

## **Remarks by Governor Lawrence B. Lindsey**

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### Here We Go Again?

Thank you. It is a pleasure to be here today to discuss some of the challenges that lie ahead in the areas of economic opportunity and community development. Frankly it's a pleasure to be anywhere but Washington D.C. Actually though, in any year divisible by four the whole country gets to glimpse the craziness that has always been a way of life in our nation's capital.

One of the problems that we have in Washington is that our focus is short term, limited only to the next election. Anything that could happen more than four years into the future doesn't register on the collective consciousness. And frankly this time frame has gotten shorter and shorter in an age of nightly polling and focus groups.

But America's cities are a testament to the effects policies enacted in the rush to the next election can have, as well as proof positive that trends that occur in a single economic cycle can last a long time. Our successes, like our failures, often occur over decades. And if we are really to be successful in our community development activities, we must take a much longer view, bearing in mind the problems that may arise as unintended consequences in the years ahead result from the political and economic environment in which we find ourselves today.

Now is a particularly appropriate time to look ahead and make plans because a confluence of forces are providing an array of opportunities that are historically unprecedented. The community development industry has finally gotten its legs and has the possibility to grow and make a lasting contribution to the revitalization of America at a magnitude heretofore unimagined. But if community development is going to succeed in an area where real success is measured in decades, it had better look ahead to a period when times will not be as propitious as they are currently.

Let me begin with some good news. Access to credit by those individuals and communities that are the target of our economic development efforts has reached unprecedented levels. One can see this from a variety of sources. This summer the financial regulators again released their annual report on the number of home mortgages granted the preceding year. The data for 1995 indicate that in a year when the number of conventional home purchase loans decreased overall from 1994, lending to African Americans, Hispanics, and Native Americans went up. The 1995 figures are part of a four-year trend with mortgages granted to these groups on a steady upswing, including significant double-digit increases from 1992 to 1994.

While one can never tell for certain what the "right" number of home mortgages given in a particular year should be, even some simple adjustments for income and demographic factors suggest that the numbers show that we have reached a point where race or ethnic-based discrepancies seem to have largely disappeared. For example, if one takes the market for conventional, non-government-assisted loans as being families who earned \$50,000 or more in 1994, then the proportion of such families getting mortgages in 1995 was 9.6 percent for whites, 8.0 percent for blacks, and 11.6 percent for Hispanics. Including all mortgages--conventional and government-assisted--and dropping the income threshold to \$25,000, shows that 6.4 percent of whites, 6.0 percent of blacks, and 7.2 percent of Hispanics got mortgages in 1995. Confining the base to married families with children, those most likely to be in the market, produces an even more compelling case that disparities have largely disappeared.

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 nonhousing 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 rose only slightly--42.5 percent in 1989 and 44.1 percent in 1992. In 1995 this proportion was 47.5 percent. But the growth in credit card use as a source of finance among nonwhites was substantial. The proportion of nonwhite families having outstanding credit card balances rose from 34.1 percent in 1989 to 42.9 percent in 1992 and to 48.8 percent in 1995. 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.

### **A Confluence of Events**

Why has all of this occurred just now? A part of me would like to conclude that this is the result of a permanent change in attitudes in America. While I certainly believe that we are a more enlightened country than five or ten or twenty years ago, that our collective consciousness has been raised, if you will, I do not believe that this is the whole story. And, there are particular pitfalls to the community development industry in believing that it can rely on an increased nobility of purpose to sustain its mission.

In the short term one can rely on a sense of guilt, or charity, or a fear of enforcement action to motivate behavior. But it will not last. The only permanent motivating force in this world is self-interest. Individuals enter into, and stick with, long-term cooperative agreements only because they are mutually beneficial. Recently we have enjoyed a set of both micro and macro economic conditions that set the stage for a whole new set of mutually beneficial relationships to emerge. But those fortuitous economic conditions will not last forever. We will be successful only if we cement in place long-term mutually beneficial relationships that can survive an adverse turn in economic events.

Without any question the most important economic development has been a decline in the underlying rate of inflation and the consequent decline in medium- and long-term interest rates. Let's do the standard math involved in any home financing decision. In 1990, fixed thirty-year mortgage rates averaged 10 percent. Recently they have been around 8 percent. The principal and interest payments on a \$100,000 mortgage declined from \$878 to \$734.

Using a standard set of assumptions regarding property tax and insurance payments and a PITI to income ratio of 28 percent, the annual qualifying income for this mortgage has fallen from \$48,771 to \$42,600. That \$6,171 decline in qualifying income comes at a very dense part of the income distribution, particularly in the minority population. And, when one considers mortgage market innovations that have eased traditional underwriting constraints, the increased opportunity that results from lower inflation and lower long-term rates is even more amplified.

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

It is important to stress the differential impact of 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. 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, prices 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. While the commitment of the Federal Reserve to preserving a low-inflation environment is unwavering, I cannot assure you that all politicians feel the same way. Nor can I guarantee you that sustaining the fight against inflation will not mean a temporary rise in interest rates at some time in the future.

