September 8, 2010

Jennifer J. Johnson, Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, NW
Washington, DC 20551

Re: Docket No. OP-1388

Dear Ms. Johnson:

The National Fair Housing Alliance appreciates this opportunity to provide comment on revisions to Regulation C, the implementing rules for the Home Mortgage Disclosure Act. Home Mortgage Disclosure Act (HMDA) data can be quite useful in helping to insure compliance with fair lending statutes, analyzing impediments to fair housing and identifying potential fair lending violations. The data is also an important resource in assessing how effective the lending community is in meeting the credit needs of various communities, particularly low and moderate income and under-served communities. Moreover, the data can be used by non-profit and other organizations to help counter patterns of disinvestment.

DATA ELEMENTS

The HMDA data has been useful in helping to identify fair lending and community reinvestment issues. However, there is no doubt that additional data elements will improve and enhance the efficacy of the data.

The HMDA data, in its current form, has raised serious questions about whether or not under-served groups have equal and fair access to quality credit. Civil rights groups, for example, have long argued that access to credit is not the key issue for many under-served borrowers but rather, access to sustainable, affordable, quality credit has been the issue. HMDA data seems to support this claim. For example, we can ascertain from current HMDA data the following:

- African-Americans and Latinos were much more likely to receive a subprime loan than their White counterparts according to Home Mortgage Disclosure Act (HMDA) data. In 2006, roughly 54 percent of African-Americans and 47 percent of Latinos received subprime loans compared to approximately 17 percent of Whites[1].
- An analysis of lending patterns in California revealed that subprime toxic mortgages were disproportionately concentrated in communities of color. For example, in Oakland, big bank lenders made 70 percent of their high cost loans in communities of color.[2]
- According to HMDA data, in 2007[3], African-Americans were more than three times as likely as their White counterparts to receive a higher-priced loan. In 2008, African-Americans were 2.63 times more likely than their White counterparts to receive a higher-priced loan.
- In both 2007 and 2008, Hispanics were more than twice as likely as their Non-Hispanic White counterparts to receive a higher priced loan.[4]
- According to HMDA data[5], the market share of African-Americans for home purchase loans dropped from 8.7% in 2006 to 6.3% in 2008. Likewise, in 2006, Hispanics represented 12.1% of the home purchase market. By 2008, their market share had dropped to 8.5% of the market.
- The 2008 HMDA data reveal continuing patterns of high declination rates for underserved borrowers.[6] The 2008 denial rate for conventional home purchase loans for African-American borrowers (36.1%) was more than 2.5 times higher than the denial rate for Non-Hispanic White borrowers (13.6%). The denial rate for Hispanic borrowers (31.1%) was more than 2 times higher than the denial rate for Non-Hispanic White borrowers. This pattern is very close to historical patterns. The 2007 denial rate for conventional home purchase loans for African-American borrowers and Hispanic borrowers was 35.3% and 29.9% respectively while the denial rate for Non-Hispanic White borrowers was 13.2%.

These findings are troubling indeed, but they do not paint the whole picture. The civil rights community believes that the data made available by HMDA is compelling and demonstrates that much more must be done to address lending disparities. However, without robust data offered by additional data points, detractors can argue that HMDA findings are not conclusive. Rather than beginning and ending the argument on this point alone, it should be resolved through the collection of additional data. .

[1] Avery, Robert, et. al. The 2006 HMDA Data, The Federal Reserve Bulletin, December 21, 2007.

[2] Stein, Kevin, et. al. *Foreclosure to Re-Redlining: How America's Largest Financial Institutions Devastated California Communities*. California Reinvestment Coalition, February, 2010.

[3] Avery, et. al; The 2008 HMDA Data: The Mortgage Market during a Turbulent Year. The Federal Reserve Bulletin, October 12, 2009.

[4] Ibid.

[5] Ibid.

[6] Ibid.

The newly enacted Dodd-Frank Wall Street Reform and Consumer Protection Act added a number of important data elements under HMDA that should prove useful in expanding our knowledge of how and why credit is made available. They include:

Age
Points and Fees
Difference between the Annual Percentage Rate and a benchmark rate
Pre-Payment Penalty term in months
Property Value
Introductory Rate Term in months
Existence of Contract terms allowing for non-fully amortizing loan payments
Mortgage Loan Term in months
Channel of Distribution
Credit Score of Applicants

Moreover, the Dodd-Frank Wall Street Reform and Consumer Protection Act makes provision for the newly established Consumer Finance Protection Bureau (CFPB) to collect additional data elements as the CFPB may determine. Those additional elements include:

Loan Originator Unique Identifier Number
Universal Loan Identifier Number
Parcel Number

NFHA fully supports the addition of the data elements set forth in the Dodd-Frank Act. These elements are critical for helping law enforcers and the public to determine whether under-served groups have access to credit under equal terms. It will also prove useful in helping to determine the type of credit extended to various groups. The additional data will allow for the use of better controls when trying to assess or explain any differences in the provision of credit and also help clarify questions about why certain disparities exist

NFHA also strongly supports the collection of the three items that are left up to the discretion of the CFPB – *Loan Originator Unique Identifier Number, Universal Loan Identifier Number, and the Parcel Number.* This information will be most useful in helping law enforcers identify any player who might have been involved in fraudulent activity. The data is also imperative for allowing effective monitoring of mortgage loans and holding the appropriate party accountable for certain outcomes. Finally, this data will be critical for linking or tying HMDA data to other data sets that might be collected by other service providers. For example, a Universal Loan Identifier Number could easily be attached to loan information that would follow through to the securitization and servicing processes. This would easily facilitate tracking the loan and would enable HMDA data to ultimately be connected or synced with HAMP data. Moreover, it would

help HMDA data be synced with data that could and should be collected by servers outside of the HAMP. Without these data elements, linking various data sets will be much more difficult if not impossible and make the job of law enforcers infinitely harder.

While NFHA supported the collection of credit scoring information because it is used by lenders in the underwriting process, we feel compelled to point out the inherent discriminatory impact we believe credit scores present. By supporting the collection of the data, we in no way mean to indicate our support of any credit scoring model or credit scoring in general. On the contrary, NFHA has long held the position that the use of credit scoring mechanisms undoubtedly perpetuates discriminatory outcomes.

Credit scoring issues continue to raise fair lending concerns. One major challenge has been the clandestine nature of the scoring mechanisms. Since the scoring systems are deemed by their creators to be proprietary, it is difficult for consumers to understand how their own personal circumstances might impact their financial scores. Moreover, there are a number of scoring systems in place in addition to the most commonly known FICO score: the Vantage score, the PLUS score, the Transunion score, etc.

There are reportedly five primary factors that have a major impact on the FICO score – payment history, account balance, length of credit, new credit and types of credit used.[7] The concern is that some of the major components impacting the FICO score can present fair lending disparities. For example, certain demographic groups have been wrongly steered to the subprime and fringe lending market – even when they can obtain credit in the mainstream market. Any credit scoring system that would give a lower score to a consumer simply because that consumer obtained a subprime or payday loan would have a disparate discriminatory effect.

Additionally, the financial sector is raising the bar on what constitutes a credit-worthy borrower. Just 10 years ago, a borrower with a 620 FICO score was deemed to be a prime borrower. Today, that borrower is looked upon cautiously. Financiers consider a higher FICO score to be more worthy of a prime borrower. African-Americans and Latinos do disproportionately have lower FICO scores than Whites. More research must be conducted to determine if credit scoring mechanisms are designed in a way that creates disproportionate and disparate outcomes. Certainly considering whether or not a person has a subprime or payday loan will have a discriminatory effect[8].

The Dodd-Frank Act failed to add a number data elements that would be of tremendous use to the public. Under current law and regulation, lenders do not need to report many borrower characteristics that they use and rely upon when making loan

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[7] http://www.myfico.com/crediteducation/whatsinyourscore.aspx

[8] For a more detailed discussion of credit scoring and its fair lending implications, see pages 11 – 16 in NFHA's Comments to FHA on the Proposed Reduction of Seller Concessions and New Loan-to-Value and Credit Score Requirements which are appended to these comments.

determinations. For example, the new law does not mandate that Loan-to-Value ratios are included in the collection of HMDA data. This may be a critical factor especially in today's environment when lenders and mortgage insurers are placing much more emphasis on the LTV in the underwriting process. Since the financial crisis hit the broader, macro economy[9] in late 2008, lenders, investors and mortgage insurers implemented more restrictive underwriting guidelines. LTV ranked chief among the more restrictive underwriting elements.

More data needs to be reported in the HMDA data to help the public and law enforcers better understand how various underwriting characteristics impact loan outcomes. NFHA supports the reporting of these additional loan characteristics:

Loan to Value Ratio
Cumulative Loan to Value Ratio
Debt to Income Ratio
Existence of Balloon Payment
Balloon Payment Due Date in terms of months from loan closing
Pre-Payment Penalty Cost in terms of % of loan
Whether Loan is a "Piggyback" or "Combination"
No doc Loan
Limited doc Loan
Loan Purpose
Type of Loan (Interest Only, Fully Amortizing Fixed, Adjustable Rate, etc.)
Adjustable Rate Lock in Period
Interest Rate
Annual Percentage Rate
Existence of Yield Spread Premium
Cost of Yield Spread Premium in terms of % of loan

Expansion of Traditional HMDA Reporting Fields

NFHA supports expanding HMDA data to include information on loan performance as well as loan modifications. A number of regulatory and industry representatives as well as public officials have stated that they could not see the foreclosure and financial crisis looming. While many civil rights and consumer advocacy representatives urged Congress and Regulators to take action to halt certain lending practices, there was a grave reluctance on the part of public officials and regulators to do so. Often, public officials would ask for detailed data to help them understand what was happening in the marketplace. Unfortunately, the data civil rights and community advocacy groups had was limited and often restricted to a particular geographical region.

[9] The financial and foreclosure crises had already begun in many predominately African-American and Latino communities in cities like Cleveland, Ohio; Baltimore, Maryland; Philadelphia, Pennsylvania; Indianapolis, Indiana; and Los Angeles, California prior to 2008.

For example, it was extremely difficult to determine the extent of subprime lending and where subprime loans were being made. This is because many lenders who were billed as prime lenders were actually making subprime or higher cost loans. There was no way to identify this until HMDA was amended and we began receiving the pricing data in 2007[10]. But this was too late. Some of the most harmful (the 2005, 2006, and 2007 portfolios) lending had already been originated by the time the pricing data was released.

When it comes to providing accurate data to help formulate the correct policy and programmatic responses, the more complete the data, the better. Had we had the data elements identified above, we could have ascertained much earlier in the process, the over-prevalence of higher cost loans in under-served areas. The public, regulators and the Government also would have been able to determine the terms and conditions of loans in areas that have been hardest hit by the foreclosure crisis much earlier in the process. This might have enabled public officials to launch efforts to prevent home foreclosures much earlier than they did. Early warning signs are critical to stemming the tide of massive neighborhood deterioration and blight. The only way to identify early warning signs is to have the correct data.

Loan Performance Data

The HMDA data should also include loan performance data. Specifically, servicers should be required to report delinquencies, defaults and foreclosures on all loans. Of course, care should be taken to ensure that the data is not reported in a manner that would jeopardize any borrower's privacy. However, this early warning mechanism will be quite useful for identifying future crises.

Loan servicers currently report HMDA-like data as a part of the HAMP process. In fact, servicers are reporting over 100 data elements, including loan characteristics information to the Treasury Department. Thus, most servicers are already equipped for and have the infrastructure to handle a data reporting function. Simply adding several more fields on the performance of the loan should be relatively easy to do and should not require a significant increase in cost.

Loan Modification Data

Loan modification data is critically important for helping to understand whether or not all borrowers who need assistance in preserving their homes are receiving it in an equitable fashion. The data can also be used to help law enforcement officials in their

[10] The Federal Reserve issued its final report on the 2006 HMDA data in December of 2007. The 2006 HMDA data was the first data to include the pricing information and this allowed the public to determine which loans were higher cost.

efforts to thwart loan modification scammers. The loan modification arena is the last frontier of fair lending compliance. Lenders have placed most of their resources on monitoring their compliance with fair lending statutes and regulations on the loan origination process. More lenders and servicers are paying attention to their servicing practices as a result of complaints that were brought by HUD, FTC and borrowers regarding abusive servicing practices[11]. However few lenders have assessed their loss mitigation and loan modification practices for fair lending compliance issues.

