CREDIT, CAPITAL AND COMMUNITIES:

THE IMPLICATIONS OF THE CHANGING MORTGAGE BANKING INDUSTRY FOR COMMUNITY BASED ORGANIZATIONS

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Credit, Capital and Communities: The Implications of the Changing Mortgage Banking Industry for Community Based Organizations

Prepared for The Ford Foundation by William Apgar, Allegra Calder, Gary Fauth and the staff of the Joint Center for Housing Studies of Harvard University. Special thanks to Dawn Patric for managing the enhanced HMDA database.

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In the spring and summer of 2003, the authors spoke with key individuals at community based development and advocacy organizations, as well as individuals involved in banking, mortgage finance, real estate and capital markets. These interviews examined the role of community based organizations (CBOs) in the context of the changing organization of the mortgage industry, the rise of subprime lending, and the resulting changes in the provision of credit to lower-income borrowers, and were invaluable to the success of the project.

We would also like to acknowledge the study Advisory Committee established by the Joint Center that provided helpful comments at each stage of the project. The Advisory Committee included senior officials from bank regulatory agencies, as well as nationally recognized experts drawn from the housing and mortgage finance industries, and national and local non-profit community development and advocacy organizations. A list of Advisory Committee members is included in the Appendix.

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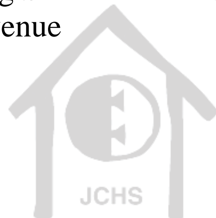

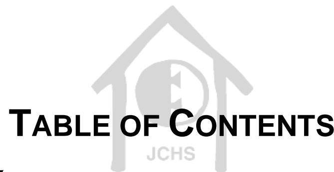

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INTRODUCTION AND SUMMARY

Today's mortgage market bears little resemblance to the one that existed just a decade ago. Key changes include the increasing use of automated underwriting, credit scoring, and risk based pricing, as well as the development of a mortgage delivery system dominated by mortgage brokers, secondary market activities and national mortgage banking and mortgage servicing operations. With new low downpayment products and a highly automated mortgage delivery system, the mortgage industry -- often operating through a network of mortgage brokers -- has dramatically expanded lending in the same low-income, low-wealth and minority neighborhoods that were once victimized by mortgage "redlining."

Yet despite the expansion of lending to previously underserved communities, the changing structure of the mortgage industry poses a set of challenging public policy problems. In most instances the new mortgage delivery system has expanded access to prime mortgages on favorable terms, yet all too often lower-income and minority communities are served by a distinctly different set of organizations offering a distinctively different mix of products. As a result of this dual market structure, many lower-income consumers suffer the consequences of a broker-led "push marketing" system that encourages unsuspecting borrowers to take on mortgage debt that they cannot afford and may not even need. In addition, some borrowers are "pushed" into accepting a 'higher-cost" subprime mortgage, even though they have a credit history, income, or other factors that would enable them to qualify them for a "lower- cost" prime loan.

These disturbing trends raise questions about the ability of current consumer protection legislation to actually protect consumers from abusive lending. Consumer protection regulations generally focus on ensuring that the loan information provided by the mortgage broker to the borrower was "fair and accurate," that the appraised value of the home was a fair representation of current market value, and that the terms and cost of the loan were provided in advance of closing for the borrower to review. Under the doctrine of "let the buyer beware," however, there are no requirements that a mortgage broker offer the best price available in the marketplace.

Potential borrowers are often not up to the challenge of protecting their own interests in the mortgage marketplace. Available survey research suggests that many consumers do not shop around for mortgages, and instead rely on brokers to provide them with information. Moreover, given the complexity of current mortgage products, even the most sophisticated borrower will find it difficult to evaluate the details of the mortgage. In short, despite all the technological innovation, today's mortgage market falls short of the competitive ideal where buyers and sellers have ready access to information about product terms and pricing. The result is a misallocation and mispricing of mortgage capital. And in extreme cases, the current mortgage structure fosters elevated levels of mortgage foreclosures that threaten the stability of the already weak neighborhoods.

Clearly, these shifts pose new challenges to community based organizations (CBOs)[1] as they seek to promote home homeownership opportunities and revitalize communities. In particular, some CBOs have refocused their advocacy efforts to increase access to prime conventional home loans for lower-income people and communities. Others have restructured their community lending programs and partnered with private sector mortgage companies to establish new automated mortgage lending, brokerage, or loan servicing operations, or created their own state of the art mortgage lending, brokerage and servicing systems. Still other nascent approaches, such as efforts to combat abusive lending practices, increase the effectiveness of homeownership counseling or expand foreclosure avoidance initiatives, are also promising.

Unfortunately, most community groups have not fully digested the enormity of the changes that have occurred in the mortgage banking industry and have failed to make the necessary adjustments. Many CBOs understand the significance of the changing market environment, but lack the resources and organizational capacity to respond effectively.

Recognizing the fact that many CBOs continue to do business as they have for decades, this report examines factors that limit the willingness and ability of CBOs to adapt to the changing

[1] In this paper community based organizations (CBOs) are broadly defined as non-profit providers of housing services, homebuyer counseling, and mortgage finance, as well as non-profit housing advocacy organizations. As used here, CBOs range from relatively small Neighborhood Housing Services organizations operating in a single neighborhood, to larger Community Development Financial Institutions (CDFIs) that may operate on a regional or even national basis.

market environment. The challenge faced by CBOs -- along with their public, private and philanthropic partners -- is to identify how best to build on the considerable strength that comes from their historical standing in some the nation's most disadvantaged communities. But local knowledge is not enough. It will take a concerted effort to enable a larger number of CBOs to reposition their efforts to promote and preserve homeownership in the constantly evolving world of mortgage banking.

Principal Findings

This report builds on the Joint Center's previous work on the Community Reinvestment Act.[2] It considers the implications of the transformed world of mortgage and financial services provision and proposes strategies for CBOs and others with an interest in revitalizing underserved communities. Analysis of Home Mortgage Disclosure Data for the 1993 to 2001 period helped untangle some of the implications, particularly for borrowers and neighborhoods, of the changed landscape. In addition to the quantitative analysis, interviews with key individuals at community based development and advocacy organizations, as well as individuals involved in banking, mortgage finance, real estate and capital markets were conducted to test our findings, expand our knowledge and explore solutions. Principal findings include:

New Technology Drives Mortgage Industry Restructuring. The advent of automated underwriting, credit scoring and risk based pricing, as well as the growing importance of mortgage brokers, national scale mortgage banking organization, and expanded secondary mortgage markets produced what some have labeled a "revolution in mortgage finance." Moreover, by increasing the capacity of the newly automated mortgage origination system to reach out to diverse segments of the market, mortgage brokers have enabled wholesale lenders to grow in scale. The result is a dramatically altered mortgage banking landscape dominated by a handful of financial services giants.

- In 2002, the top 25 mortgage originators accounted for 78 percent of the $2.5 trillion in loans originated that year. As recently as the 1990s, the top 25 accounted for only 28 percent of originations. And, consolidation has also been an important feature of the

[2] Joint Center for Housing Studies, 2002.

subprime market. In 2002, the top 25 subprime lenders, along with their affiliated brokers and correspondents, accounted for over 88 percent of the $213 billion in total subprime volume.

- In 2002, there were 44,000 mortgage brokerage firms -- almost double the number of firms that were operating in 1995 and up markedly from the estimated 7,000 firms that operated in 1987. Brokers are most prevalent in the subprime market, accounting for 44.7 percent of originations in 2002. This compares to a 29.5 percent share in the prime market.

- Aided by a strong economy and favorable interest rates, the new mortgage origination system facilitated a surge of lending to previously hard to serve segments of the market. The number of home purchase loans to low-income borrowers and/or low-income communities increased by 80.4 percent from 742 thousand in 1993 to 1.3 million in 2001. This far exceeded the 48 percent growth in home purchase lending overall.[3] By enabling thousands of credit impaired and often lower-income families to purchase a home of their own, these trends pushed the homeownership rate to record levels.

Industry Structure Perpetuates a Dual Market System. Despite substantial competition on the "supply-side" of the marketplace, today's mortgage market fails to achieve what economists term "allocational efficiency," in that similarly situated borrowers pay different prices to obtain a mortgage of given characteristics and terms. Central to this inefficiency is a market failure linked to "principal agent risk"[4] that results from the fact that brokers and correspondent lenders have different incentives than the wholesale lenders that fund the mortgage. Having no long term interest in the performance of the loan, a broker's incentive is to close the loan while charging the highest combination of fees and mortgage interest rates the market will bear. Unless checked by applicable regulations and/or the ability of the consumers

[3] These figures are based on Home Mortgage Disclosure Act data that define lower-income borrowers as having incomes below 80 percent of area median income (AMI) in 1990. Lower-income neighborhoods have an income of less than 80 percent AMI as of 1990.
[4] Principal agent risk is the risk that the agent will not act in the best interest of the principal, who must ultimately live with the consequences of the agent's decision.

to shop for the best mortgage available in the market place, the mispricing of loans, along with other abusive practices, go unchecked in the market. The results are problematic.

- Many borrowers do not seek out loans, but rather are sold loans after extensive outreach or marketing by brokers. Available survey data suggest[5] that these "push marketing" techniques often leave borrowers with mortgage loans that are overpriced and/or contain abusive features. In the extreme case, "push marketing" can saddle borrowers with debt that they are unable to repay; a situation which will lead to foreclosure and a loss of whatever equity the borrower may have had in the home.

- The bewildering array of mortgage products combined with the various available combinations of points and fees and aggressive marketing tactics with "too good to be true" offers can make shopping for a mortgage an overwhelming process for even the most sophisticated borrower. Indeed, the lack of readily available data on the price of alternative mortgage products puts the consumer at a distinct disadvantage in negotiating with a mortgage broker who has ready access to this information.

- The growing use of mortgage brokers, the lack of effective regulatory oversight the lack of readily available mortgage pricing data have combined to reinforce a dual market where some borrowers pay more for mortgage credit and/or receive less favorable treatment (or even abusive treatment) than other similarly situated and equally creditworthy borrowers.

A Prime Lending Gap Exists in Minority Neighborhoods. Despite the overall increase in access to mortgage capital, a racial gap persists in the ability of minorities to secure prime loans, even after controlling for income. It is disturbing that more than three decades after the enactment of fair lending legislation, fundamental disparities in minority access to mortgage capital remain. Many products targeted to lower-income and/or credit impaired borrowers typically have higher interest rates and less favorable terms than the conventional prime loans that serve the mainstream market.

[5] See Kim Sung and Hermanson, 2003.

- For African Americans with incomes in excess of 120 percent of area median income living in predominately African American and high-income neighborhoods, prime loans accounted for only 70.8 percent of home refinance borrowing in 2001. In contrast, the figure was 83.1 percent for lower-income white borrowers living in largely white, lower-income communities.

- Both simple descriptive statistics and more complex econometric analysis completed for this report confirm that while many legitimate risk factors contribute to the relatively low share of prime conventional loans going to African American and Hispanic borrowers and neighborhoods, race and ethnicity continue to be an important factor in determining the allocation of prime mortgage credit.

Changes in the Mortgage Industry Challenge CBO Activities. CBOs have long worked to expand access mortgage capital, but growth of the dual market and the associated rise in subprime lending undermines the effectiveness of many community based loan programs, as well as CBO homeowner education and counseling efforts. Moreover, abusive subprime lending has contributed to a rapid rise in mortgage foreclosures, particularly in the low-income and low-wealth communities where these loans tend to be concentrated.

- Once the "only game in town," community loan programs now face stiff competition from aggressively marketed, higher-cost subprime loans originated with the latest technology to quickly respond to a customer's request for a home loan. Perhaps most telling, by continuing to deploy antiquated manual systems and lacking the economies to scale needed to reduce programmatic costs, subsidies that could go to reduce the mortgage rates or otherwise benefit needy borrowers instead are being diverted to cover the costs of inefficiently run, small-scale community loan programs.

- The current mortgage market, specifically the growth of broker-led push marketing and the limited capacity of borrowers to shop for a mortgage, presents new challenges to CBO education and counseling efforts. Program graduates often gain valuable information concerning the mortgage lending process, but too often lack the detailed

information needed to evaluate which mortgage product best serves their needs. Managers of CBO educational and counseling programs interviewed for this study lamented that program graduates were frequently won over by the marketing pitches of "high cost" subprime lenders.

- The growth of higher risk subprime lending has spawned a substantial increase in foreclosures in lower-income communities. Best available data suggest that in 2002, subprime loans had a serious delinquency rate[6] of 10.44 percent, nearly 20 times higher than the rate for prime conventional loans.

CBOs Must Work To Improve Their Mortgage Lending Activities. In this dual market, some borrowers pay more for mortgage credit and/or receive less favorable treatment (or even abusive treatment) than other similarly situated and equally creditworthy borrowers. As a result, borrowers that lack the information, willingness or capacity to shop for mortgage credit, particularly those with lower credit quality and/or those attempting to purchase homes in riskier neighborhoods, remain vulnerable to overpaying for mortgages or not receiving the best terms for which they could qualify.

- Although total CBO direct lending each year numbers in the tens of thousands of loans in a mortgage industry that counts loans in the millions, CBOs can continue to play an important role as mortgage market innovators. Mirroring the activities of the best run small mortgage companies, some community loan programs are adapting new technology – including automated underwriting software – to improve the overall efficiency of their mortgage origination and mortgage servicing operations. Recognizing that many of the borrowers they seek to reach pose unique underwriting challenges, expanded use of technology can help CBOs save money on the routine aspects of their business operations and enable them to focus even greater attention on hard to serve customers.

- In deciding how best to utilize new technology, CBOs face what public management experts term the "make or buy" decision. In particular, CBOs must determine which

[6] A serious delinquency is defined as a loan that is in foreclosure and/or with a payment 90 days or more late.

elements of their mortgage origination business they will conduct "in house," (make) and which they will contract out to others (buy). Increasingly CBOs are contracting out servicing and other portions of their operations, and in doing so gain both efficiency of operations and increased capacity to focus their managerial talent in areas where they have significant comparative advantage.

- Some CBOs are attempting to generate fee income by selling mortgage originations and servicing services to others. This is part of a larger effort to examine the extent that CBOs can supplement their income by operating a range of mortgage and real estate related businesses from construction finance, real estate and mortgage brokerage to selling off some of their excess capacity to originate and service mortgage loans.

New Roles Present CBOs with New Opportunities. CBOs have long been central to efforts to expand access to mortgage capital, but the dual market structure poses serious challenges and threatens to undermine over three decades of community revitalization efforts. CBOs must consider new roles to help preserve the gains achieved.

- To improve the ability of borrowers to protect themselves from the excessive fees and abusive practices of "push marketers," CBOs could produce a "home mortgage pricing guide" that would educate borrowers about the range of rates they should expect based on their credit and past payment characteristics.

- The creation of a system of "buyer's brokers" would help potential borrowers identify the best loans for them and would begin to address the current asymmetry of information through the provision of information on terms and pricing. Unlike a mortgage broker, these "buyer's brokers" would work on behalf of the borrower.

- CBOs must also rethink their approach to advocacy. As a result of the changing mortgage market, CBOs must form new partnerships and identify new points of leverage if they are to continue effectively pressure government and industry officials alike to better address the problems that exist in today's mortgage market.

SECTION 1: NEW TECHNOLOGY DRIVES MORTGAGE INDUSTRY RESTRUCTURING

The advent of automated underwriting, credit scoring and risk based pricing, as well as the growing importance of mortgage brokers, national scale mortgage banking organizations, and expanded secondary mortgage markets produced what some have labeled a "revolution in mortgage finance." Aided by steady economic growth in the 1990s, and more recently by record low mortgage interest rates, the changing structure of the mortgage industry has fostered dramatic increases in lending to low-income people and communities. Yet these same forces have also solidified the operations of what appears to be a dual mortgage market in mortgage finance in which low-income and often minority borrowers are served by different lending organizations using a different mix of loan products than is found in the mainstream market.[7] This section summarizes these trends and assesses their implications for the evolution of mortgage markets.

Structural Shifts Have Occurred Over the Last Two Decades

Structural shifts within the industry have largely been driven by the declining importance of bank deposits as a funding source for mortgages. Historically, deposit-taking institutions, such as thrifts and commercial banks, originated the bulk of mortgages. In 1980, nearly half of all mortgages were originated by thousands of thrifts, while commercial banks originated another 22 percent.[8]

During the 1980s, many deposit-taking institutions held the loans they originated. Although mortgage insurance was an important element for Federal Housing Authority (FHA) and other government backed loans, the private mortgage insurance industry was still in its infancy. Moreover, underwriting standards and mortgage documents varied considerably from one institution to another. As a result, third party investors were reluctant to purchase mortgages that lacked standardized features and adequate credit enhancements to reduce risk.

[7] For a more complete discussion of the factors influencing the growth of mortgage lending in the 1990s see Joint Center for Housing Studies, 2002.
[8] U.S. Department of Housing and Urban Development, 1997.

Over the past two decades this system has changed. The availability of first FHA insurance and then private market insurance helped to extend the reach of the mortgage market to low-income and low wealth borrowers. The Community Reinvestment Act (CRA), passed by Congress in 1977, also encouraged banks and their affiliates to turn their attention to previously underserved markets. Though these efforts substantially expanded access to capital, they also served to segment the market into distinct mortgage delivery channels—with one set of channels offering a set of products targeted to low-income and largely minority borrowers, while others were targeted to the mainstream market.

The secondary market has also developed and matured over the last twenty years. Even as late as 1990, less than half of all mortgages were securitized and sold into the secondary market – a figure that was bolstered by the fact that at that point Ginnie Mae was securitizing virtually 100 percent of all FHA loans.[9] Today, nearly 70 percent of all home mortgages are securitized and sold into the secondary market, due largely to the growing presence of Fannie Mae and Freddie Mac in the marketplace. The ability to package and sell loans to the secondary market reduced the need to hold deposits (or other sources of cash) to fund mortgage loans. The government sponsored enterprises, Fannie Mae and Freddie Mac, along with private mortgage conduits mandated standardization of loan contracts and thus streamlined and rationalized mortgage markets -- helping to foster an increasingly efficient mortgage delivery system.[10]

The growth of subprime lending[11] was also supported in large measure by funds generated in the secondary market. Prior to the 1990s, subprime mortgages were primarily offered by large finance companies and funded with secured and unsecured debt. As recently as 1994, less than one third of subprime volume ($11 billion) was securitized. As subprime lending grew, so too

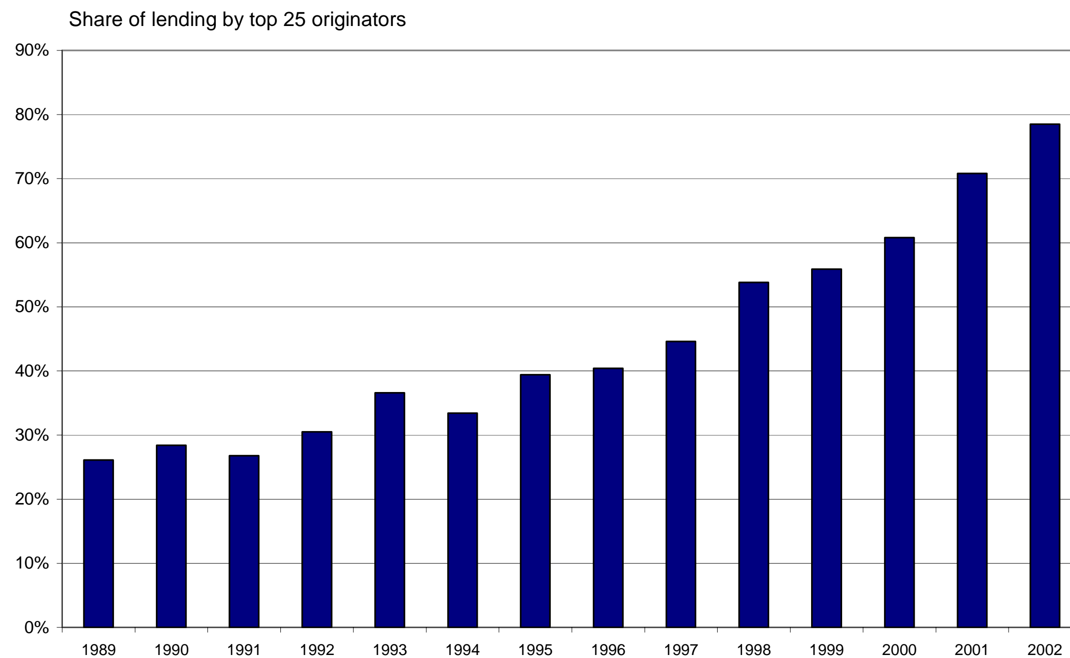
[9] Inside Mortgage Finance, 2003.
[10] See Kendall and Fishman, 1996 especially the chapter by Lewis S. Renieri, "The Origins of Securitization, Sources of Its Growth, and Its Future Potential," pp 17-30.
[11] This report uses two primary sources of data on subprime lending. The first source, Inside Mortgage Finance, 2003 gathers data from a large representative sample of mortgage companies. Later portions of this report present loan-level Home Mortgage Disclosure Act (HMDA) data on subprime loans. While HMDA does not label the loan type directly, The U.S. Department of Housing and Urban Development (HUD) supplies a list of each lender's 'specialization' in prime, subprime, or manufactured home lending. Government-backed loans are reported in HMDA, and are defined here as loans made by prime lending specialists that are insured or guaranteed by the Federal Housing Administration (FHA), the USDA's Rural Housing Service, or the Veterans Administration. For a brief description of the HUD methodology see Scheessele, 2002.

did the securitization of subprime loans. By 2002, 62.2 percent ($133 billion) of total subprime originations were securitized.[12] The growing issuance of subprime mortgage-backed securities was primarily accomplished by a handful of large mortgage banking operations and Wall Street firms. Recently, Fannie Mae and Freddie Mac have extended the reach of their secondary market purchases to include a growing share of 'Alt A' and 'A-' loans.

Consolidation Reshapes the Mortgage Banking Industry

Consolidation is one of the most striking features of industry change. As recently as 1990, the top 25 originators accounted for 28.4 percent of an industry total of less than $500 billion in home mortgages. In 2002, the top 25 originators accounted for 78 percent of the $2.5 trillion in loans originated that year (Exhibit 1). Of these, the top five originators – Wells Fargo, Washington Mutual, Countrywide, Chase, and ABN AMRO – each made more than $100 billion in mortgages comprising more than half of all loans.

Exhibit 1: Top 25 Originators Dominate Mortgage Lending



Source: Inside Mortgage Finance, The 2003 Mortgage Market Statistical Annual

[12] Inside Mortgage Finance, 2003.

Regulatory changes supported the consolidation of the financial services industry as the 1980s saw most state-level restrictions on intrastate banking relaxed or removed. [13] At the federal level, interstate banking became a reality in the 1990s. Banks could now expand beyond boundaries that had been in place since the Depression, and larger organizations increased the scale and scope of their operations through mergers and acquisitions. Many large banks took advantage of regulatory changes and consolidated retail banking operations within and across individual metropolitan areas. Growth of both regional and national banking operations reflected a desire of the larger banks to capitalize on potential economies to scale and name recognition, as well as to reduce risk by diversifying across spatially distinct markets. [14]

Lacking the economies to scale to compete in an increasingly automated business, many smaller banks and thrifts abandoned their mortgage origination activities entirely. At the same time, several large independent mortgage and finance companies continued to compete head to head with banking organizations in mortgage markets across the country. The largest, Countrywide Financial, made more than $250 billion in home purchase loans in 2002. But many other independent mortgage banking operations have either failed to grow over the past decade, or merged with or were acquired by a large banking operation. This latter category includes North American Mortgage that was acquired by Dime Savings Bank and Norwest Mortgage that merged with Wells Fargo.

As is true for the broader mortgage industry, consolidation has been a particularly important feature of the subprime lending industry. Though variation in the definition of what constitutes a “subprime mortgage” hinders precise measurement, according to one widely utilized mortgage industry source, subprime loan originations increased from $35 billion in 1994 to $213 billion in 2002. In 2002, the top 25 subprime lenders, along with their affiliated brokers and correspondents, accounted for over 88 percent of total subprime volume while the top five accounted for nearly 40 percent of total volume. Compare this to 1996 when the top 25 subprime lenders claimed only a 47 percent share and the top 5 only 20 percent.[15] Top ten

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[13] For a more complete discussion of trends in federal regulation of the banking and mortgage banking industries see Joint Center for Housing Studies, 2002, particularly Section 2.
[14] Avery et. al., 1999.
[15] Inside Mortgage Finance, 2003.

players now include major prime lenders such as Washington Mutual, CitiFinancial, Countrywide and Wells Fargo.

While readily available mortgage industry statistics present a global overview on industry consolidation, Home Mortgage Disclosure Act (HMDA) data permit a more detailed analysis of the trends in size distribution of mortgage lenders. Before proceeding, it is important to note important differences between HMDA data and the industry data presented earlier. For example, HMDA data distinguish between correspondent lenders and brokers when identifying the originator of a mortgage loan. Correspondent lenders initially fund loans under their own name before selling the loan to a larger mortgage banking operation, while brokers typically identify customers and collect the underwriting information, which is then forwarded on to a mortgage banker who directly funds the loan. The industry statistics presented earlier combine lending activity of correspondent lenders and brokers under the name of the mortgage bank that coordinates the transactions. By focusing on the initial funder of the loan, HMDA data separately identify correspondent lenders, thus giving the appearance that the industry is somewhat less concentrated than is suggested by industry statistics.

HMDA data do permit the disaggregation of mortgage lending activity by detailed lender, loan, and borrower characteristics. For example, Exhibit 2 divides organizations involved in home purchase lending into two categories: banking organizations (commercial banks and savings associations with their mortgage and their finance company affiliates)[16] and other organizations (independent mortgage and finance companies and credit unions). Exhibit 2 indicates that banking organizations led the growth of large organizations. By 2001, home purchase lending for the nine largest banking organizations totaled over 1.1 million loans, and 17 banking organizations made at least 25,000 home purchase loans. Overall, these 17 accounted for some 1.2 million of the nearly 1.4 million increase in home purchase loans that occurred from 1993 to 2001.

