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Cascade

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CRA Sunshine Final Rules Issued

By Dede Myers, Vice President and Community Affairs Officer, Federal Reserve Bank of Philadelphia

In December 2000, the four federal bank regulatory agencies issued the final rules for public disclosure and annual reporting of CRA agreements between banks and community advocates. This new Regulation G implements the CRA sunshine provisions of the Federal Deposit Insurance Act. The CRA sunshine provisions were section 711 of the Gramm-Leach-Bliley Act, which provides expanded powers for the financial services industry.

The regulation took effect April 1, 2001.

What Is a CRA Agreement?

The primary question for financial institutions and community advocates alike is: "What is covered by the new regulation?" An agreement that meets all of the following criteria must be disclosed and reported under Regulation G:

1) The agreement is in writing; and
2) It is made pursuant to, or in connection with, the fulfillment of the CRA; and
3) The parties to the agreement are one or more insured depository institutions (IDI) or affiliates and one or more nongovernmental entities or persons (NGEP);
4) The agreement provides for the IDI or affiliate to provide cash payments, grants, or other considerations having an aggregate value of more than $10,000 in any calendar year, or to make loans in an aggregate principal amount of more than $50,000 in any calendar year; and
5) One or more of the NGEPs who are party to the agreement have had a CRA communication prior to the time the parties entered into the agreement.

Written agreements do not need to be legally binding to be covered. Loan agreements are not included in the definition if they are individual loans secured by real estate. Also excluded is any loan where (a) the funds are loaned at rates that are not substantially below market rates, and (b) the loan application does not indicate or authorize the borrower to relend the funds to one or more third parties.

What Is Fulfillment of CRA?

Activities in fulfillment of CRA

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Fed Proposes Regulatory Changes to Prevent Lending Abuses

By Dede Myers, Vice President and Community Affairs Officer, Federal Reserve Bank of Philadelphia

On December 14 and 19, 2000, the Federal Reserve System's Board of Governors published a series of changes to regulations Z and C, respectively, to address predatory lending and unfair practices in the home equity market. The recommended changes, if adopted, would also increase the information available to the public and regulatory agencies about mortgage markets. This is particularly true for the subprime market, the place where community advocates believe most predatory lending practices start.

The Federal Reserve sought comments on its proposals by March 9, 2001. The financial industry and community advocates are expected to submit widely divergent views on the proposed changes.

Following are details of the proposed changes.

Regulation Z

Regulation Z implements the Truth in Lending Act (TILA) and the Home Ownership Equity Protection Act (HOEPA). When HOEPA was first enacted in 1994, the expectation was that lending abuses would be minimized by the rules created in Section 32 of TILA. Knowing that

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Message from the Community Affairs Officer

This year will be an interesting one for the community development industry. Washington was busy last December finalizing some regulations (CRA sunshine), proposing others (eliminating abusive lending practices), and passing a new bill (the Community Renewal Tax Relief Act of 2000) that will require new regulations to implement the programs it has created, for example, the new markets tax credits. This issue of *Cascade* includes an article on each; the Community and Consumer Affairs Department is committed to keeping its readers informed about the status and details of these regulations.

The reports generated by the CRA sunshine regulation will be particularly interesting to watch. Although it may be several years before there is sufficient information to make a judgment call, I predict that there are far fewer CRA agreements than Senator Gramm believes; that the benefit to the community advocates who are parties to the agreements is minimal; and that the benefit to low- and moderate-income communities and people is substantial. Only time will tell.

The benefits of the Federal Reserve System's proposed changes to regulations C, Home Mortgage Disclosure, and Z, Truth in Lending and the Home Ownership Equity Protection Act, that are designed to reduce, if not eliminate, abusive lending practices, will take longer to surface, primarily because the regulations are not in final form. Assuming the regulations are finalized by the end of this year, the changes are unlikely to take effect until 2002, which means it will be 2003 before we have an opportunity to see how many high-cost loans are made and to whom. Since the recommended changes expand the scope of lenders required to report, the public will see which lenders have the lowest (and highest) annual percentage rates (APRs). The regulatory agencies will also be able to determine if there is a pattern and practice of treating some protected classes of borrowers (female, racial minority) differently from all others. What the new data will not do is answer the age-old question: "What APR is appropriate for the borrower's credit profile?"

The regulations for the new markets tax credit program are under development. Once the regulations are completed, community development financial institutions (CDFIs) throughout the Third District will

have a new opportunity to compete for funding of nonresidential projects in disadvantaged communities. If this program is as successful as the low-income rental housing tax credits created by the Tax Reform Act of 1986, low- and moderate-income people throughout the country will see positive benefits in the nonresidential sections of their neighborhoods.

CRA Sunshine Final Rules Issued *...continued from page 1*

are defined in the regulation as: (1) comments to a federal banking agency or those included in a CRA public file; or (2) activities given favorable CRA consideration. The first point would include oral or written comments to a federal regulator about the CRA performance of an IDI, or its affiliate, that is party to a CRA agreement, or written requirements that must be a part of an IDI's CRA public file. The second point includes home-purchase, home-improvement, small-business, small-farm, community development, and consumer lending; investments, deposits, grants, or membership shares that are primarily for a community development purpose; retail banking services; and community development services. All of these are activities considered by examiners during a CRA exam.

What Is a CRA Communication?

The final rule added a fifth criterion — CRA communication — to reduce the number of agreements that would be covered by the new regulation. The definition of CRA communication includes three parts — content, timing, and knowledge — all of which are important to understand.

The regulation defines the *content* of a CRA communication to be: (1) any written or oral comment or testimony provided to a federal banking agency concerning the adequacy of an IDI's or its affiliate's CRA performance; (2) any written comment provided to an IDI about its or its affiliate's CRA performance that must be included in the institution's CRA public file; or (3) any discussion about providing or refraining from testimony before a federal banking agency or providing or refraining from written comments to an IDI or its affiliate about the adequacy of its CRA performance.

Regulation G limits the *timing* of a CRA communication to the three years prior to any agreement if the communication is oral or written to a federal banking agency and written to an IDI or its affiliate. In the case of oral communications with an IDI or its affiliate, the communication must have occurred within three years if the NGEP discusses making comments to a federal banking agency or

