Spring 2002
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this issue:

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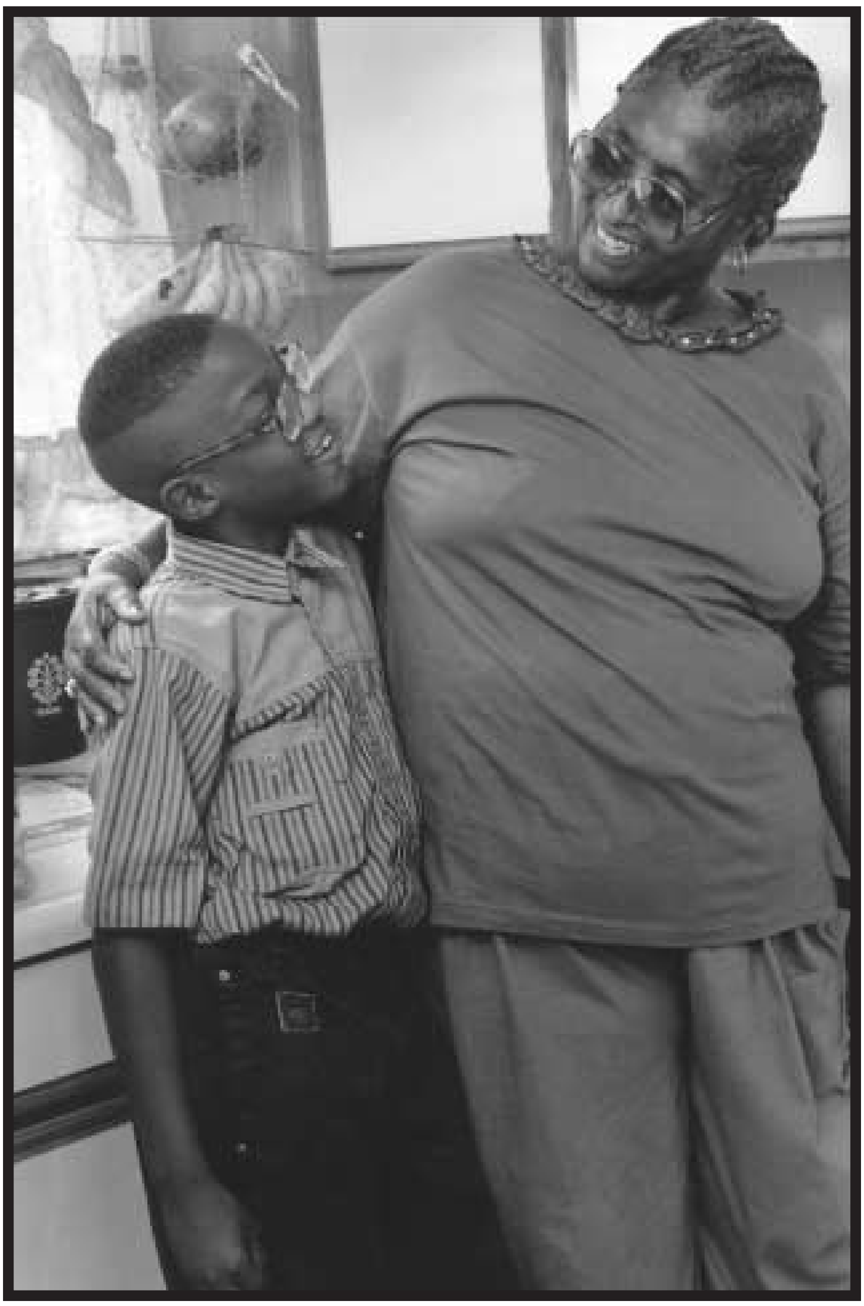
Mind the Gap

Grandparents raising Grandchildren


Janet Woodcock

Boston's GrandFamilies House, the first housing in the nation developed specifically for grandparents raising grandchildren, is a special model for a special population. On March 20, 2002, legislation to encourage development of similar projects was introduced to the U.S. House of Representatives.

by Kristin Kanders

Beatrice Allen is among a growing population of grandparents putting retirement dreams aside for parenting realities. Her plans for relaxation and travel dissipated when she decided to take in and raise her four great granddaughters who range in age from 4 to 14 years old. But the 64-year-old Allen, who has raised the children full-time for eight years, is happy to provide an alternative to foster care.

Since 1998, Allen's family has lived in the GrandFamilies® House, the nation's first housing development designed for the needs of grandparent-grandchild families.[1] Located in Boston's Dorchester neighborhood, GrandFamilies House is an apartment building that provides affordable housing and social and educational activities for 26 grandparent-headed families. It came into existence because three local nonprofit organizations, Boston Aging Concerns – Young and Old United (BAC – YOU), YWCA Boston, and the Women's

Winslow Martin

Institute for Housing and Economic Development, wanted to address the particular problems faced by a growing demographic of “skipped generation” families.

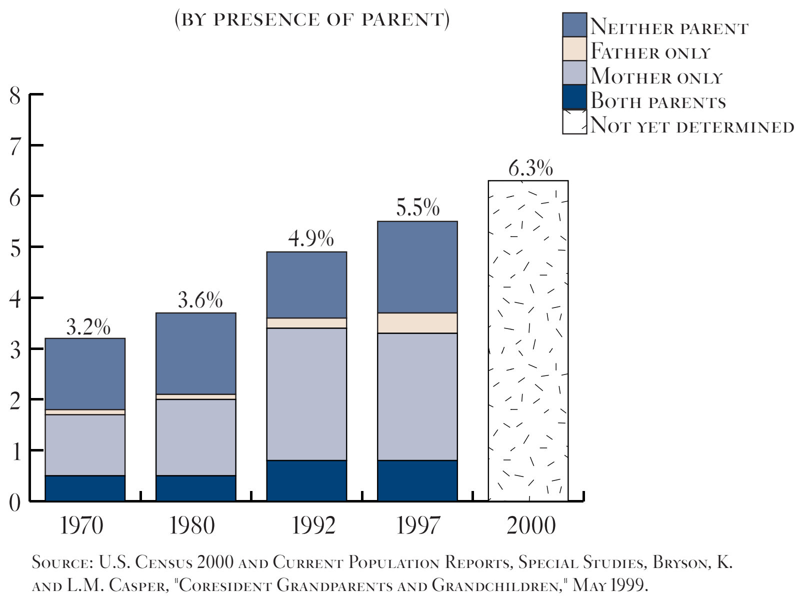
Trends and Challenges

Grandparent-headed families, especially grandparent-headed families lacking parents, began attracting attention during the 1990s when their numbers significantly expanded. According to the U.S. Census, families headed by both grandparents and no parents rose by 31 percent from 1990 to 1997; grandmother-only families increased by 27 percent. Grandparent-headed families with parents present grew slower at 13 percent. Likewise, the percent of children living in their grandparents' homes without parents grew during this time (see chart below).

The increase of grandparents raising grandchildren has been attributed to the crack-cocaine epidemic, AIDS, and incarceration.[2] Grandparents may become responsible for their grandchildren for other reasons as well, such as parental death or neglect. Children raised by their grandparents, rather than their parents, are more likely to be poor, live in the inner city, lack health insurance, and suffer health problems such as hyperactivity, poor eating and sleeping patterns, and asthma.[3]

U.S. Children in Grandparents' Home

(by presence of parent)



Source: U.S. Census 2000 and Current Population Reports, Special Studies, Bryson, K. and L.M. Casper, "Coresident Grandparents and Grandchildren," May 1999.

At the GrandFamilies House in Dorchester, almost all of the families are headed by single grandmothers, a demographic that fares worse, according to the U.S. Census, than any other grandparent-headed household. While most grandparents who are responsible for their grandchildren are married and not poor, nearly 60 percent of grandmothers solely raising their grandchildren in 1997 were poor; just over one-half described their health as “fair” or “poor,” and nearly one-half had not completed high school. Grandmothers single-handedly raising their grandchildren also tend to be black (54 percent) whereas other grandparent-grandchild households are primarily white.

The emotional pressures grandparents and grandchildren face in these situations are tremendous. First, both generations are coping with parental loss because either the parent has died, or because the parent can no longer take responsibility. For many children whose parents are alive, feelings of parental loyalty conflict with the desire to adjust to life with their grandparent. Second, some children's situations are exacerbated because they have been subjected to neglect or abuse, sometimes in utero.

Barbara Abraham, who runs a support program for grandparents raising grandchildren at the Consultation Center in New Haven, Conn., says nervousness about the new situation can be pervasive among grandparents and grandchildren alike. She adds that some grandparents harbor doubts about their parenting skills while others are not sure they have the energy, having already raised their own children. These stresses have been documented by researchers, who note that grandparents raising grandchildren are twice as likely to be clinically depressed as grandparents without parenting roles.[4] To mitigate some of these challenges, Abraham says grandparents need support, respite, education, and "solid information about benefits."

