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Testimony by

Lawrence B. Lindsey

Member, Board of Governors of the Federal Reserve System

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and the

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I am pleased to address this Committee about the concerns raised by the 1990 Home Mortgage Disclosure Act (HMDA) data. I would also like to describe how we, at the Federal Reserve, are expanding our data analysis to strengthen our fair lending enforcement and Community Reinvestment Act (CRA) activities.

Last October, when Governor LaWare, as Chairman of the Federal Financial Institutions Examination Council (FFIEC), announced the release of the 1990 HMDA data, he indicated that he found the data troubling. I fully share his concern. The preliminary analysis of the nationwide data showed that three quarters of all mortgage loan applications are approved. But the statistics on applications which were not approved showed significant differences in loan denial rates among racial and ethnic groups. For example, while 14% of whites applying for conventional home purchase loans were denied, 21% of Hispanic and 34% of African American applicants were turned down. Disproportionately high rejection rates for Hispanics and African Americans were evident even when applicants with approximately the same income were compared.

Let me be absolutely clear about the position of the Board of Governors. Discrimination based on race, sex, or ethnic background is not only illegal, it is morally repugnant. Indeed, there is only one legitimate criterion on which to base loan decisions: the expectation that repayment will be made according to the terms stipulated in the loan agreement. Our efforts must be directed at assuring that only this criterion is used to make home mortgage or other loan decisions.

The HMDA data make clear that the differences in denial rates when applicants are grouped by race do not change notably regardless of income. Turndown rates for minorities substantially exceed the rate for whites whether one looks at low income or high income groups. Similar patterns exist if one looks at neighborhoods instead of applicants. The proportion of home purchase loan denials increases as the percentage of minority residents increases regardless of the income level of the neighborhood. The fact that denial rates differ among racial groups in spite of statistically controlling for income underscores the troubling nature of these findings.

Many observers have pointed out that the home mortgage picture is more complicated than the preliminary analysis of the HMDA data indicates. These observers are undoubtedly correct. It should be noted that income is not the primary reason for mortgage denials. The 1990 HMDA data make clear that credit history was the single most commonly cited reason for credit denial for whites, African Americans and Hispanics. That fact should remind us that analysis of mortgage application decisions is analytically complicated and statistically tricky. Indeed, when the New York State Banking Department investigated the lending performance of 10 savings banks in that state, they found little suggestion of bias.

As a result of the complexity of this issue, the Federal Reserve is increasing its efforts considerably toward better understanding the HMDA information. In the interim, the HMDA data will continue to provide our examiners with a basis for further analysis of whether institutions are considering all applicants fairly. I will turn to a discussion of these activities later in my testimony.

Background on HMDA

The Home Mortgage Disclosure Act (HMDA) was passed in 1975. The law is based on the concept that the public should have access to information about the home lending activities of institutions serving their communities. One purpose of the act is to encourage balanced lending through the provision of data to financial institutions, regulators, and the public at large.

To that end, the Federal Reserve Board's efforts to collect and process the data, and make it publicly available, have been in effect for some time. Since 1980, the Federal Reserve, on behalf of the federal financial regulatory agencies, has compiled information about the home lending activities of institutions covered by HMDA -- basically, those lending institutions with offices in metropolitan areas. By matching the specific loans reported with demographic data from the census file, we produced individual HMDA reports showing the home lending picture for each reporting lender, as well as aggregate reports for lenders as a whole in each metropolitan area.

For regulators, HMDA data have augmented other procedures for detecting illegal credit practices and discrimination in consumer compliance examinations. For example, in checking for compliance with the Fair Housing and Equal Credit Opportunity Acts, examiners draw samples of mortgage files to compare with the institutions' stated underwriting policies to assure that all applicants are treated fairly. Similarly, in assessing Community Reinvestment Act (CRA) performance, HMDA data have often been a key indicator of how well banks are helping to meet the credit needs of their **entire** communities, including low- and moderate-income and minority areas.

Many banks have found that HMDA data provide valuable marketing information, enabling them to compare their performance with that of competitors. We have strongly encouraged banks to study their own HMDA data as a way to spot apparent "gaps" where credit services may not be reaching certain segments of their communities.

