Communities & Banking

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Less Costly Loans

Access to credit is a vital part of community development, but it's not the only one. Business assistance, support networks, mentoring, and of course job opportunities play major roles. Public safety, the educational system, and a host of other issues factor in as well.

And of course, access to credit hinges on a lot of different things, as the articles in this issue show. For example, in small business lending it is often transaction costs, low returns, and an assumption that "small means risky" that stymie the flow of credit. An innovative new model, the Rhode Island Area Small Business Loan Program, addresses these issues head on. The state's banks are working with the Small Business Administration and the nonprofit Ocean State Business Development Authority, and more of Rhode Island's small businesses are getting the hard-to-make, "five to fifty" (thousand dollar) loans they need.

The high cost of *borrowing*, rather than lending, is the problem addressed by the Massachusetts Soft Second Mortgage Program. For low- and moderate-income borrowers, monthly payments for total housing costs can easily exceed the share of income that conventional underwriting allows. The Soft Second program makes it possible for borrowers with low incomes to qualify for mortgages. Participating banks take advantage of the program's benefits — extremely low denial rates, strong minority participation, and excellent loan performance. Banks reach an important market, borrowers benefit from home ownership, and communities are stabilized.

Costs, for lender or borrower, aren't all that can impede credit flows. We've come to know that discrimination, whether overt, unintentional, or systemic, has played a persistent role in credit decisions. Careful studies of loan data show race to be a significant factor, above and beyond economic characteristics. Two recent events underscore the private and public sectors' efforts to remove bias from the credit markets. The Massachusetts Bankers Association and its members recently established a comprehensive set of programs to address fair lending. And ten federal agencies released a joint statement to help clarify what constitutes an illegal practice under the Fair Housing Act and the Equal Credit Opportunity Act.

Finally, the Boston Fed recently said goodbye to president Richard Syron, now chairman of the American Stock Exchange. We wish him well, and express our appreciation for his leadership in the areas of fair lending and community reinvestment, within this Bank, the region, and the Federal Reserve System. CB

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Communities & Banking explores viable roles for financial institutions in community economic development. The newsletter is produced by the Federal Reserve Bank of Boston's Public and Community Affairs Department.

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Views expressed are not necessarily those of the Federal Reserve Bank of Boston or the Federal Reserve System. Information about upcoming events and other organizations should be considered strictly informational, not as an endorsement of their activities.

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MORTGAGE LENDING: The Massachusetts Soft Second Mortgage Program

"We've always known that the Soft Second is the most affordable mortgage product out there," says Tom Callahan of the Massachusetts Affordable Housing Alliance (MAHA). "The numbers show it's the most effective one, too."

- Over 415 loans have been closed (317 in Boston).
- Household incomes are under $25,000 for one-third of the borrowers, and under $30,000 for two-thirds.
- 60 percent of the loans have gone to minority borrowers (in Boston, 72 percent).
- Denial rates in Boston are well below industry standards: 7.9 percent of all applicants, and 6.8 percent of minority applicants.
- Nearly half the properties are multi-family.

The Massachusetts Housing Partnership Fund (MHP) developed and administers the program. Basically, the banks originate two mortgages; the first can be sold to Fannie Mae and the second is partially subsidized with public funds, which also cover a loan loss reserve. Clark Ziegler, MHP's executive director, stresses that the program works for large commercial banks and small community banks alike.

The Program

Callahan, whose nonprofit organization recruits borrowers and negotiates rates with participating banks, described a typical scenario. "An applicant earning $29,500 who has a 5 percent down payment would probably be denied an $85,000 mortgage." The payments for principal, interest, taxes, homeowners' insurance, and private mortgage insurance could easily exceed the share of income allowed by conventional underwriting.

So the Soft Second program splits the loan into a smaller first mortgage and a partially subsidized second mortgage. As a result of the subsidy, monthly payments fall, increasing the borrower's chances to qualify. "And these are good loans," says Cathy Jones of Shawmut Bank's mortgage department. Homeownership counselling and publicly-funded loan loss reserves see to that.

The loans perform very well, "especially when you consider the economic turbulence of the last three years," says Florence Hagins, who got the first Soft Second loan and now counsels first-time buyers in the evenings. "Housing costs take up a huge share of many renters' income, so they're quite capable of handling a mortgage. In fact, monthly housing costs often fall."

