The Effect of GSEs, CRA, and Institutional Characteristics on Home Mortgage Lending to Underserved Markets

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Executive Summary

Chapter 1: Theoretical Overview and Study Design

- Numerous authors have evaluated the existence and degree of racial and economic disparities in the urban home mortgage market. Two main analytic strategies have been employed. Studies of the *primary* lending market have focused on factors affecting loan origination. Here, the emphasis has often been on how characteristics of neighborhoods and individuals affect the likelihood of a loan application being accepted or denied.

- By way of contrast, studies of the *secondary* mortgage market have focused on the purchasers and/or ultimate owners of loans, i.e. the lenders who assume the risk of a loan's default. Here, the emphasis has typically been on comparing the portfolios of Government Sponsored Enterprises (GSEs) with other lenders. The GSEs (Fannie Mae and Freddie Mac) are privately owned for-profit corporations. But, because they receive significant government benefits, they are expected, indeed mandated, to "lead the mortgage finance industry in making credit available for low- and moderate-income families" (Lind, 1996a).

- This report argues that both lines of research, while valuable, have been limited by a failure to simultaneously consider the many factors that affect home mortgage lending and, in particular, lending to underserved markets (low income and minority neighborhoods and individuals). Government has adopted a multi-faceted strategy to improve access to housing credit, of which GSEs are only one part. If GSEs are failing to "lead the market," it may be because other government actions have been even more effective. In particular, the effect of the Community Reinvestment Act (CRA), which states that commercial banks and savings and loans have "a continuing and affirmative obligation to help meet the credit needs of the entire community in which they are chartered" (Public Law 95-128), needs to be considered.

- Drawing on work from Williams and Nesiba (1997) and Kim and Squires (1995), we further argue that lender characteristics such as legal structure, location of control (e.g. local vs. non-local) and asset size can potentially affect lender community reinvestment performance.

- We employ an analytic strategy that simultaneously evaluates the underserved market performance of both primary and secondary market entities. Conventional mortgage lending in Indiana for the years 1992-1996 is examined. By comparing primary and secondary market lenders simultaneously and across time, we determine which types of lenders are "leading the market" and which are merely following behind. Home Mortgage Disclosure Act Data and several other data sets are employed. This is supplemented with a case study analysis of St. Joseph County, Indiana, which allows a more in-depth view of how GSEs and the Community Reinvestment Act can affect local lending. Because of their unique characteristics, a separate analysis is done of subprime and manufactured housing loans in Indiana. These higher risk, higher interest loans have become an increasingly important component of home mortgage lending in both Indiana and nationwide.

Chapter 2: Indiana MSAs, 1992-1996

- Underserved markets in Indiana experienced significant gains during the early to mid-1990s. Their number of applications disproportionately went up while their denial rates went down, causing every type of underserved market to gain an increasing share of the conventional home mortgage loans made. Unfortunately, some of these gains started to be lost in 1995, but in 1996 underserved markets were still ahead of where they had been in 1992.

- Viewed in isolation, improvements by the GSEs might seem to be a major factor in these trends. For every underserved market, GSEs were purchasing relatively more loans in 1996 than they had in 1992. However, a closer examination reveals that the loans they did not purchase were also showing significant improvements. Indeed, rather than leading the market, GSE performance almost perfectly mirrored that of mortgage companies, the primary market lenders that consistently trailed the rest. Nonetheless, while GSEs never led the market, they did at least narrow the gap between the loans they purchased and those they did not.

- Fannie Mae tended to do better with underserved markets than did Freddie Mac. However, the differences were usually small and not totally consistent across MSAs and years.

- As a whole, institutions subject to the Community Reinvestment Act (commercial banks and savings and loans) consistently made a higher share of their loans to the income-based underserved markets specified in the HUD Final Rule. However, their lead over non-CRA institutions (credit unions and mortgage companies) declined across time. Further, for race-related underserved markets, non-CRA institutions actually had the lead.

- Large lenders gained an increasing share of the Indiana conventional home mortgage market between 1992 and 1996, but we saw no evidence that this was producing detrimental effects. Differences in underserved market performance between small and large lenders were generally small and inconsistent; and if anything, the large lenders often did better than the small ones. With regard to location of headquarters and branches, we did see evidence that more distant lenders were increasing their share of the Indiana conventional home mortgage market, and that these lenders were less oriented toward serving underserved markets. We speculate, but lack the evidence to prove, that these outside lenders are helping to create increased competition for the business of served markets, and that one possible consequence is that these borrowers are getting lower interest rates or better loan terms as a result. By way of contrast, there is also increased competition for lending in the underserved markets, but it is coming from subprime lenders, and just how beneficial their activities actually are is a matter of controversy and dispute.

- Much of the decline that occurred in underserved market lending after 1994 was not so much a decline as it was a shift: conventional loans from regular lenders were replaced by government-backed loans and by loans from subprime lenders. This shift is itself a matter for concern, since the replacement loans have less desirable qualities than the originals.

