

The U.S. Housing Finance System for Low-Income Families: A Review of Recent Innovations and Changes

by Kenneth Temkin

LOW- AND MODERATE-INCOME HOUSING FINANCE IN THE U.S.

The United States homeownership rate increased dramatically during the 1990s. As of the fourth quarter of 2000, 67.5% of American families owned their own home—up from 64.0% in 1993 (U.S. Census a). Most of this gain results from large increases in homeownership rates for traditionally underserved markets: members of minority groups and low- and moderate-income families. These gains resulted from increased lending activities in such traditionally underserved markets. Between 1993 and 1997, the number of conventional home purchase loans originated to African-American borrowers increased by 72%; the increase for Hispanics was 45%. These gains are impressive, especially compared to the 22% gain of such loans originated to non-Hispanic whites during the same period (Scheessele, 1999).

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Lending in minority neighborhoods also increased during the 1990s: mortgage loan originations in predominantly minority census tracts increased by 40% between 1993 and 1997, twice the growth rate for overall lending volume in MSAs. The pattern is similar for lower-income borrowers. Between 1993 and 1997, loans to buyers with incomes less than 80% of local median increased by 38%, compared with 25% for higher-income home buyers. Similarly, lending volume in lower-income census tracts increased by 31%, more than ten percentage points higher than the increase in overall MSA lending volume (Scheessele, 1999).

Some of the homeownership gains in underserved markets result from favorable economic conditions in the 1990s. During this period, the median family income for all families increased, especially for African Americans and Hispanics. In real terms, the median income for African-American families grew almost 50%, from \$21,423 in 1990 to \$31,778 in 1999. The increase was slightly less for Hispanic families, from \$23,341 in 1990 to \$31,663 in 1999. Moreover, the median income for families with earnings in the lowest 20% of the total distribution increased, in real terms, from \$9,833 in 1990

to \$13,320 in 1999 (U.S. Census b). These increases make it easier for lower income and minority families to consider homeownership, increasing the demand for owner-occupied housing. While incomes increased during the past decade, interest rates fell. The contract interest rate for a 30-year fixed rate mortgage declined from over 10% at the start of the decade to as low as 7% in 1999 (Mortgage Bankers Association).

That higher incomes and lower interest rates explain some of the increase in homeownership in the U.S. during the 1990s is beyond dispute. But these trends do not fully explain the increase in homeownership rates during the past decade. The U.S. mortgage finance system changed substantially in the 1990s as industry participants—lenders, mortgage insurance companies, secondary market conduits and government agencies—made concerted efforts to improve their service to lower-income and minority families (Bostic and Surette, 2000; Martinez, 2000). As a result of these innovations, low- and moderate-income homebuyers, in contrast to the 1980s, now have a wide variety of products and programs to choose from when applying for a mortgage. The U.S. mortgage finance system currently offers low- and moderate-

income homebuyers a "rich tapestry" of programs that make homeownership possible for many more American families (Stegman, 1999).

It is important to note that the mortgage industry did not change in a legislative vacuum: federal legislation had a large impact on industry participants' efforts to serve lower-income and minority borrowers. In particular, the Community Reinvestment Act (CRA) and the Financial Housing Enterprises Safety and Soundness Act (FHEFSSA) created pressure on lenders and two government sponsored enterprises, Fannie Mae and Freddie Mac (which purchase mortgages from originators), to take more aggressive steps in their service of low- and moderate-income and minority families.

The Community Reinvestment Act

The Community Reinvestment Act, adopted in 1977, requires federally regulated lenders to help meet the credit needs of local communities in which they are chartered. CRA examination procedures create strong incentives for lenders to originate as many loans as possible to creditworthy low- and moderate-income borrowers and in low- and moderate-income neighborhoods. Therefore, lenders subject to CRA offer low- and moderate-income borrowers a range of mortgage choices, including FHA, conventional, and targeted affordable products in order to maximize origination volumes in areas that count in a CRA examination (Williams, 1999).

Starting in 1997, CRA examiners began to assess the performance of large banks—those with assets over \$250 million—using (1) a lending test, (2) an investment test and (3) a service test (FFIEC, 1997).¹ In a large bank lending test, examiners evaluate the institution's lending volume in low- and moderate-income areas within its assessment areas. In addition, lender's

performance under the lending test is enhanced by providing borrowers with innovative loan products with flexible underwriting standards that have been developed to meet the credit needs of low- and moderate-income individuals or families (FFIEC, 1997).

As implied by its name, the investment test measures the types of financial commitments made by financial institutions in their assessment areas. In order to arrive at an investment test score, examiners review a lender's investment portfolio; its use (if any) of innovative or complex financing arrangements; and the degree to which these investments serve low- and moderate-income areas or individuals. Lenders are also subject to a service test. In this part of the assessment, examiners analyze the distribution of a lender's branches among low-, moderate-, middle-, and upper-income geographies; the extent to which a lender's ATMs are accessible to a wide variety of customers; and the quantity, quality, and accessibility of a lender's delivery of a wide range of services (FFIEC, 1997).

Examiners score lenders on each of the three tests: lending, investment and service. As shown in Exhibit 1, ratings in each category range from outstanding to substantial non-compliance, and lenders receive a certain number of points for each score. For example, lenders receive 12 points for an outstanding score in lending, but only 6 points for the same score in service.

Exhibit 1 Points Awarded in CRA Examinations

<i>Rating</i>	<i>Lending</i>	<i>Investment</i>	<i>Service</i>
Outstanding	12	6	6
High satisfactory	9	4	4
Low satisfactory	6	3	3
Needs to improve	3	1	1

Based on the scores for each of the three categories, lenders receive a composite CRA rating. Institutions which receive 20 or more points are awarded a rating of outstanding; between 11 and 19 are rated satisfactory; between 5 and 10 are rated needs to improve; and below 5 points means that the lender is in substantial noncompliance.

As indicated in Exhibit 1, the lending test is the most important activity in receiving a favorable CRA rating. Therefore, a lender's final CRA rating will be highly dependent on its ability to originate loans to low- and moderate-income borrowers and geographies, and using flexibility in underwriting in order to achieve these objectives. In fact, a lender may not receive an overall satisfactory rating or higher unless it receives at least a low satisfactory on the lending test. In addition, no institution can receive a composite score in excess of three times the score on the lending test.

