AN ANALYSIS OF THE COMMUNITY REINVESTMENT ACT AND THE HOME MORTGAGE DISCLOSURE ACT IN IDENTIFYING HOME MORTGAGE DISCRIMINATION AND PROMOTING COMMUNITY DEVELOPMENT LENDING.

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AUTHOR'S NOTE

The thoughts and views expressed in this paper are those of the author and do not reflect the views of the Federal Reserve Bank of Atlanta.

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INTRODUCTION:

The Home Mortgage Disclosure Act (HMDA) and the Community Reinvestment Act (CRA) were created by Congress in response to concerns that lenders were not providing fair access to credit to various minority groups and to low income areas and central cities in general. Community groups and activists termed this practice redlining which has been defined as the practice of drawing red lines around disfavored neighborhoods where money would not be lent, regardless of the creditworthiness of individual loan applicants (A Citizen's Action Guide, 1992, p.3).

One of the primary criticisms of redlining was the fact that the lack of lending in certain areas, primarily the inner cities, was contributing to the overall decline of these areas through disinvestment. While residents of low income and minority areas were allowed to make deposits in financial institutions, their money was being reinvested and lent out not in their own community but in other more prosperous areas. In their article, "The Invisible Lenders: The Role of Residential Credit in Community Economies," Jean Pogge and David Flax-Hatch describe these issues:

> The practice of "redlining" was first identified and named in the late 1960s on the West Side of Chicago in the Austin neighborhood. Community residents struggling with school issues discovered that savings and loan associations...had labeled Austin a declining neighborhood and actually drawn a red line around Austin and other neighborhoods on a city map. The lenders had decided the redlined areas were vulnerable to racial change and, therefore, not a good credit risk. The resulting limitations on the availability of residential credit became a self-fulfilling prophecy, residents could not easily sell or buy homes at normal market prices, prices fell, home improvement loans were not available, homes deteriorated, and finally, many residents sold their houses at a loss and moved out. (p.85)

These issues of redlining and disinvestment were brought to light by community activists such as Associated Community Organizations for Reform Now (ACORN) who lobbied successfully for the passage of the Home Mortgage Disclosure Act in 1975 and the Community Reinvestment Act in 1977. Since their inception, these acts have stimulated great change and debate in the housing finance arena. Over time, the once adversarial relationship between community organizations and lending institutions has evolved into numerous cooperative ventures and public-private partnerships between nonprofits, community development corporations, lending institutions and various forms of financing agencies all across the country.

Many inroads have been made in the housing finance arena, yet these efforts have not been enough to stem the tide of disinvestment in our urban communities. Instead, issues of disinvestment and discrimination are complex having been created over many decades and caused by numerous factors. Yet, efforts to prevent disinvestment by lenders are similarly complex. As more information is collected through HMDA and community development attempts are made through CRA, more questions arise as to whether or not these regulations and others are the best way to solve the problems of disinvestment and discrimination in lending. In essence, the regulation of financial institutions in this manner is just one portion of the implementation strategy which must be put into place in order to deal with the problems in our cities.

BRIEF HISTORY OF COMMUNITY REINVESTMENT LAWS:

Over the past two decades, Congress has enacted several fair lending laws in an attempt to address some of the issues associated with redlining and disinvestment. The earliest of these laws was the Fair Housing Act of 1968 which prohibits discrimination in the sale or rental of a dwelling on the basis of race, color, religion, handicap, sex, familial status, or national origin. This act makes it unlawful for any person who engages in the business of making or purchasing residential real estate loans, or in the selling, brokering, or appraising of residential real property, to discriminate on the basis of the factors listed above.

A similar act, Equal Credit Opportunity Act (ECOA) was passed in 1974 to ensure the availability of credit to all creditworthy applicants without regard to race, color, religion, national origin, sex, marital status, age, or receipt of public assistance funds(Closing the Gap, 1993, p.26). Both acts were created by Congress in an effort to ensure that credit is not denied to qualified applicants on a prohibited basis or because of the location of the property (HMDA, Federal Reserve of Bank Chicago, p. 2).

The Home Mortgage Disclosure Act (HMDA) of 1975 was billed as a "right to know act" which required lenders to provide the number and dollar amount of home loans they originated each year in an effort to make such information available to the public. In 1977, Congress created the Community Reinvestment Act (CRA) which required lenders to establish community development policies and agendas aimed specifically at reinvesting money in the community. Both were later amended substantially by the Financial Institutions Reform and Recovery Act (FIRREA) of 1989 and the Federal Deposit Insurance Corporation Improvement Act (FDICIA) of 1991.

DEFINITION OF DISCRIMINATION:

The creation and subsequent evolution of the fair lending laws has reflected the debate over how to define discrimination. The dictionary definition of the word discriminate and its derivatives is quite broad. The definitions range from:

> **Discriminate** (verb)
> 1.a To make a clear distinction; distinguish: discriminate among the options available b. To make sensible decisions; judge wisely. 2. To make distinctions on the basis of class or category without regard to individual merit; show preference or prejudice: was accused of discriminating against women; discriminated in favor of his cronies. 1. to perceive the distinguishing features of; recognize as distinct: discriminate between right and wrong.
> 2. To distinguish by noting differences; differentiate: unable to discriminate colors.
>
> **Discriminating** (adjective)
> 1. a. Able to recognize or draw fine distinctions; perceptive.b. Showing careful judgement or fine taste: a discriminating collector of rare books; a dish for the discriminating palate. 2. Separating into distinct parts or components; analytical. 3. Serving to distinguish; distinctive: a discriminating characteristic.4. Marked by or showing bias; discriminatory
>
> **Discrimination** (noun)
> 1. The act of discriminating.2. The ability or power to see or make fine distinctions; discernment 3. Treatment or consideration based on class or category rather than individual merit; partiality or prejudice.
>
> (The American Heritage Dictionary of the English Language) 3rd edition. p.532)

Similarly, the definition of discrimination in lending is equally as broad and has evolved over time. The discovery, identification and redefining of discrimination in lending is reflected in the multitude of studies which attempt to address this topic. Initially, most studies and analysis focused on analyzing lending patterns and credit flows into minority and low income neighborhoods. Then, after HMDA data was expanded under FIRREA in 1989, the emphasis of discrimination in lending changed to analyzing individual loan files for patterns of discrimination in the form of credit rejection and disparate treatment based on race and income. Similarly, recent analyses have focused not on whether discrimination or disparities in lending exist, but why? From the perspective of the lender, the answer to this question has been to evaluate whether certain underwriting criteria have had an adverse impact on minorities. These definitions of discrimination are further defined as:

> **Blatant Discrimination:** The explicit use of a protected variable (race, marital status, sex, etc.) in establishing lending guidelines.
> **Disparate Treatment:** When two applicants, identical in all aspects except for a particular characteristic (such as gender, race, or property location), receive different treatment based on that characteristic. The lender, knowing the race, sex and property location of applicants, applies different credit standards on the basis of these variables. Even though the policy is not blatant, minorities are nonetheless singled out and unfairly denied credit.
>
> **Adverse Impact:** When seemingly innocuous lender policies result in the unfair denial of credit to protected classes. Adverse impact need not entail conscious mistreatment of minorities. Lender policy must meet two criteria to provide evidence of adverse impact: It must disproportionately deny credit to minorities, and it cannot be rationally related to a legitimate business purpose. (<u>Housing Research News</u>, in <u>American Banker</u>, December 22, 1993, p.9)

PREMISE OF PAPER:

Since the adoption of CRA in 1977, neighborhood activists have utilized HMDA and CRA as ways to tap into private funding for housing finance. HMDA data is commonly used to substantiate disinvestment and discrimination claims made under CRA. Over time, both acts have been amended to encourage more disclosure of home mortgage lending data and to improve community reinvestment policies.

During this evolutionary process, the validity of HMDA data in showing the true causes of mortgage discrimination have been debated and the efficiency and effectiveness of CRA have also been questioned. Newspaper series continue to shed light on discrimination and Congress is once again revisiting these issues. Yet, the question remains whether HMDA and CRA can show the entire picture and if lenders are unduly blamed. While it is essential that lenders eliminate discriminatory processes, there are a multitude of additional players and issues which contribute to the problems and issues associated with discrimination in the housing credit market.

> Discrimination in housing credit markets is most frequently thought of as an issue that could be better understood by analyzing the behavior of lenders - where they market, to whom, and how. But focusing only on lender behavior would preclude discovery of the extent to which other parties - buyers, sellers, insurers, appraisers, and others - contribute to housing discrimination and its effects (Wienk, 1992, p. 236).

In light of the impending CRA Reform, what changes should be made to the fair lending laws in order to discourage discrimination in lending. Should efforts be refocused and concentrated on identifying other factors that show discrimination? Should additional techniques be put in place such as testing or can more complex statistical analysis provide the answers we are looking for? Similarly, will changes to these acts weaken the framework which currently supports successful community development lending efforts? Overall, a multitude of policy questions are currently being debated and suggestions are being made to Congress on these issues.