NFHA conducted an informal survey of five lenders to inquire about the fair lending to inquire about the fair lending compliance measures the lenders had implemented in their shops. All of the lenders stated that they had not implemented any fair lending compliance measures in their loss mitigation or loan modification divisions. Each stated that they were focusing resources on other initiatives such as hiring loss mitigation staff or revamping their servicing systems. This highlights the need for the collection of pertinent data to determine 1) if borrowers do indeed have the same access to loss mitigation opportunities; 2) if there are differences in outcomes and; 3) if there are differences in outcomes, why those differences may exist.

Servicers should report the following information on their loss mitigation and loan modification practices:

(1) whether or not a loan mod was offered to the borrower
(2) "key terms" of the loan mod including principal reduction, extent of reduced interest rate and payment, etc.)
(3) reason for denial if there is a denial

COVERAGE & SCOPE

Coverage

The more accurately HMDA data can provide a complete and robust picture of the housing market, the more empowered the public will be to demand fair lending. In addition to increasing the amount of actual data that must be reported, Reg. C should also be expanded so that it encompasses more filers. Under current reporting requirements, community banks that only operate in rural areas and very small banks are exempt from reporting HMDA data, thereby providing the public with a limited view of lending that occurs in rural areas. Additionally, third party brokers, many of whom engaged in discriminatory lending during the subprime lending boom, are also not required to report HMDA data.

[11] In 2003, HUD and the FTC settled with Fairbanks over subprime loan servicing abuses. This case sent an alarm across the lending community causing servicers to revamp their systems and practices.

In order to provide a more comprehensive view of the mortgage market, NFHA recommends that any and all institutions that originate mortgage loans, loans secured by a residential property, or loans used for any housing related purpose be required to report HMDA data. This means that depository institutions that do not have a home or branch office in a metropolitan statistical area should have to report HMDA data. According to the 2009 reporting criteria, banks that do not have a home or branch office in an MSA/MD or have not received applications for, originated, or purchased five or more home purchase loans, home improvement loans, or refinancings on properties located in MSAs/MDs in the previous year are exempt. This exemption applies to banks that operate primarily in rural areas and offer loans for properties located outside of metropolitan areas and potentially eliminates HMDA coverage over large geographic swaths of the country and also exempts an untold number of rural financial institutions that provide loans and home financing for communities.

Additionally, requiring all institutions that originate mortgage loans, loans secured by a residential property, or loans used for any housing related purpose to report HMDA data would require that third-party mortgage brokers report on the loans that they are making. We know that mortgage brokers were one of many parties responsible for steering people of color into higher cost loans. Moreover, many brokers steered consumers into debt-consolidation loans to garner a higher mortgage amount, and therefore larger fees, even when it was not in the best interest of the borrower.

In a recent settlement with the Department of Justice, AIG subsidiaries engaged in loan wholesaling (AIG Federal Savings Bank and Wilmington Finance) agreed to pay African American borrowers $6.1 million in damages because they paid higher fees to third party brokers than similarly situated non-Hispanic white borrowers. As this settlement demonstrates, many loan wholesalers relied upon brokers to conduct their business, and many of these brokers, acting as agents for lenders, engaged in discriminatory and unscrupulous behavior.

NFHA believes that the public must have access to data by brokers because of the unique role that they often play in the lending process. This could happen in one of two possible ways:

- If the Bureau of Consumer Financial Protection requires that each loan originator, including brokers, be assigned a unique identifier number, loans made by brokers can be tracked in that way.

- Otherwise, brokers should be required to report HMDA data.

Additionally, NFHA believes that sellers of homeowners insurance and servicers should also be required to report HMDA data.

NFHA has a long history of fighting discrimination in the homeowners insurance market. Disparities in the availability of homeownership have contributed to more declinations

of coverage among homebuyers of color, and homeowners insurance providers can discriminate by offering polities with different terms or conditions to members of different racial groups, only require home inspections in non-white neighborhoods, and only require credit checks for people of color.[12] HMDA-type data collected from providers of homeowners' insurance will empower the public to identify and eliminate insurance redlining in the same way that they have worked to eliminate discrimination in the mortgage market.

Additionally, as stated above, NFHA believes that HMDA must not just measure the characteristics of loans at origination – loan performance data is also critical, as is information on requests for loan modifications, denial of loan modifications, the terms and conditions of loan modifications that are offered, the race, ethnicity, age, and gender of the applicant, the census tract of the property, and in the case of denial, the reason for the denial. In the current housing market, in which many borrowers are delinquent or in imminent danger of foreclosure, it is imperative that HMDA data on performance and modifications be made available so that the public and policy makers can analyze any disparities that exist in foreclosure prevention programs. This necessarily means expanding the coverage of HMDA to include servicers.

Scope

Lenders should be required to report on more types of loans, and should be required to report on specific details based on the type of loan that is applied for or originated. For example:

Home Equity Loans/HELOCs: Lenders should be required to report on all Home Equity Loans and HELOCs. In reporting on these loans, they should be required to report (A) the purpose of the loan, even if the loan is not being used for home improvement purposes; (B) the loan amount for which the lender determined the borrower is qualified; (C) the loan amount that the borrower requested; (D) the age, gender, race, and ethnicity of the borrower; (E) the census tract of the property

Reverse Mortgages: Reverse Mortgages are offered to elderly borrowers, and may have distinctly predatory characteristics. Under current reporting requirements, lenders do not have to report their reverse mortgage lending separately, but instead can report them as HELOCs. Lenders who provide reverse mortgages should be required to report them separately. This should include: (A) the age, gender, race, and ethnicity of the borrower; (B) whether the loan was sold with an annuity or not; (B) terms and conditions of the loan and (C) the purpose/intended use of the reverse mortgage.

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[12] Gregory D. Squires, *Racial Profiling, Insurance Style: Insurance Redlining and the Uneven Development of Metropolitan Areas*, 26 URB. AFF. 391, 298 (2003).

REPORTING ON PRE-APPROVALS

All pre-approvals must be reported – including those that are withdrawn or closed for incompleteness as well as those that are approved but not accepted.

Discrimination often occurs at the pre-approval stage and therefore, it is critical that we have data on how consumers are treated at this important stage in the process. NFHA strongly disagrees with calls to eliminate reporting on pre-approvals. Moreover, if unscrupulous lenders know that they will not have to report pre-approval data, they will encourage borrowers whom they do not want to service to go through the pre-approval process to escape monitoring and oversight on these transactions.

NFHA has conducted extensive testing on the mortgage lending process at the beginning stages, where consumers are likely to receive a pre-approval. Our testing data documents that under-served borrowers experience high rates of differential treatment based on status protected by fair lending statutes. In the mid-1990s, NFHA conducted fair lending investigations that revealed discrimination based on race in two-thirds of almost 600 tests conducted in eight cities. In two-thirds of the tests, whites were favored over African Americans; in only 3 percent of the tests, African American testers were favored over white testers. In all cases, the African American testers were better qualified for the loans than their White counterparts.

NFHA's lending testing uncovered multiple ways in which African-Americans were denied lending opportunities in the financial mainstream markets including: 1) differences in the qualitative and quantitative information provided to African-American loan seekers with African-Americans receiving inferior treatment; 2) lenders' urging African-American customers but not White customers to go to another lender for service; 3) lenders' indicating to African-American but not White customers that loan procedures would be long and complicated; 4) African-Americans' more likely to be told that they would not qualify for a loan; and 5) White customers' being much more likely to be coached on how to handle the lending process and deal with problems in their financial profiles. A study and analysis by the Urban Institute of NFHA's testing concluded that it provided "convincing evidence of significant differential treatment discrimination at the pre-application stage."[13]

The current definition of "pre-approval" may not necessarily need to be modified. However, Regulation C can be clarified to make it clear that whenever the lender collects enough information from the borrower to make a pre-approval determination, the data on that loan must be reported. Additionally, the Regulation must emphasize that whenever the lender pulls or receives credit information on the potential borrower, the lender must report that information in the HMDA data.

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[13] Turner and Skidmore. *Mortgage Lending Discrimination: A Review of Existing Evidence*. The Urban Institute, 1999.

COMPLIANCE AND TECHNICAL ISSUES

Incomplete Reporting

NFHA is particularly concerned about incomplete, missing and erroneous reporting of HMDA data and urges the Federal Reserve to take every measure to insure effective and accurate reporting of the HMDA data.

Fair housing groups have uncovered errors with the HMDA data in some fair lending complaints that have been filed under various anti-discrimination laws. For example, in some cases, the plaintiffs in fair lending cases have not been included in HMDA reporting data when they should have been. In other cases, the discovery process has revealed more systemic issues involving the incorrect collection and completion of HMDA data.

These three examples of HMDA errors are from the Toledo Fair Housing Center.

In one example involving a regional bank headquartered in Ohio, the bank adopted inappropriate practices that would result in the exclusion of borrowers from the HMDA data. In this case, a single female head of household was told by the Bank's loan officer that she would not be able to maintain a home as a single woman. The bank declared that the woman never applied for a loan even though the bank pulled her credit report and told her that, based on her credit, she would not qualify. The bank alerted the administrative agency investigating the complaint (no lawsuit was filed in this case) that the woman was not a loan applicant. Moreover, the bank did not issue her an Adverse Action Notice. As per the Fair Credit Reporting Act, she should have received an Adverse Action Notice and, it is NFHA's position that, as per the Home Mortgage Disclosure Act and its implementing regulations that she should have been deemed a "borrower" by the bank and that the bank should have reported her on their HMDA records as being denied by the bank.

In the second example, Hersey Steptoe, et al. v. Savings of America Residential Loans, et al., the Steptoes were denied a loan by Savings of America (SOA) due to lack of collateral. SOA determined that the value of the property was too low. The lender not only pulled the Steptoe's financial information but conducted an appraisal on the subject property. The Steptoes were included in the Bank's LARs but were misreported on the LARs. The Steptoes are listed as having withdrawn their loan when in fact, they were denied by the bank. Moreover, the Steptoe's loan was excluded from the Bank's Data Summary Report which tallies parts of the LAR in 6-month increments. During the discovery process, the Toledo Fair Housing Center uncovered glaring HMDA reporting violations which were subsequently documented in an expert witness report written by Dr. Calvin Bradford. That report is also attached to this document in Appendix II. For example, in one record, approximately 150 borrowers were inappropriately excluded from the bank's HMDA reports. The bank hired an expert witness who formerly worked

for a regulatory agency. This expert witness stated that HMDA reporting errors were common.

Williams et al. v. Countrywide Home Loans – In this case which was settled last year, the Williams applied for a loan and provided requisite information for the loan determination. The loan officer refused to include Mrs. Williams' income due to her impending maternity leave. Even though Mrs. Williams could demonstrate that her income would not be disrupted during her maternity leave and that her job position was secure, the lender refused to include her income and pre-approved the Williams for a very low loan amount which was based only on Mr. Williams' income. Subsequently, after a fair lending lawsuit was filed, Countrywide took the stance that the Williams had never applied for a loan and therefore would not be reported in HMDA data nor met the requirement to receive an Adverse Action Notice.

NFHA believes that these three examples are not isolations or aberrations. Rather, we believe that these examples are indicative of larger, systemic issues related to a lack of care and quality control in the reporting of HMDA data. Regulation C must be amended to emphasize the importance of reporting HMDA data, highlight the penalties for inaccurately reporting the data, and provide guidance and clarification for lenders regarding when and how they should be reporting data.

Appendix I
NFHA Comments to FHA regarding proposed new rules on Reduction of Seller Conessions and New Loan-to-Value and Credit Score Requirements

August 16, 2010

Department of Housing and Urban Development
Office of General Counsel
Regulations Division
451 7th St., SW
Room 10276
Washington, DC 20410-0500

Re: Docket No. FR-5404-N-01
Federal Housing Administration Risk Management Initiatives: Reduction of Seller Concessions and New Loan-to-value and Credit Score Requirements

The National Fair Housing Alliance submits the following comments in response to the above captioned proposal to amend underwriting procedures for the FHA program. NFHA's comments will focus on proposed changes to the credit scoring and down-payment requirements as well as FHA's obligation to ensure that its programs are administered in a way that complies with fair lending and fair housing statutes.