[16] Note that because of the ability of banking organizations to shift loans from one affiliate to the next, depositories and their mortgage company affiliates are combined in this analysis.

Exhibit 2: Large Banking Organizations Dominate Recent Growth of Mortgage Lending

	Banking Organizations				Non CRA Regulated Organizations			
Number of Home Purchase Loans	Lenders		Loans		Lenders		Loans	
	1993	2001	1993	2001	1993	2001	1993	2001
More than 50,000	2	9	154,607	1,170,870	2	3	150,676	362,286
25,000 to 49,999	5	8	148,371	300,397	5	1	153,290	42,860
10,000 to 24,999	20	19	290,205	341,208	10	15	150,836	217,492
1,000 to 9,999	174	123	516,206	379,336	128	172	331,762	480,636
Less than 1,000	3,807	3,408	350,434	284,502	1,606	1,975	204,742	227,334
Total	4,008	3,567	1,459,823	2,476,313	1,751	2,166	946,306	1,330,608

Source: Joint Center for Housing Studies Enhanced HMDA database.

At the other end of the spectrum, the data confirm that the number of banking organizations originating less than 10,000 loans shrank by 11 percent between 1993 and 2001, and the number of home purchase loans originated by this group declined by more than 23 percent. There was, however, a noticeable increase in the number of smaller independent mortgage companies that largely serve as correspondents to larger companies. Over the period, the number of independent mortgage companies and credit unions making less than 10,000 home purchase loans rose 24 percent and the number of home loans made by these organizations rose 32 percent, from 537,000 to 708,000.

Consolidation has also had a significant impact on the home refinance lending market. For example, HMDA data suggest that the 38 institutions making more than 25,000 refinance loans in 2001 accounted for 62.3 percent of all home refinance loans, up from only 33 percent in 1993. Again, much of the growth was concentrated among large banking institutions, and was enhanced by the emergence of a new mortgage origination system featuring a growing network

of smaller mortgage brokers that specialize in outreach, marketing, and loan origination activities.

New Origination System Facilitates Industry Consolidation and Growth

The growth and consolidation of the mortgage industry was aided by the creation of a highly automated origination system. This new system was anchored by the introduction and expansion of credit scores in mortgage lending, as well as the creation of automated underwriting systems. New technology and marketing approaches enabled lenders to reach customers through mass media and to interact with them via phone, fax, and internet. Lenders merged the “back office” functions needed to originate, underwrite, and service loans and created automated regional processing centers, leaving them less dependent on the physical location of their branches to reach customers.

Today, loans are originated through one of three channels: retail, correspondent, or broker. Retail activity is most akin to traditional lending where employees of a banking or mortgage banking organization reach out to potential customers, complete a mortgage application, underwrite and fund loans for those who meet the underwriting standards. Many retail mortgage lending operations conduct business from branch operations, though increasingly the marketing and even closing of loans is done by telephone or over the internet. Once funded, a retail loan may be held in portfolio by the lender, sold to another lender, or packaged and sold to the secondary market.

Just as technology has fostered consolidation among mortgage banking operations, it has also enabled dramatic growth in the number of smaller mortgage brokerage and correspondent lending firms. Correspondent lenders, for example, are typically smaller mortgage brokers, thrifts or community banks who operate much like retail lenders in that they take applications, underwrite and fund mortgages. While loans are funded in the name of the correspondent, they are then sold to a larger wholesale lender under prearranged pricing and loan delivery terms, and in compliance with established underwriting standards. Brokers, in contrast, do not fund loans, but simply identify potential customers, process the paper work, and submit the loan application to a wholesale lender who underwrites and funds the mortgage.

Two decades ago, retail lending dominated the business. Since then, particularly over the past ten years, wholesale activity, which includes both correspondent and broker channels, has grown rapidly. Concurrent with this trend has been a rise in the number of firms engaged in these activities. In 2002, there were 44,000 mortgage brokerage firms (with some 240,000 employees) engaged in mortgage brokerage and correspondent lending activities, almost double the number of firms operating in 1995 and up markedly from the estimated 7,000 firms operating in 1987.[17] In 2002, retail lending accounted for 40.2 percent of total origination volume, while brokers (30.8 percent) and correspondent lenders (29 percent) accounted for the rest.[18]

Of course industry averages mask the enormous variation that exists across individual firms. For example, over two-thirds of Bank of America's $88 billion of home mortgage lending flows through their retail channel. In contrast the retail channel accounts for less than 10 percent of total lending for GMAC-RFC, Flagstar Bank and Greenpoint Financial. Even among large wholesale lending operations, there is considerable variation in channel mix. For example, brokers constitute the largest component of ABN AMRO's wholesale activity, while Principal Residential Mortgage operates primarily through correspondent lenders (Exhibit 3).

[17] Wholesale Access Mortgage Research and Consulting. 2003. "Mortgage Brokers 2002," Press Release, August 13. Available at http://www.wholesaleaccess.com/8.6.03.mb.shtml.
[18] Estimates from Inside Mortgage Finance, 2003. These figures closely approximate data presented in *2002 Mortgage Industry Directory*, a publication of the National Mortgage News. They estimated that in the first quarter of 2002, the retail channel accounted for only 39.7 percent of all lending, with the broker and correspondent share totaling 29.9 and 30.4 percent respectively.

Exhibit 3: Channel Mix Varies by Lender

	Total 2002 Originations (Billions)	**Retail Share (%)**	**Wholesale Share (%)**	Broker (%)	Correspondent (%)
Wells Fargo Home Mortgage	**$333.0**	**48.6**	**51.4**	22.5	28.9
Washington Mutual	**$312.0**	**37.5**	**62.5**	27.5	35
Countrywide Financial	**$251.9**	**26.4**	**73.6**	26.7	46.9
Chase Home Finance	**$155.7**	**36.2**	**63.8**	23.3	40.5
ABN AMRO Mortgage Group	**$119.4**	**16.7**	**83.3**	76.1	7.2
Bank Of America Mortgage	**$88.0**	**68.1**	**31.9**	31.9	0.0
National City Mortgage Corporation	**$79.5**	**45.7**	**54.3**	50.0	4.3
GMAC Mortgage Corporation	**$71.6**	**55.4**	**44.6**	3.7	40.9
Cendant Mortgage Corporation	**$59.3**	**85.1**	**14.9**	na	na
GMAC-RFC	**$52.8**	**3.5**	**96.5**	26.7	69.8
CitiMortgage Inc	**$52.5**	**42.5**	**57.5**	23.0	34.5
Principal Residential Mortgage	**$46.7**	**12.6**	**87.4**	20.5	66.9
Flagstar Bank	**$43.2**	**9.5**	**90.5**	57.7	32.8
First Horizon Home Loans	**$34.4**	**54.9**	**45.1**	33.3	11.8
GreenPoint Mortgage Funding Inc.	**$32.8**	**5.2**	**94.8**	84.1	10.7
All Lenders	**$2,510.0**	**40.2**	**59.8**	**30.8**	**29.0**

Source: Inside Mortgage Finance, The 2003 Mortgage Market Statistical Annual

New technology fostered the consolidation of other segments of the mortgage industry as well. Nowhere is this trend more evident than in mortgage servicing and securitization. Having originated a mortgage, a mortgage lender can either do in house or contract with any one of a number Wall Street investment houses to sell their loans to Fannie Mae or Freddie Mac, and or to securitize and sell mortgage backed securities to other investors. In addition, at the time individual loans or mortgage backed securities are sold to third party investors, the initial funder of the mortgage may choose to retain some portion of these securities as a long-term investment. For example, a bank lender may originate loans, securitize them, and then immediately repurchase some share of the resulting securities to hold in portfolio. As a result, the bank

continues to invest in mortgage assets, but is able to invest in more liquid mortgage backed securities rather than individual loans.

Similarly at the time that the loans are securitized, the initial funder of the mortgage must also decide whether to sell some or all of the rights to service the mortgages in question. Recognizing that the ultimate investor in the mortgage pays a fee for mortgage servicing, this step in the overall mortgage delivery system has emerged as a distinct line of business. Some companies, including several large firms that specialize in subprime or other hard to service loans, prefer to retain servicing rights. Yet third party servicing is quite common – especially for basic prime mortgages. And, as is the case with mortgage originations in general, mortgage servicing is a highly repetitive activity characterized by substantial economies to scale linked to the effective application of the latest advances computer and telecommunications technology. As a result, the mortgage servicing business is highly concentrated; the top 25 servicers held a collective market share of nearly 62 percent in 2002, while the largest – Washington Mutual –captured over 11 percent alone.[19]

Although many large scale servicers are affiliates of some of the same financial services giants that dominate mortgage originations, typically servicers operate as distinct business units within the overall corporate structure. Interestingly, it is not necessarily the case that a servicer owned by one corporation will service all of the loans they originate. Rather servicing rights are bought and sold regularly depending on the going price to purchase these rights in the marketplace, the relative efficiency of alternative servicing entities, and the applicable business strategies of the companies involved.

New Industry Structure Fosters Intense Competition

Continued technological change should further enhance the competitive advantage of larger, national scale players leading them to dominate various segments of the new mortgage delivery system. New automated systems require substantial upfront investments and smaller companies, unable to afford such investments, are finding it increasingly difficult to remain competitive in the mortgage market. At the same time, because these technologies operate at low marginal or

[19] Inside Mortgage Finance, 2003.

incremental costs, there is fierce competition among the firms that remain in the market as they seek to offer a different mix of mortgage products and delivery methods across the country.

The growth of large national scale lenders, along with their network of brokers and correspondents and their affiliated set of mortgage servicers and investment bankers, has also fundamentally altered the nature of competition in communities across the country. Where once local banking institutions and a handful of larger regional players competed for market share, today the 25 largest national lenders typically account for over half of all lending in each of the nation's 43,000 census tracts. As will be further explained later in this report, the growing geographic reach of these mortgage giants results in the fact that there are more firms active in most neighborhoods, including low-income and minority neighborhoods, than was the case as recently as 1993.

Consider, for example, the mortgage operations of the retail banking giant Bank of America (B of A). Two decades ago, B of A was a large regional player – active in California and selected other, largely western, market areas. Through a combination of mergers and acquisitions – culminating in the recent proposed merger with Fleet Financial, B of A has assembled a national branch banking network that supports their mortgage lending operations in metropolitan areas across the country. For example, in 2001, B of A and its affiliated organizations made mortgage loans in over 200 of the nation's 301 metropolitan areas examined for this report. Other national lenders, such as Countrywide, Chase, CitiFinancial, Washington Mutual, and Wells Fargo, have a similar nationwide reach, though each uses its own combination of delivery channels.

Finally, it should be noted that the new highly automated and segmented structure of the mortgage delivery system poses challenges to the mortgage industry itself, particularly as mortgage companies have come to rely on third party mortgage brokers and servicers to extend their reach into new markets. Just as available computer and telecommunications technology has enabled large mortgage companies to consolidate their operations into centralized processing centers, new technology has also enabled them to more effectively manage their retail, correspondent, and broker networks. This is especially important to quality control, as most of the best managed companies in the business have created sophisticated software systems to

monitor the performance of their brokers and retail employees operating in distant market areas across the country to root out potentially fraudulent behavior.

Based on an expectation of continued technological advances, the outlook is for continued consolidation of mortgage lending activities and a growing reliance on mortgage brokers to take loan applications. In addition, technology should encourage evolution of a wider range of products, services and pricing, as large firms seek to identify and exploit competitive advantage in pursuit of customers in an increasingly competitive marketplace. Today, the challenge for regulators and community groups alike is not the absence of mortgage lending or lenders in their communities, but to make certain that the many entities that are present behave in a responsible manner. Providing consumers with the information and assistance needed to ensure that they get the best mortgage for which they can qualify is a related challenge.

Changing Industry Promotes Dramatic Growth in Lending

The improved ability of mortgage lenders to tap into national and international capital markets enabled borrowers to take advantage of periods of favorable economic growth and equally favorable mortgage interest rates. In addition, the surge in mortgage lending was the product of supportive government policy. Even as CRA's regulatory reach was on the decline, CRA and expanded enforcement of fair lending regulations continued to encourage lenders to serve low-income and minority markets. At the same time, growth in government-backed lending, and particularly FHA insured lending, helped the mortgage industry reach emerging low-income and minority markets. And finally, the creation of new affordable housing goals for the GSEs in the early 1990s, along with the significant expansion of these goals later in the decade, helped augment outreach and lending activity by Fannie Mae and Freddie Mac over the period.

In combination, these trends prompted dramatic growth in mortgage lending throughout the 1990s and into this century. HMDA data indicate that the number of loans for the purchase of one to four family properties in metropolitan areas increased from 2.4 million in 1993 to 3.8 million in 2001, a gain of 58.2 percent. Home refinance lending, which is more sensitive to interest rate changes, exhibited a boom/bust pattern over the same period. After reaching a record 4.5 million refinance loans in 1993, the number declined through the mid-1990s before

hitting 4.7 million in 1998, falling back again in 1999 and 2000, only to set a new record of 5.7 million in 2001.

The recent surge in home lending was led by loans to low-income borrowers and communities.[20] HMDA data show that home purchase loans to low-income borrowers and/or low-income communities increased by 80.4 percent from 742 thousand in 1993 to 1.3 million in 2001. This far exceeded the 48 percent growth in home purchase lending overall (Exhibit 4). As a result, loans to low-income people and communities accounted for 35 percent of all home purchase lending, up from 31 percent in 1993. Further, loans to these borrowers accounted for 57.4 percent of the 1.4 million-loan increase in home purchase lending between 1993 and 2001.

Exhibit 4: Loans to Low-Income People and Communities are Increasing (Thousands of Loans)

	Home Purchase				Refinance		
	Total	High-Income Markets	Low-Income Markets		Total	High-Income Markets	Low-Income Markets
1993	2406	1663	743		4452	3566	886
1994	2588	1768	820		1676	1204	472
1995	2510	1704	807		1086	761	324
1996	2893	1939	954		1781	1225	555
1997	3020	2011	1009		1953	1314	639
1998	3468	2288	1179		4689	3382	1307
1999	3703	2377	1326		3039	1973	1066
2000	3669	2372	1297		1683	1011	672
2001	3807	2467	1340		5685	3996	1689

(Note: High Income Markets are defined as containing loans or borrowers that are not eligible for CRA credit. Low-Income Markets include all loans made in low-income neighborhoods (<80%AMI) and loans made to low-income borrowers living in high-income neighborhoods (>=80%AMI).

Source: Joint Center for Housing Studies Enhanced HMDA database.

[20] Throughout this report low-income (or lower-income) borrowers are defined as having incomes less than 80 percent of metropolitan area median income, and low-income (or lower-income) communities are census tracts where 1990 median family income was less than 80 percent of the metropolitan area median.

Lending to low-income people and communities also rose sharply from 1993 to 1997 in the more volatile home refinance market. In 1998, the number of loans in the low-income segment soared to 1.3 million, only to fall back to 672 thousand by 2000. Refinancing surged once again for low-income people and communities in 2001, reaching an all time record of 1.7 million. Yet even this spectacular growth failed to match the nearly 3 fold increase in home mortgage refinancing of higher-income homeowners living in higher-income communities, as record low interest rates and a general awareness of the benefits prompted higher income borrowers to refinance.

Strong gains in lending to minorities were made over the 1990s, although increases in the number of HMDA loan records not reporting the race of the borrower makes precise tracking of these trends difficult.[21] From 1993 to 2001, HMDA data indicate that the number of home purchase loans made to African American borrowers increased by 93 percent, while for Hispanic borrowers it increased by 159 percent. In contrast, home purchase lending to white borrowers increased by just 29 percent. Minorities also posted strong gains in home refinancing with their share of overall refinance loans climbing from 13 percent in 1993 to 19 percent in 2001.

The Dual Market in Mortgage Lending

The steady growth in lending to lower-income people and communities, and especially minorities, was one of the most significant accomplishments of the 1990s. Over this period new technologies, such as automated underwriting and credit scoring systems, enabled lenders to better evaluate risk. This produced mortgages with lower downpayment requirements for creditworthy but low-income or low-wealth borrowers and higher priced loans for borrowers with less than perfect credit histories.[22] In addition, subprime, government-backed, and manufactured home loans were increasingly offered. Though these alternatives tend to be more expensive and less flexible than prime loans, they are often the best choice available for borrowers with less than perfect credit histories.

[21] Over the period 1993 to 2001, the number of home purchase loans with race missing increased by nearly 400,000 to 459,000. For home refinance loans, the increase was from 189 thousand to 1.06 million. In 2001, no information on borrower race was present in the HMDA files for some 12.1 percent of all home purchase loans, and 18.6 percent of all home refinance loans.
[22] For a more complete discussion of the factors influencing the growth of mortgage lending in the 1990s see Joint Center for Housing Studies, 2002.

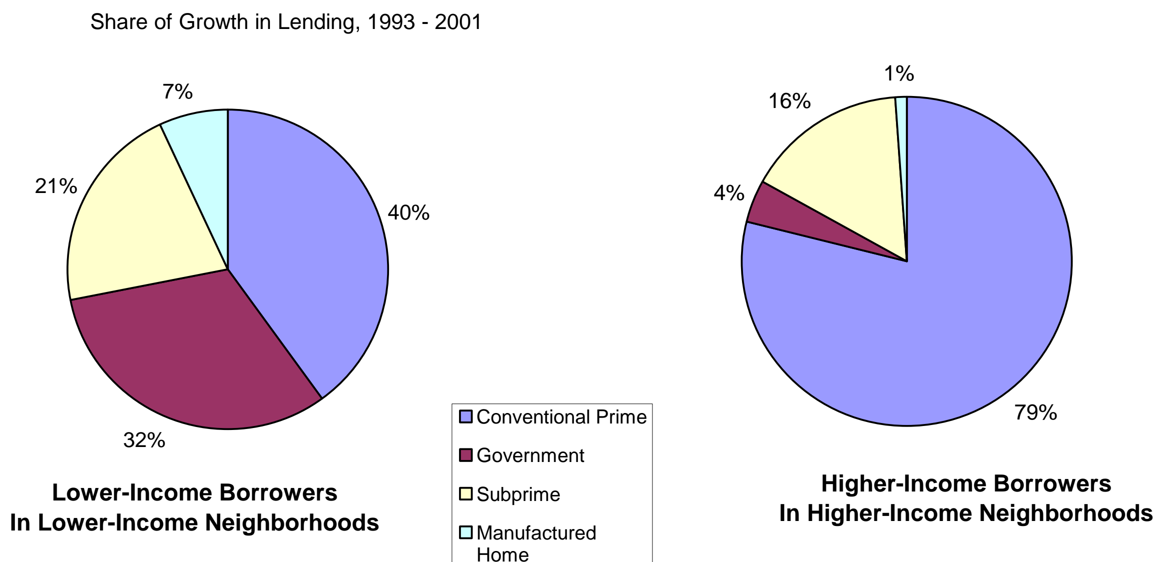
While the prime conventional mortgage market continues to be the dominant source of mortgage capital for most market segments, an increasing share of low-income and minority borrowers now obtain mortgages through the aforementioned alternative channels. By 2001, subprime lenders accounted for over 6 percent of all home purchase lending, up from just 1 percent in 1993. For lower-income households living in lower-income communities, the subprime share topped 10 percent. For the same population, subprime refinance loans accounted for a striking 27 percent of home refinance loans, a more than four fold increase in market share over the period from 1993 to 2001.

Manufactured home loans also grew notably during the 1990s, as did sales of manufactured homes. Almost half of all manufactured homes are placed on rented land and financed with personal – as opposed to real estate – loans. As a result, many manufactured home loans feature rates that are from two to five percentage points higher than those on conventional prime real estate loans.[23] Government-backed loans, particularly those insured by the FHA, also have somewhat higher interest rates. Over the 1993 to 2001 period, government-backed loans accounted for between 10 and 14 percent of all home purchase loans.[24]

Collectively, these alternative loan types were a major contributor to the overall growth of home lending. Over the 1993 to 2001 period, government-backed, subprime, and manufactured home lending accounted for nearly one third of the 1.4 million overall increase in the number of home purchase loans. Prime loans to lower-income borrowers in lower-income communities accounted for only about 40 percent of all growth in home purchase lending (Exhibit 5). This contrasts significantly with higher-income borrowers in higher-income communities where prime loans accounted for almost 80 percent of all home purchase lending growth over the period.

[23] Vermeer and Louie, 1996. See also Collins, Carliner, and Crowe, 2002.
[24] Government-backed loans may also be guaranteed by the US Department of Agriculture's Rural Housing Service or the Veteran's Administration.

Exhibit 5: Expanded Lending to Lower-Income Borrowers Has Fostered a Dual Mortgage Market



Note: Lower (higher) income borrowers have income of less than (at least) 80 percent of area median in that year. Lower (higher) income neighborhoods have income of less than (at least) 80 percent of area median as of 1990.

Source: Joint Center for Housing Studies, *The 25th Anniversary of the Community Reinvestment Act: Access To Capital In An Evolving Financial Services System,* March 2002.

A Prime Lending Gap Exists in Minority Neighborhoods

The overall expansion of mortgage lending fueled dramatic homeownership increases among minorities. Minorities represent less than one-fifth of all owners, but received 34 percent of the increase in home purchase lending, and accounted for nearly 40 percent of the total increase in the number of owners from 1993 to 2002. Nevertheless, a gap persists in the homeownership rates for minorities and whites. In 2002, the African American homeownership rate stood at 48.9 percent, the Hispanic rate at 47.4, and the rate for other minorities at 53.9 percent – all considerably below the 74.7 percent rate for whites. While the rates reflect differences in household income, wealth, age and family composition among the various racial and ethnic groups, these factors do not explain the entire homeownership gap.[25]

[25] Yinger, 1998.

There is an equally pronounced gap in the ability of minorities to secure conventional prime mortgages. In 2001, prime conventional lenders accounted for nearly three quarters of all home purchase lending to whites, but less than 50 percent of lending to Hispanics and only 40 percent of lending to African Americans. While there are noticeable income differences, on average, between borrowers of different race and ethnicity, the racial gap in prime lending persists even after controlling for borrower income. Indeed, data in Exhibit 6 suggest that a white borrower with an income of less than 80 percent of area median has a similar likelihood of obtaining a prime mortgage as an African American borrower with an income in excess of 120 percent of area median.

Exhibit 6: African Americans and Hispanics of All Incomes Lag Whites in Access to Prime Mortgages

Conventional prime loans as a share of all loans

HOME PURCHASE LOANS				
Borrower Race	**Low Income <80% AMI**	**Middle Income 80-120% AMI**	**High Income >120% AMI**	**Total All Incomes**
White	60.4%	68.5%	86.0%	74.3%
African American	30.9%	38.6%	61.5%	40.4%
Hispanic	41.1%	45.6%	68.1%	49.9%
Asian/Other	65.0%	69.5%	84.4%	76.2%
ALL Borrowers	54.2%	64.2%	83.9%	69.9%
HOME REFINANCE LOANS				
Borrower Race	**Low Income <80% AMI**	**Middle Income 80-120% AMI**	**High Income >120% AMI**	**Total Incomes**
White	86.9%	90.6%	94.1%	91.5%
African American	56.9%	66.2%	76.7%	65.4%
Hispanic	76.3%	78.7%	83.5%	79.4%
Asian/Other	85.2%	88.8%	92.8%	90.5%
ALL Borrowers	79.4%	85.9%	91.5%	87.1%

Source: Joint Center for Housing Studies enhanced HMDA database.

Moreover, the share of African Americans and Hispanics refinancing their homes with conventional prime loans also trails the white share in each of the income categories presented.[26]

[26] Use of more detailed income groupings presents a similar pattern: For home purchase and home refinance lending, depending on income, the African American share of prime lending lags that of whites by 20 to 30 percent, while for Hispanics, the gap ranges from 10 to 20 percent.

This is despite the fact that refinance lending is generally considered to be less risky than home purchase lending because loan to value ratios tend to be lower and lenders can review the payment history on the current loan to determine whether to extend new financing.

Observed differences in the prime loan share of total lending by race and income cannot be taken as proof of discriminatory practices in mortgage markets. At a minimum, the simple results presented here do not control for many of the objective factors (excluding race) that lenders use to determine whether a particular individual qualifies for a particular type of loan. Such discrepancies, however, do prompt some housing advocates to claim that the rise of alternative mortgage products has resulted in a new, and subtler, form of discrimination based on race and ethnicity in mortgage markets that nevertheless has a disparate, and largely unfavorable, impact on minority borrowers and communities.

SECTION 2: INDUSTRY STRUCTURE PERPETUATES DUAL MARKET

Today thousands of mortgage banking operations compete to offer products to millions of potential borrowers. Indeed, by several measures the market is more competitive today than two decades ago, at least as measured by the number of firms originating loans in any given market area or community. While many smaller thrifts and savings institutions have shut down their mortgage lending operations, they have been replaced by well-capitalized financial services giants with access to low-cost mortgage funds through an increasingly sophisticated secondary mortgage market. Aided by the outreach efforts of thousands of mortgage brokers and correspondent lenders, these giants have reached every corner of the market, including lower-income and minority communities. Yet despite substantial competition on the "supply-side" of the marketplace, a dual market persists.

Today, some borrowers pay more for mortgage credit and/or receive less favorable treatment (or even abusive treatment) than other similarly situated and equally creditworthy borrowers. As a result, borrowers with the ability to understand and shop the mortgage marketplace benefit from a range of product choices and the speed and efficiency of the current mortgage delivery system. At the same time, borrowers that lack the information, capacity, or willingness to shop for mortgage credit, particularly those with real or perceived lower credit quality or those attempting to purchase homes in neighborhoods with less stable and/or lower property values, remain vulnerable to overpaying for mortgages, or not receiving the best terms for which they could qualify.

