For release on delivery
10:00 a.m., EST
February 24, 1993

Statement by

John P. LaWare

Chairman

Federal Financial Institutions Examination Council

and

Member

Board of Governors of the Federal Reserve System

before the

Committee on Banking, Housing, and Urban Affairs

United States Senate

February 24, 1993

I appreciate the opportunity to speak today to this Committee about concerns related to credit discrimination in mortgage lending.

This hearing is very timely given the troubling questions that have been raised about the fairness of the mortgage lending process. Parity in how applications are considered, without regard to race, sex or other prohibited bases, is absolutely essential in our country. Let no one have any misunderstanding on the point. Racial discrimination, no matter how subtle and whether intended or not, cannot be tolerated. Simply stated, excluding any segment of our society from fundamental economic opportunities, such as home ownership and equal access to credit, is morally repugnant and illegal. Moreover, it robs the lending industry and our economy of growth potential. I can assure you that the Board is committed to vigorously enforcing fair lending laws.

As chairman of the Federal Financial Institution Examination Council (FFIEC), you asked that my testimony focus on current efforts to enforce fair lending laws and the steps being taken to strengthen them by the member agencies. I am pleased to do so. However, as my recent letter to Chairman Riegle indicated, I will be unable to answer detailed questions about the fair lending enforcement programs of the other federal banking agencies. Each of the other FFIEC agencies (OCC, OTS, NCUA and FDIC) is represented here today and they will respond to any questions you may have about their specific programs.

Before I move on to a discussion of the efforts of the FFIEC, let me give you a sense of some of the actions the Board has undertaken. First, in consultation with the other FFIEC agencies, we have implemented a system which increases our ability to analyze HMDA data for use in our fair lending and CRA enforcement efforts. Second, we are working with the Justice Department to target certain state member banks for fair lending examinations where HMDA data suggest disparate treatment of minority mortgage loan applicants. Third, we have referred a number of consumer complaints alleging violations of the Fair Housing Act to HUD and recently referred a matter to the Department of Justice. Fourth, we have taken formal enforcement actions, including assessment of civil money penalties, to enforce compliance with consumer protection laws, including the prohibitions against credit discrimination based on marital status, age and race found in the fair lending laws. Fifth, the Board has denied three applications in the last two years from financial institutions primarily because of poor CRA performance. In each case, there was significant evidence in the record that these banks were not adequately serving the credit needs of their communities. These actions demonstrate, I believe, the strong commitment the Federal Reserve has made to enforce fair lending laws.

Recent Developments

Some recent developments have changed the nature of the discussion regarding the issue of credit discrimination. The debate has moved from a discussion about whether unequal treatment is occurring, to how to strengthen enforcement of fair lending laws. One of these developments was a study completed by the Boston Reserve Bank. Another event was a settlement between the Justice Department and an Atlanta savings and loan association resulting from a fair lending investigation by the Department. In each of these cases, evidence was found of disparate treatment in mortgage lending between minorities and whites. This has increased our understanding of this complex issue and will provide a basis from which the Federal Reserve and other agencies can better focus our efforts to strengthen the enforcement of fair lending laws.

Boston Study - As I mentioned, the Boston study furthered our understanding of issues related to credit discrimination, and I would like to share with you some of its findings. During 1992, the Boston Reserve Bank undertook a detailed study of mortgage lending in the Boston metropolitan area, in cooperation with the other federal financial supervisory agencies and the Department of Housing and Urban Development (HUD). The study was initiated in response to the large differences in rates of home loan denials among white, black, and Hispanic applicants in Boston as revealed by the 1990 HMDA data: a ratio of nearly three rejections for black and Hispanic to one for white applicants. The study sought to analyze whether disparities in mortgage loan denial rates among surveyed lenders reflected the equal application of legitimate credit standards or whether race was a factor in the decisions.

Because income is the only financial attribute of loan applicants collected under HMDA, the Reserve Bank augmented the HMDA data with thirty-eight additional items of information pertaining to financial characteristics, employment experience, and credit history--data that the lenders participating in the study voluntarily provided from their files. The study revealed substantial differences in the financial and other economic circumstances of typical white applicants and those of minority applicants. Statistical analysis also revealed, however, that even after controlling for significant economic factors, unexplained differences remained in loan approval rates for blacks, Hispanics, and white applicants. Specifically, the study revealed that minority applicants with the same credit characteristics as white applicants would experience a 17 percent denial rate compared to an 11 percent denial rate for white applicants.

