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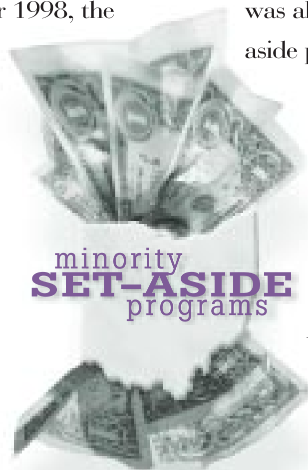
Ohio Scores a Victory in the Battle Over Set-Asides

The future of Ohio's minority set-aside program may be uncertain, but a recent challenge to the program's constitutionality has been overcome. In late November 1998, the 20-year-old program was suspended after two court decisions ruled it unconstitutional. Then, in early April, the Ohio Supreme Court ruled on appeal that part of the program is constitutional. As a result, the state prepared to resume that part of the set-aside program.

The Ohio Supreme Court's decision, which is at odds with an October decision by a U.S. District Court regarding state construction contracts, found that the set-aside law which earmarks a portion of state contracts for goods and services is constitutional. The Ohio Attorney General's Office is still in the process of appealing the other case to the 6th Circuit U.S. Court of Appeals. The lower court found that the law which reserves a portion of state construction contracts and subcontracts for minority business enterprises is unconstitutional.

The original halting of the program was announced in a November 12, 1998, memo distributed by former Ohio Governor George Voinovich to department chiefs around the state. A bonding assistance program administered by the Ohio Department of Development was also put on hold along with the set-aside program. The state's MiniLoan program, in which banks participate with the state to provide loans to small businesses, was unaffected.



Judith French, chief of the chief counsel's staff for the Ohio Attorney General's Office, said that in recent years, many states have removed or altered their set-aside programs based on whether there is evidence to prove that racial discrimination exists. Ohio has not performed a recent study of discrimination in state contracting, but, French said, the state would continue to defend its laws as written. "I think the state will exhaust its appeals on this very important issue," she said.

Certified Minority Business Enterprises in Ohio	
Average Number of MBEs from 1991–1998:	1,372
Number of MBEs in 1998:	1,292
Source: Ohio Department of Administrative Services	

As created in Ohio in 1980, the minority set-aside program, under which a share of

continued on page two

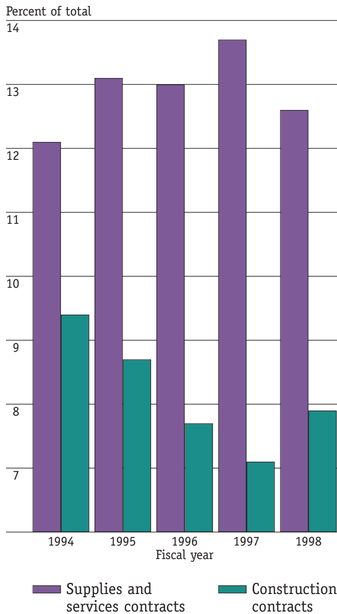
4 FFIEC Issues New Fair Lending Procedures

6 Fourth District Profile: Mortgage Finance Program Promotes Diversity in the Housing Industry

8 In My Opinion: Predatory Lending— Access to Credit Run Amok?

11 System Conference Highlights Access to Capital and Credit
Summary of Alan Greenspan's Remarks on Discrimination in Lending

Percent of Ohio's Contract Business Awarded to MBEs



Note: The State of Ohio's fiscal year runs from July 1 of the previous year to June 30 of the current year.

Source: Ohio Department of Administrative Services

continued from page one

state contracts are awarded to minority-owned enterprises, is based upon the belief that minority-owned businesses face unfair discrimination in the marketplace and therefore cannot compete on an even keel for contracting dollars, access to credit, or bonding assistance. Under Ohio's program, 15 percent of state goods and services purchases are set aside for minority-owned firms, as are 5 percent of construction contracts and 7 percent of construction subcontracts.

According to the Ohio Department of Administrative Services (DAS), in 1998 a total of 1,292 certified minority business enterprises (MBEs) received $239 million in contracts for construction or goods and services. DAS records indicate these figures approximate the required percentages set for construction and supplies and services contracts.