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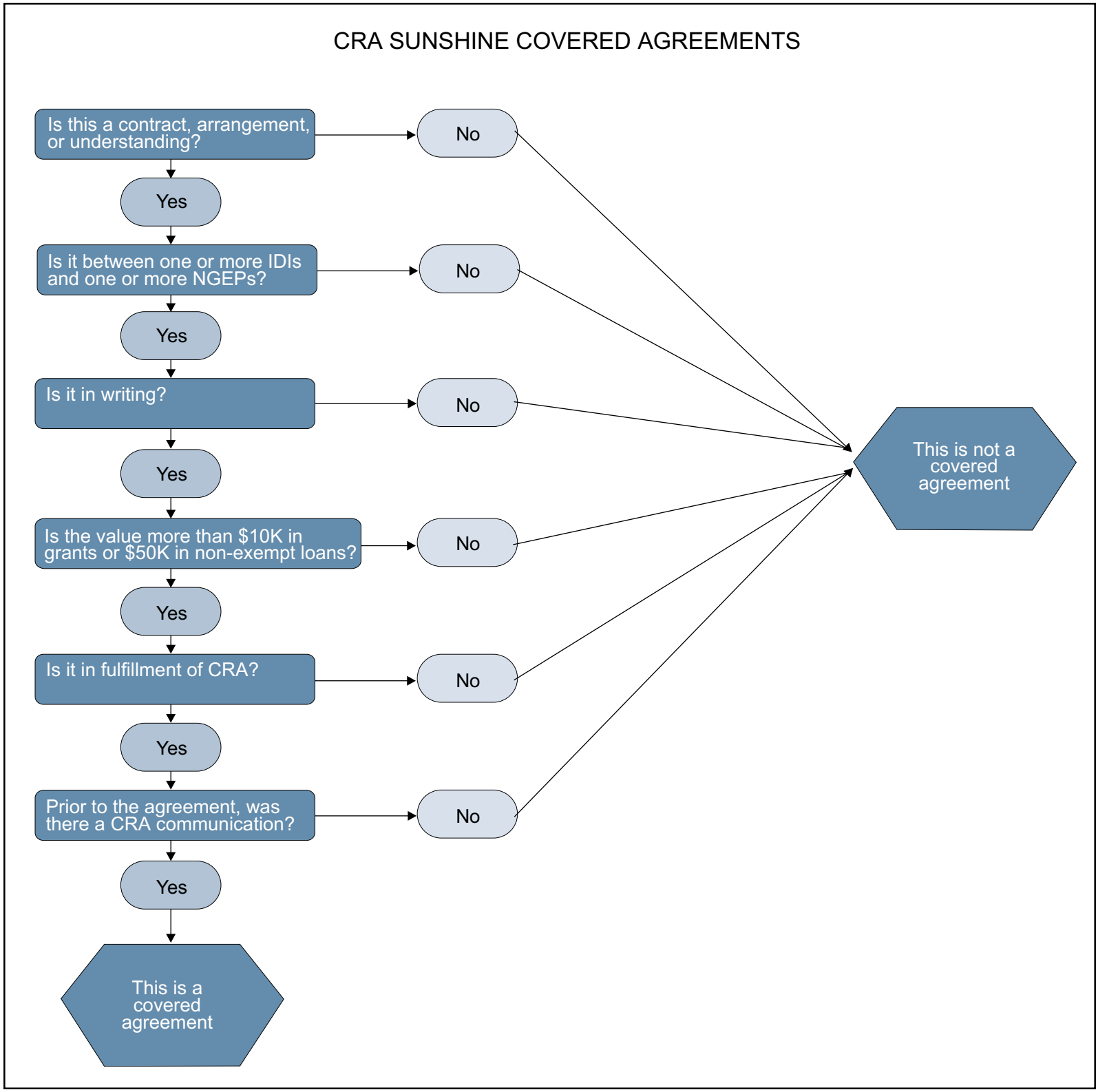

CRA SUNSHINE COVERED AGREEMENTS
Is this a contract, arrangement, or understanding?
No
Yes
Is it between one or more IDIs and one or more NGEPs?
No
Yes
Is it in writing?
No
Yes
Is the value more than $10K in grants or $50K in non-exempt loans?
No
Yes
Is it in fulfillment of CRA?
No
Yes
Prior to the agreement, was there a CRA communication?
No
Yes
This is a covered agreement
This is not a covered agreement

CRA Sunshine Final Rules Issued ...continued from page 2

written comments that must be included in the IDI's CRA public file. Any other oral communication about the IDI's performance under the CRA must have occurred within one year. If the oral communication is not about the *adequacy of the IDI's performance under the CRA*, then no CRA communication took place.

The regulation also states that a communication is defined as a CRA communication only if there is *knowledge* of it by certain representatives of the IDI and NGEP. For the IDI, a representative includes the employee who approves, directs, or authorizes a CRA agreement, an employee responsible for CRA compliance, and an executive officer of the IDI. If the communication is part of public testimony to a federal banking agency or is part of its CRA public file, the IDI is presumed to have knowledge of the communication. For the NGEP, a representative includes the director, employee, or member who approves, directs, or authorizes a CRA agreement and an executive officer who is responsible for the agreement negotiations.

Disclosure to the Public

The effective date of disclosure of covered CRA agreements is November 12, 1999. If the agreement was entered into between November 12, 1999, and December 31, 2000, it must be reported by June 30, 200l. Both IDIs and NGEPs must make a copy of the agreement available to any individual or entity upon request; however, both may withhold confidential or proprietary information covered by the Freedom of Information Act (FOIA). The disclosure must include the names and addresses of the parties to the agreement; amounts of payments, fees, and loans to be paid; how the funds will be used; what the term of the agreement is; and any other relevant information. NGEPs must submit an agreement to a federal banking agency within 30 days of request. IDIs must submit complete copies of agreements within 60 days of the end of each quarter, or they may submit a list of all covered agreements if they provide a complete copy of each agreement within seven days of the federal regulatory agency's request. The obligation to disclose a covered agreement to the public terminates 12 months after the term of the agreement.

While the *disclosure* requirements of covered agreements started with the Gramm-Leach-Bliley Act's signing date of November 12, 1999, the *annual reporting* requirement affects only those entered into since May 12, 2000. An NGEP reports to the relevant supervisory agency only in the years that it receives funds and must do so within six months of the end of the fiscal year. The NGEP may use the Form 990 that it prepares annually for the IRS to demonstrate how or where the funds it received were used. Additional information may be necessary to fulfill all requirements. If it is party to two or more agreements, the NGEP may consolidate the reports.

The IDI's annual report to its examiners, among other things, must identify the parties to the agreements; the aggregate amounts paid to parties of the agreement; and the aggregate amount to entities not party to the agreement. Consolidated reports are permitted if the IDI is party to more than one agreement; all agreements must be submitted within six months of the end of the IDI's fiscal year.

Enforcement Provisions

While there is no regulatory authority to enforce the provisions of any CRA agreement, if an NGEP willfully fails to comply with an agreement, the regulatory agency provides it with an additional 90 days to comply. If the NGEP still does not comply, the agreement becomes unenforceable by that NGEP. Regulatory agencies, using enforcement powers in the Federal Deposit Insurance Act, may enforce compliance by IDIs.

More Information

This article summarizes the major points of the CRA sunshine requirements. If the reader has further questions, a copy of the regulation and supplementary information are available at www.federalreserve.gov / boarddocs / press / boardacts / 2000. Both the supplementary information and the regulation include a number of examples that help explain the major components of the regulation.