Racial and ethnic minorities appear to be particularly vulnerable to the mispricing and "push marketing" that all too frequently occurs outside the mainstream market. Survey data suggest that for a variety of reasons – including historical mistrust of banking institutions – these individuals are least likely to comparison shop for mortgage credit. Moreover, lacking basic information about mortgage terms and rates, they are more likely to succumb to "push marketing" tactics. Whatever the case may be, it is disturbing that more than three decades after the enactment of fair lending legislation, fundamental disparities in minority access to mortgage capital remain.

Misaligned Incentives Inefficiently Allocate Credit

An efficient mortgage market allocates capital according to the risk profile of the loan and the ability and willingness of the potential borrower to pay for mortgage credit. Though efficient in many ways, today's dual mortgage market fails to achieve what economists term "allocational efficiency" because similarly situated borrowers pay different prices to obtain a mortgage of given characteristics and terms. Central to the emergence and the persistence of this allocational inefficiency is a market failure linked to "principal agent risk" that arises from the growing importance and presence of mortgage brokers and correspondent lenders in the market.

Brokers and loan correspondents, also called third party originators, have different incentives in the market than retail lenders. Third party originators work neither on behalf of the borrower nor the wholesale lender or investor who funds the loan. Instead they are compensated by the borrower in the form of origination fees and points and are frequently compensated by the wholesale lender in the form of an origination fee at the time the loan application is funded. If borrowers are aware of prevailing mortgage rates and terms, competitive pressures will force individual brokers and correspondents to offer the best product available or lose out on the business. Yet to the extent that mortgages are complex and consumers lack basic information, this competitive market check may be missing. In addition, regulation of brokers and correspondent lenders generally occurs at the state level, and consequently involves a patchwork of laws and regulations.[27] Subject to whatever regulatory constraints are effectively operating in their market, a broker's incentive is to close the loan while charging the highest combination of fees and mortgage interest rates the market will bear.

A mortgage delivery system where third party originators are compensated for making loans, but have no long term interest in loan performance is subject to the aforementioned "principal agent risk." The interests of the lender/investor (principal) and the broker (agent) are misaligned in the case of broker originated loans. The broker has little incentive to worry about whether the information presented in the mortgage application is accurate, so long as it is sufficient to cause the lender to fund the loan and trigger the payment of the broker's fees. Lacking a long-term

[27] According to Kim-Sung and Hermanson (2003) four states (Alaska, Colorado, Montana, and Wyoming) do not require licensure while more than two thirds do not have examination requirements.

interest in the performance of the loan, the broker is immune from many of the adverse consequences of failing to match the borrower with the best available mortgage or not providing accurate data needed to underwrite and assess the probability that the loan will default or otherwise prepay faster than anticipated.

At the same time, the broker has substantial incentive to provide less than accurate information, even though it is often not in the best interest of the borrower, and may not reflect the interests of the investor. This could result in the broker neglecting to check the accuracy of information presented on the borrower's loan application or falsifying income or other measures of credit worthiness or the value of the mortgaged property. Armed with inaccurate information, the lender (and the ultimate investor) may not fully understand the default risk associated with a particular loan. A prime quality borrower inappropriately placed into a subprime loan may eventually add to investor risk since borrowers saddled with an "excessive" monthly mortgage payment may be more likely to prepay than otherwise similarly situated borrowers with lower payments.

Because of these risks, the lender/investor (principal) does have a long term interest in the loan performance and has every incentive to monitor their third party originators as best they can. Typically, lenders establish clear guidelines for third party originators concerning acceptable underwriting standards and reject broker loans that fail to meet these standards. They may also require correspondents to buy back loans should a post-purchase loan review identify a problem. In addition, some wholesale lenders base broker compensation on the actual loan performance, rather than compensating on a simple "fee for service" basis. Of course these actions are time consuming and legally complex, and hence can be difficult to implement in practice. Lenders/investors, however, do have one powerful tool to hold brokers accountable; they can always terminate affiliation with any third party originator that consistently fails to meet underwriting guidelines.

While in theory these efforts should work to bring broker's actions back into alignment with those of the lender/investor, in practice they often fall short of the mark. As noted earlier, the broker has much more knowledge about the borrower's financial situation than the

investor/lender, and hence has ample opportunity to "cheat" without getting caught. In addition, brokers work with various lenders and can therefore send their best customers to one lender and divert marginal clients to lenders with looser underwriting standards and/or less capacity to hold the broker accountable.

Clearly all brokers are not out to "cheat" the system at the expense of borrowers, lenders and investors. Like wholesale lenders, brokers have incentive to protect their reputation in the market. Moreover, brokers frequently play the role of a trusted advisor and in doing so can provide useful guidance to customers concerning the loan process. Even so, with a growing number of originations coming brokers, and with mounting evidence of both the potential for and reality of broker abuse mounting, the broker segment of the mortgage market clearly merits further scrutiny.

Unfortunately the current regulatory structure is not well suited to monitor and hold mortgage brokers and other third party originators accountable for their actions. Federal regulations of mortgage lending, so called "regulation from above" focus most intensely on depository institutions subject to detailed regulation under the Community Reinvestment Act and Fair Lending Act reviews.[28] At the same time, the routine activities of mortgage brokers are largely regulated, if at all, by a patchwork of often ineffective state regulations. With the number of mortgage brokers numbering in the hundreds of thousands, state regulators often lack the resources to conduct simple licensing reviews, let alone engage in detailed monitoring of broker behavior.

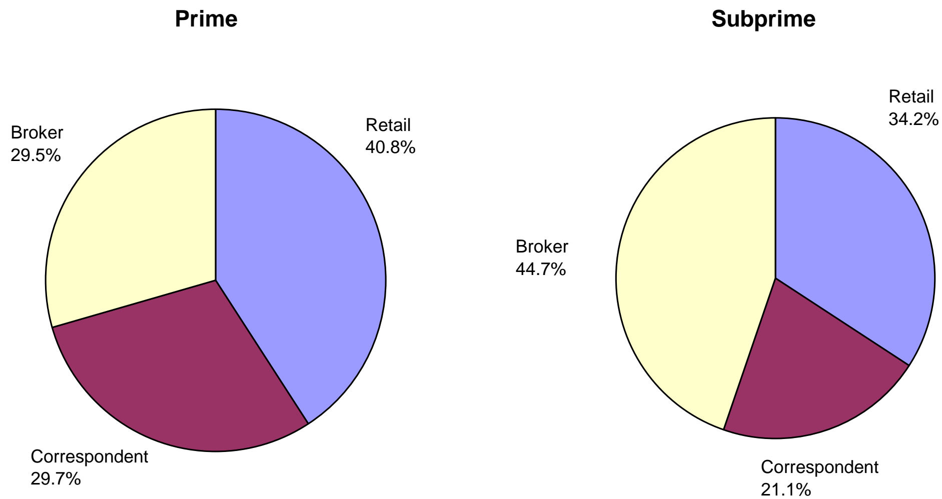
What advocates term "regulation from below" is equally hard-pressed to identify abusive broker behavior. Back when local retail banks dominated mortgage lending, community based organizations played a key role in advocating for expanded lending to low- and moderate-income communities. Unlike many mortgage brokers, retail banks have both a visible institutional presence and concerns about their reputation in the community. While larger mortgage banking and mortgage brokerage operations share these concerns, many smaller firms and individual brokers can "fly beneath the radar screen." Operating with a phone, fax, and computer, brokers

[28] For further discussion of the concepts "regulation from above" and "regulation from below," see Fishbein, 1992.

can enter a market undetected, yet still capture significant market share if they are skilled at working with national scale wholesale lenders or at selling their product directly into the secondary market. While this ease of entry represents a significant business advantage of the new mortgage origination system, it can be abused by brokers who "push" over-priced products into low-income and low-wealth communities, leaving behind problems associated with these mispriced or even abusive mortgages.

The behavior of mortgage brokers holds special significance for subprime markets. Both prime and subprime mortgages are originated by each of three channels: retail, broker, and correspondent, but the broker channel plays a dominant role in subprime lending. In 2002, some 44.7 percent of all subprime originations flowed through a mortgage broker channel, compared with only 29.5 percent for prime mortgages (Exhibit 7). In contrast, both the retail and correspondent lending channels account for a relatively smaller share of subprime loans than is true for prime loans.

Exhibit 7: Brokers Dominate Subprime Lending



Source: Inside Mortgage Finance, *The 2003 Mortgage Market Statistical Annual*

Many Borrowers Have Limited Capacity to Shop

The fact that the allocational inefficiency and potential for abuse is not easily monitored by government regulators, community based watchdogs, or even supportive private sector lenders and investors, places a substantial burden on individual consumers to fend for themselves in the marketplace. As envisioned in simple economic theory, the ability of consumers to shop for the best available price and terms can provide a high degree of consumer protection. For example, in a market where people have the ability to comparison shop, a broker may lose business if he or she pushes costs too high.

Unfortunately, given the bewildering array of mortgage products available, even the most sophisticated borrower will find it difficult to evaluate the details of a mortgage since the essence of mortgage pricing reflects decisions concerning repayment of debt over time. And there is a growing body of "behavioral economics" literature that suggests that consumers have differing and often inconsistent time preferences depending on how the choices regarding payment over time are framed.[29] For example in a recent paper, Shu (2002) argued that the complexity of discounting mathematics and an inability to estimate this function in their head leads people to turn to alternative "Short Cut Methods," such as heuristics or simplified linear models. For example, one short cut method might be for the consumer to estimate the total loan payments (number of payments times the payment size) and look for a loan that minimizes this total. If the loan terms being compared were held constant, this heuristic would be equivalent to finding the loan with the lowest interest rate. Yet over loans of various terms, the loan with the lowest total payments may not be the loan with the lowest annual percentage rate (APR).[30] Aside from APR, others focused on minimizing the length of the loan term, while for others, minimizing monthly payments was given priority.

Given that consumers utilize short cut methods, some brokers may actively promote mortgages that exploit the tendency of some borrowers to focus on monthly payments and not the APR or

[29] For good summary of this strand of literature see Thaler and Sunstein, 2003.

[30] Shu (2002) presented evidence that the problems associated with deciding what is the best way to borrow money and repay over time is not limited to "unsophisticated borrowers." Using a panel of students enrolled in the MBA program at the University of Chicago, she found that even financially sophisticated individuals have trouble determining cost minimizing alternatives for a stream of future payments.

some other more useful measure to evaluate the costs of various mortgage products. For example, a recent AARP study (Kim Sung and Hermanson 2003) examined subprime lending patterns using a random sample of 1008 individuals aged 65 and older who refinanced their home between January 1999 and December 2000. Kim-Sung and Hermanson noted that broker-originated refinance loans were nearly twice as likely to be subprime as lender-originated loans (33 versus 17 percent). They also showed that nearly half (49 percent) of the surveyed borrowers obtained a retail lender originated loan, 39 percent a broker originated loan, while some 12 percent reported receiving their loan from a home improvement contractor or some other source. A higher share of broker-originated loans went to African American borrowers (64 percent) than white borrowers (38 percent) and broker-originated loans were also more common among borrowers who were divorced or female.

What is perhaps most striking is the way homeowners in the sample searched (or in many instances did not search) for the best loan available. The AARP study supports the notion that in many instances subprime refinance loans are "sold, not sought" in that they result from the extensive and often unsolicited outreach by brokers. Kim-Sung and Hermanson found that some 56 percent of borrowers with broker-originated loans reported that brokers initiated contact with them, compared with only 24 percent of borrowers with lender originated loans. Since they did not initiate the search activity, it is not surprising that a larger share of borrowers with broker-originated loans (70 versus 52 percent) "counted on lenders or brokers to find them the best mortgage." Unfortunately, this confidence was often misplaced.

Borrowers with broker-originated loans were more likely to pay points (25 versus 15 percent) and more likely to have a loan with a prepayment penalty (26 versus 12 percent) A greater share of borrowers with broker originated loans also believed that they did not get a loan that was "best for them" (21 versus 9 percent), received a loan with mortgage rates and terms that were "not fair" (23 versus 8 percent) and did not receive "accurate and honest information" (19 versus 7 percent). Many borrowers, especially elderly borrowers, and borrowers in lower-income and/or minority areas, succumb to the marketing tactics of aggressive brokers, in effect becoming unwitting accomplices in the dual mortgage market.

These findings are echoed in a number of other studies. Survey data presented in a study by Courchane, Surrette and Zorn (2004) painted a similar picture. This study suggested that subprime borrowers are less knowledgeable about the mortgage process, are less likely to search for the best mortgage rates, and are less likely to be offered a choice among alternative mortgage terms and instruments. Similarly, another AARP survey conducted in 2003 examined consumer knowledge of the mortgage lending process.[31] While AARP reported that most survey respondents aged 45 and older understood the basic loan application process, including Truth in Lending Act (TILA) disclosure requirements, many did not. For example, more than 10 percent of all respondents were unaware that the lender is required to disclose fees before loan closing, while more than 20 percent were unaware that the lender is required to disclose the annual percentage rate (APR) of the loan prior to closing. Moreover, AARP noted that African Americans were slightly less likely than the general population to correctly answer the TILA related questions included in the survey.

The AARP survey also asked respondents about the steps they took to shop for a home equity lender. Most respondents made multiple inquiries concerning alternative home equity loan products; however, there were notable exceptions. For example, African Americans were significantly less likely than the general population (36 versus 77 percent) to shop for a home equity loan at their bank, savings and loan or credit union. AARP posited that this might be related to the fact that the African Americans surveyed were significantly less likely (72 versus 88 percent) than the general population to have a savings or checking account at one of these same institutions. Lacking access to banking services, African Americans were more likely (29 versus 10 percent) than the general population to go to a lender recommended by their contractors and more likely (21 versus 9 percent) to respond to advertisements received in the mail or over the phone.

While the studies by Courchane, Surette and Zorn and the AARP showed that many subprime borrowers *do not* shop, Guttentag (2001) went further to claim that because of the complexity of mortgage products, consumers are, in many ways, incapable of being effective shoppers. According to Guttentag, "the core reason for market failure is that effective shopping for a

[31] AARP, 2003.

mortgage is extraordinarily difficult for even sophisticated borrowers (2001: 3)." To support this claim, Guttentag documented substantial variation in broker compensation, a situation that should not exist if consumers have the capacity to shop for the best available terms. He examined a sample of conventional prime loans and found that broker profits ranged from $1,077 to $2,748 and had no apparent relationship to the level of the effort required to process the loan application.[32]

Guttentag emphasized the fact that pricing variability is not a prime or subprime issue but rather a product of the way mortgage markets function. This was followed by a detailed discussion of the characteristics of the current mortgage market, such as product complexity and the tendency for loan terms to change daily, that undermine the ability of borrowers to effectively comparison shop. For example, the difference between a thirty year fixed rate mortgage with an interest rate of 6.5 percent and 3 points and one at 7.25 percent with no points, while substantial if the loan is held to term, is negligible over a five-year time horizon. Most borrowers, however, are unaware that the length of time the loan is actually held has a tremendous influence on the effective interest rate generated by the point and rate combination.

'Rebate pricing' in which lenders compensate brokers by allowing them to keep some portion of the margin above the wholesale mortgage price, also serves to obscure the best price available from prospective borrowers. A borrower can tell from the settlement statement how much he or she will pay the broker but not how much the broker will receive from the lender for completing the deal (widely referred to as the yield spread premium or YSP). In theory some of this fee could offset the borrower's payment to the broker and the borrower's bargaining position would be greatly enhanced if this information were known to him or her. Guttentag observed that these and other structural features of the current mortgage market make it difficult to imagine that simple consumer education will correct the tendency for some brokers to overcharge unsuspecting borrowers.

Shopping for the best price is made even more difficult by the fact that mortgage borrowing involves many participants including loan officers, underwriters and processors, property

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[32] In a recent paper, Susan Woodward (2003) came to similar conclusion.

appraisers and insurers, title insurers, credit reporting agencies, mortgage insurers, abstract companies, pest inspectors, and flood insurers to name a few. In addition to the complexity of the product, the complexity of the process provides an opportunity for brokers to collude with some of these participants to skim extra cash from the borrower. Moreover, the sheer number of documents associated with a mortgage loan provides ample opportunity for a broker to introduce unfavorable provisions into the loan without the borrower's knowledge.

The above discussion is a reminder that the potential for abuse associated with "push marketing" and the surprising tendency for many borrowers not to shop for mortgages is reinforced by a mortgage delivery system that actually provides incentives for brokers and other third party originators to exploit the situation. This suggests that rooting out "push marketing" or other abusive practices requires not simply borrower education, but efforts to expand the dissemination of mortgage pricing information to facilitate comparison shopping and provides hands on assistance to help consumers select the mortgage product that is best for them. Moreover, mortgage lenders who rely on brokers to reach out to borrowers and market their products have a special responsibility to monitor the actions of their agents, and to work with federal and local authorities to craft legislative and regulatory reform to end the abusive practices that continue to mar the mortgage industry.

Racial Disparities in Mortgage Lending Persist

Numerous studies document the low shares of conventional prime lending to minority borrowers and/or neighborhoods with high concentrations of minority households. In addition to the variation by race/ethnicity of individual borrowers, there also appears to be a gap between the share of conventional prime loans made in neighborhoods of differing income, racial and ethnic makeup. For example, Joint Center assessment of HMDA data suggest that overall conventional prime lending in 2001 accounted for 89.4 percent of all home purchase lending to higher-income white borrowers living in higher-income and largely white neighborhoods. In contrast, the prime loan share for higher-income African Americans living in these same areas was only 73.5 percent. For Hispanics, the share was a higher 81.6 percent (Exhibit 8). In lower-income and largely (more than 50 percent) African American and Hispanic communities the prime loan gap was even greater still. For example, the prime loan share for lower-income African American

borrowers living in lower-income, largely African American communities fell to 31.8 percent. For white borrowers living in these same communities the prime loan share was over 20 points higher (54.5 percent).

Exhibit 8: Racial and Income Composition Further Expands Prime Lending Gap

Conventional prime loans as a share of all loans

HOME PURCHASE								
BORROWER CHARACTERISTICS								
	Lower Income <80% AMI				Higher Income >120% AMI			
Neighborhood Characteristics	White	African American	Hispanic	Asian/ Other	White	African American	Hispanic	Asian/ Other
LESS THAN 10% MINORITY								
Lower income	54.9%	29.1%	42.0%	51.2%	85.1%	67.8%	75.0%	80.3%
Higher income	65.4%	36.3%	48.4%	65.3%	89.4%	73.5%	81.6%	89.0%
MORE THAN 50% BLACK								
Lower income	54.5%	31.8%	44.5%	48.3%	85.9%	59.5%	64.3%	72.4%
Higher income	48.0%	27.7%	39.0%	48.4%	81.1%	55.0%	56.8%	68.4%
MORE THAN 50% HISPANIC								
Lower income	52.7%	32.1%	40.4%	61.0%	79.1%	48.2%	56.4%	74.0%
Higher income	48.3%	32.0%	42.6%	56.3%	73.4%	51.1%	65.5%	69.7%

HOME REFINANCE								
BORROWER CHARACTERISTICS								
	Lower Income <80% AMI				Higher Income >120% AMI			
Neighborhood Characteristics	White	African American	Hispanic	Asian/ Other	White	African American	Hispanic	Asian/ Other
LESS THAN 10% MINORITY								
Lower income	83.1%	65.9%	71.4%	72.8%	93.2%	79.1%	79.4%	90.6%
Higher income	89.4%	67.8%	81.0%	85.0%	95.7%	86.3%	90.2%	94.6%
MORE THAN 50% BLACK								
Lower income	71.0%	51.1%	68.8%	52.9%	89.7%	70.3%	76.5%	79.2%
Higher income	75.8%	57.1%	69.6%	65.0%	89.1%	72.7%	77.3%	80.3%
MORE THAN 50% HISPANIC								
Lower income	76.9%	54.3%	74.0%	81.8%	88.0%	67.0%	78.4%	86.3%
Higher income	79.3%	60.4%	77.3%	83.4%	88.0%	70.8%	82.1%	87.3%

Source: Joint Center for Housing Studies enhanced HMDA database.

Compared to home purchase lending, the conventional prime lending share of home refinance loans is generally higher in all market segments, but especially lower-income markets. This is in part a reflection of the fact that FHA has a substantially smaller presence in the refinance market. Even so, there remains significant variation in access to conventional prime home refinance loans across neighborhoods of different racial/ethnic and income mix. For example, Exhibit 8 documents that prime conventional refinance loans accounted for 95.7 percent all refinancing done by higher-income whites, living in higher-income white areas. For Hispanics living in these same neighborhoods, the prime refinance share was five percentage points less while for African Americans the prime share was 10 percentage points less.

The racial gap in lending persists in a variety of neighborhood settings. Even in areas with income growth and/or home price appreciation in excess of 75 percent over the decade, the share of higher-income African Americans with conventional prime loans trails that of white borrowers by 20 percentage points. Examining tracts with different historical mortgage denial rates reveals a similar trend. In areas with the lowest mortgage denial rates historically (and arguably containing households with the highest average household credit quality), the share of higher-income, African Americans obtaining prime loans still trails whites (Exhibit 9).

Exhibit 9: Racial Gap in Prime Lending Persists in a Variety of Neighborhood

Neighborhood Characteristics	BORROWER CHARACTERISTICS					
	Income < 80% AMI		Income 80-120 AMI		Income > 120% AMI	
	White	African American	White	African American	White	African American
Change in tract median housing value						
<10%	64.2	35.8	69.7	42.3	84.2	61.5
10 to 25%	60.1	29.0	68.8	37.3	85.7	59.9
25 to 50%	58.2	28.9	66.3	36.0	85.3	59.8
50 to 75%	60.9	32.1	69.0	38.5	86.9	63.2
>75%	60.7	32.6	69.5	42.4	87.4	65.9
Change in tract median household income						
<10%	58.6	33.1	65.9	41.5	82.7	57.7
10 to 25%	58.5	29.6	65.4	36.9	83.6	57.2
25 to 50%	60.4	30.5	68.3	38.0	85.6	61.5
50 to 75%	61.2	31.4	69.8	39.0	87.3	64.8
>75%	64.3	36.7	72.1	46.5	88.7	69.8
Tract level mortgage denial rates						
<5%	77.6	44.5	81.6	52.1	92.6	79.1
5 to 14%	65.2	33.6	71.8	41.7	87.9	67.9
15 to 25%	54.1	31.1	61.9	37.7	81.3	58.2
26 to 30%	48.6	28.5	56.3	33.8	77.5	51.7
>30%	43.6	28.9	52.8	36.8	75.4	52.7

Source: Joint Center for Housing Studies enhanced HMDA database.

Racial Disparities are Particularly Pronounced in the Subprime Market

Though there are undoubtedly different risks associated with lending to individuals with varied income and credit histories or living in different neighborhood settings, the difference across race and ethnicity with respect to the share of lending that is conventional prime, subprime, government backed or manufactured home lending can be substantial. For example, review of HMDA data on the spatial variation of prime lending has led many advocates to focus on what they call the “risk or race question” arguing that it is “race” not “risk” that explains the persistent

prime lending gap. [33] For example, in a comprehensive review of neighborhood lending patterns in Chicago in the late 1990s, Immergluck and Wiles (1999) observed that conventional prime lenders served higher-income white areas, while FHA and subprime lending was concentrated in lower-income and minority communities. Characterizing this as a "dual mortgage market," they noted that the racial disparities were too great to be explained by differences in the credit quality of the borrowers. Instead, they argued that the observed patterns resulted from the failure of "mainstream lenders" to seek out credit worthy borrowers in lower-income and minority communities.

Researchers at the U.S Department of Housing and Urban Development (HUD) similarly concluded that a lack of competition from prime lenders has enabled subprime lenders to gain a growing share of mortgage lending activity in lower-income and minority communities. In addition, they noted that racial discrepancies in lending patterns existed at the borrower level and that upper-income African American borrowers were twice as likely as lower-income, white borrowers to hold subprime refinance loans.[34] Combining HMDA data with data from the 2000 Census, Bradford (2002) found that African Americans and Hispanics were also disproportionately represented in the subprime refinance market. Moreover, he pointed out that racial disparities in lending exist in all regions and in cities of all sizes. Indeed, the study suggested that among the 331 metropolitan areas examined, some of the biggest disparities exist in the nation's smallest metropolitan areas.

Finally, based on their summary of several HUD-funded studies, Fishbein and Bunce (2000) concluded that a portion of borrowers whose credit would allow them to qualify for lower cost conventional prime loans were nonetheless receiving subprime loans. They also found that the higher interest rates charged by subprime lenders could not be fully explained by neighborhood and/or borrower risk factors.

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[33] The phrase "risk or race" was suggested by a compressive study of subprime lending patterns prepared for the Center for Community Change. See Bradford, 2002.
[34] U.S. Department of Treasury and U.S. Department of Housing and Urban Development. 2000. Hearings for this report were held in Baltimore, Chicago, Los Angeles and New York.

Detailed Studies Confirm Simple HMDA Findings

Each of the studies discussed in the previous sub-section acknowledged that part of the disparity in lending patterns undoubtedly resulted from differences in borrower and property related risk factors. To address this, several studies have gone to considerable lengths to develop data that more fully evaluate the "risk or race" question. Pennington-Cross, Yezer and Nichols (2000) examined issues related to credit risk and mortgage lending and estimated the probability that an individual borrower selected a conventional prime, subprime, or FHA insured mortgage. The study analyzed a database of home purchase loans that combined HMDA data with data from FHA administrative files, a sample of real estate transactions, and a measure of borrower credit quality. While the study confirmed that borrower income, debt, credit history and neighborhood factors significantly influence the pattern of mortgage lending, race and ethnicity still appeared to be key determinants in explaining why African Americans, Native Americans, and Hispanics are less likely to have access to lower-cost, prime home purchase loans than whites.

