The Federal Reserve Board

Remarks by Governor Mark W. Olson

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Revisiting Traditional Paths to Ownership

I'm pleased to be here today to discuss the benefits and challenges of the ownership society. Meetings such as this policy summit are extremely useful forums for exchanging ideas and working toward common goals. And, the goals of those of us involved in community development have not changed over the years. We all want to create healthy, sustainable local economies that provide good jobs, decent housing, and educational opportunities for everyone. At the core of all community development activity is the understanding that individual ownership is one of the most important components of economic and social success, whether in the form of the purchase of a home or an investment in education or a small business.

Immigrants instinctively understand that America is an ownership society and, in fact, come here in search of the ownership opportunities that increase the well-being of family members both here and at home. Immigrant communities often create their own economies, establishing the relationships necessary to support one another in finding work, starting small businesses, pursuing education, and purchasing homes. This model has worked for generations of newcomers to the United States. It exemplifies how each group finds its own formula for success based on its skills, culture, and community norms.

For many years, community development efforts were stymied by federal policies that provided one-size-fits-all programs--most of which focused on housing--to communities with very different needs. Over the last thirty years we have learned from our missteps. We now understand that effective community development involves a comprehensive approach focused not only on providing housing, but also on creating programs that increase residents' capacities to make economic contributions to the community. Such programs would support entrepreneurs, provide job training, and facilitate services such as transportation and child care. Federal policies are now designed to recognize the importance of local participation in formulating neighborhood development strategies. Successful strategies take into account the unique attributes of each neighborhood, including the skills of its labor force, existing businesses, economic synergies, and the culture and norms of the community.

As federal policy has evolved, its role has shifted from being the sole source of funding through direct appropriation to providing tax incentives and credit enhancements that encourage private investment by offsetting risk. The federal government also plays an important role in creating incentives for private investment, encouraging innovation, and protecting consumers. Federal policy, when properly implemented, can smooth the path to ownership by ensuring that markets operate efficiently.

In my remarks, I will discuss two of the most traditional and reliable paths to ownership in our society: homeownership and entrepreneurial pursuits. I will offer my views on why each is critical to the establishment of an ownership society and how changes in federal regulation and policy over time have kept these paths to ownership open to minorities and lower-income individuals.

Homeownership

Owning a home is one of the most tried-and-true paths to wealth accumulation in our economy. The purchase of a home can be a transforming experience for individuals and families. However, it takes more than a down payment to put people on the path that leads to ownership. Borrowers must be able to sustain their loans over the long term.

Part of sustaining a loan is picking the right loan. Over the past several years, there has been an explosion of new and novel mortgage products, including mortgages that allow homeowners to skip mortgage payments (which results in increasing the size of their mortgage balance) and mortgages that allow homeowners to pay only the interest on a loan, and not the principal, for a preset period at the beginning of the life of their mortgage loan. Many of these products can be useful financial tools for homebuyers and, indeed, may have helped make homeownership more accessible for some households. But to the extent that these new mortgage products promote homebuying decisions that are premised on unrealistic rates of home appreciation, they raise concerns. Some borrowers may not be able to sustain such a loan over a long time horizon if the pace of home price growth moderates. In particular, when the payments on these novel mortgages adjust upward, the homebuyer may not be able to refinance such mortgages unless the home has increased in value. Homebuyers need to understand these risks and thus financial education, as well as a down payment, is a key ingredient for creating solid footing on the path to homeownership.

Federal tax policy has long promoted homeownership by offering homeowners the mortgage interest deduction. Studies have shown that the benefits of homeownership are worth the investment. Homeowners are stakeholders in their communities. They become involved citizens and create the quality of life and character that define a neighborhood.[1] Because of these benefits, federal policy in recent years has focused on increasing the homeownership rate among segments of society, such as minorities and low-income individuals, where homeownership had previously been low. In the late 1970s, Congress passed two laws that, together, changed market dynamics for home mortgage lenders and expanded access to home loans for minorities and lower-income individuals. These laws, the Home Mortgage Disclosure Act (HMDA) and the Community Reinvestment Act (CRA) have increased access to homeownership by making the mortgage market more transparent.

