

For release on delivery  
10 a.m., E.D.T.  
October 24, 1989

Statement by  
John P. LaWare  
Member, Board of Governors of the Federal Reserve System  
before the  
Subcommittee on Consumer and Regulatory Affairs  
of the  
Committee on Banking, Housing, and Urban Affairs  
United States Senate  
October 24, 1989

## SUMMARY OF TESTIMONY

The report, which is the subject of the testimony, was submitted to the Congress by the Board of Governors of the Federal Reserve System pursuant to section 1220 of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA). Section 1220 required the Board and the other Federal Financial Institution agencies to report to the Congress on their findings on the extent of discriminatory lending practices by mortgage lenders subject to their regulation or supervision (in the Board's case, state member banks) using currently available loan acceptance and rejection statistics. In addition, the reports were to provide recommendations for appropriate measures to assure nondiscriminatory lending practices.

The Board does not currently have mortgage loan acceptance or rejection statistics of the type contemplated by section 1220. Consequently, it was unable to provide the requested analysis. Nevertheless, the Board was able to draw some conclusions about the possible extent of discriminatory conduct in the mortgage lending activities of state member banks as a result of Federal Reserve System's consumer affairs program.

There are two anti-discrimination laws for which the Board has enforcement responsibilities with respect to state member banks--the Fair Housing Act and the Equal Credit Opportunity Act. The Fair Housing Act, among other things, prohibits discrimination in a residential real estate-related transaction against any person because of race, color, religion, sex, national origin, handicap or familial status. The Equal Credit Opportunity Act prohibits creditor practices that discriminate

against an applicant because of race, color, religion, national origin, sex, marital status or age (provided the applicant has the capacity to contract); the fact that all or part of the applicant's income derives from a public assistance program; or the fact that the applicant has in good faith exercised any right under the Consumer Credit Protection Act.

Federal Reserve System efforts to detect loan discrimination by state member banks began in 1977 and include both a consumer compliance examination effort and consumer complaint effort. The consumer compliance examinations are comprehensive, scheduled at regular intervals, and are conducted by examiners at the Reserve Banks who are specially trained in consumer affairs and civil rights examination techniques. The Board and each of the Reserve Banks maintain staff who work primarily with complaints from consumers who feel they have been treated unfairly by a state member bank. The Board's staff provides general guidance and oversight to the Reserve Banks in both areas.

The examination procedures for detecting loan discrimination during a consumer compliance examination are quite detailed. They take on average almost 19 hours per examination to complete, and result in a comprehensive assessment of the institution's lending practices.

Overall, the number and nature of the violations of the Equal Credit Opportunity Act (Regulation B) and the Fair Housing Act discovered during our compliance examinations suggests that state member banks are in substantial compliance with the requirements of both Acts. We do not find policies or practices

that suggest that individual state member banks take the race of an applicant into account when making a credit decision.

In recent years the staff of the Federal Reserve System has conducted or reviewed several research studies that have examined the relationship between the racial composition of neighborhoods and residential mortgage lending. This work has been based on information obtained from records of actual loans granted rather than from loan application records.

The studies do not draw definitive conclusions about the existence or extent of racial discrimination. They are nonetheless useful because they identify the presence of differential lending patterns across neighborhoods and thus focus attention on these matters. The existence of these disparities, regardless of their cause, should at the very least prompt mortgage lenders to review their marketing and outreach efforts as well as their product offerings in minority neighborhoods.

The Board was also asked to provide recommendations for appropriate measures to assure nondiscriminatory lending practices. In light of the recent amendments contained in the FIRREA to the Home Mortgage Disclosure Act, which will assist in developing a more complete and accurate picture of mortgage lending practices than is possible today, we have no proposals for new additional legislation. We do, however, have several initiatives that are currently under review by the Board staff or subcommittees of the Federal Financial Institution Examination Council (FFIEC), which show promise.

