A Compelling Reason to Self-Test

by Paul Lubin

In 1996, Congress created a new legal privilege for data gathered by lenders during self-testing for fair lending compliance. It was left up to the Federal Reserve Board (the Fed) and Department of Housing and Urban Development (HUD), however, to define and implement the privilege through regulatory changes under the Fair Housing Act (FHA) and Equal Credit Opportunity Act (ECOA).

Both the Fed and HUD chose to define the newly privileged self-tests as voluntary activities used to evaluate compliance with ECOA and FHA. More specifically, self-testing is defined as any effort to collect information pertinent to an organization's compliance that is not readily available from loan files or applicant records. Self-tests include matched-pair mystery shopping and post-application surveys of minority and nonminority loan applicants.

Bankers and other lenders and the associations representing them asked for broader protections, especially to cover file reviews, regression analysis, second reviews, and so forth. The goal of Congress and of HUD and the Fed was to motivate bankers and other lenders to conduct more self-analyses, such as matched-pair testing, post-application testing, and broker surveys, and not merely rely on file reviews. They reasoned that almost all bankers and lenders already conduct such self-analysis as a business practice, risk management, and oversight mechanism: The idea was to encourage bankers and other lenders to use more creative types of testing so they could more precisely evaluate for discriminatory practices and compliance with the FHA and ECOA.

Although it is true that civil rights and activist consumer groups did lobby against broadening the privileged types of self-testing programs, some say that the broadening of the privileges may have turned into a greater headache for the examining agencies and the Department of Justice (DOJ) because files and applications might also have been protected from regulatory examinations and investigations.

We still do not understand what all the clamor is about. According to HUD, a 1994 survey of large depository institutions by a federal regulator found that 78 percent already performed comparative file reviews and statistical modeling as part of their fair lending oversight activities. Our own informal surveys in 1997 showed an even higher percentage than that, so motivation to perform some level of self-testing is apparently not necessary.

However, fewer institutions use the more creative approaches to self-testing (pre-application matched-pair testing and post-application testing surveys). We estimate that 40 percent of major institutions conduct these forms of testing on an ongoing basis, and approximately 20 percent of major institutions conduct these types of tests only from time to time. Nonbank-owned lenders use these more creative testing options even less. Hence, there appears to be a need for incentives to undertake the more revealing forms of self-testing.

Civil rights groups, consumer activist groups, federal agencies, and major institutions and lenders have been conducting matched-pair testing and post-testing for years. Activists and the federal agencies conduct them because of the telling information they generate about the loan process. This is particularly important given the opportunity for pre-screening and differential assistance at stages in the loan process that do not produce information that can be detected through internal audits conducted to check for regulatory violations.

Bankers and other lenders that have conducted pre-application matched-pair testing and post-application testing (surveys of approved, denied, and withdrawn mortgage loan applications) have learned that these types of creative testing methods can measure varying degrees of pre-screening and disparate treatment such as the following:

- failing to provide information or services or providing different information or services regarding any aspect of the lending process, including credit availability, application procedures, or lending standards;
- discouraging or selectively encouraging applicants with respect to inquiries about or applications for credit;
- refusing to extend credit or using different standards in determining whether to extend credit; and
- varying the terms of credit offered, including the amount, interest rate, duration, or type of loan.

If the potential customer or pre-applicant experiences any

of the above kinds of disparate treatment and decides not to apply, there will be nothing in your files to review! And what about the declined applicant who does not receive sufficient coaching or advice to maximize his or her opportunity for loan approval?

Post-application surveys completed with balanced samples of approved and denied minority and nonminority applicants monitor the existence of differential service. Used in conjunction with Home Mortgage Disclosure Act (HMDA) data, this type of self-test can help lenders evaluate the role that assistance plays (if any) in disparities in loan denial rates among minority and nonminority applicants.

In addition to uncovering potential discriminatory acts or disparate treatment, these voluntary testing programs may uncover Community Reinvestment Act-related data (for example, why your institution is not booking enough minority loans), and give you an overall review of customer treatment throughout loan application, origination, and underwriting.

The Office of the Comptroller of the Currency's revised handbook of examination procedures, issued in October 1997, describes various forms of illegal disparate treatment:

- refuses to deal with people inquiring about credit;
- discourages inquiries or applicants by delays, discourtesy, or other behaviors;
- provides different, incomplete, or misleading information about the availability of loans, application requirements, and processing and approval standards or procedures;
- encourages or more vigorously assists certain inquiries or applicants;
- discourages credit seekers by referring them to other lenders;
- waives application procedures;
- states a willingness to negotiate;
- fails to pursue information or verifications needed to complete an application;
- uses different procedures or standards to evaluate applications;
- uses different procedures to obtain and evaluate appraisals;
- waives or grants exceptions to credit standards;
- provides applicants with opportunities to correct or explain adverse or inadequate information or to provide additional information;
- accepts alternative proof of creditworthiness;
- requires co-signers;
- offers or authorizes loan modifications;
- permits loan assumptions;
- imposes late charges, reinstatement fees, and so forth; and
- initiates collection or foreclosure.

As you can see, most of the examples can be tested and evaluated very easily via pre-application and/or post-application testing.

If you have not conducted creative testing yet, or if you haven't made it part of your annual compliance program, talk to a fellow banker who has, or ask your regulator what other institutions have gained from self-testing. Matched-pair testing and post-application surveys are not new to the examiners -they have been looking at testing results and recommending such testing to bankers for years.

Even before pre- and post-testing became protected forms of self-evaluation, they were recommended by the DOJ, HUD, and all the regulatory agencies as viable, proactive forms of self-evaluation to uncover various forms of disparate treatment and FHA and ECOA violations. And now that self-testing is privileged or protected, you have even more of an incentive to take a look at these forms of testing.

Our recommendation is to continue your file reviews and combine them with pre- and post-self-testing as part of your institution's ongoing fair lending compliance program. •

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Mr. Lubin has been serving the financial industry since the early 1980's and has completed over 500 compliance testing programs for banks, mortgage companies, and finance companies.

Mr. Lubin wrote *Fair Lending: An Introduction to Self-Evaluation,* published by Freddie Mac. In addition, he has written many articles on the subject of fair lending, which have been published in *ABA Bank Compliance, The American Banker, The New York Times, American Banker* newsletters, and various ABA publications.