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MCAP'S continuing role IN ENSURING FAIRNESS IN MORTGAGE LENDING

[PREDATORY LENDING]

ALSO IN THIS ISSUE:

Profitwise

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MCAP'S continuing role IN ENSURING FAIRNESS IN MORTGAGE LENDING

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The Mortgage Credit Access Partnership (MCAP) is a program developed by the Federal Reserve Bank of Chicago, which was co-convened with six other organizations in 1996. The purpose of MCAP is to promote fair treatment in the home purchase and financing process. Over 100 organizations registered as MCAP Partners, many of which were instrumental in developing and implementing key recommendations to stem unfair practices and policies. (See the Winter 1997 and Winter 1999 editions of Profitwise for previous articles on the Mortgage Credit Access Partnership program.)

[PREDATORY LENDING]

MCAP has recently turned its attention to the issue of predatory mortgage lending. While there are a number of lending practices considered “predatory” by watchdog groups, the effect on borrowers is similar: they pay much more for mortgage credit than they can afford to pay, or their risk profile warrants, and often lose their main asset, (i.e., their home), as a result. Due to the efforts of organizations such as the Atlanta Legal Aid Society, the National Training and Information Center, the Legal Assistance Foundation of Chicago, the Woodstock Institute, and other consumer advocates, the issue is now high on the agenda of various government agencies and lawmakers.

The problem is greatest, and the practices most prevalent, within the most vulnerable populations, according to recent reports by both the National Training and Information Center and the Woodstock Institute, both MCAP Partners. Predatory mortgage lenders engage in aggressive marketing efforts directed to low-income, minority communities. Predatory lenders often target individuals who are financially distressed, but who have accumulated considerable equity in their home. These consumers may have fallen behind on medical bills, property taxes, or other expenses and they face barriers, real or perceived, obtaining unsecured credit. The result is they access equity in their homes to meet their financial needs. To the extent that low-income, minority communities are targeted, these practices are especially damaging from an economic perspective. Communities already economically disadvantaged are subjected to a further destabilizing influence, as homes are foreclosed and often left abandoned, and residents lose their primary, and sometimes only, source of household wealth.

Predatory lenders are ones that “target a particular population, take advantage of the borrower’s inexperience and lack of information, manipulate a borrower into a loan the borrower cannot afford to [re-]pay, or defraud the borrower...often these tactics are directed at a particular population, most frequently the elderly and low-income minorities, that is viewed as more vulnerable...”

From: “Understanding Predatory Lending: Moving Toward a Common Definition and Workable Solutions,” Neighborhood Reinvestment Corporation, October 1999

The Federal Reserve Bank of Chicago has led an MCAP task group examining the issue of predatory lending since December 1998. On March 30, 1999, the committee held an informational meeting at the Federal Reserve Bank of Chicago with representatives from the Iowa and Illinois Attorney General Offices, the Federal Trade Commission, the Federal Reserve Board, the Legal Assistance Foundation of Chicago, the Illinois Office of Banks and Real Estate (OBRE, the state regulator for mortgage brokers and bankers) and the Illinois Association of Mortgage Brokers. The purpose of the meeting was to present several case studies highlighting the most egregious practices, to discuss enforcement actions, and to provide an overview of proposed regulatory reforms. In June 1999, the MCAP task group held a joint meeting with a predatory lending task force organized by Neighborhood Reinvestment Corporation, which subsequently prepared a paper entitled: "Understanding Predatory Lending: Moving Toward a Common Definition and Workable Solutions," October 1999.

The Chicago Fed's task group has done comprehensive research on pending or newly enacted state legislation around the country to fight predatory lending. Two committee members, the National Training and Information Center and the Woodstock Institute, are spearheading efforts to introduce legislative reforms in Illinois. Groundbreaking legislation that prohibits certain practices, including the financing of points and fees above specified pricing trigger points, has already been enacted in North Carolina and proposed in New York.

CONVENTIONAL, SUBPRIME VERSUS PREDATORY LENDING

It is important to recognize the differences between mainstream, conventional lending methods and predatory lending practices.

A predatory lender is not necessarily interested in the credit worthiness of a borrower, as long as the borrower has sufficient equity in his home to cover the mortgage amount. The "mortgage amount" includes money disbursed to the borrower, money used to settle existing debts, or both, plus points, fees and potentially credit life or disability insurance premiums. Often, lenders engaging in predatory practices insist that the credit insurance premiums be paid in full at closing and financed into the loan, which has the added effect of inflating the mortgage amount and points associated with the transaction. Credit life and disability insurance policies can be very high cost, and generally are of little or no use to a borrower, since he is most likely to refinance the loan or ultimately lose his home through foreclosure. In either of these instances, the insurance policy simply expires and the premiums paid are lost.

For the average middle- and upper-income borrower, damaged credit or not, the credit marketplace is highly competitive, and the marketplace regulates the rates and terms of mortgage loans. "Lower income communities tend not to have as many traditional lenders, and prime lenders do not aggressively market to these areas," according to Dan Immergluck of the Woodstock Institute. "In the subprime market, borrowers are not as diligent in shopping around for rates, so competition is not effective as a means to keep pricing within reason."

While the terms “subprime lending” and “predatory lending” are often used interchangeably, there is an important distinction. The Federal Reserve and other bank regulators consistently urge banks to price for risk within their lending guidelines. It is understandable that subprime lenders charge more (fees and interest) for a loan to compensate for higher levels of risk, consistent with a borrower’s credit history.

All subprime lending is not necessarily harmful in that it increases availability of credit for higher risk borrowers. There is movement within the GSEs, government sponsored enterprises, Freddie Mac and Fannie Mae, to establish a secondary market for subprime mortgages, which would create readily identifiable underwriting standards where there is a good deal of variability presently. A subprime mortgage gives a borrower with blemished credit an opportunity to repair his credit history by making steady payments on a higher rate mortgage and later applying for a loan with more competitive pricing. When high fees and points are combined with a high interest rate, the borrower is simply giving away a substantial amount of equity, and the loan is likely not serving the borrower's interests.

