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SUMMARY

The major criticisms of public employment programs under current legislation center on three related areas: maintenance of effort, the output of the programs, and the long-run benefits to those who participate in the programs. The chief criticism of the programs from the fiscal "conservative" viewpoint is indicated in the concluding section of a booklet published by the American Enterprise Institute:

The effect of public employment programs on unemployment and increasing of public services turns out to depend on the extent to which federal funds displace state and local funds. A review of the evidence suggests that in the long run 60 to 90 percent of the public employment program funds would merely displace state and local funds. . . . Apparently public employment programs add considerably fewer jobs than the nominal number of slots they fund.¹

The author then goes on to "concede" that displacement is somewhat smaller in "countercyclical programs" than in long-run programs. Without conceding the conservative argument—and the concrete evidence is not yet in—the use of the LIP model would significantly decrease the possibility of substituting federal for local tax dollars.

The success of the LIP program in Canada cannot automatically be duplicated in the United States. The advantages offered by the LIP model, however, can be replicated in the United States with the likely benefits outweighing the costs of altering the current structure of our countercyclical public jobs programs.

On the administrative side of the issue, the Canadian model offers a simple and workable substitute for the cumbersome methods of administration employed under CETA. The responsibility for justification of proposals is placed with the applicants, not with already overburdened public bureaucracies. The limitation on the size of the projects would make the monitoring process less complicated and would also allow for easy cancellation of projects not operating as designed. Further, the problems of ongoing funding and administration are eliminated under the LIP model since all projects must have an automatic termination date. Application or extension are considered along with any new proposals.

The Canadian model also avoids both the problems associated with civil service regulations and the choice of swelling the permanent bureaucracy.

Another side benefit of implementation of the LIP model is that the CETA operation, as presently in place, could concentrate its efforts in the areas of training, retraining and other programs specifically related to anti-poverty efforts. New legislation funding countercyclical programs separate from anti-poverty programs automatically eliminates the "gray" area now present and assures that each "type" of program is run with clear delineation of its goals.

As mentioned above, the maintenance of effort questions are also remedied since the project approach and the application procedures, if strictly adhered to, virtually assure that the positions will be net additions to the employment pool. This development may lead indirectly to more pressure from the states and localities for the Federal government to institute counter-cyclical revenue sharing. This too is desirable and necessary in the current economic climate.

Although the possibility of nepotism and cronyism still exists under the Canadian model, it would be lessened if clear specifications on target groups and eligibility were written into any amendments or new legislation. The Wiseman study demonstrates that there are many factors which must be taken into account in the selection of participants. Even in a strictly countercyclical program, the needs of applicants and their families should be considered.

The costs of the Canadian model would not be any more and would possibly be less per person hired than the present structure. We may find a decrease in administrative costs and even a lower average salary than the \$7,800 per year goal of CETA. The salary levels allowable under new legislation should be carefully considered so as to allow for incentive to return to "normal" work as soon as possible. Even if the target average wage were lowered to \$7,000 per year, this would still exceed the annual earnings of 20 million full-time American workers. On the other hand, the wages must be high enough to induce people to leave the unemployment insurance roles and desire participation in the programs. A wage somewhere in between the UI benefits and that of comparable work in private industry should be the target.

Since the LIP model would allow for public agencies to apply for grants, it would facilitate the added benefit of injecting some competition into the provision of public goods and services. If a neighborhood association can plan and operate a project more efficiently than a state or local government unit, they should be given the opportunity to do so.

LIP also facilitates projects which cross city, state and Prime Sponsor lines. At present this is not possible, save the very unusual circumstances of Prime Sponsor cooperation. The opportunity for special railroad or other regional projects would be possible.

There are few who question the efficacy of public jobs programs as an effective countercyclical tool, but many who justifiably criticize its current implementation. The majority of the problems in the present system of PJP's could be virtually eliminated with the adoption of the Canadian model. Serious attention must be given to the expansion of public jobs programs in general and to the adoption of the Canadian model in particular.

¹ Alan V. Miller, "Public Employment Programs," American Enterprise Institute, 1975.

CP#004 ATZ

ABSTRACT AND ANALYSIS OF
"AN EVALUATION OF THE
MASSACHUSETTS LOCAL INITIATIVE PROGRAM (MLIP)"

In September of 1976 the Massachusetts State Manpower Services Council and Abt Associates, Inc. of Cambridge, Massachusetts entered into a contract for the purpose of evaluating the Massachusetts Local Initiative Program (MLIP). As a result of over six months work, Abt Associates, Inc. has compiled a three volume final report: Volume I, which discusses Abt's findings and recommendations for MLIP as a whole; Volume II, which documents the project-by-project basis for their findings; and an Afterword, which presents the results of a follow-up study designed to determine the effects of MLIP on its participants' subsequent employment status.

The following abstract and analysis focuses on Volume I of Abt's report. An attempt has not been made to summarize or analyze Volume II because that volume is primarily a form of documentation for the findings and recommendations contained in Volume I. The significant conclusions and recommendations of the Afterword are included verbatim.

The purpose of this abstract and analysis, prepared by Massachusetts State Manpower Services Council staff, is two-fold: (1) to summarize the key findings and recommendations contained in Abt's extensive report, and (2) to analyze the findings; with particular emphasis on the interests of CETA Prime Sponsors and Department of Labor officials, especially relating to the project approach to public service employment (which is engendered in Title VI - Part B). It is the feeling of SMSC staff that many of the findings and recommendations in the evaluation study can assist Prime Sponsors in improving the planning, program development, and operations of their Title VI-B public service employment projects; and can be of use to the Department of Labor in their work in this regard.

However, this abstract and analysis is intended to supplement the full Abt report, not to replace it. The SMSC staff strongly encourages Prime Sponsor Directors, Planning Council members, key PSE staff, and Department of Labor officials to review the entire report.

The Massachusetts Local Initiative Program

Designed and administered by the State Manpower Services Council, MLIP had three basic program objectives:

- (1) To assist an individual or group to initiate a project which is meaningful to the community.
- (2) To provide a community with a good or service which in some way improves the quality of life and is presently needed but unavailable.
- (3) To offer productive employment to unemployed persons who are certified as eligible for participation in programs operating under the administrative framework of the Comprehensive Employment and Training Act of 1973.

MLIP planned to provide short-term jobs to approximately 279 unemployed or underemployed Massachusetts residents. "These persons were put to work on 26 projects all over the state. The projects provided a wide range of community services, including recreational activities for youth, restoration of historic buildings and community clean-up. Some projects had primarily long-term objectives, involving the establishment of cottage industries or new businesses. All but one of the projects were administered by local citizens' organizations or established community service organizations; only one project was administered by an agency of local government.

Project duration was generally six months, starting in July, 1976 and terminating by January, 1977. One project began in September and will end at the time this report is being written (end of March, 1977). The projects cost between \$25,000 and \$50,000 and employed an average of 11 persons each. A total of \$1,000,000 was made available for MLIP." These funds were provided out of the Governor's 4% Discretionary Fund under Title I of the Comprehensive Employment and Training Act of 1973 (CETA).

Major Findings and Recommendations

Note: The style for this section of the abstract and analysis will be to quote directly from the Abt report and then further analyze the finding or recommendation cited. The latter analysis will not appear in quotations, and will thus be distinguishable as the thoughts of State Manpower Services Council staff.

• Findings

"Overall, the MLIP program has been successful in achieving a major portion of its goals. The most dramatic achievements have been in the provision of community services. MLIP projects tried hard to achieve the objectives that were specified in their work statements, and 19 of 26 projects were very successful. These projects achieved either most or all of their community service objectives. What frustrated projects most often were the State's budget limitations, requirements or regulations which were unidentified prior to project start-up, and their own overly ambitious plans. This latter characteristic of the MLIP projects distinguishes them from typical, public service employment projects. MLIP projects also distinguished themselves by providing services which did not represent the mere continuation of existing programs."

"Part and parcel of the program's community service success was the achievement of productive employment for majority of MLIP employees. Although precise figures were difficult to calculate, we estimated that the program filled over 90% of its planned 279 job slots."

"More than half of these jobs were full-time over the course of the project, although projects which involved discrete phases of activity usually staggered their MLIP enrollment...Between 90 and 98.5 full-time equivalent years of work were provided, at a cost of about \$9,830 per worker-year."

Analysis

A key phrase here is "MLIP projects tried hard to achieve the objectives that were specified in their work statements..." Part of the MLIP program design was a requirement that program applicants clearly define the proposed objectives and accomplishments of their efforts, in as measurable a set of terms as possible. Having to get something done, within a fixed time frame, was an important factor in the projects' success (Abt cites this factor a number of times in the report).

As is noted above, certain requirements or regulations were unclear to, or unidentified by, project operators. Thus, it is important to have a project operator's manual (which MLIP did have) and regular communication between program administrators (probably Prime Sponsors and sub-grantees) and project operators, to uncover or clarify such problems. Later in the report Abt suggests that a general orientation, problem solving, and training session be held with project operators before projects are initiated. SMSC held such a session prior to MLIP, but would probably expand such an effort - and strongly concurs with Abt's suggestion in this regard.

MLIP project directors and workers were ambitious. MLIP offered productive employment, not "make-work." Again, a good part of this can be traced to allowing local groups and individuals to initiate their own programs, in response to a community need. The MLIP Request for Proposal was quite open ended and unstructured, allowing for a variety of local ideas and programming. Working toward a set end result or the accomplishment of a discrete task also added to the productive nature of the employment. ("Undoubtedly, the existence of concrete, quantitative project objectives also facilitated increased productivity. With specific objectives and a specified time frame in which to achieve these objectives, project directors were watchful of staff productivity. One indicator of this was the percentage of terminations due to lateness, absenteeism or poor performance. According to the State's data as of October, 1976, 14 or 31% of the programs' terminees had been fired for these reasons. Projects could not afford to allow individuals who came late, didn't show up or performed poorly to remain on the job for very long.")

• Finding

"When projects encountered difficulties, the one factor which usually operated to overcome these problems was the enthusiasm of the staff. Virtually all MLIP projects achieved some of their objectives, and the one factor mentioned most often in accounting for this was "staff enthusiasm." We attribute this not so much to the careful selection of staff as to the soundness of MLIP's concepts of "local initiative" and "projects," and the basic desire for work. In many MLIP projects, particularly those involving visible products, staff worked together as a team, developing rapport and commitment to their mutual efforts. On a number of occasions, individuals from the same town were acquainted with each other prior to MLIP, and this added to the "team" spirit."

Analysis

In many cases the MLIP employees coalesced around a project and had a "vested interest" in its success. There was a real spirit and feeling of "community" in many of the projects (Hampshire Canning Center, Kangaroo's Pouch, etc.). This was due to the fact that a group of unemployed community people were able to organize a project and do something constructive for their community, their "folks." It was often important that persons from the same neighborhood or community (Crown Hill/Worcester, South Middlesex/Framingham) or of like skills (crafts people), interests (canning), and cultural backgrounds (blacks, Indians, Spanish-speaking), were drawn together.

• Finding

"The MLIP program was a good demonstration of local initiative. A quick review of the project grantees--groups like the South Middlesex Community Center, the Wampanoag Tribal Council and the Worcester Tenants' Association--reveals the 'grass roots' nature of many of these projects. Local initiative was also evidenced by the extent of linkages sought with other community groups, the business community and the press. Indeed, projects frequently cited "community support" as a key factor contributing to project success. Projects sought donations of funding, materials and administrative and technical support. Project officials occasionally expressed disappointment with the results of their efforts, but the figures tell a different story. Collectively, these projects amassed \$151,886 worth of contributed time and materials."

Analysis

This finding is important for Title VI PSE projects for at least two reasons. It shows that labor intensive PSE projects (with the CETA regulation requiring at least 85% of the funds to be spent on wages and fringe benefits) can be augmented by locally donated dollars and items (equipment, supplies, etc.) if the project has "community support." Projects may also be able to locate other funding (Community Development Block Grants, Community Services Administration funds, etc.) to mix with CETA dollars, and to be used for labor or non-labor expenditures.

As well, this aspect of "community support" may bode well for the prospects of the project continuing after CETA funding, by attaining self-sufficiency or other funding. Community support would appear to be an essential ingredient for long-term existence of any local project.

Although this information indicates that many projects can locate other resources to augment their 15% of funds for non-labor expenditures, we feel that it is important to emphasize that as much of this remaining 15% as possible must be filtered to the projects. The use of this money for specially skilled non-CETA staff, equipment, supplies, etc. is often crucial to the real success of projects.

• Finding

"MLIP projects assisted the future job prospects of employees in several ways. The program increased the self-confidence of its employees, taught new skills and provided general work experience. A few projects helped their employees find jobs, and a few employees were able to make contacts during their MLIP employment which resulted in full or part-time job offers afterwards."

Analysis

Job development and placement was not an explicit goal of MLIP, and a formal job placement mechanism was not built into each project. Obviously, however, the program's designers and the project operators hoped to see as many participants as possible locate future, unsubsidized jobs. Perhaps Prime Sponsors will want to build a more formal job development and placement mechanism into their Title VI operations (a suggested approach here is to have existing Prime Sponsor staff provide such support, rather than build this capability into each individual project.

This aspect (the post-program status of MLIP participants) is summarized in a later two page attachment, direct from the Abt Afterword.

As the report states, the increased self-confidence, new skills, and general work experience gained by the employees has added to their future job prospects. The mere opportunity to work was of importance to MLIP participants. As is noted in an interim evaluation report by Abt: "Indeed, for a majority of employees the work experience itself has been one of the most valuable aspects of the job. The opportunity to work and to say that one has worked was very important to LIP employees."

In addition, many of the MLIP employees were able to work in their areas of interest and expertise (child care, theatre arts, sculpture, crafts education, canning of foods, etc.). Many of the areas cited are not traditionally areas of public service employment. These employees could point not only to the fact that they had worked, but to the fact that they had worked in an area they had been educated and/or trained for, or experienced and interested in.

• Finding

"Type of project activity, per se, did not have an overwhelming effect on project success or failure. However, certain obstacles were particularly troublesome to certain types of projects. For example, three out of the four clean-up and beautification projects had difficulty obtaining the large equipment needed for removal of debris. Commitments from city parks departments to lend trucks were not honored. Similarly, the number of homes which could be repaired by the home rehabilitation projects was constrained by CETA restrictions on the allowable income of the households. Moreover, all of the projects which involved either rehabilitation or restoration as a principal activity were constrained by their ability to hire skilled supervisors at the CETA-authorized wage levels. For example, the Worcester Tenants' Association omitted plumbing jobs from its plan when it couldn't find a master plumber who would work for \$192.30 a week. The early onset of cold weather was a problem encountered by almost half the projects, affecting all those projects which had components of rehabilitation, restoration, clean-up or outdoor performances."

Analysis

These are hints that can be applied quite readily to Title VI-B projects. The obstacles cited (donation of trucks, skilled crafts supervisors, etc.) should be considered for similar Title VI-B projects proposed in a Prime Sponsor area, in order to avoid potential failures or disappointments due to these factors.

It is interesting to note that the "type of project activity, per se, did not have an overwhelming effect on project success or failure". Certain projects may have a local priority (health, housing rehabilitation, recreation, etc.), and these priorities may be built into project review criteria, but the MLIP evaluation findings indicate that there is not a strong correlation between type of project and project success or failure.

- Finding

"Naturally, it was much easier for us to evaluate projects which specified hard outputs. We could determine the number of acres cleaned or homes rehabilitated compared to plan. It was less easy to evaluate projects which hoped to enhance cultural pride or to teach something. Frequently, these projects had not specified concrete outputs. We believe that teaching, planning or research projects should be required to specify concrete outputs, such as working papers or curriculum materials, in the future."

- Analysis

SMSC staff concurs with this recommendation. Teaching, planning or research projects should be given all due consideration in Title VI appropriations, but the specifying of concrete outputs should add to the success of such projects (as is indicated in earlier Abt MLIP findings).

Attached is a page from the Abt report, which although it repeats a number of the findings already noted herein; is an excellent summary of some very salient points. (Attachment 1)

- Finding

"The best projects, in terms of the achievement of planned community objectives, also evidenced better planning. The project director's experience and proclivity towards management also played a role in project success."

- Analysis

This finding, along with Abt's analysis, points to two basic considerations for Title VI-B projects or similar approaches to PSE: (1) perhaps a planning period should be incorporated into projects after a project director is hired (as Abt noted, many project directors were not involved in proposal development - thus there was often a slight adjustment of plans upon their hiring and a need for orientation of staff). Such a short planning period may be a valuable investment. (2) As Abt notes, selection of project managers should include a consideration of the management experience and capability of prospective candidates, as well as their "substantive" knowledge in a particular area.

- Finding

"Only a few projects had skill training components, and these were usually of short duration or sporadic over the course of the project. Consequently, other than the apparent improvement of interpersonal skills reported by some, skill development in other areas was limited."

Analysis

Again, skill training was not an explicit objective of MLIP. The primary emphasis was on public service employment and the work experience engendered in PSE. However, Prime Sponsors may want to build a stronger skill training component into their projects, or choose PSE projects which emphasize (and measure) skill development.

- Finding

"The balance sheet on MLIP indicates that it was a reasonable investment, returning a minimum of 24 cents on every dollar expended. This means that for the \$880,000 total expenditure on MLIP there were returns of almost \$210,000, leaving the net cost at only \$670,000. These returns came in the form of increased tax payments and saved welfare and UI payments. Transfer savings were the greatest, accounting for 66% of total returns. Savings due to FICA and UI were preeminent within this category, with other transfer and various tax returns accounting for about equal amounts of the total returns. About 42% of total returns accrued to Massachusetts State government, with 58% going back to the Federal government."

Analysis

As one can see, expenditures in the area of public service employment can result in savings in other areas of public outlays (and such calculations do not include the "human capital" developed and personal satisfaction felt by employees).

As Abt notes elsewhere in the report, these savings can be increased by focusing client eligibility on current recipients of unemployment insurance and/or public assistance payments (as the new Title VI does).

(Note: The MLIP eligibility guidelines required that persons be unemployed for at least 30 days or underemployed, or economically disadvantaged, and a Massachusetts resident. 89% of the MLIP employees were unemployed prior to the program.)

Detailed information on the characteristics of MLIP participants and their post-program status are included in Abt's report. Of particular note are summary charts on page 15 of Volume I and page 8 of the Afterword.

- Finding

"MLIP was unique in comparison to other programs by virtue of its administrative structure. In the history of public service employment programming, no other program has relied so heavily on "grass roots" initiative. All but one of 26 MLIP projects was administered, on a day-to-day basis, by local residents. Some of these individuals had no other affiliation prior to MLIP. Some were employed by local citizens' organizations. Only one project was administered by a department of local government. We feel that much of MLIP's success can be attributed to its utilization of local input."

Analysis

The "grass roots", local nature of MLIP has been mentioned a number of times. But it was such an important part of the program's success that it should be reiterated.

An MLIP type approach (focusing on local, "grass roots" organizations) may require more administrative support at the Prime Sponsor or subgrantee level. But, SMSC staff feel this investment in additional technical support returns many dividends in terms of project success and benefits to participants.

One final note on this subject from Abt: "We believe that the characteristics of "grassroots" input and "smallness" have contributed critically to the success of MLIP, and we would be skeptical of future program efforts which sought to deny these features. On the other hand, MLIP's limitations must be realized. It cannot be expected to have a major impact upon unemployment rates. This would almost inevitably require much larger projects and a different administrative structure. This, in turn, would take us back to earlier, larger-scale experiments whose problems are now familiar to us."

It is hoped that some of the insights gained from MLIP will help us avoid such "problems."

• Finding

"A complaint vocalized by many projects was that financial reimbursement procedures were slow. This was bad for morale and posed cash flow problems for some individuals. When umbrella agencies covered the pay checks, they had cash flow problems...One recommendation might be to consider alternative reimbursement procedures."

Analysis

MLIP allowed advances for the projects. However, the system of advance payments did not run smoothly (due to reporting difficulties and slowness of payments) and there were instances where projects had to borrow money to meet their payroll.

This may appear to be simply an administrative problem, which can be corrected quite easily. However, the system of payment that a Prime Sponsor or subgrantee is able to put in place will have a substantial affect on the types of organizations that apply for PSE project (Title VI-B, etc.) monies. For example, many community agencies, with limited financial resources and cash flow problems, do not have sufficient capital of their own to operate a program for a month or more and then be reimbursed for their expenditures (and as indicated by the MLIP evaluation, these are just the type of organizations which can be very successful in operating such programs).

Advance payments, or some other mechanism which allows speedier payments to projects (for example, having the payroll handled by the Prime Sponsor or subgrantee, rather than the project operator) would appear to be imperative for such organizations. Of course, reimbursement or advance systems that are developed would have to conform to the Prime Sponsor's financial requirements. A number of cities and towns do not normally allow advance payments to contractors - thus the possibility of waivers or other alternative approaches would have to be investigated.

• Finding

"The Chester Threads of History Project ran into a similar type of regulatory problem. One of the objectives of the project was to establish a cottage industry and market the quilts and other crafts made in the classrooms. After project inception, however, it was learned that project staff could not sell these products while still sponsored under MLIP. At least one other project with cottage industry hopes reported learning about the regulation after grant award."

"Abt staff were surprised to learn that few of these projects were thinking in terms of self-sufficiency. We believe that this is an objective which is very consistent with local initiative, and should be emphasized in future program endeavors."

Analysis

The SMSC staff wholeheartedly agrees with the Abt evaluators that self-sufficiency can/should be a part of such future program endeavors. However, there are many regulatory requirements/issues to be addressed in this regard. The whole issue of "program income" and income generation must be thought through and dealt with by federal, state and local officials. Manpower officials should investigate the possibility of utilizing CETA monies for economic development and the creation of unsubsidized jobs - without displacing other jobs and businesses. This is a very complex issue, which is currently being researched by SMSC staff.

