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Statement by

**NANCY H. TEETERS
Member, Board of Governors of the Federal Reserve System**

before the

**Committee on Banking, Housing, and Urban Affairs
U.S. Senate**

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Enforcement of Fair Mortgage Lending Laws and Regulations

I am pleased to appear before this Committee to report on the Board's enforcement activities relating to the Equal Credit Opportunity Act (ECOA) and the Fair Housing Act. In order to give the Committee a more complete understanding of the Board's current posture with respect to the enforcement of fair lending laws, a brief discussion of the background of the Board's activities in this area may be useful.

In March 1977, the Board adopted an enhanced specialized program for enforcing all of the consumer and civil rights laws applicable to State member banks. This program ran for a two-year experimental period. In February 1979, the Board made this program, with some enhancing modifications, permanent. In adopting the program, the Board issued the following statement to indicate its commitment to the enforcement of the antidiscrimination laws:

The Board believes that any type of discrimination prohibited by the civil rights laws is detrimental to the nation and to society. The Board is convinced that such discriminatory practices by banks are not only illegal but are not in the best interests of the banks, the communities they serve, or the individuals residing in those communities. The Board will investigate thoroughly each complaint of discrimination it receives regarding a State member bank as well as any indication of noncompliance revealed during an examination of a State member bank. In any instance of unlawful discrimination, the bank will be accountable for appropriate remedies and penalties as provided for in the applicable laws and will be required to take prompt action to correct the violation.

Background of the Board's Enforcement Program

The Board has been involved in the implementation of fair lending laws through the examination process since enactment of the Fair Housing Act in 1968. The Board was also involved in the earliest stages of implementation of ECOA because of its rulemaking authority under that act. It was given the responsibility for developing regulations that prohibit unlawful discrimination in the credit granting process. Regulation B, which implements ECOA, is applicable to all extenders of business and consumer credit, including, for example, banks, credit unions, finance companies, savings and loan associations, and retailers. Since it has proven necessary to amend and interpret Regulation B from time to time, the Board's involvement in rulemaking is a continuing one.

Prior to establishing the separate consumer affairs and civil rights enforcement program in 1977, the Board had Fair Housing and ECOA enforcement procedures in place, although they were not as comprehensive or forceful as they are today.

Although your request for testimony focuses on the Board's enforcement of fair mortgage lending laws, it is necessary, in order to put the Board's activities in a more complete context, to understand the scope of the consumer and civil rights enforcement program. This program covers 13 different laws and regulations:

1. The Fair Credit Reporting Act
2. The Fair Debt Collection Practices Act
3. The Fair Housing Act (Title VIII of the Civil Rights Act)
4. The Real Estate Settlement Procedures Act
5. Regulation B (The Equal Credit Opportunity Act)

6. Regulation C (The Home Mortgage Disclosure Act)
7. Regulation E (The Electronic Fund Transfer Act)
8. Regulation H (National Flood Insurance Provisions)
9. Regulation Q (Interest on Deposits)
10. Regulation Z (The Truth in Lending, Fair Credit Billing and Consumer Leasing Acts)
11. Regulation AA (Unfair or Deceptive Acts or Practices by Banks and Consumer Complaints)
12. Regulation BB (The Community Reinvestment Act)
13. Right to Financial Privacy (The Financial Institutions Regulatory and Interest Rate Control Act)

As can be seen from this list, several relate directly to fair mortgage lending, that is, the Fair Housing Act and Regulation B, while others, such as Regulations C and BB, have a less direct, but growing, relationship.

With the growth in this area of its responsibility, the Board decided in March 1977 that a specialized enforcement program was necessary. The framework that was established at that time provided for consumer affairs and civil rights examinations that resulted in an examination report separate from the usual commercial examination report. The program also established the educational/advisory service to aid member banks in understanding the regulations' requirements, as well as more formalized complaint investigation procedures. To aid the examiners, special training schools were conducted.

After a year's experience, the Board conducted a preliminary review of the consumer affairs enforcement program. This review showed that, although examinations frequently revealed procedural violations, they

had not been as successful in uncovering evidence of banks engaging in violations of Regulation B and the Fair Housing Act Involving actual discrimination. It was felt that revisions of the existing procedures were warranted. The examination process was analyzed in order to isolate those aspects that could be improved and to develop ways to strengthen it.

