

S&Ls: ARE THEY BETWEEN A ROCK AND A HARD PLACE IN SERVING LOW
INCOME NEIGHBOURHOODS

by

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**S&Ls: ARE THEY BETWEEN A ROCK AND
A HARD PLACE IN SERVING LOW INCOME NEIGHBOURHOODS?**

By

Robert A. Brown

Submitted to the Department of Urban Studies & Planning on July 29, 1993 in
partial fulfillment of the requirements for the Degree of Master of Science in Real Estate

ABSTRACT

The mortgage industry in the United States has done an excellent job for the majority of Americans in making the dream of owning a home a reality. It has not accomplished the same level of success for minorities and low- and moderate income people, especially those living in marginal neighbourhoods. Savings and Loan Associations (S&Ls) have been the focus of considerable attention in an attempt to determine the extent they may have contributed to this inequitable variation in home ownership.

However, in the last decade the mortgage industry has undergone tremendous change that has dramatically altered how S&Ls deliver mortgage finance, particularly to low- and moderate income people who primarily live in marginal neighbourhoods. In the 1990s the market for fixed rate mortgages will be almost completely securitized which will mean that secondary market underwriting standards largely dictate how the primary market originates loans. In the past, S&Ls were able to employ flexibility in the application of their underwriting standards to meet the unique needs of marginal borrowers, especially those people living in low- and moderate-income neighbourhoods. In some cases, this flexibility was eliminated at the same time the secondary standards were adopted by the primary market.

A new drive for economies of scale and changes in technology have also altered the way S&Ls deliver mortgage finance to low- and moderate-income people, particularly those who live in marginal neighbourhoods. In the past it was the small institutions that best served the low- and moderate-income market. In the 1990s the mortgage environment favours larger institutions. Regulatory pressures have also increased in the past decade to the point that they are placing an increasing number of constraints on the ability of S&Ls to react to new opportunities to profitably serve the marginal borrower, especially the borrower living in a marginal neighbourhood.

The implications drawn from an analysis of this rapidly changing mortgage market provide insight into the difficulties S&Ls will have in the future in delivering mortgage finance to low- and moderate income borrowers, particularly those borrowers living in marginal neighbourhoods. Many of these implications are confirmed in a case analysis of

Northeast Savings, F.A. of Hartford, Connecticut, which represents a typical S&L operating in this new lending environment.

Inflexibility associated with Fannie Mae's underwriting standards has been particularly tough on Northeast's ability to serve borrowers living in marginal neighbourhoods. Fannie Mae still places considerable emphasis on a review of "neighbourhoods" in the overall implementation of its underwriting standards. Fannie Mae has continued to do this in spite of implications from empirical research and the commercial real estate collapse which both suggest a reduced role for "neighbourhood analysis" in determining the likelihood of default for any single mortgage. The problem of inflexibility in Fannie Mae's underwriting standards is illustrated in a case in which a borrower Northeast considered to be creditworthy could not obtain a refinance of an existing fixed-rate mortgage at the maximum amount because of where the property was located.

A central theme emerges from this analysis: S&Ls are between a rock and a hard place in terms of being able to effectively meet the needs of low- and moderate-income borrowers particularly those living in marginal neighbourhoods. This theme takes on greater importance when it is viewed in the context of today's home buying market in which interest rates are at a twenty year low and slower home price appreciation has made housing affordability the best it has been in nearly two decades. The time is now for players in the mortgage industry to consider proactive policies to improve future service to low- and moderate income borrowers, particularly those living in marginal neighbourhoods.

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INTRODUCTION

The mortgage industry in the United States has done an excellent job for the majority of Americans in making the "American Dream" of owning a home a reality. Yet, for many others, particularly minorities and those living in low- and moderate-income neighbourhoods, the dream of owning a home has not materialized.¹ Recent information provided through the Home Mortgage Disclosure Act (HMDA) are triggering a resurgence in the debate as to why there are such profound disparities in homeownership.² One argument that has been frequently been put forth, relates to the extent mortgage funds have been equitably allocated to low- and moderate income people, particularly those who are living in marginal neighbourhoods.³

There has never been a better time for the major players in the mortgage industry to develop proactive policies aimed at improving the degree of home ownership in low- and moderate-income neighbourhoods. The next few years should prove to be an excellent time to buy a home. Interest rates are at a twenty year low and slower home price appreciation has made housing affordability the best it has been in nearly two decades.⁴ More families are closer than ever into being able to qualify to buy a home.

Much of the attention in the past twenty years has naturally focused on primary lenders, particularly Savings and Loan Associations (S&Ls) and their record in serving minorities and low income borrowers primarily located in marginal neighborhoods. While S&Ls

¹Fannie Mae Annual Report, 1991 Chairman James Johnson's opening Remarks.

²Wachter, Susan & Issac F. Megbolugbe. 1992 *Racial and Ethnic Disparities in Homeownership* Housing Policy Debate Volume 3, Issue 2

³Eleven papers are presented in Housing Policy Debate, 1992, Volume 3, Issue 2 dealing with discrimination in the mortgage markets.

⁴Boston Globe, July 24, 1993

should share in part of the blame for under serving this segment of the population in the past, they should not necessarily be the focus of attention in the future.⁵ In the last ten years, the mortgage industry has undergone enormous change, that has shifted the responsibility to a new set of players in the industry. The purpose of this report is to analyze this rapidly evolving mortgage industry and draw implications for the future ability of S&Ls to deliver mortgage finance to minorities and low-income borrowers whom primarily live in low- and moderate income neighbourhoods. The following is a brief outline of the contents of this report:

Chapter One

This chapter is entitled "Setting the Stage". It focuses on a brief history of the traditional role of the S&L in delivering home finance in the United States mortgage industry, in order to set the stage for how to view the dramatic changes outlined in the two subsequent chapters.

Chapter Two

This chapter is entitled "The Rapidly Changing Mortgage Market". It concentrates on the mortgage industry, an industry that has undergone enormous change in the past ten years, and is expected to continue to undergo substantial change throughout the 1990's. The dominant themes analyzed in this chapter include securitization and the increasing role secondary market players have in shaping the S&L industry's lending strategies; the industry-wide drive for cost efficiencies and the subsequent trend towards larger lending institutions; and finally the impact of new technology on the underwriting process. These changes, as it will be shown, have had a dramatic impact on the ability of S&Ls to deliver

⁵ Federal Reserve Bank of Boston, October 1992 *Mortgage Lending in Boston: Interpreting HMDA Data*.

mortgage finance to low- and moderate income families, particularly those living in marginal neighbourhoods.

Chapter Three

This chapter is entitled "The Regulatory Environment". It analyses the major pieces of legislation that have had a growing impact on the way S&Ls do business. The major acts covered in this chapter include the Community Reinvestment Act (CRA), the Home Mortgage Disclosure Act (HMDA), and the Financial Institutions Reform, Recovery and Enforcement Act (FIRREA). As it will be demonstrated in chapter three, CRA and FIRREA are simultaneously hammering S&Ls from both sides and are leaving an indelible mark on the day-to-day operations of S&Ls.

Chapter Four

This chapter is a case analysis of Northeast Savings, F.A. of Hartford, Connecticut. Northeast is one of the largest thrift institutions based in New England and has retail banking offices in Connecticut, Massachusetts, New York, Rhode Island, and Southern California as well as mortgage lending offices in Southern California; Denver, Colorado; Greenwich Connecticut; and Portland, Oregon. The analysis in this chapter draws upon interviews with various executives at Northeast to determine how in practice changes in the mortgage industry have had an impact on their ability to deliver mortgage finance to low- and moderate-income people primarily living in marginal neighbourhoods.

Conclusions

When the implications drawn from the analysis of chapters one through three are considered in the context of Northeast's lending operations, it is evident that it has become increasingly difficult for low- and moderate income people primarily those people living in marginal neighbourhoods to attract mortgage funds. A central theme emerges from this analysis: S&Ls are between a rock and a hard place in terms of being able to effectively

meet the needs of a segment of the population that has been underserved in the past. As a result, this final chapter considers the implications and raises questions about future issues that should be addressed by the mortgage industry.

CHAPTER ONE

SETTING THE STAGE: THE TRADITIONAL SAVINGS AND LOAN

As a precursor to identifying the rapid changes experienced by the mortgage industry during the 1980's, it is useful to understand the traditional role of the savings and loan (S&L) prior to this period. This chapter will focus on a brief history of S&Ls.

The first savings and loan institution was established in Frankford, Pennsylvania in 1831.⁶ It was set up to collect savings via deposits and in turn make loans available for the purpose of buying a home. It was owned only by a small group of local individuals who put their savings into the institution on a long-term basis. These same people were the only ones entitled to take out a mortgage. Membership was restricted to the immediate surrounding geographic area so that the association could better monitor lending activities and control against default risk.

The size and number of savings and loan associations continued to grow throughout the 1800s and the early 1900s. Although commercial banks grew in number as well, both industries remained quite distinct. S&Ls concentrated primarily on home ownership. Commercial banks focused on the growing demand for business loans. Each industry was separately regulated. Commercial banks were primarily regulated by the federal government whereas S&Ls were the focus of state regulators.⁷

⁶Barth, J.R.. 1991. *The Great Savings and Loan Debacle*, American Enterprise Institute for Public Policy Research, p.9

⁷Ibid., p.14

It wasn't until the Great Depression that the federal government sought an increased role in S&L activities. The impetus for this involvement was twofold. First of all, economic problems associated with the depression forced many depositors at S&Ls to withdraw their savings. This, coupled with a collapse of real estate values led to the demise of many S&Ls. Secondly, as the deposit base of S&Ls continued to erode, the source of mortgage funds for future housing virtually dried up.

To address the problem of a lack of mortgage funds, the federal government enacted the National Housing Act (NHA) in 1934. A key component of this act was to provide federal insurance for the deposits of savings and loans. This insurance, it was hoped would put renewed confidence in the public to return their savings to the S&Ls. The NHA achieved its goal and the S&L industry grew tremendously over the next four decades. In fact, during this period S&Ls quintupled their market share of total financial assets at a time when the commercial bank's market share declined by more than one third.⁸

Prior to the 1980's S&Ls depended on their deposit base to provide mortgages. As a result, the traditional source of profit generation was through the management of interest rate spreads-- that is, they borrowed money (deposits) at a lower rate than they were able to earn through their lending activities (mortgages). Management interest rate spreads proved to be a successful formula during the years leading up to the 1980's because interest rates remained relatively stable during this time. However, in the early 1980s interest rates became more volatile and many S&Ls were forced into bankruptcy because they had to pay a much higher rate on deposits than they were collecting through mortgages.

