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Asset Building in America

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Communities & Banking

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Kristin Kanders
Editor, *Communities & Banking*
Federal Reserve Bank of Boston
P.O. Box 2076
Boston, MA 02106-2076
(617) 973-3997
kristin.kanders@bos.frb.org

For free subscriptions contact:
Public and Community Affairs
Federal Reserve Bank of Boston
P.O. Box 2076
Boston, MA 02106-2076
1-800-409-1333
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The Promise of Asset-Development Policies

Realizing the Promise: Individual Development Accounts

by Larry W. Beeferman

Asset-based policies can address poverty and inequality effectively and command broad support. Asset-based policies, which center on building human capital and financial wealth, address the common needs and aspirations of Americans by rewarding work, promoting initiative and self-reliance, and embodying widely shared beliefs about fairness and opportunity.

Asset-based policies invest in building capacity among Americans to achieve economic security and opportunity. They focus not just on meeting short-term needs but on building assets for the long term. Making fewer judgments about who is “truly needy,” asset-based policies promote self-reliance, initiative, and growth. At their core, asset-based policies enable individuals to acquire and renew the skills required to get a good-paying job, buy a home, start a business or new career, weather the storms of personal

or family crises, and live comfortably in retirement.

The Elements of an Asset-Based Policy Framework

A framework for asset building has many elements typically thought of as individual assets, although other assets, such as community resources, may come into play. Individual assets, however, are important because they directly affect the economic well-being of households.

Income assets are rooted in jobs that are the source of cash income and benefits. For most households, employment-based income enables them to attain economic well-being. Government policies, such as unemployment insurance and minimum wage laws, protect and enhance employment income. Other policies, including Temporary Assistance to Needy Families (TANF) and Food Stamps, provide income in cash or kind to bolster or replace employment income. Another asset is human capital, which includes the knowledge and skills that enable individuals to obtain good jobs and move up the economic ladder.

In this article, we focus primarily on financial assets, such as savings and checking accounts, stocks and

car repair) or a computer. When a disaster, emergency, or tragedy threatens to disrupt people's lives, financial assets enable them to better survive the crisis.

Financial asset-building policies have been directed primarily to the more affluent. For example, pre-tax retirement accounts help families build for the future, and home mortgage tax deductions are a direct governmental subsidy to homeowners. Tax-favored, private employer-based subsidies of medical and other benefits are not immediately directed at wealth accumulation, but they enhance the income flow available for saving.

Many low-income Americans, meanwhile, either are unable to take advantage of such policies or benefit far less from them than the affluent do. Low-income Americans are often discouraged from accumulating financial assets because they are disqualified from participation in income benefit programs such as Supplemental Security Income and Food Stamps if their assets exceed a very low level. Government policies, such as those reflected in the Community Reinvestment Act, have not been sufficient to assure that low-income households have access to mainstream financial institutions

deposits by low-income account holders matched by private and/or public sources.

Sherraden's book sparked interest and inquiries among public officials that led, in 1996, to bipartisan support for the Clinton Administration proposal to include IDAs in its welfare reform legislation. The law included an option to allow states to use federal funds for cash assistance to match savings in IDAs. Two years later, and again with bipartisan support, Congress passed the Assets for Independence Act. The Act authorized \$125 million over five years to be awarded through competitive grants to nonprofits for IDA demonstration projects. During the past three years, \$45 million has been appropriated for that purpose. In 1999 and 2000, the Office of Refugee Resettlement within the Department of Health and Human Services provided a total of \$8 million to permit states and nonprofits to offer IDAs for low-income refugees.

The Basic IDA Model

Many IDAs – both publicly and privately supported – share common features, such as similar enrollment criteria. Typically, individuals may participate if they meet certain income requirements.¹ Once enrolled, participants generally remain eligible for matches only if they make deposits into their savings accounts in specified minimum amounts and at a specified frequency. By design, all IDAs involve matched savings. To date, match rates for IDA programs have generally ranged from one to one, to three to one, although in some cases additional matches from other sources are permissible.² Match money is generally kept in a separate, parallel account. It is disbursed for allowed purposes only when the participant successfully completes program requirements, including those relating to saving.

IDA programs vary in the uses permitted for matched savings. The primary uses allowed are homeownership, small business development, and post-secondary education or job training. However, some states permit use for car purchase or repair, home repairs or improvements, one-time family medical emergencies and (limited) health care costs not covered by insurance, emergency expenses, retirement, work-related activity (such as child care), and supportive counsel-

Low-income families can save and accumulate financial assets if the proper supports are in place.

bonds, and equity in property. Clearly, financial assets afford people opportunities and empower them. Financial assets can yield a substantial amount of income to sustain everyday life. But even for the vast majority of people who must support themselves from employment, building financial assets is important and sometimes even critical. Financial assets substitute for or supplement employment income – when people lose a job, can only work part-time, or suffer a reduction in pay – or augment Social Security income during retirement. Financial assets enable individuals to make a down payment on a home, pay for education or training, or start a new business. They make possible a significant purchase such as a car (or a major

that provide services that may be crucial to saving and accumulating financial assets, purchasing a home, or starting a business. Moreover, many of these households lack the financial knowledge and skills to navigate issues of credit, debt, and asset building.

IDA Background

Individual Development Accounts (IDAs), are one prototype for policies that enable low-income families to build financial assets. A concept pioneered by Michael Sherraden in his seminal book, *Assets and the Poor*, IDAs operate from the premise that low-income families can save and accumulate financial assets if the proper supports are in place. IDAs are dedicated savings accounts containing

ing. Some IDA programs also provide or require participation in financial counseling, economic literacy or education classes, and peer support groups. They may also be linked to tax preparation services, for example, those that enable participants to receive Earned Income Tax Credit funds.

IDs and Other Asset-Building Models

Even at this early stage, a wide range of IDA models can be crafted. IDs can be targeted to serve a particular segment of the low-income population or work within a particular institutional framework. For example, an IDA program in California is geared to current or recent TANF recipients who want to build their education and skills. By contrast, another, also in California, is directed to low-wage manufacturing employees and is workplace-based rather than community-based, as are many IDs currently. A privately supported IDA program planned for Minnesota is also employment-based, but would target low-income workers more broadly and entails much greater employer support than the California one. Finally, a different program in Pennsylvania, although not workplace-based, is focused on a particular economic sector; it serves childcare workers with the larger mission of supporting a childcare workers' cooperative. Clearly, the IDA model is adaptable to a variety of settings and goals, requiring different combinations of organizational competencies and resources.

Other policies have similar goals. For example, an Individual Learning Account (ILA) effort in Pennsylvania involved an IDA-like program. It was focused specifically on using savings for increasing participants' human capital through gaining education and training that had the potential for upward job mobility, particularly at the place of employment. Both participating employers and the state provided matching funds.

These efforts may yield useful ideas for funding and operating Individual Training Accounts (ITAs) or vouchers under the federal Workforce Investment Act. States have latitude in how they design their training account/voucher systems. At least one pilot project, funded by the U.S. Department of Labor, is being carried out to link to the learning account concept. In

turn, such endeavors may provide grounding for Lifelong Learning Accounts (LiLAs) funded by employees, employers, and government, for which a foundation-funded pilot project is in the works. The project would include universal eligibility for accounts that are portable from one employer to another and would be funded through voluntary, tax-favored contributions by employees.

Other programs in Massachusetts and Oregon link gaining a financial stake to obtaining and maintaining employment for a specific period of

are linked to increased earnings. A number of personal and work-related supports are also aimed at spurring "self-sufficiency." There are no limits on the use of the escrow monies, although participants may use them for homeownership or other housing-related purposes.

A Seattle Housing Authority program is more complex and ambitious. The amounts deposited into participants' accounts are linked to their rent levels rather than earnings or savings. Rents are frozen for two-year intervals (and hence, not linked to resident earnings), but ultimately

Awareness of and support for asset-development policies are only now emerging.

time, rather than saving. The amount of the stake is tied to the length of the period during which participants work. The ability of the participants to secure and maintain their jobs is enhanced by a public subsidy of their wages, paid by the government to their employers.