To date, there has not been a definitive study that precisely measures how CRA has changed the mortgage market. The studies conducted so far are inconclusive: some analysts find that lenders subject to CRA are more responsive to lower-income customers, and these changes account for a significant share of the increased service to lower-income borrowers. Other research indicates that lenders not subject to CRA are also increasing their service to lower-income customers, thereby weakening the case that CRA is responsible for lenders originating more loans to previously underserved markets.

What is the effect of CRA? According to the National Community Reinvestment Group, lenders have committed \$1 trillion in reinvestment funds between 1977 (when CRA was adopted) and 1998. The overwhelming majority of these commitments have been signed since 1996: \$917 billion have been committed in that period, primarily due to the

large number of bank mergers that have been proposed since 1996, which have given community advocates an opportunity to raise CRA challenges to these mergers (Schwartz, 1998). In these commitments, lenders agree to initiate activities designed to increase lending and outreach efforts in underserved communities. Typically, these activities include programs related to housing; business and economic development; consumer loans; farm loans; building community capacity; banking services, branch locations, and staff policies; and needs assessment, marketing and outreach to underserved areas.

In a recent study, Litan, Retsinas, Belsky, and Haag (2000), after analyzing lending patterns between 1993 and 1998, found that CRA has had a significant impact in increasing lending for low- and moderate-income borrowers. Similarly, Schwartz (1998:296), in his study of lenders that signed CRA agreements, found that such lenders "appear to be more responsive than other banks to the credit needs of minority and low-income households and neighborhoods."

Other analysts are not so sure that CRA is the reason for increased low- and moderate-income lending. The Federal Reserve estimates that lenders subject to CRA originated about 5.3 million home purchase mortgages, worth about \$242 billion in their assessment areas between 1993 and 1997. This averages to a little over 1 million mortgages per year, representing \$48 billion. These loans are overwhelmingly conventional mortgages—only 12% of these loans are either FHA or VA loans (Board of Governors of the Federal Reserve, 1999).

It is important to note that mortgage banks, which originate nearly 50% of all home mortgages, are not subject to CRA regulations. Therefore, loans categorized, as "CRA" originations in the Federal Reserve's calcula-

tions are just a subset of all loans originated to low- and moderate-income homebuyers. Only 15% of all FHA home purchase loans originated between 1993 and 1997 are CRA loans, as defined by the Federal Reserve, while 37% of conventional loans originated during that period are in the Federal Reserve's total (Scheessele, 1999).

Using these figures, it is difficult to attribute increased homeownership rates for lower-income families to CRA lending. Compared to 1993, the number of conventional loans originated by lenders subject to CRA in their assessment areas declined, by about 200,000, from 1.139 million to 913,000. The pattern is the same for government-backed loans, which declined over the same time period from 116,000 to 94,000 loans. At the same time, total home purchase mortgages originated to low- and moderate-income borrowers increased 63%, from a base of nearly 900,000 loans in 1993 to about 1.5 million mortgages in 1997. Similarly, FHA originations to low- and moderate-income borrowers have increased 33% between 1993 and 1997, despite the decline in the volume originated by lenders subject to CRA in their assessment areas (Scheessele, 1999). These figures mean that (1) lenders not subject to CRA regulations are originating more loans to lower-income home buyers, and/or (2) lenders subject to CRA are originating more loans on properties not located in their assessment areas. In either case, CRA compliance is not a motivating factor.

Some critics of CRA argue that its provisions force lenders to originate loans and participate in markets that are not profitable. Are these charges accurate? Does CRA create an undue burden on lenders subject to its provisions? This is a difficult question to answer in a complete and definitive manner. In general, lenders do not track costs associated with CRA-related lending activities, which include loan performance measures and other costs, including overhead, in-

curred to support this type of business activity (Board of Governors of the Federal Reserve System, 2000). Therefore, it is not possible, with precision, to measure the effect of CRA on lenders' financial performance.

In the most extensive attempt to assess the impact of CRA on banks, the Board of Governors of the Federal Reserve System surveyed 500 large commercial lenders. Each respondent was asked to estimate the costs associated with CRA lending, as well as the performance of targeted affordable loan programs offered to eligible home buyers. After analyzing the results from 143 respondents, the Federal Reserve (2000:v) concluded that home purchase and refinance CRA lending, "... is either profitable or at least marginally profitable for 82% of survey respondents." However, CRA lending, especially for larger banks, is less profitable than non-CRA home purchase and refinance lending, due to higher credit losses and lower loan prices associated with mortgages originated to low- and moderate-income home buyers.

Federal Housing Enterprises Financial Safety and Soundness Act

Congress enacted the Federal Housing Enterprises Financial Safety and Soundness Act (FHEFSSA) in 1992. Its purpose is to place more pressure on Fannie Mae and Freddie Mac to serve lower-income families and lower-income and minority neighborhoods. As a result, the Act contained three provisions: quantitative targets for purchases of loans made to low-income borrowers and in low-income and minority neighborhoods; a mandate that the GSEs "lead the industry in affordable lending;" and language which prohibits the GSEs from discriminating based on prohibited factors, such as a borrower's race, ethnicity or gender, in their loan purchase activities. Rather than just provide liquidity, the GSEs under

FHEFSSA are expected to take a leading role in serving lower-income and minority families by purchasing more loans originated to such borrowers and initiating demonstrations and partnerships that facilitate affordable lending.

In response to CRA and FHEFSSA, lenders and the GSEs adapted their business practices by changing underwriting guidelines, initiating new lending programs and forming partnerships with organizations and groups connected with underserved markets. In most cases, these efforts initially began as experiments: lenders originated loans to borrowers with little or no equity, less than perfect credit and relatively high debt-to-income ratios. Many lenders, at the time these products were introduced, were skeptical that loans originated with such flexible guidelines would perform.² The existing guidelines in the early 1990s reflected the industry's common wisdom regarding acceptable underwriting standards; any changes, some lenders believed, would represent intolerable risks.

