DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT

24 CFR Parts 100 and 103

[Docket No. FR–4160–F–02]

RIN 2529–AA82

HUD's Regulation on Self-Testing Regarding Residential Real Estate-Related Lending Transactions and Compliance With the Fair Housing Act

AGENCY: Office of the Assistant Secretary for Fair Housing and Equal Opportunity, HUD.

ACTION: Final rule.

SUMMARY: This rule implements section 814A of the Fair Housing Act, which encourages voluntary compliance by lenders with the Fair Housing Act (FHAct) through lender-initiated self-tests of lenders' residential real estate-related lending transactions and, where appropriate, corrective action designed to remedy any possible violations of the FHAct revealed by such tests. This rule also makes technical amendments to the fair housing complaint processing regulations.

EFFECTIVE DATE: January 30, 1998.

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SUPPLEMENTARY INFORMATION:

I. General. Incentives for Self-testing and Self-correction

On January 31, 1997 at 62 FR 4882, the Department published a proposed rule to implement section 814A of the FHAct, promulgated at section 2302 of the Omnibus Consolidated Appropriations Act for Fiscal Year 1997 (Pub. L. 104–208, approved September 30, 1996). Section 2302, found in title II of Pub. L. 104–208, entitled the ''Economic Growth and Regulatory Paperwork Reduction Act'' (''Act''), amends the FHAct to promote compliance by establishing a privilege for lender-initiated self-tests of residential real estate-related lending transactions.

The Economic Growth and Regulatory Paperwork Reduction Act: Sec. 2302

Section 2302 adds a new section 814A to the FHAct which creates a legal and administrative enforcement privilege for ''self-tests'' conducted by entities engaged in residential real estate-related lending to determine compliance under the FHAct. This provision also adds a new section 704A to the Equal Credit Opportunity Act (''ECOA'') which creates the same privilege with respect to credit transactions by a creditor. A report or result of a self-test is privileged from disclosure if a lender conducts, or authorizes an independent third party to conduct, a self-test of a real estate-related lending transaction to determine the level or effectiveness of compliance with the FHAct, and has taken, or is taking, appropriate corrective action to address possible violations discovered as a result of the self-test.

The Act requires the Department, with respect to the FHAct, and the Federal Reserve Board (the Board), with respect to the ECOA, to implement section 2302 and define ''self-testing'' in substantially similar regulations within six months of enactment. This final rule was drafted after consideration of the comments the Department received on the January 31, 1997 proposed rule, and in consultation with the Board, the Department of Justice (DOJ), and appropriate Federal regulatory and enforcement agencies, including the Federal Deposit Insurance Corporation (FDIC), the Office of the Comptroller of the Currency (OCC), the Office of Thrift Supervision (OTS), the National Credit Union Administration (NCUA), and the Federal Trade Commission (FTC). The Act's requirement that the Board's and the Department's regulations be substantially similar, the comments received on the proposed rule, and the consultation which followed, delayed publication of the final rule beyond the six months the Act prescribed.

After reviewing both regulations, the Department and the Board have determined that there is no substantial difference in the final rules and that they should be interpreted to have the same effect except where differences in the FHAct and ECOA dictate otherwise. For example, ECOA covers non-mortgage credit transactions which are not residential real estate-related transactions under the FHAct. This dictated slight differences in the definition of ''self-test'' in the agencies' rules.

Moreover, although there are organizational differences in the agencies' rules, these differences are not intended to have any substantive effect, and merely reflect the Board's longstanding practice of publishing its interpretative rules in a separate staff commentary. The Department has no staff commentary, therefore some of this material appears in the Department's rule and other material appears in its preamble. The consistency of the Department and the Board rules is evident based on a comparison of the complete documents published by the agencies, including the preambles to the regulatory amendments and the revisions to the Board's Official Staff Commentary to Regulation B.

Public Comments

In the proposed rule, the Department invited public comments for consideration in drafting a final rule. The Department received a total of 52 public comments, 18 of which were from lenders, 16 from public interest organizations, 15 from lending industry associations, and one each from a law firm, a government agency, and an individual. The comments are addressed in the Section-by-Section Analysis of this final rule preamble. The Department revised the proposed rule based on its consideration of the comments received. The Department also made editorial, non-substantive revisions to use plain English wherever possible and to meet Congress's mandate of substantial similarity between final rules issued by it and the Board. The preamble discusses the revisions made to the proposed rule to effect a substantive change.

Existing Self-testing Policies

The Department notes that prior to the amendment of the FHAct to create this privilege, several agencies stated their enforcement policy in regard to self-testing by a lender.[1] To the extent this final rule does not contravene an agency's or department's enforcement policies, those policies remain in effect until the agency or department determines otherwise. Accordingly, for example, OCC Bulletin 95–51 (September 15, 1995) remains in effect. The Department's prior policy, on the other hand, is superseded by this regulation.

Review of Rule

As the proposed rule noted, in developing the regulation to implement the self-testing privilege, the Department seeks to provide a real incentive for innovative, effective, and non-routine fair lending monitoring and self-correction while ensuring the rights of discrimination victims. Lending discrimination, however, is an evolving area of the law, and modifications may be appropriate. Therefore, the

[1] OCC Bulletin 95–51 (September 15, 1995); Deval Patrick, Assistant Attorney General for Civil Rights, Letter to the Mortgage Bankers Association, et al. (February 21, 1995).

Department and the Board may review this rule, including the definition of self-test, after several years' experience. Should it determine to conduct such a review, the Department will seek public comment on whether the rule should be amended. A review would focus on whether the self-testing incentives created by Congress and implemented in this rule should be strengthened, and whether the definition of self-test should be broadened. Since there is a corresponding relationship between the breadth of the definition of self-test and the scope of corrective actions, the review would also examine the extent to which corrective actions as defined in the rule provide appropriate relief for victims of discrimination.

II. Changes From the Proposed Rule

This final rule includes several changes from the proposed rule:

—The statement of the general rule applying the self-testing privilege contained in § 100.140 has been modified to reflect the need to address only likely violations and to incorporate the requirement to take appropriate corrective action. As a result, § 100.141 of the proposed rule is deleted and the sections which followed were renumbered. As more fully explained in § 100.143, Appropriate Corrective Action, the revised rule provides a privilege when a lender takes corrective action which is reasonably likely to remedy the cause and effect of a violation identified by a self-test in instances where it is more likely than not that a violation has occurred.

