LEVERAGING HOUSING INVESTMENTS WITH LINKED DEPOSITS: THE EAST HUMBOLDT PARK MORTGAGE LOAN PROGRAM

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During the late 1960's, the State of Illinois, followed by other states and municipalities around the country, began to develop procedures for depositing public funds in financial institutions to further public goals as well as to earn interest. These "linked deposit" programs were initially used by state treasurers to place deposits of public funds in banks to reward them for lending for programs which met certain public needs. Included were loans which financed educational, health and other public facilities, or which provided financing for business, housing or student loan insurance programs.

These linked deposit programs served as incentives for further lending by providing institutions with lendable funds, sometimes at below market interest rates. The justification for the state government to accept lower interest rates was that, in addition to helping meet public policy objectives, increased lending would result in "multiplier effects" generating increased state tax revenues. The banks would benefit from their increased deposits by being better able to meet particular credit needs, by increased earnings due to a greater volume of lending, and by improved public image as a responsive lender.

A further refinement of this concept was one which linked public deposits to a specific lending program. In Illinois, the State Treasurer's Specific Opportunity Program was designed to assist banks in their community-oriented loan activities such as construction financing for local public works projects and emergency loan programs providing for relief after natural disasters such as floods and droughts. This program provides a commitment of public funds before the loans are made, rather than rewarding past lending behavior.

Public deposits are just one of the mechanisms which are currently being explored to help make housing more affordable to families with modest incomes. As the costs of purchase, rehabilitation and construction of housing in urban neighborhoods become greater, and the federal resources provided to housing decrease, leveraging mechanisms are increasingly being sought which would both lower the interest costs and make additional funds available to construct, purchase or rehabilitate homes and apartment buildings. One such opportunity that exists is the use of public deposits at below market interest rates to increase mortgage lending in low- and moderate-income and minority urban neighborhoods.

Interest rates on mortgages must be reduced so that families with modest incomes who have been barred from owning homes in recent years can become homeowners and can contribute to the community stability so often associated with home ownership. While programs using public deposits cannot alone solve the problems of high housing costs, they can be one part of a solution to the problems of mortgage loan affordability and availablity. A recent experience with such a program is the one just completed in Chicago's East Humboldt Park.

East Humboldt Park Mortgage Loan Program

East Humboldt Park is a working class neighborhood which houses the nucleus of Chicago's Puerto Rican community. It is a neighborhood made up of brick and frame cottages, graystone and brick two- and three-flats, and larger three-story apartment buildings. While its housing stock is typical of Chicago's working class ethnic neighborhoods, East Humboldt Park is unlike many Chicago ethnic neighborhoods in that it has been visibly ravaged by arson, abandonment and demolition. Over the past decade, more than one-third of its housing stock has been lost.

In recent years, new threats have been added to the problems of this community. The eastern edge of East Humboldt Park has become the target of real estate speculation as young professionals and artists recognize the beauty of its architecture and its convenient location. National economic conditions have increased already high levels of unemployment and high interest rates and energy costs have led to disinvestment by building owners, accelerating the cycle of deterioration and abandonment.

In order to reverse the cycle of disinvestment in East Humboldt Park and to protect the current residents from displacement due to speculation and demolition, the Westtown Concerned Citizens Coalition (WCCC) began, in 1979, to examine the ways in which local residents could be assisted in becoming homeowners who would have a stake in maintaining their neighborhood. The WCCC, with the help of the Woodstock Institute, examined the Home Mortgage Disclosure Act data to identify where local banks and savings and loan associations were making mortgage loans. Armed with the information that Pioneer Bank, which received much local business, was not making mortgage loans in the neighborhood, the coalition arranged a meeting with the president of the bank. This meeting began discussions which resulted in the establishment of the East Humboldt Park Mortgage Loan Program.