The second mortgage, held by the bank, can cover 20 percent of the purchase price, up to $25,000. For the first ten years, payments on the second mortgage are for interest only. And public funds can cover up to 75 percent of those second-mortgage interest payments during the first five years, depending on the borrower's income. The "split" between the first and second mortgage is adjusted so that buyers use

28 to 33 percent of their income for payments on both mortgages and other housing expenses, with the subsidy making up the difference between the borrower's contribution to the second mortgage and its full monthly cost. The subsidy is then gradually phased out; by year eleven the buyer assumes principal and interest payments on both mortgages. The interest rate remains slightly below market.

By limiting the first mortgage to less than 75 percent of property value, the program avoids the added monthly expense of private mortgage insurance. Underwriting is flexible, allowing 5 percent down (2 percent from a gift or grant), a favorable debt-to-income ratio, and a waived requirement of two months' payments in reserve.

The Players

Coordinated by MHP, the program combines the efforts of banks, Fannie Mae, MAHA and other community organizations, the City of Boston, and the Commonwealth. The goal is a "usable, well-supported, off-the-shelf program that banks of all sizes can pick up and use," says MHP's Tara Murphy. MHP even provides promotional materials in English and Spanish for use by banks.

Jeanne Rinaldo of Springfield Institution for Savings adds that partnership with an active community organization is key, to recruit, educate, and support the borrowers. "And our relationship with Valley Community Development Corporation has really been solidified through this program."

In Boston, eight banks participate. The Commonwealth has pledged $1 million each year since 1992, and now 19 banks and 40 communities are involved around the state. Municipalities often work with a community organization to develop a bid, which is submitted to the

Photograph by Greig Cranna

"Homeownership and owner-occupancy certainly help to stabilize a neighborhood," says Florence Hagins, the Soft Second Mortgage Program's first borrower. She now counsels first-time homebuyers several nights a week.

Executive Office of Communities and Development. The funds are awarded to MHP, for a particular municipality. MHP sets aside the funds until there's a closing, then makes payments to banks.

Participating banks originate the first and second mortgages, and can sell the first mortgage to Fannie Mae to leverage their involvement. Since interest rates are below-market, however, Fannie Mae currently buys the loans only at a discount, so most banks hold onto both mortgages. Both MHP and MAHA are working on this issue, to ensure the program's long-term viability. One solution seems promising: in New York City, Fannie Mae packages similar loans for foreign banks, who are willing to pay full price because of their limited links to low-income communities and their Community Reinvestment Act obligations.

In Massachusetts, participating banks are willing to tolerate the below-market rates. "They see that the program qualifies borrowers with very low incomes, and brings owner-occupancy to neighborhoods where it makes a real difference," says Callahan. "The loans perform very well, there's a subsidized loan-loss reserve, and the discount, after all, isn't too steep." On the other hand, MHP sees the program as workable and effective even without a discount. "Like everyone else, we want to see more loans made," says Ziegler. "Without the discount, banks would probably originate more Soft Second loans, and that's what we'd like to see."

Regardless of future changes, the program means access to the large market of low- to moderate-income applicants, without a jump in denial rates. "We're very pleased," says Shawmut's Kathy Tullberg. "It has helped us serve a population we want to reach." CB

For more information, contact Kathleen Phillips at MHP, 617-338-7868; or Tom Callahan at MAHA, 617-728-9100.

FAIR LENDING DEVELOPMENTS

In April, the Massachusetts Bankers Association and the state's Attorney General resolved a dispute over the loan file data that certain banks had provided to the Boston Fed for its 1992 study of race in mortgage credit decisions. In all, 27 banks and mortgage companies are involved in the agreement, which demonstrates "their clear commitment to fair lending," said Attorney General Harshbarger. "These lenders deserve particular credit for engaging in nonadversarial and constructive dialogue."

A three-member panel is examining the minority loan applications that were identified by the Fed as perhaps inappropriately denied. The panelists are Marvin Siflinger, executive director of the Massachusetts Housing Finance Agency; Sunny-Brent Harding, the principal at Harding and Harding, Incorporated; and Charles Ferraro, president of Graystone Mortgage Corporation. Up to 120 minority loan applications from 24 institutions are being reviewed.

In addition, the Massachusetts Bankers Association and its members will attempt to eliminate systemic barriers to equal credit access, through various initiatives:

- A program to recruit and train minorities for employment in mortgage lending.
- Sponsorship of ongoing credit and homebuyer education programs.

