Remarks
by
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One of my major efforts over the past 12 months has been to improve performance by thrifts in meeting the credit needs of their entire communities. In particular, we have been seeking ways to increase investment in underserved communities and to tackle persistent patterns of lending disparities. We vigorously advocate improved access to credit and reinvestment in our urban and rural communities; we also vigorously enforce the fair lending laws.

## What the HMDA Data Show

Early this year we took at close look at the 1997 HMDA data. I would like to discuss briefly the findings of that review, particularly as it relates to minority populations and lending patterns. My overarching observation about HMDA data is that they contain just enough information to enable anyone - lawyers, advocates, bankers, economists, or regulators - to support their position. Although HMDA data are an invaluable tool that gives us much information about lending patterns, there are many gaps and limitations in the data. Particularly as they relate to applicant characteristics and reasons for denial, these limitations make broad conclusions impossible without further research. With that observation in mind, I will tread cautiously.

Looking at the home purchase loans extended by all HMDA reporters last year, we see that originations increased the most for Asian Americans, a 12% increase over 1996, while the growth in loans to both Blacks and Hispanics, at 4% each, was double the growth rate in loans to Whites, at 2%. Lending to Native Americans increased by 1%. These increases in home purchase lending reflect in part the broad-based strength of the economy and low interest rates that prevailed in 1997, as well as the efforts of financial institutions and others to make the dream of home ownership a reality for all Americans.

Over the last five years, the HMDA data show that home purchase originations have increased 62% for Blacks, 58% for Hispanics, 29% for Asians, 25% for Native Americans, and 16% for Whites. Total home purchase loans to Blacks and Hispanics are at an all-time high, and are part of the reason the homeownership rate for Blacks and Hispanics – as well as for all Americans – reached an all-time high in the third quarter of 1998. These are some impressive numbers and represent a significant improvement over the overall situation that existed when the Federal Reserve released its 1991 study of the Boston area origination and denial rates to minority and nonminority persons.

Still, we are concerned about some of the trends that persist. First, of course, is the gap that still exists between the homeownership rate for Whites and that for minorities.

Second is the overall slowdown in the rate of growth in lending to minorities. After the large increases in the early 1990s (50+% in 1993 and 30+% in 1994) in lending to Blacks and Hispanics, the growth rates over the last three years have been much more modest, with lending to Blacks, for example, in 1996 actually lagging the national average growth rate. While we should not expect the explosive growth of the early nineties to persist indefinitely, we do expect sustained effort in reaching these underserved markets.

Third is the continued rise in denial rates as well as differences between the denial rates for Whites and for some minority groups. The denial rate for conventional home purchase loans overall increased dramatically from 17% in 1993 to 29% in 1997. During the most recent two-year period (1996 to 1997), the denial rate for Blacks, for example, increased from 48.8% to 53% while the denial rates for Whites increased from 24.1% to 25.8%. However, the ratio of denial rates between Black and Whites has remained fairly constant over the period, at around 2:1.

When analyzing the underpinnings of denial data, we think that the increase in denial rates in general for both Blacks and Whites is attributable, in part, to increased applications from lower income families and individuals. The share of all HMDA-reported applications from lower-income households increased steadily over the past several years, from 29.9% in 1993 to 34.4% in 1997. At the same time, the number of loans to lower-income households increased from 667,445 in 1993 to 920,954 in 1997, a 38% increase.

The higher denial rates in minority lending, in particular, also relate in a large way to the higher application rates by minorities to lenders that specialize in manufactured housing, and subprime lenders. As noted in an FFIEC analysis of the 1996 HMDA data, these lenders (who were separately identified) have much higher denial rates than other lenders. An analysis of the 1997 data shows that these lenders had an aggregate denial rate of 56%, while all other lenders had an aggregate denial rate of 12%.

In 1997, these lenders received 70% of all the conventional home purchase applications from Native Americans, 66% of applications from Blacks, 46% from Hispanics, and 35% from Whites. Only 11% of Asian American applications were made to these lenders. Clearly, since HMDA data do not separately identify these types of loans, they can skew the aggregate numbers in a way that does not tell the whole story.

