New Industry Developments

Discussion Comments
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Overview

The papers I have been asked to discuss address the issues of credit scoring, predatory lending, and community development venture capital. All three papers relate to a single important theme. That unifying theme is the issue of risk.

The first paper discusses alternative ways to measure individual-borrower risk and suggests that sophisticated scoring models may overstate credit risk for various underserved borrower groups. The second paper focuses on the extremely negative consequences that can occur within a market when individual-borrower risk is poorly understood or overstated. The final paper highlights the fact that broader community investments (in this instance, in the form of venture capital), can also be stifled when risks are poorly understood or measured.

My remarks will focus on the general direction and policy significance of each contribution. I will also highlight areas for further research or consideration that flow from each of the papers just presented. But, before addressing the individual papers, I would like to place those papers into a broader context.

Today's conference focuses on recent changes in the financial services arena and their impact on lower-income and minority communities. Those impacts have not been positive. The American financial system is arguably the most sophisticated and efficient in the world. And increasingly, middle- and upper-income households are benefiting from financial services' innovation and modernization. But while most households increasingly enjoy the fruits of financial modernization, lower-income, and particularly, lower-income minority households, face financial marginalization. Commercial banks, savings institutions, brokerage houses, and other intermediaries each day bring new and exciting services to the market place that more effectively link individual households to the capital markets. At the opposite end of the financial services spectrum, lower-income and minority communities are increasingly the focus of check-cashing outlets, pawn shops, rent-to-own stores, and payday lenders. The result is an increasingly segmented financial-services system in which lower-income, particularly minority, households often and increasingly pay substantially more for the financial-services transactions in which they engage. Moreover, total reliance on fringe lenders would be detrimental to households even if the fees charged by alternative financial-services firms were relatively the same as mainstream financial-services firms. The reason is that check cashiers, pawn shops, title lenders, and related financial services storefronts do not offer savings accounts. As a result, households that are solely reliant on them for financial services have neither the incentive nor the opportunity to save.

Further, the communities in which fringe lenders concentrate tend to be the breeding ground for a host of questionable, unscrupulous, or fraudulent financial-services activities such as excessive subprime lending and predatory lending. On their behalf, fringe lenders argue that their existence and success is a direct result of a lack of financial-services options for the households they serve. They point out that they are merely filling an important financial services gap. There is merit to that argument. In moderation, alternative financial-services providers play an important role in serving the needs of lower-income households that have difficulty managing credit or whose incomes force them to live on the margin. But the rapid growth of these institutions means that they are capturing an increasing number of households that should and could benefit from lower-cost, wealth building mainstream institutions available to and accessed by most American households. When added together, the proliferation of alternative financial-services storefronts and excessive subprime lending, concentrated in lower-income — particularly minority — communities will only exacerbate the growing wealth disparities between rich and poor that have captured so much public attention over the past few years. The need to better understand the financial markets, and more directly, market failure, for lower-income and minority communities, has never been more urgent.

The papers I have been asked to review address several aspects of the issues that I have just highlighted. They focus, in different ways, on how the lack of reliable information on credit risk undermines market efficiencies and leads to overpriced financial services and outright fraud for the most financially vulnerable households in our society.

Paper #1: The Influence of Bureau Scores, Customized Scores, and Judgmental Review in the Bank Underwriting Decision-Making Process

The justification for both excessive subprime lending as well as fringe financial services is that households in distressed communities are extremely high risk and these respective services are simply tailored to meet their needs. But because there is practically no publicly available data that could enable us to better understand the relationship between various levels of risk and fee structures, conversations on this subject are non-conclusive.

The first paper that examines alternative approaches to evaluating credit risk for home loans among underserved borrower groups attempts to address this issue. The research demonstrates that an intuitively reasonable custom-scoring model and judgmental loan-evaluation process can produce rejection rates that differ greatly from those produced by FICO scores. This information is useful to the extent that it suggests that FICO scores may not be the most useful or accurate measures of a household's creditworthiness. And, there remains a strong need for performance data on alternative underwriting criteria, particularly as it relates to underserved borrower groups.