⁸Barth, J.R. 1991 *The Great Savings and Loan Debacle*, American Enterprise Institute for Public Policy Research, 68

For the S&Ls that survived, deregulation was offered in 1982 by federal and state governments as a means of getting S&Ls to diversify into other types of loans and investments, in order to strengthen profitability and reduce susceptibility to interest rate squeezes. S&Ls took advantage of these new found opportunities and ventured into higher risk fields such as commercial real estate. The potential gains were higher in these fields but so to were the potential losses. The end result was the savings and loan debacle experienced in the mid 1980's which has been highlighted by massive failures which may total more than \$350 billion.⁹ In spite of this disaster S&Ls continue to remain an important part of the mortgage industry. In 1990, S&Ls held a 29% market share in all home loan originations and more importantly a 35.2% market share of all loans originated in central cities.¹⁰

⁹White, Lawrence J. 1991 *The S&L Debacle: Public Policy Lessons for Bank and Thrift Regulation* Oxford University Press p. 197

¹⁰Canner, Glen B. & Stuart Gabriel. 1992 *Market Segmentation and Lender Specialization* Housing Policy Debate. p.245

CHAPTER TWO

THE RAPIDLY CHANGING MORTGAGE MARKET

"The revolution is far from over." Fannie Mae Annual Report, 1991

The 1980's represented a decade of rapid change in the mortgage market. These changes had the most significant impact on S&Ls and one of the important markets they serve, low- and moderate-income people who live primarily in marginal neighbourhoods. This chapter is intended to identify key changes that have taken place over the last ten years and explore the various possibilities for the future, as forecasted by both academicians and industry experts. Most importantly, this chapter will draw implications on the ability of S&Ls to deliver residential mortgage finance to the low- and moderate-income borrowers, particularly those living in marginal neighbourhoods, in the context of these changes.

The next section reviews the major changes that have helped shape the mortgage industry in the last ten years including the rapid growth of securitization and in turn, an increased importance of the secondary mortgage market players. The second section identifies the trends that are expected to prevail over the next ten years such as a drive for lower costs and changes in technology. Both economies of scale and technology are common themes found in most literature on the future of the mortgage industry.

THE 1980s:

One of the major developments in the mortgage market during the 80's was securitization. By the end of the decade more than one-half of mortgage originations were securitized.¹¹

¹¹Jaffee, Dwight M. , Kenneth T. Rosen. 1990 *Mortgage Securitization Trends*. Journal of Housing Research. Volume 1, Issue 1. p. 117

According to professors Jaffee and Rosen, securitization was spurred by several factors, including "a rising mortgage credit gap (an excess demand for fixed-rate mortgage funds relative to the supply of funds available from traditional thrift lenders); innovations in financial technology, which have increased the demand for mortgages by nontraditional investors; and an increased federal presence in the mortgage market." ¹²

Securitization has helped accomplish the goal that deregulation had intended to do in the early 1980s, namely it helped S&Ls better manage their interest rate risk. That is, by having an outlet in which to sell their long term fixed rate mortgages, S&Ls were no longer vulnerable to situations when the cost of borrowed funds (short-term deposits) exceeded the return on long-term invested funds (mortgages). As it was learned in chapter one, profit generation prior to 1980 depended primarily on management of this interest rate spread.¹³ Securitization has changed the role of S&Ls in the industry from that of portfolio lenders to more fee driven lenders. This change to the mortgage industry is summarized by professors James R. Follain and Peter M. Zorn:

"The most important factor affecting the unbundling of deposit collection is securitization. It has clearly broken the link between deposit collection and origination. The 1980's have shown, without a doubt that steady deposit flows into the thrift industry are unnecessary to deliver appropriately priced and stable supplies of funds for residential mortgage finance."¹⁴

The primary conduit for this growth in securitization has been the secondary mortgage market which is dominated by three quasi-government institutions; The Federal National Mortgage Association (Fannie Mae), organized in 1938; The Federal Home Loan

¹²Dwight Jaffee is professor of economics at Princeton University and Kenneth Rosen is a professor of business at University of California at Berkely.

¹³White, Lawrence J. 1991 *The S&L Debacle: Public Policy Lessons for Bank and Thrift Regulation*. Oxford University Press. p.67

¹⁴Follain, James R. , Peter M. Zorn 1990 *The Unbundling of Residential Mortgage Finance*. Journal of Housing Research. Volume 1, Issue 1. p.73

Mortgage Corporation (Freddie Mac), established in 1970; and The Government National Mortgage Association (Ginnie Mae), originated in 1968. Both Fannie Mae and Freddie Mac are government chartered but privately held. Ginnie Mae is an agency of the Federal Government controlled by the Department of Housing and Urban Development (HUD).

The secondary market was established by the Federal Government to nationalize the source of capital for home ownership by integrating local housing markets with the national capital markets. The government's ultimate goal was to improve the geographic match between the demand for mortgages and the supply of funds for mortgages, which in the long run, it was believed, would provide a more stable supply of mortgage funds over the business cycle.

When an S&L originates fixed rate loans, it can sell them directly to the secondary market. Alternatively, an S&L can issue its own mortgage backed securities (MBS) and have the secondary market players guarantee the creditworthiness of these instruments. In either case, an S&L enters into a contractual relationship with a secondary player in order to obtain the implicit guarantee of the federal government. In making the sale, the primary warranty made by an S&L under the terms of the contract, is that the mortgages meet all applicable requirements in the secondary market agencies' selling guides. This warranty is explicitly noted in Fannie Mae's selling guide:

"If a warranty made by the lender--whether the warranty is one of the specific contractual warranties in the Mortgage Selling and Servicing Contract or this Selling Guide or was otherwise made at our request--is untrue, we may require the lender to repurchase the mortgage. We may also enforce any other applicable rights and remedies."

The contractual warranties are essentially the underwriting standards required by the secondary players. Fannie Mae divides its underwriting standards into two different classifications: eligibility requirements and underwriting guidelines (exhibit no.1).

Eligibility requirements are relatively straight forward rules that a potential borrower must satisfy before a S&L can sell the loan to Fannie Mae. The most common eligibility requirement is loan-to-value (LTV) ratio. For a conventional fixed-rate mortgage the LTV ratio is 80%.

Fannie Mae's underwriting guidelines, on the other hand, are not as straight forward in their application. Rather than being fixed rules, the guidelines are meant to be more flexible and are therefore subject to interpretation. As Fannie Mae's selling manual indicates, "these guidelines are designed to help lenders establish and implement sound underwriting criteria for mortgages that will be delivered to us."¹⁵ According to Fannie Mae's Selling Guide, they are concerned with a borrower's willingness and ability to pay the mortgage obligation. S&Ls must use the information provided in these guidelines to rationalize why they approved any given mortgage.

An example of one of these guidelines is section 209 in the Fannie Mae Selling Guide which deals with debt-to-income ratios. These are ratios that compare the borrower's anticipated monthly housing expense and total monthly obligations to his or her stable monthly gross income. They are used to determine whether the borrower will be able to meet the expenses involved in home ownership. Fannie Mae recommends a benchmark monthly housing expense-to-income ratio for conventional fixed-rate mortgages of 28% of the borrowers stable monthly income. Fannie Mae will allow an S&L to use a ratio that is slightly higher than recommended by this guideline, as long as the S&L documents factors to justify the variation.

¹⁵Fannie Mae, Selling Guide, Volume 1, p.601

Securitization in the 1980s has changed the way S&Ls underwrite loans. S&Ls do not have the same degree of flexibility that they had in the past. Now, S&Ls securitize all of the fixed rate loans that they originate, meaning that they must rely solely on the secondary mortgage market underwriting standards. Mr. Warren Lasko, Executive Vice President of the Mortgage Bankers Association of America wrote about how strong this influence had become by 1986:

"The secondary mortgage market drives the primary market. The guidelines of the big three federal secondary market agencies and, in turn the institutional demands of investors for their securities dictate to a large extent the types of mortgages and underwriting in the primary market"¹⁶

Prior to the growth of securitization, S&Ls adopted their own underwriting standards to mitigate default risk. While an S&L's standards were primarily based on industry practice, they also reflected the local experience and performance of an S&L's portfolio.¹⁷ Since S&Ls could hold these mortgages in portfolio, there was a certain degree of flexibility available when it came to underwriting loans. This flexibility did not appear to significantly impact default rates, according to Lawrence White in his book on the savings and loan debacle when he notes that "defaults of home mortgages were rare in the 1950s, 1960s and 1970s."¹⁸

However, even though S&Ls had this flexibility available to them in the past, it did not mean that low- and moderate- income borrowers particularly those living in marginal neighbourhoods, were better served. In fact, there is plenty of evidence to suggest that discrimination and redlining were prevalent during the period prior to the advent of securitization and that the underwriting flexibility S&Ls had available relative to today's

¹⁶Mortgage Bankers Association of America. 1986 *The Secondary Market for Residential Mortgages*, p.1

¹⁷White, Lawrence J. 1991 *The S&L Debacle: Public Policy Lessons for Bank and Thrift Regulation*. Oxford University Press New York p. 76

¹⁸*Ibid.*, p. 76

standards, did not translate into more mortgage money for low- and moderate-income people.¹⁹

Therefore, the major implication of less flexibility available to S&Ls is not that low- and moderate-income borrowers, particularly those living in marginal neighbourhoods will be worse off in the future. Rather, an important implication is that government policies such as the Community Reinvestment Act (CRA), which target those lenders which did not properly serve marginal people living in marginal areas, in the past, may not be as effective in the future. As it will be learned in chapter four, when responding to the demands of CRA, S&Ls require flexibility in employing certain underwriting standards. Flexibility is necessary because when targeting low- and moderate-income borrowers living in marginal neighbourhoods, S&Ls can use their expertise to pick out good and bad borrowers whose characteristics may not exactly conform to industry accepted underwriting standards. Thus, because securitization may be restricting how S&Ls pick and choose credit risks, in turn it may be putting S&Ls between a rock and a hard place in trying to satisfy CRA requirements.

Furthermore, even for S&Ls which had excellent records in serving low- and moderate-income people in the past, it will be more difficult to maintain this service in the future. For these S&Ls, serving low- and moderate income neighbourhoods depended on having a certain degree of flexibility available in order to capitalize on "niche" opportunities. If flexibility is no longer available to these S&Ls, it will have a profound effect on how this "niche" market is served in the future. Similarly, even S&Ls with good lending records will be find themselves between a rock and a hard place in trying to meet the needs of low- and moderate-income borrowers, particularly those living in marginal neighbourhoods.

¹⁹Taggart, Harriet Tee, 1981. *Redlining Urban Neighborhoods: Mortgage Risk Myths or Realities*. Massachusetts Institute of Technology Doctoral Thesis p.10

For the most part, secondary mortgage market underwriting standards are comparable in content to the ones employed by individual S&Ls in the past. All underwriting standards whether they were instituted in the primary or secondary markets, were formulated on the basis of similar theories of metropolitan development and empirical research of default theory (appendix).²⁰ The secondary market underwriting standards appear to have adopted the same theories which support the argument that the quality of a "neighbourhood" is a significant determinant for default and therefore should play an important role in the underwriting process. Evidence of this will be put forth in chapter four in an analysis of Fannie Mae's appraisal process.

The theories surrounding why borrowers default on their mortgage obligations is an interesting topic and has significant implications for this analysis (appendix). One important implication to draw from this research is that mitigation of default risks is not an exact science. Therefore, underwriting standards are applied against a population of borrowers whom it is almost impossible to know whether they are good or bad credit risks. In fact researchers as recently as 1992 have concluded that it is still almost impossible to accurately determine the probability of default of any given mortgage.²¹ As a result, when the mortgage industry uses underwriting standards it is really applying an educated guess as to which borrowers should be eligible and who should be excluded from home finance. Naturally, mortgages will be approved to some uncreditworthy borrowers and mortgages will be denied to borrowers whom would have been creditworthy.

