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Breaking Free From Some Outdated Myths

Address by

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Breaking Free From Some Outdated Myths

Thank you. It's a pleasure to be here in this beautiful setting. We all know from recent events and from our discussions here today that life is not necessarily as beautiful as our current surroundings.

Shortly after joining the Board last November, Chairman Greenspan asked me to chair the Fed's Committee on Consumer and Community Affairs. I must admit that I had no particular knowledge or expertise in that area when he appointed me. But, as someone who has spent many years in education, I thought that this was an opportunity to learn something new. At the very least, my lack of prior experience permitted me to go into this area with an open mind. Over the intervening months I've travelled throughout this country, seen first hand what's working in our cities and what isn't, and met extensively with both community groups and bankers. As an experience in what's really happening, I must admit that these last 10 months have easily beaten the years I spent in graduate school.

It was during this same period that a great deal of attention was focussed on discrimination in mortgage lending. Late last year, the nation's bank regulatory agencies released the first detailed information on the relationship between race, income, and mortgage lending, known as HMDA data. The volume of information processed was staggering, even to an old micro-data empiricist like myself. Stacked in computer printout, the data on the HMDA disclosures would nearly reach to the top of the Washington Monument.

Later this fall we will be releasing the HMDA data for 1991. We will also be releasing, through the Federal Reserve Bank of Boston, an extensive study of mortgage lending in that city that was conducted by examining 4100 actual loan files from 131 banks, savings institutions, and mortgage companies. Other regulators, notably the New York State Commissioner of Banking and the U.S. Department of Justice have been involved in similar reviews.

My comments today reflect both what I have learned from my travels, and what can be gleaned from some of these other efforts. By no means do I claim to have a monopoly on the truth. The subject we are dealing with is enormously complicated as well as being extremely sensitive, and others may draw different conclusions. But I am not going to let either complexity or sensitivity stand in the way of candor. Finding solutions to our problems is far more important.

Recently, when testifying before the U.S. Commission on Civil Rights, I heard an outstanding summary of this view by its Chairman, Arthur A. Fletcher. He said that it may be too much to ask us to change our deeply held, and often unconscious, prejudices, but it is not too much to ask to have them stop controlling our behavior. To that end, I believe that our current beliefs and behavior are tied to a series of outdated myths that hold us back from making progress in providing economic opportunity for all Americans. Unfortunately, our nation's media and opinion leaders are doing little to dispel these myths, and may actually be reinforcing them. When these myths are exposed for what they are, we will all find it in our interest to stop letting them control our behavior.

The first myth that I would like to dispel is the view held by some that there is no racially based problem in the area of mortgage lending. There is a problem and it is one which we absolutely must address.

Having said that, two important qualifications are in order. First, it does appear 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 reduced. However, that does not in any way diminish the qualitative conclusion that race based differences exist and that they must be eliminated.

Second, the evidence of race-based differences in loan approvals is overwhelmingly of a statistical nature, based on racial averages, and 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.

However, the reality in this case is not so simple. 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, between the applicant and the loan officer.

Let me clarify what appears to be going on. It appears from the available evidence that both blacks and whites who meet all of the criteria which banks have laid down for loan approvals are approved and those who clearly do not meet the criteria and are obviously bad credit risks are rejected. What is left is a sizable middle group, which comprises a majority of mortgage applicants of both races. All of these applicants could be rejected for a valid reason: level of income, job tenure, debt to income ratios, or a variety of other factors. However, with some level of effort and explanation, many of these applicants can, and often are, approved.

This makes identification of race-based decision making quite difficult during the examination process. In the case of rejected applicants, both black or white, there is almost always a non-racial explanation for the rejection. This finding was best highlighted in a recent report by the New York State Banking Commission, entitled "Are Mortgage Lending Policies Discriminatory -- A Study of 10 Savings Banks".

From this middle group some individuals of both races are accepted, but on average whites in this middle group are more likely to be accepted than blacks. Acceptance of marginal applicants generally requires a detailed explanation of any mitigating circumstances for why the applicant should be accepted. This seems to have led to what I will refer to as the "thicker file" phenomenon. There is fairly solid, albeit anecdotal, evidence that many marginal white applicants have physically thicker loan application files than marginal black applicants. This extra paper may very well represent the documentation of mitigating circumstances or evidence countering the putative reason to reject the applicant.

There have been a number of theories advanced for this "thicker file" phenomenon. It might be that white applicants have had, on average, more prior exposure to the credit process and therefore come better prepared. It might also be that loan officers spend greater time, on average, with white applicants, probing more deeply into whether they might have evidence to offset the reason that might otherwise lead to rejection. I would term this "coaching".