Still other programs are based on housing. These are available to residents of public housing and recipients of cash assistance (Section 8 vouchers) for private-sector housing. Housing-based programs involve the creation of accounts in which residents accumulate financial assets. But unlike IDs, the sums in these accounts accrue not by virtue of saving, as such, but from diversion of some rent money participants might otherwise pay to the public housing agency. The incentive in this policy is that the amount of money being deposited increases as an individual's income rises. A Massachusetts program, for example, is available only to residents whose housing is solely state-subsidized. The amount of rent diverted is linked to increased earned income and is matched by the state, one to two. Account monies pay for transition to private housing.

The U.S. Department of Housing and Urban Development's (HUD) mandated Family Self-Sufficiency Program has similar accounts but it is geared to reducing recipients' reliance on "welfare assistance," with the possible corollary of no longer requiring housing assistance. The sums deposited in the accounts

they are stepped up to market rate. While the Massachusetts and the HUD programs are individually oriented, the Seattle program is, in part, community oriented. The idea is that if large numbers of residents within a single public housing community can be engaged in the program, the individual impacts will be mutually reinforcing in ways that lead to an upward, community-wide spiral of well-being.

Toward a National Policy

In light of the foregoing descriptions, what is the best way forward for asset-development policy? First, income, human capital, and financial asset strategies, along with other complementary asset strategies, are keys to economic well-being for all families. Second, awareness of and support for asset-development policies are only now emerging, so there is time to fashion them. This requires openness to a range of ideas and a willingness to experiment.

Our federal political structure affords opportunities for such experimentation at the state level. For that reason, state asset-building strategies should be vigorously pressed. Monetary support for IDA programs at the state level, however, has been modest. The same has been true at the federal level. But because experience with IDs has been encouraging, it warrants additional federal support. Concerns about fairness, uniformity, efficiency, and funding necessarily point to federal legislation at some point.

Public and Private Methods to Finance IDAs

The Federal Financial Institutions Examination Council has ruled that banks' support of IDAs can receive Community Reinvestment Act credit. Financial institutions that receive a Bank Enterprise Award from the Community Development Financial Institutions Fund can be given up to \$50 per IDA to offset administrative costs. The federal Housing and Urban Development Department recently confirmed that Community Development Block Grant (CDBG) monies can be used for IDAs. A legislative initiative currently under consideration by the Congress, the Savings for Working Families Act, would vastly expand federal support for IDAs through a tax credit rather than a grant mechanism.

Activity at the state level in support of IDAs has been considerable. As of September 2001, 23 states had passed IDA legislation and had a state-supported program in operation. Nine use state general funds, eight provide state tax credits for IDA program contributors, six employ CDBG funds, and twelve use TANF funds to match IDA savings. (Three state-administered programs do not allow for a match.)

In New England, four states have enacted legislation in support of IDAs. Connecticut appropriated \$400,000 in state monies for match and administration of IDAs. Rhode Island authorized a pilot program for IDAs in connection with welfare reform, but TANF or other monies have not yet been allocated for the program. Maine approved a 50 percent tax credit, for a total of up to \$200,000 per year, to donations to Family Development Accounts. Vermont appropriated \$250,000 in state funds to be used for IDAs as part of its welfare reform program and an equal amount in the form of a challenge grant to be matched with private funds, to link IDA participants to the state's college savings plan. Vermont also has an IDA program funded by CDBG monies. Although no legislation for IDAs has been enacted in Massachusetts, the state has a growing network of privately supported IDAs.

Substantial private, nonprofit sector IDA initiatives have also been undertaken. To date, the largest IDA demonstration project has been the American Dream Demonstration (ADD). Supported by major private foundations, it started in June 1997, had 2,378 participants in thirteen locations around the country as of June 30, 2000, and was scheduled to end in December of 2001. ADD programs were run by private, nonprofit organizations, including six community development organizations and two each of social service agencies, bank or credit unions, housing development organizations, and collaboratives.

As of this writing, support for increasing federal monies for IDAs appears to be bipartisan. There is, however, resistance to a large-scale increase and to the potentially more open-ended tax credit funding mechanism proposed under the Savings for Working Families Act, as compared to one based on federal appropriations. Success at moving IDAs to a larger scale has its challenges and perhaps its limits. One challenge is assuring that enough organizations are available with the capacity and the access to resources to manage IDAs at an increased scale. Another challenge is designing and assuring support for multi-level and related, but possibly distinct, IDA programs. Use of tax credits targeted primarily at financial institutions may have scale limits and possible disadvantages in the way it might channel the IDA development. A refundable tax credit – along the lines of the Earned Income Tax Credit – would be better, but establishing it would be more difficult.

Of course, other initiatives offer promise – more likely at the federal, but possibly at the state level. For example, a number of Congressmen, scholars, and others have made proposals for universal children's opportunity or savings accounts. These accounts would be seeded by public money at birth and, perhaps, at significant times during youth, with opportunities for building assets through young account-holders' savings and contributions by family members and others. Such a scheme would create a financial asset-building infrastructure for all, one that could in the longer run afford real financial results to all.

Finally, as suggested in the introductory comments, a variety of assets – most often, individual ones, but frequently collective ones as well – enable individuals to enjoy economic security and opportunity. As IDAs and other strategies seem to suggest, these different kinds of asset building are intertwined and may often be interdependent. The key point is that asset development can provide an essential framework for thinking about the kinds of policies that will enable low-income families and individuals to attain economic well-being.

Endnotes

1. Individuals may participate if they (a) are eligible for Transitional Assistance to Needy Families, (b) have annual incomes at or below a specified percentage of the federal poverty level or at or below a specified fraction of area household median income, or (c) are eligible for the federal Earned Income Tax Credit.

2. Matches may be limited in amount on a monthly, annual, or multi-year basis and may be as high as \$2,000 per year and up to \$10,000 over a period of years. Programs appear to universally exempt the matching monies from state taxation.

About the Author

Larry W. Beeferman is Director of the Asset Development Institute (ADI), part of the Center on Hunger and Poverty at the Heller School of Social Policy and Management at Brandeis University. Established in 1999 with major funding from the Ford Foundation, ADI promotes and advances an asset-based policy framework through its own research and work with national and state public officials, policy analysts, and advocates. For further information, see www.centeronhunger.org.

IDA Program Outcomes

The American Dream Demonstration

by Larry W. Beeferman

The American Dream Demonstration offers the most comprehensive evaluation of IDA programs to date. The outcomes, including monthly net deposits, savings rates, and levels of continued participation, are encouraging. It should



be noted that American Dream Demonstration (ADD) participants have been described as being “more disadvantaged” than the overall U.S. population who are at or below 200 percent of the federal poverty guidelines. They are more likely to be female, African-American, and never

married. They are also “more advantaged” in that they are more educated, more likely to be employed, and more likely to have a bank account.

The data tend to refute the idea that certain groups are simply “too poor” to save.

Because of the similarity of the ADD program to other IDA programs, these results may have broad application. Indeed, a recent evaluation of a state-supported program, Family Assets for Independence in Minnesota, yielded similar outcomes for a participant population similar in many respects to the one in the ADD demonstration.

Participants: Most of the participants in the American Dream Demonstration were female; a substantial majority were in their 30s or younger; nearly half were African-American; nearly half were never-married; and overall, more than three-quarters were single by reason of divorce, separation, or widowhood. Most were in households with children, mostly one or two children; nearly four out of 10 had a high school diploma or less; and almost the same fraction had attended college but had received no degree. Nearly one-half had incomes below the poverty level and more than one-fifth had incomes below 50 percent of the poverty level; one-tenth were current welfare recipients and nearly four out of 10 were former recipients; modest numbers received additional assistance.

Savings outcomes: The data tend to refute the idea that certain groups are simply “too poor” to save and participate in an IDA program. It appears that individuals of low income, even those who receive public assistance, adhere to “middle-class” values about sacrificing and saving now for future benefits. From the program’s inception in June 1997 through the period ending

June 30, 2000, over 82 percent of the participants had positive net deposits; 99 percent had made at least one deposit. About 16 percent of enrollees left the program. The average and median net deposits per month were \$25.42 and \$17.96, respectively. For all participants, the average and median savings rates (defined as the ratio of the average monthly net deposit to gross monthly household income) were 2.2 percent and 1.3 percent, respectively. Perhaps surprisingly, the mean savings rate and, for the most part, the median savings rate appear to *rise* with *lower* income levels.