To help us gain a better understanding and perspective on this issue, and to improve the HMDA reporting structure, OTS, together with the OCC, FTC, HUD, DOJ, and Treasury sent a letter to the Federal Reserve Board in May requesting that the Board consider changes to HMDA's implementing Regulation C to require the identification of manufactured home transactions. We pointed out in our letter that this change to Regulation C is necessary given the significant differences in underwriting, denial rates, and other features in these types of transactions as compared with traditional home transactions.

Fourth, minorities are relying increasingly on government-backed mortgages. The 1997 HMDA origination data show that conventional home purchase loans to Hispanics actually declined 2.1% from 1996 levels. In the prior year, conventional home purchase lending to Blacks declined 1.5% from the 1995 levels.[1] These declines, though, were more than offset by increases in government-backed lending. Overall, government-backed

[1] In 1996, conventional home purchase lending increased to Hispanics by 0.5%. In 1997, conventional home purchase lending increased to Blacks by 2.6%. See, FFIEC Press Release dated August 6, 1998.

lending is used more frequently by minorities than by Whites. We are pleased to see increased mortgage originations to minorities. FHA and VA loans offer attractive advantages to low income persons such as lower downpayment requirements, and for many families, they may be very good products. At the same time, we want to ensure that the increased number of minority persons making use of government-backed loan programs does not result from illegal steering.

**Similar Trends Reported for Cleveland**

The 1997 HMDA data for the greater Cleveland area show some of the same trends found in the national data. The level of overall home purchase lending in 1997 in Cleveland was virtually the same as in 1996, showing a slight 0.2% decline. Conventional home purchase lending fell by 3.5%, which was almost offset by a 15.4% increase in government-backed lending. Conventional home lending to Blacks fell by 6.5%, while it fell 6% to Whites. On the other hand, government-backed lending to Blacks rose by 21.6%, while it rose 13.1% for Whites. Most of the growth in government-backed lending was to moderate and middle income applicants. The one income group that showed some growth in conventional lending was the low (less than 50% of the median family) income group, for whom conventional financing rose by 12.5%.

For conventional home purchase loans, the denial rate for Whites was 9.7% compared with 18.5% for minorities as a whole and 20.9 % for Blacks in particular. Moreover, while Blacks make up approximately 26% of the population of Cuyahoga County (based on 1994 information prepared by the Ohio Department of Development), they submitted only 8.3% of the conventional home purchase loan applications while Whites filed 70.6% of these applications. Under current regulations, race information is not required to be collected for applications taken by mail or telephone. A full 17% of the applications contained no information on race. It is possible that this large percentage of applications without monitoring information may result in part from concerned minority persons who decide to file applications by telephone or the mail in the attempt to avoid possible discriminatory factors from entering into the process. Any way you look at it, however, these recent figures on conventional home purchase applications and denials are troubling.

When we look at government-backed home purchase loans in the Cleveland area, we find that Blacks submitted 35% of their total applications for home purchase loans to government-backed programs, while Whites submitted only 16% of their applications to the same programs. Although any number of economic reasons can be advanced to explain this difference, one must still question whether financial institutions are improperly steering minority persons to particular types of products. Only further inquiry will help determine what is behind these numbers.

In trying to improve overall lending to minorities it is important that we carefully analyze and understand relevant data and determine what if any conclusions can be drawn from that data. It is also important, however, to continue to look at the lending activities of individual institutions and to assist with their efforts to better reach minority communities and individuals.

At OTS we do that in a few different ways. Most important are traditional compliance examinations, which include a review of each institution's CRA performance and their adherence to fair lending laws and regulations. We also have an active Community Affairs division that seeks to promote access to credit for low-income and minority families through education efforts, programs designed to foster public/private partnerships, and other outreach endeavors. Finally, senior management -- including our Regional Directors -- continuously emphasize the importance of serving all communities in an institution's service area in our discussions with individual institutions and in large and small forums.