—The section on Definitions, now § 100.141, explicitly includes applicant and customer surveys within the definition of self-test and makes clear that self-tests are not limited to the pre-application stage of loan processing.

—Section 100.142 now specifies that material such as appraisal reports, loan committee meeting minutes, underwriting standards or compensation records is not privileged, nor is any information or data derived from them privileged.

—As discussed above, Appropriate Corrective Action, § 100.143, now refers to ''likely violations'' rather than ''possible violations.'' Rather than requiring appropriate corrective action to address possible violations, this section now specifies that corrective action is only required when it is more likely than not that a violation occurred, even though no violation was adjudicated formally.

—The proposed rule § 100.141 requirement (now deleted) that lenders ''take whatever actions are reasonable in light of the scope of the possible violations to fully remedy both their cause and effect'' is now addressed in § 100.143(b), which requires a lender to take action ''reasonably likely to remedy the cause and effect of a likely violation.''

—A new § 100.143(c) states that to establish a privilege a lender is not required to provide remedial relief to a tester in a self-test; is only required to provide remedial relief to an applicant if the self-test identified that applicant as one who was more likely than not the subject of a violation; and is not required to provide remedial relief to a particular applicant if the statute of limitations applicable to the violation expired before the lender obtained the results of the self-test or the applicant is otherwise ineligible for such relief.

—The illustrative list of appropriate corrective actions contained in § 100.143 no longer includes notifying persons whose applications were inappropriately processed of their legal rights.

—Section 100.143(f) clarifies that taking appropriate corrective action is not an admission a violation occurred.

—Section 100.145(b), Loss of Privilege, specifies that lenders will not lose their privilege by notifying persons about remedial relief.

In discussing the public comments received on the proposed rule, the next section provides a more detailed description of these and other changes made in the final rule.

III. Section-by-Section Analysis of the Rule

Section 100.140 General Rule

Voluntary Self-Testing and Self-Correction

Section 100.140(a) states the general rule that the report or results of a self-test a lender voluntarily conducts or authorizes are privileged if the lender has taken or is taking appropriate corrective action to address likely violations identified by the self-test. The privilege applies whether the lender conducts the self-test or employs the services of a third-party. Data collection required by law or governmental authority is not a voluntary self-test.

Subsection (a) also implements the Act's requirement that a lender must take appropriate corrective action to address likely violations identified by the self-test before the privilege can be invoked. This subsection incorporates the requirement that corrective action must be taken for the privilege to apply, as stated in § 100.141 in the proposed rule. The requirement in the proposed rule § 100.141 that lenders ''fully remedy possible violations'' has been modified and is now addressed in § 100.143, Appropriate Corrective Action, which also discusses ''likely violation.''

Other Privileges

Subsection (b), a new subsection, clarifies in the final rule itself the language contained in the preamble to the proposed rule at § 100.140, which stated that the privilege of self-testing is in addition to any other privileges which may exist, such as attorney-client privilege or the privilege for attorney work product. This change was requested by some commenters. A lender may assert the privilege created by this subpart as well as any other applicable privilege.

Section 100.141 Definitions

The Act does not define ''self-test'' and authorizes the Department to define by regulation the practices covered by the privilege. The Department received substantial comment on the definition of self-test.

The Department defines a self-test as any program, practice or study a lender voluntarily conducts or authorizes which is designed and used specifically to determine the extent or effectiveness of compliance with the FHAct. The self-test must create data or factual information that is not available and cannot be derived from loan files, application files, or other residential real estate-related lending transaction records. The final rule substitutes the phrase ''residential real estate-related lending transaction records'' in place of ''records related to credit transactions'' to reflect more accurately the coverage of the FHAct.

Self-testing includes, but is not limited to, using fictitious credit applicants (testers), including matched-pair testers. It includes surveys of applicants and mortgage customers, and is not restricted to the pre-application stage of the credit process.

As the proposed rule's preamble noted, the principal attribute of self-testing is that it constitutes a voluntary undertaking by the lender to produce new—otherwise unavailable—factual information. The definition contained in the rule provides added incentives for lenders to look beyond their business records and develop new factual evidence about the level of their compliance. The rule does not define self-test so broadly as to include all types of lender self-evaluation or self-assessment. While versions of the legislation initially introduced in

Congress extended the privilege to a lender's test or review, the statute as adopted refers only to a self-test.

The Department notes that a lender's analysis performed as part of processing or underwriting a credit application is not privileged under the final rule. A lender's evaluation or analysis of its loan files, Home Mortgage Disclosure Act data or similar types of records (such as broker or loan officer compensation records) is derived from loan files, application files and other real-estate-related lending transaction records and is, therefore, not a self-test and is not privileged under this rule. However, new data or factual information created as a result of self-testing would be privileged.

A broader definition of self-testing is within the Department's rulemaking authority under the statute. A broad definition of self-testing, however, was generally opposed by Federal regulatory and enforcement agencies, civil rights and consumer organizations, and fair lending enforcement agencies.

As the proposed rule's preamble noted, principles of sound lending dictate that a lender have adequate policies and procedures in place to ensure compliance with applicable laws and regulations, and that lenders adopt appropriate audit and control systems. These may take the form of compliance reviews, file analyses, the use of second review committees, or other methods that examine lender records kept in the ordinary course of business. Notwithstanding any evaluation performed by the lender, the underlying loan records are subject to examination by the supervisory and law enforcement agencies and must usually be disclosed to a private litigant alleging a violation.

In consultation with Federal regulatory and enforcement agencies in developing the proposed and final rules, the Department found that, according to a 1994 survey of large depository institutions by one regulator, approximately 78% of the institutions surveyed performed reviews that included comparative file reviews or statistical modeling as part of their fair lending management and oversight. This is evidence that an additional incentive for such reviews may not be required. Providing a privilege for such reviews could make information now provided to supervisory agencies unavailable, and could make examinations less efficient.

A comment letter on the proposed rule from a Federal regulatory agency noted:

> We agree that a broader definition of self-test could have an unintended negative effect on the levels of cooperation between creditors and the regulatory agencies. Institutions use internal fair lending audits and reviews to monitor their compliance with the Fair Housing Act and regulatory agencies consider them valuable examination tools to identify areas most in need of supervisory attention . . . [M]oreover, a broader definition could create a more confrontational examination setting due to arguments over the scope of the privilege. There would be no clear line between documents that institutions maintain in the ordinary course of business and documents that are part of an internal audit.