While Ohio's set-aside program pertains to MBEs, an Executive Order created by Voinovich in 1997 and retained by Taft is designed to provide business assistance to "historically underutilized businesses" (HUBs). The order urges state agencies to award at least 5 percent of their available contracting dollars in the areas of construction, goods, and services to HUBs, or to business owners who have shown that they are both socially and economically disadvantaged. Businesses owned by members of racial minority groups are presumed to be socially disadvantaged under the Executive Order. The program graduates businesses upon reaching a certain degree of success and removes businesses from the program after five years.

Minority set-asides involving federal dollars (based on the Small Business Administration's 8A Program) have, so far, met numerous challenges to their constitutionality. The SBA program is designed to assist business owners who are both "socially and economically disadvantaged," where socially disadvantaged is defined as individuals who have been subjected to racial or ethnic prejudice because of their identity as a member of a group without regard to their individual qualities. Still, the situation remains mired in controversy, as this and similar programs continue to face scrutiny in the nation's judicial system.

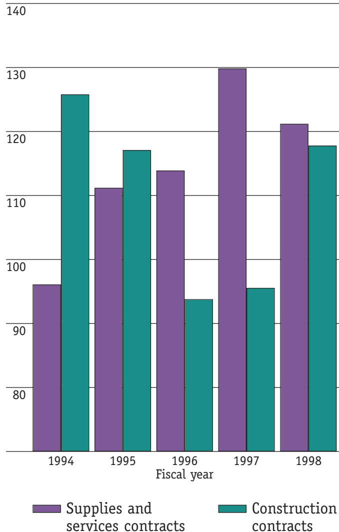
Two states, California and Washington, have recently barred the use of ethnic or gender preferences in the awarding of public contracts. Instead, these states have implemented race-, gender-, and ethnicity-neutral business development programs.

Opponents of such programs, which are typically designed to assist small, capital-deficient enterprises, say they don't go far enough to reach out to minority business owners. "There are certain barriers that minority firms have to operate through," said Franklin M. Lee, chief counsel for the Minority Business Enterprise Legal Defense and Education Fund, a Washington, D.C.-based public interest group. "It has nothing to do with the size of the business, how long you've been in business, or your knowledge of the business," he said. "It has to do with race or gender. Until those issues are addressed, they will always be at a disadvantage."

State Senator C.J. Prentiss, president of the Ohio Legislative Black Caucus, said that Ohio's set-aside program has made great strides in providing new opportunities to African-Americans, women, and members of ethnic groups. "I think left to the public good, without set-asides we would not have been able to have made the gains that we have made."

Other Ohio lawmakers feel the state should implement a race- and gender-neutral program or, at the very least, remove the set-aside laws now

Amount of Ohio's Contract Business Awarded to MBEs



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Source: Ohio Department of Administrative Services

on the books. State Senator Eugene J. Watts has introduced a bill that would remove the existing program while creating a "challenged business enterprise program" to assist startup businesses or those with low capital to get off the ground. As with the MBE program, businesses would have to be certified in order to participate, but the program would not contain preferential language with regard to race, ethnicity, or gender. "To the extent that many smaller, startup, or low-capital businesses are minority-owned, they will benefit," Watts said. Furthermore, businesses would be graduated from the program after five years.

Senator Prentiss said the bill does not recognize that research has shown disparities continue to exist among men and women and blacks and whites.

David Salona, issues coordinator for Ohio Governor Bob Taft, previously said the governor "would not support any action to totally eliminate state set-aside goals." And in an April statement to the *Cleveland Plain Dealer*, Taft said he remained "opposed to race-based set-asides and quotas in the absence of a demonstrated history of racial discrimination."

Meanwhile, the recent suspension of the minority set-aside program may have had some adverse affects on minority-owned businesses in Ohio. Stephanie McHenry, director of minority business development for the Greater Cleveland Growth Association, noted that some MBEs had a sizable percentage of business attributable to the public sector, and many of them have lost business. "Most MBEs serve as subcontractors if they participate in the set-aside program," McHenry explained. As a result of the suspension, she added, many "prime" contractors told MBEs they didn't have to do business with them anymore. Further, McHenry said, in states where set-aside laws have been struck down, there has been an 80-percent to 90-percent dropoff rate in the number of minority businesses doing business with the state.

