Community Affairs Manager's note - Issue 2, 2002

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November 1, 2002

AUTHOR

Jacqueline Nicholas

Community Affairs Officer

New faces in Community Affairs

Since my arrival at the Federal Reserve Bank of Minneapolis earlier this year to assume the role of Community Affairs Manager, I have been struck by the diversity of the community development issues and opportunities in the Ninth District. In every corner of our region, dedicated individuals from community and economic development groups, financial institutions and other organizations are finding creative solutions to a broad range of challenges. Community Affairs recently welcomed two new members who will enhance our team's ability to be a partner in meeting those challenges.

Richard M. Todd, our new Community Affairs Officer (CAO), joined the Federal Reserve Bank of Minneapolis as an economist in 1980. He has held a variety of management positions in the Bank's Research and Risk Management Departments and most recently served as vice president of information technology. He brings extensive research experience to his new role and has a keen interest in emerging community development issues.

With the addition of Senior Project Director Susan Woodrow, Community Affairs extends its home base to Helena, Montana. Woodrow joined the Minneapolis Fed in 1990 as an attorney in the Law Department and was later promoted to senior counsel. She transferred to the Helena Branch in 1999, assuming responsibility for a variety of branch functions. Although she is still involved in managing operations in Helena, Woodrow devotes the majority of her time to Community Affairs projects. Her expertise in banking regulations and Indian Country legal issues is a valuable asset for our program.

Our new team members' contributions are apparent in this issue of *Community Dividend*, which features a cover story by our CAO. Todd's article explores the assumption that financial literacy education is an antidote to predatory lending. It examines three major types of financial literacy training and finds support for cautious optimism that increased knowledge of personal finance can help consumers avoid abusive lenders. In "A Conversation With . . .," Todd joins Claudia Parliament, professor of applied economics at the University of Minnesota, in a related discussion of financial literacy education and predatory lending.

Predatory lending is the focus of our first feature, which explores a widespread property flipping scam that affected hundreds of low-income families in the Twin Cities. Our second feature reports on a community development tour of St. Paul that Community Affairs arranged for Federal Reserve Governor Susan Schmidt Bies, who recently visited the Ninth District.

As this issue of *Community Dividend*demonstrates, Community Affairs offers a variety of resources—from information on specific community development topics to the skills and knowledge of our team members. We hope those resources will help you meet the diverse challenges in your community.

FEDERAL RESERVE BANK of MINNEAPOLIS

Financial literacy education: A potential tool for reducing predatory lending?

A review of recent studies supports cautious optimism that increased financial literacy can help consumers avoid predatory lenders.

November 1, 2002

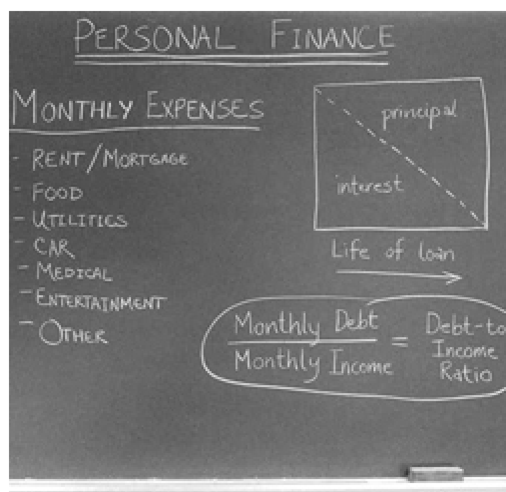
AUTHOR

Richard M. Todd

Former Vice President and Advisor to the CICD

Numerous complaints of so-called predatory lending have been reported in recent years. According to these reports, certain lenders exploit unsophisticated borrowers by inducing them to agree to disadvantageous loan contracts. A disadvantageous contract, in this context, means a loan that is overpriced or overly restrictive after adjusting for risk, in the sense that the borrower could easily do better by shopping around a little or, in extreme cases, by simply doing nothing. The extreme cases include loans seemingly rigged to yield default and foreclosure, so borrowers lose their homes or home equity to the lenders.

By its nature, predatory lending is difficult to track and measure, but growing anecdotal and circumstantial evidence has convinced many observers that it is a serious problem. In 2000, a national task force organized by the U.S. Department of Housing and Urban Development and the U.S. Department of the Treasury collected information about predatory lending from around the country. The task force reported that "there is a growing body of anecdotal evidence that an unscrupulous subset of ... actors ... engage in abusive lending practices."[1] Some policymakers have recently modified consumer regulations and laws in an attempt to curb predatory lending, providing further evidence that the problem is perceived as a serious one.



However, regulations and laws intended to curb predatory lending may have undesired consequences. They may impede the operation of legitimate credit markets, making it difficult for financially vulnerable individuals to access credit. Partly for that reason, policymakers are exploring other approaches to reduce predatory lending. Increasing the financial knowledge of borrowers is one appealing approach. If successful, it could make borrowers less susceptible to predatory loan offers and improve the operations of legitimate credit markets. With these hopes in mind, Federal Reserve System governors, the secretary of the Treasury, leading members of Congress and others have endorsed financial literacy training as a promising antidote to predatory lending.

It seems logical that delivering appropriate financial training to vulnerable borrowers will help them ward off predatory lenders. But is there evidence that this approach actually works? Unfortunately, direct evidence on training aimed at preventing predatory lending is hard to find, due in part to the difficulties involved in monitoring predatory lending. So, this article focuses on a more limited question: Does financial literacy training, of any kind, bring about positive behavioral change? Several recent studies examine the effectiveness of certain forms of financial literacy training, and a review of these studies supports cautious optimism about the ability of well-designed educational programs to bring about responsible financial decision making. This optimism, in turn, supports further exploration of financial literacy training as a tool for reducing abusive lending practices.

