Randal K Quarles: The roles of consumer protection and small business access to credit in financial inclusion

Speech by Mr Randal K Quarles, Vice Chairman for Supervision of the Board of Governors of the Federal Reserve System, at the HOPE Global Forums Annual Meeting, Atlanta, Georgia, 26 March 2018.

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Good evening. Thank you to John Bryant and Operation HOPE for inviting me today to open the HOPE Global Forums.[1] I commend our hosts for bringing together such an impressive group of speakers and attendees, diverse in their perspectives, yet all of whom share the vital goal of advancing economic opportunity and inclusion. It is fitting that this event is being held on the 50th anniversary of several notable events, including the publication of Dr. Martin Luther King's last book, *Where Do We Go from Here: Chaos or Community*, which urged unity in order to create equal opportunity, and the enactment of the Fair Housing Act of 1968, which enshrined our nation's commitment to equal access to housing. These milestones remind us of the progress we have made to date as well as the challenges that remain, and inspire us to persist in our efforts.

The conference has a robust agenda ahead. Over the next few days, you will be discussing many issues relating to financial inclusion—such as housing, small businesses, workforce participation, and other topics—to which we at the Federal Reserve share a commitment, and that we view as critical to our mission. Our economy is stronger when everyone has a chance to contribute fully and share in our national prosperity. And I personally believe that financial inclusion helps us realize a founding notion of our country—that this is a place where opportunity, innovation, and productivity are encouraged and rewarded. I'm particularly pleased to see on the conference agenda a number of sessions on issues to which we, at the Federal Reserve, devote considerable attention: access to credit and financial inclusion for consumers and small businesses. Conversations like these are enormously important to understanding the challenges Americans face and why a multitude of voices and approaches are needed to address them.

In my remarks today, I'd like to focus on the consumer protection and credit accessibility aspects of financial inclusion, and some of the ways that the Federal Reserve promotes a fair and transparent consumer financial services marketplace. In recent speeches, I have emphasized my view that we should aim for an effective safety and soundness regulatory approach that is as efficient, transparent, and simple as feasible.[2] I consider these principles to apply equally to our consumer protection supervision program; that is, we should also strive to promote consumer protection with as much efficiency, transparency, and simplicity as possible. I believe that a commitment to these principles is not only compatible with financial inclusion, but in fact helps promote it. Regulatory burden can make it harder for institutions to serve their customers and communities. This is especially the case for community banks and minority depository institutions (or MDIs), which play an important role in serving the needs of their local communities, including historically underserved populations. I'd also like to share some thoughts on an area to which I have devoted a good portion of my career: the importance of small business access to credit, which is a critical part of financial inclusion and a catalyst for economic growth in local communities.

Financial inclusion

Let me start with the foundation of why financial inclusion is important. In broad terms, financial inclusion means access to affordable financial products and services that meet the needs of individuals and businesses and that are delivered in a responsible and sustainable way.[3] At the Federal Reserve, we recognize the influence that financial inclusion has on the broader economic performance of our country.[4] Inclusion is essential to advancing the Federal Reserve's goal of promoting maximum employment, as well as supporting the stability of the financial system. Likewise, we support and share your goal of ensuring a fair and transparent marketplace for financial products and services—including credit—that can provide a pathway toward economic prosperity for all Americans.

Overall, our economy is performing well, and unemployment is low. However, many households and communities continue to face financial challenges.[5] Consider that more than two-thirds of white households own their homes as compared to less than half of African Americans and Hispanics.[6]And consider that all important human asset: education. One-third of white adults have at least a bachelor's degree as compared to one in four African Americans and 17 percent of Hispanics.[7] This matters because the advantages of a college degree for accumulating income and wealth are lifelong and inter-generational.[8] We likewise see evidence of financial disparities in the Federal Reserve's Survey of Household Economics and Decisionmaking and Survey of Consumer Finances.[9]

When individuals have unequal or insufficient access to financial products and services, such as credit, they may be deprived of a chance to fund an education, finance a business, or pursue homeownership—opportunities that can provide greater financial security for themselves and their families and future generations. And as a nation, we are deprived of the benefits of their potential contributions to the economy.