To supplement research on this question, the Board engaged an outside expert to study the Board's procedures and materials for enforcing the ECOA and Fair Housing Act and to make recommendations for changes. The consultant's report, which was delivered in May 1978, suggested a redirection of emphasis in the System's enforcement efforts with respect to the detection of credit discrimination.

A System task force was convened for the purpose of revising and redrafting the examination procedures based on these suggestions as well as suggestions made by representatives of interested civil rights groups who participated in the review. The recommendations and changes resulting from this exhaustive study were substantial and were incorporated in the final compliance program approved by the Board in February of 1979. The examination procedures and workpapers were revised to reflect the more substantive approach to consumer affairs examinations. As part of the package, the Board approved a comprehensive proposal that included:

- . a Compliance Handbook detailing examination and investigation procedures;
- . a mandatory examination frequency schedule that requires more frequent monitoring of poorly performing banks;
- . strengthened complaint investigation procedures that require on-site investigations in certain circumstances;

- . appointment of civil rights specialists in each of the Reserve Banks;
- . designation of three attorneys on the Board's staff as civil rights specialists; and
- . development of career ladders for consumer affairs examiners that are comparable to those of commercial examiners.

An important aspect of the program is the educational/advisory service, which is available to all member banks, including national banks. On request, a representative from the Reserve Bank will visit the bank and explain any aspect of the consumer and civil rights laws and regulations with which the bank needs assistance. The visit is therefore tailored to the bank's need and is particularly useful when new legislation is passed.

The complaint investigation procedures have been revised to require prompt, thorough responses to complaints, particularly those that allege credit discrimination. When a complaint alleging discrimination is received, the Reserve Banks are instructed to designate an individual to respond to the complainant or acknowledge the complaint within 15 days of receipt. The Reserve Bank requests a specific response to the complaint from the State member bank within 10 days. The Reserve Bank also contacts the complainant to obtain any information or clarification considered useful to the investigation. Based on the preliminary information, the Reserve Bank determines whether an on-site investigation is necessary. When the investigation is concluded, the complainant is again contacted and informed of the findings.

An on-site investigation occurs when any of the following appear to be present:

- . discrimination on a prohibited basis;
- . inconsistent treatment of applicants;
- . examination reports, correspondence, or other information indicate a history of discrimination; or
- . a review of the bank's internal policies, procedures, and rules concerning the complaint reveal evidence of discrimination.

Briefly, the additions to the examination procedures that were made when the program became final include:

- . the authority to interview people who are not affiliated with the bank,
- . analysis of the demographics of a bank's community to determine the impact of lending policies on that community,
- . comparing borrower characteristics and loan terms for disparate treatment; and
- . geocoding loans to determine if unwarranted disparities in geographic distribution of loans exist.

Examiners are to perform whatever analysis is necessary to reach a conclusion regarding whether prohibited discrimination is taking place. Under the revised program, the examination or investigation will continue until a conclusion is reached on every aspect of a bank's compliance posture, including discrimination.

The establishment of a career path for consumer affairs examiners was an important step helping to fulfill the objectives of the enforcement program. In order to attract and retain a qualified corps of examiners, it was necessary to eliminate the disparity in pay and status that existed in some Reserve Banks between consumer and commercial bank examiners largely because of the newness of the separate consumer compliance program. The program approved by the Board mandated that each Reserve Bank develop a career ladder for the consumer affairs examiners that parallels the opportunities available for commercial examiners.

In order to implement the approved package it was necessary to provide the resources needed to complete the additional examination steps. Based on information received from nine field tests, it was determined that the field staff should be increased from approximately 70 examiners to 138 examiners and 22 civil rights specialists in order to successfully complete the objectives of the proposed program, which now includes the Community Reinvestment Act.

A survey was conducted in June, 1979 to determine the staffing levels at each Reserve Bank. The survey showed that of the 138 budgeted examiner positions, 116 had been filled, and all of the budgeted 22 civil rights specialist positions were filled.

The Compliance Handbook was distributed to the examination staff and to State member banks as a form of educational assistance. The Compliance Handbook includes a plain-English explanation of the regulations' requirements. It also specifies examination and investigation procedures and includes extensive checklists.