\* \* \* \* \*

Mr. Chairman, I appreciate this opportunity to appear before this Senate Subcommittee to present the Federal Reserve Board's view on the extent of state member banks' compliance with federal laws which prohibit discrimination in mortgage lending. In particular, my testimony will summarize the Board's "Report on Loan Discrimination," which was submitted to the Congress pursuant to Section 1220 of the Financial Institutions Reform, Recovery and Enforcement Act of 1989 (FIRREA).

Section 1220 required the Board and the other federal financial institution supervisory agencies to report to the Congress on their findings on the extent of discriminatory lending practices by mortgage lenders subject to their regulation or supervision (in the Board's case, state member banks) "based on a review of currently available loan acceptance and rejection statistics." In addition, the reports were to provide recommendations for appropriate measures to assure nondiscriminatory lending practices.

Although the Board has a comprehensive compliance examination program to ensure that state member banks comply with the Equal Credit Opportunity Act and the Fair Housing Act, it does not currently have mortgage loan acceptance or rejection statistics of the type contemplated by Section 1220. Consequently, we were unable to provide the requested analysis. Recent amendments to the Home Mortgage Disclosure Act will require certain state member banks as well as other lenders to report this type of data, but it will not be available until the fall of 1991.

Nevertheless, the Board was able to draw some conclusions about the possible extent of discriminatory conduct in the mortgage lending activities of state member banks as a result of the Federal Reserve System's consumer compliance examination program. In addition, some information was provided by our consumer complaint program. Finally, we have followed closely the concerns over disparities in the amount of residential mortgage lending between minority and non-minority areas as detailed by studies in Atlanta, Cleveland, Detroit, and Boston - the latter conducted by the Federal Reserve Bank of Boston. These studies provide useful, but limited, insight into the issue.

#### Antidiscrimination Laws

Two laws directly prohibit discrimination in mortgage lending--the Fair Housing Act and the Equal Credit Opportunity Act. These two laws are complementary in some important respects relating to mortgage lending. For example, both set forth criteria which lenders may not consider when making credit decisions.

The objective of the Fair Housing Act is to help assure nondiscriminatory practices in all aspects of the housing market. Consequently, it applies to a wide range of persons involved in the sale or rental of housing and regulates many aspects of residential real estate-related transactions. With regard to mortgage credit, the Fair Housing Act makes it unlawful for mortgage lenders to discriminate in a residential real

estate-related transaction against any person because of race, color, religion, sex, national origin, handicap or familial status. The primary impact of the Act with regard to state member banks is to require equal treatment of applications for mortgage loans from members of a protected class.

The Equal Credit Opportunity Act and the Federal Reserve System's Regulation B, which implements the Act, are designed to assure the nondiscriminatory availability of all types of credit, including mortgage loans, to all creditworthy applicants. The Act and the Regulation prohibit creditor practices that discriminate against an applicant because of race, color, religion, national origin, sex, marital status or age (provided the applicant has the capacity to contract); the fact that all or part of the applicant's income derives from a public assistance program; or the fact that the applicant has in good faith exercised any right under the Consumer Credit Protection Act. In addition, there are certain other important requirements in the Act and Regulation relevant to mortgage lending procedures which are designed in different ways to further the overall purpose of promoting the nondiscriminatory availability of credit.

The Board has broad rule-writing responsibility for the Equal Credit Opportunity Act, but very limited enforcement authority. The Congress directed the Board to prescribe regulations to carry out the purpose of the Act for covered lenders--including, for example, all banks, other depository institutions, and mortgage lenders. In contrast, the Board is

given administrative enforcement responsibility for only state member banks.

The Fair Housing Act, itself, does not give the Board any rule-writing or enforcement authority. The Department of Housing and Urban Development and the Attorney General are designated as the responsible federal agencies with regard to such matters. Nevertheless, the procedures for the Board's consumer compliance examination program include checking for state member bank compliance with the Fair Housing Act under our general authority to assure that banks are complying with federal law.

Before I explain the Board's enforcement program, I would like to briefly explain some characteristics of state member banks to indicate the type of financial institutions on which our program is focussed and on which our conclusions are based.

