AN ANALYSIS OF UNDERWRITING AND APPRAISAL PRACTICES AND THEIR IMPACT ON CREDIT AVAILABILITY

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Summary

Two of the primary keys to understanding the issue of disinvestment in inner city and older suburban neighborhoods by <u>some</u> financial institutions are the underwriting and appraisal methods utilized by these institutions. This paper analyzes traditional underwriting and appraisal techniques and the impact they have had on the perceived prudence of lending in older neighborhoods. The paper compares these traditional appraisal and underwriting practices to the existing studies of default and foreclosure risks in older, minority and racially changing communities, concluding that the studies do not substantiate the levels of risks traditionally associated with such areas.

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> "The biggest problem with our generation of bankers is that they don't know how to do risk analysis." - Ronald Grzywinski, Chairman of the Executive Committee, South Shore National Bank of Chicago.

At the heart of the controversy over redlining, disinvestment and reinvestment is the question of risk analysis. Viewed from a lender's point of view, the decision not to lend -- or to lend on more restrictive terms -- in certain areas which he perceives as risky may appear to be a wise business decision dictated by his responsibility to protect his depositors and stockholders. Viewed from the community's point of view, such decisions cut that community off from its access to vitally needed credit.

Disinvestment studies (conducted by public officials and community groups) which document the lack of conventional mortgage money in older, minority, or racially changing neighborhoods across the country have served to dramatize the issue, and to force examination of it by public officials. These studies, however, do not <u>necessarily</u> address the question of whether lenders are making unfortunate, but essential, business decisions which negatively affect certain neighborhoods in order to avoid taking undue risk and incurring excessive losses on loans in these communities. What separates a wise business decision from one which creates a self-fulfilling prophecy of neighborhood decline is the validity and accuracy of the lenders' claim that community conditions create unacceptable credit risks.

The importance of proper risk analysis is emphasized in a quote from a publication of the nation's single largest mortgage holder:

> Generally, mortgage lenders impose credit restrictions on geographical areas because, rightly or wrongly, they believe that property values have declined or will decline so that the security behind their long-term mortgage loans will disappear before the loans are repaid. If the lender's judgement as to threatened values is correct, his action will prevent consumers from over-improving or overpaying for homes. If the lender's judgement is mistaken, he will contribute to the very decline in neighborhood values which he fears.

It is essential that lenders base their analysis of the risks involved in a loan on sound, well-informed, and trustworthy methods. The analysis of lending risks, which is called <u>loan underwriting</u>, has become more and more professionalized and subject to uniform standards. Many of these professional standards incorporate models of neighborhood life cycles and assumptions about sound neighborhood conditions which are based on little, contradictory, or fragmented evidence. The application of these models or assumptions to a specific loan, in a specific community, at a specific point in time, therefore, may not be a sound practice.

Analyzing Neighborhood Risks: Underwriting

Lenders consider the risks involved in making a loan from two perspectives. The first is the creditworthiness of the borrower. This is called credit underwriting. In the past, credit underwriting has been based on rules of thumb about what sources of income should be taken into account, how much a person should spend on housing, what is the borrower's total debt to income ratio, a person's past credit history, and even a person's race, sex, or religion. Recent changes in federal and state laws now forbid lenders from employing standards which consider the ethnicity, sex or religion of the borrower, and prohibit the arbitrary use of standards which disqualify certain sources of income, such as a wife's second income or welfare payments.

There is no body of literature linking underwriting standards to the lack of availability of credit in low-income, older, minority or racially changing neighborhoods. In spite of this fact, however, standards for determining the creditworthiness of borrowers continue to be the object of public scrutiny since it is clear that their arbitrary use by lenders can reduce, and even shut off credit to entire communities.

The second risk consideration involves what is called property underwriting. When a lender makes a mortgage loan, for example, the property serves as collateral. No lender would want to loan more than the value of the collateral. If the homeowner fails to make the mortgage payments and defaults on the loan, the lender has to foreclose and take the property. He must be able to sell that property for enough to repay the outstanding value of the loan, the lost interest payments, any unpaid real estate taxes on the property, and all of the fees and legal costs associated with foreclosing and reselling the home. If the final sale price is not enough to cover all these costs, then the lender will lose money.

The risk of default exists potentially on every loan. The lender's job is to reduce his risk to a minimum by doing careful underwriting. In order to insure that lenders are prudent underwriters, federal and state laws regulate the lending practices of depository institutions to insure that they loan less than the full market value of a property. The lender is required to have a "cushion" of some amount between the estimated value of the home and the actual amount of the mortgage. Thus the lender requires a downpayment from the purchaser to make up the difference between the sales price of the property and the amount of the loan.

Lenders have property appraised to estimate the value so that they then can determine the amount that they will loan on the property. The appraised market value may not be the same as the sales price since the actual price a person pays may be affected by unique conditions -- such as buying a home at a special low price from a relative, or paying more than it is worth because of some personal sentiment for that home. The appraisal tells the lender the estimated value of the property. However, a mortgage is a long-term loan which is paid back slowly.

Typically a lender requires about a twenty per cent downpayment as a cushion against losses from foreclosure. If the value of the property decreases rapidly, however, then this cushion may not be enough to pay all the costs associated with foreclosure. Thus, the lender must anticipate the trends in the market, and decide whether there are threats to the future value of the property which represent an unreasonable risk for a standard loan.

If the lender perceives that values currently are decreasing, or are likely to during the term of the loan, then the lender has several options: (1) the lender can impose more restrictive conditions on the loan by raising the amount of the downpayment, increasing the interest rate, or shortening the length or "term" of the mortgage. In the first case, the lender loans a smaller amount to reduce what he has at risk. In the second case, the lender charges more for taking the risk. In the last case, the lender gets paid back in a shorter time, reducing the amount of time that his money is at risk. A lender may decide that the risk is so great that he must impose two, or even all three, of these restrictions.