Logistic, economic, and legal issues can also prove burdensome. Many grandparents who take in grandchildren may need to find new housing, either to accommodate the larger family size or because they are no longer permitted to live in senior housing. They may have difficulty paying for housing due to unanticipated caregiving expenses. Similarly, grandparents who work in the labor market may find that their increased family responsibilities prevent them from working outside the home. Grandparents who are not legal guardians for their grandchildren — because they hope the parent will someday be able to reassume responsibility — often encounter difficulties enrolling grandchildren in school and health insurance. Indeed, over one-half of children living in dual-grandparent, no-parent households lack health insurance.[5]

Customizing a Supportive Environment

Shuttered for 20 years, the onetime nursing home at 214 Harvard Street was a neighborhood eyesore before it opened as the GrandFamilies House. Now, says Stephanie Chacker of BAC – YOU, it is a community asset. The four-story brick and clapboard building houses 26 families plus a live-in house manager, and the facility is customized for young and old. Safety features such as electrical outlet-covers and grab bars in the showers protect both age populations. Laundry facilities on each floor ease household chores, and the elevator makes delivering children to the in-house preschool and after-school programs run by the YWCA Boston simple. (The average age of grandparents at GrandFamilies House is in the low 60s.)

> When children arrive at the colorful play areas and classrooms, grandparents take MUCH-NEEDED respite.

A highlight of GrandFamilies House is that it is not just an apartment building; it also provides residents with educational and social activities. In the lower level, YWCA Boston leases 4,000 square feet of space for its preschool and after-school programs. An adjacent computer lab is home to the YWCA's computer-focused program that encourages intergenerational education. These programs, plus the parenting and arts and crafts classes available to grandparents, are called Generations Learning Together. But most of the time, when children arrive by elevator at the colorful classrooms and play areas, grandparents take much-needed respite. The YWCA even serves breakfast, lunch, and dinner to children enrolled in programs — the costs of which are reduced by fundraising, child-care vouchers, and a sliding fee scale. (Meals are provided by the

Janet Woodcock

Grandparent-as-Parent Figures

2.4 Million Grandparents Are Primary Caregivers for their Grandchildren

19% Are in Poverty
36% Have Been In Charge for 5 or More Years
57% Were in the Labor Market During the Previous Year
73% Are Married

Source: U.S. Census 2000 Supplementary Survey

Greater Boston Food Bank.) During summer months, nearly all children are involved in organized programs.

With 49 children (20 of them teenagers) living under one roof, life at GrandFamilies House could potentially be a loud and hectic experience. To prevent this from happening, BAC – YOU employs a full-time resident services coordinator. Through the coordinator, outside speakers, such as those from the Roxbury Defender's Office, are booked to address groups of teens and other age groups. A LISC AmeriCorps member serves as a youth coordinator, helping children with homework and other issues. Teen and GrandFamilies House resident councils also take charge to plan events, field trips, and holiday festivities. As Chacker describes, GrandFamilies House aims to be a "housing community, not just a housing complex."

In addition to the numerous services available onsite, BAC – YOU also arranges for a social worker from Parents' and Children's Services to visit the House three times a week to assist grandparents in navigating systems such as foster care, juvenile court, and social security. A child psychologist also visits with residents. To facilitate residents' transportation needs, the GrandFamilies van shuttles teenagers to weekend movies and grandparents to the grocery store; it also makes special trips for cultural outings and family events like the circus.

From a Shell To a Home

Through a survey commissioned by BAC – YOU in 1994, the nonprofit learned that a major issue challenging grandparent-grandchild households was finding appropriate and affordable housing. There were no models to follow, but BAC – YOU, which develops intergenerational housing to strengthen communities, wanted to address the need.

Together with the Women's Institute for Housing and Economic Development, the nonprofits spent a couple of years pulling together financing for the $4 million renovation. Equity and debt financing was assembled from public and private sources including the U.S. Department of Housing and Urban Development (HUD), state housing funds, low-income housing tax credits, foundations, and a Boston bank. Anne Gelbspan of the Women's Institute for Housing and Economic Development explains that because future residents couldn't "afford the [development's] operating costs even if it were debt free," the nonprofits lobbied the Massachusetts Department of Housing and Community Development and the City of Boston to provide rent subsidies. After much negotiation, the two agencies agreed to a demonstration program whereby 100 tenant-based Section 8 vouchers were allocated for grandparents raising grandchildren.

When the GrandFamilies House opened in 1998, 24 of the 26 occupant families were using Section 8 rent vouchers (most of them newly acquired) to keep rent payments within 30 percent of their income. For most of the families, the move represented a major improvement. For example, eight of the families were previously homeless and eleven were spending more than one-half of their income on rent. Others were living in substandard housing or in housing that did not accommodate their health conditions, because of stairs or other inconveniences.


Before


After
Front View


After
Rear View

BAC – YOU

Future Developments

About a dozen other cities, according to Generations United, a national organization that promotes intergenerational policies and programs, are looking to create housing for grandparent caregivers. There are many barriers, however, to developing such housing, including incorrect information and, ironically, the Fair Housing Act. First, nonprofits working to develop GrandFamilies-type housing have encountered difficulties because there is a misperception that grandparents without legal custody do not qualify as "family" and, therefore, do not meet Section 8 eligibility requirements. Second, the Fair Housing Act prohibits using preference in allocating housing; this extends to specifying affordable housing for grandparents raising grandchildren.

To address these issues and to stimulate affordable housing development for a growing demographic, the LEGACY Act was presented on March 20, 2002 to the U.S. House of Representatives. The legislation, which stands for Living Equitably, Grandparents Aiding Children and Youth, was drafted by Generations United and introduced by Massachusetts Congressman Michael Capuano (D) and Maryland Congresswoman Connie Morella (R). The legislation encourages demonstration projects (though HUD's Section 8 and 202 programs) of GrandFamilies-type housing.[6] It also aims to increase awareness about the demographic of grandparents raising grandchildren.

Despite the obstacles facing organizations that want to develop GrandFamilies-type housing, Boston's Housing Authority is earmarking 15 units in its Franklin Field development for grandfamily households. The Buffalo, New York, municipal housing authority also set aside units for skipped-generation families within its public housing. In New Haven, Conn., the community organization Casa Otoñal is busy gathering financing to build a 30-unit housing development for grandparent caregivers. Preliminary designs, says Executive Director Patricia McCann Vissepo, call for 30 units with a mixture of townhouses and flats. The project, which has been in the planning since 1999, will be for grandparents 55 years and older who have low incomes and permanent custody of their grandchildren. Casa Otoñal has developed 107 units of housing and provides social services, primarily to the Hispanic community. Construction of the first housing in Connecticut for grandparents as parents, Casa Familia, is planned for early 2003.

Organizations looking to develop housing for grandparents raising grandchildren would be well served to read the reports produced by the Gerontology Institute of the University of Massachusetts – Boston about the GrandFamilies House. The reports detail the successes of the development and ways things might be better accomplished, considering a host of issues, ranging from grandparent selection to activity expectations to housing design. As the first such housing in the nation, GrandFamilies House has made waves, and public recognition of its achievements is swelling.

Multigeneration Households

Multigeneration households (of which grandparent-as-parent households are a subset) have been on the rise since 1970. They are still rare, however, at 3.7 percent of all households nationally. They are most common in areas with high concentrations of recent immigrants, unwed mothers, and expensive housing. In California, for example, over 5 percent of all households are multigenerational. States in New England, such as Vermont and Maine, have some of the lowest percentages of multigeneration households in the nation (see below).

Resources on Grandparents Raising Grandchildren

- U.S. Census: Reports and statistics of grandparents as parents, available at www.census.gov/population/www/socdemo/grandparents.html.
- AARP: Information for grandparents raising their grandchildren, www.aarp.org/grandparents.
- Generations United: National organization devoted to promoting intergenerational strategies, programs, and policies, (202) 638-1263, www.gu.org.
- Grand Parent Again: Support resources, www.grandparentagain.com.

Resources on GrandFamilies House

- Boston Aging Concerns – Young and Old United, (617) 266-2257, or e-mail, bacyou@mindspring.com.
- Reports by the Gerontology Institute of the University of Massachusetts – Boston are available online at www.geront.umb.edu.

Endnotes

1. GrandFamilies House is a registered trademark of BAC – YOU.
2. Minkler, M., 1998. "Intergenerational Households Headed by Grandparents: Demographic and Sociological Contexts." In Generations United (eds.) *Grandparents and Other Relatives Raising Children: Background Papers from Generations United's Expert Symposiums*. Washington, DC: Generations United.
3. Bryon, K. and L.M. Casper, "Coresident Grandparents and Grandchildren," Current Population Reports, U.S. Census Bureau, May 1999.
4. Minkler M, E. Fuller-Thomson, and D. Driver. 1997. "A Profile of Grandparents Raising Grandchildren in the United States." *The Gerontologist*, 37 (3), 406-411.
5. Bryon, K. and L.M. Casper, "Coresident Grandparents and Grandchildren," Current Population Reports, U.S. Census Bureau, May 1999.
6. In Massachusetts, the demonstration program of Section 8 vouchers (sponsored by the City of Boston and Mass. Department of Housing and Community Development) supported the project.