This perception has changed: the lending industry has undergone a "quiet revolution" by offering credit to borrowers who would have previously been categorized as prohibitive risks (OCC, 1997). Now, many lenders believe that originating loans in previously underserved markets is sustainable and profitable. Moreover, lenders are aware that future mortgage market demand will be driven by increased lending to minority and immigrant households: groups traditionally underserved. There is every reason to believe that lenders will continue in their efforts to increase their service of traditionally underserved borrowers.

While lenders and other mortgage market participants use a variety of techniques to increase homeownership opportunities for underserved markets, three elements are particularly important. They are:

- More flexible standard conventional lending guidelines introduced by Fannie Mae and Freddie Mac in the 1990s that allow lenders to serve borrowers with little equity, less than perfect credit and relatively high levels of debt.
- Affordable lending programs which allow even more underwriting flexibility for eligible borrowers than standard conventional loans. Some of these mortgages are sold to the GSEs, others are retained in lenders' portfolios. Some borrowers also receive subsidized funds for downpayments and closing cost assistance.
- New institutions, including community development financial institutions (CDFIs) and community development institutions (CDCs) that make homeownership opportunities more available for underserved markets.

These techniques are used within the overall U.S. housing finance context, and may not be applicable in all foreign legal, political and economic contexts. Therefore, it is important to understand the U.S. mortgage delivery system before detailing the manner in which the U.S. market changed to improve its service of lower-income and minority home buyers. Most notably, the largest share of mortgages are originated by nondepository lenders. These companies make profits from origination and servicing fees, rather than on the difference between their cost of capital and income generated from a loan portfolio. These lenders exist because of the large secondary market for mortgages, which is dominated by Fannie Mae, Freddie Mac and Ginnie Mae. While private companies, Fannie Mae and Freddie Mac benefit from certain charter provisions which reduce costs. Ginnie Mae, on the other hand, has a direct link to the U.S. Treasury. In each case, the federal government helps to facilitate a large share of the secondary mortgage market in the United States. And, through its FHA pro-

gram, the federal government provides mortgage insurance for FHA borrowers, many of whom have relatively little equity in the transaction and/or have relatively poor credit histories. Thus, the housing finance system in the United States is characterized by a strong partnership between both the public and private sectors, which helps to enhance liquidity for mortgage lending (Lea, 1996).

In the following sections, I focus on three important changes: underwriting innovations; affordable lending and direct borrower subsidies; and innovative institutions and partnerships which connect members of underserved markets with mainstream housing finance institutions. In each case, these changes make it possible for mainstream lenders to serve lower-income and minority home buyers so that these borrowers can take advantage of the efficiencies of the U.S. housing finance system.

STANDARD UNDERWRITING INNOVATIONS

Since Fannie Mae and Freddie Mac purchase so many loans, their underwriting guidelines, summarized in Exhibit 2, have become industry standards (MacDonald, 1995). Since 1992, both Fannie Mae and Freddie Mac have made significant changes to their standard underwriting guidelines (Temkin, et al., 2001.) In contrast to GSE standards of the late 1980s, the GSEs' current standard guidelines allow borrowers to qualify for a 95% LTV mortgage (down from a maximum LTV of 90%). Allowable house payment-to-income (28%) and total debt-to-income ratios (36%) are higher as well, up from 25% and 28%, respectively. Moreover, the GSEs will now purchase loans from borrowers who do not have a formal or perfect credit history. Borrowers may still qualify for a GSE standard mortgage despite some lapsed payments, so long as they provide compensatory factors (Listokin and Wily, 2000).

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These underwriting changes make it easier for income- and wealth-constrained borrowers to qualify for standard conventional loans. During the 1990s, the GSEs made other changes to make homeownership more obtainable: emphasizing a borrower's income stability, allowing appraisers more flexibility in choosing comparable sales and allowing collateralized loans as a source borrower funds.

In addition to increasing the flexibility of their standard underwriting guidelines, the GSEs have promoted the use of credit scoring and automated underwriting to try to make the underwriting process faster, fairer and less expensive for borrowers. Each innovation, according to the GSEs, makes underwriting more objective, and reduces the potential for differential treatment of minority and lower-income applicants. Moreover, both Fannie Mae and Freddie Mac claim that credit scores and automated underwriting systems make it possible for underwriters to identify creditworthy applicants more easily, reducing the costs associated with evaluating mortgage applications. Each innovation is discussed below.

Credit Scoring

A credit bureau score is a statistical measure that estimates how likely a borrower is to pay back a loan. The score measures the relative degree of risk a potential borrower represents to a creditor and is based on the credit information contained within the files of the three national credit bureaus. Each credit bureau reports a separate credit score, which is not based on prohibited factors, such as a borrower's race, color, national origin, sex, and marital status, nor on occupation or length of time a person has resided at his or her current address (Fair Issac and Company). Instead, a credit score is calculated by a system of scorecards that have been generated using actual credit information from millions of consumer payment records.

Exhibit 2. Underwriting Guidelines for Portfolio Lending Product

<i>Guideline</i>	<i>Standard GSE</i>	<i>GSE Affordable Loan Product</i>	<i>Sample Targeted Affordable Portfolio Mortgage</i>
Maximum LTV	95%	100%	97%
Maximum CLTV	95%		103%
Downpayment	5%. Must come from borrower's funds.	Minimum of 3% equity. Fannie Mae's Flex100 and Freddie Mac's Affordable Gold 100.	3% downpayment greater of 1% or \$500 from borrowers' funds for downpayment OR closing costs. Balance of downpayment and closing costs can be made from gift, grant, downpayment assistance program, seller second.
Subordinate Financing	Secondary financing from all sources is allowed if first mortgage is less than 75% and combined LTV < 90%	Some products allow borrower to use unsecured credit for downpayment	Up to 103% CLTV
Ratios	28/36	33/38	33/42
Mortgage Insurance	Required if LTV > 80%	Required if LTV > 80%	None required
Reserves	2 months required	None required	None required
Credit History	No minimum FICO, though FICO scores lower than 660, if manually underwritten, trigger a more comprehensive review	Same as standard.	Minimum 580 FICO. Nontraditional credit reports accepted
Closing Costs	Must come from borrower. Seller can pay up to 6% toward nonrecurring closing costs when the LTV is 90% or less; 3% when the LTV exceeds 90%.	Can come from grants and gifts	Can be from gift, grant, downpayment assistance program, seller second. 3% seller concessions.