If "coaching" or the "thicker file" phenomenon represents part of the problem, then one solution to racial based disparities may well be found in improving the information flow that takes place in the credit underwriting process. In other words, give each and every applicant the opportunity for a "thicker file". This can be done by providing more information to applicants so that they are better prepared in advance of the application procedure to answer any questions about their qualifications. If loan officers are going to be coaches, then they should be careful to coach everyone, and not a few favored applicants. It certainly involves sensitizing all of those in the loan application process to the problems which exist. But let us make no mistake: race-based disparities in mortgage lending do exist and they are totally unacceptable.

The second myth I would like to address involves the economic status of blacks, 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 only 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. Such individuals are the natural applicants for mortgage loans.

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.

It is not just in the area of mortgage lending that minorities represent an underserved market. The Wall Street Journal called the 1980s the decade of minority capitalism. Between 1983 and 1987 there was a 50 percent increase in the number of businesses owned by African Americans and 81 percent increase in the number of Hispanic owned businesses. More black owned businesses were created from 1982 to 1987 than in any other comparable five year period in our history. I might also add that more Asian Americans and women went into business during this period than at any other time. These businesses not only need banks for capital, they also need them for financial expertise.

Increased awareness of the opportunities for minority lending means dispelling the myths about the lack of economic importance of minority communities. One of the places that I have seen where this myth was most successfully destroyed was in Dallas. The South Dallas - Fair Park area of that city is overwhelmingly black and generally low income, comprising roughly 80,000 residents. Prior to last year, no bank branch had operated in the area for at least two decades. Last month, NationsBank celebrated the first anniversary of its Fair Park branch. The branch had exceeded its first year target for consumer loans by 40 percent, and was one of the top 3 performing branches in the entire state of Texas. I might add that Bank One has also opened a branch four blocks away and NationsBank is planning to duplicate this success by opening similar branches in other low income neighborhoods in Texas. Where myths are destroyed, markets will work.

The third myth I would like to consider is that sweeping national solutions will solve the problems we face. Congress has recently been quite disposed to a highly prescriptive approach to regulating the banking industry. In the case of racial disparities, such an approach may seem attractive. Racial discrimination tears at the very fabric of our national ideal. While further legislation would certainly be well intentioned, I am not at all convinced that one-size-fits-all national rules represent the best approach to increased minority lending, or to improved credit availability of any sort. I am repeatedly struck as I travel around the country about that old saw -- the Law of Unintended Consequences. In too many instances it is well intentioned government policies that are exacerbating the problems we face.

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 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, your need for that coaching I discussed earlier, rises dramatically. 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. For example, seasonal part-time income is now considered regular income if the person has earned that money at least two seasons in a row, child support payments are now counted, maintenance and zoning standards for property have been liberalized, and credit history standards have been modified in a number of ways. A recent Congressional testimony by Jim Johnson, Fannie Mae's Chairman, lists 20 such changes in the last 5 years.

Indeed, the very quantity and detailed nature of these changes is proof of how complex the lending decision has become.

Recently, the Federal regulatory agencies, prompted by Congressional action in last year's banking bill, considered establishing maximum loan-to-value ratios for single family housing lending. I strongly opposed such a move because it would further exacerbate 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 Neighborhood Housing Services coordinator I spoke 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.

It is human nature to place the blame for problems on others. Some might say that for elected politicians and other decision makers it is a requirement for the job. Today we are here primarily to consider what financial institutions might do to improve minority home ownership. But those of us who are here from government must go back and consider our own policies. Government, like the medical profession, should follow the first principle of the Hippocratic Oath: above all do no harm.

The final area of mythology and ignorance which I would like to address has to do with credit itself. The level of ignorance which exists about credit is truly remarkable, given the widespread nature of its use. Nor is it an easy area to master. Highly educated people often know little or nothing about the factors used to make credit decisions.

Consider for example, the case of Jacqueline Mixon of South Dallas, who received a home improvement loan after numerous rejections. Mrs. Mixon is a college graduate and supervises 200 people. Yet she admitted that she and her husband were unfamiliar with the loan process and that this might have been a factor in their previous rejections.

The great myth that may exist among bankers is that their customers have some way of knowing their bank's credit standards and other credit decision criteria. Frankly, I consider myself to be above average when it comes to knowledge about the credit decision. Eight years ago, I was a new member of the Harvard economics faculty and my wife and I were first time homebuyers. Even with helpful suggestions from colleagues who had recently gone through the same experience, finding a home mortgage was a daunting and difficult experience.