Reviewing the evidence

For decades, financial literacy training has been offered in many different forms and settings to many different audiences. Efforts to measure the effectiveness of this training are typically organized around its subject matter and audience. Accordingly, this review of the research on financial literacy training is organized into three commonly studied categories:

- General financial literacy offered to high school students;
- Training related to retirement and savings planning, offered by employers to employees; and
- Home buying and homeownership training, offered to mortgage applicants or to homeowners who are having difficulties making their payments.

High school financial literacy training

Basic financial literacy education has been available for decades in many high schools, but only recently has its effectiveness been studied. The recent studies are far from comprehensive, but they suggest both short-term and long-term effects.

Evidence of short-term effects comes from studies of students exposed to the High School Financial Planning Program® (HSFPP) curriculum between September 1997 and January 1998. For the studies, which were conducted by researchers from the University of Minnesota and the University of Wisconsin, over 4,000 students from 188 high schools across the United States returned surveys after completing the HSFPP curriculum. More than 400 of those students completed a follow-up survey three months later, and their teachers were also surveyed.

The studies have some limitations, since their results are based entirely on the students' and teachers' subjective assessments, and no control group was used to benchmark the results. Notwithstanding these limitations, the authors concluded that "teaching personal finance in high schools can positively impact the financial knowledge, behavior, and self-efficacy levels of teens."[2] Immediately after completing the HSFPP curriculum, almost half of the students in the study reported increases in their financial knowledge. Of special note, "the area where the most students increased in knowledge was in understanding the cost of credit,"[3] which could help reduce their subsequent susceptibility to predatory lenders. In addition, about a third of the students reported changes in behavior, especially in tracking expenses and setting and achieving money-management goals. Teachers generally agreed with their students' self-assessments, indicating a "marked change in knowledge and behavior in students after participating," with "the most changes in the areas of consumer credit, car insurance, time value of money, and tracking expenses."[4] And of the subset of students who completed follow-up surveys three months after their training, nearly 40 percent had started saving money, and 31 percent reported that opening a savings account was the most important financial planning activity they engaged in after completing the course.

In many areas, at least half of the surveyed students did not report gains in their financial knowledge or changes in their behavior. Although this may seem discouraging, the authors indicate that it is partly due to the fact that many students had already adopted responsible financial behaviors before their training. In other words, the gains reported for this curriculum in large part reflect a "leveling up" of the knowledge and behavior of individuals who were not already financially savvy. This theme runs through many of the studies summarized here.

Reports that the benefits of financial literacy training persist months later are encouraging. But the benefits need to persist for years or even decades to be effective against predatory lending. At least one study suggests that they do. The study, conducted by researchers B. Douglas Bernheim, Daniel M. Garrett and Dean M. Maki, takes advantage of the fact that, historically, some states have at times mandated financial literacy education in high schools.

The study is based on financial and demographic data collected in 1995 from a national sample of 2,000 individuals between the ages of 30 and 49. Allowing for other factors that affect financial behavior, it found that adults who attended high school when their states mandated financial literacy training generally save more and accumulate more wealth than other adults. Their net worth is higher—by an amount equivalent to one year's earnings—than the net worth of adults who attended high school when their states did not mandate financial literacy training. In other words, exposure to state-mandated financial literacy education appears to be associated with more frugal adult financial behavior, even 30 years later.

As with the short-term benefits of high school financial literacy training, the long-term benefits may result from leveling up the knowledge of some individuals. When the researchers measured the effects of mandated training, they made a distinction between "individuals whose parents did and did not save more than average."[5] They found that the long-term benefits of financial literacy training are concentrated among individuals who reported that their parents' savings rates were at or below the average. The researchers concluded that "the consistency of this pattern ... provides considerable support to the view that financial education at school is a close substitute for financial education at home."[6] In other words, high school financial literacy training appears to be especially effective for individuals who did not learn the basic habits of household saving from their parents.

Ninth District Financial Literacy Standards

According to a recent study funded by the National Endowment for Financial Education, fewer than half of all states cover personal financial management in their required coursework for grades kindergarten through 12 (K-12). Only three of those states—Florida, Illinois and Rhode Island—require high school students to complete a personal finance course in order to graduate.

None of the six states in the Ninth District has such a requirement in place, but all six include economics and, to some degree, personal finance in their academic content standards. Content standards are defined expectations of what students need to know in particular subject areas, and many school districts use them as the basis for their K-12 curricula.

In addition to including economics and personal finance in their current content standards, several Ninth District states have recently considered legislation related to financial literacy education. Summaries of the relevant content standards and legislative actions appear below.

Michigan: Economics content standards from the Michigan Department of Education (MDE) emphasize an understanding of individual and household choices, business choices, economic systems, trade and the government's role in the free-market economy. (For more information, visit www.michigan.gov/mde.)

Legislation: A 2001 amendment to the state's revised school code requires the MDE to develop or adopt model financial education programs for grades K-12.

Minnesota: Economics and business content standards from the Minnesota Department of Children, Families and Learning introduce the concepts of resource management, decision making and informed consumerism in middle school. In grades 9-12, the emphasis is on personal and family resource management, financial analysis and economic systems.

Legislation: Several financial education bills were defeated in the Minnesota legislature in 1999 and 2001, including one requiring personal and family financial management and investment education for all high school students.

Montana: The Montana Office of Public Instruction's content standards for social studies emphasize the basic economic principles of production, distribution, exchange and consumption. By high school graduation, students are expected to understand financial institutions and the common products they offer. Separate standards for career and vocational/technical education emphasize basic monetary skills and financial management. (For more information, visit www.opi.state.mt.us.)

Legislation: Senate Joint Resolution No. 2, passed in 1999, urged the Montana Board of Public Education to integrate economic principles and retirement planning into the K-12 curriculum in order to improve retirement planning and saving.