Significantly, racial background generally was not found to be a factor in the case of clearly qualified or clearly unqualified applicants, whatever their race. Disparities were evident, however, among applicants with some imperfections, such as a relatively high debt-to-income ratio or weaknesses in credit history. For such applicants, national origin or ethnic background appeared to be a consideration. The authors of the study suggest differences in treatment may reflect differences in the level of assistance applicants received from loan officers to address those deficiencies, although no specific evidence from the Boston study is available on this point. The degree to which the findings reflect outright discrimination by individual loan officers and financial institutions in the market is unclear. The reason for this lack of clarity is that this was a study of the lenders in the Boston market in general and did not include a review of individual lenders to assess whether any specific individuals were treated differently because of their race. The findings do confirm, however, that greater attention is needed to ensure the fairness of the mortgage granting process.

Efforts by FFIEC to Strengthen Fair Lending Enforcement

While the FFIEC agencies have separate programs through which they enforce fair lending laws, I know that all of us take our enforcement responsibility very seriously. We have been working hard to ensure that our efforts are responsive to the concerns expressed by the Congress and others. In this regard, the FFIEC has undertaken a number of initiatives to strengthen its member agencies' enforcement of fair lending laws.

Boston study follow-up - Following the release of the Boston study results in October, the member agencies of the FFIEC issued a joint statement that addressed the issue of disparate treatment. In it, we attempted to shift the focus from a debate about whether unequal treatment is occurring to an emphasis on initiatives that will ensure it does not. The interagency statement reiterated the agencies' concerns about fair treatment of applicants for mortgage loans. The statement pointed to increased empirical data suggesting that differences in denial rates may be unsupported by economic factors. The agencies also encouraged financial institutions to intensify their fair lending education programs for management, lending personnel and consumers. We encouraged efforts to identify and promote examples of successful techniques used by institutions to ensure equal treatment of loan applicants, such as self-testing and second reviews of minority applications.

In addition, each of the agencies has underway investigations of those financial institutions that took part in the Boston study where evidence of disparate treatment was present. These investigations include review of loan files and other relevant documents to discover if any individual applicants were treated less favorably due to race. As I previously indicated, the Board did refer the name of one institution to the Department of Justice where the data from the Boston study raised concerns about that mortgage company's compliance with fair lending laws.

HMDA Analysis - Like the HMDA data for 1990, the data for 1991 indicate that greater proportions of black and Hispanic loan applicants are turned down for credit than are Asians or whites. Income levels account for some of the variation in loan disposition rates among racial groups. However, even after controlling for income, white applicants for conventional home loans in all income groupings had lower rates of denial than black and Hispanic applicants. There are, of course, many factors other than income that are relevant to a credit decision. And it would be erroneous to conclude that the HMDA disparities themselves necessarily all reflect discriminatory practices. Nevertheless, some of them may be due to the unequal application of lending criteria, and the data as a whole are obviously troubling.

Analyzing the disturbing disparities revealed by HMDA data for use in our fair lending and CRA enforcement efforts has become a high priority for the FFIEC. In this regard, I am pleased to report that the FFIEC has made significant progress in the manner in which HMDA data are both utilized and the ways in which this data are analyzed. Prior to 1989, HMDA data revealed information only about the geographic distribution of residential lending by covered institutions. Statutory amendments to HMDA, enacted in 1989, expanded disclosures to include the disposition of applications--approved, denied, withdrawn, or files closed for incompleteness--and the race, or national original, income and sex of all applicants, whether approved or denied. The amendments also expanded coverage to independent mortgage companies, that is, those that are not subsidiaries of depository institutions or holding companies.

The HMDA data enable the agencies to select specific loan files to review during onsite examinations, and also to target specific lenders for more extensive fair lending and CRA investigations. Several of the supervisory agencies, as well as the Department of Justice, are using the new HMDA data to identify institutions to review, based either on the large disparities in denial rates among different racial groups or the low number of applications from minority households compared to the racial composition in the community.

Over the past two years, the Federal Reserve, in consultation with the FFIEC agencies, has developed and implemented a computer-based HMDA data analysis system. The system, which uses both HMDA data and demographic information, is extremely versatile, and allows the new data to be examined and analyzed in a variety of ways. It provides a series of set reports (in addition to the standard HMDA tables) as well as the capability of querying the database for more tailored information about an institution's lending activity. The FFIEC is also working to develop a set of standard paper-based reports for examiners to use without electronically accessing the data base.

The FFIEC has also worked to ensure that the HMDA data is as accurate as possible. In this regard, the FFIEC issued a revised version of "A Guide to HMDA Reporting, Getting it Right," to assist institutions compile and report their data. The guide discusses the law's requirements, coverage, and management responsibilities; it also sets forth detailed directions for gathering data, plus step-by-step instructions for completing the reporting form. We have also provided, free of charge, computer software that may be used for reporting HMDA data which will help screen out inaccuracies before the data are submitted. In addition, the FFIEC has developed a process which assists reporting institutions in identifying and correcting errors.