Consumer protection

In the context of my earlier discussion of financial inclusion, federal consumer protection laws are critical to ensuring consumers are treated fairly when offered financial products and services. Discrimination and deception have no place in a fair and transparent marketplace. These practices can close off opportunities and limit consumers' ability to improve their economic circumstances, including through access to homeownership and education.

The Federal Reserve's consumer compliance supervisory program reflects our commitment to promoting financial inclusion and ensuring that the financial institutions under our jurisdiction fully comply with applicable federal consumer protection laws and regulations. Let me give two examples involving the Federal Trade Commission Act's prohibition against unfair or deceptive practices in products and services that will undoubtedly be familiar to the audience—student financial aid and mortgage lending. In the last few years, the Federal Reserve has addressed deceptive practices in these areas through public enforcement actions that have collectively benefited hundreds of thousands of consumers and provided millions of dollars in restitution.

In the financial aid context, our actions required restitution for students who were not given full information about the potential fees and limitations associated with opening deposit accounts for their financial aid refunds.[10] And in mortgage lending, our action required restitution by a bank that had given borrowers the option to pay an additional amount to purchase discount points to lower their mortgage interest rate, but that did not actually provide the reduced rate to many of those borrowers.[11]

As we mark the 50th anniversary of the Fair Housing Act, the fair lending laws remain critical in fostering vibrant communities and a fair and transparent consumer financial services marketplace. For all state member banks, we enforce the Fair Housing Act, and for banks of $10 billion dollars or less in assets, we also enforce the Equal Credit Opportunity Act. Our examiners evaluate fair lending risk at every consumer compliance exam. While we find that the vast majority of our institutions comply with the fair lending laws, we are committed to identifying and remedying violations when they occur. Pursuant to the Equal Credit Opportunity Act, if we determine that a bank has engaged in a pattern or practice of discrimination, we refer the matter to the U.S. Department of Justice (DOJ). Federal Reserve referrals have resulted in DOJ public actions in critical areas, such as redlining and mortgage-pricing discrimination. For example, in our redlining referrals, the Federal Reserve found that the banks treated majority-minority areas less favorably than non-minority ones, such as through lending patterns, marketing, and Community Reinvestment Act assessment-area delineations. For our mortgage-pricing discrimination referrals, the Federal Reserve found that the banks charged higher prices to African American or Hispanic borrowers than it charged to non-Hispanic white borrowers and that the higher prices could not be explained by legitimate pricing criteria.[12]

Efficiency, simplicity, and transparency of consumer compliance supervision

Consumers deserve to be treated fairly, regardless of the size of the banking institution. Yet, we can achieve this goal and still reduce regulatory burden through a balanced program of tailored and risk-focused supervision. Accordingly, we continue to seek opportunities to promote efficient, simple, and transparent supervision where possible, so that the institutions we supervise can focus on finding solutions that work for all consumers and communities. In an effort to promote consumer compliance, our community bank supervisory program focuses our examinations on the areas of highest consumer risk. This has improved the efficiency and effectiveness of our examinations and reduced regulatory burden for many community banks. Banks and consumers benefit when supervision is timely and effective.

Put simply, our role as supervisors should not be to play “gotcha” with our banks, but to support their compliance efforts. The Interagency Consumer Compliance Ratings System, published in November 2016, is an example of this approach.[13] This guidance provides incentives for institutions to focus on managing their consumer compliance risks, preventing consumer harm, and helping to create a culture that identifies and corrects problems. Another example of how we support our institutions is how we work with MDIs, which as I noted earlier, play an important role in serving the needs of their local communities. We have dedicated Reserve Bank staff who are in frequent contact with MDI leadership. Based on what we’ve learned in the course of this outreach, we have expanded our Partnership for Progress—a program for outreach and technical assistance to MDIs[14]—to include staff from our Community Development function, and we have enhanced our MDI-related programing.