Bankers may find the Handbook useful guidance in establishing their own programs for compliance.

Training

The Board emphasized specialized examiner training as part of the 1977 compliance program. For example, in 1979 the Board conducted two schools for consumer affairs examiners at which 58 examiners were trained. Training aids included case studies which incorporate actual bank-type documentation, workpapers and fact situations. Instructors for the examiners schools are examiners from the Reserve Banks, review examiners and attorneys from the Board staff, and attorneys from other agencies, such

as the Justice Department. The attorneys provide a thorough background of the history of civil rights laws. This background includes an analysis of pertinent issues in specific court cases and their effect on civil rights legislation.

Upon adoption of the new enforcement program, Board staff conducted a series of three regional seminars at the Reserve Banks to apprise the field staff of the new procedures.

Attorneys from the Justice Department have addressed groups of Board and Reserve Bank staff, at both the regular examiner's school and at special seminars, on such matters as the history of civil rights litigation. The lectures were comprehensive and discussed various aspects of discrimination, including the effects test analysis. These presentations were instrumental in developing the expertise of Board and Reserve Bank staff members and contributed to the training of the Board's civil rights specialists.

The Board also rotates examiners from the Reserve Banks to work with Board staff as an aid to their development. In addition, Board staff communicates frequently with System examiners to inform them of current developments.

I have just described the background of the development of the Board's compliance program. I will now describe the Board's role in utilizing the effects test as a tool for enforcing the fair lending laws in those banks for which it has responsibility.

The Effects Test

Title VII of the Civil Rights Act of 1964 prohibits the use of employment practices that discriminate against job applicants or current

employees on the basis of race, color, religion, sex, or national origin. In interpreting the act, the Supreme Court has determined that an employment practice that is applied evenhandedly and without intent to discriminate nevertheless may be illegal if it has a disproportionately adverse effect upon a so-called protected class. The technique of identifying discrimination by looking at disparate impact rather than improper intention is commonly known as the effects test.

The generally accepted understanding of the effects test, as it evolved in the courts, involves a three-stage analysis. The first stage is obtaining evidence that a policy has a disproportionate impact on a protected class. Once this has been established, a determination must be made whether a business need exists which justifies the utilization of the questionable policy. Finally, a determination must be made as to whether some alternative policy might serve the same business need and have less impact on the protected class.

The Compliance Handbook includes an extensive discussion of the effects test. The Handbook addresses discrimination in marketing practices, explicitly addresses neighborhood discrimination, and provides guidance on the effects test by setting forth the general principle of the effects test and providing a number of specific examples of practices which may have a discriminatory effect.

Even though we have enhanced training and have provided guidance on the effects test, making an effects test determination can be extremely difficult because the development of the statistical data is not an easy process. A determination regarding a justifiable business necessity is an even more troublesome task because it involves complex, judgmental issues.

The Supreme Court had no difficulty deciding that the requirement of a high school education for promotion from laborer to coal handler at an electric power plant in North Carolina disqualified blacks at a "substantially higher rate" than whites, that the requirement was not "significantly related to successful job performance, and that, consequently, it was impermissible. But that was a clear-cut case.

One example of the difficulty of determining whether a business need is supportable is the question of whether consideration of income as a standard of creditworthiness is justifiable. On the average, whites have greater income than blacks, men larger incomes than women, married persons more income than singles, middle-aged persons more than those of other ages, persons of Northern European descent more than those with ancestors from Asia, and wage earners more than welfare recipients. Thus, consideration of income--which is a basic part of judging creditworthiness for many creditors--probably disqualifies members of most of the ECOA "protected" classes at a "substantially higher rate" than middle-aged, white, Anglo-Saxon, males who are married. According to this line of reasoning, consideration of income, when subjected to an effects test analysis, could be suspect under the ECOA.

A small, but nevertheless significant, number of creditors (particularly among those using computerized credit scoring systems) do not consider the amount of an applicant's income in determining creditworthiness. They either do not find income to be predictive of ability or willingness to repay or find other factors to be more predictive. Based on this evidence, the experience of those creditors indicates that income, in certain instances, may not be "significantly related" to creditworthiness. A bank examiner, however, would have a difficult time

determining whether, for a particular bank, there is a justifiable business necessity to consider income, or whether consideration of income is "significantly related" to creditworthiness.