North Dakota: The North Dakota Department of Public Instruction's social studies content standards emphasize supply and demand, economic systems and resource management. Specific knowledge in support of these standards includes an understanding of budgets, checking, savings, credit, interest and financial institutions. (For more information, visit www.dpi.state.nd.us.)

South Dakota: Under the South Dakota Department of Education and Cultural Affairs' content standards, economics is one of four core areas of social studies education. Basic economic concepts are introduced in the early grades. In later grades, lessons in economic systems and practices are conveyed through a variety of history courses. Separate content standards for consumer and family resources emphasize resource management, personal and family financial planning, consumer awareness and insurance decisions. (For more information, visit http://doe.sd.gov.)

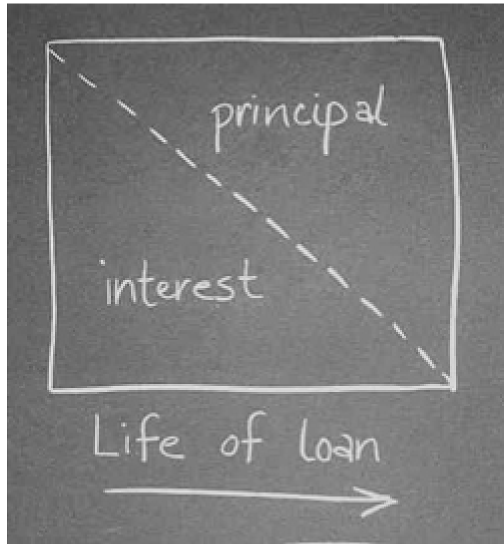
Wisconsin: The Wisconsin Department of Public Instruction's core academic standards for economics include concepts of production, distribution, exchange and consumption, with some emphasis on consumer rights and decision making. Separate content standards for business education emphasize savings, checking, credit and investments. (For more information, visit www.dpi.state.wi.us.)

Legislation: Wisconsin Senate Joint Resolution 31, dated April 11, 2001, urges the educational community to explore ways of teaching personal finance to junior and high school students. A 2002 report from the Governor's Task Force on Financial Education recommends a financial education requirement for all students.

Legislative information was obtained from the Jump$tart Coalition for Personal Financial Literacy at www.jumpstart.org.

Workplace financial literacy training

Many firms offer employees financial literacy materials or training, usually with a focus on retirement savings plans. Surveys conducted in the 1990s found that roughly three-fourths of companies provided some financial education in the workplace, in the form of summary plan descriptions, newsletters, one-on-one counseling or participatory workshops. The vast majority of workplace financial training covered topics such as asset allocation and retirement income.[7] These surveys also indicate that a key reason why employers provide financial literacy training is to boost their employees' savings plan participation and contribution rates. This may be partly due to the fact that, under many retirement savings plans, contribution limits for highly compensated managers and executives are eased if other employees' participation and contribution rates increase.



Well-designed programs of workplace financial training seem to change behavior, especially among employees who are not highly compensated. A number of studies of workplace savings plans generally agree on the following points:

- Providing generic information, especially in written form, is the least effective method of delivering training and sometimes appears to have little or no effect.
- The more specific the information is to the firm's plan or the individuals' situations, and the more frequently and personally it is offered, the more effective it is.
- Well-tailored information, especially if it is offered frequently or in person, can raise overall employee retirement plan participation and contribution rates at least as effectively as generous employer-matching programs.[8]
- With the exception of employer matching and financial education, retirement plan provisions have relatively isolated and limited effects on employee behavior.
- The effects of workplace financial training are concentrated among nonhighly compensated employees and appear to be reduced or nonexistent for highly compensated employees.

These studies provide consistent evidence that financial literacy training in the workplace can induce more prudent retirement savings behavior, at least among employees whose participation and contribution rates are initially low. However, many of the studies have significant gaps, such as failing to provide information about employees' savings behavior outside the workplace—leaving open the possibility that increased participation merely reflects a shift of existing savings into employers' plans. A few studies attempt to fill these knowledge gaps, and they bolster the view that the positive effects of workplace financial training are real and extend to the employee's household generally. For example, a study that measured all forms of savings found that the median total savings rate for employees—including savings outside the workplace—is about 20 percent higher when the employees can obtain financial training at work.[9] The study also found that spouses of these employees tend to participate at higher rates in their own employers' plans.[10]

The screening problem

Screening, or the bias that can be introduced through a study's selection process, makes it difficult to determine whether the effectiveness of some homeownership education and counseling (HEC) training is due to the training itself or the traits of the HEC participants. Researchers continue to devise statistical procedures to adjust for screening effects and correct other study flaws, but it is still difficult to define and measure the success of HEC programs. (This difficulty need not imply that HEC programs are without merit, for the screening function itself may be valuable. See the McCarthy and Quercia study referenced in the main article below for comments on how the screening provided by HEC programs has helped facilitate increased lending to low-income communities.)

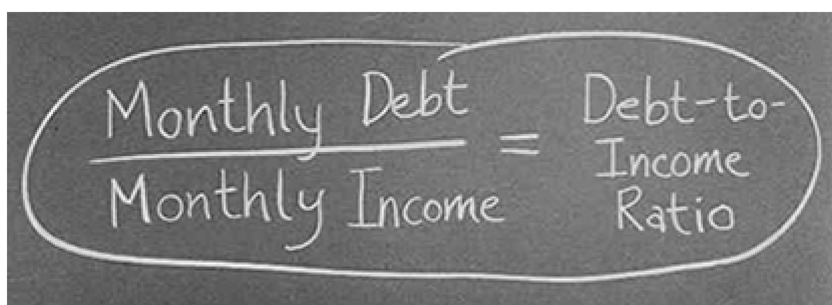
Screening effects are also a problem in some studies that focus only on recipients of high school or workplace training. However, in these cases, the gap is covered by other studies that focus on whole populations for whom training was available, without differentiating between the individuals who chose to pursue the training and those who did not. Some of these studies also provide evidence that even the availability of training was not correlated with any preexisting interest in or tendency toward financial prudence. (For example, see the Bernheim, Garrett and Maki study of high school training and the Bernheim and Garrett or Bayer, Bernheim and Scholz studies of workplace training discussed in the main article.)

