Joint Center for Housing Studies
Harvard University

Fair Lending Testing: Best Practices, Trends and Training

Paul C. Lubin

February 2008
UCC08-4

Introduction

History has shown that self-testing and self-assessment techniques are powerful tools for uncovering problems in business practices and policies. For the consumer seeking credit these problems may manifest in the inability to obtain information to make appropriate credit decisions. For the lender and financial institution it can result in unsafe business practices, discrimination and misleading or unfair practices which in turn result in lost business, damage to reputation and hefty financial penalties. For the nation these problems can result in inefficient and unsound credit markets where inappropriate credit decisions are made by the consumer and lender. These problems may ultimately limit the growth of household and national wealth.

Self-testing and self-assessment programs can help assess whether the market for credit is functioning properly and guide government policy and enforcement activities to ensure the allocation of credit is based on sound underwriting and sales practices that support the best long term interests of the consumer and the lender.

The results of self-testing programs over the last 20 years have shown changes in the credit marketplace affected the consumers' ability to make optimal credit decisions. The credit marketplace in the early and mid-1990's was more stringent in terms of underwriting policies, had less product alternatives and fewer delivery channels for the consumer to gather information and apply for a loan. The approval process was longer giving the consumer more time to search and compare loans. Ancillary products, for example credit protection, were far fewer and sales tactics were more constrained and reflected the more rigid underwriting criteria of the time. Starting in the very late 1990's and accelerating into the new century, commensurate with the growth of secondary market funding and risk based pricing, consumers were faced with an increasing number of lenders, sales personnel, delivery channels and complex product alternatives to choose from. At the same time underwriting polices became more flexible and less rigid reflecting the lenders' ability to source increasingly lower cost funding and then sell loans into the secondary market. Lenders using risk based pricing and pulling credit scores and credit information in real time required consumers to apply first before providing rate and product information. Consumers were now faced with almost instant approval limiting the ability to evaluate and compare products and lenders. Technology provided lenders and sales personnel with the ability to show consumers a variety of complex loan scenarios and alternatives. Ancillary products, for example credit protection, were often packaged into the monthly payment.

Self-testing and self-assessment results during this time reflected changes in the credit marketplace. While loan denial rates have declined, differences in treatment between protected and non-protected classes of consumers have increased. These differences are reflected in product discussion and explanation, suitability questioning, explanation and disclosures concerning annual percentage rate and fees and confusion over whether or not credit insurance is required with the loan. At the same time consumers have encountered more aggressive sales tactics. Encouragement of frequent refinancing and consolidation of secured and non-secured debt, diminished emphasis on exploring the consumers' needs and ability to pay, emphasizing reduced monthly payments without regard to loan principal and interest payments over the life of the loan and packaging credit insurance into the loan payment without informing the consumer are just some examples of the issues pointed out by self-testing or self-assessment techniques.

There are many reasons lenders and the nation should engage in self critical analysis and self-testing of lending practices.

Risk to the economy is one reason. Not treating consumers as long-term assets and not selling appropriate loan products based on the consumers' ability to pay damages wealth at the individual level. Such damage ripples thru the economy, limits long-term growth and can damage the economy as evidenced by the 2007/2008 disruptions in the credit markets.

Ethics is another reason. Strictly regulated or not, the government, consumers, community and business leaders, and lenders should abhor prejudicial and unfair treatment of customers and potential customers.

Legal liability is another reason lenders should adopt monitoring programs. Penalties associated with discrimination and unfair sales practices can be severe.

Reputation risk is still another reason. Allegations of discrimination and unfair sales practices can severely affect the ability of a lender to operate and attract customers and may therefore negatively impact the financial standing of the lender.

Business risk is also a reason. If a lender fails to offer an application and discourages an African American to apply the lender may lose a good customer and revenues will suffer. In addition if the lender fails to gather all the necessary information from an applicant the lender may recommend the wrong product and the consumer may end up with less than optimal loan terms. Ultimately this may result in higher rates of delinquencies and foreclosures which will affect profits.

Lenders owe it to themselves and their customers and the government owes it to consumers to use these and other techniques to assess lending business practices and how they affect the consumer. The costs are not great. The techniques are time-tested, and akin to the customer surveys many lenders and government agencies already perform to measure customer satisfaction and consumer opinions.

The costs of not using them, however, can be high for the lender, the economy and the consumer.

What Is Self-testing?

Self-testing offers the credit provider a critical window into the experience encountered by consumers applying for a loan. It is a voluntary undertaking designed to minimize business and legal risk. The procedure helps ensure compliance with the law and adherence to business protocols and standards.

By using self-testing a lender can help ensure the various phases of the loan process provide consumers with the necessary information to make appropriate credit decisions. It helps ensure compliance with a web of fair-lending rules and guidelines intended to insure that customers receive equal and fair treatment. In light of these rules – overseen by the Federal Reserve, the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, Office of Thrift Supervision and other Federal agencies – lenders have developed monitoring techniques to detect if they treat customers unfairly and whether this is due to race, national origin, age or sex.

The most frequently used form of self testing calls for the use of testers or mystery shoppers posing as potential or actual buyers. Unlike statistical procedures which require outcomes (loan approval, loan denial, pricing) and rely on abstract arguments and statistical principals, testing provides a record of the treatment or experience encountered by the mystery shopper or tester. In tests for discrimination, a direct comparison of the experience encountered by protected and non-protected classes of testers is made.

Another form of self-test is a post application survey which measures the assistance and treatment encountered by loan applicants.

Recently the definition of a self-test was broadened by the agencies regulating banks to include the collection of non-mortgage loan customer classification information, e.g. race, with the specific objective of ensuring compliance with the Equal Credit Opportunity Act.

Other popular tools used by lenders to ensure compliance with fair lending laws are file reviews and statistical procedures (e.g. regression analysis) aimed at identifying disparate treatment of similarly situated protected and non-protected loan applicants. These tools are not classified as self-tests but are deemed self assessments since they use information generated by everyday business processes. In contrast, self-tests produce information that is not normally available or produced by the company's business processes.

Why Is Self-testing Important?

Access to credit is critical to the economy. It enables consumers to purchase a home, purchase and operate a business, finance education and purchase an automobile. All are critical to wealth and economic growth. Self-testing helps ensure the consumer will receive the information required to make appropriate credit decisions.

The consumer faces a myriad of product loan alternatives. Choosing the wrong loan or a loan he or she cannot repay detracts from the ability to build assets. Some perhaps many consumers do not have the knowledge to select the best product. Hence he or she relies on the advice of the lender. Given the importance of the decision and the importance consumers pay to monthly payments, the consumer can be easily misled and apply for a loan that is not appropriate.

Complicating the already difficult credit decision process is how the marketplace has changed. Credit providers have increased their product offerings, expanded sales channels, and accessed third-parties to market their products and services and require the consumer to apply before providing information and then provide almost instant approval. And when searching for a loan the consumer can now choose from an even wider array of lenders and sales channels. The consumer can look toward his or her local bank, Mortgage Company, mortgage broker, finance company, sub-prime lender, Credit Card Company and Investment Company with a mortgage subsidiary. Indeed even a realtor can have a relationship with a mortgage company and can work with and refer the consumer to a lender. And then there are financial institutions operating banks, mortgage and finance companies all offering similar products but at different rates and terms. And depending upon the company or sales channel chosen the consumer can receive different information and rates and terms. Gone is the day when a limited product set and information is provided through one or two types of financial institutions and delivery channels.

The increased number of loan products and delivery channels combined with greater reliance on third party relationships and sophisticated sales and marketing programs has created more risk for both the lender and the consumer. The lender is exposed to the business and legal risk associated with charges and allegations of unfair practices, discrimination and violations of the law. The consumer faces the difficult job of choosing the right product.

What Are The Benefits Of Self-testing?

Monitoring sales and service practices helps the lender ensure that it is in compliance with the law and regulatory guidelines. Indirectly a self-test designed specifically to measure adherence to the law (e.g. Fair Housing Act, Equal Credit Opportunity Ac and Fair Trade Act) will also provide valuable information about the sales and service process and suggest areas where the financial institution can improve.

By regularly monitoring the experiences encountered by consumers the lender can detect and then resolve issues that may represent violations of the law before they result in complaints and allegations that can negatively impact reputation and sales. A plan that systematically tests sales and service practices will be viewed positively by third parties, government regulators and enforcement agencies. It is a proactive step to help ensure customers are treated fairly and honestly. Hence it has been viewed as a mitigating factor by regulators and enforcement agencies when reviewing issues uncovered during a fair lending examination or investigation. For the consumer it means a process that provides the information needed to choose the right loan at the most appropriate rates and terms.

The data or information generated through self-testing designed specifically to measure discrimination is privileged under the Equal Credit Opportunity Act (“ECOA”) and the Fair Housing Act (“FHA”). In order to encourage self-testing Congress in 1996 created a legal privilege for data gathered on a voluntary basis to specifically assess compliance with ECOA and the FHA. The regulators defined self-testing as voluntary activities carried out by a third party that collect information assessing compliance that is not readily available or collected in loan files, applicant records or through everyday normal business practices. The purpose was to encourage financial institutions to use more creative types of activities—Mystery Shopping, Post

Application Surveys and Customer Feedback - to help detect those issues that cannot readily be identified through file reviews and on-site inspections by field auditors. Since then the definition of a self-test has been expanded to include activities to classify protected and non-protected classes of consumers applying for non-mortgage loan products in order to specifically assess compliance with ECOA.