In 1976, when Congress expanded the Equal Credit Opportunity Act's coverage, brief statements in the Senate and House reports expressed the congressional intent that the effects test be used to detect credit discrimination. The Senate report accompanying the 1976 ECOA amendments merely states: "In determining the existence of discrimination ... courts or agencies are free to look at the effects of a creditor's practices as well as the creditor's motives or conduct in individual transactions." The House report says essentially the same thing.

The effects test was developed in the context of contested litigation, with each side presenting witnesses and offering evidence. Preparing for and conducting each trial takes months, sometimes years. It would be difficult to imagine the resources needed for examiners to conduct such searching investigations for each of the approximately 12,000 federal credit unions, 14,000 commercial banks, 4,000 savings and loan associations, and 475 mutual savings banks in this country that are subject to the ECOA.

I am not suggesting that the agencies are unable to make any effects test determinations. We can and have. For example, we have said in Regulation B that a creditor may not discount an applicant's alimony or pension income because of the adverse effect that such a policy would have upon women and the elderly.

When a bank chooses, for example, to ration credit by extending credit only to its current customers we can, however, only warn the bank of a potential effects test problem. Such a problem might exist, for example, in a bank whose depositors consisted primarily of white customers in a relatively integrated market area. We do not have the time or resources to perform an effects test analysis as comprehensively as that undertaken during litigation. Nor are we in a position to judge in all cases whether the policy is justified by business necessity.

The Board does not presently contemplate amending Regulation B to provide guidelines regarding the effects test. The Compliance Handbook explains the effects test in some detail and provides specific examples of practices which have a discriminatory impact. Copies of the Handbook have been distributed to all State member banks. The Board views the Handbook as an effective means of providing guidance regarding prohibited illegal practices.

Frequently, the Handbook is more useful than a regulation because it is more flexible. It communicates in what we believe to be plain English; it provides a narrative explanation of the nature and background of certain requirements; it may be amended more easily than a regulation; and, most importantly, it could ultimately be backed by the Board's enforcement authority just as a regulation would be. For these reasons, we fail to see a compelling argument for adopting regulatory changes to achieve objectives that are already being met.

The effects test still remains a useful tool for detecting the more subtle forms of credit discrimination despite the difficulties in analyzing its phases. We will continue to use the effects test as a tool for identifying potentially discriminatory practices. But in the

credit arena as in the area of employment practices, the effects test will remain largely a matter for the courts to apply.

Examination Procedures

Analysis of the implications of a bank's lending policies and practices requires a complex evaluation of information from a great variety of sources. This information comes from court cases that establish precedent on particular issues; it comes from the Census Bureau or local government bodies which provide data about the residents of a bank's community; it comes from the bank in the form of written lending policies or in interviews; it comes from residents in the community; and finally, it comes from observations made by the examiner. A discussion of the more salient aspects of the examination procedures for discrimination may be useful.

The initial focus is the bank's articulated lending policy. It is essential to establish the "articulated standards" of a bank's lending policy for two reasons. First, to make the determination that the bank's standards are nondiscriminatory, the examiner has to know what standards the bank says it uses. Next, the examiners must determine whether the standards are applied in a nondiscriminatory fashion.

The standards are first reviewed to determine if they are either overly subjective or so vague that they cannot accurately predict risk. For example, a factor that gives more weight to professional employment status might have a disproportionate adverse impact on women or minorities and, at the same time, bear little relationship to willingness or ability to repay.

When examining real estate loans, the examiner is particularly alert to underwriting criteria which, while not demonstrably related to mortgage risk, can severely limit the amount and type of credit available in older, integrated areas. Such restrictive criteria might include arbitrary cutoff points for age of property, and structural criteria such as minimum number of square feet, type of heating, and minimum setback. Census data regarding housing characteristics reveal that inner city housing is typically older, has fewer square feet, and is more likely to be affected by restrictive underwriting criteria than housing in the suburbs. An age cutoff of 20 years, for example, will have the effect of automatically denying a loan to many applicants who seek to buy property in the inner city.