(2) Another option for the lender is to insure the mortgage against loss. There are several private mortgage companies which insure part of the loan value against loss when the lender makes a loan with an unusually low downpayment, say only five or ten percent. Also, the Veteran's Administration (VA) and Federal Housing Administration (FHA) programs guarantee or insure the full value of the loan - thus making it almost risk free for the lender.

(3) The final option for the lender is simply not to make the loan at all. The charge of redlining most commonly occurs when the lender decides not to loan in a certain area at all. Requiring insurance, and/or applying restrictive terms to all loans in certain areas, however, also represents a form of arbitrary denials of credit *if* the measurable risks do not warrant these measures.

The Link Between Appraisal and Underwriting

As part of the underwriting process, both federally and state regulated lenders are required to base their estimates of the present value of a property on an appraisal.[2] An appraisal is an "expertly informed opinion" of the *present* value of the property.

There are three standard methods of appraising a property: one based on the income the property will produce; another based on the cost of construction; and a third based on comparing the property to the sales prices of comparable properties.

The last method -- called the market value approach -- is thought of by lenders as the most reliable since they can directly compare subject properties to the existing sales market. The income approach is commonly used for income-producing properties -- such as shopping centers or multi-family buildings -- not only because potential income is the primary consideration, but also because, unlike homes, there may not be enough sales of reasonably comparable income properties to use the market value approach.

The market value approach requires the appraiser to select comparable properties which have sold in the same neighborhood in the recent past. The appraiser must use his subjective judgement to make adjustments when the properties are not exactly comparable in construction, amenities, age, etc. There will always be some adjustments since no two properties are exactly alike in every way. Adjustments must also be made to account for value trends and estimated changes in value which have occurred since the time of the sales of the comparable properties. Finally, if the comparables are not taken from the same neighborhood as the property being appraised, the appraiser will make adjustments for differences in the neighborhoods which he feels affect the value of the property.

These last two considerations -- value trends and neighborhood factors -- draw upon the appraiser's [illegible] professionally informed judgement about what neighborhood conditions effect property values and what trends in values should be anticipated and incorporated in the appraisal of present value.

Aside from trying to determine the present value of a property, the lender is concerned about the longer term value trends or threats to the security of the property. This part of property underwriting is essentially like appraising except that value trends are anticipated for a longer period of time. Lenders have relied on appraisers, their professional standards, techniques and assumptions for developing their own long-term property underwriting standards. Frequently, lenders train their underwriters by enrolling them in the programs of the professional appraisal organizations.

The Professional View of Neighborhood Risk Factors

The literature, training manuals and texts of the professional real estate appraising industry define the standards, assumptions and models used in judging neighborhood factors and loan risks. A review of the development of its literature reveals the sources upon which these standards, assumptions and models are based.

The early works on appraising and real estate principles reflect views on the relationship between ethnic change, age of the community and community life cycles which still appear in much of the professional materials today. Two theories of urban decay are commonly used to support the contention that neighborhoods pass through natural life cycles and that racial change indicates a cycle of decline. Both of these theories, or models, were developed at the University of Chicago in the 1920's and 1930's. They are the "Human Ecology" model and the "Filtering Model."

The Human Ecology Model was formulated principally by the Chicago School of Sociology in the work of Robert Park, Roderick McKenzie and Ernest Burgess. It became the dominant social model of urban development. This model stems from a strong social Darwinistic tradition, where not only animals, but people were seen to survive and reach positions of power and status because they were inately the strongest species. This school was also heavily influenced by plant biology, particularly studies of how various plants would take over a piece of land previously occupied by different species. It was believed that the "invading" plant, as it was called, drove out the original inhabitants because the invaders were better suited to the particular environment.[3]

When applied to human society and the neighborhood development patterns of urban areas, in particular, this model held that different groups of people "infiltrated" and "invaded" territory held by others, and that through a process of "competition" -- which was a kind of war of survival -- the group most suited to that environment would win out and eventually take over completely. Neighborhoods and communities, therefore, were seen not so much as conscious man-made environments, but rather as natural phenomena subject to the laws "of all nature."

As the level of industrial technology in the society advanced, certain areas were seen as best suited to that level of technology, and thus become the location of the most successful businesses and residents. Areas less suited to advanced technology become inhabited by the businesses and residents least suited for survival at that state in the evolution of society and technology. Thus, areas, neighborhoods and communities were identified as going through natural life-cycles where they grow to a point of success, but then as the technology of the society develops and favors different locations, the community is invaded and taken over by lower uses and lower class people in continuing waves of invasion, competition and succession.

There are temporary plateaus of stability when the area is occupied by a homogeneous population or land use, analogous to a single species of plant taking over its most beneficial location. When this homogeneity is interrupted by the "invasion" of a different type of land use, property or class of persons, however, this starts the downward cycle. According to the literature based on the human ecology model, therefore, the process continues until the area reaches its inevitable place as a slum.

Race and the Models of Decline

Robert Park's own statement about the Eastern Europeans then occupying Chicago's slums best expresses the Darwinistic, and discriminatory biases of this human ecology model of neighborhood dynamics:

> In the great city of the poor, the vicious and the delinquent, crushed together in an unhealthful and contagious intimacy, breed in and in, soul and body, so that it has often occurred to me that those long generations of the Jukes and The Tribes of Ishmael would not show such a persistent and distressing uniformity of vice, crime, and poverty unless they were peculiarly fit for the environment in which they are condemned to exist.[4]

At the same time, a colleague of Park's, Homer Hoyt, was working on real estate models of land values. In an historical analysis of land values in Chicago, Hoyt included a discussion of race and land values. He surveyed some local realtors (members of the Chicago Real Estate Board, which prohibited members from selling to a Black on a White block). One West Side realtor gave him a list of ethnic groups ranked in descending order, from those which are most desirable to those which have the most adverse effect on property values.

