach efforts to the African-American community.
- Vicksburgh: Establish a compensation fund of \$750,000 for victims; pay a civil penalty of \$50,000; establish a customer assistance program, a fair lending policy, comprehensive fair lending training for officers, directors, and credit employees, a non-discriminatory loan review process; and a matched-pair testing program.

The scope of the privilege extends to examinations or investigations into fair lending complaints or to efforts to prove a violation of fair lending laws. The scope of the privilege encompasses actions by a government agency

or an applicant. The official staff interpretations from the Board of Governors of the Federal Reserve state that “government agency” encompasses all levels of government. These interpretations further state that “in a case brought under the ECOA, the privilege . . . pre-empts any inconsistent laws or court rules to the extent they might require disclosure of privileged self-testing data.” Therefore, the intention is that the privilege shields the results of a self-tests from federal, state, and local government agencies.

This self-testing privilege has been carefully crafted to protect the new lenders generate in order to evaluate their fair lending compliance, and thereby to encourage lenders to identify and correct any likely violations that they discover. The privilege is intended to be an incentive for lenders to use this tool to improve their fair lending compliance.

Nevertheless, some lenders forego self-testing because they believe the risks exceed the benefits. Many lenders believed this before the privilege was created, and some continue to believe it, despite the privilege. The privilege both clarifies and then reduces the risks to lenders, but it is helpful to examine the limits of the privilege.

## THE RISKS OF CONDUCTING SELF-TESTS

When a lender conducts a self-test, it creates evidence that might be used against it. That is a risk that any prudent organization needs to address. There are many persuasive reasons to go forward with self-testing, but let’s discuss the risks first.

### Risk #1: Lenders Can Lose the Privilege

Lenders can lose the self-testing privilege if the lender or a person with lawful access to the report or results:

- Voluntarily discloses any part of the report or results, or any other information privileged under this section, to an applicant or government agency or to the public;
- Discloses any part of the report or results, or any other information privileged under this section, as a defense to charges that the lender has violated the act or regulation; or

- Fails or is unable to produce written or recorded information about the self-test that is required to be retained under section 202.12(b)(6) when the information is needed to determine whether the privilege applies.

These risks can be mitigated through a comprehensive plan to maintain confidentiality and keep records, as well as through conscientious execution of that plan.

### Risk #2: Limited Use of Data Is Allowed

Assuming a violation of the ECOA or FHAct has been proven *without* the self-testing data, the data from a self-test can be used by the prevailing party or government agency *solely* to determine the penalty or remedy that is required when a violation of the ECOA or FHAct has been adjudicated or admitted. Such disclosures are limited to the particular proceeding for which the adjudication or admission was made, and this disclosure does not defeat the privilege for other purposes.

Vulnerability to this risk can be limited as well. As an example, the lenders that have been pursued by DOJ so far have all entered into consent decrees. These consent decrees have stipulated that the lender did not admit any violations of fair lending laws. Lenders that are pursued in the future are also not likely to admit to violations but will enter into consent decrees before there is any adjudication of a complaint. Furthermore, if there is an adjudication or admission, the lender could seek an order to restrict access and use of the results of a self-test to this particular, narrow purpose.

Although these risks exist and must be taken seriously, they appear to be limited in practical ways to narrow circumstances. Moreover, these risks need to be weighed against the benefits of the privilege, which are necessarily tied to the value of self-testing.

### Risk #3: The Privilege is Not Limitless

The self-testing privilege is expressly available for cases based on the ECOA or the FHAct; might not apply in cases filed *exclusively* under a state’s fair lending statute. Therefore, lenders that conduct self-tests might be required to make the results available, if allegations of

discrimination are based solely on state law. This vulnerability is limited in four ways, however –

1. Most plaintiffs are likely to bring the Reg B privilege into play, because they will generally use all of the legal theories and statutory and regulatory bases for those theories that are available, i.e., the ECOA and FHAct.
2. A few states have enacted or are considering legislation that would create a privilege for self-testing under state law.
3. As noted in staff interpretations, disclosures required because of actions pursuant to state law do not constitute a waiver of the privilege. Lenders may protect the self-testing data by seeking a protective order to limit availability and use of the data and to prevent dissemination beyond what is necessary in that particular case.
4. Most lenders conduct self-tests under an attorney-client privilege. This privilege continues regardless of state law.

## HOW DOES A LENDER BENEFIT FROM THE PRIVILEGE?

Being able to show that a comprehensive fair lending compliance program is in place and being implemented is the most persuasive factor short of producing data that a lender has a clean fair lending record. Self-testing is one of the critical components of a comprehensive program.

### Pre-Application Self-Testing

Many fair lending risks exist in the pre-application interaction between employees and customers. This is a time of high vulnerability because –

- The pre-application phase often involves people who do not have a long-term relationship with the institution and might not have had the compliance or customer service training needed to minimize fair lending risk; and
- The pre-application phase is a period during the lending process that is most accessible for

outside parties to conduct their own tests on lenders<sup>2</sup>.

Self-testing at the pre-application stage is also the only way to understand what “appropriate corrective action” might be needed for the group of customers who never have files, but who receive service and who sometimes file complaints on the basis of that service.