McHenry, also the executive director of the Cleveland Regional Minority Purchasing Council, said the challenge now is to get the corporate community to step up to the plate to make up the gap. The council, made up of 320 minority businesses and 81 corporations in Northeast Ohio, works to match opportunities for the corporations to contract with minority businesses. ■

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FFIEC Issues New Fair Lending Procedures

The Federal Financial Institutions Examination Council (FFIEC) has released new examination procedures designed to concentrate exam efforts on fair lending practices. The Interagency Fair Lending Examination Procedures, which went into effect January 4, 1999, prescribe a risk-based approach to fair-lending compliance that considers each institution's particular loan product mix, market demographics, and past performance.

According to Robert Cook, fair lending specialist at the Federal Reserve's Board of Governors, the new procedures have been developed to guide examiner judgment. "In order to ensure that our examiners are fully trained in the new procedures, we have conducted comprehensive training sessions," explained Cook.

In Cook's view, the most significant change in the exam procedures is that "in the past, examiners have been looking at virtually every loan product, but not making value judgments about the relative importance of each product."

With the new procedures, noted Cook, "examiners are taking a completely risk-based approach and using various criteria for distinguishing

FFIEC Procedures Get Mixed Reactions in Fourth District

While most bankers, housing advocates, and fair lending specialists agree on the complex nature of fair lending issues, reaction to the FFIEC's new exam procedures is mixed. The following comments were culled from a brief survey of Fourth District lending and housing professionals.

Noting that he is pleased with the new procedures, **William Senhauser**, executive director of the Equal Justice Foundation in Toledo, said, "any initiative that removes the time pressure of the examiners will result in net benefits." Senhauser added that the objective measurement system that is outlined in the new procedures will aid the accuracy of the examinations.

Charles Bromley, director of Cleveland-based Metro Strategies Group, concurred, saying, "this is a step forward [for fair lending advocacy]." Bromley said he is pleased that regulatory agencies have implemented the new procedures, noting that the procedures should assist examiners in analyzing fair lending practices, determining any violations, and, if they find any, moving the violations ahead to the Justice Department.

Karla Irvine, executive director of Cincinnati's Housing Opportunities Made Equal, said she believes it is too early to know the impact of the new procedures. "Nevertheless," said Irvine, "there has been some initial effect. The extra weight on the lending test has grabbed attention; but there remains some confusion around the investment test." She added, "attempts at getting uniformity among those conducting the examination are useful."

The new procedures were characterized as "same wine, new bottle," by **Paul Bellamy**, a research consultant with the Lorain County Reinvestment Coalition. Bellamy expressed doubts about the efficacy of the new procedures while criticizing the lending practices of certain financial institutions. "We believe that classic redlining is being reconstituted by banks and their mortgage and financial services subsidiaries as price and product discrimination," he stated. "As a consequence, low- to medium- [income] areas and minorities are relegated to B- and C-grade capital access."

between which products are examined and which are not examined. Some of the criteria that are considered are the relative amount of lending in given products, and capacity of the collected data about those products."

For example, if a banking institution is doing business in different markets and Home Mortgage Disclosure Act (HMDA) data shows that there seem to be differences in loan pricing or differences in the accept–deny ratios from one market area to another, then the examiner will select those products that show those differences. The examination process now begins well before the on-site visit, and the examiner essentially builds a scoping scenario or a scoping memo that is used to identify specific loan products and lending patterns.

Examination staff members will continue to pay special attention to certain problem lending practices such as redlining and steering (from one loan program to a less advantageous loan program, such as conventional loans to FHA or VA loans). In addition to analyzing factors such as the bank's underwriting process and use of credit scoring, examiners are looking closely at HMDA data and the bank's lending history to determine if there are potential violations.