Savings uses, intended and actual: More than half of the participants who remained in the program but had not yet made matched withdrawals intended to use their savings for a home, with lesser numbers aiming for post-secondary education and microenterprise. By contrast, as of June 30, 2000, of the participants who made matched withdrawals,

Perhaps surprisingly, the mean savings rate and, for the most part, the median savings rate appear to *rise* with *lower* income levels.

substantial and roughly equal numbers used the monies for home purchase, post-secondary education, microenterprise, and home repair, while a lesser number directed them to retirement and job training. Fewer participants than intended actually used their savings to buy a home; this may have been because the purchase of a home requires a relatively large lump-sum deposit.

Participant characteristics and program outcomes: A variety of demographic characteristics have been correlated with success in maintaining program participation. About 16 percent of the enrollees in ADD had left the program as of June 30, 2000. The exit rate was not linked to gender and was statistically the same by race; it had no statistically

significant link with income and it was not strongly linked with education, employment, or receipt of public assistance. It had no association with home ownership, pass-book-account ownership, or insurance coverage.

Savings strategies: Participants used a variety of strategies to save. Most significant was their more efficient use of resources – shopping more carefully and eating out less, followed by buying used as opposed to new clothing – and reducing consumption by spending less on leisure, followed by cigarettes and alcohol, and then, postponing visits to the doctor or dentist. More modest numbers worked more hours or sold household or personal items. To some degree they employed psychological strategies, such as direct deposit, goal-setting, mental accounting, earmarking of tax refunds, and treating the deposit as a monthly bill. Many acknowledged that as a result of participation, they had less money for leisure than they would like and were less likely to save in other ways, outside of their IDAs. Modest numbers had to give up food or other necessities or had more difficulty paying bills. These survey results are encouraging and are consonant with evaluations of ADD data suggesting that IDA deposits come from both new savings and

shifted assets; as of yet, researchers do not know the importance of each in the mix.

Non-savings and long-term impacts: The overwhelming majority of current recipients surveyed expressed confidence about their futures because they had IDAs and said that they felt more economically secure and more in control of their lives as a result. Most were more likely to make plans to acquire additional assets because they had IDAs, to make educational plans for themselves and for their children, and to make plans for their retirement. They found the economic education and training helped them to save, and many found learning about budgeting and money management particularly helpful. A number of

IDA participants pointed to support from program staff helping them to save, as well as to peer support, either by virtue of camaraderie or by learning of strategies for saving and asset maintenance.

Optimism that such outcomes may emerge is tempered by recognition that a number of personal factors appear to have a bearing on success in IDA programs and, hence, limit its

ify at a later time. Correspondingly, having a stable employment and work schedule and sufficient earned income to permit regular savings is generally important.

Success also depends upon motivation, the willingness to establish goals, and the commitment to achieve them. In this regard, client contact and individual attention appear to be important. For exam-

that even if participants are successful at saving, they need support and resources that will enable them to use their newly acquired financial assets to achieve the goals they have chosen. Thus, for new IDAs, in addition to what appear to be substantial requirements for staff at start-up, there is continued need for staff to motivate and support participants, frequently on a one-to-one basis, and to monitor their programs.

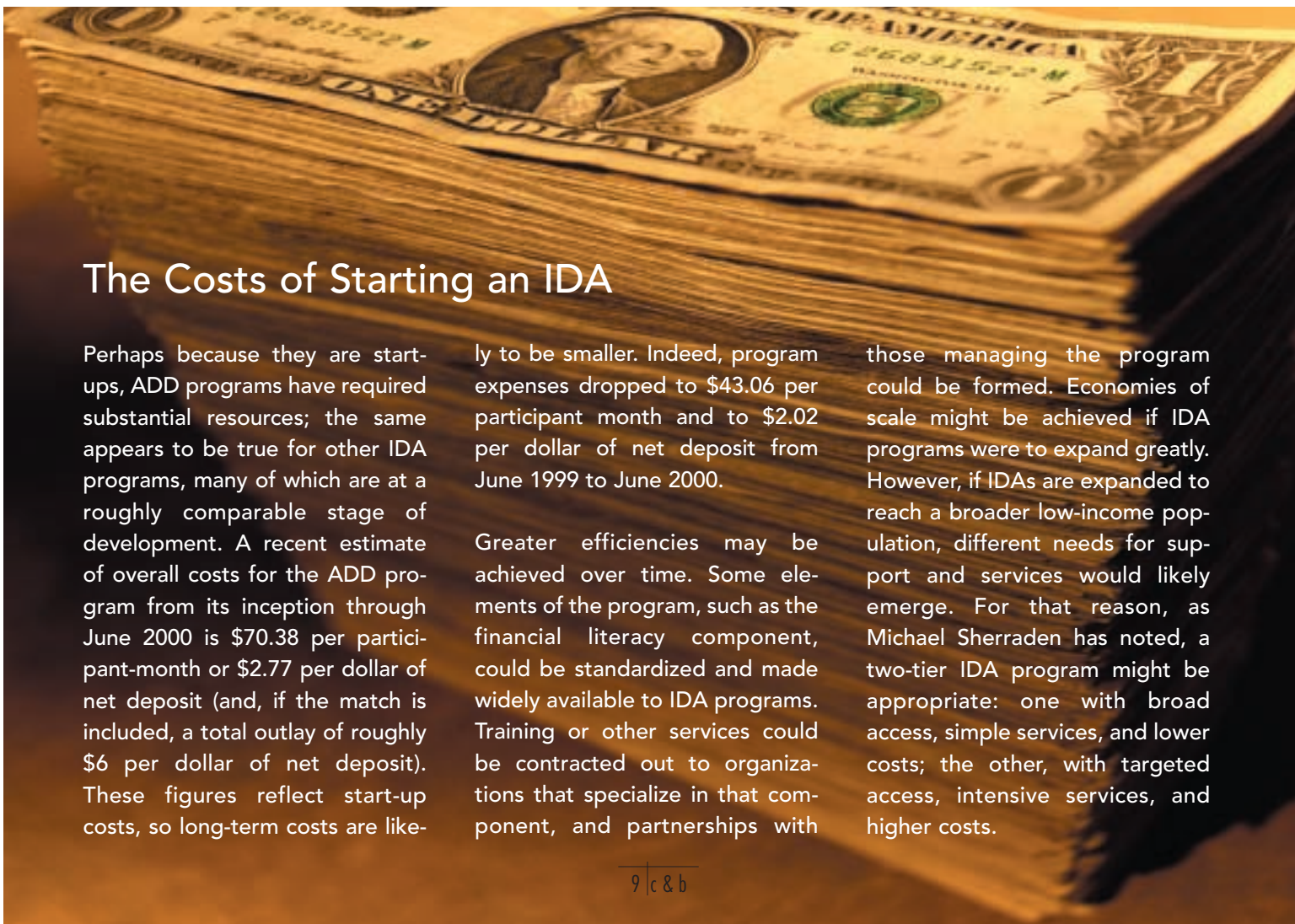
About the Author

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Participants used a variety of strategies to save. Most significant was their more efficient use of resources — shopping more carefully and eating out less.

promise for some low-income individuals. For example, those who are seriously stressed, emotionally or financially, may not be able to sustain the required commitment to the program. If debt and credit problems are obstacles to acceptance, applicants may be rejected, but if they are given the opportunity to work those problems out and gain related budgeting and income management skills in the interim, they may qual-

ple, the making of savings deposits and maintenance of saving are spurred by the match incentives, exhortations, and mechanisms that make saving easy and that lock it in. In addition, support in the form of advice, counseling, and advocacy may be necessary in the event of a personal, job, or housing-related crisis. Non-crisis supports may also be important, as is group support. Further, IDA programs recognize



The Costs of Starting an IDA

Perhaps because they are start-ups, ADD programs have required substantial resources; the same appears to be true for other IDA programs, many of which are at a roughly comparable stage of development. A recent estimate of overall costs for the ADD program from its inception through June 2000 is \$70.38 per participant-month or \$2.77 per dollar of net deposit (and, if the match is included, a total outlay of roughly \$6 per dollar of net deposit). These figures reflect start-up costs, so long-term costs are like-

ly to be smaller. Indeed, program expenses dropped to \$43.06 per participant month and to \$2.02 per dollar of net deposit from June 1999 to June 2000.