SPECIFIC PREDATORY LENDING PRACTICES

Many of the abusive and predatory lending practices were identified by William J. Brennan, Jr., Director, Home Defense Program of the Atlanta Legal Aid Society, Inc., in his statement before the United States Senate Special Committee on Aging on March 16, 1998.

AMONG THE MOST HARMFUL PRACTICES IN TERMS OF COST TO BORROWERS ARE:

- **Excessively high points and APR (annual percentage rate) for the credit risk posed by the borrower. Points are usually charged to borrowers who want to buy down the interest rate on the loan. Predatory lenders, however, charge high points with no corresponding reduction in the interest rate. The points are typically financed into the loan, causing the amount borrowed and interest paid to increase as well.**
- **Frequent refinancing, commonly referred to as “flipping,” of one high-cost loan, usually to a new, even higher cost loan.**
- **Lending to people who simply cannot afford to repay, a practice often facilitated by falsifying income sources and amounts to the funding lender, and thereby virtually guaranteeing default;**

- Negative amortization: a loan where the monthly payments are not sufficient to pay down principal and interest, and accordingly the loan balance increases over the loan term, so that at the end of the loan term, the entire principal amount plus accrued interest is due, triggering either default or a refinancing. (A negatively amortizing loan is not exclusively a predatory loan, although there are only limited circumstances where a negatively amortizing loan is appropriate, such as in a rapidly appreciating real estate market. In the context of predatory lending, it is used with a borrower likely unaware that his/her debt is increasing rather than decreasing, ostensibly to leverage a low-income household into a larger note than would otherwise be possible).

SOME OF THE SALES AND MARKETING TACTICS USED BY PREDATORY LENDERS INCLUDE:

- High pressure solicitations: Loan originators engage in extensive marketing in targeted communities. They advertise through commercials, signs, telephone solicitations, flyers, and direct mail. (Lenders can legally obtain from the national credit bureaus lists of borrowers with specific criteria in their credit report that suggest they may be candidates. You may have seen in your own mail what looks like an official document from the Social Security Administration or some other government agency, only to find upon opening the envelope that is a “check” from a home equity lender indicating a loan amount that you’ve been pre-approved to borrow. Certainly not all direct mail solicitations from home equity lenders are from ones looking to overcharge consumers, but it is a common marketing tactic among predatory lenders, as is door-to-door canvassing.)

- Home improvement scams: Contractors, acting as loan brokers, are used to solicit business. The home improvement company originates a mortgage loan to finance the home repairs they offer and then steer the homeowner directly to the lender. The home improvement work is often of poor quality and very high cost.

- Steering to higher cost loans: Some banks and mortgage companies steer customers to high-rate lenders even when a borrower qualifies for a lower-cost loan. Kickbacks and/or referral fees are paid to the loan originator as an incentive. Similarly, borrowers who apply with a subprime lender, but qualify for prime mortgage rates, are not referred to a prime lender or product, even if the prime lender is an affiliated company.

A CASE STUDY IN PREDATORY MORTGAGE LENDING

The story of Robert Jackson, a victim of predatory mortgage lending, illustrates many of these abuses. Mr. Jackson is ninety-one years old. He is black, a widower, and living on Social Security income. He retired in 1974 and bought his current home with his wife three years later from the U.S. Department of Housing and Urban Development (HUD) for $4,200. Prior to her death in 1993, Mrs. Jackson handled all of the household finances and had paid off the mortgage on their home.

After Mrs. Jackson's death, having not had any recent experience managing the household finances, Mr. Jackson found himself behind on his bills. In addition to being in debt for his wife's burial, he fell behind on his property taxes, and his roof needed repair. His wife had also left a $6,000 credit card balance behind. In August 1994, Mr. Jackson borrowed $20,000 using his home equity as collateral. He learned about the lender from a home improvement contractor who had offered to repair his roof. With this amount, he was able to pay off some of his balances and have repairs done to the roof, although Mr. Jackson notes, "they did not do a good job." Ira Rheingold, an attorney with the Legal Assistance Foundation of Chicago representing Mr. Jackson in his current foreclosure proceedings (several refinancings later), adds that the contractor was one with "a poor performance record that acts as a bird-dog for many lenders."

Mr. Jackson fell behind on his loan payments and in March of 1996 applied for a second loan for the amount of $39,000 to refinance the original $20,000 loan. Despite the increased mortgage amount, he received very little cash out of this loan, as he had accrued interest and penalties associated with the initial loan. Not surprisingly, Mr. Jackson rapidly fell behind on this loan as well. He received many phone calls, letters, and house calls from numerous mortgage brokers, anxious to extend him a new loan. The principal balance of his loan of $39,000 had, because of his missed payments and the resulting accrued interest and penalties, increased substantially. In June of 1997, Mr. Jackson applied for another loan for the principal amount of $51,750 as means to pay the balance on the previous loan, a heavy origination fee, and assorted other costs. Again, Mr. Jackson was delinquent very quickly and defaulted in the spring of 1998, according to his recollection.

In August 1998, Mr. Jackson was contacted via a mail solicitation by a lender promising him an "affordable" loan to pay off his existing mortgage plus provide him at least $3,000 in extra cash. At the closing on September 18, 1998, Mr. Jackson was surprised to find that he was being extended two loans. However facing foreclosure, he was not inclined to call off the transaction. One loan was for the principal amount of $64,350 with an Annual Percentage Rate (APR) of 14.095%. The loan was a 30-year adjustable rate mortgage in which Mr. Jackson was required to make initial payments of $699.29, but the payment did not include amounts for taxes and insurance. The second mortgage agreement bore a name of a different mortgage brokerage firm than the one that originated the first loan, but shared the same address as the lender on the larger mortgage. The second loan amount was $4,200 with an interest rate of 15%. Under the terms of this loan, a 30-year fixed rate mortgage, Mr. Jackson was to pay $53.11 per month.

