

WELCOMING ADDRESS: RESEARCH IN THE POLICY PROCESS

Edward M. Gramlich

Member, Board of Governors of the Federal Reserve System

I am pleased to welcome you to the second Community Affairs research conference, Changing Financial Markets and Community Development. For this two-day conference, we have succeeded in bringing together participants from academia, financial institutions, faith-based organizations, community organizations, foundations, and government. We have designed the conference to present new academic research on how changes in the financial markets are affecting low- and moderate-income communities and on the effectiveness of community development programs. During your time here, you will hear about changing financial markets, about the unbanked population and alternative financial service providers, and about developments in the financial industry, wealth creation, and the effectiveness of the Community Reinvestment Act. We hope that the research findings and the debate and discussion generated will leave us all better informed about community development.

The past decade has seen a dramatic change in financial services. Consolidation, globalization, deregulation, and technological innovation have altered the manner in which banks do business. But these market forces have not changed the urgent needs that are still apparent in many low- and moderate-income neighborhoods. Community development organizations have met the challenges of the new marketplace, have embraced their rapidly expanding roles, and are working to ensure that their constituents, the residents of underserved communities, have access to affordable housing as well as to fundamental financial management, credit, and wealth-building tools. Community developers have responded by becoming more knowledgeable and more sophisticated and by undertaking increasingly more complex development tasks. These groups recognize that bricks and mortar are not the only building blocks for distressed communities. Jobs, training, education, and opportunity are also vital components in the transformation of neighborhoods.

Financial institutions have likewise been challenged to find new opportunities for development. Over the past decade, lenders have found new market niches, broken geographic barriers, employed advanced banking technologies, and developed sophisticated products and services to keep pace with ever-changing financial markets.

In this dynamic environment, we continually search for information and knowledge to help us broaden our understanding of the issues facing both financial services and community development. The various research gatherings we have hosted help us write more effective regulations, develop innovative services, revitalize communities, and expand economic opportunity, especially for lower-income households. This morning I make just a few observations about the effect of research on public policy — and why it serves our interests at the Federal Reserve Board to have you continue to delve into the intricacies of issues related to financial services and community development.

Research helps to inform our decision-making process. It can help us define the issues or problems being addressed and sharpen our understanding of financial markets. It also offers us a means to challenge the assumptions we develop as we review policy options and revise regulations.

Research also enables us to quantify the likely impact of the rules we write — to see if the rules can be expected to have the desired effects or if unintended adverse consequences could ensue. Once rules and regulations are in place, research helps us measure and assess how well the law and our regulations are achieving their intended goals.

And, as a former academic, I should also stress that research is in a sense its own reward — it stimulates clearer thinking, better behavioral models, more efficient data collection, and in general more knowledge about the way community processes work.

Recently, one particular policy issue has emphasized the valuable role that research plays in informing the policy and decision-making process. Distressing reports of abusive lending practices connected with home-secured loans have captured our attention and prompted calls for regulatory action. Anecdotes about predatory loans — high-cost loans that are unaffordable, unsuitable, unfair, deceptive, or fraudulent — have proliferated around the country. And yet, the information we have about predatory lending is essentially anecdotal. We have no ready method for measuring the amount of predatory lending or determining how prevalent a problem it truly represents.

Studies of urban metropolitan data submitted under the Home Mortgage Disclosure Act (HMDA) have shown that lower-income and

minority consumers, who have traditionally had difficulty in getting mortgage credit, have been taking out loans at record levels in recent years. Specifically, conventional home-purchase mortgage lending to low-income borrowers nearly doubled between 1993 and 1999.

Much of this increased lending can be attributed to the development of the subprime mortgage market. Again using HMDA data, we see a thirteen-fold increase in the number of subprime home equity loans and a sixteen-fold increase in the number of subprime loans to purchase homes. The rapid growth in subprime lending has expanded homeownership opportunities and provided credit to consumers who have difficulty in meeting the underwriting criteria of prime lenders because of blemished credit histories or other aspects of their profiles. As a result, more Americans now own a home, are building wealth, and are realizing cherished goals.

However, this attractive picture of expanded credit access is marred by those very troubling reports of abusive and unscrupulous credit practices, predatory lending practices, that can strip homeowners of the equity in their homes and ultimately even result in foreclosure. We readily draw a distinction between the types of credit practices that are legitimate and those that give rise to concern. Subprime loans to low-income borrowers made under practices in which both lenders and borrowers truly understand the deal should go on — these are an important part of the American dream for low-income borrowers. Abusive practices should be stopped.

Though we have held discussions on the different categories of subprime loans, the credit profiles of vulnerable borrowers, and the marketing and underwriting tactics that predatory lenders employ, we find that the absence of hard data inhibits a full understanding of the predatory lending problem. Exactly what are the most egregious lending practices? How prevalent are they? How can they be stopped? Absent the available data and the analysis and relationships they reveal, rulemakers and policymakers are challenged to ensure that their actions do not have unintended consequences. We are mindful that expansive regulatory action intended to deter predatory practices may discourage legitimate lenders from providing loans and restrict the access to credit that we have worked so hard to expand.

The Board has recently proposed changes to the Home Ownership and Equity Protection Act (HOEPA) and to HMDA in an effort to enhance the public's and the regulatory agencies' understanding of the home mortgage market in general and the subprime market in particular. The expansion in the HOEPA definition of a high-cost loan will

broaden the scope of mortgage loans subject to HOEPA coverage and prohibit specific acts and practices. Changes to HMDA reporting requirements would improve the quality and utility of the resulting data by:

- increasing the number of nondepository lenders required to submit data;
- clarifying and expanding the types of reportable transactions; and
- specifying new loan elements to be included in the data, such as the average percentage rate of interest.

Increased data collection is one step in gaining a broader understanding of the business practices of subprime lenders and in helping us distinguish appropriate from inappropriate lending practices.

We will all benefit from the studies and research that result from an expanded knowledge of subprime lending. Certainly our understanding of credit discrimination has already been improved by research using HMDA data. HMDA data and the analysis that researchers and others have undertaken using the data have helped us to detect possible instances of discrimination and created a heightened awareness of fair lending issues. The new data should give us another lens with which to examine lending practices and should offer us a more complete picture of the home mortgage market — a result we could all agree is beneficial.

The Federal Reserve System works to promote a better understanding of the forces that shape our economy. This conference, I believe, will offer fresh insight into changing financial markets and community development. I hope the outcome will be more research, more study, more publication, more discussion about community development issues, and better regulatory policies. I look forward to the discussions and wish you a successful conference.

Edward M. Gramlich took office in November 1997 as a member of the Board of Governors of the Federal Reserve System to fill an unexpired term ending January 2008. Before becoming a member of the Board, Gramlich served as Dean of the School of Public Policy at the University of Michigan. He also served as Professor of Economics and Public Policy, Chair of the Economics Department, and Director of the Institute of Public Policy Studies. Gramlich has extensive governmental experience. He was Chair of the Quadrennial Advisory Council on Social Security, and Deputy Director and Acting Director of the Congressional Budget Office. He also was Director of the Policy Research Division at the Office of Economic Opportunity, Senior Fellow at the Brookings Institution, and a staff member of the Research

Division of the Federal Reserve Board. Gramlich's popular text on benefit-cost analysis is in its second edition; he has also written several other books and many articles on such topics as macro-economics, budget policy, income redistribution, fiscal federalism, social security, and the economics of professional sports. He received a B.A. from Williams College and his M.A. and Ph.D. in economics from Yale University.