Multigeneration Household Percentages around the Nation

States with Highest		New England States		States with Lowest	
Hawaii	8.2	Connecticut	3.2	North Dakota	1.1
California	5.6	Maine	1.7	Iowa	1.6
Mississippi	5.2	Massachusetts	3.1	Minnesota	1.6
Louisiana	4.8	New Hampshire	2.2	Nebraska	1.6
Texas	4.8	Rhode Island	3.2	Vermont	1.6
		Vermont	1.6		

Source: U.S. Census 2000 Brief "Households and Families."

Home Price Appreciation in Low- and Moderate-Income Markets

by Karl E. Case and Maryna Marynchenko

At the turn of the millennium, fully two-thirds of American households were homeowners. In addition, through the middle of 2000, real home prices were rising in all but a handful of major metropolitan areas in the United States. In such a climate, the benefits of homeownership seem obvious. Owners whose property appreciates accumulate wealth, and most are protected from rising out-of-pocket housing costs by fixed or slowly adjusting mortgage rates. Renter households, on the other hand, are hurt by rising real rents, and they see the dream of homeownership becoming ever more elusive.

But is homeownership the solution for all? Clearly, there are periods of time and locations where owning a home has been a liability. Examples of substantial decreases in home values have occurred in recent years in Texas, New England, California, Alaska, and Hawaii. Homeowners are also leveraged, and a home purchase is the biggest investment that most households ever make. A household that puts 10 percent down to purchase a home doubles its money if the home appreciates 10 percent. That same household sees its investment wiped out if home prices fall 10 percent.

Clearly, home price appreciation is only part of the return to investing in a home. The bulk of the return to owning accrues to the owner household in the form of valuable housing services. In addition, there are costs to be considered. The physical structure must be maintained, and even with maintenance, systems become obsolete; property taxes must be paid; mortgage interest rates and origination fees vary with time and by borrower; heating bills and insurance costs can be substantial; and, of course, there may or may not be income tax advantages to owning. Nonetheless, whether or not home prices rise or fall over time will determine to a large extent whether the investment was a good one.

This article, which is adapted from a longer paper available from Harvard University's Joint Center for Housing Studies, shows that metropolitan area housing markets have exhibited substantial differences in their patterns of price appreciation. While some areas have experienced dramatic boom and bust cycles, other areas have experienced relatively steady appreciation. The article shows neighborhood level price changes (measured by zip codes) over a period of 17 years in three major metropolitan areas: Boston, Chicago, and Los Angeles. The three metropolitan areas do not represent a random sample of the U.S. housing market. In some ways they were chosen because their housing markets have behaved very differently over time. While the experiences in three metropolitan areas cannot be generalized to the nation as a whole, we believe much can be learned from studying patterns of price movement across neighborhoods within cities.

at right: Boston, Chicago, and Los Angeles —— the three markets discussed

Boston

Reinis Kanders

Chicago

Los Angeles

Appreciation in Boston, Chicago, and Los Angeles

The Boston market experienced a dramatic boom between 1983 and 1988, with home prices rising at a nominal rate (not adjusted for inflation) of 18 percent annually and at a real rate (adjusted for inflation) of 13.8 percent over the five-year period. During the Boston boom, the low-income portion of the market experienced the highest rates of appreciation. The bottom 10 percent increased at a nominal annual rate of over 20 percent, while the top 10 percent increased at a rate of 17.4 percent. What was remarkable and telling about the price increases in Boston was how uniform and widespread the phenomenon was. Over the period, the average house in eastern Massachusetts appreciated nearly 140 percent, while housing in the poorest 10 percent of zip codes increased more than 165 percent. As a result, over $100 billion was added to household net worth over the five-year period.

Figure 1 House Appreciation in Boston
Low-End versus High-End Markets

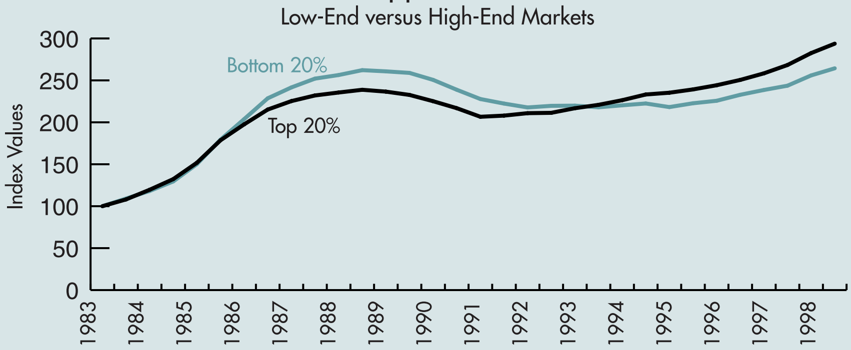


Figure 2 House Appreciation in Chicago
Low-End versus High-End Markets

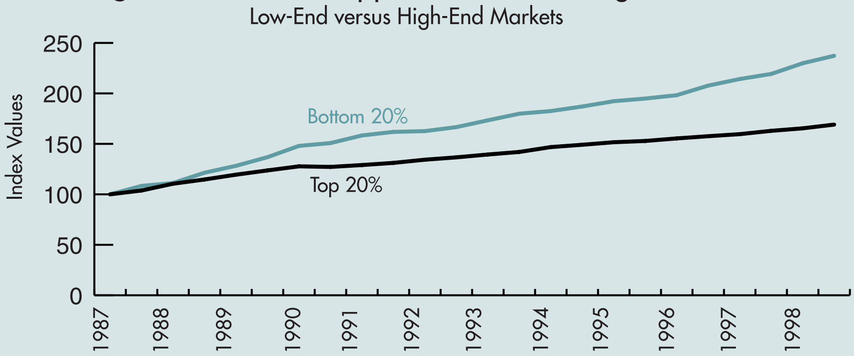
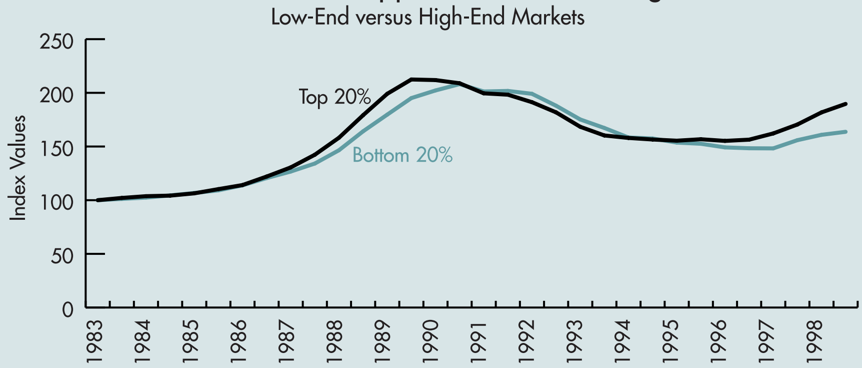


Figure 3 House Appreciation in Los Angeles
Low-End versus High-End Markets



Note: Figures 1 through 3 show nominal values.

Over the next four years, however, Massachusetts and New England as a whole experienced a severe recession. Homeowners who bought near the peak in late 1988 experienced substantial declines in value. In real terms, the total decline was close to one-third. Finally, prices turned around early in 1992 and rose steadily through the end of the observation period in 1998. During this period, the high end of the market substantially out-performed the low end. Nominal price increases in the highest income group of zip codes were three times greater than price increases in the lowest income group of zip codes. In fact, in the bottom decile, real prices actually declined at a rate of 0.5 percent annually over the six-year period.

Figure 1 shows the pattern for the entire period for the top and bottom quintiles. Over the entire boom-bust-recovery cycle, the high-end market did somewhat better than the low-end market but the differences were relatively minor. The highest quintile appreciated in real terms at a rate of 3.7 percent annually; the lowest quintile appreciated in real terms at a rate of 3.0 percent annually.

In Chicago, the pattern is completely different (see Figure 2). Real rates of appreciation were generally steady. Between 1987 and 1992, as in Boston, the top end of the distribution lagged the bottom. The same pattern continued although at a somewhat slower rate between 1992 and 1998. Overall, for the eleven-year period, the poorest neighborhoods did substantially better than the more wealthy neighborhoods. Real appreciation averaged 5.1 percent annually in the bottom decile while averaging only 1.4 percent annually in the top decile.

Los Angeles experienced a substantial boom between 1983 and 1990. The pattern of appreciation was remarkably uniform; virtually all of the 109 zip codes appreciated at approximately the same rate. Between 1990 and 1993, real home prices declined by more than one-third in Los Angeles with the largest drop occurring at the high-end of the distribution. Between 1993 and 1998, home prices in all but the top quintile stagnated in real terms.