Fed Proposes Regulatory Changes to Prevent Lending Abuses ...continued from page 1

abuses still exist, the Board is proposing the following:

1. The amendments would expand the number of mortgage loans subject to HOEPA by adjusting the price triggers used to determine coverage under the act. The rate-based trigger would be lowered by two percentage points, to eight points over the comparable U.S. Treasury security, and the fee-based trigger would be revised to include optional insurance premiums and similar credit protection products paid at closing.
2. Certain acts and practices in connection with home-secured loans would be prohibited. They include the refinancing of zero interest or low-cost loans within five years of their origination or adding payable-on-demand clauses or call provisions. The rules, if adopted, would restrict creditors from engaging in repeated refinancing of their own HOEPA loans over a short period when the transactions are not in the borrower's interest.
3. HOEPA's present prohibition against extending credit without regard to a consumer's repayment ability would be strengthened. If a creditor does not document and verify consumers' repayment ability, a refutable presumption would be created that the creditor has engaged in a pattern and practice of making HOEPA loans based on a home owner's equity without regard to repayment ability.
4. Disclosures received by consumers before closing for HOEPA-covered loans would be enhanced, so that consumers would be alerted prior to closing

that the amount borrowed is higher than initially requested because of the cost of credit insurance, points, and fees.

Regulation C

Regulation C implements the Home Mortgage Disclosure Act (HMDA), whose purposes include helping to determine whether financial institutions are meeting the housing needs of their communities. At present, HMDA requires financial institutions to report certain home-mortgage transactions (home-purchase loans, home-improvement loans, refinances, and multifamily loans) and certain characteristics of the applicants and borrowers. The proposed changes would broaden the data available on the mortgage market in general and the subprime market in particular.

1. The recommended changes include simplifying the definition of a "refinancing." The proposed change would include any refinance of existing debt, not just the portion that was the original purchase loan.
2. Lenders would be required to report requests for preapproval. The new rule would cover preapprovals that are applications for credit; a preapproval would be narrowly defined.
3. The definition of a home-improvement loan would be simplified so that all are reported. At present, HMDA allows reporting them only if the lender classifies them as such. This change would make the data more consistent.
4. Home-equity lines of credit, not just closed-end home-equity loans, would be reported. Currently, reporting lines of credit is optional.
5. The requirements for nondepository lenders would be expanded so that more lenders report loans. For example, if a large credit card bank originates home-equity loans, but they are not at least 10 percent of all its loans, the credit card company has been exempt from HMDA's reporting requirements. The proposed rules would change that.
6. Lenders would be required to report the annual percentage rate (APR) of a loan. This information would allow the public to determine if lenders offered certain rates to certain categories of borrowers. Lenders that provide below-market loan rates to low- and moderate-income borrowers may look particularly good against lenders that trick unsophisticated borrowers in protected classes.
7. The HMDA changes would require a declaration that the loan is subject to the Home Ownership Equity Protection Act.
8. Lenders would be asked to state whether the loan or application involves a manufactured home. This information is deemed important because manufactured homes are often underwritten in very different ways than single-family homes built on site.

Summary

By the time this newsletter is circulated, the comment period for both regulations' proposed changes will have passed. A large number of letters are expected, but the Board staff hopes to reach agreement on final rules by year-end.

If you would like more details on the recommended changes to either Regulation Z or C, the full text is available at www.federalreserve.gov / boarddocs / press / boardacts / 2000.

Third District HMDA Analysis 1998-1999

By Vera Bowders, Community Development Advisor, Community and Consumer Affairs Department, Federal Reserve Bank of Philadelphia

Over the past decade, the information available to the public about lending patterns has increased greatly. In 1989, reports of home-mortgage lending were expanded to include information about applications, in addition to originated loans, and demographic data about the applicants and the disposition of each application. The number of reporters was increased to include not only financial institutions that take deposits but also nonbank mortgage companies.

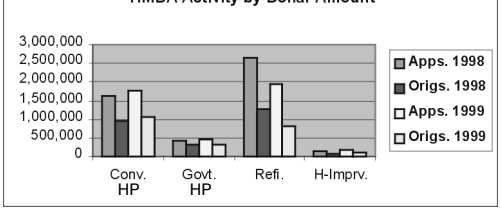
This article examines the change in number and dollar volume of Home Mortgage Disclosure Act (HMDA) applications and originations in the 18 metropolitan statistical areas (MSAs) included in the Third Federal Reserve District, which comprises the eastern two-thirds of Pennsylvania, the southern half of New Jersey, and the state of Delaware.

The following analysis is intended as a snapshot of lending activity in the MSAs of the Third District.

Applications 1998 - 1999

The number of home-purchase applications for conventional and government lending in all three states increased from 1998 to 1999. In Delaware, the increase was 4.6 percent for conventional applications and 0.5 percent for government applications; in New Jersey, the increase was 12.3 percent and 12.8 percent; and in Pennsylvania, it was 9.4 percent and 2.3 percent. Not surprisingly, the dollar amount of applications for conventional and government lending also increased: 9.9 percent and 2.4 percent in Delaware (Figure 1); 15.6 percent and 17.0 percent in New Jersey (Figure 2); and 9.5 percent and 4.8 percent in Pennsylvania (Figure 3).

Fig.1



Refinance and home-improvement loan business had very different results from home-purchase mortgage loans in the Third District's MSAs.

The number of applications for

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refinance and home-improvement loans decreased 18.2 percent and 6.0 percent in Delaware (Figure 1) and 13.7 percent and 5.3 percent in Pennsylvania. In New Jersey, refinance loan applications declined 7.4 percent, but applications for home-improvement loans increased 1.9 percent from 1998 to 1999. Similarly the

Fig.2

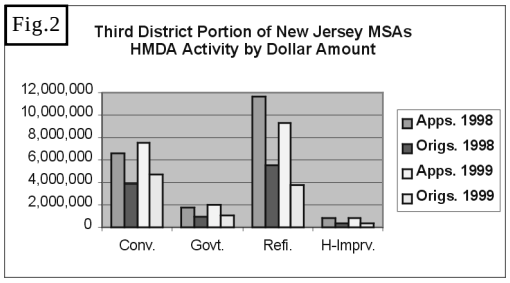
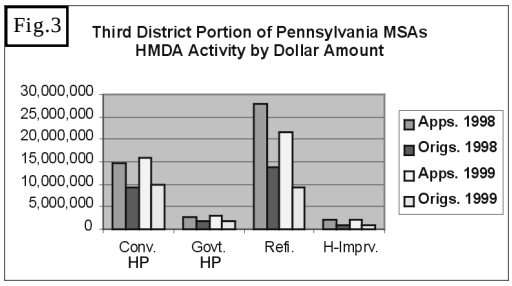


Fig.3



total dollar amount of applications for refinance lending decreased from 1998 to 1999 in all three states: 26.2 percent in Delaware (see Figure 1); 20.3 percent in New Jersey (see Figure 2); and 22.6 percent in Pennsylvania (see Figure 3). But the total dollar amount of applications for home-improvement lending increased 23.6 percent in Delaware and 2.3 percent in New Jersey but decreased 6.2 percent in Pennsylvania.

Originations 1998 – 1999

The number of originations for conventional home-purchase loans increased in the Third District MSA portions of all three states: 8.4 percent in Delaware; 10.4 percent in New Jersey; and 5.7 percent in Pennsylvania. In Delaware, the number of government home-purchase originations decreased 8.2 percent, but it increased in both New Jersey (10 percent) and Pennsylvania (2.6 percent). From 1998 to 1999, the dollar amount of originations for conventional and government lending increased 19 percent and 13.3 percent, respectively, in New Jersey (see Figure 2), and 7.3 percent and 4.6 percent in Pennsylvania (see Figure 3). In Delaware, the dollar amount of conventional home-purchase originations increased 13.6 percent while the dollar amount of government home-purchase originations decreased 5.4 percent (see Figure 1).