PAPER OUTLINE

This paper will provide an overview of the requirements of the HMDA and CRA, followed by a discussion of the typical housing finance process focusing on underwriting factors and additional factors affecting the process. Additionally, it will analyze the most recent HMDA and CRA changes and will conclude with a discussion of future issues being addressed by Congress.

HOME MORTGAGE DISCLOSURE ACT

PURPOSE:

Congress passed HMDA in 1975 as a "right to know" act in response to allegations of redlining made by community groups and other activists. The purpose of the act was to make information regarding home loans available to the public so that individuals could determine if financial institutions were serving the housing credit needs of their communities. HMDA was also seen as a way of helping regulators identify possible discriminatory lending patterns and as a way to assist public officials in making public sector investments to attract private investment to areas where it is needed (U.S.C. 2802 in Fishbein, 1992, p. 602).

REQUIREMENTS:

From the outset, HMDA applied to banks, savings and loans associations, and credit unions with assets of at least $10 million, and a branch or main office located in a metropolitan statistical area (MSA)(HMDA,Federal Reserve Bank of Chicago, p.2). It required these lenders to report by census tract, the number and dollar value of home purchase and home improvement loans they originated or purchased in metropolitan areas each year. These loans were then itemized by type: single family conventional loans, home improvement loans, multifamily loans, and loans to nonoccupants (i.e. investors). Amendments to HMDA under FIRREA and FDICIA expanded disclosure requirements to mortgage company affiliates of banks, and savings and loan (S & L) holding companies and service corporations, large independent mortgage companies and small independents (Fishbein, 1992, p. 603).

AVAILABILITY OF DATA:

Earlier amendments made to HMDA in 1980 included provisions requiring the creation of a central depository of all HMDA data in each metropolitan area. These depositories were to be located in public libraries or government offices to ensure that the public would have access to the data. Similarly, HMDA was further amended to require that all regulatory agencies provide aggregate analysis of HMDA data for each metropolitan area. This information was computerized and made available to the public on a yearly basis.

HMDA USERS:

Computerization and further refinement of data have resulted in a variety of uses and users of HMDA data. Today, HMDA data is used by community groups, state and local government agencies, news media, consumer groups, banking regulators and financial institutions. Lenders also use HMDA data in a variety of ways that were not initially intended in the original law. For instance, HMDA loan data can be used by lenders to identify markets, target special populations and or specific geographic regions and to evaluate competing lenders'activities (Fishbein, 1992, p. 605). However, the primary use of the expanded HMDA data is for community groups to support CRA claims against lending institutions.

Computerization of the data and improved availability led to increased usage of the data by community groups and other analysts studying lending patterns. Similarly, expanded data requirements under FIRREA increased the number of variables and improved the reporting format to allow for more complex statistical analysis.

EARLY HMDA STUDIES:

Early studies focused on issues of credit flow and neighborhood income characteristics. Studies were completed using loan data and census-tract data to determine the differences in lending activity between neighborhoods or between cities and suburbs. The results showed wide disparities between low-income, predominantly minority neighborhoods and more affluent, predominantly white areas (Canner 1982, p.2 in Fishbein, 1992, p. 605). During the late 1980s, two newspaper series published in the Atlanta Journal Constitution and Detroit Free Press brought widespread attention to the issues of mortgage lending discrimination. Both of these studies attempted to show substantial loan disparities between black and white neighborhoods while comparing neighborhoods with similar income levels. Overall, these studies concluded that there were substantial discrepancies in lending patterns in black and white neighborhoods. Findings of these newspaper studies were later substantiated by a lending study completed by the Boston Federal Reserve Bank in 1989.

Atlanta Journal Constitution:

In his 1988 Pulitzer Prize winning "The Color of Money" series, Bill Dedman of the Atlanta Journal Constitution compared predominantly white and predominantly minority Atlanta neighborhoods with the same income level and found that the white neighborhoods received five times as many home loans from local banks and savings institutions as the black neighborhoods (Fishbein, 1992 p. 605).

Atlanta Journal Constitution-Second Study:

A second study was completed by the Atlanta Journal Constitution in January of 1989 based on information obtained under the Freedom of Information Act from the Federal Home Loan Bank (FHLB) of Atlanta. Under this law, the FHLB provided reports from savings and loans for the nation's largest cities. These reports, which were aggregated by individual metropolitan area, portrayed loan rejection rates based on borrower characteristics. The results were that on the whole, black mortgage-loan applicants were rejected roughly twice as often as white applicants in the nation's largest cities(Dedman, 1989, in Fishbein, 1992, p.607).

Detroit Free Press:

A similar study published by the Detroit Free Press compared the number of home loans made in the city's white, middle-income neighborhoods with similarly situated black neighborhoods. The results showed that three times more loans were made in the white neighborhoods than in the black neighborhoods. They attempted to show loan demand by utilizing deed transfer data and information provided through a state disclosure law which contained more information than the HMDA data (Fishbein, 1992, p. 606).

1989 Federal Reserve Bank of Boston Study:

A lending study conducted by the Federal Reserve Bank of Boston and later published at the request of several members of Congress, supported the findings of the newspaper articles. Like the Detroit study, the Boston study used deed transfer information in place of HMDA data to estimate demand for mortgages and to analyze the patterns of mortgage lending in the City of Boston. This study attempted to determine whether differences in economic and other nonracial characteristics (primarily neighborhood characteristics) as reported in census data, might account for the disparities. The researchers found that, after controlling for neighborhood factors, predominantly minority neighborhoods in Boston had been granted 24 percent fewer mortgage loans per housing unit than predominantly white areas.

> The number of mortgage originations relative to the owner-occupied housing stock was 24 percent lower in black neighborhoods than in white neighborhoods, after taking account of economic variables such as income, wealth, and other factors (Bradbury, Case, and Dunham, in Munnell, et. al., 1992, p.5).

In total, approximately 48,000 property transactions over a five-year period were examined and the results provided further evidence of discrepancies between mortgage origination in white and black neighborhoods. Overall, Bradbury, Case and Dunham concluded that housing and mortgage credit markets were functioning in a way that hurt black neighborhoods:

> Lower mortgage origination in black neighborhoods cannot be explained away by lower levels of income and wealth, lower rates of housing development, or other neighborhood differences. Even after taking these factors into account, one still finds a substantial discrepancy between mortgage orginations relative to the housing stock in white and black neighborhoods (Bradbury, Case, and Dunham 1989, p.31 in Fishbein, 1992, p.606).

ANALYSIS OF 1989 BOSTON FEDERAL RESERVE STUDY:

The authors of the study and other critics offered several reasons for the results of the study. Among the most widely noted flaws were the inability to show demand for loans, lack of data about mortgage company activity, and the geographic aggregation of HMDA data which prohibited analysis of individual loan files. Others noted the differences in income and basic economics in minority communities and how this might limit the number of minorities who might apply for loans. Similarly, discrimination in other parts of the housing market such as the home selection process have also been cited.

Differences in Demand:

A major criticism of the 1989 study was the difference in demand for home purchase loans between minority and upper income white neighborhoods. Canner and Smith cite a lack of demand for mortgages in minority neighborhoods.

> Thus, a possible interpretation of the earlier study was that fewer mortgages were made in black neighborhoods because

> people in black neighborhoods did not buy houses as frequently as residents of white neighborhoods and therefore did not apply for as many mortgages (Munnell, et. al.,p.8, 1992).

Canner and Smith cite pre-1990 HMDA data and state that the demand for home purchase loans is less from lower income groups, than from the upper and middle income groups. They state that home purchase loans in low- or moderate-income neighborhoods constituted a small proportion (approximately 10-12%) of the overall home purchase loans made. Similarly, approximately one-third of the home purchase loans are for properties in upper-income neighborhoods (income at greater than 120% of median family income for the MSA) and the remainder were middle income properties.

Lack of Demand\Differences in Communities:

Critics of the Atlanta and Boston studies noted that the studies failed to account for the differences in demand between neighborhoods that were compared. Some suggested that these differences in demand may be a result of other factors such as reliance on government backed loans, use of home improvement loans, and inability to meet the underwriting standards established by lending institutions:

> The relatively heavy reliance on government-backed loans in Atlanta's minority neighborhoods also may have reflected differences in the ability of applicants in the two groups of neighborhoods to meet the underwriting standards for conventional loans established by creditors, including downpayment amounts and debt-to-income ratios. Information about the amount of assets available for downpayment and levels of debt burden of the Atlanta home buyers was not available (Canner and Smith, 1991, p.865).

Aggregation of Data:

Canner and Smith claim that by comparing the level of home lending per housing unit in seemingly similar minority and nonminority neighborhoods chosen based on aggregate characteristics such as neighborhood median family income, the study did not account for differences in the economic circumstances of the residents. In essence there may be additional economic factors which are not shown when the data is aggregated.