Congress enacted HMDA under two assumptions. One was that the mortgage market works more efficiently when more information about it is publicly available. Indeed, the data have been used to identify credit demand in underserved areas with unmet credit needs that might otherwise have been overlooked. The analysis and conclusions drawn from the data have also encouraged the establishment of partnerships between lenders and community organizations to meet credit needs.

The second, perhaps more familiar assumption upon which HMDA is based is that regulators need data in order to improve compliance and enforcement of fair lending and consumer protection laws. Accordingly, HMDA data are the first reference points for fair lending examinations conducted by the Federal Reserve and other banking regulators. The data help identify potential fair lending issues in the institutions regulated by the Federal Reserve and other supervisory agencies.

The recent amendments of Regulation C, HMDA's implementing regulation, build on the theme that transparency breeds efficiency in markets. The amendments require public disclosure of price information in the form of spreads between the annual percentage rate on a loan and the rate on Treasury securities of comparable maturity. This rule is designed to ensure that the data continues to provide a means for improving market efficiency, as well as for monitoring legal compliance with fair lending laws. The new data offer the public and the supervisory agencies charged with enforcing the fair lending laws a better screening tool than what was previously available. Thus, examination resources can be deployed more strategically because the data will allow the agencies to determine, in advance, which lenders and loan products may require more scrutiny. But, more important, the new data will ensure that as the marketplace develops and changes, interested parties will have the information needed to ensure comprehensive fair lending reviews.

In addition to statutes that require the collection of public data on mortgage lending, Congress has seen fit to promote market efficiency by enacting a statute, the CRA, that requires federal regulators to evaluate how depository institutions help meet the credit needs of their communities. The statute was amended in 1989 to require that those evaluations be made public. The public evaluations of CRA performance, together with the fact that the performance evaluations are considered by regulators in connection with a bank or thrift's application to merge or acquire another institution, have provided incentives for depository institutions to lend in all parts of the neighborhoods they serve, including low- and moderate-income areas.

The CRA regulations were amended in 1995 to make the evaluation standards more performance-oriented while still taking into account the diversity of business strategies among depository institutions and the variety of economic and demographic characteristics of neighborhoods. As a result, four different evaluation methods were established, and each method considers the context in which the institution operates. In other words, no matter what type of evaluation an institution receives--a streamlined examination for small institutions; a lending, investment, and service test for large institutions; a community development test for wholesale or limited-purpose institutions; or a strategic plan--the characteristics of the institution and the neighborhoods it serves are considered in assigning a performance rating.

When CRA rules were revised in 1995, the agencies committed to reviewing them again in 2002 to ensure their continued effectiveness. The review process has taken much longer than anticipated, but some progress has been made. The Federal Reserve, together with the Office of the Comptroller of the Currency and the Federal Deposit Insurance Corporation, is currently reviewing comments on our joint proposal to amend the CRA regulations. These amendments would eliminate data-reporting burdens for institutions under $1 billion in assets, provide for a new evaluation method for institutions between $250 million and $1 billion in assets, and more effectively define community development in rural areas.

In proposing these changes to the CRA, the agencies were attempting to balance the compliance burdens being placed on small community banks against community development needs in the geographic areas they serve. The proposal was designed to relieve data-collection burdens on the smaller, large banks while retaining incentives for these institutions to participate in community development activities. The proposed community development test was intended to promote substance over form and give smaller institutions recognition for activities that meet community development needs without dictating whether the activity should be in the form of a loan, an investment, or a service. This flexibility was intended to help institutions in this size category that do not have the resources to engage in a wide range of investment activities, compete more fairly with larger financial institutions.

The proposal also attempts to resolve a persistent problem for banks that operate in rural areas where census tracts tend to be middle-income but may contain distinct pockets of lower-income individuals. Although financial institutions receive credit under the CRA for activities that primarily serve low- and moderate-income individuals or geographies, the homogeneous nature of rural census tracts makes crediting such activities difficult. In fact, only 15 percent of rural census tracts are classified as low- or moderate-income tracts, and almost 60 percent of rural counties do not have a single low- or moderate-income tract. The proposal suggested several alternatives for defining what constitutes an underserved rural area and the agencies are still reviewing comments and working to determine which of these alternatives would best define the types of community development activity that should earn CRA credit.