²⁰Taggart, Harriet Tee, 1981. *Redlining Urban Neighborhoods: Mortgage Risk Myths or Realities*. Massachusetts Institute of Technology Doctoral Thesis

²¹Lawrence, Edward C et al. 1992 *An analysis of default risk in mobile home credit* Journal of Banking and Finance. p. 301

Sometimes underwriting standards are set in a way in which the latter group can represent a profitable "niche" opportunity for a specialized player in the market. The best example of this is private mortgage insurance which capitalizes on the population of borrowers who require loan-to-value ratios greater than the typical industry underwriting standard of 80%. Before this industry was established, the federal government had experience in insuring mortgages and therefore were able to provide data which justified the profit opportunities related to accepting loan-to-value ratios in excess of 80%. This combined with advances in option pricing theory now being applied to mortgage default theory, has resulted in the establishment of a viable private industry. This industry essentially serves those potential borrowers whose applications would not otherwise meet the secondary market standards in terms of LTV ratios. It is now a vital part of market in serving those households excluded by the secondary market's LTV criteria. The secondary market recognizes this important segment of the population that the private mortgage industry serves and purchases mortgages with LTV ratios in excess of 80%.

However, LTV ratios are only one type of underwriting standard which raises the question as to whether other underwriting criteria may be creating profitable niche opportunities as well. The possibility that niche opportunities exist through the very existence of underwriting standards is supported by Follain and Zorn who believe that most niche opportunities will be concentrated in low income neighbourhoods because of the way the mortgage market is forming:

"These niches will include difficult-to-standardize or -securitize loans; lenders that specialize in these loans may be able to obtain extraordinary returns because of the information they possess. "

Therefore, with the primary market's adoption of secondary market standards there is an implication that "niche" opportunities will exist and they are likely to include low- and

moderate income borrowers living marginal areas. It also follows that S&Ls are in an excellent position to capitalize on these opportunities because of the specialized experience that many S&Ls have in their own local markets. In chapter four, it will be learned that although this is the case, the newly lending environment puts S&Ls between a rock and a hard place when chasing after these opportunities.

In general, the secondary market has accomplished the goal it was set out to achieve by the federal government. The housing market has integrated with the capital markets and this has in turn provided greater liquidity and efficiency to the primary market. Professors James R. Follain and Peter M. Zorn summarize the success of the secondary market and show how the average borrower has benefited:

" From the consumer's standpoint, the development of the secondary mortgage market has been an unqualified success. Funds to purchase housing are provided on a more stable basis than in the past. Also, it appears that the combination of the secondary mortgage market and federal credit guarantees generates mortgages at a lower price than traditional thrift mortgages. For example, Hendershott and Shilling (1989) present evidence that the mortgage interest rate in the mortgage market segment in which the federal agencies operate is about 30 basis points less than in the market segment in which they are prohibited. "²²

While it is true that securitization has benefited the majority of Americans, it may be not be serving as well the segment of the population which lives in marginal neighbourhoods. Research indicates that the majority of loans sold to Fannie Mae represent middle- and upper-income homeowners.²³ Critics such as Susan Wachter of the University of Pennsylvania, suggest that "unqualified success" may be slightly strong language. Wachter

²²Follain, James R. , Peter M. Zorn 1990 *The Unbundling of Residential Mortgage Finance*. Journal of Housing Research. Volume 1, Issue 1. p.69

²³Ibid., p. 135

notes in her paper on the limits of the housing finance system that the percentage of home ownership actually decreased during the 1980s especially among low income segments of the population." ²⁴ In the future S&Ls will only originate loans that can be sold to the secondary market.

Securitization may also not be helping low- and moderate-income neighbourhoods in terms of developing a system for multi-family housing. With over \$300 billion in multifamily mortgages outstanding at the end of 1989 only 4% of the market was securitized.²⁵ Yet multifamily housing continues to be the dominant percentage of housing in many inner-city low income neighbourhoods. The main reason that securitization has not been developed yet for multifamily homes revolves around a lack of data which would help the secondary market players better assess the default risks adequately. Private mortgage insurers, for the same reasons have also not been able to enter this market.

THE 1990s AND BEYOND:

A literature review of the what to expect in the mortgage market through the year 2000 reveals a couple of common themes. The first theme relates to consolidation in the primary mortgage market where most economists agree is the area the most far reaching changes will occur:

"If the 1980's was the decade of securitization and deregulation for the mortgage industry, the 1990's is likely to be the consolidation and replacement of thrifts by banks."²⁶

²⁴Wachter, Susan M. 1990 *The Limits of the Housing Finance System* Journal of Housing Finance Volume 1, Issue 1 p. 175

²⁵Jaffee, Dwight M. , Kenneth T. Rosen. 1990 *Mortgage Securitization Trends*. Journal of Housing Research. Volume 1, Issue 1 p. 133

²⁶Rose, Peter S., Richard L. Haney, Jr. 1990 *The Players in the Primary Mortgage Market* Journal of Housing Research Volume1 Issue 1p. 95

A central prediction that is shared by many industry analysts is that "commercial banks will replace S&L's as the major source of mortgage originations by the year 2000."²⁷ This thought is also shared by the U.S. Department of Housing and Urban Development (HUD) whose gross flow data suggest that commercial banks will gain market share in mortgages at the expense of thrifts."²⁸

The major reason cited for this restructuring in the primary market is related to the drive to achieve cost efficiencies in all areas of banking including deposit collection, origination, servicing and holding. Professors Follain and Zorn make this argument in their article on the unbundling of mortgage finance:

"In our view financing costs will drive the transaction. The dominant primary market lenders will be the least cost providers of funds."²⁹

Most literature indicates that it is the larger institutions and primarily the commercial banks that have the greatest advantages in terms of economies of scale. The large banks achieve these efficiencies through servicing, cheaper debt funds, geographic diversification, access to equity capital and cheaper prices from the federal agencies (Fannie Mae gives more favourable treatment to larger lenders in the form of lower guarantee fees). As a result, the future will depend more on the fundamental economies of delivery and servicing mortgages. This trend, towards larger institutions does not bode

²⁷Wachter, Susan M., 1990 *The Limits of the Housing Finance System*. Journal of Housing Finance. Volume 1, Issue 1. p. 168

²⁸Ibid. p.168

²⁹ Follain, James R. , Peter M. Zorn 1990 *The Unbundling of Residential Mortgage Finance*. Journal of Housing Research. Volume 1, Issue 1p.69

well for the small and medium sized S&Ls since commercial banks are less restricted in terms of future growth.³⁰

How will the trend towards larger institutions impact different neighborhoods? Research indicates that it has primarily been small and medium sized thrifts that have historically served the low and moderate income neighbourhoods.³¹ Therefore a shift towards larger banks may have a negative impact on neighbourhoods with characteristics that are perceived to be riskier.

Similarly, a research study prepared in 1992 by the Federal Reserve Bank of Boston (FRBB) in its investigation of race in mortgage lending, discovered that the likelihood of being denied a mortgage on the basis of neighbourhood characteristics was significantly greater for large lenders versus small lenders.³² This implies that larger institutions do consider marginal neighbourhoods to be relatively more risky.

Furthermore, the FRBB conclusions are supported in a Ph.D. thesis prepared at MIT by Harriett Tee Taggart in 1981. Taggart notes that risk evaluations are influenced not only by effective applicant demand but by institutional agendas. Her conclusions demonstrate that small savings and loans associations tended to lend to people with higher risk characteristics than larger savings and loan associations or commercial banks.³³

³⁰Rose, Peter S., Richard L. Haney *The Players in the Primary Mortgage Market* Journal of Housing Finance Volume 1 Issue 1 p.91

³¹Taggart, Harriet Tee, 1981. *Redlining Urban Neighborhoods: Mortgage Risk Myths or Realities*. Massachusetts Institute of Technology Doctoral Thesis

³²Federal Reserve Bank of Boston, October 1992 *Mortgage Lending in Boston: Interpreting HMDA Data*.

³³Taggart, Harriet Tee, 1981. *Redlining Urban Neighborhoods: Mortgage Risk Myths or Realities*. Massachusetts Institute of Technology Doctoral Thesis

An argument may also be made that originating loans in low income neighbourhoods is less profitable relative to neighbourhoods with higher property values. Reduced profits are realized because a lender's income is generated as a percentage of the face value of the loan versus the cost, which is determined on the basis of a fixed administrative expense. According to Northeast the cost to originate a loan does not depend on the on the location or value of the property and is therefore roughly the same for each loan originated. Since profit depends on a loan's ultimate face value, it is likely that lenders would prefer higher value loans associated with middle and upper income neighborhoods over lower value loans associated with low- and moderate-income neighbourhoods. In other words from a profit perspective there is an incentive for primary lenders to target suburban neighbourhoods rather than the inner-city neighbourhoods. This same incentive may not have been in place for S&Ls prior to securitization because as it was learned in chapter one, the traditional source of profit generation for S&Ls was not fee income.

Technology

The need for achieving greater cost efficiencies is also driving development for new technology which may have an important impact on the ability of S&Ls to deliver mortgage money to marginal neighbourhoods in the future. For example, several California mortgage banking firms are testing a new technology that produces automated real estate appraisals. The June 28, 1993 issue of Real Estate Finance today, reported the motivations of the founders, in creating this new technology:

"We are interested in anything that can make the valuation process more consistent, more efficient and more cost effective. Automation offers lenders extremely low-cost quality control before they fund their loans. It offers lenders and homeowners alike immediate valuation free from personal or institutional bias."

However, personal bias may be exactly what low- and moderate-income neighbourhoods need. Sometimes neighbourhood revitalization in marginal areas occurs on a block-by-block basis. It would seem critical that appraisers be given the opportunity to reflect the specific nature of the property being appraised.

Aside from the fact that most of the trends identified in the preceding analysis look unfavourable from the perspective of low income communities, it is even less encouraging when the scale effects of these trends are considered. Growing reliance on the secondary market underwriting standards and the drive for cost efficiencies have pervaded the market on a national scale.

CHAPTER THREE

"THE REGULATORY SQUEEZE"

As it was learned in chapter one, regulatory policy has always played an important role in the residential finance industry. In the 1970s, the issue of "redlining" held national prominence. In the 1980s racial discrimination became the focus of mortgage lending and in the early 1990s S&L failures commanded most of the attention. Although the federal government has had to deal with each of these problems separately, each problem has drawn a new and different legislative response having significant implications on the ability of the primary market to efficiently meet the needs of marginal neighbourhoods. The purpose of this chapter is to look at how S&L's lending operations may be being effected by these various pieces of legislation.

ANTI-DISCRIMINATION LEGISLATION: The two major laws enacted by Congress to address the issue of mortgage market redlining and discrimination were the Community Reinvestment Act (CRA) and the Home Mortgage Disclosure Act (HMDA). HMDA was established in 1975 in response to findings in Congress that some lenders have sometimes contributed to the decline of certain geographic areas by their failure to provide adequate home financing to qualified applicants on reasonable terms and conditions. The purpose of HMDA was to provide citizens and public officials with sufficient information to enable them to determine whether depository institutions were filling their obligations. To this end, it mandated that specific data relating to loan approvals and denials be made public.

CRA was then created as a way to act on this information. Its purpose was to encourage savings associations to meet the credit needs of their local communities including low- and

moderate income neighborhoods.³⁴ An Office of CRA was created to review each associations performance in living up to these obligations. Performance is assessed on the basis of a list of criteria and a rating is established. In 1990, Congress mandated the public release of CRA ratings information.

It appears that regulatory activity associated with both HMDA and CRA has had an important impact on residential mortgage lending. Internally, S&Ls have responded to the increased regulatory activity by restructuring reporting and record keeping systems. In most situations additional levels of loan review have been implemented in order to more effectively monitor lending practices.