The number of originations for refinanced and home-improvement loans decreased in Delaware (30.3 percent and 10.1 percent), in New Jersey (28.2 percent and 8.2 percent), and in Pennsylvania (27.3 percent and 6 percent). The total dollar amount of originations for refinanced loans decreased from 1998 to 1999 in all three states: 34.4 percent in Delaware (see Figure 1), 31.9 percent in New Jersey (see Figure 2), and 32.9 percent in Pennsylvania (see Figure 3). The dollar amount of originations for home-improvement lending increased 49.5 percent in Delaware but decreased 2.5 percent in New Jersey and 0.2 percent in Pennsylvania.

Lending by Income

The number and dollar volume of all HMDA lending to applicants with incomes of less than 50 percent of MSA median income (Figure 4) increased 16 percent and 31.9 percent, respectively, in Delaware; 4.3 percent and 17.3 percent in New Jersey; and 2.3 percent and 11.3 percent in Pennsylvania.

For applicants with incomes of at least 50 percent but less than 80 percent of MSA median income (Figure 5), the number of HMDA-reportable loans decreased in all three states — 4.5 percent (Delaware), 2.7 percent (New Jersey), and 3.9 percent (Pennsylvania) — but the dollar volume increased 1 percent (Delaware), 10.1 percent (New Jersey), and 0.2 percent (Pennsylvania).

Lending by Gender/Race

When the data were analyzed by gender of borrower, the largest percent change was for joint applicants: all three states saw double-digit decreases for both number and dollar volume of loans.

Lending, when analyzed by race, showed decreases for all races in all three states with the following notable exceptions: the number and dollar volume of loans to applicants of

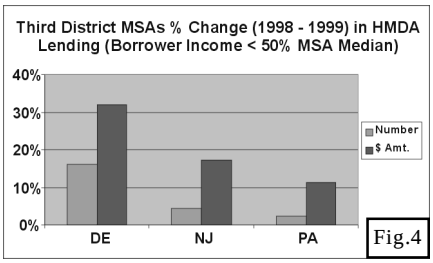


Fig.4

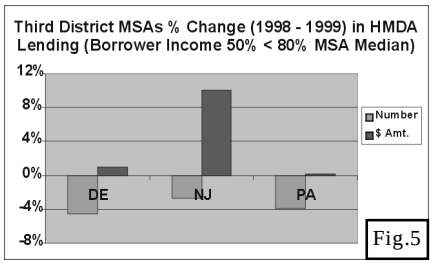


Fig.5

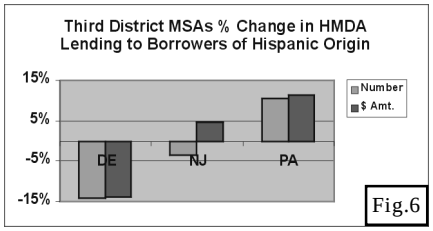


Fig.6

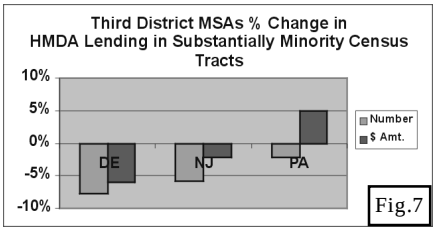


Fig.7

Hispanic origin (Figure 6) increased 10.4 percent and 11.3 percent in Pennsylvania. Although the number of loans to Hispanic borrowers decreased 3.6 percent in New Jersey, the dollar volume increased 4.5 percent. HMDA loans to black New Jerseyans increased 3.1 percent in number and 6.5 percent in dollar volume.

Lending in Minority Communities

The number of loans originated in "substantially minority" census tracts decreased in all three states, but the dollar volume increased 5 percent in Pennsylvania (Figure 7). The number of loans and dollar volume originated in "not substantially minority" census tracts decreased by double-digits in all but one instance (New Jersey, 8.7%).

Please continue to check our web site, www.phil.frb.org, for updates and additions to community profiles, particularly HMDA and CRA lending analysis.

Understanding CRA Investments Requires a New Lexicon

By Thomas J. Healy, Senior Vice President, Countrywide Securities Corporation

The views expressed here are those of the author and do not necessarily represent the views of the Federal Reserve Bank of Philadelphia or the Federal Reserve System.

The Community Reinvestment Act (CRA) investment test is an important tool for mobilizing the nation's capital markets to meet the credit needs of low- and moderate-income individuals. Unlike the lending test, which aims to directly link low- and moderate-income borrowers with the funding capabilities of depositories (dotted line in Figure 1), the investment test motivates depositories to make the link indirectly (solid lines in Figure 1) through other originators and intermediaries.

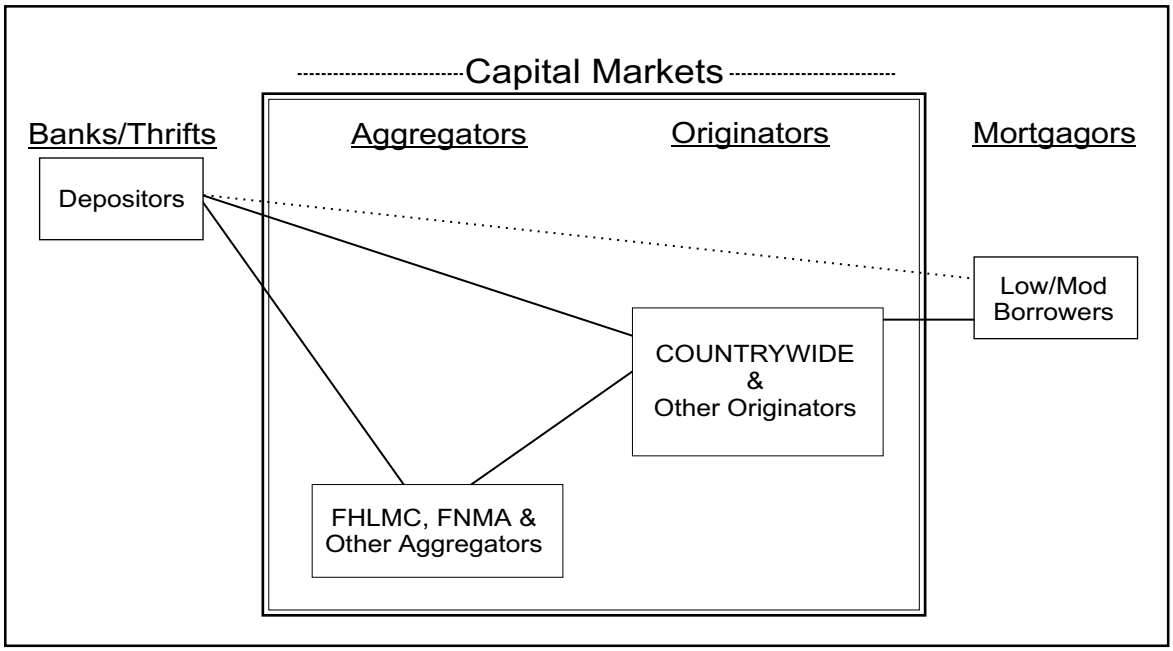
No bank or thrift can be all things to all people. Competitive strategy requires that each institution identify its greatest strengths and capitalize on them. Lending to low-income individuals, small-business lending, or project lending may not be part of your institution's key strengths. However, some institutions do these things very efficiently and effectively.