Federal Agencies' Joint Statement on Fair Lending

Ten federal agencies recently issued a joint statement on fair lending, to clarify their interpretation of the Equal Credit Opportunity Act (ECOA) and the Fair Housing Act.

Lenders may not, because of a "prohibited factor" (described below):

- fail to provide information or services
- provide different information or services
- discourage or selectively encourage applicants
- refuse to extend credit
- use different standards in determining whether to extend credit
- vary the terms of credit
- use different standards to evaluate collateral
- treat a borrower differently in servicing a loan
- use different standards for pooling or packaging a loan in the secondary market

Prohibited factors are race or color, religion, national origin, gender, familial status, handicap, marital status, age, receipt of public assistance, and exercise of Consumer Credit Protection Act rights.

Proof of lending discrimination can take three forms:

- **Overt Discrimination.** This includes expressions of discriminatory preference, whether acted on or not.
- **Disparate Treatment**, whether intentional or not, when no credible, nondiscriminatory reason explains the different treatment. This is potentially prevalent when the loan hinges on lender discretion and assistance provided to the borrower. Such assistance must be offered to all applicants.
- **Disparate Impact**, when a policy or practice that is applied equally has a disproportionate adverse impact on applicants from a group protected against discrimination. Disparate impact must be established by facts, often through statistical analysis. Fair lending laws are not violated when the policy is justified by verifiable business necessity and no less discriminatory alternative exists. Discriminatory intent is not necessary to establish a violation.

Copies of the full release, including answers to common questions, are available from the Public and Community Affairs office. Contact Sheryl Snowden at 617-973-3097, or Joel Werkema at 617-973-3390.

- A comprehensive training module for bank management and employees, covering fair lending and diversity.

- Development and distribution of educational materials on consumer finances and mortgage lending, in nine languages.

- Promotion of legislation encouraging self-testing and comparative file review, and of legislation to set up a state-sponsored reinsurance program for "non-conforming" loans.

In addition, the Association will use its best efforts to promote certain practices:

- Complaint management by an ombudsman at each institution.

- Systematic second-review programs for low- and moderate-income mortgage applicants.

- Compensation structures that encourage effective solicitation of low- and moderate-income mortgages.

Lynn Browne, senior vice president and director of research at the Boston Fed, and co-author of the 1992 study, applauded the agreement. "The study demonstrated the significance of race in some credit decisions, above and beyond economic factors," said Browne, "and this agreement will help bring credit to markets that have been inappropriately underserved, to everyone's benefit." Jane C. Walsh, who chairs the Association, suggested that "Massachusetts will be cited as the example of how fair lending can be done in a creative, positive, and effective way." CB

For more information, contact Robert Fichter at the Massachusetts Bankers Association, 617-523-7505; or the Attorney General's office, 617-727-2200.

SMALL BUSINESS DEVELOPMENT: The Rhode Island Area Small Business Loan Program

Paul Williams, Federal Reserve Bank of Boston

Interest in small business lending is on the rise at financial institutions around New England. Banks are searching for new markets, and Community Reinvestment Act performance has come under increased scrutiny. In fact, proposed revisions to CRA regulations would require banks to report small business loan data to examiners.

> A $16,000 loan "would have been difficult to make without the program, given the amount of work that goes into putting the SBA application together."
>
> Bob McCormick
> First Bank and Trust

But small business lending remains a challenging task, and more of an art than a science. It's considered risky, since many small businesses have poor records and inadequate collateral. Start-ups often base their loan request on little more than projections. And bankers say small loans take as much or more work as larger loans, while yielding smaller returns.

The need is great. The Small Business Administration's Rhode Island office reports up to 200 calls a week, a third of those for loans under $50,000. But even with the security of the SBA guarantee to minimize risk, only 26 loans of less than $50,000 were made through the Rhode Island office in the last eighteen months.

The SBA's Rhode Island Area Small Business Lending Program was developed to address this problem. Last December, a forum on impediments to small business lending was sponsored by the SBA, the Boston Fed, and the Federal Deposit Insurance Corporation. The SBA pitched the program as a cost-effective way for Rhode Island lenders to make SBA-guaranteed loans under $50,000. The Ocean State Business Development Authority, a private nonprofit corporation certified to package and service SBA loans, would act as intermediary, performing much of the work involved in making the loan. In February, 15 lenders pledged $13.1 million to the program's first year. "The banks' commitment to the Small Business Lending Program has been far greater than we had hoped for," says Henry Violet, president of Ocean State Business Development Authority.