Homebuyer training

According to Roberto G. Quercia of the University of North Carolina and Susan M. Wachter of the University of Pennsylvania, homeownership education and counseling (HEC) programs, which provide information about the financial aspects of buying and keeping a home and are usually directed at low-income individuals, "evolved from the implementation of the 1968 Housing and Urban Development Act."[11] The Act authorized "public and private organizations to provide counseling to mortgagors" affected by certain federal programs.[12] Subsequent federal legislation, including the Fair Credit Reporting Act of 1970, provided additional impetus by setting standards for granting credit and encouraging consumer education. By 1993, more than 1,000 organizations were receiving homeownership education funding from foundations, federal housing authorities and states.

Federal funding of HEC helped stimulate studies of its effectiveness, beginning with a flurry in the 1970s that has since tapered off. Recent reviews of these studies conclude that almost all are flawed and that, as a result, "it is astounding to consider what little empirical evidence there is to determine how well HEC works."[13]

Several factors make it difficult to accurately assess whether HEC leads to positive behavior changes by enhancing home buyers' knowledge. In the first place, it is even difficult to define an appropriate measure of success. One indication might be increased home buying rates for low-income clients. But increased home buying alone can be a misleading indicator. If buyers are not prepared for the ongoing financial burdens of homeownership, increased home buying could result in increased mortgage delinquencies and defaults a few years later. So a complete measure needs to consider both home buying rates and subsequent delinquency and default rates, with success indicated by some combination of more home buying and fewer defaults per buyer.[14] Many studies consider only one of these two factors.



Even if an appropriate measure of success could be established, studies of HEC's effectiveness often cannot adequately control for certain factors outside the training that affect the results. For example, completion of HEC is often required to obtain some kinds of private or public low-income mortgage financing. Low-income would-be borrowers who are organized and disciplined enough to complete the required HEC training differ, at least by those traits, from low-income buyers who avoid or fail to complete the training. Even if they learn nothing at all in their classes, HEC graduates will tend to be more successful, on average, than low-income would-be borrowers who do not complete the program. So when HEC graduates disproportionately succeed as homeowners, it is difficult to know whether their success is due to the training they received or merely to HEC's ability to "screen in" individuals who are already well suited for homeownership.[15]

Although assessing the overall educational success of HEC programs is difficult, a recent study of HEC delivery methods reinforces the common-sense view that outcomes improve when financial literacy training is delivered face to face. The study, conducted by Abdighani Hirad and Peter M. Zorn of Freddie Mac, tracked delinquency rates on 40,000 mortgages originated under a program for risky borrowers that requires participants to complete HEC. It found that borrowers who received classroom instruction or one-on-one

counseling had significantly lower delinquency rates than borrowers who received training via telephone counseling or self-study.[16] Because classroom and one-on-one instruction may require more commitment from borrowers than the alternatives do, the researchers cannot say for sure whether the lower delinquency rates result from better education or simple screening effects. In addition, lower delinquency rates are only a partial measure of home buying success, since they do not indicate the number of people who were turned down in their attempts to purchase homes. Nonetheless, the study is generally consistent with other results supporting the idea that face-to-face training is associated with desirable outcomes.

Evidence mixed but supportive

A review of the research on the effectiveness of financial literacy training shows that training offered by high schools and workplaces is associated with improved financial knowledge and behavior. These associations are especially strong for low-income or less-educated recipients, supporting the idea that financial literacy training has the potential to curb predatory lending.

However, the efficacy of HEC is less clear, due to the difficulties discussed above. Many predatory lending practices involve mortgages, and the lack of solid evidence about the success of HEC casts some doubt on the idea that financial literacy training can be an antidote to those practices.

So, although little is yet known about financial literacy training specifically targeted against predatory lending, the existing evidence on other forms of financial literacy training is partly encouraging and partly discouraging. However, the special factors that raise doubts about the effectiveness of HEC, like screening effects, might be overcome by developing delivery channels that reach across the population of individuals at risk for predatory lending. For this reason, and because of the favorable evidence on other forms of financial literacy training, the overall body of evidence seems generally supportive of the idea that well-designed, appropriately delivered financial literacy training should be considered as a tool to prevent predatory lending.

Endnotes

[1] *Curbing Predatory Home Mortgage Lending*, U.S. Department of Housing and Urban Development-U.S. Department of the Treasury (2000), p. 13.

[2] Catherine A. Huddleston-Casas, Sharon M. Danes and Laurie Boyce, "Impact Evaluation of a Financial Literacy Program: Evidence for Needed Educational Policy Changes," *Consumer Interests Annual*, vol. 45 (1999), p. 113.

[3] Sharon M. Danes, Catherine Huddleston-Casas and Laurie Boyce, "Financial Planning Curriculum for Teens: Impact Evaluation," *Financial Counseling and Planning*, vol. 10, no. 1 (1999), p. 32.

[4] Ibid.

[5] B. Douglas Bernheim, Daniel M. Garrett and Dean M. Maki, "Education and Saving: The Long-Term Effects of High School Financial Curriculum Mandates," *Journal of Public Economics*, vol. 80 (June 2001), p. 460.

[6] Ibid.

[7] Patrick J. Bayer, B. Douglas Bernheim and John Karl Scholz, "The Effects of Financial Education in the Workplace: Evidence from a Survey of Employers," Working Paper 5655 of *Working Paper Series*, National Bureau of Economic Research Inc., July 1996. Similar findings appear in B. Douglas Bernheim, "Financial Illiteracy, Education and Retirement Saving," *Living With Defined Contribution Pensions* (University of Pennsylvania Press, 1998), p. 62.

