

**Puzzling Through:
Approaching Alternative Credit Responsibly**

Remarks by
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before the
Interagency Conference on CRA
San Francisco, CA
April 17, 2000

It is a pleasure to open this conference. The puzzle exercise reminds us just how dependent we are on one another to achieve our goals. It's another way to look at partnership, which we all know is critical to success in community development.

But the puzzle analogy offers an opportunity to explore another theme that is particularly relevant to meeting the credit needs of all communities in today's financial market place.

Puzzles challenge our thinking. Whether they are visual or verbal, concrete or cognitive; puzzles stymie. They take our traditional views and assumptions and build of them barriers to the real solution to the problem presented. They trick us. They take our analytical pre-dispositions and make blinders that narrow our vision and divert us from the answer.

Responsible sub-prime lending is such a puzzle.

I hear the grumbling. "More like an oxymoron," some of you are thinking. Responsible. Sub-prime. In the same sentence? It seems impossible to many.

Others think it is a kind of credit conundrum: Charging more to people who can afford it less? Community groups are saying, "We haven't come this far to be sacrificed at the altar of risk-based pricing."

Lenders, like the good CRA citizens in this room, are saying, "sub-prime" is for those other guys. Nasty stuff. Not only is it bad for my reputation, now they say it will impact my capital requirements too!

These are very understandable reactions. But they don't help us solve the puzzle.

And I do think the "responsible sub-prime lending" puzzle has a solution—probably several solutions—that are beneficial to communities and consumers, and, at the same time, can be pursued safely and soundly by banks and thrifts.

Let me ask you to think a moment about the sub-prime market. What comes to mind? I'm willing to bet that two things pop into your head: One, the name of a sub-prime lender. Two, a story of predatory practices.

If that is all that comes to mind, you will have a hard time solving the puzzle. Hard, but not impossible.

Let me give you two clues.

First, don't think about the lender. Think about the borrower. Who populates the so-called sub-prime market? Credit dead-beats? Yes, some. Credit unfortunates? Several. What about credit capable individuals? From recent accounts, a very significant proportion of borrowers saddled with sub-prime mortgage loans are creditworthy individuals who are capable of, predictably will, and demonstrably do, perform as agreed. So says Fannie. So says Freddie. So even say the likes of the First Alliances of this world who regularly bring their loan portfolios to the secondary market on representations of the good performance characteristics of the predominant portion of its borrowers.

So, the first step to solving the puzzle is to realize that serving the sub-prime market does not require you to become a sub-prime lender. Many of those served by the sub-prime market are creditworthy borrowers who are simply stuck with sub-prime loans or sub-prime lenders because they live in neighborhoods that have too few credit or banking opportunities. More than 20 years after CRA was enacted, we still have communities that are not adequately served by insured depository institutions.

Why? Obviously, there are many reasons, and different ones in different places. But I believe that two of the reasons conventional lenders serve some markets passively or not at all are their perception that the risks of lending in certain communities are unacceptable and their belief that there are too few business opportunities in those markets. The question is whether these perceptions are real or not. It has become apparent to many retailers that many markets have been mistakenly undervalued in terms of both risk and business opportunity. They are rediscovering profitable markets in both inner-city neighborhoods like Harlem, the South Bronx, South Central LA, Little Village in Chicago and in other similar markets in close-in suburbs. In fact, the opportunities seem to be expanding, fueled by a robust economy, low unemployment, special programs designed to move people on welfare into work and rapidly changing demographics due to migration patterns.

The bottom line is an untapped customer base in underserved communities across the country. Immigrant and native-born American communities have residents who newly need the range of services mainstream financial institutions provide. Millions of unbanked or non traditionally banked Americans want and need the quality of financial services you and I take for granted. Too often these potential banking customers are being left to finance companies and check cashing businesses. Too often, insured depository institutions sit on the sidelines.

