Randall S Kroszner: Federal Reserve's initiatives to support minority-owned institutions and expand consumer protection

Speech by Mr Randall S Kroszner, Member of the Board of Governors of the US Federal Reserve System, at the Minority Depository Institutions National Conference, Chicago, Illinois, 17 July 2008.

The original speech, which contains various links to the documents mentioned, can be found on the US Federal Reserve System's website.

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Good morning. I am delighted to be here to participate in today's discussion about how we can work together to foster and preserve the strength and vitality of minority depository institutions. These institutions serve essential roles. Most important, they extend credit – which is essential to economic development and progress – to businesses and individuals in neighborhoods that otherwise may not have ready access to loans. They also foster a spirit of entrepreneurship in their communities, offer customized financial literacy education, and create products and services that address their clients' particular needs. Taken together, such activities help entrepreneurs and emerging small businesses develop and create employment, encourage the prudent and productive use of credit, and ensure more-vibrant communities and a better quality of life.

In my remarks this morning, I will focus on two important Federal Reserve initiatives. First, I will update you on our new Partnership for Progress program, which is designed to foster and support minority-owned and de novo depository institutions. Second, I plan to discuss the recent finalization of significant Federal Reserve rules implementing certain provisions of the Home Ownership and Equity Protection Act.

Partnership for progress

Following my promise at last year's interagency conference in Miami, I am excited to announce that we have made good on our pledge to design a proactive training and technical assistance program for minority depository institutions. Our initiative, known as the Partnership for Progress, was launched nationwide on June 18. The innovative outreach and technical assistance program seeks to help minority-owned and de novo institutions confront their unique challenges, cultivate safe and sound practices, and compete more effectively in today's marketplace through a combination of one-on-one guidance, targeted workshops, and an extensive web-based resource and information center.

As locally focused institutions that have deep contacts with financial professionals in their regions, the Reserve Banks have been able to ensure that we tailor the Partnership for Progress program as closely as possible to the specific needs of the institutions participating as well as the customers they serve. This program illustrates the advantages of the Federal Reserve System's unique decentralized geographical structure, which consists of the Board of Governors in Washington, D.C., and the twelve Reserve Banks that each represent a different region of the country. We also consulted with a number of executives from minority depository institutions to better understand the unique challenges that minority-owned depositories confront in raising capital, managing risks, and attracting the right talent. This process has been invaluable in helping us to target our efforts and to focus on designing a program that the minority depository institutions have told us is most crucial to them.

In recent months, I have had an opportunity to see firsthand the challenges that communities are facing in various parts of the country, which has underscored to me the importance of

programs like Partnership for Progress. I have met with local community groups, bankers, housing advocates, counseling agencies, and state and local government officials in many cities, including Atlanta, Boston, Cincinnati, Cleveland, Las Vegas, Miami, Minneapolis, and Philadelphia. As I planned for my participation in this conference, one example stood out. While in Atlanta, I visited a predominantly African-American community. In this community that spanned several miles, there were a number of vacant homes, conditions mirroring those that I have seen in other neighborhoods. However, what was different in this case, and quite disappointing, was that not a single financial institution was within view. This lack of local financial institution presence is a problem that is not unique to African-American communities. Indeed, this absence occurs far too frequently in predominantly minority communities. Our new program is intended to enhance the vital role that minority-owned institutions can play in making financial services more available and in providing access to credit in historically underserved communities.

At the core of our program, we have implemented a series of web-based modules designed to assist banks in addressing three distinctive development stages: (1) starting a bank, (2) managing its transition from a start-up to an established bank, and (3) building shareholder value once a bank has been established on a sound footing. These easy-to-use modules are presented on the program's dedicated website – http://www.fedpartnership.gov/ – and are available for your review and use at any time.

The first module of the program, "Starting a Bank," provides useful guidance on the factors that must be considered in chartering a new bank. It includes background information that details regulatory capital requirements, discusses the steps required to file an application, and explains the responsibilities of a bank's board of directors. The module has video narratives of some of the key topics to provide additional insights into, for instance, the strategic importance of strong capital for all financial institutions. Since the program was launched, "Start a Bank" has been among the most popular pages on the website.