[8] In employer-matching programs, employers supplement their employees' contributions to a retirement savings plan, up to a specified limit. For example, an employer might contribute an extra 50 cents for each dollar contributed by an employee, up to a fixed percentage of the employee's salary.

[9] B. Douglas Bernheim and Daniel M. Garrett, "The Effects of Financial Education in the Workplace: Evidence from a Survey of Households" (August 2001), p. 19.

[10] Ibid., p. 18.

[11] Roberto G. Quercia and Susan M. Wachter, "Homeownership Counseling Performance: How Can It Be Measured?" *Housing Policy Debate*, vol. 7, issue 1 (Fannie Mae Foundation, 1996), p. 178.

[12] Ibid.

[13] George W. McCarthy and Roberto G. Quercia, "Bridging the Gap Between Supply and Demand: The Evolution of the Homeownership, Education and Counseling Industry," Report 00-01 (The Research Institute for Housing America, May 2000), p. 27.

[14] Quercia and Wachter, pp. 197-198.

[15] Researchers continue to devise statistical procedures to adjust for screening effects and correct other study flaws, but it is still difficult to define and measure the success of HEC programs. (This difficulty need not imply that HEC programs are without merit, for the screening function itself may be valuable. See the McCarthy and Quercia study referenced above for comments on how the screening provided by HEC programs has helped facilitate increased lending to low-income communities.) Screening effects are also a problem in some studies that focus only on recipients of high school or workplace training. However, in these cases, the gap is covered by other studies that focus on whole populations for whom training was available, without differentiating between the individuals who chose to pursue the training and those who did not. Some of these studies also provide evidence that even the availability of training was not correlated with any pre-existing interest in or tendency toward financial prudence. For example, see the Bernheim, Garrett and Maki study of high school training and the Bernheim and Garrett or Bayer, Bernheim and Scholz studies of workplace training discussed above.

[16] Abdighani Hirad and Peter M. Zorn, "A Little Knowledge Is a Good Thing: Empirical Evidence of the Effectiveness of Pre-Purchase Homeownership Counseling," *Low-Income Homeownership Working Paper Series* (Joint Center for Housing Studies of Harvard University, August 2001), p. 14.

Federal Reserve Governor Bies tours St. Paul neighborhoods

Federal Reserve Governor Susan Schmidt Bies began her first official visit to the Ninth District with a community development tour of two inner-city neighborhoods in St. Paul.

November 1, 2002

AUTHOR

Paula Woessner

Senior Publications Editor, Community Development and Engagement

On August 14, 2002, Federal Reserve Governor Susan Schmidt Bies began her first official visit to the Ninth District with a community development tour of two inner-city neighborhoods in St. Paul. The tour, which was coordinated by Community Affairs and conducted by University Bank President David Reiling, demonstrated the positive impact of community development lending in urban neighborhoods.

The tour started at University Bank in St. Paul's Summit-University Neighborhood, where Reiling discussed the institution's history, mission, accomplishments and goals. He emphasized the bank's community development focus and described some of its products and services. (For more information on University Bank, see the sidebar below). Reiling's presentation was followed by a question-and-answer discussion with Governor Bies and other tour participants, including Federal Reserve Bank of Minneapolis President Gary Stern, Senior Vice President Niel Willardson, former Vice President and Community Affairs Officer Julie Stackhouse and members of Community Affairs.

Participants gather at University Bank in St. Paul before the tour. Pictured, from left to right: Federal Reserve Bank of Minneapolis President Gary Stern, Federal Reserve Governor Susan Schmidt Bies, University Bank President David Reiling, former Federal Reserve Bank of Minneapolis Vice President and Community Affairs Officer Julie Stackhouse, and Federal Reserve Bank of Minneapolis Senior Vice President Niel Willardson.

Following the meeting, participants visited a number of sites in St. Paul's Summit-University and Thomas-Dale neighborhoods that underwent successful rehabilitation with the help of University Bank loans. Tour highlights included:

- A variety of formerly neglected or abandoned commercial buildings that now house thriving small businesses. One of these rescued properties, the Hmong ABC building, is home to the first Hmong bookstore in the United States.
- Several formerly crime-ridden residential properties that were rehabilitated and sold to low- and moderate-income families; and
- The New Spirit Middle School, a once-abandoned building that now houses part of a Minnesota charter school.

David Reiling provides a pretour briefing on University Bank's community development investments in inner-city St. Paul.

University Bank works to improve its urban community

University Bank is a $68 million financial institution serving the diverse, economically distressed communities of St. Paul's urban core. The bank labels itself "The leader in improving our urban community" and offers a number of products and services that are designed to help inner-city neighborhoods. Nearly 80 percent of its loans go to low- and moderate-income areas of St. Paul.

In 2001, University Bank strengthened its position as a community development lender when it became the first full-service financial institution in Minnesota to be designated as a Community Development Financial Institution (CDFI) by the U.S. Department of the Treasury's CDFI Fund. CDFIs are community-based nonprofit or for-profit financing institutions that have a primary mission of community development and meet certain other criteria outlined by the CDFI Fund.

In the same year, University Bank was awarded $750,000 in low-cost, debt-like equity through the CDFI Fund's Core Award program, which provides financial assistance to CDFIs to increase their capacity to lend money in economically distressed neighborhoods. The award was matched with a debt-like equity loan from M&I Bank to University Bank, resulting in a total of $1.5 million in debt-like equity that could support approximately $20 million in asset growth.

For more information on University Bank, visit www.universitybank.com.