The final page and one-half of the MLIP evaluation are worth repeating verbatim (they appear here on one page). Abt suggests some valuable recommendations for those interested in replicating or expanding on an MLIP-type approach. (Attachment 2)

The key "conclusions and recommendations" from the Abt Afterword, which discusses the effects of MLIP on participants' subsequent employment status, are included verbatim as Attachment 3.

ATTACHMENT 1

Some Findings Regarding Project Characteristics

- MLIP received 487 applications from which to select between 20-40 projects.
- 27 projects were selected; only one dropped out of the program.
- MLIP sponsored eight projects in the Balance-of-State area, seven projects in Boston and 11 projects located in five of the six remaining prime sponsor areas of the state.
- MLIP projects were sponsored by a variety of organizations, including incorporated citizen's action agencies, schools, clubs, societies, professional associations, units of local government, and individuals.
- Four of the 26 projects were sponsored by units of local government.*
- In eight of the 26 projects, the sponsor had little involvement in day-to-day project administration.
- The eight projects which relinquished their administrative role included three of the four projects sponsored by units of local government.
- There was no clear relationship between the separation of sponsorship and administration and either project operations or outputs.
- It was helpful to involve proposal authors in project start-up activities, a criteria which was sometimes not met in projects whose sponsorship and administration were separate.
- Project directors were usually chosen on the basis of substantial knowledge rather than administrative or managerial experience, a feature which frequently affected the smoothness of project operations.
- Bookkeeping staff were frequently unskilled and required great support.
- Type of project activity, per se, was not a key factor in project success or failure.
- Certain obstacles, such as weather, equipment availability, CETA restrictions and salary limitations were particularly troublesome to rehabilitation, restoration, and beautification projects.
- Teaching, research, and planning projects were less likely than other types of projects to specify concrete outputs.

*SMSC Note: although four were "sponsored" in such a way, only one project was administered on a day-to-day basis by an agency of local government.

ATTACHMENT 2

We have tried to highlight here some of our key findings regarding the MLIP program, and to explore some of the tradeoffs which may be involved in any decision to expand MLIP. Concrete recommendations about future project and program operations appear below. These recommendations deal primarily with suggestions or modifications which could improve MLIP in the future. The list is not long because MLIP has already done many things right.

- Clarify the CETA regulations which may apply to the projects in the initial program announcement
- Consider making "prospects for self-sufficiency" a criterion for project selection
- Select projects which appear to be well-planned; look for a schedule of tasks, specified outputs, and evidence that possible problems have been anticipated
- Select projects which appear to have made an effort to gain commitments for materials; the existence of on-going relationships with agencies promising materials might be a better indicator than a mere "letter of cooperation"
- Urge the selection of participants who are currently recipients of UI or public assistance payments
- Urge that the selection of project management be based not only on "substantive" knowledge, but also on experience and interest in management
- Conduct a workshop for state personnel; familiarize staff with CETA regulations and with the appropriate state role in program administration
- Conduct a workshop for project staff at the outset; provide practice in problem-solving and planning techniques
- Select projects which will not compete with each other for limited resources in a single community
- Allow projects to start-up on a more flexible time frame, so as to better match the project's plan of activity to the appropriate season
- Consider alternative reimbursement procedures, such as utilizing the Employment Service on a contract basis for fiscal review and reimbursement
- Alter the monitoring format so as to focus more on the substantive aspects of project operations
- Encourage more inter-project exchange of ideas, problems, etc. during the course of the program
- Consider expanding MLIP to allow for projects of greater size and duration in order to have a greater local employment impact
- Consider more flexible funding arrangements in future MLIP projects, so as to enable particularly innovative or important projects to attract needed skilled personnel
- Consider making public-service oriented firms, such as large utilities companies, eligible to administer special projects

5.0 CONCLUSIONS AND RECOMMENDATIONS

This study provided us with an opportunity to determine the status of MLIP participants in the program's aftermath. Overall, our conclusions are that MLIP had a positive effect on post-employment experience. Indeed, MLIP appeared to have a direct effect for almost one-quarter of all individuals currently employed. Even unemployed people continued to be positive about their MLIP experience.

We also believe that other factors help explain the 38% rate of post-MLIP employment, as well as the continued high rate (53%) of unemployment. Most prominent among them might be local labor market conditions.

We believe that there are certain aspects of MLIP which contribute to the satisfaction expressed and the rate of people transitioning into unsubsidized, private sector employment. These features include: the program's short-term duration, its primary utilization of local organizations rather than already overburdened and possibly overemployed local governments, and its "task" orientation. These features made the experience more like a "private sector" job, without the rigid work practices and competition sometimes associated with private sector employment. In addition, the jobs provided useful services for the communities in which employees resided, and as such provided an additional source of satisfaction. If a primary goal is to maximize transition into unsubsidized, private sector employment, we believe these program aspects should be retained in future program implementation efforts.

We might also suggest that either a job development component be built into the program, or that greater linkages with the private sector be created in project planning and implementation. This might facilitate an even higher percentage of placements. If the program attempts to reach more "hard-core" disadvantaged persons in the future, these recommendations might prove especially important.

Decisions about the type of projects to be funded cannot be easily prescribed. Teaching and training type projects register high degrees of job satisfaction, but do not necessarily yield higher rates of positive transition than other project types. This seems to be more

a function of a complex of factors, including the peculiarities of a project's design, (e.g. Kangaroo's Pouch was designed to provide future employment to those trained under its auspices), local labor market conditions and individuals' skill levels.

If a program like MLIP is to demonstrate cost savings, it will be necessary to clearly ascertain its effect on the rate of unemployment compensation. In the short run, MLIP appeared to create a pool of newly eligible unemployment insurance recipients. Will these people still be collecting unemployment insurance a few months from now? A list of ways to reduce or avoid this impact should be generated and discussed.

Finally, on a more global level we would recommend that states or other units of government interested in sponsoring similar temporary job creation programs conduct evaluations. Neither of the other two states which operated LIP-like programs did this, so corroboratory information concerning costs, transition into private sector employment, etc., is not available. This information is important if the MLIP experiment is to be enlarged in the future.

INTRODUCTION

The CETA Job Creation program is designed to create permanent job opportunities for unemployed members of local communities through the creation of self-sustaining non-profit enterprises. Local CETA Prime Sponsors will allocate funds from Title VI of the Comprehensive Employment and Training Act of 1973 (CETA) to enterprises sponsored by eligible community-based organizations, community action agencies, community development corporations, or individuals. CETA funds will be used as wage subsidies to help defray the start-up costs of an enterprise; funds for capital investment must be obtained from other public and private sources. Establishing enterprises may be one way to provide long-term jobs for the community as well as training opportunities for the participants.

The passage of CETA in 1973 marked a new era in public service employment programs. CETA tried to combine the goals of reducing structural unemployment through the provision of skill training and/or subsidized, transitional employment and relying on local initiative to define spending priorities. The Department of Labor makes grants to about 400 Prime Sponsors who design and execute their own programs according to federal guidelines.

Title VI was added to CETA in 1974 in response to the recession. It was aimed at providing transitional public service employment opportunities for the disadvantaged and temporarily disadvantaged. Its underlying assumption was that the economy would improve after a year and private sector jobs would once more be available. In fact, however, unemployment rates have remained high and Title VI has been refunded annually; this temporary holding mechanism is becoming a permanent approach to the unemployment problem. The apparent ineffectiveness of this and other CETA programs in reducing the unemployment rate has been a source of dissatisfaction among Massachusetts agencies involved in em-

plovment programs. This concern has led to proposals for new uses of CETA funds to make a direct connection between public spending and permanent job opportunities. Two such proposals are the Massachusetts Local Initiative Program and the CETA Job Creation Program.

In 1976 the Massachusetts Local Initiative Program (MLIP), inspired by the Canadian attempt to solve similar problems, was sponsored by the State Manpower Service Council (SMSC). One of its objectives was similar to the traditional public service employment programs of CETA--to offer short-term productive employment to CETA-eligible persons. However, MLIP had two additional objective that carried the notion of local initiative even farther. One objective was to assist individuals or groups in initiating projects meaningful to the community. The second was to provide the community with a good or service which in some way improved the quality of life and was presently needed but unavailable. Such projects as craft guilds, craft marketing, day care centers, recreational activities for youth, restoration of historic buildings, community clean-ups, tenant associations, residential improvement programs, fisheries, and food cooperative were funded on a six-month basis. The funds came from a discretionary budget allocated to state governors under Title I of CETA. Projects were chosen according to the extent to which they provided, among other things, a product, training, or a service which was lacking in the community, the extent to which they served disadvantage groups, and the extent to which they utilized other funding sources.

Although MLIP was short-term, the SMSC's intention was to distinguish employment provided under MLIP from the isolated, agency job slots often characteristic of other public service employment programs. Thus, productive MLIP employment was to involve work proposed and performed by individuals or

groups in the community. Such work could have future value to the individual; however, MLIP was designed as a short-term job creation program that did not necessarily have any long-run impacts.

The CETA Job Creation Program is based on a similar notion--that community-based and -created projects are more likely to be beneficial to both workers and the community than are traditional isolated job-slots. In addition, however, the Job Creation Program attempts to create permanent job opportunities. Most other CETA programs provide only temporary employment or training with the assumption that private sector jobs will be available for CETA "graduates". Such jobs, however, often do not exist due to both cyclical downturns in the economy and structural problems (which are particularly severe in Massachusetts). Also, discrimination against women and minorities often prevents them from moving into jobs in the private sector. Although the latest CETA legislative revision has reoriented much of Title VI funds from job slots to project-oriented employment, the projects are still only short-term. It is important to note that CETA Job Creation is not a legislative change; rather it is an administrative attempt to more effectively use CETA funds.

By combining public and private resources, Title VI has the potential to provide self-sustaining jobs. Resources in addition to the CETA wage subsidy will be used to furnish tools and equipment useful in teaching workers new skills. The result may be higher levels of productivity than was previously feasible with MLIP projects that were funded solely with wage subsidies. Increased productivity, in turn, may lead to increased project revenues, higher wages, and self-supporting activities. Examples of MLIP projects which have potential as long-term enterprises are craft guilds, food cooperative, and canneries.

It is important to note again the conditions which the CETA Job Creation Program is trying to fulfill and which will guide the type of enterprises to be funded. First, the program is aimed at severely disadvantaged and long-term unemployed workers. (Experienced managerial personnel can be paid from the ten per cent of CETA funds not restricted to wages and from enterprise income.) Second, CETA Job Creation is aimed at creating new opportunities for the unemployed while at the same time providing a good or service meaningful to the community or to the quality of life of its members. That is, the enterprise should have a public service objective. Third, projects must not displace currently employed workers. Fourth, new enterprises must be non-profit. Fifth, CETA funds will be provided for one year only.

The next section of this Handbook (Section II) provides a more detailed description of how the CETA Job Creation Program will work, how the above conditions affect which enterprises will be the most feasible, and some of the problems that may be encountered. Part Two explains how to evaluate a project applicant: Section III explores the employment impacts of an enterprise; Section IV describes the three components used to assess the potential for self-sufficiency--management, market analysis, and financial analysis; Section V discusses how to evaluate whether a project needs the CETA subsidy. An example of the type of project that may be suitable for the subsidy is presented in Appendix 1. This case study illustrates how the steps outlined in the text of the Handbook can be applied by the Prime Sponsors to evaluate project proposals. Finally, Appendix 2 lists sources of capital and technical assistance available to Program applicants.

II. How Will CETA Job Creation Work?

A. Goals

The CETA Job Creation Program has several goals, related to providing jobs for the unemployed and inducing local economic development. Because of the constraints outlined below inherent in the CETA regulations and the difficulty in starting a viable enterprise even under ideal conditions, it is unlikely that any enterprise will meet all of these goals. However, it is hoped that every CETA enterprise will be designed to achieve at least one of the purposes described in the following paragraphs.

The basic goal of the program is the creation of permanent, good jobs for the unemployed by developing self-sustaining enterprises. An example of such an enterprise is a housing rehab business which used its first (subsidized) year to accumulate equipment, train workers and build a reputation in the community, and by the second year became a viable enterprise, providing permanent jobs for its workers.

Since achievement of this goal may be extremely difficult, we present a secondary goal: the creation of enterprises which provide skill training and entrepreneurial experience for participants. Since Job Creation projects, unlike traditional CETA employment, must produce marketable goods or services, they have the potential to train participants in marketable skills; the projects can also give their workers valuable entrepreneurial experience. This training and experience is important for individual worker mobility as well as for community economic development. An example is the Hampshire Community Canning Center, a LIP project in which a few workers used the entrepreneurial experience gained by organizing and managing the cannery in developing additional projects to stimulate the local agricultural sector. If a project gives its participants

marketable skills and experience, it may be valuable even if the enterprise ultimately fails.

Another secondary goal of CETA Job Creation is the development of enterprises which will further stimulate the local economy. Small-scale projects are generally seen as having little potential for economic development. In small towns and rural areas, however, well-placed CETA Job Creation projects can have an impact by buying from and selling to established local enterprises. One example is the network of community enterprises begun as an offshoot of a Community Action Agency in northeastern Vermont; a home building project spurred the creation of a sawmill, which spawned a logging operation, and all three utilized CETA labor.¹

B. Problems in Achieving These Goals

Three components are needed to create a viable enterprise--good management, a marketable product or service, and adequate capital. Entrepreneurial and managerial ability are crucial because enterprise creation demands creativity, dedication and the ability to inspire confidence in others (especially the enterprise's creditors.) A marketable product or service is essential for an enterprise to operate without subsidy, and capital is a prerequisite for all enterprises to get off the ground, remain solvent, and expand.

These elements are difficult for any new enterprise to obtain, but they present special problems for CETA Job Creation enterprises because of constraints inherent in Title VI regulations.² These constraints include the following:

¹Boston University Institute of Employment Policy, "Locally Directed Economic Development: The Experience in Northern Vermont," December, 1976.

²The State Manpower Services Council of Massachusetts is currently awaiting interpretation of these regulations from the Department of Labor, and some may be waived or modified for the CETA Job Creation Program.

1. Projects must employ members of the target population (Massachusetts' residents are eligible if they have exhausted their unemployment insurance benefits but their claim has not expired, or if they are not eligible for unemployment insurance benefits for monetary or non-monetary reasons.). This poses potential problems in finding an entrepreneur and in capital acquisition. The target population may not have access to personal savings, which are an important source of equity for a new enterprise. Banks often require personal equity investment as a measure of entrepreneurial commitment to a project.

2. Projects must be non-profit and have a "public service objective". The public service objective requirement will limit the type of product or service that the enterprise can sell, and may consequently limit its viability because most goods and services with a clear public service objective are not marketable. The non-profit constraint may make it difficult to attract a good entrepreneur to the enterprise, for it requires finding people who will commit a tremendous amount of energy with little desire for monetary reward. It will also prevent the enterprise from attracting investment capital, and force it to rely on contributions for initial equity.

3. Projects must not displace currently employed workers. This limits the type of product or service that the enterprise can offer by virtually prohibiting competition with existing local businesses. It dictates the creation of enterprises which will meet a new demand or one inadequately met by existing local business.

4. Projects must use at least 90% of their Title VI funds for wages and fringe benefits. This means that the CETA subsidy will not provide start-up capital. The types of capital which are the most crucial and the most difficult for a new enterprise to obtain are equity and long-term debt; a subsidy earmarked for wages will not help the enterprise obtain either of these.

5. Projects must be completed within one year. According to current interpretation of the regulations, this means that an enterprise can receive a CETA subsidy for one year only.¹ This creates problems for viability, since virtually all new businesses take from two to five years to reach the break-even point.

C. What Types of Enterprises Will Work?

Given the constraints outlined above, are there any types of enterprises which may be able to succeed in attaining self-sufficiency, providing good, permanent jobs, offering worthwhile training and experience, and/or stimulating the local economy? The answer is a qualified yes. Each proposed enterprise must be critically evaluated in terms of its potential to meet these goals, but some generalizations can be made about types of enterprises which will have the greatest chance of success:

1. Small-scale enterprises--Because of their size and relative non-complexity, small-scale enterprises have the best chance of succeeding without an experienced, high-powered entrepreneur. They are also more likely to have a non-hierarchical organizational form and hence a high degree of worker commitment, which can substitute for certain entrepreneurial qualities.

2. Labor-intensive enterprises--Since the CETA subsidy is primarily a wage subsidy and obtaining other capital will be a major problem for CETA Job Creation projects, labor-intensive enterprises can make the best use of the subsidy. For a manufacturing firm requiring \$20,000 worth of equipment/worker, the major obstacle comes in finding start-up equipment capital; a wage subsidy will hardly make a dent in the start-up expense.

¹If, however, "project" can be defined as the start-up of the business, then in subsequent years expansion or continued operation of the same enterprise could be defined as a separate project and re-funded. We are awaiting Department of Labor clarification of this issue.

Any such industry which could succeed with a wage subsidy could probably also succeed without one. For a weatherization business requiring much less equipment/worker, however the CETA subsidy could make the difference between successful or unsuccessful start-up.

3. Collectively-organized enterprises--As mentioned in connection with small-scale enterprises, non-hierarchical organization often means more worker commitment, which can substitute in part for the lack of an experienced entrepreneur. This is especially true for an enterprise created by a group of people with strong personal motivation to make it work--in a sense, they share the role of entrepreneur. This was the case in the Mass-Craft Marketing Project, a successful LIP project. Collectively organized enterprises can also provide broader training for participants by encouraging both rotation of responsibilities and opportunities for self-management.

4. Enterprises producing a good or service which is needed in the community or for which a public agency provides a captive market--This assures the enterprise a market in spite of the public service and nondisplacement constraints. One example is the Wind-O-Seal enterprise started by the Lynn Economic Opportunity Agency, which markets its product to Community Action winterization programs throughout the state. Another example would be a community-sponsored child-care center in an area with no existing child-care facilities!

5. Enterprises providing innovative products which are not currently available in the marketplace--This addresses similar marketing problems to those mentioned under the previous point. It also has economic development ramifications, because if a new product developed in a town catches on, it has great potential for expansion within the town. Job Creation subsidies are not geared to high technology industries, but could be used for small-scale, experimental production such as wind power equipment, innovative agriculture (e.g. hydroponics), devices

for handicapped people, etc.

6. Enterprises which train people in difficult skills-- Because of the one year wage subsidy, the CETA Job Creation concept is especially well-suited to projects which require long training periods or high training costs. Although such enterprises might succeed without a subsidy, it allows them to hire and train members of the target population by providing a year-long period before workers must reach full productive capacity.

7. Enterprises linked to a community development corporation (CDC), community action program (CAO) or some other well-established organization--Such a connection provides the enterprise with technical assistance and administrative support to supplement its limited entrepreneurial experience. It can also confer legitimacy on the enterprise and help provide access to capital through non-profit, tax-exempt status in the case of a CAP, and through federal and foundation grants, etc. in the case of a CDC.

8. Enterprises which are linked to other community enterprises--As in the northern Vermont experience mentioned previously, community-based enterprises whose products are linked, e.g. they buy from and sell to one another, can reinforce each other and have a significant impact on a rural or small town economy. Economic links with other public enterprises help non-profit, community-based enterprises overcome the difficulties they encounter in an economy geared to private enterprise.

No enterprise will embody all of these characteristics. However, Prime Sponsors can seek out projects with some of these qualities by distributing information on CETA Job Creation to community groups representing segments of the target population. It is likely that substantial interest can be generated, particularly given the Success of the LIP program in which project initiative came from small community groups and individuals.

D. Pitfalls to Avoid

Title VI constraints make it difficult to design projects that will meet the goals of the CETA Job Creation program. Keeping the goals in mind, therefore, Prime Sponsors should be especially cautious of the following types of enterprises:

- Projects which will provide "bad jobs", displace local workers, or fail to employ the target population
- Enterprises which will take the subsidy and fail after a year
- Enterprises which do not need the subsidy

These last two issues are closely related, because many enterprises with potential for long-term survival will not really need the subsidy to start up, and many enterprises which need the subsidy to start up will not be viable when it is withdrawn.

The remainder of this handbook is oriented toward these three issues, and suggests how Prime Sponsors can evaluate proposed projects in terms of their employment impact (Section III), potential for viability (Section IV), and evidence of need for the subsidy (Section V). Such an evaluation is a particularly difficult task. While a project's employment impact is fairly straightforward, analyzing both viability and need for the subsidy requires some knowledge of finance and experience in business. This handbook provides a framework for such analysis and suggests questions for evaluating CETA Job Creation proposals, but it does not explain how to do a thorough analysis. It is strongly recommended that after screening projects for their employment impact, Prime Sponsors seek help from knowledgeable people in finance, business or public technical assistance services such as the Small Business Administration (SBA) or the Economic Development Administration (EDA) to evaluate viability and need for the subsidy.

It is especially important to avoid raising unrealistic

expectations for the CETA Job Creation program. Some enterprises can succeed, create permanent jobs, and possibly even stimulate the local economy. Other projects, even if they ultimately fail, will provide valuable training and experience. However, the program's constraints and the difficulty of starting new enterprises must be acknowledged and considered both by Prime Sponsors and the individuals and groups applying for a CETA subsidy.

REDLINING AND DISINVESTMENT CAUSES, CONSEQUENCES, AND PROPOSED REMEDIES*

by Frances E. Werner,** William M. Frej*** and David M. Madway****

I. INTRODUCTION

For decades, mortgage redlining has flourished unnoticed in urban America. Yet it was only five years ago that the victims themselves realized that irrational mortgage disinvestment was leading their communities inexorably into cycles of decay. And it was the victims, led by the West Side Coalition of Chicago and Gale Cincotta, who built grass roots organizations which finally focused national attention on the plight of disinvested neighborhoods and the consequences of redlining on the body politic. The process of decay continues, but the speed of governmental response has been glacial; to date, only a handful of federal, state and local legislative and regulatory schemes have been proffered in an attempt to halt redlining. The hearings for which this paper was prepared are significant because they offer an opportunity for HUD to assume a leadership role in prompting comprehensive executive branch action.