This is where capital markets come in. The United States has in place very large and efficient mechanisms to move funds from capital-rich areas to capital-poor ones. These mechanisms favor providers of credit (both depositories and nondepositories) that offer cost-effective origination of loans and investments with predictable credit and prepayment characteristics. Furthermore, these mechanisms may result in a more cost-effective provision of credit to low- and moderate-income communities and borrowers than might be available directly from a local bank or thrift, while providing attractive investment opportunities to these same local banks and thrifts.

Understanding the financial dynamics of these investments, however, is akin to flying a plane in heavy fog by instruments only. You cannot see, touch, or feel how you are doing. You must rely solely on the data you see on your control panel. In addition, one instrument won't do. You need to know not only your altitude but also your rate of ascent / descent, your weight, the temperature outside, wind speed, and so on. Finally, you need to be intimately aware of your surrounding environment: Are there other planes up there? Where are they? Where are they going?

The analogy to investments is clear. You cannot touch or feel how an investment will perform. You need to rely on a variety of measures to understand not only what you're currently getting but also what will happen if (when) economic scenarios change. I have had banks ask me why they should buy a 7.0 percent mortgage-backed security when they could acquire the underlying loans and earn 7.5 percent. The answer is not unequivocal; it needs to take into consideration the return relative to each of the alternative investment's relative risks.

For instance, a mortgage loan may have a different level of risk depending on how it is originated or acquired. An "originated" loan held in portfolio carries origination risk as well as servicing, credit, interest rate, and prepayment risks (Figure 2). Purchasing the whole loan — servicing released or retained — eliminates the origination risk and possibly the servicing risk. Purchasing the security backed by these same loans, however, also effectively eliminates any reasonable vestige of credit risk (assuming the loans are wrapped in an agency security). Depending on your view and appetite for risk, the 0.5 percent premium you can earn on the whole loan referenced above may or may not be sufficient to induce you to incur the additional risks associated with it. "Which is better?" is not an easy question to answer.



Finally, any investment cannot be looked at by itself without taking into consideration your financial environment. What is your institution's overall liquidity position? Leverage ratio? Return on assets? Asset quality? Capital adequacy? Interest rate gap? Absent an understanding of these dynamics, a CRA (or any) investment cannot be prudently made. What may be an ideal invest-

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Does Home-Ownership Education and Counseling Work? Paper Cites Need for More Research

By Alan Mallach, AICP

The views expressed here are those of the author and do not necessarily represent the views of the Federal Reserve Bank of Philadelphia or the Federal Reserve System.

Expanding home-ownership opportunities has been a major goal of American public policy for the past decade. Emphasis has been on fostering home ownership in traditionally underrepresented communities, such as low- and moderate-income neighborhoods. Targeting these areas for home ownership, however, has raised significant issues, particularly the appropriateness of many home-ownership decisions and the attendant risk to lenders from potential future defaults. One key feature of many programs is home-ownership education and counseling (HEC), which is often a required part of home-ownership programs directed to low-income households. Because of its importance to the home-ownership process, HEC—its design, implementation, and effectiveness—deserves closer scrutiny.

Does HEC work? A recent paper, "Home-Ownership Education and Counseling: Issues in Research and Definition," attempts to assess what we know about the effectiveness of home-ownership education and counseling by looking at problems with previous research and by suggesting issues and topics for future research. The paper, which was produced by Alan Mallach for the Community and Consumer Affairs Department of the Philadelphia Fed, also attempts to set up consistent definitions of HEC activities to provide a coherent framework for evaluating this subject.

Over the past 30 years, 11 studies have offered empirical research into the effectiveness of HEC with respect to some aspect of home purchase or home ownership. The paper reviews these 11 studies — the last of which was carried out in 1981 — and their principal findings. Results from these studies generally show that HEC has little effect on various aspects of the home-buying decision and on future loan performance and default risk, among the groups studied. However, these studies suffered from flaws in their methodology, including small samples, limited matching of control groups, and poor data collection, to name just a few. Unfortunately, no substantial research on HEC has been undertaken over the past 20 years. But concerns about HEC and its effectiveness are still alive, as reflected in the fact that a number of reviews and critiques of the HEC literature have appeared in the past four years.

One crucial element for determining the effectiveness of HEC is a consistent set of definitions, or a "typology." Consistently defining HEC activities provides a framework for carrying out future research and evaluating its results. The factors most important to this endeavor are the stage at which HEC is provided — pre- or post-purchase; the content of HEC; the modality, or format, through which HEC is provided; and the nature of the organization providing HEC. Although within this framework content is the most significant issue — what should be imparted to the home buyer or owner at each stage of the HEC process? — the timing of HEC is of particular importance. Once the home buyer has signed a contract for a specific property, he or she has made not only the decision to buy a house but also a number of ancillary decisions, such as features of the house, monthly costs, and repair and maintenance considerations.

The paper supports the position that while counseling must begin before the home buyer makes a commitment to purchase, HEC can and should continue after the contract has been signed. While post-purchase counseling has traditionally been limited to preventing default and delinquency, the area of post-purchase counseling unrelated to default issues is of emerging interest.

Future researchers must, of course, attempt to solve the complex methodological problems that plagued earlier studies. Furthermore, researchers should bear in mind that, in essence, counseling acts as a form of intervention in two fundamental decisions: the tenure decision and the default decision. Several key questions, which also provide fertile ground for further study, are germane to both:

- To what extent does counseling affect these decisions?
- Which aspects of behavior or decision-making are affected by counseling?
- Which features of a counseling "package" affect behavior or decision-making in which ways?

Other suggested areas for future research include comparing the effectiveness of telephone counseling with that of the more intensive face-to-face counseling. Delinquency and default rates are particularly important issues, since they affect not only a lender's risk but also neighborhood stability and personal well-being. There is a need to establish benchmarks for delinquency and default rates among the various populations targeted for home-ownership initiatives so that consistent standards will exist for measuring the performance of various programs, as well as the effectiveness of HEC generally. Furthermore, research on HEC should be integrated with investigation into the effects of the different underwriting standards established by lenders, particularly those being used in lower income home-ownership programs, as well as the impact of events that affect home owners over time, such as changes in jobs and incomes, family stresses, and other factors.

As public policy continues to emphasize home ownership for low-income or minority communities and as research efforts are carried forth, several important points should be remembered. Right now, it is still un-

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New Markets Tax Credits: Economic Development Tool in Low-Income Communities

By Benson F. Roberts, Vice President for Policy, Local Initiatives Support Corporation

The views expressed here are those of the author and do not necessarily represent the views of the Federal Reserve Bank of Philadelphia or the Federal Reserve System.

The new markets tax credits (NMTC) have the potential to transform the financing of economic development in low-income communities, much as low-income-housing tax credits (LIHTCs) have done for the development of affordable rental housing.