Mr. Jackson received no funds in connection with the second loan and he believes that the loan proceeds went entirely to the loan originator (broker). He paid over $4,400 in fees on the larger loan, and he paid for separate appraisals for the two loans, which closed at the same table on the same day. Mr. Jackson had received loans totaling $68,550 and was required to make monthly payments of $752.40, which again did not include his taxes and insurance. Every six months, Mr. Jackson's rate for the larger of the two loans would adjust by the London Interbank Offered Rate (LIBOR, 6.195% at the time of this writing) plus 8.25%, but never less than 12.75% or greater than 19.75%.

Mr. Jackson's only steady income is his Social Security benefit of $795. He occasionally rents out the lower level of his house for about $400 on a month-to-month basis, although it is not a steady source of income for him. Inevitably, Mr. Jackson defaulted on the loans, and at the time of our interview was in foreclosure.

"Mr. Jackson's situation is not unique; we see these cases involving the elderly every day. Lenders' assertions that they are providing a good service to borrowers who cannot obtain credit from conventional sources are spurious from my experience," said Mr. Rheingold. "Most elderly victims, like Mr. Jackson, feel more exploited than helped. Instead of enjoying their retirement years spending time with their grandchildren or just relaxing, they are struggling to save their homes from foreclosure and themselves from homelessness, since they don't have other assets to fall back on."

A BROADER PERSPECTIVE OF THE ISSUE

"The additional cost of a high rate mortgage can make a 'high risk' loan a self-fulfilling prophecy because the higher costs become the fuel for failure...many of the high cost loans provided to low income borrowers appear to have debt to income ratios designed to create default, or force refinancing of the loan...," said William J. Brennan, Jr., Director, Home Defense Program of the Atlanta Legal Aid Society, Inc., in his statement before the United States Senate Special Committee on Aging on March 16, 1998. "It is significant that foreclosures have increased by approximately 300% since 1980. These numbers do not include the thousands of homes which are turned over to lenders voluntarily (called deeds in lieu of foreclosure) or are sold for less than their value to avoid foreclosure. The bottom line is millions of Americans are losing their homes because of unaffordable home mortgages."

Dan Immergluck, a researcher and Senior Vice President of the Woodstock Institute, offers some opinions, as well as key statistics from the paper, "Two Steps Back: The Dual Mortgage Market, Predatory Lending, and the Undoing of Community Development," which Woodstock released in November 1999:

"The explosion of the subprime mortgage lenders, who dominate refinance and home equity lending in minority neighborhoods, and the failure of regulation to adapt to this industry has left us with a two-tiered, race-based mortgage system. The lenders serving minority neighborhoods are largely unregulated, while the banks and thrifts serving non-minority, more affluent communities are heavily regulated. In 1998, in the six-county Chicago area, subprime lenders accounted for 74% of refinance applications and 58% of loans in predominantly African-American neighborhoods, compared to only 21% of applications and 10% of loans in predominantly white communities. Of the 20 lenders accounting for the most refinance applications in African-American neighborhoods, all but one are subprime firms. In predominantly white neighborhoods, all but three of the 20 leading marketers of refinance loans are prime lenders."

ADDRESSING THE ISSUE IN ILLINOIS AND NATIONALLY

Home ownership has long been recognized, and used, as a means to build wealth and stability in lower-income communities. Through pressure from community groups, and due to the obligations of banks under the Community Reinvestment Act, home ownership has increased among households that under traditional guidelines would not qualify for mortgage financing. The increase has occurred through the development and use of creative financing tools and by devoting significant public resources to this goal. Absent reforms, advocacy groups predict that predatory lending practices will reverse much of the growth in home ownership in communities where wealth building and economic growth is most needed.

In Illinois, the National Training and Information Center, the Woodstock Institute and other concerned groups have met with mortgage lending trade associations to discuss the issue and to build industry support for reasonable and fair legislative reforms. This past October in Illinois, State Representative Daniel Burke held a hearing at the James R. Thompson Center in Chicago. Members of the Illinois legislature and others interested in the matter heard personal accounts from victims of predatory lending and discussed possible changes to Illinois law to prevent further abuses. Mr. Burke introduced a bill addressing the issue in the January 2000 legislative session.

The National Association of Attorneys General (NAAG) has a predatory lending subcommittee with 20 states plus the District of Columbia represented. Tom James, of the Illinois Office of the Attorney General and a member of the subcommittee, noted that "under current laws, cases involving mortgage lending violations must be prosecuted on an individual basis, using a wide range of very mixed and often contrasting objective and subjective factual and legal tests, standards and criteria, which is a very inefficient way to address the problem." To have real impact, Mr. James concludes "would require legislation that gives us a clear definition of a high-cost loan, and enforcement power to address price gouging, insurance packing, flipping (frequent refinancing to new high-cost loans) and other practices, possibly with increased penalties for infractions involving the elderly." The NAAG subcommittee is working toward recommendations on national legislative reforms.

The Fed's MCAP predatory lending task group intends to issue its recommendations by the second quarter of 2000. Future issues of Profitwise will cover the task group's recommendations and efforts to implement them. The MCAP Partnership Report and the MCAP Summer 1999 Update are available to readers of Profitwise and others by contacting the Federal Reserve Bank of Chicago, Consumer and Community Affairs Division, at (312) 322-8232.

introducing a new WEB re

We are pleased to announce a new web site that offers a wealth of information to assist researchers, community development professionals, non-profit organizations, financial institutions, and government agencies.