Every thrift receives a compliance examination—approximately one every 24 months. As part of that examination, institutions are evaluated on their performance under the Community Reinvestment Act and on their compliance with fair lending laws.

**CRA and Fair Lending Examinations**

I would like to talk briefly about the CRA and fair lending portions of the compliance examinations, both in terms of what they do and how we are working to improve them.

First, CRA. As you know, CRA encourages regulated financial institutions to help meet the credit needs of their entire communities, including low- and moderate-income areas, consistent with safe and sound operations. CRA performance evaluations are conducted as a part of our regular compliance examinations and written evaluations of CRA performance are made available to the public. CRA evaluates an institution's record of meeting the credit needs of its community, including low- and moderate-income persons and geographies within its assessment areas.

CRA regulations do not call for the banking agencies to assess lending to minorities per se, but do require that we evaluate the performance of banks and thrifts in providing credit to persons and geographies of varying income levels within the community. For this reason, the public CRA evaluation does not specifically discuss the minority composition of an institution's assessment area or the institution's record of lending to minorities.

Nonetheless, adherence to fair lending laws and regulations is a major factor in the CRA evaluation process. If an institution is illegally discriminating, it cannot be effectively serving its community. CRA regulations specifically provide that evidence of discriminatory or other illegal credit practices will adversely affect an institution's CRA performance and rating. Accordingly, the CRA rating incorporates the fair lending analysis of the examination process.

**The Changing CRA Landscape Demands Attention**

The regulations that implement CRA were revised in 1995 after an extensive process that involved two public comment periods and several hearings. The changes were intended to ensure that CRA evaluations focused on the actual performance of institutions in meeting credit needs rather than on process considerations. Regulations went into effect for small institutions in January 1996 and for large institutions in July

1997. As a whole, we believe the rule is flexible, performance-based, and fair. However, several "big picture" issues and some implementation concerns warrant our attention.

When we issued revised rules, we indicated that we would review them again in 2002. But some of the issues we are uncovering compel us to begin an interagency review of the regulations under the CRA sooner. The financial services landscape is changing before our eyes. Every day, more institutions are using product delivery systems outside the traditional brick and mortar branch structure. It's not unusual today for an institution to use mail, telephone, loan production offices, agent relationships, or even the Internet to market and deliver banking services. The reach of these systems challenges the geographically focused evaluation criteria that underpin the CRA regulation.

We are also seeing the formation of so-called "mega-banks" with their national marketing reach, and technologically sophisticated independent mortgage companies. Their lower-priced loan products and more efficient application processing can take a big bite out of the business of smaller, community-based institutions. These smaller institutions, already facing competitive difficulties, are challenged to find creative ways to support their neighborhoods – whether through different types of loan products better matched to community credit needs, or through deposit or other financial services, or community-based investments.

Although OTS examiners consider factors such as extreme price competition from very large institutions as part of their CRA evaluations, the regulation can encourage and reward the creativity of institutions challenged by such factors better than it does now. Perhaps lending is too heavily weighted for some small institutions. For those institutions that might be able to do more good for their community through qualified community development investments and community services, is it time to consider alternative ways to meet their obligation? Moreover, making the strategic plan option a more attractive alternative may provide some flexibility for nontraditional institutions.

We need to take advantage of the regulation's inherent flexibility to address marketplace issues that were simply not significant a few years ago, but have become so recently. We may also want to take advantage of our examination experience to date to revisit concepts in a way that would lead to more community investment.

Together with our fellow regulators, we will be taking a hard look at some of these issues over the next year or so in order to determine what is and is not working under the CRA regulations. Of course, we must and we will move ahead cautiously in this area, with input from all interested parties.

**New Fair Lending Examination Procedures Coming in 1999**

As I mentioned, our compliance examinations separately analyze an institution's lending for evidence of disparate treatment or discrimination on a prohibited basis. Specifically, we closely review each thrift's adherence to the requirements of the Equal Credit Opportunity Act, Fair Housing Act, and OTS nondiscrimination regulations. Evidence of discriminatory practices has major consequences for an institution, well beyond an adverse CRA and overall compliance rating. The institution and its officers may be subject to enforcement actions and may face civil money penalties. In cases where we have reason to believe that the institution engaged in a pattern or practice of

discrimination or discouragement, we have and will make immediate referrals to the Department of Justice. If we have reason to believe a fair lending violation has occurred that does not meet the standard for making a referral to DOJ, we will refer the matter to HUD if we have reason to believe that there has been a violation of the Fair Housing Act. OTS has made 12 referrals to DOJ since 1993.