Civil rights groups, community activists, government regulators and enforcement agencies regularly use mystery shopping and post application surveys to help detect violations of the law and acts against public policy. An example of this is the results of the HUD Matched Pair Testing program assessing the treatment of minorities and non-minorities in the pre-application stage of the loan process. In addition HUD provides FHIP funds to community groups to test for discrimination in lending. And then there are the activist organizations, news organizations and class action attorneys that use Mystery Shopping and other methods to test the sales practices of financial institutions.

What Methods Are Employed To Effectively Self-test The Sales And Application Stages Of The Loan Process?

Self-testing programs can either proactively seek to uncover (and correct) deficiencies before they result in lost business, complaints or allegations of violations of the law (e.g. discrimination or unfair sales practices) or respond to an outcome such as lost business, complaints or regulatory or enforcement agency investigation.

The most effective approach is a pre-emptive or a proactive approach to uncover (and correct) any deficiencies in marketing, sales and service processes before they result in customer complaints, allegations of unfair sales practices or discrimination, inappropriate credit decisions and referrals to regulatory authorities.

The most popular and accepted methods of self-testing are pre-application inquiries or mystery shops in the form of Matched Pair Testing and Monadic Testing and Post-application customer surveys.

Matched Pair and Monadic Testing

Matched pair testing and monadic testing are classic forms of self-testing. The specific focus of matched pair testing is to determine the presence of disparate treatment in the pre-application stage of the loan process. Matched pair testing involves pairs of testers, minority and non-minority or male and female posing as potential borrowers. Sometimes matched tests can comprise triads and what is termed sandwich tests. Triad tests comprise three testers, a control, normally a non-minority tester matched against two minorities (e.g. African-American and Hispanic). A sandwich test comprises one non-minority tester matched against 2 African-American testers or 2 Hispanic testers. The testers conduct their tests (shops) separately, but each is provided with profiles or scenarios. In most cases the profiles of the testers are very similar or matched. In some cases the minority takes on a slightly better profile than the non-minority. The profiles include the purpose of the loan, (most often first time home buyer, though refinance and home equity/home improvement are also popular), loan amount, value and location of home, down payment, income and debt levels, rent as well as marital status. Profiles also include car rental and credit card payments, other loan payments, and the income of the tester and his/her spouse. The only significant difference between them is that one tester is a minority and one is not, or one tester may be a male while the other is a female or one tester may be young while the other is old. Although a well-designed matched pair testing program can also provide information about service quality and sales professionalism, the specific objective is to evaluate and compare the treatment each tester receives and if the treatment is equal.

The focus of monadic testing is to detect patterns indicative of misleading sales practices and violations of the law including section 5 of the FTC Act. It can help detect actions and patterns indicative of predatory lending. Monadic testing has become more prevalent with the rise of sub-prime lending and the increased number of product offerings and flexibility in underwriting.

Self-testing whether performed on matched basis for fair lending or monadic basis for fair or reasonable treatment can be conducted either in-person or over the telephone. Most self-testing programs are conducted in-person. However consideration should be given to telephone based testing when consumers apply over the telephone. Often lenders express concerns about testing for disparate treatment over the telephone. This author's experience as well as other studies[1] has shown that in many cases race can be accurately determined over the telephone.

[1] John Baugh, NPR Morning Edition, September 5, 2001 and Linguistic Profiling, Kedamai Fisseha, Nicolas Yannuzzi, January 12, 2007 p.10

Post Application Testing Surveys

For years, corporate America (including banks and lenders) have been using customer feedback programs to help understand customer satisfaction, assess service delivery, evaluate product preferences, pricing differential as a motivator as well as to help evaluate customer attrition.

Post-application testing is a customer feedback program which investigates the quality of the assistance and treatment provided to loan applicants (including minority and non-minority, male/female and younger/older loan applicants) after an application has been submitted. The procedure gained increasing acceptance after a Boston Federal Reserve Study, which maintained that race played a role in the mortgage decision and that differential treatment can occur at different stages of the mortgage process.

> "If white applicants are more likely than minority applicants to be coached when filling out the application they will have stronger applications than similarly situated minorities."[2]

Post application surveys can help lenders ensure fair treatment of all consumers and similar treatment of protected and non-protected classes in the various stages of the loan process. It can examine the coaching, advice, negotiation and competitive shopping and the degree to which it affects loan outcomes in the form of approval/denial, product and pricing. The approach can also help ensure fair treatment by monitoring quality of assistance and the extent to which loan applicants are informed about and understand the loan products and terms of the loan. In addition the survey monitors whether the terms of the loans changed at closing and whether the terms offered at closing differed from the terms the applicant was expecting.

The post-application survey is typically done by interviewing a sample of applicants (for example, minority and non-minority) by telephone that has completed the application process. Applicants whose applications were approved, denied or withdrawn are interviewed to evaluate whether the quality of assistance provided by the lender affected the outcome. A sample of recent loan applicants who have received formal notification of action, either approval or denial, should be interviewed. If you interview applicants prior to their formal notification, you will be unable to discern any correlation between how they were treated and whether their application was approved or disapproved. Moreover, they might misunderstand the purpose of your call and assume you are gathering more information with which to consider their application.

[2] Mortgage Lending in Boston: Interpreting HMDA Data, Boston Federal Reserve, 1992 p.10

The post-application survey should be conducted by telephone. Other alternatives such as mail surveys jeopardize the reliability and timeliness of the information. Mail surveys are subject to the willingness of respondents to fill out and mail back the questionnaire. Some recipients may have no interest in returning the survey (for example, those whose applications were not approved), or they may not take the time.

Categorizing the sample by minority and non-minority group, product group or income group, as well as by outcome (approved, denied or withdrawn), requires a large sample size. To make sure you have enough respondents, you may have to over-sample, that is; interview more members of a group than the share they represent of your business.

Using Application Data in Post Application Surveys

To help in the analysis data from the application regarding the applicant's race or ethnic origin, income, debt, debt-to-income ratio, product type (for example, a conventional purchase-money loan), underwriting office, state or region, loan amount, outcome and reason for the denial can be appended to the information collected from the interviews. Doing so omits the need to ask the respondent for the information, shortening the interview and making it easier for the applicant to respond. In addition, interviewers remain more objective if they do not see the application information.

Information from Self-testing Approaches

Matched Pair Testing

- Identifies disparate treatment
- Detects pre-screening and access
- Uncovers income/credit skepticism
- Measures product steering
- Identifies whether different information/ products are made available
- Detects selling without determining needs, suitable products and ability to pay
- Identifies disclosure or omission of costs, fees, terms
- Monitors unfair and misleading sales practices

Post application Survey

- Identifies disparate treatment
- Monitors assistance and uncovers differences in assistance
- Detects whether access differs for protected classes
- Measures whether coaching occurs for non-minorities but not for minorities
- Identifies product steering
- Measures disclosure and consumer understanding
- Targeting of potential classes for loans and frequent refinancing
- Assess the extent of determining needs and ability to repay

Trends and Findings

Early To Mid-1990's

Self-testing programs in the early to mid 1990's were used primarily to detect and help defend against allegations of discrimination. Self-testing emphasized the pre-application phase of the loan process and the extent to which pre-screening and discouragement occurred. To a lesser extent lenders made use of post application surveys to assess the application phase and the whether or not coaching and quality of assistance was similar for protected and non-protected classes. As such the self testing programs principally were aimed at identifying discrimination in the form of differential treatment.

Different Forms of Discrimination

"Discrimination in mortgage lending can take two different forms. It is important to understand the distinctions clearly, because the different forms of discrimination may require different measurement strategies, as well as different remedies. The fundamental distinction is between differential treatment and disparate impact discrimination.

Differential treatment discrimination occurs when equally qualified individuals are treated differently due to their race or ethnicity. In mortgage lending, differential treatment might mean that minority applicants are more likely than whites to be discouraged from applying for a loan, to have their loan application rejected, or to receive unfavorable loan terms—even after characteristics of the applicant, property, and loan request that affect creditworthiness are taken into account. A finding of differential treatment discrimination means that minorities receive less favorable treatment from a given lender than majority applicants with the same credit-related characteristics (as observable by the lender).

Disparate impact discrimination occurs when a lending policy, which may appear to be color blind in the way it treats mortgage loan applicants, disqualifies a larger share of minorities than whites but cannot be justified as a business necessity. A widely cited example is the policy of minimum mortgage loan amounts—setting a dollar limit below which a lending institution will not issue mortgages. More minorities than whites will be adversely affected by any given loan cutoff because—on average—minorities have lower incomes than whites and can only afford less costly houses. Policies such as minimum loan amounts, which disproportionately affect minorities, are illegal unless they serve an explicit business necessity. If these policies do not accurately reflect creditworthiness, or if they could be replaced by policies serving the same business purpose with a less disproportionate effect on minorities, then they are deemed under federal law to be discriminatory.

The point for public policy is that policies that are discriminatory in effect may have adverse consequences of equal or greater magnitude than practices that treat individuals differently on the basis of their race. Federal policy makes disparate impact discrimination illegal so that institutional policies do not simply perpetuate patterns of racial inequality, many of which are the consequence of past discrimination. In other words, achieving a world of truly fair lending will require remedies that go beyond color blindness."[3]

The prospective loan customer in the early to mid 1990's saw narrower loan underwriting guidelines than they do today or for that matter the late 1990's and early 2000. Most consumers applied for a loan in-person. Call centers and telephone applications were just gaining in popularity. The industry and regulators were focused primarily on mortgage loans. Lenders approved customers and the secondary market encouraged financing of mortgage loans based on the cash flow of the consumer. Housing expense represented no more than 28% of household income and total housing and debt obligations could not exceed 36% of income.

The typical experience of a white female mortgage loan tester and black female mortgage loan tester was:

"We decided to purchase our first home, so we visited a couple of local banks and a mortgage company. We told the representatives we just started to look for a home. They asked us about the purchase price of the home, whether we were renting now and told us we needed to put down at least 10% of the purchase price. One bank said 20%. They representatives also asked us about our income and our auto and credit card payments, how much we had in checking and savings and whether or not we were employed and how much money we make.