Businesses apply for loans through the Authority, which reviews the request and directs applicants who need help with business planning to various providers of free technical assistance. The Authority packages accepted applications for the SBA guarantee and for financing by participating lenders. If a selected bank chooses not to fund a loan, it's submitted to others for consideration. Rejected loan applicants are sent Regulation B denial letters. All approved loan amounts are remitted to the Authority, which disburses the funds and services the loans for the lending institutions. The Authority also maintains periodic contact with the borrowers.

Loans can be used for working capital, inventory, leasehold improvements, and equipment. Loan terms run from one to seven years, depending on the life of the financed assets. Loans are priced at a maximum interest rate of 2.25 percent above prime, with a 2 percent fee charged on the SBA-guaranteed portion of the loan. Half of the fee goes to the Authority for administering the program, along with a packaging fee — $250 for loans less than $25,000 and $350 for larger loans.

"Since the announcement of the program in mid-February, we've received over a thousand calls from potential borrowers," says Violet. "We've been so busy that we had to move to a larger office and hire more staff." According to Violet, many of the loans show good credits, management history, and potential. "The main reason a bank would turn them away is simply their size."

The sentiment is echoed by Bob McCormick of First Bank and Trust, which recently lent $16,000 toward the acquisition of a local delicatessen. "This loan would have been difficult to make without the program, given the amount of work that goes into putting the SBA application together." With a second small loan in the works, McCormick is pleased with the program. "It takes the burden of administering these loans off small banks," he says, "and seems to be working as it was intended." Indeed, Bob Sedgwick of the SBA's Regional Office in Boston expects to see the model replicated, first in Massachusetts and then around New England. CB

For more information call 401-528-4591.

CRA NOTES

More Information on Microenterprise, Economic Development, and Reinvestment Strategies

COMMUNITY DEVELOPMENT

From the Community Information Exchange, 1029 Vermont Avenue, N.W., Suite 710, Washington, D.C. 20005; 202-628-2981:

• *Financing Rural Community-Based Development*. $7. A companion publication, *Case Studies on Rural Community-Based Development*, contains 14 complete cases. $12.50.

• *Building Partnerships with Neighborhood Funders* details the partnerships that 13 community-based organizations have formed with banks, businesses, churches, and corporations in their areas. $7.

The Massachusetts Association of Community Development Corporations 1994 Membership Directory profiles 46 CDCs. Lists contacts, plus each organization's mission, key accomplishments, current projects, and partners. MACDC has also compiled a *1994 CDC Production Report* describing the CDCs' cumulative results. Contact Joseph Kriesberg at MACDC, 197 Portland Street, Boston, MA 02114-1716. 617-523-7002.

From Rainbow Research, Incorporated, 621 West Lake Street, Minneapolis, MN 55408. 612-824-0724:

• *Supporting Low-Income Neighborhood Organizations: A Guide for Community Foundations*. $20.

• *The Community Stabilization Project: Tenant-Directed Housing Preservation*. $8.50.

• *Venture Capital and Jobs Development Strategies for the Black Community*. $9.

Partnerships for Community Development, by Sally Habana-Hafner, University of Massachusetts at Amherst. PACT Publications, 777 United Nations Plaza, New York, NY 10017. 212-697-6222. $20.

AFFORDABLE HOUSING

Creating Community: Integrating Elderly and Severely Mentally Ill Persons in Public Housing, published by the U.S. Department of Health and Human Services and the Department of Housing and Urban Development. The National Resource Center on Homelessness and Mental Illness, 262 Delaware Avenue, Delmar, NY 12054. 1-800-444-7415. Free.

From the U.S. Department of Housing and Urban Development (Contact HUD USER, P.O. Box 6091, Rockville, MD 20850; 1-800-245-2691):

• *American Housing Survey*. Data from the most recent survey of the nation's housing stock and its occupants. $4.

• *What Is the American Housing Survey?* An overview of its uses and benefits. Describes the full range of AHS products. Free.

• *Federal Programs to Help Homeless People*. Lists more than 100

Federal programs that agencies can tap. $4.