Chapter 3: The South Bend/St. Joseph County MSA 1992-1996

- GSE activity for 1992-1996 in St. Joseph County differed substantially from the rest of the state. In just a few years, the County went from being far below average with respect to GSE purchases of underserved market loans to being slightly above average. For unclear reasons, GSEs significantly increased the percentage of underserved market loans they purchased from every type of primary market lender with which they did business.

- The county was also unusual in its level of CRA-related community activism. Statewide between 1992 and 1996, CRA institutions actually lost ground relative to non-CRA institutions with regards to underserved market performance. But this was not true for the handful of lenders that negotiated with citizen's group CA$H PLU$. In 1996, these lenders were making as much as 14 percentage points more of their loans to underserved markets than they had been before CA$H PLU$ became active. The gains were particularly large and long-lasting among the agreement signers involved in mergers, the very ones who have the most reason to be concerned about CRA. If CRA institutions did not perform as well as might be expected statewide, it may be because there was so little CRA activism to prod them.

- The influence of CRA in the county may have been understated by official statistics. During 1994-1996 the Community Homebuyer's Corporation, an entity backed largely by area CRA lenders, made a small but highly important number of loans. Indeed, if the CHC were a regular lender, the HMDA data would show it to be one of the area's leading providers of conventional loans to underserved markets. The magnitude and activities of such programs need to be more widely assessed if we are to fully understand the role that CRA is playing in underserved markets.

Chapter 4: Subprime and Manufactured Housing Loans in Indiana, 1992-1996

- Subprime and manufactured housing lenders dramatically increased their share of the Indiana home mortgage market between 1992 and 1996. The number of applications to such lenders increased 18-fold during this time. In 1992 subprime lenders made 2.3% of all the loans that went to final rule underserved markets. By 1996, the figure was 18.9%.

- In 1992, subprime lenders accounted for less than 8% of Indiana conventional mortgage loan applications that were denied. By 1996, they accounted for almost 60% of the denials. Subprime lenders rejected six times as many of their applicants as did traditional lenders. The increase in overall denial rates that occurred during this period of time was entirely a result of the increased activity of subprime and manufactured housing lenders.

- The behavior of subprime lenders is very different from lenders in the prime market. Without information on the interest rates charged, fees paid, and other loan terms, it is impossible to assess just how well subprime lenders serve underserved markets. Any future analysis of underserved lending markets needs to take into account the role these new lenders play.

Chapter 5: Discussion and Conclusions

- There does not seem to be strong evidence that CRA was the primary contributor to the gains underserved markets experienced in Indiana during the early to mid- 1990s. However, CRA may have played an important role in maintaining gains made in the past even if it did not add to them. It may also be, too, that CRA has the *potential* to do much more, and that that potential has been realized more in other parts of the country than it has in conservative Indiana. CRA could be primarily effective when citizens' groups use its provisions to encourage local lenders to provide better service to underserved markets.

- While GSES never "led the market," both they and mortgage companies (the primary market lenders that are most dependent on the secondary market and whose performance almost perfectly mirrored that of the GSEs) did show some improvement across time. Greater flexibility and new programs on the part of GSEs may have accounted for improvements in both mortgage company and GSE underserved market performance. If so, this suggests that, if GSEs were even more willing to buy loans from underserved markets, mortgage companies (and other primary market lenders) might be more willing to make them.

- The differences between small and large lenders, and between those who had a local presence and those who did not, did not seem to be as dramatic as some might have expected. This does not mean that the trend toward increasingly large lenders headquartered far away is not a matter of concern; indeed it could be that the expressed concern has led such lenders to be careful that their underserved market performance is not inferior. But, at least in Indiana, the fears of some do not seem to have been realized.

- Subprime lenders are playing an increasingly critical role in underserved markets. Given the questions and controversy concerning the practices of some of these lenders, these changes are not necessarily for the better. Indeed, trends in market share raise the disturbing possibility that subprime lenders may be stealing away borrowers who could have gotten better deals elsewhere.

- For Indiana conventional home mortgage lending during the early to mid 1990s, CRA, the GSEs, and lender characteristics may have all been secondary players to the influence of an improved economy and enhanced competition among lenders. As interest rates fell and incomes rose, home ownership may have become a reasonable goal for many that could not previously afford it. It may be too that regular lenders, not just the subprimes, realized that underserved markets offered untapped opportunities for future profits.

- Given the rapid pace of change in home mortgage lending and the recent adoption of new programs by GSEs, the key findings of this study may soon need to be updated. The year 1996 may have been too soon to assess the effectiveness of recent GSE efforts to "lead the market." An economic downturn could give the CRA and the GSEs increased importance. And, even with recent improvements in home mortgage lending, there is still a long way to go. Blacks, very low-income families, and minority and low-income neighborhoods still receive far fewer loans than their population sizes would warrant.