Working with the other federal banking regulators, we have spent the past 24 months revamping our fair lending examination procedures to improve our ability to detect evidence of lending discrimination, including redlining. We anticipate that these procedures will receive final approval shortly, and will be used by our examiners beginning early next year. You will hear a lot more about these procedures once final approval has been obtained, but I want to give you with a brief advance preview.

The uniform procedures involve steps designed to identify discrimination risk factors in residential and nonresidential lending, including indicators for:

- potential disparate treatment in underwriting;
- potential disparate treatment in pricing;
- potential discriminatory redlining; and
- potential disparate treatment in marketing.

The new procedures provide detailed guidance on:

1. Scoping
2. Compliance Management Review
3. Examination Procedures
4. Obtaining and Evaluating Management Responses

**Scoping –** Scoping enables examiners to plan their fair lending examination based on an assessment of the risk for discriminatory conduct that may arise given the nature of a particular institution's credit products, business organization and market characteristics. For example, an institution with a centralized mortgage loan approval process with rigorous adherence to well-defined underwriting standards, but that is dependent on a network of brokers who have discretion over the points paid by borrowers, and may be compensated on the basis of these points, is more likely to be examined for loan pricing discrimination rather than loan approval discrimination. Other institution-specific factors also weigh in on an examiner's risk assessment and scoping determination, such as a new loan product that has expanded beyond business plan projections, or a loan product that gets out ahead of the compliance capacity of an institution where the risk of inconsistent decision-making may raise potential discrimination concerns. Moreover, information developed from the CRA portion of the examination may indicate lending patterns that merit scrutiny as possible discriminatory redlining.

As part of this process, the examination team selects the types of credit products and the prohibited basis or "target" groups (e.g. Black applicants) to be analyzed. This information will be used to conduct the loan file review. Examiners will, based on their risk assessment, analyze the institution's decisions regarding its underwriting standards (i.e. approval/denial) and pricing (i.e. terms and conditions), as appropriate. The procedures also contain directions for analyzing mortgage redlining, commercial lending, and credit scored loan products.

**Compliance Management Review** – The Compliance Management Review focuses on determining whether the institution's policies and procedures enable management to prevent or to identify and self-correct, illegal discrimination. It also covers how management addresses its fair lending responsibilities as they relate to lending practices, training, employee guidance in dealing with customers, and marketing of products and services. This review enables examiners to determine the reliability of the institution's practices and procedures for ensuring continued fair lending compliance and the intensity of the file review to be conducted (i.e. the sampling size).

**File Analysis** – The loan file analysis will be matched to the particular type of discriminatory risk being investigated. The analytical technique applied in the investigation is based on a "benchmark/overlap" comparison. Examiners will determine who among the prohibited basis group applicants (e.g. Black applicants), denied for a particular underwriting standard, such as credit history, were least deficient on that standard. The applicants identified serve as the "benchmark" applicants who are compared to control group (e.g. White applicants) approvals who were more deficient than the benchmark on that standard, but nonetheless were granted a loan. The basic idea here is to look for approved control group applicants who appear to be less qualified than the denied prohibited basis benchmark applicants. The identified overlapping approvals and denials would be reviewed for potential fair lending problems and reasons for inconsistent treatment would be explored.

While inconsistent treatment on a particular underwriting standard is a red flag, it by no means determines discrimination. To continue the earlier example, an applicant with an acceptable credit history may have an income level that is simply too low to support the loan applied for.

**Obtaining and Evaluating Management Responses** – The final step in the process involves presenting findings to management, evaluating their explanations about any evidence of discriminatory conduct or effect, and reaching conclusions about the institution's fair lending performance. Examiners will evaluate whether management responses are consistent with previous statements, with policies and practices, and with information obtained during the file review process.