The second module, "Managing Transition," focuses on the benefits that a bank can derive from well-planned growth. Because maintaining competitive products and services is a very important aspect of managing growth, we have included a video clip on how minority depository institutions can use the natural branding inherent in their mission to stay ahead of the competition and differentiate themselves. This module provides some examples of approaches and strategies to establishing a bank that have been successfully followed by other new institutions to achieve stable and profitable performance.

The third and final module, "Growing Shareholder Value," is designed to help more-mature institutions achieve an even stronger financial footing and improve shareholder value. This module addresses key topics, such as corporate governance and performance measurement, that can help to ensure that management remains on target with the overall goals of the organization. Given that most minority depository institutions are at this stage of life-cycle development, we expect the topics in this segment, such as "Demographic Analysis," "New Product Implementation," and "Outsourcing and Vendor Management," to be particularly useful.

We expect minority institutions will use the program to help them navigate three of the most challenging periods in the life cycle of any financial institution. I expect that the program, which draws on insights from economics, accounting, finance, and regulatory compliance, will become a valuable resource for institutions at different stages of their development. In order to further expand the support that we can offer to these institutions, the Federal Reserve also plans to conduct periodic training sessions for interested participants that will address topics of particular concern and relevance to minority depositories and their bank holding companies.

We also have designated Partnership for Progress contacts in each of the twelve Reserve Bank districts and at the Board to answer questions and coordinate assistance for institutions requesting guidance.[1] I hope that you will consider contacting us for support or to provide additional suggestions for improving this evolving program. We are pleased with the initial feedback we have received since the program's launch and will continue to fine-tune and enhance the program over time. In that respect, we look forward to continuing to work with you to make this exciting program even more effective.

Home Ownership and Equity Protection Act

I would now like to turn to important new consumer protections that the Federal Reserve Board adopted earlier this week. These new rules, which implement HOEPA, were put into place to protect consumers and to help prevent a recurrence of the problems that we are now facing. The current wave of foreclosures is taking a very real toll on families and their communities, no place more so than in predominantly minority communities, where subprime loans were particularly common.

The U.S. mortgage market has seen rapid innovation in recent years. Changes, such as automated underwriting models, the evolution of the secondary markets, and specialization, have had many positive effects. Some changes in practices, however, have not been so salutary. Abusive loans that strip borrowers' equity or cause them to lose their homes should not be tolerated. Too many homeowners and communities are suffering today because of these practices, and the Federal Reserve Board's rules will better protect consumers while preserving their access to credit as they make some of the most important financial decisions of their lives.

Last December, the Board proposed changes using our authority under the Home Ownership and Equity Protection Act. In formulating that proposal, the Board sought a wide range of input and information through hearings and meetings throughout the country. In response, we received, and considered, over 4,500 comment letters sent to us from community groups, industry participants, consumer advocates, and other interested individuals. We engaged in outreach to commenters to get clarification of their concerns and weigh competing viewpoints. We gathered available data and conducted updated analyses. We undertook on-the-ground consumer testing, which has proven to be an invaluable tool for us in determining policy effectiveness, to gauge the practical effects of one of the proposed rules on individual consumers. Listening carefully to the commenters, collecting and analyzing data, and undertaking consumer testing, I believe, have led to more-effective and improved final rules.

Our goal throughout this process has been to protect borrowers from practices that are unfair or deceptive and to preserve the availability of credit from responsible mortgage lenders.

These rules expand upon interagency guidance issued last year on subprime loans. That guidance, however, only focused on certain specific subprime products, hybrid adjustable-rate mortgages, such as so called 2/28s and 3/27s, and only applied to federally supervised institutions. Our rules now apply much more broadly to cover all higher-priced mortgages, including virtually all closed-end subprime loans secured by a consumer's principal dwelling, and to all mortgage originators. These rules also cover a broad range of issues:

- lenders' assessment of consumers' ability to repay loans,
- lending with little or no documentation of income,
- prepayment penalties,
- escrow accounts for property taxes and insurance,

[1] On the Partnership for Progress program website.

- mortgage servicing practices,
- coercion of appraisers,
- misleading or deceptive advertising practices, and
- disclosure of Truth-in-Lending cost disclosures early enough to help consumers shop for a mortgage.