NFHA commends FHA for taking steps to protect the program and improve portfolio quality. Shoring up capital reserves and, in particular, preserving the integrity of the Mutual Mortgage Insurance Fund (MMIF) is an extremely important goal. FHA has developed a four-prong strategy for enhancing risk management: a) Improving appraisal standards to insure the timeliness and accuracy of the appraisal; b) Increasing oversight and monitoring of lenders; c) Implementing an increase in the upfront mortgage insurance premium; and d) Tightening under-writing and down-payment provisions. As a component of the last strategy, FHA proposes to: i) "Reduce the amount of closing costs a seller (or other interested party) may pay on behalf of a homebuyer financing the purchase of a home with FHA mortgage insurance." ii) "Introduce a minimum credit score for eligibility, as well as reduce the maximum LTV for borrowers with lower credit scores"; and iii) "Tighten underwriting standards for mortgage loans that are manually underwritten."[14]

FHA has compelling reason to make several changes to the FHA program in an effort to preserve the liquidity and integrity of the MMIF. A recent independent actuarial study conducted by Urbach, Kahn & Werlin, LLP reveals that the MMIF capital ratio is currently

[14] Federal Register/ Vol. 75, No. 135/ Thursday, July 15, 2010/ Notices, page 41220.

below the threshold mandated by the National Housing Act[15]. The law requires that the MMIF maintain sufficient capital to sustain economic difficulties. The Act requires FHA to keep a Capital Ratio of 2%. The independent auditors project that the ratio had fallen to 0.53% based on data as of September 30, 2009. While FHA projects that the Capital Ratio will grow on its own back up to the required level within several years, it is moving now to increase the ratio. FHA is therefore proposing to make a number of changes to not only improve the quality of the FHA portfolio but to ultimately increase cash reserves available to infuse the MMIF. The MMIF is a separately held reserve account that acts as a backstop in case FHA experiences higher than expected losses. FHA utilizes a financing account to cover anticipated expenses related to its mortgage loan guarantees. If there are unexpected losses, MMIF can be tapped to transfer funds into the financing account to cover costs.

While we commend FHA for taking measures to protect the program for current and future homeowners, we want to caution FHA to carefully deliberate its proposal. NFHA agrees wholeheartedly that FHA must undertake judicious and sound underwriting practices. It was a lack of attention to underwriting principles that helped lead to the current foreclosure and financial crises. However, we believe an over-reliance on credit-scoring mechanisms and down-payment requirements may have negative unintended consequences for under-served groups while contributing little to FHA's goals of improving the quality of FHA loans. NFHA encourages FHA to consider the multiple factors that have proven to contribute to loan delinquency and default patterns and to evaluate credit-score and LTV alongside other important factors that play a significant role in determining loan performance, such as pre-payment penalty characteristics, yield-spread premium provisions, appraisal quality, loan servicing quality, loan originator integrity, and loan term conditions.

FHA's Fair Lending Obligation and Mandate to Affirmatively Further Fair Housing

FHA, as a government program and a division of HUD, has a special obligation to further the purposes of the nation's fair housing and fair lending laws. It is the nation's policy to eliminate all forms of discrimination from the housing and lending markets and to expand equal housing opportunities. The national policy of eliminating discrimination in the markets, of course, includes policies and practices that have a disparate impact on protected classes under the law. Both the President and HUD Secretary Shaun Donovan[16] have iterated the nation's commitment to fair housing and fair lending. In accordance with this leadership, FHA must implement all of its programs in full

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[15] FHA Annual Management Report Fiscal Year 2009, http://www.hud.gov/offices/hsg/fhafy09annualmanagementreport.pdf

[16] See Remarks by Shaun Donovan at the National Fair Housing Alliance Conference available at: http://www.hud.gov/news/speeches/2009-06-08.cfm See also HUD Statement No. 09-206 available at: http://portal.hud.gov/portal/page/portal/HUD/press/press_releases_media_advisories/2009/HUDNo.09-206

compliance with the Civil Rights Act of 1866, the Fair Housing Act, and the Equal Credit Opportunity Act.

The federal Fair Housing Act – passed in 1968 – has the dual mission to both eliminate housing discrimination and promote equal housing opportunities. In order to promote equal housing opportunities, the Fair Housing Act requires that government agencies spend funds dedicated to housing and community development in a manner that "affirmatively furthers fair housing." This obligation is not limited to the Department of Housing and Urban Development; rather it applies broadly and means that government agencies spending housing and community development funds – and recipients of these government funds – must use those funds in way that helps create healthy neighborhoods free from all forms of illegal discrimination.

The Fair Housing Act was passed in 1968 to eliminate segregation and housing discrimination, both of which have resulted to a certain extent from past laws and policies.[17] Overcoming these problems requires comprehensive and coordinated government action, which is why the Fair Housing Act requires all federal programs relating to "housing and urban development" to "affirmatively further fair housing," or work to overcome segregation and discrimination. This obligation is broad and applies to all federal agencies and recipients of their funding.

To achieve a vision of one America without discrimination, the authors of the Fair Housing Act built into the law a provision that calls for the federal government, through all of the relevant programs of all of its agencies, to use its resources to take positive steps to break down discriminatory barriers and promote equal housing opportunity for all. The term used in the Act is "affirmatively furthering fair housing," and is defined in Section 808(d) of the Fair Housing Act:

> All executive departments and agencies shall administer their programs and activities relating to housing and urban development (including any Federal agency having regulatory or supervisory authority over financial institutions) *in a manner affirmatively to further the purposes of this subchapter* and shall cooperate with the Secretary [of Housing and Urban Development] to further such purposes. [18] (*emphasis added*)

In addition, the Fair Housing Act and the Executive Orders related to affirmatively furthering fair housing provide the following:

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[17] James Carr and Nandinee Kutty write, "The severe level of…segregation, and isolation resulting from those policies have created a complex web of socio-economic challenges that defy piecemeal and uncoordinated intervention. These problems are growing. As these problems grow, they increasingly take on grave significance for the nation beyond the sole issue of social justice." *Segregation: The Rising Costs for America,* edited by James Carr and Nandinee Kutty. New York: Routeledge, 2008, 2-3.
[18] 42 U.S.C. Sec. 3601 et seq.

- Section 805 of the Fair Housing Act lays the groundwork for this mandate by detailing discrimination in residential real estate-related transactions,;

- Section 808 of the Act spells out the responsibility of the Secretary of Housing and Urban Development (HUD) to administer the Act, and the Act's application to other federal agencies; and

- Executive Order 1106319, signed on November 20, 1962, and Executive Order 1289220, signed on January 17, 1994, together state the responsibilities of all federal agencies to administer their programs in a manner that affirmatively furthers fair housing and clarify what is meant by programs and activities relating to housing and urban development.

In plain language, "affirmatively furthering fair housing" includes eliminating discrimination as well as the proactive promotion of healthy neighborhoods and geographic opportunity for all people. For most people, housing location – where they live – determines access to opportunities, wealth, and resources.[21] Discriminatory housing policies and practices have restricted opportunities for people of color, who are much more likely than white families to live in impoverished and resource-poor neighborhoods. In fact, three times as many poor African Americans and over twice as many poor Latinos currently live in resource-poor neighborhoods as poor whites. [22] African Americans, regardless of income are likely to live in a poor neighborhood over the course of a decade, while only ten percent of Whites are expected to do the same.[23] Prospering communities, on the other hand, have access to good schools, healthcare, jobs, grocery stores, commercial enterprises, transportation, and financial services and products, among other benefits. The affirmatively furthering fair housing provision of the Fair Housing Act works to eliminate this divide. In this context, equal access to financial services and products cannot be overstated. It is therefore incumbent on FHA, in light of its important role in the financial markets, to insure that all of its programs operate in a manner that affirmatively furthers fair housing.

FHA's Role in the Housing Finance System

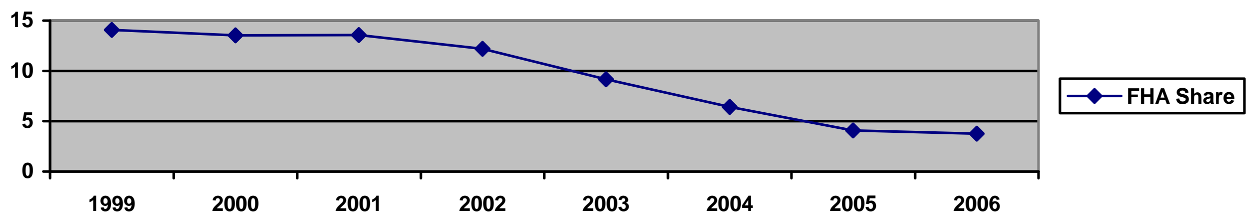
FHA's purpose is to provide a market for sustainable, quality lending that contributes to homeownership preservation and community stability. FHA is a government supported program and therefore, is not in existence to purely churn a profit; it has a real and very important public mission. That mission has been thwarted in the past by actions perpetuated by both the agency and by the private marketplace.

[19] http://www.hud.gov/offices/fheo/FHLaws/EXO11063.cfm
[20] http://www.hud.gov/offices/fheo/FHLaws/EXO12892.cfm
[21] Carr and Kutty. 2.
[22] Ibid., 14.
[23] Ibid., 14.

FHA's importance to the housing market was never made more relevant than in recent years when the program became almost a cornerstone of the residential mortgage market. With the elimination of the subprime market, FHA's importance has once again been revealed. FHA's market share has grown extensively and the program has helped to literally support the housing and housing finance market. It is therefore critical that the integrity of the FHA program be safeguarded. FHA has long been an important function of the United State's housing market. FHA was the driving force behind the suburbanization of America. The program has helped millions of Americans to realize the dream of homeownership. When the program is operated with proper oversight and controls, it has served to sustain and drive homeownership and build strong communities.

Over the previous decade, the voluminous increase in subprime lending chipped and then hacked away FHA's market share. FHA became an almost oblivious program. The subprime market was a largely unregulated space that allowed loan originators to realize hefty short-term profits without simultaneously being obligated for any negative impact on loan performance. If the loan defaulted, no one came knocking at the loan originator's door. Moreover, everyone in the subprime lending chain, from funder to securitizer to investor, was making higher profits because of the initial higher rates of return the subprime market was bearing. Loan originators were steering borrowers away from the FHA program to subprime options. As a result, FHA went from being a viable and considerable player in the housing finance market to representing only 3.77% of the market in 2006[24]. The table below illustrates FHA's declining market share.

FHA Share of Home Purchase Activity for All Homes by Numbers of Households



While FHA was used historically to bolster homeownership and stabilize communities, this benefit was unbalanced as African-American and Latino borrowers initially could not benefit from the program due to bias and discrimination. There was a time when the

[24] FHA Share of Home Purchase Activity Report, February, 2010 available at: http://www.hud.gov/offices/hsg/comp/rpts/fhamktsh/fhamkt1109.pdf

FHA market shunned borrowers of color. FHA's historical contribution to lending redlining and discrimination is well documented[25].

However, due to lawsuits and protest, the government made changes to the program's operations and FHA fast became a major lender in under-served communities. Perhaps in an effort to quickly move credit into historically under-served areas, FHA did not exercise due diligence over the lenders who were originating mortgages on its behalf. Lose standards allowed for fraudulent activity in the program and it became a bane for under-served communities. Predominately African-American and Latino neighborhoods across the United States were bombarded with abusive and predatory loans that carried with them the FHA guaranty.

FHA moved to stamp out the abusive practices and increased its enforcement and monitoring actions. The abuse in the FHA program diminished to a marked degree. However, once FHA made changes to eliminate abusive practices, subprime lending had begun to take hold and these lenders heavily penetrated under-served communities. The influence of subprime lenders spread vociferously and FHA's market share plunged to record lows.

The Subprime Market's Precipitous Climb

Comparatively, subprime lending grew during the same period at exponential rates. Subprime loans were theoretically designed for borrowers with blemished credit and for borrowers who did not wish to state their incomes but who could otherwise afford to obtain and sustain a mortgage.