Source: Listokin and Wyly, 1998.

Credit scores, which range from about 400 to 900 are based on the following factors: past payment history; amount of credit already owned by the borrower; search for and acquisition of new credit; and types of credit established (Fair Issac and Company).

Fannie Mae's and Freddie Mac's standard underwriting guidelines do not set minimum FICO scores. Indeed, their guidelines stress the fact that credit underwriting should not solely be based on a borrower's credit score, and underwriters may use compensating

factors, such as higher downpayments, or extenuating circumstances, that created a prior credit problem (Fannie Mae, 1997). Nonetheless, the vast majority of borrowers who are served by the conventional mortgage market have excellent credit: about 80% of loans originated since the first quarter of 1997 were issued to borrowers with a FICO score greater than 660 (Feshbach and Schwinn, 1999).

Analysts have found a strong statistical relationship between credit scores and mortgage performance. Using information on mortgages that were current as of March 1997, Feshbach and Schwinn found that about 20% of mortgages originated with FICO scores less than 580 had at least one missed payment during a six-month period; only 0.45% of loans with a FICO score over 720 had a late payment during the same period. Avery, Bostic, Calem, and Canner using data from 1994, found that FICO scores predict loan performance. The authors conclude: "For each type of loan, regardless of seasoning period, borrowers with lower scores have substantially higher delinquency rates than those with medium and high scores" (Avery, Bostic, Calem and Canner, 1996:632).

Although the GSEs encourage mortgage underwriters to use FICO scores when evaluating loan applications, some applicants have low FICO scores, or no formal credit histories. In these cases, lenders must use other methods to evaluate an applicant's creditworthiness. Both GSEs recommend originators assess a borrower's payment history with a variety of forms of credit, including rental payments and various types of consumer debt. By using this methodology, lenders can originate loans to borrowers who do not use credit or who do not have the type of credit history that will appear on a traditional credit report, and sell the mortgages to the GSEs.

Automated Underwriting

Credit scores are based on borrower's past use of debt, including consumer loans, credit cards and other types of financial obligations. While they are indicative of a borrower's creditworthiness, they do not take into account all of the items used by a mortgage underwriter when assessing an application. In order to fill this gap, lenders are increasingly using automated underwriting systems. These applications are based on statistical models, and assess an applicant's creditworthiness based on observed relationships between loan performance and underwriting standards (Avery, Bostic, Calem and Canner, 1996). Automated systems evaluate loans much more quickly than manual underwriters, and so are promoted by the GSEs as an aid in making homeownership more affordable (Freddie Mac).

The mortgage credit score generated by an automated underwriting system is calculated in with information that a manual underwriter would use. Fannie Mae's Desktop Underwriter®, analyzes debt-to-income ratios; whether the borrower is salaried versus self-employed; loan amortization period; adjustable or balloon mortgage; number of units in the mortgage property; co-op, condo or attached; funds from other parties; loan purpose; number of borrowers; prior bankruptcies and foreclosures; and prior mortgage delinquencies (Fannie Mae, 2000a). Freddie Mac's Loan Prospector® system uses similar variables (Freddie Mac, 2000).

The major difference between manual and automated underwriting is that an automated system can estimate a borrower's risk in a matter of minutes, as compared to a period of days or weeks needed for a manual underwriter. In addition, an automated system can simultaneously balance various risk-contributing factors in assessing an application (Pachura and Zorn, 1996). This is an important point, as many mortgage appli-

cants, especially those with lower incomes and wealth, do not meet more than one underwriting guideline. Consequently, some analysts believe that automated underwriting systems can help to standardize the underwriting decisions and, in doing so, improve the overall fairness of the underwriting process. Expediting the underwriting process can also help to reduce origination costs by as much as \$400 for each borrower (Mahoney and Zorn, 1996).

The benefits of automated underwriting, discussed above, have led to an increase in the number of mortgage applications analyzed with such a system. About 60% of lenders use one of the GSEs' automated underwriting systems, and about 75% of all lenders use some type of automated system. In 1999, 50% of newly originated loans purchased by Freddie Mac were scored through the company's automated underwriting system; 39% of such loans purchased by Fannie Mae were scored through Desktop Underwriter® (OFHEO, 2000).

But some housing market analysts are concerned that automated systems may not make it easier to serve low- and moderate-income lending. First, these systems may not be flexible enough to assess applications from previously underserved borrowers accurately. Moreover, it is not clear how lenders underwrite applications that have been referred by the system to a manual underwriter. Fannie Mae and Freddie Mac argue that lenders will spend less time on loans that are approved, thereby freeing up resources for more problem loan applications. This may happen, but there is little evidence about how these systems are being used in practice (Madison, 1999). In addition, minority mortgage applicants, on average, have lower credit scores, fewer funds available for closing and less equity available for a downpayment. Fannie Mae, in analyzing loans evaluated by its automated underwriting system, found that almost 25% of

loans originated to African-American borrowers had a loan-to-value ratio over 90%; the same data indicated that the percentage of white borrowers who received a loan with a loan-to-value of over 90% was less than 10%. Similarly, Fannie Mae found that about 16% of African American and Hispanic borrowers had less than one month reserves at closing, compared to 11% of whites. Minorities also had lower credit scores: only 20% of loans originated to African-Americans and purchased by Fannie Mae in 1999 had a borrower credit score over 740. This percentage is about one-half of the proportion of such loans originated to white borrowers (Fannie Mae, 2000b).

TARGETED AFFORDABLE LENDING

In addition to making changes to standard guidelines, lenders offer targeted affordable loans to borrowers who are eligible, as defined by their income or the location of the mortgaged property. There are two major categories of such loans: those available for sale to Fannie Mae and Freddie Mac and loan products (summarized in the fourth column of Exhibit 2) offered by lenders which contain features that make them more likely to be held in a lender's portfolio.