Civil rights and community organization comments generally opposed a broad definition of self-testing. A comment letter from a national civil rights organization said the self-testing privilege should not extend beyond the proposed rule's definition to encompass other self-evaluations and self-assessments, including fair lending business records lenders now maintain routinely. The organization said incentives for self-testing should not undermine the strong Federal interest in full relief for all victims of discrimination, and should not place an undue burden on regulators, enforcement agencies or litigants. The letter further noted:

> In general, the new privilege is likely to lead to more lengthy and expensive litigation. In the context of litigation or enforcement investigation, many lenders will have an incentive to overreach by broadly defining ''self-test'' in order to shield more information under the new privilege. Furthermore, some lenders may try to narrowly define ''any possible violation'' to mean ''only clear violations,'' and many lenders may prefer a low standard for ''appropriate corrective action.'' Plaintiffs alleging discrimination, on the other hand, will be forced to challenge every assertion of privilege.

A national community advocacy organization cited the history of legal privileges while commenting in opposition to a broad definition of self-testing. That organization said:

> Historically in this country, we have granted legal privilege in very limited circumstances. It applies to communications between individuals and their clergy, to communications between individuals and their attorneys, and in few, if any, other circumstances. In these cases, the need for open, honest and unrestricted communication is viewed as outweighing the need of the legal system for access to information. This historical practice of limiting the scope of privilege should certainly be applied in this case. It may be beneficial to encourage lenders to undertake self-testing. However, given the rudimentary nature of the nation's understanding of the problem of lending discrimination and the evolving nature of the field of fair lending enforcement, it is critical not to unduly limit the availability of information necessary to enforce the law.

Comments from lenders were generally in opposition to a narrow definition of self-testing. A coalition of national mortgage lenders and servicers said in a comment letter:

> It is clear from the statute that Congress intended a broad definition of self-test. Congress essentially forged a quid pro quo for obtaining the self-test privilege under which a lender is allowed not to disclose self-test reports if it undertakes appropriate corrective action with respect to the findings. Given this tradeoff, there is every reason to *expand* the types of self-assessments which are to be subject to this rule, not limit them. Otherwise, Congress' efforts to encourage self-tests will largely have been in vain.

At this time, the Department believes lenders already have adequate incentive to conduct routine compliance reviews and file analyses as good business practices to avoid or minimize potential liability for violations. Therefore, the Department does not believe it is now appropriate to extend the privilege to audits of actual business records. A broader privilege, which would extend to comparative reviews of file contents (whether or not conducted with use of statistical methods such as sampling and regression analysis) would greatly limit the availability of evidence of violations. To do so also would make the analysis of records lenders now maintain as part of routine fair lending activities unavailable to supervisory and enforcement agencies conducting fair lending examinations. Moreover, it could have the unintended result of effectively precluding the use of discovery and other fact-finding mechanisms by private litigants seeking relief under the FHAct.

Testing designed and used for compliance with other laws, or for other purposes, is not privileged under this rule. For instance, a self-test designed to observe employees' efficiency and thoroughness in meeting customer needs is not covered by the privilege even if it incidentally uncovers evidence of discrimination. The final rule clarifies that to qualify for the privilege, a self-test must be designed and used specifically to determine the extent or effectiveness of a lender's compliance with the FHAct, giving effect to the statutory language of the Act at paragraph 814(a)(1). If a test is designed for multiple purposes, only the portion designed to determine compliance with the FHAct would be eligible for the privilege.

Some commenters were critical of the emphasis on matched-pair testing in the proposed rule, stating such tests are expensive and may, due to a small

sample size, yield statistically invalid conclusions. In addition, some commenters maintained such tests are often inadequately performed or analyzed, leading to unwarranted conclusions. Matched-pair testing, they asserted, is impractical for many small community banks because of the expense and because testers would be obvious in many rural areas where ''strangers'' would be readily apparent to bank personnel.

As defined in the final rule, the principal attribute of self-testing is that it constitutes a voluntary undertaking by the lender to produce new factual information that otherwise would not be available or derived from loan or application files or other residential real estate-related lending transaction records. While this includes matched-pair testing, it is not limited to such testing. A lender is not required to use matched-pair testing or to test only in the pre-application process. For instance, a lender could survey mortgage brokers with whom it has a relationship to determine whether minority applicants were treated similarly to non-minority applicants, or use testers (in matched-pairs or otherwise) in the mortgage process.

Section 100.142 Types of Information

Subsection (a) provides that the types of information the privilege covers include: the report or results of the self-test; data or factual information created by the self-test; workpapers, draft documents and final documents; analyses, opinions, and conclusions if they directly result from the self-test report or results.

The final rule clarifies the self-testing privilege applies to any data generated by the self-test, as well as any analysis of that data, workpapers and draft documents. Thus, testers, attorneys, auditors, experts and others who participate in the testing, or who review the results to help the lender determine what corrective action, if any, is needed, may not be compelled to produce testimony or documents describing these matters. This assurance to lenders responds to concerns expressed in the comments.

Subsection (b) lists exclusions from the privilege. The privilege does not cover information about whether a lender has conducted a self-test, the methodology or scope of the self-test, the time period covered, or the dates it was conducted. This list of exclusions is exemplary and not exhaustive.

Commenters differed on whether lenders must disclose the fact that tests were conducted, and the scope and methodologies of the tests. A few commenters wanted the existence of the test and its methodology to be privileged. One commenter suggested that requiring lenders to disclose the existence of a self-testing program, its scope, and its methodology defeats the purpose of the privilege. That commenter stated that only the factual information underlying the analysis should be excluded from the privilege coverage. Another commenter maintained that since nothing in the statute requires disclosure of the parameters of the analysis, the regulation should not require it. Yet another commenter stated the rule should limit privilege-related disclosures to a reasonable identification of purportedly privileged documents, together with a general description of the basis of that claim.

The Department considered these views. This section of the rule is consistent with the statute, which specifically provides that only reports or results of self-tests are privileged. The statute does not prohibit an aggrieved person, complainant, department or agency from requesting information about whether and, if so, how a lender has conducted a self-test. Disclosure of the existence of a privileged self-test, the self-test's scope, methodology or the time period when it was conducted are essential to a decision as to whether to seek the final results or report or to challenge the lender's claim of privilege. This disclosure is essential to ensure the testing information at issue can properly be identified in any proceeding challenging a lender's claim of privilege.