State member banks are relatively small in size and number and many are rural. As of December 31, 1988, there were 1,109 state member banks out of a total of 13,418 commercial banks in the United States (approximately 8 percent). They hold about 14 percent of total deposits held by commercial banks in this country and 90 percent of state member banks have total assets of less than \$500 million. Over 45 percent of state member banks are not located in an MSA (metropolitan statistical area).

Moreover, state members banks are not a significant presence in the mortgage lending area. Analysis of the most recent aggregated Home Mortgage Disclosure Act statistics (1987) indicate that state member banks originated less than three percent of all home purchase loans reported.



Federal Reserve Board's Consumer Affairs Program

The Board first established a specialized consumer compliance examination program in 1977. This program required that the twelve Reserve Banks around the country conduct examinations of state member banks to determine compliance with consumer protection legislation by using a cadre of specially trained examiners. The scope of these examinations specifically included the Equal Credit Opportunity and Fair Housing Acts. From the beginning, the examiners were instructed to place special emphasis on violations involving potential discrimination of the kind prohibited by these statutes.

In 1979, the Board reassessed its enforcement responsibilities in the areas of consumer affairs and civil rights and made several changes to its consumer affairs program. This included increased training for examiners in detecting discriminatory lending practices. Changes were also made in the System's processing of consumer complaints. It also placed increased emphasis on investigating serious complaints such as allegations of loan discrimination.

In 1981, the Board re-emphasized state member bank responsibilities under the Equal Credit Opportunity Act and the Fair Housing Act, and put the banks on notice that the Board would vigorously enforce them. This reminder took the form of a Policy Statement which stated that failure to comply with certain provisions of the acts were viewed by the Board to be particularly serious and would require retroactive corrective action.

Federal Reserve System efforts to detect loan discrimination by state member banks focus on the consumer compliance examination effort. Consumer compliance examinations are conducted by examiners at the Reserve Banks who are specially trained in consumer affairs and civil rights examination techniques. The Board and each of the Reserve Banks maintain staff who work primarily with consumer complaints. The Board's staff provides general guidance and oversight to the Reserve Banks in both areas. The Federal Reserve System's consumer compliance examinations are scheduled at regular intervals, and are comprehensive. As a result, the Board has been able to maintain a high-quality examination program over the years.

Each state member bank is examined on a regular basis. The Board's examination frequency policy calls for an examination to be scheduled every eighteen months for a bank with a satisfactory record. Banks with exceptional records can be examined every two years. Those banks with less than satisfactory records are to be examined every six months or every year, depending on the severity of their problems.

The Board believes that expecting a bank examiner to master both the "safety and soundness" and consumer affairs/civil rights aspects of bank examinations is not practical given the existing complexities of both areas which continue to increase. Consequently, the Federal Reserve has developed a separate career path for consumer affairs examiners equivalent to that of commercial examiners at the Reserve Banks. The Board provides special training to these examiners.

On average, checking for compliance with the anti-discrimination laws takes almost 19 hours per examination to complete, and results in a comprehensive assessment of the institution's lending practices.

The procedures focus primarily on comparing the treatment of members of a protected class with other loan applicants. First, the bank's loan policies and procedures are reviewed. This is done by reviewing bank documents, as well as interviewing loan personnel. During this phase, the examiner will seek to determine, among other things, the bank's credit standards. After the examiner has identified those standards, he or she will then contrast those standards with a judgmental sampling of actual loan applications, especially applications received by the bank from members of a protected class. This means that the examiner is looking at the same information that the bank used to make its credit decision, including such things as credit history, income, and total debt burden. If an instance is discovered where those standards appear not to have been used, it could be an indication of prohibited discrimination. This would provide the basis for a discussion with lending personnel and/or more intensive investigation. Finally, an overall analysis of the bank's treatment of applications from members of protected classes is conducted to determine whether there are any patterns or individual instances where such members were treated less favorably than other loan applicants.

One other aspect of the examination procedures is an analysis of the geographic distribution of the bank's credits.