We answered the representatives and most said based on the information it looks like we would probably qualify for a 30 year fixed rate loan.

The representatives also asked us to apply and said when we are ready to bring in proof of income and provide checking and saving account numbers and the contract. The representatives told us about a 30 year fixed rate mortgage and told us the monthly payment and the estimated costs of the loan. The mortgage company mentioned an adjustable rate mortgage in

[3] Mortgage Lending Discrimination: A Review of Existing Evidience, The Urban Institute, June 1999 p.14

addition to a fixed rate mortgage. All the representatives said it would probably take 30 days to find out whether or not we were approved for the loan".[4]

The above basically describes the typical mortgage testing scenario and experience encountered by non-minority or white testers and minority testers in the early 1990's to mid 1990's.

During this time self-testing principally centered on the pre-application stage of the mortgage and home equity loan process. Of particular concern was whether or not lenders were pre-screening minorities and discouraging protected classes from applying. In this regard self-testing was used to measure differences in treatment between protected and non-protected classes and whether the differences were overt and subtle in nature. Overt differences are those actions which are evident to the prospective borrower. Examples include a prospective borrower told to "go to another lender," or told that he or she "will not qualify" for the loan. Subtle differences are those actions which are not noticeable to the borrower but nevertheless affect the prospective borrower's ability to make an appropriate decision about credit.

The power of the matched pair test is the side by side comparison of the experience encountered by the minority and non-minority testers.

"When first-time homebuyers begin shopping for a house, they need to learn about mortgages for which they can qualify and about house prices they can afford. This information can be provided by a variety of different sources, including mortgage lending institutions, real estate agents, and mortgage brokers. But if potential homebuyers cannot obtain full and fair access to information about mortgage financing, they may give up on their pursuit of homeownership, their housing search may be restricted, or they may be unable to negotiate the most favorable loan terms. Thus, pre-application inquiries about mortgage financing options represent a critical phase in the home buying process".[5]

Most self-testing programs involving the use of matched pair testers collected the following information:

Access

- How easy was it for minorities and non-minorities to obtain information from the lender?
- Was the tester referred to another financial institution?

---

[4] Extracted from testing conducted by Barry Leeds & Associates and the author in the early to mid-1990's p.15

[5] All Other Things Being Equal: A Paired Testing Study of Mortgage Lending Institutions, The Urban Institute April 2002 p.16

- How much time was spent with the tester?
- Did the tester wait?
- If yes, how long?

Assistance

- Were the testers treated equally?
- Did they receive the same amount of help, information and advice?
- Was help offered to complete the application?
- Who helped the tester?

Invitation to apply

- Were they encouraged to apply?
- Were they offered or did they receive an application?
- Did the representative offer to schedule an appointment to take an application
- Did the representative offer an opinion about qualification?
  - If yes, What was the opinion?

Suitability

- Did the representative attempt to uncover needs and the financial circumstances of the tester?
- What questions were asked of the testers?
- Was the tester asked about:
  - Income
  - Employment
  - Down-payment
  - Loan amount
  - Car and auto loan debt
  - Other sources of income
  - Etc.

Product availability

- What products were discussed and explained?
- What product was recommended?

Product information

- What product features and fees were discussed?

- What was the monthly payment quoted?
- What interest rate was quoted?
- What closing cost was quoted?
- How long is the approval time?
- What documentation is needed with the application?

Customer rapport

- Ask for and use the customer's name
- Stand to greet
- Introduced
- Shook hands
- Smiled
- Offer a seat
- Rushed

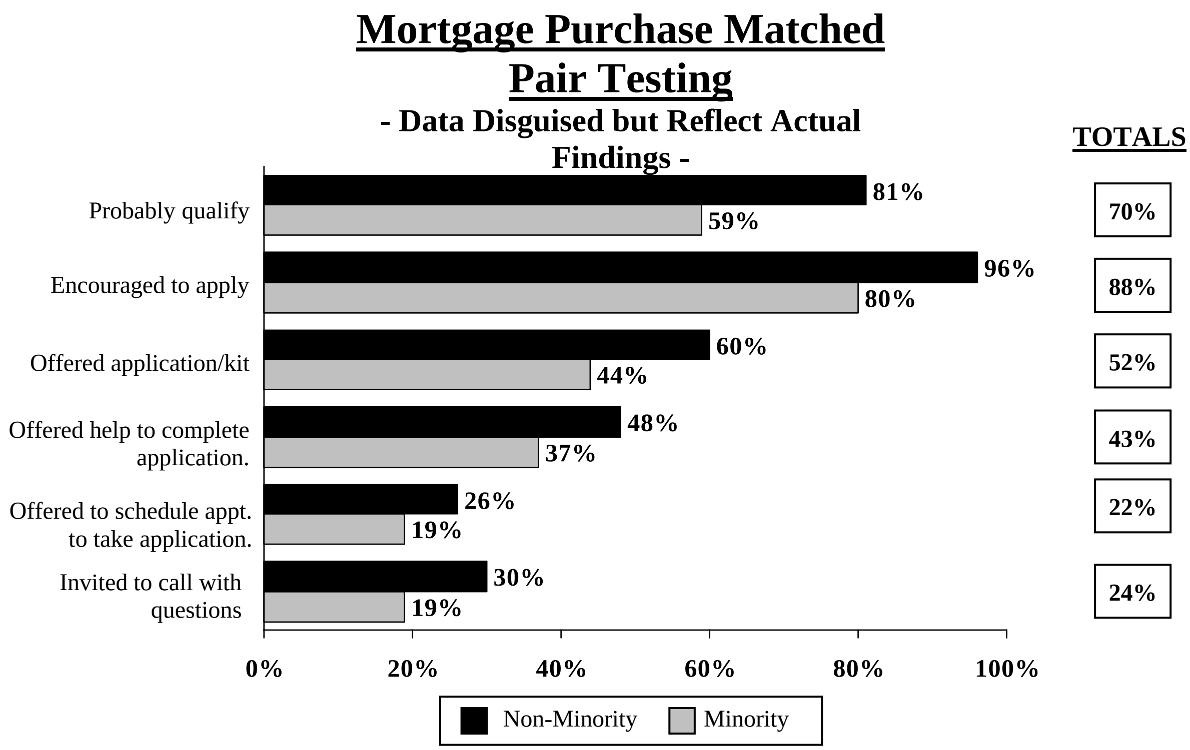
The Most Common Self Testing Findings (early 1990's – mid 1990's)

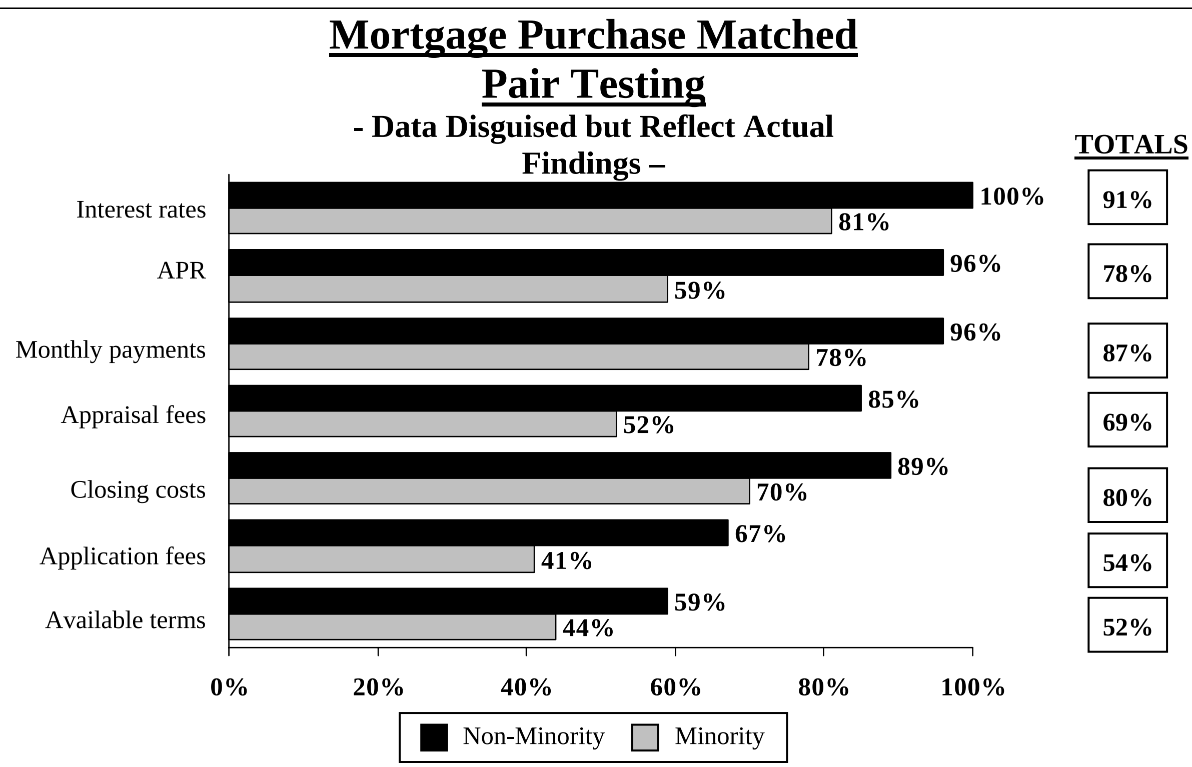
- Little or no overt discrimination found
- Evidence of subtle[6] differences in treatment by individual loan officers

The following graphs drawn from a matched pair testing program describe how matched pair self-testing results is summarized for management. The results are disguised but reflect the results. In addition to reporting differences by Non-minority versus Minority, most programs report differences by African-American versus Non-minority, Hispanic versus Non-minority and Asian-American versus Non-minority. This is critically important since reviewing results at the total minority level may mask differences by ethnic group. Statistical tests are utilized to determine differences between protected and non-protected classes. Tests are normally run at the 95% and 80% confidence levels. Statistical testing at the 80% confidence is recommended in addition to the 95% confidence level. Conducting tests at the 80% confidence requires a smaller difference between protected and non-protected classes to be deemed statistically different. Statistical testing at the 80% confidence level is therefore more likely to identify differences in

[6] Subtle differences refer to actions which are not noticeable to the borrower but nevertheless affect the prospective borrower's ability to make an appropriate decision about credit. Examples include not adequately describing product terms and features and closing costs or discussing only one type of product without adequately identifying needs. Overt differences refer to actions which are evident to the prospective borrower. Examples include a prospective borrower told to "go to another lender," or told that he or she "will not qualify" for the loan. P.18

treatment and therefore better able to help the user evaluate whether a pattern or practice of disparate treatment is present.





