Consumer Federation of America

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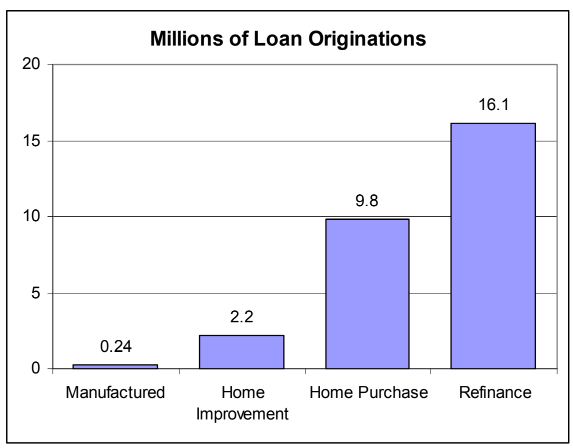
Consumer Federation of America Analysis of the Federal Reserve Bulletin's Release of the 2004 Home Mortgage Disclosure Act (HMDA) Data

In September 2005, the Federal Reserve released an extensive analysis of the 2004 Home Mortgage Disclosure Act (HMDA) data which found that minorities and manufactured home purchasers were more likely to receive high-cost mortgages from the lending industry. For the first time, the HMDA data included mortgage pricing data for loans that were more than 3 percentage points higher than comparable Treasury note yields, which helps to determine which loans are subprime or high-cost loans. The 50-page *Federal Reserve Bulletin* article presented the most recent national analysis of the publicly available HMDA data, which includes demographic information on mortgage applicants and the disposition of these applications.

Subprime Lending Remains Common

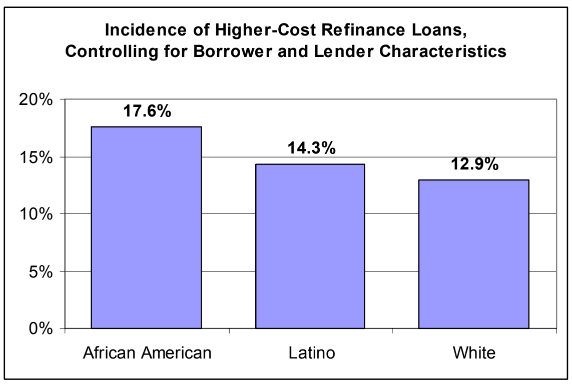
The Federal Reserve estimates that nearly one in five (19%) of all types of home loan originations (home purchase, home improvement and refinance) are sub-prime mortgages. The subprime lending market provides higher cost loans mostly to borrowers not served by the mainstream prime markets and is fertile ground for abusive lending practices known as predatory lending. High foreclosure rates in the subprime market suggest that some borrowers may be entering into loans they cannot afford. The loans that are reported under the new HMDA pricing data closely mirror the overall subprime lending market. The Federal Reserve reports that 98% of subprime first lien loans would be required to report interest rate pricing under the new HMDA requirements.



Nationally, the Federal Reserve reported that one out of seven (15.5%) HMDA reported loans of all types were made at interest rates 3 percentage points higher than the threshold Treasury rate. During 2004, the appropriate Treasury yield ranged between 4.67% and 5.54%, meaning borrowers who received these loans received interest rates ranging from 7.67% to 8.54% for their mortgages. To put this in perspective, a thirty year mortgage on a $200,000 loan would cost $141,000 more over the life of the loan at an 8 percent interest rate than at a 5 percent interest rate – or 36% more over the life of the loan. Refinance, home improvement and loans for manufactured home purchases were more likely than home purchase loans to be the higher-cost, above threshold loans. In 2004, 11.5% of conventional home purchase mortgages were priced above the threshold, compared to 15.5% of refinance loans, 21.9% of home improvement loans and 57.1% of manufactured home purchase mortgages.

These national figures generally underestimate the likelihood that average consumers will receive a higher-cost loan from lenders. First, the national data includes loans outside metropolitan areas, which tends to lower the concentration of high-cost, above threshold loans. Consumer Federation of America sampled the national HMDA data for an analysis of lending patterns in metropolitan areas and found that 14.7% of the total national refinance loans were made above the threshold, but in average metropolitan areas, 19.2% of refinance loans were high-cost, over-threshold loans.

Second, the aggregate national figure underestimates the likelihood that a consumer would receive a subprime loan because of significant regional variation. CFA found that homeowners residing in the southwestern or southeastern states are much more likely to refinance with higher interest rate subprime loans than are those that live in the Pacific or New England regions (*see* CFA study Subprime Cities, released September 8, 2005 available at www.consumerfed.org). For example, more than one fifth (20.6%) of the loans nationally CFA sampled were made in California and about nine tenths (90.2%) of the more than one million loans of all types in California were prime, or below-threshold, loans. As a result, the low subprime incidence in California has a substantial ameliorative impact on the national subprime rate.