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** Attorney, Housing Section, National Housing and Economic Development Project, J.D. University of California, Berkeley, 1975. Member of California Bar.

*** Project Planner, Economic Development Section, National Housing and Economic Development Project, M.C.P., University of California, Berkeley, 1975.

**** Attorney, Housing Section, National Housing and Economic Development Project, J.D. University of Chicago, 1964. Member of New York and California Bars.

This paper describes redlining and its consequences and suggests a variety of remedial actions, all of which could be immediately implemented by the executive branch without further congressional action. The phenomenon and consequences of redlining are discussed in some detail in order to provide the federal agencies with a conceptual framework within which to fashion the most effective remedies. It is the authors' hope that the information elicited at the hearings will do more than simply add to the already well-documented concern about redlining, but instead will serve as a catalyst for change.

II. REDLINING AND ITS ROLE IN PHASES OF NEIGHBORHOOD DETERIORATION

The social and economic well-being of any community is dependent upon the availability of credit to finance the purchase, construction and rehabilitation of homes. The problems encountered in urban areas of obtaining affordable institutional mortgages and other loans for these activities have been an increasing concern for those cities suffering from neighborhood decay and housing abandonment. This process of decay is most apparent in an urban neighborhood's pattern of decline, which begins in an all-white residential community and proceeds through progressive stages of racial change and property exploitation until it resegregates as an all black or Latin community and dies as an abandoned wasteland.

Although many factors contribute to neighborhood deterioration, the decision by an area's lending institutions to extricate themselves from neighborhoods they predict will deteriorate is critical in this process of decay. This disinvestment decision reflects a loss of confidence in the community as a viable economic investment and has grave consequences for the neighborhood as well as for the city as a whole.

The principal tactic used in the disinvestment process is "redlining," a term used to describe the practice of refusing to loan money or invest in selected geographic areas. In addition to an outright refusal to invest in a neighborhood, redlining tactics may include a number of subtler actions:¹

1. These points are summarized in Agelasto and Listokin, *The Urban Financing Dilemma: Disinvestment-Redlining*, 800 EXCHANGE BIBLIOGRAPHY, 1-2 (1975).

- requiring down payments of a higher amount than that usually required for financing properties in other neighborhoods;

- fixing loan interest rates in amounts higher than for mortgages in other neighborhoods;

- fixing loan closing costs in amounts higher than for mortgages in other neighborhoods;

- fixing loan maturities below the number of years for mortgages in other neighborhoods;

- refusing to make loans below a minimum value (thus excluding many of the lower-priced properties found in redlined neighborhoods);

- refusing to make loans on properties below a minimum size;

- refusing to make loans on the basis of presumed economic obsolescence without regard to a property's actual condition;

- stalling on appraisals to discourage potential borrowers;

- appraising property below the actual market value (thus making purchase transactions more difficult to accomplish);

- applying structural appraisal standards of a much more rigid nature than used on comparable properties in other neighborhoods; and

- charging discount "points" as a way of discouraging financing.

Whether redlining occurs as a blatant refusal to extend credit or assumes a subtler form, the end result is the same: the deterioration and abandonment of neighborhood housing. For property owners, the inability to obtain financing has serious implications. First, the lack of new funds to finance the remodeling or rehabilitation of property accelerates the decline of an area. Second, since property owners (or potential owners) can secure mortgage money only by payment of a substantial premium, additional financial pressure is placed on them. This in turn impels them to increase the cash flow from the property by further subdividing or overcrowding it.

As a policy, redlining is defended on the grounds that investment in high risk areas is an unsound business practice equivalent to mismanagement of depositors' funds and is "ultimately counterproductive, both for the depositor and for the lending institution."² In practice, however, redlining is less of a protection against unnecessary financial risk than it is a selffulfilling prophecy of decline for the targeted neighborhoods. The decision to redline is based on a subjective assessment of the likely effects of such arbitrary criteria as the age of the housing stock, the racial and ethnic composition of the neighborhood, and the income levels of the residents. This assessment of a community as an economic risk is often made prior to any evidence of actual decline, and without reference to such factors as the residents' credit ratings, the actual condition of the housing stock and the viability of the community as a whole.³

2. NAPARSTEK and CINCOLLA, URBAN DISINVESTMENT: NEW IMPLICATIONS FOR COMMUNITY ORGANIZATION, RESEARCH AND PUBLIC POLICY, 8 (1975) [Hereinafter cited as NAPARSTEK and CINCOLLA].

3. *Id.*, p. 9.

As a consequence of the decision to redline, the funds required to maintain a neighborhood's health are withdrawn. The spectrum of this withdrawal ranges from the redirection of savings to the actual relocation of the depository institution from the inner city to the suburban ring. Take, for example, this situation in Chicago.

The following chart shows the net changes in Savings and Loan Association Home Offices for Chicago and Suburbs from 1960 through September 1974:

Location	Number of Associations	
	1960	September 1974
Chicago	158	89
Suburbs	131	145
Total	289	234

Chicago had a net loss of 69 associations' home offices during this 14-year period, while the suburbs had a net gain of 14 home offices.⁴

Disinvestment insures that decline will occur. Local depositors living in redlined areas find that their savings are directed to other areas of investment — often new suburbs — instead of being used for mortgage and home improvement loans for local use.⁵ One study of redlining practices in Chicago has shown that bank mortgages in many neighborhoods amounted in dollars to less than 1 percent of the savings the residents had deposited in the banks.⁶ Another study undertaken in Washington, D.C., found that almost 90 percent of the mortgage loans made by the city's savings and loan associations went to nearby Maryland and Virginia suburbs, even though an estimated 40 to 60 percent of their savings deposits had been collected in the District of Columbia.⁷ Thus, the residents of redlined neighborhoods are doubly victimized: not only do the banks insure their neighborhoods' gradual decline, but they also deprive the residents of the rightful use of their own savings.⁸

III. PHASES OF NEIGHBORHOOD DETERIORATION

Several studies of neighborhood decline have outlined six phases of deterioration which are initiated by the disinvestment decision:⁹

4. THE ROLE OF MORTGAGE LENDING PRACTICES IN OLDER URBAN NEIGHBORHOODS: INSTITUTIONAL LENDERS REGULATORY AGENCIES AND THEIR COMMUNITY IMPACTS, 338 (1974). [Hereinafter cited as MORTGAGE LENDING PRACTICES].

5. NAPARSTEK and CINCOLLA, *supra*, note 2.

6. *Hearings on S. 1281 Before the Sen. Comm. on Banking, Housing and Urban Affairs, To Improve Public Understanding of the Role of Depository Institutions in Home Financing*, 94th Cong., 1st Sess., 191 (1975). [Hereinafter cited as *S. 1281 Hearings*].

7. *Neighborhood Decay: Is Redlining a Factor?*, CONG. QUARTERLY, 1040 (May 17, 1975).

8. NAPARSTEK and CINCOLLA, *supra*, note 2 at 9.

9. *Id.* at 9-10; see also Frei, William M., *The Home Mortgage Disclosure Act of 1975: Combating Redlining for Neighborhood Reinvestment*, 1 ECONOMIC DEV. L. PROL. REP. 6, 11-13 (January-February 1976), *S. 1281 Hearings*, *supra*, note 6 at 562.

Phase I: The Healthy Community. The neighborhood is characterized by housing stock in excellent condition, thriving local businesses, good urban services, and ready access to conventional mortgages and home improvement loans from a multiplicity of lending institutions. Property values are stable or rising, and there is a strong demand for housing in the area.

Phase II: The Decision to Disinvest. Perceiving some "risk" of deterioration, pace-setting city-wide depository institutions and some local savings and loan associations set stringent loan requirements for the neighborhood and indicate a preference for granting loans in outer-ring suburbs and relatively new inner-ring communities. Although mortgages are still made available, their terms are generally harsh: high interest rates, excessive down payments (sometimes as high as 40 percent) and short loan life.

Phase III: Redlining. The neighborhood is explicitly selected for disinvestment. Lending institutions act more aggressively to channel money to other areas and refuse to make conventional loans on the basis that the risk of property devaluation is too high. Real estate appraisers employed by the financial institutions confirm the risk on the basis of subjective criteria. Residents of the neighborhood are unable to obtain home improvement loans, thus guaranteeing that the process of decline will occur as home repairs and improvements are left unattended. Potential buyers are told that loans are unavailable and are steered to other neighborhoods. As confidence in the neighborhood is undermined, businesses and financially mobile homeowners begin to relocate in other parts of the city.

Phase IV: The Rise of FHA Insured Mortgages. The financial institutions concur in the decision to redline the neighborhood, and FHA 100 percent insured loans become the only ones available. FHA mortgages hold virtually no risk for the investor and can be pooled and bought and sold through the Government National Mortgage Association and the Federal National Mortgage Association. Substantial "front-end" profits are made in commissions, brokers' fees, "points," and servicing fees. By levying a front end finance charge on loans, early foreclosure on a mortgage becomes profitable. In such cases, unsound loans and early foreclosures make money. Thus, it is to the profitable advantage of realtors, savings and loan associations, and mortgage bankers to turn over the neighborhood since once a house is sold, the profit is secured whether or not the buyers default or simply abandon their homes.¹⁰ Stuck with deteriorated housing at inflated prices and unable to finance both mortgage payments and needed repairs, homeowner defaults and abandonment proliferate.

Phase V: Neighborhood Decline. Insured FHA mortgages and absentee landlordism compound the loss of incentive for property maintenance. Unable to refinance and improve their properties, landlords resort to overcrowding and higher rents to maximize their profits in the short run. Eventually, real

estate can no longer be sold or refinanced, and deterioration spirals as maintenance declines. Businesses and property owners leave the neighborhood, trapping only the very poor in what has become a "blighted" area. City services decline, housing code enforcement collapses and building abandonment and crime accelerate. Home and property insurance become a memory.

Phase VI: Urban Renewal. Neighborhood deterioration has become cumulative, blighted areas are torn down, and residents are "relocated." The same financial institutions which denied loans in the redlined neighborhood now stand to profit from financing housing projects for higher income families and new commercial ventures. Where the redlined neighborhood borders on a still viable business district, it is to the latter's advantage to sponsor urban renewal as a means of creating spatial externalities through which new commercial development enhances the value of the old. With this end in mind, it is possible that the initial decision to redline a neighborhood is a conscious choice aimed at bringing about urban renewal and commercial expansion.

IV. FAILURE OF THE "FILTER DOWN" THEORY

Through those disinvestment practices in which local financial institutions invest their savings in other communities, the urban poor end up subsidizing suburban development where most new housing and employment opportunities are to be found. In turn, the residents of the disinvested neighborhoods are expected to benefit from the "filter down" process whereby the poor are expected to move into the housing vacated by the more economically and socially mobile. The filtering process is based on the assumption that housing naturally deteriorates and becomes less valuable with age, eventually filtering through the social structure until it becomes available to the poor.¹¹

In practice, this filtering process has never worked adequately.¹² In part, this has been due to the inability of the housing delivery systems in the U.S. to build adequate new housing to meet demand. Without a sufficient amount of new housing fed into the system from the top, the entire process collapses. Moreover, since blacks and other minorities tend to be concentrated in the lower income levels, they have difficulty in obtaining loans for other than relatively low cost housing; thus, even when housing is available, lower income urban residents find it difficult to obtain financing. These factors have a discriminatory effect on the city's residents, explaining why a disproportionate amount of minority housing is located in run-down and declining neighborhoods.

Of even greater significance is the fact that the filter down theory is based on the assumption of upward income mobility for the entire population. The poor, however, have

10. For a description of the ravages wrought by this process in Chicago, see Brown v. Lynn, 385 F.Supp. 986 (1974) and 392 F.Supp. 559 (N.D. Ill. 1975). See also, Hood and Kushner, *Real Estate Finance: The Discount Point System and Its Effect on Federally Insured Home Loans*, 4 U.MICH. C.L. REV. 1 (1971); Madway, *A Mortgage Lender's Primer*, 8 CLEARINGHOUSE REV. 168 (69), 231-257, 479-480 (1974).

11. Duncan, Hood, and Neet, *Redlining Practices, Racial Segregation, and Urban Decay: Neighborhood Housing Services as a Viable Alternative*, 7 URBAN LAWYER 515 (1975) [Hereinafter cited as Duncan, Hood and Neet].

12. For two excellent discussions of the filtering process, see HARVEY, *SOCIAL JUSTICE AND THE CITY*, 172-3 (1973), and Myers, *Housing Allowances, Submarket Relationships, and the Filtering Process*, 2 URBAN AFFAIRS QUART. 11, 218-225 (December 1975).

4. Housing abandonment is occurring (or has occurred) exclusively in racial transition areas, or in areas that have undergone transition from white to nonwhite sometime in the past.²³

5. Lower homeownership rates and fewer conventional mortgages in black neighborhoods imply a pattern of neglect for the black segment of the housing market.²⁴

6. Holding income constant, whites have a significantly higher level of homeownership than blacks, and as the percentage of blacks increases in an area, the level of homeownership decreases.²⁵

These phenomena indicate that disinvestment has a discriminatory effect on low income groups which, in turn, has a disproportionate impact on American minorities. Ultimately, redlining can result in a neighborhood's resegregation.²⁶

It is difficult to substantiate allegations that disinvestment is motivated by racial discrimination rather than economic forces due to the overlapping of these factors. Nevertheless, there is "ample evidence on the public record of discrimination in mortgage lending"²⁷ indicating an "immediate correlation between minority areas and redlining."²⁸

The results of a 1972 HUD survey reported that nearly 1,000 lending institutions (out of 15,000 respondents) admitted that the racial and ethnic composition of a neighborhood was a consideration in assessing loan applications.²⁹ Ninety-nine flatly admitted that they considered the race of the borrower and 415 confessed that they did not make loans in areas of minority concentration.³⁰

In 1974, the regulatory agencies conducted fair housing information surveys covering lending institutions in 18 Standard Metropolitan Statistical Areas (SMSAs) in order to determine whether the supervised lending institutions were practicing discrimination in mortgage lending.³¹ These surveys collected information concerning approximately 105,000 mortgage applications. The results indicate sharp disparities in the rejection rates of white and nonwhite applicants, substantiating allegations that lending institutions have practiced widespread discrimination.

In the survey conducted by the Federal Home Loan Bank Board (FHLBB), 53,705 applications were analyzed from Atlanta, Buffalo, Chicago, San Antonio, San Diego and Washington, D.C.³² White applicants had an eight percent rejection rate compared to 18 percent for black applicants. This disparity existed in each of the six SMSAs:³³

SMSA	White Rejection Rate (percent)	Black Rejection Rate (percent)
Atlanta	7.1	12.4
Buffalo	15.4	28.8
Chicago	7.0	18.4
San Antonio	8.8	23.3
San Diego	5.4	18.2
Washington, D.C.	8.8	15.1

Similarly, disparities appeared in the rejection of white and Spanish applicants in San Antonio (8.8 percent for whites and 18.0 percent for Spanish) and in San Diego (5.4 percent for whites and 8.7 percent for Spanish).³⁴

In a second survey devised by the Federal Reserve Board and the Federal Deposit Insurance Corporation ("FDIC") in which more than 20,000 applications were analyzed for six SMSAs, whites experienced a rejection rate of approximately 12 percent compared to a minority rejection rate of approximately 22 percent.³⁵

SMSA	White Rejection Rate (percent)	Minority Rejection Rate (percent)
Baltimore	12	24
Jersey City	12	22
Tampa-St. Petersburg	11	18
Galveston-Texas City	7	18
Jackson	14	17
Vallejo-Fairfield-Napa	24	10

Finally, in a third survey devised by the Comptroller of the Currency, 12,707 applications were analyzed,³⁶ and the disparity in rejection rates for loan applications was 14.8 percent for whites compared to 24.8 percent for nonwhites.³⁷

SMSA	White Rejection Rate (percent)	Nonwhite Rejection Rate (percent)
Bridgeport	11.1	15.8
Cleveland	16.2	26.5
Memphis	13.1	23.0
Montgomery	15.6	48.5
Topeka	11.5	33.5
Tucson	9.3	22.0

23. *S 1281 Hearings*, *supra* note at 1328.

24. *Id.* at 1549.

25. *Id.*

26. Duncan, Hood and Neet, *supra* note 11 at 521.

27. SENATE COMM. ON BANKING, HOUSING AND URBAN AFFAIRS, REPORT ON FAIR LENDING ENFORCEMENT BY THE FOUR FEDERAL FINANCIAL REGULATORY AGENCIES, 94th Cong., 2d Sess., 6 (1976) [Hereinafter cited as FAIR LENDING REPORT].

28. *S 1281 Hearings*, *supra* note 6 at 1072, reported by Center for New Corporate Priorities, *Where the Money Is: Mortgage Lending*, Los Angeles County.

29. FAIR LENDING REPORT, *supra* note 27 at 6.

30. *Id.*

31. The results of these surveys are reported in FEDERAL HOME LOAN BOARD NEWS (August 19, 1975).

32. 66,320 applications were collected; of which 18 percent were not analyzed because they did not include race or other personal data. The furnishings of this data by the applicant was optional.

33. The following statistics are compiled from Tables 2.1 through 2.6, FEDERAL HOME LOAN BOARD NEWS (August 19, 1975).

34. *Id.* at Tables 2.4 and 2.5.

35. This data is cited in the complaint filed in *National Urban League v. Comptroller of Currency*, C.A. No. 76-0718 (D.D.C.), filed April 26, 1976.

36. Of 18,372 forms collected from 152 institutions, 5,665 were not analyzed because they were incomplete or appeared to contain substantial errors.

37. *National Urban League v. Comptroller of Currency*, C.A. No. 76-0718 (D.D.C.), filed April 26, 1976.

In this last survey, credit-worthiness data was included, making it possible to analyze rejection rates while holding certain factors constant. In every case, minority rejection rates are considerably higher than for whites among persons having the same gross annual income, the same gross assets, the same outstanding indebtedness, the same monthly debt burden, and the same number of years in their present occupations. Specifically:³⁸

1. Among those persons whose annual earnings fall between \$15,001 and \$25,000, the white rejection rate is 13.9 percent compared to 20.9 percent for nonwhites. Among those persons earning over \$25,000, the white rejection rate is 12.1 percent compared to 22.6 percent for nonwhites.

2. Among those persons with assets valued between \$60,001 and \$100,000, the white rejection rate is 14.0 percent compared to 18.8 percent for nonwhites. Among those persons with assets of more than \$100,000, the white rejection rate is 13.8 percent compared to 18.8 for nonwhites.

3. Among those persons with outstanding indebtedness of less than \$5,000, the white rejection rate is 14.0 percent compared to 22.2 percent for nonwhites.

4. Among those persons with monthly debt payments of less than \$100, the white rejection rate is 12.9 percent compared to 20.0 percent for nonwhites.

5. Among persons with more than five years in a current occupation, the white rejection rate is 14.1 percent and the nonwhite is 23.2 percent.

The fact that the lending institutions tend to devalue both the minority neighborhood and the minority background of the applicant doubly victimizes minorities seeking mortgage loans. A black loan applicant is likely "to encounter discrimination both because he is black and because he proposes to obtain a mortgage on property in a predominantly black neighborhood."³⁹

In addition, sexual discrimination in lending practices which has been documented by the FHLBB results in a disproportionate impact on minority families. Since a higher proportion of wives work in black families than in white families, discounting all or a substantial part of a wife's income discriminates against black families. Similarly, refusing to make loans to female headed families or imposing more stringent terms and conditions on loans to female headed families tends to discriminate against minority families who are more commonly headed by women than white families. In five of the six SMSAs surveyed by the FHLBB in 1974, the rejection rate for female loan applicants was consistently higher than for males.⁴⁰

SMSA	Female Rejection Rate (percent)	Male Rejection Rate (percent)
Atlanta	5.7	7.6
Buffalo	18.3	16.3
Chicago	10.4	7.6
San Antonio	16.8	12.5
San Diego	9.3	6.1
Washington, D.C.	12.6	9.7

38. *Id.*

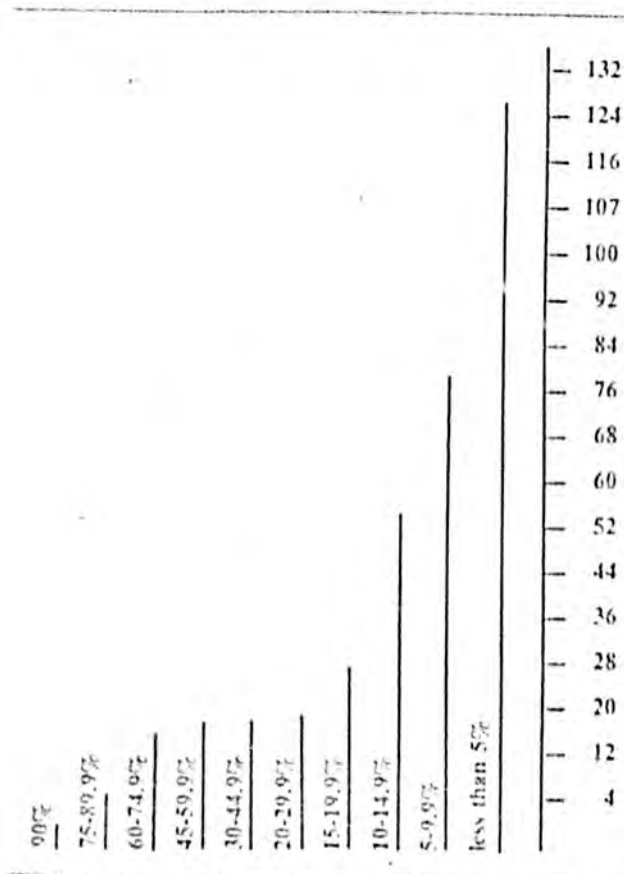
39. FAIR LENDING REPORT, *supra* note 27 at 7.