Summary of Findings: Instances Where Disparate Treatment Was Found 1991 - 1995[7]

Action	Type –Subtle or Overt
Discussed a wider variety of loans with non-minorities	Subtle
Mentioned more mortgage characteristics to non-minorities	Subtle
Follow-up phone calls made to non-minorities	Subtle
Minorities were quoted a longer approval time	Subtle
Minorities were less likely to be pre-qualified	Subtle
Minorities were less likely to be offered applications	Subtle
Minorities were quoted higher fees/interest rates	Subtle
Minorities were more likely to be told they wouldn't qualify or qualify for a lesser amount	Overt
Minorities were not told how they could "look better" on their application and non-minorities were told	Subtle
Minorities were less satisfied	Subtle
Minority testers waited longer	Subtle
Minority testers reported the transaction was rushed	Subtle

The most common differences noted above were typically drawn from bank retail offices with regard to mortgage and home equity/home improvement loans. These differences mostly involved African American versus Non-minority tests though at times less favorable treatment was noted for Hispanics.

Philadelphia Commission on Human Rights Self testing Program

In the early-mid 1990's the Philadelphia Commission on Human Rights with the support of a HUD grant, in recognition that HMDA does not require lenders to keep records of loan inquiries, conducted a pre-application mortgage lending testing program.[8]

The goal was fourfold:

1. Determine whether black testers inquiring about a mortgage loan are treated differently than white testers with regard to quality, content and quality of information and services at banks, savings and loans and private mortgage companies.
2. Whether lenders discriminate based on neighborhood.
3. Initiate complaints if violations occur.
4. Require affirmative steps by lenders to promote fair lending policies, practices and services in the future.

---

[7] Fair Lending An Industry Progress Report, Barry Leeds & Associates November 1998. Results extracted from self-testing programs undertaken by Barry Leeds & Associates and the author. P.20

[8] Mortgage Lending, Racial Discrimination and Federal Policy, Urban Institute Press, 1996 p.21

In total 192 matched tests were conducted at 68 lenders. 11 of the tests resulted in complaints to HUD. Two of the complaints involved terms and conditions at banks, one large and one small. The black testers allegedly were treated differently than white testers with regard to services and treatment. It was determined that the black testers were given less information on loan products and treated less courteously than white testers. The large bank agreed as a result of the testing to institute fair lending training. Another three complaints involved lender policies requiring 20% down. It was alleged that this policy has an adverse impact on minorities since there is a greater percentage minorities that cannot afford a 20% down payment on a property in Philadelphia. One of the lenders agreed to change its underwriting criteria to allow consumers to put down 5% on the purchase of a home. The lender also agreed to advertise the change and to arrange to have all loan officers participate in fair lending training.

The Mid 1990's to late 1990's

The mid to late 1990's saw increased emphasis on fair lending and self-testing. While the main emphasis was still on mortgage loans, emphasis turned toward home equity and home improvement as well as small business loans. The latter part of the 1990's also saw the emergence of sub-prime lending and expanded and more flexible underwriting. In parallel alternative delivery channels emerged as did automated underwriting, risk based pricing and the use of credit scores in the approval and pricing of a loan. Lenders also relied more on statistical analysis to assess the role of race in the approval decision and to help identify minority loan files to review for disparate treatment.

Self-testing

Matched Pair Testing

The experience of a white female mortgage loan tester and black female mortgage loan tester in the mid to late 1990's now varied based on the lender, its policies and the particular loan officer.

Sub-prime lender: I called and asked for information about a mortgage loan. The representative introduced himself and the company and asked for my name and why I wanted the loan. I told him it was to buy a house. He congratulated me and said it was an important step. He then asked for the purchase price of the home and then for my social security number. I said I just needed to get information so I could decide if I wanted to apply. He said that without my social security number he could not provide me with information.

Bank: I walked in the office and asked for information about a loan. The representative took my name and telephone number and also gave me the telephone number of mortgage loan officer. I arranged a time to visit the branch and meet the loan officer. The representative asked me why I wanted a loan. I said it was to buy a house. The representative then asked for the purchase price and how much of a down payment I had. He went on to ask how much I had in my checking and savings accounts, our household income and whether there were any other sources of income and cash for a down payment. He then went on to mention several products a fixed rate 30 year mortgage loan, an adjustable rate mortgage loan and something he called a first time home buyers loan.

Mortgage Company: I called the mortgage company and asked if I could come by and meet with someone about a mortgage loan. The representative asked if I had a sales contract. I said no I just started looking. The mortgage loan officer said he was busy and that when I had a sales contract to call. I said I had a house in mind I wanted to make an offer but I needed information and really wanted to meet in-person. He scheduled an appointment. When we met he asked me the purchase price and the amount of the loan. He also asked if I was currently renting and if this was the first time I was buying a home. He went on to ask how much money I had in savings and checking accounts, how much I had for a down payment, whether we were employed and how much we made. He also asked about my debt. He then mentioned the types of loans available including a Fixed Rate loan for 30 and 25 years, an Adjustable Rate Loan, Balloon Loan and FHA. He recommended the 30 year Fixed Rate Loan and went on to say that I could also apply for a Home Equity Loan at the same time and that I could use the money toward my down payment and to pay other expenses. He also mentioned a rate lock feature where I could lock in the rate for 30 or 60 days.

Pre-application testing still covered the same topics as those covered in the early 1990's. Although now whether or not lenders asked for the social security number and if they refused to provide information without a social security number was measured. In addition the pre-application shops measured whether the lender attempted to pre-approve the tester. The programs also measured the mention of a broader list of loans including adjustable rate loans, balloon mortgages, first time home buyer and FHA loans. Fees and pricing were also more of a concern as was the offer to buy down the rate and pre-payment penalties.

Many banks also tested the small business loan pre-application process to ensure compliance with the Equal Credit Opportunity Act. Small business development is an important component of wealth creation and limiting minority and female access to small business loans inhibits their ability to accumulate wealth. The small business self testing programs use traditional match pair testing and emphasized the detection of disparate treatment based on gender and race.

A typical small business scenario and profile involves a sole proprietor operating a business from the home that is seeking to expand and move into an office. Loan amounts requested typically range from $50,000 - $100,000. The testers are armed with a profile describing the business.

- loan purpose
- the nature of the business (computer consultant, photographer, etc.),
- number of employees,
- number of years in business,
- annual sales
- core checking balances,
- gross profits and income
- account receivables/payables,
- existing business loans
- name of accountant
- household income
- home owner and value
- credit/car loan debt and payments
- credit history
- savings
- equity in home and mortgage balance

Similar to mortgage and other types of self tests the small business testers monitor access to the lender and small business loan information, invitation to apply, suitability or determining the needs of the customer, product information in terms of products and product features, assistance, fees and rate and customer rapport.

Post Application Surveys

Lenders also increasingly made use of post application surveys to ensure that the quality of assistance was of a nature that maximized the opportunity for loan approval for minorities and non-minorities as well as males and females.

The typical post application survey measured:

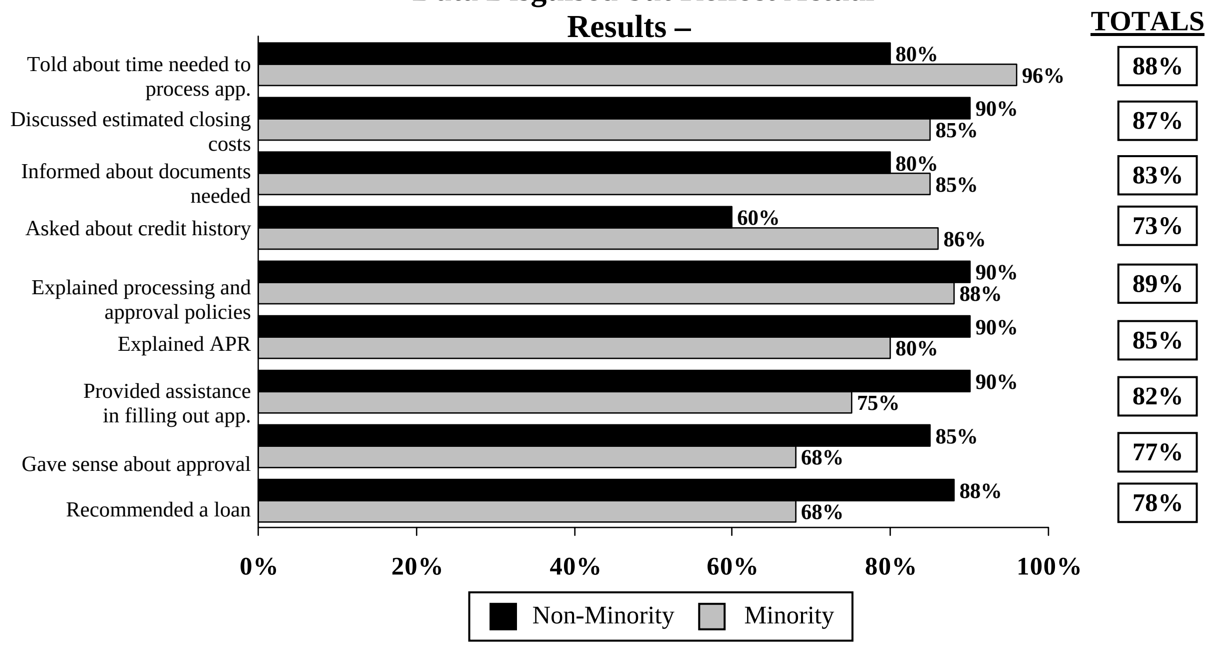
- How satisfied were the customers?
- What did they dislike and like about the loan process?
- Was it easy to meet with a loan officer?
- What products were discussed and applied for
- Did the representative provide helpful and prompt advice?
- Did the representative provide assistance in filling out the application?
- Did the representative discuss rates, APR, points, fees, closing costs, monthly payment, etc.?
- Did the representative give you any indication about whether you would be approved?
- Were you told how long the approval process takes?
- Did the representative discuss differences between loans?
- Were you contacted for additional information after applying?
- Did you have to contact the lender about problems?
- Were you given any suggestions by the representative that you were told will help you get approved?
- What type of suggestions were you given?
- Did the representative ask you to describe the neighborhood where the property is located?
- Did the representative inquire about the probability of increased income in the future?
- Did the specifics of the loan you were approved for differ in any way from what you were told at the application stage?

Of notable interest and related to the above areas is the majority consumers who recently applied for a loan and were interviewed as part of the self testing programs in most cases relay they received assistance in completing the application while a substantial minority say they did not. Similarly a substantial minority of consumers in most self-testing programs report there was no explanation of different loan alternatives nor was a particular loan recommended. In comparison only a very small percentage of consumers say the lender failed to explain the APR and closing costs associated with the loan. Finally, a small but substantial minority of consumers interviewed mentioned the interest rate of the loan changed from what they were told at application. For the most part consumers said this was related to market conditions and general changes in market interest rates or their credit score.

The following graphs drawn from a Post Application survey describe how post application self-testing results are summarized for management. Results are disguised but reflect actual results.

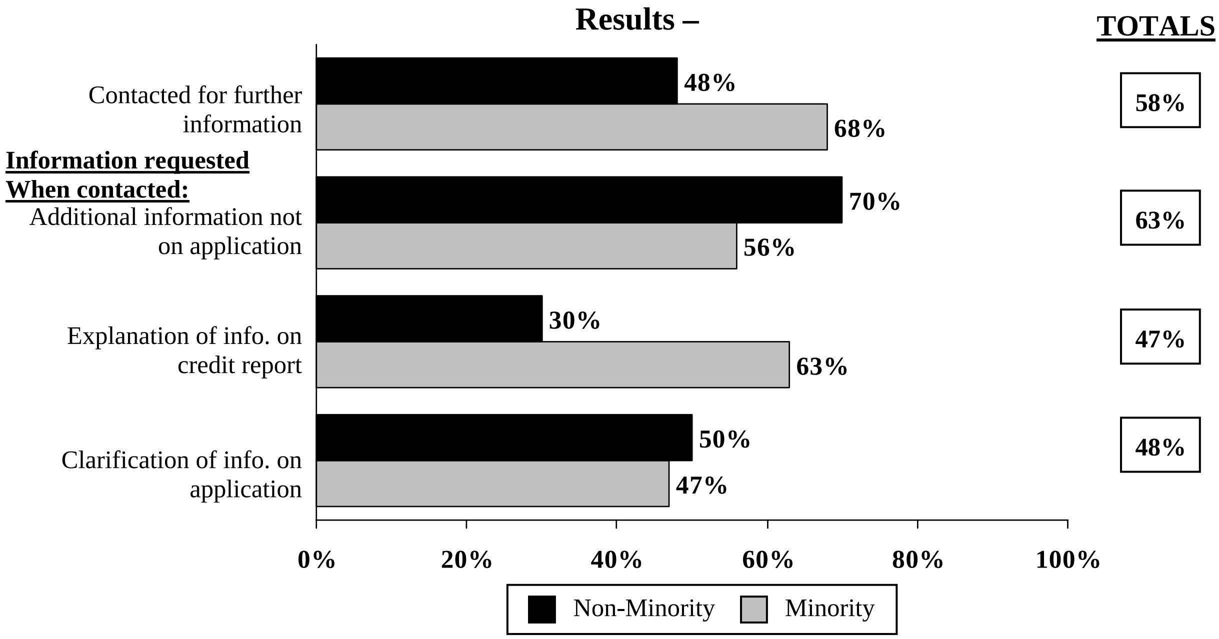
Mortgage Purchase Post Application Survey

-- Data Disguised but Reflect Actual Results –



Mortgage Purchase Post Application Survey

- Data Disguised but Reflect Actual Results –



<u>The Most Common Self-testing Findings Mid 1990's – late 1990's</u>

Pre-application testing[9]

- Heightened awareness of fair lending and treatment of minorities
- Favored treatment of minorities or protected class
- Overall less differences favoring non-minorities
- Fewer Regulation B violations ("you probably won't qualify")
- Less disparate treatment
- Lender less likely to give opinion about qualification (no differences)
- Some isolated instances (differences)
  - approval time (higher for minorities)
  - product steering (minorities to FHA)
  - more questions of minorities (assistance not skepticism)
  - non-minorities told about lock in feature and discounted rate if customer
  - less opinions about qualification to minorities
  - more documents required with application mentioned to minorities
  - less often attempt to pre-approve minorities

Post application surveys[10]

- Overall similar assistance provided
- Some isolated instances (differences)
  - Minorities less likely to say the representative recommended a loan
  - Minorities less often told about pre-approval
  - Provide less assistance to minorities in completing the application
  - Less likely to ask minorities about other sources of income
  - Less likely to provide minorities with a sense of whether or not they would be approved

The above findings are drawn mainly from self-testing programs and post application telephone surveys conducted for banks, bank owned mortgage companies, mortgage companies and smaller set of sub-prime lenders. The pre-application tests comprised in-person tests at branches and mortgage offices as well as telephone tests of call centers originating mortgages and home equity loans. Post application surveys for the most part covered mortgage and home

[9] Extracted from self testing programs conducted by Barry Leeds & Associates and the author p.28
[10] Extracted from self testing programs conducted by Barry Leeds & Associates and the author p.29

equity customers. The pre-application tests and post application surveys comprised whites, African Americans and Hispanics.

The most common differences were encountered during in-person testing at retail offices of banks with representatives selling more than one product. The most common differences were typically less favorable among African Americans though there were instances where Hispanics received less favorable treatment. At times minorities received more favorable treatment probably owing to fair lending and diversity training. This typically was among African Americans and not Hispanics. Fewer differences were typically found with dedicated mortgage originators, particularly at bank owned mortgage companies. Here the experience typically was generally of a much higher quality and very consistent.

In the mid-late 1990’s the Urban Institute conducted a pilot matched pair testing in Los Angeles and Chicago.

> “The pilot test results show that in both Los Angeles and Chicago, African American and Hispanic homebuyers face a significant risk of receiving less favorable treatment than comparable whites when they visit mortgage lending institutions to inquire about financing options. However in the majority of cases, minorities and whites received equal treatment, or when differences occurred, they were equally likely to favor the minority as the white. But in both metropolitan areas, paired testing reveals statistically significant patterns of unequal treatment that systematically favor whites.”[11]

The study goes on to say unequal treatment takes different forms in the two metropolitan areas and for the two minority groups.

In Los Angeles:

- Blacks were offered less coaching than comparable white homebuyers, and were more likely to be encouraged to consider an FHA loan.
- Hispanics were denied basic information about loan amount and house price, told about fewer products, and received less follow-up compared to Anglo homebuyers.

In Chicago:

- Blacks were denied basic information about loan amount and house price, told about fewer products, offered less coaching, and received less follow-up than comparable white homebuyers.

[11] All Other Things Being Equal: A Paired Testing Study of Mortgage Lending Institutions, The Urban Institute April 2002 p.30

- Hispanics were quoted lower loan amounts or house prices, told about fewer products, and offered less coaching than comparable Anglo homebuyers.

These patterns of unequal treatment occurred regardless of whether the two members of a tester pair met with the same loan officer or with different loan officers.

Another example of differences found in the pilot Urban Institute study is shown below.

> "Two female testers, one white and one black, visited the same Los Angeles area lender two days apart and met with the same loan officer. The testers told the loan officer that they were first-time homebuyers and needed assistance in figuring out a home price range and a loan amount for which they might qualify. The loan officer requested and obtained detailed information on household income, debts, and assets from both testers and asked about their respective credit situations. He then estimated that the white tester would qualify for a $332,500 loan to purchase a $350,000 home and, but estimated that the black tester would qualify for a $237,500 loan to purchase a $245,000 home. The loan officer told the white tester that a seller would likely pay some of the closing costs, but no mention was made about seller assistance to the black tester. The loan officer also told the white tester that it was a good idea to have a home inspection conducted prior to purchase, while the loan officer did not mention anything about the value of a home inspection to the black tester. The loan officer provided a complete loan application package to the white tester, but not to the black tester."