Our commitment to transparency also includes a robust outreach program for banks. This includes *Consumer Compliance Outlook*, a widely subscribed Federal Reserve System publication focused on consumer compliance issues, and its companion webinar series, *Outlook Live*.[15] For example, in 2017, we sponsored an interagency webinar on fair lending supervision with almost 6,000 registrants, a substantial share of which were community banks.[16]

Small business access to credit

At the Federal Reserve, we view small business credit from several perspectives. For the economy, small businesses need adequate and affordable credit in order to form, grow, and succeed; otherwise they may underperform, slowing growth and employment. For many small business owners, personal and business finances are intertwined. A well-functioning housing finance market is vital for small business owners who may draw upon the equity in their homes to fund their businesses. Student loans may be needed to help fund the education that is important for both small business owners and their employees to boost profits and productivity. And, short-term credit matters for day-to-day management of cash flow, while longer-term credit is essential for capital investments. So, entrepreneurs—just like consumers—need access to a variety of credit sources.

Recently, I had the pleasure of meeting a group of small businesses from across the country. By “small,” I mean some of these companies have just a handful of employees. The group included owners of a catering company from Dallas, a mechanical engineering company from Philadelphia, a marketing consulting firm from Cleveland, a combination bar and bakery from

Brooklyn, and a gluten-free bakery from my hometown, Salt Lake City.

They shared with me the joys of running their own businesses, of creating jobs, and of providing for their families as well as creating opportunities for their employees. They also spoke of their challenges, which I'm sure are familiar to many of you in this room. For one, the owners wear many hats, including CEO, chief operating officer, chief finance officer, head of sales and marketing, and some—quite literally—chief bottle washer. They also spoke of the day-to-day difficulties of finding, training, and retaining employees. And, they raised the challenges they often face in gaining access to working capital, the lifeblood to sustaining and growing their businesses.

The anecdotes I heard touched on three related trends we have been observing in the small business credit environment. First, although lending standards have eased since the recession and the financial condition of businesses has improved, some small business credit needs, especially for the smallest of firms and minority small business owners, continue to go unmet. According to a 2016 Small Business Credit Survey conducted by our 12 Federal Reserve Banks, some small businesses still face persistent credit gaps, even though they often seek credit in small amounts. Of the firms that apply for credit, more than two-thirds apply for less than $100,000, with substantial numbers of these applying for less than $25,000.[17] However, smaller firms often struggle to qualify for bank credit, and among firms that were denied, low credit scores and insufficient credit history were the most frequently cited reasons. In addition, our survey suggests that some low-credit-risk minority- and women-owned firms are less likely than low-risk white-owned and male-owned firms to receive financing; and if they are approved, it is for less than the amount sought.[18]

Second, there have been shifts in the composition of commercial bank lending to small businesses. Large banks' share of small business lending has grown, especially among the smallest loans. This represents a change from 20 years ago when small businesses relied more on a relationship with local community banks for access to credit. For loans under $100,000, small banks of less than $1 billion in assets now hold a 19 percent share, down from 60 percent two decades ago. Today, it is the largest banks—those with greater than $50 billion in assets—that account for more than 60 percent. Some of this trend may be due to industry consolidation, which has reduced the number of very small banks.

The composition of credit offered also is shifting. Loans entail high fixed costs that are roughly the same regardless of whether a loan is for $100,000 or $1 million, reducing the profitability of smaller-dollar loans.[19] Our data suggest that the growing share of small business lending at larger banks may be partly due to their use of automated underwriting for credit cards.[20] By providing credit cards, banks are expanding credit available to small businesses; however, some small business advocates note that this form of credit is generally more expensive and lacks the flexibility of other products.[21] For example, personal or business credit cards may be suitable for purchasing supplies, but not for payroll. In addition, this automated approach may be more "cookie cutter," meaning that firms that don't meet standard lending criteria may not qualify.[22]

These developments have created a space for the third trend we have been observing—the emergence of nonbank online alternative lenders that provide small-dollar business credit. For example, some of the large technology firms are providing credit, at a rapidly growing pace, to their built-in customer base of merchants. Several of the businesses I met with mentioned they had turned to nonbank online lenders after being turned down by banks. Some online lenders obtain access to a prospective borrower's accounting software, merchant accounts, shipping, and payroll data in real time in order to underwrite businesses. Business owners can receive funds in a couple of days or even hours.