This subsection also clarifies that loan and application files, or other real-estate related lending transaction records, or information derived from such sources, are not privileged, even if the data is aggregated, summarized or reorganized to facilitate analysis. Records related to applications submitted by testers are not ''real estate-related lending transaction records'' for purposes of this subsection and may be privileged self-testing records.

Section 100.143 Appropriate Corrective Action

Section 100.143(a) Generally

Commenters expressed diverse opinions about the standard by which corrective measures should be judged. Several wanted a ''good faith'' standard for corrective actions which would be met if the lender in good faith takes the corrective actions it determines appropriate. Neither the statute nor the legislative history suggests Congress intended a ''good faith'' standard.

Other commenters suggested a ''business judgment rule'' as a measure of appropriate corrective action. Under that standard, the prevailing practices in the lending industry would dictate what corrective actions are appropriate. As with the ''good faith'' standard, the Department believes a ''business judgment rule'' would be inconsistent with the legislative intent.

The rule does provide a standard by which corrective actions are to be measured. The action must be reasonably likely to remedy the cause and effect of a likely violation. Although an action may be taken in good faith, it may not be reasonably likely to remedy the cause and effect.

The Department further notes that a lender's determination as to whether corrective action is needed, and, if so, what type, is not conclusive in determining whether the privilege requirements are satisfied.

If a lender asserts a claim of privilege, the adjudicator would have to assess the need for, and the type of, appropriate corrective action based on a review of the self-testing results. Such an assessment might be accomplished by an in camera inspection of the privileged documents, or by sealed pleadings.

Section 100.143(a) Has Taken or Is Taking

This subsection also states that the report or results of a self-test are privileged if the lender has taken or is taking appropriate corrective action to address likely violations identified by the self-test. In some cases, the issue of whether certain information is privileged may arise before self-tests are complete or before the corrective actions are fully under way. This would not necessarily prevent a lender from asserting the privilege.

In situations where the self-test is not complete, the lender must complete the requirements of this subpart within a reasonable period of time. To assert the privilege where the self-test shows a likely violation, the rule requires, at a minimum, that the lender establish a plan for corrective action and a method to demonstrate progress in implementing the plan. Furthermore, lenders must take corrective action on a timely basis after the results of the self-tests are known. An adjudicator's final decision on whether the privilege applies should be withheld until the creditor has taken the appropriate corrective action.

Section 100.143(a) Likely Violations

The Act states that corrective action is required for possible violations. Some

commenters noted lenders have no FHAct liability for ''possible violations,'' only proven ones. The term ''possible violations'' means that there need not have been an adjudication by a court or an administrative law judge before lenders should begin corrective actions. Otherwise, corrective actions would only begin following an adjudication, which would effectively render the privilege moot.

The Act requires appropriate self-correction in the case of possible violations for the privilege to apply. To implement the Act and address the interpretation of possible violations, the final rule now refers to ''likely violations,'' which means instances where it is more likely than not that a violation has occurred even though no violation was adjudicated formally.

Although corrective actions are required when a likely violation is found, a self-test is also privileged when it does not identify any likely violation and no corrective action is necessary. The self-test incentive would be undermined if the privilege applied only when violations were discovered, because the mere assertion of the privilege would amount to an admission that it is more likely than not that a violation occurred.

Section 100.143(b) and (d) Cause and Effect

Some commenters asserted that corrective action must include both prospective and retroactive relief to fully remedy both the cause and effect of the violations. For example, in the instance of charging higher interest rates to minorities, they urged that relief would require not only lowering the rate, but reimbursing the overpayment with interest, and paying damages for pain and suffering.

The final rule requires a lender to take corrective action reasonably likely to remedy the cause and effect of a likely violation. The Department revised the phrase ''fully remedy'' that appeared in the proposed rule since, as many commenters argued, that phrase implied that damages paid, or remedies provided, would have to equal those a court would award if there had been an adjudication. It would be difficult or impossible for a lender to determine in advance whether corrective action met that standard, and the Act included no such requirement. However, there may be situations where the violation and the facts known to the lender are such that limiting the corrective action solely to out-of-pocket damages would be inappropriate. The final rule standard of ''reasonably likely to remedy the cause and effect'' intends that payments of out-of-pocket and other compensatory damages be determined on a case-by-case basis without any adjudication.

Section 100.143(b) and (d) Policies or Practices; Extent and Scope

A lender must: (1) Identify the policies or practices that are the likely cause of the violation, such as inadequate or improper lending policies, failure to implement established policies, employee conduct, or other causes; and (2) assess the extent and scope of any likely violation, by determining which areas of its operation are likely to be affected by those policies and practices, such as stages of the loan application process, types of loans, or the branches or offices where likely discrimination has occurred.

Generally, if the scope of the testing is broad, the need to examine information beyond that generated by the self-test is correspondingly broad. For example, a lender that self-tests its marketing practices and discovers evidence of discrimination may focus its corrective actions on its marketing practices, and is not required to expand its testing to other aspects of its operation. Also, for example, if the testing focuses on a particular loan officer at a particular branch, and a likely violation is found, then the lender need not commence a nationwide loan file review. Nevertheless, a comprehensive examination of that loan officer's activities would be required, covering all mortgage loan products handled by that officer.

In some instances, a pre-application matched-pair test may reveal that potential borrowers in minority areas are not offered or made aware of the full range of available loan products offered or advertised to borrowers in non-minority areas. In this case, the lender, in determining prospective relief, should examine its marketing, sales, and outreach activities both as a whole and in its individual branches, and should implement prospective actions to address the results of the test, where necessary.

Section 100.143(b) and (d) Interagency Guidance

Subsection (d) provides lenders with additional direction on what is appropriate corrective action to remedy the cause and effect of a likely violation, as required by subsection (b).

Several commenters recommended the rule should offer greater guidance on what is and is not appropriate corrective action, and on how to apply the actions listed in the proposed rule. Some suggested the actions listed were too vague, thereby diluting the self-test incentive. These commenters generally recommended that specific standards be established and limitations be placed upon the amount of corrective action required in connection with past discrimination.