Although the new procedures will apply to most examinations, each FFIEC agency may continue to use—for limited numbers of examinations—the distinct approaches it has developed for select classes of institutions. For example, such approaches may include statistical modeling to determine whether race or national origin is a factor in credit decisions. The new FFIEC procedures have been designed so that agencies have some latitude to incorporate promising exam innovations. For a number of aspects of lending, such as credit scoring and loan pricing, the "state of the art" in examinations is more likely to be cultivated if agencies have some leeway in their respective exam processes.

The FFIEC is composed of members from each of the five regulatory agencies—OCC, FDIC, Federal Reserve Board, Office of Thrift Supervision, and the National Credit Union Administration. The Interagency Fair Lending Exam Procedures are available on the FFIEC's Web site at *www.ffiec.gov*. ■

Diane Citrino, senior attorney at Housing Advocates, Inc. in Cleveland, is taking a wait-and-see attitude toward the new exam procedures. "It may be hard for the new regulations to address some of the fair lending issues, particularly loan decisions and pricing as they pertain to minorities, women, the elderly, and disabled."

Citrino stated that, despite much successful litigation, underwriting inequalities still exist. "Women and minorities still have unusually high rejection rates," she said. "In addition, these groups often pay higher interest rates and loan fees." Citrino said she is hopeful that the new exam regulations will lead to better monitoring and assessment of CRA compliance. "However, as we move forward, banks need to focus more on addressing issues such as cultural affinity."

Robert Schwemm, professor of law at the University of Kentucky, noted the value of the new FFIEC regulations will potentially be their role in bringing consistency to lenders' underwriting practices. Dr. Schwemm, who is a member of the Board of Governors' Consumer Advisory Council, explained, "one of the difficulties in lending that gives rise to claims of discrimination is the lack of uniformity in underwriting standards. If you have more uniform bank standards, then there might be less risk of suspicion of lending discrimination."

While the new FFIEC exam procedures are designed to promote uniform underwriting practices, **Daniel Morton** noted that uniformity may come at the expense of flexibility. Morton, vice president and senior counsel at Huntington National Bank in Columbus, stated, "there will probably always be a tension between uniformity on the one hand and the need for flexibility on the other. Lenders are required to treat applicants fairly and even-handedly, but we have to recognize that some applicants may need more help than others. A completely objective system could fail to take account of special needs or circumstances." Morton, also a member of the Board of Governors' Consumer Advisory Council, explained that it is not always easy to find the proper balance between uniformity and flexibility in the lending arena. "Over the past seven or eight years, there has been a trend toward more objectivity in underwriting, including more widespread use of tools such as credit scoring. However, there are probably limits on how complex an objective system can be in order to take all the variables into account. A judgmental system can adapt more readily to an applicant's specific needs, but is more susceptible to unexplained differences in treatment from one underwriter to the next. If we want to preserve flexibility, there has to be an appreciation that there will inevitably be deviations in treatment which do not necessarily mean that something illegal has occurred." ■

4th district
PROFILE

MORTGAGE FINANCE PROGRAM

Back in 1995, when the Fannie Mae Foundation established a goal to promote diversity in the mortgage and housing industries, it set about organizing the Community College Initiative. Today, this initiative supports the development of professional education and training through mortgage finance pilot programs at three community colleges in the country—Cuyahoga Community College, Miami-Dade Community College, and Los Angeles Trade-Tech College.

The Fannie Mae Foundation and Cuyahoga Community College in Cleveland launched their educational program in October 1997 after securing a $595,000 Foundation grant. Dr. Jerry Sue Thornton, president of Cuyahoga Community College, noted that this partnership "is just one of the many ways the college serves as a catalyst for economic development in Greater Cleveland." The mortgage finance curriculum offers a two-year associate's degree in applied business in real estate with a concentration in mortgage finance, and a 12-month certificate program in mortgage finance.

Now in its second year, the college has graduated 26 students from its mortgage finance program, and has a current enrollment of 48 students, of which 29 percent are employed in the industry. Students' backgrounds are varied—46 percent hold bachelor's degrees, 27 percent have completed some college, two hold master's degrees, other students are recent high school graduates, and some are displaced homemakers. The program is designed to be flexible, with the majority of the classes offered in the evening.

