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EXECUTIVE SUMMARY

Homeownership is the primary means of long-term wealth accumulation and financial security for most American families, and plays an important role in promoting neighborhood stability and civic engagement. However, the opportunities of homeownership remain beyond the reach of many low- and moderate-income (LMI) households. Minority households face additional barriers. Even today, three decades after the elimination of racial segregation and the passage of fair housing legislation, African American and Hispanic borrowers are at least twice as likely as non-Hispanic whites to be turned down for a mortgage. An enormous body of research now documents these disparities in lending patterns. Unfortunately, most of this research is designed to uncover the *problem* of a continued legacy of discrimination, differential treatment, or disparate impact, and provides little insight on alternative *solutions.*

This study analyzes successful strategies to extend mortgage lending to minority home seekers, particularly those with low or moderate incomes. Mortgage lending practices and marketing strategies used to attract, qualify, and retain minority-LMI applicants are identified and analyzed based on telephone discussions, quantitative analyses, and case studies.

FINDINGS

The lenders in this study have been the leaders in expanding homeownership opportunities among historically underserved borrowers and neighborhoods. Taken together, the lenders in this study account for approximately 10 percent of all home-purchase loans made in 1995. Econometric analysis reveals that black and Hispanic mortgage applicants are approximately 13 percent more likely to be approved at our sample of lenders than at other institutions. Some lenders were prompted to increase minority-LMI lending because of regulatory pressure or community activism. Other lenders recognize the growth and potential of this underserved market, as the “traditional” market of middle-income white families declines in significance. For still other lenders—small neighborhood thrifts, many of them minority-owned—serving the needs of minority-LMI communities is their raison d’être. Despite their outward differences, common themes emerge in the lenders’ efforts to expand mortgage availability to underserved markets.

OVERALL MANAGEMENT STRATEGIES

For minority-LMI lending initiatives to be successful, it is crucial that institutions *create a management environment in which fair lending is seen as an integral part of the institution’s mission—not just an effort to fulfill fair lending requirements.* Although profit margins may be lower on targeted lending initiatives, higher lending volume may compensate for smaller dollar loans. These lending initiatives can often lead to growth in consumer lending, home improvement loans, and savings deposits. Minority-LMI lending can be good business, and most large, successful lenders communicate this message through their mission statements or other defining documents. Some overall management strategies include:

- Creation and review of quantitative goals for minority-LMI lending;

- Clear definition of the role of Community Reinvestment Act (CRA) officers and the staff of affordable lending units in the context of the entire institution;
- Establishment of a compensation structure to encourage all staff, from CRA officers to top management, to engage in minority-LMI lending;
- Institution of ongoing staff training and professional development that extends beyond what is legally mandated.

SEEKING APPLICANTS

Applying for a mortgage is only the final stage of a series of contacts between a potential applicant and various individuals and institutions. These contacts are embedded in social networks within local communities and influence every aspect of the pre-application phase of mortgage lending. People rely on advice from their families, friends, and trusted community leaders when deciding where to apply for a mortgage. The decision to apply for a mortgage is as much social as it is economic; thus *successful strategies must identify and develop the social and community networks that encourage minority-LMI lenders to try to become homeowners and apply for a mortgage.* Among the recommendations for reaching potential applicants:

- Tailor advertising content, language, media, and distribution to reach specific underserved populations;
- Partner with local real estate professionals, churches, and nonprofits that have a close connection with the targeted community;
- Establish homeownership counseling programs to make available support and information regarding the home-buying process;
- Foster racial and ethnic diversity in-house, which will reinforce connections to the community and help generate a climate of respect for populations traditionally excluded from homeownership.

QUALIFYING APPLICANTS

In an era of declining Federal assistance, developing flexible mortgage products requires innovative partnerships between Federal sources, State and local governments, and foundations and other nonprofit organizations. Successful lenders rely on a wide variety of sources of back-up funds. Some have developed entirely new mortgage products that challenge long-held notions of what is "bankable."

In this study, we distinguish among several different types of mortgages, each of which is associated with different underwriting criteria used to qualify minority and LMI applicants:

- *GSE Standard Mortgages* represent the current industry norm; they require a minimum 5 percent down payment and as a guideline provide for a maximum 28 percent housing expense to income (front-end) ratio;[1]

[1] These terms vary by individual mortgage program. For instance, Fannie 97 with a 3 percent down payment from the borrower has a maximum front-end ratio of 28 percent with a 30-year amortization, and 33 percent with a 25-year amortizaion. Freddie Mac's Affordable 97 with 3 percent down has no front-end ratio.

- *GSE Affordable Mortgages* include more flexible provisions, such as a minimum 3 percent down payment and a 33 percent front-end ratio;
- *Portfolio Affordable Mortgages* can require a very small down payment (e.g., $250) and permit front-end ratios of 35 percent or more.

The widespread adoption of the GSE Standard and GSE Affordable Mortgages and flexible portfolio products have also changed the underwriting practices throughout the industry. Whereas Historical Mortgages (i.e., those prevailing some 10 to 20 years ago) incorporated strict and unyielding criteria that unnecessarily disqualified many prospective homeowners, today most successful lenders will be more flexible in their requirements. Lenders can:

- Provide for judicious but flexible underwriting of the borrower and property, e.g., accept alternative credit records;
- Scrutinize credit record reporting and credit scoring for errors;
- Institute multiple review procedures for denied applications;
- Institute self-testing in the underwriting and pre-application phase.

RETAINING MORTGAGORS

Although affordable mortgage lending can be nearly as safe as conventional lending, the loans usually require more attentive servicing. Minority-LMI borrowers are especially vulnerable to financial difficulties, and may be hesitant to discuss their problems with an officer of a lending institution because of the discomfort and discrimination they may have faced previously. These issues must be tackled head-on by:

- Building ongoing relationships with borrowers through post-purchase counseling;
- Providing careful monitoring and reacting quickly in the event of missed payments;
- Allowing flexibility in dealing with delinquency.

Recommended Strategies To Foster Enhanced Minority-LMI Lending

I. OVERALL MANAGEMENT PRACTICES

1. Include goal of fostering minority lending in institution's overall mission statement, lending policy statement, or similar defining document.[1, 2, 3]
2. Involve senior-level bank management in developing, implementing, and monitoring goal of minority lending.[2, 4]
3. Provide compensation practices that reward, or at least do not indirectly penalize, employees working to foster minority lending.[1, 2, 3]
4. Practice staff recruitment and promotion to foster minority lending through racial diversity of employees.[2, 3, 5]
5. Provide staff training in fair lending practices specifically, and multicultural awareness generally.[1, 2, 3, 4, 6]
6. Work with third parties (e.g., real estate agents and brokers, appraisers, private mortgage and insurance companies) committed to fostering minority lending.[3]
7. Systematically test for fairness, so that at all stages of the lending process (seeking, qualifying, and retaining applicants) minorities are treated equally.[2, 3, 4, 5, 7]
8. Provide consumer education on homeownership and home financing (e.g., offer guides to the home-buying process).[2, 3, 4, 6]
9. Appoint an ombudsperson or comparable official to receive complaints from consumers.[3]

II. SPECIFIC STRATEGIES BY STAGE OF THE LENDING PROCESS

A. SEEKING APPLICANTS

1. Provide information on loan products in minority neighborhoods via mailings,[5] canvassing, or other methods.[2, 3]
2. Establish branches or other presence in minority neighborhoods.[2]
3. Tailor and place advertising to attract minority applicants.[1, 2, 3, 4]
4. Work with Realtors/brokers active in minority areas.[1, 2, 3, 4]
5. Work with others to gain access to the minority mortgage market (e.g., government agencies, minority developers, service agencies, or CDC or nonprofit groups).[1, 2, 4]
6. Seek potential minority mortgage applicants among in-house minority and other employees.[3]
7. Conduct analyses of minority mortgage grantors to determine minority markets where the institution has limited presence or none at all.[3]

B. QUALIFYING APPLICANTS

Affordable Loans

1. Offer "affordable" loan products (i.e., loans that have such enhancements as a public-sector interest subsidy or down payment assistance).[1, 2, 3, 8]

Underwriting Standards

1. Credit history—Avoid subjective criteria (e.g., "applicant must have excellent credit") and consider extenuating circumstances in the case of credit blemishes; accept a no-credit record if a proxy measure such as rent/utility payment history is acceptable. [2, 4, 6, 7, 9]
2. Employment history—Avoid subjective criteria (e.g., "applicant must have adequate job longevity") and focus on applicant's ability to maintain or increase income, not on length of stay in a particular job. [2, 4, 6, 8]
3. Property standards—Avoid arbitrary disqualification of property on the basis of property's age, location, condition, value, amenities, or size. [2, 4, 6, 9]

Recommended Strategies to Foster Enhanced Minority-LMI Lending

4. Property appraisals/neighborhood analysis—Avoid subjective descriptors such as "desirable or stable area," "homogeneous neighborhood," "attractive appearance," and "remaining economic life."[2, 6, 8, 9]
5. Loan terms—Avoid arbitrary limits, such as minimum loan amounts.[2, 4, 5, 8, 9]
6. Obligation terms—Allow for flexibility in loan application (e.g., 28 percent housing expense to income ratio and 36 percent total fixed obligations to income ratio) where applicants have a successful record in meeting high expenses. [2, 4, 8, 9]
7. Sources of income—In addition to primary employment income, count all valid secondary sources (e.g., overtime and part-time work, second and seasonal jobs, welfare and unemployment benefits).[2, 4, 8]
8. Down payment and closing costs—Allow flexible and extended informal sources (e.g., relatives' loans and cash on-hand).[2, 4, 6]
9. Ensure that loan underwriting staff understand and apply the same discretion provided to primary lenders by third-party agencies (e.g., Fannie Mae, Freddie Mac, and PMIs.)[2, 4, 6]

Underwriting Practices

1. Document institution's underwriting standards and practices, including acceptable compensating factors, and train underwriters in the consistent application of these standards and practices.[1, 2, 4]
2. Support and don't "second guess" employees' application of compensatory factors.[2]
3. Allow for a second review—a prompt and impartial review—of all rejected loan applicants to ensure fairness.[1, 2, 3, 5, 8]

C. RETAINING MORTGAGORS

1. Provide information to new mortgagors on the obligations of homeownership and helpful strategies for meeting the obligations (e.g., allowing a financial reserve and avoiding expensive home improvements).[10]
2. Carefully explain and communicate the change in loan obligations that affect the required level of payments (e.g., interest rate fluctuations in the case of a VRM, or rising property taxes).[10]
3. Provide for careful monitoring of payments and quick reaction to loan delinquency (e.g., a telephone call ascertaining why a payment was missed and when it will be sent).[10]
4. Allow flexibility to cure delinquency (e.g., allow reduced or missed payments in the case of temporary unemployment or family illness). All reduced or missed payments should ultimately be made up.[10]

NOTES

[1] Federal Deposit Insurance Corporation, Federal Reserve Board, Comptroller of the Currency and Office of Thrift Supervision. 1993. *Suggested Lending Activities*. May 27.
[2] Federal Reserve Bank of Boston. 1993. *Closing the Gap*.
[3] Mortgage Bankers Association of America and HUD. 1994. *Fair Lending—Best Practices Agreement*.
[4] Federal Financial Institutions Examination Council (FFIEC). 1993. *Home Mortgage Lending and Equal Treatment*.
[5] Department of Housing and Urban Development et al. 1994. "Joint Policy Statement on Discrimination in Lending." 59 *Federal Register* 18, 266. April 15.
[6] Federal Reserve Bank of Cleveland. 1994. "Committed People Can Make a Difference." *Community Reinvestment Forum*. Special Issue.
[7] Federal Deposit Insurance Corporation. 1994. *Side-by-Side: A Guide to Fair Lending.*
[8] National Community Reinvestment Coalition. 1995. *Catalog and Directory of Community Reinvestment Agreements*.
[9] Federal Deposit Insurance Corporation. *Compliance Examination Manual.* Published annually by the FDIC; FAIR HOUSING SECTION II–B.
[10] Other literature. (Details in CUPR bibliography).

In sum, successful LMI-minority lending requires a broad range of actions on many fronts. The exemplary lenders examined in this study have shown the way to real-world success.

They are making important progress in reaching the formerly underserved—and they are also discovering opportunities for new business, albeit often not as profitable as traditional markets. This study will allow others to learn from their experiences.

CHAPTER ONE
BACKGROUND AND INTRODUCTION

This chapter outlines the importance and context of efforts to expand mortgage lending to traditionally neglected borrowers, and presents the methods used in this study. First, the context is set by examining:

- The importance Americans place on homeownership, and the social and economic benefits of ownership;
- The persistent gap between white and minority homeownership rates;
- Reasons for the minority homeownership gap, including the role of mortgage financing;
- Recent attempts to expand minority home financing.

Next, the methods used in this study for identifying and classifying successful lending strategies are outlined, focusing on:

- Definitions and key terms;
- Characteristics and motivations of lenders participating in the study;
- Framework used to classify strategies employed to expand minority lending.

NATIONAL HOMEOWNERSHIP ACTIVITY

The United States is remarkable for an especially high rate of homeownership. Nearly two out of every three Americans (65.4 percent in 1996) currently own their domicile. In other developed countries, such as Germany, less than 40 percent of the population own their own homes; in Western Europe, as a whole, only 56 percent of the population are homeowners.

During much of the twentieth century, there was a seemingly inexorable rise in the American homeownership rate—from about 45 percent in the pre-World War II period to 62 percent in 1960 to 66 percent in 1980 (Bunce et al. 1996, 11). By the end of the 1980s, however, the homeownership rate had dropped to 64 percent, causing much consternation (Roberts 1993, 11). HUD, secondary market funders (e.g., Fannie Mae and Freddie Mac) and others, in turn, announced ambitious wide-ranging programs to spur homeownership. Recently, the National Homeownership Strategy, a broad initiative sponsored by HUD and the public and private sectors, has established a goal of generating up to 8 million additional homeowners between 1995 and 2000 and increasing the homeownership rate to 67.5 percent by the end of the millennium (HUD 1995a, 1-5).

Homeownership is an achievable goal for most Americans. However, for certain social groups, homeownership is more dream than reality. Various segments are considered “underserved populations” (Bunce and Scheessele 1996, 17). Younger households and single-parent families with children are two such examples; only 40 percent of households under 35, and less than 40 percent of single-parent households with children, are homeowners, compared to a 65 percent homeownership rate for the general population. Minorities are another underserved population and are the focus of this study.

MINORITY HOMEOWNERSHIP GAP

Minorities are much less likely to be homeowners than the rest of the population. In 1996, the white homeownership rate in the United States was 72 percent—much higher than the rate of 44 percent for African American households and 41 percent for Hispanic households (Exhibit 1.1). This disparate pattern has existed for some time. Since the early 1980s, the white homeownership rate has fluctuated between 24 and 29 percentage points above the African American homeownership rate and between 28 and 31 percentage points above the Hispanic homeownership rate. If anything, the minority homeownership gap has worsened over time as measured by the African American/Hispanic homeownership percentage relative to the homeownership achievement of the population generally and whites specifically (Exhibit 1.1). At the same time, recent years have witnessed an absolute increase in the number of minorities who own their own homes (a 2 percent increase from 1993 to 1996). This improvement is modest, however, and has been realized by whites as well, allowing them to maintain their advantage.

To restate the minority homeownership gap in a more telling way: as of 1995 there were about 19.0 million minority (African American and Hispanic) households in the United States, of whom 8.2 million were homeowners (HUD-AHS 1997). Holding aside all intra-racial economic and demographic differences, if minorities were to attain the same homeownership rate as whites (70.8 percent in 1995), there would be 13.5 million minority homeowners, or 5.3 million *more* than is the case. Even if economic and demographic factors characterizing minorities accounted for as much as 80 percent of the lower level of minority homeownership,[1] more than one million minority households would still be precluded from homeownership because of their racial status.

This problem persists throughout the nation, although it takes different forms in different places. While most of the research on lending discrimination focuses on urban areas (due in no small part to data considerations), minorities in rural areas—including Native Americans, as well as African Americans and Hispanics—also have difficulty achieving homeownership. On the Navajo reservation located in the Southwest United States, for example—an area the size of West Virginia—a conventional home mortgage had never been granted before 1995. In an entirely different setting, the recent groundbreaking for a new housing subdivision in Detroit (Victoria Park) marked the first new home construction within the central city in nearly 50 years. For

[1] This is the finding of Wachter and Megbolugbe (1992).

EXHIBIT 1.1
Variation in Homeownership Rates by Race Among U.S. Households: 1983-1996

Race	1983	1985	1990	1991	1992	1993	1994	1995	1996
All U.S. households	64.6%	63.9%	63.9%	64.1%	64.1%	64.0%	64.0%	64.7%	65.4%
White households	69.1%	69.0%	69.4%	69.5%	69.6%	69.6%	70.2%	70.8%	71.6%
Percentage point difference between white households and U.S. total	+4.5	+5.1	+5.5	+5.4	+5.5	+6.2	+6.1	+6.1	+6.2
African American households	45.6%	44.4%	42.6%	42.7%	42.6%	42.6%	42.0%	42.8%	44.3%
Percentage point difference between African American households									
and U.S. total	-19.0%	-19.5	-21.3	-21.4	-21.5	-22.0	-21.2	-22.7	-21.1
and white households	-23.5%	-24.6	-26.8	-26.8	-27.0	-28.2	-27.3	-28.8	-27.3
Hispanic households	41.2%	41.1%	41.2%	39.0%	39.9%	39.4%	41.6%	42.4%	41.2%
Percentage point difference between Hispanic households									
and U.S. total	-23.4	-22.8	-22.7	-25.1	-24.2	-24.6	-22.4	-22.3	-24.2
and white households	-27.9	-27.9	-28.2	-30.5	-29.7	-30.8	-28.5	-28.4	-30.4

Source: U.S. Bureau of the Census

many of Detroit's residents, most of them minorities, homeownership has been an unattainable goal for nearly half a century; even for those who gained access to homeownership, the overall decline in the neighborhoods frequently led to a low or negative return on their investment. Examples like these, multiplied a thousandfold in urban, suburban, and rural settings throughout the country, illustrate how barriers to homeownership deprive minority and LMI families from one of our society's most significant avenues of wealth accumulation.

IMPLICATIONS OF THE MINORITY HOMEOWNERSHIP GAP

Annual national housing surveys conducted by Fannie Mae consistently show that the vast majority of Americans aspire to homeownership. Of those surveyed:

- 89 percent said they believed one is better off owning than renting (Fannie Mae 1994, 4 and 7).
- More than two-thirds (69 percent) said that the goal of increasing the homeownership rate should be a "very high" priority, one of the top two or three priorities, in the country (Fannie Mae 1996a, 5).
- More than two-thirds of renters said they rent because of their circumstances, not as a matter of choice (Fannie Mae 1996a, 9).

The fact that a disproportionate share of minorities is not achieving homeownership means that this segment of the population is not realizing a fundamental and near universally held American aspiration.

More is at stake, however, than just satisfying aspirations. To start, there are numerous social benefits that accompany homeownership. As long as owners make their monthly mortgage payments and cover their property taxes, they, for the most part, are in control of their dwelling (Scanlon 1996, 12). Decisions about the housing unit—from the color of the rooms, to the flowers in the garden, to the type of appliances in the kitchen—are exclusively theirs to make. Renters, on the other hand, continually face the prospect of a change in ownership and management practices, uncontrollable rent increases, and the possibility of nonrenewal of their lease. Accompanying the benefit of greater mobility that renting provides are greater instability and less control over one's domicile.

Owners also tend to be more involved in local issues and politics (Rohe and Stegman 1994a, 1994b; Scanlon 1996). Owners are more likely than renters to be involved in their communities; they participate in neighborhood group committees, vote in local elections, read local newspapers (a source of detailed political news), and are better able to name their elected officials (Rossi and Weber 1996, 22-25). These examples of greater owner "involvement" partially reflect the greater vested interest that owners have in their community.

Homeownership is not a social panacea. In their longitudinal study of low-income renters who became homeowners, Rohe and Stegman (1994a, 1994b) found that although homeownership had a positive impact on the quality of low-income home buyers' lives, it did not increase their self-esteem or perceived control over events (Rohe and Stegman 1994b, 181-182). Rossi and Weber (1996) concluded that there is little evidence that increased homeownership among lower-income populations produces social benefits or improves American society (Rossi and Weber 1996, 31-33).

But if homeownership does not address all social ills, the evidence cited above, as well as other literature (HUD 1995b, 1996a), points to at least some social benefit derived from it. Moreover, research suggests that the benefits of homeownership are bound up with improvements in neighborhood effects—e.g., greater neighborhood stability, greater community cohesion, and more stable property values. The benefits of homeownership also seem to pass on to future generations. Green and White (1994) found that homeowners' children are more likely to graduate from high school and less likely to be involved with social pathologies (e.g., crime and teenage pregnancy) than renters' children; this advantage was especially pronounced for lower-income households. Thus, to the extent that the current social benefits of homeownership are not accruing to the many minority households, this population is deprived of future benefits as well.

Homeownership also affords many economic advantages. As noted in a recent HUD study:

> Home equity is the largest source of wealth for most Americans. Median net wealth for renters is only about 3 percent of the median net wealth for homeowners. Among homeowners, about 60 percent of their wealth consists of home equity. Even among low-income homeowners, home equity comprises over half their wealth. (Bunce et al. 1996, 6)

The economic advantages of homeownership vis-à-vis renting are clear-cut. Mortgage payments, unlike rent, typically build equity. Homeowners benefit from the deductibility of mortgage loan interest and property taxes from Federal income taxes—a deduction that amounted, in the aggregate, to $58.6 billion in 1995 (Dreier 1996). Renters are denied this generous tax shelter. The overall effect is greater wealth accumulation for homeowners. Survey research reported by Rossi and Weber (1996, 12) found that owner households, on average, have about $6,000 more in savings and about $5,000 more invested in mutual funds than renter households. Thus, homeowners are able to accumulate wealth not just in home equity but in other forms as well.

Because they do not share as fully in the realization of homeownership, minorities are disproportionately precluded from the economic advancement such housing tenure provides. The figures from the most current (1993) *Survey of Income and Program Participation* are illustrative. As of 1993, the median value of asset holdings, for all households with assets, was $37,587. The median home equity for homeowning households was $46,669—almost 25 percent higher than the median value of all assets for all households. The study documents the greater wealth advantage of whites. The median asset value for white households (with assets) was $45,740; their median home equity was $49,500. The median asset value of African American households (with assets), on the other hand, was only $4,418—one-tenth of the comparable white median. The median home equity value for African American homeowners was $28,746, only about 55 percent of the comparable white average. For Hispanic households, the asset value and home equity figures were also fractions of the white attainment—$4,656 and $36,069, respectively (U.S. Bureau of the Census 1995).

As these figures suggest, home equity is, in fact, much more important to minority asset composition than to white asset conditions. For all U.S. households, equity in the home comprises 44 percent of all assets; for white households it comprises 43 percent. For African American and Hispanic households, however, equity in the home represents 60 and 57 percent of assets, respectively (U.S. Bureau of the Census 1995).

Despite other influencing factors,[2] clearly the minority homeownership gap results in economic disadvantage, over and above the social disadvantages noted earlier. Increasing minority homeownership rates cannot help but bolster asset building for African Americans, Hispanics, and other minorities. To be sure, some critics attack the use of policies in the housing market to address entrenched inequalities in income and wealth, arguing instead for addressing these disparities through education or by other means. But the Federal and State retreat from affirmative action and other race-specific policies, as well as the possible effect of an influx of former welfare recipients into the low-income labor force, make housing policy crucial for increasing opportunities for racial and ethnic minorities. Structural changes in the labor market accentuate the importance of housing market policies in redressing long-standing social and economic inequalities.

REASONS FOR THE MINORITY HOMEOWNERSHIP GAP

Economic and demographic forces both contribute to the lower incidence of minority homeownership attainment. Homeownership correlates closely with income. As of 1997, 80 percent of all U.S. households with a family income higher than the median were homeowners, compared to only 50 percent of households with a family income lower than the median (U.S. Bureau of the Census 1997). Exhibit 1.2 shows an almost linear increase in homeownership as income increases. Because minority households have much lower incomes than whites, their prospects for homeownership are reduced. As of 1995, the median African American household income ($22,393) was a mere 62 percent of the median white household income ($35,776). A similar gap was observed for Hispanics, who had a 1995 median household income of $22,860. Analyzing the income distribution by quintile further illustrates the minority income disadvantage; in 1993, over 30 percent of minority households were in the lowest income quintile, compared to only 18 percent for white households (U.S. Bureau of the Census 1993).

Even more striking than the disparities in income, however, are the limitations imposed on minority households by their low level of accumulated wealth. As noted earlier, the median wealth of minority households—a small fraction (about one-tenth) of that of the white population—reduces considerably the ability of minority households to make down payments or pay the closing costs on a home. This, in turn, precludes them from accumulating assets through homeownership (Megbolugbe and Linneman 1993).

Demographic forces are also at work. As a rule, "traditional" households in the United States, that is, married couples as compared to single-person households, have the highest

[2] For instance, homes owned by minorities may not accumulate equity as readily as others because of discrimination (e.g., location in minority neighborhoods) and other factors (e.g., urban location or siting in an area with poorer services).

homeownership rates (Exhibit 1.3). Yet "traditional" households are disproportionately underrepresented among minorities. Meanwhile, younger households (i.e., ages 35 and under) typically have the lowest homeownership achievement in the United States (Exhibit 1.4). It is precisely these younger households that are overrepresented among minorities.

Minorities' constrained income and demographic characteristics do not fully explain the disparity in homeownership achievement, however. To this end, the homeownership level for white versus minority households must be examined, controlling for income (Exhibit 1.2), household composition (Exhibit 1.3), and age (Exhibit 1.4). Using these controls, the homeownership gap observed earlier—i.e., the 20–25 percentage point discrepancy between white and minority households—is attenuated but does not disappear. Among the more affluent households—those with incomes of $50,000 to $100,000—a 10 percent homeownership gap is still observed for minorities (Exhibit 1.2). Similarly, a discernible homeownership gap is found for "traditional" minority households, that is, married couples (Exhibit 1.3), and for "prime" ownership-oriented households with respect to life cycle, i.e., those 35 to 44 years of age (Exhibit 1.4). Others have applied similar controls and have reached similar conclusions:

> About 80 percent of the difference [20 percent lower minority homeownership] can be attributed to the lower income and wealth of minority households, their greater likelihood to have family structures, such as single-headed families, that have more difficulty in affording homeownership, and other factors such as age [citing Wachter and Megbolugbe 1992]. However, as shown [in Exhibit 1.5], even married couples with children with a household head between 35 and 44 years of age still experience significantly lower homeownership rates than whites. The probability of ownership among minority households occurs much more in response to an increase in income than does the probability for white households. Thus, the gap in homeownership rates across races is much greater for lower income families than for higher income families. This difference may reflect discrimination faced by lower income families that restricts their choice of housing. Conversely, it may reflect the fact that at any given income level, minorities have fewer assets than white households. (Bunce et al. 1996, 18-19)

Discriminatory and economic barriers confront minorities, especially those with low and moderate incomes (LMI), along the entire continuum of the homeownership process—from the initial decision to become an owner, through the housing search, to the financing of homeownership and beyond (see Figure 1.1). In addition, since fewer minorities have been homeowners, it is more of a "reach" for a minority renter to decide to become a homeowner than

EXHIBIT 1.2
Housing Tenure by Household Income and Race (1993)

	All Households		**White Households**		**African American Households**		**Hispanic Households**	
Household Income	Percent Owner	Percent Renter	Percent Owner	Percent Renter	Percent Owner	Percent Renter	Percent Owner	Percent Renter
Less than $5,000	42.7%	57.3%	51.2%	48.8%	25.6%	74.5%	28.5%	71.5%
$5,000 to $9,999	42.4%	57.6%	46.2%	53.8%	31.8%	68.2%	24.1%	75.9%
$10,000 to $14,999	52.1%	47.9%	57.5%	42.5%	33.1%	66.8%	27.8%	72.2%
$15,000 to $19,999	53.6%	46.5%	57.8%	42.2%	37.9%	62.1%	29.5%	70.5%
$20,000 to $24,999	55.5%	44.5%	58.5%	41.5%	42.6%	57.4%	38.4%	61.6%
$25,000 to $29,999	62.8%	37.2%	65.9%	34.1%	44.9%	55.1%	38.0%	62.0%
$30,000 to $34,999	64.0%	36.0%	66.7%	33.3%	47.5%	52.5%	50.7%	49.3%
$35,000 to $39,999	69.0%	31.0%	71.8%	28.2%	48.5%	51.5%	51.9%	48.1%
$40,000 to $49,999	73.0%	27.0%	75.1%	24.9%	58.5%	41.5%	62.5%	37.5%
$50,000 to $59,999	78.6%	21.4%	80.2%	19.8%	65.7%	34.3%	63.3%	36.7%
$60,000 to $79,999	83.6%	16.4%	84.6%	15.4%	76.2%	23.8%	72.5%	27.2%
$80,000 to $99,999	88.1%	11.9%	89.3%	10.7%	80.6%	19.4%	72.2%	27.8%
$100,000 to $119,999	90.9%	9.1%	90.6%	9.4%	95.5%	4.5%	70.3%	29.7%
$120,000 or more	93.1%	6.9%	93.3%	6.7%	86.8%	12.4%	91.9%	8.1%

Source: U.S. Department of Housing and Urban Development, *American Housing Survey*, 1993.

EXHIBIT 1.3
Housing Tenure by Household Composition and Race, 1993

Household composition	All Households		White Households		African American Households		Hispanic Households	
	Percent Owner	Percent Renter	Percent Owner	Percent Renter	Percent Owner	Percent Renter	Percent Owner	Percent Renter
2-or-more person household	69.6%	30.4%	73.7%	26.3%	46.7%	53.3%	43.9%	56.1%
Married-couple families, no nonrelatives	80.0%	20.0%	81.8%	18.2%	68.1%	31.9%	55.7%	44.3%
Other male householder	49.7%	50.4%	52.5%	47.5%	37.2%	62.8%	25.5%	74.5%
Other female householder	44.2%	55.8%	50.6%	49.4%	30.4%	69.4%	26.9%	73.1%
1-person households	49.4%	50.6%	52.7%	47.3%	33.3%	66.7%	32.2%	67.8%
Male householder	41.1%	58.9%	44.8%	55.2%	26.1%	73.9%	22.9%	77.1%
Female householder	55.1%	44.9%	57.8%	42.2%	40.0%	60.1%	40.5%	59.3%

Source: U.S. Department of Housing and Urban Development, *American Housing Survey*, 1993.

EXHIBIT 1.4
White, African American and Hispanic Housing Tenure by Age of Householder, 1993

Age	All Households		White Households		African American Households		Hispanic Households	
	Percent Owner	Percent Renter	Percent Owner	Percent Renter	Percent Owner	Percent Renter	Percent Owner	Percent Renter
Under 25 years	12.6%	87.4%	14.3%	85.7%	6.3%	93.7%	8.3%	91.7%
25 to 29	34.9%	65.1%	39.4%	60.6%	13.7%	86.3%	20.5%	79.5%
30 to 34	51.5%	48.5%	56.5%	43.5%	24.7%	75.3%	35.5%	64.5%
35 to 44	65.3%	34.7%	70.0%	30.0%	41.1%	58.9%	42.9%	57.1%
45 to 54	75.5%	24.5%	78.9%	21.1%	55.2%	44.8%	54.2%	45.8%
55 to 64	80.5%	19.5%	83.4%	16.6%	64.4%	35.6%	61.6%	38.4%
65 to 74	80.9%	19.1%	83.1%	16.9%	62.9%	37.1%	67.2%	32.8%
75 and older	72.4%	27.6%	73.5%	26.5%	63.6%	36.4%	60.4%	39.6%

Source: U.S. Department of Housing and Urban Development, American Housing Survey, 1993.

EXHIBIT 1.5
Homeownership Rates of White and Minority Married Couples with Children and with a Household Head between 35 and 44 Years Old

Income	Whites	Minorities
Less than $20,000	62%	36%
$20,000–$39,999	79%	57%
$40,000–59,999	88%	72%
$60,000–$79,999	93%	80%
Greater than $80,000	96%	83%

Source: Bunce et al. 1996, 19

it is for a white renter. Minority renters' anxieties exceed the apprehensions of other renters considering homeownership. They worry that they will be rejected by a lender, or "will be taken advantage of," or that their property will deteriorate and they will be unable to make repairs (Bradley and Zorn 1996).

The housing search itself can also be problematic to minorities. With less income, their choice of affordable housing is constrained (Weisbrod and Vidal 1981, 472). Moreover, they face barriers related to race. In 1980, Zorn, studying housing search behavior, found that African American households rely more heavily on real estate agents than do whites; Turner[3] (1992) and others have found recurring instances of "steering" and other discriminatory behavior by real estate agents. Minorities also confront other hurdles in the search process. Newburger (1981), studying Boston; Galster, Freiberg, and Houk (1987), studying Milwaukee; and Turner and Wienk (1993), studying Washington, D.C., are consistent in their findings that houses for sale in predominantly African American neighborhoods are much less likely to be listed in newspapers and less likely to be marketed through open houses. Other barriers include lessened access to transportation (Weisbrod and Vidal 1981) and not knowing of, or pursuing, "creative" sources for finding homes, such as auctions or foreclosure sales (Hamilton and Cogswell 1997, 110-111; Ratner 1996, 122).

[3] Turner (1992) describes two national HUD-sponsored studies that provide evidence of discrimination by real estate agents during the housing search stage of the homeownership process.

FIGURE 1.1

Source: Federal Reserve Bank of Cleveland. 1994. *Community Reinvestment Forum,* Special Issue, pp. 7-8.

FINANCING AS A BARRIER TO MINORITY HOMEOWNERSHIP

In 1996, a modest-priced home in the United States cost about $94,000 (defining "modest-priced" as 80 percent of the median sales price of existing homes). To purchase this home required an annual outlay of $9,600 for principal, interest, taxes, and insurance (PITI), which at a 28 percent housing expense-to-income ratio required a minimum income of $34,000 (see calculation in Exhibit 1.6). Assuming 90 percent financing terms, that modest home also required a minimum down payment of $9,400. Arriving at these numbers would represent a quantum financial leap for the average African American renter, with a median family income of $14,700 (as of 1995) and assets in the $1,000 to $2,000 range.

Other affordability issues also constrain minority homeownership financing. The *Survey of Consumer Finances* shows that families with incomes below $50,000 are much more likely to have debt-to-income ratios above 40 percent and/or to have debt payments sixty days or more past due (Kennickell, Starr-McCluer, and Sunden 1997, 21). Since minorities have disproportionately lower incomes, they are more likely to bear higher debt-to-income ratios and have sullied credit records than are whites—thus deterring their "financability."

Discrimination may also impede minority home mortgage financing. Even before the availability of data from the Home Mortgage Disclosure Act (HMDA—enacted in 1975 and subsequently amended), numerous studies grappled with the issue of the existence and extent of lender redlining by area and race of applicants (Listokin and Casey 1980). Since HMDA was enacted, the number of such investigations has mushroomed, and many purport to have found an extensive pattern of lender discrimination:

> Research based on Home Mortgage Disclosure Act (HMDA) data suggests pervasive and widespread disparities in mortgage lending across the nation. A major study by researchers at the Federal Reserve Bank of Boston shows that mortgage denial rates are substantially higher for minorities, even after controlling for indicators of credit risk. African-American and Hispanic-American applicants in Boston with the same borrower and property characteristics as white applicants have a 17 percent denial rate compared with the 11 percent denial rate experienced by whites. . . . Mortgage credit also appears to be less accessible in low-income and high-minority neighborhoods. The U.S. Department of Housing and Urban Development (HUD) analysis of HMDA data shows mortgage denial rates to be nearly twice as high in Census tracts with low-income and/or high-minority composition, as in other tracts (21 percent versus 11 percent). (Bunce et al. 1996, 21)

EXHIBIT 1.6
Worksheet for Financing/Affording Modest-Priced Home in the United States (1996)

• Modest-Priced Home Cost[1]	$94,400
• Down Payment (10%)	- $9,440
• Mortgage[2]	$84,960
• Interest Rate[3]	7.81%
• Annual Principal and Interest	$7,346
• Annual Property Taxes[4]	$1,416
• Annual Insurance[5]	$850
• Annual PITI=	$9,612
• Income Required to Afford[6]	$34,329

[1]80 percent of the 1996 median sales price of existing homes as reported by the National Association of Home Builders
[2]$94,400 - $9,440; assumes no points
[3]FHLMC 1996 survey of lenders; assumes 30-year mortgage
[4]Assumes 1.5 percent equalized property tax rate
[5]Estimated
[6]Assumes 28 percent housing expense-to-income (front-end) ratio

These studies have been controversial. The famous Boston Federal Reserve study, cited above, has been both critiqued and supported (Rachlis and Yezer 1993), and even "redone." Fannie Mae subsequently reanalyzed the raw data used by the Boston Fed and came to a similar conclusion that a discriminatory effect was present (Carr and Megbolugbe 1993a; 1993b).

Schill and Wachter (1995) identify two types of examinations of mortgage lending behavior that have been used to identify discriminatory practices by lending institutions: *aggregate studies,* which look at the supply of home mortgage loans made in particular neighborhoods; and *accept/reject studies,* which look at the relationship between the racial composition of neighborhoods and the probability that loan applicants will be accepted/ rejected.

The authors note that aggregate studies tend to provide evidence of geographic and racial disparities consistent with the redlining hypothesis. Nonetheless, one problem with aggregate studies is the difficulty in identifying whether the disparities in mortgage lending are due to discriminatory policies by lenders inhibiting supply in these areas or due to limited demand by potential residents of these areas (Schill and Wachter 1993, 246-247; 1995, 156). Both can suppress levels of neighborhood investment and homeownership opportunities for minorities.

Throughout the 1980s, the HMDA reports provided only the aggregate number of loans and the dollar value of loans made in individual Census tracts. But in 1989, modifications to HMDA made it possible to undertake accept/reject studies. Schill and Wachter (1995) point to problematic issues with these studies, which purported to find evidence of redlining. Although minority status is correlated with loan rejection, when neighborhood risk is statistically controlled for in the model, minority status loses its significance (Schill and Wachter 1995, 156). Schill and Wachter do caution, however, that if neighborhood risk factors—which are correlated with the concentration of minorities in neighborhoods—are used in the accept/reject decision but are not related to individual default risk, then the use of neighborhood risk factors by lenders to determine eligibility would be tantamount to redlining (Schill and Wachter 1993, 272).

SPECIFIC BARRIERS TO MINORITIES IN THE LENDING PROCESS

As discussed above, many studies point to instances of discrimination by lenders against minorities, both directly or indirectly. In the view of the Federal Reserve Bank of Boston:

> Overt discrimination in mortgage lending is rarely seen today. Discrimination is more likely to be subtle, reflected in the failure to market loan products to potential minority customers and the failure of lenders to hire and promote staff from racial and ethnic minority groups. Unintentional discrimination may be observed when a lender's underwriting policies contain arbitrary or outdated criteria that effectively disqualify many urban or lower-income minority applicants. (Federal Reserve Bank of Boston 1993, 6)

There are many instances in the financing process where these subtle or unintentional acts of discrimination work to disqualify minority home seekers. It is now recognized that discrimination can take three forms: 1) blatant discrimination (illegal and now rare); 2) disparate treatment (the use of a standard or criterion that has a greater impact on a particular protected group); and 3) adverse impact (the unintended effect of a policy or practice on minority applicants that cannot be justified on legitimate business grounds) (Galster 1991). Overall, some lender management policies (i.e., those concerning worker compensation) may have the effect of disqualifying minority home seekers. Similarly, some actions by which lenders reach out to would-be borrowers, qualify them for loans, and then retain them as customers in good stead, may be discriminatory. Examples of some of the barriers to minorities along the many stages of the lending process are illustrated below.

Overall Management

Compensation—Lenders have often compensated loan officers, either entirely or in large measure, through a commission system whereby the officers are paid a percentage of the loan amounts they bring in. Such a system provides an incentive for loan production but may very well act as a disincentive for a loan officer to work with minorities, especially LMI applicants, because:

1. These loans tend to be smaller than average. In turn, commissions will be lower, since they are percentage-based. Loan officers may very well prefer to focus on larger loans that are more lucrative.
2. Compounding the above problem, minority-LMI loans often require more work for the loan officer. To a disproportionate extent, applicants are first-time home buyers, have credit blemishes, use a government-aided or other mortgage program with specialized requirements and paperwork, and have other issues that require extra time and effort. As a result, not only are the loans in question less lucrative because of their smaller size, but they also require more time and effort to close.

Outreach

Marketing—Misgivings regarding the process of home buying may be especially pronounced among minorities, who historically have been treated shabbily by lenders and may be uncomfortable with the culture of formal financial institutions. Ratner (1997, 9-10) has documented the frequent distrust and alienation African American home seekers have felt toward lending institutions. A minority nonprofit group contacted in the course of this study speaks of a "chill factor"—a sensation experienced by some African Americans in conjunction with banks. Lenders may have to mount a direct outreach program to reach minority markets. But such programs are not generally forthcoming. In fact, audits in Kentucky in 1988 and Chicago in 1989 showed that African Americans were less likely than whites to receive information about credit products and how to qualify for them (Fishbein 1992, 621).

Underwriting

Underwriting can be a minefield for minorities. For instance, appraisals of properties sought by minorities, whether done in-house by the lender or by outside appraisers, have tended in the past to be lower than expected. Often, there are insufficient comparable sales; sometimes the appraiser is unaware of an upward trend in a specific market; or more malevolently, the appraiser is sometimes biased against minority or racially mixed neighborhoods (Fishbein 1992, 629; Nakamura 1993, 7; Stanford 1995, 56). Further examples of underwriting issues that affect minorities, especially minority LMI mortgage seekers, are listed in Exhibit 1.7.

EXHIBIT 1.7
Problems Posed for Minority-LMI Mortgage Applicants
by Historical Industry Underwriting Criteria

"Objective" Underwriting Criteria	**Problems Posed for Minority-LMI Applicants**
a. *Formal credit history*	Formal credit may not have been established because of discriminatory barriers, or for cultural or other reasons (e.g., credit traditionally sought from family members instead of outside sources).
b. *Highly rated credit record*: "A" or near "A" rating	Applicants disproportionately have credit problems due to errors by the credit reporting bureaus (e.g., as a result of divorce, common last names, misused social security numbers), and other difficulties (e.g., credit agencies inadequately exploring extenuating circumstances).
c. *Stable employment:* 2 years in same job/occupation	Those on the economic margin change jobs and occupations frequently, particularly in times of rapid industrial restructuring.
d. *Property and neighborhood standards/appraisal*: "Sound" house in a "sound" neighborhood	Discriminatory influences may tinge what is considered "sound." There may also be practical appraisal limitations (e.g., acquiring sufficient comparables).
e. *Income sources*: Emphasis on formal earnings from primary job	Applicants frequently have multiple jobs and/or rely on seasonal work. Income sources may also include earnings from the informal economy and government support.
f. *Loan and obligation terms*: Set minimum loan amounts and fixed obligation terms (i.e., 28 percent/33 percent front- and back-end ratios)	The cost of the housing being sought may fall below the minimum set by a lender. Applicants may need more flexible and liberal obligation terms (e.g., 33/42 percent front- and back-end ratios).
g. *Funds to close:* Resources are solely those of the borrower and are to be contained in an established bank account	Funds to close may include gifts or loans from relatives. For cultural and other reasons, resources may be held outside of a bank (e.g., "mattress money").

Since underwriting is more of an art than a science, the judgment calls are many.[4] Among the questions lenders have to grapple with are: What are "extenuating circumstances" that can justify prior blemished credit? How long after a bankruptcy can a person be judged to be creditworthy? How long must regular rent payments be made to establish an alternate credit record if formal credit has not been secured in the past? When are frequent job changes a result of the overall economy worsening, or a particular run of bad job experiences, rather than a reflection of a poor work ethic? What is the likelihood of a second job continuing, or seasonal

[4] The subjective nature of the underwriting process has given rise to a "cultural affinity" hypothesis to explain racial disparities in approval rates.

work forthcoming, so that the income from these sources can be assumed to extend into the future? Is a house on a block reasonable security for a loan if three doors down there is an abandoned unit?

If the answers to the above and other underwriting questions are colored by racial or cultural discrimination, or by inadequate knowledge, or cultural insensitivity, or by other subtleties that work against minorities' interests, the underwriting process can be a treacherous one for minorities aspiring to homeownership. And these are not idle apprehensions. Researchers at the Chicago Fed (Hunter and Walker 1996) found that loan officers—almost all of them white—treated objective financial information differently according to the race of applicants. In particular, bad credit histories and indebtedness cut African Americans' chances of approval far more severely than those of whites.

The "statistics" of different treatment comport with the view of many minorities. The following comment was made by one minority nonprofit in the course of this study:

> Whites were given more support by the lending institution in the lending process. White applicants were called directly and told "Well, you need to write us a letter of explanation on this, this and this, or you need to get the receipts for this and this. . . ." whereas people-of-color applicants were basically told, "Look you have poor credit and you're a greater risk, and we can't lend money to you."

Many lenders traditionally have also shied away from mortgage transactions involving purchase-rehabilitation because of the complexities and uncertainties involved. Yet this type of financing is the kind sought disproportionately by minorities (Ratner 1997). Once a loan is granted, lender policies can also bear on the long-term ability of minorities to retain their financing. If they fear a risk to their security (Schill and Wachter 1993), lenders sometimes call a loan too quickly or foreclose mortgages granted to minorities, instead of trying to understand the circumstances that caused the delinquency. That behavior makes the prize for minorities securing financing short-lived.

ATTEMPTS TO FOSTER MINORITY HOME FINANCING

Recently, a renewed effort has been launched to address the minority homeownership gap. The National Homeownership Strategy, while attempting to help all Americans, underscores a "special responsibility and an important opportunity to target underserved populations and communities," including minorities (HUD 1996a, 1-4). Since financing is key to realizing homeownership, much more attention is now being paid to fostering minority access to credit. Given the multiple barriers to minorities and other underserved populations in securing credit, the responses by the public and the private sectors have been multifaceted, and have included efforts to address both affordability and discrimination. Some recent illustrative examples are noted below.

Expanding the Availability of More Affordable and Flexible Mortgages

The 1992 Federal Housing Enterprises Financial Safety and Soundness Act (FHEFSSA) called on the government sponsored enterprises (GSEs—e.g., Fannie Mae and Freddie Mac) to increase lending to lower-income borrowers and to areas underserved by private mortgage credit institutions. Three GSE financing goals were established by FHEFSSA, related to: 1) "low and moderate income,"[5] 2) "geographic,"[6] and 3) "special affordability."[7]

Spurred in part by these goals, Fannie Mae announced a Trillion Dollar Commitment in 1994 to help 10 million families—particularly those most in need—to buy homes of their own (Fannie Mae 1997, 2). Fannie Mae emphasized that a "core theme of our trillion dollar commitment is bringing down barriers . . . in order to end discrimination in housing finance" (Fannie Mae 1997, 26).