Others maintained a case-by-case analysis invites unrestrained second-guessing of difficult judgments on likely violations and remedies. Several commenters viewed the case-by-case approach as an ex post facto assessment of a lender's corrective actions. Other commenters, generally those supporting case-by-case determinations, argued that if the rule mandated any particular corrective action, it would impede fair lending litigation and/or settlement proceedings.

The Department carefully weighed the comments received and recognizes the need for certainty as to whether corrective actions are appropriate. However, it is not possible to develop a standard that would describe the specific appropriate action in every hypothetical situation. Rather, the final rule contains a standard that describes the criteria for determining the corrective action appropriate to the fact pattern involved, and retains the general categories developed by the Interagency Task Force on Fair Lending.[2] The final rule does note that not every corrective measure listed need be taken for each likely violation.

Section 100.143(c) Prospective and Remedial Relief

There were many comments with differing views on the issue of whether corrective action should be prospective only, or whether retrospective actions also should be necessary. Those favoring prospective action only argued that Congress intended to eliminate disincentives to self-testing, and that a requirement for retrospective relief deterred self-testing. Some commenters suggested that while corrective action should generally be limited to prospective relief, if the self-test has confirmed actual violations of law by the lender in connection with the lender's extension of credit to specific individuals, retrospective relief may be appropriate. Another commenter opposed any unilateral determination and payment of out-of-pocket and compensatory damages since such damages are only determinable and obligatory following a finding of a violation of the FHAct at the conclusion of a contested case.

With respect to whether remedial relief is required, the final rule does not require a lender who seeks to establish

[2] 59 FR 18266, 18270–18271 (April 15, 1994).

a self-testing privilege to provide remedial relief to individuals if the self-test does not discover evidence of likely discrimination against an actual applicant identified by the self-test. Accordingly, a pre-application matched-pair test which reveals that potential borrowers in minority areas were not offered or made aware of the full range of available loan products which borrowers in non-minority areas were offered would require prospective, but not remedial, relief because the self-test did not discover evidence of likely discrimination against an actual applicant identified by the self-test.

Were lenders required to undertake reviews of loan or application files to identify actual applicants who were victims in such instances, the result of such a review would not be privileged as a self-test under this subpart, since it involves information contained in or derived from a loan or application file. Such an outcome, therefore, could require a lender who undertook a self-test with the expectation of a privilege to be required to provide incriminating evidence.

It is also worth noting that the fact that a tester has an agreement with a lender that waives the tester's legal right to assert a violation does not eliminate the requirement for the lender to take corrective action although no remedial relief for the tester is required.

Lenders should note that while application of the privilege does not require a lender to take extra measures to identify and compensate individual victims of discrimination, such persons still may file a complaint with the Department or in court and may obtain the remedies available in such cases. A lender should consider an effort to identify such individuals as a good business practice to avoid or minimize potential liability.

The final rule does not require a lender to provide remedial relief to an actual applicant if the FHAct's two year statute of limitations [3] expired before the lender obtained the results of the self-test, or if the applicant is otherwise ineligible for such relief.

Changed circumstances might mitigate against giving an applicant certain types of relief. For example, a lender is not required to offer credit to an unlawfully denied applicant if the applicant no longer qualifies for credit due to a change in financial circumstances, although some other type of relief may be appropriate.

[3] 42 U.S.C. 3613(a).

Section 100.143(e)

Determination of appropriate corrective action is fact-based. Not every corrective measure listed in subsection (d) need be taken for each likely violation.

Section 100.143(f)

In response to commenters who fear incriminating themselves by taking corrective actions, the Department added a new subsection (f) which provides that taking corrective action by a lender is not an admission a violation occurred.

Section 100.144 Scope of Privilege

This section, which explains the nature of the qualified privilege afforded by the Act, states that the report or results of a self-test may not be obtained or used by an aggrieved person, complainant, department or agency in any: (1) Proceeding or civil action in which a violation of the FHAct is alleged, or (2) examination or investigation relating to compliance with the FHAct.

Several commenters wanted the privilege extended to encompass alleged violations of State and local fair housing laws. In addition, one commenter wanted the Department to clarify that if, in litigation involving the Real Estate Settlement Procedures Act (RESPA), a court orders a lender to perform a self-test, and to furnish the results of that test to the opposing party, those results may not later be used in a proceeding or investigation pursuant to the FHAct.

The Department did not adopt either suggestion. The Act states specifically that the self-testing privilege applies only in proceedings, civil actions, examinations, and investigations under the FHAct. Congress indicated no intent to have the privilege apply to actions under any other law, including State and local fair housing laws. The Department lacks the legal authority to extend the privilege's application beyond the FHAct. However, the Department will encourage States or localities, who have sought and received a determination that their law is substantially equivalent to the FHAct in the rights and remedies accorded, to provide a privilege equal to that provided by Congress and implemented in this rule. Such States and localities will be asked to provide a privilege through the application of their fair housing law, its regulations or binding rules, or they must agree to refer all complaints involving lending discrimination where the privilege has been invoked to the Department for processing.

The Department intends to propose rulemaking which would require States and localities seeking a substantial equivalency determination in the future to accord a self-testing privilege substantially equivalent to the Act and this subpart. Under such a rule, if the proceeding, civil action, examination or investigation is pursuant to the FHAct, or pursuant to a State or local law which has been deemed substantially equivalent to the FHAct, the privilege would apply. States and localities which do not have laws which are substantially equivalent to the FHAct may choose to adopt the privilege for use in proceedings under their laws.

As to the furnishing of information in a RESPA proceeding, the self-testing privilege applies only if the test is performed ''in order to determine the level or effectiveness of compliance'' with the FHAct. Since a court-ordered self-test under RESPA would be performed to ascertain compliance with RESPA, rather than the FHAct, the self-test would not come within the parameters of the privilege. Consequently, unless the court in the RESPA matter ordered that use of the RESPA-related self-testing information was limited to that proceeding, the information would not be privileged in a FHAct proceeding.

If, however, the RESPA court ordered the lender to produce information privileged under the Act, that information could not, by virtue of that order, be used in a subsequent FHAct case. The privilege would still apply because material privileged under this subpart may not be ''used'' in FHAct litigation, regardless of how it was ''obtained,'' unless it was obtained by the lender's voluntary disclosure. Thus, the privilege covers material obtained involuntarily in collateral litigation, such as suits filed under RESPA, the Truth-in-Lending Act, or under State laws.

