Steered Wrong:
Brokers, Borrowers, and Subprime Loans

Executive Summary

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EXECUTIVE SUMMARY

In recent years, a majority of subprime loans made in the United States were originated by mortgage brokers, who can be characterized as the "engine" of the subprime market. The rapid growth of subprime lending, which in the past decade grew from a small niche enterprise to a major driver of the U.S. housing market, was made possible by thousands of mortgage brokers across the country who delivered billions of dollars of subprime loans to mortgage lenders, who in turn packaged and sold them to Wall Street investors.

Because of their extensive involvement in originating subprime mortgages, mortgage brokers have had significant influence on which loans were originated, who received them, and at what price. Ideally, mortgage brokers present their clients with available financing options and help them choose the most suitable loan. However, the dismal performance of subprime mortgages today has put brokers and their actual practices under increased scrutiny.

In this report, we focus specifically on broker pricing patterns by systematically comparing the cost of loans provided by mortgage brokers to those provided by retail lenders, such as banks, credit unions, and mortgage bankers. Our research addresses three major questions. First, how do the costs of loans originated by brokers compare to those originated by retail lenders? Second, if significant pricing differences exist between lenders and brokers, do those differences vary according to the strength of a borrower's credit? Third, how do any pricing differences experienced by borrowers change over the scheduled life of a loan?

We find significant differences between broker and lender pricing on home loans, primarily on mortgages originated for borrowers with weaker credit histories. During the first year of the loan, borrowers with credit profiles in the subprime range pay more for brokered loans than they would have if they had obtained their loan directly from a lender. Over a four-year period, a typical subprime borrower pays over $5,000 more, and over the 30-year life of the loan, the cost gap grows to almost $36,000.

This analysis is based on 1.7 million mortgages originated between 2004 and 2006. In our analysis, we compared "matched pairs" of loans to contrast the experience of borrowers who received loans from brokers and retail lenders. By matching loans based on major risk factors (including credit score, loan type, level of income documentation, and loan-to-value and debt-to-income ratios), this approach allows us to meaningfully measure differences in costs on mortgages that represent comparable risks.

The results of our analysis reveal striking differences in loan costs depending on the origination channel. Among our findings:

Significant disparities exist between broker and lender pricing. After matching loans on objective factors that affect interest rates, the analysis reveals that interest payments were significantly higher on broker-originated mortgages in the majority of risk categories we examined.

Disparities are greatest for subprime borrowers. For people with weaker credit, brokers consistently charged higher interest rates than retail lenders. A typical subprime borrower was slated to pay $5,222 more during the first four years of a median-sized $166,000 mortgage compared to a similar borrower who received a loan directly from a lender. Over thirty years, this borrower would pay $35,874 more in interest payments, equivalent to an interest rate approximately 1.3 percentage points higher than a similar borrower with a retail loan.

Cost disparities grow greater after initial years. For subprime borrowers, significant disparities are apparent even during the first year of the loan. However, because so many subprime mortgages come with short-term introductory rates that rise substantially when they adjust, the cost disparities become more pronounced after the first four years of a loan.

Prime borrowers generally do not pay more for brokered loans. In general, people with higher credit scores—those who received prime loans—did *not* pay higher interest on broker-originated loans. In fact, some borrowers with very high credit scores who received loans from brokers achieved modest savings, although long-term savings were largely limited to fixed-rate loans.

Typical Cost (Benefit) of Brokered Loan Compared to Retail Loan

	Time in Loan		
Market Segment	1 Year	4 Years	30 Years
Subprime	$1,174	$5,222	$35,874
Near Prime	$154	$1,316	$7,094
Prime	($179)	($42)	($1,767)

Understanding Brokers' Pricing Patterns

Our analysis supports the conclusion that brokers react to market incentives predictably: they seek to maximize both the number of loans they originate and their revenue per loan. However, since charging too much per loan could drive away potential customers, brokers must find the optimal balance between these two factors. We posit that brokers shift this balance according to their perception of their customer's credit profile. Specifically, when serving customers with stronger credit, we believe brokers emphasize loan volume over revenue per loan, since customers with higher credit ratings generally have more options for financing and may be more aware of their alternatives.

People with weaker credit scores naturally pay more for mortgages than people with strong scores. However, it is very difficult for borrowers with weaker credit or less experience in financial matters to know precisely how much more is appropriate, especially since, unlike prime rates, subprime rates are not generally publicly available. In addition, subprime loans tend to be much more complex than the fixed-rate mortgages that have long dominated the prime market, making their costs more difficult for borrowers to compare.

Accordingly, we hypothesize that brokers have been able to take advantage of this situation by emphasizing maximum revenues per loan for subprime borrowers. While retail lenders probably are not immune from these dynamics, we believe the effects on the costs of retail loans are less pronounced due to more regulation, better internal controls, and concerns about reputational risk.

Not only do brokers have strong incentives to charge more per loan when this option is available with subprime borrowers, but they also have specific mechanisms available in subprime loans that

facilitate overcharging: yield-spread premiums (YSPs) and prepayment penalties. A YSP is an extra payment that brokers receive from lenders for delivering a mortgage with a higher interest rate than that for which the borrower qualifies. In the subprime market, lenders usually will pay the maximum YSP only if a loan contains a prepayment penalty. The penalty ensures that the lender will recoup their YSP payment either through excess interest collected over time or from the penalty fee, should a borrower refinance to avoid those interest costs.

Our findings are consistent with previous research indicating that brokers tend to steer subprime borrowers towards higher-cost loans even if these borrowers qualify for lower-cost loans. Yet, people who employ a mortgage broker often mistakenly assume that the broker is working for them to find the most affordable loans that will support sustainable homeownership. The results in this report demonstrate that, too often, this is not the case for subprime borrowers. The common misperception by consumers is understandable given that, until the explosive growth of the subprime market, lenders generally would not approve mortgages unless they had substantial evidence that the loan was affordable and sustainable. Home buyers and homeowners therefore have trusted their brokers as mortgage professionals to help them choose a suitable loan. This misplaced trust likely has been a factor in the current foreclosure crisis, as people who were trying to achieve homeownership or accrue savings through refinancing were given overpriced or unaffordable loans.

Based on our findings, we make the following recommendations:

POLICY RECOMMENDATIONS

- Ban yield-spread premiums and prepayment penalties on subprime loans;
- Create a system of accountability where lenders and investors share responsibility for brokered loans; and
- Establish clear broker duties to their clients.

CONSUMER RECOMMENDATIONS

- Obtain multiple quotes before committing to a home loan, with at least some from retail lenders like banks or credit unions. Do not assume that any lender will give you the best or even a good rate.
- Ensure that at least one loan option from each lender is a standard fixed-rate mortgage that pays off principal and interest every month.
- Examine both interest rate and total fee costs. Ask questions about changes in scheduled payments and how high payments can go.
- Avoid loans that have prepayment penalties that can restrict refinancing and support the yield spread premiums that lead to higher interest costs.
- Before applying for a loan, review your credit reports and credit score.