Enacted last December as part of the Community Renewal Tax Relief Act of 2000, NMTCs are authorized for a total of $15 billion in private investments by 2007, starting with $1 billion this year. NMTCs promise to bridge financing gaps; create new partnerships among investors, communities, businesses, and government; and generate jobs, services, and physical revitalization in distressed urban and rural areas.

How NMTCs Will Work

NMTCs are available to equity investors in community development entities (CDEs), which in turn will use the proceeds to make loans and investments in businesses located in low-income communities.

CDEs. The Treasury Department will certify all CDEs, which must have a primary mission of community development that is pursued by serving, or providing investment capital for, low-income communities or people. CDEs must maintain accountability to a governing or advisory board composed of residents of low-income communities.

However, certified community development financial institutions and specialized small-business investment companies will automatically qualify as CDEs, which may be corporations or partnerships. For example, a nonprofit organization could form a subsidiary, partnership, or limited liability company to act as a CDE. A CDE can meet the community-accountability requirement through its controlling parent organization.

Allocation of Tax Credit Authority. The U.S. Treasury Department will allocate NMTCs. The volume of NMTC investment starts at $1 billion in 2001 and rises to $1.5 billion annually in 2002-3, $2 billion annually in 2004-5, and $3.5 billion annually in 2006-7. Unallocated authority may be carried over through 2014. Priority for allocations will go to CDEs that have a successful community development track record (directly or through a controlling parent organization) or CDEs that intend to invest in businesses unrelated to the CDE. The Treasury Department may also add other allocation preferences and will probably ask applicant CDEs for a plan for generating public benefits.

Tax Credit Amounts. Investors will receive tax credits based on the amount of their equity investment in a CDE. Tax credits are claimed during seven years, starting on the date of the investment and on each anniversary; 5 percent is claimed for each of the first three years and 6 percent for each of the next four years. This stream of credits totals 39 percent, with a present value of about 30 percent. The investor's basis is reduced by the tax credits claimed. Investors may carry back unused credits to years ending after 12 / 31 / 00.

Qualified Equity Investments in CDEs. Equity investments can take the form of stock or any capital interest in a partnership and must be paid in cash. The investor cannot acquire a previous investment except to replace a previous NMTC investor. Equity investments must be made within five years of the tax-credit allocation to the CDE. The CDE may designate which of its investors will receive the tax credits.

How CDEs Will Finance Economic Development. A CDE can use NMTC investment proceeds to assist eligible businesses by providing loans and investments to businesses or other CDEs, purchasing loans made by other CDEs, providing financial counseling and other services, or financing its own eligible activities. For example, a CDE could develop and manage commercial real estate, such as a shopping center.

The Cousin's supermarket development in North Philadelphia is an example of an economic development project that might be carried out with new markets tax credits. The $5 million project was developed by Asociación de Puertorriqueños en Marcha, Inc., with equity from Fannie Mae's American Communities Fund, loans from the Local Initiatives Support Corporation and Wilmington Trust of Pennsylvania, and grants from city and federal sources. The supermarket created 42 jobs when it opened in 1999.

A CDE must use "substantially all" of the NMTC investment proceeds for the above purposes. When final guidelines are published, the Treasury Department will define the term "substantially all," which will include at a minimum any allowances for administrative expenses, loss reserves, and expenses related to both an initial start-up period for placing investments and a final wind-down period for recovering in-

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	Risks				
	Origination	Servicing	Credit	Interest Rates	Prepay
Originated	X	X	X	X	X
Purchased Whole Loan					
- Servicing Released		X	X	X	X
- Servicing Retained			X	X	X
Purchase MBS				X	X

ment for an institution with a large base of long-term stable deposits may be totally inappropriate for a bank reliant on short-term funding for incremental investments. The beauty of capital markets is that they not only offer incentive for additional production out of the most efficient producers, but they match these credits with those institutions that have the highest and best use for them — a true win / win situation.

In his book *Managing in Turbulent Times*, Peter Drucker, a professor at Harvard University, stated that "the greatest and most dangerous turbulence today results from the collision between the delusions of the decision makers and the realities. ...A time of turbulence [however] is also one of great opportunity for those who can understand, accept, and exploit the new realities." CRA and fair lending present such opportunities.

Approximately 55 percent of blacks and Hispanics are not yet home owners. Over two-thirds of the recent growth in households has been in minority communities. Five million new immigrants are expected to reach our borders by 2005, and our foreign-born population is expected to exceed 10 percent of our total population by 2010. There is obviously a large and growing pent-up demand for credit.

This is a tremendous opportunity if addressed properly. In addition to the direct lending that banks and thrifts do, other institutions with the requisite strengths will attempt to sate this demand and fund it through capital-markets intermediaries, thus allowing banks a further opportunity to participate. Many times, investments in these credits can be done with minimal credit risk (through a variety of credit enhancement techniques) while enjoying reasonable returns relative to the risks. (For example, studies show lower prepay volatility in low-balance mortgage-backed pools.) Also, many times, capital-markets investments have the additional benefit of enhanced liquidity. Plus they can be repurchased or pledged, and they have lower risk-based capital requirements and investment grade ratings.

Realizing the opportunity presented by these types of investments, however, starts with an understanding of the language capital-markets participants speak. And capital markets do have their own lexicon. For example, CRA officers talk about AAs, MFIs, percent HUD, and BNAs, but investment officers discuss OAS, PSA, GFees, and WAM. Understanding the jargon is necessary if you are going to understand the financial dynamics of CRA investments and be able to sell the merits of these investments to your investment officer or management.

This is the first in a series of articles aimed at relating the lexicon of capital markets to CRA investments. Subsequent articles will go into more detail about some of the terms listed above and others, as well.

For more information, contact Tom Healy at 954-759-5713 or Thomas_Healy@Countrywide.com

Profiles Updated on Web

The Community and Consumer Affairs Department of the Philadelphia Fed produces profiles of various communities in the Third District. Lending data in the profiles are updated annually. Profiles for the following communities have been updated on the Bank's web site:

State of Delaware
Clearfield County (PA)
Trenton, NJ MSA
Vineland, NJ MSA
Harrisburg-Lebanon-Carlisle MSA

You can find these updates at www.phil.frb.org / cca / index.html.

Visit our web site to find other material related to Community and Consumer Affairs, as well.

"Philadelphia Report Card" Available

Recently, the Research Department of the Philadelphia Fed put together an overall assessment of economic conditions and prospects for Philadelphia, the largest metropolitan area in the Third Federal Reserve District. Limited copies of that report are available. If you'd like a copy, call Betty Carol Floyd at 215-574-6458 or send email to betty.c.floyd@phil.frb.org. Or you can find the report on our web site at www.phil.frb.org / econ / regdata / index.html.

Does Home-Ownership Education and Counseling Work? ...continued from page 8

clear whether HEC is effective and, to the extent it may be effective, which of its features actually affect tenure and default decisions. Furthermore, because HEC can be an intrusive element in the lives of those who participate in it, its benefits should be demonstrably commensurate with the level of intrusion and with the time and energy devoted to HEC by both counselors and participants. Last, the link between HEC and loan performance — and by extension the stability of neighborhoods that home ownership supposedly promotes — remains to be clearly established.