40. The following statistics are compiled from Tables 1 through 36, FEDERAL HOME LOAN BANK BOARD NEWS (August 19, 1975).

A direct correlation between redlining and areas of minority concentration has been well documented in a study of mortgage lending in Los Angeles County.⁴¹ Using five months' lending statistics from all state licensed savings and loan associations (amounting to \$671 million in mortgage loans between January and May, 1974), the study concluded that "over a million people live in neighborhoods where there is no prospect of lending at all."⁴² A seventh of the population of Los Angeles County lives in neighborhoods which received less than 1 percent of the single family loan dollars, yet two higher income communities with just over 1 percent of the population — Beverly Hills and Palos Verdes — received one seventh of the loan dollars.⁴³

Disinvestment was directly correlated with higher percentages of minority population and lower median incomes. The all white areas of Los Angeles received about twice as much per capita loan dollars as any integrated area.⁴⁴ Lending ranged from one dollar per capita in all Hispanic⁴⁵

Table 1
Lending to Hispanic Population
(Mortgage Dollars per Capita)



Source: S. 1281, U.S. Senate Banking Committee, Hearings, II, 1073.

41. CENTER FOR NEW CORPORATE PRIORITIES, WHERE THE MONEY IS, 1063-1120.

42. *Id.* at 1065.

43. *Id.*

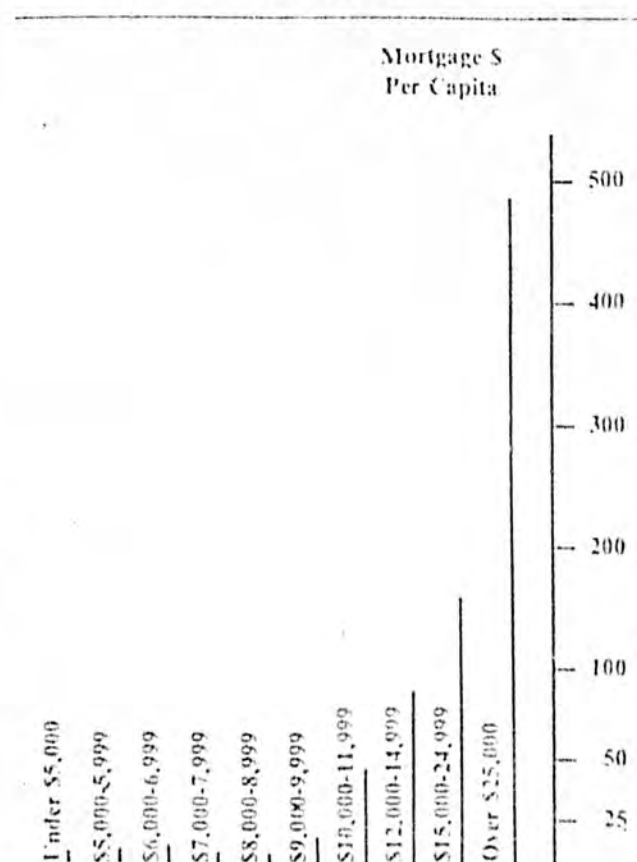
44. *Id.* at 1072.

45. "Hispanic" includes Spanish-surnamed and Spanish-speaking individuals, as recorded in the 1970 U.S. census.

neighborhoods to \$125 per capita for areas with fewer than five percent Hispanic (see Table I). Similar patterns were observed for areas of black population.⁴⁶

An even sharper disparity was observed for income levels in Los Angeles. Areas with a median family income of over \$25,000 (1970 census) had four times the per capita loan dollars than the next highest income category, and 900 times the loan dollars of the lowest income areas⁴⁷ (see Table II).

Table II
Mortgage Lending Versus Median Family Income
Los Angeles, California
1970 Census



Source: S. 1281, U.S. Senate Banking Committee,
Hearings, II, 1073.

Twelve major Los Angeles County "loan starved" or redlined communities were identified as: Compton, Covina, East Los Angeles-Boyle Heights-Echo Park, Highland Park, Long Beach, Pacoima-San Fernando, Pomona, Pasadena, San Pedro, South Central Los Angeles, Venice-Santa Monica, and West Covina.⁴⁸ Lending patterns for these areas were compared to lending patterns in San Fernando Valley (which are close to the average figures for all Los Angeles County) and to those of Beverly Hills and Palos Verdes. The following is a compilation of the study's findings:⁴⁹

⁴⁶ CENTER FOR NEW CORPORATE PRIORITIES, *WHERE THE MONEY IS*, at 1072, 1074.

⁴⁷ *Id.* at 1072.

⁴⁸ *Id.* at 1066.

⁴⁹ *Id.* at 1085-1113.

Area	Percent Minority	Average Number of Loans per 10,000 Population (Single Family)	Mortgage Dollars Per Capita
San Fernando Valley	10.7	18.1	\$55.47
Compton	86.8	1.7*	2.41
Covina-Azusa	21.6	1.4*	2.78
East L.A.-Boyle Heights-Echo Park	85.0	0.7*	1.01
Highland Park	34.9	1.8*	4.27
Long Beach	40.1	0.2*	.27
Pacoima-San Fernando	61.9	1.6*	3.53
Pasadena	50.5	1.6*	2.22
Pomona	31.8	1.5*	2.94
San Pedro	53.3	1.7*	3.75
South Central L.A.	90.1	1.6*	2.30
Venice-Santa Monica	30.6	2.5*	6.59
West Covina	44.1	0.8*	1.55
Beverly Hills-Bel-Air	9.1	73.5	617.03
Palos Verdes	7.0	77.8	454.99

*Redlined Communities

VI. PAST DISCRIMINATORY ACTIONS AND THEIR LEGAL IMPLICATIONS

On the basis of the data presented above, it is evident that the mortgage lending institutions' practices disproportionately affect racial minorities on a nationwide level. However, few lenders today would admit to a discriminatory intent and, indeed, it would be difficult to prove in a court of law that many of the practices which are neutral on their face yet have discriminatory effects were introduced for that purpose. In addition, the economic rationales put forward to justify the more subtle practices which have the effect of redlining have tended to remain immune from public scrutiny because they are generally accompanied by dire warnings of bank collapses when policy changes or even modifications are suggested.

However, when current lending practices are viewed against the backdrop of the overt discriminatory behavior of the lending institutions during the past four decades, they are easily seen as a mechanism for carrying forward and

rigidifying the effects of the prior discrimination. Thus, this brief history of racial discrimination in housing is presented not only for its independent utility as an historical reminder but also because it has direct bearing on the validity, legal and ethical, of the reasons given by lenders for their continued use of criteria which have discriminatory effects.

Redlining as we know it today is directly traceable to more traditional and overt forms of discrimination which created segregated housing patterns in our urban areas. After World War I, when blacks began moving out of the South, unequal lending opportunities resulted in immediate ghettoization, and by 1933, when the federal government began its major involvement in the delivery of housing, racial discrimination was a standard operating procedure.⁵⁰ Regardless of whether the private housing industry simply reflects private prejudice, or whether it acts on its own prejudices, "it is the real estate brokers, builders, and mortgage finance institutions which translate prejudice into discriminatory action!"⁵¹ and it is conduct, not attitude, that is the subject of civil rights laws.

Realizing the jeopardy to their own economic self interest, lenders did not absolutely refuse to deal with blacks in all areas of financing, but the dealings were on a separate and unequal basis. For example, new construction loans were impossible to obtain and blacks were restricted to existing housing stock.⁵² The housing stock available to them, due to the failure of the "filter down" theory explained earlier, was in most cases in the oldest and most deteriorated neighborhoods which were considered economic risks requiring more stringent loan terms.

While it is impossible to separate the lending institutions from the various actors such as realtors and builders necessary to consummate a mortgage transaction, there is ample evidence of the lending institutions' independent discrimination. They did more than simply react to the discriminatory appraisal practices which are described later in this paper. One savings and loan official said in the 1950s: "We make loans to colored in established areas only. If they were introduced into new areas property values would fall 50 percent."⁵³ In 1958, one report notes that the property values theory had been properly exploded and was losing strength in most lending institutions; it was, however, being replaced by a "public relations" theory which was founded on the belief that it is sound business policy to cater to the prejudices of potential white customers by not introducing blacks into white areas.⁵⁴

When the federal regulatory agencies stepped into the picture, they adopted wholesale the discriminatory practices of the institutions they were created to regulate. Two theories have been advanced to explain this phenomenon: the first is that they perceived their mission solely as one of alleviating financial distress in the housing finance industry, and racial segregation seemed unrelated to that goal; the second is that,

typical of many federal agencies and their special interest groups, there was a free interchange of personnel between the regulators and the regulatees and the already existing prejudices of the lending institutions easily became the policy of their regulators.⁵⁵ For whatever reason, by 1940 the FHI-BB's Division of Research and Statistics had published articles on the desirability of rating neighborhoods according to their racial composition.⁵⁶

This brief history of the blatant discrimination of lending institutions and their regulators has significant legal implications. In a general equitable sense, they are unable to come to the defense of their current lending practices with "clean hands." The change from an outright refusal to lend in racially mixed areas, or from the imposition of stricter standards of credit-worthiness for blacks, to a policy which is racially neutral on its face — such as denying loans on buildings over a certain age — but which has a racial effect, has the effect of perpetuating the former policies.

As discussed below in the section on fair housing responsibilities of the federal agencies and lending institutions, it is not necessary to find personal culpability in the creation of a dual housing market — it is enough if the institutions' policies perpetuate it. But here there is direct responsibility.

A. FHA and Private Financing

Regardless of whether or not the initial decision to redline a neighborhood was intended to discriminate along racial lines, the result is to make the goal of owning one's home unattainable for a large number of America's low and moderate income minority families. Unable to obtain conventional mortgage loans, these families must seek other sources of home financing.

Revisions of the National Housing Act in the late 1960's liberalized the standards of the federally insured mortgage programs, making FHA insured loans available virtually in all neighborhoods. Even these loans, however, are out of reach for many residents living in deteriorated, racially transitional areas.⁵⁷ Moreover, the FHA program itself has been accused of redlining,⁵⁸ maladministration,⁵⁹ and spurring the flight of homeowners from redlined neighborhoods.⁶⁰ In its report on housing conditions and programs in the United States, the Douglas Commission in 1969 flatly accused the FHA of entering into an unwritten agreement with lending institutions to redline inner city neighborhoods:

This tendency to neglect the poor has been reinforced and partially extended by the FHA tendency to shun the central cities and concentrate on the suburbs. The experience of members of the Commission and others con-

50. U.S. COMMISSION ON CIVIL RIGHTS, HOUSING (1961), at 16.

51. COMMISSION ON RACE AND HOUSING, WHERE SHALL WE LIVE? (1958), at 22.

52. R.C. WEAVER, THE NEGRO GHETTO (1948), at 222-227.

53. U.S. COMMISSION ON CIVIL RIGHTS, UNDERSTANDING FAIR HOUSING (1974), at 11.

54. WHERE SHALL WE LIVE? at 29.

55. HOUSING, *supra* note 50, at 159.

56. *Id.* at 17.

57. Duncan, Hood and Sect, *supra* note 11 at 518.

58. *Id.*

59. MORTGAGE LENDING PRACTICES, *supra* note 4 at 346.

60. *Id.*

vinced us that up until the summer of 1967, FHA almost never insured mortgages on homes in slum districts, and did so very seldom in the "gray areas" which surrounded them. Even middle class residential districts in the central cities were suspect, since there was always the prospect that they, too, might turn as Negroes and poor whites continued to pour into the cities, and as middle and upper middle income whites continued to move out.

The result was a general, even if unwritten, agreement between lending institutions and FHA that most of the areas inside the central cities did not have a favorable economic future, and that their property values were likely to decline....

There was evidence of a tacit agreement among all groups—lending institutions, fire insurance companies, and FHA—to block off certain areas of cities within "red lines," and not to loan or insure within them. The net result, of course, was that the slums and the areas surrounding them went downhill farther and faster than before.⁶¹

Community leaders have accused the FHA of indiscriminately insuring loan applicants "regardless of how poor they may have been as credit risks or how dilapidated the purchased homes may have been."⁶² In turn, relatively high rates of foreclosure and abandonment have been observed in neighborhoods with heavy concentrations of FHA mortgages.⁶³ Homeowners therefore associate the advent of FHA mortgages in their communities with redlining by conventional lenders and the beginning of deterioration. They begin to relocate elsewhere even though they may have had no intention of moving prior to the flight of conventional capital. According to Gale Cinotta, "Redlining and reform of FHA practices go hand-in-hand. I've never seen a city where the two problems weren't intertwined."⁶⁴

In addition to the fears associated with federally insured mortgages, the effects of FHA loans are felt through their higher direct costs in comparison to conventional loans. These

costs include the FHA mortgage insurance premium and the additional time required to process loan applications. To the extent that they are borne by the applicants, they reduce the funds available for home maintenance, further contributing "to the self fulfilling prophecy that FHA mortgages presage neighborhood decline."⁶⁵ To the extent that they are borne by the sellers who reduce the price of their homes as an inducement to buyers, they represent a loss of equity to those sellers, "contributing to the fears of homeowners in other neighborhoods where FHA mortgages may begin to appear."⁶⁶

The dearth of conventional mortgage financing has resulted in the predominance of private "contract" financing in disinvested neighborhoods. Usually these private contracts are detrimental to the buyer and the community. Non-institutional mortgage capital is generally more expensive than capital from institutional sources because interest and amortization rates are charged and rather steep discounts are levied.⁶⁷ This imposes a severe strain on the mortgagor since debt service is typically a large component of monthly installment payments. In addition, the length of maturity of a private loan is sometimes briefer than for institutional financing, causing further debt service pressures. As one study of disinvestment in Bronx County has noted:

Not unexpectedly, owners in many areas find it most difficult to increase rental receipts to the extent they will cover higher debt service costs. Under such conditions, the "rational" strategy would be to maximize revenues by any means possible. Such a strategy leads to solicitation of welfare tenants, overcrowding, illegal subdividing, maintenance skimping, and tax delinquency. Once this has commenced, abandonment is not far behind.⁶⁸

The fact that private financing is used most often by those who have been denied regular bank credit enhances the prospects of exploitation by speculators. In order to increase their number of sales, speculators frequently play on racial fears by engaging in blockbusting and forcing panic sales.⁶⁹ Moreover, speculators have taken advantage of the fact that private financing is a quasi-private transaction unlike institutional financing which is quasi-public. Lower income families who are seeking home financing and are often unfamiliar with the home purchasing process are sometimes forced to agree to clauses and conditions that are inequitable if not illegal.⁷⁰

The socioeconomic realities of the U.S. cities are such that minorities are more often dependent upon private financing and subject to its abuses. More susceptible to fluctuations in the economy, they may miss a month's service debt which can lead to immediate eviction and a total loss of all equity.⁷¹ Even if they can meet all of their payments, the higher

61. U.S. NATIONAL COMMISSION ON URBAN PROBLEMS, *BUILDING THE AMERICAN CITY* (1969) at 100-101.

It has been alleged by community groups in Oakland that HUD is presently practicing redlining. Three cases are cited. In April of this year, FHA refused to send an appraiser for property on the basis that it was located in a neighborhood of encroaching industrial and commercial concerns. In March, a HUD appraiser simply drove by and rejected a house on the basis of its location. Finally, in mid-1975, a HUD appraiser refused to look at a property below East 14th Street.

62. *Supra* note 4 at 346.

63. *Id.*

64. Zigas and Barry, *Special Report: Neighborhood Preservation: FHA: Neighborhood Friend or Foe*, HOUSING AND COMMUNITY DEVELOPMENT REP. 3 No. 9 (September 22, 1975) at 394-396.

65. *Supra* note 4 at 347.

66. *Id.* at 348.

67. Devine, *82MI Housing*, *supra* note 6 at 1343.

68. *Id.*

69. Steinheib, *82MI Housing*, *supra* note 6 at 562.

70. *Id.* at 564.

71. *Id.*

cost of private mortgages resulting from higher interest rates and shorter terms makes it difficult to maintain their properties. One study of mortgage availability in Chicago's racially transitional neighborhoods summarized the dilemma of the black family:

For the black contract buyer, the present state of affairs spells hardship, suffering, exhaustion, and despair. It means that husbands must work two and sometimes three jobs in order to make ends meet. It means that wives must work, that family life is all but destroyed, and that children must be left unsupervised, and then people ask why there is a high crime rate in black areas. It means that widows beyond retirement age must scrimp for food. Contract buying also means for many that they have chosen the lesser of two evils. Couples were faced with the choice of continuing to pay exorbitant rents comparable to their current monthly installments or buying on contract with the hope that someday they might own their own homes. It also means that they must stand under the criticism of the white minority for not maintaining their buildings and living in squalor. And it hurts all the more because they are only too well aware that they cannot do much in the line of repairs after having put all their money into the pockets of speculators through their outrageous monthly installments. It means, too, that they must face embarrassment in admitting that they entered into bad deals, especially when many of them sought out the advice of attorneys when they made their purchases. Contract buying means only one thing: frustration or the impossibility of escaping from living in a slum.⁷²

1. The Problems of Refinancing

The refusal of financial institutions to refinance paid down mortgages is perhaps even more devastating than increases in debt service costs.⁷³ Refinancing is critically important not only for rehabilitation funds, but also for capital accumulation, and in some cases, for cash flow. The main attraction of refinancing is that borrowed money is not subject to federal taxes. Without this supply of capital, there "appears to be a paucity of incentive for owner activity which adds to the viability of a particular improvement."⁷⁴ A landlord's behavior is determined as much by present yield as by expectations of future yield. Thus, an institution's unwillingness to extend refinancing not only indicates institutional disinvestment but signals owners to disinvest as well. When the prospects of selling or refinancing become increasingly remote, property owners tend to milk a property in order to accumulate as much capital as quickly as possible. Capital improvements or new investments are viewed as

adding little of ultimate value to their properties. The almost inevitable result is neighborhood deterioration and abandonment.

As soon as it becomes apparent to homeowners that capital for refinancing is not being made available, their alternative and reaction is to put their properties up for sale. As greater numbers of homeowners flee an area, a large supply of housing is placed on the market at one time. If only blacks and other lower income families are moving into an area, the supply of housing is likely to exceed demand, thus lowering property values. In turn, other homeowners feel compelled to leave the area before their properties depreciate still further. Without institutional capital to finance a sale, or if institutions are only willing to lend amounts less than the asking price, the original owner "will have to:"⁷⁵

reduce the sum of the sale price so that it matches the amount of financing being offered; or,

assume a second mortgage amounting to the difference between the sale price and available financing; or,

in the absence of capital, take back a first mortgage on the property.

In any case, the owner will realize a cash return that is less than if the market had not been constrained by a lack of institutional financing. Moreover, the owner is forced to remain attached to the property if it is necessary to take back a first or second mortgage which means that the primary objective of the transaction has not been realized.

In summary, it should be apparent that the presence of institutional lenders in the housing market is vital to the social and economic health and viability of a community. Without institutional capital, the supply of funds for the purchase, construction, rehabilitation, and refinancing of homes is extremely limited and costly. Moreover, institutional lenders contribute to overall economic stability from the neighborhood to the metropolitan level.

VII. THE ROLE OF THE FEDERAL FINANCIAL REGULATORY AGENCIES

The focus of the preceding discussion has been on the pathology of redlining. This section describes the federal agencies that regulate most of the lenders accused of the practice and suggests the ways in which their acts and omissions may have contributed to mortgage disinvestment.

For virtually every institution that originates home mortgage loans, federal examination, supervision and regulation (and protection) are facts of life. National banks are chartered by the Comptroller of the Currency ("COC"), they automatically become members of the Federal Reserve System ("FRS") (which is controlled by the Federal Reserve Board ("FRB")), and their deposits are insured by the Federal Deposit Insurance Corporation ("FDIC"). State chartered commercial banks may be admitted to membership in the FRS, in which event their deposits are also insured by FDIC. State chartered, non FRS-member commercial banks and state chartered mutual savings banks may have their deposits insured by FDIC. Federal savings and loan associations are chartered by the Federal Home Loan Bank Board ("FHLBB")

⁷² *Id.*

⁷³ Devine, 512 *U. Ill. L. Rev.*, *supra* note 6 at 1341.

⁷⁴ *Id.* at 1346.

⁷⁵ *Id.* at 1345.

and are members of the Federal Home Loan Bank System ("FHLBS"). All federal savings and loan associations' deposits are insured by the Federal Savings and Loan Insurance Corporation ("FSLIC"), which is controlled by the FHLBB. State chartered savings and loan associations may also be admitted to the FHLBS and have their deposits insured by FSLIC.

As of 1974, 75 percent of outstanding non-farm, one to four family residential mortgages were held by lenders subject to the regulatory authority of at least one of these agencies.⁷⁶ Since approximately 15 percent of the mortgages originated by regulated lenders are sold to and held by permanent investors not regulated by these agencies,⁷⁷ it is safe to say that something considerably in excess of 75 percent of the mortgage loans *originated* each year are made by regulated lenders. The only significant element in the mortgage origination business that has not fallen into this alphabet soup is the mortgage banking industry, and it has to contend with HUD.

A. Federal Home Loan Bank Board

The FHLBB was created in 1932 to supervise the FHLBS. In 1933 its authority was expanded to include the chartering and supervision of a new kind of association, the federal savings and loan association. The following year, the National Housing Act of 1934 expanded the FHLBB's authority to include the direction and management of the newly created FSLIC. In 1970 the Federal Home Loan Mortgage Corporation was set up to buy conventional mortgages and to thus provide additional liquidity for mortgage originators. The FHLBB directs and controls the FHLMC.