The list was as follows:[5]

1. English, Germans, Scotch, Irish, Scandanavians
2. North Italians
3. Bohemians or Czechs
4. Poles

5. Lithuanians
6. Greeks
7. Russians, Jews (Lower Class)
8. South Italians
9. Negroes
10. Mexicans

McMichael's Appraising Manual, often called the Bible of appraising, is a commonly used appraisal text which was first published in 1931. Appraisers were then advised to determine whether there were "undesirable racial elements" in an area.[6] The 1951 edition responds to a Supreme Court decision striking down racially restrictive covenants by saying it created "further confusion to appraising properties in foreign and Negro-occupied districts." The text then praises Hoyt's study of land values in Chicago and reproduces his ranking of ethnic groups and their effect on property values. Following this there is a discussion of how the "ingress" of certain ethnic groups precedes blight.[7] The most recent edition of the text (1975) still contains Hoyt's list![8]

This orientation is superimposed on a work which Hoyt did for the FHA in 1939, The Structure and Growth of Residential Neighborhoods in American Cities.[9] In this book, Hoyt defines what has come to be known as the "filtering" or "trickle-down" model of neighborhood decline. This model suggests that as properties and neighborhoods get older, they filter down into the hands of poorer and less capable people until they finally become slums. This filtering concept, which transforms the human ecology model into real estate terms, has been the basis for various models of the life cycle of neighborhoods in later real estate and appraisal literature.

Although Hoyt is considered the founder of the filtering model, Frederick Babcock, who gained his real estate experience while working in Chicago during the time the Chicago School of Sociology was developing, implied such a filtering concept in his influential 1932 book, The Valuation of Real Estate. After describing six characteristics of neighborhood decline, Babcock states:

> The process can be described as inevitable in all residential districts. Given time, all such areas become decadent districts or slums occupied by the poorest, most incompetent, and least desirable groups in the city. Ragged urchins play on marquetry floors.

Two pages later he comments:

> Most of the variations and differences between people are slight and value declines are, as a result, gradual. But there is one difference in people, namely race, which can result in a very rapid decline. Usually such declines can be partially avoided by segregation and this device has always been in common usage in the South where white and Negro populations have been separated.[10]

The first edition of the American Institute of Real Estate Appraisers' (AIREA) text, published in 1935, echoes Park, Hoyt and Babcock by warning of the adverse effects of the "infiltration of inharmonious racial groups." The text suggests that areas can be protected from these adverse effects by deed restrictions "which forbid whites to sell their homes to blacks."

Accompanying his testimony before a HUD meeting on Redlining in July of 1976, Walter Winius of the American Institute of Real Estate Appraisers submitted 21 articles which have appeared in the Institute's "Appraisal Journal" since 1938. "The Journal" does not represent the official position of the Institute, but was described as "A Forum for the presentation of new ideas and concepts having to do with the appraisal of real estate, many of which have ultimately appeared in our textbooks." He explained that an article in 1959 by Charles Abrams "issued a clarion call in respect to the analysis of neighborhoods." That article suggested that there had been a bias against integrated neighborhoods and against blacks, and that this bias was unwarranted. Winius cited several articles published prior to 1967 which demonstrated, using statistical studies, that racial change had no adverse effect on property values.[12] <u>Nevertheless, in the 1967 edition of the Institute's basic text, THE APPRAISAL OF REAL ESTATE, the chapter on Neighborhood Analysis reads</u>:

> The value levels in a residential neighborhood are influenced more by the social characteristics of its present and prospective occupants than by any other factor. Therefore, the appraiser must give major consideration to the importance of social data.
>
> The causes of racial and religious conflicts are not the appraiser's responsibility.

> However, he must recognize the fact that values change when people who are different from those presently occupying an area advance into and infiltrate a neighborhood.[13] (Emphasis ours.)

The Student Outline used in a 1973 session of the Institute's basic course reads:

> Ethnological information also is significant to real estate analysis. As a general rule, homogeneity of the population contributes to stability of real estate values. Information on the percentage of native born whites, foreign whites, and non-white population is important, and the changes in this composition has a significance. As a general rule, minority groups are found at the bottom of the socio-economic ladder, and problems associated with minority group segments of the population can hinder community growth. Similar comments are appropriate for occupational types in a community.[14] (Emphasis ours.)

In a slide show on single-family appraising shown during that course, the scene of a burned out store was accompanied by the words: "...One exceptional factor which may affect value is the influx of inharmonious social or racial groups."[15]

Recent Changes in the Use of Ethnicity in Appraising and Underwriting

In the past few years, there have been several attempts made by appraisal and underwriting organizations to eliminate clear references to the relationship between changes in ethnicity and property values. The most recent text of the American Institute of Real Estate Appraisers

(1973) is purged of the language in the 1967 version which mentioned racial change as a threat to values in a neighborhood.[16] In addition, they introduced in 1976 a set of sample questions and answers on race and property values to be used by their instructors to answer student questions on the subject. These answers also deny that race necessarily effects property values.[17]

The savings and loan industry is the largest originator of home loans, making more than 50 percent of all such mortgages. The Federal Home Loan Bank Board (FHLBB) directly regulates federally chartered savings and loan associations; and through its Federal Savings and Loan Insurance Corporation (FSLIC) indirectly regulates the practices of most state chartered savings and loans.