Because of lax regulation, changes in the nation's securitization statutes, and ready investors willing to pour money into the subprime lending space, more lenders got heavily involved in the subprime market. Indeed, many mainstream lenders, such as National City, Citibank, Charter One (which eventually became Royal Bank of Scotland), Wells Fargo and Countrywide, delved heavily into the Alt-A and subprime market by either establishing subsidiaries or affiliates who provided those loans or by providing them directly. Investors helped to spur the growth in this market segment by offering higher bids on loan pools that contained non-traditional mortgages. Subprime pools made of Payment Option ARMs, Hybrid ARMs, and Interest-Only loans were popular with investors. As a result, lenders pushed subprime mortgages onto their consumers. For example, Countrywide, at one time, the nation's largest mortgage lender, steered borrowers away from FHA and prime rate mortgages to subprime mortgages that contained restrictive and expensive provisions such as prepayment penalties and yield spread premiums[26]. Countrywide was not alone; other lenders were engaging in the same practices. Subprime lending grew voluminously. Subprime and Alt-A mortgages

[25] Carr and Kutty, 7 – 10.
[26] Morgenson, Gretchen, "Inside the Countrywide Lending Spree", New York Times, August 26, 2007.

grew from 9% of the market in 2001 to 40% of the market in 2006[27]. The following chart illustrates the growth of the subprime market.

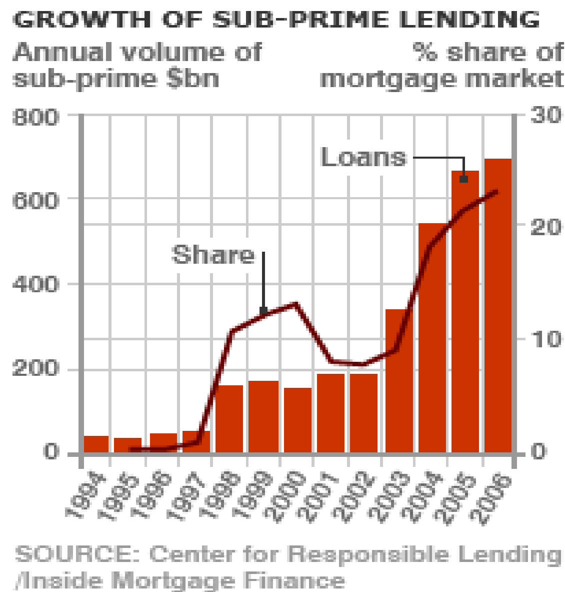


Chart available at: http://news.bbc.co.uk/2/hi/business/7073131.stm

The growth in subprime mortgages cannot be attributed alone to the growth in new homebuyers coming into the marketplace. Indeed, for most of its history, the subprime market was a refinance market, not a purchase market. Nor can the rise in subprime lending be attributed to the fact that more and more borrowers were experiencing diminished credit profiles. In fact, many borrowers who received subprime mortgages actually qualified for prime credit. Many borrowers were steered into subprime and Alt-A mortgages, most probably because of the higher short-term profits lenders could garner. An analysis conducted by First American Loan Performance found that 41% of subprime loans made in 2004 went to borrowers who actually would have qualified for a prime rate loan[28]. Another study, this one commissioned by the Wall Street Journal, revealed that in 2005, 55% of subprime borrowers would have qualified for a prime rate loan. The Wall Street Journal analysis also found that in 2006, that number had jumped to as high as 61%.[29] Federal Reserve Governor Edward Gramlich noted that half of

[27] "The Subprime Slump and the Housing Market," by Andrew Tilton, *US Economics Analyst*, Goldman Sachs, Feb. 23, 2007.

[28] Klein, Ezra, "Digging into finance's pay dirt: The risky business of payday loans and more." July25, 2010, Washington Post. Available at: http://www.washingtonpost.com/wp-dyn/content/article/2010/07/24/AR2010072400153.html

[29] "Subprime Debacle Traps Even Very Creditworthy," *Wall Street Journal*, December 3, 2007.

subprime borrowers had credit scores of 620 or higher[30]. (At the time of his statement, a score of 620 would qualify a borrower for a prime loan.)

The subprime space was highly unregulated and was replete with unscrupulous and unsound practices. As a result, the market imploded and subprime lending all but stopped. It is important to note that subprime lenders had long argued that regulators and government should not implement strong controls on the industry. They opined that tougher restrictions would dry up credit and close off the dream of homeownership to millions of Americans. Civil rights and consumer groups on the other hand argued that the type of credit being issued by the industry was largely corrupted and was the motivating factor behind precipitous foreclosure rate increases in predominately African-American and Latino neighborhoods.

Exclusive Lending Practices Lead to Fringe Lenders Dominance in Under-Served Markets

While the market was designed, in theory, to serve non-prime borrowers, the reality is that the subprime market has always been one of the primary providers of credit to certain under-served markets, such as African-Americans and Latinos. This phenomenon has traditionally had very little to do with borrower characteristics or financial profile. Rather it is related to the heavy marketing practices of subprime lenders who targeted these under-served markets because the prime, traditional lending markets shunned these borrowers.

Subprime lenders have long boasted and prided themselves on being the primary providers of credit to African-American, Latino and other under-served groups. Countrywide, at one time the nation's largest lender and a major originator of subprime loans, boasted that it was the number one lender to minority borrowers[31]. According to the subprime industry, when the mainstream finance market failed to service under-served and disenfranchised groups, they filled the needs of these borrowers. Actually, only a part of this assertion is true. Subprime lenders stepped in to fill a gap that had been created initially by private market mainstream lenders and then increased by government sponsored programs such as the Home Owners Loan Corporation and FHA. It is accurate that subprime lenders have traditionally provided credit to under-served groups. Even HMDA data bears this out. African-Americans and Latinos were much more likely to receive a subprime loan than their White counterparts according to HMDA data. In both 2005 and 2006, roughly 54% of African-Americans and 47% of Latinos received subprime loans compared to approximately 17% of Whites[32].

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[30] Kirchhoff and Block, "Subprime Loan Market Grows Despite Troubles", USA Today, December 14, 2004.
[31] Morgenson, Gretchen, "Inside the Countrywide Lending Spree", New York Times, August 26, 2007. See also "Countrywide Nation's No. 1 Lender in Emerging Markets", Reported by AllBusiness (a D&B Company), available at: http://www.allbusiness.com/personal-finance/real-estate-mortgage-loans/285920-1.html

[32] Avery, et. al., "The 2006 HMDA Data", Federal Reserve Bulletin, December, 2007.

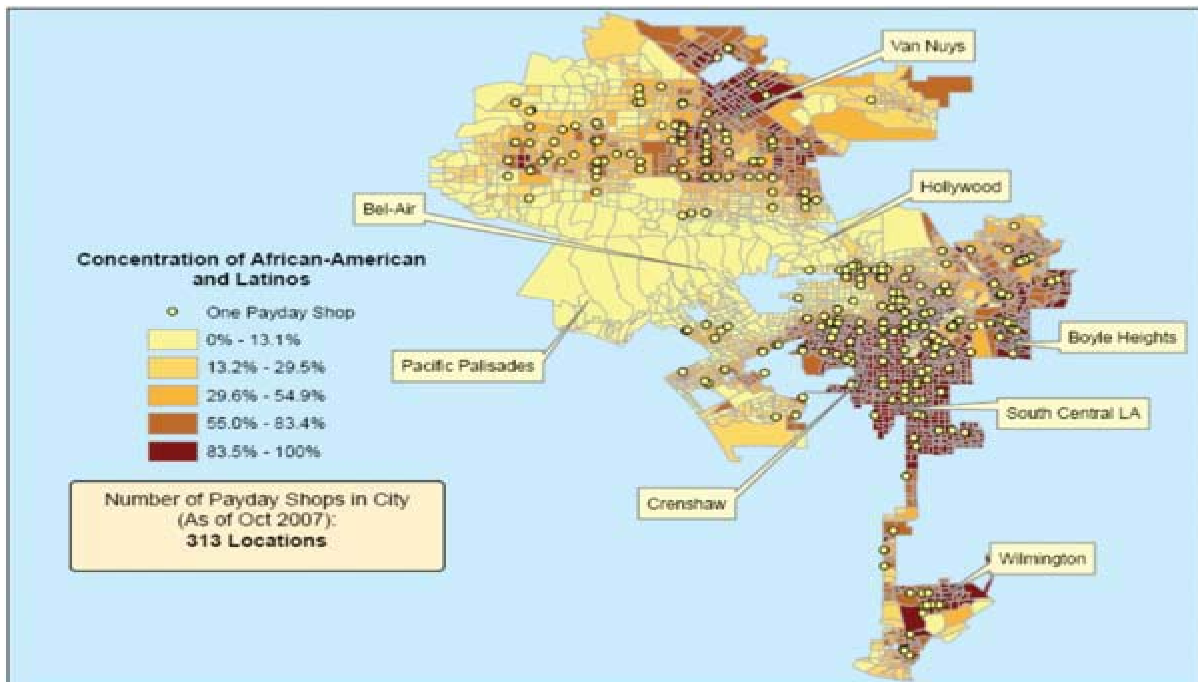
Borrowers in under-served communities do not have adequate access to prime, mainstream lenders while subprime lenders specifically target these markets. Mainstream lenders do not have the presence and market penetration in many under-served areas that subprime lenders do. One analysis revealed that there were more payday lenders in the country than all McDonalds and Burger Kings combined[33]. And these fringe lenders are concentrated in predominately African-American and Latino neighborhoods. One study, conducted by the Center for Responsible Lending found the following facts after surveying fringe lenders in California.

- "Payday lenders are nearly eight times as concentrated in neighborhoods with the largest shares of African Americans and Latinos as compared to white neighborhoods, draining nearly $247 million in fees per year from these communities.
- Even after controlling for income and a variety of other factors, payday lenders are 2.4 times more concentrated in African American and Latino communities. On average, controlling for a variety of relevant factors, the nearest payday lender is almost twice as close to the center of an African American or Latino neighborhood as a largely white neighborhood."[34]

The Study also includes several maps of communities throughout California showing this pattern. Below is the map of Los Angeles depicting the heavy concentration of Payday Shops in African-American and Latino communities.

[33] Klein, Ezra "Digging into finance's pay dirt: The risky business of payday loans and more." July25, 2010, Washington Post. Available at: http://www.washingtonpost.com/wp-dyn/content/article/2010/07/24/AR2010072400153.html

[34] Li, et. al. "Predatory Profiling: The Role of Race and Ethnicity in the Location of PayDay Lenders in California" Center for Responsible Lending, March 26, 2009.



Conversely, there is not a concentration of mainstream bank facilities in predominately African-American and Latino communities. In fact, these entities are under-represented in these areas. Under- served communities across the country are starving for quality credit. A representative example is the case of the St. Louis Equal Housing and Community Reinvestment Alliance which petitioned the Federal Reserve to insure that a local large bank comply with the nation's fair housing laws. The bank, according to the Alliance, had not made one loan to an African-American borrower since 2003. Moreover, all of the banks' branches were located in areas with less than 2% African-American population.[35] A study conducted by the National Community Reinvestment Coalition found that there are fewer commercial bank branches in minority neighborhoods[36].

Yet, while non-prime lenders have heavily penetrated communities of color, they have provided their products and services in a discriminatory fashion. Some of the nation's top subprime lenders have either settled major discrimination lawsuits or are currently defending themselves against such allegations. These lenders include Ameriquest, New Century, Household Finance, Associates, Citi, Countrywide and Wells Fargo.

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[35] Rivas, Rebecca S., "Housing Alliance calls out Midwest BankCenter for not loaning to blacks." The St. Louis American, October 14, 2009.

[36] Kirchhoff and Keen, "Minorities Hit Hard by Rising Costs of Subprime Loans", USA Today, April 25, 2007. Available at: http://www.usatoday.com/money/economy/housing/2007-04-25-subprime-minorities-usat_N.htm

The recently amended lawsuit filed by the City of Baltimore against Wells Fargo provides a glaring view of how lenders perniciously targeted African-Americans and Latinos for higher priced mortgages[37]. Two affidavits filed by former Wells Fargo employees revealed that the lender:

- specifically targeted African-American communities in Baltimore and in Prince George's County Maryland for subprime loans. Wells Fargo did not target White communities for subprime loans;
- targeted Black churches for the purpose of selling subprime loans. Employees of color were tapped to make presentations to the churches. A White employee was told she could only attend the presentations at Black churches if she "carried someone's bag";
- used derogatory language to refer to Black consumers. Blacks were referred to as "mud people" and "niggers". And employees referred to loans in Black neighborhoods as "ghetto loans". And they referred to Prince George's County as the "subprime capital" of Maryland. Comparatively, Wells' employees felt that predominately White counties like Howard County, were bad places for subprime mortgages;
- gave employees substantial financial incentives for steering borrowers who actually qualified for prime mortgages into the subprime market.