Similarly, Calem, Gillen and Wachter (2002) examined spatial variation in subprime lending across census tracts in Chicago and Philadelphia. In addition to detailed borrower data, this study incorporated a variety of tract-level measures drawn from the 2000 Census.[35] Of note was their use of tract-level risk measures, including the share of properties in foreclosure, as well as the share of individuals within the tract with low (or no) credit scores (obtained from a major national credit bureau).

While the authors conceded that more could be done to control for individual borrower risk, they asserted that race, both at the neighborhood and borrower levels, remains a strong factor in explaining the distribution of subprime lending. In particular, they found that "even after inclusion of the full set of explanatory variables, in both cities we find a strong geographic concentration of subprime lending in neighborhoods where there is a large population of African American homeowners" (2002: 14). In addition, they noted that African American borrowers, regardless of their neighborhood location, have a high likelihood of obtaining a subprime loan compared to a prime loan, concluding that both borrower race and neighborhood race matter.

[35]Census variables provided detail on income, education, and race/ethnicity.

In a recent paper, Courchane, Surette and Zorn (2004) examined whether borrowers were "inappropriately" channeled into the subprime segment. The study explored mortgage lending patterns using FICO scores and other traditional measures of risk as well as what the authors described as "borrower self-assessed credit risk factors"[36] gathered from a survey of mortgage borrowers. The paper confirmed that whether borrowers obtain subprime or prime mortgages depends in large measure on risk-related mortgage underwriting variables (including FICO score, Loan To Value, Front End Ratio) and other factors including mortgage type, market channel, shopping behaviors, opportunity to make choice, age and ethnicity.

The addition of measures of market knowledge, search behavior, and choices available contributed significantly to explaining borrower outcomes. The authors concluded that the superior performance of the "full" model in explaining whether a borrower obtained a prime or subprime loan implies that credit risk alone may not fully explain why borrowers end up in the subprime market. Rather, their paper supported the alternative view that the current mortgage delivery system produces an allocational inefficiency wherein households of similar economic, demographic, and credit risk characteristics do not pay the same price for mortgage credit.

Capital Markets Fail to Correct Pricing Disparity

The finding that an allocational inefficiency exists in the mortgage market is reinforced by a series of econometric studies that demonstrate how "principal agent risk" associated with third party originations can result in borrowers with similar characteristics obtaining different pricing depending on the process or channel through which they received their loan.[37] Building on an earlier study by Lacour-Little and Chun (1999) that demonstrated that broker-originated loans are likely to prepay faster, Alexander et. al. (2003) showed that they are also more likely to default than loans originated through a retail channel, even after controlling for credit and ability-to-pay factors. Alexander et. al. further demonstrated that prior to 1997 the different

[36] For example the survey gathers data on whether the borrower believes that they "have good credit," "pay bills on time," and are "in control of their finances," as well as information on search behavior and adverse life events such as loss of job.

[37] For example, Passmore and Sparks (1996) showed how asymmetric information and adverse selection can negate the benefits of government sponsored mortgage securitization programs; Shiller and Weiss (2000) examined moral hazard in home-equity conversions; Brickman and Hendershott (2000) investigated adverse selection in the refinancing of FHA loans; Brueckner (2000) studied the impact of asymmetric information on mortgage default, and Lacour-Little and Chun (1999) assessed prepayment risk of mortgages originated by third parties.

default characteristics of broker originated loans were not recognized in the market place and were consequently not priced accordingly. They argued due to growing capital market awareness of the "principal agent risk" associated with broker-originated loans, borrowers who receive funding via the broker channel are charged a premium over apparently similar borrowers who receive their loans through retail channels. This is a result of the need to compensate investors for the higher default and prepayment risk associated with these loans.

This discussion is a reminder that investors care primarily about being compensated for the risks they bear. The fact that a pool of mortgages includes individual mortgages with "excessive" fees or rates, or contains inaccurate information is not of interest so long as the investor is able to assess prepayment rates and/or foreclosure rates associated with these transactions. Recognizing that misrepresentation and mispricing exists, some lenders/investors simply protect their interests by buying loans from less reliable brokers at a discount rather than working to weed out "bad loans."

Of course, some lenders and investors are deeply concerned about receiving misleading information from brokers, particularly related to the appraised value of the mortgage property or the capacity of the borrower to repay the loan. As result, there is aggressive and now technologically sophisticated monitoring on the part of lenders and investors, as well as the Wall Street rating agencies that is designed to root out fraud.[38] However, these systems are costly to acquire and not universally implemented.

Given the fact that investment returns depend on the accuracy of the assumptions concerning the underlying mortgage assets and the performance of the mortgage pool, mortgage investors must decide how to manage that risk. In an extreme example, an investor could present relatively strict rules governing the process of loan originations and through a system of "representations and warranties" hold the mortgage banker accountable for any deviation from these rules. Mortgage bankers in turn could seek to hold their brokers accountable to these standards, and in effect push this risk back downstream. Since there are reputational risk considerations associated

[38] See July 2003 issue of *Inside Mortgage Technology* for a discussion of the growth of automated fraud detection systems.

with loans that go into foreclosure, such actions could pressure brokers to more closely align their practices with general industry standards.

Undoubtedly some of this is happening, but Alexander et. al. (2003) demonstrated that in the current subprime market, the tendency of brokers to charge excessive fees or present misleading information is not "corrected," but rather priced in the market. Indeed, such practices are no secret, as the details concerning the expected performance of a pool of loans are carefully disclosed for prospective investors to review. A recent assessment of financial disclosure documents for a large sample of subprime mortgage-back securities confirmed that investors focus less on whether specific loans are likely to default or prepay, and more on whether the risk-adjusted rate of return is sufficient to cover any expected losses.[39] This review demonstrated that it is standard practice for disclosure documents to first predict that a given pool of subprime loans has a very high likelihood of experiencing significant losses due to default and foreclosure – in many instances ten times as high as prime quality loans – only to then demonstrate that the mortgages have sufficiently high interest rates to protect individual investors from realizing these losses.

In a world in which the broker is detached from the lender and the lender is detached from the investor, market feedback loops are broken, or at best are slow to operate. Rather than work to root out abuse, under the current industry structure, some buyers pay more, brokers earn a premium return, and investors are compensated. Yet despite the fact that such high foreclosure rates, if realized, would have potentially devastating consequences for individual borrowers and communities, the disclosure documents simply state that the pools were priced to compensate investors for bearing the risks. The result is that the impact of foreclosures to borrowers and communities is ignored by the capital markets.

Is There an Effective Demand Side Check?

As long as the mortgage-backed securities market prices the tendency of brokers to overcharge borrowers or present misleading information into its securities, the task of ensuring nondiscriminatory pricing in the marketplace falls to regulators and to consumers themselves.

[39] See Mansfield, 2003.

Unfortunately, the current regulatory setup is not well structured to address the problems associated with mispriced mortgage credit. Indeed, while there could and should be more aggressive enforcement of laws and regulations governing deceptive marketing practices or failure to accurately disclose the terms of the borrower prior to the closing, there is limited recourse for a borrower who simply overpays. Consumer protection regulations generally focus on ensuring that the loan information provided by the mortgage broker to the borrower was "fair and accurate," that the appraised value of the home was a fair representation of current market value, and that the terms and cost of the loan were provided in advance of closing for the borrower to review. Under the doctrine of "let the buyer beware," apart from Federal Trade Commission regulations that prohibit false advertising by brokers, there are no requirements that a broker offer the best price available in the marketplace.

Nor are potential borrowers necessarily up to the challenge of protecting their own interests. A previously discussed, many consumers do not shop around for mortgages, and instead rely on brokers to provide them with information. Indeed, many consumers falsely believe that approval of their mortgage application is somehow a validation that they can handle the mortgage payments. *Nothing could be further from the truth.* At the time of closing, each of the parties in the transaction (other than the borrower) is fully aware of the probability that the loan will move to default and foreclosure. Lacking this knowledge, many borrowers willingly enter into a transaction that may impose serious financial and emotional costs on themselves *and* their neighbors.

Moreover, given the complexity of current mortgage products, even the most sophisticated borrower will find it difficult to evaluate the details of the mortgage. Yet to the extent that these more sophisticated borrowers have financial or legal advisors to guide them, they may have access to better mortgage information. At a minimum, higher-income and higher-wealth borrowers have more extensive financial resources to draw upon and hence have greater capacity to bear any excessive costs and avoid mortgage default.

The mortgage market often falls short of the competitive ideal where buyers and sellers have ready access to information about product terms and pricing. Simple economics suggests that

markets work best when consumers make informed choices concerning the goods and services they consume. Recognizing the complexity of the mortgage product, and the inherent difficulty many consumers have in shopping for the 'best mortgage product,' all too often the ideals of the competitive market are not realized. In the language of economics, there exists an "asymmetry of information" between buyers and sellers, particularly with respect to the price of mortgage credit. Mortgage industry professionals participate in numerous transactions over the course of weeks and months and have ready access to information on the set of fees, rates, and terms that comprise the overall "pricing of mortgage credit" in the marketplace. In contrast, consumers only occasionally search for a loan to purchase or refinance a home, and hence begin loan shopping with limited prior experience and equally limited access to the information needed to make an educated choice.

Consumers could spend more time and money to better educate themselves about the price and terms of alternative mortgage products, but from the perspective of the efficient use of societal resources, it makes little sense for individual consumers to devote considerable resources to ferret out information that could be readily provided by mortgage brokers and originators. Yet as previously noted mortgage brokers and originators have limited incentive to provide detailed pricing information, particularly information that would enable a consumer to compare prices of alternative products to determine whether or given the details of their income and credit history, they were getting a loan at the best price available in the marketplace.

These comments suggest that mortgage pricing information is in effect a "public good," and there is a role for government in providing the pricing information needed to support the efficient operation of the mortgage market. While improved disclosure of the terms of a particular loan offered to a consumer would help, as would continued consumer education efforts, these steps are not sufficient to achieve desired results due to the complexity of the mortgage lending process. Federal regulators operating under applicable Fair Lending and Fair Trade authorities must expand their efforts to ensure that consumers obtain the pricing information needed to make informed choices. This could take the form of a national registry of best available mortgage products, or other efforts to assist local government and community based organizations help families to better understand the pricing of mortgage products as they relate to borrower income,

credit score, and ability to meet downpayment and closing cost requirements. Such readily available information – equivalent to the “blue books” or consumer reports that have successfully guided shoppers for automobiles and other consumer durables – would help consumers find the best available deal and help better protect them from the adverse consequences of aggressive and often deceptive marketing practices. Working to enable borrowers or their trusted advisors to be better shoppers and resist such marketing practices would go a long way to not only reduce the incidence of predatory lending, but also stem the growth of foreclosures that inevitably follow in the wake of these same predatory lending practices.

SECTION 3: ECONOMETRIC ANALYSIS CONFIRMS THE PERSISTENCE OF DISCRIMINATION IN MORTGAGE MARKETS

This section summarizes the recently completed Joint Center for Housing Studies econometric analysis of the "risk or race" question. Due to the difficulty of assessing the spatial and racial patterns in mortgage lending with simple descriptive statistics, the Joint Center estimated a series of multivariate equations of the odds that a borrower will obtain a prime conventional mortgage, as opposed to a subprime mortgage. Using a logistic transformation, this odds ratio is assumed to be a function of borrower and neighborhood characteristics, as well as the lender variables that are included in the Joint Center Enhanced HMDA data base.

The econometric analysis confirmed that many factors contribute to the relatively low share of prime conventional loans going to African American and Hispanic borrowers, and to all borrowers living in predominantly African American and Hispanic neighborhoods. As is true of most previous studies on the topic, the analysis also confirmed that race remains a factor, even after controlling for a wide range of neighborhood and borrower characteristics, including several measures of risk.

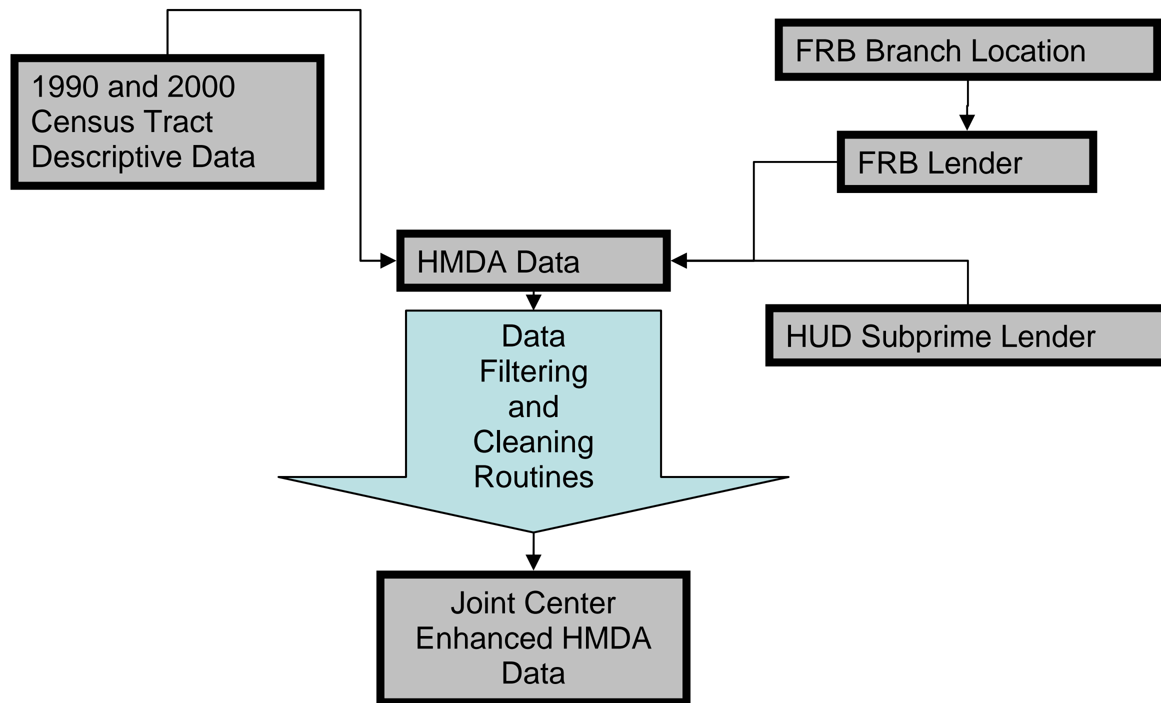
The Joint Center Enhanced HMDA Data Base

The econometric analysis presented in this report utilized loan level data submitted by financial institutions under the Home Mortgage Disclosure Act (HMDA) of 1975. As currently amended, HMDA requires mortgage lenders to report the race and income of the applicant, the state, county, and census tract of the property included in the application, the type of loan applied for and the disposition of the application for all loan applications. There are approximately 146 million records of home mortgage loan applications and transactions included in the HMDA data files for the period 1993 to 2001, HMDA data include information on both 'originated loans' and 'purchased loans.' The latter are originated by one HMDA reporting entity and sold to another, either to hold in portfolio or to be sold again into the secondary market. To avoid double counting of any particular loan, all 'purchased loans' are eliminated from the sample, a step that reduces the initial count of HMDA data records by half.[40]

[40] Details of the impact of these various data filters are presented in the Appendix to this report.

The analysis only looked at the 734 metropolitan area counties for which HMDA filers have been required to report in all years from 1993 to 2001. This geographic focus eliminated 20 percent of the remaining records, which are either in non-metropolitan counties, or in counties that were added to or dropped from the list of metropolitan counties during the study period. Geographic standardization was enforced to ensure that the additional data did not confound interpretation of trends in either the benchmarking or multivariate statistical analyses. Other records with inconsistent or missing data were eliminated from the final database, including loans with missing borrower income, missing census tract information, or missing or invalid loan information. These incremental filters bring the final count of HMDA records for the period 1993 to 2001 to 27.8 million purchase loans and 25.9 million refinance loans.

Exhibit 10: Joint Center Enhanced HMDA Database



As shown in Exhibit 10, the Joint Center Enhanced HMDA data base combines HMDA data with data from three other sources. These sources include:

> **Federal Reserve Board Lender and Branch Location Files:** The Federal Reserve Board (FRB) maintains two research databases that were used in this study. The FRB Lender file permits aggregation of individual HMDA reporters into larger organizations linked by common ownership. FRB data also identify whether a banking institution is subject to Community Reinvestment Act (CRA) regulations, as well as the location of their primary assessment area, defined as those counties within which a regulated entity has deposit-taking branches.
>
> **U.S Department of Housing and Urban Development (HUD) Data on Metropolitan Statistical Area (MSA) Median Household Incomes and Lender Specializations:** This report classifies loans relative to the overall median income for the MSA for both the income of the loan applicant and the income of the census tract where the property is located. HUD prepares annual estimates of MSA median household income, which were appended to the HMDA database. HUD also prepares an annual listing of those HMDA reporters that specialize in subprime or manufactured home lending which was also appended to the database.
>
> **Census Tract Characteristics:** The statistical analysis in this report incorporated tract data from the 2000 Census as control variables for each of the 45,000 metropolitan area census tracts. Census data for 1990 and 2000 were also linked to create several indicators of neighborhood change, including estimated change in tract income and home values over the decade.

Assessing the Prime Mortgage Gap

Simple descriptive statistics confirm the existence of a conventional prime lending gap where minorities, most notably African Americans, are less likely to obtain prime conventional mortgages, even after controlling for neighborhood and borrower income. In an effort to account for the potential impacts of other variables on the spatial distribution of conventional prime

lending, the Joint Center used the Enhanced HMDA database to estimate a multivariate equation of the odds that an individual will receive a conventional prime loan, as opposed to a subprime loan. Using a logistic transformation, the model assumed that the log of the odds of the prime conventional versus the subprime mortgage is a linear function of the borrower and neighborhood characteristics, as well as measures of neighborhood credit quality, the degree of industry competition, and the mortgage origination channel, which indicates whether or not the loan was initially sold into the secondary market or held in portfolio. Separate equations were estimated for home purchase and refinance loans.

The data used to estimate these equations were grouped according to six categories or data blocks.[41] Exhibit 11 displays the variables included in five of the six blocks. Not shown is a series of 301 dummy variables for each metropolitan area represented in the model. Variables in the other five blocks include:

Borrower: This block includes a series of dummy variables, such as race/ethnicity, income as a percent of area median income, and gender, derived from basic HMDA data. The race/ethnicity dummies use "white borrowers" as the reference category, while "male borrowers" serve as the reference category for the gender dummies. For income, the reference category is borrowers with incomes that fall between 80 and 120 percent of metropolitan area median income. Given the rise in the number of borrowers that fail to report key demographic data, this study diverged from others and included a dummy variable for "missing borrower race" and "missing gender" to examine the extent to which the growth of missing data appears to be linked to the rise in subprime lending.

Neighborhood Block: HMDA data report the 1990 census tract of the home being financed and whether or not it is located in a central city, along with the tract income as a percentage of area median income. By linking 1990 and 2000 census tract identifiers, the analysis expanded the list of neighborhood variables to include descriptions of the detailed racial composition of the neighborhood, data on the share of college educated

[41] A table of means and standard deviations of the variables used in these equations is presented in the Appendix to this report.

adults, share of household heads receiving public assistance, share of owner occupied units, and the share of all owners with a household head aged 65 or older. Finally, the variable list also included information about the housing stock in each neighborhood, including the number of single family homes as a share of the total number of housing units in the tract, the share of housing units built before 1950, and the median value of owner occupied homes.

Neighborhood Credit Quality: Building on the work of Calem, Gillen, and Wachter (2002),[42] the analysis included a series of variables to measure variation in the risk associated with making a loan in a particular census tract. Specific measures included housing turnover (or homes sales as a share of owner occupied homes), income and house value growth, historical loan denial rates, and rent to value ratio. High housing turnover signals the presence of an active resale market that should enhance the quality of available property appraisal data. Faster growth in household incomes and home values imply increasing housing demand, while lower rent to value ratio is a rough indicator of the lower market capitalization rates for a given area. Finally, a measure of the probability that an applicant for a prime conventional loan was denied over the period 1995 to 1999 was included. This last variable provided a measure of the average credit quality of residents living in and/or seeking to move into a specific neighborhood.

Competition: Some advocates have argued that the lack of prime conventional lending in an area results from an absence of mainstream lenders. And lack of competition, the argument continues, has enabled the subprime sector to gain market share, independent of other objective characteristics of the area. To assess these claims, the analysis included a block of variables designed to measure the degree of market competition in a particular neighborhood. The Herfindahl-Hirschman Index (HHI) is a measure of market competition that ranges from 1 to 10,000 where a higher number indicates that a few lenders control a significant share of loans. In addition to the HHI, two simpler and somewhat more intuitively understandable measures of competition – the total number of

[42] Note that this study focused on two metropolitan areas – Chicago and Philadelphia. In contrast, the Joint Center analysis reported here examined data for all metropolitan areas.

prime lenders operating in a neighborhood, and the number of top 25 lenders in the same area – were included. To account for the variation in size of census tracts, both of these measures were expressed relative to the number of owner occupied housing units in the tract.

Loan Supply: This report has argued that lending to low-income people and communities is characterized by a dual mortgage market, in that these areas are differentially served by third party mortgage originators offering a distinctly different mix of mortgage products. To examine potential supply side impacts on mortgage lending patterns, this block included information on the size of the lender, and whether or not the lender is a CRA regulated entity operating in their assessment area, a CRA regulated entity operating outside their assessment area, or a non-CRA regulated entity. In addition, the block included a series of variables that describe the source of funding for the loans. In particular, relative to a loan that was not sold (held in portfolio), the block contained a series of dummy variables that indicated whether or not the loan was sold to Fannie Mae or Freddie Mac or sold to another entity including non-bank issuers of primarily non-conforming securities.

Regression Results

Exhibit 11 presents estimates of the complete model including each of the five blocks of data for both home purchase and home refinance lending. Not shown in the exhibit, but included in the estimation process are the 301 metropolitan area dummy variables discussed early. In addition to the coefficient estimates, Exhibit 11 presents the ChiSq measure of the statistical significance of individual coefficients.

In general, the model performed quite well. All coefficients are statistically significant as measured by the probability of Chi-square, and most have the anticipated sign. Note that even after controlling for a relatively detailed list of variables, African Americans are shown to be less likely to receive a prime conventional loan. While Hispanic borrowers are also less likely to receive a prime conventional loan, even after controlling for the range of other variables included in the model, the magnitude of this impact is smaller than it was for African Americans. Further

complicating this picture is the fact that borrowers with "race not reported" were also less likely to obtain a prime conventional loan, suggesting that the failure to obtain racial information from all borrowers is not a random phenomenon.

Exhibit 11: Logistic Models of Probability of a Prime Loan Origination

		Home Purchase		Refinance	
Block	**Variable**	**Coeff.**	**Pr > ChiSq**	**Coeff.**	**Pr > ChiSq**
Borrower	Intercept	3.2447	<.0001	3.3878	<.0001
Borrower	1-African American Borrower	(1.1124)	<.0001	(0.6729)	<.0001
Borrower	1-Hispanic Borrower	(0.5154)	<.0001	(0.3761)	<.0001
Borrower	1-Other Race Borrower	(0.0009)	<.0001	(0.1358)	<.0001
Borrower	1-Missing Race Borrower	(0.6950)	<.0001	(0.6957)	<.0001
Borrower	1-Borrower: MSA Income <= 80%	0.0136	<.0001	(0.2395)	<.0001
Borrower	1-Borrower: MSA Income >120%	0.2396	<.0001	0.2780	<.0001
Borrower	1-Female Applicant	(0.1369)	<.0001	(0.2568)	<.0001
Borrower	1-Gender Missing	0.6181	<.0001	0.0965	<.0001
Neighborhood	2-1990 Tract: MSA Income	(0.1042)	<.0001	0.0529	<.0001
Neighborhood	2-1990 % w/in Central City	0.0032	<.0001	(0.0334)	<.0001
Neighborhood	2-Census % African American in 2000	(0.2807)	<.0001	(0.3291)	<.0001
Neighborhood	2-Census % Hispanic in 2000	0.2980	<.0001	(0.0117)	<.0001
Neighborhood	2-Census % Asian + Other in 2000	0.2773	<.0001	(0.0058)	<.0001
Neighborhood	2-Share HH w/public assistance	(1.8300)	<.0001	(0.0530)	<.0001
Neighborhood	2-Share Pop w/Bachelors Degree	0.7890	<.0001	0.9190	<.0001
Neighborhood	2-Share Owners over 65 in 2000	0.1460	<.0001	0.0558	<.0001
Neighborhood	2-Share of Owner Occ in 2000	0.1264	<.0001	0.1986	<.0001
Neighborhood	2-Share SF homes in 2000	0.0045	<.0001	(0.1880)	<.0001
Neighborhood	2-Share pre-1950 Units in 2000	(0.1010)	<.0001	(0.1750)	<.0001
Neighborhood	2-Median House Value in 2000	0.0413	<.0001	(0.0211)	<.0001
Neigh Credit Quality	4-(Turnover 2001)/100	0.0558	<.0001	0.0379	<.0001
Neigh Credit Quality	4-Chg Median Family Inc 90-00	0.0294	<.0001	0.0193	<.0001
Neigh Credit Quality	4-Change in House Value 90-00	0.0029	<.0001	(0.0003)	<.0001
Neigh Credit Quality	4-PRM CONV Denial Rate 1995-99	(3.5747)	<.0001	(2.1659)	<.0001
Neigh Credit Quality	4-Rent Value Ratio in 2000	(1.6216)	<.0001	(1.7553)	<.0001
Competition	5-HHI (In Hundreds of units)	0.0276	<.0001	0.0083	<.0001
Competition	5-Orgs in Trct/Own Occ Units	(1.7465)	<.0001	(0.8986)	<.0001
Competition	5-Top 25 Orgs in Trct/Own Occ	6.0316	<.0001	2.5508	<.0001
Loan Supply	6-FNMA (Fedl National Mtg Asso	1.5845	<.0001	2.4185	<.0001
Loan Supply	6-GHLMC (Fedl Home Loan Mtg Co	1.2821	<.0001	2.0438	<.0001
Loan Supply	6-FAMC (Fedl Agricultural Mtg	0.9202	<.0001	1.7035	<.0001
Loan Supply	6-Commercial bank	0.8269	<.0001	0.8723	<.0001
Loan Supply	6-Savings bank or saving Assoc	0.7384	<.0001	1.1586	<.0001
Loan Supply	6-Life insurance company	1.6682	<.0001	1.8010	<.0001
Loan Supply	6-Affiliate institution	(0.7550)	<.0001	0.3153	<.0001
Loan Supply	6-Other type of purchaser	(1.5315)	<.0001	(0.5780)	<.0001
Loan Supply	6-Non Assessed Lender	(1.3240)	<.0001	(2.2047)	<.0001
Loan Supply	6-Outside Assessment Area	(1.3859)	<.0001	(1.6903)	<.0001
Loan Supply	6-Org w/less than 5,000 loans	1.0694	<.0001	1.1990	<.0001
Loan Supply	6-Org w/25,000 or more loans	0.4915	<.0001	0.3061	<.0001
Percent Concordant		88.7		91.2	
Observations		2.86 million		5.48 million	

The model also generated interesting insights as to how the log of the odds of obtaining a prime loan varies according to the racial composition of the neighborhood. For example the equation confirmed that the higher the share of African Americans living in a neighborhood, the lower the odds that a borrower of any race or ethnicity will receive a prime loan. The results for Hispanics display a more complex pattern. In particular, borrowers living in a predominantly Hispanic neighborhood appear to be less likely to receive a prime conventional refinance loan. Somewhat surprisingly, borrowers living in a predominantly Hispanic neighborhood appear to be somewhat more likely to receive a prime conventional home purchase loan.