CRA and HMDA have also changed the external environment in which S&Ls operate. Through the different avenues created by these acts, community groups have been able to apply enough pressure to make lenders pay more attention to the needs of under served communities and consumers.³⁵ Mr. Allen J. Fishbein of the Center for Community Change refers to increased public scrutiny resulting from HMDA and CRA as "de facto" bank examination and "regulation from below". He argues that the public's leverage stems from specific rights under the acts such as the implicit right to intervene in an S&Ls expansion or acquisition plans on the basis poor CRA performance. Similarly, the media has taken an increased interest in the ratings which according to some research may be having an impact on which lending institution a consumer will choose.

³⁴CRA, 11,812 Purposes. The purposes of this regulation are to encourage savings associations to help meet the credit needs of their local community or communities; to provide guidance to associations as to how the Office will assess the records of associations in satisfying their continuing and affirmative obligations to help meet the credit needs of their local communities, including low- and moderate-income neighborhoods, consistent with the safe and sound operation of those associations; and to provide for taking into account those records in connection with certain applications.

³⁵Fishbein, Allen J. 1992. *The Ongoing Experiment with "Regulation from Below": Expanded Reporting Requirements for HMDA and CRA*, Housing Policy Debate, Volume 3, Issue 2. p. 625

Furthermore, recent changes in the type of data disclosed through HMDA has brought about renewed charges of discrimination in mortgage lending against all lending institutions including the S&Ls.³⁶ As a result CRA pressures should only increase in the next few years.

SAFETY AND SOUNDNESS LEGISLATION: Another ominous piece of legislation, the Financial Institutions Reform, Recovery and Enforcement Act (FIRREA) was enacted in 1989 in response to the massive failure and forced merger of hundreds of savings and loan associations in the 1980's. As it was learned in chapter one, the S&L debacle was largely a result of deregulation in 1980 and 1982 which gave S&Ls a "carte blanche" to venture into new and more risky investments. FIRREA has had the opposite effect and as a result has eliminated the many advantages S&Ls enjoyed during the 1980's. According to many researchers, FIRREA has created a relatively level playing field for all of the various institutional structures that might deliver residential mortgage finance.³⁷

However, because S&Ls have not had the same capital requirements as commercial banks in the past, a level playing field means that in the next decade they will have to grow more slowly while capital is raised to the minimum required standards. These new capital standards have already had an impact on the S&L industry. In fact, when they are combined with the lingering aftereffects of investment decisions made in the 1980s there has been a sharp decline in the number of S&Ls, from 4,005 in 1980 to less than 2,597 in 1992.³⁸

³⁶Munnell, Alicia H. et al. October 1992. *Mortgage Lending in Boston: Interpreting HMDA Data*. Working Paper No. 92-7. Federal Reserve Bank of Boston

³⁷FIRREA policies include: prohibiting S&L's from investing in junk bonds, imposing new capital requirements comparable to the commercial banking industry, requiring 70% of their assets to be invested in housing related credit and requiring that commercial real estate loans could not exceed 400% of total capital. This is outlined in the paper prepared by James Follain and Peter M. Zorn (footnote no.5).

³⁸Rose, Peter S. Richard L. Haney Jr. 1990 *The Players in the Primary Mortgage Market* Journal of Housing Research p. 93

Another major influence FIRREA has had on S&Ls delivery of mortgage finance has related to an increased presence of the Office of Thrift Supervision (OTS) to enforce and supervise the changes implemented under the act. In fact, the underwriting standards and portfolio practices employed by the S&Ls, are now being more closely watched than ever before. For example, local regulators now have enough power to restrict asset growth and even specific lending activities of an S&L in order to ensure that they comply with the new capital standards. The implication is that a new focus on safety and soundness has taken hold of the system. While this increased scrutiny may be justified in some cases it may be steering enterprising and CRA conscious S&Ls away from trying to uncover profitable niche opportunities in marginal neighborhoods. This view is shared by professor Susan Wachter in her paper on the limits of the housing finance system:³⁹

"A potential danger for the market is the prospect that tightened underwriting by thrifts, banks, and the agencies--pushed by regulators reacting to publicity and Congressional pressure created by the thrift crisis--could reduce mortgage credit availability, particularly for marginal borrowers. In turn, a restriction in the supply of credit could exacerbate local area economic and housing market weakness."

As it will be learned in chapter four, FIRREA has had a profound impact on the way S&Ls now conduct their business. The high risk ventures of the 1980's are long gone and most S&Ls have retrenched to their traditional residential mortgage business. When the legislative impacts of both FIRREA and CRA are considered in the context of the changes undergoing in the mortgage market it appears that regulation is like a double edged sword. CRA is pushing from one direction in order to get S&Ls to find new ways to meet the needs of underserved borrowers living in low- and moderate income neighbourhoods. FIRREA is coming from the other direction. Regulators want to restrict growth and

³⁹Wachter, Susan M. 1990 *The Limits of the Housing Finance System*. Journal of Housing Finance. Volume 1, Issue 1. pp. 163-185

ensure that S&Ls become more risk adverse. In the following chapter it will be learned just how significantly these two policies have been hammering S&Ls from both sides.

CHAPTER FOUR

"In 1988, we outlined a new strategy for Northeast Savings that dramatically changed the course of its business. At a time when thrift institutions, including Northeast Savings ventured into lines of business unfamiliar to them and invested in high-yielding but risky instruments, Northeast announced its decision to return to the basics of traditional thrift banking: offering residential mortgage loans and gathering retail deposits through its branch network."

George P. Rutland
Chairman of the Board and
Chief Executive Officer
1992 Annual Report

CASE ANALYSIS: NORTHEAST SAVINGS, F.A.

It was learned in the first three chapters that the mortgage industry has undergone a tremendous amount of change in the last ten years, change that is expected to continue throughout the 1990's. The following chapter is intended to demonstrate, exactly to what extent, these changes have impacted the operations of Northeast Savings, F.A. (Northeast).

The Company

Northeast Savings is a federally chartered savings and loan association and is a wholly-owned subsidiary of Northeast Federal, a Delaware corporation.⁴⁰ It is one of the largest thrift institutions based in New England and traces its history to 1834. As of June 30, 1993, the Company has total assets of \$4.0 billion, deposits of \$3.1 billion, and stockholders' equity of \$127.5 million. Northeast has 54 retail branch offices in California, Connecticut, Massachusetts, New York and Rhode Island. Northeast's primary business is

⁴⁰The following information has been taken directly from Northeast's 1992 Annual Report.

receiving funds from the public and investing those funds in single family residential mortgage loans. In fact, single-family residential first mortgage loans were \$2.2 billion or 94.2% of Northeast Savings' total loan portfolio at December 31, 1992.

Northeast had 1,171 employees as of December 31, 1992. The Company is organized primarily by separating the management of deposit activities from loan activities, with general support functions such as audit and facilities serving both business areas. Separate staffs serve deposit-specific and loan-specific operations and accounting functions. The principal executive offices of Northeast are located at 50 State House Square, Hartford, Connecticut.

Background, Strategic Redirection and Business Plan⁴¹

Northeast Savings was formed in 1982 when The Schenectady Savings Bank, F.S.B acquired savings associations in Hartford, Worcester and Boston. In 1983, the Association converted from mutual to stock form and in the process raised an aggregate of \$52.8 million of new equity capital from the public through the sale of Common Stock. In 1985, the company raised an additional \$38.3 million of new equity capital when it sold preferred stock to the public. Between 1985 and 1988, the Association pursued a high balance sheet growth strategy of purchasing wholesale assets and funding them with wholesale borrowings in order to leverage its regulatory capital. In 1989, in response to FIRREA, the association adopted a new business strategy of traditional thrift banking with a primary focus on achieving and maintaining compliance with the stringent new capital requirements imposed by FIRREA.

⁴¹The following information was taken directly from a July, 1993 prospectus prepared for the Securities Exchange Commission.

Pursuant to the strategy, the association streamlined and simplified its operations, discontinued many operations and focused on the residential mortgage business. In recent periods the company's profitability has been impaired partly on account of reductions in asset sized and partly due to severe regional recessions in the companies primary market areas, New England and California. Current objectives are to return to profitable operations, to enhance the associations regulatory capital and to enhance the ability to make acquisitions in New England markets.

SECURITIZATION: A reliance on a new set of underwriting standards.

As chapter two pointed out, securitization has dramatically changed the way S&Ls do business, particularly as it has related to the origination of fixed-rate loans. Whereas in the past income was primarily generated through the management of interest rate risk, it is now more a function of origination and servicing fees. The change in roles has meant that S&Ls are placing an increased reliance on the secondary market underwriting standards to originate loans.

The implication in chapter two was that by taking some of the underwriting discretion away from the S&Ls and putting it with the secondary market players, low- income people living in marginal neighbourhoods might suffer. It appears that this is what has happened. According to Ms. Amy D'Addetta, Vice President and Staff Counsel at Northeast Savings, maintaining flexibility in applying underwriting standards is very important when it comes to underwriting loans for low-income borrowers living in marginal neighbourhoods. Ms. D'Addetta notes that in many cases there are compensating factors which justify being more flexible in underwriting loans to people in these neighbourhoods.⁴²

⁴²Compensating factors are when a potential borrower demonstrates extraordinary commitment to owning a home through means that are not recognized in the typical underwriting process. These include bringing money to the table in refinance situations or a significant investment in home improvements.

To support her point, Ms. D'Addetta refers to what she calls the "stellar" borrower-- a low-income person who has been handling two jobs, feeding a large family and paying more in rent than they would have to pay in monthly mortgage payments. Although this kind of borrower is considered by Northeast to be an excellent credit risk, in many cases these borrowers are ineligible for a fixed-rate mortgages because of inflexible rules in Fannie Mae's underwriting standards, particularly relating to marginal neighbourhoods. This puts Northeast between a rock and a hard place. While they consider some potential borrowers of fixed rate loans to be good credit risks they cannot underwrite the loans because in many cases Fannie Mae's underwriting standards are not always flexible to accommodate for compensating factors in the same way Northeast may have done in the past, when these loans were held in portfolio. Moreover, because FIRREA regulations promote Northeast not to hold these loans in their portfolio, the mortgage cannot be originated. As a result, the borrower may be forced to postpone their home buying decision or find an alternative loan such as an adjustable rate mortgage. In either case, the mortgage industry may be missing out on a opportunity to lend to a borrower who could make a difference to a marginal neighbourhood.

According to Ms. Diane Oberle, Department Head and Senior Vice President at Northeast, they have been experiencing an increasing number of situations where Northeast has supported the decision to underwrite a loan but Fannie Mae's underwriting standards have not. To support this point, Northeast executives have identified one of Fannie Mae's underwriting standards which has been particularly burdensome to borrowers living in marginal neighbourhoods. This standard relates to Fannie Mae's policy towards declining property values, section 402.03 of Fannie Mae's Selling Guide. It states:

"Maximum financing is acceptable when property values are stable and/or increasing. The lender must not offer maximum financing in any instance in which property values are declining.

Fannie Mae defines maximum financing as an amount that is within 5% of the highest loan-to-value ratio allowed for a specific type of mortgage. In practice, Fannie Mae enforces this rule by requiring lending institutions to reduce maximum loan-to-value situations in declining markets. The implications are that if the borrower has no other means of increasing his or her down payment, Northeast cannot make the loan because it would be ineligible for sale to the secondary market, in this case to Fannie Mae. According to Northeast executives, this situation is becoming much more common. In the past, Northeast noted that they could have originated these types of loans because they were willing to employ flexibility in their underwriting standards when they identified good credit risks that did not fall in the realm of commonly used underwriting criteria.