The FHLBS was created to provide a central credit system to supplement the resources of private mortgage lending institutions. Its function is to smooth out seasonal differences between savings flows and loan closings and to supplement institutions in capital-deficient areas.

For a lending institution, the principal benefit of membership in the FHLBS is assured access to "advances" of funds, in plain language, loans, from regional Federal Home Loan Banks at low interest rates. For the economy as a whole, one of the major benefits of the system is the ability of the regional banks to transfer funds among themselves to relieve intermittent regional credit shortages. In this way, the FHLBS makes mortgage funds available in capital-deficient areas. Considerable autonomy is given to the regional banks in allocating advances, but the allocations are reviewed by the FHLBB.

The ability to obtain additional capital through this federally operated credit system is indispensable to most savings and loan associations. Eighty-four percent of all savings and loan associations, holding 98% of all resources of savings and loan associations, are members of the FHLBS.⁷⁸ Since the bulk of mortgage debt financing is held by savings and loans, regulation and supervision of the FHLBS has an overwhelming impact on home financing.

No institution is permitted to join the FHLBS unless the FHLBB approves of its home financing policy, and the FHLBB may remove institutions from membership, or deny advances to institutions whose home financing policy fails to meet the objectives of "sound and economical home financing."⁷⁹

Another aspect of the FHLBB's supervisory authority over the FHLBS which affects the availability of home mortgage funds is its regulation of the liquidity of member institutions. This means that the FHLBB requires member institutions to hold a specific portion of their total outstanding loans in short term investments, as a first line of defense against unusual withdrawal demand.

The FHLBB has encouraged the disinvestment of certain urban neighborhoods by requiring higher reserves for loans made there, a policy which has had the effect of directly decreasing the money available for loans in those areas.

The [FHLBB] examiners who come in to examine the savings and loan associations look at the high risk loans on their portfolio. They can spot appraise and if in fact in their appraisal the properties do not equal the value for which they are on the books or for which the loan was made, they are required to write those loans down . . . required to place specific loss reserves against those balances. So the best way for the institutions to avoid the restraints of the regulatory bodies is to make the majority of loans in housing areas where the property values are not going down.⁸⁰

The FHLBB's authority over members of the FHLBS is extensive; its authority over federally chartered savings and loan associations is plenary. Their very existence depends on the FHLBB, since Congress authorized it to charter, examine and regulate them to assure that they serve the dual purposes of meeting *local* thrift and home financing needs.⁸¹ The benefits of a federal charter for these institutions are significant. They have the exclusive privilege within the savings and loan community of using the word "Federal" in their titles, and enjoy, at least in the minds of many people, direct association with the federal government. Indeed, the FHLBB itself has taken the position that federally chartered savings and loan associations are "federal instrumentalities."⁸² More tangibly, they enjoy certain tax exemptions and automatic membership in the FHLBS.

The application procedures for obtaining a federal charter emphasize the Board's concern with establishing locally-focused associations. Applicants for a federal charter must submit detailed information about the savings and lending needs of the area to be served. They must designate

76. FEDERAL HOME LOAN BANK BOARD, SAVINGS AND LOAN FINANCING SERVICE BOOK (1975) at 45.

77. See, U.S. LEAGUE OF SAVINGS AND LOAN ASSOCIATIONS, SAVINGS AND LOAN FACT BOOK '75, at 29.

78. *Id.* at 95, 97.

79. See 12 U.S.C. §§1424(a), 1426(f), 1429.

80. Testimony of W. Dean Cannon, Jr., Executive Vice President, California Savings and Loan League, Special Hearing on Redlining (Calif. 1975).

81. 12 U.S.C. §1464.

82. See, Advisory Opinion of FHLBB, In the Matter of Schott v. Mission Federal Savings and Loan Ass'n (July 30, 1975), at 6-10.

local service areas from which they expect to draw their savings and make their loans,⁸³ and such designation then becomes part of the "terms and conditions" of the charter and can be viewed as obligating the association to provide lending and thrift services to the area specified in the application.⁸⁴ They must demonstrate that thrift and home financing needs exist in the designated area. Because people will travel further to obtain a loan than to deposit savings, the lending service area will likely be larger than the savings area. But applicants must show some level of local mortgage demand.⁸⁵

Another indication of the FHLBB's concern with providing local service is its requirement that some of the applicants seeking a federal charter reside in the community to be served by the proposed association.⁸⁶

The FHLBB's failure to establish standards for adequate service to the designated areas or to develop examination procedures to evaluate the performance of the associations in those areas at least arguably amounts to tacit approval of redlining. The Governor's Commission on Mortgage Practices in Illinois stated in its report:

This commission feels strongly that were the FHLBB to begin to regulate the attention of Federal savings and loans to their local primary service areas, redlining would cease its deleterious impact on older neighborhoods (communities) of major metropolitan areas in Illinois.⁸⁷

Instead, the FHLBB has chosen to focus its examinations on the solvency of member institutions. This emphasis on loan quality and net worth ratios tends to discourage investment in conventional mortgages in certain inner-city neighborhoods.⁸⁸

The agencies which supervise mortgage lending institutions traditionally have shied away from substituting their judgment for that of the lending institutions for purposes of criticizing them for loans they have chosen not to make. Rather, the agencies have confined themselves to criticizing lending institutions for loans they have made which, for credit reasons or otherwise, should not have been made.⁸⁹

The FHLBB conducts fair housing examinations of its members through questionnaires completed by examiners. The questionnaire asks whether the institution engages in various racially discriminatory practices. However, because of

the way in which it is administered and because of the absence of hard data on the racial or ethnic origin of loan applicants and loan recipients, the U.S. Commission on Civil Rights has concluded that the questionnaire has been of little value in uncovering discriminatory mortgage lending practices.⁹⁰ In fact, the FHLBB itself has never viewed the questionnaire as revealing discriminatory practices on the part of any member institution.

When the redlining of a community reaches advanced stages, local savings and loans which have previously stopped lending in the community tend to flee and relocate elsewhere. The FHLBB must approve applications by federal savings and loans on branching, merging and relocating. However, the current regulations and administrative procedures of the Board totally ignore the impact on older urban neighborhoods of the flight of savings and loans. They fail to provide any procedural safeguards to permit residents of a community about to be deserted by a savings and loan association to show adverse impact, and they fail to require a showing that the area will continue to be adequately served.

An additional function of the FHLBB is to direct the activities of FSLIC which was created in 1934 by the National Housing Act ("NHA") to insure the deposits of all federally chartered savings and loans and qualified state chartered savings and loans. As of 1974, savings and loan members of FSLIC held 97 percent of the residential mortgages held by all savings and loan associations.⁹¹

FSLIC is authorized to refuse to insure any savings and loan association which has violated its charter or has violated an applicable law, rule or regulation of FSLIC. The NHA contains a broad grant of authority for the FHLBB, as head of FSLIC, to adopt such regulations as in its judgment are appropriate to carry out the purpose of NHA. To date, the FHLBB has not used its power of terminating FSLIC coverage to discourage redlining practices of savings and loan associations.

B. Comptroller of the Currency

The COC charters and supervises national banks.⁹²

As with Federal savings and loan associations, national banks are a federal creation . . . Their status carries with it many substantial benefits: they hold the exclusive privilege within the banking community of using the word "National" in their titles; they automatically receive the benefit of FDIC deposit insurance; they are members of the Federal Reserve System; and they are protected by federal statute from certain forms of state taxation. . . . [T]hey have been treated with great solicitude

83. Checklist of Supporting Documents for Permission to Organize, FHLBB Form 756.

84. Mortgage Lending Practices, *supra* note 4 at 65-71.

85. *Id.*

86. 12 C.F.R. §543.2(b).

87. GOVERNOR'S COMMISSION ON MORTGAGE PRACTICES, HOME OWNERSHIP IN ILLINOIS, THE ELUSIVE DREAM, at 18.

88. See discussion of the testimony of Nelson Brown, Asst. Counsel, Illinois Federal Savings and Loan, in HOME OWNERSHIP IN ILLINOIS, *supra* note 87 at 24.

89. U.S. COMMISSION ON CIVIL RIGHTS, FEDERAL CIVIL RIGHTS ENFORCEMENT EFFORT (1970) at 513.

90. U.S. COMMISSION ON CIVIL RIGHTS, FEDERAL CIVIL RIGHTS ENFORCEMENT EFFORT (1974) Volume II, at 178.

91. FEDERAL HOME LOAN BANK BOARD, COMBINED FINANCIAL STATEMENTS, FSLIC INSURED SAVINGS AND LOAN ASSOCIATIONS (1974) at 128.

92. 12 U.S.C. §26.

by the courts, which have noted a quasi-governmental character about them.⁹³

National banks are generally regarded as the leaders of the financial community and enjoy the highest prestige. As of 1974, they held \$43 billion (10 percent) of the outstanding residential mortgages.⁹⁴

As administrator of national banks, COC is authorized to issue federal charters, to specify the terms and conditions of their charters, and to promulgate rules and regulations relating to these banks,⁹⁵ and to conduct examinations of them.⁹⁶

While the statutes which govern the chartering of national banks do not define or even mention the concept of local service areas, the application for a charter does require applicants to designate the geographic area where they expect to generate 75 percent of their deposits and loans. Furthermore, when investigating an application for charter, COC may look into the "convenience and needs of the community to be served by the proposed bank."⁹⁷ But COC has apparently not used this authority to require national banks to serve the communities where they are located. The COC is also charged with authority to approve the relocating, branching and merging of national banks.

C. The Federal Reserve Board

The FRB is authorized to regulate the member banks of the Federal Reserve System.⁹⁸ The FRB determines the general monetary, credit and operating policies for the FRS. It also sets the requirements for reserves to be maintained by member banks and limits interest rates paid on savings deposits. Benefits of membership in the FRS include access to its discount facilities, loans, and various financial publications which allow each bank to evaluate its financial status.⁹⁹

All national banks are members of the FRS. The Board has authority to admit state chartered banks who apply for membership, and to set the terms and conditions of membership. As of 1974, state chartered member banks held \$11 billion (4 percent) of residential mortgages.¹⁰⁰

Among the criteria used by the Board in reviewing a membership application from a state chartered bank, special consideration is supposed to be given to "the convenience and

needs of the community to be served by the bank."¹⁰¹ Even though the president of the Board, Arthur Burns, has said the first obligation of bankers is to the credit requirements of their service areas,¹⁰² there is no indication that the Board has attempted to enforce this obligation. In fact, the Board has said its authority over state member banks is limited because the primary regulatory control rests with the state chartering agencies.¹⁰³

D. The Federal Deposit Insurance Corporation

The FDIC automatically insures the deposits of member banks of the FRS. It also insures state chartered, non-Federal Reserve member commercial banks and mutual savings banks which apply for and are granted the benefits of FDIC insurance.¹⁰⁴ As of 1974, commercial and mutual savings banks insured by FDIC held \$115 billion (27 percent) of the non-farm, one to four family residential mortgages.¹⁰⁵

The statutes creating FDIC express the concern of Congress that FDIC should determine that a financial institution applying for insurance will serve the community where it is located.¹⁰⁶ The FDIC does require institutions to describe in their applications for insurance the area where its customers reside. But this information has apparently not been used by FDIC to require its insured banks to serve the credit needs of a particular area or community. The FDIC also has authority to approve branching, merger and relocation by insured institutions. But none of its regulation of these activities takes into account the impact of such moves on the service needs of the community where the institution was originally located.

E. Efforts to Prod the Federal Regulatory Agencies Into Promulgating Regulations to Enforce Fair Lending Requirements

It cannot be said that the failure of the federal agencies with regulatory authority over the home financing industry to enforce fair lending practices is due to lack of advice about how to get the job done. The Oversight Hearings Report documents the Job-like patience and repeated attempts of HUD, the Justice Department, the U.S. Commission on Civil Rights, and private civil rights and civic organizations to move the FHLBB, COC, FDIC and FRB to act.

93. U.S. COMMISSION ON CIVIL RIGHTS, HOUSING (1961) at 40.

94. FEDERAL DEPOSIT INSURANCE CORPORATION, ASSETS AND LIABILITIES: COMMERCIAL AND MUTUAL SAVINGS BANKS (1974), at 2.

95. 12 U.S.C. §260c.

96. 12 U.S.C. §161.

97. 12 C.F.R. §42.

98. 12 U.S.C. §221 *et seq.* (1970). The FRS was created, over the initial opposition of the banking industry, for the purpose of establishing a central banking system and enhancing the safety of deposits through regulation of banking practices. I.M. KOHLMETZ, JR., THE REGULATORS (1969) at 231.

99. U.S. COMMISSION ON CIVIL RIGHTS, FEDERAL CIVIL RIGHTS ENFORCEMENT EFFORT (1974) at 136, fn. 376.

100. FEDERAL DEPOSIT INSURANCE CORPORATION, ASSETS AND LIABILITIES: COMMERCIAL AND MUTUAL SAVINGS BANKS (1974) at 2.

101. 12 C.F.R. §208.5.

102. Letter from Arthur Burns to the Federal Reserve Banks of Chicago, Dallas and Kansas City.

103. Letter from Robert C. Holland to Theodore M. Hesburg, Chairman of the U.S. Civil Rights Commission, with appended Federal Reserve Board Memorandum, March 12, 1971.

104. As of December 1972, 98.4 percent of all commercial banks in the United States, and over two-thirds of all mutual savings banks, participated in federal deposit insurance. FEDERAL DEPOSIT INSURANCE CORPORATION, ANNUAL REPORT, 1972 at XII.

105. FEDERAL DEPOSIT INSURANCE CORPORATION, ASSETS AND LIABILITIES: COMMERCIAL AND MUTUAL BANKS (1974) at 2.

106. 12 U.S.C. §1816.

Fifteen years ago, the U.S. Commission on Civil Rights inquired of the three banking supervisory agencies and the FHLBB whether they were engaged in any activities to eliminate the racially discriminatory practices of their member institutions. Only the FHLBB had taken any action — a resolution expressing opposition to discrimination — and none of the other three were even in the planning state. In fact, the FRB and FDIC excused their inaction on the now familiar grounds that the introduction of blacks into a neighborhood adversely affects property values.¹⁰⁷

In 1968, with the passage of the Fair Housing Act and its statutory mandate to all federal agencies to act affirmatively to promote fair housing, the U.S. Civil Rights Commission again contacted the four agencies to point out their legal duties and to inquire about the steps taken in satisfaction of them. The sole response of the agencies was to correspond with their regulatees informing them of the requirements of the new act and vaguely indicating that sanctions could be imposed on violators.¹⁰⁸

In 1968 HUD, pursuant to its role as primary enforcer of Title VIII of the 1968 Fair Housing Act, initiated a series of meetings, which continue to this day, to assist the agencies in the formulation of enforcement procedures. Most of the elementary aspects of the enforcement program suggested by HUD in 1969 are still being sought today:

HUD officials proposed an eight point affirmative action program for the bank regulatory agencies, including issuance of regulations, racial data collection and record-keeping to monitor actual lending patterns by institutions, training of examiners in civil rights compliance, maintenance of applications by race; development of civil rights compliance review procedures in examinations, referral of fair lending complaints by the bank regulatory agencies to HUD and the Justice Department; posting of a fair lending poster; development and use of sanctions against discriminating lenders.¹⁰⁹

In 1971, the four agencies heard from thirteen civil rights and civic organizations, many of whom represented potential victims of the industry's discriminatory actions, in the form of a petition seeking the promulgation of regulations along the lines proposed two years earlier by HUD. The reaction of the agencies was barely civil and certainly not responsive.¹¹⁰

The Justice Department was not idle during these years either. The record of the Oversight Hearings includes a long exchange of correspondence between the present Assistant Attorney General in charge of the Civil Rights Division, and his predecessor, and the legal advisors of the four agencies, and their predecessors. In those letters, dating from 1972 to the present, the Justice Department provided legal advice on the authority and the duty of the agencies to enforce Titles VI of

the 1964 Civil Rights Act and VIII of the Fair Housing Act to keep racial records, to investigate charges of discrimination, and to do all those things that HUD proposed back in 1969.¹¹¹

With respect to the banking supervisory agencies, the only success HUD, Justice, and the interested organizations met with was the issuance of the requirement that an equal housing lending poster be displayed and included in media advertisements.¹¹² The FHLBB was more responsive, and its actions are dealt with separately in this paper. In addition, in 1974 the four agencies cooperated with HUD, on a pilot basis only, in collecting lending information, including racial data in eighteen metropolitan areas. Despite the disparate treatment of black and white applicants revealed in the statistics, the agencies have not yet instituted a permanent data collection system; moreover, they are not investigating the institutions involved in the survey on the remarkable theory that to do so would discourage similar voluntary efforts in the future.¹¹³ This attitude is a fairly clear indication that the agencies are not seriously contemplating a data collection system on an ongoing basis.

In April 1976, the thirteen organizations which had been rebuffed in their petition of the four regulatory agencies to issue effective enforcement regulations filed suit in federal district court to compel their issuance.¹¹⁴ Their request for relief reads much the same as HUD's original suggestions to the agencies in 1969.

Finally, while HUD has not been remiss in its obligation to prod the four financial regulatory agencies into action, it has not fully exercised its own power over that segment of the mortgage lending industry over which it has regulatory authority. The U.S. Civil Rights Commission recently criticized HUD for failing to issue regulations requiring racial data collection and affirmative action by institutions making federally insured loans, including FHA, VA and Farmers Home Administration loans.¹¹⁵ HUD alone has the authority to monitor the mortgage banking companies which are playing an increasingly larger role in the origination and servicing of loans in the inner city as the other federally regulated institutions turn to suburban investments. Also, HUD has not flexed its regulatory muscle over FNMA and GNMA, that portion of the secondary mortgage market which it may directly regulate.

VIII. APPRAISAL AND UNDERWRITING PRACTICES

Appraisal and underwriting standards play a major role in determining whether and on what terms a lending institution will extend credit to an individual to purchase, refinance, or rehabilitate a home. In fact, it could be said that appraisal and underwriting practices are the primary devices by which redlining is accomplished.

¹⁰⁷ U.S. COMMISSION ON CIVIL RIGHTS, THE FEDERAL CIVIL RIGHTS ENFORCEMENT EFFORT (1974) at 515.

¹⁰⁸ U.S. COMMISSION ON CIVIL RIGHTS, FEDERAL CIVIL RIGHTS ENFORCEMENT EFFORT (1970) at 514-515.

¹⁰⁹ OVERSIGHT HEARINGS REPORT, *supra* note 27 at 5.

¹¹⁰ *Id.* at 190.

¹¹¹ *Id.* at 79-125.

¹¹² THE FEDERAL CIVIL RIGHTS ENFORCEMENT EFFORT (1974) at 147-148.

¹¹³ FAIR LENDING REPORT, *supra* note 27 at 6.

¹¹⁴ National Urban League v. Comptroller of the Currency, No. 76-0718 (D.D.C., filed April 26, 1976).

¹¹⁵ THE FEDERAL CIVIL RIGHTS ENFORCEMENT EFFORT (1974) at 131.

The appraiser and underwriter perform two distinct functions. The appraiser estimates the "market value" of the property which is to be the subject of the transaction, a value which has been defined as "the price at which the property would sell when both the buyer and seller are willing and when neither is under any abnormal pressure."¹¹⁶ The appraiser of residential property typically uses the "market data" appraisal approach which compares the condition of the property and its location with similar properties in similar neighborhoods.¹¹⁷

The underwriter estimates the overall risks involved in making loans. One inherent risk of loaning money is that the borrower will not repay the loan. To minimize this risk the underwriter examines the applicant's "credit-worthiness," including past credit record, current debts and income, and future income prospects. To protect the lender against the risk of a defaulting borrower, the underwriter also must evaluate whether the security property will be sufficient collateral during the entire life of the loan so that a foreclosure sale of the property will yield a price equal to the unpaid balance of the loan. In making this estimate the underwriter relies on the appraiser's estimate of market value, which, in turn, was based on both the condition of the property and its location. The underwriter then uses his evaluation of the totality of the risks in determining whether to approve a loan and as a basis for setting the terms of an approved loan, i.e., amount of down payment (loan to value ratio), interest rate and repayment period (term of maturity).¹¹⁸

The appraisal and underwriting process as thus far described, insofar as it appears to be objective, involves legitimate criteria reasonably calculated to ensure a sound portfolio. Superimposed on it, however, and acting as the guiding force in the appraisal and underwriting profession is the overwhelming emphasis on the characteristics of the neighborhood in which the property is located. There is an old real estate axiom that there are three important facts relative to the value of a piece of property — location, location and location.¹¹⁹

The reference to location in fixing property value and determining risks manifests itself in two related assumptions on which appraisers and underwriters have unquestioningly relied for years. The first assumption is that racial integration has an adverse effect on property values in the integrated and surrounding areas. This assumption has been consistently reflected in major texts widely read by the profession. In fact, prior to 1950, the Code of Ethics of the National Association of Real Estate Boards, whose violation subjected realtors to disciplinary action, explicitly prohibited the introduction into any neighborhoods of "members of any race or nationality or any individuals whose presence will clearly be detrimental to property values in that neighborhood."¹²⁰ Even after the words "race or nationality" were removed, the Code was

construed the same way: blacks and other minorities were thought to have an adverse effect on land value.¹²¹

McMichael's *Appraising Manual*, a textbook for real estate agents, ranks races and nationalities according to their beneficial or detrimental effect on property values. This textbook, referred to by its publisher as "the bible of the real estate man," with its 15th printing (4th edition) released in 1970, appears to be religiously followed. One realtor testified in 1967 that many real estate manuals have been "quite emphatic on the dire results to be expected when minorities were brought into white neighborhoods" and "this axiom is still regarded as 'gospel truth' . . . by most realtors. . . ."¹²²

The second assumption underlying current appraisal and underwriting decisions is the belief that all neighborhoods have a built-in obsolescence factor. This theory of the inevitable deterioration of neighborhoods, described in some detail earlier in this paper, regards as one of the signals of decay the introduction into the neighborhood of nonconforming uses and users. Thus, appraisers are taught the "principle of conformity" which "holds that maximum value is realized when a reasonable degree of sociological and economic homogeneity is present."¹²³ The 1975 training manual of the Society of Real Estate Appraisers presents eight aspects of the neighborhood conformity principle:

- 1) Similar styles of houses
- 2) Houses of similar utility
- 3) Similar age 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, educational, ethnic and social backgrounds
- 8) Similar land uses¹²⁴

It is here that the two assumptions overlap: to the extent that the existence of different racial groups in the same neighborhood is considered a "nonconformity," the neighborhood is viewed as already on the road to decline.