To further these goals, the GSEs and others have introduced into the marketplace a new generation of more affordable and flexible mortgages. In 1989, Fannie Mae, GE Capital, and the National Training and Information Center established a pilot Community Home Buyer's Program which allowed loan applicants undergoing homeownership counseling to qualify for liberal home mortgages (i.e., low down payments and higher than average "qualifying ratios"[8]). This program went national in 1990; Freddie Mac adopted a sister program, Affordable Gold, in 1992 (Bunce et al. 1996, 25).

Integral to this new generation of affordable mortgages are liberal financial terms and underwriting flexibility designed precisely to readdress the problems noted earlier that often acted to disqualify minority-LMI and other underserved populations. Down payments are reduced and allowable mortgage debt ratios lifted. There is a new underwriting perspective. Rather than turn down applicants with no prior formal credit history, lenders now establish credit through alternate means, including timely rent and utility payment. Blemished credit can be more sensitively evaluated in the context of extenuating circumstances, such as job loss or illness. A measure of "stable" income has replaced the more rigid employment standards. Property and neighborhood appraisal guidelines have also became more flexible to allow for the financing of a broader array of housing in different areas, including urban neighborhoods on the mend. Recognizing that a family loan or gift might often be the only means through which down payment and closing costs can be met, "funds to close" requirements have also been liberalized to allow a pooling of funds. Fannie Mae and Freddie Mac have made scores of changes in underwriting guidelines. The goal, in Fannie's words, is "removing impediments that did not enhance credit quality and enabling lenders to use appropriate discretion and judgment" (Fannie Mae 1997, 11).

Enforcing Fair Access and Other Lending Responsibilities

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[5] Targets mortgages for families with less than median income.
[6] Targets mortgages for housing in areas underserved by mortgage credit institutions.
[7] Targets mortgages on housing for very low-income families and low-income families in low-income areas.
[8] Qualifying ratios measure the relationship between the income of a borrower and his/her fixed expenses for housing and for servicing total debt.

Attention to fair housing and related laws affecting lenders has also been heightened. The major statutes, as they relate to fair lending, include:

1. *Fair Housing Act (FH Act).* Enacted in 1968 (amended in 1988) as part of the civil rights legislation, the FH Act makes it unlawful for any person who engages in the business of making or purchasing residential real estate loans, or in the selling, brokering, or appraising of residential real property, to discriminate based on race, color, national origin, or religion.

2. *Equal Credit Opportunity Act (ECOA).* Enacted in 1974 (and amended 1976), ECOA enhances the provisions of the Fair Housing Act by prohibiting lending discrimination based on sex, marital or familial status, disability, age, race, color, background, national origin, or economic status of the borrower.

3. *Home Mortgage Disclosure Act (HMDA).* Enacted in 1975 (and amended 1988 and 1991), HMDA requires financial institutions (under Regulation C) to report data regarding loan applications, loan originations, and purchases, including information on the race, sex, and income of mortgage applicants and borrowers.

4. *Fair Lending Practices Regulations.* Enacted in 1978, these regulations require Federal Home Loan Bank (FHLB) members to develop written underwriting standards, keep a loan registry, not deny loans because of the age of the dwelling or condition of the neighborhood, and direct advertising to all segments of the community.

5. *Community Reinvestment Act (CRA).* Enacted in 1977 (and amended in 1988 and 1995), CRA requires financial institutions (excluding credit unions) to meet the communities' need for credit in low- and moderate-income neighborhoods "consistent with safe and sound operation of the institution." The lending institutions are required to prepare a CRA statement that defines the community and lists the types of credit available to it. Comments received in response to the statement are required to be maintained and made available to the public.

6. *Federal Housing Enterprises Financial Safety and Soundness Act (FHEFSSA).* Enacted in 1992, FHEFSSA prohibits the government sponsored entities (GSEs) from discriminating in any manner in the purchase of a mortgage because of race, sex, handicap, familial status, age, or national origin, including any consideration of the age or location of the dwelling or the age of the neighborhood or Census tract where the dwelling is located in a manner that has a discriminatory effect.

(Federal Reserve Bank of Boston 1993, 26-27)

Pressure to tighten requirements and to more vigorously enforce the safeguards of these statutes has been increased in recent years. HMDA was amended in 1988 and again in 1991 to expand the types of financial institutions required to report under the statute and the array of data they must make available. As most recently amended (1995), CRA now stresses "Performance-Based Regulations intended to focus on performance-based criteria, and not process or documentation" (Vartanian et al. 1995, 8.116.2). HUD, the Justice Department, and the regulators of the financial institutions (Federal Reserve, Comptroller of the Currency, Federal Deposit Insurance Corporation, and the Office of Thrift Supervision) have all become proactive enforcers. In 1995, a settlement was reached with Chevy Chase Federal Savings in which the bank committed to open branches and offer $140 million of cut-rate mortgages in a mainly

African American area ("Locked Out or Priced Out" 1997).[9] In a more recent (August 1997) case, one leader settled a charge brought by the Justice Department that it was discriminating against minority areas by offering $55 million in below-market interest rate loans in underserved areas.

PROGRESS IN MINORITY HOMEOWNERSHIP AND CREDIT ACCESS

The progress made in fostering minority homeownership and minority access to credit is discernible. The Joint Center for Housing Studies (1996, 16) notes that between 1993 and 1995, minorities (African Americans and Hispanics) accounted for more than 28 percent of the increase in the number of homeowners, including in absolute terms 641,000 new African American and Hispanic homeowners. The 1997 *State of the Nation's Housing* reports that minority households have grown to account for nearly 30 percent of the nation's new homeowners and in many areas are anchoring the first-time home-buyer market (Joint Center for Housing Studies 1997).

One reason for the increase is greater access to credit. Different barometers record the improvement. According to a letter sent to Rutgers by the GSE working group in 1997, the 1996 GSE performance exceeded the FHEFSSA objectives: Fannie Mae and Freddie Mac averaged, respectively, 43 percent, 27 percent, and 16 percent of their production in the three FHEFSSA specified goals. Other GSE data show progress in making credit more accessible to underserved borrowers and neighborhoods, including minority borrowers and borrowers in high minority tracts. This progress is in the nature of an inexorable uptrend, as opposed to a dramatic reversal (Exhibit 1.8).

Exhibit 1.8 lists the GSE purchases of all home purchase mortgages. GSEs are also funding a growing share of moderate-sized loans in the "FHA-eligible" portion of the market.[10] Bunce and Scheessele (1996) conclude that:

1. "The proportion of total affordable (i.e., FHA-eligible) lending going to lower-income families and minorities increased substantially between 1992 and 1995." Over this period, the share of affordable loans going to very low-income families rose from 10.8 to 14.9 percent, while affordable mortgages garnered by African Americans and Hispanics increased from 8.3 to 13.3 percent.

2. Although the GSEs "significantly improved their performance in the underserved market, the share of the GSEs' business going to lower-income borrowers and underserved neighborhoods fell short of the corresponding shares of other market participants."

EXHIBIT 1.8
Trends in GSE Home Purchase Loans

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[9] Federal agencies have worked in other ways to prod the mortgage-lending industry to expand credit access as well. HUD, for example, worked with the Mortgage Bankers Association of America to develop a Best Practices Agreement; the Comptroller of the Currency developed guides for mortgage lending to Native Americans.
[10] Bunce and Scheessele (1996, 4) define FHA-eligible loans as conventional loans that fall within the FHA maximum loan limit for each metropolitan area, which typically is equal to 95 percent of each areas' median home price. Thus, these loans are from the lower end of the market.

(Average[1] Fannie Mae–Freddie Mac Profile)

	1993	1994	1995	1996
Borrower Characteristics	**Percentage of Home Purchase Mortgages Purchased by GSEs**			
• Very low-income	6.3%	7.6%	8.0%	8.0%
• African American	2.4	3.4	3.8	3.3
• Hispanic	3.5	4.9	5.2	4.7
• First-time home buyer	30.2	31.0	32.2	32.0
Neighborhood Characteristics				
• Low-income tracts	6.7	7.8	7.9	7.9
• High African American tracts	3.0	3.5	3.7	3.5
• High Hispanic tracts	12.1	13.6	13.6	12.4
• Underserved areas	20.4	22.7	23.3	22.1

[1]Simple average of the two agencies' performance. This average is not weighted by the respective agencies' volume of mortgage purchases.

Source: GSE Working Group 1997.

In short, there is still room for improvement by the GSEs and the lending industry. Yet fundamental change has occurred in the credit markets in the last few years. Minority-LMI and other traditionally underserved households have much greater access to total home mortgages and other financing. Overall, lending statistics herald the change; from 1993 to 1996, the number of total home-purchase loans for both African Americans and Hispanics increased by 25 percent while white home purchase loans increased by only 3 percent[11] ("Locked Out or Priced Out" 1997).

These gains—the growing "democratization of credit" as Eugene A. Ludwig, Comptroller of the Currency, terms it—reflect significant changes in what the lending industry now considers as "bankable." A catalyst to these changes has been the generation of targeted affordable and community lending products brought forth by the GSEs—e.g., Fannie Mae's Community Home Buyer's Program and Freddie Mac's Affordable Gold Mortgage. Based on information compiled by Fannie Mae, participation rates by affected groups are significantly higher for targeted lending products such as the Community Home Buyer's Program loans, than for Fannie Mae's standard product lines. Whereas 20 percent of all Fannie Mae loans go to minority borrowers, 40 percent of Fannie Mae's affordable loans go to minority mortgagors. Freddie Mac has also achieved significant volume: in 1996, Freddie Mac financed homes for over 200,000 LMI families and approximately 100,000 minority families.

Lenders across the United States are using these GSE loans as they try to reach the traditionally underserved. Still other institutions are modifying the GSE loan parameters to expand affordability. These "modified" loans are generally held in the lender's portfolio. Innovations in portfolio lending, in turn, are encouraging the GSEs to further reconsider how their loan standards might be reconfigured to expand credit access. The GSE changes are sparking further rounds of creative portfolio lending. It is an era of financial ferment; trend is the thrust of the current investigation.

[11] The higher percentage increase for minorities in part reflects the more modest minority credit attainment of previous years relative to whites.

The tonal quality of this study and its place in the literature also deserve mention. For much of the last two decades, the focus of the issue of minority credit access has been on the quantitative analysis of loan data. Did the data prove discrimination, or did it reflect lenders acting as prudent fiduciaries? Community activists emphasized the former position; banks the latter.

Whatever the merits or demerits, the denouement of the statistical warfare was a change in practice by lenders to better respond to the needs of minorities and other underserved populations. The change is not as extensive or as rapid as many would like, but the facts on the ground bespeak of new lender attitudes and actions.

DEFINING SUCCESSFUL LENDING STRATEGIES

Since access to homeownership is conditioned by a complicated set of interdependent factors—variations in income and wealth among different groups, the legacy of racial discrimination, etc.—it is crucial to specify the focus of any research. This section defines the "successful strategies" documented in this report, as well as other key terms.

Essentially, the research focuses on homeownership financing for 1- to 4-unit family housing (as opposed to multifamily investment)[12] sought by minorities, especially those with low and moderate incomes (LMI). The emphasis is on:

- *Bringing minorities to homeownership,* because there is a glaring minority homeownership gap.
- *1- to 4-unit properties,* because these are the primary vehicles for homeownership and the type of fee property most sought by Americans.
- *Financing,* because credit access is a major hurdle to minorities becoming homeowners.
- *Credit strategies of particular value to LMI minorities,* because this group has the greatest homeownership gap and the most difficulty in securing credit.

The strategies that are presented here take both race and affordability into account. Examples of racially focused strategies include advertising in minority-directed media, offering counseling though predominantly African American or Hispanic churches, and/or having an extended (i.e., second or third) review of all minority loan applications that are initially denied. Examples of resource-based programs include mortgage products with low down payment requirements and other financially favorable characteristics—e.g., lower interest rates and flexible underwriting.

Both racial and affordable mortgage programs are considered to foster minority homeownership because the financing barriers to homeownership have seeds in race and in economics. The consideration of affordability also broadens the lessons contained in this study and applies then not just to minorities, but to the broader band of the LMI population seeking home mortgages.

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[12] Although the focus is on 1- to 4-unit properties, many of the strategies noted here would pertain to minorities seeking to own condominiums or cooperatives in multifamily buildings as well.

The actions and programs presented are gleaned from "exemplary or successful lenders"; their body of practice comprises the "successful strategies" in this study. For the purpose of this study these and other key terms (i.e., "minority" and "LMI") are defined below:

> *Exemplary lenders.* Lenders identified by knowledgeable observers (e.g., financial institution regulators, secondary market funders, industry associations, community and advocacy groups, and peers) as having the foremost reputations as successful providers of homeownership financing to minorities. Exemplary lenders were identified on the basis of a reputational survey, but quantitative data on lending activity was also used to confirm the success of these institutions in reaching traditionally underserved markets.
>
> *Successful strategies.* There is now a broad body of knowledge in the lending industry and among regulators regarding strategies that are successful in expanding the availability of mortgage credit to traditionally underserved markets.[13] This study draws on and refines the successful strategies defined in the literature. These strategies include mortgage marketing, underwriting, servicing, and other practices that lenders use to effectively attract, qualify, and retain minority home buyers (especially minorities with low and moderate incomes) and to avert discrimination in mortgage lending. Discrimination is defined broadly and ranges from blatant discrimination to disparate treatment (e.g., different treatment of poor credit records for African American and white applicants) to adverse impact (the unintended effect of a policy or practice on minority applicants that cannot be justified on legitimate business grounds) (Galster 1991). Success may embody—and be reflected—by many dimensions, including noteworthy minority loan production and approvals (including significant improvement from past less-than-stellar performance), minority program innovation, fair lending industry leadership, and/or noteworthy collaborations.
>
> *Minority borrowers* are defined as African American and Hispanic households. This definition does not explicitly include immigrants (except to the degree that Hispanics in some regions are more likely to have immigrated recently) or other ethnic minorities. Historically, African Americans and Hispanics have faced the most serious discrimination barriers in housing and labor markets. The business strategies developed to avert discrimination against African American and Hispanic borrowers invariably reduce bias against other racial and ethnic groups. Several of the case studies focus on lending strategies applicable primarily to Native Americans.

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[13] Prominent contributions to literature include: *Homeownership Models that Work* (America's Community Bankers 1997); *Winning Strategies—Best Practices of Homeownership Promotion* (Neighborhood Reinvestment Corporation 1997); *Models of Community Lending* (National Community Reinvestment Coalition 1997); *A Guide to Mortgage Lending in Indian Country* (Comptroller of the Currency 1997); *The Fair Lending Guide* (Vartanian et al. 1997); *Financing the American Dream—Best Practices in Affordable Homeownership Lending* (HUD 1996a); *Case Studies of Partnerships Achievement for America's Neighborhoods* (Social Compact Between Financial Services Institutions and America's Neighborhoods 1995); *MBA-HUD Best Practices Agreement* (1994); *Side-By-Side—A Guide to Fair Lending* (Federal Deposit Insurance Corporation 1994*); Policy Statement on Discrimination in Lending* (Interagency Task Force on Fair Lending 1994); *Closing the Gap* (Federal Reserve Bank of Boston 1993); *Housing Opportunities: Building on Tradition* (Savings and Community Bankers of America 1993); and *Home Mortgage Lending and Equal Treatment—A Guide for Financial Institutions* (Federal Financial Institutions Examination Council 1992).

Low and moderate income (LMI) follows the conventional programmatic definition of households whose incomes do not exceed 50 percent (low) to 80 percent (moderate) of the median income for the metropolitan area; appropriate adjustments are made for smaller families (percentage thresholds are revised upward) and larger families (revised downward).

IDENTIFYING AND ANALYZING EXEMPLARY LENDERS AND SUCCESSFUL STRATEGIES

Because exemplary lenders and their successful practices are the basis of the current investigation, considerable care was taken in deciding what types of institutions would be selected for analysis, how the exemplary lenders and their successful practices would be identified, and how the pool of successful lenders and their practices would be studied.

Types of Lenders Sought

Minority-LMI borrowers obtain homeownership financing from a variety of institutions[14]—thrifts and banks, FHA-VA and conventional mortgage lenders, national and neighborhood-based entities, and so on. Consequently, it was decided that all types of lenders would be considered in the reputational surveys—with the exception of *subprime* lenders.[15] Although the latter have often focused on minority-LMI borrowers, some subprime lenders have exploited these applicants by charging high interest rates or fees. For example, in the case of *United States v. Long Beach Mortgage Corporation*, the government alleged Long Beach Mortgage discriminated against minority borrowers in its purchase of subprime (B&C) grade loans by charging minority borrowers more "points" than white borrowers.

Achieving long-term successful homeownership, with equity buildup and successful loan repayment, is much easier to accomplish by tapping the prime market than through the sometimes usurious subprime market. In fact, many prime lenders have begun to meet the needs of the previously underserved markets. This newly emergent availability of credit from prime lenders to minority-LMI populations is precisely the focus of this study.

Identifying Exemplary Lenders and Successful Strategies

Two broad means of identification have classically been used by researchers to gauge how "good" or "bad" a lender is in serving minority-LMI markets—quantitative and qualitative.

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[14] See Bunce and Scheessele (1996).

[15] Borrowers are often rated on letter grades; those with the best records being assigned an "A" while those with tarnished credit, ranging from some late payments to a recent bankruptcy, are assigned "B" to "D" grades (Smith 1997, 57). Prime lenders are those focusing on serving the "A" or near "A" rated borrowers versus subprime lenders who serve mainly those with "B" or lower grades. There is a quantum difference in loan terms between the prime and subprime markets. As of August 1997, prime conventional mortgages in the United States had an interest rate of 7.6 percent, a one-point fee (each "point" equals one percent of the loan amount), and could be had for 95 percent or more of a home's value (or a 95 percent loan-to-value [LTV] ratio). By contrast, subprime mortgages (as of August 1997) had interest rates ranging from 8.5 to 16 percent, fees of 5 points or more, and maximum LTV ratios between 65 percent and 85 percent (Smith 1997, 57).

The quantitative method relies primarily on loan-application register data from the Home Mortgage Disclosure Act[16] (HMDA) and typically defines “good” lenders as those with relatively higher percentages of mortgage approvals for minority applicants. The qualitative method relies primarily on such means as reputation among regulators, peers, and community-based and advocacy organizations.[17] In practice, the difference between these two methods is one of nuance. For instance, a lender’s “good” reputation is often based on strong HMDA statistics. Given this intermingling, and the fact that, substantively, both approaches have merit, both selection criteria are often used. The National Community Reinvestment Coalition (NCRC), for instance, applied quantitative HMDA data to identify *America’s Worst Lenders* (National Community Reinvestment Coalition 1995), but NCRC relied on both reputation and production (and other factors) to select its more recently published *Models of Community Lending* (National Community Reinvestment Coalition 1997, 19-20).

The current study emphasizes reputation as the primary basis for selecting exemplary lenders of all types (except subprime) and uses quantitative (i.e., HMDA) data to test whether the qualitative and quantitative information comport. Reputation is stressed because of limitations in the HMDA data and because it is believed that knowledgeable financial industry participants have a good working knowledge of the leaders and innovators in minority-LMI financing.

Reputational nominations were sought by Rutgers from financial institution *regulators* (e.g., Federal Reserve Banks and Comptroller of the Currency), secondary market *funders* (Fannie Mae and Freddie Mac), *industry groups* (e.g., American Bankers Association and Mortgage Bankers Association of America), and *advocacy and community groups and activists* (e.g., Woodstock Institute and fair housing councils). A total of 25 such entities were contacted and asked “to identify financial institutions with the foremost reputations as successful providers of homeownership financing to minorities, especially to minorities of low and moderate incomes.” Twenty-three responded with nominations.

The cover and follow-up letters soliciting the nominations described successful provision of minority home financing as accomplishment on many possible fronts, including minority-LMI loan production, innovation, and leadership. These areas of accomplishment were purposely not detailed in a formulaic sense. The point of the exercise was to have the nominator identify institutions that in his or her judgment had the foremost minority-LMI lending reputations; the statement on the various possible elements of minority-LMI lending success was simply presented as a discussion point to help frame the nomination.

In addition, Rutgers and its research team (Georgia Institute of Technology and Wharton) identified some lenders noted as exemplary in the literature and identified others from a “snowball sampling technique,” i.e., as lenders were telephoned, they were asked to list their exemplary peers in the minority-LMI market.

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[16] Other quantitative measures are also employed, such as the results of pre-application testing. A comparative analysis of loan files may also be done by lenders’/regulators’ compliance departments (FDIC 1994). The results of such testing are rarely made public, however.

[17] Other qualitative measures include the citation of an institution in the fair housing literature, the receipt of fair lending awards, and so on.

In total, 200 *separate* lenders were nominated in the manner described above (many of the same lenders were repeatedly nominated from different sources). About 90 percent of the 200 names came from the regulator/funders and industry associations and community groups; the remaining 10 percent came from Rutgers and its research team. The 200-institution list is *not* a ranking of the “top 200,” but rather just how it is described—a candidate list of that number. Had more than 25 regulators/funders industry/community groups been contacted, or had all that were contacted chosen to respond (two did not), or had a wider literature net been cast, or had Rutgers and the research team been more knowledgeable of home mortgage lenders, or were the financial institutions ultimately contacted via telephone more forthcoming with identifying their peers, then a group larger than 200, with perhaps many institutions not currently included, could have been identified as exemplary. In sum, the 200 institutions identified for the study were a reasonable group to consider as having *better* minority home mortgage lending programs than other institutions, not an exhaustive group of just that number. (The 50 lenders ultimately participating in the telephone discussions and the 11 lenders singled out for case studies should be viewed in the same light.)

From the candidate list of 200 institutions, a subsample of 75 institutions was selected to be contacted via telephone primarily on the following bases:

1. *Geographic range*. Lenders from different areas of the country were sought.

2. *Institutional variations.* A variety of lenders by institutional type and financial scale were selected.

3. *Fair housing complaints.* Institutions with a major fair housing Title VIII complaint were declared ineligible.[18]

STUDY OF THE EXEMPLARY LENDERS AND SUCCESSFUL STRATEGIES VIA TELEPHONE DISCUSSIONS AND CASE STUDIES

All of the 75 institutions selected by the above criteria were called and asked if they would agree to participate in a telephone discussion of their strategies. To foster participation, the confidentiality of their remarks was pledged. Ultimately 50 agreed, and these participants are listed alphabetically in Exhibit 1.9. The three-stage winnowing process, therefore, included a 200-member candidate list that was reduced to a 75-member vetted list that was, in turn, reduced to a 50-member participant group.

We contacted representatives at each of these lenders by telephone and followed a loosely structured guide in discussing their business strategies. No questionnaire was used, but all of our discussions covered, at a minimum, four substantive areas. First, we focused on basic institutional characteristics, such as lender type (thrift, mutual savings bank, commercial bank, etc.), size, lending volume, and minority ownership. Second, we discussed strategies used by lenders to attract minority applicants: examples included target marketing and advertising,

[18] An exception was made in the case of Countrywide Home Loans. This lender was included in the study—despite having a Title VIII complaint against it—because a lender of its national size could be expected to get complaints of unfair treatment.

partnering with Realtors, nonprofits, or community groups, and similar approaches. Third, we discussed how lenders qualify minority applicants. This part of the discussion was often the most extensive, since disparate treatment and adverse impact have historically been critical in the underwriting process; consequently both regulatory scrutiny and lenders' own attempts to expand minority-LMI lending have involved considerable review of underwriting standards, provision for multiple reviews of rejections, and other approaches. Finally, we discussed strategies used to retain minority mortgagors once a loan is approved and originated. With the expansion of the secondary market, many lenders retain little connection to borrowers after a mortgage is sold; but others do retain servicing, and many lenders hold a substantial number of portfolio loans. Examples of retaining strategies include close monitoring of repayment and rapid communication with borrowers at the first sign of late payment.

The telephone discussions revealed broad similarities in the business practices of lenders active in minority and LMI submarkets, but also highlighted important variations. The telephone interviews were followed by field visits and detailed case studies with eleven lenders (approximately one-fifth of the 50 institutions participating in the study). The case studies, presented in Volume 2 of this report, allowed for more in-depth and qualitative understanding

EXHIBIT 1.9
Exemplary Lenders Participating in the Study

LENDING INSTITUTION	CITY, STATE	REGION
Affordable Housing Clearance Center	Lake Forest, CA	West
Amerifirst Mortgage Acceptance Corp.	Hempstead, NY	Northeast
Atlanta Mortgage Consortium*	Atlanta, GA	South
Avondale Community Development Corp.	Chicago, IL	North Central
Bank of America	San Francisco, CA	West
Bank United Mortgage	Houston, TX	South
Bell Federal SLA	Chicago, IL	North Central
Berean Federal Savings Bank*	Philadelphia, PA	Northeast
Boatmen’s Bank	Hot Springs, AR	South
Boatmen’s Bank	Kansas City, MO	North Central
Broadway Federal SLA	Inglewood, CA	West
Chase Manhattan Bank	Edison, NJ	Northeast
Chattanooga Neighborhood Enterprise	Chattanooga, TN	South
Citizens National Bank	Evansville, IN	North Central
City Mortgage Corp.	Anchorage, AK	West
Coast Federal Savings Bank	West Hills, CA	West
Cole Taylor	Wheeling, IL	North Central
CoreStates Bank	Philadelphia, PA	Northeast
Countrywide Home Loans*	Pasadena, CA	West
DuPage Homeownership Center	Wheaton, IL	North Central
Dwelling House SLA	Pittsburgh, PA	Northeast
Equifax Mortgage Inc.	San Juan, Puerto Rico	South
Family Home Mortgage	Danbury, CT	Northeast
First Bank of Florida (was First Federal SLA)	West Palm Beach, FL	South
First Federal Bank of California	Santa Monica, CA	West
First Mortgage Investment	Prairie Village, KS	North Central
First National Bank of Farmington*	Farmington, NM	West

EXHIBIT 1.9 (continued)
Exemplary Lenders Participating in the Study

LENDING INSTITUTIONS	CITY, STATE	REGION
Founders National Bank*	Los Angeles, CA	West
J.B. Nutter & Co.	Kansas City, MO	North Central
Key Community Development Corp.	Cleveland, OH	North Central
NAACP –NationsBank Community Dev. Resource Centers	Atlanta, GA	South
National City Bank	Louisville, KY	South
National City Community Development Center	Cleveland, OH	North Central
National Credit Counseling Services	Columbia, MD	South
Navajo Partnership for Housing*	Window Rock, AZ	West
Neighborhood Housing Services of Chicago*	Chicago, IL	North Central
Pacific South West Bank	Dallas, TX	South
People's Bank*	Bridgeport, CT	Northeast
Plus 4 Mortgage Company	Clinton Twp., MI	North Central
PNC Bank*	Philadelphia, PA	Northeast
Rondout Savings Bank	Kingston, NY	Northeast
Spectrum Mortgage Corp.	Landover, MD	South
Standard Federal Bank	Troy, MI	North Central
Statewide Savings Bank SLA	Jersey City, NJ	Northeast
Sun Trust Bank	Atlanta, GA	South
Third Federal Savings Association	Cleveland, OH	North Central
Trent Financial Inc. *	Commerce, CA	West
Ulster Savings Bank	Kingston, NY	Northeast
United Bank of Philadelphia	Philadelphia, PA	Northeast
Westview Federal SLA	Santa Monica, CA	West

* Case study institutions in bold.

of the history of attempts to foster minority lending and homeownership, as well as the difficulties presented by the structure of the lending industry, institutional inertia, and other factors. The eleven case studies undertaken in the current study are listed in boldface type in Exhibit 1.9 and are detailed in the second volume of this report. Both in the current and second volume, the case study institutions are identified by name; the remaining exemplary institutions are referred to as "exemplary lenders."

Finally, to the extent possible, all of the lenders contacted by telephone and studied in the case studies were also examined with respect to their quantitative minority lending profile using the standardized data available from HMDA (see Chapter Six). This analysis considered whether institutions identified by reputation are also exemplary from a statistical perspective. While noting certain limitations of the HMDA information in capturing the "better performance" of minority-LMI lending, that portion of the study confirms a quantitative basis for the primary qualitative reputation-based identification of exemplary performers. Dual evidence—qualitative and statistical—thus provides good reason to describe and learn from the lenders contacted in the course of this study.

WHO ARE THE EXEMPLARY LENDERS?

Exhibit 1.10 presents a breakdown of selected characteristics of all the lenders participating in the study, including institution type, assets, lending activity, and geographic distribution.[19]

The lenders participating in the study represent a wide cross section of an increasingly complex national mortgage market. The sample includes many of the nation's largest financial institutions (Bank of America, Chase Manhattan Bank, NationsBank, Countrywide Home Loans), as well as small neighborhood-based lenders such as Berean Federal Savings Bank (West Philadelphia), Founders National Bank (South-Central Los Angeles), and Dwelling House (Pittsburgh). Not coincidentally, most of the small lenders are minority-owned institutions with long-established traditions of serving borrowers shut out of conventional credit markets.

All types of lending entities are represented. Of the forty private, for-profit lenders, about two-fifths are savings and loans; one-third are commercial banks; and the remainder are mortgage bankers or mortgage brokers. These lenders include both State and Federally chartered institutions, and depending on their charter, are overseen by a variety of regulators (e.g., Office of Thrift Supervision, Office of the Comptroller of the Currency, Federal Reserve Board, and State banking departments).

[19] There are some information gaps because not all respondents were able or willing to furnish all information requested.

The geographical range of the exemplary lenders, with respect to their headquarter locations, spans the breadth of the United States. All four Census regions (Northeast, North Central, South, and West) are represented, as shown in Exhibits 1.9 and 1.10. Lenders are found in urban communities (e.g., the cities of Chicago, Los Angeles, New York, and Philadelphia), the suburbs (e.g., Danbury, Connecticut; Edison, New Jersey; Pasadena, California; and Wheaton, Illinois), and rural sites (e.g., Farmington, New Mexico; Prairie Village, Kansas).

Not immediately evident from the listing in Exhibit 1.10, but ascertained from the telephone discussions and case studies, is the broad range in financing offered by the exemplary lenders. This financing includes both FHA-VA loans, emphasized by many mortgage bankers in minority communities, and a wide variety of conventional loans offered by the institutions. (In fact, the historical differentiations among lenders who specialize in different types of mortgages are crumbling in the current era of financial industry deregulation and consolidation.) The lenders that were contacted offer loan products both for in-house portfolio purposes as well as for sale on the secondary market.

To a certain extent, the variety among these institutions is the end product of the quest for a range of entities and evolved as the original 200 institutional candidates were winnowed down to a pool of 50 participating lenders. But variety was also present among the original 200 nominees. No single location in the country, type of institution, or type of loan product has a lock on exemplary lenders or successful strategies.

Some propensities of the exemplary lenders emerge, however, even though variety is the operative finding. As is evident in Exhibit 1.10, a disproportionate number of the exemplary lenders are large institutions. A third of the lenders who responded to this query reported total assets in excess of $5 billion; for those respondents indicating their lending volume, about half estimated the number of single-family home mortgage loans at more than 1,000 annually. (Chapter Six presents a more detailed analysis of lending patterns based on 1995 HMDA data.) To some extent, the greater financial heft of the exemplary lenders may reflect the manner in which the list was derived rather than constitute a substantive finding that larger institutions tend to be more successful minority-LMI lenders. Since our identification stressed reputation, it is very likely that the larger institutions, which typically make more minority-LMI loans in absolute, if not relative, terms, and have the wherewithal to promote and publicize their efforts extensively, would be more widely known and hence garner more reputational nominations.

Other factors may also be at work. In the process of identifying the exemplary lenders, all nine regional banks of the Federal Reserve System acted as nominators. Although smaller financial institutions are members of the Federal Reserve System, the Reserve's membership tends toward the larger entities. In addition, a somewhat greater number of larger institutions, with more overlays of staff and perhaps more time to talk with academic researchers, opted to participate.

EXHIBIT 1.10
Profile of the Exemplary Lenders

Institution Type (n=40)[20]	
Thrift (savings and loan)	38.5%
Commercial bank	33.3
Mortgage bank/broker	28.2
	100.0%
Charter Type (n=40)	
Federal	55.9%
State	41.2
Both	2.9
	100.0%
Ownership (n=36)	
Minority	83.3%
Non-minority	13.9
Other	2.8
	100.0%
Estimated Assets (millions of dollars) (n=36)	
less than $100	27.8%
$101-1,000	16.7
$1,001-5,000	19.4
$5,001-15,000	16.7
$15,001-70,000	19.4
	100.0%
Estimated Annual Total Mortgage Loan Portfolio (millions of dollars) (n=24)	
less than $10	25.0%
$11-100	8.3
$101-500	37.5
$501-1,000	12.5
$1,001-36,000	16.7
	100.0%
Estimated Annual Single-Family Mortgage Loan Volume (millions of dollars) (n=16)	
less than $200	37.5%
$201-1,000	18.7
$1,001-2,000	25.0
$2,001-8,000	18.7
	100.0%
City Type of Headquarters (n=39)	
Urban location	64.1%
Suburban location	35.9
	100.0%
Extent of Service Area (n=35)	
Neighborhood	5.7%
County	17.1
Multiple counties	34.3
State	8.6
Multi-State	34.3
	100.0%
Census Region (n=39)	
Northeast	38.5%
North Central	30.8
South	12.8
West	17.9
	100.0%

Source: Rutgers University Center for Urban Policy Research, 1997.

[20] Fifty exemplary institutions were contacted by Rutgers in the course of this study. Forty are individual lenders; the remaining ten are nonprofits, consortiums, or other entities, aimed at fostering minority-LMI homeownership financing.

All of these qualifiers point to the fact that the research design may inculcate a greater representation of larger financial institutions among the 50 exemplary lenders. Other evidence must be weighed, however, to discover whether a meaningful correlation actually exists between financial institution size and minority-LMI lending outcome. (The quantitative analysis in Chapter Six partially addresses this issue.)

Another propensity of the exemplary lenders is, perhaps, their greater willingness to originate loans for their own portfolios as opposed to originate loans geared exclusively or predominantly for sale to the secondary market. We say “perhaps” because many of the 50 lenders did not discuss details of their loan dispositions, speaking of this only in generalities.

We have only an impressionistic sense of the exemplary lenders’ greater propensity to lend for portfolio than the industry norm. (About two-thirds, on average, of all 1- to 4-unit mortgages originated in the United States are sold on the secondary market). This is not meant to denigrate the underwriting revolution heralded by the government sponsored enterprises’ (GSEs) community products. On the contrary, these products have been a prerequisite for the renewed minority-LMI lending discussed earlier in this chapter. Yet added financial reach to the minority-LMI market has been afforded by the portfolio loans that are often even more flexible than the standard GSE mortgages. If our impression of the exemplary lenders’ propensity to enhanced portfolio lending is true, this propensity may be one factor contributing to their sterling performance.

In addition to for-profit entities, the study also includes 10 community and nonprofit groups and a consortium effort that facilitate mortgage lending to minority and LMI borrowers and communities. These organizations fill a crucial niche in lending to traditionally underserved submarkets. With the recent expansion of fair lending initiatives throughout the industry, many banks have developed or strengthened partnerships with the nonprofit sector. Among the organizations are:

> ***NAACP:*** The NAACP of Atlanta, Georgia has entered into a partnership with NationsBank to form a series of Community Development Resource Centers located in several Southern States. The purpose of these centers is to provide home-buyer education, credit counseling, and mortgage, consumer, and small business loans to predominantly African American clientele.
>
> ***DuPage Homeownership Center:*** Located in Wheaton, Illinois, DuPage Homeownership Center is a local agency devoted to providing pre- and post-purchase counseling to homeowners. DuPage also offers counseling to help deal with default, and budget management.
>
> ***National Credit Counseling Services:*** NCCS in Columbia, Maryland, is a nonprofit organization offering free and confidential credit counseling and debt-managing services. NCCS helps clients develop a budget, negotiate with creditors, establish a repayment plan, and acts as a mediator between the client and creditors. These services can be accessed through a toll-free telephone number, which also provides mortgage default counseling and other basic credit management information.

Navajo Partnership for Housing: The NPH in Window Rock, Arizona, is a nonprofit housing partnership that utilizes mortgage lending from financial institutions to increase homeownership opportunities on the reservation. The program targets middle- and moderate-income Navajos who have traditionally been left out of homeownership initiative programs focused on American Indians. NPH is affiliated with the Neighborhood Reinvestment Corporation through the NRC's NeighborWorks® program.

Neighborhood Housing Services of Chicago: NHS Chicago offers assistance to predominantly minority and low-income areas by specializing in home improvement and acquisition/rehabilitation loans. The organization works with borrowers, helps select a contractor, puts funds into escrow, and generally oversees the home improvement process to ensure fairness of cost and the completion of projects. NHS Chicago is also a NeighborWorks® affiliated program.

Chattanooga Neighborhood Enterprise: CNE in Chattanooga, Tennessee, is a private, nonprofit organization with a mission to develop, finance, and renovate housing in Chattanooga's and nearby Hamilton's low- to moderate-income areas. CNE provides homeowner education and counseling, and has developed affordable, safe home sites in Chattanooga as part of an initiative to revitalize the inner city. CNE is also part of the NeighborWorks® network.

WHAT MOTIVATES THE EXEMPLARY LENDERS?

There is no question that statutory, regulatory, and public pressure ("sticks" of different types) all compelled the lenders to become more proactive. These sticks include the requirements of the Community Reinvestment Act (CRA), Fair Housing Act, the Equal Credit Opportunity Act, and other lending provisions; an invigoration of the regulators' enforcement of these provisions; release of HMDA data; growth of community activist organizations, which became quite proficient in analyzing and presenting the HMDA information; and an industry wide trend toward mergers, accompanied by a very public look at CRA fulfillment. These manifold pressures are evident in the exemplary lenders' responses to our questions. One respondent was very blunt:

> The only reason these programs are in existence is CRA.[21]

Another respondent spoke of the change brought about by new CRA requirements that emphasized "results" over process:

> The banks...are now more cooperative. Before they took us out to dinners, and now they are more receptive to taking our...loans.

[21] In order to preserve confidentiality, sources for quotes in this report are only identified for those lenders who agreed to be quoted. All other quotes are identified as "exemplary lender," "exemplary institution," or by using a similar reference.

Atlanta lenders became more receptive to increasing minority-LMI lending when the Atlanta Community Reinvestment Alliance (ACRA) brought HMDA-based loan information on minority lending disparities to the fore. A group of lenders formed the Atlanta Mortgage Consortium two weeks after these disparities became front-page news in the *Atlanta Constitution's* much-publicized "Color of Money" series.

Many of the exemplary lenders also spoke of merger-related pressures. One noted:

> Our sensitivity to these matters intensified with the ________ case, HMDA numbers being brought to the fore, and pressure from community groups when bank consolidations were considered. Our merger [with _______ bank] evoked a lot of attention. We had a background of greater involvement in city and minority financing than our peers. With the consolidation with [the _______ bank], there was concern in the community whether our involvement in these areas would continue with the same vigor. Ultimately, to smooth the way to the merger, additional substantial funds was made available for minority and LMI financing.

The merger described above involved two large lenders, but even smaller-scale mergers often evoked enhanced lender sensitivity to their minority-LMI lending record. PNC, for example, had been offering minority-LMI products through the PNC Mortgage Corporation and the Delaware Valley Mortgage Plan (DVMP) for approximately twenty years, although not in particularly large volumes in the Philadelphia area. In 1991, management's desire to increase overall mortgage origination and servicing volume coincided with a protest by the activist group ACORN (Association of Community Organizations for Reform Now) over PNC's incipient merger with Bank of Delaware. As part of PNC's agreement with Federal regulators prior to approval of the merger, the bank agreed to increase mortgage lending to minority-LMI communities. The bank set a goal of $3.8 million in originations of affordable housing loans, and offered two specific products tailored to the minority-LMI market. To promote these products, the bank created the Community Development Department of PNC Mortgage Corp. It also increased its staff of community mortgage consultants, many of whom are minorities, to specialize in originations of the bank's affordable home loans (PNC 1997).

Lending institutions whose growth was achieved mostly through mergers were particularly sensitive to whether their minority-LMI loan record would pass muster with regulators and community groups. As NationsBank expanded geographically, for example, its market and service areas encompassed ever larger proportions of lower-income residents and minorities. In fact, 40 percent of NationsBank's service area now consists of low- or moderate-income Census tracts (National Community Reinvestment Coalition 1997, 14). In anticipation of its merger with CMS Sovereign and in light of pending litigation,[22] NationsBank decided to commit $10 billion to community development lending and form a partnership with the NAACP to establish six community development resource centers (see NAACP-NationsBank case study). When one regional lender merged with an Arizona bank, its expanded market area included the most heavily concentrated pocket of Native Americans in the United States. The regional lender realized it had to work to meet the mortgage needs of this historically underserved population.

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[22] Some recent examples include *Lathern v. NationsBank Corp*., Civ. Action No. 95-1805 (NHJ) (D.D.C. files Sept. 21, 1995); and *Stackhaus v. NationsBank Corp*., No. 1:96CV01077 (D.D.C. files May 10, 1996).

Sometimes, the stick of CRA and its sister requirements was applied even more directly, as the formation of one exemplary lender's community development corporation (CDC) illustrates. The CDC's parent corporation, a Federal savings bank (FSB) failed its CRA examination by the Office of Thrift Supervision (OTS) for three consecutive years beginning in 1991. In 1994, the FSB had the inauspicious honor of being one of the first lending institutions to have its senior management and board of directors removed by an OTS regulator, in large part because of its CRA failures. The FSB tried to stabilize itself by floating an initial public offering (IPO), but this financial action was denied by OTS. In 1994, OTS required the FSB to restructure or lose its designation as a licensed thrift institution. The CDC was created as part of the restructuring to help fulfill the FSB's regulatory responsibilities under CRA.

The pressure to increase minority-LMI lending came not only from Federal agencies and/or local community groups citing Federal requirements (e.g., CRA). One lender spoke of pressure to increase minority-LMI lending from the city as well as the Federal government:

> If we want to expand, to merge, to open a branch, do any type of advancement, we have to apply to a Federal agency to get permission. Part of that process is opening up our CRA compliance, and protests from community groups happen at that point. City government is involved as well. They will park their payroll and other deposits with the better-performing lenders. More than that, [City name] is very involved with redeveloping the community, and it has definite ideas about how that should be done. [City officials] definitely pressure the financial institutions into doing things their way, and they hold the litigation and the regulations over the heads of the financial institutions. The city has very definite ideas and has gone and had meetings with specific financial institutions and said, "that is what we expect you to do in terms of products that are virtually being given away." They communicate that they feel very strongly about this and they feel lenders in the city should act a certain way.

Although regulatory and political factors may have stimulated the initial expansion of minority-LMI lending, the potential profitability of serving previously underserved markets has sustained it. Some lenders point out that since the minority-LMI market historically had not been fully served by institutional lenders, it offered much pent-up demand. One lender graphically referred to "the multitudes of first-time and minority home buyers" as "low-hanging fruit."

The underlying demographics relating to market demand were also cited by some other lenders: "If we are not in this market, the minority and immigrants, lenders will be chasing an ever shrinking pool of white middle-income borrowers" (People's Bank 1997). The fluctuating lending cycle, with its ebb and flow of mortgage demand and supply, was still another pressure, noted one exemplary lender, that prompted his bank to go after the previously underserved borrowers:

> Over the past several years, the biggest thing has been the refinancing boom and the fact that now, the refinancing boom is over, the market is driving the banking industry to this particular type of borrower, driving them to the first-time home buyer, driving them to the FHA loans and the loans with some blemishes on their credit because the cream at this particular point in time, has refinanced with 7.5 percent loans and they are going to stay there.

Other changes in the marketplace—the increased aggressiveness of the GSEs in minority-LMI loan purchases and the greater flexibility among private mortgage insurers on the loans they accept—were cited by one lender as inculcating its participation:

> I think it is just a change in the philosophy of the marketplace. We are finding that these loans are becoming salable on the secondary market and private mortgage insurance companies are now insuring loans they would not have in the past. It is just the natural progression of everyone falling in line and with that, these loans become a source of business.

For some, initial profitability from the mortgages is secondary to the subsequent business opportunities they present. Countrywide, for example, notes that even if it loses money on the initial affordable mortgage, it will likely make money later on home equity loans and other ensuing business with the minority-LMI borrowers. One of the reasons why First National Bank of Farmington (FNBF) became involved in mortgage lending to Navajos and continues to pursue the business, despite the fact that the bank continues to lose money on these transactions, is that Native Americans are an essential FNBF customer base, contributing in recent years to about one-third of FNBF's consumer loan growth (FNBF 1997).

Minority-LMI mortgage financing, in short, is not simply an eleemosynary activity. As will be detailed later, almost all of the exemplary lenders are realizing a positive return from this mortgage lending activity. Still, for some of the exemplary lenders, profitability has been an acquired perspective. For these institutions, lending to the minority-LMI market was the result of pressures by outside events. It was viewed as a cost of doing business. As it turned out, the minority-LMI mortgages serendipitously realized a profit. As one lender frankly noted:

> I would say at our inception, we started, maybe not with profit in mind, but that is the way it developed and we said, there is business out there, let us go after that business. It was maybe not by design, but we just continued it and embraced it.

The lesson that there was profit to be realized is reflected in the administrative changes made by PNC with respect to its Community Development Lending Unit (CDLU). Originally, the CDLU was viewed as part of the compliance function of the bank, and administered by the arm of the bank that ensured that all required fair lending provisions were met. In time, as the CDLU loan volume grew, and its potential for further growth was better appreciated, CDLU was transferred out of compliance and is now considered a "line of business."

As more lenders have increased their minority-LMI lending, whether because of pressure or profit, a competitive vortex has been established, that has brought others, more on the sideline, into the fray. The lending industry in general became much more competitive in the 1980s and 1990s due to deregulation and financial restructuring (National Community Reinvestment Coalition 1997, 12). This atmosphere of keeping up with increasingly more aggressive competitors extended to the minority-LMI lending sector. One lender notes that "affordable housing was the thrust of where the market was going, and our competitors were there, so we decided to be more active."

Still, for many of the exemplary lenders interviewed for this study, the increase in minority-LMI lending was made out of a commitment to the neighborhoods and people they served. This commitment was especially strong among small, neighborhood-based institutions, many of which are minority-owned or controlled. Berean Federal Savings Bank, for example, was established 100 years ago as the first minority-owned thrift society in the United States. Berean's home mortgages are granted almost exclusively to residents of West Philadelphia, a largely minority neighborhood, because that is the bank's near-exclusive business and service base. Berean's home mortgages have an average value of $35,000, as contrasted with the $100,000 average value of mortgages in Philadelphia's suburbs. That is the loan size that comports with Berean's customer base—modest-income home buyers, mostly minority, in West Philadelphia who are seeking moderately priced housing. Berean's stated reason for its involvement is succinct and eloquent: "It's what we do." Similar statements were made by most of the other minority-owned institutions among the exemplary lenders. Ironically, many of these minority-owned institutions now face stiff competition from the much larger institutions which have been prodded in recent years into the minority and LMI markets.