One of the program's current students, Jacqueline Randall, talked about her experience. "I have worked in the business for nearly two years, but I have learned about aspects of mortgage banking that I did not know." She also noted that the program has helped put her in touch with many new business contacts. "I have uncovered a lot of resources, and I am surprised by the number of opportunities out there."

A former student of the mortgage finance certificate program, Ava Decembly, pointed out that the program brings together a diverse group of students with varied personal and professional backgrounds. She expects that

students, the industry, and the community will reap the program's benefits. "Students are provided with a solid foundation and recognized credentials to enter a mortgage-banking career," Decembly said. "The industry receives training support from academia through the preparation of potential employee pools. The community is rewarded with service from a diverse population of mortgage bankers who are motivated to ensure that qualified individuals can realize their dream of homeownership. This program is long overdue and significantly needed."

According to Jim Carr, senior vice president of Innovation, Research and Technology for the Fannie Mae Foundation, "the Community College Initiative responds to current mortgage industry trends by focusing on diversity, affordable housing, technology, and fair lending."

Carr explained that a key component of the program is the collaboration between local mortgage lenders, professional and trade associations, community-based organizations, educational institutions, and public-sector housing and community development agencies.

Cuyahoga Community College's mortgage finance program director, Marion A. Johnson, noted four areas where the program could benefit from assistance by local mortgage industry professionals. "First, we need individuals to serve as mentors, providing guidance, encouragement, and networking assistance. This knowledge sharing is an asset to the educational process. Second, we need instructors who are currently employed in the industry or have significant experience in the field," said Johnson. "Students really learn from someone who can take a textbook concept and make it come alive with insights from their personal experiences."

In addition to classroom instruction, Johnson explained that mortgage finance professionals could help by offering internships for program participants. "Internships expose students to career opportunities in the industry while giving them hands-on experience. Cuyahoga Community College has a number of internship agreements with local Community Development Corporations that offer students a different perspective on housing and approaches to community development." Johnson encourages potential employers, especially commercial banks and larger mortgage companies, to view the program as their first stop for hiring new employees.

Proving that learning can take place outside of the classroom, these Mortgage Finance students help demolish a house as part of the Fannie Mae Foundation Home Team Initiative.

Finally, Johnson pointed out that the program is looking for local industry representatives to work on its advisory committee. "We investigate ways of keeping the curriculum up-to-date and explore new technology applications in mortgage finance. Innovative thinkers from the industry are welcome to join us and share their time, talent, and ideas."

For more information about the mortgage finance certificate program at Cuyahoga Community College, contact Marion Johnson, program director, at (216) 987–3078. ■

in my opinion

NANCY SCHAEFER

Executive Director
Pittsburgh Community Reinvestment Group
Pittsburgh, Pennsylvania

Nancy Schaefer is executive director of the Pittsburgh Community Reinvestment Group (PCRG), a consortium of 28 community-based organizations representing more than 50 low- and moderate-income neighborhoods in the city of Pittsburgh. Established in 1988, the PCRG has successfully negotiated lending agreements with Pittsburgh financial institutions for more than $2.7 billion in reinvestment and has facilitated the sale of over $35 million in community development portfolio loans to Fannie Mae. Schaefer has 16-plus years of experience in community reinvestment; in addition to her work with the PCRG, her career includes a 10-year tenure as the executive director of the Northside Leadership Conference in Pittsburgh, a coalition of neighborhood organizations dedicated to housing and economic development.

Access to Credit Run Amok? Some Viewpoints on *Predatory Lending*

After in-depth analyses of mortgage lending for 1996 and 1997 in Allegheny County (Pennsylvania), I experienced a real eye-opener. Data from the HMDA-based study revealed that while minority loan denials had fallen 9 percent, the market share of independent mortgage companies climbed 27 percent. What does this finding signal? It means that although most loans were originating with our partner financial institutions, a significant number were being made by independent mortgage companies, many of whom are subprime lenders. The reason our minority loan denials were falling while the rest of America's rose is that many of these borrowers were being picked up by the subprime lenders, many of whom have been characterized as "predatory lenders."

