‘One Stroke of the Pen’:
Racial, Economic & Institutional Disparities in Home Mortgage lending

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Introduction

During the 1960 Presidential campaign, candidate John F. Kennedy charged that if President Eisenhower really wanted to, he “could sign an executive order ending housing discrimination tomorrow.” Just weeks before the election Kennedy intensified his attacks, claiming that “one stroke of the pen would have worked wonders for millions of Negroes who want their children to grow up in decency.”

It took more than two years, but on November 20, 1962, President Kennedy finally made that stroke of the pen himself. Executive Order 11063 banned federally funded housing agencies from denying mortgages to any person based on race, color, creed or national origin.

The anniversary of Kennedy’s order provides an opportunity to assess how well that “one stroke of the pen” worked.

Why should we care?

Kennedy was right to be concerned about housing inequality.

- The 1924 National Association of Real Estate Boards code of ethics stated that “a realtor should never be instrumental in introducing into a neighborhood… members of any race or nationality… whose presence will clearly be detrimental to property values in that neighborhood”
- During the 1930’s, the Federal Housing Administration (FHA) promoted the use of color coded maps to indicate the ‘credit-worthiness’ of neighborhoods. Racially mixed

neighborhoods were considered less credit-worthy and highlighted on maps in red, which led to the term 'redlining'

- Along with color-coding neighborhoods, the FHA further restricted blacks in their housing options by financially backing residential projects that had restrictive covenants associated with them that prevented nonwhites from purchasing homes in white neighborhoods. This excluded blacks from most suburban areas by preventing them from accessing federally insured mortgage markets. Between 1946 and 1959, "less than 2 percent of all the housing financed with the assistance of federal mortgage insurance was made available to blacks."
- Coupled with the fact that the FHA insured very little inner-city housing, the overt discrimination found in the housing market meant many black families were left out of the post World War II home buying boom and prevented from moving from the city to the suburbs.

The consequences have been dramatic:

- Homeownership is one of the primary means to accumulate wealth in the United States. Sociologist Joe Feagin notes that, historically, blacks in particular have been hurt by their lack of homeownership. Because discriminatory practices limit the ability of all African Americans, including those of the middle-class, to build up housing equity, "black parents often have been unable to provide the kind of education or other cultural advantages necessary for their children to compete equally and fairly with whites."
- Massey and Denton (1993) further noted that a consequence of housing inequality has been racial segregation and the problems associated with it.
    - Pervasive discrimination systematically channels money away from integrated areas, causing blacks to be the most spatially isolated population in U.S. History.
    - Residential segregation, in turn, has led to class segregation for blacks. While poor whites are seldom highly concentrated, poor African American families are likely to live in census tracts where approximately 30 percent of the families are poor.

- This racial and class segregation builds "mutually reinforcing and self-feeding spirals of decline into black neighborhoods" (Massey and Denton 1993:2).
- Massey and Denton therefore conclude that "racial residential segregation is the principal structural feature of American society responsible for the perpetuation of urban poverty and represents a primary cause of racial inequality in the United States" (p. viii).

1962 – Mid 1990s

Kennedy's order lacked an effective enforcement mechanism and hence had little immediate effect. However, in later years it was followed by the 1964 Civil Rights Act, the 1968 Fair Housing Act, the 1975 Home Mortgage Disclosure Act, and the 1977 Community Reinvestment Act.

Despite these efforts, the thirty years after Kennedy's order showed little signs of progress.

- In their 1993 book *American Apartheid*, Doug Massey and Nancy Denton demonstrated that study after study had shown that black and racially mixed neighborhoods receive less credit and less total mortgage money than socioeconomically comparable white neighborhoods.
    - EX: Color of Money. Dedman (1988) discovered that between 1981 and 1986, Atlanta financial institutions made five times as many home loans per 1,000 housing units in white neighborhoods as in black neighborhoods having similar income levels.
    - Finn (1989) found that, even after controlling for income and other facton, whites in Boston received three times as many residential loans per mortgageable housing unit as blacks
- A famous 1996 analysis by the Federal Reserve Board of Boston reviewed the variables that lenders themselves had said were important for their decision making, and concluded that even if two mortgage applicants were financially identical, a minority applicant would be 60 percent more likely to be rejected than would a comparable white applicant.

Mid 1990s – Mid 2000s

However, the 1980s and 1990s saw important changes in the nation's banking laws. Deregulation increased the range of products and services that banks and other financial institutions could offer, eliminated interest rate ceilings, and greatly expanded the geographical areas in which individual companies could operate. As a result, the banking industry became far more competitive – and it appeared that low income and minority borrowers benefited as a result.

Starting in 1995, home ownership rates started rising more rapidly for minorities than for whites. By 2000 homeownership rates were at an all time high for central cities (51.9 percent), minorities (48.2 percent), Hispanics (46.7 percent), households with less than the median income (52.2 percent), and blacks (47.3 percent). For most low income and minority groups, these disproportionate gains continued for about a decade. Both the Clinton and Bush administrations proudly trumpeted these developments on the Department of Housing and Urban Development's web pages.