The second major change has been a shift in attitudes among bankers and their regulators. The regulatory environment has moved dramatically from an overarching concern for bad loans on the books of the nation's banks to one which focuses on regulatory concerns more friendly to community development such as CRA and fair lending. Just four years ago, as we were working on the implementation of FDICIA legislation, the regulatory staff was proposing adopting maximum loan-to-value ratios for mortgages. The Senate Banking Committee had recommended an 80 percent cap on such LTVs. In essence, all home mortgages would have to have been accompanied by a 20 percent down payment. Can you imagine the state of the community development industry if these ideas had been implemented?

Today of course, with the nation's banks enjoying unprecedented health, the focus of regulatory and political concern has changed. We have recently completed an extended period of revamping and strengthening the Community Reinvestment Act regulations. Detailed analysis of bank lending practices down to the census tract level is now a part of our regulatory mission. Fair lending enforcement has been significantly enhanced and is now using statistical practices that are state-of-the-art in all of their technical, legal, and econometric aspects.

A similar change has occurred among the nation's banks. As other lines of bank lending

have seen increasing competition and entry by nonbank financial service providers, the focus of bank lending has moved to the consumer. In 1980 just 33 percent of total bank loans were consumer debt based--including mortgages. That figure rose to 40 percent five years ago and is 44 percent today. In addition, the securitization of consumer debt instruments for resale in the capital markets has increased both the willingness and the ability of banks to make such loans.

But just like the business cycle, the regulatory and banking cycle will not always be as favorable to consumer lending and community development as it is today. The early signs are already in place. Consumer debt-to-income ratios are now at record levels. Debt-service ratios are back to the levels they reached just before the last recession. Bankruptcies are at record highs. As a result, for the first time in this business cycle, banks are no longer, on net, making consumer credit more accessible but are instead beginning to cut back. The political tide has also turned. Last December, Congressman Kennedy held a forum, at which I testified, in which his theme was that banks were extending too much credit. Chairman Leach of the House Banking Committee held formal hearings last month on the consumer credit situation where bipartisan concern was expressed about the sustainability of existing consumer debt practices.

### **Some Previous Cycles**

The reason that we should all be concerned is that history teaches us that these cyclical swings can have some pretty profound effects. I have had other occasions to talk about some of the financial innovations that have played a role in shaping the urban landscape over the past century. Today, I would like to broaden that analysis to look at swings in public policy and the related swings in the community development and housing markets. I am going to focus on two particular cycles to give a flavor for the type of trends we should be looking for. The first is the Urban Renewal cycle of the 1950s and early 1960s. The second is the Great Society cycle of the late 1960s and early 1970s.

The Urban Renewal cycle started with the Housing Act of 1949. It declared that, "a decent home and a suitable living environment for every American family" was to be a national goal. Title I of the act was labeled "Urban Redevelopment," and it was designed to clear slums and deal with two perceived problems--the high cost of land and the existence of parcels of land in cities that were considered too small to meet perceived modern needs. More than half of the federal money spent on urban renewal in the first dozen years of the act went to the purchase of property.

While the urban planning theory behind the legislation may have seemed laudable, the actual implementation produced a very different result. Between 1949 and 1968 some 425,000 units of housing, nearly all of them occupied by low-income households were torn down while only 125,000 new housing units were built on the sites. Further, well over half of the new homes were for upper-income groups. In its implementation, urban renewal was targeted at improving the commercial attractiveness of downtown areas. The price paid for this gamble on redeveloping downtown was a reduction in the availability of low-income housing.

Ultimately this gamble on the commercial position of downtown proved a loser as commerce switched to the shopping centers located on the fringes of towns. In large part, this was the inevitable result of suburbanization. There is no question that widespread auto ownership, the baby boom, and the tastes of the public to achieve the American dream of a home in the suburbs were the main driving forces here. But government policy helped. The

Depression Era housing legislation that established the savings and loan industry created a natural market niche for middle-income home lending. Long-term mortgages at roughly 5-1/2 percent were common. This system would work well from a financing point of view until the mid-sixties, primarily because of stable interest rates, favorable demographics, and general prosperity.

Of course, this was only true of the finance end of the delivery system. In terms of social justice, the story was quite different. The FHA's official manual of the 1930s and 1940s explicitly sought to keep neighborhoods occupied "by the same social and racial classes" in the name of neighborhood stability. The manual even encouraged the use of a model covenant prohibiting the mixing of races. Although restrictive covenants were outlawed in the late 1940s and the FHA would not insure properties covered by them by early 1950, this did not put an end to segregated developments. The fact is that only 2 percent of the new FHA-insured houses were open to blacks between 1946 and 1959.

What one could call the "Urban Renewal Cycle," or more aptly the "Suburb Creation Cycle" of housing policy came to an end in the second half of the 1960s. Both economic and social trends changed to make the old cycle unsustainable. On the social side, the political neglect of the inner cities was brought to an end. Between 1965 and 1968, widespread urban disturbances occurred in many cities in the United States. The result was a spate of commissions and legislation to address urban needs. For example, the Department of Housing and Urban Development was established. The Model Cities Program was authorized in 1966. A ten-year goal of 26 million new and rehabbed housing units was set.