The FFIEC agencies continue to pursue discussions with the Department of Justice, HUD, and the Federal Trade Commission to strengthen enforcement of civil rights laws. In particular, the banking agencies also are exploring ways to work with the Department of Justice in detecting possible patterns of discrimination against minority applicants. One example of coordination involves targeted examinations of financial organizations with mortgage lending records that raise concerns. Justice Department staff may, in some instances, participate in these reviews by going into the financial institution with our examiners.

The FFIEC has also been working to increase coordination with HUD. This reflects the expanded enforcement authority assigned to HUD by amendments to the Fair Housing Act in 1990. One example is a memorandum of understanding among the agencies calling for formal referral of complaints alleging fair housing violations to each other and coordination of investigations, when that is feasible.

In December 1992, the FFIEC contracted with an outside consultant for a review of the agencies' examination procedures to enforce civil rights laws. The contractor will also review the existing training processes and recommend improvements. We believe that this third-party review will ultimately help to strengthen the enforcement of fair lending laws by providing a fresh look at the current examination procedures and training.

In March 1992, the agencies distributed to the institutions they supervise a brochure, prepared by the FFIEC agencies, entitled "Home Mortgage Lending and Equal Treatment." The brochure identifies and cautions lenders about lending standards and practices that may produce unintended discriminatory effects. It focuses on race and includes examples of subtle forms of discrimination, such as unduly conservative appraisal practices in minority areas; property standards such as size and age which may exclude homes in minority and low income areas; and unrealistically high minimum-loan amounts. I might add that the Federal Reserve published a companion brochure in 1991, entitled "Home Mortgages: Understanding the Process and Your Right to Fair Lending," to inform consumers about the mortgage application process and about their rights under fair lending and consumer protection laws.

The FFIEC is also offering specialized training for examiners from the member agencies responsible for enforcement of fair lending laws. In fact, one of these training sessions will be held next week. The issue of credit discrimination and use of HMDA data will be a focus during this session.

The Federal Reserve is committed to working within the FFIEC to develop ways to enhance enforcement effectiveness under the fair lending laws. Although substantial progress has been made, the FFIEC recognizes that its job in this area is certainly not finished.

Federal Reserve Efforts

At the beginning of my testimony I described particular efforts that the Board has taken to enforce the fair lending laws. Those actions - denial of applications, formal enforcement actions, civil money penalties, referrals to HUD and the Justice Department, and, coordination among the agencies to make the best use of the HMDA data have each been possible because the Board has had a solid program in place System-wide for many years to address our fair lending responsibilities. I would next like to describe these efforts for you in some detail.

The Board supervises approximately 1000 state member banks for compliance with fair lending laws. This has involved consumer compliance examinations, consumer complaint investigations, and community affairs efforts. The 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 also have staff members who deal with consumer complaints. In addition, the system has a substantial Community Affairs program, many of whose activities help to advance fair lending. The Board provides general guidance and oversight to Reserve Banks in these areas.

Compliance Examinations

The Board first established a specialized consumer compliance examination program in 1977. Through it the twelve Reserve Banks 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 include 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 those statutes.

Over the years, the Board has reassessed its enforcement responsibilities 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 to place increased emphasis on investigating serious complaints such as allegations of loan discrimination. We have made it clear that failure to comply with certain provisions of the fair lending laws were viewed by the Board as particularly serious and would require retroactive corrective action.

The Federal Reserve System's consumer compliance examinations are scheduled at regular intervals, are comprehensive, and are conducted by specialized examiners. Each state member bank is examined on a regular basis. An average of two-thirds of state member banks are examined each year.

Examinations are scheduled every eighteen months for a bank with a satisfactory record. A limited number of 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 examination 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 standards have been identified, the examiner will determine whether those standards were, in fact, applied uniformly using a sample of actual loan applicants. Special note will be taken of applications received from minorities, women, and others the laws were designed to protect. This means that the examiner is looking at the same information that the bank used to make its credit decision, including credit history, income, and total debt burden. If those standards appear not to have been used, or not used consistently, this would be discussed with lending personnel and a more intensive investigation would typically be undertaken. Finally, an overall analysis of the bank's treatment of applications from minorities, women, and others with the characteristics described in the laws is conducted to determine whether there are any patterns or individual instances where such applicants were treated less favorably than other loan applicants.

Another regular part of the examination includes conversations 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 insights into how the bank is serving the credit needs of its local community, particularly those protected by the antidiscrimination statutes.

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. Consequently, the Federal Reserve has developed a separate career path for consumer affairs examiners equivalent to that of our commercial examiners. The Board provides them with special training, including instruction on CRA and fair lending laws. New examiners attend a three week basic consumer compliance school. Examiners with 18 to 24 months of field experience attend a week long advanced compliance school and the one week advanced CRA class. This training is supplemented as necessary by special training sessions at the Reserve Banks. For example, last week, the San Francisco Federal Reserve sponsored a conference for all the agencies which focussed on issues relating to credit discrimination.