Fannie Mae

Fannie Mae has two community lending models—the Community Home Buyer's Program and Fannie Neighbors—to increase homeownership opportunities for low- and moderate-income households. The Community Home Buyer's Program uses borrower income as qualifying criteria for program participation. Fannie Neighbors uses the location of the subject property as the qualifying criteria.

Although the appraisal guidelines for standard and affordable lending mortgages are the same, other underwriting guidelines for Fannie Mae's affordable lending products

differ from guidelines for standard loans. Three downpayment options are available under the Community Home Buyer's Program and Fannie Neighbors: the regular downpayment option, the 3/2 Option, and Fannie 97. Under the regular downpayment option, the minimum down payment is 5% of the sales price and must come from the borrower's own funds. Under the 3/2 Option, the borrower must also provide 5% of the sales price, but only 3% must come from borrower's own funds. The remaining 2% may come from other sources such as gifts or government programs (Community Seconds). Under Fannie 97 the minimum cash downpayment is 3% and must come from the borrower's own funds.

Fannie Mae establishes higher debt-to-income ratios for borrowers in affordable lending programs because low- and moderate-income home buyers often allocate a higher portion of their income to debt, particularly housing. The one exception is loans originated under the 3% downpayment option available under Fannie 97; this is done in order to prevent layering multiple high risk factors. The Fannie 97 debt-to-income ratios are the same as the conventional mortgage ratios. For loans originated under the regular downpayment option and 3/2 Option, the maximum monthly housing expense-to-income ratio is 33% (compared to 28% for standard mortgages) and the maximum monthly total debt to income ratio is 38% (36% for standard mortgages).

Similar to standard guidelines, Fannie Mae accepts nontraditional mortgage credit reports from borrowers in affordable lending programs. These credit reports consider payment history on obligations not normally included in the standard credit report such as rent and utilities, insurance, medical bills, school and childcare and local department store bills. Fannie Mae has developed a standard format for considering these non-traditional credit histories. Nontraditional

credit histories may be used as a substitute for or supplement to traditional credit histories obtained from consumer agencies.

Freddie Mac

Freddie Mac's affordable lending programs include three affordable lending programs: Affordable Gold 5, Affordable Gold 3/2, and Affordable Gold 97. Affordable Gold 97, the newest of the three products, allows 97% LTV ratio. The entire 3% downpayment must come from the borrower's personal resources. Like Fannie Mae's Community Home Buyer's Program, borrowers must be income eligible for Affordable Gold 97 mortgages. Qualifying borrowers cannot have an income above 100% of area median income. The exceptions are California (120%), Hawaii (170%), and New York City and Boston Metropolitan Statistical Areas (120%). Affordable Gold has no maximum PITI-expense-to-income ratio and the monthly debt-to-income ratio is 38% to 40%. Lenders are required to use automated underwriting and consider credit scores.

Affordable Gold 3/2 requires a 95% LTV ratio. Three percent of the downpayment must come from the borrower's personal resources. The remainder may come from other sources such as a gift, government or nonprofit program, or sweat equity. Borrowers' income limits are the same as those established for Affordable Gold 97. However, income limits may be higher in certain areas targeted for community development by Freddie Mac or another government or private organization. Like Affordable Gold 97, there is no maximum housing expense-to-income ratio and the monthly debt-to-income ratio is 38% to 40%.

Affordable Gold 5 requires a 95% LTV and the entire 5% downpayment must come from the borrower's resources. With several exceptions, borrower income limits are the

same as those for Affordable Gold 97. The exceptions are for properties in areas targeted for community development (like Affordable Gold 3/2) and properties in areas designated as a Central City; a census tract with median family income 80% or less of area median; a census tract where non-whites or Hispanics are 50% or more of the population. There is no maximum housing expense-to-income ratio and the monthly debt-to-income ratio is 38% to 40%. Lenders are required to use Loan Prospector.

In addition to the Affordable Gold Program, other Freddie Mac affordable lending products include HOME WORKS! and Neighbor Works. These products are designed to coordinate with other programs to promote homeownership for low- and moderate-income households. HOME WORKS! aims to leverage funds from the federal HOME Investment Partnership Program administered by local housing agencies and is available to lenders through a negotiated agreement with Freddie Mac. HOME WORKS! mortgages are available for rehabilitation or purchase of owner-occupied single-family properties. Underwriting criteria for home purchase mortgages are generally the same as those for Affordable Gold 97. The maximum LTV ratio is 97% and the 3% downpayment must come from the borrower's own resources. Borrowers' income limits are the same as those established for Affordable Gold 97 (generally no higher than 100% of area median income). Income limits may be higher in certain areas targeted for community development by Freddie Mac or another government or private organization. HOME WORKS! mortgages do not impose a maximum housing expense-to-income ratio. The debt payment-to-income ratio is 38% to 40%.

PORTFOLIO AFFORDABLE LENDING PRODUCTS

Some lenders have introduced targeted affordable mortgage products with underwrit-

ing guidelines even more flexible than those allowed by Fannie Mae and Freddie Mac under their affordable product lines. In many cases, lenders use these programs in their effort to comply with the Community Reinvestment Act (Federal Reserve Board, 2000). These programs generally are targeted to borrowers who have incomes below 80% of area median, or purchase a home in a census tract with a median income below 80% of area median. Lenders use these eligibility criteria because CRA examiners base a large part of their evaluation on the extent to which lenders originate mortgages to lower-income borrowers or in lower-income neighborhoods (FFIEC, 1997).

While there are many different types of products offered, in general targeted portfolio affordable loans have several features—higher allowable loan-to-value and payment-to-income ratios, more flexible sources of borrower contribution, and more liberal credit underwriting standards—that make them affordable to lower-income borrowers. Column 4 in Exhibit 2 details the underwriting guidelines for a sample portfolio affordable loan product offered by a U.S. lender. Moreover, some portfolio loan products do not require borrowers to have mortgage insurance, and provide mortgage finance at below market interest rates. These two features are not available from any GSE product. The GSEs' charters require them to purchase loans with credit enhancements. As a result, they may only buy loans with recourse back to the seller, mortgage insurance, or in a sale in which the seller retains ten percent participation.