It's called the Consumer and Economic Development Research and Information Center (CEDRIC). Its principal mission is to foster research related to consumer and economic development issues such as consumer and small business financial behavior, access to credit, affordable housing, and community development and reinvestment. Created and maintained by the Federal Reserve Bank of Chicago, CEDRIC has a research repository that includes abstracts of research studies as well as full text articles, reports, working papers and other studies generated by Federal Reserve researchers and analysts as well as academicians, government agencies, and non-profit organizations. CEDRIC also provides a subject listing describing research included in the repository; announcements of upcoming events; a collection of valuable data resources; a glossary of community development terms; and links to CEDRIC partners.

CEDRIC is a comprehensive research tool designed to help economists, analysts and other professionals identify consumer and economic development related research. It includes a *Glossary of Community Development Terms,* covering a wide array of relevant terms and concepts. For terminology beyond the scope of this web page, the user is directed to a variety of other online glossaries, including a *Glossary of Consumer Credit Terms* and a *Glossary of Financial Regulators and Institutions*. In addition, CEDRIC highlights high-quality, reliable online data sources. Drawing upon the data collection and analysis expertise of the Chicago Fed's Consumer Issues Research Unit, we have provided a brief description about the numerous electronic databases and information systems, encompassing the fields of statistics, econometrics, economics and finance.

CEDRIC'S REPOSITORY SUBJECT LISTINGS ARE HIGHLIGHTED BELOW:

Community and Economic Development
Investment/development, urban stability, empowerment/enterprise zones, rural/agricultural issues, community development centers, and inner city rejuvenation;

Consumer Financial Behavior
Access to credit, consumer wealth, mortgage delinquencies, mortgage defaults, credit delinquencies, credit defaults, bankruptcy, culture and credit, income distribution, and alternative financial services;

Housing
Mortgage lending, location preferences, appraisal process, homeownership patterns, private mortgage insurance, and housing search process;

Indian Reservation Development
Affordable housing, community investment, legal considerations, access to credit, and banking services;

Institution Behavior
Branch banking, credit scoring, fair lending, redlining, affordable/low-income housing, profitability and regulations, homeowner insurance, pricing of credit, geographic patterns, financing alternatives, CRA, ECOA & FHA activities, GSE & FHA activities, secondary market underwriting and minority-owned institutions.

Small Business
Entrepreneurship, failures, minority/women issues, lending, financing, and development.

Two search options have been developed to provide CEDRIC users with an efficient way to retrieve relevant information. One can conduct a quick search by clicking on one of the six major subject areas located on the Repository Subject Listing page to view all of the documents related to that subject. Similarly, one can perform a focused search by specifying keyword(s), author(s), and/or title information.

CEDRIC also serves as a forum for sharing relevant information about unique projects, initiatives, and events taking place across the nation. Currently, CEDRIC features an academic conference, Business Access to Capital and Credit, hosted by the Community Affairs Departments of the Federal Reserve System on March 8-9, 1999 in Arlington, Virginia. CEDRIC offers easy access to the complete conference proceedings, which includes papers and summaries of the papers presented by distinguished economists and scholars from across the country. These proceedings are designed to further the understanding of small business lending and credit issues among

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Consumer and Economic Development Research and Information Center (CEDRIC)

scholars, practitioners, and policymakers. Furthermore, the Events page announces relevant upcoming conferences, seminars, forums, and workshops taking place across the country.

Finally, CEDRIC users are encouraged to contribute to the site's database by submitting relevant publications, articles, abstracts, working papers and other studies. By utilizing a user-friendly Submission Procedure interface, researchers and analysts have the opportunity to share valuable information with CEDRIC's ever-expanding audience and, thus, foster future research on the topics related to consumer and economic development. To date, CEDRIC has established partnerships with over 60 organizations, including academic journals, non-profit organizations, professional associations and government agencies. You can learn more about CEDRIC's partners by visiting the Partner Listing page, which includes contact information as well as website links.

Visit CEDRIC located on the Federal Reserve Bank of Chicago's public website at **www.frbchi.org** by following the 'Community Development Research Center' link listed under 'Resources.' For further information, please contact CEDRIC's coordinator at **cedric@chi.frb.org**.

"If you want to move people, it has to be toward a vision that's positive for them, that taps important values, that gets them something they desire, and it has to be presented in a compelling way that they feel inspired to follow." – Dr. Martin Luther King, Jr.

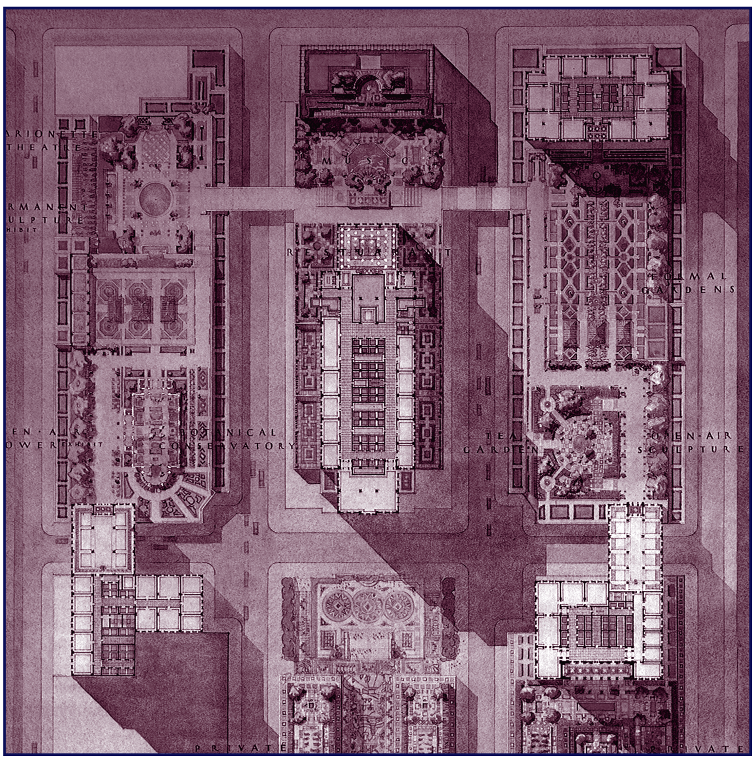
core city NEIGHBORHOODS

a dream fulfilled – empowered to build

Core City Neighborhoods (CCN) has always been a community-based organization. The seeds of the organization were planted in 1984 by four women who began asking some fundamental questions about neighborhood empowerment. Together, Sr. Theresa Blaquiere, Shirley City, Almena Jones and Bernice Richmond began sharing their hopes and visions for the community. From their early organizing effort, CCN's mission gradually began to unfold. As the four women walked door-to-door talking to the residents and businesses in the area, people started to express their ideas and interests regarding the community. It was from this sharing of a common vision that Core City Neighborhoods began to take shape.