Figure 3 shows the pattern in Los Angeles for the top quintile and bottom quintile over the 15 years.

During the first seven years of the cycle, top and bottom quintiles experienced similar booms; during the bust, the low-end fell the least; over the last five years of the observation period, the high-end did somewhat better than the low end.

To summarize, while substantial differences in the pattern of home price appreciation and depreciation can be observed across time and across the three metropolitan areas, by and large, lower-income neighborhoods have done reasonably well in comparison with higher-income areas of the same cities.

Equity Accumulation in Boston, Chicago, and Los Angeles

Next, we designed an experiment to estimate the potential wealth accumulation of ownership during different time periods in the three metropolitan areas (see sidebar on page 12). Figures 4 through 6 show equity buildup, assuming an 80 percent mortgage, for the median homebuyer in the top and bottom deciles of zip codes who purchased a home in one of the three markets in 1987.

For example, the median value of houses in the top decile of zip codes in Boston was estimated to be $390,642 in 1987. A household purchasing that house in 1987 would begin with equity of $78,028. By 1991, that equity would have fallen by nearly 40 percent to $48,889. By 1995, however, the household equity would have risen to over $100,000, and by 1998 to nearly $200,000. At the other end of the income distribution, the median value of houses in the bottom decile in Boston was estimated to be $59,426 in 1987. A household purchasing that house would begin with equity $11,885. By 1991, that equity would have eroded to $9,630, and by 1995 it would stand at just $5,518. Finally, by 1998, the investment would have increased to $13,323, producing a nominal leveraged rate of return of just 1 percent.

In Chicago, rates of appreciation have been more steady, and lower-income neighborhoods have consistently outperformed higher-income neighborhoods. Equity would have grown at 14.2 percent annually at the high-end, but equity growth in the lowest decile averaged over 20 percent annually.

Figure 4 Equity Buildup in Boston
Home Purchase in 1987

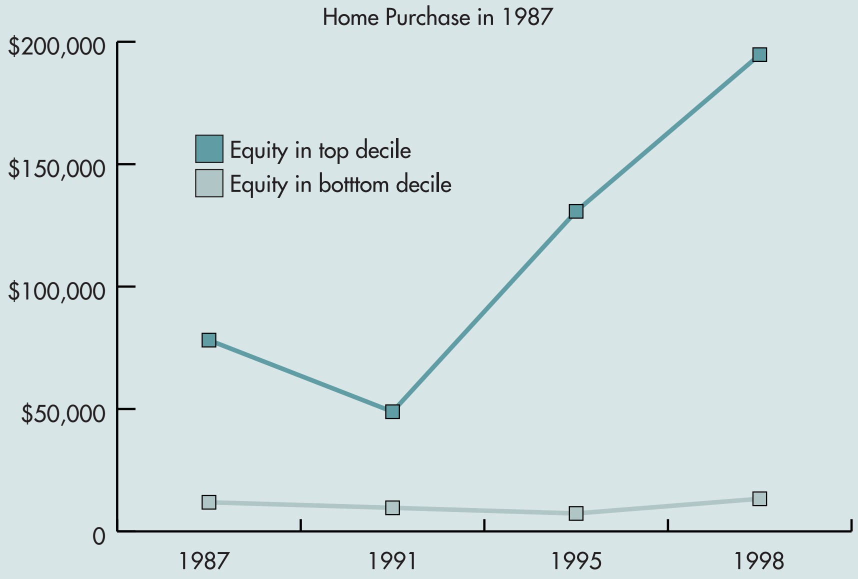


Figure 5 Equity Buildup in Chicago
Home Purchase in 1987

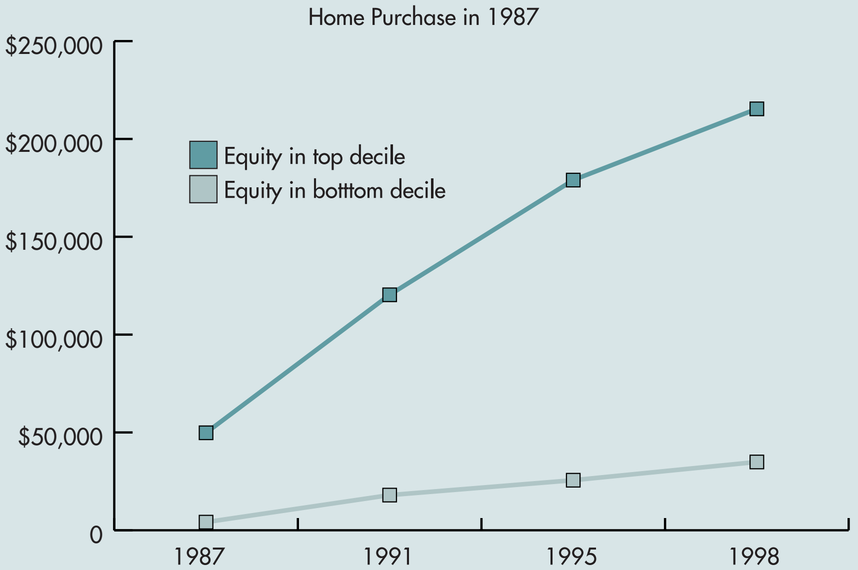
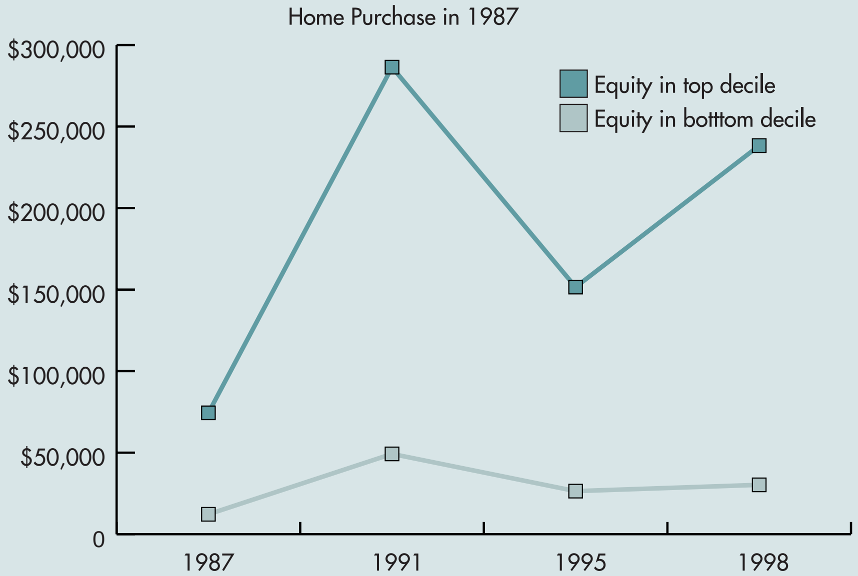


Figure 6 Equity Buildup in Los Angeles
Home Purchase in 1987



Where the Numbers Come From

Broad Trends of Home Appreciation

The patterns of change in home value described in the article are estimated with repeat sales price indexes. Case-Shiller weighted repeat sales indexes were used where available. In addition, the Office of Federal Housing Enterprise Oversight (OFHEO) makes available state level repeat value indexes produced using Fannie Mae and Freddie Mac data. While OFHEO uses a similar index construction methodology, their indexes are in part based on appraisals rather than exclusively on arms-length transactions. Case-Shiller indexes are estimated only with arms-length transactions and use controls, to the extent possible, for changes in property characteristics. Nonetheless, to capture broad movements over long time periods, the indexes tend to track each other quite well.

On average, house prices in the United States have risen 137.8 percent since 1980, while prices in general (measured by the consumer price index) increased 105.9 percent. In addition, house-price increases have exceeded inflation in eight of the nine census regions. Over 20 years, the largest increases have been in New England, the Mid-Atlantic, and the Pacific regions. Only in the West South Central region have house prices fallen in real terms since 1980. During the last year and the last five years, real house prices have increased in all nine census regions.

Comparing Poor and Wealthy Neighborhoods Within a City

To explore appreciation variations within a city, we used zip code level indexes produced by Case Shiller Weiss Inc. We also used the 1990 Census to break the zip codes into groups based on income. This allowed us to compare appreciation among the wealthiest 10 percent of zip codes and the poorest 10 percent of zip codes.

A total of 428 indexes were available from the three metropolitan areas chosen. The Boston data are made up of 235 zip code indexes with observations between the first quarter of 1983 and the second quarter of 1998. The Chicago data represent 84 zip codes with observations between the first quarter of 1987 and second quarter of 1998. The Los Angeles data contain information on 109 zip codes between the first quarter of 1983 and the second quarter of 1998.

Estimating Equity Accumulation

For the second part of the article, we estimated median home value for each zip code grouping from the American Housing Survey. The data contain cross-tabulations of house value and income, which were smoothed together using economic formulas. The most recent releases of data were for 1993 in Boston and 1995 in Los Angeles and Chicago; these figures were then inflated/deflated with Case Shiller Weiss zip code indexes back to 1987 and forward to 1998.