Primary lenders are not under similar constraints: they can waive the mortgage insurance premium. Since mortgage insurance, on average, costs 50 basis points per year (\$500 on a \$100,000 mortgage), targeted loans that waive the requirement are more affordable to lower-income borrowers. Lenders originating such loans are exposed

to a higher level of risk, and use home buyer counseling and more aggressive servicing to help lower the probability of borrower default. In a recent survey of lenders, the Federal Reserve Board (2000) found that about one-third of lenders required borrowers receiving an affordable loan to take some sort of prepurchase home buyer counseling.

While it is difficult to sell these loans to the secondary market immediately after origination, they may be sold to investors under certain market conditions. Securitizers use affordable loans as collateral for mortgage-backed securities that use the real estate mortgage investment conduit (REMIC) structure. In such a transaction, the underlying cash flow generated from the mortgages used as collateral is structured in order to create certificates that differ by expected maturity and risk grade. The REMIC structure mitigates some of the credit risks associated with the underlying mortgages to certain investors, while allowing those investors with a higher risk tolerance to earn above market returns. Certificates, or bonds, that represent the lowest credit risk to investors are included in the senior tranche, while other certificates, that are more risky, are issued as part of the subordinate tranche (DeLiban and Lancaster, 1995).

This structure allows originators to sell portfolio affordable loans for their full value, since investors in the subordinate tranches are exposed to the risks associated with higher defaults for loans that do not conform to standard underwriting guidelines. While these transactions provide additional liquidity for portfolio affordable lending, they are not feasible in all types of interest rate environments. Indeed, these transactions became feasible: (1) when prevailing interest rates dropped below coupon rates of affordable portfolio loans, and (2) after the loans had seasoned and demonstrated satisfactory performance that allowed rating agencies and potential investors to analyze the

risks and returns associated with mortgage-backed securities issued with targeted affordable loans as underlying collateral (Temkin and Johnson, 2000).

DOWNPAYMENT ASSISTANCE PROGRAMS

Downpayment assistance programs have been developed to increase the amount of equity lower-income families can contribute towards a home purchase. In some programs, borrowers are required to make a contribution toward the downpayment: these funds are supplemented with grants and loans. Oftentimes, the loans provided as downpayment assistance are forgiven if the borrower remains in the house for a specified period of time; in other programs the borrower has to repay the loan once he or she sells the property. In Exhibit 3 we present some examples of downpayment assistance programs available to lower-income home buyers. Note that, in many cases, the funds used in the program come from the federal government through the HOME program, which provides funds to eligible jurisdictions to use for housing initiatives.

The 12 Federal Home Loan Banks in the United States also provide funds for downpayment assistance programs as part of each bank's Affordable Housing Program. While each bank may design its own program, downpayment assistance may be made available to borrowers with incomes less than 80% of area median. The Federal Home Loan Bank of Chicago's Downpayment Plus program is typical of this type of assistance. First-time homebuyers with an income less than 80% of area median are eligible to receive up to \$3,000 in assistance for a downpayment, closing costs, prepayments due at the time of settlement, homeownership counseling and the creation of a reserve account. The loan does not have to be repaid by the borrower if he or she remains in the property for more than five

Exhibit 3 Examples of Downpayment Assistance Programs

<i>Program Name</i>	<i>Description</i>	<i>Requirements</i>	<i>Participating Institutions</i>
HouseHartford, Hartford, CT.	Families are eligible for a no-interest loan of up to 7% of the purchase price of the home. Loan is forgiven if borrower lives in property for five years.	Borrowers must contribute 3% of the house price and have an income less than 80% of area median	City of Hartford with federal HOME funds, Fannie Mae, and private lenders.
One Percent Downpayment Loan Program, Detroit, MI.	Borrowers are eligible for a no-interest second mortgage of up to 2% of the house price. Loan is repaid once first mortgage is refinanced.	Borrowers must contribute 1% of the house price and have an income 60% of area median or less. Houses must be valued less than \$60,000.	Michigan State Housing Development Authority with federal HOME funds.
Minneapolis/St. Paul HOME Program, Minneapolis and St. Paul, MN.	Downpayment grants are available. Borrowers may receive the difference between the downpayment required by a FHA mortgage and a \$500 borrower contribution.	Borrowers repay the grant through various forms of community service that is valued at \$25 per hour.	A pool of funds created by the Family Housing Fund of Minneapolis and St. Paul.
Downpayment Assistance Program, Memphis, TN.	First-time homebuyers receive a loan for up to \$10,000 in downpayment assistance.	Borrowers defer payment on the downpayment until they sell their home.	Federal HOME and CDBG funds.

Source: Michael A. Stegman, 1999, *State and Local Affordable-Housing Programs: A Rich Tapestry*, Washington, D.C., Urban Land Institute.

years. The borrower must repay a pro-rated share of the principal if he or she moves out of the home within five years of receiving the loan (Federal Home Loan Bank of Chicago).

The programs highlighted in Exhibit 3 reduce the amount low-income families have to borrow at market rates when purchasing a home. Other programs, described in Exhibit 4, match the savings of lower-income families in order to increase the amount of funds they have available for a downpayment. The purpose of these programs is to increase the incentives for lower-income families to save towards a downpayment, or other

activities, such as paying college tuition, which will help them achieve self-sufficiency (Stegman, 1999).