To further explore the impact of neighborhood and borrower race on the odds of obtaining a prime loan, Exhibit 12 presents the race/ethnicity variables for two alternate specifications. The first specification, described as the "simple model," included only the borrower and neighborhood blocks and the metropolitan area dummy variables. In contrast, the "full model" discussed earlier, included the metropolitan area dummy variables plus information from each of the five data blocks. Note that the "simple model" included many of the variables presented in earlier studies of the "risk or race question." Because HMDA data contain information on borrower and neighborhood characteristics, for example, the census tract and metropolitan area of the loan, many studies have limited themselves to these variables. These studies typically found that there are significant variation in lending patterns by the racial and ethnic characteristics of the borrower and the neighborhood.

Exhibit 12: Race Coefficients for Alternative Logistic Model Specifications

	Model Specification	
	Simple Model	**Full Model**
Home Purchase Loans		
African American Borrower Coefficient	(1.08)	(1.11)
PR > ChiSq	<.0001	<.0001
Hispanic Borrower Coefficient	(0.53)	(0.52)
PR > ChiSq	<.0001	<.0001
% African American in Neighborhood Coefficient	(0.93)	(0.28)
PR > ChiSq	<.0001	<.0001
% Hispanic in Neighborhood Coefficient	0.25	0.30
PR > ChiSq	<.0001	<.0001
Refinance Loans		
African American Borrower Coefficient	(0.92)	(0.67)
PR > ChiSq	<.0001	<.0001
Hispanic Borrower Coefficient	(0.46)	(0.38)
PR > ChiSq	<.0001	<.0001
% African American in Neighborhood Coefficient	(1.02)	(0.33)
PR > ChiSq	<.0001	<.0001
% Hispanic in Neighborhood Coefficient	(0.10)	(0.01)
PR > ChiSq	<.0001	<.0001

Note: Simple Model includes explanatory variables from Borrower, Neighborhood and MSA specific effects blocks. Full model includes all explanatory variables.

Critics have suggested that these simple studies are flawed, in that they failed to account for other important variables – not included in basic HMDA data – that also influence lending patterns. According to this view, the "left out variable problem" can bias the coefficients on race/ethnicity to the extent that the omitted variables are correlated with race. Comparison of the coefficients on race and ethnicity in the "simple" and the "full" models demonstrated that concern over left out variables is warranted. In general, the addition of supplementary information, including other lender characteristics, as well as information on neighborhood level credit quality, served to reduce the extent that observed disparities can be directly attributed to racial factors alone. For example, the coefficients of both the home purchase and refinance equations for "percent of African Americans in the neighborhood" become noticeably less negative (suggesting a smaller prime lending gap). A similar shift was observed for the "African American borrower" coefficient, but this occurred only in the refinance equation.

While the logistic formulation is the preferred econometric estimating technique for models of this type, they do pose difficulty when it comes to interpreting the magnitude of the impact. To better assess the impact of the richer specification of the "full model" on the "risk or race question," both models were used to estimate the predicted probabilities of obtaining a prime conventional loan for various combinations of neighborhood and borrower racial and ethnic characteristics (Exhibit 13). As before all other variables in the equation were set equal to their sample means. This approach isolated the impact of race and ethnicity from other variables.

In Exhibit 13, white borrowers living in "white neighborhoods" [43] are shown to be highly likely to obtain a prime conventional mortgage regardless of which model is deployed. In contrast, there is a noticeably lower probability of securing a prime conventional mortgage for an African Americans borrower living in an "African American neighborhood" and a Hispanic borrower living in a "Hispanic neighborhood." [44]

Exhibit 13: Racial Differences in Probability of Prime Lending Estimated with Logistic Model

Loan Type	All Metro Neighborhoods Simple Model	All Metro Neighborhoods More Complex Model
Home Purchase		
White Borrower, White Neighborhood	94.9%	96.1%
African American Borrower, African American Neighborhood	73.4%	86.0%
Hispanic Borrower, Hispanic Neighborhood	87.1%	95.2%
Refinance		
White Borrower, White Neighborhood	94.5%	96.0%
African American Borrower, African American Neighborhood	72.0%	89.8%
Hispanic Borrower, Hispanic Neighborhood	86.6%	94.2%
Home Purchase Gap		
Prime Gap African American Borrower, African American Neighborhood	21.5%	10.1%
Prime Gap Hispanic Borrower, Hispanic Neighborhood	7.8%	.9%
Refinance Gap		
Prime Gap African American Borrower, African American Neighborhood	22.5%	6.2%
Prime Gap Hispanic Borrower, Hispanic Neighborhood	7.9%	1.8%

[43] "White neighborhoods" are defined as those census tracts where the population is 90 percent white.
[44] An "African American neighborhood" is a census tract where African Americans constitute at least 50 percent of the population, while a "Hispanic neighborhood" has at least a 50 percent Hispanic population.

The Exhibit then compares the results for whites, African Americans and Hispanics to create a measure of the prime lending gap controlling for all of the variables included in the model. Consistent with the discussion of the raw coefficients, the racial gap measured by the "full model is smaller." Indeed, for Hispanics, the gap virtually disappears. For African Americans, however, the prime lending gap persists, even after accounting for a wide range of other potential contributing factors.

Other Factors Influence the Prime Lending Gap

While much of the discussion has focused on race, the "full model" provided insights into a number of other factors that contribute to spatial variation in lending patterns. For example Exhibit 14 presents estimates of the impact of various other neighborhood characteristics on the probability that a borrower will receive a prime conventional loan. Here impact was measured as the change in probability of receiving a conventional prime loan that would result from a one standard deviation change in the neighborhood variable.[45] Setting each of the other variables in the model to their sample means isolated the independent effect of the variable in question.

Exhibit 14: Neighborhood Characteristics Influence Probability of Receiving a Prime Conventional Loan

Impact of one standard deviation change in tract share of:	Home Purchase Loans	Refinance Loans
Household heads receiving public assistance	-0.3%	0.0%
Adult population with Bachelor's Degree	0.9%	1.1%
Owners over 65	0.1%	0.0%
Owner-occupied	1.1%	0.2%
Homes built before 1950	-0.2%	-0.4%
Denied prime loans 1995-1999	-2.0%	-1.4%

[45] In interpreting these results, it is useful to note that a plus or minus one standard deviation variation around the mean of a variable includes roughly two-thirds of the observations in the sample. Thus a one standard deviation shift identifies a range of variation that is noticeably above or below the mean of all census tracts for the variable in question, but still represents a quite common occurrence.

While decidedly smaller than the race/ethnicity impacts, Exhibit 14 does demonstrate that other neighborhood characteristics contribute to the observed spatial pattern of prime lending. The measure of neighborhood credit quality appears to have the biggest impact in that higher denial rates in the past are linked to noticeably lower prime conventional lending. Alternatively, areas with relatively high shares of college educated individuals appear more likely to secure prime conventional loans. Note that this finding holds even though the model has already controlled for neighborhood and family income. These findings are consistent with the earlier discussions suggesting that subprime lenders may target neighborhoods with borrowers with limited capacity or willingness to shop for mortgages.

With the "full model" it was also possible to isolate the impact of lender characteristics and secondary market treatment of loans. In these calculations, the base case was a "portfolio loan," made by a CRA-regulated entity, operating in their CRA designated assessment area, and not sold to a secondary market entity or other institution. Two general points emerge from the impact estimates presented in Exhibit 15. Even controlling for detailed borrower and neighborhood characteristics, the way in which a loan is made, or the lending channel matters. For example, there is a more significant prime lending gap for loans made by entities not subject to CRA oversight. A similar finding holds for CRA regulated banking institutions operating outside of their assessment areas. This tendency is especially pronounced for home refinance loans. Unlike traditional assessment area lenders, other mortgage entities and their growing mortgage broker network are the principal contributors to the observed prime mortgage lending gap.

Exhibit 15: Probability of Obtaining a Prime Conventional Loan Varies by Lender Characteristics and Secondary Market Conduit

Change in Probability of Prime Conventional Loan for LOANS MADE BY:	Home Purchase Loans	Refinance Loans
CRA Regulated Lender Out of Assessment Area	-5.9%	-8.5%
Non-CRA Regulated Lender	-5.3%	-11.4%
Change in Probability of Prime Conventional Loan for LOANS SOLD TO:		
Fannie Mae	5.0%	6.8%
Freddie Mac	4.6%	6.5%
Commercial Bank	3.9%	4.5%
Savings Bank or Savings Association	3.6%	5.4%
Affiliate Institution	-6.3%	1.9%
Other type of purchaser	-13.7%	-4.8%

Note: Comparison relative to portfolio loans made by CRA regulated entities operating within their assessment areas.

Next, though largely invisible to the borrower, the ultimate funder of the loan matters as well. Note that loans destined for Fannie Mae or Freddie Mac were much more likely to be prime loans, than loans that flowed through other conduits. This is especially true for the category "other types of purchasers." These entities are generally large issuers of non-conforming securities, including subprime loans. Of course, in many ways these impacts simply reflect the structure of the secondary market, where some types of entities – for example Fannie Mae and Freddie Mac – historically have specialized in creating a secondary market outlet for prime conventional mortgages. Even so, the results also provided evidence that despite controlling for a range of borrower and neighborhood attributes, there remain distinct differences in the funding of subprime loans, a result that is consistent with the fact that the dual mortgage market is intricately linked to the structure of the larger mortgage industry.

SECTION 4: CHANGES IN THE MORTGAGE INDUSTRY CHALLENGE THE ACTIVITIES OF COMMUNITY BASED ORGANIZATIONS

The mortgage market in the United States has evolved into one of the most efficient capital markets in the world. Even so, many lower-income and minority borrowers still do not gain access to the best mortgages for which they could qualify, and defaults and foreclosures, particularly on subprime loans, are on the rise in many lower-income communities across the country. This section begins with a brief review of the historical role played by community based organizations in expanding access to capital in disadvantaged communities, and continues on to discuss how the dual mortgage market structure threatens to undermine over three decades of community revitalization efforts. The section concludes with an assessment of the implications of these trends for CBO direct loan programs, as well as their homebuyer education and counseling and political advocacy.

The Historical Role of Community-Based Organizations

CBOs have long been central to efforts to expand access to mortgage capital to low-income people and communities. Seeking to rally public support against redlining - the systematic denial of mortgage credit to neighborhoods and groups in less prosperous sections of US metropolitan areas - grass roots organizations began in the 1960s and 1970s to mobilize residents of economically distressed neighborhoods. Banks were one logical target of this activism. Indeed, much of the effort that led to the passage of the Community Reinvestment Act (CRA) in 1977 was built on the simple proposition that federally insured and regulated commercial banks and thrift institutions had an affirmative obligation to lend in areas where they maintained deposit taking operations or were otherwise chartered to serve.

What emerged from the combination of community-based activism and legislative efforts was a period in the 1980s and early 1990s described by one community leader in Chicago as the "Golden Age of Community Activism;" a period when CBOs put significant pressure on banks to expand the reach of their lending and banking activities. Dubbed "regulation from below," community groups armed with Home Mortgage Disclosure Act (HMDA) data and backed by the

legislative mandate of CRA pressured federally regulated banking organizations to increase the number of loans made to minority and/or low-income borrowers.[46]

These local lending initiatives got a shot in the arm in the mid-1970s when. Congress chartered two national non-profit organizations: the Neighborhood Reinvestment Corporation (NRC) and Neighborhood Housing Services of America (NHSA). NRC provides financial support, technical assistance, and training for community based revitalization efforts to what has emerged as a national network of local NeighborWorks Organizations. NHSA pioneered the creation of a secondary market outlet for local mortgage lending efforts aimed at traditionally underserved markets.[47] In addition, major foundations such as the Enterprise, Fannie Mae, Ford and MacArthur, along with national non profit organizations such as the Center for Community Change, the Housing Assistance Council, the Local Initiatives Support Coalition, the National Community Reinvestment Coalition, and the National Low Income Housing Coalition also provided crucial support to local CBOs in their advocacy and organizing and economic and housing development efforts.

The relationship that evolved between community groups and banks involved both 'collaboration' and 'confrontation.'[48] Negotiations between community groups and local banks focused on mortgage or small business lending, provision of banking services in particular low-income areas, and the weak record of particular institutions in serving minority communities. The result was an expanded array of new products with more flexible underwriting standards that made it possible to qualify many borrowers that had previously been rejected.

Of course, many CRA-eligible customers presented additional lending risks that banks were reluctant to tackle. One common approach employed by CBOs was to "restore the market" by developing new lending programs that relied on both public and foundation monies, as well as grants and below market rate capital from the banking industry to write down mortgage interest rates, help borrowers make the required downpayment, or otherwise assist borrowers unable to qualify for a market rate loan. These loan programs not only expanded access to capital in

[46] Fishbein, 1992.
[47] For more complete description of these organizations see Neighborhood Reinvestment website at www.nw.org
[48] Schwartz, 1999.

underserved communities, they also became a significant revenue source for selected CBOs. Reflecting the views of many CBOs engaged in direct lending activities, Bruce Gottschall, the Executive Director of the Neighborhood Housing Services of Chicago (NHSC), observed that you have to "figure out how you actually get paid for what you're doing," (Husock 2002: 5,6) and use the funds to help subsidize other organizational activities.

Though hailed by many as representing the best of innovative lending programs, many lenders predictably described these new CBO/bank partnerships as "CRA-led extortion." Even so, faced with activism that could delay planned mergers and/or damage their reputation in the market, many bankers reluctantly entered into negotiations with community groups and began to aggressively expand their outreach to low-income and/or minority neighborhoods. And with the emergence of inter-state banking, the number and scale of CRA commitments to make loans, investments and services to minority and low-income households increased dramatically. Indeed, one analyst estimated that there has been almost $1 trillion dollars committed by banks for CRA activities since 1992, a figure that includes several multi-billion dollar commitments made by national scale lenders.[49]

In addition to the creation of local lending programs and new product choices, community groups and banks joined forces to promote homebuyer education. Over time the efforts of counseling and financial literacy networks operated by the Neighborhood Reinvestment Corporation, the National Community Reinvestment Coalition, ACORN, the Urban League and others have helped thousands of families to realize their dreams of homeownership. Homebuyer education and counseling programs have also emerged as an important revenue source for CBOs. What started out as an opportunity for lenders and community groups to work together, has grown to a nationwide network of community-based homebuying counseling and education programs, and has become good business for both banks and community groups.

Adverse Consequences of the Dual Market Structure

Despite over 25 years of successful efforts to expand access to capital in lower-income communities, the growth of subprime lending and the dual market pose a serious threat to the

[49] NCRC, 2001.

stability and vitality of lower-income communities. The relatively low share of conventional prime loans in the lower-income and minority segments of the market raises questions about whether all borrowers receive credit at the most favorable pricing and terms for which they could qualify. Since even small increases in the interest rate of a loan can impact a borrower's ability to meet monthly payments and cover basic living expenses, this question merits investigation. Moreover, default and foreclosure rates are higher for subprime, government backed, and manufactured home loans, which can destabilize the already weak neighborhoods where these loans tend to be concentrated. Finally, the incidence of abusive lending practices appears to be more prevalent in the subprime market.

1. The Growth of Alternative Mortgages and Abusive Practices

While the growth of mortgage lending to credit-impaired borrowers has expanded access to capital, it has also exposed borrowers to numerous abuses, such as predatory lending, that exist in today's mortgage marketplace. The HUD/Treasury Task Force Report observed that while mortgage lending is regulated by both state and federal authorities, none of the existing statutes and regulations governing mortgage transactions clearly defines predatory lending. As commonly described in existing literature, predatory lending may involve mortgage bankers and brokers, realtors, appraisers, home improvement contractors, or others involved directly or indirectly in mortgage lending. Predatory practices not only include outright deception and fraud, but also efforts to manipulate the borrower through aggressive sales tactics or to exploit their lack of understanding about loan terms.[50]

In an extensive review of the policy issues, Engel and McCoy (2002) noted that while predatory lending practices can and do occur in all market segments, such practices are concentrated in the subprime segment. Engel and McCoy described three distinct mortgage markets: the prime market, the "legitimate" subprime market, and the predatory market. They argued that predatory lenders target vulnerable borrowers who are typically disconnected from credit markets and therefore lack information about best available products or are subject to lingering mortgage market discrimination and other social and demographic forces.

[50] U.S. Department of the Treasury and U.S. Department of Housing and Urban Development, 2000.

Engel and McCoy documented numerous predatory practices that strip the borrower's home equity, burden the borrower with higher interest rates and fees, or disregard the borrower's ability to repay thereby setting them up for foreclosure. In the most egregious examples, unscrupulous real estate agents, mortgage brokers, appraisers, and lenders dupe unsuspecting borrowers into purchasing a home at inflated prices or with significant undisclosed repairs. These practices harm borrowers and their communities, and they also impose costs on mortgage investors and insurers.

Mortgage loans are priced in the secondary market based on assumptions concerning the underlying market value of the asset. By reducing true equity in the home (the true market value less the amount of the mortgage), an inflated appraisal makes it difficult for a borrower to sell their home and repay the mortgage in a time of distress. This, in turn, increases the likelihood that the mortgage will go into default and increases the magnitude of losses incurred by the mortgage insurers and investors during the foreclosure process.

2. Alternative Mortgage Products Have Higher Costs

In theory, prime loans are available to the "best" borrowers on the "best" terms and rates in the marketplace. In practice, however, the mortgage market does not live up to that standard. Many borrowers are offered a subprime loan even if they could have qualified for a prime conventional loan at a prime mortgage interest rate.

The extent of the harm done to a particular borrower, who could qualify yet fails to secure a prime loan, depends on the credit characteristics of the individual borrower and the loan type that is secured. The HUD/Treasury Task Force (2000) estimated that more than half of all subprime loans originated from July through September 1999 had interest rates in excess of 10.5 percent, well above rates for prime loans over the same period, which ranged from 7 to 8 percent. Clearly, the cost of not obtaining a prime loan can be substantial. Indeed, Mortgage Information Corporation (1999) (now LoanPerformance) data for 1999 suggested that 17 percent of subprime borrowers paid more than 4 percentage points above prime rates.

These higher cost loans can add substantially to the housing cost burdens of lower-income families. For example, Joint Center estimates show that a 30-year fixed rate loan of $100,000 at 7 percent produces a monthly payment of $665. The monthly payment for a 10 percent loan of the same size and type would be $213 higher. Not obtaining the best mortgage rate available in the market is not only unfair, it also substantially increases the mortgage burden of for low-income, owner families, and may be the first step to eventual default and foreclosure. [51]

In addition to higher interest rates, subprime loans typically include higher fees to compensate the lender for the higher default and prepayment risk. Through hearings in five cities, the HUD/Treasury Task Force Report found many instances "… of fees that far exceeded what would be expected or justified based on economic grounds, and fees that were 'packed' into the loan amount without the borrower's understanding" (2000:2) The report also noted the all-too-common practice of making loans irrespective of the borrower's ability to repay. In these instances, high front-end fees – often rolled into the mortgage and paid out of the equity claimed by the lender during the foreclosure process – are sufficient to compensate the lender even when the probability is very high that the borrower will default on the loan.

3. Rising Foreclosures Threaten Neighborhood Stability

Whatever factors sustain the high levels of subprime or other alternatives to prime lending in lower-income and/or minority neighborhoods, foreclosures are on the rise in many neighborhoods across the country. The National Training and Information Center estimated that the foreclosure rate in Chicago stood at 4.7 percent in 2001 - over ten times the national average foreclosure rate for prime conventional loans. In the nine low-income neighborhoods served by Chicago Neighborhood Housing Services, the foreclosure rate reached 7.7 percent. Overall, some 40 percent of all completed foreclosures in Chicago were in these nine target neighborhoods. Yet, these communities represented only 5 percent of all mortgage originations in 2001 and accounted for just 18 percent of the city's population.[52]

[51] Joint Center for Housing Studies, 2002.
[52] Collins, 2003.

The recent surge in foreclosures in many low-income and minority communities appears to stem from the growing presence of subprime lending, and in particular the extension of loans to borrowers with limited capacity to repay, or at rates that are well above market. Employing the best available data on loan performance, Cutts and Van Order (2003) estimated that, as of June 2002, the serious delinquency rate for conventional prime loans was 0.55 percent (serious delinquency is defined as loans that are already in foreclosure and/or with payments that are 90 days or more late). In contrast, subprime loans had a serious delinquency rate of 10.44 percent, nearly 20 times higher. Further, the more risky subprime loan examined by Cutts and Van Order (labeled in the study as 'C' or 'CC' loans) had rates as high as 21 percent. Subprime serious delinquency rates were more than twice those of FHA insured mortgages (4.45 percent), the traditional source of many foreclosure problems. Though hardly in evidence a decade ago, subprime loans are now the most default-prone mortgage segment of the home loan market.

Increasing default and foreclosure rates have led many analysts to question whether the recent increase in low-income homeownership – built in part on the rapid growth of subprime lending – is sustainable or even desirable. A HUD study of Baltimore noted that the number of foreclosures increased from 1,900 in 1995 to over 5,000 in 1999 and that the growth was particularly pronounced in African American areas.[53] The study further documented that over a quarter of the subprime loans in foreclosure in the first quarter of 2000 were less than a year old and over half were less than two years old. The high shares of loans in foreclosure less than two years after origination suggests that many borrowers may have lacked the capacity to repay the loan at the time it was made.

To date there have been over ten studies of foreclosure activity in individual metropolitan areas. Though economic factors obviously play a role, these studies paint a remarkably consistent picture of the rising incidence of foreclosure in a period of strong economic growth, led in large measure by the relatively high incidence of foreclosure among subprime loans in lower-income and minority neighborhoods.[54] One notable exception is Rochester, New York. Although historically many Rochester home buyers were victimized by abusive lending practices in the

[53] U.S Department of Housing and Urban Development, 2000.
[54] See for example, Gruenstein and Herbert, 2000a and 2000b.

FHA segment of the mortgage market, more recently the rise in foreclosures appears to be the result of the persistent decline in property values in central city neighborhoods.[55]

Foreclosures can have a devastating impact on the families who lose their home and are left with a damaged credit record. Not only is their ability to secure a home loan in the future undermined, but the cost of borrowing for other purposes, such as purchasing a car to get to work, will be higher. Foreclosures have equally severe impacts at the neighborhood level. In distressed neighborhoods, foreclosed properties may remain vacant for a prolonged period of time, depressing property values and becoming a magnet for crime. By discouraging families or new businesses from moving into a neighborhood, high foreclosure rates contribute to neighborhood instability and stigma.

4. Regulations Fail to Keep Pace

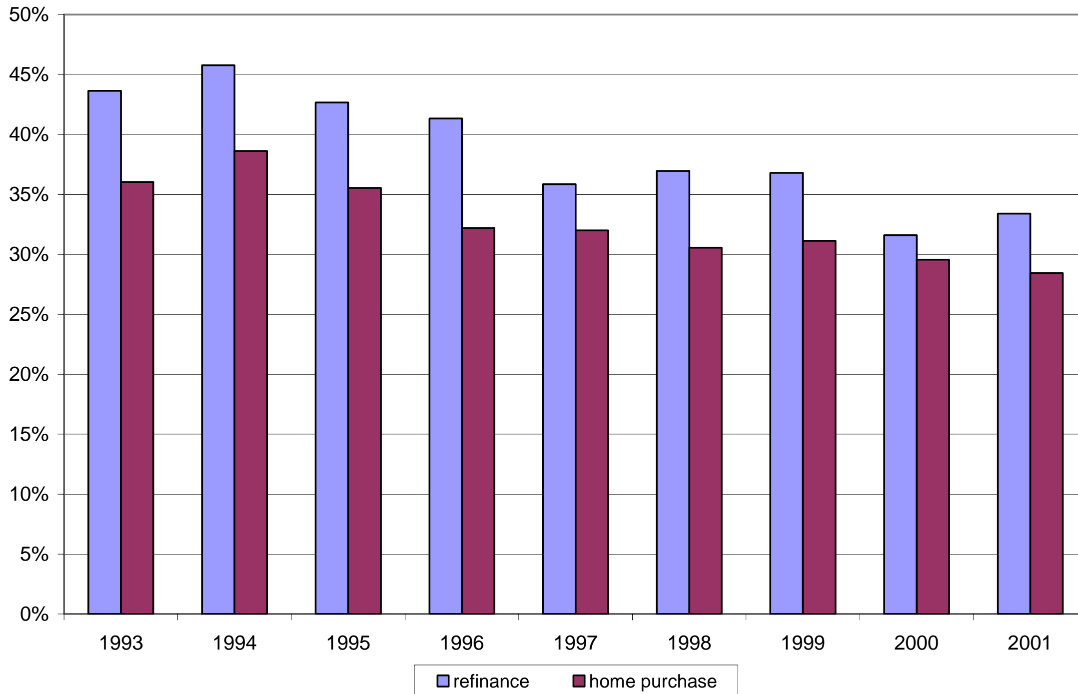
Despite the adverse consequences of the dual market, mortgage lending regulations have not kept pace with the changing marketplace, especially in the lower-income and minority segments. When Congress passed the Community Reinvestment Act (CRA) in 1977, depository institutions – including many locally based banks and thrifts – dominated mortgage lending. CRA responded to the claims that savings and loan associations and banks were 'redlining' low-income areas, in effect denying credit based on racial characteristics of the neighborhood rather than the creditworthiness of individual loan applicants.