The problem posed by discriminatory appraisal and underwriting policies is most visible in the practices of local savings and loans. But appraisers and underwriters influence the availability of credit at the local level in more indirect ways. For example, the federal agencies which insure or guarantee mortgages and the private mortgage insurance companies use standard appraisal and underwriting criteria to evaluate the risks prior to approving mortgage insurance applications. The criteria used by these insurers naturally influence the lending policies of local lenders who are anxious to prove loans which satisfy the requirements of the mortgage insurers.

116. MORTGAGE LENDING PRACTICES, *supra* note 4 at 110.

117. *Id.* at 114.

118. Discussion paper, *Appraisal and Underwriting Practices of Residential Loans in Seattle Neighborhoods*, OVERSIGHT HEARINGS at 212-213.

119. MORTGAGE LENDING PRACTICES, *supra* note 4 at 110.

120. *Zuch v. Hussey*, P.H.E.O.P. Rpt. ¶13,708 at 14, 511-14, 512, n.12, (E.D. Mich. 1975).

121. R. HELPER, RACIAL POLICIES AND PRACTICES OF REAL ESTATE BROKERS, 23 *et seq.* (1969).

122. *Hearings on S.1358, S.2114 and S.2880 (Fair Housing Act of 1967) before the Subcommittee on Housing and Urban Affairs of the Senate Committee on Banking and Currency*, at 407.

123. AMERICAN INSTITUTE OF REAL ESTATE APPRAISERS, THE APPRAISAL OF REAL ESTATE, 40 (6th ed. 1964).

124. AN INTRODUCTION TO APPRAISING REAL PROPERTY, at 6-11.

For example, HUD Handbook instructions to FHA appraisers adopt the principle of conformity: "To obtain its maximum value, the property must conform to its existing surroundings in size, age, condition and style, and should attract an occupant of similar economic status."¹²⁵ The Handbook also adopts the "life cycle" concept of a neighborhood, the inevitability of neighborhood deterioration, and the idea of the adverse effect of neighborhood conditions on the particular property.¹²⁶ The Handbook contains no cautions limiting consideration of such factors to the immediately surrounding block or blocks, or warnings about the subjective nature of such evaluations. Finally, the appraisers are instructed to consider the general income level of the neighborhood when estimating the value of the property, indicating that marketability (and hence value) increase with the conformity of the subject property to the neighborhood.¹²⁷

Many mortgage loans made by local lenders are sold to other private lenders across the nation and to the federal government in what is called the secondary mortgage market. The federal markets, the Federal Home Loan Mortgage Corporation ("FHLMC"), the Federal National Mortgage Association ("FNMA"), and the Government National Mortgage Association ("GNMA"), are described in greater detail in another section of this paper. These secondary markets use appraisal and underwriting standards to determine which mortgage loans they will buy. Since a majority of local residential loans are sold in the secondary mortgage market, local lenders are induced to make loans which satisfy those secondary market appraisal and underwriting criteria.

The FHLMC on their Residential Appraisal Report,¹²⁸ under the general heading of "Neighborhood," contains boxes to check off whether the property values in the neighborhood are increasing, stable or declining. In addition, under the same general heading, the form calls for a ranking as good, average, fair, or poor of the following neighborhood characteristics:

1. Employment stability
2. Adequacy of shopping
3. Convenience to schools
4. Quality of schools
5. Recreational facilities
6. Level of taxes
7. Adequacy of utilities
8. Neighborhood compatibility
9. Protection from adverse influence
10. Police and fire protection
11. General appearance of properties
12. Appeal to market

The form contains no cautions concerning the subjective evaluations inherent in some of these evaluations — for example, the assessment of "neighborhood compatibility" or

"protection from adverse influences"; nor does it specify the meaning of an "increasing, stable or declining neighborhood."

One study of the federal secondary mortgage market notes that GNMA and FNMA (when it purchases insured or guaranteed mortgages) do not do their own underwriting, but rely instead on FHA's or VA's and the private seller's underwriting judgments.¹²⁹ As has been shown above, they are, in effect, relying on the judgments of mortgage insurers and lenders who, in turn, have relied on appraisal techniques which redline.

In the context of these interrelated influences affecting the availability of credit at the local level, reform should not be limited to changing only the appraisal and underwriting practices of local lenders. The local lenders do not operate in a vacuum. Without a uniform reform of appraisal and underwriting standards, local lenders' ability to make credit available on a nondiscriminatory basis would be restricted because they would have difficulty insuring or reselling those mortgages.

IX. DATA GATHERING AND ANALYSIS TO DETECT REDLINING

As residents of neighborhoods across the country became aware of the fact that they were victims of redlining, they soon realized that basic lending information concerning deposit and loan patterns was not available to assist them in documenting the practice. Efforts to induce the institutions to disclose such data voluntarily usually met with the response that it was either impossible to collect or that it was confidential. Lobbying federal, state and local governments proved more successful, and the spate of ordinances, regulations and statutes dealing with "the public's right to know," and which were all recently issued or enacted, is described in this section. Unfortunately, the requirements of the various disclosure rules and legislation fail in many respects to arm the public with complete enough information to detect and act on redlining practices. The model proposed in this section for pinpointing redlining underscores these inadequacies and provides guidelines for future disclosure requirements and analysis.

A. Provisions and Limitations of Federal, State and Local Legislation and Regulation

1. The Federal Home Mortgage Disclosure Act of 1975

The Federal Disclosure Act¹³⁰ applies to depository institutions which are federally insured or regulated, or which originate loans insured or guaranteed by HUD or intended to be sold to the federal secondary mortgage market.

The number of loans and the principal amount of the following categories of loans must be itemized: total mortgage loans; home improvement loans; FHA or VA loans (except on

125. HUD HANDBOOK, 4150.1, VALUATION ANALYSIS FOR HOME MORTGAGE INSURANCE, ¶1-13(d).

126. *Id.* at ¶1-13(b) and 1-17.

127. *Id.* at ¶1-36(d).

128. FHLMC, *Single Family Underwriting Computer Matrix*, reprinted in BNA, HOUSING AND COMMUNITY DEVELOP. REP., 70,0703.

129. E.Kenny, *The Secondary Mortgage Market: FNMA and GNMA and FHA-Insured Single-Family Homes*, in THE ROLE OF MORTGAGE LENDING PRACTICES IN OLDER URBAN NEIGHBORHOODS, 230-231, 252.

130. 12 U.S.C. §2803 *et. seq.*

multifamily dwellings); other mortgage loans (except multifamily dwellings); loans on multifamily dwellings; and nonoccupant loans (except on multifamily dwellings). The information is compiled for each census tract (zip codes may be used only under certain circumstances) and must be supplied for all loans purchased and originated by the institution.

The Board of Governors of the Federal Reserve System is instructed to issue regulations implementing the Act,¹³¹ although all agencies with regulatory authority over depository institutions are empowered to enforce the Act. In addition, the Federal Reserve Board may by regulation exempt from the Act's requirements any state chartered depository institution if it determines that the institution is subject to requirements substantially similar to those imposed under the Act.

The deficiencies of the federal law are obvious: For example, it does not require disclosure of the origin of the institution's deposits on a geographical basis; there is no data relating to rejected applicants; also missing is information such as the race, age, sex and income level of all applicants; and no information on deposit patterns is required. A further defect is that the institution is not required to take any affirmative steps towards informing the public of this information, and is only required to make the disclosure statement available to the public upon request.

2. Illinois

The state of Illinois has enacted a disclosure law¹³² requiring lending institutions (banks, credit unions, savings and loan associations, insurance companies and mortgage banking companies) to disclose semiannually the number of loan applications and the total dollar amount of loans granted within each census tract or zip code area which lies within a county having a population of more than 100,000 persons. The Director of the Illinois Department of Financial Institutions is required to make copies of the data available for public inspection, and each financial institution is required to have the data available for public inspection in each of its offices during regular business hours. Institutions that fail to file promptly are fined, and an intentionally false filing is a felony.

The city of Chicago has approached disclosure differently by requiring it of all lenders who bid annually on the approximately \$2 billion in city and school funds available for deposit.¹³³

The information required includes the number and total amount of loans made within the six county Chicago SMSA; the average interest rate for all loans; and the down payment as a percentage of all amounts. In addition, for the city of Chicago, the lender must provide information on the number, total amount, and terms and conditions of FHA-VA loans made within each census tract. The lender is also required to submit the number and total amount of all construction and home improvement or rehabilitation loans made within each

census tract in the city of Chicago. Finally, the lender must indicate separately the number of savings accounts and checking accounts and the total dollar balances of those accounts for each census tract within the city of Chicago.

3. Massachusetts

On August 1, 1975, the Massachusetts Commissioner of Banks issued directives requiring disclosure of mortgage lending practices. The information required includes the number of mortgages, average interest rates, outstanding balances, and the number of foreclosures, itemized according to geographical location. The banks must also indicate the geographical distribution of deposits. For a specified number of areas the information is to be collated by census tract with the remaining areas (including all cities and towns within the Boston SMSA) by zip code. The disclosure requirement applies to all state chartered banks and credit unions having \$20 million in deposits and with main offices located within the Boston SMSA. The requirements will also be imposed upon any institution, provided twenty-five or more of its depositors having an average of \$50 or more in their savings account for a period of at least six months, petition the Commissioner of Banks requesting such information. The information is to be available to the public at the offices of the bank and at the office of the Commissioner of Banks. The disclosure requirements are implemented by incorporation into the Annual Report of Examination for state chartered banks and credit unions.

4. New York

The New York State Banking Department has issued a regulation¹³⁴ requiring all state chartered financial institutions to submit annual reports to the Banking Department indicating the number and dollar amount of loans made and rejected for each census tract or zip code area in the state. The disclosure statement must also indicate the geographical origin of the institution's deposits. Records maintained must also indicate the race, sex, marital status, age, income level, and the years spent in present employment for each application. Finally, the reasons for rejected applications must be noted on the record. The disclosure statements will be made available to the public in an annual report issued by the Banking Department.

5. California

The California Commissioner of Savings and Loans has imposed the most detailed disclosure requirements thus far required by any federal, state or local government. While they will not reveal patterns of deposits, they will provide excellent information on the characteristics of successful and rejected loan applicants and the real estate in question. Also, since they were developed in the context of a comprehensive enforcement scheme designed to eliminate redlining, they go beyond mere disclosure for the sake of public information. The patterns of redlining revealed in the statistics are to be used by the state in

131. These regulations were issued and became effective June 11, 1976. See 41 Fed. Reg. 2391 (June 14, 1976).

132. Financial Institutions Disclosure Act, H.B. No. 1103.

133. MUNICIPAL CODE OF CHICAGO, MUNICIPAL DEPOSITORIES, Ca. 7, §§7-30 - 7-41 (June 10, 1974).

134. Supervisory Procedure 6-107, N.Y. State Banking Department, effective May 1, 1976-1980.

proceedings by the savings and loan commissioner against associations found to be guilty of the practice, in acting on charter, merger, or branching applications of savings and loans, or by the rejected applicant who files a complaint of redlining.

All state licensed savings and loan associations will be required to report comprehensive information on each real estate loan and home improvement loan made and denied, and also certain information on loans purchased and sold. The information to be reported relates to the character of the neighborhood, the loan, the borrower/applicant, and the property, as follows:

1. *Neighborhood:* census tract
2. *Loan:* purpose; type (e.g., FHA, VA, conventional); loan amount (including amount requested when different from amount granted); amount going toward improvements in the property and old balance (in cases of refinancing); interest rate; term to maturity; fees; points; whether or not variable rate.
3. *Borrower/Applicant:* race or ethnic descent; total family income; the sex, age, and income of the borrower/applicant. The sex, age, and income of the co-borrower/applicant (if there is one); and whether or not the borrower intends to reside in the property.
4. *Property:* type of property; number of units; appraised value; selling price; age of house; square footage of improved living area.

The regulations also require disclosure of marketing policies and programs. Each association is required to furnish every applicant (and to make available to the public) a pamphlet explaining the association's criteria for deciding whether and under what terms and conditions to approve a mortgage loan application. If the loan is denied, or terms are imposed which are more onerous than usual, the applicant must be provided with a clear statement of the reasons for denial or variation in terms, and given notice of the right to file a complaint with the Savings and Loan Commissioner.

B. A Model for Pinpointing Redlining

The problems of both pinpointing redlining practices and formulating programs which might aid in its amelioration are compounded by the absence of extensive empirical data on urban lending patterns. The passage of the Home Mortgage Disclosure Act of 1975 which took effect June 28, 1976, and terminates four years thereafter, is an initial, but inadequate, step in determining where redlining is occurring.

Though the Federal Home Mortgage Disclosure Act will make public what has previously been confidential information, it does not require mandatory analysis and public dissemination of the information. Given the fact that those persons most directly concerned with redlining are the lower income groups concentrated in disinvested neighborhoods, it is an unfair burden on their resources to require citizen initiation in the analysis and dissemination of loan data. It would seem appropriate, therefore, that regulations modeled after the previously discussed California Reporting and Disclosure Requirements be issued at the federal level in order to have the necessary information available to adequately

investigate mortgage practices. In addition, it should be required that:

- lenders document and identify the reasons for all loan refusals, including those made by telephone; and,
- lenders provide regular periodic analysis of the loan data to determine whether certain areas are being excluded from receiving loans and whether racial and/or ethnic minorities are being restricted in loan activities.

An aggregation of this type of information compiled by individual financial institutions could prove to be extremely useful in analyzing socioeconomic and demographic trends as they relate to lending practices at both the metropolitan and national levels. At the same time, since redlining is a practice which most immediately affects Americans at the neighborhood level, a model to determine if redlining is occurring in selected neighborhoods needs to be developed.¹³⁵ Essentially, such a model requires the comparison and analysis of lending behavior in two or more neighborhoods. Redlining should be suspected in at least one of the neighborhoods and not suspected in at least one other.

Since the model will concentrate on data aggregation and analysis at the neighborhood level, the first priority is a clear and concise identification of the physical boundaries of the neighborhoods. Generally, this identification process will involve isolating areas with common socioeconomic, racial and/or ethnic, and housing stock characteristics. Community groups should be consulted in this process to insure the boundaries' validity and reliability. Once the neighborhoods to be investigated have been defined, the census tracts therein will be used for statistical comparison. In the event that two or more neighborhoods jointly share census tracts, these tracts can be allocated to the neighborhoods according to the following scheme:

1. Where a neighborhood contains more than 50% of a census tract's area, it can be allocated to that neighborhood.
2. Where multiple sharing of a census tract occurs, the tract can be allocated to the neighborhood containing the largest portion of it.

Naturally, a valid study of redlining requires comparison between different yet internally homogeneous areas. In some cases, a census tract may encompass both a declining, redlined area and a thriving, higher-income area. These factors must be kept in mind when choosing neighborhoods for investigation.

Neighborhood demographic profiles should be developed as a framework to infer levels of mortgage demand and to distinguish the neighborhoods' relative socioeconomic characteristics. Since redlined neighborhoods share some characteristics, certain measurements or proxies can be used to determine which neighborhoods are likely prospects for institutional disinvestment as well as to infer what factors may have provided the impetus for redlining. Multiple regression analysis can be used to determine which variables are significant in explaining mortgage lending activity in a city. These variables or proxies fall into four general categories:¹³⁶

135. *NIJ 1981 Hearings*, *Supra* note 6 at 493-495, report by Fred William M., *Discriminatory Lending Practices in Oakland*, where most of the following points are discussed.

136. The following variables and their significance are discussed in Ahlbrandt, *Mortgage Lending in Pittsburgh*, *Public Policy Series No. 6*, 9-10 (1975), (unreproduced).

1. *Economic Variables.* Median family income is used to describe the economic level of the neighborhood. The amount of time properties stay on the market indicates the economic viability of the neighborhood.

2. *Neighborhood Variables.* The percentage of vacant units is used to measure one aspect of the neighborhood: living environment; as the vacancy rate rises, it is assumed that the quality of the neighborhood deteriorates. The homeownership rate is used as a proxy for the relative stability of the neighborhood; higher rates are assumed to indicate a more stable neighborhood. The crime rate is used to measure one aspect of the quality of life; a higher incidence of crime is assumed to indicate a less desirable environment and a greater risk for potential investors. The age of the housing stock is used to measure a neighborhood's relative desirability for investment, and the number of abandoned houses is used to indicate relative disinvestment and deterioration.

3. *Racial Variables.* Nonwhite population as a percentage of total population and the percentage change in nonwhite population 1960-1970 are used to measure the significance of race to mortgage lending practices.

4. *Demand for Mortgage Financing.* The number of real estate transactions is used to account for the differences in mortgage demand between neighborhoods.

Once this data has been collected, it can be used in the following sequence of steps to pinpoint redlining and to infer what criteria has been the basis for the disinvestment decision:

Step I. Comparison of the proxy measurements for all neighborhoods to be investigated and identification of the suspected redlined neighborhoods which are generally defined as encompassing a low median income, a high percentage of minorities, a high percentage of vacant units, older housing stock, low rate of homeownership, and long periods of time that properties spend on the market.

Step II. Analysis to determine whether there is any basis for the suspicion of redlining based on the data provided by the lending institutions. If substantial differences exist between neighborhoods in the number of conventional loans granted or denied, the terms of the loans, and/or the number of FHA mortgages, further analysis is warranted.

Step III. Correlation of the proxy measurements with the data on loan transactions. If neighborhoods which are characterized by equal credit-worthiness (as indicated by sharing comparable economic profiles) experience substantial differences in lending practices, then the allegation that redlining is occurring cannot be ignored and further analysis is warranted.

Step IV. Examination of the possible criteria influencing the disinvestment decision (racial distribution, age of housing stock, etc.) and analysis of the possible impact redlining has had on a neighborhood (using data on the number of abandoned houses).

Whenever possible, this model should incorporate comparative data over a period of time. This time element becomes extremely important in determining the actual role disinvestment plays in neighborhood decline for, on one hand, victims allege that redlining is both a cause of and catalyst for neighborhood decline. On the other hand, financial institutions justify disinvestment as a response to deterioration. If it can be shown statistically that a neighborhood's decline commenced or substantially

quicken after disinvestment, the victims will have justification for their claim that redlining has not only fostered but actually caused central city deterioration.

X. REMEDIAL ANTI-REDLINING EFFORTS BY FEDERAL AND STATE GOVERNMENTS

Only one federal agency and two state governments have gone beyond the mere disclosure of lending patterns and have taken steps to provide remedies for residents of redlined neighborhoods. They are the FHLBB, the Illinois legislature and the California Commissioner of Savings and Loans. Each government's actions are described below.

A. The Anti-Redlining Efforts of the Federal Home Loan Bank Board

Because the FHLBB is the only one of the four financial regulatory agencies to have acknowledged and acted upon the adverse effects of redlining, it is worth taking a closer look at their policies and implementing regulations. There is some danger that the other three regulatory agencies — because they have shown a decided lack of imagination in the area thus far — may regard the FHLBB's efforts as a model and duplicate them. While certain aspects of the FHLBB's activities are commendable, others are gravely deficient and should be modified.

Briefly, as of March 1, 1976, the FHLBB had taken the following steps which bear on redlining:

1. It had published regulations requiring non-discrimination in federally-assisted programs and providing for a complaint procedure.¹³⁷
2. It had published regulations requiring non-discrimination in lending.¹³⁸
3. It had published guidelines interpreting its nondiscrimination requirements.¹³⁹
4. Its general counsel had written two opinions further expanding on the nature of discriminatory lending practices.¹⁴⁰
5. It had instituted equal opportunity review procedures as part of its regular examination of member institutions.¹⁴¹

137. 12 C.F.R. §529.

138. 12 C.F.R. §528.

139. 12 C.F.R. §531.8.

140. Opinion letter dated from FHLBB General Counsel to FHLBB Office of Housing and Urban Affairs March 21, 1974; and EOP Memorandum, from William Sprague to OES Professional Staff, May 23, 1975, concerning non-discrimination.

141. *Hearings Before the Senate Committee on Banking, Housing and Urban Affairs, Oversight on Equal Opportunity in Lending Enforcement by the Bank Regulatory Agencies*, 94th Cong. 2d Sess. 45-53 (1976). [Hereinafter cited as OVERSIGHT HEARINGS.]

MEMORANDUM ONE

ISSUES AND RESPONSES

NEED FOR A PUBLIC BANK

Q: What are the concerns and problems that led to the conceptualization of the public bank?