The Federal Reserve Bank of Philadelphia will sponsor a meeting later this spring to discuss the results of this paper. Copies of the complete paper are also available.

For more information about the meeting or to get a copy of the paper, call Dede Myers, Community Affairs Officer, at 215-574-6482, or send email to: Dede.Myers@phil.frb.org. For information on HEC research, call Alan Mallach at 609-448-5614 or e-mail him at a.mallach@worldnet.att.net.

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vestments. In addition, a CDE must trace how tax credit investments are put to eligible uses if less than 85 percent of its gross assets are so invested.

Eligible Businesses and Communities. Many types of businesses are eligible for assistance, including nonresidential real estate and nonprofit businesses, and several tests are designed to ensure that they operate primarily in eligible communities. However, some businesses are explicitly excluded, including those engaged in managing rental housing.

Eligible communities are census tracts in which a poverty rate of at least 20 percent exists; the median family income (MFI) does not exceed 80 percent of the statewide MFI; or, in metropolitan areas, the MFI does not exceed 80 percent of the greater of the statewide MFI or the metropolitan area's MFI. The Treasury Department may also approve an area within a census tract as a low-income community.

Recapture. Investors risk losing the tax if substantially all of the cash proceeds are not used for eligible purposes; the investor cashes out the equity investment in the CDE within seven years; or the CDE ceases to be a qualified CDE. The Treasury Department will write rules for correcting violations within a reasonable period to prevent unwarranted recaptures. The NMTC provisions constitute Section 45D of the Internal Revenue Code.

What NMTCs Can (and Cannot) Do

Understanding what NMTCs can and cannot do is the first step to making the most of this new tool. NMTCs can provide a significant boost to rates of return for economic development investors. The tax credits should work to bridge moderate gaps in financing businesses and commercial and industrial real estate development. They can make a critical difference for the many ventures that can generate significant cash flow and repayment of capital but cannot generate enough to get off the ground without some initial help.

However, NMTCs will not directly reduce investment risks substantially. Moreover, NMTCs offer a much more shallow subsidy than do housing credits. In present-value terms, the NMTC is worth about 30 percent of the investment made. By contrast, the LIHTC generally has a present value of up to 70 percent and up to 91 percent in distressed and high-cost areas.

In addition, the LIHTC is based on the cost of building the housing, not on the amount invested. As a result, the LIHTC alone can drive an investment. In contrast, NMTCs are based on the *amount invested* in a CDE. Therefore, NMTC investors will need substantial cash flow and capital recovery / appreciation, in addition to the tax credits, to generate a reasonable return. Furthermore, unlike LIHTCs, the NMTCs claimed will reduce the investors' tax basis, exposing investors to additional capital-gains liability when they terminate their investments, and investment commitments may not have bridge financing.

Next Steps

This spring the Treasury Department plans to issue guidance on CDE certification requirements and NMTC allocation issues and to raise tax issues for public comment. However, the competition for NMTC allocations is not expected to open until key tax issues are resolved, this fall at the earliest.

The Federal Reserve Bank of Philadelphia expects to hold a meeting on the NMTC later this year. If you are not on the *Cascade* mailing list and would like to receive an invitation to the meeting, please send an e-mail message to that effect to: betty.c.floyd@phil.frb.org.

For information on the NMTC, contact Valerie Chang, Vice President, Local Initiatives Support Corporation, 733 3rd Avenue, New York, NY 10017; (212) 455-9800; fax: (212) 370-9427; e-mail: vchang@liscnet.org; web site: www.liscnet.org.

Predatory Lending: Some Tips for Diagnosis and Prevention

By Irv Ackelsberg, Managing Attorney, Community Legal Services, Inc., Philadelphia

From time to time, important issues are raised or information learned by parties outside of the Federal Reserve System. To provide a balance of viewpoints, the Community and Consumer Affairs Department, at its discretion, will print articles of interest to a broad audience. The following article by the managing attorney of Community Legal Services, Inc., in Philadelphia describes the thought processes his staff uses to decide the merits of a complaint about a lender. Some of our readers may find this informative.

The views expressed in this article are those of the author and do not necessarily represent the views of the Federal Reserve Bank of Philadelphia or the Federal Reserve System.

Poor communities throughout America have always suffered both from a lack of access to traditional credit markets and from exploitation by high-cost substitutes that fill the void, from finance companies to loan sharks. The poor pay more for just about everything they buy, and that includes credit.

During the 1990s, a whole new industry, known as "subprime" home-equity lenders, brought an avalanche of credit to poor neighborhoods. Searching out established home owners for mortgages to consolidate their debt or to improve their houses, these subprime lenders have targeted certain consumers for high-cost loans with harmful loan terms that have earned them the label "predatory" lenders. The magnitude of these abuses has risen to the level of a national epidemic that has caught the attention of journalists, legislators, and banking agencies throughout the nation.

What is "predatory lending," and how do you spot a "predatory" mortgage loan? Answers to these questions lie both in the characteristics of the loan transaction itself, particularly the cost of credit charged to the borrower, and in the story behind the transaction, such as the purpose of the loan or the extent to which the borrower was targeted or deceived. Once the characteristics of predatory lending are understood, it becomes easier to consider ways in which we can protect our family members and neighbors from the threat posed by these "equity thieves."

How Can You Recognize a Predatory Mortgage Loan?

1. How well can the borrower articulate the purpose of the loan?

Probably the most common feature of predatory lending is that the consumer is induced into borrowing more than she needed or can afford. For example, requests for a limited amount of home-improvement money can be stretched into loans that refinance existing mortgages and pay off credit-card balances and utility bills. Because many fees included in the loan are percentage-based, unscrupulous brokers and loan officers who are seeking to maximize fees will try to push the loan amount as high as an appraisal will allow. It is always a good idea to try to determine whether the borrower was seeking credit for a particular purpose and in a particular amount. If the lender found the borrower, instead of the other way around, that is a danger sign, as is confusion on the part of the borrower over why the money was borrowed in the first place.

2. The HUD-1: Follow the money.

The most important loan document for reconstructing a predatory loan story is the settlement statement, known as the HUD-1. This document is the transactional road map, showing how much was borrowed and, more important, where all the money went. The HUD-1 contains an itemization of all the fees charged by the lender or by a broker that were included in the principal of the loan, as well as payments to third parties, including various high-cost and unusual settlement fees, and premiums for unnecessary credit-insurance products. In the typical predatory loan, these upfront costs to the borrower could constitute as much as 10 to 20 percent of the loan amount.

If you already know that home improvements were financed, figure out who got the home-improvement money and how much. If this was a consolidation loan, figure out who

got paid, something the borrower will often not be able to tell you. Pay particular attention to any mortgage refinancings and try to figure out whether the refinancing made any sense from the borrower's point of view. Was the old mortgage delinquent at the time? What were the monthly payments and the rate? Was the old mortgage a recent one? Be alert for cases of serial refinancings, done by the same or different companies. This is the problem called "flipping," where companies refinance repeatedly in order to continue to convert more and more equity into loan fees.