After considering a number of alternatives, it was decided to pursue a linked-deposit strategy which linked deposits from the Illinois State Treasury with below market interest rate mortgages in East Humboldt Park. The partnership consisted of the Illinois State Treasurer, Pioneer Bank, which originated the mortgage loans, and two community-based organizations which marketed the program, screened the applicants and monitored compliance with the requirement that purchasers live in the homes.* The program was marketed to people already living in the community, but was available to anyone who agreed to live in the property purchased and could

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*A second program was offered in tandem by the city's Department of Housing to make low-interest deferred payment rehabilitation loans available to purchasers of property under the mortgage loan program. No loans, however, were made for rehabilitation. This was due, at least in part, to borrowers' fear of government red tape, program delays, and the consequences of a city building inspection.

meet the bank's normal loan underwriting criteria. Although most of the applicants were low- and modest-income families, there was no income requirement for program participation.

The State Treasurer already had both a basic allocation program in place which awarded state deposits to commercial banks as a reward for engaging in specific community-oriented loan activities and its Specific Opportunity Program, which made deposits for particular purposes. The Specific Opportunity Program, however, had not yet been used in inner-city neighborhoods and presented some problems for mortgage loans, as state monies could be committed for no longer than one year.

Lengthy discussions between the State Treasurer's office, the bank and the community resulted in an agreement between the parties. The State Treasurer deposited $1 million in Pioneer Bank on a reimbursement basis as the bank approved mortgages under the program. The reimbursement deposits would earn 7 1/2% interest for one year and were renewed for a second year at the same rate. As an incentive to Pioneer Bank to participate in the program, an additional $1 million of state money was deposited in the bank. The incentive deposits earned interest of 1% below prevailing rates and were deposited for a total of two years.

The bank made almost $1 million in mortgage loans in the community at 10% interest per year.* The bank used its normal underwriting standards for these loans, with the understanding that the lower-than-normal interest rates would make the housing affordable to community residents. While the state deposits remain in the bank for no more than two years, the mortgage interest rates are guaranteed for 10 years, and amortized over 25 years. Initially, some of the loans required a 20% downpayment and the remainder only a 10% downpayment. Private mortage insurance was purchased by the bank for each 10% downpayment loan and the borrower paid the 1/2% premium.

Two community organizations played a crucial role in this program. The Spanish Coalition for Housing, a HUD-certified counseling agency located within the neighborhood, screened all program applicants and accompanied them to the bank for their application interview. The purpose of the process was to save the bank staff time by discouraging ineligible applicants from applying, and to discourage real estate agencies involved in speculation or promoting gentrification in the neighborhood from using the program to their own ends. It also helped the applicants to feel more comfortable during the application interview at the bank.

The Westtown Concerned Citizens Coalition, the umbrella organization which initiated the talks which led to the program's development, assumed

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*When the program began, conventional interest rates were around 15%. At the end of the program, conventional rates had dropped to around 13%.

responsibility for marketing the program to area residents and monitoring program operation. It will continue to monitor compliance with the residency requirement after houses are occupied.

The first loans under this program were made in the spring of 1981. By the spring of 1982, however, the program had come to a halt with only 12 loans made and about $250,000 of the loan funds dispersed. The reasons for this were varied: a change in community organization leadership had left a gap with no individual responsible for the overall operation of the program; there were fears by some participants that the program was being abused by real estate speculators; the target area delineated for the program was too small; communication between the bank and the community groups had become strained; and perhaps most importantly, few neighborhood residents were able to afford a 20% downpayment. The partners went back to the bargaining table to try to remedy the problems with the program and to get it restarted.

After six months of meetings, a new agreement was executed and the program began again in October of 1982. A few key changes to the program were made: only a 10% downpayment was required on the mortgage loans, the program boundaries were expanded, and monthly meetings were held to ensure better communication among the participants. The results were gratifying -- within less than a year, 23 additional loans were made and all program funds were dispersed!