When maximum financing is requested by a borrower whose property is located in an area that is identified as declining, Fannie Mae requires an S&L to reduce the loan-to-value ratio by 5%. However, the ratio can be reduced by more or less depending on the rate of decline offered in the comparable's analysis found in the appraisal report. The purpose for having an S&L make the reduction is so that Fannie Mae will have a "hedge" or comfort level in case property values drop further. As noted in the appendix a concern that equity values get too low is consistent with the equity hypothesis of default theory which says that the amount of equity one has in their home is the single most important determinant for default.

According to Northeast executives, they are not advocating for a complete abolishment of Fannie Mae's policy on declining neighbourhoods. Rather, Northeast would like to see a more flexible approach by Fannie Mae for properties located in neighbourhoods undergoing revitalization and change. Northeast executives believe strongly an increase in owner occupied housing will have a significant and positive impact on marginal

neighbourhoods. Northeast executives also believe that there are a significant number of borrowers located in these marginal neighbourhoods that could make the transition from renters to homeowners if they were allowed maximum financing.

Unfortunately, determining a rough estimate for the number of people who are in this category would be extremely difficult because records of declined applicants are usually not sufficiently detailed for this purpose. However, if there ever was a time in the housing cycle that would favour the existence of this type of borrower, the time is now. Mortgage rates are at a twenty year low and slow house appreciation has made the gap between renting and owning a home smaller than ever.⁴³

One problem Northeast executives site with Fannie Mae's maximum financing policy is how the "declining neighbourhood" label is arrived at. Northeast executives do not believe that the way Fannie Mae identifies declining markets necessarily paints an accurate picture of these neighborhoods. Declining markets are identified under the Fannie Mae underwriting standards through the appraisal. Form 1004 is the standard appraisal form required for loans sold to or backed by Fannie Mae (exhibit #2). The second section relating to an appraiser's neighbourhood analysis, includes a box that is to be checked by the appraiser in the event that property values in the neighbourhood in which the subject property is located, have been declining. According to Ms. Tamy Kaschuluk, Chief Appraiser at Northeast Savings, because of an absence of good statistical data, the determination of property value trends is highly subjective and in many cases simply reflects an appraiser's intuitive judgment. In determining property value trends for a neighbourhood appraisers are somewhat restricted in terms of availability of information.

⁴³Zorn, Peter M. 1989 *Mobility-Tenure Decisions and Financial Credit: Do Mortgage Qualification Requirements Constrain Home Ownership*. AREUEA Journal, Vol. 17 No.1 p.1

In many cases they rely on conversations with local real estate brokers and/or their own local knowledge.

The lack of information appraisers have in completing the declining market check box on appraisals raises a concern that potential borrowers in some marginal neighbourhoods may be excluded from the opportunity to obtain maximum financing even when their property values are not declining. The research of Taggart (1981) demonstrated that in many cases during the 1970s, appraisers valued urban properties considerably less than market prices of comparable sales on the basis of predicted decline in property values, even when price trends had steadily increased for several decades.⁴⁴

Fannie Mae has also acknowledged the limits of this check list system as recently as June 30, 1993 when the neighbourhood section of the appraisal form was modified. Although Fannie Mae did not change the "declining market" check box, they did eliminate the rating grid for neighbourhood analysis on the new form which will officially be adopted January 1, 1994 (exhibit no. 3). The old form used to require an appraiser to simply categorize a neighbourhood's appeal to the market, into one of four types; either good, average, fair or poor. This meant that if a neighbourhood was undergoing revitalization, this type of positive change would not be reflected in the analysis.

In Fannie Mae's opinion, the new form provides an appraiser with more opportunity for a detailed description of the neighbourhood. According to Ms. Tamy Kaschuluk, Chief Appraiser and Executive Vice President of Northeast, Fannie Mae's modification to this form should be a positive change for marginal neighbourhoods because it will allow appraisers to offer better insight into the specific influences that impact property values in

⁴⁴Taggart, Harriett Tee. 1981. *"Redlining Urban Neighborhoods" Mortgage Risk Myths or Realities.* Massachusetts Institute of Technology. Doctorate Thesis

the neighbourhood as opposed to simply checking a box. However, Ms. Kaschuluk warns how important it is to have only appraisers with detailed local knowledge perform appraisals in these neighbourhoods.

To support the claim that Fannie Mae's policy dealing with declining market values can put S&L's between a rock and a hard place, Northeast has made available for this research a specific case that was dealt with during the fall of 1992. The following is a brief summary of the case:

In 1992, Mr. Norm Keyes and Ann Keyes of New Haven, Connecticut applied to Northeast Savings, F.A. for a fixed rate mortgage loan in the amount of \$86,000 to refinance their existing mortgage also held by Northeast Savings, so as to take advantage of lower mortgage rates.⁴⁵ A fixed rate mortgage is preferred over other alternative types of mortgages such as adjustable rate mortgages because of the current state of the economy in which interest rates are at a twenty year low. Mr. and Mrs. Keyes have excellent employment and credit records and exhibit all of the attributes necessary to repay an \$86,000 mortgage. The property was appraised for \$95,000 which Northeast fully supported was reflective of the value of the property. In the report, the appraiser indicated that there were no physical, functional, or external inadequacies noted concerning the property and no repairs or modernization was needed. The report also indicated that the property had been well maintained with many recent improvements made to the interior of the property by the Keyes.

However, the appraiser also noted in the neighbourhood section that property values in the immediate neighbourhood had been declining. As a result, in order to the keep the mortgage eligible for sale to Fannie Mae, Northeast Savings was required to deduct from the maximum loan amount which could have been offered (90% loan-to-value ratio because it is a refinance) a percentage equal to the annual decline in values in the neighbourhood. In accordance with the Fannie Mae standard, the maximum loan-to-value ratio was adjusted to 85% and Northeast Savings committed to lend \$80,750 as opposed to the \$85,500 it could have lent without the declining values criterion. This amount was inadequate to meet the Keyes's needs to refinance their existing mortgage. In the end, they were offered alternative products such as an adjustable rate mortgage even though they preferred a fixed rate loan based on their own analysis of the market.

⁴⁵Please note that the names have been changed to ensure confidentiality

The situation involving the Keyes highlights how Northeast is in between a rock and a hard place in terms of being able to offer mortgage finance to low- and moderate income neighbourhoods. Northeast could not offer maximum financing even though they felt that these people were stellar customers (their current mortgage was being held by Northeast and it indicated a flawless payment record). Moreover, there were compensating factors in that the Keyes had also recently sunk additional money into home improvements for the property. According to Northeast executives, numerous phone calls were made to Fannie Mae in an attempt to get the maximum financing rule waived. The effort was to no avail. Fannie Mae stood its ground and refused to accept the loan.

The "between a rock and a hard place" position Northeast was in, is further highlighted by the fact that the Keyes indicated that did not have to live in the subject neighbourhood and would be able to obtain maximum financing if they chose to move to other areas such as a suburban location. However, they chose to stay in the inner-city because in part they believed it would help stabilize the neighbourhood by way of maintaining an owner occupied residence.

The situation involving the Keyes is a good example of how the "neighbourhood analysis" section of Fannie Mae's appraisal form influences an S&L's underwriting decision. More importantly, it raises a larger scale question as to whether Fannie Mae's use of this "neighbourhood analysis" is appropriately weighted in the overall underwriting decision vis-a-vis other factors proven to be important in determining mortgage default risk. This question was raised by the executives at Northeast in order to see if Fannie Mae's underwriting standards could be relaxed in a way that would produce little or no significant increase in risk while enabling more potential borrowers to qualify for mortgages. The following analysis reviews empirical research on default theory, some of

which is outlined in the appendix of this report, to give additional insight into how this question may be answered.

Harriett Tee Taggart in her research into the extent neighbourhood characteristics contribute to mortgage default, concluded that underwriting standards which attempt to proxy neighbourhood risks are a poor predictor of mortgage default and have been traditionally overemphasized by lenders.⁴⁶ This opens the debate as to whether the secondary market underwriting standards, now dictating how the primary market lenders originate loans, properly and appropriately account for neighbourhood risk. On the surface, one would expect neighbourhood risks to have a significant impact on mortgage performance. The following analysis concludes that this may not be the case.

According to empirical research, the direct link between neighbourhoods and mortgage default risk are weak. However, certain influences within neighbourhoods do influence property values and the relationship between property values and mortgage default is significant.⁴⁷ Therefore, the justification for mitigating against neighbourhood risks is justified by the significance loan-to-value ratios have demonstrated in past empirical research as a determinant for mortgage default.

However, the significance of this relationship is what is important when considering how big a role neighbourhoods should have in the overall application of underwriting standards. Neighbourhoods are only one variable which influence a property's ultimate value. Other factors, such as macro economic variables, personal preferences and property attributes are all considered by a prospective home buyer in his or her decision to

⁴⁶Taggart, Harriett Tee. 1981. *"Redlining Urban Neighborhoods" Mortgage Risk Myths or Realities*. Massachusetts Institute of Technology. Doctorate Thesis

⁴⁷Commonly accepted appraisal theory draws a link between house prices and neighbourhoods.

buy a home.⁴⁸ This draws an important implication for the extent neighbourhoods should be emphasized in underwriting standards. That is, because of the indirect link between neighbourhood characteristics and mortgage default, the actual significance neighbourhoods have in predicting default is actually diluted. Therefore to rely to a large extent on neighbourhoods would not be accounting for the real determinants of mortgage default.

Perhaps this is why in the past, when researchers have tried to analyze a direct link there has been little if any significance in the relationship. Ms. Harriet Tee Taggart in completing her Ph.D. research tested the significance of the direct link between neighbourhood characteristics and mortgage default and found the results to be as expected:

" After controlling for household financial characteristics and loan terms, none of the property or neighbourhood characteristics nor appraised value of the property were important for conventional loans. In sum, the conventional loan status outcomes indicate that economic data on the household, rather than non-financial borrower attributes and property or neighbourhood characteristics, provide the soundest information on risk probabilities associated with an individual mortgage.

In her conclusions, Taggart warns that past underwriting standards have placed too much emphasis on neighbourhoods as a determinant of defaults.⁴⁹ In spite of Taggart's findings, neighbourhood characteristics are still considered important determinants of mortgage default. Clear evidence of the importance that neighbourhoods still hold in lending decisions was demonstrated in 1992, by the Federal Reserve Bank of Boston (FRBB) in their investigation into lending discrimination in Boston. In this study, a ratio of rent to

⁴⁸DiPasquale, Denise & William C. Wheaton 1993 *The Economics of Real Estate Markets* Draft copy of book forthcoming from Prentice Hall

⁴⁹Taggart, Harriett Tee. 1981. *"Redlining Urban Neighborhoods" Mortgage Risk Myths or Realities.* Massachusetts Institute of Technology. Doctorate Thesis

the value of housing stock in a census tract was used as a proxy for marginal neighbourhoods. The FRBB reasoning behind this proxy was that the ratios would be higher in areas perceived as being high risk since the flow of earnings per dollar capital invested should be greater. The FRBB's conclusions support Taggart's earlier research that lenders still place considerable emphasis on neighbourhoods in deciding whether to approve or deny a prospective borrower for a loan. In fact, for applicants in the Boston area the probability of being denied a mortgage because of where the property was located equaled the probability of being denied a mortgage on the basis of LTV ratio. These conclusions are remarkable considering that LTV ratio is a significant determinant for default and that neighbourhood characteristics are not.