At least part of this progress can probably be credited to the Community Reinvestment Act, which encourages depository institutions to meet the needs of borrowers in all segments of their communities consistent with safe and sound banking practices. In the 1990s citizen groups and governmental entities, armed with information obtained via the Home Mortgage Disclosure Act, increasingly used the CRA to pressure lenders to reach out to qualified borrowers that had been underserved in the past. As a result, some traditional lenders expanded their outreach efforts to minority markets, sometimes offering not only loans but home ownership programs that helped borrowers improve and manage their credit.

But, what was less widely recognized or acknowledged was that not everyone was suddenly getting 30-year fixed-rate mortgages with low interest rates. Historically, there had been more or less only one mortgage rate for all borrowers. A borrower was either granted a loan at that rate, or the loan was denied. Starting in the 1990s though, rather than be rejected, borrowers often could get a loan, if they were willing to go to subprime lenders who offered less favorable terms along with higher interest rates.

The use of these loans differed greatly by race. Researchers from the Federal Reserve Board found that, by 2005 and 2006, more than 50% of loans made to blacks were higher-priced, compared to less than 18 percent of the loans made to non-Hispanic whites. These higher rates may have been justified for those who could not get a home any other way. However, at least in the 1990s, an estimated one half of subprime borrowers had credit scores that would have qualified them for lower-cost conventional loans. Unfortunately, ignored by traditional lenders, low income and minority groups turned to the subprime lenders that were actively seeking their business through television advertising and direct mail targeted to their neighborhoods.

Although the exact number is subject to debate, at least some subprime lenders also engaged in predatory practices.

- These practices included reverse redlining, where lenders targeted minority, elderly, and low-income homeowners and charged them higher interest rates and fees unrelated to the credit risk posed by the borrower;
- negative amortization, where payments are structured so that lower monthly payments do not even cover interest, causing the principal balance to increase;
- prepayment penalties that keep borrowers from refinancing at lower rates; excessive fees, which sometimes exceed 10 percent of the loan amount;
- loan flipping, where creditors pressure borrowers to repeatedly refinance their loans (often because they cannot afford the payments on their previous loans), providing the creditor with additional income from points and fees charged;
- and asset-based lending, where the loan is based not on the ability to repay but solely on the equity in one's home.
- In his recent book, <u>Kickback: Confessions of a Mortgage Salesman</u>, Ted Janusz describes how the process worked:
    - "If somebody came in wearing cowboy boots and ripped-up jeans, those are the people you took to the cleaners on fees."… Lenders who found a mark would make sure the money was ending up in their pockets. For example, they would tell the borrowers that they could have a 9% interest rate, but when the paperwork

> cleared, their low credit rating would force them into an 11% rate—often without the borrower even knowing it. The resulting dividends, thousands of dollars in each case, fell into the lenders' laps. “You hear companies offer fabulous rates, but what are they paying in closing costs to get them?” Janusz says. “It would be like comparison shopping for cars only looking at the headlights.”

Reviewing these developments in testimony before Congress in 2000, William Apgar made the prophetic warning that “for millions of low- and moderate-income families, minorities, seniors, and others not well served by the primary market place, predatory lending threatens to turn the American dream of homeownership into an American nightmare.”

Questionable lending practices were not just limited to the subprime market. Several other new and risky practices developed.

- These included no-doc loans, where borrowers were not required to provide proof of income (the worst of the no-doc loans were reported in the press, fittingly, as NINJA loans; this referred to loans made to borrowers with “no income, no job and no assets.”);
- interest-only loans, where the principal was not paid down;
- and adjustable rate mortgages, where the loan was based on the ability to pay the low opening interest rate, not the rate the loan would jump to in later years.
- Many of these practices were based on the assumption that housing prices would continue to rise – and when that assumption proved wrong, major problems developed.

In short, during this period the “old inequality” of fewer loans to minorities was slowly declining. But a “new inequality”—characterized by less desirable loan terms, exposure to predatory practices, and a lack of consumer protection— was taking its place. Combined with increasingly risky practices in lending to other groups, the stage was set for the crisis that was to follow.

The Situation Today

Minority home ownership rates are still higher than they were in 1994. But, high unemployment rates, falling home prices, and questionable lending practices have all led to a dramatic rise in home mortgage foreclosures that is adversely affecting members of all races.

- The U.S. Labor Department reports that, between the start of the recession in December 2007 through September 2009, the unemployment rate doubled to 9.8 percent with an additional 7.5 million people joining the ranks of the unemployed. The September 2009 rates differed sharply across groups with 9 percent of whites unemployed compared to 15.4 percent of blacks and 12.7 percent of Hispanics.
- The Joint Center for Housing Studies at Harvard University adds that personal bankruptcies almost doubled between 2006 and 2008 (from 600,000 to 1.1 million). The JCHS further estimates that real home equity was 41 percent lower in the fourth quarter of 2008 than it had been at its peak a few years earlier.
- In early October 2009, a Congressional Oversight Panel headed by Elizabeth Warren of Harvard reported that, between July 2007 and August 2009, 1.8 million homes were lost to foreclosure and another 5.2 million homes began the foreclosure process. *One in eight mortgages is currently in foreclosure or default.* Each month, an additional 250,000 foreclosures are initiated, resulting in direct investor losses that average more than $120,000.
- These numbers are expected to rise for the foreseeable future, and the troubled economy may cause more and more homes with prime loans to enter into foreclosure as well.