3. Look for predatory features in the note.

Loan sales people tend to focus almost entirely on what the monthly payment will be, as opposed to the amount of the loan, points and fees, and other aspects of the transaction. Among the tricks commonly used by predatory lenders to keep the payment down, at least temporarily, are balloons and variable rates. In loans containing a balloon, the loan is amortized over a long term, but then the entire balance of the loan comes due in one "balloon" payment long before the term expires. While balloon payments may make sense for a borrower who is expecting a lump-sum payment shortly (for example, an estate or insurance settlement), it does not make sense for a borrower on a fixed income.

In variable-rate loans, the contractual rate rises in accordance with some published rate index. In predatory loans, one typical scenario is for the borrower to pay an artificially low "teaser" rate for three years to be followed by frequent increases in accordance with an established index.

Both balloons and variable rates will appear in the note or in a supplement to the note. Prepayment penalties are also usually found in the note.

4. What did the borrower's income and expenses look like at the time of the loan?

While traditional mortgage lenders are extremely unlikely to make loans to people who lack the income to repay them, predatory lenders are prone to minimizing the importance of repayment ability. Develop a budget for the borrower as she was at the time of the loan. Did the loan provide the client with any noticeable improvements to her monthly cash flow, and even if it did, did the contractual payment leave her enough to pay for essential, recurring monthly expenses? If there is a co-debtor for the loan, was the co-debtor actually a part of the borrower's household and a realistic contributor to future payments?

What Advice Can You Give Those Who Are Vulnerable to Predatory Lending?

1. Beware of mortgage brokers' fees.

Often predatory loans are arranged by brokers who are paid a fee out of a loan, generally a percentage of the loan amount. Therefore, the broker has an incentive to increase the amount of your new loan. Sometimes, the broker may get an additional cash payment from the lender as a reward for getting the borrower to pay a higher rate than she had to. Brokers rarely identify themselves as brokers and often advertise vague promises about helping to solve financial problems. They rarely explain how they make their money. You should ask the broker to clearly explain what he gets for "helping" you.

2. Beware of promises of lower interest and lower payments.

Refinancing a mortgage to lower an interest rate can be a good thing to do, but if the new transaction has big fees loaded into the loan, the borrower may actually end up paying more. Similarly, promises about lower monthly payments can also be half-truths; for example, where the old payment included taxes and insurance and the new one does not, or where the new, lower payment is scheduled to increase in the future through an adjustable rate or balloon structure.

3. Advise consumers not to borrow more than they need.

Brokers and lenders may try to convince borrowers to consolidate bills unnecessarily as a way to make the loan as big as possible. Remind consumers that a mortgage puts their home at risk, and this risk should never be made bigger than it has to be.

4. Get advice before signing loan papers.

This is always the best protection from being victimized by predatory practices. Consumers need to be told over and over that no matter how good the deal sounds, no matter how desperate they are, they should *never* put a mortgage on their house without first talking to a housing counselor or a lawyer. In some cities, such as Philadelphia, free counseling is available to low-income residents through publicly funded housing-counseling agencies.

5. Encourage people to talk about money matters with family and friends.

Money has become a private affair. Most people are more likely to talk about their sex lives than their finances. But the less talking we do about money troubles, the easier it is for predatory lenders and their brokers to trap our families and friends. This means we may have to risk being a little nosy to protect each other. Senior citizens are often ashamed about owing money, which makes them particularly vulnerable to predators and particularly in need of our attention.

Pennsylvania Brownfields Fund Moves into Implementation Phase

By Jennifer Burke and Rachel Fleet, Program Directors, The Development Fund

The views expressed here are those of the authors and do not necessarily represent the views of the Federal Reserve Bank of Philadelphia or the Federal Reserve System.

The planning for a financial intermediary for brownfield-redevelopment projects in Pennsylvania continues to move ahead. Pre-development, feasibility, and design phases for the intermediary, Financial Resources for the Environment (FRE), are being completed.

The 60-member FRE Task Force is finalizing underwriting guidelines, developing financial projections, and drafting legal documents. Later this year, a national search will be launched for a president to manage the entity. Participants in a borrowers' focus group, which met in Harrisburg in December 2000, verified the need for FRE.

At a task force meeting in late January, it was agreed that FRE would seek economically viable situations that are, at present, unbankable. The task force has generally agreed that FRE's financial underwriting standards will be consistent with the most flexible of bank lending programs, targeting borrowers that cannot obtain bank financing because of concerns regarding environmental contamination.

FRE is to be structured as a public-purpose for-profit limited liability company. Underwriting will include both financial and environmental criteria.

FRE is being designed so that it can apply later this year for certification as a community development financial institution (CDFI). Certification would enable FRE to obtain core equity / permanent capital grants and possibly technical assistance grants. Financial institutions would obtain Community Reinvestment Act credit more easily for FRE investments if it is certified as a CDFI. Subsequently, financial institutions could apply for Bank Enterprise Awards from the CDFI Fund. In addition, bank and other corporate investors in CDFIs may qualify for recently announced federal new markets tax credits.

The FRE initiative, which was conceived by Phoenix Land Recycling Company, is being implemented with the assistance of The Development Fund (TDF), a 38-year-old nonprofit organization that has developed 12 financing intermediaries in nine states.

TDF also is helping launch the California Environmental Redevelopment Fund (CERF). The statewide fund has obtained investor commitments of $38 million from 15 financial institutions and has received several positive indications from other large and medium-size investors. CERF's first round of investments was expected to close in late March.

The FRE task force is co-chaired by William F. Hecht, chairman, president, and CEO of PPL Corporation, and James J. Lynch, president and CEO of Fleet Bank-Pennsylvania. Core sponsors include the Pennsylvania Department of Environmental Protection (DEP), PPL Corporation, Fleet Bank, and the Federal Reserve Banks of Philadelphia and Cleveland. Leading FRE funders are DEP, the William Penn Foundation, and the Vira I. Heinz Endowment.

The task force includes representatives of financial institutions, other corporations, and public agencies, as well as environmental attorneys and other experts in brownfields redevelopment. Extensive work has taken place in committees on financing products and organizational structure. Financial-underwriting and environmental-underwriting subcommittees have been formed.

FRE meetings are typically held in Philadelphia or Harrisburg at six-week intervals. Recent meetings have been held at the Federal Reserve Bank of Philadelphia.

For copies of the interim report or to discuss participation on the task force, contact Sidney W. Johnston, Executive Director, The Development Fund, 231 Sansome Street, 6th Floor, San Francisco, CA 94104; (415) 981-1070; fax: (415) 981-1075; e-mail: sjohnston@tdfsf.org.

Calendar of Events

National Community Development Lending School

Case Western Reserve University, Cleveland, OH
July 22-26, 2001
Sponsored by the Federal Reserve Bank of San Francisco and the Federal Reserve Bank of Cleveland in partnership with Case Western Reserve University
For program and registration information, please contact Fred Mendez at (415) 974-2722 or check the web site in mid-April at http://www.frbsf.org/news/events/index.html

International Summit on Community and Rural Development

Duluth, MN
July 22-25, 2001
For information, visit www.minnesotaruralpartners.org, or call Marcie McLaughlin, Minnesota Rural Partners, at 507-829-5636.

American Bankers Association
Community and Economic Development Conference

Renaissance Harborplace Hotel
Baltimore, MD
September 17-19, 2001

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