Statistical or Regression Models

Statistical modeling was increasingly used by lenders as a self-assessment tool during this time. The Boston Fed Study in the early 1990's demonstrated how statistical modeling could be used to determine whether race is a factor in the loan decision process. Increasingly regulators during fair lending exams and lenders used the tool to assess discrimination in lending. It offered the advantage of examining a large amount of data points in a timely manner and could identify for lenders files of minority applicants that were denied that were similar to non-minority applicants that were approved.

> "One of the most significant new elements in the lenders self-assessment toolbox during this time period was regression analysis. Fueling this use were OCC fair lending examination procedures using regression analysis. The OCC used Logit regression an analysis to evaluate the extent to which many variables predict the outcome of one variable, the dependent variable. In fair lending examinations, a prohibited basis would be the dependent variable and the bank's underwriting standards would be the variables used in the analysis.

> Examiners using regression analysis will begin by looking at the variables identified by the bank as important in its underwriting. The bank uses the variables because the bank believes or has found that the variables are important to predict the applicant's performance. The examiner's analysis adds a prohibited basis as a dependent variable to determine whether that factor, e.g., race, has predictive value as to outcome.
>
> The OCC has used regression analysis side by side with file analysis in the same institutions to make sure they get the technique right. Because the circumstances and market issues for each bank vary, there is no single analysis model. Examiners customize the models to the specific examination. Cross believes that this is a valuable improvement to how the OCC does fair landing analysis. What matters in this approach is whether a finding is statistically significant."[12]

<u>2000 – 2007</u>

The nature and use of self-testing changed in 2000. In addition to ensuring adherence to Equal Credit Opportunity Act and Fair Housing Act, self-testing addressed violations of section 5 of the Federal Trade Commission Act (FTC Act) and helped lenders detect unfair sales practices.

The rise of risk based pricing, credit scoring models; automated underwriting and increased funding from the secondary markets brought with it an expanded credit marketplace in terms of lenders and a wider array of product offerings. Almost every credit market was affected, including mortgages and home equity, personal consumer and unsecured lines of credit, small business and credit card. Along with the expanded credit marketplace came the sale of ancillary products, e.g. credit protection, unemployment insurance, etc. Many lenders also moved into complementary product lines to garner more fees, e.g. title insurance. Sub-prime lending grew dramatically along with expanded product sets, delivery channels, sales forces and sales and marketing programs aimed at attracting customers and with it fees.

Consumers faced a sharply increased number of product choices and lenders. These choices are present across different types of credit, mortgages, refinance, home equity, credit cards, unsecured credit lines, auto and personal loans. And the way lenders deliver products changed. Now a lender markets its products through stores, telephone, internet, mail and third parties (e.g. mortgage brokers). In addition the approval process accelerated. Consumers can now apply and be

[12] Steve Cross, Deputy Comptroller for Compliance Management, addressed the students attending ABA's National Graduate School of Compliance Management, June 1998. Bankers Online p.33

approved for many products within minutes. Gone are the days where the length of the process gave consumers the chance to search, acquire knowledge and build comfort with the product.

Some lenders adapted their training and sales scripts to fit the new environment of fast and flexible credit. Some sales scripts emphasize an initial rapport building or introductory stage and then move quickly to obtain the consumer's social security number in order to run a credit score and thereby fit the consumer into a product. Little education is offered to the consumer. Other lenders offered the consumer "what if" scenarios in terms of monthly mortgage payments and potential savings over current loans. This is potentially misleading in so far as the "what if" scenario may not be accurately incorporating the terms of the current loan.

These developments created an environment more prone to representatives engaging in unfair or deceptive acts or practices. This in turn can lead to customer dissatisfaction,; harm to a company's reputation, and even litigation and government enforcement actions. Customers need to be especially careful in so far as they run the increased risk of applying for the wrong product and paying higher rates and fees. Lenders engaging in practices that harm customers can undermine the lender's reputation and its ability to retain customers.[13]

An example of unfair acts is the allegation against the former Associates. The allegations involved representatives making false statements about the benefits of debt consolidation. The allegations included the Associates calling customers and describing how the consumer could save money each month through an Equity Advantage Plan, typically a home equity loan. Here the Associates representative would show the consumer a "What-if scenario" showing the purported monthly savings and benefits of consolidating short term, unsecured debt and home loan debt in a new home equity loan typically 15-20 years. This comparison assumed the same monthly savings over 15-20 years even though the short term debt was for 5 years. In addition, the What-if scenarios did not factor in real estate taxes and insurance, which consumers needed to pay out of pocket. Still another allegation against The Associates involved packing or selling unwanted or needed products to consumers. Here the allegations included that representatives told consumers that payment protection was included in the monthly payment quote but did not describe the added cost of the payment protection. In many instances representatives included

[13] AL 2002-3 Advisory Letter Subject: Guidance on Unfair or Deceptive Acts or Practices Date: March 22, 2002 p.34

payment protection in the monthly payment quote without telling the customer payment protection was included.[14]

In the credit card arena sales practices became increasingly important. Using risk based scoring models credit card companies aggressively marketed their credit cards and ancillary products. These marketing and sales campaigns and the expansion into new and different product lines and delivery mechanisms fostered increased risk in an environment without adequate oversight.

Providian Financial a credit card company grew quickly in the late 1990’s into 2000. It marketed primarily to the sub-prime market credit cards and ancillary products (e.g. credit protection, unemployment insurance and auto and dental membership plans).

During this time Providian faced increasing allegations of unfair and misleading sales practices and entered into a Consent Order with the Office of Comptroller of the Currency in June 2000 requiring $300,000,000 in restitution to consumers for its alleged unfair or misleading sales and marketing practices. The allegations included unfair and deceptive practices regarding credit protection and not disclosing the credit protection was limited to the number of months paid-in as well as other restrictions. The allegations also included deception regarding a no annual fee card and the card company not disclosing the purchase of credit protection for $156 per year was required to obtain the no fee card. Still another allegation included the deceiving customers about a guaranteed savings rate without ever revealing the amount of the savings. Customers who were dissatisfied with the rate reduction had to pay 3% of the outstanding balance in order to transfer balances to another financial institution. And the customers had to prove to Providian’s satisfaction within 90 days the interest rate they were previously paying in order to obtain the savings. If the customer did not Providian then would charge the maximum rate allowed under the account agreement often 21.00%. Providian also marketed a reward for opening an account without telling the customer he or she was required to transfer a minimum balance, “Real Check Program”. All allegations maintained the bank did not adequately disclose the features and restrictions of the programs.[15]

---

[14] FEDERAL TRADE COMMISSION, Plaintiff, v. Civil No. CITIGROUP INC., CITIFINANCIAL CREDIT COMPANY, ASSOCIATES FIRST CAPITAL CORPORATION, and ASSOCIATES CORPORATION OF NORTH AMERICA, Delaware corporations, COMPLAINT FOR PERMANENT INJUNCTIONAND OTHER EQUITABLE RELIEF p.35

[15] Comptroller of the Currency Administrator of National Banks Washington, DC 20219June 28, 2000 Fact Sheet p.36

Citifinancial (the company that acquired The Associates) and Providian undertook self testing programs to ensure that its sales practices were fair and consistent applicable law, as did many lenders during early 2000's.

Providian undertook a customer satisfaction program. The program entailed mystery shopping to ensure that its telephone representatives were dealing fairly with customers and prospects. The program consisted of a series of carefully scripted scenarios to test the telephone representative's product knowledge and adherence to company protocol and standards. It also instituted a customer satisfaction feedback program which entailed calling credit card customers on a quarterly basis and measuring customer satisfaction with Providian. At the same time the company instituted a call monitoring program whereby all calls were recorded to eliminate "slamming a practice whereby telemarketers sell unwanted services.[16]

Citifinancial the firm that acquired Associates undertook a self testing program which assessed its pre-application and application sales practice in the form of mystery shopping.[17] The purpose of the self testing was to ensure its policies were being followed and to enhance customers' confidence in its practices.

In the sub-prime area testing programs have been conducted by community groups. One such testing program was completed by NCRC.

In one set of its testing program NCRC employed pre-application matched paired tests. 40 of the tests were in-person or site tests and 8 of the tests were conducted over the telephone. The tester contacted the lending institution and indicated that they (the tester and spouse) were interested in obtaining a home equity loan. All testers were given a profile indicating that they were qualified for a prime loan. All tester profiles indicated that the testers were married and were long time homeowners with substantial equity in their homes. All testers had a low loan to value ratio (below 80% after the requested home equity loan), a good debt to income ratio (below the 36% often used for conventional loans), and the tester represented that they had good credit. While tester profiles were substantially similar, African-American testers were given profiles which made them slightly more qualified, in that they had more income, better ratios, higher credit score, and longer time in the home and on the job.

---

[16] USA Today, May 8, 2001 p.36
[17] American Banker June 24, 2002 and July 24, 2002 p.36

NCRC conducted subprime fair lending testing of large lenders in six major metropolitan areas throughout the United States. The tests covered 12 subprime lenders with retail outlets serving the metropolitan areas of Atlanta, Baltimore, Chicago, the District of Columbia, Los Angeles, and New York City. The tests were conducted with the assistance and cooperation of local NCRC members, community organizations, civil rights activists, and consumer protection organizations.

