For release on delivery
12:00 Noon EDT
September 14, 1995

What Do We Do For An Encore?

Remarks by

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to the

National Bankers Association

New York, New York

September 14, 1995

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Thank you. It is my pleasure to be here today at the National Banker's Association Awards Luncheon. During my four years at the Board I have had the pleasure of meeting with you in many settings and under many different circumstances.

In general, our past meetings have focussed on the challenges that were before us. To a large extent you are a microcosm of the banking industry, but one which is more susceptible to the regulatory and economic changes of the last decade. Relative to much larger institutions, your organizations have more difficulty affording the costs of a massive increase in regulatory compliance or a major structural shift in our economy. And, as we have discussed many times in the past, many regulations which are designed to target the largest institutions in the industry have major unintended consequences for your institutions.

Frankly, we as regulators have not provided sufficient recognition of the special role that your institutions have played in extending credit and banking services more generally to historically underserved groups in the population. As our regulatory apparatus has become ever more detailed, we have driven the industry increasingly toward a one-size-fits-all model. This makes your job more difficult. You have survived, often in markets that others have neglected, during the most challenging economic period the banking industry has faced since the 1930s. And the regulatory and technological trends now facing the industry seem to be favoring large institutions with undifferentiated customer bases, and not institutions with the kinds of specialized roles that have been your mission.

To a large extent your institutions have served the role of a niche bank. Recent data indicates, for example, that 59 percent of applications at minority owned banks were from predominantly minority neighborhoods. Thus, you are susceptible to competition from very large institutions looking to get into your market. In many cases your market may not be well defined on a geographic basis, but includes target populations that have been historically underserved even if they are geographically dispersed, women for example. Frequently, the services you have provided to your communities aren't easily quantifiable, but involve taking on the vital tasks of providing community leadership and counselling. Therefore, the increasingly quantitative and geographic-based CRA reforms we are implementing certainly will create new challenges for many of you.

The Democratization of Credit

Today, as a change of pace, I would like to focus on some good news and its potential consequences for both your industry and for regulators as the 1990s unfold. Data from a variety of sources show that there has been a dramatic trend toward the democratization of credit during the past few years. A trend which started in the credit card industry has now expanded to include home loans. Individuals with relatively modest incomes, and individuals from minority ethnic and racial backgrounds, have never had greater access to credit than they do today. Having had such dramatic success in extending economic opportunity, I think we as a Nation and as an industry should stop and reflect on what we may be doing right. After all, success stories in extending economic opportunity seem to be in relatively short supply these days. Maybe we should take a look at what the banking industry has done to achieve this success and ask the question: "What do we do for an encore?"

Let me begin with what I thought was the great under-reported news story of the summer. Back in July the financial regulators released their annual report on the number of home mortgages granted the preceding year. Conventional home purchase loans granted to blacks rose 54.7 percent between 1993 and 1994. The comparable rates were 42 percent for Hispanics and 15.7 percent for whites. In economics, a 54.7 percent increase in just about anything is a staggering, or at least a newsworthy, economic statistic. Nor was this a one year event, but part of a multi-year trend. For black applicants, the increase from 1991 to 1992 was 26 percent followed by a 36 percent increase from the same reporting institutions between 1992 and 1993. In both cases, the rate of increase was significantly more than for the population as a whole. Looking at the HMDA data makes it clear that conventional home purchase mortgage lending has gone up at a much faster rate for black families than for white families over the 1991-1994 period.

The explosive increases in mortgages granted to underserved populations can also be seen in terms of income. In 1990, for example, only 14 percent of all conventional home purchase mortgages went to individuals earning less than 80 percent of their area's median income. By contrast, more than 63 percent of such loans went to individuals earning more than 120 percent of their area's median income. In 1994, the proportion of mortgages going to low and moderate income families in the population rose to 24 percent, while those going to the upper income group fell to 49 percent. Later, I would like to put these figures into some perspective regarding the overall size of the home mortgage market.