On the economic side, the combination of inflation and government regulation of interest rates produced rapid disintermediation of funds out of the housing market in the late 1960s. To ease those constraints, the savings and loan industry was allowed to offer a 50-basis-point premium over commercial banks to attract deposits. But even this proved insufficient as the problem of housing access was hindered by the outmoded Depression Era delivery system of finance. In 1967, which was otherwise a boom year for the U.S. economy, real residential investment ran 14 percent below its 1964 pace. And for the entire period of the late 1960s, housing starts ran almost one-third below their 1959 peak. Needless to say, this combination of social and economic forces created political pressure for change that became irresistible, and the Great Society cycle began. In 1968 Congress allowed the FHA to adjust the ceiling mortgage rate above the statutory rate. It also authorized section 235, allowing HUD to provide mortgage assistance to allow the interest rate paid by the buyer to be as low as 1 percent and the downpayment to be as low as \$200. For all intents and purposes, a flood of essentially free money began pouring into the housing market. This rapid political response and flood of government money created problems of its own. By December 1970, the natural abuses of section 235 became apparent. A report to the House Banking Committee concluded, "The Department of Housing and Urban Development and its Federal Housing Administration may be well on its way toward insuring itself into a national housing scandal... FHA has allowed real estate speculation of the worst type to go on." Substandard homes bearing inflated mortgages coupled with the practice of "flipping" by unscrupulous speculators was the natural result of this virtually free access to funds. A 1972 internal HUD audit indicated that HUD was paying substantial premiums for the design and construction of multifamily projects. Press articles appeared that referred to HUD as the nation's largest slumlord.

So, the Great Society cycle of massive urban housing subsidies came to a crashing end with

a de facto housing moratorium in 1973. Donald Sullivan, in his article on housing in the 1970s contained in Gertrude Fish's *The Story of Housing*, summed up the lesson we should all learn very well: "In designing programs to allow low and moderate income Americans to participate in the dream of homeownership, few realized that a tighter control or performance system would be necessary for monitoring purposes. Federal money suddenly became available ... as well as FHA insurance. The granting of FHA insurance to homes of such poor quality that they clearly would not survive the life of the mortgage was basically fraud."

The effect of this boom-bust cycle on our nation's cities was horrendous. Chicago's Mayor Richard Daley told a Senate committee in 1975: "Most major cities in the U.S. have been left with thousands of abandoned and vandalized structures in what had been desirable neighborhoods." Les Coplan of the San Francisco Home Loan Bank testified: "We had 2,000 foreclosures in Oakland. Some of them were section 235 loans; the rest resulted from the breakdowns that followed 235."

The key fact that Coplan was on to was that if defaults and foreclosures reach a crucial level, not only those who default turn out to be losers. A neighborhood cannot survive when a number of its homes become abandoned. They quickly become targets for vandals, and now in the 1990s, become havens for the drug trade. The result is a decline in the entire neighborhood as it becomes a less desirable place to live. Deteriorating property values lead to increasingly risky lending conditions, a natural cutback in capital, and still further declines in property values.

### **Here We Go Again?**

All of this history should lead us to some sobering reflection. Are we now at another peak and about to enter another crash in the economic, political, and regulatory underpinnings of our urban redevelopment and homeownership efforts? There is at least superficial resemblance to the two earlier cycles I discussed. The economics most closely resembles the 1950s cycle of low interest rates coupled with low inflation. The politics and regulatory environment most closely resembles the late 1960s when efforts to channel funds to urban redevelopment were most desirable. My suspicion is that in spite of these comparisons we still have some time if we act prudently to prevent problems in the future. I suggest three steps.

First, I think that it is vital for all of us to realize that a low-inflation environment is crucial to urban redevelopment and homeownership opportunities for low- and moderate-income individuals. Unfortunately, some of those politicians who express the most concern about these issues do not understand this fact. The political temptation to try to solve economic problems with the printing press is probably as old as government, but it simply does not work. And bad as it is for the economy at large, it is a disaster for the stability required for financing homeownership opportunities to those on the first rung of the economic ladder.

Second, it is crucial that urban development practitioners seek permanent partners in the private market. To do so they must rely on the only thing that achieves this permanence--the establishment of mutual self interest--not charity, and not a regulatory club. I have often heard, and am sympathetic to, the argument that CRA is needed to get the attention of banks and "get them to the table." Well, we have gotten their attention and they are at the table. Now it is the responsibility of urban redevelopment practitioners to keep them there.

Third, we must avoid overpromising and overcommitting. We do no one any favors by

putting a family that is not ready or able to carry the responsibilities of homeownership into a home of their own. If that family does not make it, it is economically, socially, and spiritually devastated. If there are enough of these families, the entire neighborhood may suffer. Whether it is homeownership or small business creation, the binding constraint we now face is not access to financial capital, it is access to human capital. Neither the problems of our cities, nor the success of our nation as a whole resulted from some sudden action. It required a long, patient process involving a lot of hard work. Today we must rededicate ourselves to these principles. We do this not because we feel the job isn't worth doing, but because it is the only way the job will ever get done.

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