The minority-owned lenders are not the only institutions committed to the areas they serve, however. First National Bank of Farmington, for example, has devoted much effort to Native American lending because it is located in a classic "border community"—a community immediately adjacent to an Indian reservation—and its service area population has a large Indian representation. In an entirely different geographical setting, one of the forces prompting People's Bank to become involved in minority-LMI financing is that it was founded, and is still headquartered, in Bridgeport, Connecticut, a poor and heavily minority city.

In short, a complicated mosaic of forces is at work. The influences of sticks, carrots, and historical service roles all interact. While the CRA may have been the initial impetus, as lenders entered the minority-LMI market and learned that profit was to be had, economic return became a driving force. In making these loans in greater numbers, the service role of the institution was, in turn, reinforced. With this reinforcement emerged an enhanced receptivity to a more proactive role in serving the traditionally underserved.

These events also coalesced with larger changes in the business world. Enhanced minority-LMI urban lending comported with businesses' professed greater sensitivity to the larger environment, worker satisfaction and sense of accomplishment, "quality of life" of the workplace, and the like. (At the same time, of course, there were counterforces, such as "downsizing" so businesses could become internationally competitive.) Garry Carley, Executive Vice President of Standard Federal Bank, Troy, Michigan, echoed this view:

> Yes, we have a CRA obligation to ascertain [the needs of] and serve the community. We also have a corporate commitment to be a good citizen. Our employees, as members of the communities in which we do business, felt better about themselves, their company, and their community as a result of our community investment activities. So, our affordable housing initiatives benefit us in multiple ways. (Willis-Boyland 1993, 8)

In other words, a change in the accounting calculus of financial institutions has taken place. "Profit and investment are being seen not just in financial terms, but in social terms as well—investment in building capacity and building neighborhoods and partnership between financial institutions and communities" (National Community Reinvestment Coalition 1997, 17).

As in all endeavors, personal relationships played a role in fostering these changes. In the early 1990s, Angelo R. Mozilo, one of the two founders of Countrywide, worked with Jim Johnson, then CEO of Fannie Mae, to help develop some of the latter's affordable mortgage programs. This personal tie was one reason why Countrywide ultimately became the largest originator of Community Home Buyer's loans in the United States (Countrywide 1997).

The personal relationships that developed between lenders and the "third sector" (e.g., community-based organizations [CBOs], nonprofits, foundations, and others) became a further important influence on the exemplary lenders. The often acrimonious contention between lenders and the third sector at merger hearings has already been described, but in time, as lenders and the third sector began to work together and to better understand their respective roles, personal and professional ties developed that reinforced the mutual effort to increase minority and LMI lending. One bank official and the head of the La Raza, Arizona Council became personal friends; this bond intensified the affordable Hispanic lending efforts by this bank's mortgage unit. Meanwhile, the person responsible for affordable lending at People's Bank, Waldo Williams, was a native of Bridgeport, whose ties with People's went back to his high school days when he was an intern at the bank. Williams helped forge new ties between People's and Bridgeport's minority community. Cathy Coleman of First National Bank of Farmington served on the board of the Navajo Partnership for Housing (NPH) and developed a personal friendship with Eric Bauer of NPH. This friendship fostered FNBF's Native American lending program as well as NPH's understanding of the conditions that needed to be met to enable banks to give mortgages on Indian reservations.

The better understanding between banks and third-sector parties was also bolstered by job transfers across these sectors. Numerous CRA officers contacted by Rutgers in the course of this study had a background in civil rights work or a stint at a nonprofit. In turn, some of the nonprofits were staffed by former lenders or others with experience in various aspects of real estate. Some lenders had even spent time at a nonprofit on a sabbatical or "released time" basis from their financial institution jobs.

In the course of the study, Rutgers came into contact with this third sector involved in fostering minority-LMI lending. A brief note on some of its motivations will enable a better understanding of the partnerships that ensued—partnerships that were crucial to the lending process.

In an oversimplification of history, the third sector's emphasis during the 1960s and 1970s was protest; however in the 1980s and 1990s, as government intervention and public subsidy became less likely, the third sector turned more to intervention and service. A move to foster minority-LMI financing was ripe for third-sector involvement, since intervention in this arena would also serve other objectives. The NAACP's partnership with NationsBank, for example, was prompted by a combination of elements of HMDA data coming to the fore; NationsBank's proposed mergers, and the NAACP's desire to chart an enhanced service role for itself.

SUCCESSFUL STRATEGIES

Since successful strategies comprise many discrete actions, it is appropriate to organize the actions into categories. Prior efforts suggesting ways for lenders to enhance their minority-LMI financing have used different listings or organizational approaches. The 1992 Federal Financial Institutions Examination Councils (FFIEC) *Home Mortgage Lending and Equal Treatment—A Guide for Financial Institutions* (1992) includes recommendations under the headings of: 1) loan origination process; 2) appraisal process; 3) marketing process; and 4) private mortgage insurance. The 1993 Federal Reserve Bank of Boston's *Closing the Gap* groups its recommendations into 10 divisions: 1) staff training; 2) hiring/promotion practices; 3) compensation structure; 4) underwriting standards/practices; 5) alternative loan products; 6) second review polices; 7) marketing strategies; 8) buyer education; 9) third-party involvement in the loan process; and 10) testing fairness in lending practices.

The 1994 MBA-HUD *Best Practices Master Agreement* includes initiatives under the headings of: 1) self-testing; 2) outreach to brokers and community organizations; 3) education, training, and recruitment; 4) job opportunities; 5) consumer education and outreach; 6) training for mortgage lending staff; 7) underwriting standards; and 8) market analysis. In tandem, the MBA-HUD *Best Practices Agreement* includes such components as: 1) fair lending goals; 2) lending strategies; 3) second review programs; 4) self-monitoring and corrective efforts; 5) community-outreach and marketing; and 6) workforce.

A more recent HUD guide, *Financing the American Dream—Best Practices in Affordable Homeownership Lending* (1996a), includes 10 best practices: 1) partnering; 2) flexibility; 3) understanding the market; 4) homeownership education; 5) homeownership counseling; 6) affordable homeownership loan products; 7) prudent underwriting criteria; 8) enhanced servicing; 9) early intervention; and 10) default mitigation.

Clearly, previous research has not produced agreement on the appropriate conceptual categories for analysis. In the current study, the successful strategies will be presented in the form of a *process* that mimics the fundamental elements of creating a loan—i.e., establishing and operating an entity to do the financing, referred to here as "overall management," and then implementing the loan through the stages of "attracting," "qualifying," and "retaining" the borrower. Exhibit 1.11 shows this schema and briefly notes the encompassing elements. "Overall management" includes such actions as senior management involvement in fostering minority-LMI lending, as well as the formulation of compensation practices to encourage—and to remove any disincentives for—such financing. Outreach strategies include minority-directed advertising and the solicitation of referrals from in-house minority employees; qualifying strategies are dominated by the dual consideration of affordable loan products and flexible underwriting; and the retaining stage's strategic focus is on enhanced servicing and default mitigation.

The limitations of the organizational schema of Exhibit 1.11 are acknowledged. It does not include all possible actions (some, not individually identified, are included in the "other" or "miscellaneous" groupings). Numerous actions could have been alternatively classified. Is diversity in the workforce and soliciting mortgage leads from that workforce, for example, a management or an outreach strategy? Is a home-buying fair an outreach or a qualifying strategy? The point is not the specific taxonomy but rather the importance of organizing many actions into a staged schema that mimics the lending process, albeit in an oversimplified fashion.

Classifying business practices according to these stages of the lending process facilitates an understanding of the varied roles of different institutions in the industry: the configuration of Exhibit 1.11 would be slightly different for mortgage bankers than for savings and loans, for example.

A menu of successful strategies ranges from the less significant elements to the most fundamental. Among the less significant elements, for example, is terminology. One exemplary lender recommends replacing reference to homeownership or credit "counseling" with the term "consultation," since the word counseling may have a pejorative connotation, as in drug counseling. Another exemplary lender takes issue with the reference to "outreach" to minority and LMI would-be applicants, and recommends "business development." The latter term, according to this lender, connotes a financial objective that will be taken more seriously, whereas

EXHIBIT 1.11
Successful Strategies to Foster Minority-LMI (M-L) Lending

Other for-profit entities such as mortgage insurors; secondary market GSEs; CBOs-nonprofits; and the public sector

Partnering

I. OVERALL MANAGEMENT

1. Stipulate provisions in defining documents (e.g., charter)
2. Involve senior management
3. Provide monetary incentives (and remove disincentives)
4. Provide staff training
5. Other management strategies

II. IMPLEMENTATION

A. Attracting Applicants

1. Advertise in media directed at M-L markets
2. Proactively establish business relationships with realtors active in M-L communities
3. Work with community organizations to enhance M-L outreach activities
4. Encourage racially/ethnically diverse workforce and seek mortgage referrals from in-house employees
5. Provide homeownership education and counseling (or refer to other providers)
6. Other outreach strategies*

B. Qualifying Applicants

1. Provide *financially affordable mortgages* (e.g., allow small down payments and high debt ratios)
2. Provide for *flexible underwriting of the borrower and property*
   Examples:
   a) *Credit history*: accept alternate measures (e.g., rent and utility payments) to establish credit history; correct erroneous credit reporting; allow/encourage explanations for minor credit blemishes; and apply credit scoring judiciously
   b) *Employment/income history*: stress continuity of earnings rather than length of employment and count all income sources (e.g., from boarders and all adult household members)
   c) *Assets*: be flexible on funds required to close (e.g., allow short-term accounts and “mattress money”)
   d) *Property and neighborhood standards/appraisals*: avoid arbitrary disqualification (e.g., properties below a certain price); recruit/train unbiased and knowledgeable appraisers; encourage repairs to properties to qualify them; stress positive attributes of neighborhood
3. Provide for multiple reviews to ensure that M-L applicants are treated in the same manner as all other applicants
4. Test to ensure fairness
5. Other qualifying strategies*

C. Retaining Mortgagors

1. Provide post-purchase counseling on the obligations of homeownership, and tips such as setting aside a financial reserve and avoiding expensive home improvements
2. Provide for careful monitoring of payments and quick reaction to loan delinquency (e.g., a telephone call or, where possible, a visit by the servicer ascertaining why a payment was missed and when it will be sent)
3. Allow flexibility to cure delinquency (e.g., allow reduced payments in the case of temporary unemployment or family illness)
4. Other retaining strategies*

*This is a miscellaneous group of strategies not specifically listed in the exhibit, but discussed in each respective chapter. This “other” group of actions tends to be less significant and/or applied less frequently in practice.

"outreach" has a euphemistic neutrality and connotes an eleemosynary activity. The GE Mortgage Community Resource Center in Philadelphia trains its staff to say "people" rather than "consumers" or "minorities" (America's Community Bankers 1997, 86). (For the sake of clarity, this study will continue to use the conventional terms "outreach," "counseling," and "minorities.")

Among the more fundamental elements successful strategies address are where branches will be located, what types of loans will be offered, and whether the loans will be kept in portfolio or sold off to the secondary market. Both less significant and major actions should be considered by lenders seeking to expand their minority-LMI financing, to see what makes sense for them, where their strengths lie, and where they need remediation. In this regard, Rutgers' listing of successful strategies is akin to a checklist for self-assessment. In the following chapters, after describing each successful action, a discussion is presented on what types of actions work best for different lenders in diverse lending contexts.

Underlying all the discussions is the assumption that lenders will, in the course of fostering minority-LMI financing, establish partnerships with other for-profit entities, government entities, and the third sector. The report does not dwell on partnering as a separate strategy, because it is part of almost all of the separate activities that make up successful strategies. To reach the disaffected, for example, a lender will typically join forces with a church or neighborhood group; counseling involves similar alliances. Local Realtors may also help with outreach. To provide affordable mortgage products, the financial clout of the GSEs is typically sought; private mortgage insurers are also courted. Involvement of the Federal, State, and local governments as well as CDCs can help keep minority-LMI borrowers' costs down. Making sure that these households remain long-term, successful borrowers, again, often requires a joint effort by the lender and a nonprofit counselor.

Nonetheless, if partnering is a prerequisite to minority-LMI lending, it is also a source of tension. Tension is always evoked when disparate entities try to work together. If a bank underwrites a nonprofit's counseling program, is that nonprofit obligated to refer all the counseling graduates to its benefactor, the bank? Must it refer all its graduates to a Realtor of the bank's choosing? Realtors, counselors, and lenders all view the mortgage process from different perspectives and may sometimes be at loggerheads. The Realtor wants to finalize the sale; the counselor wants to make sure the home seeker is ready to assume the responsibilities of homeownership; and the lender is caught in the middle of the contretemps. Partnering is often touted as a mantra. Although we recognize its importance in minority-LMI lending, we also view it as an area of friction. If we know the underlying causes of that friction, we can help temper the conflict. In the following chapters, we note many successful examples of partnering.

CHAPTER TWO
OVERALL MANAGEMENT STRATEGIES

STIPULATE PROVISIONS IN CHARTERS AND OTHER DEFINING DOCUMENTS

Lending institutions, by law, must prominently post their nondiscriminatory policies. Certain depositories are also required to prepare CRA statements and other documents showing how their service responsibilities are met. Guides to enhanced fair lending recommend that institutions go beyond these minimal requirements. The Boston Federal Reserve Bank's *Closing the Gap* suggests that "the board of directors of a lending institution may also wish to establish a written policy on equal opportunity lending. . . . This policy can describe the institution's commitment to the community and to minority and lower-income consumers and explain how its products can meet home buyers' needs" (Federal Reserve Bank of Boston 1993, 13).

Many of the exemplary lenders contacted in the course of this study pointed to their formal statements on minority affordable lending, and stressed the importance of establishing a commitment in writing. The comments from four of those lenders shown below are illustrative:

1. The vision statement for the bank basically says that the bank wants to go out there and partner with the community. They want to be part of the neighborhood. They want to bond and build lasting relationships. They also want to deliver to the customer what the customer would not ordinarily expect from a banking institution. . . Our mission statement of this affordable housing unit is to provide mortgages in those areas and those communities that may not, or would not otherwise, have the opportunity.

2. Our mission statement specifies us as a "catalyst" for open and free lending. We all came from the mind-set of fair lending.

3. Yes, it's written, and the reasons we have those kinds of statements is because of the culture of the institution. The title page of our business plan has it; every year we have a statement of condition that refers to it. Over the years, we include this paragraph: This institution exists to change the homeownership conditions for poor and minorities. Our mission statement is basically that the commercial bank is here, geared towards sensitivity of African Americans, Hispanics and women, and other minorities.

4. The vision statement for this institution explicitly states that the bank sincerely seeks to form partnerships with local communities and build lasting relationships that foster community development.

Many of the mortgage bankers also spoke of amending their mission statements and similar defining corporate documents in the wake of signing a Best Practices agreement with HUD. These agreements committed the bankers to a series of companywide marketing, lending, and human resource practices aimed at increasing loans to low-income and minority borrowers. Countrywide, for example, publicly pledged to be a leader in the affordable and fair lending arena; in October 1994, it became the first mortgage lender in the nation to sign HUD's

Declaration of Fair Lending Principles and Practices. Another mortgage banker, noting with pride that it was the third Best Practices signatory in the country, spoke of the written commitment his institution had made to develop its LMI business and to build that business in the future. A third exemplary mortgage company, after signing a Best Practices agreement, actually revised its mission statement to comport with the goal of enhanced affordable lending.

Some lenders have also decided to chart their progress in minority-LMI lending formally, even though not required by law. With the changes in CRA, one exemplary lender (because of its small size) no longer needed to publish a CRA statement. Yet it continued to produce such a statement because:

> We feel that it is good to have it in writing, even though it is not necessary and the regulators don't look at it anymore. It is still good to have it in writing, have a mission statement, have it written down, so you can formulate your other plans around that particular statement.

Still, some exemplary lenders noted that there were no explicit provisions for fostering minority and LMI lending in their mission statement, their lending policy statement, or similar defining document because "talk or words were cheap," and that they did such lending without a formal statement:

> Minority lending is definitely in the entire thrust of our company. I hire minorities, I work in the minority community. We do a tremendous number of things like home-buying seminars, training seminars for both agents and the general public, and we market in bilingual. We are very active in the Hispanic community, so that allows us or actually pushes us in that direction and it is a very concerted effort on our part to work that effort, that market. Whether we have written it down as a mission statement or corporate minutes of our meetings, probably not. (Trent Financial 1997)

Interestingly, some exemplary lenders reported emphatically that they had no formal statements relating to minority-LMI lending. In fact, they were of the opinion that a race-based statement or lending policy would be discriminatory and illegal. One institution stated, "Nothing that we do is race driven; our policies and strategies are income, not race driven." This sentiment was echoed by two other exemplary lenders, who commented: 1) "Every loan has to be evaluated on its merits, not race"; and 2) "There are no specific mandates as relate to minority lending. We don't use that focus. A person is a person. A client is a client."

There were, however, instances of conceptual amnesia among these lenders, in the sense that some of the most vociferous protestants of race-driven statements or actions later, in discussions with Rutgers, spoke of specific minority-oriented advertising, or of having a second or third review for minority loan applications. The discomfiture about race-driven policy that emerged in the lender discussions appears to reflect a larger societal unease with how race should enter into decision making and when such incorporation constitutes discrimination, by way of reverse discrimination.

Many lenders said, in effect, "our actions are not race driven . . . but." The following sequence of dialogue between Rutgers and an exemplary lender is illustrative:

Rutgers: Do you have any policies to seek out, qualify, and retain minority mortgagors?
Lender: No, our policies are not affected by race.
Rutgers: Do you have polices for LMI borrowers?
Lender: Yes, we have quite a few.
Rutgers: What share of your LMI borrowers are minority?
Lender: Somewhere between half and nearly all. (Most responses were in the upper tier of this range.)

References were also made to geography, not race, as a major focus. As one exemplary lender explained:

> We don't specify any particular ethnic or religious background as a target area. We are more focused on geographic areas with the center of [the city] deserving our primary focus. Coincidentally, most of the people in that area happen to be of African American ancestry.

An interesting sidenote to the race discomfiture by some lenders was the response of the minority-owned institutions. These entities often have explicit operating statements and policies to promote minority lending. At the same time they noted they would not, and could not, turn away a non-minority applicant. But the notion made them uneasy. Because their funds are often limited, arranging a mortgage for a non-minority applicant would deplete funds that would otherwise be available to minority borrowers, the prime targets of their mission statements. Compounding the dilemma is the fact that the non-minority applicants are often only marginally qualified; they are referred by realtors specifically because the minority lender has a reputation for dealing with applicants with credit and other blemishes. The irony is inescapable: a minority bank lending to—or at least receiving loan applications from—the least qualified white borrowers, when the bank wanted to focus its resources on funding minorities. The minority institution was prepared to stretch its underwriting parameters to "make" a loan, but it preferred to do so only for the marginally qualified minority applicant, who might not receive sensitive treatment elsewhere—not for the marginally qualified white borrowers who had more sources to turn to. One minority exemplary lender described the situation as follows:

> Management and the directors have really been driven to fulfill a need that blacks and other people who haven't had homeownership opportunity are able to get it . . . Our whole background in real estate lending comes from a black real estate agent—my father—and other black real estate agents coming out of the 1950s who really were not welcomed at lending institutions. And those lending institutions weren't particularly interested in making inner-city loans. So there was a need for [our institution] to exist. And it existed, and fulfilling that need has been our driving culture.
>
> The customers that we were getting were primarily black customers. We got white customers because from time to time white people, white real estate agents, heard that there was this institution that was tying to help folks who couldn't go anywhere else. . . I can remember, after I first started working here, when you really had to be concerned, particularly when interest rates were very high, you just didn't have the money to lend, and you were trying to find diplomatic ways of prioritizing your choices and say that this money is really for someone who is black and is poor.

INVOLVE SENIOR MANAGEMENT

Senior management involvement has been recommended in many published guides on fostering minority-LMI lending. Management here is used in a broad sense to include the governing body of an institution and the senior staff responsible for the decision making and for providing the supervision necessary to carry out the objectives of the financial institution. *Closing the Gap* recommends a series of interventions to be undertaken by a lender's board of directors and management (Federal Reserve Bank of Boston 1993). Under staff training, for instance, it recommends that the board adopt a policy that provides all employees with regular ongoing training to protect prospective borrowers from biased treatment. It also recommends that the board establish a policy to detect and eliminate underwriting biases, and that management should establish this policy by reviewing and revising, if necessary, its underwriting standards and practices (Federal Reserve Bank of Boston 1993, 10, 13).

Examples of senior-level involvement in minority-LMI lending are also found in numerous prior studies on Best Practices. *Models of Community Lending,* for example, notes that at Marquette National Bank (MNB), the CRA officer reports to a senior vice president who, in turn, reports to MNB's president (National Community Reinvestment Coalition 1997, 64). At Coast Federal Bank, marketing and advertising to reach Hispanic and other underserved populations are formally reviewed and approved by the board of directors; and senior staff from Sacramento Savings Bank serve on the board of the Sacramento Home Loan Counseling Center (Federal Home Loan Bank of San Francisco 1994, 19-20). First Interstate of Arizona's CEO, William Randall, was personally involved in the development of the Home to Own affordable mortgage program; as part of that process, he chaired a working group of the bank's senior staff, nonprofit organizations, community-based housing advocates, and government agencies (Johnson and Macias 1995, i). America's Community Bankers' *Models that Work* (1997) cites numerous similar examples of senior management involvement in minority-LMI lending (66, 68), and the *Case Studies of Partnerships Achievement for America's Neighborhoods* is also replete with examples (Social Compact Between Financial Services Institutions & America's Neighborhoods 1995, 45, 101, 108).

Almost all the exemplary lenders studied by Rutgers had senior-level management activity involved in their minority-LMI ending efforts. Staffers at these lenders underscored the importance of this involvement. Noted one CRA officer: "Putting staff (relating to affordable lending) on paper is great, however, if you don't have the backing of the management staff, it's not going to work very well."

One way in which top management got involved was through the *explicit commitment to the importance of fair lending and minority financing*. In 1969, long before CRA and other legislation had been enacted, the board of directors of one exemplary institution adopted resolutions affirming its commitment to equal lending opportunity, and the board publicly recommits itself each year in November. The board commitment is distributed to all bank employees and appears in lending policy, underwriting, and other related publications. Another exemplary lender's annual state of the company address includes a review of the year's progress in fair lending and sets goals for improvement in this regard.

The personal involvement of a company's top management tier in matters relating to minority-LMI lending affirms the seriousness of the commitment. At one exemplary lender, the president always inquires about that institution's annual ranking in *America's Best and Worst Lenders,* published by the National Community Reinvestment Coalition. (This lender typically ranks in the "best" grouping.) The chairman of this institution is credited with "setting the tone for our focus on low- and moderate-income and minority lending and fostering homeownership as the basis of our business." Affordable lending is seen by another exemplary lender's staffers as a "top-down effort," with the chairman personally involved. At People's Bank, the annual community service awards ceremony is always attended by the CEO. The cumulative effect of this personal involvement by those in authority sends a powerful message to an organization that minority-LMI lending is to be taken seriously.

Another way management reinforces the importance of minority-LMI financing is by setting *specific goals*. At one exemplary lender, a "community action committee" consisting of high-level officials meets quarterly to assess targets for underserved neighborhoods as well as underserved individuals. In the case of another exemplary lender, a mortgage performance committee consisting of very senior management establishes annual performance goals for the bank as a whole and on a state-by-state basis. The goal in all instances is to have the bank's minority lending mirror the HMDA data. Thus, in the year when the national HMDA files revealed that 18.9 percent of all loans were made to minorities, this lender established a national goal for itself that 20 percent of all mortgages be given to minorities. Senior bank management then established plans to meet that goal through marketing, loan pricing, and so on.

Another exemplary lender's senior management sets annual goals of three types: 1) LMI loans as a percentage of total loans; 2) percentage of loans in LMI Census tracts; and 3) minority loans as a percentage of all loans. Setting the objectives includes a review of the bank's performance the prior year on these three measures, a look at what "the competition was doing," and consideration of "market opportunities" (i.e., household income, housing prices, and minority incidence in any given area).

Another manifestation of senior management involvement is their *leadership by example* through participation in civil rights, affordable housing, and other organizations important to minority and LMI populations. One exemplary lender's chairman has served for many years as a director and head of the executive committee of Detroit's NHS and has also been involved in Detroit Renaissance and New Detroit Inc. (formed after the 1967 riots to ease racial tensions). People's CEO is active in the Bridgeport, Connecticut NAACP; a regional lender's senior vice president serves on the National Committee for Affordable Lending; First National Bank of Farmington's CRA officer is on the board of the Navajo Partnership for Housing.

Leadership by example also extends to work in the field. One exemplary lender strongly believes in door-to-door canvassing of minority and LMI neighborhoods in order to increase market share in these areas. This institution described its recent efforts to canvas between twenty and thirty homes in targeted neighborhoods, discussing such issues as home improvement and mortgage products. The bank's president, along with other senior management, actively participated in this door-to-door effort.

Still another manifestation of senior management involvement is the frequency of CRA, fair lending, affordable housing, and similar activities as either a *line responsibility of, or supervised by, senior bank personnel*. One exemplary lender has an internal CRA committee composed of directors of the bank; another's CRA responsibilities are headed by an executive vice president who answers directly to the president; and yet another's CRA committee, which is comprised of the president, chairman, and senior executives, makes quarterly presentations to the board of directors. PNC has a senior vice president in the bank's Pittsburgh headquarters with oversight for the bank's overall CRA responsibilities, and this individual works closely with the managers of the Community Development Departments in each of PNC's local markets. Countrywide has a fair lending committee that meets quarterly to gauge progress in this area; the committee is composed of the president, heads of major production divisions, and other senior officials.

The staff at financial institutions, as at other corporations, are sensitive to the nuances of authority. If CRA, fair lending, and other charges are the responsibilities of junior staffers, with little senior oversight, the message is loud and clear: These are not very important matters. If, however, CRA matters and minority-LMI lending are the purview of the most senior and powerful individuals within a lending institution—as was the case among the exemplary lenders—the message is equally powerful: These are critical concerns, and your job and advancement may very well be linked to the progress of minority-LMI lending.

Some staffers at the lending institutions also revealed their perceptions of the different "risks" involved in pursuing minority-LMI lending, including:

1. *Adverse Publicity.* Minority-LMI lending is a rather public type of endeavor for a lending institution and may well involve instances of adverse publicity from neighborhood organization protests or investigative newspaper reporting or shrill complaints from applicants who are turned down. Some staffers responsible for such lending know banks abhor bad publicity and fear their careers may suffer. (At the same time, many such staffers also enjoy their work for the service it provides.)

2. *Cautious Economics.* Even if minority-LMI lending is profitable, it may show less of a return than other bank endeavors. Even a profitable minority-LMI loan portfolio may, at times, have "alarming" loan statistics, as measured by standard industry indicators. The 30-day delinquency percentage can be quite high, for instance, although the longer-term repayment record (60-, 90-, and 120-day delinquency rates) generally improves as the first-time home buyers become better acclimated to their financial responsibilities. Another potential trouble point is the sale of minority-LMI loans to the secondary market. Since the secondary market wants only the best of these loans, when these sales occur, the loan performance of the minority-LMI mortgages remaining in a bank's portfolio will spike downward. Read out of context, this decline can appear troublesome. Financial statistics on loans are typically reported only in their classic guises (e.g., cost-to-cost ratios and 30-60-90-day delinquencies). As a result, return is measured only in dollars and does not include such benefits as good will or community improvement. Bank

staffers involved in minority-LMI lending understandably are concerned that their loan records appear less than stellar.

3. *Overspecialization.* Given the complexities, it takes time to become proficient in affordable lending. New loan products have to be learned, CRA and other government requirements need to be mastered, and contacts have to be established with a panoply of government and nonprofit entities. Some staffers voiced apprehension that if they focused on affordable lending and stayed in the specialized affordable lending departments, they might narrow their career opportunities.

Management at some of the exemplary lenders has already addressed many of these employee concerns. The senior vice president in charge of residential lending at one exemplary lender became aware of a *Wall Street Journal* investigation of major lenders (including his own) that was to focus on the high percentage of minority mortgage rejections compared to white rejections. The investigation coincided with this institution's expansion into the minority community and a rising number of minority loan applications, many from less-qualified borrowers who had never applied for a mortgage before. In short order, this lender experienced a rising number of minority rejections. It was faced with the choice of either back-pedaling its marketing efforts to "show better statistics" or pursuing its initiative, a course likely to draw adverse notice in the pending *Wall Street Journal* article. The senior vice president approached the bank's CEO and explained the situation. The CEO told him "don't back off, we will support you." The CEO was not interested in the merits or demerits of minority rejection percentage as an indicator of fair lending performance (and in this case it was misleading). He was willing to support the minority lending initiative—and the staffers associated with the initiative—despite what could have been withering adverse publicity.

In Arkansas, because of the seasonality of work and other factors in the area served by one exemplary lender, incomes are very low. Housing prices are depressed as well, but not to the same degree. Consequently, this active exemplary lender was receiving many loan applications from minority-LMI populations in Arkansas with front-end ratio percentages in the high 30s and back-end ratio percentages in the high 40s. By comparison, the maximum front- and back-end ratios allowed by the most affordable Fannie Mae and Freddie Mac loans are in the low 30s and 40s, respectively. When this lender's senior loan officer explained the situation to the bank president and indicated that the institution would have to go beyond the GSEs' parameters to make minority-LMI loans, the president strongly supported the initiative, aware that the bank would have to hold these loans in portfolio.

PROVIDE MONETARY INCENTIVES (AND REMOVE DISINCENTIVES)

Lending institutions have traditionally based their loan officers' compensation to a large, if not exclusive, extent on commission. Such an approach discourages work on small, hard-to-qualify loans—precisely the profile of the typical minority-LMI loan. Providing monetary incentives for minority-LMI lending, and correspondingly removing any disincentives, is, therefore, an essential management action. As one of the Best Practices guides notes: "The compensation structure for loan production staff should not discourage them from working with lower-income or financially unsophisticated applicants" (Federal Reserve Bank of Boston 1993, 12). A joint communiqué from the four bank regulators recommended the "use of commissions or other monetary or nonmonetary incentives for loan officers to seek and make safe and sound . . . loans in minority communities" (FDIC 1993). Other forums echoed similar refrains (Federal Home Loan Bank of San Francisco 1994, 4).

One exemplary lender denied there was a compensation problem:

> You have to change your mind-set about this. We start with a very strong marketing and outreach program, bring volumes of people into the program, and minimize the fallout rates from that volume. Incentive compensation is a powerful lure, so why not apply it to the affordable market?

Most of the exemplary lenders, however, recognized that incentive compensation could prove problematic to the minority-LMI market, and they tackled the problem in various ways:

1. *Place all personnel on straight salary.* If everyone involved in loan production is paid a salary, the disincentive to work on small, hard-to-qualify loans is removed. This practice was followed by the First National Bank of Farmington, among others. These lenders were comfortable that straight salary and productivity are compatible.

2. *Place only the affordable housing unit (or officer) on straight salary*. Rather than compensate everyone on a salary basis, some of the exemplary lenders have a salary plan for just the loan officers focusing on the affordable market.

3. *Keep the basic commission approach but modify it to remove disincentives to minority-LMI lending.* There was substantial creativity among the exemplary lenders in concocting a hybrid solution. One "grossed up" affordable loans so that a $30,000 or $40,000 mortgage "counted" as a standard $50,000 loan for commission purposes. Another did not adjust the actual loan amounts but instead doubled the commission percentage (from one-half to one percent) on affordable loans. Countrywide paid commissions on affordable loan production but based the commission on the *number* of loans, not the *dollar* value, so an affordable loan counted as much for commission purposes as a larger mortgage. Countrywide's intention was to "create a level playing field, so that a loan is a loan no matter its size or who it comes from" (Countrywide 1997). Another exemplary institution paid a bonus to its loan officers for all mortgages granted through the Atlanta Mortgage Consortium; one exemplary lender offered a $50 bonus for each affordable loan; another gave an extra $50 for each new low-income borrower that a loan officer brought into the bank; yet another gave a $50 bonus for each FHA loan granted. The objective of these bonuses was explained by one lender as follows:

   > On our affordable loan program, our originators are paid a "bonus" for each loan made; it's not broken down by minority, but of course this includes a lot of minorities. This compensates for the additional work and lower loan values.

One exemplary lender had a creative approach that combined many of the elements noted above. To start, a loan officer could choose whether his/her commission would be calculated on a unit basis (number of loans closed, with loans of differing amounts each counting as one unit) or a dollar basis (dollar value of the loans closed, with the commission as a sliding percentage[1] applied against this aggregate value). If the latter approach was elected, this exemplary lender added bonuses to encourage work on affordable loans. For each loan granted to an LMI borrower and for each loan made in an LMI neighborhood (Census tract), the bonus was calculated as follows:

Number of Loans	LMI Borrower and/or LMI Area Loan Bonus*
1-2	$50
3-4	$150 (retroactive to first)
5+	$300 (retroactive to first)

*Bonus is doubled with dual conditions.

To clarify, a bonus was earned for satisfying either one of the conditions (LMI borrower or LMI neighborhood). However, the bonus was doubled if both conditions were present (LMI borrower mortgaging a property in an LMI neighborhood). And the bonus was based on the volume of loans retroactive to the first such loan made. Thus, if four loans were closed to LMI-borrowers purchasing homes in LMI neighborhoods, the bonus would be $300 ($150 x 2, since the dual conditions were met) for all four loans, or $1,200 in total.

Exhibit 2.1 illustrates the effect of the bonuses. The exemplary lender's LMI mortgages had a maximum amount of about $50,000, against $100,000 for its "average" loans. An affordable loan with the *dual* conditions noted earlier—LMI borrower and an LMI neighborhood—would often be smaller, about $35,000. A loan officer could "reasonably" expect to close about 7 "average" loans a month, versus a maximum of 6 affordable loans and even fewer dual-condition affordable loans. The comparable compensation would have been as follows:

EXHIBIT 2.1

	Monthly Loan Compensation		
	Average Loan	Affordable Loan	
Commission Factors		LMI borrower *or* LMI neighborhood	LMI borrower *and* LMI neighborhood
1) Number of Monthly Loans Closed	7	6	5
2) Average Loan Amount	$100,000	$50,000	$35,000
3) Total Loan Amount (1 x 2)	$700,000	$300,000	$175,000
4) Percentage Commission	.45%	.45%	.35%

[1] The sliding percentage varied by the number of units (loans closed) as follows:

Number of Units	Commission
1-3 units	25 basis points or .25%
4-5 units	35 basis points or .35%
6-7 units	45 basis points or .45%
8-9 units	55 basis points or .55%
10+ units	65 basis points or .65%

	(7 units)	(6 units)	(5 units)
5) Percentage Compensation (3 x 4)	$3,150	$1,350	$613
6) LMI bonuses	Not eligible	$1,800 (6 units x $300)	$3,000 (5 units x $600)
7) Total Compensation (5 + 6)	$3,150	$3,150	$3,613

Although the compensation end result is not always so nearly equivalent for average versus affordable lending, the bonus approach described above goes a long way toward providing compensation parity for affordable lending.

Some lenders have instituted a hybrid salary *and* commission *and* bonus approach. People's Bank, for example, pays its inner-city account officers a base salary; a bonus if they get involved in the community; and on top of that, a percentage commission. One lender gives draws against anticipated future commission; however, if a loan officer works on affordable loans, and in a given month earns commissions that are less than the draw, no deduction against the draw is paid.

PNC Mortgage Corp. has designed a hybrid system to encourage an optimal mix of conventional and minority-LMI mortgage originations. Three levels of originators are employed, with a different compensation structure for each one. A level-one originator at PNC Mortgage, a community mortgage consultant, is paid a base salary plus a commission for each of the first five mortgages that he/she originates; a still higher commission for each of the next five; and yet a higher commission for every loan over the first ten. According to management, most level-one originators collect only the base salary, because their job description and evaluation incorporate a significant amount of outreach activities, not just production. A second-level originator at PNC Mortgage, a (branch) mortgage consultant, is assigned a certain locality to serve. Bank branch mortgage consultants resemble conventional mortgage originators and generate a combination of loans—conventional, private banking, jumbos, and CRA products. They are given a choice between a base salary plus commission compensation structure, or a compensation structure based purely on commission. The third level of originator, a standard loan officer, is paid pure commission, according to a graduated scale, based on volume.

It is important to note that the incentives PNC's branch mortgage consultants are paid are volume-based, not size-based. Originators are rewarded to the same degree for a CRA and/or Delaware Valley Mortgage Plan loan of $35,000 as they are for a conventional $50,000 loan. To date, this arrangement has been satisfactory with the bank's originators, because volume has been strong for both products; approximately one-half of the loans to first-time home buyers in the Philadelphia market in recent years have been minority-LMI DVMP products. Management believes that this salary structure encourages originators to educate themselves about—and to promote—all the bank's various products. When an originator meets with a Realtor and can offer that Realtor's client a choice of conventional, FHA, VA, Fannie Mae, or minority-LMI products, he/she has a better chance of selling a product tailored to the client's needs.

The essential point, however, is that compensation should work for, rather than against, minority-LMI lending. This approach can include placing everyone on salary, placing the affordable loan unit/loan officers only on salary, or keeping a commission approach and layering it with all sorts of creative incentives so that a minority-LMI loan pulls its weight for compensation purposes. The creative reformulations encompass inflating the value of the affordable loan ("grossing it up") for commission purposes; increasing the commission percentage on such loans; counting commissions on a loan unit, not loan dollar basis; and having bonuses and salary–commission combinations.

Compensation reform should extend beyond the loan officers. If minority-LMI lending is a serious concern to a lending institution and the institution wants to encourage the entire organization to strive toward that goal, then everyone whose compensation is tied to performance should be affected by the minority-LMI results. A number of the exemplary lenders have followed this strategy. One, for example, has what it refers to as a "disaster scenario." If it does not meet its annual CRA objectives with respect to dollar and loan amounts in minority and LMI markets, then *no one* in the company gets a bonus, including the president. At People's, the senior vice president in charge of residential lending, and other senior management, also have bonuses linked, in part, to meeting CRA objectives. Another exemplary lender describes its hierarchical system of bonuses in this way:

> The individual market manager's bonus is tied partially to how well his market has reached the bank's CRA objectives. For the regional manager, his compensation is also tied to those goals, but it is tied to the aggregate of those goals. There is an understanding that if he is doing well in one market, but not so well in another market, he is not entitled to full compensation because he has not met goals across the board. Taking it to the next level, to the national people, compensation is based on how well all the regions are meeting CRA objectives.

Some tensions exist, of course, between the goal of tying a full compensation to minority-LMI lending—to make sure that loan officers and senior management aggressively pursue such financing—and the goal of keeping such lending affordable to the borrower. One exemplary lender's experience with "overages" is illustrative:

> Loan officers traditionally have the ability to charge additional overages or points to make more money. We, in an effort to not discriminate, limited the amount of overages on CRA loans. That had the effect of discouraging our loan officers. Why should they spend time and effort on a $40,000 loan, where they can only get a half percent overage, where on a $100,000 loan, they can get a 2% or 3% overage. Our analysis revealed that though we had a strategy that we thought was going to protect the minority and low/income from gouging prices if you may, it served to discourage loan officers from doing that kind of business if they could make more profits elsewhere.
>
> Now we have removed those barriers and said you can charge overages on any loan amount, in any market. We monitor, however, very closely on a monthly basis for disparity in those overages by race, by income, and by sex of the borrower.

PROVIDE STAFF TRAINING

A variety of training is recommended in the guides promoting fair lending published by Federal regulators.[2] The following recommendation is a good example:

> Staff training is a crucial component of a financial institution's efforts to combat possible discriminatory lending practices. All employees involved in the loan process should be familiar with the Federal laws that protect prospective borrowers from biased treatment, as well as applicable State laws. Training should address such laws and regulations as the Equal Credit Opportunity Act (Regulation B), the Fair Housing Act, the Home Mortgage Disclosure Act (Regulation C), and the Community Reinvestment Act. In addition to a regular training program on compliance with laws,

[2] These guides include *Home Mortgage Lending and Equal Treatment: A Guide for Financial Institutions* (FFIEC 1991), *Closing the Gap—A Guide to Equal Opportunity Lending* (Federal Reserve Bank of Boston 1993), *Suggested Lending Activities* (FDIC et al. 1993), *Side by Side* (FDIC 1994), *Joint Policy Statement on Discrimination in Lending* (Interagency Task Force on Fair Lending 1994), the respective regulators' compliance manuals (e.g., FDIC's *Compliance Examination Manual* 1994), and the MBA-HUD *Best Practices Agreement* (1994).

> financial institutions should ensure that employees have been trained on how they are expected to treat customers, since poor customer service can be perceived as discrimination. Lenders may also wish to consider training designed to encourage employees to accept and appreciate racial and ethnic diversity. (Federal Reserve Bank of Boston 1993, 10)

It stands to reason that a company trained in fair lending and cultural sensitivity will be more of an equal opportunity lender. Many banks recognized for fair lending leadership by such entities as the regional Federal Reserve Banks have extensive training programs. The training efforts of the San Francisco Federal Savings and Loan Association are listed below:

> San Francisco Federal's board of directors adopted a fair lending program in October 1993. As a result, its mortgage division loan staff have participated in various fair lending training programs, including videos, articles, and speakers pertaining to diversity, equal treatment, equal credit opportunity, and fair housing. The mortgage division's sales manager, using materials provided by the Professional Development Group of Minnesota, hosted a series of one-day interactive diversity workshops for loan staff (and a special session for senior management) to increase awareness and facilitate attitudinal changes.
>
> All mortgage division staff have viewed *Understanding Equal Treatment*, a practical video guide to understanding fair lending laws. San Francisco Federal considers this video an important component of a week-long, new loan agent training program in which agents view the video and then discuss relevant issues. The video *True Colors* has been viewed by senior management, all members of the CRA and fair lending committees, and all underwriting staff. The human resources department provides ongoing equal employment opportunity training for San Francisco Federal managers, including review and discussion of the video *Valuing Diversity*.
>
> Members of San Francisco Federal's CRA department visit regional loan offices on a quarterly basis to update mortgage division staff on affordable home loan products, community seconds, mortgage credit certificate programs, and other community-related programs. In September 1994, the CRA staff conducted a tour of the regional offices to introduce an updated affordable home loan package. (Federal Home Loan Bank of San Francisco 1994).

Most exemplary lenders contacted said they had similarly extensive training programs. Typically, the banks offered two cycles of training—an introductory round for new employees and periodic subsequent instruction. The initial training lasted anywhere from a few days to a few weeks, and included an overview of the basic provisions of the Community Reinvestment Act, Fair Housing Act, Equal Credit Opportunity Act, and other legislation; cultural sensitivity instruction; the basics on the mortgage products offered; and some field training (e.g., going to a branch office to observe mortgage application intake, then spending some time with underwriters). Although there were some cases where all new employees received the same fair lending and cultural sensitivity training, more often the banks presented a gradation of training so that new workers slated for customer contact had longer, more extensive instruction. Training materials included proprietary booklets, manuals, videos, and material (e.g., tapes) that can be rented or bought from various banking organizations.

The following excerpts describe the initial employee training given by five different exemplary lenders:

1. We have a required workshop/training program on fair lending for anyone (lending officers as well as branch managers) who makes residential loans; this consists of a customer-designed videotape, with the CEO on tape emphasizing the institution's commitment to fair lending, as well as a workbook that goes along with a training seminar.

2. We have a standard practice within the organization that each new recruitment class that begins training, irrespective as to where they will wind up, whether in customer service or not, be given a presentation on CRA and fair lending. We use written materials, lectures, and a role-play customer forum.

3. Loan officers go through training when they first start. It consists of about two weeks of full-time training and they go out in the field and are mentored by existing loan officers. Then they come back again and have some follow-up training that includes attention to fair housing. It covers compliance, and they go over the regulations on nondiscrimination.

4. Our bank uses some videotapes that show our employees what discrimination can be. This is all in the training side, to show where discrimination can happen, when you don't even intend it to happen. That is a conscious[ness] level that the board wants from us in training that everyone is treated as well as possible.

5. We have diversity training for all new employees; we have done training internally, through our human resources division, as well as through an outside expert to foster sensitivity when dealing with minorities.

Not surprisingly, the larger exemplary lenders typically had the most formalized programs, frequently administered by separate training departments, charged with just that single (instructional) responsibility. The training efforts frequently took advantage of sophisticated training media. One exemplary institution's new employee instruction included:

1. An introductory component stressing compliance with the spirit, as well as the letter, of all CRA/fair lending legislation, and emphasizing the lender's involvement in community development.
2. Instruction in the details and nuances of fair lending requirements, with a focus on key questions that the lender's appraisers, processors, and other staffers face in various lending and customer service situations.
3. Instruction at fair lending workshops where the institution's different lending divisions have training classes specific to the regulations that the divisions will likely confront.
4. Presentation of the CRA and fair lending video produced by the lender's corporate communications unit, as a prelude to discussion.

5. Utilization of a CD-ROM interactive training program on fair lending; employees then must take a test on the computer prepared by the lender's compliance department.

Following initial training, lenders generally also offered ongoing instruction. Although instruction was typically given to all staff, the topics covered and the level of detail presented varied by type of employee, with the most attention given to customer contact persons (as opposed to, say, back office workers). As one exemplary lender explains:

> On an annual basis, any customer contact person is required to complete CRA training. This talks about CRA in relation to the bank's mission, has an overview of the changing CRA requirements, and then how employees can be part of the CRA process. Instruction also stresses that employees should be aware of income differences and racial differences and how the bank's products are designed to service those differences.
>
> Every other year the bank has detailed fair lending [training] which includes all the fair lending laws. Periodically, the bank has diversity training, however, we are restructuring this training because we are not pleased with the results; it was too general. It wasn't focused enough on what the bank does on a day-to-day basis.

The above lender developed its CRA training in-house and has done the same with the fair lending instruction, with a consultant's assistance. It brings in an outside firm, however, to do the diversity training. Currently, in addition to trying to improve its diversity training, this lender is also trying to link its CRA, fair lending, and diversity instruction with its ongoing total quality management (TQM) planning.

Another exemplary lender offers a "topic of the month" training program for all employees that consists of lectures on such subjects as the Community Reinvestment Act (January), Fair Housing Act (February), Equal Credit Opportunity Act (March), Home Mortgage Disclosure Act (April), and so on. Yet another institution often turns to videos developed by banking organizations for ongoing training. It belongs to the Bankers Video System, where a $300 monthly fee entitles the institution to borrow up to 5 videos at a time on such subjects as compliance and customer service.