We at OTS are encouraging the institutions we regulate to look hard at their changing marketplace. We are asking them to think about their future strategically and figure out who their customers will be, what products and services they will want, and how those financial services needs can be met. It may be that thrifts, or banks, can provide these services directly. Or the best way may be through strategic alliances, agency relationships, or as part of a larger corporate family.

Each community presents its own unique circumstances, so it takes dedication, understanding and persistence to have an impact. But it is an investment we believe will pay off. Traditional financial institutions should not concede undervalued and underserved markets to the high margin, sub-prime specialist. These markets are full of creditworthy borrowers and profitable depositors and users of other financial services. Lenders must develop ways to effectively market to these communities. By working with community groups or marketing consultants knowledgeable about how to reach these new customers, traditional institutions may well find a gold mine, and will almost certainly find good new business.

Let me give you an example. A CEO of an ethnic thrift in a major urban area recently told me of his institution's transformation. The ethnic characteristics of the neighborhood served by his institution had changed dramatically in recent years. His institution was not doing as well as it had been until he focused on the fact that the neighborhood had become Hispanic. Sounds odd, but if you don't live in the community or walk the beat so to speak, it is amazing how quickly you can become out of touch. So he hired a staff fluent in Spanish and he built a new facility to attract the Hispanic customer. Business picked up. The thrift is doing quite well. Sometimes it is as simple as looking around you. Other times, it may take a little more to figure out your market and your niche.

As for mortgage lending, so for small business lending. Why should able, enthusiastic and proven small businesses in underserved neighborhoods be relegated to impersonal, high-interest credit card borrowing—when they can borrow at all—when they want to expand? Working with them will not only provide them with better credit products, improving their business prospects, but as they grow, they'll stick with those who supported them, enhancing your business.

In today's competitive environment, most financial institutions cannot do business as they always have. Maintaining your existing customer base is critical; after all, we all know how much less it costs to keep a customer than to gain a new one. But in this market it is just as important to look to the future and determine who your new customers will be. It's time to reexamine those neighborhoods that haven't been served by a financial institution in years—which may be right in your own backyard—and figure out what is going on there. At OTS, we want to help the industry we regulate recognize that and continue to prosper in new, and even better, sustainable ways.

Thus, the first clue to our “responsible sub-prime lending puzzle” teaches us to recognize the value in markets that have been labeled “sub-prime.”

Now for clue number two: The word “responsible” in the phrase “responsible sub-prime lending” is a two-way street.

First, as much as CRA is about credit opportunity as a right, it is equally true that credit, once granted, is a responsibility. Credit goes to those who have not only a need, but who have the ability to manage credit responsibly. You all know this and will not argue with me about it. However, we too often, too easily, gloss over the implications of this proposition.

All lenders are required to underwrite their loans safely and soundly. CRA did not suspend this requirement. It is expressly part of CRA. The fundamental requirement of safety and soundness is repeated in the regulations. As a consequence of this reality, lenders differentiate among borrowers, because borrowers have different credit profiles, whether they are being evaluated under an automated or judgmental underwriting system. Those borrowers who have failed to demonstrate their reliability forfeit their claim to be treated as well as those who are recognizably creditworthy. We cannot turn underwriting on its head and argue otherwise. Even if the law allowed it, the market would not.

But all of the best underwriting standards are based on past experience with large numbers of applicants. In other words, they evaluate the likelihood of performance or the risk of default. They are not causal models. Borrowers are assigned risk rankings, not scarlet letters, based on their attributes. Within many rankings the majority of borrowers perform. It is just that the odds become worse the lower we go in the risk profile. To compensate, lenders raise prices. It is rational behavior. It follows that those who seek credit and have past performance deficiencies—and I want to emphasize here that just because someone does not have a conventional credit history or lives in a neighborhood in which a lender has not worked before does not mean that person has credit problems—must expect to pay more for credit and earn their way back to creditworthiness.

But at what price? That is the question that brings us to the other side of the two way street named “Responsible.”