Greater efficiencies may be achieved over time. Some elements of the program, such as the financial literacy component, could be standardized and made widely available to IDA programs. Training or other services could be contracted out to organizations that specialize in that component, and partnerships with

those managing the program could be formed. Economies of scale might be achieved if IDA programs were to expand greatly. However, if IDAs are expanded to reach a broader low-income population, different needs for support and services would likely emerge. For that reason, as Michael Sherraden has noted, a two-tier IDA program might be appropriate: one with broad access, simple services, and lower costs; the other, with targeted access, intensive services, and higher costs.



The Network

Turning Savings Dreams
into Reality

by Kathleen Gill



“Never doubt that a small group of committed individuals can change the world. Indeed it is the only thing that ever has.” – Margaret Mead

On a recent Wednesday night at the Roxbury Boys & Girls Club, a group of men and women ranging in age from 25 to over 50 gathered to discuss an issue of common concern: homeownership. With \$120 already in their savings accounts after just four meetings, each participant planned to save \$1,500 within the year and ultimately to purchase a home. This accomplishment will be all the more meaningful because the average annual participant income is under \$35,000.

This group is part of a program known as “The Network,” an Individual Development Account (IDA) group with a twist – it prepares participants to purchase a home in just one year, instead of the two to three years of the more standard program. The Network is run by a faith-based collaborative of five organizations composed of the Black Ministerial Alliance, Christian Economic Coalition, Emmanuel Gospel Center, Greater Boston Interfaith Coalition, and United Christian Financial Services Association. Its IDA program is founded on the principle that the keys to eco-

conomic advancement are savings and financial literacy.

The United States has long been plagued by a low personal savings rate. A June 2001 paper on personal savings states, "There is widespread perception that the rate of . . . personal savings [in the United States] is too low."¹ Although economists argue about whether the measure has been distorted by not counting pension contributions and capital gains, on average the United States saves very little. On a personal level, the inability to save regularly and control one's financial life can have dire consequences. In the low- and moderate-income community, lack of good financial habits can lead to poverty and permanent indebtedness.

The Network in Boston's Roxbury and Mattapan neighborhoods is seeking to assist the low- and moderate-income community in increasing savings rates through economic education. The goal of the program is for each participant to save \$1,500 in an individual development account



Peer teaching allows students of The Network to help their classmates and to feel empowered.

and to use these savings, plus program matching funds, for a down payment on a home. The program was developed by the Reverends Frank Kelley, Brian Gearin, and Bishop Glen Prospere.

Last year, The Network asked four churches to pilot their newly created IDA program. While the organizers had anticipated a group of perhaps 30 participants, the initial orientation attracted 130 community members from both within the four churches and among friends of parishioners. As of June 2001, of the original 88 enrollees, 61 had completed the program's savings requirements and 50 weeks of training.

While most of these graduates have begun searching for a home, the expensive Boston housing market has made it difficult to find one in the appropriate price range. To date about eight or nine have purchased a home or are in negotiations to buy. The program has now begun its second round of training, with 86 participants.

Before beginning their IDA program, the three ministers extensively researched existing programs and then adjusted their program model to better fit the communities they know so well. The resulting program varies from the traditional IDA program in a number of significant ways. A traditional IDA program, as developed by the American Dream Demonstration Project, generally lasts between two and three years. Participants are asked to save \$25 to \$50 per month, and group meetings occur between once per week and once per month. Program funds match participant savings from \$1 to \$1 all the way up to \$6 to \$1. The average match rate is \$2 to \$1.

The Network Program in Boston lasts for one year, meeting 50 times, and participants are asked to save aggressively. Each "student" saves \$30 each week, or \$120 per month. At the end of the program, students receive a \$4 to \$1 match, bringing their savings total to \$7,500. This amount can then be used as a down payment on a house. The matching

dollars are from two sources, the Federal Home Loan Bank of Boston and the City of Boston.

The rationale behind the short program duration and high savings rate is threefold. First, the single-year duration and weekly involvement encourage student retention. Second, the high amount of savings is necessary to purchase a home in Boston's expensive housing market. Third, the high savings rate increases a student's emotional investment in the class. "The amount was enough to have people think about changing their spending habits," says the Rev. Gearin.

Since meetings take place on a weekly basis and students save on a weekly basis, it is more likely that real behavioral change can occur. Says the Rev. Kelley, "How could you be accountable for a lifestyle change if you are only [saving] once a month? If you are saving every week, it becomes part of your life." The meetings are also structured differently than the traditional,

instructor-based model. In a traditional model, a trained professional guides students to financial literacy through a series of lectures and exercises. The Network follows a peer-group model with facilitators treated as invited guests. Students run their own meetings, creating a feeling of empowerment.

The program curriculum is divided into three, roughly equal, phases. In the first phase, students develop financial literacy. They meet in small groups to discuss matters such as credit reports, credit repair, saving, budgeting, amortizing a loan, and other financial matters. The second part of the program's curriculum revolves around financial stewardship. In this phase, the group discusses developing financial goals, ethics in business, taxes, and money management. The final portion of the curriculum is prima-

volunteers who act as facilitators. The program operates in church basements, and the administration of savings is done by the group itself. Each week, the elected student treasurer collects savings from the students and issues receipts. The money is then deposited in a local bank where it earns the savings-account interest rate and is not subject to fees. Students are issued their own ATM cards, with which they can make deposits and check balances. The ATM cards are designed so that the students cannot use them to withdraw money.

Edith Senfuma, a 29-year-old former resident of Roxbury, is a case study of how well the program has worked. "If it wasn't for Reverend Kelley and the other teachers, I don't know when I would have bought a house. I always dreamed of owning a home, but I didn't think it was pos-

proud owner of a two-family home in Rhode Island. While high Boston housing costs precipitated her move out of state, she has managed to achieve her goal of owning a home.

Reina I. Galindo, a 45-year-old single mother from the South End, is another success story, although she hasn't bought a home yet. Galindo has never owned a home nor have her parents. Says Galindo, "The class has been a wonderful experience. Many minority people have never known how to go to the bank and ask for a loan, fix their credit, save money. I always thought it would be too hard; now it has become a whole lot easier to understand." She also found that having the meetings in a church setting made it easier to believe in her dream of homeownership, and the support that she received from other participants energized her to complete the pro-

Students are issued their own ATM cards. . . . designed so that the students cannot use them to withdraw money.



gram. She says she thinks about money differently now. Since finishing the program, she has continued to save and hopes to buy a home sometime soon.

Endnotes

1. Bernheim, Douglas B. and Daniel M. Garrett, "The Effects of Financial Education in the Workplace: Evidence from a Survey of Households," National Bureau of Economic Research, revised June 2001.

About the Author

Kathleen Gill worked as a Community Affairs Specialist with the Federal Reserve Bank of Boston for the past three years. *Communities & Banking* wishes her well in her future endeavors.

rily technical assistance. During this stage, a series of presentations introduces students to home inspectors, bankers, conveyancing attorneys, realtors, and other professionals involved in the home-buying process. The goal is to eliminate the fear of approaching professionals.

To keep costs down, the program is run by the three ministers and a small group of highly committed

sible right now," says Senfuma. She learned about the program through the People's Baptist Church. She thought it sounded like a good idea until she attended the first meeting and heard that she would need to attend every week for 50 weeks. As a student and employee, she didn't believe she would have time. However, with encouragement, she made the commitment and succeeded. Last month she became the



Savings



Income



Money



Work



Earnings



Taxes



Assets



Getting Back Earned Income

by George Samuels

The Earned Income Tax Credit provides additional income to working families and individuals, yet there is increasing evidence that millions of dollar in credit benefits go unclaimed each year. According to John Wancheck, Earned Income Tax Credit (EITC) Campaign Coordinator at the Center on Budget and Policy Priorities, a nonpartisan research and policy institute, “Past research and the continued experience of community groups who conduct EITC outreach and free tax preparation programs indicate that substantial numbers of eligible workers do not claim the credit.”

In tax year 1999, 19 million working families and individuals across the United States received over \$30 billion in credit refunds. Over 625,000 New Englanders received close to \$1 billion, about \$1,460 per claimant. However, recent reports indicate that \$9 million in earned income credit was unclaimed by Boston residents. An estimated 10 to 15 percent of qualified New

Englanders did not claim the federal credit.¹ As a result, workers in New England possibly missed out on \$91 million to \$104 million.