In the spring of 1985, a steering committee consisting of residents, business people and other community groups representatives was formed. Participants shared their vision of community and economic development. Boundaries were established for the neighborhood to encompass a 3.5 square mile area. The geographic area served is comprised of an area of west Detroit between West Grand Boulevard, to the north and west, Michigan Avenue to the south to I-96 and Martin Luther King, Jr. Boulevard to the south to Grand River Avenue and Rosa Parks Boulevard to the east. The community and economic agenda for the new organization included housing advocacy and small business retention as well as crime prevention, training and job creation. Along with the physical and economic revitalization agenda, a social and human development component surfaced as an essential part of CCN's mission.

Core City Neighborhoods was incorporated in 1985, and an 18-member board of directors was elected to govern the organization. A 12-member housing board and 3 subsidiary non-profit housing corporations were established to oversee housing activities. From the beginning, CCN's ability to attract volunteers from the neighborhood and the business community was a major strength. By 1992, the number of staff members had expanded to 18 and CCN had established itself as one of Detroit's leading community-based organizations. The organization's mission soon included a housing arm that managed four multi-family apartment buildings, a landscaping business able to secure and manage contracts with the City of Detroit, a community outreach and organizing arm, and an elaborate youth and family program.



Today, CCN remains a community-driven, membership-based organization which engages its community members in a decentralized form of planning and decision-making. Proud of its strong community cohesiveness, tradition and values, the people who live within the community's boundaries maintain a strong sense of community identity and an equally strong willingness to create positive trends within the neighborhood through CCN's resources.

Since 1997, CCN has been headed by Executive Director, Joyce Rhyan. Ms. Rhyan brings 12 years of experience in urban planning, urban design, historic preservation, redevelopment planning and neighborhood planning to the organization. Ms. Rhyan has been a major force in helping the organization fulfill its dream through the refinement and implementation of existing plans.

Ultimately, the mission of Core City Neighborhoods is two-fold. The first is to strengthen the social and human development of the community and its residents. The second is to stimulate physical and economic development of the area.

Social and Human Development

CCN's social and human development includes community organizing and outreach, as well as adult and youth leadership development. These efforts often focus on encouraging residents to take action together for the purpose of building community ties while meeting a concrete need in the process. Current programs and services include parenting classes, youth programs and block club initiatives.

Physical and Economic Development

The physical and economic development agenda for CCN includes housing services to private property owners, housing development, small business retention and development, crime prevention and new efforts in training and employment.

CCN'S ACCOMPLISHMENTS

Housing Development

One CCN neighborhood, The Martin Luther King, Jr. redevelopment area, has been the focus of a major ongoing planning effort. The 300-acre site, located within Detroit's Empowerment Zone, is bounded by the Jeffries Freeway to the west, the Ford Freeway to the north, Grand River to the east, and the namesake street, Martin Luther King, Jr. Boulevard, to the south.

A preliminary analysis of this area by CCN indicated that, of 5,269 housing units, 829 were vacant and much of the remaining housing stock was in fair or poor condition. The City of Detroit owned approximately 50% of the total land in this area. Commercial development within the local area had been sporadic. Many buildings had been abandoned. In addition, according to 1990 census information, this area is considered to be a low-income area with over 53% of its residents having income levels below the poverty line. Within The Martin Luther King, Jr. redevelopment area, the Alberta W. King Village apartment community, named in honor of the civil rights leader's mother, is CCN's most industrious project to date. Construction of the apartment complex began in February 1998 and was completed in April 1999. This new multi-family development includes 12 buildings which house 121 units. The development occupies 11 acres, and consists of 12 one-bedroom, 84 two-bedroom and 24 three-bedroom units. This rental property targets low- and moderate-income residents with a maximum income of 60 percent of the area's median income level. Alberta W. King Village was developed by Core City Neighborhoods in partnership with the Michigan State Housing Development Authority (MSHDA), the National Equity Fund (NEF), the Local Initiative Support Corporation (LISC), Comerica Bank and the City of Detroit.

The total development cost of the Alberta W. King Village apartment community was approximately $10 million, and it is the largest residential development constructed by a community-based nonprofit development corporation in the Detroit Empowerment Zone, the City of Detroit and the State of Michigan.

Housing Acquisition and Rehabilitation

To preserve good housing stock and to increase the actual number of units, a CCN strategy has been to purchase highly visible multi-unit residential properties which serve as an anchor and a catalyst for further housing development. Since 1989, CCN has purchased and renovated four buildings which house 52 units, valued at $2 million.

In addition, CCN has gained experience by managing and leasing two multi-family apartment buildings under its ownership. Its Property Management Division has made significant improvements to these properties. Local job creation and related forms of economic development within the neighborhood are the types of favorable results that are spurred by these housing-related activities.

Minor Home Repair

The Minor Home Repair Program is a Community Development Block Grant funded program through the City of Detroit. CCN is in its tenth year of administering this program in the Core City area. The program, which targets low-income homeowners in need of structural improvements, was augmented by a grant from the Federal Home Loan Bank of Indianapolis and made available through an arrangement with Standard Federal Bank. As of 1998, $667,010 had been expended in the repair of homes in the CCN area under the Minor Home Repair Program.