"We were delighted to have Governor Bies and President Stern tour our community and see what a bank with a community development mission can accomplish. Describing how the bank and the community have benefited through their investments in each other reinforces our belief that you can 'Do well and do good.'"—*David Reiling, president, University Bank*

"It was a pleasure to visit St. Paul and learn about the innovative program that University Bank has undertaken. The tour underscored the important role that community banks can play in revitalizing urban neighborhoods."—*Federal Reserve Governor Susan Schmidt Bies*

First Accounts awards grants

November 1, 2002

The U.S. Department of the Treasury's 2002 First Accounts program has awarded $425,812 to Native American Development Corporation of Billings, Mont. The funds will be used to connect 290 low- and moderate-income unbanked people on four Native American reservations to accounts at First Interstate Bank over a two-year period.

Another First Accounts grant, awarded to the National Credit Foundation in Washington, D.C., and the Washington Credit Union League in Federal Way, Wash., will also benefit individuals in the Ninth District. A network of 27 credit unions in eight states—including Montana and North Dakota—will use the $532,570 grant to connect 14,100 unbanked people to accounts at insured depository institutions over 18 months.

The First Accounts program was established to support innovative projects that expand access to financial services for low- and moderate-income people. In 2002, the program awarded 15 grants totaling more than $8 million.

FEDERAL RESERVE BANK
OF MINNEAPOLIS

CDFI Fund awards NACTA grants

November 1, 2002

The Community Development Financial Institutions (CDFI) Fund recently awarded its first-ever Native American CDFI Technical Assistance (NACTA) grants. The grants, which are a new component under the 2002 CDFI program, support organizations that help Native American and Alaska Native communities access financial services and capital. This initial group of NACTA awards includes 36 grants totaling more than $2.5 million, with an average amount of approximately $75,000.

Ninth District NACTA award recipients are: Blackfeet Reservation Development Fund, Inc., Browning, Mont.; Community Reinvestment Fund, Inc., Minneapolis; Emerging Native American Business Lending, Inc., Harlem, Mont.; Hannahville Indian Community, Wilson, Mich.; Impact Seven, Inc., Almena, Wis.; Lac Courte Oreilles Federal Credit Union, Hayward, Wis.; Native American Community Development Corporation, Browning, Mont.; Oglala Sioux Tribe and Oglala Sioux Tribe Partnership for Housing, Pine Ridge, S.D.; Rosebud Sioux Tribe, Rosebud, S.D.; Sisseton Wahpeton Sioux Tribe, Agency Village, S.D.; and Sovereign Leasing and Financing, Inc., Polson, Mont.

Indian business groups receive grants

November 1, 2002

The St. Paul-based Archibald Bush Foundation recently awarded grants to two Twin Cities organizations that promote the growth and development of Native American-owned businesses.

The Minnesota American Indian Chamber of Commerce, located in Minneapolis, received $50,000 to fund a research project examining Native American businesses in Minnesota; and the Minnesota Indian Economic Development Fund in St. Paul was awarded $200,000 to expand services to Native American entrepreneurs.

FEDERAL RESERVE BANK OF MINNEAPOLIS

Property flipping in the Twin Cities

In the late 1990s, a widespread mortgage scam targeted at low-income neighborhoods was uncovered in the Minneapolis-St. Paul metropolitan area.

November 1, 2002

AUTHOR

Nikki Foster

Community Affairs Analyst

In the late 1990s, a widespread mortgage scam targeted at low-income neighborhoods was uncovered in the Minneapolis-St. Paul metropolitan area. Predatory lending, in the form of property flipping, had taken hold in the Twin Cities.

Predatory lending in brief

Predatory lending is difficult to define, but it usually involves at least one of the following practices:

- Asset-based lending, or basing a loan on the value of a customer's home equity instead of his or her ability to repay the loan.
- Loan flipping, or convincing customers to refinance repeatedly. High points and fees are added each time the loan is refinanced; and
- Fraud and deception, which usually consist of using false loan documentation or other falsified documents to conceal the true nature of the loan. 1/

The last practice reflects what happened in Minneapolis. Twin Cities mortgage-foreclosure-prevention counselors and housing professionals noticed an alarming increase in the number of low-income homeowners who were on the verge of losing their homes. Many of these homeowners had high-interest-rate mortgages, hidden second mortgages and no escrow accounts. The purchase prices of their homes were much higher than the market values of other homes in their neighborhoods. In addition, many of their homes had been purchased and sold on the same day. As Twin Cities housing leaders investigated further, they found that phony appraisals and loan documentation were being used to finance home purchases for low-income borrowers. This fraud and deception formed the basis of one of the more extreme examples of predatory lending: property flipping.

Property flipping defined

Property flipping is the practice of purchasing a home and rapidly reselling it at an inflated price to an unsuspecting borrower. Fraudulent documentation and misleading loan agreements are used to trick the buyer into thinking that the property is worth more than its actual value and that the mortgage terms are reasonable.

A property flip might work like this: an investor purchases a home for its market value of $50,000. The investor obtains a fraudulent appraisal stating that the house is worth more than its market value. The same day, the investor sells the home for $100,000 to an unsuspecting buyer.

The fraud doesn't stop there. To finance the purchase, the investor seeks a mortgage from an out-of-town subprime lender for 70 percent of the inflated price, or $70,000. The lender, seeing a low loan-to-value ratio and having little knowledge of the local housing market, is inclined to approve the loan. In some cases, the investor will also falsify loan documentation, such as income verification, in order to ensure that the loan is approved. The investor offers to pay the closing costs for the borrower and also agrees that the remaining 30 percent of the home price, or $30,000, will be financed through the use of a second mortgage. The investor promises that the second mortgage will be forgiven in full if and when the homeowner sells the home. Despite this promise, monthly mortgage payments include hidden second mortgage payments.

