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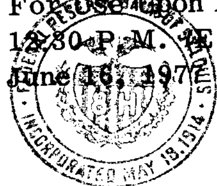

Remarks of

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BOARD OF GOVERNORS

FEDERAL RESERVE SYSTEM

to the

American Bar Association National Institute on "Consumer Credit"

New York, New York

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IN DEFENSE OF DISCRIMINATION

Most of you who practice law probably share my interest in how our language subtly but distinctly changes the meaning of words in common usage. While I am not enough of an English scholar to know whether this trend is accelerating in its velocity, it seems to me that words are changing meaning faster. I now hear words on television and in other public media which recently were reserved for barracks room conversation.

There are many examples of this change. The word "drugs", for instance. As you and I grew up, we thought of "drugs" as having a life giving connotation. The availability of life sustaining drugs produced a very positive mental image when you used that word. Unfortunately, today it now has the opposite effect and usually denotes a very negative mental image of someone whose life is shortened by their use.

"Economy" is another example. In soap boxes it means large; in automobiles it now means small.

But the word I want to talk about today is "discriminate." My 1975 edition of the Webster's New Collegiate Dictionary shows the evolution of this word. Its derivation is clearly from the Latin _discriminatus_ which means to distinguish between. In its transitive sense the verb is defined

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as "to distinguish or differentiate by discerning or exposing differences." In its intransitive sense one meaning says "to make a distinction", another says "to use good judgment." But the most modern definition is "to make a difference in treatment or favor on a basis other than individual merit."

Most of you as members of the Bar are more familiar with this latter definition. One of the subjects of this Conference is the Equal Credit Opportunity Act which prohibits discrimination against any applicant on the bases of sex, marital status, race, religion, age, national origin and so forth. Now that this broadened Act has become effective, creditors are turning to many of you for interpretation in order to assure that they are complying with the true meaning of the statute. Many of you are reminding your clients that the Act does not prohibit the showing of a difference, but only the showing of a difference that is hostile or adverse to the applicant as a result of considerations based on the prohibited bases.

The passage and implementation of this statute have brought into sharper public focus the question of determining who is creditworthy and the considerations used by creditors in making that determination. This public interest by our consumer oriented society springs from our widespread dependence upon consumer credit. The very efficient distribution system which we enjoy does not allow a great deal of margin for errors in credit judgment, since increased losses and collection costs would drive up the cost of the distribution of goods and services throughout our land.

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We sometimes get the mistaken idea that someone is either creditworthy or not. This is too often equated with some legal or social right. All of us need to be reminded that creditworthiness is a concept which exists only in the value system of a specific creditor for a specific transaction. It must exist also in qualitative and quantitative terms. Even to an individual creditor a conclusion of creditworthiness is only a present estimate of a future probability. When determining that an applicant is creditworthy, a creditor decides that the probabilities that the debt will be repaid are sufficiently high so that the creditor is willing to assume that risk of nonpayment.

With these considerations in mind it is obvious that creditworthiness must be a function of the creditor's risk premium charges as well as the characteristics of the applicant. The determination is related also to the period of time over which the risk is assumed as well as to the potential net profit of the creditor.

When we limit by law a creditor's legal capacity to judge creditworthiness we are tampering with a major component of our economic system. I believe the Congress in framing the Equal Credit Opportunity Act tried to walk the fine line between arbitrary, capricious and irrational considerations of creditworthiness on one hand and a wide latitude for creditors to make individual credit judgments on the other. The statute is generally successful in making this fine distinction.

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Unfortunately, however, the application of the so-called "effects test" may confuse this fine distinction and throw the applicability of the statute into doubt. A special study of credit scoring systems which are based on mathematically predicted variables has been made by Professor Chandler at Georgia State University. He determined that of the 42 most commonly used predictive variables there was not a single one that did not result in the showing of a distinction related to one of the prohibited bases. Coupled with the knowledge that increasingly plaintiffs are using purely statistical devices as indirect proof of a discriminatory pattern or practice, this fact is causing many of your creditor clients discomfort. The possible consequences of applying the effects test in the area of credit discrimination led the Board of Governors to treat the effects test so circumspectly in our regulations.

The Equal Credit Opportunity Act is not the only legislative area in which our society has attempted to prohibit the showing of a distinction in the extention of credit. The oldest of these is an area in which many of you have had a considerable amount of experience, our state "usury" laws. I have always rebelled at this terminology for these laws. Unfortunately, too many people have read the Bible and noticed that usury has a religious as well as a legal connotation. However, I don't think that most of the laws labeled "usury" really pertain to the biblical subject. My own interpretation of the biblical admonition was to prohibit the act of the unscrupulous against

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the defenseless. Most of these laws are not designed for this purpose, but are only price control legislation.