Two ways in which this can be done is by plotting the location of the bank's accepted and rejected loans in a selected category on a map, and/or by use of Home Mortgage Disclosure Act data, if available. These data are then cross-referenced to census data, or other available information which identifies low- and moderate-income and minority neighborhoods. The geographic analysis has two functions. First, it may highlight lending practices evidenced by a geographic pattern that negatively impacts<sup>4</sup> on members of a protected class. Second, it is used in evaluating the bank's performance under the Community Reinvestment Act.

Another regular part of the examination includes conversations initiated by the examiner with persons in the community knowledgeable about local credit needs. The examiners will routinely ask about public perceptions of the availability of credit to minorities and low- and moderate-income persons. This information may suggest that a particular area of the bank needs additional scrutiny and may provide crucial insights into how the bank is serving the credit needs of its local community, particularly those individuals in the community protected by the antidiscrimination statutes.

There are, however, two significant reasons why these procedures, extensive as they are, may not provide absolute assurance that there have been no individual instances of discrimination.

First, state member banks, as most lenders, provide a certain amount of flexibility in their credit standards. This

reflects the fact that variations are normally found in each applicant's request for credit. In addition, numerous factors are used to establish creditworthiness (e.g., the amount and reliability of income, employment history, other debts, credit history, adequacy and availability of loan collateral, length of time at present residence, the existence and nature of deposit relationships), and this increases the difficulty in determining with any degree of certainty whether a member of a protected class was denied credit due to the fair application of credit standards or to discrimination.

Second, the pricing, structure and even availability of loans also vary. These variations are primarily due to business considerations which might include, for example, the perceived risk of loan default, usury or other legal requirements, the bank's cost of funds at any given time, and liquidity considerations. Such factors often make it more difficult to determine whether those who obtained credit, albeit on different terms, were treated equally.

For these two reasons, making conclusive judgments as to whether any particular variation is due to legitimate business reasons or discrimination is an inexact and difficult task. Discrimination can occur in many subtle ways, and it seldom leaves a visible audit trail. As a consequence, we can rarely be certain that discrimination has occurred, and we seldom make this formal finding. However, it is not uncommon for examiners to fully explore a questionable variation through conversations with bank personnel. This aspect of the examination process may play

a substantial role in sensitizing lenders to the issue of discrimination.

As part of the examination procedures, examiners are instructed to review bank practices and policies regarding pre-application contact with potential customers. In this regard, it is often difficult for compliance examiners to determine, with certainty, what type of interaction may have occurred between potential applicants and the bank before an application is received. If applicants are being discouraged from submitting an application, and there is no documented evidence of such treatment, it is possible the examiner will not learn of this improper bank conduct unless the affected applicants come forward.

Overall, the number and nature of the violations of the Equal Credit Opportunity Act and the Fair Housing Act discovered during our compliance examinations suggest that state member banks are in substantial compliance with the requirements of both Acts. While there are several procedural requirements of Regulation B and the Fair Housing Act which some state member banks have not followed, as detailed in our report, these violations do not directly involve the antidiscrimination provisions.

In summary, we do not find policies or practices that suggest that individual state member banks take the race of an applicant into account when making a credit decision. Moreover, the very fact that bank personnel know that examiners will be closely scrutinizing their behavior, through review of bank

records, probably has a considerable influence on helping to discourage discriminatory conduct by individual employees.

#### Home Purchase Lending Disparities by Race

In recent years the staff of the Federal Reserve System has conducted or reviewed several research studies that have examined the relationship between the racial composition of neighborhoods and residential mortgage lending. Copies of these materials, which pertain to Atlanta, Boston, Cleveland, and Detroit were included in our report.

The Federal Reserve work has all been based on information obtained from records of actual loans granted (either from data obtained pursuant to the Home Mortgage Disclosure Act or from local government property records) rather than from loan application records. Consequently, these studies do not specifically address the question raised in section 1220, which is the extent of mortgage lending discrimination revealed in a review of loan application and disposition records. Nevertheless, the studies do provide some insights into the relationships between race and home lending.