During the same period, a 1987 Los Angeles homebuyer with an 80 percent mortgage would have experienced quite a ride. In the top and bottom deciles between 1987 and 1991, equity roughly quadrupled. For the same homebuyers, the gains from the boom were roughly cut in half by the bust. Gains in equity over the last three years of the observation period in Los Angeles were largely concentrated in the upper-income brackets.

Conclusion

Despite the complex pattern of house-price changes, several things can be concluded. First of all, whether homeownership is a good or bad investment clearly depends on the time of purchase, conditions in the regional economy, and the dynamics of supply and demand at the local level. Second, since home purchase is almost always leveraged, particularly among low-income households, effects of price changes on equity accumulation over particular periods of time can be dramatic.

Among low-income households, homeownership has been an excellent vehicle for asset accumulation since the early 1980s in Boston. The same can be said for low-income homebuyers who purchased in Chicago in 1987 and for homebuyers who purchased in 1995 in any of the three cities. However, significant periods of decline have led to substantial losses for low-income households in Boston and Los Angeles.

Clearly from these data, one cannot conclude that homeownership for low-income households is in general a good or bad strategy for accumulating wealth. As we argued above, home appreciation is but one component of the overall return to an investment in housing. But appreciation is an important component, and the results presented here are at least somewhat encouraging.

About the Authors

Karl E. Case is the Katherine Coman and A. Barton Hepburn Professor of Economics at Wellesley College where he has taught for 25 years. He is also a visiting scholar at the Federal Reserve Bank of Boston. He is a founding partner in the real estate research firm of Case Shiller Weiss, Inc. and serves as a member of the Boards of Directors of the Mortgage Guaranty Insurance Corporation (MGIC), Century Bank, The Lincoln Institute of Land Policy, and the New England Economic Project.

Professor Case received his B.A. from Miami University in 1968, and his Ph.D. in Economics from Harvard University in 1976. He is author or co-author of five books including *Principles of Economics*, *Economics and Tax Policy*, and *Property Taxation: The Need for Reform*, and has published numerous articles in professional journals. For the past 15 years, his research has focused on real estate markets and prices. He has authored several studies that attempt to isolate the causes and consequences of boom and bust cycles and their relationship to regional economic performance.

Maryna Marychenko is a research analyst with Analysis Group/ Economics in Boston. She was a 2000 graduate of Wellesley College in Economics.

Updating Home Mortgage Disclosure Act

by Carol Lewis

The Federal Reserve Board approved revisions to Regulation C and its Official Staff Commentary at its meeting on January 23, 2002. Regulation C, which implements the Home Mortgage Disclosure Act (HMDA), annually requires certain lenders to collect, report, and disclose data about loan originations, purchases, and refinancings of home purchase and home improvement loans. HMDA's purpose is threefold. First, HMDA provides the public with data to show whether financial institutions are serving the community's housing needs. Second, the Regulation helps public officials target public investments to areas where they are needed (thereby attracting private investment); and third, it provides data about borrowers that can be used to identify discriminatory lending patterns or practices.

Lenders will be required to report information on loan pricing. . . . in response to subprime lending

The Board imposed several changes to Regulation C to improve the integrity and usefulness of the HMDA data and to streamline the Regulation. Specifically, the Board's intent was to improve the data in order to facilitate fair lending analysis and provide more accurate information regarding the home mortgage market and subprime lending. In its review of the proposed amendments and comments received, the Board weighed the benefit of the regulatory changes against the burden they would impose on lenders.

In general, the amendments increase the number of nondepository lenders required to collect and report data, impose additional data reporting requirements, including reporting pricing data on higher-cost loans, and revise several regulatory definitions. The amendments will become effective January 1, 2004.[1]

Expanding Coverage

The Board expanded the Regulation's coverage of nondepository lenders to provide the public with more complete information on the mortgage market. Regulation C covers two categories of financial institutions: depository institutions and for-profit nondepository lenders engaged in mortgage lending. Under the current Regulation, in general, a nondepository mortgage lender is covered if, in the preceding calendar year, its home purchase loan originations, including refinancings of home purchase loans, equaled or exceeded 10 percent of its total loan originations and its total assets are over $10 million. The Board noted that there are nondepository lenders that originate a large number of reportable loans, but are not covered by the Regulation because they have a significant amount of lending in other areas. Under the revised Regulation, the Board added a dollar volume test of $25 million. A nondepository lender will be covered by Regulation C if its prior year home purchase loan originations, including refinancing of home purchase loans, equals or exceeds the threshold amount, even if those loans do not equal at least 10 percent of the institution's loan-origination volume, measured in dollars.

Additional Data Reporting Requirements

The revised Regulation contains several changes with regard to the compilation of loan data. Lenders will be required to report information pertaining to loan pricing. This revision is in response to the substantial growth in subprime lending and the increased variation in loan pricing and its relationship to the assessment of credit risk.

The Board's original proposal would have required lenders to report and disclose the annual percentage rate (APR), as determined by Regulation Z, Truth in Lending, for all loan applications and originations. Under the final rule, lenders will report the rate spread between the APR on a loan and the yield on Treasury securities with comparable maturity periods, for loan originations in which the APR exceeds the applicable Treasury yield by a percentage or threshold specified by the Board. The Board concluded that this approach would adjust pricing data for changes in market conditions over time, focus on higher cost (subprime) loans, and limit reporting burden because fewer loans would be subject to the reporting requirement.

The Board has set tentative thresholds of 3 percentage points for first lien loans and 5 percentage points for subordinate lien loans. The Board sought public comment by April 12, 2002 to determine the appropriateness of these thresholds. It will announce its decision via a press release.

Lenders will only be required to report this information for originations of home purchase loans, secured home improvement loans, and refinancings. This reporting requirement does not apply to incomplete, withdrawn, denied, or approved (but not accepted) applications. It also does not apply to purchased loans and unsecured home improvement loans.

The amended Regulation will also require lenders to identify loans involving manufactured housing. HMDA reporters will refer to the U.S. Department of Housing and Urban Development definition of manufactured homes to determine whether a loan should be reported as such. If the lender does not reasonably know whether the loan is for a manufactured home, and cannot determine through reasonable means, the lender will report the property type as a one-to-four family dwelling. The Board believes that identifying applications and loans for manufactured housing will improve the integrity of HMDA data because manufactured housing loans are underwritten differently from other housing loans and have higher denial rates.

Additional Amendments

• The revised Official Staff Commentary redefines a home purchase loan to include a second mortgage loan that finances all or part of the borrower's down payment for the first mortgage. The first and second mortgage are reported separately as home purchase loans.

• The Loan Application Register (LAR) will have separate entries for loan purpose and type of property involved.

• The Board deleted the provision that permits, but does not require, depository institutions with assets in the preceding year of $30 million or less to collect data on applicants' race, ethnicity, sex, and income.

• The term metropolitan statistical area (MSA) will be replaced with "Metropolitan Area," a term used by the Office of Management and Budget.

• The term "dwelling" has been further clarified in the Official Staff Commentary to exclude transitory residences such as hotels, hospitals, and college dormitories, whose occupants have principal residences elsewhere.

• The revised Staff Commentary clarifies that an institution must report a denial on the original terms requested by the applicant when the institution makes a counteroffer and the applicant does not accept the offer or does not respond.

The revised Regulation will require lenders to report certain requests for preapprovals of home purchase loans. A preapproval is deemed an application (and therefore reportable) if the lender completes a comprehensive credit check and issues a written commitment to the applicant that extends a home purchase loan for a designated period of time. The covered preapproval may be subject only to a limited set of conditions as set out in the regulation.

Lenders will be required to report preapproval denials as well as originations.[2] The Board is including denials in order to provide more complete data on home financing availability and more useful data for fair lending analyses. Lenders have always been required to report preapprovals that resulted in loan originations. The preapprovals, however, were indistinguishable from other loan originations. The revised Regulation will require lenders to enter a separate code for preapprovals resulting in originations.

Lenders may, but are not required to, report preapprovals that are approved but not accepted by the applicant. The Regulation has not changed with regard to prequalifications: prequalifications are not applications under Regulation C.

The Board is also requiring lenders to report the HOEPA (Home Ownership and Equity Protection Act) status of its loans. HOEPA provides special disclosure protections to consumers entering into certain high-cost mortgage loan transactions. While such information can be obtained from lenders during bank examinations, the Board felt that such data could be obtained more efficiently from the HMDA Loan Application Register (LAR). This amendment will also ensure that HOEPA status can be obtained from nondepository lenders that are not subject to regular examinations. This is important because nondepository lenders extended 57 percent of the dollar volume of loan originations reported under HMDA for year 2000.[3]

The Board revised Appendices A and B to conform collection of ethnicity and race data under Regulation C to Office of Management and Budget (OMB) guidance. The OMB recommended that the question of Hispanic ethnicity be posed separately from the question of race. The Board believes that it is important to have uniform standards throughout the federal government. Under the new system, the ethnicity and race questions posed for self-identification will be separate. For ethnicity, the data will show whether the applicant is Hispanic, Latino, or neither. In addition, there will be five racial categories: American Indian or Alaska native; Asian; Black or African American; Native Hawaiian or other Pacific Islander; and White. The applicant will no longer have the option of checking off "other" but will be able to select more than one category.