I'd now like to focus in more detail on some key features of this wide-ranging set of rules and discuss a few of the most important changes that we have made since our proposal this past December because I think they are illustrative of how we approached these issues.

On one issue, loan affordability, we proposed a rule that would have required a lender to make sure that a borrower could afford the monthly payments before a loan is made. This step sounds like common sense, but unfortunately, as some loan originators pushed off more and more of the risk to investors, they made increasingly riskier loans to people who simply could not afford them. So we proposed a rule to address that problem, and it spelled out how a lender should assess this ability to repay, building on the earlier interagency guidance on subprime loans. Lenders would have violated the proposed rule if they engaged in a pattern or practice of making loans without considering consumers' repayment ability.

During the public notice period, we received a number of comments on the "pattern or practice" element of the proposed rule, and we conducted further outreach to both consumer advocates and industry participants. Many advocates objected to this heavy burden of proof, calling into question the effectiveness of the intended consumer protection. Some mortgage lenders, however, suggested that the "pattern or practice" provision did not provide a safe harbor that would ensure compliance and that their procedures for compliance would, by necessity, be equally robust under either version of the rule. At the end of the day, we agreed that this provision would have limited the intended effectiveness of the rule and that removing it, along with clarifying other requirements, would not impede the availability of credit to borrowers. Accordingly, the final rule establishes a lender's responsibility to assess a borrower's ability to repay on *every* loan originated, effectively giving wronged consumers a private right of action without demonstrating that their case was part of a broader pattern.

In addition, the new rule requires that the lender take into account future, predictable changes in payments in determining repayment ability. A lender complies, in part, by assessing repayment ability based on the highest scheduled payment in the first seven years of the loan. For example, on a 5-1 ARM with a payment for the first five years based on a discounted interest rate, the lender would use the scheduled payment in the sixth and seventh years, which is based on the fully indexed rate.

Another element of our proposal that received many comments was a rule limiting prepayment penalties. On the one hand, numerous commenters argued that prepayment penalties can result in lower interest rates paid by the borrower. Although there are exceptions I will mention in a moment, a number of studies have found that loans with prepayment penalties carry lower rates or annual percentage rates (APRs) than loans without prepayment penalties having similar credit risk characteristics.[2] On the other hand, the rate benefit was called into question by many, who asserted that prepayment penalties

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[2] Chris Mayer, Tomasz Piskorski, and Alexei Tchistyi (2008), "The Inefficiency of Refinancing: Why Prepayment Penalties Are Good for Risky Borrowers", Gregory Elliehausen, Michael E. Staten, and Jevgenijs Steinbuks (2008), "The Effect of Prepayment Penalties on the Pricing of Subprime Mortgages", *Journal of Economics and Business*, vol. 60 (Jan.-Feb.), pp. 33-46; Michael LaCour-Little (2007), "Prepayment Penalties in Residential Mortgage Contracts: A Cost-Benefit Analysis," unpublished paper, January; Richard F. DeMong and James E. Burroughs, (2005), "Prepayment Fees Lead to Lower Interest Rates", *but see* Keith S. Ernst (2005), "Borrowers Gain No Interest Rate Benefits from Prepayment Penalties on Subprime Mortgages," research report, (Durham, NC: Center for Responsible Lending, January), http://www.responsiblelending.org/pdfs/rr005-PPP_Interest_Rate-0105.pdf.

may lock borrowers into unaffordable loans, particularly adjustable-rate loans whose payments may change dramatically. Prepayment penalties were also criticized because of the way they reinforce another potentially abusive practice – yield spread premiums, or YSPs. Some lenders' rate sheets show that mortgage brokers can earn bigger YSPs, which are essentially commissions, by increasing consumers' interest rates, and the biggest increases are allowed only if a loan contains a prepayment penalty.

After an exhaustive analysis of the issue and all available data, the Board concluded that the costs and benefits of prepayment penalty provisions on higher-priced mortgages depend, to an important extent, on the structure of the loan. It has been common in the subprime market to structure loans to have a short expected life span. This aim has been achieved by building in a significant payment increase just a few years after loan consummation. With respect to subprime loans designed to have shorter life spans, the injuries from prepayment provisions are potentially the most serious as well as the most difficult for a reasonable consumer to avoid. Moreover, according to research, the rate reduction for a prepayment penalty provision on such short-lived loans is smaller and, in absolute terms, quite limited. For these loans, therefore, the Board concluded that the injuries caused by prepayment penalty provisions outweigh their benefits, and we did ban them for these loans – specifically, loans in which the principal-and-interest payment can change within the first four years.