The decoupling of mortgage lending from branch-based deposit-gathering institutions has challenged a basic premise on which CRA was based. Consequently, CRA mandated intensive review of lending in 'assessment areas' (defined as areas where banks maintain deposit-taking branches) has been seriously undermined. Indeed, banking organizations operating outside of their CRA assessment areas today constitute the fastest growing segment of the residential mortgage market. Between 1993 and 2001, the number of home purchase loans made by CRA-regulated institutions in their assessment areas as a share of all home purchase loans fell from 36.0 percent to 28.4 percent (Exhibit 16). Even as Congress, through the Gramm-Leach-Bliley Act of 1999, focused on financial services modernization, CRA, while protected, was not made

[55] The Housing Council, 2000.

to conform with the rapidly evolving world of mortgage banking and financial services—let alone anticipate and limit the most predatory practices.[56]

Exhibit 16: Assessment Area Lending Has Fallen Steadily



Source: Joint Center Enhanced HMDA Database

Finally, HMDA data collection efforts have also failed to keep pace with the changing mortgage market. Over the years, HMDA data have been the primary tool used to complement street-level activism by community advocates. These groups have used HMDA to evaluate, and in some instances register complaints with regulators about, the performance of specific lenders in their communities. Despite its earlier importance, HMDA's usefulness waned as reporting requirements failed to adequately track the growth of subprime lending, particularly high-cost lending done by consumer lending organizations, and other non-depository lenders. The failure of Congress and the federal regulators to adapt HMDA collection activities to reflect market trends, not only limited the capacity of CBOs to accurately track lending patterns in their

[56] For further discussion see Apgar and Duda, 2003.

neighborhoods, it also hindered their ability to evaluate the competitive threat that subprime lending presented to their own direct lending initiatives.

To better understand the implications of the rapid expansion of mortgage product offerings, particularly as related to lower-income households and communities, the Federal Reserve Board issued a rule in January of 2002 to expand the number of non-depository institutions subject to HMDA reporting to disclose pricing data on higher cost loans, and to specifically identify loans on manufactured housing.[57] Though the new regulations were modest in scope, and the implementation of the rule governing the reporting of the APR on "high-cost" loans was delayed until January 2004, for the first time, CBOs will be able to identify the presence of particular subprime lenders operating in their communities and assess if and how these lenders work to undermine the effectiveness of their direct lending programs. Unfortunately, regulators have been reluctant to require lenders to include data on credit scores or other factors required to assess whether the rate is appropriate given the creditworthiness of the borrower, data that are generally accessible to large financial services companies operating in the marketplace, but difficult, if not impossible for CBOs to attain.

Growth of Mortgage Giants Blunts CBO Advocacy

The changing structure of the mortgage industry also challenges the ability of CBOs to ensure that the residents they serve are treated fairly in the mortgage market. Due to the rapid growth of mortgage lending to lower-income and minority borrowers and neighborhoods, advocates today must focus less on whether any lending takes place, and more on whether the lending that does take place is done at the best rates and terms for which borrowers would qualify. Unfortunately, HMDA data do not provide detail on the characteristics of new mortgage products and CBOs are increasingly challenged to hold large financial services giants accountable for their actions.

[57] In particular, the new rule extended HMDA coverage to non-depository institutions making more than $25 million mortgage loans, and to report whether a loan is "high cost" as defined by the Home Ownership Protection Act as well as to report the spread between the annual percentage rate (APR) and the yield on the comparable Treasury security when the spread exceeds 3 percent for first-lien loans and exceeds 5 percentage points for subordinate-lien loans.

1. Changing Industry Structure Impacts CBO Negotiating Leverage

Changes in the regulatory and market environment have noticeably impacted the ability of CBOs to enlist lenders to support their mission. One manifestation of this phenomenon is the decline of locally-specific lending agreements negotiated between banking institutions and CBOs. Once the "bread and butter" of community organizing efforts, these "bilateral agreements" are increasingly being replaced by highly visible unilateral commitments made by larger regional and national scale lenders. Several bankers conceded that as they have grown in scale and their lending operations have become more sophisticated, the need to work with community groups has lessened. And as institutions become regional and national in scope, they not surprisingly feel less accountable to particular local markets.

In the past, CBOs helped banks identify 'good borrowers' with limited or no credit history living in distressed neighborhoods. Now, advocates and lenders alike acknowledge that due to automated systems, banks now possess so much data about potential borrowers that their need for assistance in marketing and outreach has eroded, allowing banks and community-based organizations an opportunity to partner in new ways.

For many community leaders, the growing number of unilateral commitments represents what they fear is a shift in the balance of power toward large lending institutions. This is not to say that banks ignore CBOs or that CBOs no longer advocate for expanded lending. However, Chicago area advocates asserted that even banks with a long history of partnering with local community groups are pulling back. "Chicago is a special case, and banks have more reason to deal with us, given the high visibility role that Chicago area advocates play in the national arena. But even the same banks that are renewing CRA commitments here in Chicago are refusing to sign comparable agreements in other cities."

The decline of "bilateral agreements" also has implications for the ability of community groups to secure funding and technical assistance from this new breed of larger, more sophisticated mortgage banking organizations. Historically, locally-based institutions were a major source of both funding and guidance for CBOs, which is why they lament their decline. The executive director of a Baltimore CBO watched financial support for his organization dwindle when their

local bank was acquired by a national mortgage banking operation. For the twenty years prior to this acquisition, the local bank was not only a major financial supporter of the CBO, but also "walked the neighborhood with us and helped us craft some innovative programs."

While funding, albeit at reduced levels, from the new national mortgage bank continued, this executive director felt that his organization lost the close personal relationships and the various forms of technical assistance, support and guidance that had been shared between the local bank and the CBO. However, many lenders maintain that they are willing to fund programs so long as they have some assurance that they are of a high standard and are meeting the stated goals.

Many CBOs continue to work with the locally-based, CRA-regulated entities that remain in their cities and demonstrate surprisingly little knowledge about the new participants in the mortgage market. CBOs are not alone in this respect as many public officials, researchers and foundation officers demonstrate a similar lack of knowledge about the new players in the mortgage market. This is, in part, due to the invisibility of mortgage brokers and other lenders who may not have a physical presence in a city, yet do a substantial business. CBOs and their supporters need to better understand the new players and begin to forge new relationships. Clearly, the lack of a physical branch makes this task more challenging than in the past, but to continue to succeed in their advocacy efforts, CBO leaders must continuously update their knowledge of the changing mortgage industry structure and the new generation of mortgage industry leaders.

2. Impact on Community Loan Programs

As discussed earlier, in an effort to expand access to capital, many CBOs developed what appeared to be highly successful programs to originate loans to underserved neighborhoods either directly or in partnership with a CRA-regulated lending institutions. For a time, limited competition from the private sector meant that even the smallest and most inefficiently operated program could succeed simply by being 'the only game in town.' However, many communities that once lacked mortgage lenders are now awash in capital.

Data in Exhibit 17 depict the number of loans, and the number of lenders, as well as the number and share of the largest national lending organizations (top 25 lenders) operating in census tracts

of varying income and racial characteristics. These data confirm that transformation in the number of lenders and loans made in communities across the country. For example, in 1993, in predominantly minority, lower-income census tracts, there were 15.7 home purchase loans made on average. These loans were made by an average number of 8.4 lenders, including an average of 2.4 of the nation's top 25 lenders. By 2001 these figures had jumped to 30.3 loans, made by an average of 15.1 lenders, including 5.9 of the nation's top 25 lenders.

Exhibit 17: Mortgage Lending Expands in Neighborhoods of Varying Income and Racial Composition

	Number of Home Purchase Loans		Number of Lenders		Number Top 25 Lenders		Share of Loans by Top 25 Lenders (Percent)	
Income < 80% AMI	**1993**	**2001**	**1993**	**2001**	**1993**	**2001**	**1993**	**2001**
Predominantly White	32.6	52.2	11.9	19.7	2.9	7.4	25.4	46.8
Predominantly Minority	15.7	30.3	8.4	15.1	2.4	5.9	32.3	49.7
Income 80-120% AMI								
Predominantly White	60.9	90.1	19.4	28.5	4.9	10.4	26.2	47.8
Predominantly Minority	42	72.5	17.9	26.2	5	9.8	33.3	51.7
Income >120% AMI								
Predominantly White	90.8	117.3	26	32.2	7	12.1	30	51.3
Predominantly Minority	64.9	106.5	21.8	28.5	5.6	10.3	32.8	54.9

Note: Predominantly white neighborhoods have less than 10% minority population, while predominantly minority neighborhoods have more than 50% minority population.

Source: Joint Center for Housing Studies enhanced HMDA database.

While there remains a clear tendency for more lenders (including top 25 lenders) to seek out customers in higher-income and largely white areas, the growth in the number of lenders serving lower-income areas is nevertheless impressive. From 1993 to 2001, the number of loans made to predominantly minority, lower-income census tracts almost doubled, as did the number of total lenders and top 25 lenders active in these areas. Moreover, by 2001, top 25 lenders accounted for close to half of all loans made in predominantly minority, lower-income areas – a figure that reflects the growing share of activity of these mortgage giants in neighborhoods across the country.

Entry of large scale lending organizations into low-income markets has fundamentally altered neighborhood scale lending activities. Faced with competition by highly efficient top 25 lenders, smaller regional and local banks that were once active partners in locally crafted lending initiatives have either abandoned their mortgage lending operations entirely, or now serve as loan correspondents to larger national lenders. Even banks with a strong commitment to CRA activities confirmed that increasing competition among banks for CRA-eligible loans has made it difficult to deal with 'special cases.' One banker said, "We continue to work with local groups to identify potential borrowers and work on individual case files, but we lose money on this part of our business. Today, you have to be an automated, high-volume lender to make money in the residential mortgage business."

While automated systems make it easy to process applications for prospective buyers with credit characteristics that fall within the norms of standard programs, the entry of large, well-capitalized players into the lower-income market segment, does not mean that the new mortgage delivery system necessarily provides "competitive pricing" to all market participants. Even as automation has lowered the cost of reaching borrowers with well established credit, it remains a more complicated – and more expensive – proposition to identify programs that fit the needs of families with little or no credit history. As the head of one major banking organization observed, "my retail guys don't have the patience to serve those borrowers who don't conform to standard underwriting guidelines, and we are hard pressed to pay them enough to have the incentive to do so." As a result, an increasingly large segment of the subprime market is now left to smaller scale brokers and others who develop the local knowledge and contacts to engage in the "high touch" lending needed to reach out to the traditionally underserved. Once again, the broker dominated mortgage system has done a good job at expanding access to credit, but in doing so has exposed some of the nation's most vulnerable citizens to mispricing and abusive lending practices.

3. Impact on CBO Homebuyer Education and Counseling

The growing complexity of mortgage products, combined with the rise of broker originated loans and well capitalized and aggressive push marketing campaigns present new challenges to home buyer education programs. The national focus on home buyer education builds on the

fundamental proposition that consumer education enhances the fairness and effectiveness of the mortgage market. A recent study on home buyer counseling determined that its impact depends, as might be expected, on the type of counseling offered (Hirad and Zorn 2002). The study found that less expensive forms of counseling – including telephone and shorter one-day group counseling sessions -- had little to no impact, at least when compared with more extensive (and expensive) one-on-one counseling efforts.

This finding raises serious questions about the effectiveness of current counseling operations. While greater product selection is generally good for consumers, the myriad of mortgage options present in today's market can easily overwhelm even the most sophisticated borrowers. CBOs interviewed for this report described how all too often borrowers who had completed home buyer education programs were won over by the marketing pitches of subprime lenders. The head of a Boston based counseling group noted that in the past, most of their counseled borrowers were able to obtain "good loans" through one of the area's community loan programs, but today that was often not the case. "It breaks our heart," he observed, "that people graduate from our program, only to end up in a high cost mortgage that could bankrupt them."

This then is the challenge that an expanded array of mortgage products produces. In the past, limited choices often meant that there were only a few choices – most typically a CRA-induced bank loan program. As the market expands, communicating the advantages and disadvantages of the various available mortgage products becomes even more important. Lower-income borrowers must have access to the type of loan specific and trusted advice currently available to higher-income borrowers; information to evaluate any current loan offer against the best terms available in the market. While in principal, the 'let the buyer beware' approach could limit abusive pricing in the market, the complexity of current mortgage products suggests that consumer education alone will not address the problem. Today, counseling programs must not only arm potential borrowers with basic information about mortgage loans, but also provide them with the capacity to select the best loan available from a bewildering array of products marketed by brokers with strong incentives to place the borrower in the most expensive mortgage possible.

Conclusion

After decades of success in expanding access to capital to historically underserved communities, CBOs and their funding partners face new challenges. Traditional approaches to direct lending are less effective in today's environment. Moreover, CBOs must recognize that the leverage they once held over CRA-regulated local banks is slipping away. Over the last decade, larger banking organizations have learned much about how to expand lending operations into previously underserved market areas. Moreover, they are now better equipped to fulfill – if not totally embrace – their CRA obligations. To continue to work effectively today, CBOs must not only retool their mortgage lending operations, but also strengthen their capacity to assist borrowers to protect themselves from abusive lending, to mitigate the serious consequences of the rise in foreclosures that threatens to undo decades of community revitalization efforts.

SECTION 5: CBOS MUST WORK TO IMPROVE THEIR COMMUNITY LOAN PROGRAMS

Filling a void left by the redlining of low-income and minority neighborhoods, for over thirty years, CBOs across the country initiated new programs to "restore the market" for home mortgage lending. With the advent on the 1990s of new and highly automated mortgage delivery systems, and benefiting from the knowledge gained from previous CBO loan programs, subprime lending grew rapidly into previously underserved communities. Despite having access to subsidized money and better pricing, many CBOs found it difficult to compete with the extensive marketing campaigns and fast turn around times of these more sophisticated and technologically proficient subprime lenders. This is unfortunate. Even though many subprime lenders seek to extend mortgage credit to higher risk, low-income, low-wealth and/or minority borrowers at fair prices and favorable terms, all too frequently subprime lending saddles borrowers with excessively high costs, fees, and abusive practices that can turn the American dream of homeownership into a nightmare of mortgage delinquency and default.

Even though CBO direct lending activity each year numbers in the tens of thousands of loans in a mortgage industry where activity is measured in the millions of loans, CBOs have the potential to regain their historical role as mortgage market innovator and advocate for enhanced access to credit in historically underserved communities. To do so, however, will require CBOs to fundamentally rethink and in many instances to dramatically restructure their direct lending operation. This section examines the potential for CBOs and national non-profit financial intermediaries – supported by their private, public, and philanthropic partners – to make better use of emerging technologies to enhance their lending operations. It begins with a discussion of how one of nation's most prominent CBOs, Neighborhood Housing Services of Chicago (NHSC), built a successful community loan program only to later witness their success undermined by the advent of subprime lending. Following a brief review of how NHSC is now responding to this challenge, the section then turns to a more general discussion of innovative ways CBOs can expand the reach of their mortgage banking operations. Finally, this section discusses how CBOs are supplementing their income by expanding into the real estate and

mortgage brokerage business, as well as selling mortgage servicing services to local government and other small loan programs.

NHSC Adapts to a Changing Market Environment

A recent case study of the Neighborhood Housing Services of Chicago (NHSC), documented the forces that prompted the early growth and more recent restructuring of one of the nation's leading community based loan program (Husock 2002). Like other Neighborhood Housing Services organizations, in the early 1980s, NHSC introduced a revolving loan fund to make small home improvement loans to borrowers unable to secure a bank loan. The effort was initially supported by foundation grants and funds from the Illinois Housing and Development Agency, and later by federal Community Development Block Grant funds. In 1995, a pledge of $41 million in below market rate loan capital from Continental Bank (later part of Bank of America) shifted the program into high gear, and enabled NHSC to expand its loan operations to include home purchase loans, as well as second mortgages to help meet closing costs and downpayment requirements, or to fund needed home rehabilitation.

Yet by the end of the 1990s, NHSC's highly successful loan program was in trouble. Despite lower interest rates – as much as 900 basis points lower than prominent subprime lenders such as Household Finance Corporation – NHSC had lost business to aggressive subprime lenders and their network of highly motivated brokers. In part, NHSC's inability to compete reflected their commitment to quality lending. NHSC's lending program requires that borrowers complete rigorous, and often time consuming, home buyer education. In contrast, most subprime lenders have no such requirement, and instead offer fast decisions and turnaround times that appeal to families anxious to purchase a home of their own.

Subprime lenders, and their network of brokers and correspondents, also used their marketing savvy and state of the art origination technology to reach a broad segment of NHSC's target market in a cost effective manner. Although well known in Chicago, NHSC could not compete with the dollars spent by the subprime lenders on direct mail, billboard, radio and television advertising. Nor could they match the speed (and low cost) at which these well capitalized lenders originated loans. As a result, many potential home buyers in Chicago neighborhoods

who might have qualified for a less expensive NHSC loan, obtained more costly subprime loans. Worse still, NHSC found that, in some cases, its counselors had spent weeks advising families on the intricacies of home mortgage finance, only to lose these potential customers and the associated fee income to a subprime lender.

Unfortunately, the Chicago situation is common suggesting the need for new approaches. ACORN reported that many members of its national lending network find it difficult to place their loans in the highly competitive market place as did participants in a roundtable discussion held by Neighborhood Reinvestment's Campaign for Homeownership. Indeed in establishing their goals for 2003 to 2007, the Campaign stated that today, "almost anyone can get a mortgage," but often at "higher rates and more restrictive terms." As a result, the Campaign's new strategy has a renewed focus on "credit pricing" and more extensive monitoring of the "rates special populations actually receive" to better address the new competition in the market.[58]

Aided by a planning grant from the MacArthur Foundation, NHSC retooled its mortgage lending operations – from front to back. It cut costs and reduced the time needed to originate a loan by consolidating mortgage underwriting and loan origination operations in a central location. It freed up additional resources by contracting with a major Chicago based bank to service its loans. Similarly, working in partnership with Chicago area banks, NHSC created a $100 million loan facility enabling them to sell loan pools to Chicago area banks. This arrangement not only allows NHSC to replenish funds available to make new loans, it dramatically reduces the interest rate, credit and collateral risk associated with originating and holding loans in portfolio. And finally, it has recently partnered with a city and subprime industry representatives to develop a comprehensive foreclosure avoidance program designed to both clean up the mess left by abusive subprime lenders, as well as insure that future lending in their targets area adheres to the highest industry standards.

[58] For further description of the effort see the Neighborhood Reinvestment web site at www.nw.org

Retooling Community Loan Programs

In addition to the newly revamped NHSC operations, there are a number of other remarkably successful lending initiatives that employ state of the art program design and procedures to reach credit-impaired, low wealth and low-income borrowers.

1. Using Technology to Improve Program Operations

Recognizing the need for cost effective and timely mortgage delivery systems, CBOs and other non-profit organizations are using the latest technology to support innovative lending to historically difficult to serve borrowers. Chattanooga Neighborhood Enterprises (CNE) first deployed automated underwriting technology nearly a decade ago. The efficiency gains of this new technology not only enhanced the quality and speed of their underwriting decisions, it also lowered the cost of loan origination, making loans a stable revenue source for the organization. To date, CNE has extended below market rate mortgages to nearly 6,000 borrowers, and is able to earn a small “profit” to help underwrite the cost of other programmatic operations.

Self-Help Credit Union’s Community Advantage Program (CAP) is another leading example that uses state of the art technology to support an affordable lending initiative. Under the program, banks around the country deploy best available technology to originate loans to “high risk” borrowers according to flexible lending guidelines developed in partnership with Self-Help. Banks in turn sell these loans to Self-Help and Self-Help assumes the default risk. Using funds provided by the Ford Foundation, Self-Help retains a portion of the default risk that is sufficient to enable them to sell the loans into the secondary market through Fannie Mae. In turn, the participating banks are required to use the proceeds of these loan sales to fund new loans to low wealth families, and the process starts all over again.

The results of the CAP are impressive indeed. As of 2002, Self-Help has provided $1.5 billion in financing to 22,000 low- and moderate-income buyers in 46 states and the District of Columbia. In exchange for helping participating banks get credit toward their CRA obligations and Fannie Mae to its federally mandated affordable lending goals. Self-Help assists thousands of families and accesses an effective mortgage delivery system with nationwide reach.

Despite the success of these and other programs, many CBOs resist the use of automated underwriting and other technologically advanced systems. One common explanation offered by CBO leaders interviewed for this report was that automated underwriting systems would limit their ability to tailor loan products to meet the specific needs of their customers. Fearing that these systems place undue weight on inaccurate or incomplete credit scores, one respondent described automated systems as “technological redlining.”

These concerns have some merit. First and foremost automated underwriting systems utilize what many perceive to be flawed credit reporting data. Noting the significant discrepancy in credit scores as reported by the three major credit repositories – Equifax, Experian, and Trans Union – a recent study conducted by the Consumer Federation of America and the National Credit Reporting Association (2002) concluded that one in five consumers is at risk of being misclassified into the subprime market due to inaccurate information in credit reports. Common reporting errors included the failure to report a revolving charge account that was in good standing or a mortgage account that had never experienced a late payment.

While they acknowledge the limitations of the underlying credit reporting data, proponents of automated underwriting systems argue that well designed systems have not only improved the ability to correctly evaluate and price mortgage risk, they have also enabled many lenders to reach out and extend credit to borrowers with less than perfect credit records, limited capacity to make a down payment, or other characteristics that previously would have limited their access to credit. Moreover, the best automated underwriting systems seek to offset the limitations of credit reporting by combining data from all three of the major credit repositories, including aggregate credit scores and other specific measures of consumer behavior (such as a recent bankruptcy) likely to be more accurately estimated in their evaluations, and placing less weight on what they know to be usually unreliable data. Even so, with the exception of the yet to be released fair lending review of the automated underwriting systems of Fannie Mae and Freddie Mac conducted recently by HUD, there has been only limited independent review of these systems. Absent detailed and objective evidence to the contrary, many advocates continue to harbor suspicions related to the fairness of these systems.

Opinions are split between those that argue that some lenders use automated underwriting systems as an excuse to deny loans to credit worthy borrowers, and those that contend that this need not be the case. One CNE official observed that automated underwriting enables CNE to quickly fund the "easy cases," allowing them to devote additional staff time and effort to serve borrowers with more substantial credit blemishes, or those with "thin or inaccurately reported credit histories." In short, for CBOs with the capacity to monitor their use, automated underwriting systems can be designed to reflect the underwriting criteria, and the values and norms of the CBO, while at the same time substantially improving operational efficiency.

Undoubtedly, more could be done to properly evaluate the credit quality of low-income people living in low-income communities. For example, Pay Rent, Build Credit, Inc. is a new consumer-directed credit bureau that enables renters to demonstrate timely payments of rent and other recurring bill payments to build a credit history.[59] There will be further improvement in the ability of lenders and others to report and credit bureaus to gather needed data and to translate this data into meaningful mortgage evaluation tools. This will better equip lenders to tailor automated underwriting systems to serve the needs of "so-called" nontraditional borrowers. Indeed, many individuals interviewed for this study noted that there was already a "bewildering array" of mortgage products available. In short, crafting mortgage programs to meet local needs remains a challenge. Yet there is ample opportunity to fashion a diverse set of loan products that meet community needs that tap into the efficiencies offered by automated underwriting, risk-based pricing, and state of the art mortgage servicing.

2. Contracting Out: The Make or Buy Decision

With the Community Advantage Program, Self-Help combined market rate capital with socially motivated funds to expand access to capital. Chattanooga Neighborhood Enterprise was also able to lend "blended capital" with favorable rates and terms. Many community loan funds have also amassed sizable pools of "socially motivated money" tapping Community Development Block Grant and other government funds, as well as securing below market rate funds from foundations and charitable organizations. Yet as noted in the Chicago NHSC example, many CBOs continue use manual underwriting and other antiquated systems. Even those that have

[59] For more information see the Pay Rent, Build Credit, Inc. website at www.payrentbuildcredit.com

attempted to automate lack the scale of operations to realize the full benefits of what often can prove to be costly technology. Either way, inefficiently run programs risk losing business to private sector competitors. And more troubling, every subsidy dollar that is wasted on inefficient operations is one less subsidy dollar available to benefit low-income and low wealth borrowers.