Bias perpetuated by both the private and public sectors created and fostered the separate and unequal financial system that still exists today. Racism is still present in the American marketplace and it is inextricably tied to inequality in our lending and financial markets. The nation has a systemic problem, as a clear look at our financial landscape reveals.

- African-American and Latino homebuyers "face a statistically significant risk of receiving less favorable treatment than comparable Whites when they ask mortgage lending institutions about financing options."[38]
- African-Americans are much more likely than their White counterparts to receive a loan denial.[39]
- African-Americans and Latinos are more likely to receive payment-option and/or interest-only mortgages than their White counterparts. [40]

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[37] A copy of the complaint is available at http://www.relmanlaw.com/docs/BaltimoreWellsFargoComplaint.pdf

[38] Turner, et al. *All Other Things Being Equal: A Paired Testing Study of Mortgage Lending Institutions*. The Urban Institute, 2002.

[39] Carr and Megboulugbe. "The Federal Reserve Bank of Boston Study on Mortgage Lending Revisited." *Journal of Housing Research*, Volume 4, Issue 2, Fannie Mae, 1993.

[40] *Exotic or Toxic? An Examination of the Non-Traditional Mortgage Market for Consumers and Lenders*. Consumer Federation of America, May, 2006.

- African-Americans and Latinos are much more likely to receive a subprime loan than their White counterparts according to HMDA data. Roughly 54% of African-Americans and 47% of Latinos received subprime loans compared to approximately 17% of Whites.
- Even higher income African-Americans and Latinos receive a disproportionate share of subprime loans. According to one study that analyzed more than 177,000 subprime loans, borrowers of color are more than 30 percent more likely to receive a higher-rate loan than white borrowers, even after accounting for differences in creditworthiness.[41]
- An analysis by the Center for Responsible Lending shows that borrowers residing in zip codes whose population is at least 50 percent minority are 35 percent more likely to receive loans with prepayment penalties than financially similar borrowers in zip codes where minorities make up less than 10 percent of the population.[42]
- Moreover, an ACORN study revealed that high income African-Americans in predominantly minority neighborhoods are three times more likely to receive subprime loans than low-income whites.[43]
- A study of payday lending in Illinois revealed that payday lenders are much more concentrated in zip codes with high African-American and Latino populations[44]. Yet another study conducted in North Carolina revealed that payday lenders were disproportionately concentrated in African-American neighborhoods[45].
- According to a HUD study analyzing homeownership sustainability patterns among first-time homebuyers, it takes African-Americans and Latinos longer to become homeowners. However, once homeownership status is attained, these groups lose their status the quickest. The study reveals that the average homeownership stay for Whites, Latinos and Blacks is 16.1 years, 12.5 years and 9.5 years respectively.
- After foreclosure, the duration of renting or living with relatives is 10.7 years for Whites, 14.4 years for African-Americans and 14.3 years for Latinos.[46]

Clearly, communities of color have not had access to quality credit but rather, have been shunned by the financial mainstream. These communities have simultaneously been plagued by lenders who peddled abusive, high-cost, unsustainable mortgages in a

[41] See Bocian, D. G., K. S. Ernst, and W. Li, *Unfair Lending: The Effect of Race and Ethnicity on the Price of Subprime Mortgages*, Center for Responsible Lending, May 2006, p. 3.

[42]Bocian, D.G. and R. Zhai, *Borrowers In Higher Minority Areas More Likely to Receive Prepayment Penalties on Subprime Loans*, Center for Responsible Lending, January 2005.

[43] *The Impending Rate Shock: A Study of Home Mortgages in 130 American Cities*. ACORN 2006.

[44] The Woodstock Institute. Reinvestment Alert No. 25, Chicago, Il. (April, 2004). http://woodstockinst.org/document/alert_25.pdf.

[45] Davis, D., et al. *Race Matters: The Concentration of Payday Lenders in African-American Neighborhoods*. Center for Responsible Lending, Durham, NC., 2005

[46] Donald R. Haurin and Stuart S. Rosenthal, *The Sustainability of Homeownership: Factors Affecting the Duration of Homeownership and Rental Spells.* U.S. Department of Housing and Urban Development Office of Policy Development and Research, December, 2004.

discriminatory fashion. As a result, the financial and foreclosure crises have hit these under-served areas tremendously hard. Borrowers of color are disproportionately represented in foreclosure claims and communities of color experience higher foreclosure rates than the general population. There is no doubt that foreclosures in African-American and Latino neighborhoods are inordinately high. A new study released by the Center for Responsible Lending reveals that a home owned by an African-American family is 76% more likely to go into foreclosure that a home owned by a White family[47]. A study by United for a Fair Economy found that the foreclosure crisis will result in the greatest loss of wealth for Latinos and African-Americans in modern history[48]. The study reveals that African-American and Latino borrowers will lose over $200 billion dollars as a result of the crisis.

The confluence of these facts leads to a glaring conclusion – the credit scores of millions of African-Americans and Latinos have been and will be negatively impacted as a result of unscrupulous and even discriminatory practices. As described above, FHA must take due diligence to carry out its programs in a manner that complies with civil rights laws.

Every care must be exercised to protect against discriminatory or disparate outcomes in the FHA program. NFHA stands firmly behind FHA's goal to improve the quality of FHA loans. However all of the program's components must be implemented in a way that is fair and will not result in a stifling of credit to deserving borrowers. The history of lending discrimination in the United States is long and complicated. Yet it has present day manifestations. One of those manifestations is the disparity that we see in the way credit has been distributed. It is therefore, incumbent upon FHA to appropriately assess risk and to utilize underwriting controls that will have the greatest positive impact on the program while simultaneously preserving credit for under-served borrowers.

Credit Scoring Mechanisms Can Have a Discriminatory Impact in the Marketplace

Credit scoring mechanisms may very well pose a disparate impact when applied to under-served markets. FICO scoring mechanisms are not transparent. The formulas are proprietary and not disclosed to the public. The FICO score is not driven by bill payment history alone. There are a number of factors that go into determining the score and those factors are not very clear in terms of how they might impact a borrower's score.

While the independent variables and their weighting in the FICO scoring system are unknown and proprietary, we do know several general, broad characteristics that impact the score. They are: payment history, amounts owed, length of credit history, new credit, and types of credit used. The chart below, taken from Fair Isaac's website, illustrates the value the score reportedly assesses to each of these broad categories

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[47] Bocian, et. al., "Foreclosures by Race and Ethnicity: The Demographics of a Crisis", The Center for Responsible Lending, June, 2010.
[48] Rivera, et. al., "State of the Dream 2008", United for a Fair Economy, January, 2008.

although the values may change based on the particular characteristics of the borrower. Fair Isaac is the developer of three of the major credit scoring mechanisms (Beacon® score, Experian/Fair Isaac Risk Model score, and Emperica® score) used by lenders.

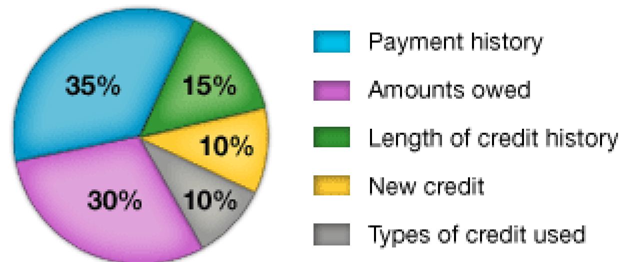

Chart developed by Fair Isaac and available at: http://www.myfico.com/CreditEducation/WhatsInYourScore.aspx

Of these broad categories used to determine the credit score, all of them pose concerns about disparate impact and unintended discriminatory outcomes. We therefore caution FHA to exercise greater diligence when considering the application of credit scoring mechanisms in the underwriting process. Below is a more detailed description of the fair lending concerns related to various components of the FICO scoring system.

Payment History

The payment history component of the score includes information on how timely borrowers made their debt payments, including loans secured from subprime lenders and Payday lenders. As outlined above, borrowers of color are disproportionately, and sometimes unscrupulously, targeted by fringe and subprime lenders. African-American and Latino borrowers unduly receive residential mortgage loans in the subprime sector and disproportionately access credit through fringe lenders like payday shops. Non-prime loans carry much higher default and delinquency rates[49] – not necessarily because of the borrower's characteristics – but more often than not because of the characteristics and features of the loans themselves. The landmark study "Risky Mortgages or Risky Borrowers: Disaggregating Effects Using Propensity Score Models"[50],

[49] According to Mortgage Bankers Association National Delinquency Survey Data released 5/19/2010, the seasonally adjusted delinquency rate was 6.17% for prime fixed loans, 13.52% for prime ARM loans, 25.69% for subprime fixed loans, 29.09% for subprime ARM loans, 13.15% for FHA loans, and 7.96% for VA loans. Foreclosure starts rate was .69% for prime fixed loans, 2.29% for prime ARM loans, 2.64% for subprime loans, 4.32% for subprime ARM loans, 1.46% for FHA loans, and .89% for VA loans. These trends have held steady. The same data released 8/29/2009 revealed the following: the seasonally adjusted delinquency rate was 6.41% for prime loans, 25.35% for subprime loans, 14.42% for FHA loans, and 8.06% for VA loans. The foreclosure inventory rate was 3% for prime loans, 15.05% for subprime loans, 2.98% for FHA loans, and 2.07% for VA loans. Data available at www.mbaa.org.

[50] Lei Ding, Roberto G. Quercia, Janneke Ratcliff, and Wei Li, "Risky Borrowers or Risky Mortgages:

conducted by the University of North Carolina at Chapel Hill and the Center for Responsible Lending, compares a loan portfolio made through a program that provided lower cost fixed rate loans to low and moderate income borrowers to a loan portfolio made of subprime loans. The study is unique in that it compares two similar groups of borrowers. Using propensity score match methodology, the researchers were able to isolate borrowers with similar characteristics in the two groups. The divergent variable between the two groups were the loan terms and conditions borrowers received and the channel borrowers used to obtain the mortgages. While the borrower characteristics between the two groups might have been similar, the loan performance outcomes were not. The LMI lending program had much lower default rates than the subprime portfolio. Indeed, the resultant default rate for the subprime portfolio was 4 times higher than that for the LMI lending program portfolio.

Moreover, the study found that loan characteristics and origination channel had a compelling impact on loan performance. Specifically, the existence of prepayment penalties, adjustable rates, and elevated costs negatively impacted the loans' performance – this is even after controlling for credit score. Additionally, loans originated through broker channels resulted in higher default rates.

This data is quite compelling as it goes against the grain of the logic behind scoring mechanisms. This study, and others, suggests that a borrower may well end up with a damaged credit score not because the borrower was negligent in some fashion but rather because the borrower accessed a loan through a broker or received loan terms that increase the likelihood of delinquency and default.

The data is intriguing for another reason. Each of the identified characteristics that contribute to the likelihood of default – prepayment penalties, adjustable rate mortgages, higher costs and fees, broker originations - are all associated with common lending patterns in under-served communities. As discussed above, African-Americans and Latinos unduly receive higher cost mortgages, loans with prepayment penalties, and adjustable rates. Additionally, these groups, because they are under served by mainstream prime lenders, disproportionately rely on mortgage brokers to access credit.

The data suggests that African-Americans and Latinos will undoubtedly experience higher rates of poor performance in payment history – not necessarily because these borrowers are particularly negligent but because of the types of financing, loan terms and conditions and lending streams they tend to access.

Amounts Owed

Disaggregating Effects Using Propensity Score Models" Center for Community Capital, University of North Carolina at Chapel Hill , September 13, 2008. Available at http://www.ccc.unc.edu/abstracts/091308_Risky.php

This calculation is comprised of multiple factors and again, Fair Isaac does not reveal in detail what all of these factors are and how they are weighted. However, the company does report that this category takes into consideration the amount of credit available to a borrower for certain types of revolving and installment loan accounts. To the extent that under-served communities have restricted access to credit, and in particular, the type of credit that will likely be reported in a positive fashion to credit repositories, this category can pose a disparate discriminatory impact.

This document discusses above in detail the lack of quality credit available to communities of color. There is a dearth of mainstream bank branches but a plethora of payday lending shops and other fringe lenders. Moreover, a considerably higher percentage of African-Americans and Latinos do not have a relationship with a depository banking institution.