Differences in Income and Basic Economic Situations:

Other critics have noted the disparities in overall wealth and income between white and minority households.

> that it is not so much racial discrimination but patterns which reflect fundamental differences in the economic circumstances of population groups (whether already living in or seeking to reside in the different areas) and in market specialization by different types of lending institutions (Canner and Smith, 1991, p.864).

In the article entitled "When Even Having Equal Income Is Not Enough," Ronald Zimmerman examines differences in income between whites and minorities:

> in this country low-and moderate income blacks and some other minorities have significantly less income and wealth on average than their white counterparts....This income polarity also holds true for the middle- and upper-income groups. Within each income group, the incomes of whites tend to cluster near the top of the income range while the incomes of blacks tend to be distributed near the middle to lower end of the income range. Because minority households have fewer cash resources, their ability to purchase homes and increase their wealth is impeded. This suggests that the widespread mortgage loan distribution patterns reflected by the Home Mortgage Disclosure Act data may be largely a consequence of these differences and should not be surprising (p.8).

However, Zimmerman goes on to state that studies have shown that even at all income levels, even if income is the same, more mortgage loan applications from black applicants than white applicants are denied. Zimmerman summarizes:

> a key factor in the answer may be that even at middle- and higher-income levels, a tremendous difference in wealth still exists between blacks and whites. (p.9)

Discrimination in the Housing Market:

The authors of the Boston study noted that the study did not account for discrimination in the housing market which in turn might account for lower numbers of minority mortgage applicants.

> The study, however, could not distinguish between discrimination in the housing market and discrimination in the mortgage market. From the available data, it was not possible to sort out the precise role played by lenders, as opposed to buyers, sellers, developers, realtors, appraisers, insurers, and others (Munnell, et, al., 1992, page 8).

CONCLUSIONS FROM THESE EARLY STUDIES:

As a result of this study and others, it became increasingly more evident that there was a considerable difference in lending between white and minority areas. Consequently, the question of whether discrimination exists has been redirected to focus on where discrimination occurs and why.

> HMDA data have long been the primary source of public information about the geographic distribution of home loans originated and purchased by financial institutions. Dozens of studies have examined the distribution of home loans across neighborhoods stratified by residents' income and race...For the most part, one basic lending pattern has stood out: Considerable differences exist in the levels of home lending activity across neighborhoods within the local communities when the neighborhoods are grouped by median family income or racial composition (Canner and Smith, 1991, p.864).

FIRREA AND FDICIA AMENDMENTS TO HMDA

INTRODUCTION:

As a result of the debate sparked by the Boston study and reoccurring media coverage, Congress revisited the issue of discrimination in lending. Amendments made to HMDA under the Financial Institutions Reform and Recovery Act (FIRREA) of 1989 and again in 1991 under the Federal Deposit Insurance Corporation Improvement Act (FDICIA) have significantly changed reporting requirements and strengthened the role of HMDA in detecting discrimination in lending. Studies using expanded HMDA data have shown discrepancies in lending rates between whites and minorities. However, many still debate whether HMDA data is sufficient proof of discrimination.

A New Focus for Determining Discrimination:

Under FIRREA, data disclosure for the HMDA must include information on three additional variables: race, gender and income. With these additional factors, the emphasis in lending discrimination switched from analysis of mortgage credit flow into similar neighborhoods divided by race, to analysis of individual loan files and cases of credit rejection which evidenced discrimination. Given access to individual loan files, the concern has changed from redlining, that is differential treatment by lenders based on location of property, to discrimination defined as differential treatment of applicants based on race or other personal traits rather than economic characteristics (Munnell, et. al., 1992, p.9).

Amendments Under FDICIA:

Changes under the FDICIA included expanding HMDA reporting requirements to all small mortgage companies (thereby making almost all firms in the full-time business of mortgage lending subject to HMDA reporting). The FDICIA also mandated that lenders must provide loan applicants with a copy of the appraisal report of the property to be purchased so that applicants can contest underappraisals by unfamiliar real estate agents. Amendments under FDICIA also called for the Justice Department to investigate discrimination cases and to seek actual and punitive damages. Several such cases have recently been conducted (See Shawmut case under Community Reinvestment Act).

Amendments Under FIRREA:

Significant changes to HMDA include expanded data reporting requirements, a new reporting format, improved tabulation of data and accessibility, and changes in reporting coverage. These changes are explained in detail below:

1) Expanded Data:

- Expanded data to include race, gender, and income level of borrowers and loan applicants.
- Mandated data collection for ALL loan applications even if credit is not granted.

2) New Reporting Format:

- Changed loan reporting format to Loan Application Registers (LARs).
- Required lenders to file LARs with their federal regulator.
- LARs give option to cite reasons for loan denial by category.

3) Improved Tabulation of Data and Accessibility:

- Required the Federal Financial Institutions Examination Council (FFIEC) to tabulate data into reports.
- Expanded tabulation format from one annual report totalling loan activity in each metropolitan area to as many as 30 tables for each lender depending on information provided by lender and the metropolitan area.
- Designated HUD as collector of mortgage company data.

4) Changed Reporting Coverage:

- Extended coverage to 400 independent mortgage companies
- Required institutions to report loans sold within the same calender year of purchase or origination and also required classification of loans by type of secondary market entity.
- Required the FFIEC to disclose certain raw data contained on the LARS for individual lenders.
- Exempted small depositories with assets of $30 million or less.

FINDINGS FROM EXPANDED HMDA RESULTS:

The first expanded HMDA data results were made public in October of 1991. Studies of the 1990 HMDA data by the Federal Reserve Board showed large disparities. Many of these disparities were addressed by a study completed by Glenn B. Canner and Dolores S. Smith of the Federal Reserve Board staff using preliminary HMDA data. Canner and Smith reported on the following categories:

- Volume of Application
- Use of Various Home Purchase Loan Products
- Overall Approval Rates
- Approval Rates of Minorities
- Conventional Home Purchase Loans
- Government-Backed Home Purchase Loans
- Home Improvement Loans
- Relation of Approval Rates to Neighborhood Income and Composition

- Approval of Home Purchase Loan Applications
- Neighborhood Income
- Neighborhood Racial Composition
- Neighborhood Income and Racial Composition
- Approval of Home Improvement Loan Applications

(Canner and Smith, 1991, p.867-873)

General Information:

In total, Canner and Smith stated that approximately 5.26 million home loan applications were reported under HMDA for 1990. These applications were broken down by housing size of one to four families or multifamily which was defined as five or more families. The majority of applications were for homes which were one to four families. They were as follows:

3.09 million for home purchase,
1.02 million for home refinancing,
1.10 million for home improvement,

The remaining balance, (approximately .05 million) was reported for multifamily dwellings, however this figure was not broken down into the categories listed above. Canner and Smith also noted that approximately 74% of the home purchase loan applications were for conventional mortgage loans and the remainder were for government-backed forms of credit such as FHA, VA and FmHA loans (Canner and Smith, 1991, p. 867).

Significant Findings:

Significant findings from the preliminary HMDA data included evidence that minorities had a strong reliance on government backed loans, minorities had higher denial rates, and denial rates increased as the proportion of minorities increased. The results of the study are discussed in more detail below.

Strong Reliance on Government Backed Loans by Minorities:

• Government-backed loans are much more likely to be used by households with relatively low incomes than by households with high incomes.

• Black applicants and (to a smaller extent Hispanic applicants) are more likely than either white or Asian applicants to seek government-backed home purchase loans

• Even after controlling for applicant income the data still indicates that blacks, and to a lesser extent Hispanics, are more likely than whites to use FHA and VA loans.

• Overall Approval Rates for conventional home purchase loans and government-backed loans were 72.3 and 71.1 respectively.

Higher Denial Rates for Minority Applicants:

• Nationally, about 14.4 percent of white applicants for conventional home purchase loans were denied credit in 1990 as compared to 33.9 percent for black applicants and 21.4 percent for Hispanics.

• Denial rates for Government Backed Home Purchase Loans were 26.3 percent for blacks, 18.4 percent for Hispanics, and 12.8 percent for Asians, compared with 12.1 percent for whites.

• Overall, denial rates for Home Improvement Loans are higher than for home purchase loans.

• Denial rates for Home Improvement Loans were 36.9 percent for black, 32.5 percent for Hispanic, and 24.6 percent for Asian American, and 17 percent for white applicants.

Increasing Denial Rates as the Proportion of Minority Residents Increase:

• Loan denial rates decline as the income of the residents of an area increases.

• Loan denial rates increase as the proportion of minority residents increases.

• For the most part, whether the neighborhood is low or moderate income, middle income, or upper income, the proportion of home purchase loan applicants denied credit increases as the percentage of minority residents increases.

Similar Findings for 1992 HMDA Data:

The HMDA data for 1992 was released in the fall of 1993. It showed similar patterns of disparity between the races. This data shows that 36 percent of black applicants for mortgage loans were turned down, while only 16 percent of white applicants had their loan applications denied (England, January, 1994, p.41).