In 1974, an opinion from the General Counsel for the FHLBB stated that consideration of the ethnic composition of the area where a loan is to be made is a violation of Civil Rights Law.[18] Moreover, later regulations adopted by the FHLBB state:

> The use of lending standards which have no economic basis and which are discriminatory in effect is a violation of law even in the absence of an actual intent to discriminate. However, a standard which has a discriminatory effect is not necessarily improper if its use achieves a sound business purpose which cannot be achieved by means which are not discriminatory in effect or less discriminatory in effect.
>
> Refusal to lend in a particular area solely because of the age of the homes or the income level in a neighborhood may be discriminatory in effect since minority group persons are more

> likely to purchase used housing and to live in low-income neighborhoods. The racial composition of the neighborhood where the loan is to be made is always an improper underwriting consideration.[19] (Emphasis ours.)

The U. S. League of Savings Associations is the trade organization of the savings and loan industry. Among the functions which this organization performs is the training of lenders seeking advancement in the industry. For years the organization has trained its members on the use of its own recommended appraisal form, known as the "Green Hornet " (Residential Appraisal Form 17-PRA). One of the items on this form asked for the "ethnic composition" of the area. The appraiser -- either a staff member of the S & L, or a contract appraiser -- was to check off either "stable" or "unstable" conditions.

In response to the 1974 opinion of the General Counsel of the FHLBB, this form was changed to replace ethnic information with data on "sales velocity." In the League's underwriting text, the wording surrounding the copy of the Green Hornet form was not changed. In addition, the League's 1975 text, Lending Principles and Practices, states that racial change, even fear of racial change, is identified with increased volume of sales -- thus linking sales velocity to ethnic change.[20]

Definition of Stable Neighborhoods

These changes have deleted direct statements that racial change leads to declining communities. The definition of a neighborhood as relatively homogeneous, however, remains. Both the 1967, and the recent(1973) editions of the AIREA text defines a neighborhood as "a homogeneous grouping of individuals, buildings or business enterprises within, or as part of, a larger community."[21] Both versions go on to say:

> Residential neighborhoods assume many of the characteristics of the individuals who live in them. These neighborhoods express the mutual desires of people with comparable interests, related traditions, and similar social and economic status.[22]

The notion that a neighborhood should be homogeneous in order to remain stable or to increase in value is reinforced by what appraisers and underwriters call the principle of conformity. The American Institute of Real Estate Appraisers states that "the principle of conformity holds that maximum value is realized when a degree of sociological and economic homogeneity is present."[23] The manual of the Society of Real Estate Appraisers (SREA) presents eight aspects of the principle of conformity:

1. Similar types of houses.
2. Houses of similar utility.
3. Similar age and size of houses.
4. Similar quality of houses.
5. Similar price range of houses.

> 6. Residents' income in the same general bracket.
> 7. Residents of similar cultural, education, ethnic and social backgrounds. (Emphasis ours.)
> 8. Similar land uses.[24]

The AIREA, in their most recent text, claims that it is "the appraiser's minimum task to analyze the neighborhood in accordance" with the seven principle factors which they claim are advantageous to a neighborhood. One of these factors is "a homogeneous population with a sense of civic responsibility."[25]

Thus while overt references to the adverse effects of racial change on property values have been expunged from recent texts and appraisal forms, the appraiser is left with definitions of stable and desirable neighborhoods which rely heavily on the notions of homogeneity and conformity. The recent version of the AIREA's text removed explicit statements about religious and racial factors but replaces it with this vague statement:

> No matter how attractive a particular neighborhood may be, it does not possess maximum desirability unless it is occupied by people who are reasonably congenial. This imples a community of interest based upon common social or cultural backgrounds. Above all, home purchasers with children usually desire the best advantages that they can afford: and this includes compatible families as neighbors.[26]

It appears that a uniform statement that racial change harms neighborhood values has been replaced by a new position leaving this decision up to the individual appraiser, guided by the neighborhood definition of homogeneity and the principle of conformity.

The Cycle of Decline Model

The belief that neighborhoods inevitably, or at least typically, pass through a life cycle of birth and death has been extracted from the work of Park and Hoyt and placed at the core of the professional appraisal and underwriting wisdom on neighborhood risk analysis. The model has permeated not only real estate literature, but popular beliefs as well. Nonetheless, surprisingly little research has been done on the causes of decline and improvement since Park first introduced the theory in the 1920's based on his analogy to plant behavior.

To test the theory, a study would have to test all the possible causes of decline against each other over a large number of different communities across the country. Such a study would have to be continually repeated to insure that as time passed and the environment changed, the causes of decline didn't also change. All of these studies would have to favor a single model or set of causes in order to justify the acceptance of the model. Among the things which would have to be taken into account as causes of decline or improvement would be not only age and racial change (as is the case with the model used in underwriting texts), but also the individual market behavior of the residents, the actions of government bodies, the impacts of lending decisions on the viability of the neighborhood economy, external conditions such as the state of the regional and national economy, the rate and location of new development, and finally, the interrelationships among all of these factors.

No such study exists! What exists are some fragmented, often conflicting, studies of these individual factors. Most research is based on one, or a small group of communities in one location at one point in time.[27]

Most contemporary descriptions of life cycle models were designed to describe how heavily blighted or abandoned areas progressed to this state.[28] Obviously such areas declined from an earlier and healthier condition. These models can, and do, break down this decline into several stages. There is no indication in such studies, however, that all communities should be expected to pass through these cycles.

The most recent, and most popular, example of life cycle models was published by HUD in 1976. This model is called The Dynamics of Neighborhood Change, and was produced by Public Affairs Counseling -- a division of the Chicago-based Real Estate Research Corporation.[29] The model is based on literature existing before 1974 and not on any new research in the area. The bibliography shows that many of the major disinvestment studies in existence at the time were not included.[30] Much of the literature cited are personal case studies from members of the appraisal and underwriting industry.