If neighbourhoods don't deserve to play such an important role in the underwriting process it raises the question as to where the perceived high risks associated with marginal neighbourhoods originate? Perhaps one reason is the media coverage of crime and poverty prevalent in these areas.⁵⁰ Alternatively, it may be because of the negative fall-out of ill-fated lending experiences in the past. According to Ms Amy D' Addetta of Northeast, charges from CRA officials and pressure from community groups has helped to identify a number lenders who have failed to meet their obligations to low- and moderate income neighbourhoods. However, as Ms. D'Addetta notes, the traditional response by these lenders to such allegations has been to arbitrarily and sporadically throw money at marginal neighbourhoods without necessarily qualifying lending risk on a loan-by-loan basis. As a result, Ms. D'Addetta notes the percentage of defaults are extremely high relative to normal lending practices, which in turn only exacerbates the perceptions of high risks in these areas. Ms D'Addetta believes that it is possible that some of these lenders

⁵⁰It would be interesting to compare the significance of neighborhood risks in lending decisions in Los Angeles before and after the riots in 1992.

considered investment in marginal areas lost money from the outset. In any event, it may have left a bad mark on the area for which it was meant to help.

Similarly, the 245(b) program introduced in 1980 did little to eliminate the perceptions of high risk associated with low income neighbourhoods. Under this program, a unique low LTV ratio loan policy was established to aid housing affordability during times of high interest rates. Unfortunately, it was introduced precisely at a time when house price inflation was declining which resulted in a high percentage of default rates. As a result, perceptions may have reacted to this disaster by assuming that much of the cause of the default was related to the neighbourhoods as it was to the exogenous factors.

Perhaps, an over emphasis of neighbourhood risk in mortgage underwriting is the same conclusion that the commercial mortgage industry inadvertently reached after experiencing the massive real estate collapse of the late 1980s. In underwriting commercial properties in the last decade, banks placed considerable emphasis on appraised values rather than on the major trends affecting demand for this space such as changes in employment and other macro-economic variables. Empirical research in commercial real estate suggests that rents and demand are more a function of what is happening to the tenants rather than the commercial "neighbourhood".⁵¹ As a result, commercial lenders who loaned against properties located in some of the prime commercial districts found the values of the properties backing the loans to decrease significantly. It can be argued that one reason commercial lenders were caught off guard was that they were preoccupied with appraisal reports and therefore may have lost sight of the real determinants of risk for their properties, namely the tenants. The end result was a massive number of defaults that has dramatically changed the future of this industry.

⁵¹DiPasquale, Denise & William C. Wheaton 1993 *The Economics of Real Estate Markets* Draft copy of book forthcoming from Prentice Hall

Whether it is the commercial or residential mortgage industries, the challenge is to try to accurately as possible mitigate default risk. In the commercial industry in the 1990's commercial lenders are protecting against future defaults by not lending. In fact, there is a significant lack of capital in the commercial market. However, unlike the commercial mortgage industry, over cautious lending policies in the residential sector can lead to more serious social consequences. To understand this added concern, Taggart's research also investigated various perspectives on capital investment in marginal areas. According to Taggart, one of these perspectives maintains that urban disinvestment (and therefore decline) is a by-product of capital investment and institutional marketing decisions.⁵² In other words, decline in marginal neighbourhoods to a certain extent can be a self-fulfilling prophecy. Therefore risk perceptions associated with marginal neighbourhoods can be changed by proactive investment strategies in the mortgage industry. The implications from this perspective are that the government has a role to ensure that the residential market players are not mitigating perceived rather than real default risks.

The issue of to what extent "neighbourhoods" represent real risk should be of more research by the federal government in light of Fannie Mae's continued reliance on neighbourhoods in the underwriting process. It is highly likely that Fannie Mae should reduce the emphasis the "neighbourhood analysis" has in the overall lending decision. As previously mentioned, Fannie Mae has made an initial attempt at changing the impact of neighbourhood analysis, through modifications to the standard appraisal form. However, these changes may not have gone far enough. While the neighbourhood analysis section offers valuable support to an appraiser's final estimated value, it is still entering into the lending decision in other ways which may be more detrimental to low- and moderate

⁵²Taggart, Harriett Tee, 1981 *Redlining Urban Neighbourhoods: Mortgage Risk Mmyths or Realities*. MIT Press p. 75

income neighbourhoods. The "declining market" check box determined whether a borrower would be eligible for maximum financing. Therefore it has significant influence in the underwriting process over and above simply supporting the appraised value and may be having a big impact on low- and moderate-income people living low income neighbourhoods. As a result, it would not seem unreasonable for Fannie Mae to waive this requirement at minimum for properties located low- and moderate income neighbourhoods.

TECHNOLOGY

In chapter two it was learned that in the drive for greater cost efficiencies, the mortgage industry is embracing many new forms of technology. It is difficult to forecast to what extent this technology will impact the underwriting process for low- and moderate income neighbourhoods. However, one example offered by Northeast does not bode well for marginal neighbourhoods. According to Ms. Tami Kaschuluk, Chief Appraiser and Executive Vice President for Northeast, a recent movement to computerize the appraisal business may not necessarily benefit marginal neighbourhoods.

The reason as Ms. Kaschuluk points out, is that low- and moderate-income neighbourhoods require appraisers who have local specialized knowledge and who can accurately assess unique neighbourhood characteristics. If a new technology takes away the ability of appraisers to apply their local knowledge it may be most detrimental to marginal neighbourhoods. Unfortunately, a system that eliminates an appraiser's judgment is exactly what is being suggested by the founders of this technology. In fact, one claim that the innovators of this new technology are making is that statistical valuation could be used instead of appraisals for loans under \$100,000.00.⁵³ Ms. Kaschuluk's initial

⁵³Wise, Christy June 1993 *California Lenders Automating Appraisals* Real Estate Finance Today p.11

impressions of this technology are not favourable when viewed in the context of marginal neighbourhoods because it would only take the discretion away from the areas that need it the most.

REGULATORY INFLUENCE

It was learned in chapter three that S&Ls are under an increasing amount of regulatory pressure. The pressure has come from a double edged sword. First of all, regulations aimed at limiting growth conflict with a key success factor in the industry requiring larger economies of scale. Secondly, CRA regulations aimed at ensuring that S&Ls become more aggressive in marginal communities conflict with Fannie Mae's attempts to find new ways to return default risk back to the S&L.

The increased regulatory control has had an impact on the way many S&Ls do business and it has led a few associations to openly criticize the regulators' preoccupation with internal systems and record keeping which they say puts them at a disadvantage when compared with larger institutions and commercial banks.⁵⁴ In order to better comply with the intent of CRA, Northeast Savings implemented a "Second Look" program whereby an application rejected by an underwriter is reviewed first by an underwriting manager, secondly by a departmental vice president and thirdly by a CRA Committee comprised of senior staff from various departments within Northeast. According to Ms. Vicki Bextel, Managing Underwriter at Northeast, all loan underwriting decisions are reviewed thoroughly in order to ensure full compliance with CRA. More importantly, Northeast executives personally want to ensure that they have pursued every avenue possible in order to get the borrower in a marginal neighbourhood approved.

⁵⁴Fishbein, Allen J. 1992. *The Ongoing Experiment with "Regulation from Below": Expanded Reporting Requirements for HMDA and CRA*, Housing Policy Debate, Volume 3, Issue 2. p. 627

While S&Ls are doing their best to respond to the needs of CRA officials, pressures are mounting from an opposite direction as Fannie Mae tries to shift default risk back over to the S&L. In the mortgage industry default risk is termed product risk. In theory, when S&Ls securitize mortgages via the secondary market, product risk is transferred to the secondary market players. A risk transfer makes sense since secondary market investors benefit from the mortgage's cash flow. In practice however, a full transfer of risk is not always the case. In fact, according to Ms. Diane Oberle, Senior Vice President at Northeast Savings, Fannie Mae is demanding that S&Ls buy back an increasing number of loans that have gone bad. For example, in the past twelve to fifteen months, Northeast has seen an increase in the number of loans they been asked to buy back because of foreclosure. Fannie Mae has sited underwriting faults and pre-existing construction problems in these requests.

The growing number of repurchase requests by Fannie Mae can likely be explained by a combination of two factors. First of all, mortgages originated in the last five years were underwritten at a time when there was significant deflation thereby increasing the probability of default in the present period (see note on default theory in appendix). Secondly, in response to a growing number of defaults Fannie Mae might be scrutinizing an S&L's interpretation of the underwriting guidelines more closely to look for flaws in order to transfer risk back to the S&L.

If the latter case is true, S&L's are really between a rock and a hard place. On the one hand, CRA is promoting more aggressive lending in marginal neighbourhoods and on the other may be Fannie Mae who may be trying to come up with new ways to make the S&Ls assume default risk. According to Mr. David Boughton, Senior Vice President and Default Services Manager at Northeast, most of the buy back requests result in some kind of negotiated settlement between the S&L and Fannie Mae. However, he did note that

these requests can sometimes be unreasonable such as recently, when Fannie Mae requested that Northeast buy back a bad mortgage because the borrower hadn't signed the copy of the tax return in the mortgage file. Although, Northeast was able to argue successfully against this particular request, Fannie Mae has recently been successful in making Northeast repurchase three loans.

Executives at Northeast agree that proper underwriting should be their responsibility. However, they strongly believe that Fannie Mae should assume all of the default risk. According to Mr. Craig Smith, Senior Vice-President of Northeast, if S&Ls cannot benefit from interest rate spreads by holding mortgages in portfolio, they should not be responsible for default risk, provided all of the contractual obligations have been satisfied. Smith implies that there is no incentive for an S&L to take a short-term approach and sell unqualified loans to Fannie Mae. This would be a breach of their contractual relationship and as a result, Fannie Mae could take alternative steps to penalize an S&L. For example, Fannie Mae can charge a higher guarantee fee or in extreme cases terminate the purchase agreement with the S&L.

Northeast is also being squeezed another way by regulatory pressures. In chapter two it was learned that future survival will depend on financial institutions achieving economies of scale which means they must grow rapidly in order to better compete. This would imply that Northeast should be growing its operations at a rapid pace in the next decade in order to establish a solid competitive position in the marketplace. According to Northeast, further growth is a top priority, but the prospects of achieving this are diminished by regulatory pressures. In the 1992 annual report, a list of the regulatory controls that constrain the opportunities for growth are made identified and FIRREA is cited as one of the leading causes:

"Of primary importance were the Office of Thrift Supervision (OTS) regulations promulgated as a result of the Financial Institutions Reform, Recovery and Enforcement Act of 1989 (FIRREA); and the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA), especially the prompt corrective action regulation issued by the federal banking agencies on September 29, 1992, which, in effect, finalizes the 4% core capital requirements for institutions that are not rated MACRO 1. An additional factor was the final rule issued by the OTS effective May 11, 1992 which permits federal savings associations to branch interstate to the full extent permitted by federal statute. This rule greatly increased the opportunities for out-of-state institutions to enter the states where we now operate branches, thus diminishing the value of our franchise."

Thus, FIRREA is similar to CRA in that it puts Northeast in a rock and a hard place in terms of being able to react to the new competitive demands in the mortgage market. Northeast like any other S&L in the market place, needs to be competitive in order to be in a better position to serve low- and moderate-income neighbourhoods. As it was learned in chapter one, S&Ls in 1990 held a 37% market share in the central city housing markets. A further regulatory squeeze will severely diminish their ability to continue to serve this market.