One of the larger exemplary lenders is currently developing a "Fair Lending" game that depicts how discrimination can affect mortgage financing and how it should be avoided. All employees have to participate in the "Fair Lending" game, from senior management on down, and all have to take and pass (with a minimum 80 percent grade) a discrimination test, contained in the game. Records of each person's performance are retained. This lender has also contracted with Bankers Training and Consulting Company to provide training modules on Regulation B (ECOA), the Real Estate Settlement Practices Act (RESPA), and HMDA.

Since minority-LMI lending requires knowledge of the wide variety of affordable mortgage products that have been developed in recent years, ongoing training helps keep staff abreast of changes in the industry. PNC Mortgage Corp, for example, provides both written and on-line operational training procedures, communicates product changes to the bank's branches, and gives loan officers ample loan product training materials. Since PNC frequently partners with other institutions in developing minority-LMI loans, ongoing instruction is extended to these entities as well, e.g., nonprofit housing counseling agencies. Anytime a new product is introduced, or a current product is modified, counselors are invited, along with the bank's underwriters and loan officers, to review the new developments. Furthermore, the training is not limited to product changes within the bank; PNC recently sponsored a seminar on Federal Housing Administration (FHA) loans for housing counselors even though it has, as yet, no FHA lending. To enable counselors to better understand the PNC loan process, the bank took counselors to its regional loan-processing center so they could sit across the table from PNC loan processors and underwriters and talk about how to qualify LMI loan applicants.

OTHER MANAGEMENT STRATEGIES

Many of the exemplary lenders believe that a fundamental prerequisite to fair lending, and a basic management responsibility, is to consciously establish as "fair" an atmosphere as possible within the financial institution itself. Recruiting and promoting minority workers gives rise to a diverse workforce and management group—and, in turn, to a greater institutional sensitivity. Opening employment opportunities for the neighborhoods served by the lender also gives a better understanding of local conditions and cultural norms. Diversity should extend to the most senior oversight positions, including the board of directors. One exemplary lender described its management imperative as follows:

> Racism is systemic in [this] area—it's so deeply inbred in whites. In our company, a long time ago, I realized we would have to change the whole culture—try to take it out completely from the day-to-day culture—no racial slurs, no sexist slurs, etc. This is our marketplace, and we respect them, and respect is the critical issue. Senior management has to do this.

The trade-offs of centralizing affordable lending in a separate unit versus disbursing this activity across all loan officers is another management concern. A separate unit concentrates expertise in affordable mortgages and flexible underwriting, and this has been, in fact, the route taken by numerous large lenders such as PNC and NationsBank.[3] (National Community Reinvestment Coalition 1997, 84) Disbursing the responsibility may increase outreach, however. At many exemplary lenders, both tactics are employed; the question is how to promote synergies between the two.

PNC Mortgage Corp., for example, has divided the overall geographic area it serves into 9 regional markets, with each of the 9 regional markets offering its own line of minority-LMI products based upon the underlying demographics. This approach allows each regional office to tailor products to the particular needs of its area's customers but at the same time inhibits product standardization—a goal of large, volume-driven mortgage companies like PNC Mortgage Corp. Through regional consolidation, the bank has achieved large economies of scale in production, processing, and servicing on the conventional side of its operation. Since approximately fifteen different market-based CRA programs are currently offered across the nine regions, upper

[3] NationsBank can concentrate, in part, because its partner in the Community Development Resource Centers, the NAACP, does significant outreach.

management has attempted to reduce the number through greater standardization to try to match the economies of scale achieved on the conventional side of its mortgage operations. But regional management has fought the product standardization initiative—although it has allowed its local processing operations to be folded into the bank's large regional processing center, with lower costs as a result. Process consolidation is especially important for minority-LMI products since they are generally more costly to process than conventional loans. At the same time, product standardization—going from, say, 15 to 9 mortgage offerings—may mean that a degree of flexibility has been lost.

The whole industry is grappling with this issue. The GSEs are pushing toward loan consolidation, as the Fannie Mae Home Buyer and the Freddie Mac Affordable Goal mortgages become the standards for minority-LMI lending. Although it is undeniable that processing consolidation and mechanization have allowed financing to be made available to many minority-LMI home seekers while at the same time offering efficiencies and savings in processing, the trade-offs are discussed in more detail in later chapters.

CHAPTER THREE
STRATEGIES TO ATTRACT APPLICANTS

ADVERTISE IN MEDIA DIRECTED AT MINORITY-LMI MARKETS

If a lender wants to reach the minority-LMI population, advertising directed toward these groups is essential. Many of the Best Practices guides highlight this approach (Federal Reserve Bank of Boston 1993, 19-20; FDIC 1994, 11, 29; MBA-HUD 1994). Some of the exemplary lenders downplayed the importance of advertising, however. One, for example, believed that as a minority-owned and -oriented lender since 1890, most people it wanted to serve already knew of it. This institution believed that advertising was too expensive for the increase in lending it would achieve. (This lender did do some advertising, however.)

Others found alternative means of securing minority-LMI loan applicants more compelling than advertising. One exemplary lender found relationship-oriented outreach—e.g., working with Realtors and participating in community events—more useful than advertising. Although one exemplary lender advertises in minority newspapers and on minority radio stations, it also stressed relationship-oriented outreach:

> Our most successful efforts are grassroots; anyone who thinks you can do an ad with a black face and have customers walk in the door is terribly mistaken. When we were starting first-time home buyer's seminars, we held them at night in the inner city to make it convenient to people in the neighborhoods, and advertised heavily, and we wound up with many white suburbanites complaining about having to drive into the city. And when that happens, you have to ask yourself why you're not tapping into the networks. I'm a white banker, in an office tower downtown, and what do they know about me?
>
> So now we are trying to tap into the neighborhood networks, which involves being out there in the neighborhoods, and getting known by word of mouth. Recently, we found that we had a rather low market share in African American lending in [City name]. We found one of the reasons is that we weren't very well connected to the Caribbean community. [City name] has the highest concentration of Jamaicans in the U.S. We first went to the Urban League, and this didn't get us much; then we went to the Caribbean social clubs, and this got a better response. And our minority employees in affordable lending are working to connect with the local community.

Advertising Formats

An overwhelming share of the exemplary lenders emphasized the importance of advertising directed to minority-LMI markets and applied a variety of advertising techniques. Listed below are those mentioned according to their frequency of utilization:

1. *Minority-oriented radio.* This medium was the one chosen most frequently. Berean advertised on WBAS, Philadelphia's African American radio station; a Florida lender on WPLM and WFXY, Miami's Hispanic stations; and First National Bank of Farmington on the Navajo language radio. Radio, generally—and minority radio, specifically—was deemed a cost-efficient medium to reach a large minority-LMI listenership. As one lender noted, "Not everyone has a television, and the person we

want to reach will often be commuting early in the morning listening to their radio." (This lender targets radio spots during commuting times.)

2. *Minority-oriented local newspapers.* Newspaper advertising was also a common choice, with bank ads placed in such minority and/or neighborhood papers as *New Observer* (Philadelphia, Pennsylvania); *Defender* (Chicago, Illinois); *El Latino* (Miami, Florida); the *Navajo Times* (Window Rock, Arizona); and *Mountain Eagle* (Kingston, New York). Lenders noted that these newspapers offered benefits similar to the minority-oriented radio stations.

3. *General circulation newspapers.* These newspapers were tapped less frequently because of cost considerations, and they were thought not to be as direct a conduit to the minority population as the minority radio/local papers. Where general circulation advertising was used, lenders found that certain newspapers had a greater minority readership than others, and naturally turned to those papers. In Chicago, the *Sun Times*, rather than the *Chicago Tribune,* was the paper of choice; in Jersey City, New Jersey, the *Hudson Journal* was preferred to the *Star-Ledger*; and in Pittsburgh, the *Pittsburgh Courier* was chosen over *The Times*. To further target their audience, the lenders would concentrate their newspaper ads in geo-coded editions where available—i.e., editions circulated by zip code or Census tract.

4. *Other print media.* A variety of other print media were tapped, including flyers, pamphlets, and informational brochures distributed in minority-LMI neighborhoods. One lender's bus ads received a positive response in Chicago. Like the above mentioned early morning radio spots, this lender thought its bus advertisements reached commuters of modest circumstances—a prime group for its purposes; and the buses traveled throughout Chicago's minority-LMI neighborhoods. Another exemplary institution maintained a list of all the renters in the areas it served and mailed a variety of information to this target group. Yet another lender published a quarterly magazine entitled *Our Neighbors* and distributed it to 100,000 households and 25,000 small businesses within a 3-mile radius of each of its branches. *Our Neighbors* had articles of local interest, a column on general financial services (e.g., how to budget and how to save), a letter from the lender's president describing events/services at the bank, and less subtle, bank marketing coupons for discounts on mortgage products. Another exemplary institution placed mortgage advertisements in the Yellow Pages as means of reaching, in its words, the "financially disconnected."

5. *Television.* A few lenders, reaching out to the large markets served by general television stations, used this medium. Countrywide was the quintessential example. More typical was the use of selected advertising on minority-oriented cable channels. Some lenders created their own "infomercials."

The exemplary lenders undertook a number of other creative marketing and advertising efforts. One institution did a quarterly credit needs survey in those zip codes in Chicago where minorities or LMI individuals constituted 50 percent or more of the local population. The survey consisted of a two-page questionnaire, to be mailed back to the bank in a bank-addressed stamped envelope. The survey ascertained if the respondent had—or needed—a mortgage; if he/she banked with the lender or any other financial institution; if he/she belonged to any community organization (the addresses of the organizations were requested); and what he/she thought was the neighborhood's most pressing housing, and other, needs. The questionnaire also sought ranking of different factors that would prompt (or had prompted) the respondent to apply for a home mortgage, including bank location, interest rate levels, charges, pre-approval conditions, and so forth. The survey gave the lender insight into the credit needs and aspirations of Chicago's minority-LMI neighborhoods. It was also a great marketing tool, prompting institutional recognition as well as generating a list of key future mortgage prospects, and helping the lender identify popular neighborhood groups it should contact.

Advertising Content

Recognizing that minority-LMI groups might not be as familiar or comfortable with financial institutions as the general population, advertising was often of a background or "development" nature. The copy focused on some of the basic services of the financial institution (deposit and checking accounts, and consumer loans as well as mortgages); its openness and convenience (e.g., the fact that it welcomed first-time depositors and had neighborhood locations and flexible hours); and its record of commitment and assistance.

One exemplary lender's affordable housing unit credited some of the receptiveness it encountered in Philadelphia's minority-LMI neighborhoods to an outstanding general recognition advertising campaign that the parent bank had been running for years. In fact, prior to late 1996, this unit did little LMI-directed advertising of its own. The general campaign highlighted the bank's presence in Philadelphia and its service to different neighborhoods—and, as the affordable housing officer explained, "did a very nice job of having [the bank] known out there in the community."

Another institution ran several "general awareness" advertisements. One ad congratulated a community group that had won an award and then listed the deposit and other services it offered, as well as the location of its branches in different neighborhoods.

For an institution like Berean, which was already well-known in its West Philadelphia service area, community recognition advertising was not necessary. Still, it ran some background advertising spots:

> We really don't advertise for loans; most of our advertising is for deposits and then the applications naturally flow. We stress three themes in our advertising and other communications. First, our identity; we are African American. Second, we have been in here longer than you have. Third, we do all the things a normal big bank does. (Berean Federal Savings Bank 1997)

Background developmental advertising helped the lenders set the stage for specific mortgage-directed advertising to the minority-LMI population. Recognizing that this population is often on the economic margin and has probably experienced financial reverses (e.g., unemployment); has low expectations about its prospects; has little or no knowledge (or misinformation) about credit and homeownership; and is wary of institutional lenders, the lenders realized that their advertising must address these issues head-on, with the message that home mortgage/homeownership is readily achievable. Most exemplary lenders' outreach advertising used almost the same words to develop their theme:

◊ "Easy—really—living the dream" (Countrywide)
◊ "If you thought the dream was out of reach—think again" (Bank of America)
◊ "Home buyer—helping you along the way" (Standard Federal)
◊ "Put you right at home" (NationsBank)
◊ "Housing is a possibility for all Chattanoogans" (Chattanooga Neighborhood Enterprise)
◊ "Let's show you (how to buy)" (Trent Financial)
◊ "A home of your own!—creating financial solutions" (Atlanta Mortgage Consortium)
◊ "These people thought they couldn't afford homes—at Bank United Mortgage we thought they could" (Bank United Mortgage)
◊ "You too can own a home" (Equifax Mortgage)

Much of this advertising echoes the theme of the GSEs' announcements, such as Fannie's trillion dollar commitment to "putting people in homes" (Fannie Mae 1996a, 4; Freddie Mac 1997). The GSE linkage is not coincidental—many of the banks are partners with Fannie Mae and Freddie Mac. Many have also structured their own programs along the line of the GSE programs.

Sometimes testimonials from those who achieved homeownership were included in the advertising copy, acting as a "plug" for the lender. Interestingly, one exemplary lender, which did no background or general advertising, did do some advertising about the kinds of mortgages it had made with the aim of increasing *deposits*, as well as mortgages.

> We have a brochure called "Meeting People's Needs—Questions and Answers About _________ Savings and Loan" on the front page. It includes various "stories" on the second page. One is "The Success of _________ is More than Just Statistics." It's about meeting the needs of the welfare mother—and we name the person (she said we could do this) who had five children. She was living in a house paying $175/month rent and the house was put up for sale for $12,000. The mother was in stress as to where to go. And [the story] goes on to tell how we were able to [secure a mortgage for her]. (It was a difficult loan). We link this with "Why should I put my money in_________?" Answer: By putting your savings in_________, you help create mortgages that are bringing new life to disadvantaged communities, and ultimately you're helping yourself.

What is the best way to present the message of achievable mortgage lending and homeownership to the minority-LMI population? A few of the exemplary lenders just used the same copy they used trying to reach the overall population (e.g., "Get your home from us"), and simply placed the ads in minority-oriented media. But most of the lenders tried to incorporate some measure of cultural sensitivity in their minority-LMI advertising. One institution used minority talent for its ads—e.g., it featured people of color in photographs and hired minority-owned advertising agencies to write copy. Another tried to include what it described as "ethnic flavor" in its advertising; for example, it linked the homeownership dream with the famous "I have a dream" speech by Martin Luther King. Extra advertising was run around the time of King's birthday.

Lenders active in Hispanic markets ran ads in Spanish. When an S&L, located in Los Angeles, decided to increase its marketing to the Hispanic districts of southern California, it ran radio ads on Hispanic stations, developed a brochure in Spanish, installed an automated loan "pre-qualifier" program in Spanish that could be accessed over the phone, and increased the number of bilingual loan agents. Other lenders in Florida and California took similar actions. Countrywide analyzed Census and other data to identify areas of Hispanic concentrations and targeted Spanish-language advertising accordingly.[1]

Cultural sensitivity is more an art than a science, however. Some lenders cautioned that it was a thin line in advertising between appearing sensitive to minorities' lack of familiarity with the home lending process and appearing condescending. One lender noted that an institution has to be careful about a "one-size-fits-all" approach, such as simply advertising in Spanish to reach the Hispanic market. Recognition that the Hispanic community is often composed of multiple nationalities is important, as another exemplary lender pointed out:

> There are differences in terms of marketing. Starting with the Hispanic community, it all depends on who you are trying to reach, the established Hispanic versus the newcomer. You need to be very sensitive and aware that there are different dialects of Spanish. In some cases, depending on who you are trying to target, you may be better off going with a mainstream publication in English, using a Hispanic face on the ad, versus going through a Spanish publication with a Spanish ad. The English mainstream newspaper is for the more established, whereas the Spanish publication is more for newcomers. That is a little bit different than with the African American publication or ad; there, we have been effective in using the different avenues, the different publications that do focus on the African American community.

The loan product may also have a bearing on marketing strategy. In the experience of one exemplary institution, direct mailings were the most effective form of advertising for home repair loans, especially in older neighborhoods. When it tried to market its first-time home-buyer loans through direct mail, however, the response was paltry. But the institution found advertising on cable TV worked well for the affordable purchase mortgages, and explained the difference as follows:

> When you are thinking about fixing up your house is not while you are watching the TV, but when you are talking to your neighbors, friends, and relatives. It is also a trust issue, someone you believe in. TV marketing does not convey trust. And yet there are people who might be first-time home buyers, who have a gulf between them and a bank. And they are watching something on TV that says, "Come to a free seminar and learn how to buy a house." Well, I will just call the 1-800 right now and register for a home-buying seminar.

ESTABLISH RELATIONSHIPS WITH REALTORS ACTIVE IN MINORITY-LMI COMMUNITIES

Strategic alliances with Realtors are advocated by many of the Best Practices Guides (e.g., MBA-HUD 1994), and examples of these alliances are cited in the fair lending and

[1] The Rutgers dialogue with lenders about operating in two languages raised some interesting issues. Some questioned whether a mortgage could be legally applied for in Spanish in states where English has recently been made the "official language." One noted a cyberspace problem. An exemplary lender said it used to be able to "take" a mortgage application in Spanish, using a Spanish application form. Now, that intake information is being entered on laptops and electronically transmitted to a central processing facility, however, the Spanish service is no longer offered. The laptop intake cannot be done in Spanish, at least for the moment.

affordable housing literature (America's Community Bankers 1997, 102; National Community Reinvestment Coalition 1997, 14; Willis-Boyland 1993, 36).

Some of the exemplary lenders disliked partnering with Realtors. One even stressed the need to contact the would-be minority-LMI home buyers *before* they were actively engaged in the search process:

> Obviously a Realtor is in business to do his or her job, and they may, or may not, be as sensitive to a person's position, whether it be financial or credit, at the time they talk with them. The challenge is to some degree reach into the community before contact is made with a Realtor, even before people are seriously thinking about homeownership. Because once you get to that point of working with a Realtor, you are pretty well focused as a consumer, good, bad or indifferent, that I want this home. And there may be some things that you need to attend to before that becomes a reality. So the challenge is from an outreach standpoint, [reaching] people early on.

Staff at another exemplary institution was vociferous about bypassing Realtors as a means of minority-LMI outreach:

> A lot of people feel that the Realtors blockbusted the hell out of the city. The community groups that we work with, the people who are on our boards who stayed in the neighborhoods, hate them. It is that simple. So we keep our distance. In fact, there are some very, very bad lending products out there that Realtors steer people into because, if you are breathing and have a social security number, you can buy a house in this country now. Contrary to what you hear about accessibility for minorities, there is no problem for accessibility for minorities. The problem is quality accessibility. People should be told in many cases not to buy a house, because their credit is so bad or their ratios don't work or they don't have enough down payment, but unscrupulous real estate and mortgage brokers will get them into a house anyway.

Still, most exemplary lenders viewed partnering with Realtors as a key step in reaching out to the population. In Countrywide's experience, in the affordable and minority market (especially in the Hispanic segments of the market), Realtors have a very significant role to play in the home-buying process. Countrywide has worked frequently with such groups as the National Association of Real Estate Brokers (NAREB), the organization of African American real estate professionals, or Realtists™. Another institution said that it too had reached out more often to the (minority) NAREB than to the (predominantly white) National Association of Realtors (NAR™). Yet another lender said that it networked through Hispanic and African American Realtor associations.

Many exemplary institutions, in fact, bemoaned the insufficient number of minority Realtors and hence the lost outreach opportunities. One observed that there were not enough real estate professionals in general servicing urban areas, minority Realtors included. Another lender, which has worked well with minority Realtors in Detroit to reach would-be minority home buyers, rued the paucity of minority Realtors in Detroit's suburbs.

Of course, one does not have to be a minority Realtor to serve a minority home seeker. But, in practice, many minority home seekers look for Realtors with ethnic backgrounds similar to their own. There is also a matter of practicality. Berean partnered with African American family-owned real estate agencies[2] in West Philadelphia primarily because the major real estate chains, like ERA and REMAX, were not active in West Philadelphia. The major chains clustered in more affluent city neighborhoods and suburbs (Berean Federal Savings Bank 1997).

How do lenders partner with Realtors to reach the minority-LMI population? Lenders revealed their general types of interactions:

1. *Referrals*. A referral by Realtors to lenders of individuals in the home-buying process is the most common interaction. The referral may come at the outset of the home-buying process or after an initial rejection when the Realtor refers the would-be home buyer to a lender who has a reputation for making the "difficult" mortgages. The referral process also works in reverse. When individuals finish a lender-sponsored counseling program, the lender often passes on a list of Realtors active in the particular neighborhoods in which the would-be buyers are interested.

2. *Counseling.* Lender-sponsored home-buying counseling often encompasses segments on "searching for a home." These segments frequently include some relevant materials prepared by a Realtor, or more likely, a lecture by a Realtor on the subject. Similarly, in the course of Realtor-provided counseling, a lender is often involved in the financing discussion. Counseling provided by other groups, such as nonprofits, frequently involves joint appearances by lenders and Realtors.

3. *Qualifying Applicants***.** Realtors do more than just show homes; some serve, in effect, in a "junior lender" role. They explain the basics of how to seek out and qualify for financing; they help compile the materials needed for a loan application, such as pay stubs and rent payment receipts; they can pull a credit report and run financial pro formas (i.e., determine whether a buyer will qualify given certain underwriting standards). Berean has developed a good working relationship with Realtors in West Philadelphia: "We trained the Realtors in underwriting and now many are taking on responsibilities of explaining obligations to applicants, cleaning up credit, and other things that if Berean had to do entirely on its own would overwhelm us" (Berean Federal Savings Bank 1997).

One interesting sidenote to the expanding role of Realtors in the financing process is that as many local Realtors are consolidating into regional and national chains, they are becoming vertically integrated with mortgage providers. Century 21 agents, for instance, are linked to a Century 21-affiliated mortgage company. The upshot is that the "natural" partnership of Realtors and lenders is now being replaced by the exclusive partnering of Realtors with their affiliates. As a result, other financial institutions are viewed as competitors. Some exemplary lenders said that they were experiencing a contraction in the number of Realtors with whom they could partner, because of the trend toward Realtor chains. Berean did not face this problem because the real estate chains are not present in West Philadelphia.

WORK WITH COMMUNITY ORGANIZATIONS TO ENHANCE MINORITY-LMI OUTREACH

[2] Not all lenders succeeded in establishing links with minority Realtors. One lender pointed out that many of the minority Realtors they approached to foster contacts with the LMI population reacted negatively to being labeled, or stigmatized, as catering to low-income individuals.

Linkages of lenders with the nonprofit sector is particularly important for successful outreach to the minority-LMI population.[3] Alliances with churches were very common. One exemplary lender ran home-buyer fairs in conjunction with the First AME Church, and together with other lenders, was an integral component of the church's Operation Hope program, which focused on first-time homeownership. Another lender worked with 80 African American ministers in Detroit; yet another joined with a coalition of Chicago churches to build affordable housing. A different exemplary lender gave seminars on entry level FHA-VA loans in churches in Los Angeles. The Atlanta Mortgage Consortium worked with an Atlanta group called Concerned Black Clergy and numerous individual churches. One lender described partnering with African American and Hispanic churches in Hartford to jointly sponsor "informational evenings" on entry-level mortgages. Before the partnerships were formed, the churches wanted to know what the lender's intentions were. One pastor inquired: "What are you doing to my people, and what are you doing for my people?"

One exemplary lender established a close working relationship with a political activist group known as "People Engaged At This Community Effort" (PEACE), whose board of directors consisted of church pastors. This lender would arrange for these pastors to send out flyers to their congregations on joint PEACE-bank home-buyer fairs, consumer credit counseling, and other subjects. Ironically, and not coincidentally, years before PEACE had staged protests against this lender on the grounds that it was not adequately serving minority-LMI neighborhoods.

[3] The Best Practices literature heralds such alliances (Federal Reserve Bank of Boston 1993, 19; Willis-Boyland 1993, 9; HUD 1996a, 4). Most of the lenders studied here followed this practice.

Another exemplary lender described its multifold involvement with churches:

> This is a cultural thing. In a lot of African American churches, you have hand-held fans, and we distribute fans to local churches. On front we put an image, something like Martin Luther King, and on back is our name, mentioning our commitment to fair lending.
>
> We also have a dinner for minority pastors—an annual thing—focused more on our commercial lending side, but we spend time talking about individual needs of their congregations in residential lending.

One exemplary institution sought to make loans to churches for construction and other purposes, as a conduit to marketing its affordable housing mortgage products:

> Another way we have gotten into the minority market is to make lots of loans to churches. Some banks shy away from this, because nobody wants to foreclose on a church. We think differently. It establishes relationships with churches, then it gets parishioners interested in us.

Lenders also had linkages to the full spectrum of nonprofit organizations. One worked with churches, CDCs, Neighborhood Housing Services, nonprofits specializing in credit repair and counseling, and local branches of national organizations, such as the Urban League. Another partnered with Neighborhood Housing Services (and, in turn, the Neighborhood Reinvestment Corporation), Consumer Credit Counseling Services, Local Initiatives Support Corporation, and a multitude of Hispanic, African American, and other ethnic and LMI-oriented neighborhood entities. The case studies in Volume Two, list scores of nonprofits with whom the exemplary institutions worked to attract, qualify, and retain minority-LMI borrowers.

The membership of these nonprofit organizations and the participants in their activities are disproportionately minority-LMI; they are a natural resource for lenders looking to reach out to these populations. One exemplary lender bought the mailing lists of the nonprofits it aligned with and used these lists to directly market mortgages. Nonprofits are much more than nodes of the poor and people of color, however. As one lender noted, “CDCs really have their fingers on the heartbeat of the neighborhood, and they share that knowledge with us.” In fact, this institution credited the CDCs with sensitizing it to the need voiced by neighborhood residents for purchase-rehabilitation financing in addition to simple purchase mortgages.

Partnering with the third sector also serves the important role of enhancing a lender’s credibility among the minority-LMI population. Portions of this population tend to be uncomfortable with institutional lenders. By joining with the nonprofit sector, these apprehensions are assuaged. One exemplary lender partners with churches, neighborhood associations, and similar entities because, in its words, “These groups have the most believability in the community. It makes it much easier to get in touch with a receptive audience.” This institution typically asks church pastors and other nonprofit leaders to take the lead in arranging when and where home-purchase orientations will be held.

Yet another exemplary lender recognizes that to many minority-LMI households, applying for a loan is the “most unfriendly experience possible.” This lender worked with several nonprofit organizations in Detroit to calm prospective home buyers’ apprehensions. Another exemplary lender arranged its sequence of outreach sessions to build on the nonprofits' credibility:

> We run workshops, jointly sponsored with a local nonprofit, to capitalize on their ability to reach out into the community and have a certain level of credibility. That is absolutely key. Because, again, in terms of name recognition, in terms of just getting a family in the situation where they are comfortable to not only attend, but to ask questions, we want to make sure that they understand that there is an advocate for them there at this meeting, at this workshop. In many cases, we may start a presentation, or in some cases, the nonprofit may start the presentation just talking about what they do in terms of counseling and hand holding and the preparation, and then we will come in and talk about the mortgage process itself, what to expect, the reason why we ask for certain things, income and debt, the unknown process.

The third sector also provides a variety of talents that lenders either don't have or would find hard to replicate. One lender partnered, for example, with local CDCs on a purchase-rehabilitation program because the CDCs had the expertise and people in place to inspect a house, interview a client, "spec" the work, and oversee the contractor. It would not have made economic sense for this lender to try to replicate these functions in-house.

ENCOURAGE RACIAL/ETHNICALLY DIVERSE WORKFORCE

A diverse lender workforce gives an overall imprimatur of fairness to a company, but there is a pragmatic benefit as well. Encouraging employees to refer family members and acquaintances to the bank is an effective form of outreach, and seeking mortgage referrals from in-house employees is, in fact, a strategy frequently recommended in the Best Practices literature. The MBA-HUD agreement suggests that mortgage bankers "make best efforts to establish and maintain employment practices that encourage development of a workforce that reflects the cultural, racial, and ethnic diversity of the lender's market" (MBA-HUD 1994). The Federal Reserve Bank of San Francisco gives awards to its members based, in part, on their personnel practices. San Francisco Federal was lauded for its goal of having its branch personnel mirror the local community populations. This goal was realized through the lender's persistence in posting job openings in minority newspapers and on minority-oriented bulletin boards (Federal Home Loan Bank of San Francisco 1994, 3).

A few of the exemplary lenders studied also touted employee diversity as a means of outreach. One noted that it went out of its way to recruit employees from the minority neighborhoods it served. It attended local job fairs and retrained minority personnel already working in the savings end of its business (e.g., tellers) to become loan officers. This lender believed that the heightened cultural sensitivity of its minority loan officers and their referrals were essential parts of its operations. In a similar vein, Trent Financial's workforce is 90 percent minority; its employees were strongly encouraged to network and bring in loan referrals from family members and acquaintances. Diversity was viewed by Trent as a necessity in the polyglot market of Los Angeles, and Trent consciously recruited minorities by going to job fairs staged by the Los Angeles Urban League and attending other kinds of minority hiring programs. Indeed, in addition to mortgage referrals from its minority employees, Trent sought "job referrals"—Trent's minority loan officers were asked to recommend people they knew who might be interested in entering the mortgage business. Berean also fostered outreach through its largely minority staff. Berean noted, however, that this policy sometimes caused problems if the people referred ultimately did not qualify for a loan. Another exemplary lender used its employees to help find persons in need of mortgage assistance and thought this approach was a "good source to the community." Another noted:

> We do pick up a lot of in-house referrals. We found and hired a qualified originator who was a minority, who knew all the people, and he has been an excellent source of connections, putting someone out on the street getting a lot of minority applications.

Most lenders in this study, however, did not turn to their minority staff members for formal or even informal outreach. This was the only instance where a recommendation by the Best Practices literature was not matched in practice by the exemplary lenders. Lenders said they did not recruit (or did not deliberately recruit) minority employees. Most of the lenders generally gave employees who referred a loan applicant a small honorarium or other token of recognition. But these gifts are not thought of as a means of minority-LMI outreach.

Some lenders were frank in acknowledging that much more could be done to diversify their workforce:

> That is one thing where we need to strengthen our efforts. We do have a good mix of employees, but even now we still have a challenge of our workforce reflecting our community. The one thing that I have found in my years working for mortgage companies or working for banks, is that in the Southwest, you don't have a lot of ethnic minorities working in the mortgage industry. Not because you don't have people out there trying to get into the business, but a lot of it has to do with, a lot of the focus for ethnic minorities just has happened in, say, the last three to five years, in my view. I think that it has taken a little while for lenders to recognize that borrowers do want to talk to an ethnic minority that is similar to theirs. And in some cases, someone who can offer them the language opportunity, communicating in their own language, to facilitate the process is also key, if it is one of the Asian languages or Spanish. I think that in the Southwest, I can't speak for the rest of the country, there are very few lenders, if any, out there who have been able to match their workforce to the community.

Some lenders also felt some discomfort assigning minority staff to deal with minority applicants. On the one hand, they recognized the cultural sensitivity, and often language, benefits of such assignments. Yet as one lender pondered, "Is it a form of racism, slotting people in that manner?" This lender gave the example of telephone inquiries. At his bank, managers fielded each call and would try to discern, as neutrally as possible, the caller's ethnicity, income, or other status (e.g., whether the caller was a recent immigrant); a staff person of similar background would then be assigned to follow up. The lender wondered whether it was proper.

PROVIDE HOMEOWNERSHIP EDUCATION AND COUNSELING

A substantial segment of minority-LMI households have little or no previous experience with homeownership, have limited financial and budgeting capacity, and therefore, have a tarnished financial record (HUD 1996a, 9). As a result, motivation to become a homeowner is not nearly as strong as it would be if the financial benefits of owning a home were known. The home search and financing process is even more foreboding than it would be if accompanied by demystifying instruction. Obtaining a mortgage is that much harder if past credit issues are unaddressed. And the ability to remain a successful homeowner diminishes if the long-term responsibilities are not appreciated and accepted. Removing these impediments is the charge of homeownership education and counseling.[4]

The exemplary lenders were involved in a wide range of homeownership education and counseling programs. They had no set approach, but, as a rule, instruction reflected a process that went from the general to the more detailed.

The lenders typically provided basic homeownership information at homeownership fairs, a "lunch to learn," an "informational evening," or other similar informal forums that would be advertised in flyers and other media. The instruction would last anywhere from one hour to a few hours or a day and would cover general topics, such as "Why be a homeowner?" and some of the basics of the process, such as "How to find a home," or "What is a mortgage?" Details on the lenders' products would not typically be presented at these forums, only general information on the mortgages available would be disseminated. Credit reports would sometimes be pulled during these sessions. They would consist of brief "in file" overviews, as opposed to the more comprehensive "tri-merged" credit reports (i.e., those merged from the three major credit bureaus).

The point of the introductory session (or sessions) was to evoke further interest, as well as to present the basics and get a sense of where people stood: Were they close to homeownership? Should they be encouraged to pursue a mortgage application in the short term? Were they further away, needing an intermediate level of counseling? Or did they require extensive credit and other remediation that could take months or even years?

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[4] The Best Practices literature acknowledges the importance of such instruction. *Closing the Gap* points out that instruction is a significant and effective way for lenders to familiarize themselves with the needs of the minority-LMI market and to address the challenges of that market (Federal Reserve Bank of Boston 1993, 21). Similar advice is found in sister guides (HUD 1996a, 9-12; HUD 1995a, 7-1, 7-8; Neighborhood Reinvestment Corporation 1997, 3, 7, 27, 30, 42, 43; America's Community Bankers 1997, 68, 76; Savings and Community Banks of America 1993, 37; Federal Reserve Bank of Philadelphia 1993, 5; Federal Reserve Bank of San Francisco 1994 19, 20).

Although these session(s) were sometimes offered by the lender alone, typically the lender partnered[5] with community groups. Sometimes the sessions were sponsored jointly by the lender and a nonprofit. At other times, a session would be given officially by a nonprofit, but a lender (and others) would be asked to speak, or vice versa. The exact format was not important, as long as the effort was a cooperative one, bringing together the lender and a nonprofit partner. An official at one exemplary institution explained:

> We do counseling with community groups. We tried to do our own seminars at each of our branches last year, and I think at one, one person came, and the others no one came. Now we have a relationship with a homeownership association. They had a homeownership fair and we had a booth there; 120 people came. Our best seminars are when we link up with the community group and they support having us there and bring their constituents; that is how we get the people to come.

Following the introductory session(s), a second, more comprehensive instruction stage ensues, where the full details of the mechanics of home buying are presented. A credit report is either pulled for the first time, or an earlier cursory report is supplemented by a more comprehensive analysis. As more is known about the would-be purchaser, counseling of different types—budget planning, credit repair, and so on—could ensue.

At the second stage, a more intense level of preparation was key. As one lender noted, "the introductory seminars or workshops are really just the point of entry for people; it is afterwards, that those who decide to pursue will need considerable help to get them through the bumps of the process."

The exemplary lenders took different tacks in preparing the minority-LMI households for homeownership in this "second stage." Many relied mainly, or even exclusively, on nonprofits. For example, after one institution pulled a credit report, if credit counseling was needed, the would-be applicant was referred to NHS. Another lender joined a consortium of lenders who funded a CDC specifically to provide the education and counseling. This lender used to do this work in-house, but found the consortium-partnered approach to be more efficient. The Atlanta Mortgage Consortium conducted its own course. Berean relied on ACORN for homeownership preparation; another institution on ACORN and NHS; and yet another on the nonprofit Philadelphia Council for Homeownership. The NAACP-NationsBank Community Development Resource Center is, itself, a partnership in which the NAACP provides the education and counseling components.

Some of the exemplary lenders took on the responsibility of preparing homeowners themselves. One developed a series of "mini courses" on such subjects as budgeting, credit, home inspection, and maintenance responsibilities. It offered 22 hours of instruction; most people didn't need more than 10 hours, however. Another used to refer people who needed

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[5] Partnering in counseling is not without some conflicts. The NAACP–NationsBank case study notes the dilemma of the NAACP in referring its counseling graduates to banks other than NationsBank at a point in time when NationsBank didn't offer the most competitive mortgage terms. (This situation was only temporary.) PNC noted some tension in the three-way relationship among Realtors, counselors, and lenders. Realtors would refer clients needing instruction to counseling agencies, yet the counseling agencies were not beholden to the Realtors. (They could recommend that the person counseled should drop the housing search because of a severe credit problem, or, if being qualified was not an issue, recommend that the person seek housing in a number of neighborhoods using a variety of Realtors. This caused Realtors consternation that "their" clients would be dissuaded or referred to another agent. Lenders were caught in the middle of this embroglio (see PNC case study).

assistance to outside sources. Over time, however, the latter became dissatisfied with the instruction given, which it viewed as "cosmetic." As a result, it developed a program in-house.

Countrywide, more than most of the exemplary lenders, emphasized preparation of would-be mortgage applicants. It provides free homeownership counseling, via its House America Center, to any interested party through a 1-800 service. The counseling staff that fields calls on this line are at a central location in California; bilingual (Spanish and English) counselors are available. Counselors are able to pre-qualify callers for a home loan, or guide them through a personalized financial course of action, and may work with them for up to a year or more to help them qualify for a home loan. Callers with credit problems are sent a free booklet entitled *Your Credit and You*. The booklet provides home buyers with information and directions for how to resolve credit problems and reestablish good credit.

The Countrywide Counseling Center focuses on helping callers who will probably be able to qualify for a home mortgage within a year. Callers who need more extensive counseling and a longer period to prepare for homeownership are referred to outside counselors.

Although most lenders can't match the glitz of a National Counseling Center, many of the exemplary institutions have developed formal counseling guides and formal lesson plans for home study programs that take anywhere from 5 to 20 hours. Examples include Bank of America's *Homebuyer's Program Guide* (1996), NationsBank's *Buying a Home: A Guide for First-Time Buyers* (1995), and the Atlanta Mortgage Consortium's *Community Home Buyer's Program*. Many of these guides are patterned after materials developed by the GSEs, such as Fannie Mae's *A Guide to Homeownership* (1994) and Freddie Mac's *Discover Gold Through Homeownership Education* (1995). The private mortgage insurors (MI), have published manuals as well. The *Home Purchase Education Program* (1994), for example, was developed by a major private mortgage insuror, the Mortgage Guarantee Insurance Corporation (MGIC).

These linkages are not coincidental. An important component of the exemplary lenders' minority-LMI financing is the generation of affordable mortgages sanctioned by the GSEs and MIs. As an accompaniment to the new more liberal financing, the GSEs and MIs require that the mortgagors complete an education program (often referred to as "counseling"). The GSEs and MIs developed their guides to establish a framework for this counseling, and the industry has followed suit.

The case studies make it clear that education and counseling are the linchpins for providing financing to minority-LMI populations. Counseling provided by the Navajo Partnership for Housing, for example, is a prerequisite for Native Americans who want to qualify for mortgage financing. NationsBank joined the NAACP as a partner in the Community Development Resource Centers (CDRCs) partially because of the CDRCs' outreach prowess. A main function of the Atlanta Mortgage Consortium was providing counseling for its consortium members. PNC partners with an array of Philadelphia nonprofit counselors.

Given the importance of counseling, Rutgers examined this subject thoroughly. We looked at ten major counseling programs. This review included examination of: materials published by GSEs (Fannie Mae and Freddie Mac) and private mortgage insurance companies (e.g., MGIC); materials developed by some of the exemplary lenders (e.g., Bank of America and NationsBank); materials referenced by some of the exemplary lenders (e.g., GE Community Home Buyer's Program); and specially developed materials (for Native Americans). In Exhibit

3.1, the ten programs are listed in the vertical column. Each program was analyzed by its inclusion and coverage of basic topics of housing counseling. The topics are listed horizontally and include pros and cons of homeownership, budgeting, choosing a home, negotiating a contract, obtaining a mortgage, and other activities including maintenance. As is evident, the counseling efforts developed a common, albeit not identical, body of topics.

There is reasonable agreement among lenders about what the “bundle” of basic homeownership skills need to be. The various counseling programs are characterized by historical and other linkages. The GE Community Home Buyer program, for example, and the Fannie Mae loan product by the same name, were originally joined in a pilot effort. In turn, Fannie Mae and Freddie Mac set the basic standards for the industry. But, common elements do not mean identical programs. Lenders must customize their instruction as local conditions warrant. In Hartford and other Connecticut cities, a common route to homeownership for the less-advantaged is to purchase a 2-, 3-, or 4-unit property, live in one unit, and rent the others. As a result, People’s Bank, headquartered in Bridgeport, added to its homeownership counseling instruction a section on the responsibilities of a small-scale landlord (e.g., collecting rent).

OTHER OUTREACH STRATEGIES

A number of the exemplary lenders spoke of the importance of having an actual presence in minority-LMI areas as a means of outreach. One noted, “If you have a facility—that is a marketing statement in itself.” As part of its outreach effort, another exemplary institution opened offices in areas where it (and other lenders) had not had full-service branches in the past—including three offices in very low-income communities. Its purported motive: to be in the community and offer convenient access to its loan products.

Yet another said the primary reason for its success in minority-LMI lending was its location in minority-LMI neighborhoods.[6] This institution is located in the midtown or central city of Kansas City—in contrast to many other Kansas City lenders who cluster in the southern portion of the community. It described mortgage lending as being “territorial,” with loan officers going out into neighborhoods on a daily basis to call on Realtors and others. In a territorial business, presence is important.

[6] Three other reasons were also mentioned: participation in a wide variety of affordable loan programs; longevity [the company was founded 1951]; and the fact that the lender was an independent company.

EXHIBIT 3.1
Common Topics of Housing Counseling Programs

	Pros and Cons	Prequal-ification	Credit	Budget	Loan Product	Choose a Home	Contract	Inspec-tion	Obtain Mortgage	Closing	Home Maintenance	Avoid Fore-closure	Other
Fannie Mae[1]	X	X		X	X	X	X	X	X	X	X	X	X
People's Bank[2]			X	X	X			X	X		X	X	X
AMC[3]	X		X	X		X		X	X	X	X	X	X
NationsBank[4]	X	X	X	X	X	X	X	X	X	X	X	X	X
Bank of America[5]	X	X		X	X	X		X	X	X	X	X	X
Countrywide[6]		X	X						X				X
MGIC[7]		X	X	X		X	X		X	X	X	X	X
GE[8]	X	X	X	X		X	X	X	X	X		X	X
Our Home[9]	X	X		X	X	X			X	X	X		X
CNE Fastrak[10]	X	X	X	X	X	X	X	X	X	X	X	X	X

[1] Fannie Mae. 1994. *A Guide to Homeownership*. Washington, D.C.: Fannie Mae.
[2] People's Bank. 1993. *A Dollar and Sense Guide to Home Ownership.*
[3] Atlanta Mortgage Consortium. *Community Home Buyer's Program*. Atlanta: Atlanta Mortgage Consortium.
[4] NationsBank. 1995. *Buying a Home: A Guide for First Time Buyers*. NationsBank Corporation.
[5] Bank of America. 1996. *Home Buyer's Program Guide*. Bank of America.
[6] Countrywide Home Loans. 1995a. *A Feeling Called Home: A Report on Countrywide's Declaration of Fair Lending Principles and Practices*; 1995b. *Your Credit and You*.
[7] Mortgage Guarantee Insurance Corporation. 1994. *Home Purchase Education Program: Participant's Manual*.
[8] GE Capital Mortgage Corporation. 1992. *The GE Community Home Buyer's Program: Affording a Home in Today's Market*.
[9] U.S. Department of Housing and Urban Development. 1995c. *Our Home: Achieving the Native American Dream of Homeownership*.
[10] Chattanooga Neighborhood Enterprise. 1994. *Fastrak to Homeownership*. Chattanooga: Chattanooga Neighborhood Enterprise Inc.

Countrywide's outreach also stresses local presence. As described in the case study, Countrywide has hundreds of offices. In addition, as part of its House America program, the company has opened House America retail branches in a number of inner-city locations across the country, including Atlanta, Chicago, Detroit, Los Angeles, Newark, Oakland, and Washington, D.C.

A bank doesn't have to have Countrywide's scale to ensure a presence in historically underserved areas, however. One of First National Bank of Farmington's (FNBF) most important outreach strategies to Native Americans is the single branch it opened on the Navajo Reservation—one of the very first bank branches to be located there. That branch makes a powerful marketing statement; in an area bereft of banks, it serves complementary functions as well. Its Navajo employees refer family members and acquaintances to FNBF for mortgages; the branch is also the site of FNBF-sponsored consumer education classes.

CHAPTER FOUR
STRATEGIES TO QUALIFY APPLICANTS

Even with aggressive efforts to broaden the pool of applicants, attempts to expand lending to traditionally underserved groups will falter unless these borrowers are able to qualify for suitable financing. This chapter presents our findings on the strategies used by exemplary lenders to qualify applicants. We first discuss efforts to develop innovative mortgage products, which in today's rapidly changing housing-finance environment generally require partnering with local governments, nonprofits, and others to develop new ways of financing homeownership. We then discuss strategies used by successful lenders to incorporate flexibility into their underwriting standards, to institute multiple reviews for rejected loans, and to conduct testing to ensure fairness.

PARTNERING ASSISTANCE

In an era when deep subsidies are largely unavailable from government (with some exceptions such as grants from CDBG and HOME), one way to allow the less-advantaged to secure homeownership is through a layering of numerous elements of assistance. Each one of these elements is usually modest. However, in the aggregate, they can provide a powerful subsidy. This layering personifies the partnership strategy so prevalent in minority-LMI mortgage lending. It involves support from the public, private, and nonprofit sectors.

The Best Practices literature calls for just such lender partnering. The MBA-HUD Best Practices agreement calls upon mortgage companies to "participate . . . in public and private affordable housing . . . programs . . . in order to increase market share among underserved populations" (MBA and HUD 1994, 4-5). In a similar vein, *Closing the Gap* calls for lenders to participate in programs offered by Federal, State, and local agencies and to develop affordable loan products of their own (Federal Reserve Bank of Boston 1993, 17).[1]

The importance of partnering is underscored by the GSEs, as indicated in the following remarks by Freddie Mac:

> A key element of Freddie Mac's Community Development Lending (CDL) approach is the use of strong public-private alliances. By joining forces with organizations that have existing infrastructures currently working to reach underserved communities, we add value and assure synergy between the participating organizations. By offering our expertise in the design and implementation of affordable homeownership programs, we are also investing in communities and helping local housing institutions build their capacity to produce greater results. CDL contributes to the creation of housing delivery systems that are sustainable within communities themselves over the long term, with each organization doing what it does best and maximizing the efficiency and productivity of day-to-day operations. (Fischer 1998)

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[1] These recommendations are echoed elsewhere (HUD 1996a, 13-14), and voluminous examples are given (HUD 1996a, 4-8; Neighborhood Reinvestment Corporation 1997, 1, 8; America's Community Bankers 1997, 49, 123; Social Compact 1995, 15, 20; Savings and Community Banks of America 1993, 4-5, 30, 37; National Community Reinvestment Coalition 1997, 33).

Most of the exemplary lenders were involved in a multidimensional effort to provide affordable and flexible financing, and the breadth of support was a key factor in the success lenders had in bringing many minority-LMI households to homeownership. In particular, the exemplary lenders took advantage of, and were involved in, an array of mortgage ventures using numerous varieties, or layers, of public assistance:

1. One exemplary lender offered FHA loans with "soft seconds"—second mortgages that didn't have to be immediately repaid. These second mortgages, in turn, were funded by HUD CDBG grants.