An analysis undertaken by the San Francisco Federal Reserve Board reveals that, in that region, the unbanked tend to be low-income, young, non-white adults who lack a college degree. The analysis goes on to reveal that approximately half of African-Americans and Latinos do not have a checking or savings account and that the unbanked are concentrated in lower income census tracts[51]. This analysis also documents the preponderance of payday lenders and check cashers in predominately African-American and Latino neighborhoods.

The lack of access to mainstream lenders may well impact the ability of under-served consumers to access revolving or installment lines of credit from quality financiers. And if these borrowers experience undue difficulty in accessing quality credit, they may well suffer a lower credit score from a system that considers how much "extra" credit they may have available in certain revolving and installment accounts.

Length of Credit History

More analysis needs to be conducted to determine how this category impacts under-served borrowers. Presumably, the longer the length of time a borrower has had an account, and to the extent that that account is reported to the credit repositories, the higher the borrower's credit score. If this is indeed the case, then borrowers with little access to revolving or installment credit will be negatively impacted by this component.

New Credit

[51] "Understanding the Unbanked Market in San Francisco", Federal Reserve Bank of San Francisco. Presentation available at http://www.frbsf.org/community/resources/banksfpresentation.pdf

This component takes into consideration the number of newly opened accounts. It is unclear just how the scoring mechanism assesses new credit. However, if newly established credit has a more debilitating effect on the credit score, then this component too may present fair lending concerns.

As discussed above, credit access is a major challenge for under-served groups and these groups are much more likely to be unbanked. It stands to reason, therefore, that under-served groups will be among those who are newly entering the credit markets and therefore, establishing new accounts.
This is another area where much more analysis is needed to determine how this component may impact under-served groups.

Types of Credit Used

Again, Fair Isaac does not reveal exactly how it calculates the type of credit a borrower may use in the generation of the credit score. However, it has generally been thought that certain types of credit, like credit provided by finance companies, are looked upon less favorably than credit provided by other lenders, like depository banking institutions. If this is indeed the case, this category may well present the largest danger in terms of disparate impact for borrowers of color.

This is another category that relates to the type of credit accessible to borrowers of color. It has been well demonstrated that certain under-served groups, like African-Americans and Latinos, have historically predominately accessed mortgage loans and other forms of credit through finance companies as opposed to depository institutions.

This is not because these groups necessarily wanted to obtain financing through a finance company venue but rather because these groups were largely steered to these lenders or because these were the only lenders available in the community. Loan originators have reported that they were instructed to steer borrowers of color to subprime divisions[52]. It may well be that borrowers who receive their mortgage from Household Finance are rated differently than borrowers who receive their mortgage loan from Household Bank. Even if a borrower pays her mortgage in a timely fashion, a credit scoring mechanism may "ding" her because it presumes that she presented a greater risk if she had to access her mortgage loan or another form of credit from a finance company. The credit scoring mechanism does not take into account that many borrowers end up where they end up not because they pose some greater risk but, rather because the loan originator will realize a higher profit by referring or placing the borrower in a higher cost distribution channel.

[52] Powell, Michael, "Bank Accused of Pushing Mortgage Deals on Blacks", The New York Times, June 6, 2009.

FHA will need to undertake comprehensive analysis of this measurement to determine how the scoring model handles borrowers who access credit from fringe or higher cost lenders and, more specifically, how this might impact borrowers of color.

FHA Should be Leary of an Over-Reliance on Credit Scoring Mechanisms

NFHA cautions against an over-reliance on credit-scoring mechanisms and warns FHA to judiciously consider increasing down-payment requirements as this will undoubtedly impact low-wealth consumers who are able to afford and handle homeownership.

Credit-scoring mechanisms are an insufficient measure for predicting and managing performance as the current crisis has revealed. FHA stated in its comment notice that its intent in proposing underwriting changes was to insure that FHA borrowers can repay their mortgages. However, simply establishing a credit score floor and increasing down-payment requirements will not achieve this goal. Indeed, an over-emphasis on FICO score may not have the intended effect. While FICO is designed to assess risk and predict a borrower's performance, recent analyses have disclosed the ineffectiveness of the scoring mechanism. Default rates for all borrowers have increased precipitously, despite credit score and one study found that "higher FICO scores have been associated with bigger increases in default rates over time."[53] A closer look at borrowers who originated subprime mortgages reveals that for borrowers with the lowest FICO scores (500 – 600), the rate of seriously delinquent loans was twice as large in 2007 than it was in 2005. Comparatively, for borrowers with the highest FICO scores (above 700) the rate of seriously delinquent loans was almost four times as large in 2007 than it was in 2005. Borrowers with lower FICO scores saw a 100% increase in seriously delinquent loans while borrowers with higher FICO scores saw a 300% increase in seriously delinquent loans. The study's authors conclude that "the credit score has not acted as a predictor of either true risk of default of subprime mortgage loans or of the subprime mortgage crisis."[54] The heavy reliance on FICO during the most recent housing boom has contributed to the system's ineffectiveness. Industry analysts even recognized the flaws in FICO[55]. In a document written to clients, an analyst at CIBC World Markets called FICO scores "virtually meaningless".[56]

Borrowers with higher FICO scores are in many cases behaving like borrowers with very low scores. Some analysts in reviewing private loan portfolios have found that in some cases loan characteristics were more predictive of loan performance than the borrower's FICO score.

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[53] Demyanyk, Yuliya, "Did Credit Scores Predict the Subprime Crisis?", The Regional Economist, Federal Reserve Bank of St. Louis, October, 2008.
[54] Ibid.
[55] Gandel, Stephen, "Lenders Look Beyond Credit Scores to Gauge Who's a Risk", Time, January 9, 2009. Available at: http://www.time.com/time/business/article/0,8599,1870450,00.html

[56] Foust, Pressman, "Credit Scores: Not-So-Magic Numbers", Bloomberg Businessweek, February 7, 2008.

Indeed, both FICO[57] and Transunion have released reports that indicate that borrowers with higher FICO scores are performing in uncharacteristic ways. These borrowers, in a trend never before seen, are more likely to pay their credit card debt than their mortgage loan debt. Even more proof that credit score alone cannot predict performance.

Many lenders who either do not rely on credit scoring mechanisms at all or rely on them to a minimum, experience default rates that are better than the industry average. Golden West Financial, a lender that did not rely on FICO because of its unpredictable nature, experienced a default rate of .75% while the industry average for the same class of loans was 1.04%[58]. Golden West relied on careful underwriting, including income and asset verification and employed a different mechanism for compensating appraisers. Instead of compensating an appraiser based on the number of appraisals completed, Golden West compensated appraisers on the accuracy of the appraisal over the life of the loan. Underscoring the tentative reliability of the FICO score, a Golden West representative reported that some of Golden West's best clients had very low FICO scores and some of their worst clients had high FICO scores. The North Carolina State Employees' Credit Union indicated that for their borrowers who would be classified as subprime, the default rate is 1.25%, well below the industry average. NCSE attributes the higher default rates among subprime loans with higher interest rates and poor underwriting practices[59].

It was common for lenders to put aside tried and tested underwriting practices and substitute them for a borrower's credit score. In order to maximize short-term profits, lenders took great strides to increase volume. Of course, one way to increase volume was to shorten the time it took to approve a loan. In this environment, the FICO score became a proxy for sound underwriting. Even Fair Isaac admits that lenders were too reliant on the model[60].

This is a mistake that FHA should never make. The FICO score should not be used as a major underwriting mechanism. Nothing takes the place of good, sound, accurate underwriting practices, such as verifying employment, income and assets, assessing how well a borrower pays his financial obligations – including non-traditional forms of credit, and obtaining a solid, quality and accurate appraisal. FICO and other credit scores do provide a quick, low-cost assessment of a borrower. However, that assessment should

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[57] Tedeschi, Bob, "Even High Score Borrowers at Risk of Mortgage Default", New York Times, March 10, 2010.

[58] Ibid.
[59] Ibid.
[60] Sullivan, Bob. "Credit Scores 102: A Crisis, and some Changes", MSNBC, The Red Tape Chronicles, March 18, 2008. Available at: http://redtape.msnbc.com/2008/03/having-taken-a.html

be viewed as only one small piece of a much larger pie. FHA must avoid the enticement of relying too heavily on this form of quick, relatively inexpensive data.

Importance of Careful and Accurate Data Analysis

One of the most troubling outcomes of the financial and foreclosure crises has been the frustratingly dearth of quality data related to loan performance, housing price declination, and foreclosure prevention initiatives. This can be a devastating occurrence since it is only with judicious and thorough analysis of quality, pertinent and accurate data that we will truly understand the impact of the crises and be able to protect against poor loan performance and insure sustainable lending.

During the recent crash of the financial markets, even those at the highest levels of government as well as industry leaders erred in their judgment and assessment of the finance system. The New York Times reported that even Secretary of the Treasury, Hank Paulson made inaccurate projections about the extent of the crisis. "Throughout the spring of 2007, Mr. Paulson declared that 'the housing market is at or near the bottom,' with the problem 'largely contained.'"[61] Other government officials and lending business representatives declared that the crisis would be contained in the subprime market and that there would be no to little spill-over effect. These pronouncements were wrong – largely because government and business leaders were not considering all of the data available and were misreading the data they did have.

The independent auditor's report indicates that in order to determine the Capital Ratio, FHA management does make projections about claims it will experience based on market performance data, loan history performance and other information. The independent auditor's report also outlines some items that it believes impacts risk. Those factors include loan delinquency information, unemployment, historical claim patterns, and changes in housing prices.

The independent auditor's report highlights the critical importance of quality data to enable FHA to accurately assess loss projections. The report states: "Currently, FHA does not have an effective process to assess and document the impact of other potential risk factors or leading indicators, such as delinquencies or unemployment data that may impact program performance and either support the reliability of management estimates based on the model, or provide evidence to support an adjustment of the model estimates. Federal accounting standards allows an agency to integrate management assumptions when current models may not be reliable."[62]

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[61] Becker, et. al. "The Reckoning – Bush's Philosophy Stoked Mortgage Bonfire", New York Times, December 20, 2008.

[62] Urbach, Kahn & Werlin, LLP, Independent Auditor's Report, November, 2009. Available at: http://www.hud.gov/offices/hsg/fhafy09annualmanagementreport.pdf

The report does indicate that acceptable accounting procedures allow FHA management to make market projections. However, by broadening its outreach and conducting more extensive analysis of available data, FHA can build a more comprehensive and robust cadre of information about the housing finance market and develop more accurate projections. Specifically, by reaching out to civil rights and consumer protection agencies, FHA can glean a better understanding of under-served markets, improve the accuracy of its market projections, and avoid implementing measures that can have a disparate impact on protected class borrowers.

Characteristics That May Impact Loan Performance Better than Credit Scoring Mechanisms

FHA might fare better in improving overall loan performance and ultimately lowering claims by focusing even more on its monitoring and oversight of lenders and paying close attention to loan terms and provisions. Improving the quality of the underwriting process can greatly contribute to the quality of the underlying portfolio. Other lenders, such as those referenced above, have had this experience.
Moreover, ensuring that borrowers are not receiving abusive loan terms can also greatly impact loan performance. Studies have indicated that the presence of yield spread premiums, prepayment penalties, higher fees and costs, and broker originated loans contribute to the likelihood of default. In addition, home value depreciation is fast becoming a major predictor of foreclosure – so called strategic foreclosure. The Boston Fed issued a report in which it found that home price depreciation is a leading cause of loan defaults[63]. This conflicts with common belief that rising delinquencies are attributable to unaffordable mortgages.

The point is that relying on down-payment restrictions and credit scoring mechanisms too much may actually not improve FHA's ability to manage or assess risk. Current study indicates that there are many factors contributing to the continued record levels of mortgage default and these factors will only be understood through careful analysis.

Down-Payment Restrictions

Down-payment restrictions will have a negative impact on low-wealth borrowers. FHA should evaluate other loan programs, including programs operated by Community Development Financial Institutions to determine if its proposed down-payment restrictions will have the impact it intends.

The data is clear. Borrowers of color not only make less money than their White counterparts, but they have significantly fewer assets. Loss of wealth will be one of the

[63] Adelino, Manuel; Gerardi, Kristopher; Willen, Paul, "Why Don't Lenders Renegotiate More Home Mortgages? Redefaults, Self-Cures, and Securitization". Federal Reserve Bank of Boston, July 6, 2009. Available at: http://www.bos.frb.org/economic/ppdp/2009/ppdp0904.pdf

most critical fallouts of the foreclosure crisis for African-Americans and Latinos. These groups start out at a disadvantage when it comes to median net worth. On average, for every dollar in net worth held by Whites, Latinos have about 12 cents of net worth and African-Americans have about 9 cents. If home equity is excluded, for every dollar in net worth held by Whites, Latinos have about 8 cents of net worth and African-Americans have about 5 cents. The following table, based on census data, reveals the stark disparities between various groups as compared to Whites.