Not only were these folks getting mortgages, but many were also signing on for home equity loans at exorbitant rates. At the Pittsburgh Community Reinvestment Group (PCRG), we are heavily involved in helping people become first-time home buyers, or making sure that they can get a home by obtaining a mortgage. But at the same time, we had been largely ignoring people who were *already* homeowners, but who needed home equity loans. It struck us that there are unknown numbers of people who fall into the "equity theft" pit—and that could have serious ramifications for our neighborhoods.

The truth of the matter is that predatory lending takes advantage of people who have very small incomes, but a lot to lose. Predatory lending very clearly targets senior citizens on fixed incomes, minority groups, and low-income homeowners—all of whom have struggled to put their hard-earned dollars into buying homes. In many cases, their homes are *all* that they have. When they become involved in home equity loans with subprime lenders, they often do not understand how much they are putting at risk.

There is no exact definition of predatory lending, but it is generally when a lender takes advantage of homeowners' lack of knowledge of financial transactions by "selling" them a loan that far exceeds what they can afford. Such loans, usually of the home equity variety, are accompanied by excessively high fees that are not disclosed at the beginning of the transaction.

PCRG sought expert help to better define what we were dealing with in predatory lending from a national expert, William J. Brennan Jr., of the Atlanta Legal Aid Society. Mr. Brennan testified before the U.S. Senate's Special Committee on Aging last spring, distributing a 32-point exhibit that cataloged the abusive practices of predatory lenders. Examples include:

- Deceptive solicitation practices—the $20,000 check you get in the mail that looks a lot like your Social Security check. If you cash it, it's considered a loan.
- Home improvement scams—sign the contract, and you're really signing a note.
- Mortgage broker kickbacks—they help you find the "best" loan; you pay the broker a fee, as does the predatory lender, who builds the cost back into your deal through referral fees and increased interest.
- "Flipping," or successive, repeated refinancing of a loan by rolling the balance of an existing loan into a new loan. Additional fees are added each time and the terms are extended, thus incurring more interest.
- Loans exceeding 100 percent of the value of the home. Homeowners are lured into taking loans to consolidate consumer or unsecured debt. The amount of these loans exceeds the fair market value of their houses, locking them into a high-cost loan with all the attendant fees and potential for flipping, and no chance of refinancing.

There are many more abusive practices, not the least of which is the high-pressure collection tactics that lenders use once the loans are made. The dangers of these abuses are very real: Not only do homeowners run the risk of losing their homes, but we could also see a trend toward neighborhood and community disintegration as long-time homeowners are forced out.

I should make the point here that not all subprime lenders are bad. "Subprime" is a misleading word, really referring to lenders who make loans to borrowers whose credit is blemished by late payments or defaults. They do fill a niche for high-risk borrowers, though the borrower will pay substantially more. Many banks, in fact, have developed subsidiary finance companies to fill this financing void.

The time is ripe for such financing mechanisms, and that may be why so many predatory lenders are springing up. Property values have appreciated, equity in homes is high, and more people struggle with maintaining acceptable credit reports. In addition, a vacuum is created in some neighborhoods where there is a paucity of banking services, and predatory lenders zoom in on these targets. With many states lacking strong consumer protection laws, usury legislation, or moderate caps on interest rates, it is a perfect climate for predators. The profitability of predatory lending is staggering: Such lenders claim that their high fees and interest make up for the higher-risk nature of their borrowers, but where is the risk when you've got a person's home to place against it?

I think the real difficulty here is that borrowers' options are not being explained when they apply for home equity loans. There are many reasons to apply for a loan, such as financing home repairs, taxes, or consolidation of consumer debt. While banks frequently refer customers to finance companies when they cannot score highly enough to obtain a loan with them, the reverse rarely occurs.

We are doing our research on the ground with the challenge of predatory lending, because we often don't learn of these situations until someone is already in trouble. PCRG has been a community success story, thanks in part to the

continued on page ten

continued from page nine

efforts of its financial institution partners, and I am proud to say that in the greater Pittsburgh area we have one of the most competitive mortgage markets there is. I hope that we can organize once again to combat this new challenge.