Thus, a good part of the problem that we face in reducing disparities has to do with myth and ignorance. There is a widespread lack of recognition of the size and potential value of minority lending. This may adversely affect both strategic planning by institutions and the judgment of individuals making loan decisions. We have created a needlessly complex conundrum of regulations which attempt to substitute rules for reason. Standardization, while well-intentioned, limits the ability of individuals within the system to meet the needs of individuals who are different from the standard. Finally, the widespread ignorance of credit rules in the population may not be met by sufficient willingness of lending institutions to provide information to their customers.

I think that these problems are all personified in the case of Willard Brown of St. Louis. Mr. Brown, who is an African American, was rejected four times before finally getting a mortgage loan. He had steady employment -- over 20 years at the same job, a salary in excess of $30,000, and an outstanding credit report. The reason for his rejection was high credit card debt, which put his ratios in excess of Fannie Mae guidelines. But, Mr. Brown had cash in the bank, in fact more than enough to bring his ratios into line. None of the first four loan officers suggested that he do so, although it would have meant a good loan to a qualified customer.

Mr. Brown's case is one in which the lending institutions obviously ignored the potential of the black community, were hamstrung by needlessly complicated guidelines, and failed to make their process clear to their customers. In practice, this case reflects both the "thicker file" and the coaching phenomenon I spoke of at the beginning of this talk. This case is not only exemplary of the ignorance I spoke of, it indicates a strong predilection on the part of the lender to resist any effort to disclose the facts. Such behavior reflects not only a potential problem in racial attitude, it reflects a fundamental problem of business attitude. The key to solving our lending problems, I believe, lies in good old fashioned business sense about how to run a service business: how you treat the customer is key.

Back in May, here in Los Angeles, I recommended to the members of the California Bankers Association that they experiment with using shoppers at their institutions to test the fairness of their lending practices. Such shoppers should explicitly work for the bank as what they are gathering is proprietary information regarding customer service. In combatting discrimination, it is important to make sure that loan officers are extending the same courtesy and even the same level of coaching to all customers of all races. But, an equally low level of assistance to both black and white customers is not the answer. We need more customer education for everyone. Banks must make clear what is expected of the customer, or the customer is bound to end up with a bad feeling. In fact, heightened sensitivity to the opportunities offered by minority lending are appropriate all the way up the decision hierarchy.

Community outreach is also an important way of providing quality service while finding new customers. Huntington National Bank in Columbus, Ohio, has begun a lending program which works through churches in black neighborhoods. The program includes classes on how to apply for loans along with basic credit information. Let me note that the program could prove a good way for Huntington to evaluate credit risk by providing a potentially valuable credit reference. Here is a way of gathering more information in making an informed loan judgment, the exact reverse of the simple statistical approach, which actually requires discarding valuable information.

Another outreach technique used by some lending institutions is simply providing a second, internal review of mortgage applications that are turned down. Usually this is done by separate officers or committees that can take a fresh look at each application and ensure that policies are applied in the same manner for all applicants.

A multi-bank approach which has proven successful in expanding minority lending is the use of mortgage review boards. In Boston and Detroit, rejected mortgage applicants may forward their applications to the board to appeal the outcome of a lending decision. Members of the review board are banking and thrift institutions which are active in local mortgage lending. Rejected applicants who meet the Board's criteria are provided loans by Board members on a rotating basis. Philadelphia has a similar, but more aggressive, program targeted at specific neighborhoods which involves automatic referral of applications that, based on a preliminary review, suggest rejection. It also entails a community outreach component, use of flexible underwriting standards, and credit counseling. Because it adds a second judgment, this program helps ensure the fairness of the loan process. It also promotes consumer education and understanding of the mortgage market.

A final hurdle to success is the need to seek greater flexibility in lending criteria and to reinsert judgment into the loan process. In spite of the advantages of the secondary market in the form of liquidity, there are costs in terms of the variety of people served. Ultimately, the solution is for banks to take on more of their mortgage loans for their own portfolios, and not sell them in the secondary market. Of course, this means that the bank, not the market, must absorb any credit risk from such loans. But ultimately, our capital markets will catch on to this. Banks which keep mortgages for their own portfolios have an incentive to know something more about their customers than banks which resell packaged portfolios of mortgages in the secondary market. Once that information gets out, it should be clear which is the smarter bank in which to invest. I might add that one large national bank has already decided to keep a larger share of its minority mortgage and small business loans in its own portfolio.

I would like to close with one final observation. By any standard, America is the most successful multi-racial society that history has ever known. That doesn't mean that things are fine -- they're not. But we've got everyone else who has ever tried beat by a long shot. I think the reason for this is our willingness and constant efforts to try to make things better. I am very happy to be part of this meeting today, which I believe is yet another example of Americans, coming together, in just such an effort.