In deciding how best to structure their operations, CBOs face what public finance experts term a 'make or buy' decision. Neighborhood Housing Services of Chicago (NHSC) once again provides a valuable example of the issues surrounding this decision. Despite being one of the nation's largest community-based loan programs, NHSC lacked the internal organizational capacity to fully benefit from the latest loan origination and servicing technology, and was consequently unable to sell loans into the secondary market in a cost effective manner. As result, some share of the subsidy present in its below market capital pools was increasingly diverted to cover the costs of program operations.

To help address these issues, NHSC outsourced their loan servicing operations to MB Bank, which has improved the quality and lowered the costs. While NHSC opted to "buy" access to technology through its partnership with MB Bank, other groups choose to "make" or create their own mortgage lending and servicing capacity in-house. This tendency to keep functions in-house reflects, in many ways, a legacy of conditions that prevailed when these programs first appeared on the scene. Until recently, many CBOs were the only entities willing to lend in distressed inner city communities. Absent the availability of potential partners with knowledge of lending in their target area, they had little choice but to "go it alone," and that impulse remains today.

Yet, today CBOs have a richer set of options. As noted earlier, there has been dramatic increase in private sector lending in most low-income and minority areas, and equally substantial growth in the number of organizations – especially well capitalized, large financial services organizations – making loans in these areas. The "buy approach" acknowledges the expanded array of potential partners and enables smaller community groups to tap into state of the art loan origination, servicing and packaging, by outsourcing these functions to an existing mortgage lender. The advantage of outsourcing is that the larger players in the mortgage industry have up

to date technology and considerable economies to scale. For example, their counselors may handle high volumes of loans and gain the valuable experience necessary to help with loan loss mitigation. In addition, by outsourcing some or all aspects of mortgage lending, a CBO can focus its attention on activities that take advantage of its presence in the neighborhood, such as pre- and post purchase counseling, neighborhood outreach, advocacy and foreclosure avoidance.

Some CBOs interviewed for this project were apprehensive that the "buy approach" would not be cost effective and/or would leave them with little or no control over their mortgage lending operations. This need not be the case. One CBO in Boston is contemplating partnering with a large mortgage lender to originate and service a loan product that the CBO would design and fund with low-cost money obtained from foundation grants. The CBO would continue to provide home counseling and engage, when needed, in foreclosure avoidance efforts, two areas where they perceive their presence in the community adds value. At the same time, they recognize that by outsourcing some mortgage origination and servicing functions to a private sector partner, they may achieve greater efficiency in their overall lending operations.

The "buy approach" requires identification of a willing and able partner, which is not always easy. For example, one small Midwest CBO contracted with a local bank to service their loan portfolio only to later have to terminate the contract and return to servicing "in house." Yet it is important to observe that the local bank agreed to take on the servicing task as a "favor" to the CBO. They quickly discovered, however, that the job of servicing a portfolio of community loans was more difficult than first imagined.

Yet despite the negative experience noted above, contracting out to a capable partner should both lower costs and improve the overall quality of the community loan programs. Certainly, many capable potential partners exist. For example, as a result of its partnership with NHSC, MB Bank is exploring the possibility of providing similar services to other CBOs. The Boston area CBO discussed earlier solicited the advice of a leading financial services expert to identify a list of qualified potential partners. Intervention by a national network of community loan programs or a national foundation could accelerate the move to outsourcing key elements of community loan programs through the development of a pre-screened list of qualified partners, and/or by

assisting local CBOs with the often difficult task of conducting the due diligence required to select a suitable partner.

Creating New Sources of Fee Income

As CBOs have lost the support from many now defunct former banking partners, they have been forced to rely more heavily on their direct lending efforts as a source of fee income. Yet without the scale economies of the large private market players, this is a difficult business proposition. Even so, many small CBOs continue to originate and service a handful of mortgages. Some claim to actually make money, but frequently these statements reflect a failure to accurately count the costs of operations, rather than a carefully honed estimate. And in too many instances, this situation diverts subsidy dollars to compensate for inefficient operations that should go to reduced mortgage rates.

One way to address problems associated with small scale lending programs is to expand the scale of operations by selling excess capacity to others. For example, the Neighborhood Housing Services of Phoenix (NHS Phoenix) is looking to translate its success at servicing its own loan portfolio into a new business opportunity. Having mastered the intricacies of adapting an off the shelf loan servicing software package to meet its own mortgage servicing needs, NHS Phoenix can service additional loans at a relatively low marginal cost, and earn a small profit in doing so. NHS Phoenix already has contracts in place to service loans for several local government-funded revolving loan funds, as well as the loan portfolio of a local Habitat for Humanity group.

Similarly, CNE is considering offering their services to other CBOs in the region, groups that would benefit from contracting out for more cost effective loan origination or loan servicing services, but may be reluctant to secure these services in the open marketplace. Many smaller CBOs currently lack the scale and capacity to take advantage of technologically driven business opportunities. For these organizations, it will be especially important to identify the aspects of the community revitalization process where they do have a strong competitive advantage.

In addition to loan servicing, several CBOs identified real estate and mortgage brokerage as a potential source of revenue. The NHS of the Inland Empire now has several real estate brokers

on staff to handle the marketing and sales of homes that it builds and rehabilitates. The NHS of Santa Fe is planning a full service company that will provide real estate and mortgage brokerage, as well as mortgage origination and servicing. In this way, it hopes to capture some fee income from graduates of its home buyer counseling programs, as well as earn additional fees from the sale and financing of homes in its single-family construction programs.

These business ventures are not for everyone, however. Recognizing the difficulty of building a business of sufficient quality and scale to be profitable, one CBO in California decided not to sell its services to others. Since they already had mortgage brokerage capacity, this CBO felt it could easily ramp up to sell these services to others. Nevertheless, they worried that operating a mortgage brokerage business would detract their attention away from working on other important revitalization initiatives. They were also reluctant to invest the time and energy to develop what they perceived to be a potentially cyclical activity. In particular, they were concerned that given cyclical nature of the business, funders might see any downturn in business as a failure.

Despite the difficulty of operating a small scale, and potentially cyclical business venture, other CBOs interviewed for this report were nevertheless considering entering the mortgage brokerage business. A recent survey reported that some 34 CBOs now broker just over 5,000 loans totaling $210 million (Hornburg 2003). Though the motivations for entering the non-profit brokerage business varied, CBOs surveyed cited providing their clients with better-priced mortgages and expanding upon existing relationships with mortgage industry partners. The challenge, of course, is to establish an operation of sufficient scale. Indeed, non-profits broker average just over 150 loans each.

Clearly further expansion of these efforts will be needed to realize their full potential. Yet the CNE and NHS Phoenix examples illustrate that by aggregating the volume from a number of smaller community loan programs, there is potential for a non-profit entity, or a community minded for-profit player, to create a profitable business outsourcing mortgage banking and mortgage services to a wider market. What is needed is for a national organization – such as

Neighborhood Reinvestment Corporation – to step forward and support the growth of a limited number of entities that specialize in selling services to small scale CBO loan programs.

Conclusion

Though the details of these programs differ, they share a common goal of supplementing overall CBO program operations with fee income. While this can be a worthy goal, care must be exercised to select business ventures suitable for small scale operations that take advantage of CBOs' visible and trusted presence in their community. To the extent that this is the case, even relatively small scale CBOs may be able to develop a profitable real estate brokerage business. At the same time, name recognition and community savvy is no guarantee that a small scale organization will ever be able to efficiently service a small loan portfolio, or package and sell loans into the secondary market – two tasks that exhibit substantial scale economies often lacking in all but the largest of CBO programs.

The ability of smaller CBOs to respond to the changing lending environment has important implications not only for individual CBOs, but also the future of the organizational structure of the non-profit housing industry. If, as seems likely, a few non-profit organizations are able expand the size and scope of their loan origination and servicing operations, the non-profit housing industry will face the challenge of maintaining the strong "community" ties that are a critical element of their ability to serve diverse neighborhoods.

Finally, national organizations will need to step-up their capacity to train and provide technical assistance to CBOs seeking to exploit these niche opportunities. Absent this assistance, many CBOs – along with the special knowledge of neighborhood conditions – may be either rendered ineffective, or disappear altogether from the scene. Fortunately, as will be described in the next sections, there are other important roles that smaller CBOs can play – including providing homebuyer education and counseling and participating in foreclosure avoidance efforts – that benefit from their extensive knowledge of local market conditions and the trust they have engendered after years of neighborhood service.

SECTION 6: NEW ROLES PRESENT CBOS WITH NEW OPPORTUNITIES

The growth of mortgage lending to low-income and low wealth individuals has expanded access to homeownership for millions, yet the new mortgage delivery system has left in its wake continuing problems associated with the mispricing of mortgage credit, not to mention the abusive practices encountered by some borrowers in the subprime market. While historically CBOs mounted efforts to confront these abuses, to be effective in today's rapidly changing world, CBOs and their allies must develop new programs and new strategies.

This section identifies roles that CBOs can play to expand access to capital in a manner that promotes affordable and stable long-term homeownership opportunities, while at the same time providing assistance to existing homeowners struggling to cope with high debt burden and at risk of losing their home through foreclosure. Finally, this section discusses recent effective advocacy campaigns to promote needed regulatory reform and to pressure current market participants to pursue best practices in mortgage origination, servicing and foreclosure avoidance.

Helping Homebuyers Get the Best Mortgage Available

The complex array of available array of mortgage products can overwhelm even the most knowledgeable borrower. Yet the consequences of this knowledge gap vary across borrowers. For example, many higher-income borrowers have access to financial or legal advisors to guide them through the intricacies of the borrowing process. In communities where homeownership is prevalent, borrowers can also obtain useful advice from family and friends. Even in situations where such advice is not forthcoming, borrowers with more extensive financial resources have a greater capacity to make their monthly payments, even if they overpay for their mortgage credit. In contrast, borrowers with fewer financial resources are more likely to suffer adverse consequences due to over priced mortgages.

In an effort to protect more vulnerable borrowers, CBOs have engaged in a wide ranging set of homebuyer outreach, education and counseling efforts. Yet in the face of aggressive "push marketing" by many subprime lenders, CBO efforts must be revised to ensure that low-income consumers obtain the best mortgage credit available in the market.

1. Enhancing Home Buyer Education and Outreach

To be successful, any homebuyer education program must be visible to the intended beneficiaries. Historically real estate brokers referred credit-impaired customers to CBOs for counseling and to help them identify an appropriate loan product. While many real estate brokers continue to make these referrals, as a result of increased competition, mortgage real estate brokers can now refer clients to any one of a number or mortgage brokers operating in their area. Indeed, several respondents noted that referrals by real estate brokers had "dried up." The intense competition in the marketplace makes it harder for CBOs to maintain their visibility.

Not only do shifting patterns of referrals limit the capacity for CBOs to identify potential customers, they also pose other policy challenges. Turner (1993) suggested that referrals made by real estate brokers may not always be in the best interest of the borrower. In the most benign cases, these referrals may simply reflect the desire of the real estate broker to sell the property as quickly as possible. In the more pernicious cases, a referral may reflect illegal collusion or racially discriminatory practices on the part of real estate and mortgage brokers. Regulations in this area do require that real estate brokers fully disclose their relationship (if any) with the mortgage broker and behave in a non-discriminatory manner with respect to racial minorities. Yet applicable regulations also recognize that real estate agents represent the seller of a home, and consequently real estate agents have no particular obligation to help the borrower secure "the best available mortgage."

Acknowledging the need to guide borrowers through the mortgage application process, many local CBOs are ramping up their efforts to reach out to prospective buyers. One common approach is to host a homebuyer fair and invite a prescreened group of mortgage brokers and lenders to participate. These homebuyer fairs seek to educate prospective buyers and help them identify specific mortgage products and providers that are best suited to meet their needs. In addition, they help increase the visibility of the CBO in the community and increase the likelihood that potential homebuyers will take advantage of the more extensive homebuyer education and counseling programs available.

To publicize their programs, some CBOs have placed ads in newspapers and distributed informational brochures at local supermarkets. Others have launched more extensive media campaigns. For example, one New York City CBO ran a series of commercials on a local Chinese language radio station, which expanded their ability to provide home buyer education and counseling services to the new immigrant population that was a growing presence in their target neighborhood.

Yet lacking the resources needed for sophisticated market research and the funding needed to mount a wide scale media campaign, CBO advertising often struggles to find a place in the more expensive radio and television markets. Moreover, even when they do take the airways, CBO ads often promote homebuyer education and counseling programs. This message may have limited appeal, at least when compared with a competitor's ad promising to approve a mortgage application in a matter of hours, if not minutes, even for borrowers with "bad credit."

Drawing attention to abusive brokers and lenders can be another way to warn potential borrowers of truly abusive lending practices. Working in cooperation with national campaigns such as Freddie Mac's 'Don't Borrow Trouble,' CBOs are redoubling their efforts to help low-income families avoid predatory lenders. In a closely related effort, the Fannie Mae Foundation has launched a series of ads to help potential borrowers better manage their credit. These ads feature a toll free telephone hotline that enables low-income and low wealth borrowers get in touch with experienced credit counseling agencies operating in their communities.

Even these well funded initiatives, however, must confront the fact that the airwaves and advertising media are now saturated with the outreach efforts of mortgage brokers and lenders targeting the low-income, low wealth market. While any advertisements are required by law to be factually correct, they are not required to offer information concerning better products available. As a result, many consumers are lured into taking out a loan, whether they can afford the payments or not, while offers by CBOs to provide homebuying education and counseling or otherwise assist them in identify the best mortgage available go unheeded.

2. Improving Access to Loan Specific Information

For most consumers, shopping for mortgage credit is a rare occurrence, and assembling the needed information to shop the market is difficult. This information mismatch can be a serious problem. In the language of economics, there exists an "asymmetry of information" between buyers and sellers, particularly with respect to the price of mortgage credit. Mortgage industry professionals participate in numerous transactions over the course of weeks and months and have ready access to information on the set of fees, rates, and terms that comprise the overall "pricing of mortgage credit" in the marketplace. In contrast, consumers begin shopping for a loan with limited prior experience and equally limited access to the information needed to make an informed choice.

To level correct this asymmetry, potential borrowers need detailed information that will enable them to search for the "best" available mortgage and to better understand the likely consequences of entering into any specific mortgage transaction. Here, CBOs can play an important role as a wholesale distributor of mortgage pricing information. Borrowing from the automobile "blue books" or consumer reports that have successfully guided those shopping for automobiles and other consumer durables, CBOs could develop a "home mortgage pricing guide" that includes available information on the best loan prices and terms available to a borrower of any given credit profile, income, and ability to make a downpayment. It is important not to underestimate the complexity of assembling such a "blue book." Mortgage companies readily advertise their low annual percentage rates, but full understanding of mortgage pricing requires information on the nature and extent of fees, prepayment penalties and other charges. For example, a lump some upfront fee may have limited impact on estimated APR when allocated over the 30 year life of a mortgage. But since few families will hold a mortgage for 30 years, such calculations are inherently misleading to less than knowledgeable consumers.

While daunting, the task of assembling a "home mortgage pricing guide" is not insurmountable. Such an effort could focus on rating a variety of generic alternative mortgages stripped of all their marketing "bells and whistles. To keep the magnitude of the task in perspective, it is important to remember that the detailed pricing information required to construct the guide is well known to mortgage brokers and other industry participants. For example, most major

lenders regularly post "rate sheets" that provide this information to their network of retail, broker, and correspondent lenders. Making the information contained in these rate sheets more readily available could help borrowers shop for the best product, determine when to refinance, and better evaluate unsolicited offers.

While individual CBOs, or national housing networks working with foundation support, could develop this "home mortgage pricing guide," there exists a strong public interest in funding this activity. This follows from the fact that mortgage pricing information is in effect a "public good," and there is a governmental role in providing the price information needed to support the efficient operation of the mortgage market. Federal regulators operating under applicable Fair Lending and Fair Trade authorities must expand their efforts to ensure that consumers obtain the pricing information needed to make informed choices. This could take the form of a national registry of best available mortgage products, or other efforts to assist local government and community based organizations help families to better understand the pricing of mortgage products as they relate to borrower income, credit score, and ability to meet downpayment and closing cost requirements

3. Providing Buyer's Brokers to Improve Mortgage Shopping

Some industry experts suggest that even increased price transparency may be insufficient to insure that individuals are effective shoppers, and call for efforts to expand the ability of low-income and low-wealth homebuyers to access much needed advice on particular mortgage products. A recent Fannie Mae survey emphasized the importance to borrowers of having access to a trusted advisor to help guide them through the mortgage process.[60] Unfortunately, many community groups interviewed for this study seem reluctant to fill that role, feeling that such assistance goes against the goal of empowering people to make their own decisions. Yet given the complexity of the available mortgage products, like consumers in general, low-income and low-wealth borrowers would benefit greatly from having assistance in assembling the information needed to make an informed choice. Also it is important to recognize that if CBOs hold back from assuming the role of trusted advisor, there are many less than trustworthy brokers unfortunately all to eager to step in and fill the information void.

[60] Fannie Mae, The National Housing Survey, 2001. Examining the Credit-Impaired Borrower.

One approach is to expand the capacity of CBOs to work with buyers individually to search for the best mortgages. Of course, for such a service to be helpful, CBOs must keep abreast of mortgage market trends for credit, and be recognized by potential borrowers as a trusted source of information. Indeed, some CBOs are already gearing up to develop a mortgage brokerage business with the explicit goal of using their good standing in the neighborhood to become a 'buyer's broker,' while at the same time earning a small fee for the service. Like the trusted advisors available to many higher-income borrowers, a buyer's broker would provide lower-income income and/or less knowledgeable borrowers access to information on available mortgage terms and pricing. Like mortgage brokers these buyer's brokers would help borrowers qualify for and procure a lone but unlike mortgage brokers, buyer's brokers would work on behalf of the borrower.

To do this efficiently, CBOs will need to acquire automated tools to evaluate the risk profile of individual borrowers, and develop the capacity to identify the best products available in the market. Again, this will be difficult, but not impossible. Today, mortgage pricing and terms are largely determined by credit history, income, and a limited number of other factors. Using software similar to that developed by large-scale mortgage originators or secondary market players, CBOs could help address the current complexity that now works to the detriment of many borrowers

CBOs, of course, would have to be mindful of the real or even perceived conflict of interests inherent in assuming the role of buyer's broker. For example, to the extent that a particular CBO receives funding from a particular lending institution, they may be pressured to recommend this institution's products even in situations where more advantageous products exist in the marketplace. Needless to say, a CBO's failure to provide proper safe guards to avoid either a real or perceived conflict of interest would quickly erode the trust that community residents have placed in their organization.

Guttentag (2001) proposed another version of a buyer's broker system in which for-profit mortgage brokers agree to a fixed, up front fee which would compensate them to use their expertise to shop on behalf of the borrower for the best mortgage. For a fee consumers could

secure the services of a market professional that would be contractually and legally accountable for finding them information about the best terms available in the marketplace. Moreover, these brokers would be contractually bound to work in the "best interests" of the borrower, and hence the borrower would have legal remedies should this broker fail to make a good faith effort to perform as expected.

New Focus on Foreclosure Avoidance

Clearly, the extension of loans to borrowers with limited capacity to repay has contributed to the rise in foreclosures. This imposes hardships on individual families and also threatens to limit home sales, dampen home price appreciation and destabilize communities. Rising foreclosures are also of concern to the mortgage banking industry, as foreclosure processes are slow and expensive, and in many instances, the best option for all parties concerned is to modify the terms of the loan in a manner that helps keep the borrower in the home.

Aware of the financial and reputation costs of foreclosures, many large lender/servicers are partnering with (or looking to partner with) CBOs to develop more effective foreclosure avoidance efforts. The recently announced Home Ownership Preservation Initiative (HOPI) is a good case in point. A partnership between the City of Chicago and the Neighborhood Housing Services of Chicago, HOPI is challenging large subprime mortgage lenders servicers to create new foreclosure avoidance tools. Concerned about their ability to conduct business in the city, as well as the reputational risk of being associated with Chicago's growing foreclosure problem, representatives of several large mortgage companies have joined HOPI to see if they can create mutually beneficial alternatives to current foreclosure practices.

As described below, CBOs that once focused on getting people into a home – through pre-purchase counseling and direct lending –are now pressuring lenders, particularly subprime lenders, to fund loan products and loan loss mitigation programs that help delinquent borrowers remain in their homes. As HOPI and other emerging CBO efforts illustrate, this requires renewed efforts to expand outreach to financially distressed borrowers, as well as enhance the effectiveness of credit counseling efforts and the use of existing foreclosure avoidance resources.

1. Expanding Outreach to Distressed Borrowers

Over the past five years, servicers have developed sophisticated triage models to identify which of their various intervention strategies will minimize loan losses to investors that arise from foreclosure related loss of mortgage principal payments. These strategies, collectively know as loan loss mitigation activities, include programs to restructure the mortgage debt in a manner that allows the borrower to continue to meet their monthly mortgage payments, as well as to help distressed borrowers quickly sell their homes and avoid foreclosure procedures that can be costly to all parties involved in the transaction.[61]

In many instances, these loan loss mitigation efforts could benefit both the lender/investor and the borrower, yet servicers report that they often have trouble reaching financially distressed borrowers. Indeed, mortgage industry experts and CBO officials repeatedly point out that many loans fail without contact ever being established with the borrower, or occurring after problems have become too severe to rectify. The pilot partnership between Homecomings Financial Network[62] and Neighborhood Housing Services of Chicago (NHSC) is a promising way to address this problem. Homecomings believes that some borrowers that are unwilling to talk to them directly will talk to NHSC instead. In another effort to limit losses by boosting contact rates, both Countrywide and Homecomings have partnered with NHSC to hold 'workout clinics' at the NHSC offices during which dozens of workouts were conducted over the course of a weekend.

Municipal resources can also be used to overcome information bottlenecks. Several cities, including Chicago, have begun providing foreclosure avoidance information through 311 systems. Chicago supports a variety of community-based to programs to help finance workouts for borrowers in the early stages of default. Through expansion of its public service advertising campaign, the City hopes to encourage borrowers to call the "311" number to obtain assistance in handling past due mortgage debt. This will include referring borrowers to a special "help desk" to connect borrowers to available foreclosure avoidance resources.

[61] For a discussion of new approaches to subprime servicing see Cutts, 2003.
[62] The servicing arm of GMAC-RFC.

2. Improving on Credit Counseling

Of course, expanded outreach is no better than the assistance borrowers receive when they accept the offer of help. For borrowers in trouble on their mortgage, credit counseling offers both promise and risks. When administered by skilled counselors with the borrower's interests in mind, counseling can help borrowers chart the best course to navigate their financial difficulties. Credit counseling can literally be the difference between saving and losing a home. When done poorly, however, counseling is a waste of time and money. When done unscrupulously, it simply makes a bad situation worse. As the industry becomes increasingly supportive of these efforts, the pressure for counseling to be done effectively should increase.[63]

HOPI contains many features that illustrate the productive role that CBOs can play in loan loss mitigation efforts. Upon contacting NHSC, under HOPI, borrowers are offered the option of independent credit counseling or speaking with a Homecomings representative based in the NHSC office. The partnership allows the organizations to work together to craft appropriate workouts and provides borrowers with a trusted advisor to guide them through what can be an intimidating process. Since Homecomings benefits directly from foreclosures that are averted, they have agreed to pay for the credit counseling if the borrower chooses to use it.

As CBOs move to form new partnerships with credit counseling agencies, they must first address several issues. First, a more effective method must be devised to separate legitimate and effective agencies from others. Many consumers currently rely on the IRS' 'non-profit' designation as evidence that the agency will act in their best interests, but this is by no means the case. Many entities currently involved in substantial telemarketing efforts to lure debt ridden borrowers into accepting there services are under investigation by State Attorneys General across the country.[64]

Next, even among those agencies that are not out to take advantage of borrowers through excessive fees and referrals for costly ancillary services, not all credit counseling agencies have

[63]Ameriquest's best practices, for example, include provisions for free credit counseling by a non-affiliated, non-profit third party. GMAC-RFC also pays for counseling and has formed an alliance with three credit counselors called the Credit Counseling Resource Center (CCRC) to "help individuals restore financial balance to their lives."

[64] See for example the discussion on abusive credit counseling offered in Mansfield, 2003.

the skills needed to counsel borrowers facing mortgage-related problems. Indeed, to date the effectiveness of various counseling methods has been subject to little empirical scrutiny. Different methods and programs must be evaluated and results disseminated so that the more effective approaches supplant the less effective methods. As a result, CBOs have an important role to play. As a trusted community advisor, CBOs can expand the ability and willingness of distressed borrowers to seek credit counseling assistance and direct borrowers to high quality programs with a demonstrated track record of actually helping financially distressed borrowers.

3. Effectively Targeting Subsidies for Foreclosure Avoidance.

While the magnitude of the costs is unknown, foreclosures, especially those in underserved areas, are widely thought to trigger enormous local, state, and federal government expenditures on activities such as crime prevention. Consequently, efforts to reduce the number of foreclosures or to limit the degree of financial distress suffered by the homeowner and deterioration of the property can save money that the government would have been forced to spend down the line. To the extent that neighboring home values and foreclosure probabilities are impacted by foreclosure events, municipalities may also have a responsibility to help protect neighboring owners from such ripple effects.

Identifying where and how best to introduce public funding into foreclosure avoidance efforts is no easy task. For example, national mortgage industry leaders, including Fannie Mae and Freddie Mac, have developed mortgage programs designed to refinance borrowers out of abusive "high cost" loans. Selected cities (Chicago and Boston) and states (Pennsylvania) provide public subsidies to help write down the costs of such refinance efforts. Unfortunately, these programs are not well known. For example, one distressed asset specialist estimated that in roughly one-third of foreclosures there is some public money available, but that it is rarely accessed because there is no systematic method of making borrowers or servicers aware of the programs available in their area.