The model describes neighborhood decay in terms of these five stages: Healthy, Incipient Decline, Clearly Declining, Accelerating Decline and Abandoned. The model does not claim that decline is inevitable once it begins, as did Babcock. However, the model is based on the existing real estate literature, and reflects many of the racial considerations we have examined.

A "healthy" neighborhood is described by a series of physical, social and economic characteristics. One of those characteristics is "moderate to upper income levels," and another is, "Ethnic homogeneity."[31] As a neighborhood moves into "incipient decline," it is seen as reaching a critical point, since spontaneous recovery from a later stage of decline is seen as extremely difficult.[32] Two of the characteristics which describe a move into the stage of "incipient decline" are listed as "aging housing stock," and "influx of middle income minorities." In the "clearly declining," stage "decrease in white in-movers" and "more minority children in schools"[33] are listed as two characteristics.

The document identifies even the perception of racial change as a factor which might accelerate the process of decline. It reads:

> What is important is how fast the neighborhood declines...First, the cause of the original softening is important. If, for instance, the cause was racial change in neighborhoods some distance away and the intervening neighborhoods are similarly changing, then the rate of decline may increase rapidly. Turnover may shoot up and the neighborhood may move from 'incipient decline' to 'clearly declining' very quickly.[34]

Although there is a lack of evidence in support of such models, they are clearly stated as facts in the appraisal and underwriting professions. For example, the most recent text of the SREA reads:

> All neighborhodds exhibit a life cycle which varies only in the intensity and duration of each phase. The phases are:
>
> (1) <u>Development and Growth</u>. This is the period during which prices are increasing, and the neighborhood is built up.
>
> (2) <u>Stability</u>. This period may last from approximately the 10th to 15th year of the life of the neighborhood, perhaps through its 40th year. This is generally the period of highest value and attractiveness of the neighborhood.
>
> (3) <u>Transition and Decline</u>. This occurs as the attractions of the neighborhood are offset by those of new, competitive areas. The properties become functionally obsolescent, as does the pattern of the neighborhood. New uses begin to move in, and transition frequently results in lower values.
>
> (4) <u>Renewal and Rehabilitation</u>. In some instances, it is possible to renew and revive a neighborhood. Examples may be found in nearly every city: e.g., Old Town in Chicago, and Society Hill in Philadelphia.[35]

Homogeneity, Conformity, and Mortgage Risks

In spite of the emphasis which appraisers and underwriters have placed on the need for homogeneity and conformity of land uses, building types, styles of construction and social characteristics of the residents and aside from some studies of race and property values, there are not studies which systematically compare homogeneous and heterogeneous communities to assess the risk posed by lack of conformity and uniformity. These notions were based on the Human Ecology model derived from analogies to plant behavior.

Though there have been no systematic studies, there is some indication that mixed land uses and building types may actually be beneficial. A major study carried out for HUD tried to estimate the optimum land mix best suited for environmental impacts. This study, The Costs of Sprawl, cited a high degree of mix between commercial, industrial, low-rise and high-rise development as the most beneficial. Moreover, while underwriters have been looking critically at mixed use patterns in older communities, they have viewed the development of the Planned Unit Development (PUD) concept for new development as a sound, even risk reducing, technique. One of the basic tenets of the PUD is that the developer is allowed to mix land uses and combine single-family, multi-family and commercial or industrial uses within the same development area. By not depending upon one particular style of building or one particular market, the developer is supposed to minimize the risk of failure in the project and maximize the development of socially and economically sound communities.

Risks Posed by Race and Racial Change

1. Property Values and Racial Change

An analysis of the major studies on property values and race reveals that in all but one of the studies, property value trends either increased or remained about the same after racial change.[36] In the one study which documents that prices did not rise after racial change -- "Racial Succession and Changing Property Values in Residential Chicago" -- the author notes that values were declining prior to Black entry.[37] Seven of the studies which considered the socio-economic factors of the incoming blacks, indicated that the blacks had either a higher class level or a higher income level than the whites who already lived in the area.[38] Finally, there are two studies of racially changing areas in Chicago which arrive at different conclusions about racial change and property values.[39]

The existing studies of property values and racial change do not take account of the effects of disinvestment. There are some areas where racial change has taken place and where property values have declined, or risen at rates lower than in comparable white areas. One would expect that disinvestment, once it takes place, would eventually effect property values. There is one study which examined both disinvestment and property values.

A detailed study of disinvestment in Northwest Philadelphia compared similar communities, one which changed racially and one which did not.[40] The area which changed racially actually showed increases in family income, level of education and employment status compared to the area which did not change. The study traced both the level of conventional mortgages and the property values in the two areas. Generally, property values rose more in the racially changing area <u>prior</u> to heavy disinvestment by conventional lenders. <u>After</u> several years of disinvestment, property values in the racially changing area slowed and increased at a lower rate than properties in the all white area.

2. <u>Studies of Mortgage Default and Foreclosure</u>

There are a number of studies of factors which predict default and foreclosure. Most of the studies were carried out in the 1960's, during a period of unusually high foreclosure rates throughout the lending industry. Most focused on FHA and VA loans and paid little attention to the factors associated with conventional loans. Since 1970, several more studies have been done, but most of them, like the earlier studies, have serious methodological problems, such as poor and biased samples; exclusion of several factors believed to be important in delinquency and foreclosures; lack of data on a neighborhood level; and lack of attention to explaining the causes of the statistical relationships presented.[41]

Most of the studies suggested that delinquencies and foreclosures were related to factors representing the individual characteristics of the borrower, the conditions of the loan, or the condition of the property.[42] Of the three studies which suggest that neighborhood factors do influence delinquency and foreclosure rates, two of these studies were carried out in the Pittsburgh area.[43]

The one study which was not carried out in Pittsburgh was done by FNMA.[44] It covered only two FHA low-income programs, and used zip codes as the basic unit of analysis. It did not consider the individual loan characteristics which previous studies had found to correlate with mortgage risk. While there were some correlations with neighborhood (actually zip code) characteristics, they were not strong and race was not one of these factors. Interestingly, this study showed that the level of indictments for illegal use of federal housing programs was one of the most important predictors of foreclosure in one program.[45]

A Pittsburgh study found that no neighborhood characteristics were associated with both delinquency and foreclosure, and that only high neighborhood unemployment was associated with foreclosure.[46] All the neighborhood factors together could explain only twelve percent of the delinquency levels and nine percent of the levels of foreclosures on the loans studied.