In the end, the investor makes a large profit on the deal. By purchasing the house for $50,000 and helping the homeowner secure financing for $70,000, he or she makes $20,000 when the house is sold. The homeowner, on the other hand, is left with an inflated mortgage, a high monthly payment and a home in need of significant repair or rehabilitation.

Task force addresses the issue

In order to determine the extent of the problem and identify possible solutions, the Property Flipping Task Force was organized in Minneapolis. Under the leadership of city officials, numerous nonprofit organizations, government agencies, lenders, secondary market representatives, legal firms, and others joined together to pool resources and help families who were victims of property flipping.

The first goal of the task force was to identify the extent of the problem. Task force members conducted outreach and research to identify the number of properties involved. They estimate that 450-500 properties were flipped. A local newspaper's analysis of the problem resulted in similar numbers. According to the *StarTribune*, 300-450 properties were flipped between 1995 and 1999. 2/ A comparison of the homes' original sales prices (the prices the investors paid) to the flipped sales prices (the prices the homebuyers paid) revealed that on average, homebuyers were paying twice the market value of the home. See the table below for more information.

Original Prices vs. Flipped Prices

A comparison of original sales prices to flipped sales prices in the Twin Cities between 1997 and 1999.

	Total original sales price	Total flipped sales price
Confirmed flips	$5,900,000	$11,800,000
Suspected flips	$31,000,000	$63,000,000

Source: Property Flipping Task Force, May 2000.

The property flippers recruited buyers from homeless shelters, laundromats and churches. Most of the homebuyers were low-income, and the flips were geographically concentrated in North Minneapolis neighborhoods.

Next, the task force studied how property flipping affected Twin Cities neighborhoods. The effects proved to be far-reaching and included:

- Increased foreclosures and/or bankruptcies due to high housing costs and repair bills;
- Increased property values—and, consequently, an inflated real estate market—due to fraudulent appraisals;
- Destabilized neighborhoods due to increased foreclosures and property deterioration; and
- Increased demand for legal resources to undo fraudulent transactions.

Once the task force felt confident that the extent and effects of the problem were understood, members formed Home to Stay, a multiagency program to help victims of property flipping avoid foreclosure and decrease their monthly housing costs. Home to Stay partners identified the mortgage company that held the majority of the fraudulent loans. They then negotiated to modify the loans and replace mortgages in default with deed-in-lieu-of-foreclosure agreements. (A deed-in-lieu-of-foreclosure agreement involves giving the property deed to the lender in order to avoid foreclosure. In exchange for the deed, the borrower is allowed to stay in the home for a set period of time and, depending on the terms of the agreement, may make rent payments to the lender.)

The program also partnered with Twin Cities Habitat for Humanity and Fannie Mae to refinance a portion of the loans. The mortgages refinanced by Fannie Mae were pooled, converted to government-backed securities and sold to the Evangelical Lutheran Church of America and United Methodist Church pension funds.

In some cases, refinancing required the borrower to take on as many as four mortgages: the first were 30-year, fixed-rate mortgages; the second helped to reduce the principal in order to keep the monthly payment affordable; the third was dedicated to rehabilitation costs and the fourth paid for closing costs. The second, third and fourth mortgages were financed with help from state government and nonprofits and are deferred until the home is sold.

As of December 2001, a $2 million investment by Fannie Mae had helped 29 families refinance their mortgages. Twin Cities Habitat for Humanity's $400,000 investment helped six additional families. Families assisted through the program have, on average, four members and a total household income of $31,750. Before refinancing, their average monthly mortgage payment was $872.22. The new average payment is $588.57—nearly $300 less.

The task force built an education component into the Home to Stay program. Because refinances make up a large portion of predatory loans, the task force wanted to increase borrowers' awareness of predatory lending to prevent them from refinancing into another predatory loan. The task force also wanted to ensure that homeowners were equipped with the information they needed to maintain and, in some cases, significantly rehabilitate their homes. To meet these education goals, the Home to Stay program required the borrowers who received refinanced loans to attend two years of homeowner education and counseling and to either contribute 50 hours of sweat equity to their homes or perform 50 hours of community service.

Lessons learned: partnerships and prevention are key

Property Flipping Task Force members learned two major lessons as they addressed the issue of property flipping in the Twin Cities. First, they learned that partnerships were essential for their success. The task force relied on numerous partners—including nonprofit organizations, state and city governments and private lenders—to pool resources and identify flipped properties, rework the loans, develop the Home to Stay program and provide counseling. Volunteer legal help was key in correcting the deceptive loans and negotiating with the lenders that held the first mortgages. Legal assistance also resulted in the prosecution of close to 20 parties involved in the property flipping. All of the partners provided unique expertise and helped ensure that scarce resources were leveraged to help as many families as possible.

Second, task force members learned that prevention may be the most cost-effective way to address property flipping. On average, it cost $40,000 per family to correct the predatory loans, and more than 50 families are currently waiting for assistance. The task force faces the continuing challenge of committing resources to help the remaining families. As the task force reflected on the enormous cost of correcting fraudulent loans, members agreed that the best way to prevent future property flipping and other predatory practices may be to educate and counsel homebuyers. Armed with knowledge of the mortgage process, homebuyers might be less likely to enter into costly or fraudulent transactions. The task force now focuses on homebuyer education initiatives, and its members have joined Don't Borrow Trouble, a public education campaign designed to draw attention to predatory lending and provide all potential homebuyers with information that will help them avoid deceptive or abusive lending practices.

1/ Governor Edward Gramlich, member of the Federal Reserve Board of Governors, speaking at Cleveland State University in March, 2001.

2/ Steve Brandt, "Reeling from Deals," Star Tribune, September 12, 1999.

A conversation with ... Claudia Parliament and Dick Todd

Community Dividend discusses financial literacy with Claudia Parliament, professor of applied economics at the University of Minnesota and director of the Minnesota Council on Economic Education, and Richard M. Todd, Community Affairs Officer and vice president of risk management at the Federal Reserve Bank of Minneapolis.