IS EXPANDED HMDA DATA SUFFICIENT EVIDENCE OF DISCRIMINATION?:

While these statements show strong disparities in lending patterns by race and income, many dispute whether HMDA data is sufficient to prove mortgage credit discrimination. Many argue that the expanded HMDA data does not include important factors which effect mortgage credit decisions, specifically factors of creditworthiness and collateral:

> The data have important limitations, however, and care must be taken in drawing conclusions from observed lending patterns. Foremost among these limitations is a lack of information about factors that are important in determining the creditworthiness of applicants and the adequacy of the collateral offered as security for their loans. Without taking into account such information, one cannot determine whether individual applicants or applicants grouped by a common characteristic (such as race or gender, have been treated fairly (Canner and Smith, 1991, p. 859).

Canner and Smith cite a list of omitted variables which are important to the mortgage decision but not directly shown by HMDA data. These factors are all integral parts of the decision to grant a mortgage. They include creditworthiness, property value, debt history, collateral, consumer's income, outstanding debts, equity, amount of downpayment, employment experience, debt repayment history, and property appraisal (Canner and Smith, 1991, p.875). Thus, in order to determine if discrimination in lending is occurring in the form of credit rejection it is important to evaluate all the factors which are considered in the lending process. Galster suggests statistical analysis using all variables to compensate for these omissions:

> The recently released 1990 HMDA data will be inadequate for this task, because crucial control variables such as credit and employment history, indebtedness, and assets and characteristics of the property were not gathered (Galster 1991b) ...What is needed is a sophisticated, multivariate estimate of demand and supply functions for mortgages based on a large, robust, current database of individual households and (accepted and rejected) applicants for mortgages. Creation of such a database would necessitate access to lenders'loan files, presumably mandated by federal or state regulatory agencies.(Galster, 1992, p.650)

A study completed by the Federal Reserve Bank of Boston entitled, "Mortgage Lending in Boston: Interpreting HMDA Data," (Munnell et al.) attempted to incorporate all the variables associated with the mortgage lending process into a statistical model to test to see if race was a significant factor. In completing the study the Federal Reserve Bank of Boston augmented HMDA data collected from lenders' loan files with 38 additional variables.

BASIC MORTGAGE APPLICATION PROCESS

The following is a description of the basic mortgage application process as it was described by Munnell, et. al. The three main steps of the basic mortgage application process are a quick review of the application for viability, verification of the information and appraisal of the property, and evaluation of the obligation ratios and consideration of any compensating factors which might influence the decision (Munnell, et al, 1991, p.10).

Once a lender is selected, the applicant completes a standard loan application form which is reviewed by an intake person or a loan officer to ascertain whether the loan is viable. At this time the loan application can be denied if the information does not appear to be viable. However, there is some concern that applicants are informally prescreened and turned away before any application is ever completed. Some have suggested the use of paired testing to identify discrimination at the prescreening stage (Fishbein, 1992, p. 621),(Galster, 1992, 651).

Verification and Evaluation of Ratios:

Once the application is deemed viable, the lender investigates and verifies the financial ability and inclination of the applicant to repay the loan, and determines if there are sufficient liquid funds for a down payment and closing costs. These factors are verified by checking employment, credit history, and bank deposits.

Obligation Ratios:

After credit history and employment are established, the lender must evaluate several key ratios which summarize the applicant's wealth, income, debts, and assets. Together these ratios are used to evaluate whether the applicant has the ability to support the loan. These ratios are:

Housing Expense/Income: which measures proposed monthly housing expenses relative to income.
Total Debt Payments/Income: which measures the total debt payment obligations relative to income.

In general, lenders estimate a household should spend approximately one-fourth of its income (28%) on housing and only about one third of its income (36%) on total indebtedness. Similarly, these ratios are guidelines established by Fannie Mae and Freddie Mac which indicate whether the mortgage can be sold in the government insured secondary market.(see below)

In the past, lenders traditionally expected buyers to make a downpayment amount of at least 20 percent of the purchase price of a house. However, buyers can pay as little as 5 percent down provided they purchase private mortgage insurance, which protects the lender in case the borrower fails to repay the loan. Other such special programs are available through the secondary market such as the Fannie Mae 3/2 Option and Freddie Mac's Affordable Gold program (England, January, 1994, p. 44).

If the application is still viable, an appraisal of the property is completed in order to calculate the loan-to-value ratio. The loan-to-value ratio compares the amount and terms of the loan to the appraised value of the property. The standard ratio is 80%, however, if private mortgage insurance is used the ratio can be higher (typically, 80% is the ratio used by the secondary market purchasers). Lenders must also evaluate the type and terms of the loan requested as well as personal characteristics such as age which may effect the ability to continue working or dependents which may require more money to support.

Evaluation of Numbers and Compensating Factors:

Less then 20 percent of borrowers have perfect applications and lenders must weigh compensating factors in order to approve applications (Munnell, et. al., 1992, p.12). For example a high debt to income ratio can be compensated for with a large down payment,a good record of carrying high housing expenses, a strong propensity to save and a high level of liquid assets, or an excellent potential for future earnings based on education and training.

Similarly, credit history problems can sometimes be compensated for with the following: favorable letters from creditors, extenuating circumstances such as an adverse judgment in a civil suit or prior life circumstances which have changed for the better.

It is important that potential flaws in a loan application be brought to the attention of the applicant so that they may have the opportunity to correct the problems which prevent them from securing a loan. (Some note that white applicants have a larger propensity to be "coached" as to how to improve their applications). Another alternative is to provide credit counseling and homebuyer seminars to assist prospective applicants.

SECONDARY MARKET:

The secondary market plays a large role in home financing. Fishbein notes that lenders covered by HMDA sold approximately 2.3 million loans to secondary market entities in 1990 (p.619). The secondary financiers purchase loans from the primary market and provide government backed insurance on these loans. The secondary market financiers are:

Federal National Mortgage Association-(FNMA) referred to as Fannie Mae, which is a federally chartered private corporation providing a secondary market for residential mortgages.

Federal Home Loan Mortgage Corporation (FHLMC) referred to as Freddie Mac, which is a quasi-governmental agency that purchases mortgages from insured depository institutions and HUD-approved mortgage bankers.

Government National Mortgage Association (GNMA) referred to as Ginnie Mae, is a government corporation which provides a secondary market for housing mortgages and special assistance to housing mortgages financed under special HUD mortgage insurance programs.

These agencies have established certain guidelines based on underwriting criteria under which they will purchase and insure a loan. Fannie Mae and Freddie Mac guidelines are 28% for housing expense/income, 36% for total debt payments/income and 80% loan to value ratios for purchasing home loans from the primary market. However, these are just guidelines which can be changed based on compensating factors (see Munnell, et. al., 1992). However, the primary lender must take these standards and guidelines into account when attempting to sell off loans to the secondary market. Thus, some critics argue that this process may be unfairly impacting the decision to approve the loan:

Some argue that the need to conform to secondary market underwriting guidelines...reduces the willingness of local lenders to be flexible in idiosyncratic cases - cases most often presented by minority applicants. Yet others argue that, by spreading risk and augmenting liquidity of lenders, secondary markets are a boon to putatively riskier segments of the population (Galster, 1992, p. 657).

HMDA AND CREDIT REJECTION
Differential Treatment or Disparate Impact?

INTRODUCTION:

In essence, the basis of the Boston Study was to evaluate what factors went into the home purchase process and to attempt to identify through the use of statistical modeling where credit is rejected and if there is differential treatment based on race. From this study, it was determined that minorities often receive disparate treatment. In some cases this disparate treatment may be a result of arbitrary underwriting standards which unintentionally have a disparate or adverse impact on minorities.

1992 BOSTON FEDERAL RESERVE STUDY:

The study was based on the 1990 expanded HMDA DATA which showed that minorities in the Boston Metropolitan Statistical Area were 2.7 times more likely to be denied mortgage loans as whites. In order to account for the omission of key variables such as credit histories, loan-to-value ratios, and other factors, the Boston Fed augmented the study with some 38 additional variables collected from individual loan files selected to cover the financial and employment variables considered in the home mortgage lending decision. Including this information reduced the disparity between minority and white denials from 2.7 to 1 ratio cited above to a ratio of 1.6 to 1 respectively (Munnell et. al., 1992, page 2).

Study Methodology-Definition of the Model:

Information on 38 variables was requested for 1,200 conventional mortgage loan applications made by blacks and Hispanics in 1990 and from a random sample of 3,300 applications made by whites from lenders in the Boston Metropolitan Statistical Area. Additional data about neighborhood characteristics was gathered from census data and a statistical model was created to test whether race was a significant factor in the lending decision once financial, employment and neighborhood characteristics were taken into account. These variables were summarized in the following model:

P(D) = f(F,R,L,T,C) where:

P(D) = Probability of a lender denying a mortgage application.
F= Applicant's ability to carry the loan
R= Risks of default
L= Potential loss associated with default and foreclosure
T= Terms of the loan
C= If the lenders judgment is influenced by the race or other personal characteristics of the applicant which might affect the likelihood of denial (Munnell,et. al., 1992, p. 13).