- *Interim Evaluation of the Single-Family Property Disposition Demonstration*. Assesses the program that sells homes at a discount to selected local government agencies and nonprofit organizations. $4.
- *Directory of Technical Assistance and Training*. Information on programs currently funded by HUD. $4.
- *1993 Income Limits for Low-Income and Very Low Income Families*. Lists by family size the income limits used to determine eligibility for federally assisted housing, for every county and MSA in the United States. Hard copy, $25; diskette, $20; by state, $5.
- *Evaluation of Resident Management in Public Housing*. $4.

SMALL BUSINESS DEVELOPMENT

The Credit Process: A Guide for Small Business Owners, published by the Federal Reserve Bank of New York. A resource for small businesses, for organizations that assist them, and for lenders that target the small business market. Describes sources and types of financing, business plans, and the compilation of financial data for applications. Copies are available from James Sharpe, Federal Reserve Bank of Boston, Public and Community Affairs, P.O. Box 2076, Boston, MA 02106-2076. 617-973-3459. Free.

Microenterprise Credit Programs: Projecting Financial Viability. A computer model and manual enabling the user to develop credit program projections over a twelve-year period. The diskette (3.5" or 5.25") requires Lotus 1-2-3 (version 2.2 or above). The Small Enterprise Educational and Promotional Network (SEEP), 777 United Nations Plaza, New York, NY 10017. 212-697-6222. $18.

Building a Microloan Program: Considerations for the Development Lender, a report on policies, procedures, and strategies to help sustain the future growth of microlending. From the National Council for Urban Economic Development, 1730 K. Street, N.W., Suite 915, Washington, D.C. 20006. 202-223-4735. Members, $40, Non-members, $42.50.

FAIR LENDING

A new training video, *Closing the Gap: A Guide to Equal Opportunity Lending*, produced by the Federal Reserve Banks of Boston, Chicago, and San Francisco. The 24-minute video outlines a comprehensive set of practices to ensure fair lending at financial institutions. Contact Vidicopy at 1-800-708-7080; ask for Meredith Mullins or Carl Mayer. $9.95 (less for bulk orders).

A report on HUD's national fair housing summit, summarizing the proceedings and participants' recommendations. $14. 1-800-343-3442.

The Changing Faces of American Borrowers: Maximizing Lending Opportunities, an 18-minute video that trains community bankers in equal treatment of borrowers, and includes a ten-step plan to ensure fair lending. Produced by the Independent Bankers Association of America and the Federal National Mortgage Association. IBAA, One Thomas Circle, N.W., Suite 950, Washington, D.C. 20005; ATTN: Regina. 1-800-IBA-VIEW (ask for Regina). $25 plus $2.36 shipping.

Fair Lending Conference

The Federal Financial Institutions Examination Council has announced three fair lending seminars for presidents, chief executive officers, and directors of financial institutions. The focus will be on fair lending issues and on policies that ensure nondiscriminatory lending practices. The sessions will be held in:

- Washington, D.C., July 18
- Chicago, August 19
- San Francisco, November 4

For more details and a registration form, contact the Federal Financial Institutions Examination Council's Fair Lending Division, at 703-516-5588.

The Federal Financial Institutions Examination Council is made up of the Federal Reserve Board, the Federal Deposit Insurance Corporation, the National Credit Union Administration, the Office of the Comptroller of the Currency, and the Office of Thrift Supervision.

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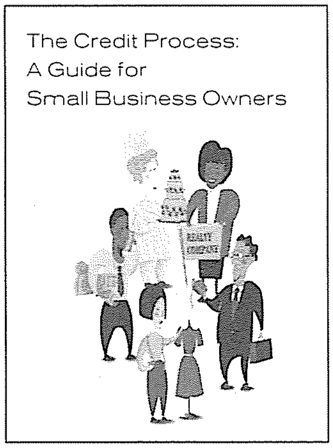

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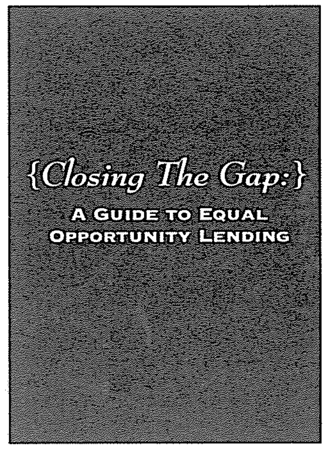

A training film from the Federal Reserve Banks of Boston, Chicago, and San Francisco

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