Minorities, because of their greater reliance on high-cost subprime loans and the even greater impact that the recession has had on them, have been especially hard hit.

- The Pew Research Center reports that between 2004 and 2008, the non-Hispanic white home ownership rate fell from 76.1 percent to 74.9 percent, a 1.2 percent point drop.
- But, during that same period of time, African American home ownership went from 49.4 percent to 47.5 percent, a 1.9 percentage point decline.

- Between 2005 and 2008 the Latino home ownership rate fell by even more, from 56.2 percent to 53.6 percent, a fall of 2.6 percentage points.

To combat the rise in foreclosures, in March 2009 the Obama administration began the Home Affordable Mortgage Program (HAMP). HAMP is designed to help homeowners modify their loans so they have more affordable terms. Some feel the program is already a failure: by September 2009, only 1,711 permanent modifications had been made, and anecdotal reports abound of borrowers who have tried to renegotiate their loans only to face lenders who were unwilling or unable to do so. But, the program is still young, and the administration contends that eventually as many as 3 to 4 million foreclosures will b e prevented.

Unfortunately, in its October 2009 report, the Congressional Oversight Panel had limited optimism for the program's long-term success, at least as it is currently structured. The Panel warned that, even under the best of circumstances, HAMP would be "swamped" and would prevent fewer than half of all foreclosures. HAMP was not designed to address foreclosures caused by unemployment, which now appears to be a central cause of nonpayment, further limiting the scope of the program.

Presumably, given a shortage of buyers, it would make more sense for lenders to renegotiate loans than allow homes to go into foreclosure. Several explanations have been offered as to why this is not happening:

- Lenders are used to making loans using highly automated underwriting processes. They lack the staffing and the expertise that are required for the time-intensive process of customizing loans for individual borrowers.
- Thanks to falling home prices, up to a third of all mortgages may now be "underwater" i.e. the borrower owes more than the home is worth. Lenders may be unwilling to accept losses on these homes. Some borrowers may feel that they are better off cutting their losses rather than continuing to pay more than their home is worth.

- Lenders fear that if they do renegotiate loans, they may come under legal attacks from investors, even if such renegotiations might save them money in the long run.
- Legal remedies may be more limited than they are for other types of lending. Judges can and do routinely reduce the amounts owed for other types of loans, e.g. cars and credit cards, but they do not have the authority to do the same with home mortgage lending.

None of this means that the situation is hopeless, but it does suggest that new efforts may be called for. It is better to do everything we reasonably can to help people stay in their homes than to allow their properties to go vacant and abandoned, sometimes bringing entire neighborhoods down with them in the process. Government could put greater pressure on lenders to work with borrowers on modifying loan terms. Rather than just offering better terms on loans that are still more than what the house is worth, lenders could be encouraged to cut their losses by reducing the principal owed, possibly with the help of additional government resources. Judges could be given greater leeway in modifying home mortgage loan terms. In the long run though, the best solution may be a strengthened economy.

Conclusion

With the stroke of a pen, John F. Kennedy began a process that he thought would put an end to housing discrimination. If he had known what things would be like 47 years later, he would no doubt be disappointed.

- Despite his order and several other legislative efforts, inequality in lending and home ownership has continued. Blacks and Hispanics have been more likely to have their loan applications denied than similarly qualified whites, and when they have been approved it has often been with terms that were much less favorable than those given to others.
- Further, banking and lending innovations that were unheard of in Kennedy's time initially produced home ownership gains, but are now causing hardship and grief for members of all races.

Many would argue that government and lenders need to do more to deal with current problems, and need to take steps to prevent these problems from continuing in the future. It would be unfortunate, however, if those steps included abandoning Kennedy's goal of ending discrimination in lending.

- A crisis that has been produced, in part, by greedy, irresponsible, risky and sometimes even predatory practices should not become an excuse for not offering fair, reasonable and affordable loans to qualified buyers of all races. Many people blame the current economic crisis on misguided efforts to promote home ownership; but in reality, during the 1990s genuine progress was being made in low-income and minority home ownership before greed, stupidity and predatory practices were allowed to go unchecked.
- New home ownership can be encouraged by fair interest rates and by programs designed to help people learn how to manage their finances.
- For those who cannot or should not become home owners, the provision of quality affordable rental housing should be a top priority.

The American dream of home ownership became a nightmare for many during the 2000s; but by reversing the excesses and abuses of the past several years, and with the help of an improved economy, the dream can become viable again, not only for blacks and Hispanics but for members of all races.