The studies show:

(1) that there are differences in the number and dollar volume of conventional home purchase and home improvement loans extended to borrowers in different neighborhoods;

(2) that, after accounting for differences in neighborhood income levels, in the number of housing units across neighborhoods, as well as in other selected control variables, areas with predominantly black populations receive fewer home purchase loans, but more home improvement loans, from commercial banks and thrift institutions than similar predominantly white neighborhoods, and

(3) that a significant portion of the home purchase finance extended in predominantly black neighborhoods is supplied by non-depository institutions, such as mortgage companies, and, except for Boston, most of these loans are either government-insured or guaranteed (apparently high home prices in Boston has precluded some potential loan applicants from using FHA-insured financing in recent years).

Each of the studies discusses various factors which may account for these loan patterns. For example, the Boston study describes in some detail the complex interaction of demand and supply in both the housing and mortgage markets that combine to jointly determine the distribution of home purchase loans across different neighborhoods. Because the distribution of loans reflects the joint determination of supply and demand factors, many of which are closely related to each other, interpreting the significance of any particular variable is extremely difficult.

The studies, however, do not draw definitive conclusions about the existence or extent of racial discrimination. They are nonetheless useful because they identify the presence of differential lending patterns across neighborhoods and thus focus attention on these matters. For example, the finding that mortgage bankers and other non-depository sources of finance are a dominant source of credit in many predominantly minority areas has raised questions about the adequacy of bank and thrift institution marketing and community outreach in these communities. In addition, the observation that FHA-insured financing is heavily used in minority middle-income neighborhoods suggests that depository institutions could garner a larger share of the home loan market in these neighborhoods if more of them



offered FHA-insured loans or similar low downpayment, privately insured conventional mortgage alternatives. Finally, the existence of these disparities, regardless of their cause, should at the very least prompt mortgage lenders to review their marketing and outreach efforts as well as their product offerings in minority neighborhoods. We have recently stressed this responsibility in a joint agency policy statement on the Community Reinvestment Act.

Recommendations

The Board was also asked to provide recommendations for appropriate measures to assure nondiscriminatory lending practices. In light of the recent amendments contained in the FIRREA to the Home Mortgage Disclosure Act and the Community Reinvestment Act, we have no proposals for new legislation.

The amendments to the Home Mortgage Disclosure Act will--

- (1) extend coverage of the Home Mortgage Disclosure Act to essentially all types of mortgage lenders;
- (2) require disclosure of data on the disposition of loan applications (in addition to data on loans originated and purchased); and
- (3) require disclosure of data on the race, sex, and income level of borrowers and applicants.

These amendments will provide new information about the characteristics of loan applicants which will enhance the ability of examiners to determine whether a lender's credit standards are being fairly applied. Also, the extension of the coverage of HMDA to include essentially all mortgage lenders will provide a

more complete context in which to judge a bank's mortgage lending efforts.

FIRREA amends the Community Reinvestment Act to provide that after July 1, 1990, the written evaluation of a depository institution's record of meeting the credit needs of its local community made by the institution's regulatory agency must be disclosed to the public. Public disclosure will increase the significance of the evaluation of the bank's performance with that Act because it will likely lead to increased dialogue between banks, examiners, and community groups.

The Board believes that the new enhancements to these two statutes will assist in developing a more complete and accurate picture of mortgage lending practices than is possible today, and that no additional legislation is necessary. There are, however, several additional initiatives under review by the Board's staff or subcommittees of the Federal Financial Institution Examination Council (FFIEC), which are referred to in the report.

In closing, I would like to emphasize the Board's commitment to vigorously enforcing the antidiscrimination laws for which it has responsibility. Home ownership is a important part of the American dream and we all want to assure that every American, regardless of race, is treated fairly if he or she pursues that goal. To this end, we think our enforcement program helps provide confidence that state member banks are providing mortgage credit on a nondiscriminatory basis.