Significant Findings of 1992 Study:

The primary finding of the Boston study is that overall a significant gap in lending between whites and minorities is still evident, when other factors such as financial, employment, and neighborhood characteristics, are taken into account. The study finds that in Boston, black and Hispanic applicants with the same economic and property characteristics as white applicants would experience a denial rate of 17 percent rather than the actual white denial rate of 11 percent.

The study also finds that on average, minority applicants have greater debt burdens, higher loan-to-value ratios, weaker credit histories and they are less likely to buy single-family homes than white applicants, and that these disadvantages do account for a large portion of the differences in denial rates. However, the additional information provided by the 38 variables reduces the disparity between minority and white denials from the original ratio of 2.7 to 1 to roughly 1.6 to 1:

> Minority applicants in the Boston area, on average, do have greater debt burdens, higher loan-to-value ratios, and weaker credit histories, and they are less likely to buy single-family homes. But these disadvantages account for only a portion of the difference in denial rates. In the end, a statistically significant gap remains, which is associated with race (Munnell, et. al., 1992, p.2).

The study also cites a series of additional findings and issues which are important to take into account. These problems include the issue of creditworthiness, issues of lender discretion in weighing compensating factors, flexibility of the secondary market, disparities in incomes between the races, influences of the neighborhoods and housing stock, relationships between loan to value ratios and private mortgage insurance.

Creditworthiness:

While the study showed that minorities with unblemished credit credentials are almost certain (97 percent) of being approved, it also notes that most borrowers, whether white or minority, rarely have perfect credentials and lenders have considerable discretion over the extent to which they consider compensating factors (p.3).

Lender Discretion and Compensating Factors:

The study also notes that the issue of lender discretion and compensating factors is an important factor in discrimination in lending. Similarly, the results of the study show that lenders have considerable discretion in making loan decisions when weighing compensating factors and that this discretion is not equally distributed between the races:

> The results of the study suggest that given the same imperfections in a mortgage application, whites seem to enjoy a general presumption of creditworthiness that blacks and Hispanics do not. Lenders seem more willing to overlook flaws for white applicants than for minority applicants (p.3).

Financial Characteristics:

The authors suggest that the loan disparities between whites and minorities may be attributed to financial characteristics, credit histories, and other economic factors:

> As reported in other surveys, black and Hispanic applicants have considerably less net wealth and liquid assets than whites. Black and Hispanic applicants also tend to have poorer credit histories than whites (p. 25).

Neighborhood Characteristics and Housing Type:

Characteristics of the neighborhood or house selected for purchase may also be an issue. For example, the study showed that

Blacks and Hispanics in Boston are substantially more likely than whites to be purchasing a two- to four-family home. This may be a direct result of the housing stock which is available within the city where the majority of the minority population is currently concentrated. The authors state that the lenders may perceive a higher risk involved with these two- to four-family homes:

> The higher proportion of two- to four-family homes among denied applicants, for whites as well as for blacks and Hispanics, suggests that lenders perceive more risk associated with financing the purchase of such properties (p.25).

Loan to Value/Insurance:

Another economic difference noted by the study is that minorities tend to have higher loan-to-value ratios which necessitate more costly private mortgage insurance:

> Blacks and Hispanics also make lower down payments and have higher loan-to-value ratios than whites...Since the secondary market will not accept a mortgage with a loan-to-value ratio in excess of 80 percent without mortgage insurance, minorities apply more frequently for private mortgage insurance (p., 25).

Secondary Market Flexibility:

The study also showed that the secondary market was considerably more flexible in applying or allowing for compensating factors. While typical secondary market standards for obligation ratios (housing expense to total income and total debt) are 28 and 36 respectively, the Fed study showed that more than half of the applications in the study sample exceeded these numbers and some were as high as 36 and 44 based on certain compensating factors:

> The difficulty is that unless primary market lenders apply the flexibility in a nondiscriminatory manner, minority applicants will not benefit to the same degree as white applicants (p.3).

DISPARATE IMPACT OF UNDERWRITING:

The results of the Boston Fed study showed that credit rejection based on race did occur. However, it also suggested that certain lending standards were having a disparate impact on minorities. In effect, while lenders were not practicing overt discrimination, a more subtle, unintentional discrimination may be occurring as a result of underwriting policies which effectively disqualified minorities from obtaining a loan. In his article,"When Having Equal Income is Not Enough," Zimmerman states:

> The distinction between differential treatment and disparate impact is an important one. Although differential treatment is expressly illegal, disparate impact may not be since the law recognizes certain business reasons as valid defenses to charges of discrimination based on disparate impact (p.10).

Some of the factors in the underwriting process which may have this effect are listed below:

• Credit history and employment stability are important in calculating default risk, however, loan-to-value ratios, availability of private mortgage insurance and neighborhood characteristics can effect the stability of the property value. Loan to value ratios are important because "the more equity borrowers have in their properties the less likely that declining property values will cause them to abandon their homes to the lender." (Munnell, et. al,p.16).

• Stability of Value: inner city properties carry a higher risk of capital loss. Difficulty of calculating risk ratios in inner city neighborhoods based on census tracts (Munnell, et. al., p. 17).

• The appraised value does not reflect the uncertainties of whether or not a property will rise or decline in value. This is why lenders are economically motivated to avoid investing in areas that are perceived to be risky (Munnell, et. al., p. 17).

• If, because of differences in education and skills or labor market discrimination, minorities are concentrated in jobs that have a higher risk of unemployment, then unstable incomes could be the reason for denials that appear to be attributable to differential treatment in the lending decision (Munnell, p.15).

OTHER STUDIES AND SOLUTIONS:

New York State Banking Department Study:

On March 17, 1992 the New York State Banking Department issued a study of the mortgage lending policies and practices of 10 savings banks in the New York City area. In completing the study, examiners inspected 2,670 mortgage applications (both approvals and denials) and concluded that all of the banks' underwriting criteria were applied in a generally consistent manner and did not discriminate on the basis of race, gender, or geography (Galster, p. 650). However, some of the results did show that the underwriting standards used could have had a disparate impact on some minorities and females.

Closing the Gap: Boston Federal Reserve Bank:

In the summer of 1993, the Boston Federal Reserve Bank published a guide entitled Closing the Gap: A Guide to Equal Opportunity Lending in an effort to provide lenders with ideas and recommendations on ways to prevent discrimination in lending. The guide outlines issues and strategies for eliminating the disparities in lending and ways to ensure fair access to credit. The guide states the importance of establishing underwriting guidelines which do not contain arbitrary or unreasonable measures of creditworthiness.

Property Standards and Minimum Loan Amounts:

Review property standards and minimum loan amounts, "for arbitrary rules related to age, location, condition, or size of the property which may negatively affect applicants attempting to purchase two-to four- family homes, older properties, or homes in less expensive areas."

Flexible Ratios:

"Special consideration could be given to applicants with relatively high obligation ratios who have demonstrated an ability to cover high housing expenses in the past. Many lower-income households are accustomed to allocating a large percentage of their income toward rent. While it is important to ensure that the borrower is not assuming an unreasonable level of debt, it should be noted that the secondary market is willing to consider ratios above the standard 28/36."

Down Payment and Closing Costs:

Because it is sometimes difficult for prospective homebuyers,particularly low-income borrowers, to accumulate enough savings to cover the loan process, it has been suggested that lenders allow gifts, grants, or loans from relatives, nonprofit organizations, or municipal agencies to cover portions of these cost. Similarly, cash on hand should be accepted if the source can be documented and applicants pay bills in this way regularly.

Credit History:

Lack of credit history should be accepted because some people "pay as they go" to avoid debt. Other forms of credit can be used such as review of utility, rent, telephone, insurance, and medical bill payments. Similarly, "paying off past bad debts or establishing a regular repayment schedule with creditors may demonstrate a willingness and ability to resolve debts."

Property Appraisal/Neighborhood Analysis:

Freddie Mac allows neighborhoods undergoing revitalization to be assessed on their potential as well as their existing condition and Fannie Mae accepts block-by-block underwriting analyses in urban neighborhoods being rehabilitated. "Terms like "desirable area," "homogeneous neighborhood," and "remaining economic life," are highly subjective and allow room for racial bias and bias against urban areas. The same holds true when lenders evaluate properties based on their market appeal or compatibility with the rest of the neighborhood."

Employment History:

"It is important to distinguish between length of employment and employment stability. Many lower-income people work in sectors of the economy where job changes are frequent. Lenders should focus on the applicant's ability to maintain or increase his or her income level, and not solely on the length of stay in a particular job."