Results

NCRC reports the testing showed 45% rate of disparate treatment based on race. The types of differences in treatment reported by NCRC include:

- Differences in interest rates quoted.
- Differences in information given regarding qualification standards, fees, required ratios, interest rates, loan programs, and terms of loans.
- Differences in levels of courtesy and service.
- Differences in materials and literature given.
- Differences in number and types of questions asked of the testers.
- The White testers were more often "referred up" to the lender's prime lending division.
- The White testers were more often quoted interest rates.
- The White testers were quoted lower interest rates, or range of rates.
- The White testers were given more detailed information.
- The White testers were often assumed to be qualified, and given recommendations based upon assumed qualifications.
- The loan officers spent more time with the White testers.
- The White testers received more follow-up.
- The Black testers were often asked about the condition of their house; the White testers were not.
- The Black testers were more often asked what they wanted to do with the money.[18]

[18] Testimony of the National Community Reinvestment Coalition Josh Silver, Vice President of Research and Policy Before the Subcommittee of the House Financial Services Committee on Financial Institutions and Consumer Credit Regarding Abusive Mortgage Lending Practices, Exotic Mortgages, and Foreclosures Tuesday, March 27, 2007 p.38

NCRC provided narratives on two of the tests.

> In Baltimore, testers met with the same loan officer at a branch of the subprime affiliate of a major national lender. The Loan Officer assumed the White tester was overqualified and without asking any financial questions, told her she could get better rates at the prime branch of the parent company. The Loan Officer also gave the White tester general rate ranges. However, the Loan Officer would not give the Black Tester any rate information, citing the need for a credit check. The Loan Officer crumpled and discarded the Black tester's application when she would not reveal her Social Security number.
>
> In another test in Baltimore at a suburban branch of a major subprime lender, the White tester was told of a 5.75%, 30 year fixed interest rate, while the Black tester was told the 30 year rate was 8.85%. The White tester was told the 2 year adjustable rate was 4.99% and the Black tester was told the rate for that product was 7.6%. The Black tester was told that since her husband made more money (just slightly more), the lender would rely on the husband's income and credit. The White female tester was not asked about income, nor told about this policy.[19]

Discrimination by Mortgage Brokers in Wholesale Channels

From 2004 to 2006, NCRC conducted mystery shopping of mortgage brokers, both large and small.[20] NCRC's broker testing yielded 106 total complete, matched-pair tests. Individuals located in the metropolitan areas of Atlanta, Baltimore, Chicago, the District of Columbia, Houston, Los Angeles and Saint Louis tested brokers that were local, established businesses. In conducting the broker testing, NCRC found several companies with particularly egregious initial results. In these cases, testers were again dispatched for follow up testing to confirm and further investigate the practices of these companies.

Of the 106 total tests, 84 separate companies were tested, the difference being as a result of 22 follow up tests.

NCRC describes some of the results as follows:

1. African Americans and Latino's were discouraged 25% of the time concerning their efforts to meet with a broker, while Comparison testers were discouraged only 12% of the time in their efforts to obtain credit.

[19] Testimony of the National Community Reinvestment Coalition Josh Silver, Vice President of Research and Policy Before the Subcommittee of the House Financial Services Committee on Financial Institutions and Consumer Credit Regarding Abusive Mortgage Lending Practices, Exotic Mortgages, and Foreclosures Tuesday, March 27, 2007 p.39

[20] Testimony of the National Community Reinvestment Coalition Josh Silver, Vice President of Research and Policy Before the Subcommittee of the House Financial Services Committee on Financial Institutions and Consumer Credit Regarding Abusive Mortgage Lending Practices, Exotic Mortgages, and Foreclosures Tuesday, March 27, 2007 p.39

2. Brokers spent more time with white shoppers then African Americans and Latinos, spending on average 39 minutes with white testers and only 27 minutes with African American and Latino testers.
3. White mortgage seekers received greater encouragement over sixty percent of the time, while African Americans and Latinos were questioned about their credit over 32% of the time. White shoppers were only questioned about credit 13% of the time.
4. White mortgage seekers had specific products discussed with them 91% of the time, while African Americans and Latinos had specific products discussed with them 76% of the time. Further, White testers received two rate quotes for every one quoted to African American and Latino testers.
5. NCRC documented pricing discrimination in 25% of the fair lending tests, and noted that fees were discussed 62% of the time with white testers but only 35% of the time with "protected testers."
6. Fixed rate loans were discussed 77% of the time with white testers but only 50% of the time with African American and Latino testers.

The NCRC testing clearly shows the power of self-testing and in particular mystery shopping as a tool to identify the experience of potential loan customers. Self-testing clearly portrays the sales process and the ease or difficulty consumer's face in obtaining information.

The ability of consumers to obtain information in the pre-application phase of the loan process has become even more important with the proliferation of products to choose from. The use of self-testing by lenders not only helps to manage risk but can also ensure that consumers are receiving the information needed to make appropriate credit decisions.

Lender Self-testing To Detect Discrimination

During this time the use of self-testing to detect discrimination also saw some changes. Lenders started to conduct more limited or targeted self-testing or mystery shopping programs. The more limited programs are termed "temperature" checks or evaluations. This approach is much smaller in scale and cannot be used to determine whether or not patterns or practices exist across the organization. Rather a smaller but more concentrated number of tests are conducted in selected major markets and delivery channels. For example a multi-state bank can examine its pre-application loan process in three – five major markets deemed “higher risk”. In a self-test designed to measure adherence to ECOA and FHA a financial institution can select major markets and markets with a high proportion of protected classes. Testing would be conducted in these markets under the premise that if a problem or major area of risk exists the issue will manifest itself in these markets. The learning gained from the tests in these markets is applied to other markets.

Still another approach is to target markets and products where HMDA data, account growth, withdrawn application and statistical modeling indicate a greater source of risk, e.g. substantially higher minority denial rates, disproportionately fewer minority loans applications, higher minority application withdrawal rates or a disproportionate number of minorities and older customers carrying credit insurance. Such an approach seeks to determine whether the cause is due to disparate treatment or misleading sales practices. Disparate treatment can include pre-screening or discouraging minorities from applying, steering protected classes toward certain products without regard to their suitability or providing minorities with a different level of assistance and coaching.

Lenders also became concerned with wholesale and indirect lending channels as they recognized the risk and liability associated with funding third party loans. Mystery shopping or self testing programs test mortgage brokers on a matched pair and monadic basis. Mortgage brokers are selected for testing based on size of business, complaints, file reviews and regression models. The tests have become more targeted, specifying the protected classes, African American, Hispanic, Asian, gender and age of the testers and the product scenario to be tested. Tests are conducted on-site and via the telephone. Post application surveys are used both in terms of mortgage brokers and auto. The surveys are conducted with recently closed mortgage and auto loan customers. The interview covers the entire loan process, pre-application or sales, application and underwriting and closing. The survey determines if customers are satisfied with and understand the product purchased. It measures the customer’s knowledge of the terms and conditions of the loan, whether or not the terms and conditions met the customer’s expectation and any ancillary products sold and if these products were properly explained to the customer.

Summary of Findings:
Instances where disparate treatment and other issues were found in 2000-2007[21]

Pre-application Testing

- Little or no overt differences
- More subtle differences
  - Different information
  - Different questioning
  - Different products discussed
- More favorable treatment of minorities
  - Emphasizing market share in emerging customer segments
  - Increased sensitivity to minorities
- The use of credit scoring in the sales process at times resulting in differential treatment favoring non-minorities
- Gender differences some favoring males, Hispanic female vs. Hispanic male, African American female vs. African American male, etc
- Insufficient staffing to handle Spanish calls
- Telephone based service differences at times favoring non-minorities
- Differences in:
  - Approval time quoted, longer for minorities and females
  - Closing costs quoted, inconsistent
- Poor or no explanation of points and APR to minorities and females
- Problematic markets
- Inconsistency in small business loan information based on dedicated loan officers versus bankers

Post application Testing

- At times a greater willingness to help non-minorities
- Non-minorities more likely to say the loan officer offered a positive opinion on likely approval
- Older customers report receiving less information and help than younger customers
- Some confusion about the nature and requirement of credit insurance between minorities and non-minorities
- Confusion as to the role of the mortgage broker and their relationship to the lender for both minorities and non-minorities
- At times minorities more likely to say "delays cost us money"
- Minorities more likely to report being contacted by the lender to ascertain interest in the lender's products
- Minorities more likely to say the lender did not return my calls
- Non-minorities more likely to report the loan officer offered a recommendation

At times differences were found when consumers were asked for a social security number during the pre-application sales process. This was noted for the most part at finance, mortgage and sub-prime lenders. This seemed to result in the minority receiving far less and sometimes no information. This was true for African Americans and Hispanics. When differences were noted concerning information provided to testers they occurred for the most during in-person tests with branch employees at retail banks, mortgage companies (both bank owned and independent) and finance companies. There were also more problematic markets due to differences in treatment between minorities and non-minorities. These markets are for the most part consistent across lenders. There were also some individual cases at retail banks, especially during home equity and to some extent mortgage pre-application testing were more favorable treatment of minorities was

[21] Extracted from self testing programs conducted by Barry Leeds & Associates and the author p.43

found. In these cases the financial institutions were conducting fair lending and diversity training and efforts were underway to develop business in minority and especially Hispanic communities.

When post application survey results reported a greater willingness to help, recommend a loan and offering an opinion about likely qualification among white loan applicants they were generally encountered at mortgage and bank owned mortgage companies, finance companies and sub-prime lenders. This was also true of comments “delays cost us money” which was mentioned in a small percentage of surveys with loan applicants. The issues regarding credit insurance reflected a small percentage of minority and non-minority loan customers who indicated confusion about the product. This occurred at finance companies and sub-prime companies as these lenders offered the product.