There was, of course, no mention of this on the evening news programs. One might have higher hopes for the print media, particularly our elite publications. But, the

Washington Post failed completely to carry the story. The New York Times buried the story on page D-6. Neither paper has been shy about printing negative news stories about this issue, however.

The Role of Denial Rates

This is the fifth year for which expanded HMDA data has been made public, and, except for this year's media silence, it has always been controversial. The first time the data was released roughly coincided with my arrival at the Fed back in the fall of 1991, so I remember it well. That data, which made national headlines, indicated that blacks were more than twice as likely as whites to be turned down for a conventional home purchase loan. Even after accounting for differences in income, very wide disparities in denial rates remained. These disparities were widely cited as evidence of discrimination. On the other hand, both the industry and the banking regulators maintained that denial rates, particularly ratios of denial rates for different groups, were not good indicators of market activities. Some took this logic further to deny that there was even a problem.

Still, it was apparent to me as a novice, that even at a minimum there was a clear breakdown in communication between the banking industry and the minority community. Indignant charges of intentional discrimination and racism were met by equally indignant denials. The data, and the rhetoric it was producing, were polarizing the discussion and as a result, inhibiting useful and much needed communication. Significantly increased outreach efforts were clearly needed. Thoughtful and concerned people in both the industry and community groups began talking at the local level, ignoring the highly polarized national debate. In individual cities across the country ties were gradually forged and case-by-case community oriented partnerships began to take hold. This proliferation of specialized banking programs, community outreach, and economic development partnerships began to pay off.

Both the regulatory agencies and banking trade associations have stepped up their resources and training in this area. The secondary market as well as the private mortgage insurance industry have taken steps to ensure that their standards do not hamper financial institutions' ability to serve all of its neighborhoods. Lenders have improved their delivery of credit and have been quite creative in mitigating risk through such vehicles as second reviews of denied applications, homebuyer education programs, credit counseling, and lending consortia.

Interestingly, the original cause of the highly charged atmosphere -- the disparities in denial rates -- turned out not to be a good indicator after all. In spite of the staggering increase in home mortgage loans granted to minority groups in the last five years, the ratio of denial rates in the last HMDA report was virtually unchanged. In 1994, black applicants were denied 33.4 percent of the time compared with a 16.4 percent denial rate for whites. In 1990, the comparable figures were 33.9 percent and 14.4 percent. In retrospect, the reported denial rate disparities served a useful purpose in prompting useful outreach activity. At the same time, they generated more heat than light. Some might argue that there are times when heat is what's needed rather than light. But with the progress of the last few years, it is clear that the use of denial rate ratios is not an analytically enlightening indicator of lending opportunities.

Low Inflation's Positive Effect on Housing Affordability

I believe the sustainability of the efforts to increase lending to minority and low and moderate income Americans is the result of a number of factors coming together. One major factor has to do with the affordability of homeownership. Let's do the standard math involved in any home financing decision. In 1990, fixed 30 year mortgage rates averaged 10.01 percent. In 1994 they averaged 7.47 percent. The principal and interest payments on a $100,000 mortgage declined from $878 to $697. If one figures on annual property tax and insurance payments as 2.5 percent of the home's $125,000 value, this adds $260 to the monthly payment. Thus, we have seen a decline in monthly PITI from $1138 to $957 for this typical home between 1990 and 1994. As we know, the standard PITI to income ratio is 28 percent. Thus, the annual qualifying income for this mortgage has fallen from $48,771 to $41,014. That $7757 decline in qualifying income comes at a very dense part of the income distribution, particularly in the minority population. For example, the number of black families qualifying for this mortgage rises from 1,350,000 to 1,887,000, an increase of 537,000, or 40 percent. Among Hispanic families, the increase is 359,000.

Let me use these figures to stress something that I have learned as a Federal Reserve Governor and as someone active in promoting homeownership opportunities to low and moderate income Americans. There is a school of thought among some politicians that fighting inflation is bad for low and moderate income people. Frankly, I think that is debatable as a general proposition. The increased financial sophistication of the well-to-do makes them much more able to avoid, or even benefit from the ravages of inflation. But I can say unequivocally that inflation is bad for providing opportunities for homeownership.