Definition Changes

Refinancings will continue to be reported under Regulation C, but the Board has tightened the definition. A refinancing is a transaction in which a new obligation satisfies and replaces an existing obligation by the same borrower. The present Regulation requires a lender to report refinancings of home purchase and home improvement loans and allows lenders to choose from four scenarios in deciding which refinancings to report. To promote more consistent data reporting among HMDA reporters, the Board has narrowed the definition of a reportable refinancing to those transactions in which both the existing and the new loan are secured by a lien on a dwelling. The definition will not include refinancings of unsecured debt.

The Board has also amended the definition of a home improvement loan. Under the current Regulation, reportable home improvement loans are defined as loans made in whole or in part for home improvement purposes and that are classified by the lender as home improvement loans. The amended Regulation removes the classification requirement for dwelling-secured home improvement loans. Dwelling-secured home improvement loans will be reported regardless of how the lender classifies the loan. The Board indicated that for dwelling-secured loans, it is not unduly burdensome for lenders to ascertain the intended purpose of the loan because of the documentation and the interaction already involved between the lender and applicant in a secured transaction. The lender may rely solely on the applicant's statements to determine the purpose of the loan. The Board, however, maintained the classification test for unsecured home improvement loans, recognizing the greater burden of determining the purpose for an unsecured loan. Lenders will not have to determine the purpose of every loan and can depend on their own classification systems: if the lender chooses not to classify the loans as home improvement loans, then they are not reportable.

This review of the changes to Regulation C is by no means all-inclusive. Readers should refer to the amended Regulation and the Official Staff Commentary for a more in-depth review of the changes to the Regulation. (The web address is: www.federalreserve.gov/regulations/regref.htm#c.) There may be further changes to the Regulation in the near future as well. When the Board announced changes to Regulation C in February 2002, it also requested public comment on three proposed changes to the Regulation. The first, as mentioned above, pertains to the appropriate threshold for collecting pricing data on higher cost (subprime) loans. The second proposal would require lenders to ask telephone applicants for their race, ethnicity, and sex. The final proposal would require lenders to report lien status for applications and originated loans. The comment period for these proposals ended on April 12, 2002 and the Board will issue a press release when it has decided whether to implement these changes. Readers who have questions regarding Regulation C or other Federal Reserve regulations are encouraged to call the Federal Reserve Bank of Boston consumer regulation hotline at (617) 973-3755.

Endnotes

1. A May 2, 2002 Board press release noted the delay of the effective date from January 1, 2003 to January 1, 2004. It also informed of an interim amendment mandating the use of 2000 Census data in HMDA reporting beginning January 1, 2003.
2. Regulation C continues to require that the financial institution collect data regarding applications for originations and purchases of home purchase loans, home improvement loans, and refinancings.
3. HOEPA is implemented in section 226.32 of Regulation Z.

About the Author

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A Number or a Person?

perspectives on credit scoring and fair mortgage lending

article four in a five-part series

THIS FOURTH ARTICLE IN THE CREDIT-SCORING SERIES FOCUSES ON ISSUES AT THE PERSONAL LEVEL. HOW CAN LENDERS AND CONSUMERS BE TRAINED TO PROVIDE FAIR SERVICES AND GET THE BEST DEAL FOR THEMSELVES? IN THIS ARTICLE, A CONSUMER CREDIT REGULATOR, BANK LENDER AND COMPLIANCE OFFICER, AND A COMMUNITY ADVOCATE SHARE THEIR PERSPECTIVES.

In the past, the terms "thick-file syndrome" and "thin-file syndrome" were used to describe the allegation that white and minority mortgage applicants received differing levels or quality of assistance in preparing mortgage applications. These terms were used primarily before the advent of credit scoring in mortgage lending. In the current mortgage-market environment, credit and mortgage scoring are used more frequently than judgmental systems; this means that the quality of assistance provided to applicants is even more important. Given the increased reliance on automated underwriting, this article addresses what lenders should do to ensure the following:

* The lending policy is strictly observed and that any assistance offered to loan applicants or prospective applicants to improve their credit score is offered equitably.
* Applicants have a clear understanding of the importance of their credit score to the approval and pricing processes.
* Staff training and oversight regarding credit policy and fair lending guidelines are adequate to provide consistent and fair treatment of loan applicants.

Article Series Background

Credit scoring is an underwriting tool used to evaluate the creditworthiness of prospective borrowers. Used for several decades to underwrite certain forms of consumer credit, scoring has become common in the mortgage lending industry only in the past 10 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 mission of the Federal Reserve System's Credit Scoring Committee is to publish a variety of perspectives on credit scoring in the mortgage underwriting process, specifically with respect to potential disparities between white and minority homebuyers. The introductory article of the series provided the context for the issues. The second article dealt with lending policy development, credit-scoring model selection, and model maintenance. The third article explored how lenders monitor the practices of their third-party brokers, especially for compliance with fair-lending laws, pricing policies and the use of credit-scoring models.

Contributor Backgrounds

William L. Lund is director of the Maine Office of Consumer Credit Regulation. A graduate of Bowdoin College and the University of Maine School of Law, he worked in private practice and with the Maine Attorney General's Office prior to assuming his current position in 1987. Mr. Lund has served as chair of the Federal Reserve Board's Consumer Advisory Council. He writes and speaks frequently on consumer law issues.

John M. Robinson III is the audit director/compliance officer and Community Reinvestment Act officer for Midwest BankCentre in St. Louis. Robinson has 16 years of banking experience with the last 10 in internal audit and compliance management. He is a graduate of Westminster College, of Cambridge University's master's program, and of the American Bankers Association's National Compliance School. He is chairman of the Missouri Bankers Association Compliance Committee and a board member and speaker on compliance topics for the Gateway Region Center for Financial Training.

Ken Dunlap is the loan processing manager/chief underwriter for Midwest BankCentre. Dunlap has 11 years of experience in mortgage underwriting, compliance, Home Mortgage Disclosure Act and Community Reinvestment Act reporting, and loan platform maintenance. He is a graduate of Southeast Missouri State University and has been with Midwest BankCentre for five years.

Josh Silver has been the vice president of research and policy at the National Community Reinvestment Coalition (NCRC) since 1995. He has a major role in developing NCRC's policy positions on the Community Reinvestment Act (CRA) and other fair-lending laws and regulations. He has also written congressional testimony and conducted research studies on lending trends to minority and working-class communities. These studies include NCRC's "Best and Worst Lenders," and a report on the performance of Fannie Mae and Freddie Mac in financing home loans for minority and low- and moderate-income borrowers. Prior to joining NCRC, Silver was a research analyst with the Urban Institute. He holds a master's degree in public affairs from the Lyndon B. Johnson School of Public Affairs at the University of Texas in Austin and a bachelor's degree in economics from Columbia University.

William N. Lund

Maine Office of Consumer Credit Regulation

As a regulator enforcing Maine's credit reporting laws, I have tried to learn as much as I can about credit scoring. The ingenuity of the scoring models and the complexity of the applied mathematics are very impressive, and I have no doubt that use of such scores permits creditors to make fast decisions on consumers' applications. However, from the consumer's perspective, I harbor great concerns about the exponential growth in the use of such scores, not only for credit decisions, but also for seemingly unrelated charges such as automobile insurance premiums. I can summarize my concerns as follows:

Concern #1: Credit scoring has led to a "re-mystification" of the credit reporting system.

In 1969, during the debate on the original Fair Credit Reporting Act (FCRA), Wisconsin Sen. William Proxmire spoke of the congressional intent behind the law: "The aim of the Fair Credit Reporting Act is to see that the credit reporting system serves the consumer as well as the industry. The consumer has a right to information which is accurate; he has a right to correct inaccurate or misleading information, [and] he has a right to know when inaccurate information is entered into his file. . . . The Fair Credit Reporting Act seeks to secure these rights."

In other words, passage of the FCRA represented an effort to "de-mystify" the credit decisionmaking process. In the years since passage of the Act, consumers, creditors, and regulators have become relatively comfortable with the use of traditional credit reports.

However, I fear that the creation and use of credit scoring systems constitutes a step backward from the goals of the Fair Credit Reporting Act to make credit reporting data accessible, understandable and correctable, and to make credit reporting agencies responsive to consumers. In other words, just as the FCRA de-mystified the storage and use of credit information, credit scoring is now serving to re-mystify that process.

Concern #2: A double impact results when an error in the underlying data impacts a credit score.