2. Another exemplary institution cooperated in a loan program that utilized soft seconds and even "soft thirds" (third mortgages) available from Pittsburgh's Urban Renewal Authority (URA). In turn, URA funded the subordinate mortgages from its HUD CDBG allocation.

3. PNC took advantage of soft seconds given by the city of Philadelphia (funded by that city's CDBG), as well as below-market-interest rate (BMIR) financing made available by the Pennsylvania Housing and Finance Agency (HFA).

4. People's utilized BMIR financing from the Connecticut HFA; other exemplary lenders did the same through the Illinois, New York, and other State equivalents.

5. One exemplary lender offered affordable mortgages with down payments and closing costs subsidized by HUD's HOME program. Another, using a HOPE 3 grant from HUD, was able to offer a 100 percent loan-to-value ratio loan.

6. First National Bank of Farmington gave BMIR financing for Navajo housing and community development purposes through a grant received from the Federal Home Loan Bank's (FHLB) Affordable Housing Program (AHP). Other exemplary lenders tapped AHP, as well as other subsidies from the FHLB, such as the Community Improvement Program (CIP).

7. One exemplary lender combined FHA-VA liberal underwriting standards with a Michigan State tax credit that added 20 percent to the value of the deductibility of mortgage interest and taxes against a homeowner's income. Another capitalized on a city of Dallas subsidy that amounted to up to 20 percent of the mortgage principal for LMI borrowers.

In addition to this potpourri of Federal, State, and local subsidies, the exemplary lenders availed themselves of monies from foundations and other third-sector representatives. A partial list of the third sector contributors includes the Enterprise, MacArthur, Ford, and other national foundations; such city-directed funders as the Cleveland and Victoria (Newark) Foundations; educational institutions such as the University of Pennsylvania; and prominent neighborhood-urban revitalization entities, such as the Local Initiatives Support Corporation.

To the monies from the public and third sectors, the lenders often made contributions of their own. Sometimes the contribution was in the form of a below-market interest rate. NationsBank's affordable loan products (CR2, CR5, and CR7), for example, offered interest rates 50 basis points below the market for moderate-income mortgages. The exemplary lenders participating in the Delaware Valley Mortgage and Atlanta Mortgage Consortiums (e.g., PNC and Sun Trust) also agreed to a discount of half a percentage point. For other institutions, a subsidy was given in the form of time donated. One vice president at a major bank has been working two full years on Indian lending issues; she has yet to close a single home mortgage for a Native American household on a reservation.

Lenders have also made cash contributions to groups in the third sector that make minority-LMI lending possible. PNC, for example, contributed to Philadelphia's ACORN; First National Bank of Farmington contributed to the Navajo Partnership for Housing; and NationsBank funded the NAACP in the form of support for the Community Development Resource Centers. Still, lenders are profit-making entities; there is a limit to the financial contributions they are willing to make.

ANALYTIC FRAMEWORK FOR CONSIDERING MORTGAGE CHANGES

To better understand the change that has been wrought in the minority-LMI mortgage arena, it is instructive to examine the basic characteristics of different mortgage formats. For the purposes of discussion, Rutgers poses three mortgage guises operative currently (i.e., operative today and offered roughly since 1990). The first guise is the "standard" mortgage and constitutes the current basic instrument of home finance in the United States. The characteristics of this mortgage are very significantly influenced by the government sponsored entities which dominate the secondary market—Fannie Mae and Freddie Mac. As such, we refer to this loan as the GSE Standard Mortgage.

Although the envy of the world, this standard mortgage is beyond the financial grasp of many disadvantaged Americans. Over the last decade, a more affordable product has evolved. Its basic parameters have been set by Fannie Mae and Freddie Mac, since lenders' propensity to offer new products stems largely from the GSEs' willingness to buy the affordable loans on the secondary market. The GSEs use different programmatic terms for these loans, such as Community Home Buyer's Program or Affordable Gold, to reflect their function and parentage; Rutgers refers to them all as GSE Affordable Mortgages.

A third type of home loan has also evolved that Rutgers terms a Portfolio Affordable Mortgage. The term portfolio mortgage, in financial industry terminology, refers to loans kept in-house by a lender for its investment purposes, as opposed to loans sold to outside investors. Nothing about a portfolio loan inherently differentiates it from a standard GSE issue. In fact, banks may keep loans in their portfolio for a while and then sell them on the secondary market. In practice, however, when dealing with minority-LMI financing, the loans kept in portfolio tend to be somewhat more flexible than others in financial and underwriting terms. They are typically kept in portfolio because they exceed the financial and underwriting parameters set by the GSEs.

The GSE Standard Mortgage, GSE Affordable Mortgage, and Portfolio Affordable Mortgage comprise both common and distinct elements which are detailed below. To further set the perspective of the current advances in mortgage qualification and affordability, we shall also sometimes refer to what is termed the Historical Mortgage—the standard mortgage that dominated the market prior to 1990.

The creative reformulation that has advanced minority-LMI lending involves all these various loan products. The quantum change involved the shift from the Historical Mortgage to the GSE Standard and GSE Affordable Mortgages with the GSE Affordable Mortgage being particularly significant to the would-be minority-LMI home buyer. The Portfolio Affordable Mortgage then incrementally advanced the changes. The process was somewhat convoluted. Some Portfolio Affordable Mortgages preceded the GSE interventions of the last decade, for example. Today, GSE Standard and GSE Affordable Mortgages are offered side-by-side with the Portfolio Affordable products. Still, the Portfolio Affordable Mortgage is very much the product of the GSE Standard and GSE Affordable Mortgage, especially the latter.

The process continues to be a dynamic one; it involves a broader range of participants than just the mortgage originators. A bank may form a pilot joint venture with a GSE, for example, in the expectation that as its portfolio loans mature, it will be able to recapitalize by selling off the seasoned mortgages to that GSE.

Private mortgage insurance companies and other for-profits have been inextricably involved in the financing changes, as have government entities and the third sector. Rutgers' objective in formulating the tripartite mortgage division—GSE Standard, GSE Affordable, and Portfolio Affordable (with the Historical Mortgage cast to set the perspective of changes over time) is not to designate a market leader, for there is much credit to be shared (and much remains to be done). Rather, the aim is to better understand the changes in the market.

The various mortgage guises typically differ in their basic parameters—their *financial characteristics* and their *borrower-property underwriting criteria*. The former includes such fundamental financial considerations as the loan's interest rate, the loan-to-value ratio, the specified maximum debt ratio, and so on. The latter includes criteria relating to the credit, employment, and income record of the would-be mortgagor; the condition and attractiveness of the property to be mortgaged (as well as that of the surrounding neighborhood); and the assets acceptable to close the transaction. Although all of the above items are often referred to as "underwriting" collectively, for the purposes of this discussion, the financial characteristics and borrower-property criteria will be considered separately and discussed in turn.

PROVIDE FOR FINANCIALLY AFFORDABLE MORTGAGES

As shown in Exhibit 4.1, the GSE Standard Mortgage requires a minimum 5 percent down payment or, equivalently, offers a very high maximum (95 percent) loan-to-value (LTV) ratio. At the very high LTV levels of the GSE Standard Mortgage, most of the down payment and closing costs must be paid by the home buyer,[2] and only moderate levels of debt are

[2] This varies according to the LTV. For instance, secondary financing from all sources, which can be used for the

permitted—a maximum guideline[3] of 28 percent of income committed to the housing expense ("front-end ratio") and 36 percent of income committed to all debt, housing and otherwise ("back-end ratio"). The interest rate is the prevailing market charge and private mortgage insurance is required for LTVs above 80 percent. For those who are able to afford it, the GSE Standard Mortgage is a reliable vehicle for purchasing or refinancing a home.

That designation leaves out the financially disadvantaged, and to address that gap, the GSE Affordable Mortgages were created. Numerous individual subvariations of this type are covered in Exhibits 4.2 and 4.3 (e.g., Fannie Mae's Fannie 97 and Freddie Mac's Affordable Gold 97), but their overall framework is summarized in Exhibit 4.1.

The focus of these affordable loans is to get people into homeownership; accordingly, the GSE Affordable Mortgages are sometimes limited to purchase, not refinance.[4] They are designed to help the less-advantaged; thus, the loans are typically targeted to people earning no more than the area median income. The GSE Standard Mortgage has no such income limitation—one just needs to be able to afford it. The GSE Affordable Mortgage is not subsidized in the sense of a below-market-interest rate; a market rate is charged. However, the standard financial requirements are materially modified. Recognizing that the mortgagors have very modest assets,

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down payment and closing costs, is allowed if the first mortgage is less than 75 percent LTV and if the first and secondary financing combined does not exceed 90 percent LTV. When the down payment is 20 percent, or greater, the entire amount can be gifted to the home buyer.

[3] The GSE front- and back-end ratios are "guidelines" that a lender uses to qualify a borrower. If the ratios exceed the "guidelines" of the program, a lender, with compensating factors documented, can make the loan with higher ratios.

[4] This is the case for Fannie Mae's Fannie 97 and Freddie Mac's Affordable Gold 97. Fannie 97 is also available for no cash-out rate-term refinances of existing Fannie 97 mortgages.

EXHIBIT 4.1
Mortgage Financial Characteristics

Mortgage Characteristics	*GSE Standard Mortgage*	*GSE Affordable Mortgage*	*Portfolio Affordable Mortgage*
Purpose	Serve all borrowers/areas	Serve low-moderate income borrowers and underserved areas	Same as GSE Affordable
Application	Purchase or refinance	Purchase or refinance—with exceptions[1]	Primarily purchase
Targeted Income	No income limits	Maximum 100% of area median income—with exceptions[2]	Maximum 80% to 100% of area median income—with exceptions[3]
Investor	GSE	GSE	Portfolio
Debt Ratios: Front/Back (Guideline Maximums[4])	28/36	33/40[5]	Maximum 35/42; majority at 33/38
Minimum Down Payment	5% with MI 20% without MI	3-5%[6]	3% or less (as low as $250)
Minimum Borrower Contribution	5%[7]	3-5%[8]	Minimal—1-2% or less ("sweat equity" may be allowed)
Maximum Loan-to-Value Ratio (LTV)	95% with 5% down payment 80% with 20% down payment	95% to 97%	97% or higher
Private Mortgage Insurance (MI)	Required for LTVs over 80%	Required	May or may not be required
Subordinate Financing			
Down Payment	Secondary financing from all sources allowed if first mortgage is less than 75% LTV and combined LTV does not exceed 90% LTV	Secondary financing may be allowed from gift, grant, or subsidized loan up to a total LTV of 97%[9]	May be allowed—frequently with more liberal terms than GSE Affordable
Closing Costs	Seller can pay up to 3% of the lesser of sales price or appraised property value if LTV is greater than 90%; and up to 6% of the lesser of sales price or property value if LTV is below 90%	Up to 2% of the borrower's down payment may come from a gift, grant, or other sources[10] Seller may contribute up to 3% of the lesser of sales price or appraisal property value	Essentially the same as GSE Affordable; some products allow higher contributions from seller and other sources[10]
Interest Rate	Market	Market	Occasionally one-half point below market
Reserves	Two months required	Typically one month required—with exceptions[11]	Frequently not required
Home-Buyer Education	Not required	Required—with exceptions	Required

Notes:

[1]The GSE Affordable Mortgages are often formally referred to as "community lending products." A few of the GSE Affordable Mortgages (e.g., Fannie 97 and Affordable Gold 97) are limited to purchase only (with exceptions), while most others can be used for either purchase or refinance. See Exhibits 4.2 and 4.3.

[2]Income may exceed median in high-cost areas and targeted locations (e.g., high-minority Census tracts and central city locations). See Exhibits 4.2 and 4.3.

[3]Varies by program with maximum incomes from roughly 50% to 150% of area median income.

[4]These are the "normal" guideline maximums that can be exceeded with compensating factors.

[5]The maximum guideline front-end ratio in the Fannie Mae affordables is 33%; Freddie Mac has no maximum front-end ratio. The maximum back-end ratio is 38% for Fannie Mae's Community Home Buyer's Program and 36% for Fannie 97; Freddie Mac allows a 40% guideline maximum. See Exhibits 4.2 and 4.3.

[6]It is 3% for Fannie Mae's Fannie 97 and Freddie Mac's Affordable Gold 97, and 5% for Fannie Mae's Community Home Buyer's Program (CHBP) and CHBP with 3/2 option, and for Freddie Mac's Affordable Gold 3/2 and Affordable Gold 5.

[7]The minimum borrower contribution is 5% (with or without MI). A minimum 20% down payment is required when MI is not placed on a loan; however, the borrower need only make a 5% contribution from his or her own funds. The balance of funds may be in the form of a gift.

[8]It is 3% for Fannie Mae's Fannie 97, Fannie Mae's CHBP with 3/2 option, and Freddie Mac's Affordable Gold 97 and Affordable Gold 3/2. It is 5% for Fannie Mae's Home CHBP and Freddie Mac's Affordable Gold 5. Where the minimum borrower contribution is 3%, an additional 2% is allowed from gifts, grants, and subsidized second mortgages (community seconds).

[9]Applies to Fannie Mae's Fannie 97 and Freddie Mac's Affordable Gold 97.

[10]Other sources include unsecured loans from nonprofits, government agencies, employers, or relatives, where repayment is limited or not required.

[11]One month reserve is required by Fannie Mae's Fannie 97 and Freddie Mac's Affordable Gold 97 and Affordable Gold 3/2. One month is recommended, but, not required for Freddie Mac's Affordable Gold 5. Reserves are not required for Fannie Mae's CHBP or CHBP with 3/2 option.

EXHIBIT 4.2
Financial Characteristics of Fannie Mae Standard and Affordable Mortgages

		Fannie Mae Affordable Mortgages		
Mortgage Financial Characteristics	**Standard Fannie Mortgage**	**Fannie Mae Community Home Buyer's Program℠**	**Fannie Mae Community Home Buyer's Program with 3/2 Option℠**	**Fannie 97®**
Application	Purchase or refinance	Purchase or refinance	Purchase or refinance	Typically purchase only[1]
Targeted Income	No income limits	100% of area median income, with high-cost area exceptions: Boston MSA 120%; New York MSA 165%; State of California 120%; State of Hawaii 170%. Income restriction waived in central city, low/mod income Census tracts, minority Census tracts and underserved areas	100% of area median income, with high-cost area exceptions: Boston MSA 120%; New York MSA 165%; State of California 120%; State of Hawaii 170%	100% of area median income, with high-cost area exceptions: Boston MSA 120%; New York MSA 165%; State of California 120%; State of Hawaii 170%
Investor	Fannie Mae	Fannie Mae	Fannie Mae	Fannie Mae
Debt Ratios: Front/Back (Guideline Maximums)	28/36	33/38	33/38	28/36 (30-year loan) 33/36 (25-year loan)
Minimum Down Payment	5%—with MI 20%—without MI	5%	5%	3%
Minimum Borrower Contribution	5%	5%	3% (2% may come from gift, grant, or subsidized second)	3%
Maximum Loan-to-Value Ratio (LTV)	95%	95%	95%	97%
Private Mortgage Insurance (MI)	Required for LTVs over 80%	Required	Required	Required
Subordinate Financing				
Down Payment	Secondary financing from all sources allowed if first mortgage is less than 75% LTV and the combined LTV does not exceed 90%.	Not allowed for minimum down payment.	2% of the down payment can come from gifts, grants, secured or unsecured loan from a nonprofit, government agency or employer.	Not allowed for minimum down payment.
Closing Costs	Must come from borrower. Seller can pay up to 6% toward nonrecurring closing cost when the LTV is 90% or less; 3% when the LTV exceeds 90%.	Same as Fannie 97	Same as Fannie 97	Closing cost assistance can be in the form of gifts, grants, secured or unsecured loan from a nonprofit, government agency, or employer. Seller may contribute up to 3% toward closing costs.
Interest Rate	Market	Market	Market	Market
Reserves	Two months	None	None	One month
Home-Buyer Education	Not required	Required (may be waived)	Required	Required
Comment	Conventional first mortgage for owner-occupied principal residence, (second/vacation homes and investor properties permitted at lower LTVs). Not typically used by LMI borrowers	Program used nationally for low- and moderate-income borrowers	Allows for community grant involvement and lower contribution from borrower's own funds	Liberal down payment requirement but stricter debt ratios required as well as reserve

[1]Fannie 97 is also available for no cash-out rate-term refinances of existing Fannie 97 mortgage.
Source: Fannie Mae; Listokin, Barbara and David. 1997. Rutgers University, Center for Urban Policy Research; Johnson, Ryan M. and Elsa Macias. 1995. *Home to Own: A New Model for Community-Based Low-Income Mortgage Lending*. Morrison Institute of Public Policy, Tempe, Arizona.

EXHIBIT 4.3
Financial Characteristics of Freddie Mac Standard and Affordable Mortgages

Mortgage Financial Characteristics	Standard Freddie Mortgage	Freddie Mac Affordable Mortgages		
		Affordable Gold 5℠	**Affordable Gold 3/2℠**	**Affordable Gold 97℠**
Application	Purchase or refinance	Purchase or refinance	Purchase or refinance	Purchase only
Targeted Income	No income limits	100% of area median income with high-cost area exceptions (e.g., 120% in California). No income limits in central city, low/mod income Census tracts, or high minority Census tracts. Income limits may be higher in areas targeted by specially negotiated programs.	100% of area median income with high-cost area exceptions (e.g., 120% in California). Income limits may be higher in specially targeted areas.	100% of area median income with high-cost area exceptions (e.g., 120% in California). Income limits may be higher in specially targeted areas.
Investor	Freddie Mac	Freddie Mac	Freddie Mac	Freddie Mac
Debt Ratios: Front/Back (Guideline Maximums)	28/36	No front-end maximum; 38% to 40% back-end maximum	No front-end maximum; 38% to 40% back-end maximum	No front-end maximum; 38% to 40% back-end maximum
Minimum Down Payment	5%—with MI 20%—without MI	5%	5% (2% may come from gift, grant, or subsidized second)	3%
Minimum Borrower Contribution	5%	5%	3%	3%
Maximum Loan-to-Value Ratio (LTV)	95%	95%	95%	97%
Private Mortgage Insurance (MI)	Required for LTVs over 80%	Required	Required	Required
Subordinate Financing				
Down Payment	Secondary financing from all sources allowed if first mortgage is less than 75% LTV and the combined LTV does not exceed 90%.	Not allowed for minimum down payment.	2% of the down payment can come from gifts, grants, secured or unsecured loan from a nonprofit, government agency or employer.	Not allowed for minimum down payment.
Closing Costs	Must come from borrower. Seller can pay up to 6% toward nonrecurring closing cost when the LTV is 90% or less; 3% when the LTV exceeds 90%.	Same as Affordable Gold 97	Same as Affordable Gold 97	Closing cost assistance can be in the form of gifts, grants, secured or unsecured loan from a nonprofit, government agency, or employer. Seller may contribute up to 3% toward closing costs.
Interest Rate	Market	Market	Market	Market
Reserves	Two months required	One month recommended, but not required	One month required	One month required
Home-Buyer Education	Not required	Required but may be waived for refinancings and if borrower puts up two months reserves	Required but may be waived for refinancings	Always required

Source: Freddie Mac; Listokin, Barbara and David. 1997. Rutgers University, Center for Urban Policy Research; Johnson, Ryan M. and Elsa Macias. 1995. *Home to Own: A New Model for Community-Based Low-Income Mortgage Lending*. Morrison Institute of Public Policy, Tempe, Arizona.

only a minimum down payment is required—3 percent to 5 percent of the purchase price. And not all of the down payment has to come from the borrower; 2 percent of the 5 percent is sometimes allowed to come from gifts or grants. The low down payments are mirrored by very high loan-to-value ratios (as high as 97 percent); and because these ratios are so high, private mortgage insurance is always required. Moreover, since closing costs, and not just the down payment, can be a hurdle to homeownership, payment of these costs with the GSE Affordable Mortgages can sometimes come from sources other than the borrower, such as a grant or a subsidized loan from a nonprofit group.[5] Because the mortgagor's income is constrained, higher front[6] and back ratios of 33 percent and 40 percent, respectively, are allowed. To better prepare the first-time home buyer in homeownership skills, homebuyer education generally is required.

The side-by-side comparison of the GSE Affordable Mortgage against the GSE Standard Mortgage, shown in Exhibit 4.1, (with further detail in Exhibits 4.2 and 4.3) emphasizes the changes between the two and the significant jump in affordability the GSE Affordable Mortgage offered. Across the board, the exemplary lenders lauded the contributions of the GSE Affordable Mortgages in enabling them to expand LMI-minority-based homeownership. For many of the exemplary lenders, the GSE Affordable Mortgage and the loans they use for minority-LMI purposes are indistinguishable with respect to the financial terms. Either all the loans they make are intended for sale to the GSEs (immediately following their origination, or subsequently), or they are comfortable with the GSE's specifications for all the loans they plan to keep in portfolio.

Some of the exemplary lenders offer even more liberal terms than the GSEs, however; these terms are listed under the Portfolio Affordable Mortgage heading in Exhibit 4.1. One important distinction involves the resources that a would-be borrower needs to assemble for the down payment, closing costs, and other purposes:

1. Both the GSE Affordable Mortgages and the Portfolio Affordable Mortgages typically allow a maximum 97 percent LTV mortgage, thus requiring a 3 percent down payment.

2. Under the GSE Affordable Mortgages, all (or a large share) of the 3 percent must come from the borrower, whereas under some of the portfolio products, the borrower contribution can be less than 3 percent; sometimes 1 percent or 2 percent, or even a token dollar down payment, suffices. The remainder—the difference between the 3 percent and the borrower contribution—can come from gifts, grants, or other sources.

3. Subordinate financing (e.g., a second mortgage) that is used to cover closing costs or to contribute to the down payment is allowed by both GSE Affordable Mortgages and Portfolio Affordable Mortgages. The terms of the latter are sometimes more liberal in this regard, however. The GSEs typically limit the source of subordinate financing (e.g., to a Federal, State, or local government, a

[5] Depending on the specific GSE Affordable Mortgage as detailed in Exhibits 4.2 and 4.3.
[6] Freddie Mac's GSE Affordable Mortgages have no maximum front-end ratio.

nonprofit or religious organization, or the borrower's employer). The portfolio lenders are more liberal in this regard.

To illustrate, both of the most liberal GSE Affordable Mortgages—Fannie Mae's Fannie 97 and Freddie Mac's Affordable Gold 97—require a 3 percent minimum borrower contribution. In contrast, one exemplary lender's affordable mortgage, although nominally requiring a 4 percent minimum down payment, allows buyer contributions as low as $250, with the rest to come from gifts or grants. One PNC loan (part of the "Living in Philadelphia" program, a negotiated product with Freddie Mac) has up to a 105 percent LTV (with a silent second mortgage to pay for down payment and closing costs). Such a high LTV-silent second combination would be impermissible under most GSE Affordable Mortgages.

These Portfolio Affordable Mortgage allowances were introduced in recognition of the minimal assets available to many minority-LMI households for the down payment and closing costs. The resources of these households are so insubstantial that even the greatly reduced GSE Affordable Mortgage requirements (e.g., a 3 percent down payment) can prove too great an obstacle.

All GSE products (with LTVs above 80 percent) also require private mortgage insurance—the cost of which frequently amounts to about a one-half percent charge on the outstanding loan balance.[7] Some of the portfolio mortgages (e.g., NationsBank CR2, PNC–DVMP Lower Income Target Program) do not require private mortgage insurance. Instead, some of the portfolio lenders self-insure their loans. They have found this coverage less expensive than what was offered by an outside private insurance company. Furthermore, some of the Portfolio Affordable Mortgages (NationsBank CR2, CR5, CR7, and Atlanta Mortgage Consortium loans) offer a 50 basis point interest rate discount off the market rate in certain instances, such as when a borrower has a "moderate" income.

Still, even though the Portfolio Affordable Mortgages modified some of the GSE Affordable Mortgages' financial characteristics, they have ended up much more alike than different. Like the GSE products, the portfolio loans are intended for LMI, underserved, and often first-time home buyers; both require counseling, even though under certain circumstances counseling can be waived. Although there are exceptions, both have very similar maximum LTVs, in the high 90 percent range; similarly, both typically are pegged to market interest rates. Both have very similar obligation ratios—a front-end of approximately 33 percent and a back-end at 38 percent to 40 percent, or somewhat higher. At times, portfolio lenders have pushed these ratios even higher, but they have generally been compelled to retreat. The Atlanta Mortgage Consortium, for example, originally allowed a 50 percent back-end ratio, but in light of rising delinquencies modified the ratio to a maximum 42 percent.

Sometimes the more liberal financial characteristics of the portfolio loans are offset by other more stringent characteristics. One exemplary lender requires only a 1 percent borrower contribution; however, it charges a .375 percent premium above the market interest rate, mandates an extra $50 monthly payment for a neighborhood stabilization fund, and opens its program to those earning up to 140 percent of the area median income. The GSE Affordable

[7]Generally, premiums are based on LTV, coverage, and other factors.

Mortgages, on the other hand, charge a market interest rate, have no stabilization fund requirement, and are targeted to lower-income borrowers—typically those earning a maximum 100 percent of the areawide median income. Another exemplary lender allows a minimum down payment of only $250; however, for mortgages exceeding $55,000, its maximum allowable front- and back-end ratios are lower than the GSE Affordable Mortgage rates—30 percent and 35 percent, respectively.

Still, most of the portfolio loans are characterized by somewhat more overall liberal financial requirements than those of the GSE Affordable products. The PNC case study illustrates this point dramatically. PNC makes portfolio loans precisely because they are more affordable to Philadelphia's minority-LMI population than the standard Fannie Mae Community Home Buyer Program and Freddie Mac Affordable Gold variations. (At the same time, however, this liberal portfolio lending is straining PNC.) A further delta of affordability is offered by the underwriting flexibilities, addressed below.

PROVIDE FOR FLEXIBLE UNDERWRITING OF THE BORROWER AND PROPERTY

The Best Practices literature is replete with calls for more flexible underwriting. The FDIC *Compliance Examination Manual* cautions that narrowly stipulated underwriting requirements—e.g., that the applicant have an "excellent" credit rating, "adequate" job longevity, and be purchasing a home with an "attractive appearance" in a "stable" area—can foster possibly unlawful discrimination by disproportionately denying minority mortgage applicants (FDIC 1994, 33). *Closing the Gap* calls for lenders to reevaluate their underwriting practices and to permit more flexible standards (Federal Reserve Bank of Boston 1993, 15). In a similar vein, the MBA-HUD Best Practices agreement calls upon lenders to promote flexible underwriting and to keep abreast of the discretion practiced by GSEs and other third parties (MBA and HUD 1994, A5-8).[8]

Many of the exemplary lenders studied by Rutgers acknowledged that industry underwriting practices had been a barrier to minority-LMI financing in the past; these populations, with fewer resources, often could not pass muster when the classic underwriting criteria were applied. Although some of the exemplary lenders, especially the neighborhood-oriented institutions, had been underwriting flexibly for years, this practice has become much more broadly diffused and was reinforced by the changes in acceptable underwriting established by the GSEs.

These changes have been quite significant. Historically, many underwriting standards concerning credit history, employment history, asset verification, and so on were very strict, as is detailed in Exhibit 4.4 under the label Historical Mortgage. Since 1990, however, underwriting requirements have been made more flexible for *both* the GSE Standard Mortgages and the GSE Affordable Mortgages. In fact, these two types of mortgages currently have nearly

[8] Similar recommendations and examples of such underwriting best practices can be found in HUD 1996a, 15-16; HUD 1996a, 4-10; Social Compact 1995, 113; National Community Reinvestment Coalition 1996, 2; Willis-Boyland 1993, 12; Federal Home Loan Bank of San Francisco 1994, 7.

indistinguishable underwriting standards.[9] Still, some institutions, in making loans for their portfolio and not the secondary markets, have ventured even further, adding an extra increment of mortgage qualification flexibility.

The changes in underwriting are summarized in Exhibit 4.4. The various underwriting considerations are divided into five sections: 1) credit history; 2) employment/income history; 3) asset verification; 4) property-neighborhood standards/appraisal; and 5) other. Each of these considerations, in turn, is explained below.

Flexible Underwriting for Credit History

There are three private credit bureaus or credit "repositories" in the United States: Equifax, Trans-Union, and Experian (formerly TRW) (Harney 1997, A-9). A credit bureau report from any of these repositories contains: 1) basic identifying data (name, social security number, date of birth, employment information); 2) types of credit in use; 3) length of time that the accounts have been open and payment behavior; 4) how much allowable credit has been accessed; and 5) if the consumer is seeking new sources of credit (Fair, Isaac and Company 1997, 2).

The credit bar for the Historical Mortgages was high. Institutions typically demanded a strong credit bureau report. Credit misdeeds were treated harshly. It was difficult to obtain a mortgage if a bankruptcy or foreclosure or other legal action had taken place within the past seven years.

The current GSE Standard and GSE Affordable Mortgages have changed the credit world, however (Exhibit 4.4). Recognizing that some people may not have obtained formal credit in the past, the GSE Standard and GSE Affordable Mortgages allow credit to be established via alternative means. And realizing that credit misdeeds may occur, especially among lower-income

[9] There are very few technical differentiations. One instance: boarder income is included as a compensating factor for higher qualifying ratios for GSE Affordable Mortgages but not for GSE Standard Mortgages.

EXHIBIT 4.4
Mortgage Borrower and Property Underwriting Criteria

<table>
<tr><th rowspan="2">Underwriting Criteria</th><th colspan="3">Mortgage Type</th></tr>
<tr><th>Historical Mortgage</th><th>GSE Standard Mortgage and GSE Affordable Mortgage</th><th>Portfolio Affordable Mortgage[1]</th></tr>
<tr><td rowspan="3">I. Credit</td><td>a. Strong formal credit record required</td><td>a. Credit can be established through alternate means
Blemished credit is not sufficient grounds for denial
• Occasional lapses accepted
• Extenuating circumstances accepted</td><td>a. Essentially the same parameters as GSE Affordable, with somewhat greater flexibility
Examples:
• Medical actions discounted
• Greater receptivity to extenuating circumstances</td></tr>
<tr><td>b. Strong credit bureau report required</td><td>b. Flexible treatment of credit scoring</td><td>b. Credit scoring is de-emphasized</td></tr>
<tr><td>c. No legal action (i.e., judgment, bankruptcy, or foreclosure) within past seven years</td><td>c. Legal actions two years or older can be discounted with reestablished payment history and no late payments</td><td>c. Legal actions may be discounted after one to two years if action is explained (e.g., extenuating circumstances) and clean repayment record has been maintained</td></tr>
<tr><td rowspan="7">II. Employment/ Income</td><td>a. Must document same occupation and employee history for two years, minimum</td><td>a. Must document income (not necessarily job/employer) stability for two years</td><td>a. Must document income (not necessarily job/employer) stability for one to two years</td></tr>
<tr><td>b. Overage (e.g., bonuses) and seasonal income only included if consistent over two-year period and expected to continue at same or increasing level into future</td><td>b. Similar to Historical Mortgage; overtime and bonuses are averaged over a two-year period</td><td>b. Same as Historical Mortgage</td></tr>
<tr><td>c. All third-party provided income included if there is a history of such payments and income is expected to continue into the future (no mention of special treatment, e.g., gross-up of nontaxable income)</td><td>c. All third-party provided income counted; nontaxable income is “grossed-up.” (Sometimes social security income is also “grossed-up.”)</td><td>c. Same as GSE Affordable Mortgage</td></tr>
<tr><td>d. Tax benefits of homeownership not included as income</td><td>d. Same as Historical Mortgage</td><td>d. Tax benefits of homeownership may be included as income</td></tr>
<tr><td>e. “Boarder” income not included (rental income is included)</td><td>e. Boarder income included as a compensating factor for higher qualifying ratios for GSE Affordable Mortgage, but not for GSE Standard Mortgage</td><td>e. Same as GSE Affordable Mortgage</td></tr>
<tr><td>f. In addition to primary applicant’s income, only income of comortgagors is included</td><td>f. Same as Historical Mortgage</td><td>f. Income of all adult household members may be counted (even noncomortgagors)</td></tr>
<tr><td>g. Strict verification on all income components required</td><td>g. Verification on all income components required; verbal confirmation may suffice[2]</td><td>g. Essentially the same as GSE Affordable Mortgage, with exceptions</td></tr>
</table>

[1]The GSEs sometimes purchase portfolios of Affordable Mortgages when lenders need liquidity relief.
[2]Alternative documentation of income is acceptable, with the option of the borrower providing original pay stub(s) and two years IRS or W-2 forms and the lender verifying current employment by telephone.

EXHIBIT 4.4 (continued)
Mortgage Borrower and Property Underwriting Criteria

Underwriting Criteria	*Mortgage Type*		
	Historical Mortgage	***GSE Standard Mortgage and GSE Affordable Mortgage***	***Portfolio Affordable Mortgage***
III. Asset Verification	a. Asset history must be verifiable (cash on hand not accepted)	a. Asset history must be verifiable; for GSE Affordable Mortgage, cash on hand is acceptable in specific situations	a. Assets not always verified and cash on hand frequently accepted
	b. Borrowers must provide all funds for down payment and closing costs	b. A portion of funds for down payment/closing costs may be provided by outside sources	b. Generally the same as GSE Affordable, but some allow most/all down payment from outside sources
	c. Only gifts from family members allowed; monies identified as gifts must be verified as such (e.g., letter from family member specifying that transfer is absolute and repayment not required)	c. Gifts allowed from family members (after the borrower contribution is satisfied); public grants acceptable, but transfers from seller and Realtor are restricted	c. Gifts generally allowed from more sources than GSE Affordable (e.g., transfers from seller or Realtor are permissible)
	d. Collateralized loan (e.g., on personal property) is acceptable as asset with strict verification	d. Collateralized loan more readily acceptable	d. Same as GSE Affordable
IV. Property-Neighborhood Standards/ Appraisals	a. Neighborhood counts in appraisal (positive and negative)	a. Positive aspects of neighborhood are stressed (e.g., recent rehabilitation or new construction)	a. Same as GSE Affordable
	b. Property economic and functional obsolescence negatively affects valuation	b. Obsolescence discount deemphasized by recognition of wider range of acceptable standards	b. Same as GSE Affordable (often good condition of property is stressed and home inspection required to avoid situations where properties need major repairs early on)
	c. “Comps” (comparable sales) utilized are restricted by distance (from subject property) and time (sales within last six months)	c. Greater range of “comps” accepted	c. Same as GSE Affordable
V. Other	a. Contingent liability debt (e.g., cosigned loan) included in total debt (back-end) ratio	a. GSE guidelines concerning contingent liability debt require the lender to verify a history of documented payments by the primary obligor and ascertain that a history of delinquent payments does not exist for that debt. When this cannot be done, the lender includes the contingent liability as long-term debt when calculating the borrower’s qualifying ratios.	a. Same as GSE Affordable—contingent liability debt may be excluded from back-end ratio if the primary borrower has a consistent payment history that is verifiable
	b. Pooled asset funds (i.e., those drawn from formal/informal alternative savings accounts, such as su-sus) may not be included in assets even if the funds drawn are not repayable	b. Pooled asset funds may be used for both GSE Standard and Affordable Mortgages and are subject to guidelines established for cash on hand	b. Pooled asset funds more readily acceptable

Source: Fannie Mae; Freddie Mac; Listokin, Barbara and David. 1997 Rutgers University, Center for Urban Policy Research.

households and those new to using credit, the GSE Standard and GSE Affordables are more tolerant of occasional credit lapses, as long as a pattern is not indicated and the lapses are due to extenuating circumstances (e.g., illness, unemployment linked to downsizing, or a spouse's death). Actions older than two years are discounted if payment history has been reestablished and there have been no late payments. [10]

In cases of no prior credit use, which numerous exemplary lenders said was a common occurrence among the minority-LMI population, an alternate credit record is established by looking at rent, utility, and other regular payments. One of these lenders encouraged casting as wide a net as possible to collect evidence of "regular" payments, and mentioned church tithing and informal grocery store accounts as examples.

The Navajo Partnership for Housing, however, found that many Native Americans have no traceable regular cycle of payments. Many reside with relatives—and therefore pay no rent—usually in a unit with no utilities, hence no utility bills. People's Bank pointed out that the recipients of the regular payments from would-be mortgage applicants may not always be forthcoming with information. A bodega owner, for instance, who has numerous cash accounts with customers, might not want to—or cannot—acknowledge that source of income to a bank. People's Bank also mentioned the sometimes untoward motives of landlords. When contacted by the bank or credit bureau about a tenant's payments, a landlord sometimes "worsens" the record of a timely payer, because the landlord does not want to lose such a tenant to homeownership. Alternatively, landlords sometimes "improve" the record of slow payers because the landlords are only too happy to have these tenants leave.

Exemplary lenders also decried the time it took to establish alternative credit on utility payments. Utility companies are not always quick to provide records of utility payments, and if the payments were made in cash, the mortgage applicant may not have a record of payment (i.e., a cancelled check). Although new companies (e.g., CREDCO) have been formed to meet the needs of establishing alternate credit records, and existing bureaus (e.g., Experian) now provide this service as well, these companies often simply report the information collected. The time-consuming effort of assembling the materials still, typically, has to be done by the applicant, the intake staff at the lender's office, and/or by a homeownership counselor. [11]

Still, the exemplary lenders believed that they were routinely successful in establishing credit by alternative means, as per the GSE guidelines. One noted:

> We use a "nontraditional credit file"—utility payments, rental payments, etc. . . . We often find that [applicants] don't have bad credit . . . they have *no*

---

[10] Current GSE Standard and Affordable Mortgage guidelines state that a bankruptcy must have been discharged fully and the borrower must have reestablished good credit and demonstrated an ability to manage financial affairs. The GSEs consider an elapsed time of at least two years between the discharge of the bankruptcy and the mortgage application as sufficient time to reestablish credit. Generally, GSEs will not purchase or securitize a mortgage if the borrower has been a defendant in mortgage foreclosure proceedings that were completed in the past three years. In general, the GSEs have become more flexible with regard to isolated instances of minor delinquency, when no adverse pattern is evident, particularly if the delinquency was over two years ago.

[11] The credit reporting agencies and other companies have begun to take more of the burden of documenting the alternate credit reports.

> credit. So we document it with nontraditional standards. We have [successfully] based this on the GSEs' approach in this area over the past few years.

For many of the exemplary lenders, blemished credit is a thornier issue. One stated: "We breathe a sigh of relief when someone has no credit as opposed to bad credit." Blemished credit is a common problem in the underserved markets. The Navajo Partnership for Housing indicated that more than 90 percent of the people it counseled had blemished credit records. Other exemplary lenders, dealing with different segments of the minority-LMI population, had similar experiences. The blemishes come in many forms and are the result of a variety of forces.

Lesser economic resources. Those at the margin are more prone to fall behind in payments than the average mortgagor. The CRA officer at First National Bank of Farmington, for example, noted that there is little economic resilience on an Indian reservation: "If an Indian loses his job at the utility plant or at BIA (Bureau of Indian Affairs), there is not necessarily a second job, so of course payments slip."

Minorities and LMI populations also have fewer resources in the way of medical coverage. They are disproportionately less covered than the population at large; many have no coverage. A blemished credit record may often follow their receipt of medical care because: 1) the person treated did not have the resources to pay; 2) there are slip-ups (e.g., Medicaid is supposed to pay, but in the interim, a credit action is filed by the physician and the hospital); or 3) work lost to either the medical problem or caring for a household member with a medical problem diminishes income. One exemplary institution pointed out:

> A lot of minorities don't have insurance coverage, so they get nailed by doctors with judgments and all that. You don't find that in the upper-income levels, because they had insurance coverage or the company takes care of it, or whatever.

Lesser familiarity with credit. Many poor and minority populations are simply unfamiliar with the mechanics and importance of credit. An exemplary lender noted:

> Many urban and low/mod (income) persons do not have the benefit of parents sitting around the table and talking about budgeting and savings, and writing checks. The underserved are not aware of certain things and are not being taught that in schools, by parents, or guardians. So there is a lack of education and a lack of awareness of how important certain things are and how you must put yourself in a good credit position for a major purchase, such as a home.

There is a prosaic yet consequential side to this lack of awareness. Berean Federal Savings Bank spoke of numerous customers who had bad credit histories because they had received a dunning notice from a department store or hospital that was in error, and people simply did not know enough or did not have the time to clear up the matter. Some bank customers also did not know there was a two-week grace period for missed payments.

Prior credit. Past credit delinquencies are more common when the only credit available comes attached with usurious rates. This is the catch-22 of minorities and LMI populations. To some extent, the credit abuses of the past have robbed them of their credit opportunities of the future. First National Bank of Farmington (FNBF) spoke of this situation with respect to Native Americans. FNBF pointed out that these people are the poorest of the poor. In the past, they spent much less on housing than other Americans, either because there were no mortgages to be had, or because they lived in very low-rent public housing, or with their families. One avenue of spending available to them—with ready, but expensive, credit attached—was for automobiles and trucks. Car or truck payments of $400 or $500 a month are not uncommon among some Indian households, according to FNBF. With little economic resilience, these households, not surprisingly, often fell behind in payments. Ironically, according to FNBF, these households were not dissuaded from such delinquency by any apprehension that it might mar their chances to obtain a home mortgage in the future, since home mortgages were unavailable to them. FNBF, the Navajo Partnership for Housing, and many others are now trying to make home loans for Indians a reality. But, a major hurdle is redressing the destructive credit cycle of the past.

Cultural biases. Often, the line between a slow payer, to whom a creditor will extend forbearance, and a miscredit, against whom a creditor decides to file a credit action, is very thin. Minority-LMI persons often are not given the benefit of the doubt. As one exemplary lender related:

> My perception is that many of the low- and moderate-income [populations], because of the credit experiences they have had, run a risk of greater credit problems. Less access to traditional credit. When they have traditional credit, I think that the creditors have been less willing to work with them than with others. So we tend to see more credit blemishes.

Incorrect credit records. Most of the exemplary lenders reported a disproportionate number of incorrect credit bureau reports for minorities and LMI households. Berean Federal Savings Bank and Trent Financial noted that as many as 25 percent of the minority-LMI households they dealt with had credit histories tarnished by incorrect credit reports. Trent added humorously that for its clientele [Trent's customers are 90 percent minority], the acronym TRW[12] really stands for "This Report's Wrong" (Trent Financial 1997).

According to the experiences of exemplary lenders, (admittedly anectodal rather than statistical), errors are more frequent for minority-LMI persons because:

1. There are similarities in names or errors in the spelling of names, especially among individuals of Hispanic descent, or immigrant groups. Variations in what name a woman uses in common law marriages or after a divorce adds to the conundrum.

2. Social Security (SS) numbers, which are supposed to infallibly identify a person, may not be infallible if people don't know their SS number or have been using someone else's.

3. Reporting errors. As noted earlier, a medical judgment that shows up on a credit bureau report may very well be in error. Although a middle-class majority household may spend the time to rectify the error, minority-LMI households, that may be less

[12] As noted earlier, TRW a credit repository, has since been renamed Experian.

> familiar with the system, may not. As a result, the error remains on their credit record.

One exemplary lender sends potential mortgage applicants to NHS for counseling:

> NHS runs a credit bureau report. There have been a couple of times when a credit report was shown to the people and they said "This is not mine." There is the whole issue of the Social Security numbers with immigrants using each other's Social Security numbers.

Some of the exemplary lenders indicated that they had flexible credit policies long before the GSEs changed their credit standards. Berean noted, "We push really hard on credit; this has been our policy for years. We allow all kinds of flexibility—criminal record and credit blemishes." Yet, most of the lenders acknowledged that the GSEs had revolutionized the industry. Credit now needs to be only reasonably good, not sterling, and past credit experience can be viewed as part of an overall assessment of the applicant, with compensating and extenuating circumstances acknowledged. As one lender explained:

> We [now] take alternative documentation; we are flexible on some blemished credit. This has been done since the 1990 establishment of programs [by the GSEs].

A look at how lenders deal with medical-related credit blemishes today is also instructive. One exemplary lender noted:

> Many times a minority does not even know what their credit background is, and it is an experience to see their credit report and then sit down and ask "What happened here?" Unpaid medicals are common. If it is a collection account and the doctor reported them and they explained it to us, we will probably accept an explanation from such a person, especially when they don't have medical coverage—and you find that in minorities more. So we will recognize it. If you find a judgment on an upper-income person in the same way, we will probably look at it differently. We will look at it more favorably on the minority side of it than on the upper-income side of it.

A different exemplary lender recounted similar experiences:

> I think that there is not any real boilerplate of what is acceptable. We will accept reasonable explanations for credit problems. We will discount medical collections, especially in the African American community. (When I say "especially," we will do it for anybody, but we see it more predominantly in the African American community, where you have hospital–medical collection accounts.) Culturally, or actually because of centuries of discrimination, a lot of people never had hospitalization insurance, so they end up with that kind of a blemish on their credit record. So we discount that, and we don't even pay attention to collection accounts from medical institutions or doctors.

"Extenuating circumstances" are given much more credence by the exemplary lenders. One lender joined a consortium that, as a matter of policy, will not disqualify an applicant on medical-related collection issues. Another discounts slow retail payments in January (after the Christmas gift-giving season). PNC views all medical collections and utility delinquencies judiciously. As PNC explains, in order for a utility customer to qualify for hardship assistance (i.e., to get special dispensation from a utility company), the customer must first be delinquent in payment. Countrywide stresses the importance of local branch underwriting—as contrasted with a centralized unit taking on this function. It assumes a branch's greater knowledge of, and sensitivity to, local conditions that could affect the credit histories of applicants, and gives, as one example, a major plant closing that might temporarily spike up credit delinquencies in an area.

The more flexible the credit standards become, however, the more some lenders, and borrowers, try to stretch them even further. Some exemplary lenders complained that if they applied the maximum measure of flexibility in underwriting, especially in credit underwriting, the number of questions raised by the GSEs as part of their quality control oversight would increase.[13]

Lenders who feel constricted by the GSEs have responded by lending more to portfolio. These lenders acknowledge that the GSEs have been a significant force in changing the industry's perspective on what is bankable, but they also point out that the way to extend the concept of affordability for minority-LMI populations is to not be bound by the GSE underwriting parameters. (See Exhibit 4.4.) One exemplary lender noted:

> At the loan application stage, we are as flexible as possible; we're not just a mortgage company, so we can hold many of these things in portfolio. If it doesn't qualify for Fannie or Freddie, then we will hold it in our portfolio. At the basic underwriting level, we understand that the GSEs are flexible, but you can't go too far beyond their

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[13] The GSEs examine loan files when they are selected for review under the GSE's quality control program. Reviews may be one of three types: random selections, early payment defaults, or post-foreclosures. When issues arise from an underwriting review, the GSEs provide the lender an opportunity to explain how it underwrote the loan. It should be noted that the GSEs have acted to support lender flexibility in underwriting. An example is the policy concerning "repurchases"—loans lenders have been required to "purchase back" from the GSEs. Repurchases for Fannie Mae decreased substantially in 1997 in response to several initiatives introduced, including Fannie Mae's Community Home Buyer's Program Clean Slate, under which a lender would not have to repurchase any Community Home Buyer's Program loan sold to Fannie Mae that had 24 months of timely payment and was not ineligible.