Therefore the reduction in inflation during the 1980s, and the continuation of that policy during the 1990s, has done more for homeownership opportunities among the lower income groups than any program administered by the government.

It is important to stress the differential impact on inflation between those who already have their homes and those who are seeking to buy. Our system of long term fixed interest rates and the home mortgage interest deduction makes increasing inflation highly profitable to those who already have financed their homes. That is why we all grew up being taught that homes were a great inflation hedge. Part of our monthly payment goes to servicing that inflation risk, but we get a tax deduction for it. So well-to-do homeowners pay only a portion of the increased selling price of their homes in their mortgage payment.

If, however, you are simply in the market for physical shelter, and not a tax-shelter or inflation-shelter, high inflation, and consequently higher long term interest rates, price you out of qualifying for a home. Furthermore, if your income is fairly moderate, you may not even qualify for the home mortgage interest deduction. Thus, a low inflation environment is a key to maintaining homeownership opportunities.

Credit Availability in a Broader Context

But, the large increases in homeownership possibilities are not the only evidence of widescale increases in the extension of credit to traditionally underserved markets. While we do not directly collect racial and ethnic data on non-housing extensions of credit, evidence from the Federal Reserve's Survey of Consumer Finances gives good reason to believe that the penetration of underserved markets in the credit card business was as dramatic, and preceded the large scale increases in mortgage credit. The Survey is taken every three years, including 1995. The preceding two surveys, in 1989 and 1992, showed that the proportion of white families with outstanding credit card debt was virtually unchanged -- 42.5 percent in 1989 and 43.8 percent in 1992. But, the growth in credit card use as a source of finance among non-whites was substantial. The proportion of non-white families having outstanding credit card balances rose from 34.1 percent in 1989 to 41.9 percent in 1992. Of course, the numbers of people actually having credit cards is much higher. This suggests that a potentially debilitating economic burden has been lifted from a significant share of the population who can now meet economic emergencies and time their purchases with greater ease.

These increases in credit availability raise an interesting question. What level of credit extension signals that all ethnic groups are being appropriately served? The real answer is that we cannot know for sure. Just as we could not tell from the rejection rate ratio whether or not discrimination was occurring, we cannot tell for certain what the "right" number of home mortgages given in a particular year should be. But, even some simple adjustments for income and demographic factors suggest that the 1994 numbers show little race or ethnic-based discrepancies.

For example, if one takes the market for conventional, non-government-assisted loans as being families earning $50,000 or more, then the proportion of such families getting mortgages in 1994 was 10.6 percent for whites, 9.7 percent for blacks, and 13.0 percent for Hispanics. Including all mortgages, conventional and government-assisted, and dropping the income threshold to $25,000 shows that 6.8 percent of whites, 6.4 percent of blacks, and 7.2

percent of Hispanics got mortgages in 1994. This is, of course, an inexact method of estimating the size of the market and obviously families below those thresholds also qualified for mortgages.

There are many factors that help determine differences in demand. For example, married couples are more likely to be in the market for home mortgages than are unmarried individuals. Combining marriage and income as defining the base, then 7.7 percent of white married households, 9.1 percent of black married households, and 9.5 percent of Hispanic married households earning at least $25,000 got mortgages in 1994. While far from definitive, such statistics do indicate that significant race-based shortfalls in meeting demand in the aggregate were not present in 1994.

The Success of Community-Based Partnerships

The second factor in achieving our success has been the forging of partnerships at the local level. Traditionally underserved markets are often times examples of market failures, most often associated with what we economists call a classic public goods problem. Individual economic players rarely find it in their interest to enter a particular market because the value of a single agent's investments would be adversely affected by the absence of investment by others. This is why locally based partnerships between financial institutions, non-profit community organizations, local governments, and neighborhood residents that sprang up to bridge the communications gap at the national level in the 1990s have been so successful.