East Humboldt Park Mortgage Loan Program Results

The results of the mortgage loan program indicate that it was a success in providing homeownership opportunities to modest-income community residents. Loan amounts were small, and borrowers reflected the ethnic and racial composition of the neighborhood. Specifically, 72 applicants were referred to Pioneer Bank by the Spanish Coalition for Housing. Thirty-five loans were made, of which 26 borrowers were Hispanic, five were white and four were black. The average (mean) loan amount approved was $27,767, with a mean sale price of $31,706.* Purchase prices ranged from a high of $92,000 for a four-unit property to a low of $10,000. Only two program borrowers paid over $50,000 for their buildings.

Program results also indicate that the program and procedural amendments which went into effect in October of 1982 were productive: Between May 1981 and September 1982, a total of 12 loans was made. Between October 1982 and September 1983, a period of only one year, a total of 23 loans was made.

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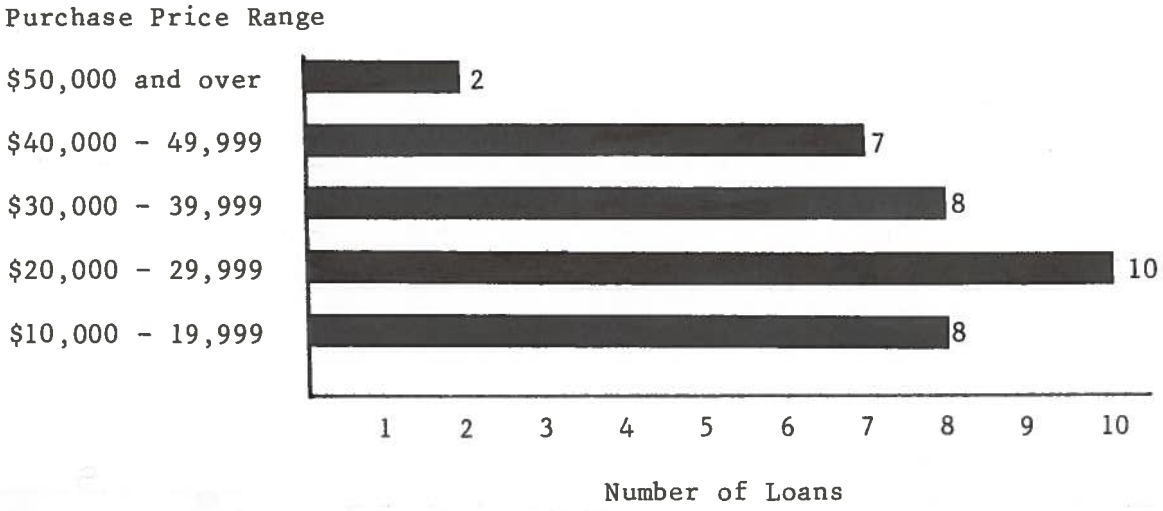
*This compares to an average metropolitan Chicago sales price of $73,937 for the first half of 1983.

Table I. Loan Characteristics by Ethnicity and Race

	All	Hispanic	White	Black
Number of Loans Approved	35	26	5	4
Median Income of Borrower	$20,724	$20,362	$21,204	$24,763
Median Purchase Price	$29,000	$25,000	$36,000	$41,500
Median Loan Amount	$25,650	$22,500	$32,400	$37,200

Figure 1. Loan Distribution by Purchase Price



These results indicate that a program such as this, which is geographically targeted and marketed, but which does not have income restrictions, can successfully reach a modest-income group. It also demonstrates the success of the technique. While the program was initially cumbersome to set up due to inexperience with the technique, loans were processed quickly and easily by the bank using its normal procedures, and there was little that had to be done by the State Treasurer's staff. The bulk of the program operation work was carried out by the community groups responsible for screening and marketing the program and by the loan officers of Pioneer Bank. The continuing financial responsibility falls on Pioneer Bank, which will hold and service the low-interest loans for the eight years in which they do not receive special linked deposits from the State Treasurer.

