For release on delivery
10:45am, EDT
September 24, 1993

Real Progress Without Unintended Consequences

Address by

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to

The Federal Reserve Bank of Cleveland's

Annual Community Reinvestment Forum

Columbus, Ohio

September 24, 1993

When President Clinton announced last summer that he wanted the financial regulatory agencies to work together to reduce the burden of and improve the results from the Community Reinvestment Act (CRA), he indicated to the nation's banks and consumers that CRA could undergo a sea change. The President wanted to focus on three types of community reinvestment activities -- lending to low and moderate income individuals, small businesses and farms; investment in low and moderate income neighborhoods; and the provision of banking services to low and moderate income neighborhoods. His stated desire was to create "...more objective, performance-based CRA assessment standards that minimize the compliance burden on financial institutions while stimulating improved CRA performance."

I applaud the President's timely and important initiative and am working with my fellow Board members and colleagues at the other agencies to fulfill the vision that President Clinton has articulated. However, I must insert one note of caution. No plan, however well created and executed, can take the place of prudent and consistent reason and judgement in the lending process. Fair lending is not initiated by governmental agencies but by individual lenders across the nation.

From its inception, the Community Reinvestment Act was deliberately vague. Congress wisely chose to avoid even the appearance of prescribing the allocation of credit. CRA, as legislatively defined, required financial institutions to demonstrate that their deposit facilities served the convenience and needs of their communities including the "continuing and affirmative obligation to help meet the credit needs of the local communities in which they are chartered". Regulators were required to "encourage such institutions to help meet the credit needs of the local communities in which they are chartered consistent with the safe and sound operation of such institutions".

In recent years, CRA has come under attack for its apparent failure to fully meet its stated objectives. This criticism is not without basis. Inner cities still suffer from disinvestment. Large sections of the population do not have ready access to a bank branch. Statistical studies indicate that racially based differences in mortgage approval rates do exist, even after taking economic variables into consideration.

When all is said and done however, the question still remains -- will more specific guidance by Congress and/or the regulators in fact generate the desired result -- equal access to credit for all creditworthy Americans? Before looking forward to see if we can answer that question, let us first look back to the early days of our nation for some possible guidance.

Although we may like to think otherwise, the CRA concept is not a new one. The proper role of banks in their communities has been a controversial subject since the start of our country. In Philadelphia, the Bank of North America was chartered in 1782 by some of our nation's leading citizens including Alexander Hamilton and Benjamin Franklin. The story of their experience is an illustrative one.

The Bank of North America focussed primarily on financing commerce through the thriving port of Philadelphia. Pennsylvania's farmers, who dominated the state legislature, felt that the bank was not lending enough to them. They succeeded in their drive to repeal the bank's existing charter and replace it with a much more restrictive one. This was truly a Phyrric victory. The bank's fortunes declined, as did banking services. The result was a prolonged slump in economic activity in Pennsylvania, a slump which also adversely impacted the farming community.

I think that there are some important lessons to be drawn from this early experience. First, political supervision of bank lending practices is nothing new, and may be an inevitable part of a democratic society. That may not comport well with the theoretical model of a completely free financial services industry, but then neither do other aspects of banking including federal deposit insurance and lending at the discount window. The supervision and regulation function certainly provides a public good, from which banks benefit, by providing a reassurance to depositors. For better or worse, political oversight of bank lending practices is an inevitable extension of these other aspects of government regulation of banking.

The second lesson of history is that moving in a purely political direction of banking, or heavy handed credit allocation, is not only bad for banking, it is harmful to society as a whole. This was of course the historical result in Philadelphia. In more recent times, the effects of misguided credit allocation were evident in the economies of Eastern Europe, a region whose patterns of development we all agree would be foolish to emulate.

Thus, CRA is part of a longstanding balance between the need for some political oversight of the lending process, and the problems which result if such oversight becomes excessive. However, we must bear in mind that because political oversight is at best a blunt instrument, striking an appropriate balance between constructive oversight and overburdening regulation has always been a difficult task. In recent years, that oversight has escalated as it increasingly appeared that discrimination has continued to permeate the lending process. The issue of mortgage discrimination burst to the forefront when CRA ratings and HMDA data were made public in the late 1980's. The heat was turned up again as recent events in our urban areas as well as a new activist Administration have further highlighted the dramatic need for investment in communities across the nation.