Not so long ago lenders reserved the “prime rate” for their best customers. This observation naturally implies that banks had customers that were not their best customers and who didn’t receive “prime rate.” Curiously, we didn’t label either the less-than-best customers or their local lenders, “sub-prime.” We accepted that sound distinctions were made and priced accordingly—the notion of risk-based pricing. We should think no differently today. This is especially true when we have far more powerful technical tools and empirical analysis to help lenders differentiate among borrowers. These tools allow us to reach further down the credit scale with greater confidence.

The key is deceptively simple: Manage the risk. Simple; because managing risk is what the banking business is all about. Deceptive; because risk factors vary across products and markets and must be managed in an uncertain and changing economy. In March 1999 the four federal banking agencies published joint guidance on sub-prime lending. It is mandatory reading for all those engaged in, or contemplating entry into, the sub-prime market. The text has a cautious tone about it. But the fact that it exists is a qualified endorsement of sub-prime lending by banks and thrifts—when done responsibly and prudently.

This brings me to two dilemmas inside our puzzle: What is responsible sub-prime lending and to what extent is it proper for bank or thrift regulators to endorse or encourage the industry to pursue particular types of business? I'll address the latter first. The regulator's role in this regard is properly constrained. Choice of business strategies remains at all times with the institution. CRA does not dictate the business plans of institutions. Its mandate is (in the words of the statute) "to encourage" a bank or thrift to meet the credit needs of its entire community, safely and soundly. The role of the regulator is to evaluate the performance resulting from the choices made by the institution against the credit needs of the local communities it serves.

When it comes to responsible lending in a community, I believe the regulator's role is to be sure that an institution considers its business options and deliberates knowledgeably about the choices presented. Financial institutions should not jump into a market segment because it is in vogue. Neither should they reject it out of hand without exploring its pros and cons. Thrifts and banks should understand their market options, evaluate their management capabilities and potential, and plan strategically to execute their choices.

Which brings me to the other dilemma of how to maintain the very real distinction between responsible sub-prime lending and predatory lending. I am well aware that there is a difference between the two. In fact, in my mind, the former is the most effective antidote to the latter. Insured depository institutions that provide responsible competitive credit alternatives, including prime loans, to the market targeted by predatory lenders can drive those predatory lenders out. To make certain of this, however, regulators need to be clear about what distinguishes responsible risk-based pricing from predatory lending.

Responsible credit alternatives come in many forms. They embrace credit enhancement strategies, including in particular pre- and post-purchase housing counseling, as well as risk-based pricing strategies. Flexible terms and conditions can open up options that are unavailable under traditional product specifications. This has been demonstrated in a variety of loan programs that many of you have taken a leading role in creating.

But I am also aware that alternative loan terms can be abused. To foster competitive diversity in mortgage finance opportunities, in the early 1990's OTS broadened most of its lending regulations. By virtue of the Alternative Mortgage Transaction Parity Act—a formerly obscure statute enacted in 1982 for safety and soundness reasons—those freedoms were extended to state housing creditors. For those of you unfamiliar with the

Parity Act, the statute enables state-licensed housing creditors to enter into alternative mortgage transactions, such as variable rate loans, without regard to state law, so long as they comply with the regulations on such transactions that apply to, generally speaking, OTS-regulated institutions. OTS has no regulatory or enforcement authority over these state-chartered entities. Rather, our sole statutorily-assigned role is to designate which OTS lending regulations affecting alternative mortgage transactions are appropriate and applicable to housing creditors when they make such loans under the Parity Act.