The benefits of the program were to the borrowers, who were able to purchase otherwise unaffordable homes, and to avoid the threat of future displacement; to the community, which now has an additional 35 homeowners to increase its stability; to Pioneer Bank, which improved its lending record in its community and established a working relationship with the community organizations; and to the people of the city and the state who indirectly benefit from stronger neighborhoods. This experience indicates that the technique of linking short-term public deposits with mid-term loans can successfully lower interest rates to a level where housing becomes affordable to lower-income people.

Conclusion

Linked depositing can be a simple, inexpensive, flexible, effective mechanism which state or local governments can use to help achieve specific community development or other public policy objectives. Linked deposits can be used to reward lenders that have done a good job of meeting particular credit needs, or can be used as incentives for involvement in specific lending programs. The deposits can earn market rates of return or can earn below market rates depending on the needs of the depositor and the nature of the program.*

A well-structured incentive deposit program, such as the East Humboldt Park Mortgage Loan Program, can benefit all the participating entities. The public depositor benefits by having its deposits accomplishing two things at once -- generating direct and indirect revenue and helping achieve its public policy objectives. The program need not involve more than a minimum of staff time after it has been established.

The lender benefits by having available a larger pool of lendable funds, by increasing its good will in the community, and by earning origination fees, rate spread, or other income from the program. After the program is set up, the costs above normal operating expenses for the program are minimal. The lender assumes little or no additional risk and is not asked to make imprudent loans. (Pioneer Bank assumed some future interest rate risk as it guaranteed the below market rates for ten years even though the below market rate deposits were available for only two years.)

The benefits to the community depend upon the nature of the program. Programs designed to increase investment in homes, apartments or businesses in a particular neighborhood can produce a variety of benefits. The

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*Linked deposits need not be restricted to the public sector. Any individual or organization with idle funds can deposit them in ways which achieve both social and financial objectives. Foundations, corporations, pension funds, religious institutions, and individuals can (and do) participate in linked deposit programs.

stability of the neighborhood can be increased, the commitments of the loan recipients to the neighborhood can be expanded, the quality of the housing stock improved, the confidence of other investors restored, jobs created, etc.

The experience of the East Humboldt Park Mortgage Loan Program suggests that an effective incentive deposit program needs several key ingredients or attributes. First, the program must be well structured with clear roles and expectations for all parties and effective mechanisms for monitoring the progress of the program and the performance of the participants. Effective lines of communication among the participants must be maintained.

Second, the program should be as simple as possible and should be as close to normal business practice as possible. In the East Humboldt Park Program, three of the four participants were responsible for doing what they already did with minor variations. The Westtown Concerned Citizens Coalition communicated with its constituency about the program, the Spanish Coalition for Housing conducted screening and counseling, the bank underwrote loans, and the State Treasurer authorized deposits. Only the Chicago Department of Housing attempted to carry out a complicated role which was not part of its normal activity. It attempted to underwrite rehabilitation loans. The only part of the program which did not work was the rehab loan component. Not one rehab loan was extended over the two and a half year life of the program.

Third, the program must be designed to be usable by the target group. If the target group is low- or moderate-income, sufficient subsidies must be available to make the program affordable. In East Humboldt Park, the subsidy came in the form of below market interest rate deposits. Other forms of subsidy such as reducing principle or interest with Community Development Block Grants can be used instead of (or in addition to) below market deposits. In addition, if the loans are to be made outside normal underwriting practices, risk-reducing mechanisms must be part of the program. In East Humboldt Park, private mortgage insurance was used to offset the additional risk incurred by Pioneer Bank when the depositor made a smaller than normal downpayment (less than 20%).

Fourth, it is essential that the community have a role in designing and monitoring the lending program. If the community, through a neighborhood organization, participates in shaping the program, the program is more likely to be responsive to the needs of the community. The chances of community acceptance will be greatly increased, and the risk of inadvertently damaging the community will be minimized. If neighborhood-based groups participate in the implementation, it can save the other parties time and money. Neighborhood group participation in the monitoring of the program can provide prompt notice of problems which may arise or of changing neighborhood needs.