Community groups have often used the data to assess the home lending performance of institutions currently doing business in their neighborhoods, as well as those seeking to do so by merging with or acquiring a local institution. Through the CRA protest mechanism and other means, these groups and others have the opportunity to use the HMDA data and voice their concerns about a banking organization's CRA performance. HMDA data have also provided the basis for numerous studies over the years--by community groups, academic and news organizations, the Federal

Reserve and others--of how home loans are distributed across neighborhoods, income and racial groups.

With the statutory changes that took effect in 1990, HMDA data now provide an even more valuable tool to all parties concerned -- especially to us, the regulators. For the first time, HMDA data collected for 1990 included information about applications that are denied or withdrawn; about the race, sex and income of applicants; and about the secondary market purchasers of loans sold by lending institutions. The data also include, in about 60% of cases, the principal reasons cited by lenders for credit denial.

Gathering and analyzing this new data represent a substantial commitment of resources by all the agencies. In fact, the new HMDA data was the most massive data collection effort ever undertaken by us, involving nearly 9,300 reporting institutions, representing about 24,000 reports for metropolitan areas, and more than 1.2 million pages of data. About $2.8 million has been spent to develop the system to process the HMDA data, and as of September of last year, the agencies had spent an additional $2.6 million to process the 1990 HMDA data. Last year we were able to make the data public about six months after the reporting deadline, and we are looking at ways to speed up the processing time starting with the 1991 data.

<u>Caution Regarding Raw Data and The Boston Study</u>

Although the HMDA data provide very useful information, the data are not perfect and we urge caution in drawing too many conclusions from a preliminary review of the data. This problem with drawing conclusions from the raw data is not just theoretical. It would be a mistake to discount the effect of a variety of factors that are at work in the loan process. According to the HMDA reports filed for 1990, credit history was the single most common reason for credit denial. However, the HMDA data do not contain any information regarding applicants' credit histories or a wide range of other factors that lenders consider in evaluating loan applications such as debt to income ratio or job experience and tenure.

We also must bear in mind the statistical ramifications of volume. For example, an institution which has a very aggressive outreach program compared to an institution in which no such effort is made will undoubtedly generate a higher volume of applicants. However, the institution with the outreach program may be statistically penalized for the effort because gathering a greater number of applications may result in receiving a large number from less qualified borrowers. This, in turn, may result in higher rejection rates in areas with high concentrations of low- and moderate-income people. This could be one reason why some minority-owned institutions turned down requests for home purchase loans relatively more frequently than other HMDA lenders.

The need for a better understanding of the data and more careful analysis is clear. As a result, the Board has authorized the Federal Reserve Bank of Boston to conduct--in consultation with other federal supervisory agencies--a detailed study that should help answer some of the questions raised, at least in the Boston area, in our preliminary review of the HMDA data. In the study, we plan to gather additional data on African American, Hispanic and white applicants from over one hundred financial institutions operating in the Boston area. We believe that this data may prove useful in designing programs to reduce racial disparities in mortgage rejections.

The Boston study will give us an indication of which creditworthiness criteria are used by financial institutions in making mortgage loan decisions. Let me stress that this does not mean ratifying the existing set of criteria. Some of these criteria may have evolved through custom, and may not be statistically linked to the likelihood of timely servicing of the loan. This information may stimulate financial institutions to reassess their criteria for determining creditworthiness. The incoming information might also help us inform consumers about actions they could take to improve their likelihood of loan approval.

The second benefit of the Boston study will be an improved ability to determine how much of the discrepancy in lending rates among racial groups is accounted for by key financial and employment variables that loan officers consider in their credit evaluations. To the extent that these financial variables do not explain the discrepancies, we intend to use the HMDA data to guide examiners to specific loan application files for more extensive review.

Other Steps to Improve Enforcement

In spite of the limitations, the HMDA data are already augmenting the work of our examiners. For example, in CRA examinations HMDA data now provide a more precise picture of lending patterns for individual banks, and for the market as a whole. For example, examiners can now look at how application activity is distributed among various segments of the community; whether lending in low- and moderate-income neighborhoods is, in fact, proportional to low- and moderate-income borrowers; to what extent the sex of applicants seems to be related to the bank's propensity to lend; whether approval rates are higher for different types of loan products (such as conventional vs. government-insured mortgages); and how a bank which is being examined compares to its peers in its share of lending in specific neighborhoods. Such information, along with information gathered about other aspects of CRA performance during the course of the examination, can provide a more solid indication of areas of both strength and weakness of institutions with respect to CRA.