November 1, 2002

The National Council on Economic Education (NCEE), founded in 1949, is a nonprofit organization devoted to helping young people understand and function in the global economy. Through a nationwide network of state councils and university-based centers, the NCEE provides training and materials designed to help teachers of grades kindergarten through twelve (K-12) instill an understanding of economics and personal finance in their students.

To learn more about the council's activities and the effectiveness of economic and financial literacy education, Community Dividend *spoke with Claudia Parliament, professor of applied economics at the University of Minnesota and director of the Minnesota Council on Economic Education (MCEE), one of the state councils organized under the NCEE; and Dick Todd, Community Affairs Officer and vice president of risk management at the Federal Reserve Bank of Minneapolis.*

Community Dividend: Claudia, would you briefly explain the mission and activities of the MCEE?

Claudia Parliament: Our mission is to provide Minnesotans with the economic and financial understanding they need to function effectively in a complex global environment. We accomplish that by providing professional development for teachers, student programs, and quality curriculum materials, and we conduct research and community outreach.

We believe that the best way to increase economic and financial literacy is to work with students and youth, and the way to reach them is to prepare their teachers. Those teachers will teach students every year for many years, so providing professional development opportunities for them is the best way to introduce and maintain economic and financial literacy in the K-12 curriculum.

CD: The NCEE was organized more than 50 years ago. Do you think there's a greater need for financial education today than there was a few decades ago?

CP: Definitely. The whole financial services industry has become much more complex than ever before, in terms of options and the ease with which consumers can get involved in various credit and investment opportunities. As the complexity has increased, the need for understanding has increased, and financial education has become a pressing need.

Dick Todd: I agree entirely. We're asking people at young ages to make complicated decisions in this area. We need to give them the skills to make those decisions well.

CP: And I think there's a growing awareness, probably as a result of globalization and the increasing interdependence of our economies, that we must understand our economic system, since it affects our country and reaches down into our homes. I think many people are realizing that students need to understand more about the synergy between economics and financial education—that you can't have financial literacy if you don't understand the economic system within which you're operating.

CD: Our cover story discusses financial literacy training for K-12, adult homebuyers and employees. How do you assess the efficacy of these programs? And do they seem to be successful so far?

CP: The U.S. Department of Agriculture's Cooperative Extension Service, in conjunction with the National Endowment for Financial Education, studied the impact of 10 hours of financial literacy instruction on high school students. The students' knowledge and understanding improved, based on a pre- and post-content test. Three months after the training, the majority said they had improved their spending habits and, most importantly, started to save.

To evaluate our own efforts, we test the teachers who go through our program to see if they've increased their content knowledge. We generally get a 30 percent increase in understanding after only a two-day workshop. We haven't researched the impact on the students' knowledge, because our energies are focused on providing the next training program, but that'd be a good research project

to undertake—to see how students change their use of credit and how their net worth and their savings rates are affected.

DT: A recent study of adults found that savings rates and net worth were higher for individuals who went through school systems where financial education was mandated. It also found evidence that these effects are strongest among people whose parents were judged to be poor financial managers. In general, other studies in this area tend to show that financial literacy training has its strongest effects among the people who seem to be the most financially vulnerable.

CD: There's a possibility that the people who seek out financial literacy education may be more motivated or financially literate than the average person. Does this pose a problem for assessing the effectiveness of the training?

CP: Yes, but instead of focusing on that issue, I prefer to focus on a solution. The solution is to provide financial literacy education at the elementary and middle school level, and to make it part of the curriculum, so it's not an option. Elementary and middle school students are a captive audience, so you can reach all income levels and all ethnic and racial groups. Introducing the training at that level follows the 4-H model, where you educate the kids and they bring the information home to their parents. In the materials that we're encouraging educators and school districts to use, the students have take-home assignments to work on with their parents or guardians. It seems like we're just trying to get the adults to help the students, but we're also reaching out to the adults and providing them with financial education.

CD: So that's one way to reach a broader audience. How do you reach other people who aren't inclined to seek out financial literacy training on their own?

CP: Cooperative Extension makes an effort to reach a broad audience. The Minnesota Extension Service has a capacity area called Family Resource Management, and personal finance is a high priority within that area. I think the extension services in every state put a similar priority on personal financial literacy.

CD: Do you think increased financial literacy can combat predatory lending?

DT: In my view, if people are learning the basics of financial literacy—like how to do comparison shopping, for example—then that's helping to address the predatory lending problem. Consumers who borrow from predatory lenders obviously aren't doing enough comparison shopping.

CP: I agree. Our efforts aren't focused specifically on trying to avoid predatory lending, but we teach the fundamentals that people need to know in order to be informed consumers—like basic decision-making skills, and how to budget, save and do comparison shopping. I support the principle that the more informed consumers are, the less likely they'll be to fall victim to predatory lending.

Wisconsin commission receives Pioneer Award

November 1, 2002

The National Association of Development Organizations Research Foundation recently named the Northwest Wisconsin Regional Planning Commission (NWRPC) as first runner-up for the 2002 Pioneer Award for Leadership in Entrepreneurial Promotion in Rural America (Pioneer Award). The award, which recognizes organizations that successfully address challenges facing rural entrepreneurs, is funded by the Appalachian Regional Commission and the Kauffman Center for Entrepreneurial Leadership at the Ewing Marion Kauffman Foundation.

The NWRPC, located in Spooner, Wis., was recognized for a variety of economic development activities, such as creating a revolving business-loan fund and establishing a regional business-incubator network.

Other Pioneer Award designees are: Northwest New Mexico Council of Governments, Gallup, N.M. (first place) and Northeastern Pennsylvania Alliance, Pittston, Pa. (second runner-up).