Another commenter suggested the final rule's use of the term ''agency,'' with regard to those who may not obtain or use privileged information, must be construed to encompass State, municipal and other agencies. The Department agrees that ''agency'' would include a State or local agency that sought to obtain or use the privileged information in a proceeding or civil action alleging a violation of, or an examination or investigation relating to, the FHAct, or pursuant to a State or local law which provides for the privilege and has been deemed substantially equivalent to the FHAct, as discussed above. If, however, the State or local agency sought the information under the auspices of a law, other than

those discussed in the preceding sentence, including a State or local fair housing law, the privilege would not apply.

Section 100.145 Loss of Privilege

This section explains the circumstances that would cause documents to lose their privileged status. Generally, the self-test report or results are not privileged if the lender or person with lawful access to the report or results, or any other information otherwise privileged under this subpart, discloses or uses the report, results or such information as a defense to charges a lender violated the FHAct, or fails or is unable to produce self-test records or information needed to determine whether the privilege applies. This section has been revised to clarify that the privilege is lost if the lender discloses privileged information, such as the results of the self-test, but that the privilege is not lost if the creditor merely reveals or refers to the existence of the self-test. As discussed, future rulemaking will address record retention requirements.

The Department received a number of comments on this section of the proposed rule. Several commenters wanted the rule to specify that unauthorized disclosure would not forfeit the privilege. The Department did not adopt this suggestion. To do so would require a plaintiff to disprove a lender's assertions as to what its internal policies, practices, and chain-of-command are, which is an unreasonable burden. Moreover, the statute provides that the report or results of a self-test are not privileged if disclosed by a person with lawful access to the report or results. Accordingly, disclosures made by such persons are treated as disclosures made by the lender, without regard to whether the person was authorized to make the particular disclosure. Existing law adequately addresses the issues of scope of employment and agency.

Under the rule, a lender's production of records in response to a judicial order, or a disclosure in a case where the privilege does not apply, e.g., in a non-FHAct case, does not necessarily mean that the lender intended to give up the privilege voluntarily. Accordingly, if such disclosures are not voluntary, e.g., under a court order, they will not affect the privileged status of the documents.

One commenter stated that without a record retention requirement, lenders could conduct self-tests, find violations, and destroy all records without taking corrective action. According to this commenter, the rule should require any records, results, analyses, work product, or other material related to or created from self-tests to be maintained by the lender and/or its agents for at least 48 months if litigation or an enforcement action is pending against the lender. The Department's proposed rule included no provision on record retention. Since the issue was not addressed in the proposed rule, the Department has not included it in the final regulation. Instead, the Department in the near future will propose for comment a rule on record retention as it relates to self-testing information and the FHAct, with appropriate recognition of the ECOA requirements in this area. In the meantime, to assert the self-test privilege, lenders who are subject to ECOA must comply with the record retention requirements of the Board's rule for ECOA purposes.

Some commenters wanted the regulation changed to specify that release of part of a report only forfeits the privilege as to that part of the report released. However, the statute does not permit this result, since it states that release of ''all, or any part of, the report or results'' waives the privilege.

In the proposed rule, the Department solicited comments on whether the regulation should provide that lenders could voluntarily share privileged information with a Federal or State bank supervisory or law enforcement agency without the information losing its privileged status in litigation by private plaintiffs. The disclosures on which comments were solicited, however, would have caused the documents to lose their privileged status with respect to all supervisory and law enforcement agencies, e.g., HUD and DOJ, as well as the Board, the OCC, the FDIC, the OTS, the NCUA, and the FTC.

A substantial number of commenters supported the idea. According to these commenters, this would encourage lenders to seek guidance from regulators in developing appropriate corrective actions. The commenters stated further that the Department should draw no negative inferences from a lender's decision not to provide information voluntarily. Another group of commenters wanted mandatory sharing of self-test results with regulatory and enforcement agencies to ensure that the scope of the remedy is appropriate and that the remedy is entirely and effectively implemented. One commenter strongly opposed allowing lenders to voluntarily share privileged information with a supervisory agency while maintaining the privilege as to private litigants. Yet, another commenter argued that such a mechanism directly conflicts with the statute, which specifically provides that voluntary disclosure in such instances constitutes a waiver of the privilege. A number of other commenters similarly maintained there is nothing in the statute which suggests the Department could adopt a partial waiver of privilege. Furthermore, they maintained, the law of privileges generally does not recognize a right to waive a privilege (as with the attorney-client privilege) only as to some parties but not others. According to these commenters, several bank counsel expressed reluctance to rely on such a split privilege if based on the Department's rulemaking authority, absent specific legislative language, or a court ruling upholding such an interpretation of the privilege.

Other commenters supported limited disclosure to determine whether appropriate corrective action had been taken, but opposed any interpretation of the privilege that allowed blanket protection for all voluntary disclosures of ''self-tests'' to banking or enforcement agencies so as to immunize banks or enforcement agencies from disclosure in private litigation. Another commenter asserted the Act was enacted to provide creditors with the necessary protection to encourage them to self-test, not to promote cooperation between creditors and their regulators.

The Department concluded that a mechanism that would permit lenders to provide privileged information to the independent financial regulatory agencies, and simultaneously to enforcement agencies, e.g., HUD, DOJ, while still maintaining a privilege as to private litigants, is not allowed by the statute. Such a mechanism might help lenders secure certainty that the privilege was properly asserted. However, some commenters were concerned that allowing disclosure to the regulatory agencies with simultaneous disclosure to enforcement agencies might result in enforcement action if the self-test were not within the statutory privilege, and that this would be a deterrent to self-testing. The process would also raise resource issues concerning the capacity of the regulatory and enforcement agencies to issue advisory opinions. In any case, after careful study, the Department determined that in addition to the policy consequences, this step is not allowed by the statutory language.

Section 100.146 Limited Use of Privileged Information

This section provides for a limited use of privileged documents that will not be treated as a voluntary disclosure affecting the privileged status of the

documents under § 100.144. The report or results of a privileged self-test may be obtained and used solely for the purpose of determining a penalty or remedy after a violation of the Act has been formally adjudicated or admitted. Disclosures for this limited purpose may be used only for the particular proceeding in which the adjudication or admission is made. Information disclosed under this section remains otherwise privileged under this subpart.

Section 100.147 Adjudication

The Act provides that the privilege may be challenged in any court or administrative law proceeding with appropriate jurisdiction. The Department expects such challenges to be resolved according to the laws and procedures used for other types of privilege claims, such as attorney-client or attorney work product.