**How the New Procedures Will Help**

These new procedures are more detailed and comprehensive than those currently in place and were designed to enhance our ability to determine whether or not an institution is discriminating. The inclusion of specific techniques to analyze redlining should prove useful in our continued efforts to uncover and eradicate this offensive, illegal practice. Examiners and institutions involved in the testing phase of the new procedures found them to be thorough and expressed confidence in the conclusions reached by the process. Implementing these new procedures will require that we devote more resources to this portion of our examination process, but we believe that the effort is clearly worthwhile.

While our procedures for identifying violations of fair lending laws and regulations have been strengthened, the serious negative consequences of finding such violations remains the same. We will continue to vigorously employ all remedies at our disposal, including enforcement actions and referrals to the DOJ or HUD to firmly and expeditiously address discriminatory practices, as warranted.

**What Do Special Purpose Credit Programs Offer?**

I want to mention one other step we have taken to specifically encourage more lending to minorities. In June, we released guidance to thrift institutions to help explain Special Purpose Credit Programs allowed by the ECOA and Regulation B. This guidance was prompted by inquiries we received from several thrift institutions interested in pursuing these programs who were struggling with available guidance, and with Regulation B's bar against collecting monitoring information on other than applications for real estate-related loans. These institutions wanted to develop special small business lending programs to enable them to serve various minority segments of their markets. They knew that these special programs could help them meet legitimate credit needs that they saw in their communities.

In order to qualify as a special purpose credit program, Regulation B contains two main requirements:

- first, the institution must describe in writing the class of persons the program is designed to benefit and the procedures and standards for extending credit under the program.
- second, the institution must administer the program to extend credit to a class of persons who, under the institution's customary standards of credit worthiness, probably would not receive such credit or would receive it on less favorable terms than are ordinarily available to others applying to the institution for a similar type and amount of credit.

Since these institutions had never done small business lending, they did not have any basis to conclude one way or another, based on their own data, whether minority small business owners would not receive credit, or would receive it on less favorable terms than ordinarily would have been available to other small business owners. As a result, they perceived they could not set up a small business special credit program. Our guidance explains that they can, indeed, set up such a program, even though they had never done small business lending, by relying on their own research or data from outside sources, including governmental reports and studies to determine that a program will benefit a class of people who might be denied credit or receive it on less favorable terms.

If an institution relies on either its own research or outside studies to determine that a program would benefit a particular class of people, then it may establish a special purpose credit program and collect data that would otherwise be prohibited, such as the race or national origin of applicants for small business loans. The data collection should enable the institution to monitor the special purpose credit program to determine whether it is indeed meeting the needs of its target audience.

We hope the guidance helps institutions, community groups, and others learn more about this area. We are pleased to provide guidance to particular institutions seeking to

develop their own programs in a manner that will conform with applicable laws and regulations.

**OTS' Community Affairs Program: Geared To Help**

In addition to the examinations we conduct, our Community Affairs staff educates financial institutions about how to better serve minority communities and borrowers. One of our goals is to improve the availability of financial services by promoting safe and sound lending, investment, and services in those areas of greatest need. Promoting access to credit for low-income and minority families within all communities to meet housing and other needs is a key component of our efforts. Through the Community Affairs Program, we do a number of things to encourage and facilitate the industry's community development efforts. For example, we educate financial institutions about community development issues and opportunities to help address credit and financial services needs in underserved markets. We help the industry learn about government programs and other resources available to them to help provide additional funding for affordable housing or economic development initiatives in their areas. And, we help educate about what others are doing, as a means of sharing best practices in community development.