CONCLUSIONS

In the first three chapters implications were drawn as to how S&Ls may be increasingly being squeezed in their attempts to deliver mortgage finance to low- and moderate income neighbourhoods. It was then confirmed in chapter four, through a case analysis of Northeast Savings, F.A. of Hartford, Connecticut that many of these implications hold true and in fact, S&Ls are between a rock and a hard place in serving low- and moderate-income Americans, especially those living marginal neighbourhoods. Northeast typifies a medium sized S&L operating in this new lending environment which means for smaller institutions the implications have an even greater impact.

Since 1831, in a period that spanned almost 150 years, the traditional S&L operated with a natural link between borrowing and lending in the surrounding local community. In the 1980's securitization and deregulation broke that link and put S&Ls to a large extent at the mercy of other players in the mortgage industry to deliver mortgage finance to low and moderate income neighbourhoods. Now, in the 1990s, to understand the delivery of mortgage finance by S&Ls to the low- and moderate-income market, one must understand the configuration of other players--government agencies, appraisers, and other primary lenders--all of which shape the way the environment in which households seek mortgage finance. In the foreseeable future, a new set of trends including the drive for cost efficiency and technology, are taking hold of the mortgage industry. Similar to changes in the past, they will have a profound impact on the way S&Ls operate. Throughout the many upheavals, government regulation has been a double edged sword aimed at ensuring on the one hand, a constant and affordable supply of mortgage funds is delivered to all Americans versus the other which has been aimed at trying to ensure that it is delivered by a stable and efficient industry. However, it was learned, that while the two sets of policies are not directly in conflict with each other, they are in conflict with the way S&Ls will

need to respond to new factors in the industry such as increased pressure from Fannie Mae and the drive for cost efficiency. The opposing signals that regulation is sending, diminish an S&Ls ability to compete in the future and therefore meet the needs of low- and moderate income people, particularly those living in marginal neighbourhoods.

The implications drawn in this report present a new set of challenges for the mortgage industry in the years ahead. What appears to be inflexibility on the part of Fannie Mae's underwriting standard may be having a detrimental impact on the ability of enterprising S&Ls to serve low- and moderate income people living in marginal neighbourhoods. Fannie Mae enjoys many benefits not available to primary market players. In light of the implications that Fannie Mae is overemphasizing "neighbourhoods" in the underwriting process it would not seem unreasonable to ask Fannie Mae to institute more flexibility into the process. For example, Fannie Mae should consider waiving the maximum financing clause for properties located in central city neighbourhoods. Furthermore, Fannie Mae should consider eliminating the "declining market check box" at a neighbourhood scale in favour of a declining market synopsis on a metropolitan market basis in which good statistical data would be available to support price trends. Judgment of individual neighbourhoods should be considered solely through the qualitative analysis offered by the appraisal as outlined in Fannie Mae's new appraisal form. However, as previously discussed neighbourhood analysis should not factor significantly in the process.

The issue of how to better serve low- and moderate income Americans takes on even greater importance considering today's favourable borrowing environment from the perspective of potential home owners. Interest rates are the lowest they have been in 20 years and house prices are depressed. When these two factors are combined, housing has become more affordable and may represent a huge opportunity for renters to make the

transition to home ownership, a decision that the majority wasn't even able to consider five years ago.

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INTERVIEWS

Northeast Savings, F.A.

<u>Name</u>	<u>Title - Department</u>
Craig W. Smith	Senior Vice President, General Counsel/East and Secretary - Legal
Amy A. D'Addetta	Vice President and Staff Counsel - Legal
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Diane Oberle	Department Head, Senior Vice President - Residential Administration
Raymond O'Connor	Vice President - Treasury
Tami Kaschuluk	Chief Appraiser, Executive Vice President - Appraisal
Victoria Bextel	Vice President - Underwriting
David Boughton	Senior Vice President - Default Services Manager

Exhibit No.1
Fannie Mae's
Underwriting Standards

1. ELIGIBILITY CRITERIA:

<u>Item</u>	<u>Description</u>	<u>Fannie Mae Policy</u>
201	Eligible Mortgages	- includes firsts, seconds, FRMs and/or ARMs.
202	Eligible Borrowers	- resident and immigration status
203	Season Requirements	- age of loan
204	Occupancy Status	- type of ownership
205	Mortgage Amount Limits	- \$203,150 for single unit residence.
206	Mortgage Term	- 30 years
207	Downpayment Requirements	- minimum cash of 5%
208	Loan-to- Value Ratios:	- no insurance - with insurance
	First mortgage	- 80% - 95%
	Refinance	- 80% - 90%
209	Mortgage Insurance	- required on part of the loan exceeding 75% LTV
210	Lien Requirements	- must be first lien
211	Open-end Advances	- accepted
212	Capitalized Mortgages	- accepted
213	Mortgage Payments	- fully amortized, level payments
214	Escrow Deposit Accounts	- required for taxes, mortgage insurance
215	Subordinate Financing	- allow subordination of other mortgages
216	Leasehold Estates	- accepted as long as there is a market.
217	Interest Rate Buydowns	- accepted
218	Adjustable Rate Mortgages	- accepted (different LTV requirements)
219	Converted ARMs	- accepted if converted to FRM
220	Cooperative Share Loans	- accepted only as negotiated transactions.
221	Energy Improvement Loans	- accepted if for the purpose of energy improvement
222	Rehabilitation Mortgages	- for rehabilitating existing single family
223	"Home Seller" Mortgages	- accepted
224	Inclusionary Zoning	- accepted
225	Manufactured Housing	- accepted
226	Biweekly Mortgages	- biweekly payment schedule accepted.
227	Balloon Mortgages	- accepted
228	Growing Equity Mortgages	- accepted on a negotiated basis only.
229	Community Mortgages	- accepts pre-negotiated special program loans
230	FannieNeighbors Mortgages	- accepts loans in low-income areas.

Exhibit No.1 (Continued)
Fannie Mae's
Underwriting Standards

2. UNDERWRITING GUIDELINES:

<u>Item</u>	<u>Description</u>
101	Standard Documentation
102	TimeSaver Documentation
103	Refinancing Documentation
201	Employment and Income
202	Self Employed Borrowers
203	Funds for Closing
204	Liabilities
205	Credit History
206	Credit Report
207	Net Worth
208	Maximum Financing Terms
209	Debt to Income Ratios
210	Underwriting High-Ratio Mortgages
211	Underwriting Adjustable Rate Mortgages
212	Underwriting Converted Adjustable Rate Mortgages
213	Underwriting Mortgages Subject to Buydowns
214	Underwriting Cooperative Share Loans
215	Underwriting Second Mortgages
216	Underwriting Mortgages Secured by Energy-Efficient Properties
217	Underwriting Community Lending Mortgages
218	Underwriting Mortgages Secured by Properties in Special Assessment Districts

Exhibit No. 2
Fannie Mae's Appraisal Form #1004
Neighbourhood Analysis

Property Description & Analysis										UNIFORM RESIDENTIAL APPRAISAL REPORT										File No.					
Property Address _____					Census Tract _____					LENDER DISCRETIONARY USE															
City _____					County _____ State _____ Zip Code _____					Sale Price \$ _____															
Legal Description _____										Map Reference _____										Mortgage Amount \$ _____					
Owner/Occupant _____										Date of Sale _____										Mortgage Type _____					
Sale Price \$ _____										Loan charges/concessions to be paid by seller \$ _____										Discount Points and Other Concessions _____					
P&E Taxes \$ _____										Tax year _____ HOA \$ Mo _____										Paid by Seller \$ _____					
Lender Client _____										De Minimis PUD _____										Source _____					
LOCATION _____										NEIGHBORHOOD ANALYSIS															
BUILT UP _____										Employment Stability _____															
GROWTH RATE _____										Convenience to Employment _____															
PROPERTY VALUES _____										Convenience to Shopping _____															
DEMAND SUPPLY _____										Convenience to Schools _____															
MARKETING TIME _____										Adequacy of Public Transportation _____															
PRESENT LAND USE _____										RECREATION FACILITIES _____															
LAND USE CHANGE _____										Adequacy of Utilities _____															
PREDOMINANT OCCUPANCY _____										Property Compatibility _____															
SINGLE FAMILY HOUSING PRICE _____										Protection from Detrimental Cond _____															
AGE _____										Police & Fire Protection _____															
LOW _____										General Appearance of Properties _____															
HIGH _____										Appeal to Market _____															
PREDOMINANT _____																									
Note: Race or the racial composition of the neighborhood are not considered reliable appraisal factors.																									
COMMENTS _____																									
DIMENSIONS										TOPOGRAPHY															
Site Area _____										Size _____															
Zoning Classification _____										Shape _____															
HIGHEST & BEST USE _____										DRAINAGE															
PRESENT USE _____										View _____															
UTILITIES _____										LANDSCAPING															
ELECTRICITY _____										DRIVEWAY															
GAS _____										APPARENT EASEMENTS															
WATER _____										FEMA FLOOD HAZARD Yes* _____ No _____															
SANITARY SEWER _____										FEMA MAP ZONE _____															
STORM SEWER _____																									
COMMENTS: Apparent adverse easements, encroachments, special assessments, side areas, etc. _____																									
GENERAL DESCRIPTION					EXTERIOR DESCRIPTION					FOUNDATION					BASEMENT					INSULATION					
Units _____					Foundation _____					Slab _____					Area Sq Ft _____					Roof _____					
Stories _____					Exterior Walls _____					Crawl Space _____					Finished _____					Ceiling _____					
Type (Det, Att) _____					Roof Surface _____					Basement _____					Ceiling _____					Walls _____					
Design (Style) _____					Gutters & Downspts _____					Sump Pump _____					Walls _____					Floor _____					
Existing _____					Window Type _____					Dampness _____					Floor _____					None _____					
Proposed _____					Storm Sash _____					Settlement _____					Outside Entry _____					Adequacy _____					
Under Construction _____					Screens _____					Infiltration _____										Energy Efficient Items _____					
Age (Yrs) _____					Manufactured House _____																				
Effective Age (Yrs) _____																									
ROOM LIST																									
ROOMS		Foyer		Living		Dining		Kitchen		Den		Family Rm		Rec Rm		Bedrooms		# Baths		Laundry		Other		Area Sq Ft	
Basement																									
Level 1																									
Level 2																									
Finished area above grade contains _____																									
Rooms _____ Bedrooms _____ Baths _____ Square Feet of Gross Living Area _____																									
SURFACES					HEATING					KITCHEN EQUIP					ATTIC					IMPROVEMENT ANALYSIS					
Floors _____					Type _____					Refrigerator _____					None _____					Good Avg Fair Poor					
Walls _____					Fuel _____					Range/Oven _____					Stairs _____					Quality of Construction _____					
Trim/Finish _____					Condition _____					Disposal _____					Drop Stair _____					Condition of Improvements _____					
Bath Floor _____					Adequacy _____					Dishwasher _____					Scuttle _____					Room Sizes/Layout _____					
Bath/Wainscot _____					COOLING _____					Fan Hood _____					Floor _____					Closets and Storage _____					
Doors _____					Central _____					Compactor _____					Heated _____					Energy Efficiency _____					
Fireplaces _____					Other _____					Washer/Dryer _____					Finished _____					Plumbing Adequacy & Condition _____					
					Condition _____					Microwave _____										Electrical Adequacy & Condition _____					
					Adequacy _____					Intercom _____										Kitchen Cabinets Adequacy & Cond _____					
																				Compatibility to Neighborhood _____					
CAR STORAGE					Attached _____					Adequate _____					House Entry _____					Appeal & Marketability _____					
No Cars _____					Detached _____					Inadequate _____					Outside Entry _____					Estimated Remaining Economic Life _____ yrs					
Condition _____					Built-in _____					Electric Door _____					Basement Entry _____					Estimated Remaining Physical Life _____ yrs					
Additional features _____																									
COMMENTS																									
Depreciation (Physical, functional and external inadequacies, repairs needed, modernization, etc.) _____																									
General market conditions and prevalence and impact in subject/market area regarding loan discounts, interest buydowns and concessions _____																									