Once again, there is a role for CBOs to ensure the effective utilization of available public resources. In addition, to helping distressed borrowers refinance, CBOs could be a conduit for funding a variety of loan loss mitigation options. As noted earlier, servicing firms have elaborate

human and software systems to manage the delinquency, default and foreclosure process. In many instances, these evaluation tools may suggest that foreclosure is the best option for the investor, even in situations where home retention options would become viable with the addition of a modest public subsidy. This would essentially extend the margin of borrowers that would be able to remain in their homes based on their financial ability and 'desire' alone.

Determining how government money could best be deployed is a challenge, however. One promising option is to make funds available to enhance loss mitigation and foreclosure avoidance efforts already employed by servicers. Since resources are likely to be limited, localities must create clear borrower and neighborhood eligibility standards to ensure that limited public funds target those most deserving of assistance and/or produce the greatest public benefit. Further, avoiding a situation where government money substitutes for funds, forbearance, and forgiveness that lenders would have offered on their own is problematic.

Some have suggested that these programs should be operated by CBOs, but it is not obvious that CBOs have the capacity to evaluate which borrowers are likely to succeed with the infusion of a few thousand dollars more into the loss mitigation process. Rather than directly administer the foreclosure avoidance funds, it might be better for CBOs to help establish and monitor the use of clear guidelines for the program. Private servicers, as part of their existing loan loss mitigation operations could then determine whether or not a borrower meets the criteria established for public assistance, and, if the borrower is eligible for assistance, complete the transaction.

New Approaches to CBO Advocacy

CBOs working in low- and moderate-income communities must now confront a series of complex considerations related to industry trends, the limitations of the existing regulatory framework and the marketplace, and the preferences and choices of individual consumers. While some organizations are expanding their efforts to assist borrowers, other organizations have mounted campaigns to challenge what they perceive to be abusive activities of lenders operating in their community. For example, Des Moines Citizens for Community Improvement reviewed court house records to identify households facing foreclosure. They then identified the lender that appeared to be responsible for making loans at inflated terms. Through skillful use of

the media they obtained restitution for the borrowers who apparently "paid too much" for their credit, and encouraged other borrowers to avoid this lender in the future. In addition, helped by the involvement of the Iowa Attorney General's office, they were able to extract a pledge from the lender to fund more appropriately priced loans in Iowa.

The Des Moines effort is one of a growing number that demonstrate how advocacy can adapt to changing market conditions. By identifying a set of problem loans, they focused attention on the increasingly important issue of foreclosures. Then, working in partnership with state officials, they were able to obtain a settlement that not only brought relief to victims of past abuse, but also expanded the ability of future borrowers to secure appropriately priced home loans in the future.

1. Developing New Data on Abusive Lending

The rapid rise of subprime lending and associated increase in foreclosures has caught many, from industry and policy analysts to government officials and community activists, off guard. This is largely due to the fact that there is little data available to government agencies charged with tracking the mortgage sector of the economy or to the general public. Although information on individual foreclosures is generally on file at court houses or land registry offices, there has been almost no effort to systematically harvest these records. Even where available, data from foreclosure documents often fail to identify key characteristics of the mortgage loan or the identity of the originator, funder, or servicer - information essential to illuminating the factors that precipitate foreclosures.

Enhanced foreclosure data would also help local officials to better meet the challenges of foreclosure earlier in the process. Availability of detailed data on foreclosure and loan performance at the local level could isolate emerging foreclosure 'hot spots.' CBOs could work with local officials to automate existing 'court house' data thereby making it more widely available. Having a database capable of identifying areas with elevated rates of foreclosure filings would enable local city officials – working in partnership with local community based organizations as well as interested mortgage servicers - to take appropriate action sooner.

Due to the complexity of the mortgage foreclosure process, it would also be useful for CBOs to work with local governments to create a 'foreclosure hot spot protocol,' or a plan formulated in advance of problem detection that describes specific actions designed to minimize the adverse consequences of pathological foreclosure levels. For example, municipal tax collection agencies could refrain from aggressively pursuing delinquency judgments against individual owner occupants residing in foreclosure hot spots. Such forbearance activities could help individual owners avoid foreclosure, and to the extent that they could help stabilize a local market, forbearance programs could actually increase the amount of taxes collected in the area over time.

2. Advocating For Improved Laws and Regulation

Another promising approach refocuses CBO advocacy on finding new ways to improve the regulatory framework for mortgage lending and providing underserved households with better access to basic banking services. Many CBOs have allied with consumer, civil rights, labor, and other interests to build broad based support for public policies and other efforts aimed at preventing predatory lenders and fringe bankers from exploiting low-income consumers.

For example, despite a less than supportive federal policy environment, CBOs continue their efforts to adapt or "modernize" CRA to cover a greater share of mortgage market and other lending activities. These advocates hope to convince banking regulators to update the present geographically-based assessment area definitions for CRA reviews so that examiners can take into account the growing share of bank lending that occurs outside of these areas. They are also looking for ways to apply CRA rules to subprime affiliates of banks to prevent these institutions from engaging in predatory and other exploitative lending practices.

In light of recent allegations that Fairbanks Capital Corporation engaged in abusive subprime mortgage servicing practices, advocates are encouraging federal regulators to take a hard look as this important segment of the mortgage banking industry. While awaiting the release of new Federal Trade Commission guidelines on what constitutes fair approaches to mortgage servicing, Ameriquest – one of the nation's largest subprime issuers and servicers – was the first to release a comprehensive set of "best practices" for subprime mortgage servicing. Under the leadership of the Mortgage Bankers Association of America, other subprime mortgage servicers are now

hard at work creating their own set of "best practices." To the extent that advocates can pressure both regulators and industry participants alike to weed out predatory practices in the subprime servicing arena, the results can only serve to enhance ongoing CBO efforts at foreclosure avoidance.

Advocates are also working on strategies to prompt regulatory changes at the state and local level. In Massachusetts, CBO advocates recently won passage of a 'CRA-like' regulation for mortgage companies and a community reinvestment requirement for insurance companies. CBOs and their allies have successfully endorsed the passage of tough new state anti-predatory lending standards in a number of states including Illinois, Georgia, North Carolina, New Jersey, New York, and New Mexico. The National Community Reinvestment Coalition is working to create and anti-predatory lending member network to challenge discriminatory practices and promote fair access to credit.

The experience of CBOs in negotiating CRA agreements has been adapted and successfully applied to efforts to change the business practices of non-CRA regulated financial institutions. For example, faced with inadequate consumer protection laws, CBOs and their national networks have persuaded individual subprime lenders to discontinue certain abusive mortgage practices, such as the sale of single-premium credit life insurance (SPCI). SPCI is a low-value product which adds an up-front payment to the loan amount. Since few borrowers benefit from this form or insurance, advocates designated the addition of SPCI as a particularly egregious example of predatory lending. Since, CRA did not apply to most of the lenders offering SPCI, CBO activism took other forms. Advocates convinced the two secondary market entities -- Fannie Mae and Freddie Mac -- not to purchase loans containing this product, and encouraged the Federal Reserve Board of Governors to amend the existing Home Ownership and Equity Protection Act regulations. This had the effect of requiring lenders offering SPCI to abide by additional consumer protections for high-cost mortgages. One by one the major subprime lenders agreed to stop offering SPCI.

Others are moving beyond mortgage lending to develop a variety of community-based responses to the two-tiered financial system that imposes unreasonably high costs for consumers without

access to mainstream banking services. For example, due to pressure from advocates, federal bank regulators adopted policies to prevent banks from "renting their charters" to payday lenders looking to circumvent state limits on the interest that can be charged for these short term, extremely high priced loans. Further, one welfare rights organization challenged a major national banking operation to offer direct deposit accounts for families participating in a welfare-to-work program. In Birmingham, a church-based group worked in partnership with local banks to fund a financial literacy campaign in a local housing development that included efforts to teach young adults how to manage credit card debt and to start to save for future needs.

3. Creating New Partnerships for More Effective Advocacy

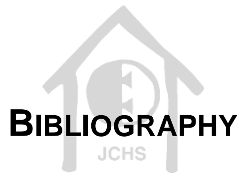
The continued consolidation in the mortgage industry necessitates changes in the way CBOs relate to these mega-institutions. Consequently, some CBOs are looking for ways to join forces with other local, regional, and national organizations to address matters of common concern. Working through their support organizations and networks, CBOs have joined forces with banks and the secondary mortgage market entities to fund financial education and counseling efforts managed by a single community partner that serves as a conduit for numerous smaller participating groups. Such arrangements can be particularly important in areas that lack significant community-based capacity. For example, as an outgrowth of a region-wide planning effort, Region 2020, a Birmingham, Alabama based non-profit is working to form a Community Development Financial Institution that could serve as a conduit for the charitable contributions and CRA-related investments of locally based banks.

CBOs, aware that bank support for their work may be declining, have mounted campaigns to diversify their funding bases. One executive director noted: "CRA gave community groups access to bank resources, but times are changing. We have to convince other major corporate players that the health of our communities is not just important to the mortgage and banking sector – it affects all business." Consequently, some CBOs are turning to other private sector institutions and trying to get corporate leaders from the health care, manufacturing, service, and other sectors to "walk the neighborhoods with us," and learn first hand what effective CBO approaches can accomplish.

Conclusion

Each of the examples presented in this section illustrates both the promise and complexity of the roles that CBOs can play in today's market. Once CBOs could work to organize neighborhood, stand outside a local bank and protest the lack of mortgage lending in their community. In many instances, their list of demands was simple. Some pushed banks to commit to lending in their target neighborhoods. Others persuaded banks to fund counseling or other initiatives. Today, however, both the growing industry concentration and the complexity of mortgage programs make it difficult to know exactly how to put pressure on the system, much less to understand exactly what to ask for should an advocacy campaign succeed.

CBOs must work to improve the ability of consumers to shop wisely for mortgage products, and they must work to offset the negative consequences of abusive lending and resulting foreclosures that threaten to undermine decades of community revitalization efforts. To do so requires CBOs to increase their understanding of how today's technologically sophisticated mortgage market operates, as well as to develop new approaches to advocacy that will be effective in the rapidly changing world of mortgage lending.



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SECTION 6: APPENDIX

A-1: Filtering of Raw HMDA Data Creates Usable Data

A-2: Means and Standard Deviations of Independent Variables

A-3: Impacts of Independent Variables (Exclusive of MSA Effects) for Logistic Model of Home Purchase Prime Conventional Loan Probability

A-4: Impacts of Independent Variables (Exclusive of MSA Effects) for Logistic Model of Refinance Prime Conventional Loan Probability

APPENDIX TABLE A-1: FILTERING OF RAW HMDA DATA CREATES USABLE DATA

	1993	1994	1995	1996	1997	1998	1999	2000	2001	All Years
Home Purchase Loans (Millions)										
All HMDA Records	5.3	6.1	6.4	7.5	8.0	9.5	10.1	9.9	9.4	72.2
After Exclusion of Non-Origination Records	3.2	3.5	3.5	3.8	4.0	4.5	4.8	4.8	4.9	37.1
After Exclusion of Rural Records	2.6	2.8	2.7	3.1	3.2	3.7	4.0	4.0	4.1	30.3
After Exclusion of Records with Missing Borrower Income	2.6	2.8	2.7	3.0	3.1	3.6	3.9	3.9	4.0	29.5
After Exclusion of Records with Invalid Data	2.4	2.6	2.5	2.9	3.0	3.4	3.7	3.6	3.8	27.8
Refinancing Loans (Millions)										
All HMDA Records	8.6	4.3	3.0	5.1	6.1	13.0	10.7	7.2	16.3	74.3
After Exclusion of Non-Origination Records	6.1	2.5	1.6	2.6	2.8	6.7	4.4	2.4	7.9	37.0
After Exclusion of Rural Records	5.2	2.0	1.3	2.1	2.2	5.6	3.5	1.9	6.6	30.4
After Exclusion of Records with Missing Borrower Income	4.7	1.8	1.2	1.9	2.1	4.9	3.2	1.8	5.9	27.6
After Exclusion of Records with Invalid Data	4.4	1.7	1.1	1.8	1.9	4.7	3.0	1.7	5.6	25.9

APPENDIX TABLE A-2: MEANS AND STANDARD DEVIATIONS OF INDEPENDENT VARIABLES

		Home Purchase		Refinance	
Block	Variable	Mean	Std Dev	Mean	Std Dev
Borrower	Intercept	1.00	-	1.00	-
Borrower	1-African American Borrower	0.04	0.21	0.04	0.19
Borrower	1-Hispanic Borrower	0.06	0.24	0.05	0.21
Borrower	1-Other Race Borrower	0.09	0.28	0.07	0.25
Borrower	1-Missing Race Borrower	0.12	0.33	0.18	0.39
Borrower	1-Borrower: MSA Income <= 80%	0.23	0.42	0.23	0.42
Borrower	1-Borrower:MSA Income >120%	0.51	0.50	0.50	0.50
Borrower	1-Female Applicant	0.22	0.42	0.19	0.40
Borrower	1-Gender Missing	0.09	0.28	0.13	0.34
Neighborhood	2-1990 Tract: MSA Income	1.18	0.38	1.17	0.37
Neighborhood	2-1990 % w/in Central City	0.28	0.43	0.27	0.43
Neighborhood	2-Census % African American in 2000	0.08	0.15	0.08	0.16
Neighborhood	2-Census % Hispanic in 2000	0.10	0.15	0.09	0.15
Neighborhood	2-Census % Asian + Other in 2000	0.07	0.08	0.07	0.09
Neighborhood	2-Share HH w/public assistance	0.02	0.03	0.02	0.03
Neighborhood	2-Share Pop w/Bachelors Degree	0.33	0.18	0.32	0.18
Neighborhood	2-Share Owners over 65 in 2000	0.22	0.13	0.22	0.11
Neighborhood	2-Share of Owner Occ in 2000	0.73	0.20	0.74	0.19
Neighborhood	2-Share SF homes in 2000	0.74	0.23	0.76	0.21
Neighborhood	2-Share pre-1950 Units in 2000	0.27	0.27	0.30	0.27
Neighborhood	2-Median House Value in 2000	1.81	1.18	1.89	1.29
Neigh Credit Quality	4-(Turnover 2001)/100	0.27	0.99	0.26	0.73
Neigh Credit Quality	4-Chg Median Family Inc 90-00	0.44	0.77	0.44	0.67
Neigh Credit Quality	4-Change in House Value 90-00	0.50	2.82	0.50	2.27
Neigh Credit Quality	4-PRM CONV Denial Rate 1995-99	0.15	0.08	0.15	0.08
Neigh Credit Quality	4-Rent Value Ratio in 2000	0.06	0.02	0.06	0.02
Competition	5-HHI (In Hundreds of units)	7.12	4.13	5.88	3.21
Competition	5-Orgs in Trct/Own Occ Units	0.04	0.08	0.05	0.07
Competition	5-Top 25 Orgs in Trct/Own Occ	0.01	0.02	0.02	0.02
Loan Supply	6-FNMA (Fedl National Mtg Asso	0.21	0.41	0.21	0.41
Loan Supply	6-GHLMC (Fedl Home Loan Mtg Co	0.16	0.37	0.16	0.37
Loan Supply	6-FAMC (Fedl Agricultural Mtg	0.00	0.01	0.00	0.00
Loan Supply	6-Commercial bank	0.02	0.14	0.02	0.13
Loan Supply	6-Savings bank or saving Assoc	0.01	0.10	0.01	0.10
Loan Supply	6-Life insurance company	0.00	0.03	0.00	0.02
Loan Supply	6-Affiliate institution	0.07	0.26	0.06	0.24
Loan Supply	6-Other type of purchaser	0.20	0.40	0.16	0.37
Loan Supply	6-Non Assessed Lender	0.32	0.47	0.30	0.46
Loan Supply	6-Outside Assessment Area	0.36	0.48	0.36	0.48
Loan Supply	6-Org w/less than 5,000 loans	0.27	0.45	0.22	0.42
Loan Supply	6-Org w/25,000 or more loans	0.51	0.50	0.63	0.48

APPENDIX TABLE A-3: IMPACTS OF INDEPENDENT VARIABLES (EXCLUSIVE OF MSA EFFECTS) FOR LOGISTIC MODEL OF HOME PURCHASE PRIME LOAN PROBABILITY

Block	Variable	Mean Value	High Value	Low Value	Mean Value Prob.	High Value Probability	Low Value Probability
Borrower	Intercept	1.00	1.00	1.00	92.8%	92.8%	92.8%
Borrower	1-African American Borrower	0.04	1.00	-	92.8%	81.7%	93.1%
Borrower	1-Hispanic Borrower	0.06	1.00	-	92.8%	88.9%	93.0%
Borrower	1-Other Race Borrower	0.09	1.00	-	92.8%	92.8%	92.8%
Borrower	1-Missing Race Borrower	0.12	1.00	-	92.8%	87.6%	93.4%
Borrower	1-Borrower:MSA Income <= 80%	0.23	1.00	-	92.8%	92.9%	92.8%
Borrower	1-Borrower:MSA Income >120%	0.51	1.00	-	92.8%	93.6%	92.0%
Borrower	1-Female Applicant	0.22	1.00	-	92.8%	92.1%	93.0%
Borrower	1-Gender Missing	0.09	1.00	-	92.8%	95.8%	92.5%
Neighborhood	2-1990 Tract: MSA Income	1.18	1.56	0.80	92.8%	92.6%	93.1%
Neighborhood	2-1990 % w/in Central City	0.28	1.00	-	92.8%	92.8%	92.8%
Neighborhood	2-Census % African American in 2000	0.08	0.22	(0.07)	92.8%	92.5%	93.1%
Neighborhood	2-Census % Hispanic in 2000	0.10	0.25	(0.05)	92.8%	93.1%	92.5%
Neighborhood	2-Census % Asian + Other in 2000	0.07	0.15	(0.02)	92.8%	93.0%	92.7%
Neighborhood	2-Share HH w/public assistance	0.02	0.05	(0.01)	92.8%	92.5%	93.2%
Neighborhood	2-Share Pop w/Bachelors Degree	0.33	0.51	0.15	92.8%	93.7%	91.8%
Neighborhood	2-Share Owners over 65 in 2000	0.22	0.35	0.10	92.8%	92.9%	92.7%
Neighborhood	2-Share of Owner Occ in 2000	0.73	0.93	0.54	92.8%	93.0%	92.7%
Neighborhood	2-Share SF homes in 2000	0.74	0.96	0.51	92.8%	92.8%	92.8%
Neighborhood	2-Share pre-1950 Units in 2000	0.27	0.54	(0.00)	92.8%	92.6%	93.0%
Neighborhood	2-Median House Value in 2000	1.81	2.99	0.64	92.8%	93.1%	92.5%
Neigh Credit Quality	4-(Turnover 2001)/100	0.27	1.27	(0.72)	92.8%	93.2%	92.4%
Neigh Credit Quality	4-Chg Median Family Inc 90-00	0.44	1.21	(0.32)	92.8%	93.0%	92.7%
Neigh Credit Quality	4-Change in House Value 90-00	0.50	3.32	(2.32)	92.8%	92.9%	92.8%
Neigh Credit Quality	4-PRM CONV Denial Rate 1995-99	0.15	0.23	0.08	92.8%	90.8%	94.5%
Neigh Credit Quality	4-Rent Value Ratio in 2000	0.06	0.09	0.04	92.8%	92.6%	93.1%
Competition	5-HHI (In Hundreds of units)	7.12	11.25	2.99	92.8%	93.5%	92.0%
Competition	5-Orgs in Trct/Own Occ Units	0.04	0.11	(0.04)	92.8%	91.9%	93.7%
Competition	5-Top 25 Orgs in Trct/Own Occ	0.01	0.03	(0.01)	92.8%	93.5%	92.1%
Loan Supply	6-FNMA (Fedl National Mtg Asso	0.21	1.00	-	92.8%	97.8%	90.3%
Loan Supply	6-GHLMC (Fedl Home Loan Mtg Co	0.16	1.00	-	92.8%	97.4%	91.3%
Loan Supply	6-FAMC (Fedl Agricultural Mtg	0.00	1.00	-	92.8%	97.0%	92.8%
Loan Supply	6-Commercial bank	0.02	1.00	-	92.8%	96.7%	92.7%
Loan Supply	6-Savings bank or saving Assoc	0.01	1.00	-	92.8%	96.4%	92.8%
Loan Supply	6-Life insurance company	0.00	1.00	-	92.8%	98.6%	92.8%
Loan Supply	6-Affiliate institution	0.07	1.00	-	92.8%	86.5%	93.2%
Loan Supply	6-Other type of purchaser	0.20	1.00	-	92.8%	79.1%	94.6%
Loan Supply	6-Non Assessed Lender	0.32	1.00	-	92.8%	84.0%	95.2%
Loan Supply	6-Outside Assessment Area	0.36	1.00	-	92.8%	84.2%	95.5%
Loan Supply	6-Org w/less than 5,000 loans	0.27	1.00	-	92.8%	96.6%	90.6%
Loan Supply	6-Org w/25,000 or more loans	0.51	1.00	-	92.8%	94.3%	91.0%

APPENDIX TABLE A-4: IMPACTS OF INDEPENDENT VARIABLES (EXCLUSIVE OF MSA EFFECTS) FOR LOGISTIC MODEL OF REFINANCE PRIME LOAN PROBABILITY

Block	Variable	Mean Value	High Value	Low Value	Mean Value Prob.	High Value Probability	Low Value Probability
Borrower	Intercept	1.00	1.00	-	91.9%	91.9%	91.9%
Borrower	1-African American Borrower	0.04	1.00	-	91.9%	85.5%	92.1%
Borrower	1-Hispanic Borrower	0.05	1.00	-	91.9%	88.8%	92.0%
Borrower	1-Other Race Borrower	0.07	1.00	-	91.9%	90.9%	91.9%
Borrower	1-Missing Race Borrower	0.18	1.00	-	91.9%	86.5%	92.8%
Borrower	1-Borrower:MSA Income <= 80%	0.23	1.00	-	91.9%	90.4%	92.3%
Borrower	1-Borrower:MSA Income >120%	0.50	1.00	-	91.9%	92.9%	90.8%
Borrower	1-Female Applicant	0.19	1.00	-	91.9%	90.2%	92.2%
Borrower	1-Gender Missing	0.13	1.00	-	91.9%	92.5%	91.8%
Neighborhood	2-1990 Tract: MSA Income	1.17	1.55	0.80	91.9%	92.0%	91.7%
Neighborhood	2-1990 % w/in Central City	0.27	1.00	-	91.9%	91.7%	91.9%
Neighborhood	2-Census % African American in 2000	0.08	0.24	(0.08)	91.9%	91.5%	92.3%
Neighborhood	2-Census % Hispanic in 2000	0.09	0.24	(0.05)	91.9%	91.9%	91.9%
Neighborhood	2-Census % Asian + Other in 2000	0.07	0.16	(0.02)	91.9%	91.9%	91.9%
Neighborhood	2-Share HH w/public assistance	0.02	0.05	(0.00)	91.9%	91.9%	91.9%
Neighborhood	2-Share Pop w/Bachelors Degree	0.32	0.50	0.14	91.9%	93.0%	90.5%
Neighborhood	2-Share Owners over 65 in 2000	0.22	0.33	0.11	91.9%	91.9%	91.8%
Neighborhood	2-Share of Owner Occ in 2000	0.74	0.93	0.55	91.9%	92.1%	91.6%
Neighborhood	2-Share SF homes in 2000	0.76	0.97	0.55	91.9%	91.6%	92.2%
Neighborhood	2-Share pre-1950 Units in 2000	0.30	0.58	0.03	91.9%	91.5%	92.2%
Neighborhood	2-Median House Value in 2000	1.89	3.18	0.60	91.9%	91.7%	92.1%
Neigh Credit Quality	4-(Turnover 2001)/100	0.26	0.99	(0.47)	91.9%	92.1%	91.7%
Neigh Credit Quality	4-Chg Median Family Inc 90-00	0.44	1.11	(0.24)	91.9%	92.0%	91.8%
Neigh Credit Quality	4-Change in House Value 90-00	0.50	2.77	(1.76)	91.9%	91.9%	91.9%
Neigh Credit Quality	4-PRM CONV Denial Rate 1995-99	0.15	0.23	0.07	91.9%	90.5%	93.1%
Neigh Credit Quality	4-Rent Value Ratio in 2000	0.06	0.08	0.04	91.9%	91.6%	92.2%
Competition	5-HHI (In Hundreds of units)	5.88	9.09	2.66	91.9%	92.1%	91.7%
Competition	5-Orgs in Trct/Own Occ Units	0.05	0.12	(0.02)	91.9%	91.4%	92.3%
Competition	5-Top 25 Orgs in Trct/Own Occ	0.02	1.00	-	91.9%	99.3%	91.6%
Loan Supply	6-FNMA (Fedl National Mtg Asso	0.21	1.00	-	91.9%	98.7%	87.2%
Loan Supply	6-GHLMC (Fedl Home Loan Mtg Co	0.16	1.00	-	91.9%	98.4%	89.0%
Loan Supply	6-FAMC (Fedl Agricultural Mtg	0.00	1.00	-	91.9%	98.4%	91.9%
Loan Supply	6-Commercial bank	0.02	1.00	-	91.9%	96.4%	91.8%
Loan Supply	6-Savings bank or saving Assoc	0.01	1.00	-	91.9%	97.3%	91.8%
Loan Supply	6-Life insurance company	0.00	1.00	-	91.9%	98.6%	91.9%
Loan Supply	6-Affiliate institution	0.06	1.00	-	91.9%	93.8%	91.7%
Loan Supply	6-Other type of purchaser	0.16	1.00	-	91.9%	87.4%	92.5%
Loan Supply	6-Non Assessed Lender	0.30	1.00	-	91.9%	70.6%	95.6%
Loan Supply	6-Outside Assessment Area	0.36	1.00	-	91.9%	79.4%	95.4%
Loan Supply	6-Org w/less than 5,000 loans	0.22	1.00	-	91.9%	96.6%	89.6%
Loan Supply	6-Org w/25,000 or more loans	0.63	1.00	-	91.9%	92.7%	90.3%

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