	Median Net Worth	**Median Net Worth, Excluding Home Equity**
Hispanic Householders	$9,750	$1,850
Black Householders	$7,500	$1,166
Non-Hispanic White Householders	$79,400	$22,566
All Households	$55,000	$13,473

Source: "Net Worth and Asset Ownership 1998-2000". Household Economic Studies. U.S. Census Bureau (2003)

In his testimony before the National Commission on Fair Housing and Equal Opportunity, Dr. Melvin Oliver, Dean of Social Sciences at the University of California at Santa Barbara, discussed the profound effects of predatory lending practices and the foreclosure crisis on borrowers of color:

> "No other recent economic crisis illustrates better the saying "when America catches a cold, African Americans and Latinos get pneumonia" than the subprime mortgage meltdown. African Americans, along with other minorities and low-income populations have been the targets of the subprime mortgage system. Blacks received a disproportionate share of these loans, leading to a "stripping" of their hard won home equity gains of the recent past and the near future. To understand better how this has happened we need to place this in the context of the continuing racial wealth gap and its intersection with the new financial markets of which subprime is but one manifestation.
> Family financial assets play a key role in poverty reduction, social mobility, and securing middle class status. Income helps families get along, but assets help them get and stay ahead. Those without the head start of family assets have a much steeper climb out of poverty. This generation of African Americans is the first one afforded the legal, educational, and job opportunities to accumulate financial assets essential to launch social mobility and sustain well-being throughout the life course.[64]"

[64] The Future of Fair Housing: Report of the National Commission on Fair Housing and Equal Opportunity, 2008, pg. 34-35. Available at: http://www.nationalfairhousing.org/Portals/33/reports/Future_of_Fair_Housing.PDF

FHA must realize and fully understand the impact of increased down-payment requirements on under-served groups as these consumers are least likely to have extensive cash reserves handy to meet down-payment standards. FHA should examine ways to create partnerships with organizations serving low-wealth consumers to broaden the reach of its programs and to design policies and guidelines that will effectively serve this segment of the population. For example FHA could examine Individual Development Account programs operated by successful non-profits, to determine if it can make changes to its program to improve service to low-wealth consumers while simultaneously maximizing portfolio quality.

Concluding Remarks

The need to protect and preserve the integrity of the FHA program is very important, and NFHA generally supports FHA's measures to shore up capital reserves. Without a properly capitalized MMIF, the program will be at jeopardy. However, any changes to FHA's underwriting guidelines must be assessed for their impact on under-served markets, and in particular, classes protected under the nation's civil rights statutes.

The changes to how FHA proposes to manage risk include using credit-scoring and down-payment restrictions in a new way and NFHA cautions against an over-reliance on these two elements of underwriting. Sound underwriting practices include many more components than credit-scoring and down-payment controls. NFHA believes that FHA and America's borrowers will be much better served if FHA conducts more analysis of these proposed underwriting considerations to understand how they truly impact loan performance in today's turbulent housing finance market.

Respectfully Submitted,

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APPENDIX II

AFFIDAVIT OF CALVIN BRADFORD

IN THE UNITED STATES DISTRICT COURT
FOR THE NORTHERN DISTRICT OF OHIO
WESTERN DIVISION

Hersey H. Steptoe, et al.	*	Case No. 3:89CV7329
Plaintiffs	*	Hon. Nicholas J. Walinski
v.	*	AFFIDAVIT OF CALVIN BRADFORD
Savings of America Residential Loans, et al.	*	
Defendants	*	C. Thomas McCarter Sup. Ct. No. 0012986 Newcomer & McCarter 421 N. Michigan, Suite D Toledo, Ohio 43624 TELEPHONE: (419) 255-9100 FAX: (419) 255-9198
	*	

State of Illinois)
) ss.
County of Cook)

I, Calvin Bradford, am an adult citizen of Illinois.

1. My field of specialization is discrimination in housing and lending. I have worked in this field since 1972. My resume is attached hereto as Exhibit A. I have been engaged in research in this area at three universities and have taught in this area at two universities. I have published extensively on this subject, particularly about the role and practices of appraisal as they relate to credit discrimination in housing. I have testified before committees in Congress on these issues

and have served as an expert in several legal cases. My work was used by the U.S. Department of Justice in its suit against discriminatory appraisal practices (U.S. v. American Institute of Real Estate Appraisers, et al. [C.A. No. 76 C 1448; Northern District of Illinois]). I have been qualified as an expert and have testified in several cases in this area. In addition, I have expertise in research methods and statistical analysis. My Ph.D. in sociology is with a specialization in statistical methods. I have also taught courses in methodology and been qualified as an expert witness in statistical analysis.

2. Real estate appraisals have played a particularly important role in the history of credit discrimination in housing. Appraisers are seen as the experts in the factors that determine value. The appraisal of a property being used as collateral for a loan (a mortgage in this case) provides the lender with the basis for determining what value the property has if it needs to be reclaimed to redeem a default on the loan. While the property serves as collateral, the appraisal is the means of determining the value of this collateral. As the profession of appraisal was formalized in the 1930s, the racial discrimination in the society at large was incorporated into the process of appraisal. The profession developed various principles and models that were used to determine value. One such principle stated that maximum value was achieved when the people in a community were of the same social, economic and ethnic composition. Models were developed

to describe the "life cycles" of communities. In many ways, these models described "the influx of inharmonious ethnic groups" as a process of "invasion" and "succession" that contributed to decline and eventual blight. Therefore, using these principles and models, the identification of, or anticipation of, racial change was used as an indication that values were about to decline.

3. Before the suit filed against the professional appraisal organizations by the Justice Department in 1976, many professional appraisal texts, courses, policies, and even commonly used appraisal forms, specifically provided for the identification of the racial composition, and changes in racial composition, as indicators of declining property values. Other surrogate measures for racial change were also used - such as the age of properties (discrimination has forced most minorities to live in older neighborhoods), mixed property uses (these older neighborhoods typically had more diverse property uses than the newer or suburban areas), or rate of change (exploitation of racial fears by realtors led to panic peddling, resulting in very high rates of turnover in racially changing communities). These models and principles were not based on empirical evidence. When empirical studies were done at later dates - with a large number done in the 1960s, the evidence did not support the beliefs that race had any unique relationship with declining values. Nonetheless, these models and principles continued to be used. The settlement reached in the Justice Department suit brought about massive changes,

including changes in these tests, teachings, principles, models, and even the code of ethics of the largest such professional appraisal organization - the American Institute of Real Estate Appraisers.

4. In addition to the racial biases incorporated directly in the appraisal process, the models, principles, and attitudes of the appraisal industry were incorporated into the process of property underwriting. In making a property loan, the lender engages in two types of underwriting - credit underwriting and property underwriting. The appraisal is part of the property underwriting process, where the lender considers the ability of the property to serve as collateral for the loan. An appraisal is supposed to provide an estimate of the present value of a property. In addition to this present value, the lender wants to consider whether the property will maintain its value over the life of the loan - at least to the extent that the value does not decline below the value of the loan. In order to anticipate future value, the property underwriting process relies on the principles and models of the appraisal industry to project future value trends. Here, lenders historically incorporated the same discriminatory principles and models as the appraiser to anticipate future declining values based on racial change or anticipated racial change. This created a double dose of discrimination in the lending process, once through the appraisal directly and then through the use of appraisal techniques in the property underwriting process of

the lender. It was for this reason that the suit filed by the Justice Department in 1976 included as defendants the Mortgage Bankers Association of America and the United States League of Savings Associations (the professional organization of savings and loan associations like Savings of America).

5. The biases in the appraisal and underwriting process were the main contributors to the practice of lending discrimination known as redlining. The term was taken from the old FHA practice of literally drawing red lines on maps around communities where it would not insure loans. If the conventional mortgage lenders used these discriminatory practices to deny loans to minorities or to minority communities, then these communities surely would decline - if for no other reason than the lack of access to credit to purchase and maintain the homes. Thus, where there was no empirical relationship between race and decline, the practice of redlining could impose a relationship as a result of its own discriminatory behavior. Then, decline becomes a self-fulfilling prophecy. In the 1970s the anti-redlining, or reinvestment, movement grew across the country to deal with this problem of massive discrimination in the lending markets.

6. Both the civil rights movement of the 1960s and 1970s and the anti-redlining or reinvestment movement of the 1970s and 1980s produced laws to combat this racial discrimination in credit. The Fair Housing Act of 1968 specifically prohibited discrimination in lending - noting that this included the variation in terms and conditions of a loan. The Equal Credit

Opportunity Act of 1976 clearly prohibited discriminatin in any type of loan process. The Community Reinvestment Act of 1977 defined an "affirmative obligation" on the part of all Federally insured savings institutions (except credit unions) to serve the needs of all the people and communities in their defined service areas.

7. Recordkeeping has been an important part of discovering lending discrimination. The intitial piece of legislation proposed by the reinvestment movement was what eventually became the Home Mortgage Disclosure Act of 1975. Originally, the bill provided for individual reporting of loans and data on race and income. In its final form, this act required all Federally insured commercial banks, mutual savings banks, and savings and loan associations (such as Savings of America) to record and make public the number and dollar amounts of housing loans, by census tract, for all metropolitan areas where they have an office. These data have become a critical resources in reviewing the lending patterns of these institutions. These data are used by the bank examiners as well as a myriad of public agencies, civil rights groups, fair housing groups, and community organizations to review lending patterns of financial institutions. Numerous studies have been done, almost all of them showing that minority communities receive lower rates of lending - even when controlling for factors of income and housing characteristics. One study which I conducted estimated that these data are used as many as 7,500

times each year in reviewing lending records.[1]

8. In 1976, while the Justice Department was suing the professional appraisal and underwriting organizations, a group of thirteen civil rights organizations filed suit against the four Federal regulatory agencies charged with regulation of commercial banks, mutual savings banks, and savings and loan associations (National Urban League, et al. v. Comptroller of the Currency, et al. (C.A. No. 76-0718: D.D.C.). This suit charged the regulatory agencies (The Federal Reserve Board, the Comptroller of the Currency (OCC), the Federal Deposit Insurance Corporation (FDIC), and the Federal Home Loan Bank Board (FHLBB) [now the Office of Thrift Supervision - OTS]) with failing to implement the Fair Housing Act by failing to require racial recordkeeping on loan applications and originations. The suit followed several years of efforts to get these agencies to adopt racial recordkeeping voluntarily.

9. When the Fair Housing Act was first passed, the financial institutions regulatory agencies considered keeping data on race, but failed to implement the plans. A 1971 survey by the Federal Home Loan Bank Board received only 74 responses - but 30% of the respondents indicated that they did not make loans in minority and lower-income communities.[2] A 1973 HUD questionnaire to all regulated financial institutions reported a 97% response rate.[3] Data for the 50 cities with the largest minority populations indicated that 18% of the lenders admitted discrimination against minority communities. Still no data on race were collected. In 1974, the four banking regulatory

agencies participated in a one-time pilot survey program on all home loan applications.[4] In reviewing the results before the Senate Banking Committee, M.I.T. economist Lester Thurow indicated that there was virtually "a zero probability" that the consistent patterns of higher loan denials for minorities could have occurred without a pattern of race discrimination.[5]

10. In settling the Urban League suit, three of the regulatory agencies (the FDIC, the FHLBB, and the OCC) adopted loan log registers with data on race and income. These logs are known as the Loan Application Register (LAR). The LAR contains information on individual housing loan applications, including data on race, income, appraised value, location of the property, and the reason for loan rejections. The Federal Home Loan Bank Board (now the OTS) does not require lenders to submit the full LAR to the regulatory agency for review.