The examiners have been instructed to consider the implications of such lending policies as the use of the remaining economic life of real estate as an underwriting criteria. An estimate of the remaining economic life of a piece of property can be a highly arbitrary number which might be used in an improper fashion. We have always interpreted economic life as a carefully considered value which should accurately reflect the condition of a parcel of real estate. When used properly, remaining economic life can be a more precise indicator of value than an adjective describing the condition of property.

Alternative approaches, such as an adjective describing the condition of a piece of property, may also be used in a subjective fashion and may lead to abuse. For these reasons, we caution examiners to be very

precise in analyzing loan underwriting criteria. We also identify for the examiners those criteria, such as age of property, that are clearly impermissible.

For this and other reasons, it is important for the examiner to become familiar with the housing and demographic characteristics of a bank's community. Earlier this year, the System's examiners were provided with census data for each Standard Metropolitan Statistical Area that was tracted as of the 1970 Census. Using the bank's community delineation contained in its Community Reinvestment Act statement, the examiner is then able to develop a better understanding of the potential impact a bank's lending standards may have on its community.

Since 1970 census data may, in many cases, give an outdated and incomplete picture of a bank's current community, the examiners have been instructed to conduct interviews outside the bank, when necessary, to get a better idea of current neighborhood composition. These interviews are to be undertaken with community groups, neighborhood housing groups, local minority leaders and city officials. The interviews outside the bank become particularly crucial for banks in rural areas where no census data are available.

Interviews outside the bank are useful for purposes other than obtaining current demographic information. Interviews provide an opportunity for examiners to ascertain how the community perceives the bank is performing its lending function. In addition, interviews with persons outside the bank are likely to be a useful source of information regarding such practices as "prescreening" or "steering" of customers to or away from certain financial institutions.

The bank's loan application activity is then analyzed to determine the proportional representation of the various segments of the community in the bank's accepted and rejected loan application files. By utilizing monitoring data, when available, to identify applicants who are members of protected classes, the examiner reaches a preliminary conclusion as to whether the bank's lending policies have a disproportionate impact on protected classes in the bank's community.

If the examiner reaches a preliminary conclusion that discrimination is present, the examiner then tests the validity of that conclusion by analyzing the treatment of individual applicants. A determination is made whether exceptions to the loan policy are justified and if there appears to be any pattern to the exceptions that might favor one class at the expense of another.

Once the examiner has arrived at a final conclusion regarding the existence of discrimination, the findings are reviewed with management of the bank being examined. The results are then summarized and placed in the examination report. The examiners are instructed to put all significant findings in the open section of the examination report. Consequently, findings regarding effects test issues are placed in the open section of the report regardless of whether they are substantiated or potential problems.

Every attempt is made to correct violations during the examination process, or in subsequent correspondence or follow-up examinations. The cease and desist order is the final enforcement vehicle the Board can utilize. This year, two cease and desist orders were issued that dealt with consumer matters, both of which involved ECOA violations. One of

these orders required the bank to conduct a file search and release from liability any applicant whose signature had been illegally required on a mortgage instrument.

Geographic Distribution of Loans

In those institutions that are subject to the Home Mortgage Disclosure Act, the examiners analyze information contained in the HMDA statement. By reviewing the bank's annual record of mortgage lending by census tract, the examiner can gain some impressions regarding the geographic distribution of mortgage and home improvement loans and the impact that might have on protected classes within the community. This information is useful for assessments under the Community Reinvestment Act as well as the Fair Housing Act and ECOA.

When necessary to arrive at a final assessment of a bank's lending performance, the geographic distribution of loans that are not covered by the requirements of the Home Mortgage Disclosure Act is also considered by the examiner. These loans include all types of non-real estate credit and all loans made by banks that are not subject to the HMDA reporting requirements. The analysis is quite time consuming, but can be made by manually geocoding loans on a map. The focus is essentially the same; to determine if low income or racially integrated areas are wrongfully being denied credit.

Prescreening

Examiners determine if prescreening exists by analyzing a bank's procedures for interviewing applicants and observing some of

these interviews taking place. Examiners also gain a great deal of information by interviewing people outside of the bank.

One method of determining the existence of prescreening that has been suggested is that of "testing." Briefly, testing is a procedure that involves sending two financially comparable credit applicants, one of which is a member of a protected class, to the same institution. The treatment given one applicant is compared with the experience of the other to determine if the member of the protected class was wrongfully denied or discouraged from applying for credit.