We will be making efforts to educate people on the front-lines with regard to mortgage and home equity financing. Teams of bankers, along with agency staff and volunteers, will canvass door-to-door in targeted neighborhoods, providing people with the knowledge to make educated choices. I would like our theme to be "Better Shop Around," because we want people to understand that they have choices. By shopping around for a loan, they can seek out the best deal for themselves. They need to ask questions about the prices of loans, fees they may incur, and the exact terms of the deal. They can and should ask for a signed declaration in writing prior to making a decision. And they can go to as many finance companies or banks as they want.

PCRG hears reports every day that our low-income residents are bombarded with loan offers by mail, television, and radio—seemingly every hour! They need to know how to decide, and we'll be airing our message as well.

What can people do for themselves? Shop around for the right deal, educate themselves about what's available, join a neighborhood group, or read their AARP newsletter. Even AARP is getting involved in fighting this pervasive problem. Home-buyer education and credit counseling are now available statewide in Pennsylvania through the concerted efforts of many agencies and the Pennsylvania Housing Finance Agency.

Predatory lending has gained national attention. In Washington, D.C., proposed financial modernization legislation would allow financial institutions more flexibility in competing globally and permit banks to expand into insurance, securities, and other businesses. PCRG is asking our senators and representatives to include language that would also expand the reach of HMDA and the Community Reinvestment Act. HMDA currently does not provide information on the annual percentage rates and interest rates of loans, but this information would be extremely helpful in identifying lenders using predatory practices. As financial institutions diversify, the CRA must be updated and expanded to cover mortgage and finance companies, credit unions, and insurance companies.

A Mortgage Reform Working Group composed of industry representatives and consumer groups has been meeting in Washington for the past two years, and it is anticipated that legislation will be proposed in 1999. With six major agenda items, including substantive protection against predatory lender abuses, this legislation is expected to bring about positive results for both consumers and financers. For borrowers, the act would ensure the disclosure of mortgage credit costs to consumers in a timely fashion, allowing them to shop more effectively. This would mean that borrowers could receive a binding quote that clearly sets forth in writing the costs of funds (the interest rate and any points) and any required settlement services—all before they make a decision or sign for a loan. For lenders, it would help to minimize their regulatory burden.

Obviously, such legislation would address my original concern that uneducated consumers are more likely to be burned by predatory lenders. People who need loans would have the opportunity to review all the facts relating to their situation before making the all-too-important decision of whether to put the homes they own at risk. Education and disclosure are critical keys to closing the door on predatory lending practices. ■

case study

Predatory Lending: A Case Study

Mr. F is a 72-year-old African-American man who can neither read nor write. Retired and living alone on Social Security, he has owned his home in Georgia for 31 years. In 1991, he borrowed $16,499 from a finance company that, in the ensuing years, flipped the loan three times, charging additional fees and interest each time, adding in life insurance premiums totaling more than $5,500. He was forced to refinance with another company, which turned around and sold the loan again. In the end he owed $33,000, with an annual percentage rate of 16.185 percent. Unable to make his payments, he is now seeking Chapter 13 bankruptcy in order to save his home from foreclosure and himself from homelessness. PCRG later learned that his loan had been sold yet again.

Federal Reserve System Conference Highlights Access To Capital and Credit

Board of Governors Chairman Alan Greenspan recently discussed the topic of discrimination in lending at a research conference sponsored by the Federal Reserve System. In addition, Board of Governors member Edward M. Gramlich discussed trends in small business lending.

The academic conference, held March 8–9, 1999, in Arlington, Virginia, brought together economists and scholars from the Federal Reserve System, as well as colleges, universities, and major research institutions. Research topics included the effects of financial consolidation on lending; credit scoring and securitization of small business loans; access to credit for minority-owned businesses; and microlending.

"IT IS IMPORTANT FOR LENDERS TO UNDERSTAND THAT FAILURE TO RECOGNIZE THE PROFITABLE OPPORTUNITIES REPRESENTED BY MINORITY ENTERPRISES NOT ONLY HARMS THESE FIRMS, IT HARMS THE LENDING INSTITUTIONS AND, ULTIMATELY, ROBS THE BROADER ECONOMY OF GROWTH POTENTIAL."