During 1998, the Community Affairs Program sponsored three widely attended conferences. In April, our Northeast Region sponsored a conference in New York on urban home ownership. We brought together about 200 thrifts, other lenders, and community groups to hear about programs that work, the issues involved, such as fair housing, and related subjects. In August, our Midwest and West Regions joined forces with the State of New Mexico to sponsor a conference in Albuquerque on lending on tribal lands. Our third conference was sponsored by our Southeast and Midwest Regions and focused on rural economic development, including affordable housing and business development problems facing small rural communities. While I was unable to attend the New York conference because I was testifying on Capitol Hill, I did participate in the other two. What made these conferences so successful was that the participants actually got together to work on long-term relationships, share ideas on new projects, and, most importantly, strike deals.

Aside from education, we promote partnerships at the local level between financial institutions, community organizations and others to address specific community development needs. Partnerships enable financial institutions to do more in their communities than they can do on their own.

Over the past several years, unprecedented numbers of strategic alliances involving financial institutions have been established. There are statewide lending consortia to address multi-family affordable housing problems in rural parts of North Carolina, Georgia and Alabama, where no one financial institution has the capacity or the expertise to provide that type of financing. But they all have an interest in helping to meet that need.

Thrifts and other banks have formed strong partnerships with local Neighborhood Housing Services groups across the country who provide homeowner education and counseling for prospective low income, mostly first-time home buyers, as well as help with rehabilitation and financing. Many of the people these organizations reach are minority families and single mothers with children. Here in Cleveland, for

example, the NHS offers an array of services to individuals with an average income of $22,000, including home buyer counseling programs, home buyer clubs, home weatherization services, home loans and revolving loan funds for things such as downpayment assistance. The Cleveland NHS, whose clients are about 50 % minority, works in partnership with local banks and thrifts, local government, local insurance companies, utilities, and others to serve lower income residents.

Financial institutions are also partnering with CDCs or local CDFIs to provide micro-business loans, for example, in underserved communities. This enables the institutions to support micro lending without doing it directly, as many cannot. But it also positions the institutions to take advantage of business opportunities presented by the microbusinesses as they grow and as their needs for financial services grows.

Partnerships involving government agencies such as HUD, USDA, SBA, etc. can also help financial institutions better serve underserved markets while reducing credit risk. The ability to leverage finite public sector funds with private sector financial resources enables financial institutions to take an active, if indirect, role in community development initiatives.

While I'm on the topic of our Community Affairs Program, I want to mention that our Central Region, which includes the state of Ohio, hired Claude Becker in May of this year to coordinate the community affairs efforts of the region. Claude has extensive experience in community development having worked in the banking and community development environment for the past 25 years.

Before joining OTS, he served as President and CEO of the Affordable Housing Lending Consortium, which developed and renovated over 5,000 units of affordable housing totaling more than $50 million dollars in CRA community development loan participations. He also served as the Southeast Coast Manager for the Principal Financial Group investment division (a subsidiary of PMLI Co), Regional Lending Manager for BankAtlantic, and SVP/Division Head for Residential Lending at Barnett Bank. He is a valuable asset and brings a wealth of experience to our Community Affairs Program.

Claude wanted to be here today, but he is in Wisconsin – helping lenders learn more effective ways to meet their CRA obligations. Feel free to contact him at our Chicago office at (312) 917-5022 if you would like to introduce yourself and discuss your issues and ideas.

**And in Conclusion –**

I believe that rigorous enforcement of the fair lending laws, education through the Community Affairs program, coordinated efforts through partnerships to better reach underserved markets, and continued enhancement of our CRA evaluation process represent some of the key factors needed to bridge racial lending gaps. We must continue to build on what works and not be discouraged by the failure to achieve instant success on every front. Clearly, significant progress has been made in the past decade to address some of the seemingly intractable problems of illegal redlining, discriminatory credit practices and the lack of adequate investment in underserved areas our communities. The 1993 to 1997 HMDA numbers demonstrate real improvements in mortgage lending to

minority populations. However, as I mentioned, the most recently released HMDA data still shows some trends requiring that we re-intensify our efforts where needed.

We at the OTS will continue to do our part through continuing improvements to our compliance examination and community affairs programs. Each of us here today plays an important role in the ongoing challenge to ensure that the affordable housing needs of our citizens are met on a nondiscriminatory basis and that vital community development objectives continue to be advanced. I look forward to working with you in the future.

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