Landscaping/Weed and Debris Removal Service

CCN's economic development activities include a Landscaping / Weed and Debris Removal Service which provides jobs for difficult to place persons, as well as individuals receiving public assistance. CCN is the first community based organization to receive a weed and debris removal contract from the City of Detroit and Wayne County. The organization currently is responsible for the maintenance of approximately 10 million square meters of land per year.

Crime Prevention

CCN mobilizes residents to secure and protect their investments. Patrols, auto etching, and watch programs have been excellent prevention tools. Funding by the Automobile Theft Prevention Authority and the City of Detroit Block Grant has enabled CCN to provide an etching program and education related to automobile theft prevention. In addition, CCN has provided several workshops aimed at reducing auto theft and other crimes.

FUTURE PROJECTS AND PROGRAMS

CCN plans to continue its development projects within the Martin Luther King, Jr. Redevelopment Area during the coming year. By mid-year 2000, CCN plans to begin construction on Phase 2 of the Alberta W. King Village. Phase 2 will be funded by MSHDA and result in 75 additional low-income housing rental units. In addition, CCN plans to begin construction of a 45,000 square-foot neighborhood shopping center that may house amenities such as a drug store, hardware store, restaurant, laundry center and other facilities. The cost of the two projects is expected to be $8 million and $4.1 million, respectively.

In summary, to paraphrase a letter sent to CCN residents by Executive Director Rhyan, "much has been achieved since CCN was established 15 years ago. The organization has made substantial progress in a number of key areas. Nowhere was that realized more than when construction was completed at the site of the new Alberta W. King Village Apartment Community in April 1999. As a result, the City of Detroit, the State of Michigan and the nation have an inspiring new model to follow. But perhaps most importantly of all, the residents of our neighborhood once again saw the rebirth of new, modern and affordable residential housing."

THE USE OF Formal and Informal FINANCIAL MARKETS among black households[1]

Sherrie L.W. Rhine, Manager and Economist
and Maude Toussaint-Comeau, Economist

Consumer and Community Affairs Division
Federal Reserve Bank of Chicago

SUMMARY

A fundamental understanding of consumer financial behavior is necessary for the development of effective policy. The paucity of information about the financial choices made by minority households prompted the Federal Reserve Bank of Chicago to conduct a unique survey in Chatham, a predominantly Black community in the City of Chicago. This article documents the use of banking products and services, the patronage of alternative financial service (AFS) businesses and the role of informal financial markets in this community. These findings are offered to fill some of the information gaps and to encourage additional research about the use of formal and informal financial markets within minority communities.

The survey found that roughly one out of every five households is without a checking and/or savings account. Check cashing outlets and currency exchanges (AFS businesses) are patronized by the majority of households in the survey.[2] Interestingly, these businesses also are patronized by over half of all households with a pre-existing relationship with a bank. By comparison, informal financial networks appear to play an important role among households who either are faced with financial distress or in need of additional financial assistance in purchasing a home.

OVERVIEW OF FINANCIAL MARKETS

A household gains several advantages from holding a deposit account with a financial institution. In terms of time and actual expense, payments for personal transactions often can be made at a lower cost. Households are shielded from risks associated with holding uninsured cash reserves and are availed with approximately 20 consumer protection laws and regulations safeguarding individuals from unfair, discriminatory and predatory lending practices. (Board of Governors of the Federal Reserve System, 1997).

Despite the potential benefits from holding a deposit account, a large number of households remain unbanked, especially among lower-income or minority families. For example, Hogarth and O'Donnell (1997) find that almost 37 percent of all U.S. Black households are without either a checking or savings account. Among White households, however, they determine that less than 8 percent fall into this category. To meet financial transactions and credit needs, unbanked households often rely on check cashing outlets, currency exchanges or pawn shops (Swagler, et al., 1995). The cost of these alternative financial services has been shown to be almost twice as large as comparable banking services offered in the formal financial markets (Green and Lechter, 1998). As evidenced by the increase in class action lawsuits against major check cashing companies for alleged full disclosure violations, it is unclear that consumers patronizing AFS businesses are adequately protected against unfair lending or predatory business practices (e.g., Chicago Sun-Times, 1999).

As pointed out by Bond and Townsend (1996), credit services can be provided by a diverse set of institutions ranging from informal networks of family, friends and social organizations to mainstream financial markets. Informal networks provide relationship-based financing often predicated on criteria different than formal financial markets. Cost advantages in information gathering, ability to utilize effective enforcement mechanisms and potential willingness to share greater risks related to implicit or explicit credit contracts are factors associated with informal markets unlikely to be present in formal financial markets. Informal networks also may be particularly well suited as a source of short-term or small dollar amount financing often unavailable from formal sources.

SURVEY DESCRIPTION AND RESULTS

Chatham was chosen as the site of this study because it is a distinct and well-recognized ethnic neighborhood. Located on the south side of the City of Chicago, Chatham became predominantly Black during the 1950s (Chicago Fact Book Consortium 1995). The Federal Reserve Bank of Chicago conducted the survey in Chatham between 1997 and 1998.[3] The fieldwork resulted in the completion of 194 randomly selected household interviews. Based on the survey, median family income in 1996 was $35,000, classifying Chatham as a middle-income community.

A household's link to the formal financial market is captured through information collected about the use of a checking and/or savings account, various investments and longer-term savings accounts, and holdings of various loan products. Table 1 highlights the use of these financial instruments by household income to ascertain whether this relation varies at different income levels. As shown, 79 percent of all respondents reported having a checking and/or a savings account. The proportion of households using a checking and/or a savings account increases from 58 percent among households in the lowest income quartile to 92 percent of the households at the highest income levels. By contrast, 21 percent of the respondents had neither a checking nor a savings account. The proportion of households without a checking and/or savings account decreases with household income from 42 percent of households in the lowest income quartile to 7 percent among those in the highest income quartile.