This issue is increasingly important given the industry's movement to risk-based pricing. There is real potential to incorporate inherently biased risk-assessment models into even more complex systems. If that happened, those systems might provide an undeserved assumption of credibility to models that systematically charge more for mortgage credit based on poorly specified, inaccurate, and inappropriate risk assessment methodologies and tools. Of course, the paper's obvious weakness is the lack of performance data that would enable us to determine the validity of the alternative risk-assessment methods presented in the paper. But we should be cautious in criticizing the paper for the lack of information in that arena. For the more we criticize the paper, the more we reinforce one of the authors' principal points: the need for more and better performance data to evaluate the accuracy and fairness of alternative underwriting approaches.

Paper #2: The Law and Economics of Remedies for Predatory Lending

The second paper on predatory lending is groundbreaking for a variety of reasons and should be considered required reading for any policy analyst interested in the subject of predatory lending. The paper makes three particularly important contributions to the discussions on predatory lending.

First, and perhaps most importantly, it provides a useful set of criteria to define the practice of predatory lending. Often, discussions on predatory lending suggest that there is a bright blue line between predatory lending and subprime lending. The reality is that there is a very large gray area between the two. This paper is one of the first that directly addressed that issue.

A major predatory lending issue should be the systematic provision of high-cost loans to borrowers who could have reasonably received credit in the prime market. In these instances, loans may not contain the extremely abusive features that are commonly associated with predatory loans such as single-premium credit life insurance, balloon payments, prepayment restrictions that do not benefit the borrower, and related terms. Those loans might simply be high cost — marketed to households due to their financial vulnerability and protected-class characteristics such as race/ethnicity, age, or physical or mental challenges. In fact, this gray area is perhaps more important and destructive at a community level than the more infamous predatory lending behavior because it impacts many more households and involves significantly more money.

The typical subprime mortgage is roughly 300 to 400 basis points higher than a comparable prime-market loan. But even one percentage point can result in enormous wealth stripping from a family on a modest-priced home. For example, consider the difference in the cost of an $80,000 mortgage over its 30-year life, assuming only a one-percentage point increase in the interest rate. Assuming a prime-market rate of 8 percent, the long-term difference between an 8 percentage point and 9 percentage point mortgage is more than $20,000. The difference in cost over the life of the mortgage at the more typical 300 to 400 basis point differential would range from more than $60,000 to more than $80,000. And many minority households have loans that greatly exceed that typical 300 to 400 basis point differential. The traditional assumption that predatory lending must contain some set of egregious loan terms is in some important ways distracting. The failure to provide households with roughly equal creditworthiness equal access to credit on equal terms should be a violation of fair lending, equal credit opportunity and/or anti-predatory lending laws. This paper opens that door by encouraging regulators and others not to focus solely on a narrow set of loan provisions as defining characteristics of predatory lending.

The second contribution this paper makes is its thoughtful discussion of the evolution of the market trends that fueled the growth of subprime and, ultimately, predatory lending. For example, many other writers have focused on the role that securitization has played in this arena. But this paper goes beyond the fact that loans have been securitized and deals with the reality that information asymmetries between the secondary markets and primary lenders have helped to promote predatory lending.

The fact that secondary market participants may not have been aware that they were purchasing predatory loans should not mean that they should be absolved from being responsible for their actions. But an awareness of information asymmetries is important in policy discussions, particularly between financial institutions, nonprofit institutions, and regulatory agencies when they meet to discuss the roles of various actors in promoting predatory lending and how best to manage or regulate it in the future.

The paper's third strong point is the vast array of legal strategies that might significantly help to shut down predatory lending practices. Not only do the authors focus on major legal theories and strategies and address possible legislative as well as judicial strategies, they also highlight several obscure legal strategies and concepts. This is important because predatory lending is complex and the more strategies available to attorneys representing victimized households, the better. The solutions section also carefully focuses on the possible negative economic repercussions of possible strategies and discourages enactment of legislation or promulgation of regulations that might have a particularly negative impact on legitimate providers of subprime loans.