At the same time, we have been working to develop additional practical applications of the enhanced data for the examination process. Access has been provided to the mainframe computer for our examiners through the use of our software capabilities. Examiners can now readily retrieve and analyze this wealth of new data. We regard this type of automation capability as essential, given that the new HMDA aggregation tables for a single institution can be several hundred pages in length. We continue to make additional modifications to enhance the examination process for fair lending and CRA. To accomplish this, the Federal Reserve has made a substantial investment of resources, and will give further advancement of this work high priority.

We are not acting alone in this process, but in concert with the other federal financial regulatory agencies to implement the HMDA analysis system. Because only 7% of the HMDA lenders are under the direct supervision of the Federal Reserve, we have been sensitive to the need to ensure that the other agencies have access to the HMDA data stored on the Board's mainframe, and to coordinate with them any necessary adjustments or additions to the system. An interagency working group has also been formed to work on more advanced analytical tools and training for examiners from all the agencies.

While we are working on the application of uses for the HMDA data to strengthen the examination process, we have been drawing on other methods at hand to promote compliance with fair lending laws. FIRREA allowed the imposition of civil money penalties to address <u>any</u> violation of law and regulation. We have already used this power to impose fines in the consumer area and other such enforcement actions addressing violations of the Equal Credit Opportunity Act and noncompliance with the CRA are in process. Although the actions to date have involved fair lending issues other than racial discrimination, we will not hesitate to impose the stiff fines that the law now permits for all types of violations.

During 1991, we began a series of meetings with the Department of Justice, the Department of Housing and Urban Development, the Federal Trade Commission and the other financial institution regulators to discuss fair lending issues and our enforcement activities. In particular, we have been in contact with Department of Justice staff about an ongoing investigation of mortgage lending practices in Atlanta, which may lead to new techniques for determining whether a lender has illegally discriminated against creditworthy applicants. The financial institution regulators are in the process of retaining a consultant to review our civil rights enforcement training and procedures. These efforts should help us design new tools for analyzing the fairness of an institution's mortgage lending activity.

The FFIEC has just released a new brochure entitled Home Mortgage Lending and Equal Treatment that will be useful as we continue to emphasize the education of lenders, as well as consumers, about potential pitfalls in the mortgage lending process. The publication alerts lenders to subtle forms of discrimination that can occur, perhaps unknowingly, in the lending process, and how to avoid them. We are sending copies to all the banks we supervise, expecting that it will prompt many of them to take a closer look at some of the long-accepted loan origination, underwriting, appraisal and marketing practices that can have unintended discriminatory effects. We published a similar guide for consumers entitled Home Mortgages: Understanding the Process and Your Right to Fair Lending just over a year ago.

<u>Community Economic Development</u>

In short, we are committed to continued efforts that can detect and prevent illegal credit discrimination--but we are not stopping there. The ultimate goal of these laws is to assure that safe and sound lending takes place in every community in the country and that it is done fairly. We have long believed that this goal could be achieved by other programs that serve as a counterpoint to enforcement activities. Consequently, for many years the Federal Reserve, through its Community Affairs Program, has worked with lenders around the country to refine community development lending strategies. In 1991, we shared this type of experience and expertise through nine newsletters published by Reserve Banks, 124 conferences and seminars and more than 300 speeches at the invitation of banking and community organizations. Examples of these efforts include a new community development finance curriculum designed to teach bankers, nonprofit organizations and others the basic skills of community development lending using actual case studies; the development of manuals and software by Reserve Banks that can help lenders structure sound loans where public and private funds are involved; and our provision of technical support to multi-bank mortgage lending pools that are attempting to make housing credit more readily available to lower income and minority communities in several states. While many of these initiatives have a broader focus than just minority housing concerns, they all contribute to the assurance that we are making progress in helping financial institutions serve their entire communities.

In conclusion, I am concerned, as you are, about the direction and use of the HMDA data. I am also deeply concerned about the many complex problems that seem to underlie the numbers. Obviously, there is a great deal to be done. The Federal Reserve stands ready to work with you, the industry, consumers and others in furthering this important effort.