Respondents did not make wide use of home-related financing during the previous five-year period. While the age profile of this community (relatively older population) may have contributed to the lackluster activity in these credit markets, it remains unclear that life-cycle effects alone can fully explain the level of credit activity observed. As shown in **Table 1**, 9 percent of all households had a home mortgage or refinance loan, 6 percent had a home equity loan, and 3 percent had a home expansion loan over the previous five-year period. Car loans were the most frequently reported loan type, ranging from 8 percent among households at the lowest income quartile to 45 percent of the households at the highest income quartile. Finally, almost 50 percent of all respondents held at least one credit card, reaching 72 percent of all households in the highest income quartile.

TABLE 1
FORMAL FINANCIAL SOURCES BY HOUSEHOLD INCOME QUARTILE

Financial Instruments	Total # of Households	Percent of Sample	1st Income Quartile	2nd Income Quartile	3rd Income Quartile	4th Income Quartile
Checking and/or Savings Accounts	153	79%	58%	82%	84%	92%
Checking Account	121	62%	23%	64%	71%	85%
Savings Account	126	65%	42%	64%	71%	85%
No Checking or Savings Account	41	21%	42%	18%	16%	7%
CD, IRA, Mutual Funds, etc.	36	19%	8%	13%	24%	35%
Credit Accounts – Last 5 years						
Credit Card	95	49%	16%	31%	60%	72%
Home Mortgage/Refinance	18	9%	3%	8%	18%	15%
Home Equity Loan	11	6%	0%	8%	8%	10%
Home Expansion Loan	6	3%	3%	0%	3%	7%
Appliance/Furniture Loan	10	5%	3%	10%	10%	2%
Student Loan	6	3%	0%	0%	3%	10%
Car Loan	50	26%	8%	23%	29%	45%
Sample Size	194	100%	24.5%	25.2%	24.5%	25.8%

NOTES:
Income Quartile 1 includes households with income <17776 (n = 38). Income Quartile 2 includes households with income, 17776 <=inc. <35000 (n = 39). Quartile 3 includes households with income, 35000 <=inc. <50000 (n = 38). Income Quartile 4 includes households with inc. > = 50000 (n = 40). Percentages may not add up to 100 due to rounding.

Table 2 compares the characteristics of households based on their use of selected formal and alternative financial services. AFS businesses include services from either currency exchanges or check cashing outlets. Column 2 displays the characteristics of households holding a checking and/or a savings account, while Column 3 reflects households with neither type of account. Households with a checking or saving account tended to have higher incomes and were more likely to be employed, more highly educated, older, male, married, and owners of a home, a car or other large assets (Column 2). Conversely, unbanked households were inclined to have lower incomes and were more likely to be unemployed, less educated, younger, female, unmarried, and without a home, a car or other large assets (Column 3).

Households that patronized AFS businesses are separated according to whether or not they also possessed a checking account. As shown in Column 4 of Table 2, 46 percent of the AFS-user households were without a checking account. As expected, the proportion of these households declines at higher income levels, falling to 20 percent of all households in the highest income quartile. Interestingly, the majority of households patronizing AFS businesses also have a relation with the formal financial sector. Specifically, 54 percent of all households utilizing AFS services also have a checking account (Column 5).

This suggests that having physical access to a formal financial institution does not necessarily preclude use of AFS services. Additional research is presently underway to gain insights into the extent to which particular AFS products or services are utilized by these households.[4]

TABLE 2
HOUSEHOLD CHARACTERISTICS BY SELECTED FINANCIAL SERVICES

	Total Sample (1)	Checking or Savings (2)	No Checking and No Savings (3)	AFS Users Without Checking (4)	AFS Users With Checking (5)
N	194	153	41	68	80
Percent of Total	100%	79%	21%	46%	54%
Gender					
Male	71	83%	17%	47%	53%
Female	123	76%	24%	45%	55%
Marital Status					
Married	71	84%	15%	33%	67%
Not Married	123	76%	24%	53%	47%
Age					
18-24	9	55%	44%	89%	11%
25-34	29	76%	24%	46%	54%
35-44	50	72%	28%	47%	53%
45-59	49	88%	12%	39%	61%
60-64	16	87%	13%	36%	64%
65 and up	41	80%	20%	43%	57%
Education					
Less than HS	15	80%	20%	36%	64%
HS or equivalent	109	81%	19%	47%	53%
College and Above	43	91%	9%	20%	80%
Household Income					
1st Quartile	38	75%	25%	82%	18%
2nd Quartile	39	86%	14%	45%	55%
3rd Quartile	38	93%	7%	44%	56%
4th Quartile	40	89%	11%	20%	80%
Employment Status					
Employed	120	84%	16%	40%	60%
Retired	44	84%	16%	39%	61%
Other/Not employed	18	56%	44%	67%	33%
Unemployed	10	40%	60%	80%	20%
Assets					
Home/land/other	84	93%	7%	28%	72%
Car	127	90%	10%	31%	68%
Credit Cards	95	96%	4%	67%	32%

NOTES:
The percentages reported in columns 2 and 3 are based on the total number of households in the sample, N = 194.
The percentages reported on columns 4 and 5 are based on the total number of AFS user households, N = 148.