Programs that provide downpayment assistance to home buyers are expensive, since they provide up-front subsidies and are repaid, if at all, with deeply discounted interest rates. Listokin, et al. (1999) estimate that a downpayment assistance program implemented to provide a \$10,000 asset supplement to "homeownership-oriented" families—those with a household head between 25 and 55 years of age and an income between \$15,000 and \$80,000—would cost

Exhibit 4 Downpayment Match Programs

<i>Program Name</i>	<i>Description</i>	<i>Requirements</i>	<i>Participating Institutions</i>
Hawthorne HOPE Matching Grant Program, Los Angeles, CA.	Participants are required to open an account with Hawthorne Savings, a Los Angeles-based bank with a \$50 contribution. Hawthorne matches subsequent deposits up to a maximum of \$5,000.	Borrower must be enrolled in a home buyer counseling program operated by Hawthorne Savings for a minimum of six months and demonstrate on-time payment performance of his or her installment debt. Borrower must purchase a home in designated income-eligible census tracts.	Hawthorne Saving
Individual Development Account (IDA) Program of the State of Indiana	Participants open IDAs in financial institutions; these accounts are managed by local Community Development Corporations. Participants' deposit contributions are matched up to \$900.	Participants must receive public assistance and have an income less than 150% of the poverty line. IDA funds can be used for education, training, business development, or to purchase a primary residence.	State of Indiana and private contributors, who receive tax credits
Individual Development Account Demonstration Program, North Carolina	Participants' savings are matched, in some cases, on a 5/1 basis.	Participants must agree to a two-year commitment to attend home buyer counseling and savings. They must have an income no greater than 80% of area median.	North Carolina working group on IDAs and the State Department of Commerce

Source: Michael A. Stegman, 1999, *State and Local Affordable-Housing Programs: A Rich Tapestry*, Washington, D.C., Urban Land Institute

\$53 billion. Even a modest \$5,000 asset supplement targeted for such families would costs a total of \$6.7 billion. As a reference point, the entire proposed fiscal year 2001 budget for the U.S. Department of Housing and Development is \$32 billion.

NEW INSTITUTIONS

A number of new institutions have been created to provide credit in areas that may be underserved by mainstream financial institutions. These new types of institutions, which

are often categorized under the umbrella—"community development financial institutions" (CDFIs)—consist of a number of different types of lenders. Vidal identifies five distinct types of institutions: community development banks, bank-owned CDCs, community development credit unions, community development loan funds, and microenterprise loan funds (Vidal, 1995). The U.S. Department of the Treasury, as part of its Community Development Financial Institution Program, recognizes five types of CDFIs as well; but rather than for-profit

CDCs, the CDFI fund offers support to community development venture capital funds (General Accounting Office, 1998). Each type of institution is designed to meet credit needs of lower-income families and residents of underserved communities, but do so in different ways (McLenighan and Tholin, 1997; Vidal, 1995).

Community Development Financial Institutions

Community development banks are the largest and most sophisticated CDFI. The oldest, South Shore Bank of Chicago, started in 1973 (Taub, 1984). Now the country has a number of community development banks: some of the largest are Elk Horn Bank and Trust in Arkansas; Community Capital Bank in Brooklyn, New York; Self-Help Credit Union in North Carolina; and the Shore Bank and Trust Company in Cleveland, Ohio (Tholin, 1994).

In general, community development banks are the most costly and time-consuming CDFI to initiate. In 1992, Parzen and Kieschnick estimated that start-up costs associated with securing a charter, incorporating, and other types of start-up expenses, such as printing stationery, amounted to between \$85,000 and \$190,000. Moreover, community development banks must raise enough capital to satisfy regulatory minimum standards. In metropolitan areas, as of 1992, the OCC required that new banks had to have a minimum of \$3 million in equity, the majority of which must be in the form of common or preferred stock (Parzen and Kieschnick, 1992). Regulators, however, can require even higher levels of equity for new community development banks. Brooklyn's Community Capital Bank had to raise \$8 million in equity when it opened in 1991 (Vidal, 1995).

All community development banks have relatively modest assets, and are unable to originate large volumes of loans. Even South

Shore, the oldest and largest community development bank in the country, currently has only a modest \$840 million of deposits. In comparison, First One, a large Chicago-based bank, had \$261 billion in assets as of the end of December 1998 (Banc One, 1998). This relatively small asset base places a constraint on the amount of loans that community development banks can originate. Since 1973, South Shore has originated about 12,500 loans worth about \$550 million to families and businesses in South, Near-South and West Side communities (South Shore Bank). However, at one time, South Shore was one of the only providers of home purchase and rehabilitation loans in some Chicago neighborhoods. By originating loans, which performed reasonably well, other lenders began to originate loans in South Shore's coverage area. As a result, South Shore cut back its home purchase lending activity (Parzen and Kieschnick, 1992).

Unfortunately, there is very little evidence about the specific purposes of loans originated by community development banks, or the performance of loans they originate. What is known, however, is that community development banks handle accounts with relatively small deposits, which increases the average administration cost per depositor. Nonetheless, community development banks do provide a broad range of services to customers who may otherwise use other institutions, such as pawnshops and check-cashing facilities, for their financial services.

Bank-owned CDCs are institutions that are capitalized by major commercial banks in order to channel funds into lower-income communities. As of 1995, Vidal reported that commercial lenders had invested or committed over \$300 million to bank-owned CDCs; the average commitment was \$2.5 million, but the median was much smaller—at \$500,000. Unlike community development banks, bank-owned CDCs do not offer cus-

tomers a full array of financial services. Rather, these institutions generally provide equity and debt financing for affordable rental housing development.

Community development credit unions are similar to community development banks: they are depository institutions that promote community development, through lending in targeted neighborhoods. Start-up costs associated with initiating a new credit union are less than those for a community development bank. Newly chartered credit unions are not required to pay a fee to regulators. With volunteer assistance, new credit unions can be started for as little as \$1,500. Moreover, newly established credit unions do not have minimum equity requirements. Rather, they must demonstrate a sufficient number of interested members are willing to join, and commit to signing up a set number of members within a set period of time. Most credit union applications are approved with 500 people committing to join (Parzen and Kieschnick, 1992).

While credit unions can be started with less financial resources than community development banks, they must be established to meet the credit needs of their members, who must share a particular characteristic—such as living in a certain neighborhood, or being employed by a given company or government agency. As of 1996, the National Federation of Community Development Credit Unions had 130 member organizations which, collectively, had \$194 million of loans outstanding (McLenighan and Tholin, 1997).