A second Pittsburgh study by George von Furstenberg and Jeffrey Green represents the most detailed study of neighborhood characteristics and delinquency in mortgage payments.[47] The study found no conclusive relationships. It could not identify any clear relationship between racial characteristics of an area and delinquency rates. The study did find a relationship between the age of the mortgaged property and delinquency, but this was not consistent with an earlier, more extensive, study made by vonFurstenberg alone.[48] The von Furstenberg and Green study suffers from the fact that all the loans studied came from one lender, and do not represent the general market, or even all of Pittsburgh.

The most recent study of mortgage risks was produced by Andrew Brimmer for the U.S. League of Savings Associations.[49] It was published in April of 1977. This report attempts to separate risk from racial discrimination. It concludes that inner city, minority communities represent higher risks. However, the study was not based on any <u>new</u> research. The conclusions were based on an earlier study from the FHLBB which showed that minority-owned S&L's did not perform as well as white owned S & L's.[50]

The study had no data on the actual location or conditions of any loans made by any of the white or minority S & L's, but simply assumed that the white S & L's loaned in white areas and that the minority institutions loaned in inner-city, minority areas. The FHLBB study of minority institutions was not intended to evaluate the lending risks in any area. Like most other such studies, it draws attention to the lack of management expertise -- not lending risks -- as the major cause of low performance by minority institutions. Thus, this study is of limited value since its findings are based on the unfounded assumption that certain minority institutions did not perform well because they were lending in minority neighborhoods.

There are several examples of sound lending opportunities in older, minority, racially changing communities for lenders who ignore the conventional wisdom of decline and risk. At HUD's meeting on discrimination in mortgage lending, held in Hartford in 1974, Robert Gnaizda, a public interest lawyer, presented a study which showed how the largest savings and loans in California had redlined the Mission District of San Francisco. Then he indicated that a minority-owned institution, formed in the last two years, had placed 88% of its loans in the Mission District with not one current delinquency, default or foreclosure.[51] In testimony before HUD's Philadelphia Meeting on Redlining in 1976, James Vitarello of the Washington, D. C. Residential Mortgage Investment Commission, gave an example of another minority-owned institution in Washington (Independent Federal Savings and Loan Association) which has 89% of its loans in the City of Washington. It has no defaults on any of these loans.[52]

In the South Shore community of Chicago, which had been defined as being "clearly declining," a local group of investors bought out the bank which was trying to move out of the area because the racial change and alleged decline had made it impossible for them to survive. The new owners set out to make the bank a vehicle for community development. They have reversed the bank's losses and turned larger profits each year. Last year alone, the bank made 52 home loans in its community. It has only two defaults and no foreclosures on these loans.[53]

In Philadelphia there is a program by several of the commercial and mutual savings banks to revise their underwriting practices in order to include older neighborhoods. The new underwriting criteria permit conventional lending in any block which does not have more than ten percent of the properties abandoned and vacant. Even if the abandonment rate is higher, conventional loans will be made if there is evidence of community activity to put the block back on its feet.[54]

In spite of what many lenders consider these excessively liberal definitions of a sound neighborhood, the delinquency rate for the Philadelphia Plan has been as low or lower than for mortgages in the suburban areas around Philadelphia.[55]

Conclusion

The purpose of this paper has been to describe the training literature of appraisers as a means of better understanding the extent to which built-in biases about the desirability of racially and economically homogeneous communities influence risk analysis. The review should not be taken as a condemnation of appraisers and underwriters, but rather as an attempt to understand how professional training has contributed to the biases that many of them have against lending in older, minority, racially changing, low-income and mixed use neighborhoods.

Many of the underwriting practices used to estimate risk are based on general assumptions of the negative effects of race, age, mixed use and community life cycle. These assumptions seem to have little or no basis in fact -- especially when applied as universal principles. They do not inform us about the actual risks in older, racially changing, minority or mixed use communities. It is not immediately evident what the actual risks in lending in such communities are. What is clear is that the existing rule of thumb methods for judging that risk are not valid or reliable. The actual analysis of risk in a neighborhood must be based on information from that specific community and not on a study conducted in another community, in another state and at some other point in time.

One of the problems which faces those who realize that the old assumptions are not valid is that underwriters have used them for so long that they have not developed data bases of actual measures of risk for the communities they serve. Accordingly, underwriters are not trained to define and recognize what are legitimate indicators of risk.

This lack of sophistication in doing risk analysis is a general problem, and does not apply simply to older communities. The reliance on assumptions that new developments were sound investments due to their being the first of the growth stages in the life cycle of a community have led to massive investments in suburban residential and commercial developments by banks and savings and loan associations. The financial crises and shaky financial status of several of the nation's largest banks, and several savings and loan associations, has not been due to risks involved in lending in older, racially changing, or minority communities. Rather it has been due, in part, to the <u>unanticipated</u> risks involved in speculation in some resort areas, suburban and large-scale commercial developments.

This suggests -- as the Grzywinski quote at the beginning implies -- that lenders must undertake risk analysis on a case-by-case basis, and discard broad generalities and arbitrary rules of thumb. <u>Lenders have a legitimate concern</u>

about protecting their investment in case of foreclosure. They must be able -- especially in the early years of a loan before substantial equity has been built up -- to recoup not only their investment in properties, but also the ancillary costs associated with foreclosure. In order to do this, they must be reasonably certain that the value of the property always exceeds the value of the loan on that property. This requires that they do careful, but individualized, appraisal and underwriting in advance.