With respect to subprime loans structured to have longer expected life spans, however, the Board concluded that the potential for harm from prepayment penalties is lower relative to potential benefits, warranting restrictions but not a ban. Our analyses indicate that for fixed-rate loans, borrowers can obtain meaningful interest-rate reductions on loans that contain provisions for prepayment penalties, and performance on these loans has typically been superior. These factors generally reduce the negative impact of prepayment penalties, so for these loans, we added a restriction limiting the length of the prepayment penalty period to no more than two years.

Another change has to do with how we define the loans that we most want to cover. Our principal goal was to cover the vast bulk of the subprime market, where most of the problems have been and where consumers may need the most protection. The challenge is that there is no one accepted definition of what makes a loan "subprime."

We anticipated, and received, a number of comments about this problem and sought solutions. We looked at available sources of data on mortgage rates and concluded that the best source for our purposes is a survey called the Primary Mortgage Market Survey®, published by Freddie Mac. The Federal Reserve will publish our own index, called the "average prime offer rate," that will be based on Freddie's survey and other market data, and if we need to adjust the index over time, we can. We will still cover nearly all of the subprime market plus a sizable fraction of the so-called Alt-A market, as we intended with our initial proposal, but the new approach will do so in a more accurate and consistent way, and therefore better ensure that we protect at-risk consumers without impinging on the prime market.

Protecting borrowers with responsible underwriting standards can also provide a broader benefit of enhancing the integrity and proper functioning of the mortgage market by increasing investor confidence. Ensuring that ability to repay by underwriting and documenting income, for example, can help to reduce investor uncertainty about the performance of mortgage-backed securities. Effective consumer protection thus can produce a complementary benefit for consumers by helping to revive mortgage funding markets and potentially improving credit availability.

Finally, I'd like to highlight one other change that shows how hard it can sometimes be to craft solutions that work. In December, we proposed a rule that we hoped would address some of the problems posed by YSPs. The heart of the rule involved an agreement that the broker and borrower would sign early on that would spell out the broker's compensation and how they are paid.

As the public comment period was under way, we began consumer testing to see how this process would actually work. We engaged a firm that specializes in this testing and conducted a rapid round of tests this spring with individual consumers. The firm developed and tested a form in which the broker would agree to total compensation and make certain disclosures that we thought would help consumers make informed decisions. Throughout the testing, revisions were made to the form in an effort to improve comprehension. The testing revealed two problems.

The first problem is that many participants believed, after reading the disclosure, that the broker would be obliged to find them the lowest interest rate and best terms available, which is not true. The second problem was that many participants came to believe that working through a broker would cost them more than working directly with a lender, which is not necessarily true either. The firm tried to correct these misunderstandings, but no matter what it did to change the language, the forms continued to confuse consumers more than inform them.

Our consumer testing led us to the conclusion that our approach was not serving its intent – that is, to better inform consumers. We are continuing to try to find an approach that would be effective, but we did not want to hold up all the other consumer protections while we worked on it. As a result, we decided to withdraw the proposed provision on mortgage broker compensation, and we will continue to explore other approaches as part of the ongoing update of our mortgage rules already under way. Some may have preferred that we stick with our proposal, but creating a rule that informed consumers in theory, but only served to confuse them in practice, would have helped no one.

Conclusion

In closing, I would like to underscore the Federal Reserve's commitment to preserving and supporting minority depository institutions. I look forward to continuing our constructive dialogue on finding the best and most practical ways to address the challenges that these banks confront. I am confident that we will be successful in ensuring that these companies remain strong and continue to provide critical financial support to their communities.

I also want to stress that finalizing our HOEPA rules does not represent the end of our efforts to improve transparency and consumer protections in mortgage lending. We will continue to work diligently to determine how best to address the issue of yield spread premiums. Further, we will collaborate with our partner agencies to enforce these rules and to monitor their impact on the market to ensure that they are effective in achieving their goals of protecting borrowers from abusive practices and preserving the availability of credit from responsible mortgage lenders.