Says Wancheck, “There is concern about specific groups of workers whose eligibility may not be evident to them.” These groups of workers include foster parents, working grandparents with custody of grandchildren, workers whose children are over age 18 but are attending school full-time, and workers who care for adult relatives who are permanently disabled. Further, a study by the Urban Institute reports that many more Hispanic workers, as compared to non-Hispanic workers, do not claim the credit.² Language barriers and fears of deportation may explain part of this disparity.

Credit Brief

The Earned Income Tax Credit is a refundable income tax credit that provides supplementary income to working families and individuals. The credit is the government’s pri-

mary aid program to the working poor in the United States.

Unlike most tax credit programs, the earned income credit reduces the amount of income tax a person owes and can also provide a refund. For example, if a person owes \$200 in income taxes and is eligible for \$2,000 of earned income credit, she would receive an \$1,800 refund. Working families and individuals whose incomes are less than \$31,152 can qualify for the credit.³ Families can qualify for the maximum credit depending on the number of qualifying children they claim (see Table 1). Typically, a qualifying child is any child under the age of 19 or, if a full-time student, under the age of 24.

Eligible workers can claim the credit by completing Schedule EIC and attaching it to their tax return. The Internal Revenue Service makes an effort to notify workers it believes are eligible for the credit; however, workers who are exempt from filing tax returns (because of low wage earnings) are not contacted and may lose out on receiving benefits.

In addition to the federal program, 16 states offer the credit. The state credits are anywhere from 5 to 32 percent of the federal credit (see Table 2).⁴ For example, if the state credit is set at 15 percent and a worker qualifies for \$2,000 in federal credit, then that worker would be eligible for \$300 in state credit. Fortunately for New Englanders,

Table 1
Income Limits and Maximum Credits for EITC

Worker Status	Income Limit	Maximum Credit
No Children	\$10,380	\$353
One Child	\$27,413	\$2,353
Two or More Children	\$31,152	\$3,888

Note: Tax year 2000. This is not a tax table. Do not use it to complete income tax returns.

four states have a program in place.⁵ In Massachusetts and Vermont, a worker could receive the credit as a refund. But in Rhode Island or Maine, the worker can only

Tax Assistance (VITA) programs.” He notes that commercial tax services charge fees that reduce the benefits of credit refunds and conduct heavy advertising campaigns in low- and moderate-income communities.

“This points to the need for more community-based, free tax preparation programs that enable workers to fully benefit from the credit,” says Leavy.

The IRS sponsors VITA programs, but they are not available in every community. Community organizations can host a VITA site and recruit volunteers to help with tax preparation.

With the credit amount increasing to as much as \$4,088 in tax year 2001, the opportunity cost of not claiming the credit is great for eligible workers and their local communities that could benefit from the additional consumer spending. The challenge will be to create outreach strategies that transcend language and other barriers that now prevent some eligible workers from claiming the credit. To get involved, see the resources list below.

Additional Tax Programs for Working Families

Two other federal tax credit programs – the Child Tax Credit and the Child and Dependent Care Credit – are noteworthy because they can work in concert with the Earned Income Tax Credit. Below is a summary of how the programs can be used.

First, a taxpayer must pay federal income taxes in order to claim the Child Tax Credit. This credit is worth up to \$500 per child, and can give a taxpayer back some or all of the

income tax taken out of her paycheck, as well as offset any additional taxes she owes at the end of the year. Single parents with incomes up to \$75,000 and married parents with incomes up to \$110,000 can claim the Child Tax Credit.

Second, a taxpayer must pay federal income taxes as well as child or dependent care expenses to claim the Child and Dependent Care Credit. This credit is a tax benefit that is available to families. Eligible taxpayers can receive reimbursement for 20 to 30 percent of their dependent and child care expenses, depending on income. The credit can be as much as \$720 for a taxpayer with one child and \$1,440 for a taxpayer with more than one child or dependent.

Four states in New England also offer Child and Dependent Care programs. Maine offers a refundable credit, and Rhode Island and Vermont offer non-refundable credit programs. Massachusetts offers a deduction for child and dependent care expenses. Connecticut offers no program, and New Hampshire does not collect personal income tax.

Endnotes

1. This is a rough estimate based on conversations with IRS officials and an earlier study. See Scholz, John K., “The Earned Income Tax Credit: Participation, Compliance, and Anti-poverty Effectiveness,” *National Tax Journal*, 47:1 pp. 63-87, March 1994.
2. Phillips, Katherin R., “Who Knows about the Earned Income Tax Credit?” The Urban Institute, Income and Benefits Policy Center, January 2001.
3. Information from “Factsheets on the 2001 EIC,” Center on Budget and Policy Priorities, March 2001.
4. Johnson, Nicholas, “A HAND UP: How State Earned Income Tax Credits Help Working Families Escape Poverty in 2001,” Center on Budget and Policy Priorities, October 2001.
5. Connecticut does not have an EITC program. New Hampshire has no personal income tax on earned income.

About the Author

George Samuels is a Community Affairs Supervisor with the Federal Reserve Bank of Boston.

Table 2
EITC Benefits for Selected States in New England

State	Percent of Federal Credit
Maine	5 (non-refundable)
Massachusetts	15
Rhode Island	25.5 (non-refundable)
Vermont	32

Note: Tax year 2001.

eliminate any taxes owed up to the credit amount.

EITC Outreach

In response to the reports of missed credit benefits, many local, state, and federal officials have stepped up their efforts to promote the earned income credit. In Boston, city officials are already planning free training and outreach efforts in concert with local Internal Revenue Service (IRS) officials and community groups.

Paul Leavy, who conducts EITC outreach in Massachusetts for the IRS, asserts that outreach has already begun for tax year 2001. He points to two main goals for this year’s efforts. One is to increase overall participation in the credit program through heightened public awareness. The other is to encourage New Englanders to volunteer to conduct free tax preparation services, especially in low- and moderate-income and immigrant communities.

Says Leavy, “The IRS indicates that 60 percent of those who do claim the EITC use commercial tax services to file their returns. Fewer than one in ten have their tax forms prepared for free by Volunteer Income

EITC Resources

Taxpayer Education Coordinator and Volunteer
Income Tax Assistance (VITA) Program for New England
Internal Revenue Service
JFK Federal Building, Stop 40726
15 New Sudbury Street
Boston, MA 02203-9112
(617) 316-2501 in Boston, MA
or (800) TAX-1040 outside of Boston

For additional EITC outreach materials, please visit the Center for Budget and Policy Priorities at <http://www.cbpp.org/eic2001/index.html> to download. To order a free copy, e-mail eickit@cbpp.org, call (202) 408-1080, or fax (202) 408-1056.



LENDERS AND THIRD-PARTY BROKERS

PERSPECTIVES ON CREDIT SCORING
AND FAIR MORTGAGE LENDING

ARTICLE THREE IN A FIVE-PART SERIES



The rise of predatory lending practices has put increasing pressure on lenders to oversee the practices of their third-party mortgage brokers. Third-party mortgage brokers solicit customers and generate loans on behalf of lenders. How lenders oversee the practices of their third-party mortgage brokers, especially for compliance with fair lending laws, pricing policies, and the use of credit scoring, is the focus of this article. Contributors to this installment in the article series — including a lawyer, regulator, consumer advocate, and retired Department of Justice counselor — were asked to respond to the following statements and questions:

While lending institutions may actively review and assess their own credit-scoring models for potential unlawful disparities, it is also important for lenders to monitor their relationships with third-party brokers. Mortgage brokers make credit available in communities that do not have traditional lending institutions. Lenders establish relationships with third-party brokers to reach these markets.

Lenders need to consider how their third-party brokers comply with fair lending laws and use credit-scoring models. Lenders who knowingly work with non-compliant brokers and take no action may be liable as co-creditors. The following situations may lead to increased regulatory risk exposure for the lending institution: The lender may build in a high broker overage tied to the credit score; the broker may obtain a credit report or credit score and use it to underwrite and price a proposed deal prior to submitting it to a lender; or a broker may screen applicants or steer them to higher-priced products even if the applicant's overall risk profile (credit score) does not necessarily warrant it.

Considering the credit-scoring issues outlined above, what strategies can lenders adopt to better manage their third-party broker relationships? What can third-party brokers do to ensure compliance with fair lending regulations?