Anyone who has been involved in community development recognizes the importance of both HMDA and the CRA. These laws were designed to make the mortgage market more transparent, and they have largely succeeded. Since their enactment, lenders have found lines of business that had not been previously tapped. New partnerships have been established between lenders and community organizations to meet the credit needs that have been identified through the use of HMDA data. In general, the story has been positive for communities and lenders alike. Still, challenges remain.

At the same time that regulatory policy encouraged lenders to serve previously underserved individuals, technological advances in the loan-underwriting process allowed lenders to price for risk more efficiently, expanding access to mortgage credit. This expansion has occurred largely in the subprime market and has had both positive and negative effects.

Today, data show record high homeownership rates among low-income and minority borrowers, yet the reports of lending abuses and increased foreclosure rates loom as dark clouds on an otherwise bright horizon. Even though subprime mortgage delinquencies generally are falling, default and foreclosures associated with such mortgages may have adversely affected some neighborhoods. Thus, while it is encouraging that technology has increased the efficiency of the mortgage market, the small yet significant segment of the market in which problems persist cannot be ignored. Foreclosure rates in some areas have increased dramatically since the early 1990s--the same time frame in which the subprime market experienced its most rapid growth. As we all know, foreclosures do not affect just the borrower who loses his home; they affect the entire community. Multiple foreclosures in one neighborhood will bring down the property value for all homeowners in the neighborhood. In addition, foreclosures cause other negative consequences that will eventually affect even qualified borrowers approved for good loans from responsible lenders. This phenomenon threatens the continued viability of homeownership as a path to the ownership society we seek to establish for lower-income individuals.

As a regulator, I believe it is important that we tread lightly in response to market inefficiencies. Predatory lending is a serious problem that needs to be addressed in a way that preserves incentives for responsible subprime lenders so that worthy borrowers with imperfect credit can become homeowners. Constricting the market by pinpointing what might be considered predatory lending and returning to a situation where some borrowers have very limited access to credit is not an ideal solution. We want to encourage, not limit, mortgage lending by responsible lenders in low- and moderate-income markets.

In an effort to provide the proper incentives while still protecting consumers in the high- cost mortgage market, in 1994 Congress enacted the Home Owners Equity Protection Act (HOEPA). HOEPA helps curb predatory lending by requiring disclosures and limitations on loan terms for home mortgage loans with rates or fees above a certain percentage or amount. After a series of hearings, the Board in 2002 extended the scope of the HOEPA regulations. By not making high-cost loans illegal, but rather mandating special consumer protections for such loans, the market can continue to meet the credit needs of higher-risk borrowers.

Periodic reviews of regulations such as HOEPA, HMDA, and the CRA are essential to maintain a regulatory framework that is relevant to a dynamic marketplace. I believe that the changes to the HOEPA thresholds, together with the new HMDA pricing data and CRA adjustments--whatever their final form--will continue to provide depository institutions with the incentive to serve their markets as fully as possible and build opportunities for homeownership.

Entrepreneurship

Federal policy has evolved not only in the area of housing, but also in the area of economic development. I was struck by the remarks of Congresswoman Stephanie Tubbs-Jones at the Small Business Development Conference sponsored by the Federal Reserve Bank of Cleveland in May 2002. She described her mission in Congress as creating jobs. Having worked on Capital Hill for many years, I can tell you that this outlook was not common among elected officials thirty years ago. The understanding that sustainable communities are as dependent on the creation of good jobs as they are on the availability of decent, affordable housing is, I believe, a relatively new construct in our political discourse.