> thresholds. On the other hand, when we decide to hold things in our portfolio, we can ignore their numbers.

Some of the exemplary lenders praised the FHA, and contrasted it with conventional market "mind-sets." As one explained:

> With FHA, it is usually a matter of explaining the issues related to credit. If you give them a detailed explanation, why the situation occurred and why it should not impair the borrower's ability to pay the loan, then you can make that case. On the conventional side it is not that easy. You have two problems: 1) you usually deal with a credit score, and that represents an absolute decision; and 2) now you must get explanations, and sometimes lenders are hesitant to take loans like that and pass them off onto Fannie or Freddie. What we would like to do is to gradually try to expand the box on the conventional side to ensure that more people are able to get into the conventional door.

Credit underwriting, when lending to portfolio, is a "nuanced change" from GSE policy. It may mean greater tolerance for medical collection problems for minorities and LMI populations. It may mean that more January retail store late payments will be tolerated, along with slower wintertime payments on utility bills. It may mean giving the benefit of the doubt that the next economic downturn will not affect a particular applicant. It may mean a shorter time frame needed to re-establish credit after an "action"—i.e., judgment, bankruptcy, or foreclosure. GSE underwriting calls for at least two years of timely repayment of remaining debt and other obligations after an action. One exemplary lender, in loaning to portfolio, discounts actions after one to two years; other exemplary lenders have shortened that period to a year. The logic is that if someone is responsible in meeting all debt obligations for a period of twelve to twenty-four months, that person is probably able to handle a mortgage.

Portfolio lending decisions may also pay less heed to credit scoring.[14] Credit scores are developed from the credit bureau reports. The most common is the one developed by Fair, Isaac

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[14] Credit scores are compiled by credit bureaus and use data on borrower credit histories to determine a statistical analysis about "good" or "bad" customers. Mortgage scoring ranks specific mortgage loans in terms of their relative credit risk and uses data on the type of loan; the type of property; data from the credit score; information from the loan application, LTV and debt-to-income ratios; cash reserves; and the applicant's years on the job to forecast the likelihood of default for individual mortgage loans.

An example of mortgage scoring is Freddie Mac's Gold Measure. As described in *Freddie Mac's Tools for Expanding Markets* (Freddie Mac 1997, 46-47), Gold Measure is a program that helps balance the risk factors that lenders must consider when using the underwriting flexibilities of the Affordable Gold Program. Gold Measure provides a worksheet that identifies borrower and loan characteristics to help evaluate credit risk.

Freddie Mac developed Gold Measure after statistically analyzing millions of loans and over 100 variables to determine what factors, when combined, increase risk and the likelihood of a loan going into default. The worksheet measures these factors within the following categories: credit; income; loan size, collateral; assets; debt payment-to-income ratio; loan/property type.

Correlated to Freddie Mac's statistical findings, risk units (RUs) are assigned for each of the factors on the worksheet. When the number of RUs for each category are added together, the total RUs provide a guideline for the risk associated with the loan.

This summary of worksheet RUs shows how Freddie Mac's Gold Measure worksheet quantifies risk factors and risk offsets:

Risk Factors Measured by the Gold Measure Worksheet

and Company, Inc., known as the FICO score.[15] FICOs run from above 800 to below 400. The scores purportedly rank-order applicants according to the likelihood that they will default in the future, with higher scores indicative of lower default risk and lower scores indicative of higher default rates. (See Exhibit 4.5.)

EXHIBIT 4.5

FICO Score	*Interpretation*
720 and above	Risk of loan default is statistically very low
660-719	Risk of loan default is low
620-659	Risk of loan default is higher
Below 620	Risk of loan default is statistically very high

The GSEs strongly encourage lenders to use credit scoring as one of the components of credit risk assessment, and mention FICO specifically (Fannie Mae 1995, 2). Fannie Mae and Freddie Mac both have expressed the view in memoranda that FICO scores below 620 denote relatively high credit risks that loan underwriters should not approve unless there are compensating factors (e.g., a lower LTV mortgage) or extenuating circumstances (Fannie Mae 1995; Fannie Mae 1997; Freddie Mac 1995).

The GSE guidelines repeatedly stress, however, that credit scores such as FICO "should not be the sole determining factor in reaching an underwriting [decision]," but rather should be part of an overall evaluation of the applicant (Fannie Mae 1997, 11). Again, this is a matter of nuance.

For portfolio lenders, credit scores often cast less of a shadow on the overall underwriting evaluation than they do for straight secondary market lenders. The portfolio lenders more readily accept applicants with lower scores than the comfort range of the GSEs; they often accept FICOs in the mid 500s. In general, portfolio lenders seem to place less credence on the scores than their straight secondary market-oriented counterparts.

Risk Factors	**Risk Units (RUs)**
97% LTV	11
1 month's cash reserve	5
38% debt-to-income ratio	2
FICO bureau score 712	0
Total RUs	18
Risk Offsets	
Another borrower with income on the application	-2
Total offsets	-2
Net RUs	16
Guideline	15

Loans with scores equal to or less than 15 RUs are generally acceptable for sale to Freddie Mac provided no other risk is apparent from the review. If additional risks are found, they must be documented and factored into the decision on determining the investment quality of the loan. With a score of 16 RUs, the loan is generally acceptable for sale to Freddie Mac only if there are documented offsets that are not captured in the Gold Measure worksheet.

As with credit scoring, mortgage scoring, by making underwriting less subjective, can possibly aid minority-LMI mortgage applicants. But as with credit scoring, mortgage scoring has elements (e.g., the FICO score) which if applied mechanically can work to the detriment of the marginally qualified.

[15] FICO scores are based on complex statistical evaluations of the raw data in the credit bureau reports and relate those factors most highly correlated with credit repayment performance.

PNC's experience is illustrative. The bank intakes information from a would-be borrower on a laptop and churns that data to arrive at a credit score. The applicant is then "tracked." As one PNC official noted: "If the score is high enough, I move them [the applicants] to sellable (i.e., secondary market) products. If I know that I have problems with credit that will not get past the secondary market, then I move them to a portfolio product" (PNC 1997). PNCs portfolio borrowers typically have FICOs below 619 (in the GSE gray area); many have FICOs in the 500s.

The experience of an exemplary nonprofit is somewhat similar to PNC's. It looked at FICOs:

> ...for entertainment value only, because our applicants often have lower credit scores. We have people who average around 550. The GSEs cutoff is something like 620. Our average deal is 550, so we are way under where they would be. But we can make them work and they turn out to be very good homeowners with excellent track records. Even better than our home improvement loans.

The experience of this nonprofit shows why this study refers to Portfolio Affordable Mortgage lending as a "nuanced difference," rather than a marked departure, from the GSE Standard Affordable Mortgage lending. Lenders such as this one sometimes place loans initially in their own portfolio, and after they are seasoned, sell them to the GSEs. One lender noted that the GSEs "also cut us some slack on some of our deals."

Credit scoring is a very controversial topic; it has critics, yet there is statistical evidence that credit scores "work well for all types of borrowers regardless of income and race" (Wildausky 1996). (Susan Wachter and Paul Calem [1997] have also found that credit scoring helps in underwriting affordable loans). It is not the intent of this study to analyze the scoring quantitatively. It is instructive, however, to briefly note some of the misgivings the lenders contacted by Rutgers had about credit scoring, especially as it related to minority-LMI populations. Again, these misgivings are anecdotal; they do not represent a statistical compilation.

1. *Credit Critical Mass*. One concern of lenders was the balancing of "good" credit with "bad." Since minority-LMI persons typically have used credit less often than the general population, if they have experienced bad credit (as many have), their delinquencies will have more impact on their overall credit score.

2. *Insufficient Scoring Nuances*. Another concern was that the computerized scoring did not distinguish between different types of credit blemishes, nor did it adequately incorporate explanations. The proverbial example was problems with medical collections which are so common in the minority-LMI population that many of the lenders routinely discount such blemishes. Computerized scoring does not discount medical-related delinquencies, however. Nor, claimed many lenders, do the credit bureaus raise the score after such a blemish is explained (e.g., after it is demonstrated that the medical charge had indeed been paid to the hospital or physician or that the indicated credit blemish is actually an error resulting from double billing). Many exemplary lenders indicated that mortgage applicants with numerous medical credit

problems (not uncommon) could not get above a 550-600 FICO, even with an explanation. While the GSEs do purchase loans with FICO scores below 620, they require compensating factors or extenuating circumstances—and these conditions are far from universally available for minority/LMI mortgage applicants.[16]

One minority nonprofit decried the scoring's mechanistic approach that does not incorporate the cultural nuances of credit that characterize the African American households it counsels:

> We're very leery on credit scoring. One reason we're very leery of it is because who's put together the models? A banker. They don't have a clue. They don't know. They go in at eight and come out at five. They don't have a clue. All they know is that their bills get paid.
>
> I'm trying to get lenders to send us people that have been rejected by low scores to get underneath the veneer and see what caused the rejection based on the model. Was it the slow paying? Was it the slow payment that was ten months old versus eight months old, did that make a difference? Was it the medical payment? What was it that bounced them out of the system? Was it a missed child care payment that sent the score down? Yet the situation is one where child care is informally being paid by the ex-spouse who is solidly employed.
>
> I am appalled at the credit scoring. We have told several lenders, if you use it, you will become a nonlender to our community again.

3. *Credit Shopping*. Minority-LMI persons may very well go to more places to inquire about credit than the average mortgage applicant, since they have a harder time qualifying. They may, in fact, be counseled to "shop around" by the numerous agencies involved in improving consumer education and credit skills. Yet, the very act of credit shopping hurts one's credit score.

   Federal Reserve Governor Lawrence B. Lindsey can attest to the high cost of credit shopping. Lindsey, who earns a six-figure salary, was turned down for a Toys-R-Us credit card because he received a low credit score due to multiple requests for his credit report during a six-month period (Wildausky 1996, 307). The Lindsey incident involved retail credit as opposed to mortgage credit and retail creditors may look at scores differently than mortgage creditors. Nonetheless, credit shopping may affect the ability to secure credit—for all purposes.

4. *Credit Card Balances.* People in the United States generally borrow against the equity in their house or take out a personal line of credit. Since minority-LMI populations typically don't have the luxury of the former, they must turn to the latter, a personal line of credit—to the extent that they use bank credit at all. Commonly, their personal

[16] The GSEs have publicly stated that it is inappropriate to decline a loan solely because of a low FICO score. GSE policy is that the lender should determine if there are compensating factors that support approval of the loan or if extenuating circumstances exist that resulted in a low score. Written evidence on underwriting low FICO scores is found in such documents as Fannie Mae's lender letter 01-97.

bank line will be issued through a credit card. Computerized credit underwriting reportedly downgrades credit scores if there are any high credit card balances, however—even if the credit card holder's income is commensurate with the balance and even if the credit card repayment record is good.

5. *Accuracy of the Underlying Information.* Credit scores are derived from the information assembled by the credit repositories. If credit bureau reports are wrong—not an uncommon event for minority-LMI persons—then the computerized score will also be an inaccurate indicator of credit capacity.

Despite the problems associated with credit scoring, the exemplary lenders did recognize that the process has some merits. (See Wildausky 1996; and Wachter and Calem 1997.) Since underwriting is an act of judgment, and that judgment can be tinged by racial or cultural bias, efforts at underwriting mechanization that reduce the number of judgment calls, such as credit scoring, can foster the goal of equal treatment. Some of the lenders referred to studies commissioned by Freddie Mac that showed that more minority applicants had qualified for mortgages with the help of credit scoring than without it (Countrywide 1997).

Exemplary lenders recommend *applying credit scoring judiciously*. They recognize scoring's benefits—its attempt to add greater standardization to underwriting and in so doing reduce the racial and cultural biases that have tinged the process in the past. They also recognize its inevitability; the lending industry is moving inexorably toward automated underwriting, and credit scoring is part of that process. They recognize its foibles; scoring may be very similar to a Scholastic Achievement Test (SAT) with built-in cultural bias. Still, most people recognize that the SAT has benefit if used with discretion—and so does credit scoring. As a start toward this judicious use, deleting medical judgments in the scoring programs should be considered.

Credit scoring can also be useful as a tracking device. Applicants with high scores are an order of magnitude more creditworthy than applicants with low scores and are closer to successfully securing a home mortgage, especially through a mortgage product slated for the secondary market. Applicants with somewhat lower scores need more work. Their bureau reports and credit scores have to be carefully scrutinized for the underlying accuracy of the data and the mechanics of the scoring. The reports by FICO and others contain "score factors" or "adverse action code explanations" that give insights into the scoring; these would need to be reviewed. This review might lead, in turn, to a higher re-score on a second go-around. If the same score is maintained and if the applicant is "referred back" by the GSEs, the lender can make a "case" to the GSEs (e.g., explain that the lower score is due to questionable medical judgments). If the application still does not meet secondary market criteria, the loan can be taken in portfolio. Multiple exemplary lenders have made portfolio loans to applicants whose credit records placed them outside GSE standards without incurring unacceptable delinquencies. Applicants with the lowest scores should be referred to counseling for longer-term credit repair, however. Only after they have repaired their credit should they reapply.

Countrywide advocated this tracking approach for credit scores and implemented it in the following manner:

> For other lenders, the FICO scores might be more cut and dry. We use them as a way to say the people above this score, that is a slam dunk, you don't have to spend any time on that one. Just make sure it is all documented, get it together and approved. We don't use it as a disqualification. We use it as "let us get the easy ones done right now." The ones below that, we have to work with them and say what else is there here that makes the loan.
>
> A little side note: Our chairman, his personal reaction to anything that resembles a computerized score versus looking a human being in the eye and figuring out whether you should give them the loan, is just not the way to go. He thinks that all lending is a personal, local type of thing. He gets red, emotionally upset, when you talk about credit scores.
>
> We also recognize that the jury is still out on scoring and there have been studies that it actually qualified more minority applicants than it disapproved because it made the underwriter more comfortable with different credit histories. There are a couple of late payments here but this score is still okay. Yet, I don't want some computer to validate if I am good or not good.

Most exemplary lenders shared Countrywide's ambivalence toward scoring. The question facing the industry now is how to realize the benefits of scoring without adversely affecting the historically underserved (Wildausky 1996).

Flexible Underwriting for Employment, Income, and Assets[17]

The Best Practices literature has called for greater flexibility regarding employment, income, and asset underwriting, and recent years have witnessed sweeping changes in this area in tandem with greater flexibility on the part of the GSEs (Federal Reserve Bank of Boston 1993,

[17] In considering employment, income, assets, and property neighborhood standards and appraisals, the exemplary lenders' underwriting practice was essentially the same as the GSEs' for their Standard and Affordable Mortgages. Accordingly, the discussion of these practices is briefer than the discussion of credit underwriting.

13-14; Federal Home Loan Bank of San Francisco 1994, 7).[18] (See Exhibit 4.4.) The exemplary lenders essentially follow these GSE criteria. Some of the more portfolio-oriented lenders have introduced incremental flexibilities. They include the income of all adult household members, not just those that are co-borrowers to the mortgage note, for instance. (The GSEs require a co-signing commitment.) Allowing this pooled income reflects the reality of many mortgage applicants (especially minority-LMI immigrant households) where the collective household must contribute to the mortgage payment. The same logic applies to the *cunedas*, or informal loan collectives. If immigrant populations are accumulating assets in this fashion, albeit not a "bank" in the formal sense, why not count the resources assembled in *cunedas* as assets for closing? (The GSEs have recently relaxed their standards on the *cunedas*.)

Another feature of mortgage flexibility concerns income verification. The lending industry has a difficult choice in this regard: do you recognize the existence of the underground economy so important to the poor and immigrant populations and count unreported, or "quasi-reported," income for mortgage qualification purposes? Or do you insist that the only countable income is that which is reported to the IRS and verified by that agency? The Historical Mortgage had the latter as a standard. The current GSE Standard and GSE Affordable Mortgages allow some flexibility in that "confirmation" of continued income may sometimes suffice.[19] A few of the portfolio affordable mortgages are especially lenient. One exemplary lender, located in California where there is a large underground economy, accepts a maximum of $1,000 a month of undocumented income—if that income comports with the household's expense pattern (e.g., if the household is spending $2,000 a month and has IRS reported income of only $1,000).

Another exemplary lender in California described how it changed its asset policies to comport with its large Hispanic market:

> We have gone and designed basically specific underwriting guidelines for the Hispanic culture—a lot of cash on hand and they don't have to have formal institutional financial relationships.
>
> This is not cookie-cutter off the computer, and we have trained underwriters in-house in the new policy.
>
> The Hispanics may not have any banking accounts established. They come to us and say, I want to buy this home, I am dealing with XYZ realtor, I have the cash at home, I have $15,000 and I am going to get another $10,000 gift from a combination of my three

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[18] Current underwriting with respect to employment, income, and assets has been significantly liberalized, especially in comparison to what we refer to as the Historical Mortgage. This is true for both the current GSE Standard Mortgage and the GSE Affordable Mortgage. For both of these mortgages, earning "capacity" over the near term (1-2 years) is stressed (not just the same job, employer, or occupation); overage and seasonal income is more generously included, as is third party and other income; and the verification requirements have been somewhat relaxed. Assets, too, are regarded more leniently. For instance, closing costs can come from outside sources and monies for the down payment can be of a "shorter duration" (e.g., cash-on-hand is acceptable following specified guidelines). Alternative documentation of income is acceptable with the option of the borrower providing original paystub(s) and two years of IRS or W-2 forms with the lender verifying current employment by telephone.

[19] The GSEs have specific guidelines for the acceptance of cash-on-hand that call for the deposit of these funds in a financial institution at the time of loan application.

> brothers. The question is, how do you get comfortable that the money is truly not borrowed. If it was borrowed do you truly care?
>
> We simply ask the applicant to deposit the money into our bank and make sure that their name is the only name on the account. This gives us a pretty good degree of comfort.

Another lender dilemma concerns third-party income. The current GSE Standard and GSE Affordable Mortgages count all types of third-party income, such as welfare (aid to families with dependent children or AFDC), alimony, and child support (if a continuous payment history can be shown and is likely to continue into the future)—and allow this income to be "grossed-up"—a lender colloquialism for the addition of 15 to 30 percent of the nominal value of any payments that are nontaxable, to reflect their after-tax value. Such support is common among the economically disadvantaged, and the "gross-up" accurately reflects the greater worth of nontaxable income. The problem for the lenders, however, is how to treat welfare in today's political climate—not whether to "gross it up." Should welfare be considered "stable" when welfare as we know it is changing?

Philadelphia, like many cities, has a large immigrant population, and a quarter of Berean's mortgage applicants receive some type of public assistance. The share is less, but still quite high, among PNC's minority-LMI applicants. In 1996, national policy limited public assistance for immigrants. Since both lenders have a goodly number of immigrants seeking mortgages, underwriters at both Berean and PNC had to make a decision in that year. Should they count welfare for immigrant mortgage applicants—necessary in many cases for the applicants to qualify? Or should they discount such income, and if so by how much? In the end, the underwriters decided to count immigrants' public assistance in full, but they realized that they were qualifying people for a 30-year loan with income that could cease, or be reduced within a year. Ultimately, Pennsylvania announced it would fully fund immigrants' public support regardless of national funding policy. But this is not the end of the dilemma. Welfare support continues to evolve, and how it evolves has a critical bearing on minority-LMI financing.

Flexible Underwriting for Property and Neighborhood Appraisals

The Historical Mortgage was underwritten using the old real estate adage of "location, location, location." As a result, the neighborhood surrounding the property to be mortgaged (i.e., the subject property) was carefully evaluated. Likewise, the subject property was carefully scrutinized. Its value (which affects the mortgage size) was established by recent comparable sales ("comps"), with attention given to such qualities as "economic and functional obsolescence."

The potential problems of applying such classic property-neighborhood standards and appraisals to minority-LMI financing are legion, and the Best Practices literature has called for change (Federal Deposit Insurance Corporation 1994, 28; Federal Deposit Insurance Corporation 1995; Federal Reserve Bank of Boston 1993, 14). The current GSE Standard Mortgages and the GSE Affordable Mortgages have, in fact, introduced considerable underwriting flexibilities in this regard. The positive aspects of a neighborhood are stressed (e.g., recent rehabilitation), and neighborhood effects are deemphasized (only the immediate block(s) of the subject property is taken into account). Current GSE Standard and GSE Affordable Mortgage underwriting also deemphasizes the application of "obsolescence." Why apply suburban levels of amenity if there is a wider range of acceptable standards (and market demand) for older neighborhoods and properties? The central argument behind altering the criteria to assess property or neighborhood effects is the recognition that demand in central city neighborhoods supports prices and values for properties that are not comparable to suburban areas from which previous perceptions derived. The current GSE guidelines for these mortgages call on appraisers to accept a broader range of comparables. The exemplary lenders' underwriting on this point is a near carbon copy of the GSE guidelines.

Classic economic obsolescence is also downplayed by the exemplary lenders. They accept, at the full market price, subject properties with small rooms, unusual room configurations, tiny kitchens, few bathrooms, bathrooms in the basement, and so on, because those are the prevailing conditions in some minority-LMI areas and buyers accept those conditions. What the lenders do emphasize, however, is that the property be in reasonable condition so that the new homeowner will not be confronted with costly repairs—the bane of some prior programs, such as Section 235. To that end, lenders often require a home inspection, and they are quick to bemoan the fact that the nominal guardians of habitability, such as city housing inspectors or other professionals, are not fulfilling their charge. Berean recounted an instance where an appraiser, who purportedly had visited a West Philadelphia property and assessed it valued the property at a goodly price. The appraisal included a photograph; the photograph showed that the property had no windows!

Nevertheless, the exemplary lenders, in general, praised the job being done by appraisers in adapting to the new GSE standards. The lenders said that urban lending was made easier by the growing cadre of appraisers, including minority firms, with an enhanced sensitivity to, and experience in, city neighborhoods.

Still, challenges remain. The appraisal for Victoria Park, Detroit's first new housing subdivision in half a century, was accomplished by getting comps for the nearest equivalent suburban homes some 30 miles away, because there were no comps for new housing subdivisions in-city. But how do you appraise a subdivision on an Indian reservation, where the nearest comp on the reservation may be hundreds of miles away, and where the market off the reservation is patently different? This is not an idle question. Start-up of HUD's Section 184 program—an innovative mortgage guarantee administered by HUD's Office of Native American Programs (ONAP)—was thwarted by the paucity of comps. How could a mortgage be given on a property if it was so hard to value? The problem was made worse by an interim ONAP directive stating that in the absence of sufficient comps, appraised values should be adjusted downward by 25 percent (Northwest ONAP 1995). This directive effectively reduced the maximum allowable size of the Section 184 mortgage that could be given against an Indian's property when just the opposite, a high LTV loan, was needed. Ultimately, ONAP rescinded the 25 percent "no-comp" discount.

THE PROCESS OF REFORMULATING THE FINANCIAL CHARACTERISTICS AND UNDERWRITING FOR MINORITY AND LMI LENDING

In the foregoing presentation of the basic mortgage components that comprise successful strategies, we have put forth a tripartite streamlined schema of the GSE Standard Mortgage, the GSE Affordable Mortgage, and the Portfolio Affordable Mortgage—with a Historical Mortgage added for enhanced perspective. Admittedly, the real world of mortgage lending doesn't always break down into such neat divisions. Yet, to better understand what constitutes successful strategies, it is important to understand the sweeping changes that have occurred in the lending industry. Compared to the Historical Mortgage, the GSE Standard and especially the GSE Affordable Mortgage fundamentally changed the lending industry's view on what borrowers and properties are bankable and what financial terms are prudent. The exemplary lenders in this study are essentially building on those changes, and some are making further "nuanced" changes and expanding mortgage access.

While the GSEs, working at the national level, are setting global policies, lenders, sensitive to local conditions, are better able to customize their products. It appears to make sense for a lender in California, where the underground economy is so strong, to allow unreported income. It seems to make sense in an area where bankable renters routinely pay 30 to 40 percent of their income for housing for a lender to allow higher front-end ratios than the industry standard. It also makes sense for a lender giving a mortgage on an Indian reservation essentially to disregard standard appraisal practice on comps. It makes sense for a lender to experiment with self-insurance as opposed to private mortgage insurance. Yet it may not make sense for the GSEs to establish any of these practices as national norms; in fact, by charter, the GSEs may not be able to do so (i.e., GSE loans must have private mortgage insurance if the loan-to-value exceeds 80 percent). We believe that the goal should be to allow national policies that permit local customizing. The forces that drive the secondary market—to establish the mortgage as a financial commodity, to standardize products, to automate for efficiency—all can run counter to individual lender crafting for the local market. The tension is that much greater in the minority-LMI market because by its very nature, this lending produces more of a custom-crafted artifact.

Scoring embodies financial fungibility, standardization, and automation. This is a hard fit for the minority-LMI market, and much is at stake:

> The current trend toward standardized and automated loan origination may inadvertently increase the alienation felt by many minority, immigrant, and poor white borrowers. Because their creditworthiness (and character) may not be fully portrayed in the standardized forms and scoring criteria, their applications may not be accurately evaluated. When loans are unfairly denied, not only the applicants but all of their acquaintances may be discouraged from approaching mainstream lenders. To attract creditworthy borrowers with these backgrounds at the same time they are working to improve loan origination efficiency, mainstream lenders must demonstrate to the affected communities that they are interested in obtaining their business and will give their loan applications a fair evaluation. (Ratner 1997, 10)

We believe that tension between the respective roles of the GSEs and local lenders is not a destructive force; it can be a creative force. Each prods the other, as do other participants in the financial process. Fannie Mae developed the Community Home Buyer's Program with GE Capital and the National Training and Information Center as a pilot effort; Fannie Mae took it national; some local lenders took it one step further. In a similar vein, Freddie Mac notes that pilots help in the developmental stages, but that the results of pilots need to be incorporated into mainstream business practices whenever possible (Fischer 1998). This dynamic will lead in time to the GSEs further refining their products and lenders making additional nuanced changes. This reiterative, creative process is key to the development of successful strategies. We now turn to further strategies to qualify minority-LMI applicants.

PROVIDE FOR MULTIPLE REVIEWS

One way to guard against unfair treatment by an individual underwriter, as well as to prevent the loss of business opportunities, is to have prompt and impartial multiple reviews of rejected applications. This policy is encouraged in the Best Practices literature and many examples of its application are given (MBA and HUD 1994; Federal Reserve Bank of Boston 1993, 18; Federal Home Loan Bank of San Francisco 1994, 8-9; Interagency Task Force on Fair Lending 1994).

Almost all of the exemplary lenders had some type of multiple review. In a few instances, the process was informal. At one institution, where there was no formal second review policy, if a loan file had been turned down by an underwriter; the loan officer (who often had met with the applicant and taken down the credit information) and the branch manager could advocate for the loan and argue that it was a "doable deal." This kind of loan officer–branch manager advocacy was commonplace at this institution.

Berean Federal Savings also had no formal second review procedure:

> We don't now have a formal review process; later this year we are starting a quality assurance program. But even now, the informal way this works is that if I turn you down for a loan, the applicant has the right to go to my boss. And sometimes the boss has said, "make this loan." And sometimes I've said "you're out of your mind." So he signs and not me. (Berean Federal Savings Bank 1997)

Most of the exemplary lenders, however, implemented a formal, multiple (two, three, and four) review process after an initial loan denial. One exemplary lender in Philadelphia illustrated the breadth and depth this approach could take. Once an application is submitted to this institution, the path to an approval/rejection decision is highly formalized and standardized. At no time during the process can any one party force the application to be rejected; it must be a consensual decision, arrived at by all involved in the decision-making process. An underwriter in this bank's affordable lending unit (ALU) reviews the application and makes a recommendation. An approval requires the borrower to obtain private mortgage insurance; a rejection sends the loan application to a second underwriter to be reviewed; the second underwriter makes a recommendation as well. If rejected again, and the application is from the metropolitan Philadelphia market, the application is forwarded to the Delaware Valley Mortgage Plan (DVMP) credit committee to be examined at its weekly meeting. If one of the other member lenders of the DVMP is willing to underwrite the loan, the applicant is referred to that institution. If the application is from outside the metropolitan Philadelphia area, after a second rejection, it is sent to the bank's internal credit committee for review. If the application is rejected by this committee, or if none of the DVMP members is interested in picking up the Philadelphia application, it is sent to be reviewed by the bank's fair lending committee to ensure that fair treatment was received. The fair lending committee is part of the bank's compliance unit, which must review all loan applications that are categorized as part of a "protective class" before they can be denied.

At each stage of the bank's review process, the application is not merely accepted or rejected; possible solutions to problematic issues are discussed. For example, if an applicant has debt ratios that are considered undesirably high, the reviewer(s) will attempt to ascertain if the bank could help the applicant refinance and pay down some of the debt, or obtain a gift from a relative. If the applicant lacks a credit history, other sources of credit documentation will be discussed as possible substitutes. Throughout the entire review process, the emphasis is on finding ways to approve the application rather than seeking reasons to deny it.

As the above example attests, a lender's multiple review process is an intricate matter, and this report will not trace every quirk. In a generalized sense, however, different patterns of review can be discerned.

Multiple Reviews for All

Many exemplary lenders conducted multiple reviews for *all* initial loan rejections, whether the applicants were minority or majority, LMI, or higher-income individuals. Subsequent to the multiple review of all files, the compliance department at many banks examined the files to ensure fairness to protected classes. Numerous exemplary lenders conducted second reviews of all denied applications (or declinations), with further compliance department oversight. Some of the lenders conducted three reviews for all initial turndowns—and then forwarded the files to the compliance department. One institution conducted second and third reviews of all files by a declination committee consisting of 10 employees from different departments of the bank, including the CRA officer. The committee jointly reviewed each rejected loan file to determine if a case could be made for approval.

Multiple reviews were often, but not always, done by committee:

> Sometimes we have had 3 or 4 reviews until we get the desired result hopefully, which is to get it approved, not everyone does. The underwriters will bring it to me and I have been doing this for 22 years, and say, "Look we have this problem and this is why we think it won't go." And I'll get out my creative brain as much as I can and try to find a way to make the loan. If I still think that it is a problem, I will run it by a person in our office, who has been doing this for 32 years and say, "Hey, what do you think about this," and frankly, if the two of us can't come up with an answer, these people should probably continue renting. (Trent Financial 1997)

Multiple Reviews For All and Special Review for Protected Classes

A number of exemplary lenders conducted a second review for all initially rejected loans and a third (sometimes more) review(s) for protected groups (not counting the compliance department's oversight). At one exemplary lender, all initially denied applications routinely got a second review, and minority loans under $100,000 got a third review. At two other institutions, a second review was conducted for all initial rejections, and minority loans got a third review. And at yet another lender, as a last step, the bank president was required to sign off on any minority denial. For other lenders, the LMI status of the borrower triggered further review. One institution required second reviews for all initially denied applications and third reviews of applicants for its portfolio LMI mortgages. Yet another conducted a second and third review for all declinations; however, in these reevaluations special consideration was paid to LMI applicants. They were slotted for "special attention" by this bank's most senior underwriters (a process akin to Trent's approach for all applicants).

One lender's multiple reviews focused primarily on protected classes. All initially denied applications were reviewed by this lender's vice president, and a rejection was not final without the VP's sign-off. LMI applications got a third review by a committee.[20] As a further level of reconsideration, the senior VP for residential lending attended a high-level review committee meeting every quarter and justified in detail all declinations for minority loans, regardless of the applicant's income. The justifications were submitted in writing (about 1-2 paragraphs for each applicant). The justifications and the committee's decision (it can overturn the initial denial) went into the bank's minutes, which regulators can review.

Multiple Reviews Only for Protected Classes

Some of the exemplary lenders reevaluated only declinations of protected classes of applicants, but the composition of that "protected class" varied by institution. One lender conducted a second review of all initial minority declinations and any loan in Cleveland. Another lender had a second review for all LMI and first-time home-buyer mortgage applications. Yet another revisited all LMI declinations. One institution performed a second review of all applications from what it referred to as the "HMDA protected groups" (race, sex, and national origin). And this lender was careful to include in these reviews "all files that had been in the loan

[20] This lender has done a number of "risk share" insurance loans in recent years, in which it agrees to share part of the insurance risk with a private mortgage insuror.

process, however incomplete the file." This precaution was instituted to guard against underwriters discouraging "protected" individuals to drop out of the loan application process early on. By reviewing even the most incomplete files, the bank believed it could detect any underwriter bias at this early stage. Another exemplary lender had a Second Look Program (second review) for all LMI declinations and all minority declinations regardless of income. A decline by the second review required a sign-off from the head of the loan department.

Interestingly, Countrywide used to require multiple reviews of all minority and LMI declinations, but it has changed its procedure:

> We were the first lender to have a true second review process. In fact, our chairman looked at a number of these when we first started out. I think in 1992, we started doing this. We looked at every minority and low-income borrower turndown and it was getting kind of ridiculous because we had three or four different levels of reviews, all the way to the chairman. If you wanted to deny one of those loans, that's where you had to go. Then we found out that we were overturning the decisions in the branches so infrequently that it was a waste of time and we were just taking too long to get people their decision. Either you are approved or not approved. So what we do now instead is that we monitor our branches on their minority and lower-income (either condition) turndowns. If they get out of whack and they have too many denials of minorities or low income, then we want to take a look at what they are doing. (Countrywide 1997)

There does not appear to be one correct approach for deciding which declinations should be subject to further review. Reviewing all declinations guards against the questionable or unequal treatment of any applicant. Reviewing just "protected" groups targets those who are most likely to be treated unfairly. But any time one particular group is targeted and not another—whether it is minorities of any income, or LMI persons, or first-time home buyers—tensions arise and concerns over reverse racism surface.

One lender referenced the "Joint Policy Statement on Discrimination in Lending," which is excerpted below:

> Q3: Does a second review program only for loan applicants who are members of a protected class violate laws prohibiting discrimination in lending?
>
> A: Such programs are permissible if they do no more than ensure that lending standards are applied fairly and uniformly to all applicants. For example, it is permissible to review the proposed denial of applicants who are members of a protected class by comparing their applications to the approved applications of similarly qualified individuals who are not members of a protected class to determine if the applications were evaluated consistently. It is impermissible, however, to review the applications of members of a protected class in order to apply standards to those applications different from the standards used to evaluate other applications for the same credit program or to apply the same standards in a different manner, unless such actions are otherwise permitted by law. (HUD et al. 1994, A4-9)

The questions raised by the lender were: What constitutes the "uniform standards" which are "permissible"? And what constitutes the "different standards" which are "not permissible"? If only minority declinations are to be considered by the most senior underwriters or a senior vice president, or require a sign-off by the bank president, does that constitute "uniform treatment"—i.e., does it ensure that minorities are treated equally? Or does it constitute "different treatment," since only minorities receive this senior staff attention which may improve their chances for approval?[21]

We raise this issue not to engage in legalisms but to report the lender unease that surrounds actions targeted to minorities or other groups. Clarification on this matter is called for by the Department of Justice and the financial regulators.

Lenders also spoke often of the more prosaic issue of the time-consuming nature of multiple reviews. Second, or subsequent, reviews typically involve committees that meet only periodically (e.g., the DVMP meets every two weeks). Lenders mentioned with irony how the front end of the loan process—the information intake and underwriting—has been greatly expedited by computerization (e.g., Fannie Mae's Desk Top Underwriter, Freddie Mac's Loan Prospector®). It now takes no longer than a few days, sometimes even a few hours, to get an initial decision. But the back end, the second review, takes much, much longer. Banks wondered how they could expedite the multiple review process but still ensure sufficient time for careful deliberation. As mentioned earlier, Countrywide replaced its multiple review process with a statistical analysis of branch lending patterns. Few of the other lenders seemed inclined to follow suit, however. Most thought that the multiple review programs helped to further the goal of minority-LMI homeownership.

TEST TO ENSURE FAIRNESS

To ensure fair treatment of mortgage applicants, financial institutions should test that consistent standards are being applied. *Closing the Gap* calls upon lenders to systematically review loan files to ensure fair treatment, and calls upon larger lenders to use statistical analysis to detect discrimination (Federal Reserve Bank of Boston 1993, 24). The theme of the FDIC's *Side-by-Side—A Guide to Fair Lending* is that testing a lender's treatment of different groups of credit seekers on a "side-by-side" basis is a good way to foster fairness. The FDIC study encourages testing at various points in the loan process, including pre-application testing—to inspect the treatment of *potential* applicants—and a subsequent comparative analysis of loan files—to compare treatment after submission of an application (Federal Deposit Insurance Corporation 1994, 1).

Lenders responded to questions about fair lending issues for this study, but the respondents were typically either in the CRA or loan departments, not the fair lending compliance unit. Therefore, the results reported below may understate the full measure of the testing being done.

Pre-application Testing

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[21] *The Fair Lending Guide* recommends that "as a general matter, the second review process should include a review of a broad selection of marginal denied applicants, *not* just minority denials (Vartanian et al. 1995, 9.09).

Some of the lenders did a formal "side-by-side" test of the treatment of potential applicants. One paid a firm to "bring a minority and non-minority person—physically and financially similar—to the bank and see how they are treated." The test also included telephone inquiries from minority and non-minority applicants who "communicated" their racial identities (e.g., they indicated their current place of residence).

Many other exemplary lenders recognized the benefit of this paired testing but did not apply it, in large part because of the cost involved. One lender mentioned an upper five-figure quote for such work. Instead, lenders employed other forms of pre-application testing. Some sent a minority and a majority customer, who were not matched, to a branch to see if they were treated differently. Some simply had a minority "mystery shopper" make a telephone call or a personal visit. The shopper's treatment would then be analyzed.

Analysis of Loan Files

Another common type of test was to pull loan files and compare the acceptances and rejections of minority versus non-minority applicants to see if they were accorded equal treatment. One exemplary lender employed a variation of this test. Every year it would totally "reprocess" 10 percent of its loan files. It would take the information that had been gathered originally (the original applicants were not re-interviewed); it would then reprocess each loan, using a different appraiser, credit source, processor, and underwriter to reach a decision (approve or disapprove). This decision was compared to the original to measure the bank's consistency in deciding whether—and how much—credit should be extended. If inconsistencies were spotted, the lender would scrutinize them for possible racial or other bias.

Other Testing

A variety of other testing was also performed. One exemplary lender did a monthly analysis of denial rates by branch and by individual underwriter and loan officer.[22] "Anytime the denial rate appears excessive, or the withdrawal rate [share of applicants withdrawing] is high—anything that flags suspicion—we look at those that were not originated to ensure that the basis is credit or collateral, not race or income."

Understandably, the larger lenders often did the most comprehensive testing. Countrywide, for example:

1. Performs matched pair (minority and non-minority) testing of persons applying for credit;

[22] A minority mortgage rejection rate that exceeded twice the rejection rate for all applicants was deemed by some lenders to be a red flag of possible discrimination. The rationale for this was that in a broad sense the lesser economic resources of minorities (i.e., fewer assets and more credit issues) would cause them to be rejected for a mortgage twice as frequently as whites. If that 2:1 rejection ratio was exceeded, discrimination was suspected. The lenders who mentioned this admitted that the 2:1 ratio was not statistically determined but was a working "rule of thumb" that had some after-the-fact validity (e.g., bank branches or individual underwriters that exceeded the 2:1 rejection ratio were found after testing to have treated minorities unfairly). The crudeness of this rule of thumb—and its very possible discriminatory effects—speaks for itself.

2. Contacts people (minority and non-minority) who have applied for a loan to ascertain how they were treated;
3. Conducts a monthly statistical analysis of all of its branches. It measures what it calls the denial disparity index (DDI), which is the ratio of the denials to minorities over the denials to white applicants. If a branch's DDI is significantly greater than 1, Countrywide examines the branch's policies and staff.

> We probably impose a harsher test than anybody else because our overall denial disparity index is 1.3 to 1, whereas in the industry it is about 2 to 1, if you look at black and Spanish rejections versus white rejections. It does not take very much for us to scrutinize a branch because we don't tolerate a high DDI. (Countrywide 1997)

4. Measures market share.

> You can have a low denial rate to minorities because you don't get any applications from minorities. So market share is another measure of service that we scrutinize. (Countrywide 1997)

In short, as a group, the exemplary lenders acknowledged the benefits of testing; however, those that tested varied in their method. Cost, as noted, dissuaded some from effecting the most elaborate (e.g., matched pairs) testing. Others, especially those less subject to regulatory oversight (e.g., mortgage brokers), believed that testing was unnecessary. "We don't test because we are paid to close loans and we'll do every one that's doable" (Trent Financial 1997). Lenders also expressed some apprehension that the testing results might be used against them.

> We don't self-test because the problem is that if you find anything at all, you have to reveal it. And there is no guarantee you will be protected from either criminal or civil action. There were some general ambiguous statements on this recently, but it is still not clear you can be protected. So nobody wants to do self-testing.

Recent legislation provides a limited privilege to lender self-testing results [Pub. L. 104-208 (section 2302)]. Effective January 30, 1998, a new section (814A) was added to the Fair Housing Act (FH Act) stipulating that: "A report or result of a self-test is privileged from disclosure if a lender conducts, or authorizes an independent third party to conduct, a self-test of a real-estate related lending transaction to determine the level of effectiveness of compliance with the FH Act, and has taken, or is taking, appropriate corrective action to address possible violations discovered as a result of the self-test."[23]

OTHER STRATEGIES

Training

The explosion of new mortgage products that has allowed a broader range of people to qualify for homeownership has put pressure on underwriters and loan officers to master a great deal of new information. Training is key, but training involves more than simply presenting the facts of the new mortgage products. A number of the exemplary lenders spoke of the need to

[23] See *Federal Register*, Volume 62, No. 243, December 18, 1997, pp. 66424-66433; quotation is from p. 66424.

change the traditional mind-set of mortgage underwriters concerning what is bankable. One stated:

> It’s a matter of education, a matter of having to take the blinders off and let people know, especially the underwriters, that a loan may not fit into a box perfectly. It’s an educational process.

Codify Underwriting Standards

As the programs proliferate and more is asked of the underwriter, the need for codification is evident. Many exemplary lenders have spent considerable effort codifying their underwriting standards in both written (e.g., manuals and guidebooks) and electronic formats. Yet there are limits to the ability to codify every lending situation.

Encourage and Support Underwriter Discretion

Underwriters should be familiar with the level of discretion the GSEs and others in the secondary mortgage market allow. And the lending institutions should support the underwriters in applying discretion. As an interesting sidelight, Berean allows each of its underwriters 10 approvals a year that no one in the organization can challenge.

Involve Underwriters in Activities to Retain Applicants

Exposure to the reality of delinquency and foreclosure can hone an underwriter’s sensitivities in evaluating a mortgage application. Some of the exemplary lenders (the smaller ones) require the person who recommended a loan be approved to contact the delinquent borrower. Presumably, the person who recommended the loan established some rapport with the borrower, and having reviewed the borrower’s credit, employment, and other records, is in the best position to direct a workout.

Cultural Sensitivity

After years of operation in Los Angeles, one of the most diverse areas of the country, Trent Financial loan officers have noted that the many ethnic groups in this city possess different attitudes toward financial transactions, savings, and Realtors. Since Trent loan officers have been able to form good relationships with members of some Mexican, Cambodian, Vietnamese, and Filipino communities by closing loans successfully, they have found it relatively easy to find more clients within these groups. Personal relationships with loan officers formed the foundation for future transactions within these communities. The inner-city African American population, however, as a rule tends to be less trusting, Trent explains. They prefer officers to prove themselves by providing thorough technical explanations of the mortgage process, which assures them of the officer's professional ability.

Trent loan officers have also become well-versed in the different preferences within racial groups. For example, Hispanics in Southern California come from virtually every country in South and Central America, and include large numbers who have been born in the United States. In general, Trent officers have found prospective home buyers from Central America to have higher levels of education and understanding of the mortgage process. They tend to know what they want and are relatively demanding, whereas many Mexican home buyers are less educated and more willing to let the loan officer handle the mortgage process. There are also differences among Asian subgroups: many Chinese clients are reluctant to share the personal financial information required to pre-qualify for a loan, preferring instead to work with their own real estate agents rather than Trent's loan officers. By contrast, Cambodians, Vietnamese, and Filipinos tend to be more trusting and open to inquiries about their finances.

Cultural sensitivity cannot be taught at a once-removed lunch lecture on the subject. It must be learned directly by lenders working with the diverse groups in their service areas. Yet there is a thin line between cultural sensitivity and social and ethnic stereotyping and lenders must be vigilant in distinguishing between the two.

CONCLUSIONS

The dramatic restructuring of the lending industry in the early 1990s has alerted many lenders to the profitability of traditionally neglected submarkets. Increased regulatory scrutiny has also pushed lenders to evaluate critically the impact of their practices on protected classes. And community activism has pushed lenders to make commitments to affordable lending initiatives. All of these changes have expanded lending to LMI and minority borrowers and inner-city neighborhoods.

Despite the importance of these sweeping changes, successful lending strategies ultimately hinge on specific provisions of mortgage products, underwriting standards, and procedures for testing or multiple reviews. As this chapter shows, many lenders have demonstrated great innovation and commitment to fair and affordable lending by constantly seeking out ways of expanding mortgage availability. They have partnered with nonprofits, local governments, and others to develop and offer innovative mortgage products; they have ensured that underwriting standards are sufficiently flexible to qualify LMI and minority borrowers, consistent with safe and sound lending practices; and they have instituted multiple reviews and self-testing to ensure that the entire institution remains committed to expanding homeownership opportunities. While the mix of strategies most suitable to qualify applicants may vary from one institution to another, this chapter highlights the most important components of successful initiatives underway in the industry today.

CHAPTER FIVE
STRATEGIES TO RETAIN MORTGAGORS

Once a loan is approved and originated, the way it is monitored and serviced can play an important role in its long-term performance. From the perspective of lenders, enhanced monitoring and servicing minimize delinquency and default rates and justify a continued commitment to minority-LMI lending. From the perspective of borrowers, the way in which monitoring and servicing are conducted can help them remain in their houses and continue to profit from homeownership, even in the event of financial hardship.

It is generally recognized that loans to historically underserved borrowers require more attentive servicing than standard loan products (e.g., GSE Standard Mortgage). Standard servicing is typically restricted to maintenance of payment records, escrow account administration, and collection efforts. In targeted minority-LMI lending initiatives, however, lower household wealth and income increase the likelihood of financial crises that will interfere with the repayment of loans or force households into unacceptable alternatives. Relatively little is known about the performance of affordable loan products (Mills and Lubuele 1994; Quercia and Stegman 1992; see also Johnson and Macias 1995, F1-F8), but it is likely that they present fundamental differences in the long-term profile of delinquency and default probability.