- A: 1. Redlining -- Redlining is a policy of banks in New York and across the country to avoid investing for new home construction and mortgages in "undesirable" communities. The observable phenomenon that many sections of the State of New York, particularly our cities and low income communities, are unable to obtain financing for new home construction and that existing property renovation and rehabilitation are virtually impossible is the result of this bank policy. The pervasive effects of redlining undermine the very financial structure of our cities and low-income communities.
2. Municipal Bond Market -- The erosion of the municipal bond market is the result of another bank policy. The repeal of the Port Authority covenants and the UDC crisis have shaken the confidence of the banks in the municipal bond market. The recent suspension by Standard and Poor's of New York City's "A" rating has further eroded this confidence. As a result, the financing of municipalities has become an increasingly costly burden.

3. Community Development -- The perception by the banking community that community development is not profitable has led to an almost total lack of long-term capital for community development. As a result, neighborhoods have nowhere to turn for funds making community decay all but inevitable. Lack of this kind of funding by the banks represents a severe disservice to the people of the communities from which the banks draw their funds.
4. Venture Capital -- Venture capital is high risk capital for new industrial and commercial enterprises. This flow of money to innovative businesses is essential to keep the state's economy healthy and to provide a base for future job creation. Being basically risk averse, the banking community has shunned these investments resulting in an almost total absence of risk capital in the state.
5. "Strip mining" of Capital -- The disintermediation of monies has resulted in the flow of money from rural areas to small villages, from towns into cities of increasing size, and finally into the major money centers. Ultimately, this money is exported to other states and countries where it

can earn the higher rates of return than are currently available in the state. Increasingly, monies deposited in New York State are being used to finance development elsewhere in this country and abroad. Doubtless, this process will be accelerated by the statewide Branch Banking Law, and in that context, the following direct quote as reported in the Rochester Democrat and Chronicle, April 10, 1975, from Arthur M. Richardson, President and Chief Executive Officer of Security, New York State Corp., an upstate regional bank holding company, is of relevance:

"To the international giants like Citi-bank, Chase Manhattan and others, their upstate banks are like strip mining operations. The raw material, money, is extracted from our local communities to be used anywhere in the world where they can get the best terms regardless of local consequences."

MORE GOVERNMENTAL BUREAUCRACY

- Q: Are there alternatives to a state bank in order to accomplish the same purposes? In other words, do we need a new institution and a new governmental bureaucracy?
- A. Yes, we do. For perfectly sound reasons having to do with maximizing earnings per share in the case of commercial banks, and the less clear purpose of increasing capital surpluses in the case of savings banks and Savings and Loans, the banking institutions have historically been unable and continue to be unable to deal adequately with the collection of problems referred to previously. It is pointless to berate the FHA for its historic reluctance to insure in urban areas, (leading to the self-fulfilling prophetic results of disinvestment) and it is equally unproductive to criticize banks

for preferring to loan under insured and reduced risk circumstances. However, the socially undesirable results of these policies are observed in the geographical distribution of the New York State savings banks' mortgage portfolio as of December 31, 1974. At that time 44.21 percent or \$19,115,000,000 of mortgages were in insured VA or FHA mortgages. Conventional one and two family mortgages were only 18.3 percent of the portfolio or \$7,797,000,000 worth. Of the total mortgage portfolio of the savings banks, 51.8 percent or \$22,396,000,000 worth was in New York State and the balance or 48.2 percent being \$20,840,000,000 was in mortgages outside of New York State.

Clearly, the private sector is not serving the needs of the state. A new governmental agency is needed in order to stimulate the private sector to better serve public needs.

YARDSTICK COMPETITION

Q: How will the state bank effect the performance of existing banking institutions?

A: There is at present no adequate yardstick by which the performance of conventional banking institutions can be measured relative to their performance as underwriters and market creators of governmental financing. Experience in North Dakota with the State Bank of North Dakota established in 1919 is valid historic precedent for seeking to establish this yardstick.

A multiplicity of incentive and guarantee insurance programs would not be sufficient to produce an efficient, coordinated system of public purpose federal and state programs. However, through direct

competition and indirect support, the state bank can act as a positive influence on the existing banking structure and thereby achieve a healthy level of "yardstick" competition.

MANAGERIAL COMPETENCE

Q: Where would the managerial competence come from to run this large scale enterprise?

A: National examples abound of special purpose financial institutions such as farmers credit programs and other public purpose banking efforts which have been run competently and profitably so that capital structure is owned by the client population although policy continues to be set by the executive and by Congress. Even private lending institutions will privately admit that there is no reason to suppose the state cannot run this effort in a profitable manner. Attracting competent management is not an insurmountable obstacle.

UNIVERSAL PANACEA?

Q: Are you seriously trying to tell us that this bank is going to solve New York State's financial problems and the financial problems of the cities?

A: Of course not. Opponents of the bill will seek to destroy this valuable institution by imputing to it such vast goals and objectives that it must necessarily fall of its own weight. It will of necessity have relatively modest resources with which to operate.

ANOTHER UDC?

Q: Why isn't this just another UDC?

- A: 1. Profitability -- The whole operational premise of UDC was that it was a developer and builder of last resort. The public bank would not be exclusively a lender of last resort. The public bank is charged with the responsibility of being profitable.
2. Flexibility -- UDC is entirely limited to the most difficult form of long term financing whereas the public bank has unlimited flexibility to lend both long and short.
3. Cash Flow -- It was never contemplated that the cash flow from UDC projects would be adequate to pay debt service until the projects were, in fact, complete. It should also be remembered that the banks refused to loan to UDC prior to the completion of the projects.
4. Regulation -- The public bank would be subject to the regulation of the banking department whereas UDC was essentially unregulated.
5. Intent -- There is little relationship between a development organization such as UDC and a bank. These organizations were designed for different purposes and there is no reason to suspect that they will be subject to the same pitfalls.

SOURCES OF FUNDS

Q: Where will the money come from?

- A: The money will come from a variety of sources including:
1. Capitalization of \$50 million of first instance funds;
 2. Municipal deposits and state deposits which at year end

1974 totalled \$3.4 billion on hand in state chartered commercial banks;

3. It is contemplated that local assistance funds projected to be \$6.2 billion for 1975 will be transferred through the state bank producing an average daily deposit in excess of \$11.5 million a day;
4. The state bank will solicit time deposits of all varieties including day of deposit to day of withdrawal, time deposits, certificates of deposits and other like debt instruments. Under consideration is the possible exemption from federal, state and local taxation of interest earned on time deposits in the state bank;
5. The state bank will solicit demand deposits;
6. It is contemplated that the state bank will be an eligible recipient of grants both federal and state and other forms of public assistance to pursue its objectives.

UNSOUND AND DESTRUCTIVE COMPETITION

Q: Won't the state bank destroy other commercial and thrift institutions?

A: Not at all. The state bank will work closely with such institutions and will function in some respects like the import-export bank. It could participate in loans with other banks and could administer loan insurance and guaranty programs. It should be remembered that banking as a regulated industry is a protected industry and it is not the purpose of the public bank to limit competition but to increase competition. The combined effect of the bank holding law and the statewide banks

banking law are far more significant events relative to decrease of competition than the state bank could ever be.

INSURANCE

Q: What security will the depositors have that their money will be there when they want it?

A: In addition to the moral authority of the State of New York we are exploring whether it is more appropriate to obtain Federal Deposit Insurance or create a State Deposit Insurance as the State Bank of North Dakota did. Either of these alternatives should provide depositors with firm safeguards that their deposits are secure.

MEMORANDUM TWO

/ "HISTORICAL PRECEDENT -- THE BANK OF NORTH DAKOTA"

HISTORY

- The Bank of North Dakota opened in 1919.
- It is owned by the state government, not private stockholders.
- It sought to save farmers from ruinous falling agricultural prices following World War I. At that time, private bankers were quick to foreclose on property and slow to grant loans. As a result, the state successfully stepped in and saved many farmers from financial ruin.

OPERATIONS

- It is run like any other bank and as such, seeks sound, profitable investments.
- Its assets are four times greater than any other bank in the state.
- According to Forbes magazine (1/15/75), its rate of return on assets is almost twice as great as any of the 100 largest banks in the United States.
- It does little direct lending and soliciting of deposits. Rather it seeks large corporate and state accounts and acts to participate in loans initiated by other banks.
- One of its most valuable functions is to act as a primary market for small municipal bond issues.

MODEL FOR NEW YORK STATE

- New York has parallel problems to those for which the North Dakota Bank was established. For example, the issue of redlining and the lack of capital flowing to low income communities is analogous to the problem faced by farmers in North Dakota.
- In addition, many New York municipalities and state authorities would benefit from the role the North Dakota Bank plays in bolstering the market for municipal and state bond issues.

SUMMARY

- The Bank of North Dakota proves that a state government can be successful in the banking business.
- The Bank of North Dakota also proves that social, public interest needs can be met while profits are simultaneously pursued.
- The Bank of North Dakota provides a positive competitive influence on the banking system to act in the public interest as well as aid to the existing private banking structure by participating in loans by banks.

MEMORANDUM THREE"BANKING HISTORY"INTRODUCTION

- Banking in New York is a complex scheme of commercial banks and trust companies, savings banks, savings and loans, credit unions, state and federal regulatory agencies.
- This is the result of an historically decentralized banking system with over 13,700 separately incorporated commercial banks.
- This is an unusual system. Most other nations have a powerful central bank which does not exist in the United States.

EARLY BANKING

- In 1791, the First Bank of the United States was established. It was jointly owned by the federal government and private investors. Political division in Congress prevented renewal of its charter in 1811 but it did act to establish banking as an industry in the United States.
- From 1811-1816, private banks proliferated. With little control and regulation, these banks irresponsibly issued notes causing inflation and widespread monetary disorder.
- In 1816, Congress created the Second Bank of the United States. This bank ran into political trouble with President Andrew Jackson and in 1836, its charter was not renewed.

MODERN BANKING

- In 1864, Congress approved the National Bank Act which provided for a national currency and federal chartering of banks. It provided the first real regulation and supervision of the banking

system. This Act brought order and stability to banking for a while.

- Despite the stability achieved under the banking act, true banking reform and the beginnings of modern banking began with the Federal Reserve System, established in 1914.
- In 1935, after the wave of banking failures during the depression, the Federal Deposit Insurance Corporation was established. The FDIC has brought stability and confidence to the banking system.

BANKING REGULATION

- Banks can either be chartered federally by the U.S. Comptroller of the Currency or by the state through the State Banking Department. Federally chartered banks are regulated by the Comptroller of the Currency and must become members of the Federal Reserve System. State chartered banks are regulated by the State Banking Department and by the Federal Reserve Board if they choose to join the Federal Reserve System.
- Membership in the Federal Reserve System imposes certain restrictions on banks but also grants them borrowing privileges. State chartered banks that don't join the Federal Reserve System are supervised by FDIC.
- State chartered savings and loan associations and credit unions are regulated by the State Banking Department. Federally chartered savings and loan associations fall under the supervision of the Federal Home Loan Bank Board.

TYPES OF BANKS

Commercial Banks

- They are corporations owned by shareholders.
- They may be federally or state chartered.
- They may provide the following services:
 - time deposits,
 - checking accounts,
 - bank credit cards,
 - consumer and business loans, and
 - home and corporate mortgages.

Savings Banks

- In theory they are owned by their depositors. However, actually there are no owners. Operating capital comes from depositors rather than shareholders.
- Savings banks are permitted by Federal Reserve Board and the FDIC to pay higher interest rates on deposits than commercial banks.
- Savings bank services include:
 - savings accounts,
 - home mortgages and general real estate financing, and
 - passbook loans and savings banks life insurance.
- Savings banks cannot offer checking accounts, personal loan services, or bank credit cards.

Savings and Loan Associations

- They are similar to savings banks and subject to many of the same limitations.
- Savings and loan associations are owned by depositors similarly to savings banks.

There is limitation on savings and loans for investing their assets in home mortgages. Otherwise, they operate the same as savings banks.

Credit Unions

- These are organized around existing institutions or organizations and are not generally open to the public.
- Credit union members own the organization and get paid dividends in lieu of interest.
- Credit unions engage mostly in consumer loans for the benefit of their members.

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January, 1973

Linked Deposits

THE ILLINOIS PLAN
BY ALAN J. DIXON, STATE TREASURER

For some years now, the office of the State Treasurer in Illinois has aided taxpayers by investing public funds putting their money to work, to generate revenue for the State and accomplishing other goals as well.

The investment programs of the Treasurer's office in Illinois have been developed to accomplish four goals:

- a. Maximum earnings
- b. Stimulate economy of the State
- c. Provide an even geographic spread of State funds
- d. Benefit deprived and needy citizens

We believe that the combination of these programs, developed and modified during the past six years has been highly successful in meeting these goals.

In addition, interest returned to the State's General Revenue Fund constitutes one of the chief sources of major revenue, amounting to more than \$63 million last year, thanks to day-to-day attention to investment at optimum interest rates.

Two of the investment programs employ the linked-deposit concept. That is, time deposits are made with banks on condition that a specific lending action be taken by each bank at our request.

- ① Our Specific Opportunity ^[Program] uses the "linked-deposit" concept to encourage banks to participate in the financing of a particular project or projects. For example, when our state was in danger of losing \$95 million of federal subsidized housing because interim financing couldn't be found, we persuaded a group of banks to supply the necessary funds. In turn, we agreed to allot funds to interest bearing time deposits. I would like to point out that not all projects have

to be of this magnitude. As an example, a time deposit was made with a small downstate bank to encourage purchase of bonds to effect modernization of a sewage treatment plant. When the corn blight disaster hit Illinois, we made available interest bearing time deposits to rural banks to encourage them to extend agricultural loans. This same program has promoted Small Business Administration and student loans. It is clear to us that the program has alerted the banking community to the desirability of becoming involved in public programs. Time deposits are allocated under this program when funds are available. We do not attempt in any way to ease or alter the credit requirements of the financial institution.

A study for the Ford Foundation of the "Illinois Plan" was completed in October, 1968. It researched at great length the economic impact of our investment program using the "linked-deposit" concept. One section of the report concluded, "As indicated by our economic flow model (Part III-A) such shifts would generate income multiplier effects within the state several times larger than the state deposits themselves -- assuming the banks lend all they can based on such deposits. This would, in turn, create sales tax receipts providing an annual rate of return to the state almost as large as, or perhaps larger than, the interest earned on the deposits themselves." It should be noted that this report was made before Illinois had an income tax. The multiplier effect creating additional income taxes was not considered.

② Our Community Services Program also utilizes the "linked-deposit" concept but after, rather than before the fact. In effect, it rewards banks for their past history of involvement in community service oriented loans. The types of bank activity recognized include such areas as a bank purchases of local tax anticipation

warrants, student loans, Small Business Administration loans, pollution abatement loans and so forth.

Under this program, proposals are taken each year from banks wishing to participate. This year 874 of the 1160 Illinois banks applied for and received deposits. We determine a minimum rate and banks must bid at or above that rate. Banks are requested to report their outstanding loans in 13 categories listed on the proposal form.

We determined the categories on the basis of responses to a questionnaire we sent to all of the Illinois banks. They were asked to list the types of loans which they felt should be recognized as community service oriented.

In order to eliminate subjectivity from our allocation, we use a computerized system based on a mathematic proration formula. Each bank's outstanding loan record by category is input to the computer, the formula applied, and each bank's time deposit is calculated. The term of the deposit is one year.

(3) Our third program, the Basic Deposit Program, acknowledges the right of all Illinois communities to share in the use of public funds, as long as they can demonstrate a need for deposits. The emphasis is on interest rate bid. The major Chicago banks are not eligible for participation in this program.

[Six big Chicago banks held 52% of Illinois deposits in 1970]

Proposals are taken each year. The bid form submitted reports the bank's total outstanding loans, the amount of the time deposit requested and interest rate they are willing to pay. A minimum rate is established and those banks applying above this minimum are awarded larger deposits. The term of the deposit is one year.

Again this is a computerized allocation. Awards are made through a mathematic proration between the funds available for deposit, and the relationship of a bank's weighted outstanding total loans to the total outstanding loan of all

qualified banks applying for State funds. It is a proration of what one bank's weighted outstanding loans bear to the total of all applying banks weighted outstanding loans. Weights are injected for rate bid and size of the bank.

(4) In order to maintain necessary liquidity, short term investments are also made. Again we attempt not only to obtain high yield but to the extent possible obtain a return from the multiplier effect. We therefore shy away from sterile investments such as government securities and place short term time deposits: 30, 60 and 90 day. To obtain a good geographic spread, these funds are placed with banks around the State who are willing to pay the prevailing Chicago rate.

The Ford Foundation study referred to above, concluded, "With certain modifications, the acceptance and use of the linked-deposit concept by more State Treasurers and other controllers of funds would further the welfare of the states concerned and the nation as a whole."

It is my own belief that Treasurers of all public funds ought to put to work, at interest, the funds in their custody, treating the interest returned as a source of revenue and thus helping to avert new or higher taxes.

SCOMM

#9:117

STATE OF ALASKA

THE LEGISLATURE

BUDGET AND AUDIT COMMITTEE

JUNE 9 1980

AUDIT DIVISION
POUCH W-ALASKA OFFICE BUILDINGFINANCE DIVISION
POUCH WF-STATE CAPITOL

November 15, 1977

MEMORANDUM

TO: Interested Legislators

FROM: Milt Barker *MB*
Fiscal Analyst
Legislative Finance Division

SUBJECT: TAPS Tariffs

Protests of proposed Trans-Alaska Pipeline tariffs averaging \$6.20 per barrel were filed with the ICC by the State, the U.S. Department of Justice's Antitrust Division, the Arctic Slope Regional Corporation, and the ICC's own staff.

After reviewing these protests, as well as the ICC's Order (now overruled by the Supreme Court) suspending the proposed tariffs, I am forwarding sections from the ICC staff protest which seem to provide the most comprehensive discussion of the proposed rates. Section 7 (pages 23-32) covers the rate of return decision, the determination of which will have the largest impact on the tariff.

Also included from the ICC staff report is section 9 (pages 38-40) regarding some possible anti-competitive aspects of the pipeline's operation. Of course, as argued in other protests, a high tariff in and of itself is the greatest threat to future competition for North Slope leases and production.

MBB:pw
Enclosures

Before the
INTERSTATE COMMERCE COMMISSION

Effective Dates:	June 20, 1977	June 20, 1977	June 20, 1977
Tariff References:	BP Pipelines, Inc. ICC Nos. 1&2	Mobil Alaska Pipeline Co., ICC Nos. 1&2	Sohio Pipeline Co. ICC No. 742
Rates per Barrel:	635¢	631¢	616¢
Nature of Proposals:	Initial tariffs on petroleum moving from Prudhoe Bay, Alaska, to Valdez, Alaska.		

Effective Dates:	June 30, 1977	June 30, 1977	July 1, 1977
Tariff References:	Arco Pipe Line Co. ICC No. 1030	Exxon Pipeline Co. ICC Nos. 124 & 125	Amerada Hess Pipe- line Corp., ICC Nos. 1&2
Rates per Barrel:	604¢	627¢	644¢
Nature of Proposals:	Initial tariffs on petroleum moving from Prudhoe Bay, Alaska, to Valdez, Alaska.		

PROTEST AND PETITION

OF THE BUREAU OF INVESTIGATIONS AND ENFORCEMENT
FOR SUSPENSION AND INVESTIGATION

PETER M. SHANNON, JR.
Director

EDWARD D. GREENBERG
Special Counsel for Pipelines

Bureau of Investigations and
Enforcement
Interstate Commerce Commission
12th and Constitution Avenue, N.W.
Washington, D.C. 20423

Of Counsel:

LEONARD S. GOODMAN
7119 Sixteenth Street, N.W.
Washington, D.C. 20012

5. Temporary Rates Ranging from \$4.54 to \$5.00
for Individual Carriers are Justified and
Should be Permitted on One Day's Notice

In the "Background" section of this Protest, we suggested that consistent with the absence of antitrust immunity, the six tariffs separately present the question of the appropriate interim rates pending the investigation into the cost and valuation of the pipeline. We, therefore, propose to recommend a group of six rates ranging from \$4.54 to \$5 that the Commission should permit to become effective on one day's notice, and to serve as the basis for its investigation into the cost and valuation issues.

Even if the Commission accepts all the carrier's original construction cost figures in this interim period pending the investigation, it should not allow any rates higher than presently needed to cover the reasonably estimated costs plus fair return. Temporary or interim rates as high as we here recommend are likely to be found too high once the Commission has investigated, among other things, the numerous cost overruns. Rates ranging for the individual companies from \$4.54 to \$5, therefore, will necessitate the inclusion of a refund provision in any order authorizing their filing.

There are five basic elements of the pipeline rates that must be considered before the Commission can decide whether to suspend the published rates or any others that may be filed, namely,

- (a) Operating costs.
- (b) Depreciation.
- (c) Removal costs.
- (d) Return on valuation.
- (e) Federal and State income taxes.

Let us then briefly consider each one.

Operating costs. The carriers have proposed operating costs that average 93 cents per barrel. This figure compares to the following projected figures used in other published studies:

Mortada study^{16/} 78¢

Drexel-Burnham^{17/} 51¢

Wainwright^{18/} 73¢

^{16/} "The Determination of Equitable Pricing Levels for North Slope Alaskan Crude Oil" prepared for FEA by Mortada International, Dallas, Texas (November 1, 1976). A copy of Chapter IV of this Study is attached hereto as Appendix E for the information of the Commission. See pp. IV-19 and IV-23 of that Study, which refers to 52¢ for operations and an additional 26¢ for property taxes.

^{17/} "The North Slope: Paradise Lost? An Industry Analysis." Drexel Burnham & Co., Inc., April, 1976, Table II-B for 1978.

^{18/} "Petroleum Industry," Wainwright Securities, Inc., April 1, 1977, Table 10, or 40¢ for operations and 33¢ for property taxes.