Appraisal and underwriting training and techniques will continue to be the subject of close public scrutiny until consumers feel that their access to credit, and their housing choices, are not being artificially limited by outmoded methods of doing risk analysis.

Footnotes

[1] Hilbert Fefferman, "The Redlining of Neighborhoods by Mortgage Lending Institutions and What Can Be Done About It," Redlining: A Special Report by FNMA (Washington: Federal National Mortgage Association, January, 1976), p. 28.

[2] Banks and savings and loan associations often sell the mortgages they originate to institutions in what is called the secondary mortgage market. The largest of these institutions are government agencies - the Government National Mortgage Association (GNMA) - or are government regulated - the Federal National Mortgage Association (FNMA) and the Federal Home Loan Mortgage Corporation (FHLMC). These institutions are also required to appraise the properties securing the mortgages they intend to purchase.

[3] The first complete presentation of these concepts appears in Robert E. Park, Ernest W. Burgess and Roderick McKenzie, The City (Chicago: University of Chicago Press, 1925).

[4] Robert E. Park, The City, p. 45

[5] Homer Hoyt, One Hundred Years of Land Values in Chicago (Chicago: The University of Chicago Press, 1933), p. 316.

[6] Stanley McMichael, McMichael's Appraising Manual (Fourth Edition; Englewood Cliffs: Prentice-Hall, 1951), pp. 156 and 161.

[7] Stanley McMichael, McMichael's Appraising Manual (Fourth Edition; Englewood Cliffs: Prentice-Hall, 1951), pp. 156 and 161.

[8] Stanley McMichael, McMichael's Appraising Manual (Sixth Edition; Englewood Cliffs: Prentice-Hall, 1975).

9 Homer Hoyt, The Structure and Growth of Residential Neighborhoods in American Cities (Washington, D. C.: Federal Housing Administration, 1939).

10 Frederick Babcock, The Valuation of Real Estate (New York: McGraw Hill Book Company, 1932), pp. 89 and 91.

11 American Institute of Real Estate Appraisers, Real Estate Appraisal (Chicago: 1935), Text no. 9, p. 10.

12 Statement of Walter Winius before: Office of Fair Housing and Equal Opportunity, U. S. Department of Housing and Urban Development, Administrative Meeting on Redlining and Disinvestment as a Discriminatory Practice in Residential Mortgage Loans (July 14-16, 1976 in Philadelphia) Transcript of July 14, pp. 14-15.

13 American Institute of Real Estate Appraisers, The Appraisal of Real Estate (Chicago: American Institute of Real Estate Appraisers, 1967), p. 90.

14 American Institute of Real Estate Appraisers, Student Outline - Course 1-A - Real Estate Appraisal (Chicago: American Institute of Real Estate Appraisers, 1973), p. 166.

15 Slide show presented in "Course 1-A - Appraisal of Real Estate" taught by the American Institute of Real Estate Appraisers (Chicago, Illinois, November 6, 1973).

16 American Institute of Real Estate Appraisers, The Appraisal of Real Estate (Chicago: American Institute of Real Estate Appraisers, 1973).

17 Statement of Walter Winius (supra. note 12).

18 Opinion from the FHLBB General Counsel to the FHLBB Office of Housing and Urban Affairs (March 21, 1974).

19 12 C. F. R. 531.8(b) and 531.8(c).

20 See U.S. League of Savings Associations, "Residential Appraisal Form (17-PRA) and Lending Principles and Practices (Chicago: U. S. League of Savings Associations, 1975), p. 67.

21 American Institute of Real Estate Appraisers, The Appraisal of Real Estate, Fifth Edition (1967), p. 82 and Sixth Edition (1973), p. 88.

22 Ibid.

23 Ibid., Sixth Edition, p. 40.

24 Society of Real Estate Appraisers, An Introduction to Appraising Real Property (Chicago: Society of Real Estate Appraisers, 1975), p. 6-11.

25 American Institute of Real Estate Appraisers, The Appraisal of Real Estate, Sixth Edition, p. 99.

26 Ibid., p. 96. See also Plaintiff's Response to the First Set of Interrogatories of the Defendant American Institute of Real Estate Appraisers, filed by the U.S. Department of Justice in the case of U. S. v. American Institute of Real Estate Appraisers, et.al., C. A. No. 76 C 1448 (N.D. Illinois, 1976) for a detailed history of how direct statements about the adverse effects of racial change on property values were gradually replaced with more subtle references to "homogeneity" and "congeniality" in the professional appraisal literature.

27 For example, William Grisby (Housing Markets and Public Policy. Philadelphia: University of Pennsylvania Press, 1963) studied filtering in one Philadelphia neighborhood only - yet his work is widely used as a major restatement of the filtering model applying to all neighborhoods; George Sternlieb and Robert Burchell studied small multi-family properties in Newark and concluded that property decline was largely a result of low demand - and that this decline created significant risks to a lender (Residential Abandonment: The Tenement Landlord Revisited. New Brunswick: Center for Policy Research, 1973); while Frederick Case studied inner city lending in nine cities

and concluded that there were opportunities for sound lending, but that lenders were not taking advantage of them (Inner City Housing and Private Enterprise. New York: Praeger, 1972).

28
Most recent models of decline are modifications of: National Urban League and the Center for Community Change, The National Survey of Housing Abandonment (New York: April, 1971).

29
Public Affairs Counseling, The Dynamics of Neighborhood Change (Washington, D. C., U. S. Department of Housing and Urban Development, 1975). This model was based on previous work on abandonment done by Real Estate Research Corporation for HUD.