The fact that a large percentage of credit report data is accurate is of little comfort to a consumer whose report contains harmful errors. If errors in the underlying data result in a low credit score, in effect the original error is compounded.

In addition, the consumer now finds himself twice removed from the actual problems. A credit-scoring system creates a new layer of data, and that new layer separates the consumer from the raw data. The system as a whole becomes less accountable to consumers. When the Federal Trade Commission ruled that credit scores were not "consumer reports" under federal law, score providers remained without legal responsibility to disclose the score, or even to notify previous recipients at the consumer's request.

Concern #3: Because there are so many different products, and because these products are ever-changing, consumers cannot be educated about common rules or standards.

Let's look at the current range of products: TransUnion has Emperica, Experian uses Experian, Fair Isaac and Equifax both offer Beacon. In addition, Fannie Mae has developed Desktop Underwriter, while Freddie Mac uses its Loan Prospector. Other lenders use Axion or Pinnacle.

Over the years, those of us who assist consumers with credit-report issues have managed to get our arms around the "big three," but it is much more difficult to make sense of the myriad variations on the credit-scoring theme.[1] Even something as simple as score values is very confusing: My files contain the statements of four different experts who describe the range of scores in the basic Fair Isaac (FICO) model as 300 to 900, 400 to 900, 336 to 843, and 395 to 848. If product offerings are such that the "experts" can't agree on basic information, how can consumers be expected to gain a meaningful understanding of the scoring process and its impact?

> Why can't reason codes be specific, as in, "The fact that your 1972 Pinto was repossessed in January results in a reduction of about 40 points from your score." Don't we have the technology to do that?

Concern #4: Reason codes. Everyone gets four generic codes, regardless if their scores are good or bad.

Reason codes are four numbers, found at the bottom of a credit-scoring report. They equate to generic reasons why the given score isn't higher. For example, on one basic FICO model, Code #28 means "Too many accounts"; Code #5 means "Too many accounts with balances"; and Code #4 means "Too many bank or national revolving accounts."

Four codes are provided, whether your score is 400 or 800. For those with great scores, four may be too many. For those with low scores, four may be too few. And why can't reason codes be specific, as in, "The fact that your 1972 Pinto was repossessed in January results in a reduction of about 40 points from your score." Don't we have the technology to do that?

In addition, some of the factors used to determine scores seem illogical on their face, the most obvious being the effect of closing existing, older, unused credit accounts. From most real-life perspectives, closing such accounts should be a good thing. From a scoring perspective, however, that action harms a score in two ways: First, it increases the ratio of used credit to available credit, by reducing the denominator of that fraction. Second, it decreases the average age of a consumer's credit lines, resulting in further score reduction.

As another example, industry sources have told me that a consumer gains points for doing business with established banks, but loses points for doing business with small-loan companies or check-cashers, even if payment histories are identical. In other words, there is good credit and bad credit, which may have more to do with a consumer's neighborhood and lifestyle than with an accurate prediction of the chances of future repayment.

And consider the advice that consumer advocates have given for years: Compare APRs and shop

If a consumer pays cash for purchases throughout his or her life, should that result in an increase in a consumer's auto insurance rate?

around for credit to get the best deal. Shopping around these days means piling up inquiries on one's credit report. Despite recent efforts within Fair Isaac-based models to discount groups of inquiries, the fact remains that numerous inquiries negatively impact credit scores. (In one basic FICO model, Reason code #8 translates to "Number of recent inquiries.")

The growing use of credit scores for noncredit decisions compounds the illogical results. For example, if a consumer pays cash for purchases throughout his or her life, should that result in an increase in a consumer's auto insurance rate? That has been the actual outcome when "thin" files result in low credit scores, which are subsequently (and legally) used by insurers to set insurance-policy premiums.

Concern #5: Creditors will likely begin to rely too heavily and exclusively on credit scores, despite "instructions" to the contrary. Creditors are busy, and underwriters are often not rewarded for taking risks. The logical outcome will be a dependency on credit scores and a reluctance to look to a broader picture. What was introduced as a tool expressly to be used in balanced conjunction with other criteria, is quickly becoming a litmus test. To quote Chris Larsen, CEO of online lender E-Loan: "Lenders are increasingly relying on these scores. Many loan products, including some home equity loans and auto loans, are based almost entirely on your FICO score."

Conclusion
Many aspects of the credit scoring process have now gotten ahead of the ability of consumers to make sense of the system, and of regulators to meaningfully assist those consumers. Providers of credit scores should be required to share responsibility for ensuring the accuracy of the underlying data, for correcting that data, and for disseminating the correct information if requested by the consumer. Despite repeated assertions by the industry that credit scoring is not a mysterious black box, the lack of any uniformity, oversight, or accountability makes that analogy too close to the truth.

John M. Robinson III and Ken Dunlap
Midwest BankCentre

Lending policies must be observed to ensure sound financial business decisions and to avoid any potential disparate treatment of applicants.[2] At the same time, policies must allow lenders to evaluate individual credit needs and varying applicant scenarios. Lenders must be conscious of nontraditional applicants for whom relaxed underwriting may be key in obtaining a loan. For example, Midwest BankCentre offers the Freddie Mac Affordable Gold "97" mortgage product for first-time homebuyers. This program, in contrast to many others, allows for a 3 percent down payment from any source, such as a gift.

How a mortgage credit decision is made is one of the two keys of potential discrimination. Prescreening is the other. Underwriting standards and policy adherence are very important. Allowing excessive overrides creates an atmosphere for potential discrimination. When a lender decides to override an established and proven underwriting decision, the reason is personal more times than not. Banks should have workable, clearly written policies and underwriting guidelines. Every lending decision should be fully and clearly documented, especially if a lender overrides a prescribed credit score and makes the loan. Lending institutions must give equal assistance to all applicants. To avoid problems with loan policy standards, the following steps should be taken:

* Review bank policies and procedures. Compare them with actual file reviews.
* Review all underwriting and credit score overrides. Look for patterns.
* Review loan files and denials for adequate documentation. Look at

all forms, documents, and disclosures in the files.

Generally speaking, the average mortgage applicant, especially the first-time home buyer, does not understand clearly how a credit score affects the mortgage outcome. Applicants who have never had a loan or a problem with a loan decision probably have never heard of a credit score. Knowing how to use a credit score involves knowing what is in the score and what it does and does not tell about the prospective applicant. Because the score is based on data provided by a credit bureau, applicants should be instructed on how to rectify any error or problem that appears on their credit bureau reports.

If a bank or creditor does not use a credit bureau service, then the applicant's credit history is not recorded. These scores do not reflect information such as the amount of down payment, income, cash flow, or other mitigating assets. The score is only part of the applicant's credit picture. Therefore, one may conclude that too much reliance on credit scores or on automated decisions could raise flags of disparate-impact issues.[3] In actuality, there may be many reasons why a low score would not be a negative in the bank's decision. For example, a large down payment or significant cash flow could justify overriding a low score. We do make loans to applicants who may not have stellar credit – Freddie Mac guidelines allow for A- offerings – but the interest rates are usually higher.

To ensure consistent and fair treatment of loan applicants, all lenders in the bank should know the products offered and always explain to prospective applicants the loan product choices and their associated potential costs. We need to take our responsibility to customers seriously. We earn the trust of customers by how we treat them.

Lenders using their own instincts instead of a score have a different perspective on customer relationships. When looking at the overrides in credit scores, management should look at the decisions made, by location and by whom (branch/lender). Management should look at patterns and at loans that have gone bad and compare them with any initial credit score. Self-testing and self-analysis with an eye on patterns and trends related to any disparity are vital to the organization.

Lenders should follow these two basic steps. They should disclose and explain any conditions for a product or service as well as the benefits of each one. And, they should offer the same product to everyone who has comparable qualifications.

To ensure fair and equal treatment of all customers in the application of our credit policies, Midwest BankCentre's compliance department holds annual mandatory fair-lending and diversity awareness training seminars for staff. The sessions are intended to generate discussion about how well employees understand fair-lending laws and issues of cultural diversity in the workplace. We use a video entitled "True Colors," the ABC News "Prime Time Live" telecast, and each attendee receives the booklet "Closing the Gap: A Guide to Equal Opportunity Lending," published by the Federal Reserve Bank of Boston. We have also used other videos from corVISION Media Inc., in particular, "Valuing Diversity at the Interpersonal Level." Participants complete and discuss a self-assessment checklist that underscores their own perceptions of understanding differences and adopting changes.

Being a community bank, we do not rely heavily on credit scoring; we still consider the individual borrower's overall credit reputation. Because we continue to have direct interaction with our applicants throughout the credit process, it is important that our mortgage lenders receive ongoing training in what constitutes fair and consistent treatment.

Josh Silver

National Community Reinvestment Coalition

All of us have credit scores, but most of us don't know what they mean. If we knew what they meant, would we be more likely to get approved for a low-cost loan? The answer is probably, but the disclosures of credit scores have to be meaningful if they are to be helpful to the borrower.