Finally, in some cases, it may be necessary to have a knowledgeable outside participant in the design and monitoring of the program. This can be particularly important if some of the parties are relatively unknown to each other and the program is innovative. The East Humboldt Park Mortgage Loan Program would probably not have gotten off the ground if Woodstock Institute had not been involved. Its familiarity with the limits and possibilities of both banks and neighborhood groups helped overcome initial suspicions and shape effective, feasible roles for each. The Institute's knowledge of the State Treasurer's Special Opportunity Program and of risk-reduction mechanisms helped insure that the program would meet the needs of the target neighborhood. The Institute's continuous monitoring and evaluation of the program helped identify the problems when it was foundering and its ongoing assistance was essential to the redesign of the program which resulted in its ultimate success.

The successful completion of this experimental program indicates that broad use of linked deposits may well be one part of the solution to the problem of affordable housing for modest-income families. The full solution will require a range of public, private and philanthropic participants and of conventional loans, subsidies, insurance pools, and other programs combined. No one set of programs alone will meet every type of housing need. However, linked deposits have the potential to make a substantial contribution to such "combination" solutions by providing lendable funds to meet community development needs.

APPENDIX

REVISED

MEMORANDUM OF UNDERSTANDING

EAST HUMBOLDT PARK MORTGAGE LOAN PROGRAM

Based on a series of meetings held between the parties involved, the following revised memorandum of understanding has been prepared to address some of the problems that have arisen in the operation of the above referenced program. It represents the understanding among the parties of the tasks to be performed by each in the implementation of the program. This memorandum of understanding is divided into two sections. The first describes the Mortgage Loan Program for purchase only and the second describes the Purchase/Rehabilitation Loan Program. This memorandum of understanding will be in effect for a period of twelve months from the date of execution by all parties.

Mortgage Loan Program (Purchase Only)

Participants: State Treasurer's Office, Pioneer Bank, Spanish Coalition for Housing, Westtown Concerned Citizens Coalition

Amount: Up to $1 million in mortgage loans.

Mortgage Terms: 90% loan to value (10% down payment)
10% interest per year
Amortized on a 25 year schedule
Loan not repayable or interest rate renegotiable in less than 10 years.

Program Area: Area bounded by Armitage Avenue, Western Avenue, Augusta Boulevard and Homan Avenue.

Eligible Borrowers: Anyone purchasing a home for their own occupancy in the eligible area.

Eligible Buildings: Buildings with one to four units located in the eligible area.

State Treasurer's Role: The State Treasurer's office will deposit up to $1 million with Pioneer Bank on a reimbursement basis as the bank approves mortgages available under this program. Reimbursement deposits will earn 7½% interest for one year and upon maturity will be renewed for a second year at the same rate.

As an incentive to Pioneer Bank for their participation in the program, the State Treasurer's office will invest an additional $1 million at Pioneer in a one year time deposit earning interest at 1% less than prevailing market rates for one year certificates

of deposit. The Treasurer's office will make this incentive deposit at the bank's request any time subsequent to the initiation of the program. Upon maturity, this deposit will be renewed for a second year at the same rate or lower if market conditions dictate at the time of renewal.

In addition, Pioneer Bank will also be eligible for additional state deposits at prevailing rates subject to the normal investment procedures of the State Treasurer's office.

Pioneer Bank's Role:

Pioneer Bank will make up to $1 million of residential loans bearing interest at 10% and not requiring the payment of more than 2 points in the East Humboldt Park area of Chicago. The mortgage loans will be amortized on the basis of a 25 year schedule and the loans will not be repayable or the interest rate renegotiable in less than 10 years. All remaining loans will be made in amounts of 90% of the appraised value. These loans will be covered by private mortgage insurance. In addition, Pioneer Bank will prepare a monthly status report specifying:

- number of applications received
- number of mortgage loans made, amounts of loans and loan to value ratios
- number of rehab loans made, amounts of loans and loan to value ratios
- number of loans rejected and reasons
- status and dates of receipt of all outstanding loan applications
- total loans made to date - number and volume.