ARTICLE SERIES BACKGROUND

CREDIT SCORING is an underwriting tool used to evaluate the creditworthiness of prospective borrowers. Utilized for several decades to underwrite certain forms of consumer credit, scoring has come into com-

mon usage in the mortgage lending industry only in the last ten years. Scoring brings a high level of efficiency to the underwriting process, but it also has raised concerns about fair lending among historically underserved populations.

The purpose of the Federal Reserve System's Credit Scoring Committee is to collect and publish perspectives on credit scoring in the mortgage underwriting process, specifically with respect to potential disparities between majority and minority homebuyers in the home search or credit application process. The introductory article of the series (Spring 2000 issue of *Communities & Banking*) provided the context for the issues. The second article (Winter 2001) dealt with lending policy development, credit-scoring model selection, and model maintenance.



CONTRIBUTOR BACKGROUNDS

EDWARD KRAMER is a civil rights attorney and director and co-founder of The Housing Advocates, Inc., a fair housing agency and public interest law firm founded in 1975. The organization receives monies from the U.S. Department of Housing and Urban Development, private foundations, and various local governments. One of the programs operated by The Housing Advocates is the Predatory Lending Project. The Project provides legal assistance to low- and moderate-income residents to prevent predatory lending activities and other consumer fraud problems, especially in distressed areas of Cleveland. When violations of the law are identified, they are referred to private attorneys or to the Fair Housing Law Clinic. The Clinic is a joint venture between The Housing Advocates, Inc. and Cleveland State University's Cleveland-Marshall College of Law.

CHRISTOPHER A. LOMBARDO is the Assistant Director for Compliance in the Office of Thrift Supervision's Central Region. Based in Chicago, he manages compliance examination, community affairs, and consumer affairs programs affecting savings institutions in a seven-state area that stretches from Tennessee to Wisconsin. Lombardo has 18 years of regulatory experience with the Office of Thrift Supervision (OTS) and its predecessors; regional office policy and enforcement work with OTS and the Federal Deposit Insurance Corporation; and compliance policy work in Washington, DC. He has led interagency policy initiatives and has been active in examiner and industry education. The Office of Thrift Supervision, an office within the U.S. Department of the Treasury, is the primary federal supervisory agency for savings associations.

KATHLEEN MULLER is the executive director of the HOPE Homeownership Center in Evansville, Indiana. Muller has been with HOPE for about 12 years. HOPE provides housing counseling services to residents throughout the entire Evansville area. For 35 years, HOPE has been helping families assess their need for housing and their ability to buy through credit and budget analysis, and it certifies their eligibility for special innovative loan packages. During the past year, HOPE served 450 individuals and families.

ALEXANDER C. ROSS recently retired from the Civil Rights Division of the Department of Justice, where he worked for over 35 years on lawsuits brought by the United States to enforce civil rights statutes forbidding discrimination in voting, employment, education, public accommodations, housing, and lending. His position for many years prior to retirement was Special Litigation Counsel for the Division's Housing and Civil Enforcement Section, where he investigated and prosecuted matters involving a pattern or practice of discrimination in home mortgage and consumer lending. Ross was the Division's lead lawyer in several landmark fair lending cases.

EDWARD KRAMER THE HOUSING ADVOCATES, INC.

Financial institutions can have a great deal of control over the practices of their third-party mortgage brokers, especially for compliance with fair-lending laws, pricing policies, and the use of credit-scoring models.

There is a close relationship among traditional financial institutions, mortgage brokers, and real estate agents. Brokers know where to get their clients financed and lenders have a history of doing business with certain mortgage brokers and real estate agents. It is a symbiotic relationship. Lenders know who is breaking the law and who is skirting the law. They know who are the "bad guys." In fact, those were the words used by a mortgage broker who recently confided, "We know in our industry, and certainly the financial institutions know, which mortgage brokers are really doing a disservice to clients."

The reason mortgage lenders know the "good guys" from the "bad guys" is that they have dealt with them over a number of years. In a situation where there have been excessive defaults on loans from the same mortgage broker, or if defaults often occur within several months after the loans, it is not difficult for a financial institution to gather evidence of what happened and of potential wrongdoing. There may have been problems with these loans: The applications or income levels may have been falsified, the credit report may have inconsistencies, or the credit score may not be sufficient to justify the loan.

At the opposite end of the spectrum, it would be relatively easy for financial institutions to identify mortgage brokers who try to maximize their commissions by charging some borrowers more than what is "usual" and "fair" in points, rates, and fees. These are situations where borrowers should be able to qualify for traditional "A" loans but are being offered subprime "C" loans.

One strategy for financial institutions to avoid third-party liability is to test loan application files. In this fair lending review, the Truth in Lending Act and the U.S. Department of Housing and Urban

Development Good Faith Estimate – documents regarding the costs of the loan – should be examined. Financial institutions should look at appraisal costs and other fees to

financial institutions should do if they are going to be good neighbors and good businesses for our community. They need to make a commitment to the community, which was

dient wrongful acts of their employees. However, great evils require strong remedies, and the old rules of the law require that when one of two innocent people must suffer, the one whose acts permitted the wrong to occur is the one to bear the burden of it. [Citations omitted.]

“CERTAINLY THE FINANCIAL INSTITUTIONS KNOW WHICH MORTGAGE BROKERS ARE REALLY DOING A DISSERVICE TO CLIENTS.”

determine if they may be excessive or unusual. They should look for credit life insurance packages built into the loan and see whether the consumer is being required to pay for this insurance up-front or for the life of the loan. If financial institutions begin to see inconsistencies from broker to broker, that should send up a red flag. Such a pattern should result in a closer scrutiny of all new loans being submitted by this particular mortgage broker.

Unfortunately, predatory lending practices are often being funded by financial institutions. This situation may be driven by the need to comply with Community Reinvestment Act (CRA) obligations. The Act was meant to ensure that financial institutions meet the credit needs of all communities in their assessment areas, including low- and moderate income neighborhoods. However, in a perverse way, CRA has in some cases had the opposite effect. Banks, rather than using their own branch system of loan offices, instead closed down branches, limiting access and services to these customers. These banks have relied upon third parties, mortgage brokers, and real estate agents to generate CRA loans.

Lending in this way to low- and moderate-income borrowers can be profitable for financial institutions, but it can cause severe hardships for the consumer who is often a minority and/or female head-of-household. A third-party arrangement allows unscrupulous mortgage brokers or real estate agents to misuse or abuse the system. Banks are really assessing, “Will this help me meet my CRA needs and will it meet our profit motive?” So when some argue that the third-party system is more efficient, what they really mean is that it is more profitable. However, this is not necessarily what

the original purpose of the Community Reinvestment Act – to require banks to commit themselves to the community, to those neighborhoods in their credit service areas that they have not served in the past.

What are the risks if financial institutions don’t respond to today’s predatory lending issues? They face new and costly legislative and regulatory initiatives. More important, they face substantial risk of litigation. Unlike the Truth in Lending Act or other consumer laws, federal and state fair housing laws place special obligations on the entire housing industry, including financial institutions. One of these obligations is that the duty of fair housing and fair lending is non-delegable. Almost a quarter century ago, in one of the first cases involving a racially discriminatory refusal to make a home loan, our federal court found in favor of the victim of discrimination. In *Harrison v. Otto G. Heinzeroth Mortgage Co.*, 430 F. Supp. 893, 896-97 (N.D. Ohio 1977) the court held as follows:

Thus the Court has no difficulty in finding the defendant Haugh liable to the plaintiff. Under the law, such a finding impels the same judgment against the defendant Company and

This decision is not unique in the law. The courts have rejected arguments from real estate brokers that they should not be held liable for the discriminatory acts of their independent agents. *Marr v. Rife*, 503 F.2d 735 (6th Cir. 1974) and *Green v. Century 21*, 740 F.2d 460, 465 (6th Cir. 1984) found that “under federal housing law a principal cannot free himself of liability by delegating a duty not to discriminate to an agent.” Furthermore, using the analogy to the Fair Housing Act, the courts have found that finance companies have a non-delegable duty not to discriminate under the Equal Credit Opportunity Act, which cannot be avoided by delegating aspects of the financing transaction to third parties. See *Emigrant Sav. Bank v. Elan Management Corp.*, 668 F.2d 671, 673 (2d Cir. 1982); *United States v. Beneficial Corp.*, 492 F. Supp. 682, 686 (D.N.J. 1980), *aff’d*, 673 F.2d 1302 (3d Cir. 1981); *Shuman v. Standard Oil Co.*, 453 F. Supp. 1150, 1153-54 (N.D. Cal. 1978).