Financial services industry and community organizations have learned that they each have skill sets that the other doesn't possess. Let me give you a couple of examples. Bill Goodyear, Chairman of BankAmerica Illinois said at a Capitol Hill symposium this past May, "We are a bank. We know finance. The groups we partner with have the contacts and the sensitivity to the local neighborhood issues and challenges that we don't." One of the most successful partnerships they have had is with Peoples Housing, a Chicago community development corporation. Here in New York City, Neighborhood Housing Services (NHS), headed by Fran Justa, partners with no less than 180 financial institutions in the city of New York. The banks sign on because these community based non-profits have a proven record of success in the business of community development. Through strategic investment, the NHS of New York has strengthened entire neighborhoods, laying the groundwork for additional private investment thereby creating a viable market in the neighborhood once again. I have had the opportunity to witness first hand literally dozens of these partnerships during my tenure at the Board.

The story of local success through partnership may also be a reason to think that heavy-handed government regulation may actually prove counterproductive. While banks and community groups were organizing and partnering locally, we at the national level were ensconced in a two year effort to rewrite the regulations which implement the Community Reinvestment Act. During the two years I spent working on the CRA reform, I frequently heard criticisms from locally based economic development activists that our regulatory efforts were making their jobs harder because we were changing the rules of the game just at the time everyone was starting to play. While I take some pride in having worked through some of the very vexing detailed issues involved in rewriting a regulation wholesale, I sometimes wonder if it was all worth it. After all, the enormous improvement shown in the mortgage data was taking place throughout the nation while I was cloistered with my colleagues in Washington. All of this improvement in the data occurred before we ever issued our new regulations.

What is Next?

What Do We Do For an Encore? Frankly, I think that our country should be proud of its accomplishments in this area. The banking industry began to look for answers to difficult and long standing problems. It now appears to have found them, or at the very least be on the right track. Of course, we need to maintain vigilance and an unflagging commitment to fair lending in order to maintain this success. But, as the lack of press attention to our achievements thus far attests, the opinion leaders of this country seem unwilling to give the country credit for having made progress at all. As a result, I think that we are about to enter a pernicious debate which may ill serve both the country and the target populations we all care about.

I have often gone on the record as saying that the public does not benefit from periods of extreme policy activism followed by periods of neglect -- hot, then cold regulation if you will. Public policy should be temperate, consistent and predictable. Although there are hundreds of temperate people involved in successful partnership projects outside the Beltway, inside the Beltway there aren't a lot of temperate people around. The same two groups seem to be dominating public discourse -- the extreme policy activists, the HOTS if you will, and the advocates of benign neglect, the COLDS. In the case of credit availability and mortgage lending in particular, we must proceed very carefully. We have achieved impressive results in increasing access to credit for all Americans and continuing on this path should be our goal. The HOTS and the COLDS both have the wrong approach.

The HOTS are citing the rise in mortgages to minority groups as evidence of the success of government enforcement of anti-discrimination rules and urge further aggressive enforcement of them and of CRA as the way to keep the industry's "feet to the fire". Actually, the evidence suggests that there has been plenty of press, but relatively little formal litigation in the fair lending area. No cases have gone to court. None of the legal theories in this area have been tested. As a result, we do not know where the law stands in this area -- particularly with respect to disparate impact issues. And, as I mentioned before, if CRA is to be credited, it is the old set of CRA regulations which were in effect during this period, not our new more "performance-based" set.

This is not helpful to either banks or to the target communities in which we are trying to increase access to loans. The prevailing legal and regulatory cloudiness becomes a dangerous fog for the industry as statistics alone increasingly form the basis for enforcement actions and CRA evaluations. Our ability to crunch numbers often far exceeds the quality of the data that are analyzed, with the result in some situations, that a statistical analysis gives a patina of correctness to theories that cannot be corroborated with live testimony or real world experience. Thus, the zeal to address a problem that, as a systemic matter, we all agree must be addressed may be misdirected in individual cases by statistics and untested legal theories.