One commenter recommended the privilege remain in effect during the period in which an adjudicator is determining whether the privilege applies. The Department agrees. As with other privileges, a lender's claim that information is privileged protects that information from disclosure during the time the adjudicator is determining whether the lender is entitled to the privilege. However, the adjudicator may order the lender to disclose the information so that the adjudicator can determine whether the privilege was invoked properly. The adjudicator may require in camera proceedings, the filing of documents and pleadings under seal, and the production of documents to other parties under a protective order limiting the purpose for which they may be used. If the adjudicator orders disclosure for the limited purpose of determining whether the privilege was invoked properly, the information is protected from use in any proceeding, civil action, examination or investigation until the adjudicator determines the privilege does not apply.

One commenter urged that since assertion of, and challenges to, the privilege will result in more lengthy and expensive litigation, the Department should include a provision for attorney's fees and costs for private plaintiffs who successfully challenge the assertion of the privilege. If a judge finds, during the discovery phase of a proceeding, that a lender improperly invoked the privilege, the judge may order appropriate sanctions, including those provided by Rule 37 of the Federal Rules of Civil Procedure or by 24 CFR 180.540. In appropriate circumstances, this may include attorneys' fees and costs. Moreover, the FHAct and its implementing regulations specifically provide for the award of attorney's fees to the prevailing party in any court or administrative proceeding.[4] A party is entitled to reasonable attorney's fees and costs to the extent provided under the Equal Access to Justice Act.[5] Any award of fees would be made in accordance with those provisions.

Section 100.148 Effective Date

Lenders and others may invoke the self-testing privilege regarding self-tests undertaken prior to the effective date of the final rule, but not if either a formal complaint has been filed involving matters covered by the self-test, or if the privilege has been lost pursuant to § 100.145. A complaint filed in a court with jurisdiction over the FHAct is a ''formal complaint.'' Moreover, as the proposed rule preamble noted, a formal complaint alleging a FHAct violation includes one filed with the Department or a substantially equivalent agency (pursuant to subsection 810(f) of the FHAct, 42 U.S.C. 3610(f)). Any other interpretation would conflict with Congress' intent in the Fair Housing Amendments Act of 1988 to establish an administrative process that is an equally effective alternative to the filing of a complaint in a Federal court.

Technical Correction to 24 CFR Part 103

A final rule published October 4, 1996 (61 FR 52216) consolidated HUD's hearing procedures for nondiscrimination and equal opportunity matters in a new 24 CFR part 180. In that rulemaking, conforming changes were made throughout 24 CFR to replace references to parts eliminated as a result of the consolidation with references to new part 180. Although part 103 was included in the list of parts in which all references to part 104 were to be replaced by 180, paragraph (b) of § 103.215 contained two references to 104, and only the first reference was changed to 180. The reference in this paragraph to § 104.590 is corrected to read § 180.545. Similarly, references to part 104 are corrected to read part 180 in §§ 103.1(c), 13.230(a)(1), 103.405(b)(2) and (3).

IV. Findings and Certifications

Regulatory Planning and Review

This rule has been reviewed in accordance with Executive Order 12866, issued by the President on September 30, 1993 (58 FR 51735, October 4, 1993). Any changes to the rule resulting from this review area available for public inspection between 7:30 a.m. and 5:30 p.m. weekdays in the Office of the Rules Docket Clerk.

Unfunded Mandates Reform Act

Title II of the Unfunded Mandates Reform Act of 1995 establishes requirements for Federal agencies to assess the effects of their regulatory actions on State, local, and tribal governments and the private sector. This rule does not impose any Federal mandates on any State, local or tribal governments or the private sector within the meaning of the Unfunded Mandates Reform Act of 1995.

Environmental Impact

In accordance with 40 CFR 1508.4 of the regulations of the Council on Environmental Quality and 24 CFR 50.19(c)(1) of the Department's regulations, the policies and procedures contained in this rule do not direct, provide for assistance or loan and mortgage insurance for, or otherwise govern or regulate property acquisition, disposition, lease, rehabilitation, alteration, demolition, or new construction, or set out or provide for standards for construction or construction materials, manufactured housing, or occupancy, and therefore, are categorically excluded from the requirements of the National Environmental Policy Act.

Impact on Small Entities

The Secretary, in accordance with the Regulatory Flexibility Act (5 U.S.C. 605(b)) has reviewed and approved this rule, and in so doing certifies that this rule will not have a significant economic impact on a substantial number of small entities, because the rule only proposes to implement a statutory provision that allows an evidentiary privilege for the report and results of self-tests of FHAct compliance undertaken by lenders.

Executive Order 13145, Protection of Children From Environmental Health Risks and Safety Risks

This rule will not pose an environmental health risk or safety risk for children.

List of Subjects

24 CFR Part 100

Aged, Fair housing, Individuals with disabilities, Mortgages, Reporting and recordkeeping requirements.

24 CFR Part 103

Administrative practice and procedure, Aged, Fair housing, Individuals with disabilities, Intergovernmental relations, Investigations, Mortgages, Penalties,

[4] *See* 42 U.S.C. 3612(p), 3613(c)(2), and 3614(d)(2); 24 CFR 180.705.

[5] 5 U.S.C. 504.

Reporting and recordkeeping requirements.

Accordingly, parts 100 and 103 of title 24 of the Code of Federal Regulations are amended as follows:

PART 100—DISCRIMINATORY CONDUCT UNDER THE FAIR HOUSING ACT

1. The authority citation for part 100 continues to read as follows:

Authority: 42 U.S.C. 3535(d), 3600–3620.

2. In subpart C, new sections 100.140, 100.141, 100.142, 100.143, 100.144, 100.145, 100.146, 100.147, and 100.148 are added to read as follows:

§ 100.140 General rules.

(a) *Voluntary self-testing and correction.* The report or results of a self-test a lender voluntarily conducts or authorizes are privileged as provided in this subpart if the lender has taken or is taking appropriate corrective action to address likely violations identified by the self-test. Data collection required by law or any governmental authority (federal, state, or local) is not voluntary.

(b) *Other privileges.* This subpart does not abrogate any evidentiary privilege otherwise provided by law.

§ 100.141 Definitions.

As used in this subpart:

Lender means a person who engages in a residential real estate-related lending transaction.