This emergence of online lenders is part of a broader evolution of financial technology—or "fintech"—as seen in a wide range of products and services for both consumers and small businesses. I'm not surprised to see this important topic on your conference agenda. The use of fintech to expand access to credit has great promise and also associated risks. For example, online origination platforms and more sophisticated algorithms may enable credit to be underwritten and delivered in a manner that is still prudent but with greater efficiency, convenience, and lower processing costs. And as regulators, we do not want to unnecessarily restrict innovations that can benefit consumers and small businesses. At the same time, our interest is in ensuring that banks understand and manage their risks when introducing new technologies or partnering with fintech companies, and that consumers and small businesses remain protected.[23] This is why the Federal Reserve has been engaged in a broad and multidisciplinary effort to develop a robust understanding of the technologies and activities in this space, in order to study fintech's opportunities and risks, and assess policy and supervisory implications.[24]

Fintech is also one of the factors driving calls for regulators to modernize the Community Reinvestment Act, or CRA, as technology changes how financial products and services are accessed. As I'm sure most of you know, the CRA is an important law that recognizes banks' affirmative obligation to meet the credit needs of the communities they serve, including low- and moderate-income communities. The CRA promotes financial inclusion by encouraging banks to extend mortgages, small business loans, and other types of credit as well as to provide investments and other services in communities where they take deposits, consistent with safe and sound banking operations. The arrival of new financial technologies, along with significant industry consolidation and other structural changes, has changed the way that financial services are delivered to consumers and the ways in which banks lend in communities. We continue to study these shifts, and share the common goal of improving the current supervisory and regulatory framework for CRA to further the statute's core objective of promoting access to credit and financial inclusion.

Conclusion

Finally, I'll note that we will continue to learn about issues concerning financial inclusion through our research, such as by collecting new data in our Survey of Household Economics and Decisionmaking and Survey of Consumer Finances that I mentioned earlier. The information we gather helps us better understand factors affecting consumers and households, including low- and moderate-income and historically underserved populations. We also continue to convene experts and practitioners from industry, academia, and community-based organizations to help provide context on what we are seeing in the data, to identify emerging issues, and to consider where there may be data gaps and opportunities for additional research. In addition to yielding important insights that inform our policymaking, we hope these efforts can support the conversations you are having at conferences like this one.

Thank you, again, for inviting me to speak at your conference as we mark the notable anniversaries that this year brings. Together, our work clearly has a great deal of synergy, and I thank you for your efforts. Making the economy work for the benefit of all Americans, including lower-income communities, is of the utmost importance.

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1 The views I express here are my own and not necessarily those of the Federal Reserve Board or the Federal Open Market Committee.

2 See, e.g. Randal K. Quarles, "Early Observations on Improving the Effectiveness of Post-Crisis Regulation" (speech at the American Bar Association Banking Law Committee Annual Meeting, Washington, DC, January 19, 2018).

3 "Financial Inclusion," World Bank, last modified April 5, 2017.

4 See, e.g., Lael Brainard, "Why Opportunity and Inclusion Matter to America's Economic Strength" (speech at the Opportunity and Inclusive Growth Institute Conference, sponsored by the Federal Reserve Bank of Minneapolis,

May 22, 2017); Janet L. Yellen, "Perspectives on Inequality and Opportunity from the Survey of Consumer Finances" (speech at the Conference on Economic Opportunity and Inequality, Federal Reserve Bank of Boston, Boston, MA, October 17, 2014); Ben S. Bernanke, "The Level and Distribution of Economic Well-Being" (speech before the Greater Omaha Chamber of Commerce, Omaha, NE, February 6, 2007).

5 The Board's *Monetary Policy Report (PDF)* has included a discussion of the economic experiences of major demographic groups. See, e.g., "Have the Gains of the Economic Expansion Been Widely Shared?" in *Monetary Policy Report* (Washington: Board of Governors, June 21, 2016), p. 6.

6 According to the U.S. Census Bureau's "Quarterly Residential Vacancies and Homeownership" statistics for the fourth quarter of 2017, the homeownership rates by race were 72.7 percent for non-Hispanic white households; 42.1 percent and 46.6 percent for black and Hispanic households, respectively; and 58.2 percent for Asian, Native Hawaiian, and Pacific Islanders. See www.census.gov/housing/hvs/files/currenthvspress.pdf.