Now apply this case law to financial institutions that refuse to monitor their relationship to mortgage and real estate brokers. These lenders can be subjected to substantial damage awards. Playing ostrich will not insulate them from any illegal actions of mortgage brokers and real estate agents with whom they deal.

WHEN SOME ARGUE THAT THE THIRD-PARTY SYSTEM IS MORE EFFICIENT, WHAT THEY REALLY MEAN IS THAT IT IS MORE PROFITABLE.

the defendant Heinzeroth, its president, for it is clear that their duty not to discriminate is a non-delegable one, and that in this area a corporation and its officers are responsible for the acts of a subordinate employee, even though these acts were neither directed nor authorized. This ruling troubles the Court to some extent, for it seems harsh to punish innocent and well-intentioned employers for the disobe-

If a pattern and practice can be shown, then financial institutions are assumed to have control. They have the ability to say “yes” or “no.” They have a right to monitor and determine whether or not these “independent actors” are breaking the law. If they knew or should have known, they can be held liable.

Financial institutions and mortgage brokers should also follow another

example of the real estate industry. The larger real estate firms have their own “in-house” Fair Housing Program to train their staff. Large companies have their own programs because they want to make sure that their real estate agents are aware of the law and of company policies. They want these policies imple-

and the independent broker to be the point of contact with the applicant/borrower and the processor of the loan. The lender/broker relationship is covered by a mutual agreement that the other party is suitable and reliable. The lender provides the broker with its underwriting guidelines, highlighting

ships with mortgage brokers, this most notably includes compliance with laws such as the Fair Housing Act, Equal Credit Opportunity Act, Home Mortgage Disclosure Act, Fair Credit Reporting Act, Real Estate Settlement Procedures Act, and Truth in Lending Act. These laws are relatively new; in addition, there are rules governing the privacy of consumer financial information, consumer protection rules for insurance sales, and the Flood Disaster Protection Act. This demonstrates that we’re not describing free enterprise as envisioned in the eighteenth century by Adam Smith.

WHAT ARE THE RISKS IF FINANCIAL INSTITUTIONS DON’T RESPOND TO TODAY’S PREDATORY LENDING ISSUES? . . . THEY FACE SUBSTANTIAL RISK OF LITIGATION.

mented. All employees and independent contractors must know the law, the company’s policies, and that everyone will uphold fair housing and fair lending laws.

CHRISTOPHER A. LOMBARDO OFFICE OF THRIFT SUPERVISION

Before addressing a financial institution’s relationships with mortgage brokers, we ought to identify three facts that represent changes in the mortgage business landscape over the past decade.

First, financial institutions increasingly rely on fee income. Interest rate spreads are, and are likely to remain, razor thin. Second, automation (including credit scoring), securitization, and specialization have revolutionized who does what and how they do it. Third, financial institutions rely on independent mortgage brokers to maintain a steady supply of loan originations. Employees in financial institution branches typically no longer generate the business. Call this progress-in-action in a free enterprise system, or call this a recipe for disaster. In reality, the system is far from free: It is heavily regulated. With the scourge of predatory lending, personal and individual disasters have become more common, or at least more widely recognized. Systemic disasters remain rare.

We also ought to clarify our terminology. As is most common, I will consider the financial institution (insured depository institution) to be the funding, originating lender,

any deviations from market standards. The lender provides the broker with rates, fees, and term information – weekly, daily, or as needed. Operating under a lender/broker arrangement, the broker registers a rate lock-in and processes the paperwork. The loan passes down one of two main paths: the lender table-funds the loan and reviews it afterward, or the lender reviews and approves each loan package prior to closing.

Numerous custom and hybrid lending arrangements exist. However, one ought to consider what a financial institution examiner sees: performing loans; the occasional rejected deal, if the lender documented it; and the occasional defaulted loan. The examiner does

LENDERS OUGHT TO BE EXPERT IN SPOTTING A LOAN THAT YELLS, “RUN, DON’T WALK, FROM THIS DEAL!”

not know what transpired between the broker and the borrower. The examiner does not know who ordered, paid for, or prepared the application. Lenders should know this information and ought to be highly selective about the brokers who bring them business. Lenders ought to be expert in spotting a loan that yells, “Run, don’t walk, from this deal!” The standard to which a lender should be held responsible for a broker’s act, error, or omission is a “knew or should-have-known” standard.

The compliance examiner assesses how well a financial institution manages its compliance risks and responsibilities. Regarding relation-

Beyond the U.S. Department of Housing and Urban Development’s advertising rules implementing the Fair Housing Act and the Federal Reserve Board’s advertising rules implementing the Equal Credit Opportunity and Truth in Lending Acts, thrift institutions are prohibited from any inaccuracy or misrepresentation regarding contracts or services, including any and all aspects of their mortgage lending. The examiner gets a glimpse of lender activities and an even briefer look at what the broker has done. Well-managed financial institutions make it a point to take a good look at what the broker has done, but it is very difficult for the lender to police the broker’s activities. With the growing awareness of predatory

lending, most lenders now have systems in place to detect transactions that involve fee packing, equity stripping, and flipping. Lenders have shifted from presuming that the refinancing deal presented for funding is what the borrower originally needed or wanted, and many are applying some sort of benefit-to-the-borrower standard.

As a general observation, mortgage market automation (including credit scoring), standardization, and specialization have not posed great hazards for most financial institutions. Financial institutions have internally motivated systems for identifying and correcting problems outside the supervisory and enforce-

ment process. The fee-driven nature of the business and reliance on broker business do pose hazards, however. Every financial institution has stories of mortgage brokers who proposed compensation arrangements that would violate the Real Estate Settlement Procedures Act. Most lenders have stories of broker efforts to push unsophisticated individuals (with or without marginal credit scores) into higher-priced deals that offer greater compensation to the broker. The issue of unearned fees and kickbacks is fairly easy to spot. The issue of pushing individuals into higher-priced deals, however, defies detection, often until much damage has been done.

The uniform interagency examination procedures adopted by the federal banking supervisory agencies for fair lending focus on activity at the margin. In general terms, it is in transactions with marginal applicants that underwriting discrimination may be

identified. The same holds for pricing and the use of credit scoring. A financial institution, therefore, needs to have a vigorous review

“MOST CONSUMERS WHO CONTACT A MORTGAGE BROKER EXPECT THE BROKER TO ARRANGE A LOAN WITH THE BEST TERMS AND AT THE LOWEST POSSIBLE RATE.”

system in place for broker actions. This review system should reinforce the lender's message about the kinds of deals it is seeking and the kind of treatment that will be extended to prospective customers.

Aside from individual credit transactions, lenders who stray far from the mainstream market are most exposed to allegations of credit discrimination. Regulators are more sensitive to issues involving innovation, automation, cost control, and income stability. It is in this testing of new ideas that we try to draw a line between acceptable and

unacceptable risk-taking. Financial institutions whose stated or unstated goal is to skate on the edge of the law should expect and be prepared