11. The importance of these data for the enforcement of the Fair Housing Act and the Equal Credit Opportunity Act are evident in the reactions of Congress to a newspaper series that showed that these data were not being used by the regulatory agencies, even though they revealed large differences in rejection rates between whites and minorities. When the summary data from these logs was secured by the Atlanta Journal and Constitution through a Freedom of Information Act request, the data revealed huge differences between white and minority rejection rates in metropolitan areas all across the country.[6] These data listed disparities in loan rejection rates for

whites and minorities for the fifty largest metropolitan areas in the country, and stories appeared in many local newspapers. The analysis revealed that the disparities in lending over the years had actually increased. This precipitated amendments to the HMDA in 1989 that required lenders - this time including mortgage banking companies - to disclose loan application data by race, sex, and income. The regulation adopted by the Federal Reserve Board literally revised the LAR forms and made them the basis of the public disclosure.

12. This history reveals the critical importance of these recordkeeping requirements for the investigation of individual cases and patterns of lending discrimination. Without accurate and complete records, there is no effective way to analyze a lender's patterns of discrimination. The purpose of the data is to allow one to analyze loan records to see if differences in the terms and conditions of loans and the levels of denials and reasons for denials were related to the race of the applicants or the racial composition of the communities where the properties were located. In order for this analysis to be made, all records must be maintained - and maintained accurately. Data for all areas and all applicants must be maintained - so that comparisons can be made among similar applicants and among applicants from different types of communities. Any elimination of the records or systematic omissions and errors reduces the ability to make sound comparisons.

13. In this case, where appraisals are an issue, it is particularly important that there be complete and accurate reporting of the race of applicants, income, the location of loans, the sale price, the appraised value, and the reasons for denials. This provides for an analysis comparing applicants of different races (or seeking loans on properties in communities with different racial compositions), but similar incomes. The analysis can review whether the rates of denials vary with the race of the applicants and areas. Secondly the analysis can determine whether the denial of loans for reasons of lack of collateral (low appraised value) or generally lower appraised values relative to sales price vary with race of the applicant or the racial composition of the area. This requires access to full and complete records for all the areas served by the lender and all the applications made to the lender during some reasonable study period.

14. The OTS has chosen not to review the individual LAR as an initial step, but to review the summary data. If a lender provides a summary that does not reflect the actual LAR data - and indeed, reflects lower rates of denials for minorities than the data in the LAR, for example, then the agency would be deceived by this data and not discover the difference in treatment reflected by the actual LAR data. Of course, a lender engaged in discrimination has an incentive not only to alter the data summary reports, but to alter the LAR as well, so that cases of discrimination or differential treatment of minorities are not recorded in the LAR either. These data

sets were imposed by a settlement of a fair housing case and are now substantially required by Congress. This attests to their importance and value in discrimination cases. Any failure to report these data accurately denies minorities their rights to data created to aid the investigation of discrimination in lending as a result of decades of bias. Thus, any effort to eliminate records for any part of the area or for any population served by the lender constitutes a destruction of critical data, and in this case evidence, of potential discriminatory behavior.

15. I have reviewed the affidavits of William Fall and Jennifer Teschner. I have reviewed copies of the Loan Application Registers for Savings of America (SOA) from January 1, 1986 through October 31, 1989 for the Toledo area. Finally, I have reviewed the Data Submission Reports for SOA for Toledo from January 1, 1986 through December 31, 1987. My opinions are based on a reliance on the accuracy of factual data and statements reflected in all of the above documents. Based on these documents and my own training and expertise it is my opinion that the treatment of the appraisal in the case of the Steptoe loan (case #798289) on the property at 2313 Robinwood reflected an improper and arbitrary evaluation which was to the detriment of these black applicants. Moreover, it is my opinion that the records on appraisal patterns and loan decisions as reflected in the above documents indicates a pattern of differential treatment not only of black applicants,

but of the predominantly minority community of the Old West End (OWE) where the property the Steptoes sought to purchase was located.

16. Savings of America is required by its regulatory agency to provide written underwriting policies. The provisions of the Savings of America policy manual cited by Jennifer Teschner in her affidavit define a proper policy and practice for the review of appraisals and for making changes in a final determination of value. As the provisions indicate, changes should be carefully noted and documented, since a change, especially a large reduction in value "proportionately weakens the overall credibility of the appraisal." In the case of 2313 Robinwood, the original valuation was not recorded in ink as required. A significant reduction was made in the original valuation. This change was not documented, as required. As indicated by William Fall, this reduced valuation was based on the use of improper comparables from a price range too low for the neighborhood, even though both Mr. Fall and Ms. Teschner provide evidence that there were reasonable comparables and other evidence that were available. The revised evaluation did not take proper note of the excellent condition of the property and all of its features (especially the finished third floor) or its full size of living space. This reduced evaluation, done improperly both in its treatment of comparables and the subject property and in not following proper procedures was to the detriment of the black applicants.

17. The documents indicate that 2313 Robinwood was subsequently sold for $115,000 to another applicant receiving a loan from a different institution. The appraised value for that loan in that case was the same $115,000 that was established by Mr. Clunk's initial SOA appraisal. Moreover, SOA used the initial $115,000 value for its comparable file in other appraisals for white applicants. As reported by Ms. Teschner, Savings of America also recognized the value of the finished third floor and the full size of the living area in these appraisals for white applicants. All of this gives credibility to the position that even though SOA improperly reduced the value of the appraisal for a black applicant in the OWE community, the institution clearly recognized that the property had a value equal to the original offering price in other cases where the property was used.

18. Comments about time of the market and market appeal can be used as surrogates for indicating the racial composition of an area. Ms. Teschner's affidavit documents how such comments were commonly used for properties in the OWE, but not commonly used in the white, Perrysburg community. In addition, the comments on OWE files for time on the market simply did not reflect a problem, since the difference in average time on the market for OWE and Perrysburg is not large, and since the average time on the market for Toledo is well within lending industry guidelines for an active market. Finally, in the specific case of the comments on the file for 2313 Robinwood, the house was sold twice within two months, indicating an

especially strong individual property in the market. These comments and the predominance of these comments in OWE files indicate a pattern and undocumented differential treatment of homes located in the minority, OWE, neighborhood.

19. Ms. Teschner has calculated the incidence of appraisals in the OWE and Perrysburg communities where the appraisal was below the purchase price or where the value would require a reduction in the loan amount to satisfy a 90% loan to value ratio. These are clearly cases where the appraisal adversely affects the applicant. The statistics she produces define a clear pattern of differential impacts for both the OWE community as an area, and for blacks in the OWE as individuals. For whites in the OWE, the incidence of the adverse affects of low appraisals was 29%. For blacks it was 54% of the time. Whites in Perrysburg experienced adverse appraisals only 23% of the time. Minorities as a whole experienced adverse appraisals in the Perrysburg community only 15% of the time (calculated as 1 in 7, omitting the case with the race unknown).

20. Ms. Teschner also presents several tables displaying the loan decisions by race and by decision category for both the Perrsyburg and OWE communities. I have extracted from her figures all of the cases except those that were withdrawn and those with no decision indciated. This leaves all the cases where the data are complete and for which Savings of America actually made the determination on the loan decision. This represents all the cases where SOA either accepted the loan as

applied for (Category #1), accepted the loan with changes that were acceptable to the borrower (Category #2), and all the categories where SOA either denied the loan or changed the terms so that they were not acceptable to the borrower (Categories #3-6). For the Old West End the results are:

Applicants	All Loans Decided	Denied or Conditions Not Accepted	% Denied/ Not Accepted
		Old West End	
All	57	24	42%
White	44	17	39%
Minority	15	7	47%
		Perrysburg	
All	96	23	24%
White	89	21	24%
Minority	7	2	29%

As in the other patterns, these data include both higher rejection rates for the OWE and higher rejection rates for minorities, with the highest rejection rates being for minorities in the OWE.

21. In addition to the patterns reflected in the data for which there are complete records, there are patterns of data omission. The Loan Application Register (LAR) does not reflect any appraisal having been recorded for 2313 Robinwood (Case #798289) even though two appraisals were actually made. The LAR also indicates that this application was withdrawn, when it appears to have been denied - since no notice of withdrawl was ever made in the file and no notice of an intent to close the case was ever sent to the Steptoes, as required to classify a

case as withdrawn. In addition, Ms. Teschner's affidavit notes that the branch manager, Karen Godfrey, corrected two files that incorrectly listed the loans as withdrawn when they had been rejected. But, these changes do not appear on the LAR. Such omissions systematically reflect a pattern where loans from minority communities and/or minority applicants are listed as withdrawn (a decision of the applicant) rather than as denied (a decision of the lender).

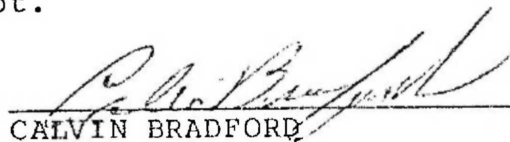
22. Much of the data in the LARs is incomplete. These errors can seriously misrepresent the patterns in lending in this set of data required by the regulatory agency specifically to review instances of discrimination and patterns of discrimination. Aside from the many errors in the actual LAR data, there are clear errors in transferring the LAR data to the Data Summary Report which tallies certain parts of the LAR for six-month periods. The Steptoe application, for example, was disposed between July 1, 1987 and December 31, 1987. But the Data Summary Report does not include this loan, since no loan of this amount appears in either the appropriate category for a loan withdrawn or denied. Thus, a loan reflecting the denial of credit to a minority in a minority community was not reported on the form used to track racial patterns in lending.

23. In the larger scope, the Data Summary Report for the prior period (January 1, 1987 through June 30, 1987) indicates that there were 248 loans pending at the close of this period.

However, at the end of 1987 (for the report dated from July 1, 1987 through December 31, 1987 - the period of decision on the Steptoe loan) the report indicates that only 47 loans were processed. Yet it lists only 43 loans pending. Even if no new applications came in during this period, this means that 158 loans were dropped without a record of any action. This would be 64% of all the loans pending at the beginning of that period. Such errors of this magnitude go beyond range of any conceivable process of simple errors and raise questions about the sytematic elimination of records in a reporting system designed to reflect discrimination in lending.

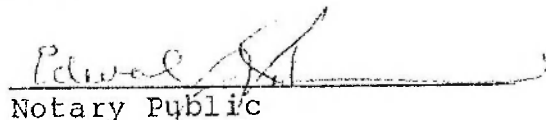
24. Based on these factors, it is my conclusion that both in the treatment of the Steptoe's loan application and in the larger patterns of appraisal and lending decisions, Savings of America's process and actions reflect patterns that adversely affect minorities and minority communities, as well as patterns that obstruct the legitimate process of investigation of fair housing issues both by federal regulatory agencies and individual plaintiffs.

Affiant further sayeth not.

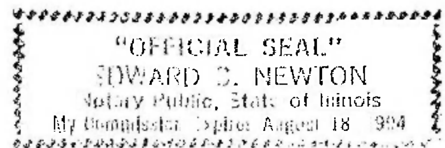


CALVIN BRADFORD

Sworn to before me and subscribed in my presence this ____ day of ________________, 1991.



Notary Public



Notes

1. See for example, Calvin Bradford and Paul Schersten, A Tool for Community Capital: The Home Mortgage Disclosure Act - 1985 - National Survey - A Working Paper (Cooperative Community Development Program of the Hubert Humphrey Institute of Public Affairs of the University of Minnesota, 1985) for a description of the range of studies using mortgage lending data.

2. Federal Home Loan Bank Board, Office of Housing and Urban Affairs, 1971 Urban Lending Survey, 1972.

3. U.S. Department of Housing and Urban Development, Office of Fair Housing and Equal Opportunity, Private Lending Institutions Questionnaire: Initial Report on Returns (April 24, 1974). While the report was never published, it appears in some Congressional hearings. See for example, U.S. Senate Committee on Banking, Housing and Urban Affairs hearings on "Equal Opportunity in Lending - Oversight on Equal Opportunity in Lending Enforcement by the Bank Regulatory Agencies," March 11 and 12, 1976 (Washington, D.C.: U.S. Government Printing Office, 1976).

4. Federal Home Loan Bank Board, Fair Housing Information Survey - Form a Approach (Washington, D.C., August 18, 1974); Federal Reserve Board and the Federal Deposit Insurance Corporation, Fair Housing Survey - Form B Approach (Washington, D.C. May 2, 1975); and Comptroller of the Currency, Fair Housing Lending Practices Pilot Project - Form C Approach (Washington, D.C., July 14, 1975).

5. See Hearings on "Equal Opportunity in Lending" (note 3 above), pages 2-4.

6. Bill Dedman, "Racial Lending Gap Less in South Than in Midwest," The Atlanta Journal and Constitution, January 22, 1989.

Comments of :

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