The paper also points to the weaknesses and limitations of solutions such as consumer education and additional disclosure requirements as potentially placing an unrealistically high burden and expectation on consumers. The paper presents perhaps one of the most thoughtful series of questions to date that should be addressed when considering the use of consumer financial education and counseling as a strategy to combat predatory lending.

This paper has its strengths, but, like any work, it is not without its weak spots. Three areas could be addressed to improve the paper even further. The paper carefully reviews the role of various market players in creating an environment wherein predatory lending could thrive. But it is silent in pointing out that federal regulatory oversight has failed to protect the financial interests of those lower-income and protected-class households who need protection the most. The failure of government to effectively manage the moral hazards created by information asymmetries from securitization and reduced commitment to creditworthiness by many of the new market players, including non bank and subprime lenders, led to deception and fraud and eventually made predatory lending possible and rampant.

In fact, government has not only been on the sidelines, but when it was in the game, they were often on the wrong side. There is no mention in the paper, for example, of how federal policies related to the Home Owners Loan Corporation or FHA underwriting criteria during the middle part of the 1900s directly and explicitly promoted segregated communities. And these communities now serve as the convenient market for abusive and discriminatory lenders to target.

The authors highlight, but do not discuss, a classic case of regulatory failure. That failure was the lack of aggressive steps on the part of government, immediately after the passage of fair lending and equal credit opportunity laws, to ensure that protected class households and their communities were fully protected and integrated into the larger, mainstream financial-services markets. The lack of any specific regulatory actions designed to meet the unique needs of disenfranchised households and communities is an issue that should not be overlooked as we consider the justifications for future federal policy and regulatory intervention and oversight.

Closely related to this issue is the weakness of the paper to highlight the need for better data collection. The paper thoughtfully discusses information asymmetries but does not address perhaps the single most important information asymmetry — the information gap between the behavior of subprime lenders and fringe lenders and the public's awareness of that behavior.

Information can often be a most powerful cure. The enhancement of the Home Mortgage Loan Disclosure Database with applicant attributes such as race/ethnicity, age, and gender powerfully demonstrates this point. At the time the advocacy community was attempting to have borrower-attribute data added to the Home Mortgage Disclosure Act (HMDA), there were many who argued that additional information would not do any good because it could only show who was rejected for mortgage loans but could not explain why. In retrospect, we know that view was wrong. From its immediate release, the enhanced HMDA data provided the spark that ultimately ignited a sea of change in the affordable lending arena. That data, which showed that Blacks and Hispanics were routinely rejected for home mortgage loans two, three, five and sometimes as high as seven times more frequently as non-Hispanic White households with similar incomes, brought swift condemnation from the general public, advocacy agencies, and regulatory institutions. In fact, many private financial institutions were so disturbed by the data that they unilaterally committed their institutions to address these huge disparities.

Better information would greatly help to identify major trends in lending to protected-class households and would likely begin to slow down some excessive fringe and subprime lending activities without any further regulatory actions. But even if that did not occur, better information on broad trends by various financial institutions would improve the ability of advocacy organizations and regulatory agencies to identify questionable activity for further examination.

The second shortcoming of the paper deals with its suggestions, or lack thereof, on how to promote vibrant and competitive markets as a solution to excessive subprime lending. The paper carefully points to the need to avoid actions that would limit legitimate private-market activities. But its suggestions to promote more competitive markets is limited to a few recommendations to enhance legitimate subprime lending. While some of these ideas are worth further exploration, the broader issue of integration of the markets is not raised.

Over the long term, a more comprehensive set of policies might look at ways in which regulatory agencies can help expedite the movement of the financial markets away from separate markets for subprime and prime credit and toward a market characterized by a continuum of credit in which all borrowers enter through the same door and receive credit based on their individual risk characteristics. This robust risk-based pricing environment would eliminate the blunt pricing cutoffs between prime and subprime lending and could lower costs for all borrowers, including credit-impaired applicants. But as I stated earlier, caution should be taken not to institutionalize poor credit-risk appraisal models into sophisticated risk-based pricing systems.