The examination procedures for detecting loan discrimination are set forth in the Board's <u>Consumer Compliance Handbook</u>. These procedures take on average 29 hours per examination to complete, and result in a comprehensive assessment of the institution's lending practices. Assessing a bank's performance under the Community Reinvestment Act takes, on average, an additional 39 hours to complete.

While much of the Board's recent effort to improve its fair lending examination procedures have been in concert with the FFIEC, we have underway a number of individual initiatives that we believe will strengthen our own consumer compliance examination program. They represent a continuation of our ongoing efforts to improve our examination techniques and are indicative of our commitment in this area.

The Board has authorized its Division of Consumer and Community Affairs to hire an individual whose primary job responsibility will be to work in the area of fair lending enforcement. This person will help to coordinate our efforts in this area and assist our examiners in analyzing the complex issues associated with detection of credit discrimination.

The Federal Reserve is also developing the capability to map the geographic location of a bank's lending products, including mortgage loans with computer programs. This mapping will include demographic information for the bank's local community. We believe that this type of analysis and presentation will enhance our ability to assess a bank's CRA performance in meeting the credit needs of its local community, including minority areas. It should also be helpful in evaluating a bank's geographic delineation of its local CRA service area to ensure that it does not exclude low- and moderate-income neighborhoods.

Finally, Federal Reserve examiners have begun testing a system that will use a statistical model, much like the model used in the Boston study, to analyze HMDA data and information drawn from loan files from individual institutions for purposes of helping to determine compliance with fair lending laws. Notwithstanding the usefulness of the HMDA data, the data alone are not sufficient to determine whether a lender is discriminating unlawfully. Specifically, the data do not reflect the wide range of financial and property related factors that lenders consider in evaluating loan applications. Consequently, our use of a statistical model will include detailed information from specific application files. We hope, and expect, that use of such a model will enable our examiners to more effectively identify any questionable application files.

Consumer Complaint Program

The Federal Reserve's consumer complaint program is an important element in our overall efforts to enforce fair lending laws. The investigation procedures in this regard provide special guidance with respect to complaints involving loan discrimination. Such complaints, given appropriate circumstances, will prompt an on-site investigation by Reserve Bank personnel at the state member bank accused of discrimination. As mentioned previously, we have a referral agreement with HUD for mortgage complaints. I should note that the Federal Reserve System receives few complaints alleging loan discrimination and few of these, after investigation, have been resolved in favor of the complainant.

Community Affairs Program

The Board believes that ensuring fair access to credit can, in addition to enforcement of fair lending laws, be advanced by focussing on positive actions that a lender may take to address such concerns. Consequently, through its Community Affairs program, the Federal Reserve conducts outreach, education, and technical assistance activities to help financial institutions and the public understand and address community development and reinvestment issues. During 1992, resources devoted to Community Affairs activities at the Reserve Banks were increased to enable the Federal Reserve System to respond to the growing number of requests for information and assistance from banks and others on the Community Reinvestment Act, fair lending, and community development topics. Efforts were expanded to work with financial institutions, banking associations, governmental entities, business, and community groups to develop community lending programs that help finance affordable housing, small and minority business, and other revitalization projects. For example, the Federal Reserve Bank of Kansas City sponsored a conference for bankers on "Credit and the Economically Disadvantaged," focusing on barriers faced by minority borrowers and steps banks can institute to ensure that credit is offered on an equitable basis. The Boston and New York Reserve Banks cosponsored a conference on credit issues affecting economic development programs for Native Americans, especially those living on reservations. These are but an example of a comprehensive community affairs program at work throughout the Federal Reserve System.

Conclusion

In my view we are beyond the point of debating whether disparate treatment of minorities is occurring in credit markets. We've known for some time that certain segments of our society, particularly minority consumers and minority small business owners, have difficulty obtaining credit. This has had an impact on the ability of minorities to build businesses, own homes, accumulate wealth, and, generally, participate in our economy on an equal footing. We now know that this difficulty that may not be justified by economic factors alone.

The process of fully integrating the minority community into the economic mainstream of our country as quickly as possible should be the ultimate goal of efforts to strengthen enforcement of fair lending laws. I have concentrated today on agency initiatives. But it's important not to overlook those positive actions that lenders have taken to help improve access to credit. Many lenders have undertaken critical self-analysis of their activities and this has resulted positive programs like reexamination of credit criteria, second reviews of lending decisions affecting minority applicants, and specialized consumer credit education on qualifying for credit. These are only a few of the initiatives recently undertaken by some lenders.

In conclusion, I appreciate the opportunity to appear before you today to testify on the important and complex issues regarding credit discrimination. The Board and the FFIEC share your concerns about this issue and we look forward to working with the Congress and others to address this important topic.