Third, aggregating all types of loans together underestimates the likelihood that consumers will receive high-cost loans for the types of loans that are most often subprime. Refinance and home improvement loans are more likely to be high-cost, over-threshold loans than home purchase loans. Home purchase loans made up nearly one third (31.7%) of all HMDA loans in 2004 but only one fifth (19.9%) of over-threshold loans.

Higher Rates of Subprime Lending to African Americans and Latinos

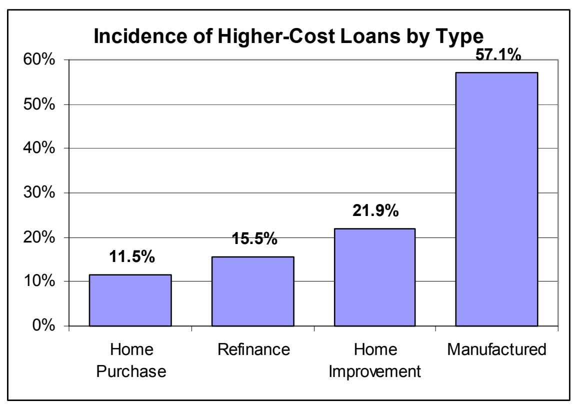
Despite the limitations of the Federal Reserve presentation of the data, the Federal Reserve reports that the impact of subprime lending does not affect all consumers equally. There is significant disparity in the incidence of high-cost loans between racial and ethnic breakdowns, and these disparities persisted even when the Federal Reserve controlled for borrower and lender characteristics. This is especially true of the loans most likely to be subprime. About one eighth (12.9%) of white refinance mortgage borrowers received high-cost loans compared to more than one third (34.6%) of African American and nearly one fifth (19.3%) of Latino refinance mortgage borrowers. Even when the Federal Reserve controlled for borrower characteristics such as income, size of loan and location of the property as well as lender characteristics, 17.6% African Americans and 14.3% of Latinos received high-cost refinance loans compared to 12.9% of white borrowers.

There were similar patterns for other types of loan products. Less than one in ten (8.7%) white home purchase mortgage borrowers received high-cost loans compared to one fifth (20.3%) of

Latinos and nearly one third (32.4%) of African American home purchase borrowers. Even when controlling for borrower and lender characteristics, 15.7% of African American and 11.6% of Latinos received high-cost home purchase mortgages compared to 8.7% of whites.

The Federal Reserve noted that there are many possible explanations for the racial and ethnic disparity in the pricing of mortgages. The credit risk of the borrowers, the cost of funds for the lender, pre-payment risk, lender overhead expenses and servicing costs, discretionary pricing for some lending channels including mortgage brokers, and the varying financial sophistication of borrowers can all contribute to price variation for borrowers. The Federal Reserve does not rule out discriminatory lending practices as a potential cause of the racial disparity. The article noted, "Adjusting the HMDA data for borrower-related factors plus lender is insufficient to account fully for racial or ethnic differences in the incidence of higher-priced lending; significant differences remain unexplained."

Adjustments for lender choice were found to have an even larger impact than borrower traits in accounting for the disparities. The borrower characteristics such as income and metropolitan locations contributed less to the disparity than the lender characteristics such as the type of lender (mortgage company, bank or thrift) or mortgage channel (mortgage broker versus loan officer). For example, adjusting for borrower characteristics alone reduced the disparity between African Americans and whites for refinance loans by 5.1 percentage points but adjusting for lender disparity reduced the disparity by an additional 6.8 percentage points. Adjusting for borrower characteristics reduced the disparity between whites and Latinos for refinance loans by 0.8 percentage points, but adjusting for lender characteristics reduced the disparity by 3.4 percentage points. Recently, Federal Reserve Board Governor Mark Olson noted in a speech that "Blacks and Hispanics are much more likely than whites to obtain credit from institutions that concentrate more of their business on higher-priced loans."



However, the Federal Reserve made the unusual attempt to address these differences by applying outside research performed by the Credit Research Center (CRC) at Georgetown University's McDonough Business School to control for factors not contained in the HMDA data. The Federal Reserve has never applied outside analysts' research to the HMDA data in previous years, and it appears that this unusual step was made because the Federal Reserve found unexplained racial disparities in the subprime lending patterns. CRC analyzed eight subprime lenders and used proprietary information to control for more borrower characteristics than are contained in the HMDA data including the credit score of the borrower, the loan-to-value ratio, whether the loan had a fixed or adjustable interest rate, whether the loan was originated by a broker, whether the applicant waived the required income certifications (a so-called "low documentation" note) and whether the loan included a pre-payment penalty. CRC determined that there was very little racial disparity once these additional factors were included.