It should be noted that the instances of disparate treatment and other issues noted above for “2000-2007”, “mid 1990’s – late 1990’s” and “1991-1995” were found during self-testing programs voluntarily undertaken by lenders. As such it may be argued that the results underestimate the extent of these issues among all lenders. The results portrayed represent a variety of financial institutions, including mid-size and large retail banks, bank owned mortgage companies, finance companies, sub-prime lenders and tests among mortgage brokers. Many of these programs are conducted with lenders with substantial branch networks and number of employees making the management of sales and service practices extremely difficult. Often the self-testing programs were undertaken due to complaints, investigations and others undertaken as part of a fair lending program. Hence the findings are drawn from a mix of lenders some have problems or have reason to believe there are problems and sought to identify problems, the extent of the problems and take remedial actions to resolve the problems. Other lenders undertook self-testing prior to a fair lending exam. Many of the findings are drawn from programs that are ongoing and conducted every year or every other year. In addition some of the most common issues and instances of disparate treatment were found at the lenders who conduct testing over time and are probably are a direct reflection of the changes in the industry, management and employee turnover. For example the introduction of credit scoring, risk based pricing and desktop underwriting at times resulted in consumers and protected classes receiving less information in the loan process as representatives would often proclaim the need for a credit report before providing loan information.

Best Practices to Ensure Fair Lending

Early-mid 1990's

Many lenders in the early and mid -1990's adopted practices and policies to ensure fair and equal treatment in the loan process. These included:

- Implemented ongoing internal/external compliance risk management program consisting of loan file reviews and pre-application testing and post application surveys.
- Examined HMDA data for areas where minority applications were underdeveloped and denial rates were above average
- Testing
  - Retail
  - Pre-application testing
- Fair lending training of staff
- Diversity training of staff
- Provide clarifications of the sales and service process to employees
- Systemizing pre-application and application procedures

Closing the Gap

The Boston Federal Reserve in 1993 published Closing the Gap.[22] The publication outlined a comprehensive approach for combating discrimination in mortgage lending. Many of the approaches outlined in the publication were adopted by lenders. These included 1. Staff training to ensure all employees involved in the loan process was familiar with fair lending laws, Equal Credit Opportunity Act (Regulation B), the Fair Housing Act, the Home Mortgage Disclosure Act (Regulation C), and the Community Reinvestment Act as well as how to treat prospective customers, 2. In order to ensure minorities feel welcome during the application hiring and promotion practices should foster racial and ethnic diversity, 3. Compensation structure for loan production staff should not discourage loans to lower-income or financially unsophisticated consumers, 4. Underwriting standards and practices should be consistent and mechanisms must be in place to ensure compensating factors used in approving loans are applied consistently without regard to race, 5. Property standards and minimum loan amounts should be checked for arbitrary rules which may negatively affect applicants buying two – four family

[22] Boston Federal Reserve, Closing the Gap, April 1993 p.46

homes, older properties and homes in less expensive areas, 6. Obligation ratios should not exclude consumers who have demonstrated an ability to carry or cover high housing expenses in the past from obtaining a home loan, 7. Down payment and grants should be considered to allow lower income consumers to not have to acquire the savings to cover the costs of the loan, 8. Credit history policies with regard to consumers with no credit history or problems should be reviewed to recognize that certain cultures encourage consumers to avoid debt and pay as you go. Financial institutions should take into account willingness to pay debt promptly through review of utility, rent and telephone payments. Successful payoffs of past due debt and credit counseling for lower income consumers who met unforeseen circumstance should be considered, 9. Distinguishing between employment length and employment stability and the ability to maintain or increase income is important for lower income consumers who work in sectors where job changes are frequent, 10. Reviewing and monitoring the origination and underwriting process will help determine whether the institution is treating all potential and actual applicants fairly. Use of a checklist by loan production staff helps ensure all compensating factors are requested and that borrower are informed about the institution's lending policies, 11. Lenders should be aware of alternative loan products that lower the costs and risks of lending to customers that do not meet conventional underwriting standards, including federal, state and local agencies or develop products to serve these customers in cooperate with government and non-profit organizations, 12. Second reviews of rejected applicant loan files, including comparing rejected loan files to similarly situated approved applicants, 13. Surveys of loan customers and the community should be undertaken to ensure the institution is perceived to provide quality service, when operating mortgage subsidiaries should ensure that referral practices do not illegally pre-screen, the institution should use HMDA data to review the disposition of loan applications, their volume, location and composition and whether there are unexplained low numbers of minority applications or high percentage of denied minority applications, 14. Testing fairness in lending practices should be undertaken by systematically reviewing loan files, statistical analysis can help determine if underwriting practices and assistance are consistently applied to applicant of different races, testing of the pre-application stage of the loan process can be undertaken through the use of matched pair testing using minority and non-minority mystery shoppers.

Mid 1990's to Late 1990's

Many of the best fair lending practices adopted in the early 1990's were carried over. However file reviews, statistical modeling and regression analysis and post application surveys increased in use across lenders.

- Implemented ongoing internal/external compliance risk management program, examined HMDA data for areas where minority applications were underdeveloped and denial rates were above average
- Pre-application testing
  - Retail
  - Wholesale (brokers) on a limited basis
- Post-application testing
- File reviews
- Regression analysis to determine denied minority loans with similar characteristics as non-minority approved loans
- Fair lending training of staff
- Diversity training of staff
- Board of directors oversees and receives regular feedback on compliance
- Checklist of do's provided to loan representatives and retail personnel
- Providing clarifications of the sales and service process to employees
- Systemizing pre-application and application procedures

2000-2007

The uses of self-testing in 2000-2007 have expanded. Today many lenders are applying the best practices to control risk in the sale of credit products. Some of these practices include:

- Management taking a pro-active role in endorsing and using the results of self-testing
- Including fair treatment in the company's mission statement
- Training to educate and communicate that fair treatment means more business
- Training on products to ensure consumers are conveyed sufficient information about terms, costs, conditions and risks
- Employee understanding of the requirements associated with ECOA, FHA and FTC Act

- Building employee tools and protocols that help ensure adherence to the law, fair treatment and the company's sales and service model
- Ensure consumers receive uninhibited and clear information to help make informed decisions during the shopping phase of a loan[23]
- Discuss and determine the borrower's ability to repay when recommending and approving loans[24]
- Employee compensation programs should not steer consumers to any one product
- Ongoing measurement of employee adherence to protocols
- Ongoing third party monitoring for quality applications and adherence to policy
- The frequency of the testing matches business volume, employee turnover and changes to the business model as well as external factors associated with third-party reviews and testing.
- Pre-application testing and post application surveys conducted on an annual or bi-annual basis
- Testing different products and delivery channels
- Integrating the pre-application and post application self-testing methods and results with ongoing file reviews and statistical analysis

The Office of the Comptroller of the Currency issued an advisory letter outlining steps national banks should take to help ensure fair sales practices.[25]

- Verify that information provided to consumers is complete and accurate and is not likely to mislead or deceive a reasonable consumer. This includes a review to ensure that customers receiving the information can reasonably be expected to understand the information about products or services -- including any material limitations -- without having to do "detective" work.
- Avoid the use of claims such as "guaranteed," "pre-approved," and "lifetime rates," if there is a significant possibility that consumers will not receive the terms that have been advertised, and this possibility is not described adequately.

---

[23] Interagency Guidance on Nontraditional Mortgage Products Risk, October 4, 2006 p.49

[24] Interagency Guidance on Nontraditional Mortgage Products Risk, Federal Register, October 4, 2006, Interagency Statement on Subprime Mortgage Lending, Federal Register, July 10, 2007 p.49

[25] AL 2002-3 Office of the Comptroller of the Currency Advisory Letter Subject: Guidance on Unfair or Deceptive Acts or Practices Date: March 22, 2002 p.49

- Provide a clear, up-front disclosure of any contract provision that permits a change in the terms of the products or services that are offered.
- Avoid engaging in promotions of a product or service that highlight a particular benefit, if that benefit will be negated by another aspect of the transaction. For example, a product should not be promoted as having "no annual fees" if the product requires the consumer to pay annual premiums for another linked product, such as mandatory credit life insurance, or if the agreement would permit imposition of such a fee at any time, and this possibility is not described adequately.
- Review telemarketing scripts used to market products to bank customers for accuracy and to ensure that they fairly and adequately describe the terms, benefits, and material limitations of the product or service being offered.
- Clearly notify consumers in connection with "free trial periods" for services -- at the time of an initial solicitation and subsequently -- if the consumer will be required to affirmatively act to cancel the service at the end of the trial period to avoid being billed for service past the trial period. Get clear and affirmative consent to terms and billing arrangements.
- Follow the guidance relating to due diligence in selecting a third-party vendor, monitoring vendor performance, and maintaining proper documentation about vendor management in OCC Advisory Letter 2000-9, "Third Party Risk," issued August 29, 2000, and in OCC Bulletin 2001-47, "Third Party Relationships," issued November 1, 2001. Appropriate due diligence includes a review of the competence and business practices of the third party, as well as the financial capacity of the third party.
- Ensure that contractual arrangements with third-party service providers protect the bank against risk. For example, a bank should carefully consider whether a contract with a telemarketer contains any financial incentive that could lead the telemarketer to mislead consumers. As another example, if a telemarketer’s compensation is based on initial sales, and is unaffected by whether a consumer subsequently cancels the product or service, the telemarketer may have an incentive to mislead the consumer regarding the nature or benefits of the product or service.
- Ensure that promotional or other information in a solicitation or other communication does not conflict with or contradict required consumer disclosures, such as TILA and Privacy notices. Such conflict or contradiction could result in the disclosures not being "clear and

conspicuous," as required by those laws, as well as the communication as a whole being deceptive in violation of the FTC Act.

- Institute appropriate procedures to ensure that consumer complaints and other communications are reviewed for indications that the institution’s marketing or solicitations might have misled a consumer.
- Maintain procedures that ensure that payments are promptly posted.
- Monitor loan collection activities, including collection calls, of any third party on behalf of the institution.