A task force of the Examination Council is presently reviewing the feasibility and desirability of testing. Because the issue affects all the agencies whose supervised institutions make mortgage loans, the Examination Council provides a logical forum in which to explore this matter.

Adoption of Data Collection Systems

A question has been raised as to whether Regulation B should be amended to require more comprehensive data notation. In the event that a change in the existing monitoring requirements of Regulation B is deemed advisable, it would be inappropriate to make the additional requirements a part of Regulation B. This is because the regulation currently covers all creditors, many of which, such as mortgage bankers, are not subject to routine examinations. It would be unnecessarily burdensome to subject those creditors to additional recordkeeping requirements where the information may never be used. Under Regulation B the Board has authority to institute an enhanced data collection system,

applicable to State member banks, under a separate regulation should that prove to be the proper course of action.

Some other agencies have developed their own data notation packages. The Board is currently studying the experiences of those agencies in their respective supervised institutions to evaluate their systems' effectiveness and feasibility. The methodologies of the three agencies appear to be variations of the same central theme. The data collection is mandatory, and identify not only the personal characteristics of the applicant, but certain characteristics of the property and the credit extension as well. The examiners then use these "data logs" to generate a profile of the bank's lending policy and compare the treatment of applicants generally with that afforded members of protected classes.

The quality and quantity of data available to the other agencies' examiners, due to their enhanced data collection, may prove to be better than that available to ours. That is why we are closely monitoring their experiences. The difference between the types of comparisons made possible under these mandatory recordkeeping requirements and those made by the System's examiners, however, appears to be more one of form than of substance. When the monitoring data presently called for are available, the Federal Reserve examiners are able to identify loans to members of protected classes. The examiners are also instructed to determine the bank's articulated lending standards by sampling and interviewing techniques. Examiners look for disparate treatment of protected classes by analyzing loan applications and making comparisons with the bank's articulated lending standards. The type of comparisons made and the type of data that are analyzed by examiners from the different agencies therefore appears to be the same.

One major difference appears to be the format in which these data are organized. Where mandatory recordkeeping exists, the burden is on the loan officer to collect and organize the data for the examiners. Under the Board's procedures the burden is placed on the examiner to collect and organize the data.

Our experience has suggested that the magnitude of the problem may not justify the expense associated with additional recordkeeping requirements. Only a very small proportion of the residential mortgages outstanding are held by State member banks. In fact, in dismissing the suit brought by the Urban League against the Board, the Court noted that the mortgage loans held by State member banks "account even in the aggregate for only a miniscule percentage of home mortgage loans. Procedures adopted by the other agencies may not be cost effective when applied to State member banks.

The Board will continue to evaluate the methodology and results of the other agencies' data collection efforts. To the extent that the current procedures can be materially enhanced by the adoption of mandatory recordkeeping requirements, the Board will consider doing so.

Monitoring Field Experiences

We have been asked whether the Board would consider maintaining data on patterns of violations, on effects test situations, narratives to accompany the citation of violations, and the frequency and effectiveness of making contacts outside the banks.

The Board currently analyzes this kind of information on a case-by-case basis. In addition, our system is designed to accumulate

data on the numbers of violations. While the accumulation of data on additional categories might be very useful, our experience indicates that an automated system does not have the capacity to summarize meaningfully any narrative information. An alternative would be to collect this information manually from each of the 1,000 examination reports prepared every year, but our experience suggests that doing so would be unduly cumbersome.

We are nearing the completion of a revision of our data system. We have attempted to accommodate the need for more qualitative information in the data system and will consider broadening the categories. However, because the data system compiles only numerical information, the inclusion of narrative information in the computerized data system would not be workable.

Regulation B Enforcement Guidelines

A question has also been raised as to the status of the Inter-agency Regulation B Enforcement Guidelines. New draft Guidelines have been prepared based upon the public comments. The new draft has been field tested by each of the agencies participating in its development. The results of the field tests are currently being compiled. A task force will reconvene shortly to determine if additional revisions will be necessary to accommodate any problems in implementation that were identified. There is no fixed timetable for completion of the Guidelines. However, we anticipate that they will be considered by the Examination Council and the agencies early next year.