Sources of Income:

"In addition to primary employment income, Fannie Mae and Freddie Mac will accept the following as valid income sources: overtime and part-time work, second jobs (including seasonal work), retirement and Social Security income, child support, Veterans Administration (VA) benefits, welfare payments, and unemployment benefits."

Second Review Process:

Review rejected applications to ensure that compensating factors are handled fairly.
(Closing the Gap, 1993, p.13-14).

OTHER FACTORS IN THE HOMEBUYING PROCESS:

A final consideration is the possibility of discrimination in other parts of the homebuying process. Galster notes that agent prejudice, steering by real estate brokers into specific areas, property appraisals and housing search behavior can all be effected by racial stereotypes, prejudice and discrimination.

> the author posits that whites' racial stereotypes motivate discriminatory treatment of minority loan applicants, both directly at the loan origination and underwriting stages and indirectly at the property appraisal stage. White loan officers may have personal prejudices against minorities, or they may believe that objective indicators of risk do not fully measure the likelihood of minorities'default risk and thus engage in statistical discrimination. White appraisers acting on their stereotypes may systematically undervalue properties in minority neighborhoods. Such underappraisals,

when coupled with economic forces in the housing market objectively limiting property values, tend to downgrade lenders'perceptions of the value of the collateral securing the prospective mortgage loans. Given particular rules promulgated in the secondary mortgage market, discriminatory home appraisals may lower lenders'perceived returns on a prospective loan by rendering it ineligible for sale in the secondary market (Galster, 1992, p.644).

THE COMMUNITY REINVESTMENT ACT:

DEFINITION OF CRA:

The Community Reinvestment Act arose out of specific concerns of redlining and disinvestment in our nation's cities:

> In the years leading to the passage of the CRA, there was considerable concern about ensuring fair access to credit, especially in the inner cities... Many people felt that the visible economic decline of urban areas was aggravated by financial institutions, which were seen as taking deposits out of the neighborhoods from which they came and investing them elsewhere ("A Citizen's Guide to the CRA", 1992, p.3).

Enacted by Congress in 1977, the Community Reinvestment Act was an attempt to make lenders participate more fully in community development. As a result, the CRA requires lenders to establish community development policies and agendas aimed specifically at reinvesting money in the community.

BASIS FOR CRA:

Under state and federal law, depository institutions must obtain charters from state and federal regulators in order to operate. Through these charters, depository institutions are granted specific privileges and responsibilities, such as federal deposit insurance and access to the Federal Reserve System's lender of last resort facility (CRA, A Citizens Action Guide, p. 14). In return for these government backed services, banks and savings institutions are expected to serve the communities in which they receive charters to operate. Based on this premise, the Community Reinvestment Act explicitly expanded the term "community" to include: "to help meet the credit needs (both housing and non-housing) of the entire communities in which they are chartered, including low and moderate-income neighborhoods."(12 U.S.C. 2901, in Fishbein, 1992, p.610)

PURPOSE AND SCOPE OF CRA:

While the CRA has been implemented in order to facilitate community development activities, it does not require that specific types or loan amounts must be made in certain areas. In turn, it does not call for mandated credit allocations in certain areas and overall it explicitly states the need for financial institutions to stay within the safety and sound banking practices outlined by the banking industry to protect individual investments (A Citizens's Guide to the CRA, 1992, p. 3).

ENFORCEMENT OF CRA:

CRA is enforced and monitored by one of the four federal agencies listed below. Each has a specific jurisdiction.

1) The Federal Deposit Insurance Corporation (FDIC) supervises state chartered banks that are not members of the Federal Reserve System.

2) Federal Reserve System (FRS) supervises state-chartered banks that are members of the Federal Reserve System.

3) Office of the Comptroller of the Currency (OCC) supervises national banks.

4) Office of Thrift Supervision (OTS)(formerly the Federal Home Loan Bank Board) supervises federally and state chartered savings associations as well as federally chartered savings banks (A Citizen's Guide to CRA, 1992,p.1).

CRA Examinations:

Under CRA each of these regulators is required to periodically examine and assess the CRA performance of each of the lenders that they supervise. Examinations range in frequency from 6 months for an institution with a poor performance rating on its last exam, to every 24 months for a large national bank, to as long as 6 or 7 years for small community banks (Fishbein, p. 611). Review of an institution's CRA performance is part of a larger examination process in which regulatory agencies review the institution's financial soundness, management stability, and compliance with civil rights and consumer laws. The CRA process is also initiated when lenders make requests to expand or alter their businesses specifically through mergers and acquisitions. The CRA performance rating is reviewed by the supervisory agency when the following four applications are requested:

-obtain federal deposit insurance (including start-up or "de novo" institutions and conversions from a state to national charter and vice versa),

- establish a branch or other facility authorized to receive deposits, or relocate a main office or existing branch (including federally insured branches of foreign banks),

- merge, consolidate, or acquire another financial institution, or acquire deposits from another financial institution,

- form a bank or savings association holding company (A Citizens Guide to CRA, 1992, p.9)

Under CRA, institutions are required to inform the public when such applications are made in order to allow for public comment. The public is notified through legal notices published in local newspapers. The institutions must also post informational signs in the lobby, and lists of pending applications and evaluations are available from the regulatory agency.

EXEMPTIONS FROM CRA:

A number of financial institutions are exempted from complying with the CRA. These institutions include: correspondent banks, trust companies, check clearing agents, and credit unions. Similarly, CRA does not apply to nondepository institutions such as mortgage credit companies, mortgage bankers, or mortgage companies at this time. These institutions are regulated by individual states. Critics see this exemption as a flaw in the CRA policy because recent studies have shown the that the secondary mortgage market plays a strong role in lending in low income and minority neighborhoods. Similarly, bank holding companies are not responsible for directly complying with CRA, however, each of its subsidiary financial institutions must prepare CRA Statements for which the holding company is held liable.

AMENDMENTS TO CRA UNDER FIRREA:

In 1989 the Community Reinvestment Act was amended by the Financial Institutions Reform, Recovery and Enforcement Act (FIRREA). This act added significantly to the original CRA framework by changing the evaluation system and making specific provisions about public disclosure of CRA ratings. These changes were made in order to allow the general public more access to CRA evaluation and to provide more detail and criteria in the evaluation system. The changes made to the CRA under FIRREA were a direct result of "a basic congressional dissatisfaction with the adequacy of the exam process in the absence of community group challenges to expansion applications" (Fishbein, 1992, p.616). Congress also felt that regulators were inflating CRA ratings and in making these ratings open, the public would have a better chance to evaluate the system.

EVALUATION SYSTEM:

As a result of FIRREA, the original CRA rating system was changed from a numeric scale of one to five to a four-tiered scale with descriptive ratings. These ratings are Outstanding, Satisfactory, Needs to Improve, and Substantial Noncompliance. Each of these ratings measures the degree to which the institution is actively involved in the following five major community reinvestment categories:

- **I. Ascertainment of Community Credit Needs**
- **II. Marketing and Types of Credit Offered and Extended**
- **III. Geographic Distribution and Record of Opening and Closing Offices**
- **IV. Discrimination and Other Illegal Credit Practices**
- **V. Community Development**

These categories (I-V) are further defined by 12 Assessment Factors which are summarized below:

I. Ascertainment of Community Credit Needs:

Assessment Factor A: Activities conducted by the Institution to ascertain the credit needs of its community, including, the extent of its efforts to communicate with members of its community regarding the credit services being provided by the institution.

Assessment Factor B: The extent of the institution's marketing and special credit-related programs to make members of the community aware of the credit services it offers.

Assessment Factor C: The extent of participation by the institution's board of directors in formulating policies and reviewing the institution's performance with respect to the purposes of the Community Reinvestment Act (Development of a CRA program).

II. Marketing and Types of Credit Offered and Extended:

Assessment Factor I: The institution's origination of residential mortgage loans, housing rehabilitation loans, home improvement loans, and small business and small farm loans within its community; or the purchase of such loans originated in its community.

Assessment Factor J: The institution's participation in governmentally-insured, guaranteed, or subsidized loan programs for housing, small businesses or small farms.

III. Geographic Distribution and Record of Opening and Closing Offices:

Assessment Factor E:
The geographic distribution of the institution's credit extensions, credit applications, and credit denials.

Assessment Factor G:
The institution's record of opening and closing offices and providing services at offices.

IV. Discrimination and Other Illegal Credit Practices:

Assessment Factor D:
Any practices intended to discourage applications for types of credit set forth in the institution's CRA Statement(s).

Assessment Factor F: Evidence of prohibited discriminatory or other illegal credit practices.

V. Community Development

Assessment Factor H:
The institution's participation, including investments, in local community development and redevelopment projects or programs.

Assessment Factor K:
The institution's ability to meet various community credit needs based on its financial condition and size, and legal impediments, local economic conditions and other factors.

Assessment Factor L:
Other factors that, in the regulatory authority's judgement, reasonably bear upon the extent to which an institution is helping to meet the credit needs of its entire community.