For standard loans, delinquency and default probabilities are, by definition, extremely low at the beginning of the repayment period (otherwise the loan would not have been approved). After several years, most borrowers have increased their income and accumulated substantial equity in the house, minimizing delinquency and default likelihood. Thus, the risk to lenders is greatest in the early to middle years of repayment. (Mills and Lubuele [1994] reason that default and foreclosure probability increases for three or four years after origination before declining.) For households whose income and savings do not increase, however, the risk profile may remain higher than the profile for standard products throughout the life of the loan. Consequently, broader conditions in national and regional economies that reduce the income and assets of groups traditionally underserved in the mortgage market also increase the likelihood of delinquency, default, and foreclosure. The decline of working-class employment opportunities for residents of inner cities; the increase in poorly paid, part-time jobs; and the rising cost of health care all have had disproportionate effects on the financial stability of minority-LMI households. These factors set the broader context behind recent concerns regarding the prudence of affordable lending initiatives. The Mortgage Guaranty Insurance Corporation (MGIC), for example, recently reported that purchasers with debt ratios over the 33/38 threshold went delinquent at a rate 60 percent higher than the rate for all other borrowers.

The factors contributing to overall delinquency and default rates, however, are not solely economic; they include crucial social and behavioral factors. First-time borrowers, particularly those from groups traditionally excluded from ownership by economics or discrimination, place an extremely high social and cultural value on homeownership and go to great lengths to meet their obligations. Models that predict delinquency and default as a rational economic choice for borrowers who have negative equity in a home, for example (i.e., when debts exceed the value of the home), are inappropriate to describe the seemingly irrational choices made by households bent on doing everything humanly possible to keep their home. Conversely, many borrowers do not have an extensive knowledge of the formal financial transactions and requirements of an increasingly sophisticated credit market. Having already missed a payment date, borrowers in financial trouble may reason that a few more days will make little difference. Or they may not appreciate the importance of close communication with lenders, who are often receptive to altering payment arrangements as long as the borrower remains committed to repayment. Particularly for people with unhappy family or personal experiences, in housing and credit markets that have historically been discriminatory and hostile, the prospect of discussing mortgage repayment obligations with an officer of a lending institution while in the midst of a personal or financial crisis is most certainly *not* a desirable activity. Retaining minority-LMI borrowers sometimes revolves as much around social issues as it does around economic ones.

These considerations lie behind this study's two major findings on the effect of retaining strategies on the success of minority-LMI lending initiatives. First, there is no evidence that affordable lending efforts—whether they are CRA-related, targeted to underrepresented groups, or based on income thresholds—are necessarily incompatible with the profit motive of the mortgage lending industry. Although profit margins are generally recognized to be lower for these loans, many lenders perceive a large potential volume in these markets that have been underserved in the past. Lower profit margins on these mortgages may be compensated by growth in consumer or home-improvement lending. And a growing body of evidence confirms that these loans are as safe as—in some cases safer than—conventional products (Federal Reserve Bank of Philadelphia 1993; Mills and Lubuele 1994). Second, and equally important, achieving the twin goals of profitability and broadening homeownership opportunities requires fundamental changes in how loans are serviced. Automated record keeping and reminder notices in the mail are not sufficient. Servicing these loans requires more comprehensive approaches in the relationship between mortgagor and mortgagee.

The current environment of lending industry consolidation and restructuring—at a time when nearly two-thirds of all loans originated are sold off into the secondary market—presents serious challenges to innovation in servicing. This study reveals a wide variety of approaches used by different lenders to retain minority-LMI borrowers. The successful lenders in the study include many large and medium-sized institutions that have few explicit provisions for post-closing counseling or monitoring of repayments, since both the loans and servicing are sold off to servicing specialists or the secondary market. Yet, small, neighborhood-based lenders view their customers in a different light. One senior officer at a minority-owned thrift noted that: "We really need to start doing some work on post-closing counseling. We're just a credit-happy society; not just poor people need to pay attention to this." Rather than outlining a formal post-closing or early intervention plan, however, this officer lamented the lack of contact between inner-city working-class residents and middle-class people who supported his institution: "We really need to get some of these people in rubbing shoulders with some of our borrowers, some of our savers."

Some common themes emerged among the exemplary lenders. The broad array of strategies used by these lenders to retain minority-LMI borrowers fell into three main categories: 1) enhancing the content and scope of post-purchase counseling; 2) instituting procedures for careful monitoring during repayment; and 3) providing for flexibility to cure delinquency and avoid foreclosure.

PROVIDE POST-PURCHASE COUNSELING

The Best Practices literature advocates active post-purchase contact on the part of the lender to ensure the successful retention of borrowers (America's Community Bankers 1997; HUD 1996a, 7-1; Neighborhood Reinvestment Corporation 1997). Post-purchase counseling normally includes information on budgeting for maintenance or repair; advice on the reporting procedures associated with a mortgage (i.e., how to interpret an escrow account statement); and related issues. Post-purchase counseling is most critical in minority-LMI lending to older urban neighborhoods; the older housing stock of these areas usually requires more maintenance and repair and demands, in turn, more careful planning of household budgets to ensure sufficient reserves.

Although usually restricted to counseling, post-closing contact with borrowers sometimes includes a broader range of efforts to integrate new homeowners into a community. Neighborhoods, Inc. of Battle Creek, Michigan, for example, coordinates a post-purchase initiative that "is a means of reducing delinquency, but it is also an intentional effort to connect new home buyers to other neighborhood residents and activities in the neighborhood" (America's Community Bankers 1997, 76). Neighborhood Housing Services (NHS) of Ithaca, New York runs a Home Buyer Reunion that includes not only financial management counseling but also "testimonials" to give "home buyers an opportunity to talk about their home-purchase experiences [with other recent home buyers]" (Neighborhood Reinvestment Corporation 1997, Case 58). Current NHS customers who have not yet purchased a home are also invited to this event, in part so that recent home buyers can "inspire people who have not yet bought a house." In short, the consensus of the Best Practices literature is that post-purchase initiatives can help borrowers plan their finances, avoid late payments or delinquencies, and solidify relations among homeowners in a community.

Since most of the exemplary lenders contacted provided a broad range of homeownership information at an early stage in the loan process—or partnered with another organization to provide this information—relatively few of these institutions offered extensive counseling after the loan had been made. Many of the exemplary lenders, however, stated that they offered some form of post-closing counseling either on an informal, ad hoc basis, or in a short (30 minutes to one hour) session at closing.

Ongoing changes in the mortgage lending industry—the increasing separation of the application, origination, and servicing functions—have also prompted some of the exemplary lenders to institute limited post-closing sessions for the first time. One stated:

> A few years ago, we started something. When we approve a loan, we do a 30-minute counseling session, and inform them of all the aspects of payments, late fees, etc. We do this for every borrower, to try to establish goodwill, establish a personal relationship so they understand exactly what is involved in the transaction. *We do this because so many of our loans come through a broker* [emphasis added]. So sometimes we approve loans without ever having met the person. This counseling session gives us an opportunity to make a relationship with the borrower.

Several exemplary lenders undertake more extensive post-purchase contact with borrowers. Among these are lenders who view loan servicing as a way to find new business or referrals from their borrowers. Typically, they will provide ongoing homeownership advice or information to their customers. For small institutions oriented to low-income or minority neighborhoods, this approach is seen as an important component of long-term business development:

> We try very hard to maintain contact with every borrower we work with because of the business reason. We want to continue working with them and get referrals from them. In this community—and I think that it is true in all minority communities—trust is probably the most important thing that you are going to develop with a client. By the time we close a transaction with someone, we have been working with them for 30, 40, or 60 days or sometimes longer ... and by that time they get to know us pretty well. We have tried very, very hard to maintain a really strong, credible reputation in the neighborhood. When you talk to us you are going to get straight stuff. (Trent Financial 1997)

A second group of exemplary lenders who offer extensive post-purchase counseling are those involved in partnerships with nonprofits, community-based organizations (CBOs), or city or State agencies. These partnerships often provide an efficient division of labor. Potential borrowers complete pre-application homeownership counseling at a nonprofit or CBO; then they apply for and receive a mortgage from an affiliated lender; finally, they are referred back to the nonprofit or CBO for post-purchase counseling—either through a formal program or on an as-needed basis.

In some cases, these relationships with CBOs and city or State agencies alert lenders to the unique challenges that face minority-LMI buyers after closing. Several lenders in the Chicago area, for example, offered loans through a State-subsidized homeownership program that involved counseling provided by a nonprofit. It quickly became clear that post-purchase issues required attention, and the lenders responded accordingly. One exemplary lender stated:

> We developed an emergency loan fund because inexperience with these lower down payments, and the stretch with the debt-to-income [ratio]. Say the tree falls on the house and breaks through the roof. With little down, and a big bill, they are finding that people are forced to walk. So what we did, as a group of lenders, is put money in and IHDA [Illinois Housing Development Authority] matched it to form a $40,000 emergency loan fund. So in the term of these loans, if that should be the case, and the borrowers can't fix it on their own or their own savings, they can get a zero percent emergency loan from this fund.

Finally, as with many facets of the financial industry, technological solutions have been developed to assist in retaining borrowers. Freddie Mac, for instance, has developed Early Indicator, a tool provided to loan servicers to help them "stay alert to the risks of borrower default" and to "target their counseling efforts to borrowers most in need." (Freddie Mac 1997, 7).

PROVIDE FOR CAREFUL MONITORING DURING REPAYMENT

It is universally recognized that quick response to payment difficulties on the part of the institution servicing the mortgage is important. And there is general consensus that these efforts are even more important for borrowers from traditionally underserved groups. The Best Practices literature strongly advocates enhanced servicing for borrowers from traditionally underserved groups (HUD 1996a). The manner in which lenders monitor repayment often contributes to the long-term success of minority-LMI lending initiatives. The GSE Affordable Mortgages, for instance, often require Fannie Mae-directed servicing. Fannie Mae's Fannie 97 requires "special servicing"; Freddie Mac's Affordable Gold 97 requires "strong servicing" that meets Freddie Mac criteria. (Lenders are able to choose, however, how they will meet this "strong servicing" requirement.)

Most lenders stress the importance of a rapid response when payment is not received on the first of the month. Many lenders contact borrowers either before assessing late charges or prior to the 15th of the month. An increasing number of lenders now contact borrowers if payment is not received by the tenth of the month.[1] Fannie Mae's 97 percent loan-to-value mortgages, in fact, require servicers to send reminder notices on the tenth of the month. As one lender noted,

> In the past year or so, we noticed a slight uptick in delinquencies in our CRA pool, and it's important to catch this early on. You have to convince the borrower early on not to get behind, because as soon as they get a late fee, then they are not paying 8 percent, but it's really 13 percent. And then if they get close to thirty days late, they say, "Oh, I'm already late." You never want the customer to lose hope or to lose faith.

In an effort to understand the borrower's situation and find a way to bring the mortgage current as soon as possible, many exemplary lenders have instituted formal procedures either to review a borrower's loan files or to initiate contact through a third party. As noted earlier, some lenders stipulate that the person who originated the loan contact the borrower once a payment is late. Other lenders that partner with CBOs and nonprofits use these organizations to initiate contact when payment is late. Freddie Mac's Early Indicator software is designed to provide quick and accurate assessment of the need for early intervention.

ALLOW FLEXIBILITY TO CURE DELINQUENCY

In the event of mortgage delinquency, the Best Practices literature recommends lender flexibility to bring borrowers back to current status as soon as possible (HUD 1996a; Neighborhood Reinvestment Corporation 1997). Flexibility to cure delinquency is usually in the interests of all parties. Foreclosure means financial ruin for low-income households; it is a costly and time-consuming process for lending institutions; and it means another nonperforming property from the perspective of a municipal government.

Most lenders are willing to consider forbearance agreements, modified interest rates, or similar arrangements when circumstances merit. One lender noted: "Maybe they can afford to make the payment, plus $25.00 [to make up for a payment missed because of illness]. Because

[1] The executive director of the Atlanta Mortgage Consortium has gone so far as to pay a home visit on the occasion of a first late payment.

we just don't want a foreclosure." Another lender was willing to consider mortgage assumptions in some cases: a relative of a delinquent borrower, for example, may be willing to step in and take over mortgage payments for the property. In some cases, regional economic conditions required a great deal of flexibility. One New England institution in a depressed local economy reported doing "thousands" of workouts, for both LMI and conventional loans, after this region's severe recession of the early 1990s. In this situation, of course, the collapse of inflationary housing markets made foreclosure less attractive from the lender's perspective.

The GSEs consider lenders the primary contact with borrowers, often working in tandem with community-based organizations or in other community alliances. As with strategies used to ensure careful monitoring of repayments, the nature of contact between the lender and borrower is crucial. As one small minority-owned thrift pointed out: "We try to 'propose' solutions, rather than say: 'What are you going to do?' People who don't make payments on time are often embarrassed or shamed, and so they are hesitant to talk. But once the conversation starts, we are willing to do almost anything.... Right now I have two borrowers paying only principal until they get jobs" (Berean Federal Savings Bank 1997). The importance of individual relationships and contacts with borrowers is most apparent in the operations of small neighborhood-based lenders. For these institutions, particularly those based in low-income inner-city areas, or areas where property values declined in the early 1990s, business practices cannot be distilled to simple hard-and-fast criteria. Flexibility is key at all stages of the lending process, from the formulation of underwriting guidelines to the development of strategies for curing delinquency. As one exemplary lender described:

> We don't have a formula. We just try to recognize the dignity of a person. He's doing his best. You have to show him that doing his best has to provide for a stable source to repay a loan. You have to inform him that he's got a direct relationship to our savers who are providing this money and that if he doesn't perform, our savers, our association, will not stay in business. Our savers' funds are in jeopardy. You have to build a relationship with people. One of the things our examiners have learned about us over the years is that—they would come in and see our high delinquencies—and for a long while I just didn't quite understand how they looked at it. But if you've got the same examiner coming back maybe every couple or three years, or maybe year after year, and then he would see the same delinquencies and at some point he would say: "Now, wait a minute, you've still got this loan that's been delinquent for the last five years." I'd say: "Yes, we've still got it and we're still working with him," and he says: "Oh! You don't foreclose on your loans when they become badly delinquent?" And I said: "Oh, no, we work with them. And the people just don't stop paying. They come back and they try to make amends. They keep paying even though they're delinquent." [And the examiner would say:] "Oh, yeah, and they aren't mad at you?" "Oh, no, we have a good relationship. We go out and visit. My father prayed with them."

Observations such as these, repeated in different forms by many of the small neighborhood lenders we contacted, illustrate the way in which the mortgage transaction is embedded in the relationships among borrowers, lenders, and investors. As the mortgage industry has become increasingly consolidated, the relationships between the different parties involved have become blurred. Many borrowers now make mortgage payments to institutions they do not know, which pay interest to anonymous investors or savers.

Consequently, as in other areas of the lending process, partnerships with local nonprofits and CBOs have become important components of large and medium-sized lenders' strategies to retain borrowers. Such collaboration allows larger institutions to tap into the neighborhood connections at the local level and try to counter the anonymity of transactions between borrower and lender. Some of the exemplary lenders kept track of local groups that had contact with a borrower. PNC Bank, for example, devised a system of "referral source codes." In the event of a late or missed payment, "if a counseling agency was involved then we try to get that into the record so that when the counselor brings that file up on the screen, if it is delinquent, they will be able to see that there is a counseling agency that originally was involved with credit counseling. . . and we ask them to become involved with our credit counselors to work with the borrower to try to come up with some type of forbearance or repayment" (PNC 1997).

For other lenders, this collaboration involved even more active participation on the part of the collection staff. One exemplary institution noted:

> We actually had the head of the collection department work with the person at the community group that was assigned to work with post-closing counseling. If our buyer became delinquent, the community group wanted to be notified immediately and they would contact the customer . . . the collection department, the community group, and the customer would all work together. This arrangement has been very effective in helping the buyer to get out of the problems. They seem to have a closer tie, and the buyer is a little bit more willing to go ahead and tell what the true problem is to the nonprofit group, and that has worked really well.

Consequently, these partnerships sometimes require that borrowers consent to information-sharing between the lender and a third party. One large lender, as part of its affordable loan program, requires borrowers to sign a disclosure agreement authorizing the lender to work with a local nonprofit or other third-sector entity.

CONCLUSIONS

In sum, to foster the long-term success of the minority-LMI loans, enhanced servicing, early intervention, and default mitigation need to be provided. These are simply prudent business procedures. Prudent business practice is an important theme for lending to the less advantaged. Such lending is by no means a charitable activity; it is a moderately profitable enterprise for most institutions. In our discussions, we asked lenders about the performance and profitability of their LMI mortgages.[2] While few lenders were willing to offer specific details, the discussions highlighted two important findings. First, there was no consensus on the performance of LMI loans in comparison to industry standards. Although several large lenders reported that their LMI loan delinquencies were running substantially higher than delinquencies on their "standard" loans, numerous small lenders, and large institutions with innovative partnerships with nonprofits, had LMI delinquencies at the same level or lower than their "standard" portfolio. But the delinquencies are only snapshots in time—they will no doubt vary as more loans are seasoned and sold to the GSEs. They will vary as the lenders themselves become more seasoned in making the loans. The case studies point to this learning curve. Furthermore, delinquencies are a composite of different nonpayments that mean very different things (e.g., 30-day versus 120-day late payments).

Exemplary lenders overwhelmingly find their overall LMI lending to be at least break-even or somewhat profitable. Their comments are telling. One lender said: "We have inclinations to help the community and make money at it." Other lenders' comments highlighted the strong motivation of first-time borrowers to avoid delinquency and default: "Once on the books, the LMI loans work out as good or better because the borrowers don't want to lose the roof over their heads." None of the lenders we spoke to saw any contradiction between the profit motive and affordable lending efforts. Lenders' comments on this subject ranged from "this is good business" to "it is absolutely profitable." With the practices noted in this and previous chapters, successful strategies can lead to even more successful businesses in the future.

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[2] It was not expected that lenders would track minority lending, but many lenders closely monitor their affordable lending operations.

CHAPTER SIX
STATISTICAL ANALYSIS OF LENDING PATTERNS

INTRODUCTION

The availability of data on individual home mortgage loan applications made possible by revisions to the Home Mortgage Disclosure Act (HMDA) has spawned scores of studies seeking to ascertain whether racial discrimination persists in the lending industry. But these studies are plagued by a number of limitations, and considerable controversy persists over what can—and cannot—be inferred from statistical models of the loan disposition process. In this study, the extensive insights gleaned from telephone discussions with exemplary lenders (Chapters Two through Five of this volume) and case studies of a range of these institutions (Volume Two) permit us to undertake a limited integration of qualitative findings with quantitative data. This chapter presents an analysis of the observed lending patterns of institutions participating in the study, and compares these patterns to national trends. Each stage of the analysis confirms that the business practices pursued by the selected exemplary lenders are associated with significant improvements in lending to minority borrowers.

BACKGROUND

The purpose of this chapter is to complement the qualitative research design used in this study with a quantitative analysis of observed lending patterns. To what degree are the strategies pursued by the exemplary lending institutions associated with significant improvements in lending to minority applicants? It is important to bear in mind that this analysis is not intended to confirm either the presence or absence of discrimination in the lending process. Recent advances in qualitative and survey research on mortgage lending and housing markets have demonstrated two critical limitations of studies based solely on secondary data sets. First, the most commonly used data (the individual loan application records released under the Home Mortgage Disclosure Act) contain no information on applicant financial characteristics (net worth, credit history, etc.). Critics have thus charged that highly publicized studies on discrimination suffer from omitted-variable bias (Liebowitz 1993; Zandi 1993; Horne 1993). If legitimate risk variables correlated with race are omitted from models of the lending process, then any observed effect of race on the probability of loan origination (or denial) will be overestimated. Although the extensive data collection efforts of the Boston Fed allowed a particularly rigorous analysis of the full array of factors considered by lenders (see Browne and Tootell 1995), most HMDA-based studies remain vulnerable to the charge of omitted-variable bias.

The second limitation pertains to the relationship between secondary data sources and different stages of the lending process. HMDA records, for example, describe only one transaction in a complicated chain of encounters between applicants and a variety of institutions and representatives—Realtors, appraisers, insurance providers, and lenders. These data are therefore extremely sensitive to selection bias, complicating attempts to use HMDA to evaluate the business practices of particular institutions. Especially high approval rates for minority applications, for instance, may reflect pre-screening or other types of disparate treatment, while *low* approval rates might result from aggressive outreach efforts and a large pool of minority applicants with marginal or poor credit histories. The uncritical use of HMDA tabulations would suggest—erroneously—virtue in the former case and discrimination in the latter.

In light of these limitations, our purposes in this chapter are twofold. First, we use HMDA records to describe the overall scope of lending among the exemplary lending institutions participating in this study. Basic tabulations are used to determine the degree to which these lenders' market base (e.g., composition of applicant pool, neighborhood characteristics) differs from national trends.

Second, we compare the lending patterns of the subject institutions to national norms, and use standard econometric methods to control for institutional and individual variations. The purpose is to verify that the business practices documented elsewhere in this study lead to significantly different patterns in loan origination in comparison to the rest of the lending industry.

The analysis proceeds in four parts. First, we outline the main features of the data sets that provide the basis for the analysis of lending patterns. Second, lending patterns for lenders participating in the study are analyzed for 1995, and compared to national market trends. In the next section, an aggregate cross-sectional approach is used to model the loan origination process. Fourth, a cross-sectional time-series analysis is applied to a small sample of lenders participating in the current study. Our findings confirm that lenders participating in the study exhibit significant differences in their pattern of loan originations when compared to national market trends, and several institutions have made significant changes in their practices in recent years.

ANALYSIS

Data

We assembled several data sets for the analysis. First, a nationwide file was constructed for all institutions reporting residential loans in the 1995 HMDA files. This data set was restricted to home-purchase applications for one- to four-family dwellings, and included only applicants coded as white, African American, or Hispanic. We excluded all observations with either validity or quality edit failure codes, thus reducing the nationwide total to 4,680,853 applications. For 30 of the 40 lenders who participated in the study (recall that 10 of the 50 entities studied were counseling agencies and the like), we were able to positively verify reporting information and identify HMDA records; this yielded a subset of the national file. An additional subset was created that excludes the four largest lenders from the group of study participants. Finally, for the time-series analysis, a separate data set was constructed with matched 1992 and 1995 HMDA records for five of the lenders participating in the study. A comparison group was constructed by selecting all applications received by lenders operating in one of the States as the five select institutions; owing to significant changes in reporting requirements between 1992 and 1993, comparison lenders were retained on the basis of matching identification numbers for both years.

Residential Lending Activity in 1995

The lenders participating in the study for whom HMDA information was available account for a sizable fraction (seven percent) of all applications filed nationwide in 1995. This figure is biased by the inclusion of several of the nation's largest residential lenders. Given the distinctive business practices of large lenders with complex organizational and geographical structures, separate tabulations are presented in Exhibits 6.1 and 6.2: one includes all subject lenders and another excludes the four largest institutions participating in the study; each of these four lenders received more than 40,000 applications in 1995.

The lending patterns of the selected exemplary lenders suggest a fairly complicated picture in relation to national market trends (Exhibit 6.1). On the one hand, the most commonly used industry indicator confirms greater lending activity to the minority market among the selected exemplary lenders: these institutions attain substantially higher origination rates for both African American and Hispanic applicants than the national average. The selected lenders originate loans to 70.9 percent of all African American applicants, compared to the national average of only 52.4 percent; for Hispanic applicants, the respective figures are 75.6 percent, compared to only 60.8 percent. The remaining measures of loan disposition (denial and withdrawal rates) also suggest greater minority lending activity at these institutions. These findings confirm the validity of the reputational survey, and underscore the success of these institutions in serving the minority market. Interestingly, the selected lenders' origination rates exceed national figures for whites as well as minorities: the subject lenders originate loans to 81.6 percent of all white applicants, compared to only 67.1 percent for the national average.

Alternative measures suggest a more complicated picture, however. The selected lenders are indistinguishable from national trends when measured in terms of minority loans as a share of their total residential lending volume (14.9 percent), and minorities comprise a slightly smaller proportion of the applicant pool for the subject lenders (16.3 percent vs. 17.3 percent). More importantly, however, there is evidence of variation in the applicant pool: in every racial category, the selected exemplary lenders attract applicants who report higher household incomes and seek larger loans for homes in more affluent neighborhoods than the national averages. For example, African American applicants to our sample of lenders report incomes 17 percent higher than the nationwide pool of African American applicants ($46,604 vs. $39,943); obtain loans 9 percent larger ($88,772 vs. $81,161); and apply in Census tracts with slightly higher income levels ($37,689 vs. $36,750). It is possible, therefore, that comparatively high origination rates at lenders participating in the study result from a pool of relatively easy-to-qualify minority applicants.

Excluding the largest lenders from the tabulations sheds further light on these questions (Exhibit 6.2).[1] While the average number of applications filed suggests that our reputational

[1] In many respects, institutional change to foster minority and LMI lending may be more difficult in particularly large institutions. It is also more difficult to ascertain the day-to-day operations of large, complicated, and hierarchical organizational structures, complicating our attempt to evaluate qualitative and quantitative insights on the lending process. Additionally, many large lenders opt to spatially separate the process of taking applications (e.g., in designated branches) from that of underwriting (e.g., in regional processing centers); this structure makes it difficult to evaluate the relative importance of different strategies (e.g., innovative outreach strategies in a local branch vs. flexible underwriting criteria in a distant processing center) in fostering increased lending to minority and LMI neighborhoods.

EXHIBIT 6.1
Descriptive Statistics for Exemplary Lenders and All Lenders Reporting 1995 HMDA records, by race

		1 Lenders Included in Study	2 All Lenders*
Total applications	*White*	306,423	3,869,900
	African American	30,715	445,781
	Hispanic	29,168	365,172
Minority share		16.3 %	17.3 %
Average number of applications per lender	*White*	10,214	867
	African American	1,024	100
	Hispanic	972	82
Total originations	*White*	250,149	2,598,583
	African American	21,769	233,372
	Hispanic	22,056	221,979
Minority share		14.9 %	14.9 %
Average number of originations per lender	*White*	8,338	582
	African American	726	52
	Hispanic	735	50
Origination rate	*White*	81.6 %	67.1 %
	African American	70.9 %	52.4 %
	Hispanic	75.6 %	60.8 %
Average applicant income ($)	*White*	67,016	56,304
	African American	46,604	39,943
	Hispanic	48,077	44,165
Average approved applicant income ($)	*White*	65,888	61,461
	African American	47,728	45,084
	Hispanic	48,316	47,380
Average loan amount ($)	*White*	113,722	98,528
	African American	88,772	81,161
	Hispanic	95,466	89,368
Withdrawal rate	*White*	10.9 %	14.2 %
	African American	13.7 %	14.9 %
	Hispanic	12.9 %	15.4 %
Average tract median family income** ($)	*White*	47,143	43,458
	African American	37,689	36,750
	Hispanic	37,662	34,821
Average ratio of tract to MSA median family income**	*White*	122.2 %	115.3 %
	African American	97.9 %	96.7 %
	Hispanic	101.4 %	101.8 %
Average tract minority population percentage**	*White*	12.7 %	12.8 %
	African American	45.0 %	42.6 %
	Hispanic	43.8 %	42.2 %

Notes: * Figures reported in column 2 also include statistics for institutions participating in the study.
** These variables refer to average Census tract characteristics of properties for which applications are received (not excluding denials and withdrawals). These figures therefore measure aggregate neighborhood characteristics of *demand* for mortgages, not its *supply*.
Data Source: 1995 HMDA LAR Records.

EXHIBIT 6.2
Descriptive Statistics for Subset of Exemplary Lenders and all Lenders reporting 1995 HMDA records, by race

		1 Lenders Included in Study (excluding 4 largest)	2 All Lenders*
Total applications	*White*	40,697	3,604,152
	African American	5,415	420,496
	Hispanic	5,219	341,217
Minority Share		20.7 %	17.4 %
Average number of applications per lender	*White*	1,565	404
	African American	208	47
	Hispanic	201	38
Total originations	*White*	32,278	2,380,692
	African American	3,758	215,381
	Hispanic	3,537	203,456
Minority Share		18.4 %	15.0 %
Average number of originations per lender	*White*	1,241	267
	African American	145	24
	Hispanic	136	23
Origination rate	*White*	79.3 %	66.1 %
	African American	69.4 %	51.2 %
	Hispanic	67.8 %	59.6 %
Withdrawal rate	*White*	10.9 %	14.4 %
	African American	12.4 %	14.9 %
	Hispanic	13.2 %	15.5 %
Denial rate	*White*	9.8 %	19.5 %
	African American	18.3 %	33.9 %
	Hispanic	19.0 %	24.8 %
Average applicant income ($)	*White*	64,880	55,486
	African American	38,282	39,439
	Hispanic	40,426	43,770
Average approved applicant income ($)	*White*	63,413	61,021
	African American	41,119	44,745
	Hispanic	39,813	47,145
Average loan amount ($)	*White*	101,825	96,977
	African American	70,969	80,214
	Hispanic	72,236	88,409
Average tract median family income ($)**	*White*	46,427	43,133
	African American	33,110	36,591
	Hispanic	34,573	34,542
Average ratio of tract to MSA median family income**	*White*	122.3 %	114.7 %
	African American	90.4 %	96.5 %
	Hispanic	93.9 %	101.7 %
Average tract minority population percentage**	*White*	12.8 %	12.8 %
	African American	49.7 %	42.5 %
	Hispanic	46.3 %	42.2 %

Notes: *Figures reported in column 2 exclude the four largest lenders among those participating in the study but include those in column 1.

**These variables refer to average Census tract characteristics of properties for which applications are received (not excluding denials and withdrawals). These figures therefore measure aggregate neighborhood characteristics of *demand* for mortgages, not its *supply*.

Data Source: 1995 HMDA LAR Record

survey disproportionately identified larger institutions, some of this effect could be a result of the HMDA reporting system.[2] More importantly, however, the results for the remaining exemplary lenders (i.e., with the four largest excluded) confirm that favorable origination rates are not simply a result of a more qualified applicant pool (at least as measured by income). Although white applicants to these remaining exemplary lenders have higher incomes ($64,880 vs. $55,486), the average income of minority applicants (and of minorities approved for mortgages) is lower at the selected lenders than in the national sample. Moreover, the average income of loans made to minority applicants appear to be more heavily focused to neighborhoods with lower incomes and higher proportions of minority residents. For example, African American applicants to our selected lenders report incomes three percent below the nationwide figure ($38,282 vs. $39,439); those approved report incomes eight percent lower ($41,119 vs. $44,745) and the loans they received were 11 percent smaller ($70,969 vs. $80,214). In comparison to the national norm, the “typical” property for which our selected lenders received an application from an African American home seeker was in a neighborhood with lower income ($33,110 vs. $36,591) and more minority residents (49.7 percent vs. 42.5 percent).

Finally, there are substantial *geographical* differences in the applicant pools of these institutions; these variations distinguish the selected lenders from national market trends, but cross-lender variation within our sample is also apparent, reflecting underlying dynamics in the geography of urban housing market processes. Exhibit 6.3 presents detailed lending data for each of the exemplary lenders participating in the study for whom HMDA records are available. In order to preserve confidentiality all identifying information is excluded from this table, and the lenders are listed in random order. Inspection of the neighborhood-level characteristics of the properties for which lenders receive applications points to persistent racial and income segmentation of the housing market. For all of the selected lenders, the average tract income of properties for which applications are received from whites exceeds the comparable figure for African Americans, while the neighborhood minority composition is lower for white applications than for African Americans. A similar pattern is apparent when whites are compared to Hispanics, although the gap is slightly less pronounced (and in four cases, the average income of properties for Hispanic applications is actually higher than that for whites). In general, however, segmentation continues: despite significant distinctions in business practices, outreach efforts, and other factors, white homeowners applying to these lenders continue to apply for loans in higher-income, predominantly white neighborhoods, while minority home seekers continue to apply in neighborhoods with lower incomes and greater minority percentages. These issues provide a reminder of the tensions between the two distinct goals of fair lending and fair housing efforts: increasing access to higher-value, suburban housing markets (which offer greater possibilities for home appreciation and asset-building) and directing mortgage investment into low- and moderate-income minority neighborhoods in central cities (which may be characterized by reduced rates of home appreciation).

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[2] All of the average figures reported for the nationwide samples in Exhibits 6.1 and 6.2 are based on the number of unique ID numbers listed in the HMDA loan application register files. Lenders with complex organizational structures (bank holding companies, those separating commercial and residential lending subsidiaries, etc.) commonly report under multiple ID numbers. The average figures in these exhibits therefore describe *reporting entities* rather than discrete lending institutions.

EXHIBIT 6.3A
Detailed Lending Statistics for Selected Exemplary Lenders Included in Study

Code	Applications			Minority	Originations			Minority	Origination rates		
	White	*African American*	*Hispanic*	**Share**	*White*	*African American*	*Hispanic*	**Share**	*White*	*African American*	*Hispanic*
A	701	70	68	16.4	632	52	56	14.6	90.2	74.3	82.4
B	1	32	17	98.0	1	26	15	97.6	100.0	81.3	88.2
C	2,970	375	1,065	32.7	2,498	263	811	30.1	84.1	70.1	76.2
D	38	74	.	66.1	25	54	.	68.4	65.8	73.0	.
E	3,709	249	649	19.5	2,118	104	337	17.2	57.1	41.8	51.9
F	111	16	26	27.5	90	8	22	25.0	81.1	50.0	84.6
G	9,669	1,696	620	19.3	8,098	1,223	405	16.7	83.8	72.1	65.3
H	34,716	3,893	1,919	14.3	28,269	2,879	1,474	13.3	81.4	74.0	76.8
I	1,024	45	1	4.3	885	34	1	3.8	86.4	75.6	100.0
J	1,740	200	15	11.0	1,416	128	6	8.6	81.4	64.0	40.0
K	2,515	293	229	17.2	2,095	199	179	15.3	83.3	67.9	78.2
L	46,553	2,164	1,717	7.7	43,130	1,852	1,548	7.3	92.6	85.6	90.2
M	3,297	587	1,434	38.0	2,346	370	987	36.6	71.2	63.0	68.8
N	1,270	148	35	12.6	1,034	99	29	11.0	81.4	66.9	82.9
O	1,155	199	28	16.4	999	156	24	15.3	86.5	78.4	85.7
P	34	55	1	62.2	26	47	1	64.9	76.5	85.5	100.0
Q	1,397	234	96	19.1	1,182	181	76	17.9	84.6	77.4	79.2
R	5	16	.	76.2	3	9	.	75.0	60.0	56.3	.
S	1,445	108	83	11.7	1,168	73	63	10.4	80.8	67.6	75.9
T	5	.	6	54.5	4	.	1	20.0	80.0	.	16.7
U	416	12	7	4.4	354	10	6	4.3	85.1	83.3	85.7
V	16	6	.	27.3	13	5	.	27.8	81.3	83.3	.
W	885	58	243	25.4	457	31	145	27.8	51.6	53.4	59.7
X	210	80	39	36.2	194	69	36	35.1	92.4	86.3	92.3
Y	5,233	729	142	14.3	4,821	557	123	12.4	92.1	76.4	86.6
Z	8	27	1	77.8	7	21	1	75.9	87.5	77.8	100.0
AA	116,559	12,665	15,165	19.3	98,188	9,362	12,120	18.0	84.2	73.9	79.9
BB	2,674	92	411	15.8	1,730	34	212	12.4	64.7	37.0	51.6
CC	169	14	3	9.1	82	5	1	6.8	48.5	35.7	33.3
DD	67,898	6,578	5,148	14.7	48,284	3,918	3,377	13.1	71.1	59.6	65.6

Note: Lender identities suppressed to preserve confidentiality; letter codes are included solely to indicate separate entries for different institutions, and are assigned in random order.

Data Source: 1995 HMDA LAR Records.

EXHIBIT 6.3B
Detailed Lending Statistics for Selected Exemplary Lenders Included in Study

Code	Average Applicant Income			Average Approved Applicant Income			Average Loan Amount		
	White	*African American*	*Hispanic*	*White*	*African American*	*Hispanic*	*White*	*African American*	*Hispanic*
A	87,217	63,643	57,544	88,358	69,000	58,054	140,158	123,692	116,946
B	167,000	68,469	28,529	167,000	61,846	29,133	660,000	147,462	79,600
C	58,244	43,661	40,276	58,390	43,791	41,277	93,628	79,856	63,300
D	81,263	42,595	.	72,120	40,685	.	97,640	45,796	.
E	116,764	86,783	66,536	113,196	95,211	63,362	220,760	178,346	136,837
F	49,982	64,000	52,461	46,311	72,750	52,864	95,811	103,625	100,818
G	51,363	34,762	35,268	51,736	36,025	38,054	78,420	65,679	58,217
H	62,327	42,103	47,915	62,438	42,416	47,877	110,360	81,952	94,126
I	46,256	34,089	61,000	47,476	33,118	61,000	58,336	44,618	55,000
J	51,652	37,205	33,667	53,276	39,961	32,833	74,075	62,438	31,167
K	87,616	45,273	42,616	87,472	46,271	42,531	161,100	89,573	85,771
L	63,937	53,439	52,863	64,300	54,100	53,021	107,348	90,414	94,414
M	57,525	35,894	28,647	57,054	36,141	27,869	86,508	60,552	50,420
N	38,832	34,743	29,800	39,996	38,020	30,241	65,586	58,758	52,862
O	43,702	32,312	44,286	44,055	31,910	45,250	77,130	57,673	62,708
P	25,706	21,400	48,000	25,692	21,915	48,000	45,577	42,362	64,000
Q	59,079	40,222	28,344	61,537	42,055	28,461	84,785	64,204	50,711
R	22,400	42,188	.	22,333	51,444	.	41,667	35,778	.
S	86,433	36,972	54,277	87,827	39,082	57,429	127,266	68,479	97,063
T	89,600	.	46,333	96,250	.	32,000	122,250	.	32,000
U	61,274	49,250	93,000	61,715	47,400	105,333	84,418	74,200	102,167
V	56,813	74,000	.	52,308	77,800	.	86,154	65,000	.
W	103,362	68,776	57,914	100,794	68,645	54,669	216,484	162,968	155,283
X	75,048	37,200	41,667	74,216	37,609	40,417	128,572	78,290	100,139
Y	59,737	39,252	38,239	60,114	40,700	38,496	91,116	60,181	55,862
Z	95,125	47,296	51,000	93,714	44,429	51,000	106,857	62,714	64,000
AA	59,320	47,206	47,547	59,565	48,197	48,037	106,149	96,140	100,265
BB	58,239	44,478	33,723	60,474	58,412	35,684	92,150	95,471	58,250
CC	54,142	48,643	116,333	71,341	75,200	160,000	37,463	34,000	29,000
DD	86,018	52,709	55,861	83,838	53,840	56,255	144,738	92,475	103,639

Note: Lender identities suppressed to preserve confidentiality; letter codes are included solely to indicate separate entries for different institutions, and are assigned in random order.

Data Source: 1995 HMDA LAR Records.

EXHIBIT 6.3C
Detailed Lending Statistics for Selected Exemplary Lenders Included in Study

Code	Average Tract Median Family Income			Average Tract to MSA Median Family Income Percentage			Average Tract Minority Population Percentage			Withdrawal Rate		
	White	*African American*	*Hispanic*	*White*	*African American*	*Hispanic*	*White*	*African American*	*Hispanic*	*White*	*African American*	*Hispanic*
A	48,096	25,660	37,162	112.5	60.0	86.9	14.2	59	31.5	7.6	8.6	5.9
B	83,334	37,585	34,925	213.5	96.3	89.5	16.7	87.9	82.8	0.0	6.3	0.0
C	38,602	31,521	29,288	122.7	108.0	103.6	28.9	42.3	58.5	9.7	14.4	11.9
D	38,859	31,477	.	92.7	75.1	.	34.8	72	.	10.5	9.4	.
E	61,275	45,254	42,961	146.5	110.5	105.7	23.6	58.7	52.6	21	16.5	16.8
F	47,474	33,454	36,675	111.0	78.2	85.8	19.3	74.9	42.3	7.2	12.5	11.5
G	40,188	32,803	33,832	117.0	97.0	102.2	11.7	41.0	37.0	6.4	8.3	6.9
H	46,200	36,300	39,423	119.1	94.2	104.5	10.2	42.5	35.1	11.8	12.2	13.0
I	36,501	26,562	.	108.9	79.2	.	5.3	33.8	.	6.6	11.1	.
J	37,416	27,735	31,539	117.3	85.2	104.1	7.1	45.6	4.9	11.3	13.0	40.0
K	61,783	41,399	41,265	117.3	82.1	80.4	8.2	38.3	31.8	11.3	17.4	9.6
L	48,015	40,400	40,770	121.0	101.2	105.2	5.4	41.1	10.2	3.4	4.8	2.3
M	44,934	36,380	31,665	122.0	97.4	86.7	23.7	54.0	50.2	16.0	16.9	18.6
N	38,990	32,734	39,096	105.7	87.2	104.8	9.0	33.4	20.0	8.8	12.2	8.6
O	42,432	33,948	41,193	112.2	89.9	109.1	9.2	36.8	18.8	8.5	13.6	14.3
P	27,431	22,318	35,779	89.5	72.8	116.8	19.0	52.6	22.0	11.8	5.5	0.0
Q	42,426	26,362	25,617	116.6	72.2	70.2	8.1	68.0	20.9	13.2	9.4	3.4
R	30,659	27,059	.	93.5	82.5	.	16.2	52.4	.	20.0	0.0	.
S	46,605	32,319	42,240	123.9	85.4	110.4	10.3	44.0	15.0	13.6	22.2	16.9
T	57,104	.	34,541	126.3	.	98.0	20.6	.	53.0	20.0	.	16.7
U	45,867	33,414	58,797	119.9	85.0	141.3	5.8	24.4	7.4	11.3	8.3	0.0
V	44,273	39,198	.	104.9	92.9	.	10.4	45.1	.	12.5	0.0	.
W	63,966	47,178	38,939	151.8	116.9	95.1	23.4	56.1	62.5	14.2	15.5	9.1
X	54,115	32,485	31,260	128.1	76.0	73.4	12.8	76.4	55.0	7.6	8.8	5.1
Y	44,161	28,445	31,024	121.4	78.0	85.1	5.7	63.9	17.5	5.4	11.9	7.0
Z	38,097	35,909	35,952	90.9	85.7	85.8	39.1	56.3	25.0	0.0	11.1	0.0
AA	44,922	39,005	37,659	118.3	100.4	101.5	14.5	44.1	45.5	9.1	14.2	12.4
BB	41,063	37,075	31,498	119.5	108	94.1	14.2	27.9	39	13.9	9.8	6.8
CC	40,399	22,175	52,506	110.7	60.8	143.9	7.9	69.4	24.1	14.2	14.3	0.0
DD	51,755	39,314	40,225	131.2	100.8	107.3	12.9	45.1	38.0	18.5	17.9	17.7

Note: Lender identities suppressed to preserve confidentiality; letter codes are included solely to indicate separate entries for different institutions, and are assigned in random order.

Data Source: 1995 HMDA LAR Records.

The results in Exhibit 3 provide tentative confirmation that lenders in this study have, as a group, achieved an exemplary record of extending mortgages to minority applicants. In comparison to the national average, racial disparities in origination rates are reduced by approximately one-third among the subject lenders. The composition of the applicant pool among the selected exemplary lenders may contribute somewhat to narrowing this gap; but this bias appears to be extremely small. A more rigorous consideration of the lending patterns of these institutions, however, requires a multivariate approach to control for factors considered in the lending process.

Cross-Sectional Analysis of Lending in 1995

To control for factors considered by lenders, we calibrate a series of loan origination models incorporating a standard set of variables describing applicant, property, and institutional characteristics (Exhibit 6.4). First, variables are coded for the limited set of applicant characteristics provided in the HMDA files, including sex, gross annual income, and the presence of a co-applicant (the latter possibly correlating with greater stability of income). Given the focus of the study on lending to African American and Hispanic borrowers, the RACE variable is coded to 1 for these groups and 0 for whites (thus excluding all other groups). Two variables denote characteristics of the property: loan amount requested (LAMOUNT), and a dummy coded 1 for applications filed for owner occupancy as a principal dwelling (OCC).[3] A single neighborhood variable is included as a proxy for intra-urban variations in residential mortgage demand: COWN measures the number of owner-occupied housing units in the tract in which the property is located. Finally, lender variables include a measure to control for possible variations by institutional size (NAPP), as well as a series of regulatory agency dummies to control for the varied underwriting criteria and loan products associated with different segments of the lending industry (e.g., Canner and Gabriel 1992).

Pooled Analysis

The first stage in the analysis is a pooled model of all loan applications filed in 1995 (Exhibit 6.5). With the exception of one of the agency variables, all parameter estimates in this formulation are significant at the five percent level or better. The signs of the coefficients for the control variables are generally in line with expectations: loans are more likely to be originated for non-minority, male household heads with higher incomes who file applications for higher-value properties.

The procedure used to assess the fit of the model to the data requires some clarification. Since the dependent variable is binary (i.e., the loan is either originated or it is not), standard measures of model fit (such as an R^2) are inappropriate. Most researchers use a simple classification table to compare: a) the number of cases for which the model predicts that a loan will be originated; and b) the observed outcome (i.e., whether the loan was actually originated). This procedure yields an intuitively simple and readily interpreted "percent predicted correctly" (PPC) measure.

Unfortunately, this conventional approach can be extremely unreliable. Since the output of binary choice models consists of probabilities, all observations for which the model predicts a 49 percent origination probability or less are classified as "rejections." Conversely, observations with at least 51 percent probabilities are classified as "originations." Depending upon the overall probability of rejection for the entire sample, then, comparing observed and predicted outcomes can yield low PPC measures for otherwise well specified models.

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[3] Some studies replace the separate terms for applicant income and loan amount with a variable denoting the ratio of income to the amount of the loan requested. We experimented with this alternative specification, and while the estimate for this term is as anticipated (negative), it precipitates only negligible shifts in the parameter estimates reported in our models.

EXHIBIT 6.4
Variables Used in Loan Origination Models

Dependent Variable:	
ORIG	Loan originated? (0=no, 1=yes)
Independent Variables:	
LENDER	Lender participating in study? (0=no, 1=yes)
APINC	Applicant gross annual income (thousands of dollars)
LAMOUNT	Loan amount (thousands of dollars)
RACE	Race (0=white, 1=African American or Hispanic)
SEX	Sex (0=female, 1=male)
COAPP	Coapplicant? (0=no, 1=yes)
NAPP	Number of applications received by lender
COWN	Number of owner-occupied units in Census tract of property
OCC	Owner occupancy (0=no, 1=yes)
AG1	Agency: Office of the Comptroller of the Currency
AG2	Agency: Federal Deposit Insurance Corporation
AG3	Agency: Federal Reserve Board
AG4	Agency: Office of Thrift Supervision
AG5	Agency: National Credit Union Association

Note: Reference category for agency dummies is Department of Housing and Urban Development

Data Source: 1995 HMDA

EXHIBIT 6.5
Pooled Probit Model of Loan Origination, 1995

Variable	*Estimate*
INTERCEPT	0.599***
RACE	-0.263***
LENDER	0.379***
RACE*LENDER	0.0194**
APINC	0.000543***
LAMOUNT	0.000421***
SEX	0.00522000*
COAPP	0.0882***
NAPP	-0.00000267***
COWN	0.000022***
OCC	0.0135***
AG1	-0.000759
AG2	0.186***
AG3	0.106***
AG4	0.0732***
AG5	0.199***
Observations	3,138,775

Note: *Coefficient significant at P<0.05; **P<0.01; ***P<0.001.