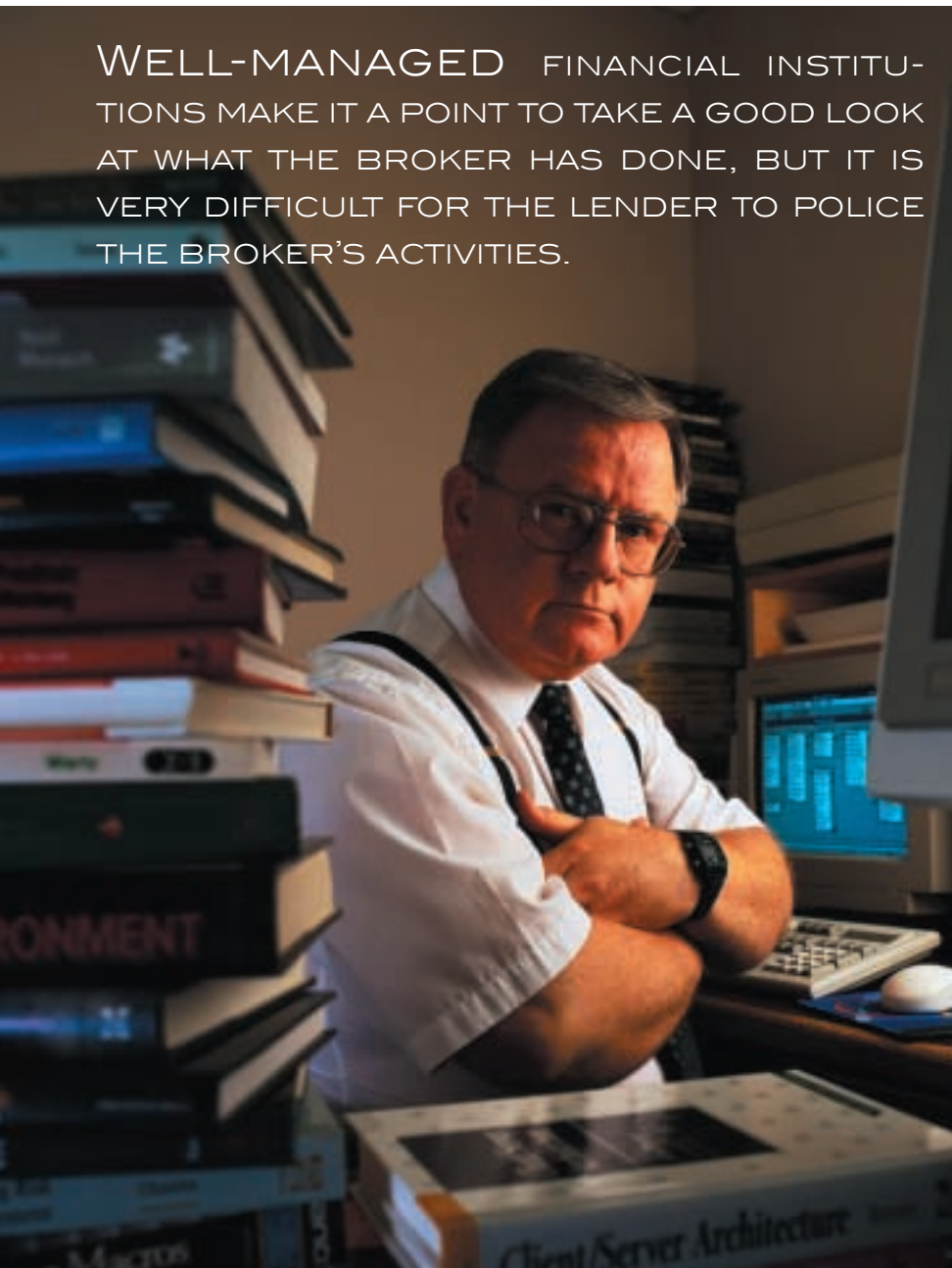
to deal with problems – some of them potentially huge.

Lenders need to seek assurance that scoring representations accurately reflect their applicants' scores, particularly when the score drives the approve/deny decision, but also when it results in a loan pricing or product steering decision and, ultimately, when it impacts broker or lender compensation, even indirectly. Aside from scrutinizing documents, lenders should require brokers to provide copies of all credit reports and scoring information generated for a mortgage application. Lenders should also require copies of all loan applications generated. The final application that the borrower sees, but may not read, at closing may bear little resemblance to the representations of the broker and borrower from start to end of the transaction.

The lender may be restricted under his/her correspondent agreement from making direct contact with a mortgage applicant. However, the broker should be willing to encourage lender contact to learn the applicant's understanding of the lending process, rather than lose all of that lender's business and see the borrower damaged along the way. A short post-closing lender survey completed by the borrower can be a useful evaluation tool for lenders. The purpose is to identify deals closed under some duress or involving fees and terms that the borrower did not understand or agree to, and to isolate these to particular brokers. These issues are best dealt with before the borrower is in default or sitting in the office of his or her congressional representative.

The vast majority of financial institutions manage their mortgage broker relationships in an acceptable manner, as we have found from years of regular compliance examinations. Our more recent and detailed inquiry into the ability of

WELL-MANAGED FINANCIAL INSTITUTIONS MAKE IT A POINT TO TAKE A GOOD LOOK AT WHAT THE BROKER HAS DONE, BUT IT IS VERY DIFFICULT FOR THE LENDER TO POLICE THE BROKER'S ACTIVITIES.



financial institutions to steer clear of predatory lending practices while working through independent brokers and seeking fee income has both reinforced the observation that the industry is doing a good job and highlighted some new concerns. That credit scoring and improved access to individual credit information has added speed and reduced cost is generally accepted. What has been done with that new information remains an open question for both lenders and regulators.

KATHLEEN MULLER HOPE HOMEOWNERSHIP CENTER

The use of credit scoring alone does not ensure that low-cost credit remains available to persons who could qualify for it. Lenders should always have multiple criteria to balance or offset shortfalls in a person's credit score, which could be reduced by a hesitancy to use credit at all. For example, if a customer scores 10 to 25 points less than the minimum score determined to be necessary for loan qualification, but they have three or more years on the job, that strength of character could offset the low score. In addition, third-party mortgage brokers who do not try to look at credit scoring in a flexible way – such as looking at work history – and rely on poor scores without honest subjective analysis, may benefit from higher-cost loans.

During a recent training session in Evansville on “Predatory Lending: A Professional Alert” for brokers, appraisers, inspectors, title agents – all those who deal with the consumer along the path to getting a mortgage – Nick Tilima of Education Resources suggested, “Most consumers who contact a mortgage broker expect the broker to arrange a loan with the best terms and at the lowest possible rate. Most mortgage brokers do just that, and charge a reasonable fee for their services. However, in the subprime market, there are mortgage brokers who do just the opposite. That is, the broker will attempt to sell the borrower on a loan with the most fees and highest rate possible so that the broker will get more compensation. Some of these brokers may charge fees of 8 to 10 points. In addition, the bro-

ker may get additional compensation from arranging a higher-than-necessary interest rate for the consumer. For example, the consumer may qualify for an eight percent interest rate, but if the broker can sell the consumer a nine percent rate, he can keep the differential.” To address this issue, standardized fee schedules would go a long way toward ensuring fair lending to individuals with lower credit scores.

Brokers and lenders also should be aware that high credit scores do not necessarily mean a loan is guaranteed. What may have generated the score to begin with – the ability to handle many credit lines on a timely basis – enhances most credit scores. However, the lender is ignoring the fact that multiple obligations also burden the person's ability to repay a new debt.

Since lenders and brokers may take advantage of a consumer's lack of knowledge or poor credit rating to charge high interest rates and hidden fees, disclosure and pre-loan education are a must. At a minimum, everyone should be required to have some sort of education before buying or refinancing a house. Consumers would be well advised to address the credit problems that keep them from being considered for a prime loan; but if they cannot correct these problems, they should be aware of the availability of subprime loans that are not predatory.

ALEXANDER C. ROSS DEPARTMENT OF JUSTICE (RETIRED)

To ensure compliance with fair lending laws, it is essential that the broker be fully informed of the lender's underwriting criteria. Further, whenever credit scores are affected by information gathered by the broker, the broker must do as good a job as the lender in documenting the borrower's qualifications.

When credit scores are used to accept or deny a loan application, the broker's obligation is the same as it would be with manual underwriting. If the broker (a) fails to obtain documentation or (b) screens out applicants without adherence to the same processes the lender uses with its direct

applicants, both broker and lender are headed for trouble.

When credit scores affect pricing, the broker must depend on full and accurate use of the lender's pricing criteria in order to avoid surprises and legal problems. For example, if the broker thinks it is presenting a “B” quality loan and has priced it with the borrower accordingly, the deal may not work if the lender prices it at “B-.” On the other hand, if a broker knows the borrower has “A” credit but places the loan with a subprime lender at an unnecessarily high price in order to increase the broker's profit (when that lender would accept higher broker fees), the broker risks involving itself and the lender in deceptive practices, Real Estate Settlement Procedures Act violations, and, if members of protected groups are adversely affected, possible violations of the fair lending laws.

This concludes the third installment in our series. The Federal Reserve System's Credit Scoring Committee thanks the respondents for their participation. The fourth installment will deal with the level and consistency of assistance provided to prospective borrowers in the loan application process, and the degree to which applicants are informed about credit scoring in the mortgage application and underwriting process.