Pioneer Bank will send each month's report to all parties signing this agreement no later than the tenth day of the following month.

Spanish Coalition for Housing's Role:

Spanish Coalition for Housing will screen prospective borrowers for program eligibility and will provide counseling to them on financial aspects of home ownership. They will refer all eligible applicants to Pioneer Bank. No program loans will be made by Pioneer Bank to applicants who have not been referred by Spanish Coalition for Housing.

In addition, Spanish Coalition for Housing will prepare a monthly status report specifying:

- number of inquiries
- number forwarded to Pioneer Bank
- characteristics of clients forwarded
  - ethnicity
  - current residence

- current ownership status
- family size
- number of inquiries not forwarded and reasons.

Spanish Coalition for Housing will send each month's report to all parties signing this memorandum no later than the tenth day of the following month.

Westtown Concerned Citizen's Coalition's Role:

The Westtown Concerned Citizen's Coalition will be responsible for preparing a program marketing plan to ensure that residents of the program area and potential future residents of the area are aware of this special program. The Westtown Concerned Citizen's Coalition will also be responsible for coordinating this information/marketing activity, working closely with the Spanish Coalition for Housing.

Westtown Concerned Citizen's Coalition will prepare a monthly status report on their marketing activities which they will send to all parties signing this memorandum no later than the tenth day of the following month.

Finally, Westtown Concerned Citizen's Coalition will be responsible for closely monitoring the program's process and convening meetings of all participants if problems arise.

This agreement shall be in effect for twelve months from the date fully executed.

STATE TREASURER

_____ _____
By: (name) DATE

PIONEER BANK

_____ _____
By: (name) DATE

SPANISH COALITION FOR HOUSING

_____ _____
By: (name) DATE

WESTTOWN CONCERNED CITIZENS COALITION

_____ _____
By: (name) DATE

FACT SHEET
East Humboldt Park Loan Program

Mortgage Loan Program

Participants	Illinois State Treasurer, Pioneer Bank, Spanish Coalition for Housing, Westtown Concerned Citizens Coalition, Woodstock Institute.
Amount	Up to $1 million in mortgage loans.
Mortgage Terms	10% interest per year with 10% downpayment. Amortized on a 25-year schedule. Interest rate renegotiable after 10 years.
Program Area	Area bounded by Armitage Avenue, Western Avenue, Augusta Boulevard, and Homan Avenue.
Eligible Borrowers	Anyone purchasing a home for his or her own occupancy in the eligible area and able to meet the bank's underwriting standards.
Eligible Buildings	Buildings with one to four units located in the eligible area which meets the bank's underwriting standards.

Participants' Roles

State Treasurer	1) Deposited $1 million in Pioneer Bank for two years at an interest rate 1% below the prevailing rate as an incentive for Pioneer Bank to participate in the program. 2) Reimbursed Pioneer Bank for mortgages made under this program as they were made. Reimbursement deposits earned interest at 7 1/2% per year for two years.
Pioneer Bank	Made mortgage loans to borrowers using their normal underwriting standards.
Spanish Coalition for Housing	Screened prospective borrowers and accompanied applicants to Pioneer Bank.
Westtown Concerned Citizens Coalition	Initiated discussions leading to program design. Marketed the program to community residents. Convened monthly meetings to monitor progress and solve problems.
Woodstock Institute	Provided technical support to program design and implementation.

Program Results

The Borrowers	Thirty-five loans were made, 26 to Hispanics, 5 to whites, and four to blacks. Median income of the borrowers was $20,724.
The Loans	Median home purchase price was $29,000. Median loan amount was $25,650. Thirty-three loans were made for homes selling for $10,000-50,000; only two loans were made for homes costing more than $50,000.
The Community	Thirty-five new homeowners are expected to contribute significantly to neighborhood stability in East Humboldt Park.