Finally, this kind of self-testing is also the only way to –

- “Match” arguments with other groups that do testing and bring complaints based on that testing, and
- Show some basis for the steps a lender will want to take and potentially characterize as appropriate corrective action.

### Post-Application Self-Testing

Another way to ensure a clean fair lending compliance record is to understand customer perceptions of the service they receive. An effective way of learning about these perceptions is to conduct self-testing in the form of a survey of customers. The survey questions can be formulated so that they cover all phases of a credit transaction, and the sample can be drawn so that it allows for effective analysis to compare the treatment given to protected and non-protected class customers.

By learning about these perceptions, lenders can understand better the kinds of policies, practices, or service failings that generate likely and perceived violations of fair lending laws. In understanding them, lenders can develop and implement a plan for appropriate corrective action.

---

<sup>2</sup> At least as far back as March, 1998, the Fair Housing Council, in Washington, D.C., conducted pre-application testing (mystery shopping) for the purpose of identifying likely violators of fair lending laws. In April, 1998, pre-application testing in the Dallas-Ft. Worth area was the basis for a settlement with AccuBanc Mortgage Corp. In that settlement, AccuBanc Mortgage (now part of National City Mortgage) agreed to provide \$2.1 billion in loans to minorities and low- and moderate-income applicants over the next three years. Community groups throughout the country, funded by HUD, continue to conduct these shops and to raise concerns with lenders.

## Using the Privilege

Lenders can use the privilege to their advantage by strategically revealing information outside the privilege that sheds positive light on fair lending compliance efforts,<sup>3</sup> while maintaining the shield to protect what could be construed as likely violations. For example –

The fact that a lender has conducted self-tests, information on the methodology, time frame, and scope of the self-testing are not privileged. Although these pieces of information can be protected by the attorney-client privilege, they can also be revealed when and if such a revelation would be helpful in indicating that a diligent and pro-active compliance program is in place. Similarly, a lender can create further evidence of a diligent and pro-active compliance effort by adeptly indicating that it has taken appropriate corrective action for all pre-cursors to possible violations it has discovered. Taking such action is not an admission that it has violated fair lending laws or regulations, nor is it a disclosure of the results or reports on its self-testing.

## Necessary Steps

As they consider the self-testing privilege, lenders should carefully think about the entire spectrum of their fair lending compliance activities and how self-testing efforts complement the other parts of that spectrum – e.g., data analysis, comparative file reviews, second review programs, fair lending training, review of policies and procedures, and other compliance measures.

When conducting a self-test, lenders should ensure that their program:

1. Is carefully designed and planned for fair lending compliance purposes;
2. Ensures that entire internal team or an outside consultant –
  - a) Is focused on fair lending compliance as the primary objective of the self-test,

<sup>3</sup> The actual use of this information will depend on the circumstances in which the lender finds itself, but these ideas suggest ways to capitalize on the privilege.

- b) Is sensitive to and takes appropriate steps to prevent any disclosures during testing, during data analysis, or during report writing, as well as after the self-test has been completed,
  - c) Is able to reach conclusions and recommend appropriate corrective actions indicated by those conclusions,
  - d) Delivers a final report in a timely way<sup>4</sup>, and
  - e) Has implemented procedures for maintaining all records for 25 months or delivering all records to the lender for storage.
3. Keeps the focus on the action plans and maintains a smooth, logical, and privilege-protecting transition between open acknowledgment that self-testing has been done and the action plans stemming from it.
  4. If conducted on a multi-year basis, shows the effectiveness of fair lending training or other corrective actions that have been taken over time.

## CONCLUSION

Self-testing provides valuable insight into the pre-application phase of the lending process and into customer perceptions of treatment for those who are concerned about fair lending compliance.

A credible compliance initiative, in the form of self-testing, and responsive action following that initiative, if needed, have proven their worth over the years. Since 1992, the lenders that have entered into a consent decree with the DOJ were in a stronger position because they had or were in the process of taking action to address the compliance deficiencies they had identified. Self-testing results and responsive actions were not used against the lenders. Instead, they were risk mitigating factors in determining the remedies for those lenders' alleged violations.

The new self-testing privilege, as discussed here, makes it easier for lenders to realize the value in self-testing.

<sup>4</sup> Please see Official Staff Interpretations of amendments to Reg B, Section 202.15(a)(2).

To gain this privilege, lenders must carefully plan and implement their self-testing program so that it meets four key criteria –

- Have fair lending compliance as its primary purpose;
- Create new data that cannot be derived from loan files or other existing sources;
- Lead to appropriate corrective action to remedy likely violations; and
- Be conducted voluntarily.

Although it is not an absolute shield, this new privilege should give all lenders confidence about the security of self-testing results. Since the creation of this privilege, no lenders have vigorously challenged to reveal the results of a self-test. Moreover, lenders can confidently indicate that they have voluntarily conducted self-tests and have taken appropriate corrective action, as needed – without losing the privilege and without admitting that any likely violations had been discovered.

© Copyright 2006 ADI Compliance Consulting, Inc., all rights reserved.