7 U.S. Census Bureau, Current Population Survey, 2017 Annual Social and Economic Supplement, "Educational Attainment in the United States: 2017," December 14, 2017.

8 William R. Emmons, Ana H. Kent, and Lowell R. Ricketts, *The Demographics of Wealth: How Education, Race and Birth Year Shape Financial Outcome (PDF)*, Essay No. 1 (St. Louis: Federal Reserve Bank of St. Louis, February 2018).

9 For example, data from our Survey of Household Economics and Decisionmaking (SHED) show that in 2016, only about half of white households had three months of emergency savings, but this was the case for less than two-fifths of black and Hispanic households. The 2016 SHED is at www.federalreserve.gov/consumerscommunities/shed.htm. See also the Survey of Consumer Finances at www.federalreserve.gov/econres/scfindex.htm.

10 In the Matter of Cole Taylor Bank, Docket Nos. 14–021-E-SMB, 14–021-CMP-SMB (July 1, 2014);In the Matter of Higher One, Inc., Docket Nos. 15–026-E-I, 15–026-CMP-I (December 23, 2015);In the Matter of Customers Bank, Docket Nos. 15–027-B-SM, 15–027-CMP-SM (December 6, 2016).

11 In the Matter of Peoples Bank, Docket No. 17–041-B-SM (November 28, 2017).

12 See, e.g., DOJ settlements with Midwest BankCentre; SunTrust Mortgage Inc.; and Countrywide Financial Corporation. More information about recent referrals to the DOJ can be found in the Federal Reserve's annual report at www.federalreserve.gov/publications/2016-ar-consumer-and-community-affairs.htm#14890.

13 See www.ffiec.gov/press/PDF/FFIEC_CCR_SystemFR_Notice.pdf.

14 See the partnership's website at www.fedpartnership.gov.

15 See consumercomplianceoutlook.org/ and consumercomplianceoutlook.org/outlook-live/.

16 Federal Reserve System, "2017 Interagency Fair Lending Hot Topics," *Outlook Live* webinar series, November 16, 2017.

17 While there are many working definitions of "small," figures from the Small Business Credit Survey (SBCS) use firms with less than 500 employees as a proxy for small businesses. Some 28 percent are seeking credit in amounts less than $25,000 and 42 percent reported seeking between $25,000 and $100,000. The SBCS is available at www.newyorkfed.org/medialibrary/media/smallbusiness/2016/SBCS-Report-EmployerFirms-2016.pdf.

18 According to special analyses of the Joint Federal Reserve Banks' Small Business Credit Survey, among low-credit-risk firms, 60 percent of minority firms that were approved received only partial funding, whereas 68 percent of low-risk, non-minority firms were approved for the full amount of financing requested. Women-owned firms also reported a funding gap. Among low-credit-risk firms, 48 percent of women-owned firms received all of the financing requested, compared to 57 percent of men-owned firms. Reports are available at www.newyorkfed.org/smallbusiness/small-business-credit-survey-employer-firms-2016.

19 BAI Banking Strategies, "Making Small Loans Profitably," July 7, 2015.

20 Based on Federal Reserve analysis of FR-Y14 data for scored loans and cards (i.e., underwritten by owner's personal credit) for 2007 to 2016.

[21] Record of Meeting (PDF), Community Advisory Council and the Board of Governors, May 26, 2017, p. 2.

[22] See Rebel A. Cole, Lawrence G. Goldberg, and Lawrence J. White, “Cookie Cutter vs. Character: The Micro Structure of Small Business Lending by Large and Small Banks," *Journal of Financial and Quantitative Analysis* 39, no. 2 (June 2004): 227–51. Also see Karen Gordon Mills and Brayden McCarthy, “The State of Small Business Lending: Innovation and Technology and the Implications for Regulation,” Working Paper No. 17–042, (Harvard Business School, December 1, 2016), p. 36.

[23] See, e.g., Carol A. Evans, “Keeping Fintech Fair: Thinking about Fair Lending and UDAP Risks, " *Consumer Compliance Outlook* (Second Issue 2017).

[24] See Lael Brainard, “The Opportunities and Challenges of Fintech” (speech at the Conference on Financial Innovation at the Board of Governors of the Federal Reserve System, Washington, DC, December 2, 2016).