— Alan Greenspan, Chairman
Board of Governors of the Federal Reserve System

Barriers in Lending Still Exist, Greenspan Says

Discriminatory lending practices adversely affect both the economy and lending institutions, Chairman Alan Greenspan said in his keynote address.

"It is important for lenders to understand that failure to recognize the profitable opportunities represented by minority enterprises not only harms these firms, it harms the lending institutions and, ultimately, robs the broader economy of growth potential," he said.

Greenspan referred to recent academic studies that indicate there are discrepancies in the turndown rates for minority-owned small business applicants. Income, balance sheet factors, or credit histories do not readily explain all of these differences, Greenspan said. Considerably more work needs to be done to take account of possible explanatory factors not included in studies to date, he said, adding, "if, after such examination the gap persists, it raises disturbing questions."

To the extent that market participants discriminate, either consciously or unconsciously, Greenspan said, credit does not flow to its most profitable uses and distribution of output is distorted. "In the end, costs are higher, less real output is produced, and national wealth accumulation is slowed," he said. "By removing the non-economic distortions that arise as a result of discrimination, we can generate higher returns to human capital and other productive resources." Greenspan said mass-market approaches to small business lending might help to reduce discrimination in lending. In addition, new intermediaries, such as community development corporations, micro-business loan funds, or multi-bank and investor loan pools, are building expertise in serving the small- and minority-business marketplace, he said.

Greenspan also noted that while businesses both large and small must have access to credit, they must first have equity capital if they are to be considered viable candidates for debt financing. "Equity acts as a buffer against the vagaries of the marketplace," Greenspan said. "The more opaque the business operations, or the newer the firm, the greater the importance of the equity base." Greenspan added that continued efforts to develop the markets for private equity investment will result in an innovative and productive

continued on page twelve

continued from page eleven

business community. This is especially true, he said, in lower-income communities, "where the weight of expansive debt obligations on small firms can severely impede growth prospects, or more readily lead to business failures."

"WHILE LOCALLY BASED COMMERCIAL BANKS AND THRIFT INSTITUTIONS PLAY A ROLE IN THE SMALL BUSINESS CREDIT MARKET, SO DO OUT-OF-MARKET PROVIDERS."

—Edward M. Gramlich
Board of Governors of the Federal Reserve System

Currently, the Federal Reserve System is working on its third survey of 6,000 small businesses, to be known as the *1998 Survey of Small Business Finances*, Greenspan noted. This new information should add greatly to the industry's knowledge of changes taking place in small business finance, he concluded.

More Information on Credit-Constrained Firms Needed, Gramlich Observes

Governor Edward M. Gramlich, in his address, discussed current trends in small business lending, as well as what remains to be learned. Gramlich said a study of the new Community Reinvestment Act data, reported in the September 1998 *Federal Reserve Bulletin*, offers some important information. "While locally based commercial banks and thrift institutions play a role in the small business credit market, so do out-of-market providers," Gramlich said. "Overall, the new CRA data reveal that out-of-market lenders are numerous in both urban and rural banking markets and they generally outnumber in-market institutions."

Gramlich also noted there is a lack of information about the incidence of loan denials and the profile of credit-constrained firms, especially those owned by women and minorities. "We know little about the application of flexible underwriting criteria and liberal repayment terms offered to small business borrowers and about how those firms perform when these techniques are utilized," Gramlich said. He observed that further research is needed on the continuing effects of bank consolidation, the use of credit scoring, and the increasing incidence of out-of-market and non-bank financial service providers. In addition, he said, the industry would benefit from learning more about the kinds of technical assistance and information that assists women- and minority-owned small businesses to become more attractive candidates for credit.

The complete texts of both Greenspan and Gramlich's speeches are available on the Web at *www.federalreserve.gov/boarddocs/speeches/current/*. For more information, contact the Community Affairs Office at the Federal Reserve Bank of Cleveland, at (216) 579–2846. ■

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