Economic development is now commonly understood to be an essential component of successful community development strategies. As the role of large industrial and manufacturing firms in the overall economy declines, small businesses have become critical to creating jobs and economic growth. In fact, the Small Business Administration reports that small businesses employ half of all private-sector employees and, more importantly, have generated 60 to 80 percent of new jobs annually over the last decade. In Ohio, small business proprietors' income in 2003 increased by just over 10 percent, from $22.3 billion in 2002 to $24.5 billion in 2003. With numbers like these, it is easy to understand how economic development and small business growth also open the doors to the ownership society.

Good jobs with decent wages and benefits provide the basis upon which individuals can begin to save and invest. An essential building block of all economic development is investment, and when private investment does not provide enough capital to stimulate economic growth in a community, public/private partnerships become necessary. Federal policies also help set the stage for lasting economic development by establishing a fair and transparent regulatory system. Federal, state, and local governments promote economic development by providing access to capital and offering various financing options for new and emerging businesses. In addition, financial institutions and community-based organizations provide capital to firms that qualify for their programs.

Federal, state, and local governments also provide valuable technical assistance to small businesses. Providers of advisory services offer business owners a wide array of programs, including business plan development, market strategy design, and management strategies for growth. At the federal level, the SBA cosponsors Small Business Development Centers and offers several other programs that provide valuable resources for small businesses as they develop and grow. The SBA reports that last year 2.44 million entrepreneurs received business counseling and technical assistance through one or more of the agency's advisory training programs.

The Department of Commerce's Minority Business Development Agency (MBDA) is another example of a federal initiative supporting economic development. It was created specifically to foster the establishment and growth of minority businesses by providing funding for a network of business development and resource centers throughout the country that provide minority entrepreneurs with one-on-one assistance. MBDA recognizes that the minority-owned business sector presents a huge growth opportunity, as the minority population is expected to grow from 30 percent of the current population to more than 50 percent by the year 2050. Nonetheless, MBDA recognizes that while minorities account for 30 percent of the population, minority firms constitute only 15 percent of all businesses and employ only 4 percent of the nation's employees, generating 3 percent of U.S. business revenues. These numbers reflect the fact that minority-owned businesses tend to be in non-asset-based industries, such as service, construction, finance, real estate, and insurance. MBDA believes that minorities continue to face systemic barriers to accessing the capital markets, and the agency is dedicated to removing these impediments.

The Federal Reserve also recognizes the importance of information sharing and creating infrastructures that support information flow. Consistent with its mission of promoting economic growth, the Federal Reserve promotes small-business development, particularly in underserved markets, through its Community Affairs Offices. These offices, located in Federal Reserve Districts around the country, provide technical assistance, host workshops and conferences, publish newsletters and reports, and sponsor research to help educate market participants. For example, last fall the Community Affairs Office here at the Federal Reserve Bank of Cleveland partnered with the Federal Reserve Bank of New York, state and local government, and financial institutions to convene a conference titled "Big Ideas for Small Businesses." Conferences in Ohio and Pennsylvania provided important information on establishing and developing businesses as well as demystifying the lending experience for entrepreneurs.

All of these efforts on the part of government agencies--whether federal, state, or local--have the goal of stimulating a self-sustaining process of economic development that will create good jobs and lead to upward mobility. Most successful entrepreneurs see opportunity in the context of their own skills and a particular need in their community or market with which they identify. The exact recipe for success in any one place will not be determined by a government agency, but by the community itself, with the government acting as a supportive partner.

Conclusion

In closing, I believe the progress that has been made by policymakers in the field of community development over the last thirty years has been remarkable. Community development practitioners have always understood the value of ownership in building sustainable communities; however, public policy designed with flexibility and nuance better achieves the goals of homeownership and small-business ownership. Community development strategies that plant a seed from the community and grow with the help of government and private-sector providers of capital promise to be even more successful over the long term. I look forward to hearing the ideas and suggestions that come out of this conference as we continue to refine policies to meet the challenges ahead.

Footnotes

1. See William M. Rohe, Shannon Van Zandt, and George McCarthy (2001), *The Social Benefits and Costs of Homeownership: A Critical Assessment of the Research,(170 KB PDF)* (Cambridge: Joint Center for Housing Studies of Harvard University). Return to text