To better understand the use of formal and informal markets as a source of financing, we turn to information about the primary (largest dollar amount) financial sources used by households in the home purchase process. As shown in **Table 3**, 40 percent of all respondents are home-owners, with the majority of home-buying activity financed primarily through the formal sector (61 percent). Personal savings also represented an important primary source of funds, with 16 percent of the households purchasing their home entirely from personal savings. Only 10 percent of the homeowners used the informal market as a primary home financing source. Because the number of primary informal loans is relatively small, caution should be exercised when making direct comparisons among sources of financing. Even so, we observe that some of the loan terms differ between the formal and informal markets (e.g., lower interest rates for informal loans). In addition, households receiving a relatively large loan through informal sources also had a much lower mean income level than households financed by the formal sector. It is reasonable to believe, however, that informal financial markets are most often used as a supplement or secondary source for home financing. In fact, 23 percent of all homeowners utilized informal sources to finance some portion of their home purchase.[5]

TABLE 3
PRIMARY SOURCES OF HOME FINANCING

	n	Mean Interest Rate (nominal) (%)	Mean Loan Amount ($1996)	Median Purchase Price ($1996)	Mean Household Income ($1996)
Formal					
Bank	22	7.3 (19)	82211 (21)	102210 (19)	43589 (21)
Mortgage Company	13	10.4 (11)	82613 (13)	97006 (13)	67380 (10)
Finance Company	3	10.7 (3)	61948 (3)	74221 (3)	57500 (2)
Government Agency	3	6.7 (3)	57340 (2)	76829 (3)	47500 (2)
Other Formal	5	30.5 (2)	8%	116896 (5)	37429 (4)
Undeclared Formal	1	—	—	144928 (1)	76000 (1)
Total Formal	47	9.6 (38)	78215 (42)	92734 (44)	50622 (40)
Percent of Homeowners	61				
Informal					
Relatives	3	0 (1)	72962 (2)	160861 (3)	39500 (2)
Social Organization	2	4 (2)	111532 (2)	11532 (1)	1185 (1)
Undeclared Informal	3	—	—	119595 (2)	34333 (3)
Total Informal	8	2.7 (3)	92247 (4)	50272 (6)	30531 (6)
Percent of Homeowners	10				
Personal Savings	12	—	—	137818 (11)	50986 (8)
Percent of Homeowners	16				
No Source Reported	10	—	—	82870 (3)	49750 (8)
Percent of Homeowners	13				
Total Homeowners	77				
Percent of Sample	40				

NOTES:
Median year of all house purchases is 1970. Figures relate only to the single largest loan used by each household. Number in parentheses indicates reported observations used to construct means.

A unique feature of our survey is its collection of information about a household's response to events that occurred over the previous five-year period causing financial distress. As shown in **Table 4**, these household responses include seeking financial assistance from formal and informal sources, changes in labor market activity and other behavioral responses. The most frequently cited events resulting in financial distress included substantial unemployment or periods of unusually low income, death or illness of a family member, and large increases in living expenses. Table 4 provides some insights into the response patterns of households facing financial distress as well as the response pattern conditioned on a specific financial setback. Overall, 29 percent of all households (56 of 194) reported having experienced at least one financial setback over the previous 5-year period. The most common reaction by households was the liquidation of existing assets (e.g., savings and checking accounts). Seeking financial assistance from informal sources and delaying or failing to pay debts also were frequently utilized responses. Conversely, formal sources were infrequently used when a financial setback occurred.

TABLE 4
HOUSEHOLD RESPONSES TO FINANCIAL SETBACK

	All Sources of Financial Setback	Illness or Death	Unemployment	Increase Expenses
Responses	8	3	6	5
Formal Financing	16	17	17	6
Informal Financing	20	12	11	9
Use Existing Assets	8	2	13	9
Increase Labor Reduce Consumption	13	5	12	7
Delay/Fail to Pay	16	7	16	3
Total Number of Households Responding	56 (100%)	23 (41%)	29 (52%)	14 (25%)

NOTES:
Sum of responses is greater than total number of households responding due to multiple responses. Number in parentheses indicates percent of total households that experienced financial setbacks. There were 5 households that cited responses as "other."

POLICY IMPLICATIONS AND RECOMMENDATIONS

While caution must be exercised regarding the policy implications that can be drawn from any one study, our research supports several recommendations. First, educational programs, conveying the benefits from having a deposit relationship and informing consumers about AFS costs, appear to be warranted. In essence, these programs will help consumers, especially lower-income households, make informed choices among financial products and services. Second, our findings confirm the need to learn more about the demand for and use of formal financial products. Community development lending opportunities as prescribed by the Community Reinvestment Act (CRA), flexible consumer loan programs, and low-cost deposit accounts could prove useful in meeting the financial service needs of lower-income and minority households. In summary, this study highlights the potentially important roles that informal markets may play as a source of financing. Continued research is needed to extend our understanding of the circumstances and characteristics inherent to a successful informal network, especially within racial/ethnic communities.

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ENDNOTES

[1]The opinions expressed in this study are the authors' and do not necessarily represent the opinions of the Federal Reserve Bank of Chicago or the Federal Reserve System. This article is an abbreviated version of an article published in the Consumer Interests Annual, volume 45, 1999.

[2]As discussed by Caskey (1994), in several states including Illinois, firms that cash customers' checks for a fee are referred to as 'currency exchange' businesses. Hence, a currency exchange firm and a check cashing outlet function in virtually the same way, with the majority of revenues derived from check cashing fees.

[3]The Chatham project also included a random survey of small business owners. See Huck, et al. (1999). The survey instrument was adapted from a survey developed for a study of Little Village, a predominantly Hispanic community situated on the southwest side of the city of Chicago. The Little Village Survey was originally developed and funded by the Center for the Study of Urban Inequality at the University of Chicago. For a discussion of the survey instrument, see Bond and Townsend (1996)

[4]As pointed out by Caskey (1997), it is possible that services provided by AFS businesses are uniquely different than the services offered by a deposit institution. Also, consumers may not be fully aware of the cost differential between these two types of financial service providers. This view also is supported by Fontana (1997). Conversely, Koonce, et al. (1996) offer evidence suggesting that consumers do know that price differentials exist between AFS businesses and formal financial markets.

[5]Detailed information about the use of informal sources in the home financing process is available from the senior author of this article.

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