30
For example, not included were two studies which have set the tone of much later work on redlining and disinvestment studies: Northwest Community Housing Association, Mortgage Disinvestment in Northwest Philadelphia (Philadelphia, 1973) and Home Ownership Development Program, City of Baltimore, Home Ownership and the Baltimore Mortgage Market (Baltimore: City of Baltimore, 1973).

31
Public Affairs Counseling, The Dynamics of Neighborhood Change, p. 20 - Figure 2: "The Neighborhood Change Process."

32
Ibid., pp. 11-19.

33
Ibid., p. 20 - Figure 2.

34
Ibid., p. 18.

35
Society of Real Estate Appraisers, An Introduction to Appraising Real Property, p. 6-16.

36
See Calvin Bradford and Dennis Marino, Redlining and Disinvestment as a Discriminatory Practice in Residential Mortgage Loans (Washington, D. C.: U. S. Department of Housing and Urban Development, Office of Fair Housing and Equal Opportunity, 1977) section entitled "Evidence

Relating Racial Factors to Mortgage Risk" and the annotated bibliography for a summary and listing of the major studies on race and property values.

37
Frederick E. Schietinger, "Racial Succession and Changing Property Values in Residential Chicago," Urban Sociology, E. Burgess and D. Bogue, eds. (Chicago: University of Chicago Press, 1964), pp. 86-89.

38
Thomas Gilette, "A Study of the Effects of Negro Invasion on Real Estate Value," The American Journal of Economics and Sociology, Volume 15 (January, 1957), pp. 151-162; Erdman Palmore, "Integration and Property Values," Phylon, Volume 27 (Spring, 1966), pp. 15-19; Erdman Palmore and John Howe, "Residential Integration and Property Values," Social Problems, Volume 10 (Summer, 1962); Chester Hunt, "Integrated Housing In Kalamazoo," Research Report on Integrated Housing in Kalamazoo (Kalamazoo, Michigan: Upjohn Institute for Community Research, 1959), pp. 3-25; Chicago Urban League, Housing Costs in the Black Submarket of Chicago: A Reassessment of the Filtering Model (Chicago: Chicago Urban League, 1977); Luigi Laurenti, "Effects of Nonwhite Purchases on Market Prices of Residences," The Appraisal Journal, Volume 20 (July, 1952), pp. 314-329; and Luigi Laurenti, Property Values and Race (Berkeley: University of California Press, 1960).

39
Brian Berry, "Ghetto Expansion and Single-Family Housing Prices: Chicago, 1968-1972," Journal of Urban Economics, Volume 3, Number 4 (October, 1976) sees values declining while the Chicago Urban League (supra. note 38) sees values increasing with racial change.

40
Northwest Community Housing Association, Mortgage Disinvestment in Northwest Philadelphia (supra. note 30).

41
See Kerry Vandell, Barbara S. Hodas and Rachel Bratt, Financial Institutions and Neighborhood Decline: A Review of the Literature (a report prepared for the Federal Home Loan Bank Board by the Joint Center for Urban Studies at Harvard-MIT, under the direction of Arthur P. Solomon, November 1974) and Calvin Bradford and Dennis Marino (supra. note 36) for detailed reviews of the literature on mortgage risks.

[42] *Ibid.*, Vandell *et al*, pp. 72-75 and 89-93, and Bradford *and Marino*, pp. 81-88 and 148-153.

[43] George von Furstenberg and Jeffrey Green, "The Effect of Income and Race on the Quality of Home Mortgages: A Case for Pittsburgh," George von Furstenberg, Ann R. Horowitz and Bennet Harrison, eds. *Patterns of Racial Discrimination, Volume I: Housing* (Lexington: Lexington Books, 1974) and Alex Williams, William Beranek and James Kenkel, "Factors Affecting Mortgage Credit Risk in Urban Areas - A Pittsburgh Prototpye Analysis," presented at the American Real Estate and Urban Economics Association Meeting, December 29, 1973.

[44] Federal National Mortgage Association, Office of Economic Anlysis, *Estimation of the Socio-Economic Determinants of Foreclosures on 221(d)2 and 235 Mortgages* (Washington, D. C.: 1974).

[45] Section 221(d)2.

[46] Williams, *et*. *al* (*supra*. note 43).

[47] Von Furstenberg and Green (Supra. note 43).

[48] The complete summary of the four articles which von Furstenberg wrote from this earlier study can be found in: George von Furstenberg, *Technical Studies of Mortgage Default Risk: An Analysis of the Experience with FHA and VA Home Loans During the Decade 1957-1966* (Ithaca, New York: Center for Urban Development Research - Cornell University, 1971).

[49] Brimmer and Company, Inc., *Risk vs. Discrimination in the Expansion of Urban Mortgage Lending* (Chicago: U.S. League of Savings Associations, April, 1977).

[50] William D. Bradford, "The Viability and Performance of Minority Controlled Savings and Loan Associations," Research Working Paper No. 62, prepared for the Office of Economic Research, Federal Home Loan Bank Board (1975).

[51] Statement of Robert Gnaizda before: Office of Fair Housing and Equal Opportunity, U. S. Department of Housing and Urban Development, Administrative Meeting on Discrimination in the Financing of Housing (May 20-21, 1974 in Hartford, Connecticut), Transcript of May 21, pp. 260-261.

[52] Statement of James Vitarello before: Office of Fair Housing nad Equal Opportunity, Administrative Meeting on Redlining and Disinvestment (supra. note 12), July 15, pp. 215-216.

[53] Judith Barnard, "Money Matters," Chicago Magazine (February, 1977).

[54] Dennis Marino, The Philadelphia Mortgage Plan (Chicago, Illinois: Woodstock Institute, July, 1977).

[55] Ibid.