OTS is conducting a review of its lending regulations to determine their effect in today's markets not only on the savings associations we regulate, but also on state-licensed housing creditors who may be making alternative mortgage transactions under the Parity Act. On April 5th, we published an Advance Notice of Proposed Rulemaking on Responsible Alternative Mortgage Lending which seeks comment to assist us in this review. The ANPR poses a series of questions about lending practices and seeks public input. The comment period ends on July 5th, so if any of you have insights about predatory practices or opinions on how OTS should implement the Parity Act, I encourage you to comment. Our goal is to determine whether it is necessary to change our lending regulations in order to help curb egregious lending practices, and if so, how to do it without handicapping long-standing safe and sound lending practices or legitimate programs reaching out to under-served populations and communities.

Of course, there are other ways of constraining abuses in the alternative loan market besides issuing new regulations. In fact, OTS believes the most effective strategy to combat predatory lending has three parts: enforcement, education and encouragement of responsible alternatives. We've already discussed the third leg—encouragement of responsible alternatives. Ultimately, I think that's the big winner; but enforcement and education are also critical.

Vigorous enforcement of existing laws and regulations can help curtail abusive loan terms and practices. We are working on an interagency basis to examine the state of the law and to determine where we might strengthen its enforcement. This interagency work includes the federal financial institution regulators, the Federal Trade Commission, the Department of Justice, the Department of Housing and Urban Development (HUD), and the Office of Federal Housing Enterprise Oversight (which, together with HUD, regulates Fannie Mae and Freddie Mac). This interagency effort will help clarify for all of us—regulators as well as lenders and borrowers—the boundaries between responsible sub-prime lending and predatory lending.

Education—of both investors and communities—is the final part of the equation. For example, those who provide liquidity to lenders in under-served communities by buying their loans can be more discerning. CRA was not meant to blindly reward loan purchases that ultimately undermine community development. Secondary market makers are beginning to recognize that predatory loans are not good business. They have chosen to be part of the solution, not part of the problem. I applaud them for their initiatives.

They demonstrate that the well-oiled machine of loan securitization need not bog down when it ceases to accept fraudulent or abusive loans as grist for its mill. They have responded attentively, not as regulators, but as market savvy investors who recognize the hazards predatory loans bring to loan portfolios. So far, we have heard from the GSEs; I hope the private securitizers step up to the plate also, rather than seeing Fannie's and Freddie's refusal to buy certain product as a business opportunity.

As for community groups, in addition to their role in helping bridge the gap between financial institutions and communities vulnerable to predatory lending—helping financial institutions develop and market those responsible lending products and other needed financial services—community organizations have an education role. Those of you working with home-buyer education and counseling need to teach your clients how to be discerning consumers—after they buy their homes. Learning what questions to ask and how to evaluate the answers is critical to making an informed choice. So is learning to say “no” to “opportunities” that are too good to be true.

The trickier issue is how to reach community residents who own their homes and are not involved in home owner education and counseling programs. Community based organizations and others—including financial institutions with elderly account holders—need to target the very same markets as the predatory lenders and aggressively reach out to potential borrowers and arm them with valuable information to give them the tools to stay out of the predatory lenders' reach. For example, you can:

- Identify reliable home improvement contractors and home equity lenders.
- Establish early warning networks and intervention game plans for implementation when unscrupulous contractors or lenders make an appearance in your neighborhood.
- Encourage community members to build broad-based banking relationships with federally-insured depository institutions, including initially, for example, Individual Development Account programs, Electronic Benefits Transfer programs, and first-time investor programs,.
- Work with local schools, faith-based organizations and seniors groups to get the word out about predatory lending scams, how to avoid them and who to call with questions.

I realize that community based organizations can't do it all, but often you are in the best position to reach vulnerable populations. Financial institutions and others can help (for example, by developing educational materials)—and I hasten to add, get CRA credit for doing so.

With all of us working together to define the parameters of responsible lending, and recognizing the unique role we each play in the financial marketplace, these dilemmas can be resolved and work on our puzzle can continue. Remember the three parts to the solution: enforcement, education and encouragement of responsible lending, and you'll remember that we're all parts of the puzzle that, when put together, means credit availability and economic development and all the good things that brings, for all of our neighborhoods.