Discrimination tears at the fabric of our democratic society. It also tears at the fabric of our faith in capitalism and the market. One of the great advantages of the market is that it is supposed to be color blind. If that turns out not to be the case, then the foundations of our economic system as well as our political system are at risk. So discrimination is a fight that we as a society must win. It is for this reason that

I see fair lending issues as having the greatest potential for further legislative and regulatory activity -- activity which may have at its root the increasing use of statistics.

Statistics have played a major role in our consideration of the mortgage discrimination problem of late. Their role as an enforcement tool is just now beginning, and is likely to increase dramatically in the years ahead.

But as a long time micro empiricist, I am well aware that statistics can play only a supporting role in our quest. For understanding the limitations of statistical analysis may be key to solving the underlying problem and establishing truly equal credit opportunities for all Americans. While statistical analysis can highlight inequity, it cannot eliminate it. That must be done on an individual basis, on the front lines, at the level of the applicant and the loan officer.

However, the use of statistics can, and has, provided a baseline from which to start. Take for instance, the use of HMDA data. While community activists, bankers, regulators and legislators are all familiar with the limitations of the HMDA data, the HMDA data do indicate that there is a racially based problem in mortgage lending.

Having said that, two important qualifications are in order. First, it is widely acknowledged that the HMDA data exaggerate the extent to which approval rates differ for racial reasons. When economic factors other than income are incorporated into the analysis of HMDA data, the disparity between black and white approval rates is sharply reduced.

Second, the evidence of race-based differences in loan approvals is overwhelmingly of a statistical nature, based on racial averages. It is very hard to document by examining specific loan applications, such as during the bank examination process. Accepting this fact is difficult for those who seek simple, straight-forward explanations for the racial disparities. It's always easier when there's a smoking gun and an identifiable culprit.

Last fall, to clarify the HMDA data, the Federal Reserve Bank of Boston ran what is certainly the most comprehensive statistical analysis of lending patterns by race that has ever been conducted. That study found that what I would call "old style" discrimination did not exist. That is, clearly qualified applicants of any race were approved for loans and clearly unqualified applicants of any race were rejected. The days when members of minority groups who meet all of a bank's criteria for lending are rejected anyway, seem to be gone. I believe that is why bankers believe so strongly that they do not discriminate.

However, what the study also found was that a careful statistical comparison of applicants who were less than ideal indicated that imperfect white applicants were more likely to be approved than imperfect black applicants. Three types of explanations for this have been advanced. First, some have argued that the results are proof that racism still exists in our society and in the banking industry. From a statistical point of view, there is no way that this hypothesis can really be tested. It may be true. My own judgment is that while some racism may exist, it is probably not the dominant factor in bank decision making. The institutions in question all have stated policies against discriminatory practices, and the extent of discrimination found, which affects roughly 7 out of every 100 minority applicants, does not comport with racism as dominating the process. I say that with the understanding that <u>any</u> amount of discrimination is totally unacceptable.

The second hypothesis is that there is no racism in the process, that in fact the banks have gotten their lending practices about right. What is missing from the Boston study is a careful look at the long term default risks on these loans. It is true that the Boston study did not go into a detailed examination of the actual loan files to see if some other explanation for rejection existed. Where this has been done, some of the disparate rejection rate has been explained. But, ultimately this hypothesis, like the racism hypothesis, cannot be statistically tested. We cannot tell today what the ultimate outcome of the loans we make today will be. Nor will we ever be able to tell what the hypothetical performance of rejected loans would have been. So, like the first hypothesis, I accept that this one might well be the case, but that the evidence before me today does not support it.

The third hypothesis is that some racially disparate loan practices are occurring in spite of bank policies to the contrary. This hypothesis not only comports with the Boston findings, it also suggests that relatively minor adjustments in institutional behavior will be appropriate remedies. The Federal Reserve Bank of Boston has recently put out a pamphlet on these remedies called <u>Closing the Gap: A Guide to Equal Opportunity Lending</u> which I commend as important reading for all individuals in the financial services industry.

Let me also stress that as long as behavior exists which appears outrageous to reasonable individuals, the threat of legislative and/or regulatory action, with all of its attendant burdens remains likely. Banks have a responsibility not only to end the practice of discrimination, but end the appearance that discrimination is occurring as well. As long as large numbers of minority customers remain dissatisfied with the treatment they receive, greater regulation remains a likely prospect. Or, as President Jordan of the Federal Reserve Bank of Cleveland has argued, "This problem is not solved until everyone agrees it is solved."