Two other CDFIs—community development loan funds and microenterprise loan funds—do not provide mortgage finance to lower-income families. Community development loan funds finance community development projects that include housing construction, new business start-up support, and other economic development efforts. Microenterprise loan funds target very small compa-

nies or individuals, and offer small loans—ranging between \$250 and \$10,000—to entrepreneurs interested in starting a business, or to small business owners who require small loans (Tholin, 1994).

Community Development Corporations

CDFIs should be distinguished from community development corporations. CDCs engage in a number of activities that improve the overall quality of life in lower-income urban neighborhoods. Unlike CDFIs, which have a narrow mission to provide credit, CDCs:

“Are self-help organizations, governed by residents, businesspeople, and other leaders of the communities they serve. They plan improvements to solve local problems, building on neighborhood assets” (Walker, and Weinheimer, 1999:1).

The number of CDCs has expanded greatly, from about 100 in the late 1960s to 2,200 in 1995, to a current level of 3,600 active institutions (Stoecker, 1997). This increase is due to two major factors. First, starting in the late 1970s, three national intermediaries: the Enterprise Foundation, Local Initiatives Support Corporation (LISC); and the Neighborhood Reinvestment Corporation (NRC) provided a conduit for foundations, corporations, and government to channel money to CDCs. In addition, all three organizations provide technical support to CDCs, and increase these organizations' capacity to conduct community development activities (Liou and Stroh, 1998).

Second, shifts in federal housing policy created an opportunity for CDCs to produce more affordable housing. Under the Reagan and Bush administrations, the federal government cut back its support of project-based affordable initiatives, such as public housing. This created an increase in demand for affordable housing, which CDCs

attempted to meet by using the low-income housing tax credit and funds provided by localities through the federal government's community development block grant (CDBG) and HOME programs (Mayer, 1990).

CDCs, although generally small,³ have been able to become active and significant players in many urban real estate markets. Through 1997, CDCs have built 550,000 units of affordable housing, 71 million square feet of commercial development, and originated over \$1.9 billion of economic development loans to 59,000 businesses. And, CDCs no longer just focus on housing production. Indeed, CDCs have responded to criticisms that their activities were too narrow in scope, and have begun to work on initiatives that are more comprehensive in nature (Glickman and Servon, 1998). This change represents opportunities, but also challenges, as CDCs move beyond their core competencies and expand their activities in areas that require skills different than housing development (Vidal, 1997).

Although CDCs have moved beyond housing, most do not originate mortgages. CDCs concentrate their housing-related efforts on developing affordable units, mostly for lower-income renters (National Congress for Community Economic Development, 1999). CDCs also develop owner-occupied units; and this strategy is becoming an even larger component in many neighborhood revitalization efforts. Owner-occupied units account for about 22% of units developed by CDCs in urban areas. Nevertheless, CDCs that develop owner-occupied units often refer their customers to specially designed lending products originated by other institutions, such as commercial banks. In many cases, participants can only receive mortgages after completing a home buyer education course, which provides information to home buyers about the steps needed to become a homeowner and financial management skills

(Quercia and Wachter, 1997). More than half of the nation's CDCs provide homeowner counseling, and many CDCs also pre-qualify potential homeowners before sending them to a lender (National Congress for Community Economic Development, 1999).

CONCLUSIONS: THE NEW LANDSCAPE IN MORTGAGE LENDING

The U.S. mortgage finance system has made great strides in meeting the needs of more low- and moderate-income families. Through experimentation, lenders have come to realize that new mortgage products can be used to qualify borrowers without sacrificing profits. As a result, low-, moderate-income and minority homeownership rates increased in the 1990s, in part because mainstream lending institutions adopted new business models and offered more flexible loan products that were unimaginable even ten years ago. Target borrowers may now apply for mortgages that finance the entire purchase price of the home, and in some cases, receive below-market interest rates. Moreover, many of these programs do not require borrowers to purchase mortgage insurance. Borrowers also benefit from more flexible conventional mortgage underwriting standards; Fannie Mae and Freddie Mac now purchase mortgages originated with lower downpayments and higher debt-to-income ratios than in the past.

In addition, new institutions, including CDFIs and CDCs work to bring credit and affordable housing into low- and moderate-income neighborhoods. These organizations, while small compared to mainstream lenders and developers, help to fill niche markets sometimes overlooked by housing institutions. By demonstrating markets, these institutions can help connect underserved neighborhoods with new sources of capital.

This "quiet revolution" in the lending industry has been driven by legislative requirements of CRA and FHEFSSA, but are sustainable because many lenders perceive low- and moderate-income lending as a profitable and essential aspect of their day-to-day operations. Indeed, lenders recognize that the mortgage industry's growth can only be sustained by serving more minority, low- and moderate-income, and immigrant families, since these groups are over-represented among renters. As a result, lenders and the GSEs now require more borrowers to attend formal home buyer counseling classes in order to reduce the probability that these new homeowners will fall behind in their mortgage payments.

These changes suggest that lenders are now better able to serve lower-income and minority home buyers; they have more experience in underwriting non-traditional borrowers better relationships with community organizations in underserved communities, and originate loans to borrowers who are more familiar with the home buying process. Given these trends, it is no surprise that more lower-income and minority families own their home. There is no reason to believe that lenders will reduce these activities, since they are still subject to CRA. Moreover, many lenders realize that this type of lending is profitable, and will continue to contribute to the industry's profits over the long term.

NOTES

¹ Institutions with assets less than \$250 million are evaluated under a streamlined review; they are only subject to a lending test. In a small bank lending test, an examiner uses five criteria: a reasonable loan-to-deposit ratio; the percentage of loans in a bank's assessment area, the bank's distribution of loans to individuals of different incomes; the geographic distribution of loans; and the bank's record of responding to written complaints to make a determination.

² GE Capital offered the first affordable lending product in 1989 under its Community Homebuyer Program, which allowed borrowers to place less than five percent down and higher debt-to-income ratios. It became the model for Fannie Mae's products offered under its Community Home Buying Program, and Freddie Mac's affordable products offered to borrowers under its Affordable Gold initiative.

³ According to the National Congress of Community and Economic Development, 60% of CDCs employ 10 or fewer full-time staff.

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