The National Community Reinvestment Coalition (NCRC) does not believe that credit scoring has revolutionized access to credit, and neither has the advent of subprime lending, for that matter. Instead, the strengthening of the Community Reinvestment Act (CRA) and the stepped-up enforcement of fair-lending laws have been the major forces behind the explosion of credit for minority and low- and moderate-income borrowers during the 1990s. Lenders made only 18 percent of their home mortgage loans to low- and moderate-income borrowers in 1990. The low- and moderate-income loan share surged 8 percentage points to 26 percent by 1995, but by 1999 it had climbed only 3 more percentage points, to 29 percent.

Let's review the major events coinciding with the big jump in lending during the first part of the 1990s and the major events during the lending slowdown in the second half. Congress mandated the public dissemination of CRA ratings in 1990 and the improvement of Home Mortgage Disclosure Act (HMDA) data to include the race, income, and gender of the borrower. In 1995, after a highly visible and lengthy review process during previous years, federal banking agencies strengthened CRA regulations to emphasize lending performance as opposed to process on CRA examinations. During the same time period, the Justice Department settled several fair-lending lawsuits with major lending institutions. After 1995, the mortgage industry widely adopted credit scoring, and subprime lending took off. Home mort-

How a mortgage credit decision is made is one of the two keys of potential discrimination. Prescreening is the other.

gage lending increased in the first part of the decade as policymakers strengthened and applied CRA and fair-lending laws. Lending slowed down in the second half of the decade; during this period, credit scoring and subprime lending were on the rise. Economic conditions played less of a role in the different trends in lending because we were blessed with a tremendous economic recovery during the entire 1990s.

The reason credit scoring was not responsible for the explosion of home-mortgage lending to low- and moderate-income borrowers is that credit scoring is not designed to serve those who have the least experience with the financial industry. Officials at one large bank NCRC interviewed for this article stated that they do not use credit scores in their approval decisions regarding special affordable-loan programs. They indicated that those people among the low- and moderate-income population who are targeted by special affordable-loan programs have low credit scores because they do not have much of a credit history. Instead, the bank uses nontraditional credit history, such as evaluating the timeliness of rent and utility payments. It is likely that CRA encouraged this bank to establish the special affordable-loan programs. For this large bank, and probably for many other banks, CRA has more to do with increasing lending to low- and moderate-income borrowers than credit scoring.

Why disclosure would help

While credit scoring has not had a noticeable impact on increasing credit to traditionally underserved borrowers, meaningful disclosures of credit scores would nevertheless help increase access to affordable credit. The optimal time for disclosure is before a customer applies for a loan. If a customer obtains a credit score and the major factors affecting that score before reaching the loan application stage, he would have a good idea of his creditworthiness. The customer would be in a better position to know if he was getting a good deal on the loan or whether to bargain with the lender.

The caveat is that a consumer must have a clear understanding of what the credit score is and what factors affected his score. The disclosure of the number itself has little meaning. If the credit score is low, for example, the consumer needs to know which factors in his credit history had the most impact on lowering the score. He could then decide whether to delay applying for the loan and how best to clean up his credit. For this reason, HomeFree – USA, a counseling agency in Washington, D.C., and a member organization of NCRC, always includes credit-score counseling in its homebuyer preparation courses. Similarly, NCRC educates consumers about their credit scores in its financial-literacy curriculum.

Although credit scores are imperfect estimators of creditworthiness, disclosure of credit scores can help reduce the incidence of discrimination in prices, particularly in the area of subprime lending. Fannie Mae's chief executive officer has been quoted as saying that 50 percent of subprime borrowers could have qualified for lower rates. Freddie Mac issued a statement on its web page a few years ago saying that up to 30 percent of subprime borrowers could have qualified for lower-priced credit. A paper commissioned by the Research Institute for Housing America concluded that after controlling for credit risk, minorities were more likely to receive subprime loans.

An unanswered question is how many borrowers who were inappropriately placed into the subprime loan category could have avoided this if they had simply known about their credit scores. Also, how many of them could have obtained lower interest rate loans, even if the loans remained subprime? For example, if an educated borrower knew his score was 620, which is generally considered A- credit, and was quoted an interest rate 4 percentage points higher than the widely advertised rate, he would know that he was being overcharged. While other underwriting factors, such as loan-to-value and debt-to-income ratios, also contribute to the pricing decision, meaningful credit score disclosures alert borrowers when quotes are (or at least seem) far higher than they should be.

As California was passing a law requiring credit bureaus to disclose credit scores, Fair Isaac, one of the major firms producing scores, took a constructive step and made credit scores available for a small fee through its web site, www.myfico.com. The company also has a description on its web page of the major factors influencing the score and the weight of each factor.

Meaningful credit score disclosures alert borrowers when quotes are (or at least seem) far higher than they should be.

How banks should disclose and use credit scores

The new California law also requires banks to disclose credit scores to consumers applying for loans. California is the only state to require this disclosure. Several bills working their way through Congress would also require credit bureaus and banks to disclose credit scores.

For the consumer, it is advantageous to be armed with credit-score information and to take action to improve the score, if needed, before applying to a bank. However, if a consumer does not have a credit score prior to application, disclosure by the lending institution is still valuable. In a loan-approval decision, for example, disclosure of the credit score will help the borrower understand why his loan had a certain interest rate. If the interest rate is in the subprime range, the borrower may want to take steps to improve his credit before closing on the loan. In the cases of loan denial, a lender is required under the Equal Credit Opportunity Act to send a borrower an "adverse action notice." If the reason for the rejection involved one of the factors in a credit score, that factor must be discussed in the adverse notice.

Lending institutions can run afoul of fair-lending laws quickly if they are not careful about using credit scores when helping borrowers apply for loans. For example, in 1999, the Department of Justice settled a fair-lending lawsuit with Deposit Guaranty

National Bank over Deposit Guaranty's alleged arbitrary and discriminatory use (or disregard) of credit scores. The lawsuit came about after an examination by the Office of the Comptroller of the Currency concluded that Deposit Guaranty disregarded credit scores when approving loans for whites but rejected blacks with similar credit scores. As a result, the black rejection rate was three times the declination rate for whites.

It is important and valuable for a bank to institute a review process for declined applicants, especially for those on the margins of approval. Such a review process may help banks make more loans to minority and low- and moderate-income applicants with little traditional credit history. A judgmental review process must establish consistent criteria by which to overrule credit scores. Such criteria can include consideration of nontraditional credit, including rental and utility payment histories.

Disclosure with a twist

The NCRC believes that information in the HMDA data about credit scores could be instrumental in resuming steady increases in access to credit for minority and low- and moderate-income borrowers. Several months ago, the Federal Reserve Board asked for public comment on its proposal to include the annual percentage rate (APR) in HMDA data.

In response to the Federal Reserve's proposal, NCRC pointed out that the APR, along with credit-score information, could vastly improve our knowledge of how credit scores impact pricing and approval decisions. Because many kinds of credit scores exist, it would be difficult to interpret what actual numerical scores mean if they were added to HMDA data. At the very least, the loan-by-loan data could indicate if a credit-scoring system was used and the type of credit-scoring system, such as a bureau or custom score. Policymakers would then have important insights as to whether most loans to minority and low- and moderate-income borrowers are credit-scored and whether banks using credit-scoring systems are more or less successful in approving loans to traditionally underserved borrowers. Community groups and counseling agencies could then use this additional information in HMDA data in their advice to borrowers about which banks are most likely to use credit-scoring systems in a fair manner to provide loans at reasonable rates.

Conclusion

In announcing a Bush Administration proposal to provide the public with data on the quality of nursing homes and Medicare health plans, Thomas Scully, a senior official at the Department of Health and Human Services, stated: "Collecting data and publishing it changes behavior faster than anything else." The motivational force of data disclosure under CRA and HMDA has helped activists and the public at large work with banks to increase lending to minority and working-class borrowers. Meaningful disclosures of credit scores to consumers and incorporating credit-score information in HMDA data would be two more valuable tools for building wealth in traditionally underserved communities.

This concludes the fourth article in our series. The Federal Reserve System's Mortgage Credit Partnership Credit Scoring Committee thanks the respondents for their participation. The topic of the fifth article is the use of counteroffers, overrides, and second reviews of credit-scored applications. The article will address where disparate treatment may occur and help identify solutions; it will appear in an upcoming issue of *Communities & Banking.*

Endnotes

1. "Big three" refers to the credit-scoring products used by the three credit-reporting bureaus: Experian, TransUnion, and Equifax.
2. Disparate treatment is defined as a situation in which a lender treats a credit applicant differently on the basis of race or any other prohibited factor. It is considered by courts to be intentional because no credible, nondiscriminatory reason explains the difference in treatment.
3. Disparate impact is defined as a situation in which a lender applies a policy or practice equally to credit applicants but the policy or practice has a disproportionate adverse impact on applicants from a group protected against discrimination.