Additional CRA Requirements:

As part of the CRA statement lenders must also provide the following information, which must be updated and approved each year by the Board of Directors of the institution:

- a map showing the local community that the institution serves,
- a list of the types of loans the institution is willing to make within its community,
- a notice of the process by which the public can comment on the institution's CRA performance.

(A Citizens Guide to the CRA,1992, p.7).

In completing the CRA evaluation, examiners also take into account the institution's size, expertise, financial strength, the type of community it serves (rural or urban), and local economic conditions. Examiners also evaluate the institution's competition and business strategy (A Citizen's Guide to CRA, 1992, p.4).

Public Access:

All institutions are required to establish a **"CRA Public File"** which is open to the public and includes such information as:

- any response the institution has made to the public's comments,
- the institution's CRA Statements for the past two years,
- the most recent CRA Performance Evaluation prepared by its regulatory agency; this must be placed in the file within thirty business days after the institution receives it. If the institution chooses, it may also include any response it has made to the Performance Evaluation. (A Citizen's Guide, 1992, p.8).

A final requirement is the **CRA Notice** which must be posted in the lobby of each institution. This notice makes public the following information: where the public can obtain copies of the CRA Statement, where to send comments about the institution's CRA Statement, how to contact the supervisory agency, how to access the information, and whether or not the institution is owned by a holding company (A Citizen's Guide to the CRA, p.8).

CONTESTED APPLICATIONS:

Activists have successfully utilized the CRA process and HMDA data to attack lending practices of some banks as well as to challenge merger and expansion requests. Fishbien of the Center for Community Changes, estimates that approximately 300 challenges have been brought by community groups against expansion requests. Yet, he notes that few result in outright denials, and many are withdrawn after settlements are negotiated by community groups.

> Although neither sanctioned nor enforced by regulators, this informal dispute resolution mechanism is viewed favorably by community groups. It has been estimated that these agreements have resulted in anywhere from $7.5 million to $20.0 billion in targeted loan commitments to low- and moderate-income areas, far exceeding the conditions that would have been imposed by regulators (Fishbien, 1992, p 612).

Several institutions have been denied the ability to merge or purchase other banks in part because of CRA performance. The first such case was Continental Bank Corporation which was denied permission for merger in 1989.

Justice Department Investigations Under FIRREA:

Other banks, such as Decatur Federal Savings and Loan Association, have negotiated settlements of approximately $1 million with the Department of Justice after being charged with discriminating against prospective black homebuyers when marketing home mortgage loan products and deciding whether or not to grant mortgage loan applications (Department of Justice Press Release, Sept. 17, 1992). While the Decatur Federal suit alleged violations of the Federal Fair Housing Act and the Equal Credit Opportunity Act, it was the first such "pattern or practice lawsuit" brought by the government against a mortgage lender.

A similar settlement was negotiated between Shawmut National Corporation, (New England's third-largest banking institution) and the Justice Department over allegations of discrimination in lending. While at the same time, Shawmut's application to purchase the New Dartmouth Bank of Manchester, New Hampshire, was blocked by the Federal Reserve Board for failing to meet their requirements under the Community Reinvestment Act.

The Justice Department has since settled the case because the company had agreed to take steps to prevent discrimination in the future and pay at least $960,000 to black and Hispanic customers who were denied loans. While Shawmut denied the allegations it agreed to pay $10,000 to $15,000 to any black and Hispanic customers who could provide evidence of possible discrimination. (New York Times, Tuesday December 14, 1993). Despite the terms of the settlement the company has plans to renew its applications for purchase of New Dartmouth and begin proceedings for two additional acquisitions. In response to the Shawmut case, Attorney General Janet Reno stated:

> "The measures taken by Shawmut should serve as guidance to all others in the lending industry," the Attorney General said. "Today Shawmut conducts formal reviews of its rejected minority applicants, it teaches front-line employees how to insure that every applicant is given full and fair consideration, and it conducts random tests to determine whether its loan officers are discouraging minority applicants from applying for loans." (New York Times, December 14, 1993)

POST-FIRREA CRA RESPONSE:

Despite the amendments made to CRA under FIRREA, many still feel CRA is ineffective. Activists cite CRA ratings as too broad and blame lenders for being more interested in process rather than product. Some lenders, on the otherhand, cite positive CRA success stories. Others agree that the CRA process requires too much unnecessary paperwork and feel overregulated by the CRA process. Overall, these criticisms as well as political pressures have resulted in a general movement to reform CRA.

CRA REFORM AND SOLUTIONS FOR CHANGE

INTRODUCTION:

Despite the changes which have been made under CRA of 1977 and subsequent amendments made under FIRREA, a debate continues over the effectiveness of this law. As a result, the issue of CRA reform is currently being debated. Some feel that the CRA is improperly being used as a "catalyst for major social reform," an effort which is threatening its effectiveness as a tool to ensure equal access to credit (Cummins, American Banker, July 22, 1993, p.1). Others agree that there are flaws in current CRA policy. Mr. Eugene Ludwig of the Federal Reserve Board cites:

> Institutions that are not planning to make any corporate applications have, until now, faced almost no consequences for unsatisfactory CRA performance, aside from the public relations (Cummins, American Banker July 20, 1993).

Another Federal Reserve Board Governor, John LaWare states another criticism:

> Briefly stated, the concern is that the agencies have become too focused on the process and the documentation of that process in their evaluations of lenders' performance. They have been less concerned with the actual lending results that have been achieved - or not achieved, depending on one's perspective (The Journal of Commercial Lending January, 1994, p.6).

Richard F. Syron, president of the Federal Reserve Bank of Boston, cautioned lawmakers about the scope of CRA:

> Fundamentally, we have to realize that it is about equal access to credit, and that alone is not a panacea for any number of economic problems (Cummins, American Banker, July 20, 1993, p.1).

CLINTON CRA REFORM DIRECTIVE:

In July of 1993, President Clinton unveiled his Community Development Bank proposal and directed the four bank and thrift regulators to reform CRA. Among Clinton's suggestions were performance based standards for banks and thrifts in the following three areas: lending, including residential mortgages loans; investment, including investment in Community Development Corporations and Community Development Projects; and banking services, including the location of branches in low- and moderate-income neighborhoods (England, September, 1993, p.43). Similarly, Clinton directed the Federal Reserve Board to provide more guidance on how institutions will be evaluated and to find ways to cut the CRA paperwork burden.

CURRENT RESPONSE TO CRA REFORM:

Since the President called for CRA reform in July, a multitude of issues and solutions have been raised. Federal Reserve Board Governor John P. LaWare summarized the president's directives as well as the solutions which are currently being proposed in a recent article appearing in The Journal of Commercial Lending (January, 1994, p.6):

> The president indicated that he, too, was worried that the agencies' enforcement had focused too much on documentation of the process and not enough on the actual community reinvestment lending that was being done. He asked the agencies to take the following steps to improve the situation:
>
> • Consult with the industry, community groups, and congressional leadership to find ways to make the CRA more performance-oriented.

- Make the standards for judging performance more clear and more objective.

- Promote consistency in the application of those standards.

- Reduce paperwork and other regulatory burdens.

- Maintain adequate flexibility to address the unique needs of the many communities being served.

- Institute more effective sanctions for dealing with lenders with consistently poor performance.

- Complete the reform of the rules relating to the CRA by the beginning of 1994.

RECOMMENDATIONS FOR REFORM:

While President Clinton asked that the reform measures be put in place by early 1994, the debate continues and the public comment period may be lengthened. According to LaWare the following reforms are currently being reviewed:

- Numerical Criteria
- Evaluation of CRA Plans
- Special Treatment for Small Institutions
- Incentives
- Inclusion of Noncredit Services

Numerical Criteria:

Initially, Clinton proposed providing guideposts or performance based criteria for what constitutes good CRA practices, specifying how much lending an institution should do: what type, where, and to whom. This proposal has drawn criticism from both sides. Some fear that these guideposts will amount to quotas and mandatory credit allocation. Others feel that specifying numerical criteria may be too definitive:

> Kevin Kane, president of CRA Consultants, Inc., of Boston, says the performance-based proposals emerging in Washington "will result in quotas." This will not occur because the regulation imposes quotas per se, he explains. Instead, banks and thrifts will despair of finding enough good credits to meet the "specific guideposts"... and "they'll throw away credit criteria,"... For example, if bank examiners are pressuring them for not having at least say, 20 minority loans, "the banks will just do it, make 20 loans to minorities and consider them hazardous or throwaway loans," Kane says. If this were to happen, "it would have an adverse impact on building creditworthiness among low-income communities," (England, September 1993,p.44).

Similarly, numerical criteria may create more problems than solutions. LaWare states:

> despite their general advocacy of a more performance based evaluation system, some community group representatives are concerned that such a series of numerical standards will quickly become a recitation of maximums, and lenders will have no interest in going beyond specified base-level criteria (The Journal of Commercial Lending (January, 1994,p.8).