Finally, the broader issue of financial services, in general, in lower-income and minority communities should not be ignored. So long as disenfranchised lower-income and minority communities are inappropriately viewed as excessively high risk areas, and competition for mainstream financial services are limited, those areas will continue to be plagued by high levels of unscrupulous, if not fraudulent, financial-services providers who will simply shift their focus to those activities that are the least regulated.

Further, the lack of vibrant financial services markets, for both personal and business investments, also limits investment for broader community development activities.

Paper #3: Community Development Venture Capital

My last comment relates to the final paper presented on this panel. It addresses the potential role for venture capital in lower-income communities, and by extension, the lack of venture capital in these communities. It highlights the fact that venture capital can be a valuable tool for communities and a profitable vehicle for investors.

The paper is important because it traces the growth of the venture capital industry and highlights the fact that venture capital is increasingly a viable tool to promote community reinvestment activities. But the study is short on data, which limits its usefulness.

I am cautious not to criticize the paper's shortcoming on shortage of data. This lack of data is not the fault of the author; rather, it highlights an important possible role for regulatory agencies to more carefully examine the financial markets in distressed communities to help financial institutions and communities better understand their full market potential.

The real shortcoming of the paper is that it does not identify at least two major and systematic issues that arise in the context of venture capital for projects in lower-income and minority communities.

First, community development finance does not exist in a vacuum. An investment on one side of a street will be greatly influenced by what is located or ultimately located across from it. In vibrant investment markets, environmental uncertainties such as this and others are limited or minimized. In vibrant markets, private market priorities, as well as government's role with respect to zoning requirements, long-range plans, building codes, and related issues, are generally well known and provide a firm basis of information upon which to base investment decisions.

In lower-income and minority communities, there is often great uncertainty about all these issues and more. Issues such as the possible impacts of high crime rates, inability or ability to secure vacant or abandoned properties for subsequent investments, and local government's understanding of the need to work closely with developers to ensure the long-term viability of new investments are often open questions that discourage private investors.

Second, venture capital is only one form of specialized financing that might be used to promote community investment. By implication, the paper suggests that development of specialized financial intermediaries should be a goal of public policy. There are currently many specialized institutions attempting to meet the financing needs of lower-income and minority communities, including community development commercial banks, community development thrifts, community development credit unions, community development trust funds, and community development REITS. Research shows that intermediary efficiency of this fragmented and specialized development financing system is significantly lower than other types of intermediation, such as corporate finance or housing finance. Moreover, the trend in financial services is the shedding of institutional fragmentation in favor of institutional consolidation, process integration, and functional or product specialization. While specialized intermediaries might be useful to pilot or test products or approaches, the longer-term goal of community investment ought to be the full integration of these activities into the financial mainstream. This fully integrated system would involve public, private, and nonprofit institutions and would be able to fulfill the capital needs for families, businesses, and economic development projects at the community level.

Conclusion

The conference today addresses the financial services environment for lower-income and minority households and communities in a comprehensive and broad-based fashion. The need to bring market efficiencies to America's distressed communities cannot be overstated.

Over the past four decades, a variety of interventions have been launched to help improve the condition of impoverished and economically deprived communities. But despite the expenditure of hundreds of billions of dollars, many communities are not much better off today than they were decades ago; in fact, some are in worse shape.

Of the many innovative community development strategies and programs that have been launched, few, if any, have taken a direct and pointed aim at the financial-services infrastructure that serves distressed communities. Yet we know that access to mainstream wealth-building institutions is the most time-tested and proven way to build individual wealth and, ultimately, community wealth.

The significance of the Federal Reserve System’s sponsorship of today’s conference cannot be overstated. It is my hope that today’s conversation will evolve into a much more robust focus on the full array of financing needs of households and communities that have not benefited from the efficiencies and power of the American financial-services infrastructure and the enormous capabilities it offers.

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