I would also urge the HOTS to heed some of the warning signs now coming from recent lending experience. Statistical studies conducted by Freddie Mac and the PMI industry are suggesting that mortgage loans with low downpayments to individuals with questionable credit histories are showing high default rates. A more careful examination of the data indicates that the screening and homebuyer education programs which those borrowers went through were probably inadequate. It is important to remember that all parties to a mortgage, particularly the homebuyer, lose when a mortgage goes into default.

During my four years at the Board dealing with CRA issues, I have frequently noted that the real shortage in community development activities isn't money, but qualified professionals with the appropriate skills and patience to make a program successful. The statistical studies I cite above indicate that those people are still in short supply. They do not indicate that low downpayment loans can't be made or that people with questionable loan histories can't become responsible borrowers. The numbers do suggest that those transformations will not happen overnight or happen costlessly. We have made a fundamental mistake in thinking that results-based analysis, such as counting "dollars out the door" is the best or the only way to look at our success in this area. Aggressive lending just to achieve some numerical targets may create the kind of lending results which do not provide a solid foundation for long term and sustained community development efforts.

Just as the HOTS have it wrong, so do the COLDS. Some are already interpreting the adverse delinquency data as proof positive that such loans cannot, and should not, be made. That is as false a conclusion as those who believe in ever more aggressive enforcement. From the outset, many of the efforts at creating more flexible underwriting criteria have been experimental, and billed as such. We do need to know which lending criteria are effective at sorting out the quality of credit risks and which are merely acting as obstacles to homeownership opportunity. We also need to know which types of remedial efforts are successful and which are not.

Those who would propose that we simply do away with CRA and other types of programs, and who do not come up with a constructive alternative are doing a disservice to the country. On balance, I believe that CRA has been instrumental in helping to meet the credit needs of many underserved areas and among historically underserved groups including minorities and low and moderate income Americans. Billions of dollars have been invested in communities across the nation as a result. Literally thousands of Americans have achieved their dream of home ownership because financial institutions responded to their CRA obligations. Bank branches are opening in neighborhoods where financial services have not been available for over twenty years. These are positive developments. Spreading opportunity widely benefits all of us with a stake in our democratic capitalist system.

Those with a zeal to deregulate should instead seek to incorporate a workable CRA package into an overall urban development strategy based on deregulation. There is no shortage of deregulatory actions which would enormously benefit community-based economic programs. These include regulations affecting banking and financial markets, labor regulations which inexcusably drive up the cost of low and moderate income housing and urban redevelopment programs, cost-ineffective HUD requirements and mandates, and EPA rules which make sensible uses of abandoned urban real estate non-economic. An urban policy that increases the flexibility and creativity allowable under CRA and recognizes the wide variety of financial services needed and the enormous diversity of the markets involved could be a powerful tool to those in the business of community development.

Of greatest concern to me is the reluctance of some of the politicians active in this area to sit down and compromise on CRA. For example, the CRA provisions in the Regulatory Relief bill have been used by opponents of the bill as a political football, helping to bring movement on this issue to a grinding halt. Indeed, some of the leading opponents of reform are refusing to negotiate the issue, saying that they will oppose any and all changes in CRA provisions. Surely this cannot be the best strategy for the long term success of CRA and for community development activities. Unfortunately, some politicians have seized upon it as a red flag designed to rally the political troops, rather than as an effective weapon for change.

So, I am left extremely troubled with the seriousness with which our country is willing to face up to what is probably our most serious social problem -- the deterioration of our inner cities and economic opportunity for the individuals who live in them. It seems that neither our national media nor our politicians seem aware of success when it stares them in the face. And, not recognizing success is a virtual guarantee that we will not select policies which will lead to success in the future. I began this discussion wondering what we should do for an encore. Maybe I should be worried instead about why so many of the politicians and so much of the media snuck out of the show at intermission.