Finally, if lenders are ultimately forced to make marginal loans, Representative Bruce Vento (D-MN) states that lenders will "set up risk pools" to pay for the bad loans which will increase the cost of mortgages to everyone and eliminate some applicants from the market (England, September 1993, p.44).

Evaluation of CRA Plans:

This proposal would allow lending institutions to develop their own plan for addressing CRA responsibilities. Examiners would judge the institutions on how well they meet their plan. However, the problem with this proposal is how to establish the process for creating such a plan, specifically, to what extent should the community be allowed to participate in the creation of such a plan. Questions remain as to whether the public should have direct involvement, provide general approval and agreement or if it is sufficient to make the plan available for public comment. Additionally, such a system may become difficult for examiners to evaluate. However, LaWare suggests that this proposal would allow lenders to tailor each institution's Community Reinvestment plan to the needs of the community and the capabilities of the institutions.

Special Treatment for Small Institutions:

This proposal would allow small lenders and lenders in nonurban settings special treatment in complying with the CRA. Initially this concept was put forth in the House Banking Committee for institutions with assets of less than $100 million (Fishbein, 1992, p.633). Proponents argued that in order to stay in business, these small institutions had to be meeting the local credit needs of the entire community. Similarly, proponents also argued that small banks were unnecessarily burdened with excessive documentation and record keeping under CRA. Activist groups such as ACORN, oppose special treatment for small institutions. LaWare states:

> Many lenders and some financial industry associations have forcefully argued that small financial institutions should be specially handled, particularly those located outside urban areas. I am sympathetic to this idea as a matter of principle, provided the idea is carefully implemented. There are many ways in which the CRA's primary concerns do not quite

> fit the small lender/nonurban setting. Clearly, the financial institutions in this setting have an effect on their communities. In some cases, this effect is even more significant than that of lenders in large urban areas where there are numerous lending institutions from which to choose. If the unique nature of small banks and the needs of their communities can be reconciled, this reform movement may affect this matter positively. (p.6)

Incentives:

This proposal would provide incentives for good performance such as a safe harbor from community protests in the application process. Under safe harbor provisions, community groups could only lodge complaints against expansion requests for institutions receiving poor ratings (Fishbien, 1992, p.633). Opponents of such ideas note that incentives should not be necessary to get lenders to comply with the law. While LaWare suggests that such incentives may help motivate lenders more, he notes that opponents have little faith in the efficacy of the agencies' examination ratings. He also notes that lenders may need to collect more data to substantiate claims, and therefore the paperwork burden may increase instead of decrease as planned.

Include Noncredit Services:

A final category in the CRA reform movement is to alter the CRA to give recognition to services other than lending such as low-cost checking accounts, credit counseling, government check cashing, and branch locations. LaWare notes that this proposal seems to have the least amount of opposition, however, the CRA only covers credit services, and the legality of such additions must be reviewed further.

OTHER CRA REFORM ISSUES:
Judgement Factor/Computerized Underwriting:

Other solutions have been suggested such as using computer models and statistics to evaluate lending standards, however critics argue that it is impossible to standardize the process using computers:

> We can't take away the judgement of individual financial institutions about what is good credit. You can't put that into a computer because there are too many uncertainties. Representative Bruce Vento (D-MN) (England, September, 1993, p.44).

Similarily, others agree that it is difficult to eliminate judgement, because the underwriting process requires a certain amount of subjectivity:

> the problem with modeling expert opinion is that it is not a science, but more of an art, Burt Ely a bank and thrift analyst (England, p.44).

Market-Share Comparison:

A market-share comparison test has been suggested as a method to evaluate banks' lending performance in low-income and moderate-income areas. This method would be used to measure each lender's performance based on a market share comparison with other lenders. However, critics argue that such comparison will lead to vicious competition and big banks will be able to "buy" their market share and smaller banks will lose out (American Banker, February 9, 1994).

GENERAL CRITICISMS OF THE CRA REFORM PLAN:

Others note that overall, the plan appears to be unworkable, vague, and a retreat from current rules. A recent study produced by the General Accounting Office cites the following concerns:

- Whether the plan will actually improve lending performance, instead of encouraging banks to stay out of poor neighborhoods or make unsafe loans.

- Whether the market-share test, a key element of the plan, is appropriate or even workable in many circumstances.

- Whether examiners are "prepared to handle the increased work load from a time or expertise standpoint" and how will they ensure consistency in using the wide discretion the plan provides.

- Whether the agencies are prepared to undertake the practical aspects of implementing the plan.
(Cummins, American Banker, February 7, 1994)

CONCLUSION:

One of the primary questions being debated with CRA reform is just what is that legal responsibility of lenders in preventing redlining and disinvestment in our nation's cities? How specific must the fair lending laws such as the Home Mortgage Disclosure Act and Community Reinvestment Acts be in responding to these issues? Is it enough to attempt to curb discrimination by providing equal access to credit, or are traditional underwriting standards too strict for some portions of our society? Hence, is it enough for lenders to reevaluate their procedures in attempt to amend unintentional discrimination. Will attempts to revamp the CRA undercut the progress made between lenders and communities in formulating cooperative ventures? Finally, the issues of redlining and disinvestment in our cities are complex and eliminating discrimination in lending is just one aspect of the efforts which must be taken to improve these areas.

RECOMMENDATIONS FOR FUTURE ANALYSIS:

Numerous policy analysts have attempted to address the larger policy issues which are associated with discrimination in lending. In general they call for further investigation of discrimination, racial prejudice, general racial perceptions and stereotypes, and disparities in economic status between the races. And others suggest that the emphasis be put not only on lenders but also other parties such as buyers, sellers, insurers, and appraisers.

In his article "Research on Discrimination in Housing and Mortgage Markets: Assessment and Future Directions," Galster suggests a holistic approach for eliminating discrimination in housing and mortgage markets. This approach involves studying the detection of discrimination, causes of discrimination, and consequences of discrimination. From these analyses he provides several policy initiatives related to preventing discrimination. The basis of his argument is that discrimination in the housing and mortgage lending markets are linked both directly and indirectly through:

> (1.) interracial economic disparities in income, wealth, occupations, and social status (2.) the stereotypes of white households, real estate agents and landlords, property appraisers, and loan officers hold about minorities and the neighborhoods minorities occupy; and (3.) minority homeseeker's and mortgage-seekers' perceptions about how these markets operate (p. 641).

As a result he suggests further analysis of the following areas:

Mortgage Markets:
1. at the pre-application stage using paired testers;
2. at the application disposition stage using multivariate statistical procedures (and, perhaps, nonpaired testing); and
3. the potential adverse impacts of standard lending criteria. (p. 652)

Housing Market discrimination:
Analyses of agent prejudice, customer prejudice, potential customer prejudice, and expectations of discrimination. (p.653)

Policy Related Research:
Analyses of the relationship between interracial economic disparities, whites' racial stereotypes, and minorities' perceptions of the market - and how fair housing/lending policy might affect these disparities, stereotypes and perceptions. (p. 665)

Similarly, in his article, "Policy Directions Concerning Racial Discrimination in U.S. Housing Markets," Anthony Downs provides a summary of 34 different research and direct action policies aimed at "ending unequal treatment of households in housing transactions because of their race or ethnicity"(p.685). A sample of these recommendations is listed below:

- Determine how owners of sale or rental units in black neighborhoods market their available units. (They do not seem to advertise in major newspapers or use open houses). (Turner)

- Determine how brokers in black neighborhoods get listings and contact potential buyers. (Turner)

- Determine how the process of searching for available housing units differs for whites and minority-group members. (Wienk)

- Determine how minority home purchasers and purchasers of housing units in minority neighborhoods search for and obtain mortgage financing and homeowners' insurance. (Wienk)

- Conduct surveys to discover how "typical" white and black households define desirable racial integration in terms of specific percentages of black and white households. Also determine how variations in these percentages influence their willingness (1) to remain in a mixed area, and (2) to move into a mixed area.

- Establish detailed mortgage lending reporting requirements for Fannie Mae and Freddie Mac concerning the number and dollar amounts of mortgages they purchase; the income, racial traits, and gender of the borrowers; the census tracts where the properties are located; and loan-to-value ratios. Make public all the resulting reports right after each reporting period. (Fishbein).
(in Downs, 718-723).

Overall, the issue of discrimination in housing and mortgage markets is complex and multi-faceted, reflecting larger social, cultural and economic issues which have evolved over decades in our nation's cities. It is important to study the issue of discrimination in lending in the context of the larger social issues which have had an effect on disinvestment in our urban areas such as crime, long term racial segregation, population loss, the loss of jobs to the suburbs, and a declining tax base. As a result, no single institution can be held responsible for the resulting disinvestment, and in turn no single law or government action will solve the problem. Analysts must determine what the overall cumulative effect these additional forces have on disinvestment in our nation's urban areas. Only this type of holistic approach and understanding will lead to effective changes in providing better housing opportunities for all citizens.

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