The prospective regulatory burden which might result from not solving this problem is potentially enormous. Left unchecked, a total reliance on statistics in credit enforcement will ultimately lead to a complete replacement of bank judgment and reason regarding loan approval with statistical rules. I fear that in some instances, the use of statistics to establish discrimination may go too far. At the Federal Reserve we are using computer based statistical models as a part of our examination process. However, these models are only used to select particular loan applications to examine more closely. The statistical models in and of themselves will not, and should not, be used to determine whether discrimination exists. Instead, the computer will select individual matched pairs of actual applications to be examined. We believe that this will improve the efficiency of the examination process by reducing randomness in selecting applications to be examined.

The potential overuse and abuse of statistics in this area threatens the imposition of a burden in at least two ways. First, the use of statistical models as the sole criteria especially when the details of such models are unknown to the banks being examined, means that no bank can know what rules it actually has to comply with. It would be like replacing the speed limit on our nation's highways with some computer determined "Conditions Adjusted Velocity" formula in order to enforce traffic laws and not tell motorists what the Conditions Adjusted Velocity formula was. Laws can only work if people know what they have to do to obey them.

Second, the likely result of statistics based examination of loan approvals is statistics based approval of loans. This, in turn is likely to work against individuals who do not meet the "normal criterion" of a one-size-fits-all statistical rule. One need only look at the historic performance of the secondary market to see that minorities and other disadvantaged groups find themselves only further disadvantaged by such inflexible practices.

Statistics, however, are not only used by regulators. They also play a role in our nation's media. Statistical analysis when done well is an infinitely complicated and painstaking procedure. But when statistics are run on the evening news or in headlines across the country they are frequently reduced to the lowest possible common denominator. For example, in the Boston study's sample, roughly 7 out of every 100 minority applicants for a mortgage are rejected for reasons that cannot be explained by factors other than the individual's race or the racial composition of the neighborhood into which the applicant is buying. To the average editor or producer, 7 out of 100 may not be a sufficiently dramatic statistic -- it won't give legs to the story. So, the most widely reported number from the Boston Study indicated that a black applicant was 60 percent more likely to be turned down for a mortgage than a comparable white applicant. Both statistics are absolutely correct with respect to the study. However, the 60 percent statistic gives little indication to applicants of what their actual chances of acceptance are. As more than 70 percent of minority applications are approved, a 60 percent higher rate of rejection would seem to needlessly discourage potential applicants.

Another area where the media do not appropriately portray reality involves the economic status of African-Americans, and particularly the change in that status in the past decade. This is a very important subject to address because both banking in general, and mortgage lending in particular, are profit driven businesses. Lending will take place where there is money to be made, or more precisely, where it is perceived that there is money to be made. Unfortunately, there is a widespread myth, reinforced by the media, that the great majority of blacks live in poverty, and that little progress has been made recently in ending that situation.

The facts could not be more different. During the 1980s tremendous gains were made by the great majority of black families. Between 1981 and 1990, median black family income rose 12.3 percent after controlling for inflation. By contrast, the income for the median white family rose 9.2 percent. Black income growth particularly outpaced white income growth among those families most likely to be first time homebuyers. After controlling for family size, the top quintile of black families saw their real income rise 28 percent during the 1980s. The second quintile of black families enjoyed a 19 percent gain. The proportion of black families living in suburban counties rose by a third and the proportion of black families earning real incomes over $50,000 rose by 42 percent.

Not only that, but the situation is likely to get better in the next generation due to significant gains in black educational achievement. During the 1980s, the SAT scores of black children rose 23 points in math and 20 points on the verbal test, compared with essentially stagnant scores for white students. The black dropout rate from high school fell from 18 percent to

13 percent over the same period. These facts augur well for future black income gains.

So it cannot only be left to bankers to eliminate both the practice and the perception of discrimination. All parties involved in this volatile and emotional issue must practice in their professions what physicians, in taking the Hippocratic oath, practice in theirs -- above all do no harm. Above all, this means that any regulatory or legislative "fix" must be carefully and thoroughly considered. The potential for pernicious, albeit unintended, consequences is great.