Residential real estate-related lending transaction means the making of a loan:

(1) For purchasing, constructing, improving, repairing, or maintaining a dwelling; or

(2) Secured by residential real estate.

Self-test means any program, practice or study a lender voluntarily conducts or authorizes which is designed and used specifically to determine the extent or effectiveness of compliance with the Fair Housing Act. The self-test must create data or factual information that is not available and cannot be derived from loan files, application files, or other residential real estate-related lending transaction records. Self-testing includes, but is not limited to, using fictitious credit applicants (testers) or conducting surveys of applicants or customers, nor is it limited to the pre-application stage of loan processing.

§ 100.142 Types of information.

(a) The privilege under this subpart covers:

(1) The report or results of the self-test;

(2) Data or factual information created by the self-test;

(3) Workpapers, draft documents and final documents;

(4) Analyses, opinions, and conclusions if they directly result from the self-test report or results.

(b) The privilege does not cover:

(1) Information about whether a lender conducted a self-test, the methodology used or scope of the self-test, the time period covered by the self-test or the dates it was conducted;

(2) Loan files and application files, or other residential real estate-related lending transaction records (e.g., property appraisal reports, loan committee meeting minutes or other documents reflecting the basis for a decision to approve or deny a loan application, loan policies or procedures, underwriting standards, compensation records) and information or data derived from such files and records, even if such data has been aggregated, summarized or reorganized to facilitate analysis.

§ 100.143 Appropriate corrective action.

(a) The report or results of a self-test are privileged as provided in this subpart if the lender has taken or is taking appropriate corrective action to address likely violations identified by the self-test. Appropriate corrective action is required when a self-test shows it is more likely than not that a violation occurred even though no violation was adjudicated formally.

(b) A lender must take action reasonably likely to remedy the cause and effect of the likely violation and must:

(1) Identify the policies or practices that are the likely cause of the violation, such as inadequate or improper lending policies, failure to implement established policies, employee conduct, or other causes; and

(2) Assess the extent and scope of any likely violation, by determining which areas of operation are likely to be affected by those policies and practices, such as stages of the loan application process, types of loans, or the particular branch where the likely violation has occurred. Generally, the scope of the self-test governs the scope of the appropriate corrective action.

(c) Appropriate corrective action may include both prospective and remedial relief, except that to establish a privilege under this subpart:

(1) A lender is not required to provide remedial relief to a tester in a self-test;

(2) A lender is only required to provide remedial relief to an applicant identified by the self-test as one whose rights were more likely than not violated;

(3) A lender is not required to provide remedial relief to a particular applicant if the statute of limitations applicable to the violation expired before the lender obtained the results of the self-test or the applicant is otherwise ineligible for such relief.

(d) Depending on the facts involved, appropriate corrective action may include, but is not limited to, one or more of the following:

(1) If the self-test identifies individuals whose applications were inappropriately processed, offering to extend credit if the applications were improperly denied; compensating such persons for any damages, both out-of-pocket and compensatory;

(2) Correcting any institutional policies or procedures that may have contributed to the likely violation, and adopting new policies as appropriate;

(3) Identifying, and then training and/or disciplining the employees involved;

(4) Developing outreach programs, marketing strategies, or loan products to serve more effectively the segments of the lender's market that may have been affected by the likely violation; and

(5) Improving audit and oversight systems to avoid a recurrence of the likely violations.

(e) Determination of appropriate corrective action is fact-based. Not every corrective measure listed in paragraph (d) of this section need be taken for each likely violation.

(f) Taking appropriate corrective action is not an admission by a lender that a violation occurred.

§ 100.144 Scope of privilege.

The report or results of a self-test may not be obtained or used by an aggrieved person, complainant, department or agency in any:

(a) Proceeding or civil action in which a violation of the Fair Housing Act is alleged; or

(b) Examination or investigation relating to compliance with the Fair Housing Act.

§ 100.145 Loss of privilege.

(a) The self-test report or results are not privileged under this subpart if the lender or person with lawful access to the report or results:

(1) Voluntarily discloses any part of the report or results or any other information privileged under this subpart to any aggrieved person, complainant, department, agency, or to the public; or

(2) Discloses the report or results or any other information privileged under this subpart as a defense to charges a lender violated the Fair Housing Act; or

(3) Fails or is unable to produce self-test records or information needed to determine whether the privilege applies.

(b) Disclosures or other actions undertaken to carry out appropriate

corrective action do not cause the lender to lose the privilege.

§ 100.146 Limited use of privileged information.

Notwithstanding § 100.145, the self-test report or results may be obtained and used by an aggrieved person, applicant, department or agency solely to determine a penalty or remedy after the violation of the Fair Housing Act has been adjudicated or admitted. Disclosures for this limited purpose may be used only for the particular proceeding in which the adjudication or admission is made. Information disclosed under this section remains otherwise privileged under this subpart.

§ 100.147 Adjudication.

An aggrieved person, complainant, department or agency that challenges a privilege asserted under § 100.144 may seek a determination of the existence and application of that privilege in:

(a) A court of competent jurisdiction; or

(b) An administrative law proceeding with appropriate jurisdiction.

§ 100.148 Effective date.

The privilege under this subpart applies to self-tests conducted both before and after January 30, 1998, except that a self-test conducted before January 30, 1998 is not privileged:

(a) If there was a court action or administrative proceeding before January 30, 1998, including the filing of a complaint alleging a violation of the Fair Housing Act with the Department or a substantially equivalent state or local agency; or

(b) If any part of the report or results were disclosed before January 30, 1998 to any aggrieved person, complainant, department or agency, or to the general public.

PART 103—FAIR HOUSING—COMPLAINT PROCESSING

3. The authority citation for part 103 continues to read as follows:

Authority: 42 U.S.C. 3535(d), 3600–3619.

4. In the list below, for each section indicated in the left column, remove the reference indicated in the middle column from wherever it appears in the section, and add the reference indicated in the right column:

Section	Remove	Add
103.1(c)	Part 104	Part 180 of this chapter.
103.215(b)	104.590	180.545.
103.230(a)(1)	Part 104	Part 180 of this chapter.
103.405(b)(2)	104.410(b)	24 CFR 180.410(b).
103.405(b)(3)	104.410(a)	180.410(a).

Dated: December 8, 1997.

Susan M. Forward,

General Deputy Assistant Secretary for Fair Housing and Equal Opportunity.

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