However, the CRC research material that the Federal Reserve relied on to minimize the differences in the incidence of higher-priced lending was not presented in full in the *Federal Reserve Bulletin.* Since few details of this research were provided, the findings are not readily verifiable and the applicability to the entire lending industry is difficult to determine. This prevents other analysts from analyzing or assessing the application or implications of the CRC research.

There are some obvious concerns even based on the limited evidence presented by the Federal Reserve. Although CRC contends it analyzes eight subprime lenders that made 22 percent of higher-cost loans, it is a smaller share (18.5%) of the more than 1.0 million higher-cost refinance loans and much smaller share (6.1%) of the more than 700,000 high-cost home purchase loans that the Federal Reserve reports in its analysis. Second, since the identity of the lenders is concealed, it is impossible to assess the extent to which the sample is representative of the subprime lending industry. There is wide variety between the performance of different lenders, different affiliates of the same company, and the same lender in different markets. As a result, it is difficult or impossible to assess whether the CRC results, as presented, can be applied to the entire lending industry.

Other Federal Reserve Board's findings include:

- Lenders required to file HMDA disclosure made more than 28 million loans in 2004 – 9.8 million home purchase mortgages, 16.1 refinance mortgages and 2.2 million home improvement mortgages.

- Few lenders made high-cost loans. 3,300 lenders made no over-threshold, high-cost loans and 2,300 lenders made fewer than 10 over-threshold loans. The nearly 500 lenders who made more than 100 subprime loans constituted 96% of all higher-priced lending.

- African American borrowers had slightly higher interest rates on high-cost loans for all types of loans than whites or Latinos. In general, African American borrowers with high-priced loan products had interest rates which were between 10 and 15 basis points higher than whites or Latinos.

- African Americans and Latinos were rejected for home purchase, refinance and home improvement loans more frequently than whites even when controlling for borrower and lender characteristics. African Americans were nearly twice as likely as whites to be rejected for home purchase mortgages (denial rates of 18.2% and 10.9% respectively) and Latinos were nearly rejected 35% more frequently than whites (denial rate of 14.8%) even when controlling for borrower and lender characteristics.

- Refinance lending declined by about one third between 2003 and 2004, primarily as a result of rising interest rates.

- In 2004, 90% of loans were conventional as opposed to government-backed mortgages. The increase in the flexible underwriting and subprime lending contributed to the limited use of government-backed mortgages (which used to be the primary access to credit for borrowers with compromised credit).

- A large number of the mortgages are likely made to real estate investors. Non-owner-occupied purchasers represent about one seventh (15%) of all mortgages, up from between 4.5% and 5.5% during the period between 1990 and 1995.

- Fewer applicants for mortgages on manufactured homes are approved and those that are approved often pay higher interest rates. More than half (53.7%) of manufactured home purchase mortgage applications were rejected compared to one in seven (14.9%) site-built mortgage applications that were denied. More than half (57.1%) of manufactured home purchase mortgages were higher-cost loans compared to 11.5% of site-built home purchase loans.

- Loans made within a lender's Community Reinvestment Act (CRA) assessment area have a much lower incidence of high-priced lending for borrowers of all racial and ethnic categories.

Conclusion

The pricing variations found in the Federal Reserve HMDA release reinforce concerns about whether the lack of competition from mainstream prime lenders in these markets increase the chances that borrowers in certain communities pay more for credit. The Federal Reserve overview also indicates that pricing disparities may also result from discriminatory pricing for some lending channels including mortgage brokers and varying sophistication of borrowers. While discretionary pricing is not, by itself, unlawful, it can result in less sophisticated borrowers paying higher prices than others. Many consumers are unaware that they can bargain with lenders on terms and rates. Research literature indicates that discretion in pricing is likely to correlate with race, ethnicity, income and neighborhood. In fact, the Federal Reserve announced it has already used the new data to select about 200 lenders for closer review to determine if discrimination is affecting pricing decisions.

Consumers have every right to expect that the mortgage funds they borrow from lenders are priced fairly, based on legitimate risk-factors and not the result of opportunistic pricing that takes advantage of the lack of borrower knowledge and financial sophistication. In a sense, the release of the new pricing data has accomplished one of the purposes the Federal Reserve said it intended – it has shined a bright spotlight on industry practices that are not well understood by consumers. CFA calls upon federal and state banking regulators, states attorneys general, and other enforcement officials to step-up their oversight of the subprime market to ensure that lenders are fully compliant with federal and state consumer protection and fair lending requirements.