In proposing the CRA review, President Clinton has rightly noted that it is performance not paperwork which indicates whether a financial institution is meeting the needs of its entire community. I agree with the Comptroller of the Currency, Eugene Ludwig, when he testified last summer that "... between a rigid system of numerical targets and the system we have today, there is considerable room for improvement". However, the devil is always in the details. We must be ever careful to not put into motion the law of unintended consequences. It is often well intentioned legislation or regulatory improvements which can exact a very high and unintended cost.

Consider for example, the legislation and organization which created the secondary mortgage market in this country. Fannie Mae has, by most accounts, been quite successful at its main mission: to provide liquidity to the mortgage market by creating easily traded mortgage backed financial instruments. But a price has been paid for such liquidity. Increasingly, banks have moved to standardized lending practices as they have seen their mortgage business evolve into that of a broker, rather than a conventional lender. It is no longer crucial that banks know their customer, but rather that their customers fit a predetermined profile. Credit evaluation is based increasingly on quantitative criteria, rather than qualitative judgments.

If you're a one-size-fits-all customer, you have probably benefitted greatly from this approach. If you are one of those people who is different from the norm, as I mentioned earlier, you may have been inadvertently left out. Let me say that Fannie Mae recognizes this problem and is striving to make sure its guidelines take a broader array of applicants into account.

Yet another example of unintended consequences arose last year when the Federal regulatory agencies, prompted by Congressional action in the FDIC Improvement Act, considered establishing maximum loan-to-value ratios for single family housing lending. I strongly opposed such a move because it would have further exacerbated the difficulty of obtaining a loan for individuals who do not meet the normal criteria. I was particularly concerned about the impact of this on mortgage lending to low and moderate income families who have limited funds to cover closing costs, let alone provide a major downpayment. In fact, the fewer such rules we have, the easier it will be for non-traditional borrowers, who are often members of minority groups, to obtain credit.

As I've travelled around the country I've seen numerous other examples of well intentioned government policies that are making access to housing more difficult, particularly for minority groups. For example, consider the cap on the size of loans eligible for FHA insurance. As a result of these limits, FHA loans are virtually unavailable in New York City, where the overwhelming majority of housing costs more than the limits allow. Nearly every coordinator for the Neighborhood Housing Services (a national housing and redevelopment organization) I have spoken with felt limited by the Davis-Bacon legislation which drives up the cost of housing construction and limits job opportunities for inner city residents. In city after city, rules regarding the taxes owed on vacant land or on abandoned buildings are inhibiting the development of low and moderate income housing and the development of communities.

Inner cities and other hard-to-value areas are also particularly starved for development funds in part because of appraisal requirements imposed by law. The whole appraisal area is, at best, an art not a science. This is particularly true in areas where communities are changing. Yet the Congress has mandated costly appraisal requirements which are retarding community development. We at the Fed exercised the maximum latitude the law allows us in setting a $100,000 threshold on formal appraisal requirements and are seeking comment on raising this threshold further to $250,000.

In addition to community redevelopment being constrained by the unintended consequences of many different pieces of legislation, we cannot overlook the dramatic changes that have been made in the nature of bank regulation and their effect on banks' available capital. By international agreement, our banks are now judged on the amount of capital they have relative to their outstanding loans. For a well capitalized institution this means that they must have at least 6 cents in so-called Tier One capital for every $1 in loans they make. The only way to increase loans is to increase capital. There are two ways to increase capital: after-tax profits, which increase capital dollar for dollar, and new stock offerings. These new stock offerings, in turn, depend upon bank profitability. Every dollar in unnecessary costs imposed on banks means $16 less in loans that the bank is able to make.

Of course, this does not mean that we must do everything possible to maximize bank profits. Far from it. Regulation to protect consumers and depositors and to enforce existing regulation is essential. But our regulation must be cost effective. Excessive regulation, by diminishing bank capital, and therefore by a multiplier effect, the amount of funds that banks can lend, could end up hurting the intended beneficiary of the regulation. We must be committed to making regulation as cost effective as possible.

Let me revist my initial question. Will more specific guidance by Congress and/or the regulators in fact generate the desired result -- equal access to credit for all creditworthy

Americans? Perhaps. But certainly not without a price. National solutions to local problems generally cost more in time, resources and money than local solutions to local problems. But the divisive problem of discrimination cannot be left to idle. As a nation, we cannot move forward if the specter of racism is not removed -- at any price.