Like every other attempt to governmentally control prices, these laws have seldom worked unless the ceiling is placed at a level high enough to enable most transactions to take place. Those borrowers who would usually pay higher interest rates due to greater risks or other costs are often those discriminated against because the price ceiling is below that necessary to attract funds for their use.

Money is highly fungible and transportable. Yet its cost to the public is politically sensitive. This situation has created a hodgepodge of pricing devices. Practices and developments such as discounts, add on interest, extra fees, closing costs and similar devices are largely the result of political compromises to devise ways to get around an unrealistic price control limitation.

It might also be argued that many of these devices were invented by lenders as a means to confuse or deceive the public from the true cost of the use of credit. Fortunately, the Federal Truth in Lending statute now makes such deceptions ineffective. No one would argue that the truth in lending concept of measuring the cost of credit is an absolutely pure one. Yet our national effort toward encouraging a better knowledge by the borrower of the relative costs of credit is an improvement compared with the alternatives.

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The truth in lending concept could be a basis for a fundamental change in state "usury" attitudes and the laws which result therefrom. If creditors are required to disclose the cost of credit on a reasonably comparable basis, isn't it time that the states stopped these artificial practices which encourage deception? They would then focus on better ways for the defenseless to be protected against the unscrupulous. A few states now restrict lenders' conduct which has been decided to be unfair or deceptive for reasons not related to the price of the credit.

A third type of credit distinction or discrimination is now receiving a great deal of public attention. This is the concept of geographical discrimination, commonly known as redlining. While many are speaking out against it in various ways, there is not a commonly accepted definition as yet. It is not clear whether the concept applies only to housing credit or applies equally to all forms of credit. One early use of the term was in the writing of auto insurance.

Some of redlining's strongest critics view the practice as being fundamentally racially based. If this is true, there is no need for additional legislation. As you and I already know, racial discrimination is clearly covered under the present Equal Credit Opportunity Act. That Act very explicitly prohibits any hostile differentiation based not only on the race of a specific applicant but on considerations of race in general -- whether they are of the neighborhood or the other tenants in the property.

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To many people redlining is the refusal of financial institutions to consider real estate investments in a specific geographic area. This practice is likely to be grounded in two past conditions. First, we have gone through a long period of relative unattractiveness of housing credit investments. We have had a mortgage money shortage. This shortage in turn has its roots in our public policy to build a wall around housing credit -- not requiring that housing credit compete with other forms of investment. This practice has produced short-term swings of feast and famine in housing credit, thus discouraging many lenders from participating in housing credit programs -- even when these yields are attractive.

The other basis of geographical exclusion is the result of typical herd instinct reaction to losses by some lenders. We have to recognize that there have been some losses in many urban areas, particularly in the blighted central city neighborhoods. The results were that lenders began blindly to run. They did not adjust their programs to meet the new risk and rewards balance. Furthermore, many Federal or local governmental subsidized credit programs created new risks and supplanted the private market which had existed in many of these neighborhoods.

As we work toward solutions to the problem of geographical differentiation, we need to bear in mind several objectives. We should stop our attempts to substitute governmental procrustean formulae for the total result of many individual risk and reward analyses. We must preserve the right to discriminate - to show a difference.

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At the same time, we can and should provide the information necessary for objective, factual analysis. For example, local governments could produce maps showing those older areas which have not suffered abandonment or vandalism and in which the local government is pledged to continue providing full municipal services. A charting of foreclosures by location, amount and type of loan would help lenders estimate the probabilities of future market price stability.

And we must develop ways to reduce or spread risk so that the rewards look proportionately higher. Our best results of channeling resources through the years have been based on providing incentives for private decisions to, yes, discriminate in favor of the desired purpose. These incentives for private action can be in the form of better information about the relative rewards and risks or they may be in the form of direct subsidies to the users of such credit which will thus enable them to offer higher rewards to creditors.

The best incentive for private action is probably the most difficult to achieve. Private initiative often works hardest when government intervenes least. Therefore, if we can resist the temptation to demand that government "do everything," it is more likely that the private sector will become active. The past record on this type of approach has been poor, for seldom have we given it a real chance to work. Impatient to get quick results, mistakenly thinking that government action only costs the other fellow, we continue to

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demand more and more intervention. Yet it is a rare case when passing a law and throwing money at it cures any problem.

Our economic system has been constructed on the concept of private ownership of property and on economic freedom of choice in the use of that property. The aggregate free choices, and differentiation of our people have been the means by which our resources are allocated and our potential developed. Let us never lose sight that this capacity to discriminate -- in the nonsocial meaning of that word -- has been one of the means by which this country has become great.

True, there are times when any society must deny the freedom of individual action in order to protect, preserve or benefit the group as a whole. But we must be vigilant to assure that any abridgement of individual choice, any denial of the right to discriminate, takes place only when the total benefits to society derived therefrom clearly outweigh this loss of freedom.

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