The proposed operating costs per barrel assume a throughput of only 1.2 million barrels per day. Most studies we have seen reflect an increase to 1.6 million barrels by about 1980^{19/} Arco advises us that, (1) it uses a 4.3 year average flow for the initial tariff, and (2) it expects to attain 1.6 million barrels per day by mid-1980. For the first 4.3 years, Arco's average flow rate will be about 1.3 million barrels/day. Moreover, the carriers' average figure of 93¢/B requires investigation since it may reflect further cost overrun. For purposes of an interim rate only, we recommend that the Commission use the carriers' proposed figure of 1.2 million B/day, and operating expenses projected by each carrier.

Depreciation^{20/} The carriers propose average depreciation and amortization of 83¢ per barrel based on investment, excluding land, of \$9.280 billion and a service life of 25 years. In later pages, we show that a 25-year life is too conservative, even for interim rates, and that the Commission should use not less than 27.5 years as the projected service life. For a service life of 27.5 years, the annual average depreciation and amortization is 77¢/barrel^{21/} which should then be apportioned to each carrier in accordance with its percentage of ownership.

^{19/}For example, see Mortada study, App. E hereto, at p. IV-20.

^{20/}Including amortization of overhead and capitalized interest during construction at 6 percent.

^{21/} $(\$9.280 \text{ billion} \div 27.5 \text{ years}) \div 438 \text{ million barrels.}$

Removal costs. The carriers report that they commissioned a study of the costs of removing the pipeline and restoring the surface. We have not seen this study, but it nevertheless raises certain conceptual questions that we later discuss. The carriers advise that the study projects a one-time cost, 25 years hence, of \$1.049 billion, which some of them adjust for inflation. If amortized over 25 years, the annual average cost in 1977 dollars becomes 9.6¢ per/barrel. Consistent with our treatment of depreciation expense in this interim period, we recommend the use of a 27.5-year life, and hence amortize the removal costs in current dollars on the basis of 8.7¢/barrel^{22/} which also may be apportioned on the basis of percent ownership.

Return on valuation. The fair return on valuation standard to compensate both the debt and the equity holders in the pipeline carriers is now under review in Ex Parte No. 308 (Sub-No. 1). We recommend that those standards be explored as well in this proceeding in the context of the particular circumstances surrounding the construction of this pipeline.

We will later show that the very high rates exceeding \$6 that are proposed here seem to reflect an irrational allowance of the entire return on valuation as a return solely for the stockholders. Only in this way can we understand the total returns of over \$2 for equity and \$1.59 for interest, which the carriers seem to propose.

^{22/} (\$1.049 billion ÷ 27.5 years) ÷ 438 million barrels.

In the meantime, we recommend that the Commission employ a 10 percent return on valuation as it has historically been computed without prejudice to reconsidering the various elements of value that enter into the rate base computation. We recognize that the Commission has relied in the past on an 8 percent return on valuation for crude oil pipelines^{23/} Use of that standard here, however, would limit the return on equity to less than 6 percent. A return on valuation of 10 percent comports with the results of recent studies we have seen on the TAPS initial tariff rates, as follows.^{24/}

	Tariff Rate (c/B) (1)	Returns for (c/B)			Implied Percent of Valuation (Col. 4 ÷ 222)
		Debt (2)	Equity (3)	Total (4)	
Mortada	450	157	72	229	10.3%
Drexel-Burnham	460	149	83	232	10.4
Wainwright	423	160	56	216	9.7

An original cost rate base would amount to about \$9.295 billion, including \$9.28 billion for improvements and \$15 million for land, if we accept for present purposes the entire construction cost without adjustment for cost overruns. The

^{23/} Minnelusa Oil Corp. v. Continental Pipe Line Co.,
258 I.C.C. 41, 53-54 (1944).

^{24/} For references to the sources of these figures, see Appendix A hereto, p. 3.

^{25/} 2,225 c/B based on \$9.747 billion ÷ 438 million B/yr.

valuation becomes \$9.747 billion once reproduction cost and other elements of the valuation are included. Consequently, a 10 percent return is equivalent to an annual cost of 222¢/barrel.^{26/}

Federal and State income taxes. For many years, the Commission has recognized only actual taxes, rather than imputed or "normalized" taxes in its rate cases. In the Williams case,^{27/} it allowed normalized taxes. We recommend that the Commission use normalized taxes on an interim basis until the actual tax rates can be determined. The Commission should expressly recognize that such taxes will not be paid at least in the foreseeable future. They, therefore, provide a substantial cushion in the interim rates that in themselves warrant the addition of a refund provision in the order.

"Normalized" taxes here refer to the statutory Federal rates of 48 percent and the State of Alaska rate of about 9.4 percent. Since the State tax is deductible for Federal purposes, the effective overall income tax rate on a normalized

^{26/} (\$9.747 billion x 10%) ÷ 438 million barrels. We do not mean to suggest that reproduction cost will increase the valuation once the original cost investigation has been concluded, or that the concept of reproduction cost will ultimately have any application here.

^{27/} Petroleum Products, Williams Brothers Pipe Line Co., Docket No. 35533, decided by the entire Commission on reconsideration December 3, 1976.

basis is 52.9 percent. The normalized tax computation follows:

1. Return on valuation	222¢/B
2. Less deductible interest	<u>159</u>
3. Return for equity after taxes	63
4. Equivalent percent (100% - 52.9%)	47.1%
5. Return for equity before taxes (line 3 - line 4)	133.8¢/B
6. Income taxes (line 5 - line 3)	70.8¢/B

Summary. Based on the foregoing, the average interim rate becomes \$4.72 based on the following average costs:

Operating costs	93¢/B
Depreciation	77
Removal costs	9
Return on valuation	222
Income taxes	<u>71</u>
Avg. interim rate	432¢/B

The carriers have reported to the Bureau of Accounts that their interest costs in 1978 will be \$695 million (see App. A hereto), or less than 159¢/B, leaving 63¢/B for equity. Since equity comprises less than 15 percent of capitalization, the equity component is about 318¢/B, ^{28/} and the return for equity under the recommended interim rate will average a generous 20 percent after taxes.^{29/}

^{28/} (15% x \$9.295 billion) ÷ 438 barrels = 318¢/B.

^{29/} 63¢ ÷ 318¢ = 19.81%. The carriers' average cost of debt is 8.8 percent (i.e., \$695 million ÷ (85% x \$9.295 billion)).

On the other hand, as we explained earlier, we do not recommend that the Commission employ an average interim rate. The maximum interim rates justified for the individual carriers are shown below:

<u>Carrier</u>	<u>Percent Ownership</u> (1)	<u>Total Costs & Return</u> ^{30/} (2)	<u>Max. Interim Rate (¢/B)</u> (col. 2 ÷ col. 1) ÷ 438 mill.
Sohio	33.34%	\$662.5	454
ARCO	21.00	446.3	485
Exxon	20.00	438.2	500
BP	15.84	318.5	459
Mobil	5.00	105.2	480
Union	1.66	36.3	499
Phillips	1.66	35.3	486
AmHess	<u>1.50</u>	<u>30.2</u>	<u>460</u>
Totals	100.00%	\$2,072.5	473 ^{31/}

Consequently, interim rates of \$4.54 to \$5.00 protect the carriers, prevents exorbitant returns in an interim period, and, when combined with a reasonable refund provision, also protects the shippers and other interests affected by the rates.

^{30/} Appendix A, p. 1. Figures are in millions of dollars.

^{31/} Differs from \$4.72 due to rounding.

6. Proposed Rates Exceeding \$6.00
Should Be Suspended, Since the
Carriers Greatly Overstate Costs

a. Carriers Overstate Depreciation

The carriers use a 25-year life to amortize the construction costs and capitalized interest associated with TAPS. For the original cost of \$9.2 billion, including capitalized interest of \$1.3 billion, the carriers project average depreciation and amortization expense of 84 cents per barrel.^{32/} Since the carriers have understated the life of the pipeline by failing to use at least a 27.5-year life, they have overstated this expense.

In the FPC Recommendation of May 1, 1977, that commission found, as follows (at p. III-19):

Natural recovery mechanisms (without the injection of produced water) should result in recovery of from 32% to 35% of the original oil in place (OOIP). This oil recovery should be achieved over a period of 25 to 30 years.
(emphasis added)

The FPC relied on, among others the Van Poolin study (see Appendix B hereto) which describes a similar range.

One of the basic studies of oil and gas production presented on that record was Exhibit EP-53, a three-dimensional computer model, sponsored by El Paso Alaska Company. That stud

^{32/}

(\$9.2 billion ÷ 25 years) ÷ 438 million barrels per year. The latter figure assumes an average flow-rate of 1.2 million barrels per day.

as described by the administrative law judge, estimated deliverability of oil from the main area over a period of 28 years.^{33/}

The range of 25 to 30 years also corresponds to the so-called "Mortada Study" prepared for the Federal Energy Administration in 1976. In that study, FEA's consultant assumed 26.5 years for the life of TAPS for tariff computation.^{34/}

Other studies have relied on much longer periods of life for TAPS. For example, in a financial study of TAPS by Wainwright Securities, Inc.^{35/} earlier this year, the operating life of 35 years was used (at p. 40) to compute a tariff rate of \$4.23 and TAPS' potential earnings. None of these studies increase service life to account for production in fields adjacent to the main one for the purposes of the tariff computations.

The carriers, therefore, have chosen the lowest pipeline service life over which to depreciate and amortize costs. We believe the mid-figure (i.e. 27.5 years) of the conservative range found by the FPC is more reasonable for purposes of the present initial rates than the low end chosen by the carriers. There are definite indications that such mid-figure is a minimum figure; and that following investigation, a longer life will be shown for TAPS.

^{33/} See Initial Decision in El Paso Alaska Company, Docket No. CP 75-96, Feb. 1, 1977, p. 29.

^{34/} Appendix E hereto, p. IV-19. The FPC also relied on this study. See Recommendation, p. III-B-1.

^{35/} Wainwright study, supra, at p. 40.

b. Carriers Overstate Removal & Restoration Costs

The same problem of useful life inheres in the carriers' proposed annual accrual to cover the projected one-time cost of at least \$1.049 billion to remove the pipeline and related facilities and to restore the surface to its former state at the end of the service life of the pipeline, or what has also been termed TAPS' "negative salvage value." Assuming a 25-year life, the carriers seek to recover the one-time future expense over a period of 25 years, and hence seek to charge the shippers at least \$41.96 million per year or 9.6 cents per barrel per year.

On the other hand, the carriers differ among themselves over how much should be amortized with at least one carrier claiming total removal and restoration costs, including 25 years of compounded inflation, of over \$4 billion. The differing estimates submitted by the carriers are set forth below:

	(\$ Millions) Annual Amount of Removal Costs Reported to Bur. of Accts.	Percent of Total	Total Cost Assumed by Carrier (Col. 1 - Col. 2) x 25 Years
Amerada Hess	\$.629	1.50%	\$ 1,048
Phillips	.6965	1.66	1,049
Sohio	14.0	33.34	1,050
Union Alaska	.697	1.66	1,050
BP	7.178	15.84	1,133
Arco	13.2	21.00	1,571
Exxon	16.4	20.00	2,050
Mobil	8.513	5.00	4,257

At the outset, we have doubts that all these monies will be used even in 1977 dollars, or that it is fair to begin collecting such sums so early. Under the Agreement and Grant of Right-of-Way between the Department of the Interior and the carriers of January 23, 1974, the carriers are obligated to rehabilitate property or a natural resource that has been "seriously damaged or destroyed" (para. 13A), which is yet to be defined. The carriers are not obligated even on termination to rehabilitate any area affected by an act of war or negligence or willful misconduct of others using the property (Id.).

The qualifications to the carriers' alleged liability to rehabilitate must obviously be taken into account in an investigation before shippers are required to provide full indemnity, and allowance must be made by the Commission for these important factors. In such matters, it would not be consistent with shipper interests to resolve all doubts in favor of higher tariff rates.^{36/} The interim rates in the meantime should reflect no greater amortization than the \$1.049 billion over 27.5 years.

^{36/} See Bebchick v. Public Utilities Commission, 318 F.2d 187, 192-94 (D.C. Cir. 1963), cert. denied, 373 U.S. 913, involving a track removal and repaving obligation of a bus company.

7. Proposed Rates Exceeding \$6.00
Should Be Suspended Since the
Carriers Overstate Their Revenue
Need

We have reproduced in Appendix A, p.2, hereto the expense figures supplied to us by each of the pipeline carriers. We have not received actual costs of equity figures. Nevertheless, we are convinced that in no case would the total expense column, including return, reach the over six-dollar tariff rates that are the subject of this protest.

We must surmise how the carriers reach such high tariff rates. We need not look long, however, for it seems the parent companies have represented to the FPC that this Commission will allow the carriers' equity holders to retain the entire return on valuation, and that interest expense must be accounted for separately as an "operating expense."

For example, the parent companies of these carriers represented to the FPC in the recently concluded gas pipeline case that the ICC would generously allow them 30 percent returns on equity, as follows:^{37/}

The only comparable project of the size and complexity discussed herein that has received private financing is the Alyeska oil pipeline. If that line receives the usual ICC treatment

^{37/} FPC Recommendation, supra, at p. XII-45. The FPC allowed 18% on equity, after taxes, which it reduced to 11% if cost overruns should become excessive.

of allowing a 7-8 percent rate of return after taxes and interest on ICC valuation (i.e. total assets), and a 75/25 debt to equity ratio is assumed, the after-tax return on equity would be in the 28-32 percent range. (emphasis theirs).

The FPC refused to accept such an expectation as any reasonable estimate of the cost to attract capital to the pipeline industry:^{38/}

Since, however, the major consideration of the oil producers, who were the ones to finance the oil pipeline, was to get the oil to market, it is difficult to draw any conclusions regarding the rate of return on their pipeline investment they "required" in order to finance it.

The FPC considered instead the actual profitability and financial structure of the integrated petroleum companies. It found that in the 1966-1975 period on average the companies earned 11.8 percent after-tax on equity, and during the three-year period 1973-1975, earned an average after-tax return on equity of about 14.8 percent.^{39/}

Aside from a bare table of figures in the recent Williams Brothers case, ^{40/} where the matter was not discussed, we fail to find any other reported pipeline rate case that awards the entire return on valuation to the equity holders of the pipeline. On the contrary, we find indications that "the usual ICC treatment" of this matter is to allow the return on valuation

^{38/} Id.

^{39/} Id. We have attached as Appendix F hereto the Chase Manhattan Bank financial statistics for the group of 28 petroleum companies on which the FPC relied (d.c. App. XII-A of the Recommendation).

^{40/} Docket No. 35533, Petroleum Products, Williams Brothers Pipe Line Company, supra, esp. at p. 16.

to cover the pipeline's total cost of capital, that is, both long term interest and all payments to stockholders.

For example, in Reduced Pipe Line Rates and Gathering Charges, 243 I.C.C. 115 (1940), the Commission on its own motion entered into a general investigation in 1934, which, as subsequently broadened, included all the rates, rules and practices of 37 carriers by pipe line. The Commission served the respondents with a questionnaire requiring the submission of financial, property and rate data for a 5-year period; later years were added in the reopened proceeding.

For the year 1935, the last full year for which the Commission had data, it computed the excess earnings of the carriers over an 8 percent return on value in a seven-column appendix (at p. 148). The columns were headed as follows:

1. Transportation revenue
2. Transportation expense including depreciation and taxes.
3. Earnings or excess of revenue over expense.
4. Value of property used.
5. Return on value.
6. Earnings needed to return 8 percent on value.
7. Excess actual earnings over 8 percent return.

It is significant here that "transportation expense" (col. 2)

excluded interest, which was to be covered by "earnings or excess of revenue over expense" (col. 3) and hence by the return on value (col. 5). To show that this was in fact the Commission's method of calculation, we have recomputed the "transportation expense" figures in the Reduced Rates table for 5 carriers from reported figures for 1935 that are known to exclude interest.^{41/} They equal the expense figures that the Commission relied on in Appendix D.

Pipeline Co. (1)	Interest on long-term debt (2)	Transp. Expense ^{42/} (excluding interest)			Transp. Exp. in App. D (6)
		Operating (3)	Taxes (4)	Total (5)	
Arkansas Pipe Line Co.	24	219	120	339	339
Gulf Pipe Line Co. of Pa.	133	971	760	1,731	1,731
Pure Transportation Co.	1,086	1,443	621	2,064	2,064
Shell Pipe Line Corp.	1,208	7,157	1,876	9,003	9,034
Tide-Water Pipe	10	486	181	667	667

Accordingly, the long-standing practice of the Commission in fact has been to include interest as an element of the return on valuation for pipelines.

It cannot logically be otherwise. The rate base includes the entire investment in used and useful property; and the rate of return is developed from the costs of the entire capital devoted to the enterprise. The "capital costs of the business...

^{41/} See Transport Statistics, 1935, p. S-161. The figures for three other carriers are impossible to reconcile with the Appendix D data; the figures of at best one other carrier include interest.

^{42/} Id.

include service on the debt and dividends on the stock."^{43/}

As Prof. Westmeyer has succinctly stated:^{44/}

In other words, a fair return must be sufficient to enable the railroad industry [or other mode of carriers] to maintain its credit by making regular payments at acceptable rates of interest on its fixed obligations, and if there is any expectation of financing improvements by the sale of stock, an acceptable rate of dividends must be paid as well.

It appears that TAPS will be capitalized with about 15 percent equity and 85 percent debt. Since a 10 percent return on valuation is equivalent to 222¢/B, and 15 percent of the original cost is equivalent to 318¢/B,^{45/} the allowance of the entire return on valuation to the stockholders means an effective return on equity of 70 percent.^{46/}

It is true that in 1941 most of the owning companies signed a consent decree with the Department of Justice placing a restriction on dividends of 7 percent of valuation.^{47/} In 1957 the Department of Justice brought a suit contending that the carriers' payment of 7 percent of valuation to their stockholders did not result in a "fair" dividend. The Supreme Court held that, nevertheless, the parties to the decree

^{43/} Federal Power Commission v. Hope Natural Gas Co., 320 U.S. 591, 603 (1944).

^{44/} Westmeyer, Russell E., Economics of Transportation, Prentice-Hall, Inc., p. 208 (1956).

^{45/} $(15\% \times 9.295 \text{ billion}) \div 438 \text{ million B/yr.}$

^{46/} $222\text{¢} \div 318\text{¢} = 69.8\%$

^{47/} United States v. Atlantic Refining Co., C.A. No. 14060, D.D.C. decided December 23, 1941.

had so agreed, and the Court could not read the decree differently,^{48/}

simply because another reading might seem more consistent with the Government's reason for entering into the agreement in the first place.

As we next show, (1) the dividend restriction was worded the way it was apparently because the pipeline industry in 1940 had virtually no long term debt, and (2) that with so much debt capital having replaced the equity capital of the carriers, a dividend restriction now provides no standard for a fair return.

In Appendix G hereto we have reproduced Table 6 from the Verified Statement of David L. Jones, an economist and witness for this Bureau in Ex Parte No. 308, Valuation of Common Carrier Pipelines. The last column of that table shows that in 1940, the funded debt of the oil pipeline industry was merely 10 percent of total capitalization. Consequently, in 1941, the Department no doubt believed that in those circumstances a dividend restriction of 7 percent of valuation provided an effective limitation on both earnings and payout, although worded only in the form of a restriction on payout. It apparently took the industry about five years to discover that a higher debt/equity ratio would permit their lawfully circumventing the decree.

^{48/} United States v. Atlantic Refining Co., 360 U.S. 19, 24 (1959).

Appendix G shows that by the mid-forties the industry began to shift from a low debt/equity ratio to a high one. In this way, the oil companies could reduce equity investment and convert an overall 7 percent return, that resulted from the payout restriction, to a much higher return on equity.

For example, let us assume that in 1940 the valuation was equal to capitalization. The changes that occurred in the debt/equity ratio over the years produced the following increases in the return on equity in the absence of any effective protests or complaints before this Commission:

<u>Year</u>	<u>Capitalization</u>		<u>Effective Return on Equity at 7% of Valuation</u>
	<u>Percent Debt</u>	<u>Percent Equity</u>	
1940	10%	90%	7.7%
1950	64	36	19.4
1960	73	27	25.9
1970	82	18	38.9
1975	93	7	100.0

The consent decree has been treated as purely a dividend restriction by the pipeline companies, and exploited to produce large returns on equity. The consent decree payout limitation is clearly no standard for just and reasonable earnings on equity, and should not be followed by this Commission in this proceeding.

The Commission should not accept, even on a temporary basis, rates like those proposed in the subject tariffs that are premised on granting the entire return on valuation to the carriers' equity holders.

9. Rules and Regulations in the
Proposed Tariff May Be
Unreasonable and Anti-Competitive

Several of the rules and regulations in the proposed tariffs may violate prior holdings of this Commission, or are otherwise unlawful, and should be investigated.

Minimum Tender. The BP tariff requires the tender of at least 30,000 barrels over a thirty-day period from one shipper consigned to one consignee and one destination (Rule 6). The Amerada Hess tariff requires a minimum tender of 5,000 barrels (Rule 4); and the Sohio tariff, 10,000 barrels (Rule 25). The minimum of 10,000 barrels may be met by two or more shippers to a common consignee under the Mobil Alaska tariff (Rule 19).

In Reduced Pipe Line Rates and Gathering Charges, 243 I.C.C. 115, 136 (1940), the entire Commission found that a 10,000-barrel lot is as large as it could find reasonable to serve as a minimum tender, and that any higher minimum would be unreasonable.^{56/} The Commission noted that the large refiners can meet a large minimum-tender requirement "without difficulty" (Id.); but smaller refiners could have difficulty.^{57/}

^{56/} Cf. Restrictions on Service by Motor Common Carriers, 126 M.C.C. 303, 324-25 (1977), proscribing unreasonable minimum weight requirements.

^{57/} The decision on this point was later affirmed on further hearing (272 I.C.C. 375, 382-83 (1948)).