Exhibit No. 3 Fannie Mae's Revised Appraisal Form Neighbourhood Analysis Section

X X	UNIFORM RESIDENTIAL APPRAISAL REPORT										File No.								
Property Address			City			State			Zip Code										
Legal Description																			
Assessor's Parcel No.			Tax Year			RE Taxes \$			Special Assessments \$										
Borrower			Current Owner			Occupant			Owner Tenant Vacant										
Property rights appraised			Fee Simple			Leasehold			Project Type			PUD Condominium (HUDVA only) HOAS Mo							
Neighborhood or Project Name						Map Reference			Census Tract										
Sales Price \$			Date of Sale			Description and \$ amount of loan charges/concessions to be paid by seller													
Lender/Client						Address													
Appraiser																			
Location		Urban		Suburban		Rural		Predominant occupancy		Single family housing		Present land use %		Land use change					
Built up		Over 75%		25-75%		Under 25%		Owner		PRICE \$ (000)		AGE (yrs)		One family		Not likely		Likely	
Growth rate		Rapid		Stable		Slow		Tenant		Low		High		2-4 family		in process			
Property values		Increasing		Stable		Declining		Vacant (0-5%)		Predominant		Commercial		To					
Demand/supply		Shortage		In balance		Over supply		vacant over 5%											
Marketing time		Under 3 mos		3-6 mos		Over 6 mos													
Note: Race and the racial composition of the neighborhood are not appraisal factors. Neighborhood boundaries and characteristics:																			
Factors that affect the marketability of the properties in the neighborhood (proximity to employment and amenities, employment stability, appeal to market, etc.):																			
Market conditions in the subject neighborhood (including support for the above conclusions related to the trend of property values, demand/supply, and marketing time -- such as data on competitive properties for sale in the neighborhood, description of the prevalence of sales and financing concessions, etc.):																			
Project Information for PUDs (if applicable) -- Is the developer/builder in control of the Home Owners' Association (HOA)? <input type="checkbox"/> Yes <input type="checkbox"/> No Approximate total number of units in the subject project _____ Approximate total number of units for sale in the subject project _____ Describe common elements and recreational facilities:																			
Dimensions			Site area			Corner Lot <input type="checkbox"/> Yes <input type="checkbox"/> No			Topography			Size							
Specific zoning classification and description						Zoning compliance <input type="checkbox"/> Legal <input type="checkbox"/> Legal nonconforming (Grandfathered use) <input type="checkbox"/> Illegal <input type="checkbox"/> No zoning						Highest & best use as improved Present use Other use (explain)							
Utilities		Public		Other		Off-site improvements		Type		Public		Private		Landscaping		Driveway Surface		Apparent easements	
Electricity						Street								FEMA Special Flood Hazard Area		Yes <input type="checkbox"/> No <input type="checkbox"/>			
Gas						Curb/gutter								FEMA Zone		Map Date			
Water						Sidewalk								FEMA Map No.					
Sanitary sewer						Street lights													
Storm sewer						Alley													
Comments (apparent adverse easements, encroachments, special assessments, slide areas, illegal or legal nonconforming zoning use, etc.):																			
GENERAL DESCRIPTION			EXTERIOR DESCRIPTION			FOUNDATION			BASEMENT			INSULATION							
No. of Units			Foundation			Slab			Area Sq. Ft.			Roof							
No. of Stories			Exterior Walls			Crawl Space			% Finished			Ceiling							
Type (Det./Att.)			Roof Surface			Basement			Ceiling			Walls							
Design (Style)			Gutters & Dwnspnts.			Sump Pump			Walls			Floor							
Existing/Proposed			Window Type			Dampness			Floor			None							
Age (Yrs.)			Storm/Screens			Settlement			Outside Entry			unknown							
Effective Age (Yrs.)			Manufactured House			Infestation													
ROOMS		Foyer	Living	Dining	Kitchen	Den	Family Rm	Rec Rm	Bedrooms	# Baths	Laundry	Other	Area Sq. Ft.						
Basement:																			
Level 1																			
Level 2																			
Finished area above grade contains			Rooms:			Bedroom(s):			Bath(s):			Square Feet of Gross Living Area							
INTERIOR		Materials/Condition		HEATING		KITCHEN EQUIP		ATTIC		AMENITIES		CAR STORAGE							
Floors				Type		Refrigerator		None		Fireplaces #		None							
Walls				Fuel		Range/Oven		Stairs		Patio		Garage # of cars							
Trim/Finish				Condition		Disposal		Drop Stair		Deck		Attached							
Bath Floor				COOLING		Dishwasher		Scuttle		Porch		Detached							
Bath Wainscot				Central		Fan/Hood		Floor		Fence		Built-in							
Doors				Other		Microwave		Heated		Pool		Carport							
				Condition		Washer/Dryer		Finished				Driveway							

APPENDIX

I. DEFAULT RISK AND UNDERWRITING STANDARDS

In the mortgage industry, risk associated with the possibility of default of individual mortgages loans is termed "product risk". Product risk is mitigated through the implementation of underwriting standards in both the primary and secondary markets. The first section of this appendix is devoted to providing a better understanding of the current theoretical models used to explain mortgage default risk. These theories have formed the basis from which mortgage underwriting standards were created and how they are used today.

EMPIRICAL RESEARCH

Much research has been conducted in the past 30 years in an attempt to better understand product risk. As recognized by Vandell (1978), "being able to assess such risk increases the efficiency of the mortgage market through improved pricing, term setting, and other credit allocation techniques. Conversely, inability to diagnose such risk can result in missed profit opportunities, loan losses, and risk minimizing practices such as "red lining". The next section investigates the three main areas of risk considered significant as determinants for default risk in mortgages. They include borrower characteristics, neighborhood or property characteristics and macro economic variables.

Borrower Characteristics

Most of the empirical research during this period has focused on a borrower's ability and willingness to repay debt. In general, the major theories can be grouped into two schools of thought. One hypothesis relates to "ability-to-pay" and argues that default is most

likely to occur when borrowers have insufficient cash flow to meet their mortgage payment obligations. In this view, if a home owner assumes an unexpected financial burden such as divorce or unemployment which reduces household income below expenses would increase the probability of default.

The other school of thought is known as the "equity hypothesis". It relates a borrower's decision whether or not to default primarily on the amount of equity in their home. When the equity in a home is positive, an owner is motivated to protect this value since in many situations it is likely to be the largest financial asset in his or her possession. With positive equity a home owner is more likely to sell or refinance before going into default.

Alternatively, when equity is marginal or negative, there may be an incentive to default since refinancing or selling may not make financial if the proceeds from a sale or refinance are not sufficient to retire the mortgage debt and cover expenses associated with the sale or refinance. In this view, default is viewed as a rational option that relieves home owners of debt and shifts a capital loss to the lender. It is interesting to note that even when in a negative equity position most homeowners do not default on their mortgages. Perhaps this is due other reasons such as social pressures and/or the natural desire to avoid establishing a bad credit history.

In empirical research studies carried out over the last twenty years both hypothesis have shown a strong statistical relationship as determinants for default. However, it is clear that they are also interrelated. For example, even when a borrower's income falls below expenses the actual decision whether or not to default may be based on the amount of equity in the home. As a result, lenders have relied on both of these theories to predict how a loan will perform. For example, Fannie Mae's underwriting standards, shown in exhibit no. 2, place relatively equal emphasis on both schools of thought.

While there has been significant research undertaken with respect to default theory it is still almost impossible to accurately determine the probability of default of any one given mortgage. In 1992, researchers Lawrence et al., in their review of mortgage default theory, noted that statistically, it is easier to forecast general risk and return characteristics of a portfolio than the expected outcome on a particular loan. This is the same view held by Webb(1982) ten years earlier when he noted that while a financial institution should be able to use historical default rates to forecast the number of loans that will terminate in foreclosure. It is much more difficult however, to predict specifically which loans will result in foreclosure."

One reason research has not been able to get a better understanding of the determinants of default risk has been a lack of data on a large scale which can accurately reflect the changing financial positions of borrowers and their corresponding equity positions. However, even if this information was available it is clear that the decision to default is subject to a lot of discretion on the part of both the borrower and the lender. Therefore other less tangible factors may weigh into the decision. Similarly, one must be careful in drawing conclusions from existing portfolio performance as a measure for making future modifications to lending standards. Portfolio results reflect what lenders have actually considered their decision to approve or deny a loan rather than what should be considered in the future.

Neighbourhood and Property Characteristics

The study of neighborhood and property characteristics as a determinant of default has not been the focus of much empirical research conducted in the past 30 years. This is ironic considering how widely used they are in current underwriting standards. The next section is based on research conducted in 1981 by Harriett Tee Taggart, a Ph.D. student at MIT.

Taggart learns that the use of neighborhoods and property characteristics in mortgage underwriting standards dates back to the 1920's and 1930's at the same time both appraising and underwriting standards were developed. She contends that underwriting standards related to neighbourhood characteristics are based on two theories of metropolitan development which generally classify urban neighbourhoods as high risk. One is the theory of neighborhood conformity in which people of equal socio-economic status, race and ethnicity, and housing stock of comparable age and type, are assumed to maximize residential property values. The second is that neighbourhoods follow a distinct life cycle pattern consisting of growth, stability and decline. Taggart notes that alternative theories have since been developed which contradict these original ones.

In order to better understand the relationship between neighbourhoods and default risk, Taggart used the same statistical models as those used in the study of borrower characteristics and applied them to neighborhood and property characteristics. Her research analyzed loans in Boston and was based on two loan samples of equal size, one of conventional mortgages and the other of federally insured so as to assess the determinants of a lender's decision to award one type of loan or the other. The determinants of delinquency and default risk were evaluated, separately for each loan type. In both sets of analyses, urban neighbourhood characteristics were examined to assess any statistical effects they might have after controlling for individual borrower, property, and loan factors. In her study Taggart concludes that:

" After controlling for household financial characteristics and loan terms, none of the property or neighbourhood characteristics nor appraised value of the property were important for conventional loans. In sum, the conventional loan status outcomes indicate that economic data on the household, rather than non-financial borrower attributes and property or neighbourhood characteristics, provide the soundest information on risk probabilities associated with an individual mortgage.

Macro Economic Variables

A recent study conducted in 1991 (Cooperstein et al.) confirms the strong influence of interest rates and inflation on defaults. Cooperstein's work supplements previous research on borrower characteristics, specifically loan-to-value ratios. The purpose of Cooperstein's research was to determine a more accurate model for loan defaults could be derived by adding in the effects of interest rates and therefore inflation. Cooperstein's results were positive and concluded that interest rates or inflation move in asymmetric fashion to the probability of default. This makes intuitive sense in that rising inflation (reflected by high interest rates) would fuel house prices thus creating an equity cushion for home owners and therefore reducing the likelihood of default. It is therefore less risky for lenders to originate mortgages during periods of inflation versus periods of deflation as was recently experienced in the last few years.