Data Source: 1995 HDMA LAR Records.

As Browne and Tootell (1995) argue, a more appropriate evaluation of model fit is to compare model predictions to observed frequencies of originations for different groups of applicants. In other words, how many of the applicants for whom the model predicts a relatively high probability of origination actually received loans? This approach involves three steps. We first rank the applications in deciles according to the model-predicted probability of loan origination (see the first column in Exhibit 6.6). Second, we calculate the average predicted probability for the observations within each decile. Finally, for each decile we calculate the percentage of applications actually originated.

This procedure confirms that the model fits the observed pattern of loan origination remarkably well, with the sole exception of applications at the top end of the distribution. It is possible that the discrepancy for these home seekers (predicted origination rate of 91.4 percent versus an actual rate of only 73.5 percent) results from trade-up home buyers reaching beyond their means. Overall, however, the model fits the data remarkably well.

For brevity, we focus here on the three coefficients of most substantive interest: those for minority applicants (RACE), for lenders participating in the study (LENDER), and the interaction term between these two indicators (RACE*LENDER). The negative and significant estimate for the RACE term confirms that the likelihood of approval and origination is reduced for African American and Hispanic applicants, even after controlling for loan amount, income, and other measures incorporated in the model specification. By contrast, the positive estimate for lenders participating in the study (LENDER) implies that all applicants, regardless of race, enjoy greater likelihood of approval and origination after controlling for these factors. This result implies that the findings of the tabular analysis presented earlier cannot be attributed solely to the characteristics of the applicant pool (at least as measured by this limited set of variables). Lenders participating in the study achieve substantially higher origination rates among all races, and this effect persists after controlling for applicant, property, and institutional characteristics. The RACE*LENDER interaction term focuses specifically on the practices of the selected lenders with respect to minority applicants: the positive and significant estimate on this variable confirms that minority home seekers who apply to the selected lenders are significantly more likely to receive a loan than are minority applicants at the non-selected lenders.

Estimating the magnitude of these effects is complicated by the nonlinear nature of binary choice models. We therefore calculate the difference in predicted probability of loan origination for different combinations of RACE and LENDER. For example, we calculate the origination probability for the average white home seeker who applied to the selected exemplary lenders; we then substitute a zero for the LENDER term and recalculate the probability (see the first line in Exhibit 6.7). The difference between these two probability values thus represents the effect of the subject lenders' business practices for increasing origination rates for whites.

EXHIBIT 6.6
Goodness of Fit for Pooled Probability Model

Probability Range	Average Predicted Origination Probability	Actual Origination Frequency
0-10%	—	—
10%-20%	19.8	18.6
20%-30%	27.0	27.6
30%-40%	32.4	29.9
40%-50%	43.3	37.9
50%-60%	56.0	52.7
60%-70%	67.1	67.1
70%-80%	76.3	77.3
80%-90%	82.6	81.7
90%-100%	91.4	73.5

Source: Loan origination model based on 1995 HMDA LAR records.

Differences in predicted probabilities confirm the success of the selected exemplary lenders in increasing origination rates for all borrowers, but particularly for minorities (Exhibit 6.7). For whites, the average home seeker applying to one of the selected lenders enjoys a 10.3 percent greater likelihood of approval in comparison to whites applying to other institutions. For minorities, this figure is substantially increased: African American and Hispanic applicants enjoy a 13.2 percent greater likelihood of acceptance and origination by applying to the selected lenders.

EXHIBIT 6.7
Difference in Origination Probability by Minority and Lender Status, 1995

Probability I	—	Probability II	=	Probability Difference
White applicants to select lenders		White applicants to nonselect lenders		0.103
Minority applicants to select lenders		Minority applicants to nonselect lenders		0.132

Source: Loan origination model based on 1995 HMDA LAR records.

These findings imply that the business practices of lenders included in the study are associated with increased approval and origination rates regardless of race, but that the effect of these increases is especially pronounced for African American and Hispanic home seekers. Best Practices in lending benefit all borrowers, but are especially beneficial to minority home seekers.

Decomposition Analysis

Nationwide, origination rates for whites in 1995 were 67.1 percent, compared to 52.4 percent for African Americans and 60.8 percent for Hispanics; for the selected exemplary lenders, these figures are 81.6 percent, 70.9 percent, and 75.6 percent. The selected exemplary lenders, therefore, achieve a narrowing of the white-African American origination gap from 14.7 percent to 10.7 percent, and of the white-Hispanic gap from 6.3 percent to 6.0 percent.

To what degree do these results simply reflect variations in the applicant pools of the different lending institutions? To address this question, loan origination models are calibrated separately for white and minority applicants, and the results are used to perform a partial decomposition analysis (Blinder, 1973; Oaxaca, 1973). This standard econometric technique is now used in a wide range of studies to distinguish the different *treatment* of group members from the effects of their different individual *characteristics*. In the case at hand, the method involves the substitution of mean values and coefficient estimates for a reference group (whites) and a comparison group (minorities) to calculate predicted origination rates for one group of applicants if they were treated the same way as the other group. The method provides estimates of the proportion of the racial disparity in origination rates which stems from "endowment" effects (e.g., lower minority incomes) and that reflect "discrimination" (e.g., different evaluation of the characteristics of minorities in the application processing phase) (see Carr and Megbolugbe 1992 and others). As with the pooled analysis, a standard probit specification is used to model origination probability separately for whites and minorities; separate models are also calculated for the national sample and for the selected exemplary lenders. These models yield highly significant parameter estimates (at the 1 percent level or better) for all except one variable.[4] Results are presented in Exhibits 6.8 and 6.9.[5]

The decomposition results confirm substantial contrasts between the selected exemplary lenders and the nationwide group of lenders. Nationally, the difference in predicted origination probability for whites and minorities is 9.69 percent, compared to 8.12 percent for lenders participating in the study. For both sets of institutions, most of this racial difference cannot be accounted for by applicant characteristics, but results from decisions made in the application processing phase. This small reduction (from 9.7 percent to 8.1 percent) confirms that racial disparities in access to mortgage finance continue to be a problem throughout the industry; these findings must be strongly qualified, however, since the models reported here do not include information on credit history and other criteria important in the underwriting process.

Comparing minority and white origination probabilities within each group of institutions reveals further contrasts between the selected exemplary lenders and their peers. Nationwide, the predicted origination rate for minorities is 65.5 percent; if there were no racial differences in the application processing phase, these home seekers would have had an origination rate of 74.5 percent. Thus, for these institutions, loans are originated to minorities at a rate 12.0 percent less than expected after controlling for all variables in the model. For the selected exemplary lenders, the predicted origination rate for minorities is 75.5 percent; eliminating racial differences in application processing would boost this rate to 82.2 percent. For these institutions, then, loans are originated to minorities at a rate 8.7 percent less than expected. After controlling for all applicant and institutional characteristics, therefore, lenders participating in the study have managed to narrow racial disparities in loan origination by 27 percent.

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[4] The coefficient for SEX for white applicants in the national sample is insignificant.

[5] The variable for institution size reported in Exhibits 6.8 and 6.9 is not comparable to the average figures cited in Exhibits 6.1–6.3: each of the selected lenders, for example, received an average of 10,214 white applications in 1995, while Exhibit 6.9 reports a mean of 90,396 for NAPP. The much larger values in Exhibits 6.8 and 6.9 result from the calculation of an institution level variable for each applicant. Specifically, the figure cited in Exhibit 6.9 represents the sum of the number of applications received by lenders, for each white applicant, divided by the total number of white applicants.

EXHIBIT 6.8
Decomposition of Differences in Expected Origination Rates
For All Lenders Reporting 1995 HMDA Records

Variable	(1) White Coefficients	(2) Minority Coefficients	(3) White Mean	(4) Minority Mean
INTERCPT	0.5846861	0.3340580	1	1
LENDER	0.3847969	0.3841069	0	0
APINC	0.0005767	0.0004023	60.5890	45.0380
LAMOUNT	0.0002689	0.0014899	99.1910	83.1975
SEX	-0.0032921	0.0313634	0.7896	0.7054
COAPP	0.1030741	0.0230980	0.6461	0.5537
NAPP	-0.0000026	-0.0000027	60170.4700	52584.3700
COWN	0.0000219	0.0000199	1584.7000	1489.4900
OCC	0.0136746	0.0181488	0.9332	0.9516
AG1	0.0268076	-0.0740583	0.1804	0.1875
AG2	0.2142571	0.0959063	0.1674	0.1359
AG3	0.1436762	-0.0305168	0.1204	0.0738
AG4	0.1214509	-0.1000361	0.1691	0.1439
AG5	0.2522199	-0.0547960	0.0149	0.0083
(5) p(origination): white means, white coefficients columns (1) * (3)				75.21%
(6) p(origination): minority means, minority coefficients columns (2) * (4)				65.52%
(7) p(origination): minority means, white coefficients columns (1) * (4)				74.50%
(8) p(origination): white means, minority coefficients columns (2) * (3)				66.09%
Total difference, expected white origination rate less minority expected rate [(5) - (6)]				9.69%
Minorities treated as white, endowment effect [(5) - (7)]				0.71%
Minorities treated as white, treatment effect [(7) - (6)]				8.97%
Expected minority origination rate if treated as white (7)				74.50%
Less minority origination rate (6)				65.52%
=				8.97%
Divided by origination rate if treated as white (7)				12.05%
For minorities, loans are originated 12% less often than expected				

EXHIBIT 6.9
Decomposition of Differences in Expected Origination Rates
For the Sample of Selected Lenders

Variable	(1) White Coefficients	(2) Minority Coefficients	(3) White Mean	(4) Minority Mean
INTERCPT	0.58468607	0.33405798	1	1
LENDER	0.38479687	0.38410690	1	1
APINC	0.00057666	0.00040229	70.8707	49.5233
LAMOUNT	0.00026892	0.00148986	125.8215	95.9577
SEX	-0.00329210	0.03136338	0.8268	0.7310
COAPP	0.10307412	0.02309798	0.7270	0.6461
NAPP	-0.00000264	-0.00000267	90395.5700	92315.7400
COWN	0.00002193	0.00001985	1583.8600	1489.2100
OCC	0.01367458	0.01814882	0.9648	0.9783
AG1	0.02680755	-0.07405830	0.4564	0.4031
AG2	0.21425712	0.09590629	0.0033	0.0037
AG3	0.14367618	-0.03051680	0.0223	0.0191
AG4	0.12145091	-0.10003610	0.1461	0.1493
AG5	0.25221987	-0.05479600	0.0000	0.0000

(5) p(origination): white means, white coefficients columns (1) * (3)	83.13%
(6) p(origination): minority means, minority coefficients columns (2) * (4)	75.01%
(7) p(origination): minority means, white coefficients columns (1) * (4)	82.19%
(8) p(origination): white means, minority coefficients columns (2) * (3)	76.90%
Total difference, expected white origination rate less minority expected rate [(5) - (6)]	8.12%
Minorities treated as white, endowment effect [(5) - (7)]	0.94%
Minorities treated as white, treatment effect [(7) - (6)]	7.18%
Expected minority origination rate if treated as white (7)	82.19%
Less minority origination rate (6)	75.01%
=	7.18%
Divided by origination rate if treated as white (7)	8.74%
For minorities, loans are originated 8.7% less often than expected	

The Role of Geographical Demand Variations

The analysis thus far confirms that lenders identified in the reputational survey have achieved a record of lending to minorities that is significantly different from national trends as measured in HMDA data. Further, these differences remain after controlling for applicant and lender characteristics. The business practices analyzed in this study are associated with significant increases in lending to all applicants, and especially to African American and Hispanic home seekers.

These findings do not, however, address the relationship between individual-level lending patterns (i.e., narrowing the gap between white and minority applicants) and geographical variations in lending (i.e., CRA-related mandates to serve all neighborhoods from which deposits are taken including low- and moderate-income communities).

We therefore reestimated the pooled probit model reported in Exhibit 6.5 with an additional variable (GEO) measuring the proportion of each lender's applications that were filed for properties located in Census tracts with median incomes below 80 percent of their respective MSA median. While this reestimated formulation yields parameter estimates of the same sign as those in the original model, the magnitude and significance of several coefficient estimates is altered (compare Exhibit 6.10 with Exhibit 6.5). The GEO variable proves negative and significant, indicating that origination probability is reduced for applications filed at lenders drawing larger shares of their business from moderate- and low-income neighborhoods. Given the limited scope of applicant information included in the public release versions of HMDA, this result is unsurprising: the reduced income and more unstable employment opportunities available to residents of low- and moderate-income neighborhoods mean that they are more likely to have blemished credit records. If they apply to local institutions which draw much of their business from low- and moderate-income neighborhoods, then these lenders will be more likely to reject applications on the basis of credit criteria not captured by the income variable. The result is that lenders based in these neighborhoods appear to be less favorably disposed to all applications (thus yielding the negative coefficient for GEO).

Most of the remaining variables in this model are unaffected by the addition of the geographical measure. As with the earlier specification, origination probability is significantly reduced for minority applicants, while all applicants to the selected exemplary lenders enjoy an increased likelihood of approval and origination. Still, the RACE-LENDER interaction term proves insignificant in this model (although its sign and magnitude remain similar). Thus, after controlling for variations in the neighborhoods from which lenders draw their mortgage business, minority home seekers are *not* more likely to receive approval at lenders participating in the study than at other lenders.

The addition of the geographical measure in this model exacerbates certain multi-colinearity problems and requires careful inspection of the model parameters along with the partial correlation between GEO and the other variables of interest (RACE, LENDER, and RACE*LENDER). For RACE and LENDER, these colinearity issues are not serious. The positive partial correlation between GEO and RACE (0.12), along with the negative coefficient of GEO, suggests that omitting the geographical variable leads to a downward bias in the coefficient for RACE. Put another way, part of the racial difference in origination rates can be accounted for by the fact that minorities are more likely to apply to lenders drawing much of their business

EXHIBIT 6.10
Pooled Probit Model of Loan Origination with Geographical Control, 1995

Variable	*Estimate*
INTERCPT	0.797***
RACE	-0.238***
LENDER	0.370***
RACE*LENDER	0.00257
APINC	0.000534***
LAMOUNT	0.000347***
SEX	0.00517000*
COAPP	0.0842***
NAPP	-0.00000277***
COWN	0.0000199***
OCC	-0.00526
AG1	-0.0156***
AG2	0.150***
AG3	0.0781***
AG4	0.0327***
AG5	0.166***
GEO	-1.291***
Observations	3,138,775

Note: *Coefficient significant at P<0.05;**P<0.01; ***P<0.001.

Data Source: 1995 HMDA LAR Records.

from low- and moderate-income neighborhoods. Differences in the parameter estimates from the two models, however, indicate that this downward bias is very small. Similarly, a negative partial correlation between GEO and LENDER (-0.04) together with the negative estimate for GEO, suggests that omitting the geographical variable leads to upward bias in the coefficient for LENDER. Put another way, the higher origination rates for the selected lenders can be attributed in part to the fact that our institutions draw smaller shares of their applicants from low- and moderate-income neighborhoods. Again, however, differences in the parameter estimates from the two models confirm that this downward bias is very small.

For the RACE*LENDER interaction term, however, geographical variations prove more important. The negative partial correlation between this term and the geographical variable is very small (-0.004), suggesting that minority applicants are marginally more likely to apply to those lenders participating in the study that have lower values of GEO. This bias is important; addition of the geographical measure eliminates the significance of the coefficient for RACE*LENDER. Consequently, at least part of the higher origination rates for minorities are explained by neighborhood-level variations in the source of applicants.

Pooled Time-Series Analysis

The final stage of the quantitative analysis involves an examination of changes in lending patterns over time. As documented elsewhere in this study, the mortgage lending industry underwent dramatic changes in the early 1990s. Rising competition and increasing consolidation of banks and other financial institutions raised concern among fair lending advocates over branch closings and possible disinvestment from minority neighborhoods. During the same period, however, CRA challenges increased regulatory scrutiny, and lenders' recognition of the profit potential of underserved markets greatly increased flows of mortgage credit to LMI and minority home buyers.

In our study, many lenders emphasized the importance of recent changes in their outlook or policies with regard to LMI and minority lending. On the one hand, these lenders recognized that demographic changes mean that white, middle-class home seekers comprise a shrinking share of the market; on the other hand, some lenders acknowledged the importance of community groups, negative local publicity, or regulatory oversight in increasing their lending to minority and LMI borrowers. The net effect of these changes on observed lending patterns, however, remains unclear.

To examine changes in lending patterns, therefore, we selected a subset of the exemplary institutions and modeled their lending decisions in the recession year of 1992 and in the more buoyant market of 1995. Five lenders were selected who explicitly referred to changes in their institution's policies or practices in the previous five years. These lenders include a large Statewide bank in New England with a professed long-standing commitment to LMI and minority lending that was strengthened in the early 1990s; a small savings bank based in an inner-city neighborhood in a large Eastern city that reported rapid expansion in the early 1990s; a mid-sized commercial bank in the Midwest that began new initiatives in response to examiners' comments in 1993 regarding its underrepresentation in LMI lending; a large thrift in California that reported expanding LMI efforts in 1991; and a mid-sized thrift in a large Midwestern city that expanded LMI initiatives in the early 1990s. This small sample of lenders is clearly not representative. While the discussions with lenders ascertained information on the recent history of LMI and minority initiatives, not all lenders were able to identify significant changes in institutional practice; moreover, in some cases the representative with whom we spoke had tenure of only a few years. The results of this analysis should, therefore, be viewed as illustrative rather than definitive.

Two data sets were assembled for the time-series analysis. The first includes all loan applications meeting the criteria used in the cross-sectional analysis that were filed with the five selected lenders in 1992 and 1995; this data set includes a total of 12,324 applications. The second data set includes applications meeting the same criteria that were filed in one of the States in which the five selected lenders conducted the majority of their mortgage business.[6] Because of significant changes in HMDA requirements in 1993 which altered the composition of lenders reporting applicant data, we further restricted this control group to those lenders with matching identification numbers in both years. This criterion, therefore, excludes new reporting entities as well as institutions undergoing significant restructuring during this period. The control group includes a total of 781,452 applications. The final adjustments to both databases involve the

[6]One of the selected lenders conducted the vast majority of its business in one metropolitan area, and so the control group for this lender is restricted to applications filed in this MSA.

coding of a dichotomous variable for the year in which each application was filed (YEAR=1 for 1995, 0 otherwise), and the interaction of this variable with the race term to highlight changes in minority origination probability in this three-year interval.

The results of the time-series analysis are presented in Exhibit 6.11, which includes separate probit models of loan origination for the five selected lenders and the control group. Results are generally in line with expectations, although the comparatively smaller sample for the selected lenders reduces the significance of some coefficient estimates in comparison to the control group. Goodness-of-fit statistics suggest that both models provide fairly accurate predictions given the limitations of the underlying data (Exhibit 6.12). The model for the control group displays wide deviations between predicted and observed originations for applicants at both tails of the probability distribution, however; this poor fit is at least partly attributable to small sample sizes at the probability extremes (each of the three lowest deciles in Exhibit 6.12 contain fewer than 50 applicants). Given the considerable time and effort that prospective buyers must expend prior to filing an application, the mortgage applications depicted in HMDA data are extremely self-selecting, and thus the sample includes few borrowers with very low acceptance probabilities. Conversely, few applicants are perfect, so few applications enjoy acceptance probabilities at the top end of the distribution. In sum, the time-series models fit fairly well for the control group, and remarkably well for the sample of five selected lenders.

The parameters of interest in these models are those for minority applicants (RACE), year of application (YEAR), and the interaction between these two (RACE*YEAR). For both models, the significant and negative estimate for RACE is as expected: approval and loan origination is significantly reduced for African American and Hispanic applicants after controlling for all other factors included in the model. Similarly, the significant positive estimate for the year of application is also unsurprising: the combination of a rebounding job market and continued low interest rates dramatically increased mortgage lending activity in the early 1990s. Indeed, several lenders noted that after the initial drop in interest rates, refinancing activity dissipated such that expansion of home-purchase mortgages was the only way of expanding residential lending in an increasingly competitive environment.

The RACE*YEAR interaction term focuses specifically on changes in loan originations to minorities during this period. This coefficient is positive and significant for the selected lenders as well as the control group: minority applicants enjoyed a greater likelihood of approval and origination with the increased competition and fair lending enforcement initiatives of the early 1990s.

EXHIBIT 6.11
Pooled Time-Series Analysis of Loan Origination, 1992 and 1995

	Selected Lenders	Control Group
Variable	Estimate	Estimate
INTER CPT	0.548***	0.598***
RACE	-0.575***	-0.325***
YEAR	0.458***	0.128***
RACE * YEAR	0.283***	0.0822***

APINC	0.000927***	0.000732***
LAMOUNT	-0.00121***	-0.00112***
SEX	0.00531	-0.0307***
COAPP	0.0393	0.120***
COWN	0.0000244	0.0000163***
OCC	0.147**	0.137***
AGI	0.487***	-0.116***
AG2	—	0.00847
AG3	0.402***	0.103***
AG4	—	-0.0860***
AG5	—	-0.0446
NAPP	-0.000161***	-0.00000145***
Observations	12,324	781,452

Note: * Coefficient significant at p<0.05; ** p<0.01; *** p<0.001

Data Source: 1992 and 1995 HMDA LAR Records.

EXHIBIT 6.12
Goodness of Fit for Pooled Time-Series Models

	Selected Lenders		Control Group	
Probability Range	Average Predicted Origination Probability	Actual Origination Frequency	Average Predicted Origination Probability	Actual Origination Frequency
0%-10%	—	—	5.9	20.0
10%-20%	—	—	16.2	48.4
20%-30%	26.9	20.0	25.9	46.8
30%-40%	37.2	33.8	36.1	41.9
40%-50%	45.6	48.2	46.7	42.2
50%-60%	56.4	55.4	57.2	54.8
60%-70%	62.9	60.6	66.0	65.8
70%-80%	77.2	79.4	75.3	75.7
80%-90%	84.3	85.2	81.9	80.6
90%-100%	92.9	89.4	91.2	79.2

Source: Loan origination model based on 1992 and 1995 HMDA LAR records.

To measure the magnitude of these changes, we calculate differences in predicted probability for selected combinations of RACE and YEAR. To obtain the figure reported in the first line of Exhibit 6.13, for example, we first calculate the origination probability for the average white applicant to the selected lenders in 1995; we then set the coefficient for YEAR equal to zero, and recalculate the probability. The difference between these values implies that white applicants' origination probability increased 13.9 percent between 1992 and 1995 at our sample of lenders.

This procedure confirms that origination probabilities have increased over the study period for applicants at all lenders in the control group. The increase is nearly twice as high for minorities (7.4 percent) as for whites (3.9 percent). These figures are considerably higher for the selected lenders, however, where white origination probability increased 13.9 percent, and the increase for minorities was 27.5 percent. This result confirms that changes at these institutions have had a dramatic effect on increasing originations for African American and Hispanic home seekers. Yet the interpretation of these results must be tempered by the greater racial disparities at these institutions at the beginning of the study period. For the control group, differences in predicted probabilities between white and minority applicants declined from 11.4 percent in 1992 to 8.0 percent in 1995, a reduction of 30 percent. For the selected lenders, the racial difference in probability stood at 22.1 percent in 1992; it declined more than 50 percent to 10.5 percent in 1995.

These results suggest that the selected lenders' practices led to significant improvements in lending patterns in the early 1990s, but that these institutions began from a less-than-exemplary record of minority and LMI lending. Inspection of loan records for these lenders in 1995 confirms this expectation: even after the improvements implied by this analysis, one lender reported an African American origination rate substantially below the nationwide average, while another received no applications from African American home seekers; two lenders posted Hispanic origination rates well below the national average, while another received only one Hispanic application.

CONCLUSION

As with all secondary data sources, HMDA files provide only a limited view of the mortgage lending process. Accordingly, this study is designed to shed light on the business strategies and day-to-day operations that lenders pursue to reach and serve neglected markets. But the quantitative analysis presented in this chapter complements the qualitative findings discussed elsewhere in the report. Three findings stand out from our analysis of HMDA records.

First, the lenders included in the study achieve minority origination rates that are substantially higher than the national average. This improvement is especially pronounced for African Americans, where the selected exemplary lenders register rates more than 18 percentage points above the national average. These institutions also post higher origination rates for whites.

Second, these higher origination rates persist after controlling for relevant individual applicant characteristics and institutional-level factors. Probit models indicate that African American and Hispanic applicants' likelihood of receiving a loan is increased 13 percent by applying at the selected exemplary lenders. While racial differences in approval and origination rates persist at most institutions, and could be influenced by credit record, household asset, and other disparities, the selected exemplary lenders have narrowed the racial disparity by 27 percent when compared to other lenders.

Third, there is evidence of significant change in mortgage lending in the early 1990s. Probit models for a small sample of lenders and a paired control group suggest that certain institutions have dramatically improved their lending to minority borrowers; some institutions, however, began from relatively poor records.

These findings provide strong confirmation for the association between improved lending to minority applicants and the business strategies documented in this study (Chapters Two through Five of this volume, and Volume Two). The exemplary lenders, identified via reputation, are by numerous measures found to be "quantitatively exemplary" as well. Nevertheless, important challenges remain. Racial disparities in approval and origination rates persist among most lenders—and even if differences in household assets or credit history are responsible, at least part of these underlying differences are within the realm of public policy. Moreover, the continued racial and income segmentation of urban housing markets provides a reminder of the tensions between two distinct goals of fair lending and fair housing efforts. Increasing access to higher value, suburban housing markets offers greater prospects for home appreciation and asset-building; channeling mortgage investment into low- and moderate-income minority neighborhoods in central cities improves community stability, but may offer reduced rates of home appreciation. Ultimately, tackling discrimination and inequity in urban housing markets requires a multifaceted effort, of which mortgage finance is only one part.

EXHIBIT 6.13
Difference in Origination Probability for White versus Minority Applicants, 1992 and 1995

	Probability I	—	Probability II	=	Probability Difference
Selected lenders	White applicants, 1995		White applicants 1992		0.139
	Minority applicants, 1995		Minority applicants, 1992		0.275
	Minority applicants, 1992		White applicants, 1992		-0.221
	Minority applicants, 1995		White applicants, 1995		-0.105
Control group	White applicants, 1995		White applicants 1992		0.039
	Minority applicants, 1995		Minority applicants, 1992		0.074
	Minority applicants, 1992		White applicants, 1992		-0.114
	Minority applicants, 1995		White applicants, 1995		-0.080

Source: Loan origination models based on 1992 and 1995 HMDA LAR Records.

CHAPTER SEVEN
SUMMARY AND CONCLUSIONS

Relatively little is known about the business practices and personal insights of staff and management of lending institutions that have achieved success in removing barriers to mortgage financing in traditionally underserved markets. This study identifies and analyzes mortgage lending practices and marketing strategies used by lenders to attract, qualify, and retain minority home buyers—particularly those with low or moderate incomes. Lenders recognized as particularly innovative in reaching underserved markets were identified through an extensive reputational survey of Federal regulators, industry groups, and community/nonprofit groups.

Telephone discussions were conducted with 50 lenders, and quantitative analyses were performed for those institutions reporting HMDA data; on-site visits and in-depth studies were conducted with eleven of these institutions. Taken together, the lenders in this study account for approximately 10 percent of all home-purchase loan originations made in 1995. Econometric analysis reveals that African American and Hispanic mortgage applicants are approximately 13 percent more likely to be approved at our sample of lenders than at other institutions.

KEY FINDINGS

The mortgage lending industry has undergone substantial change in the 1990s, and the lenders in this study have been the leaders in expanding homeownership opportunities among historically underserved borrowers and neighborhoods. Some were prompted by regulatory pressure or community activism; others have recognized the growth and profit potential in minority-LMI lending as the "traditional" market of middle-income white families has grown more slowly; still other lenders—small, neighborhood thrifts, many of them minority-owned—have always served the needs of minority-LMI communities.

Despite their outward differences, common themes emerge in the lenders' efforts to expand mortgage availability to underserved markets. We organize these varied business strategies into four categories:

- Overall management strategies: policies that create an environment conducive to minority-LMI lending.
- Seeking applicants: strategies to broaden the pool of applicants and tap latent demand among traditionally neglected markets.
- Qualifying applicants: strategies to ensure that lending decisions are based solely on repayment ability, not on irrelevant criteria that may disproportionately affect minority-LMI applicants.
- Retaining mortgagors: practices to minimize default and delinquency rates of minority-LMI lending initiatives.

The successful strategies noted in this study, which comport with the recommendations of the "Best Practices" literature, are recapped in Exhibit 7.1 below:

EXHIBIT 7.1

Recommended Strategies To Foster Enhanced Minority-LMI Lending

I. OVERALL MANAGEMENT PRACTICES

1. Include goal of fostering minority lending in institution's overall mission statement, lending policy statement, or similar defining document.[1, 2, 3]
2. Involve senior-level bank management in developing, implementing, and monitoring goal of minority lending.[2, 4]
3. Provide compensation practices that reward, or at least do not indirectly penalize, employees working to foster minority lending.[1, 2, 3]
4. Practice staff recruitment and promotion to foster minority lending through racial diversity of employees.[2, 3, 5]
5. Provide staff training in fair lending practices specifically, and multicultural awareness generally.[1, 2, 3, 4, 6]
6. Work with third parties (e.g., real estate agents and brokers, appraisers, private mortgage and insurance companies) committed to fostering minority lending.[3]
7. Systematically test for fairness, so that at all stages of the lending process (seeking, qualifying, and retaining applicants) minorities are treated equally.[2, 3, 4, 5, 7]
8. Provide consumer education on homeownership and home financing (e.g., offer guides to the home-buying process).[2, 3, 4, 6]
9. Appoint an ombudsperson or comparable official to receive complaints from consumers.[3]

II. SPECIFIC STRATEGIES BY STAGE OF THE LENDING PROCESS

A. SEEKING APPLICANTS

1. Provide information on loan products in minority neighborhoods via mailings,[5] canvassing, or other methods.[2, 3]
2. Establish branches or other presence in minority neighborhoods.[2]
3. Tailor and place advertising to attract minority applicants.[1, 2, 3, 4]
4. Work with Realtors/brokers active in minority areas.[1, 2, 3, 4]
5. Work with others to gain access to the minority mortgage market (e.g., government agencies, minority developers, service agencies, or CDC or nonprofit groups).[1, 2, 4]
6. Seek potential minority mortgage applicants among in-house minority and other employees.[3]
7. Conduct analyses of minority mortgage grantors to determine minority markets where the institution has limited presence or none at all.[3]

B. QUALIFYING APPLICANTS

Affordable Loans

1. Offer "affordable" loan products (i.e., loans that have such enhancements as a public-sector interest subsidy or down payment assistance).[1, 2, 3, 8]

Underwriting Standards

1. Credit history—Avoid subjective criteria (e.g., "applicant must have excellent credit") and consider extenuating circumstances in the case of credit blemishes; accept a no-credit record if a proxy measure such as rent/utility payment history is acceptable. [2, 4, 6, 7, 9]
2. Employment history—Avoid subjective criteria (e.g., "applicant must have adequate job longevity") and focus on applicant's ability to maintain or increase income, not on length of stay in a particular job. [2, 4, 6, 8]
3. Property standards—Avoid arbitrary disqualification of property on the basis of property's age, location, condition, value, amenities, or size. [2, 4, 6, 9]

EXHIBIT 7.1 (continued)

Recommended Strategies to Foster Enhanced Minority-LMI Lending

4. Property appraisals/neighborhood analysis—Avoid subjective descriptors such as "desirable or stable area," "homogeneous neighborhood," "attractive appearance," and "remaining economic life."[2, 6, 8, 9]
5. Loan terms—Avoid arbitrary limits, such as minimum loan amounts.[2, 4, 5, 8, 9]
6. Obligation terms—Allow for flexibility in loan application (e.g., 28 percent housing expense to income ratio and 36 percent total fixed obligations to income ratio) where applicants have a successful record in meeting high expenses.[2, 4, 8, 9]
7. Sources of income—In addition to primary employment income, count all valid secondary sources (e.g., overtime and part-time work, second and seasonal jobs, welfare and unemployment benefits).[2, 4, 8]
8. Down payment and closing costs—Allow flexible and extended informal sources (e.g., relatives' loans and cash on-hand).[2, 4, 6]
9. Ensure that loan underwriting staff understand and apply the same discretion provided to primary lenders by third-party agencies (e.g., Fannie Mae, Freddie Mac, and PMIs.)[2, 4, 6]

Underwriting Practices

1. Document institution's underwriting standards and practices, including acceptable compensating factors, and train underwriters in the consistent application of these standards and practices.[1, 2, 4]
2. Support and don't "second guess" employees' application of compensatory factors.[2]
3. Allow for a second review—a prompt and impartial review—of all rejected loan applicants to ensure fairness.[1, 2, 3, 5, 8]

C. RETAINING MORTGAGORS

1. Provide information to new mortgagors on the obligations of homeownership and helpful strategies for meeting the obligations (e.g., allowing a financial reserve and avoiding expensive home improvements).[10]
2. Carefully explain and communicate the change in loan obligations that affect the required level of payments (e.g., interest rate fluctuations in the case of a VRM, or rising property taxes).[10]
3. Provide for careful monitoring of payments and quick reaction to loan delinquency (e.g., a telephone call ascertaining why a payment was missed and when it will be sent).[10]
4. Allow flexibility to cure delinquency (e.g., allow reduced or missed payments in the case of temporary unemployment or family illness). All reduced or missed payments should ultimately be made up.[10]

NOTES

1 Federal Deposit Insurance Corporation, Federal Reserve Board, Comptroller of the Currency and Office of Thrift Supervision. 1993. *Suggested Lending Activities*. May 27.

2 Federal Reserve Bank of Boston. 1993. *Closing the Gap*.

3 Mortgage Bankers Association of America and HUD. 1994. *Fair Lending—Best Practices Agreement*.

4 Federal Financial Institutions Examination Council (FFIEC). 1993. *Home Mortgage Lending and Equal Treatment*.

5 Department of Housing and Urban Development et al. 1994. "Joint Policy Statement on Discrimination in Lending." 59 *Federal Register* 18, 266. April 15.

6 Federal Reserve Bank of Cleveland. 1994. "Committed People Can Make a Difference." *Community Reinvestment Forum*. Special Issue.

7 Federal Deposit Insurance Corporation. 1994. *Side-by-Side: A Guide to Fair Lending.*

8 National Community Reinvestment Coalition. 1995. *Catalog and Directory of Community Reinvestment Agreements*.

9 Federal Deposit Insurance Corporation. *Compliance Examination Manual.* Published annually by the FDIC; FAIR HOUSING SECTION II–B.

10 Other literature. (Details in CUPR bibliography).

Overall Management Strategies

For minority-LMI lending initiatives to be successful, it is crucial that institutions create a management environment in which fair lending is seen as an integral part of the institution's mission—not simply an unprofitable effort to fulfill fair lending requirements. Although profit margins may be lower on targeted lending initiatives, higher lending volume may compensate for smaller dollar loans. Additionally, these lending initiatives can often lead to growth in consumer lending, home improvement loans, and savings deposits. Minority-LMI lending is good business while doing good. Most large successful lenders communicate this message through their mission statements or other defining documents.

In addition to formal pronouncements, top-level management at most successful institutions takes an active leadership role and sets annual or quarterly quantitative goals for minority-LMI lending. Top management must also clearly define the role of Community Reinvestment Act (CRA) officers and the staff of special affordable lending units in the context of the entire institution. Overspecialization in affordable lending should not narrow career opportunities. A compensation structure should also be established that removes all disincentives to minority-LMI lending. Commissions should be structured in such a way as to encourage all loan officers—not simply CRA specialists—to become familiar with and promote all products offered by the lender. Several exemplary lenders even link top management compensation to minority or LMI lending goals. Finally, overall management strategies must include comprehensive provisions for ongoing staff training that extends well beyond legally mandated procedures. One large eastern lender, engaged in a partnership with a local nonprofit housing counseling organization, regularly brings counselors to its centralized loan processing facility to meet with underwriters and discuss how to qualify potential applicants.

Seeking Applicants

Recognition of the large untapped market for homeownership among minority-LMI households is growing. Unfortunately, simply changing underwriting criteria or offering a wider array of loan products is generally insufficient to tap this latent demand. Applying for a mortgage is only the final stage of a series of contacts between a potential applicant and various individuals and institutions. These contacts are embedded in social networks within local communities and influence every aspect of the pre-application phase of mortgage lending. Many minority-LMI renters, for example, may not believe they can qualify for a mortgage until a friend, neighbor, or housing counselor describes the process. They may be discouraged from looking in certain areas or applying to certain lenders by Realtors. The decision to apply for a mortgage is as much social as it is economic; thus, successful strategies must locate and develop the social and community networks that encourage minority-LMI renters to try to become homeowners and apply for a mortgage.

For tapping into these social and community networks, formal advertising as well as personal contacts are necessary. When they do advertise, many successful lenders seek out minority-owned radio stations and newspapers; some use ads on buses whose routes pass through moderate-income or minority neighborhoods. Others distribute customized promotional materials to selected addresses within their market area. In all of these media, the goal is to convey the message that homeownership is accessible.

Establishing business relationships with Realtors active in minority-LMI communities is also an important component of outreach. In some instances Realtors may even agree to play a role in “pre-qualifying” applicants. Even more important, however, lenders must work with community-based organizations to reach out to minority-LMI markets. These partnerships may take the form of an alliance with churches that offer counseling for potential first-time home buyers; partnerships with nationally affiliated nonprofits (e.g., the Urban League or NAACP); or alliances with CDCs, credit counseling agencies, local housing advocacy groups, or any of a multitude of other organizations. Active outreach efforts can also include extensive participation in home-buyer “fairs.” Finally, fostering a racially and ethnically diverse workforce sometimes allows lenders to develop connections to underserved markets. Most lenders do not actively recruit minority applicants through minority employees, but a diverse workforce reinforces connections to the community and helps to generate a climate of respect for populations traditionally excluded from homeownership.

Qualifying Applicants

Successful strategies to qualify LMI and minority borrowers encompass efforts to: a) expand the availability of affordable mortgage loan products; and b) use flexibility in underwriting that is consistent with safe and sound lending practices.

This study distinguished among several different types of mortgages, each of which is associated with different underwriting criteria used to qualify mortgage applicants. GSE Standard Mortgages represent the current industry norm; GSE Affordable Mortgages, such as Fannie Mae’s Community Home Buyer’s Program and Freddie Mac’s Affordable Gold, include more flexible provisions; and Portfolio Affordable Mortgages include products developed by individual lenders which exceed secondary market thresholds, and thus are held by the institutions in their own portfolios. All of these affordable mortgage products represent significant advances in mortgage lending practices, and are distinctly different from the standard mortgages that dominated the market prior to 1990—what we refer to in this study as Historical Mortgages.

Integral to successful lending industry strategies is the revolution in financing terms heralded by the GSE Affordable and Portfolio Affordable Mortgages. These loans have lowered down payment requirements, have increased permissible front-end and back-end ratios, and have made other financial changes important to qualifying many more minority-LMI borrowers.

The widespread adoption of the GSE Standard and GSE Affordable Mortgages and more flexible portfolio products have also changed underwriting practices throughout the industry. Whereas Historical Mortgages incorporated strict and unyielding criteria that unnecessarily disqualified many prospective homeowners (e.g., they required a sterling formal credit record and proof of long-term employment at one job), today most successful lenders will consider applicants without formal credit records. They will build alternative credit files for applicants from rent, utility, or similar payment records; this is an important change since many minority-

LMI households have historically been excluded from formal credit. Similarly, employment stability is now defined in terms of ability to maintain a consistent level of income, rather than ability to hold a single job. Underwriting standards on property characteristics have also been altered to avoid arbitrary size or configuration criteria which could disqualify properties in inner-city neighborhoods.

Continued underwriting vigilance is still necessary. Especially with respect to minority-LMI applicants, formal credit reporting systems are believed to contain errors, and these errors raise serious concern as the lending industry is moving towards automated credit scoring. Ongoing efforts by the GSEs and the lending industry to address possible credit miscues must be maintained.

In light of the persistence of racial disparities in lending decisions in parts of the industry, successful strategies must also require careful evaluation of the process by which loan applications are turned down. The successful lenders employ a wide variety of formal review strategies for loan rejections.

Self-testing is another important means to ensure fairness in the way customers and potential customers are treated—not only in the formal underwriting process, but in the pre-application phase. Testing strategies employed by successful lenders include the use of paired "testers" (i.e., similarly qualified white and minority customers), analysis of individual loan files, and extensive quantitative analysis of lending patterns. It is important to clarify, however, that adverse results from self-testing should not expose lenders to legal actions. (Assurances on this point have recently been forthcoming.)

Retaining Mortgagors

While some studies conclude that affordable loan portfolios are as safe as standard loan portfolios, this study finds a mixed picture. Some lenders report higher delinquencies on their affordable loans, while many others report no significant differences. In all instances, however, the affordable loans require more attentive servicing than standard products. Minority-LMI borrowers are especially vulnerable to financial difficulties. At the same time, they or their families have often found the housing and credit markets discriminatory and hostile—so they may be hesitant to discuss mortgage repayment obligations with an officer of a lending institution while in the midst of a financial crisis.

Successful lending initiatives require tackling these issues head-on, by building ongoing relationships with borrowers through post-closing counseling; by providing careful monitoring and quick reaction in the event of missed payments; and by allowing for flexibility in dealing with delinquency. Clearly, the changing structure of the lending industry has complicated these efforts by fragmenting the activities of loan origination and servicing. Many borrowers now make mortgage payments to distant, anonymous institutions with which they have no familiarity. Nevertheless, successful lenders who retain servicing, or who retain loans in portfolio, emphasize the importance of close communication.

The Promise and Limits of Successful Lending Strategies

The successful strategies "menu" noted in the sections above includes a changed way of thinking as well as a compendium of actions. The go-it-alone mentality will not work; lenders must partner with the many players in the industry and, equally important, join with the public and third sectors. Cultural sensitivity must permeate the lending institution's way of doing business.

Not everything has to be ordered from the menu of successful strategies practiced by the exemplary lenders. The full menu should be considered carefully, however. In fact, it can act as a useful checklist for lender self-evaluation, with those actions that most comport with a lender's given situation considered first.

Neighborhood lenders in minority-LMI neighborhoods have less cause to advertise aggressively to reach their constituents; they are already there. At the same time, making their service role better known to the community will attract depositors and, ultimately, foster their mortgage provider role. A smaller lender may very well not be able to afford extensive matched-pairs testing nor, pragmatically, would it be able to establish a separate, specialized affordable lending unit. Yet it can afford a mystery shopper "test"; it should incorporate a second review of initial declinations; and its underwriting staff can stay in a general unit but still be trained in affordable mortgage products and underwriting. Depending on their capitalization, lenders will be more or less able to loan to portfolio. Those with deeper pockets can do more in this regard. Those less amply capitalized will concentrate on the many variations of GSE affordable mortgages that the secondary market accepts.

The menu items should be sampled, with some digested and others discarded. Reach out to programs provided by others. If they work, fine; if not, consider providing the service in-house. Consider the same approach with appraisers. Experiment. Allow a "silent second" and see what happens; ponder self-insurance; try out different loan officer compensation policies.

The successful strategies developed by the exemplary lenders are field-proven. The exemplary lenders as a group make about 300,000 home mortgages a year, of which 40,000-50,000 go to minorities. Their minority loans annually aggregate to about $4 billion. The exemplary lenders put forth extensive LMI loans as well. There is much we can learn from the exemplary lenders and we should pay heed to their recommendations (Exhibit 7.2).

EXHIBIT 7.2
Recommendations by the Successful Lenders to the Lending Community

GSEs	• Expand secondary market affordability initiatives • Carefully monitor the application of, and effects from, credit scoring • Accept individual loans that exceed stipulated thresholds as long as overall loan package assembled by the lender meets secondary market standards
Private Mortgage Insurance Companies	• While numerous private insurors are striving to make mortgage loans more affordable, others need to work toward achieving the same flexibility as the GSEs
Regulators	• Clarify how results from lender self-testing will/will not be used • Clarify the bounds of racially targeted strategies (e.g., should a second review be conducted only for "protected classes"?) • In auditing, evaluate "safe and prudent" standards in relationship to the market served. For example, current accepted general and administrative (G&A) cost ratios may be inappropriate for lenders expanding their minority-LMI lending[1] • Consider possible adverse LMI lending consequences from House Resolution 10[1] • Better clarify how "performance" is defined under new CRA regulations
HUD	• Protect FHA and continue the efficiency reforms of this agency • Allow the use of 203(k) loans by investors such as CDCs; 203(k) loans are now restricted to owner occupants • Continue vigorous pursuit of National Homeownership Strategy

[1]See Berean Federal Savings Bank case study.

There is, admittedly, tension in lending to the less advantaged. On the one hand, public policy seeks to expand mortgage availability to provide the benefits of homeownership to families who have long faced barriers in housing markets; on the other hand, some lenders balk because providing mortgage financing to households of modest means is less profitable than lending to their more prosperous neighbors. These loans are smaller than conventional products; they require extensive efforts to piece together financing from Federal, State, local, and nonprofit sources; they require more work in underwriting, origination, and servicing; and in some cases, these loans entail a higher risk of delinquency and default than conventional products.

Nevertheless, our findings indicate that the profitability picture is more encouraging than one might suppose. Although some successful lenders achieve lower profits on these loans, higher volumes compensate for reduced profitability in many urban markets. Underserved markets represent a sizable latent demand for mortgage financing, and the aggressive action of these successful lenders is in large measure a response to this market potential. Successful lenders recognize, however, that there is a significant learning curve to targeted lending initiatives. The mortgage financing industry is only gradually repositioning itself to serve these markets, and the new types of outreach efforts have entailed hefty start-up costs. But as these successful strategies are more widely applied, the lending initiatives will become more cost-effective. Additionally, the outreach efforts often stimulate demand for other products.

From a public policy perspective, although the lending strategies can open homeownership to millions of minority-LMI families, the expansion of mortgage availability can play only a partial role in increasing access to homeownership. Unstable employment, low income, and negligible assets remain serious barriers for millions more. Mortgage lending practices cannot be separated from broader efforts to combat economic and racial inequalities in American housing markets.

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2. Redlining and Racial Discrimination in Lending

3. Strategies to Foster Minority and Moderate-Income Homeownership Financing

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