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Center for Responsible Lending Comment on Federal Reserve Analysis of Home Mortgage Disclosure Act Data

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SUMMARY

On September 8, 2006, the Federal Financial Institutions Examination Council (FFIEC) released home loan information collected under the 2005 Home Mortgage Disclosure Act (HMDA). Following this release, researchers from the Federal Reserve Board of Governors published an analysis of the HMDA data that focused on higher-priced home loans.[1] In this review, we summarize some of the key information included in the Federal Reserve article and offer brief comments.

In general, the Federal Reserve article provides a helpful overview of pricing patterns in home loans originated in 2005. The Center for Responsible Lending (CRL) found the following points to be of particular interest:

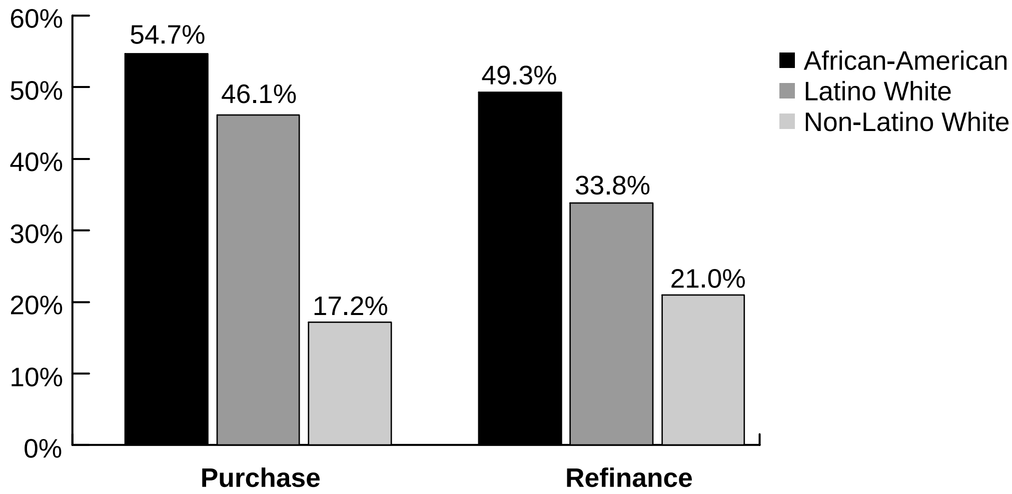
1. Between 2004 and 2005, the proportion of loans defined as "higher-rate" increased dramatically.

- 24.6 percent of 2005 conventional first-lien *purchase* originations were above the rate-spread reporting threshold, compared to 11.5 percent in 2004, an increase of 114 percent.
- 25.7 percent of 2005 *refinance* loans were above the rate-reporting threshold, compared to 15.5 percent in 2004, an increase of 66 percent.
- For 2005, the "higher-cost" category more accurately reflects subprime loans. Specifically, some of the increase in the proportion of originations that were higher-rate in 2005 reflects relative changes in short-term and long-term interest rates, that is, the "flattening" of the yield curve. As a result of these changes in the general interest rate environment, a much larger share of subprime loans are captured by HMDA's rate-spread threshold in 2005 than in 2004.

2. A majority of loans to African-American borrowers were higher-rate, while more than one-third of loans to Latino[2] borrowers were higher-rate.

- 54.7 percent of African Americans who purchased homes in 2005 received higher-rate loans 49.3 percent of African Americans who refinanced their homes received such loans.
- 46.1 percent of Latino borrowers who purchased homes in 2005 received higher-rate loans, compared to 33.8 percent of Latinos who refinanced their homes.

Incidence of Higher Cost Loans, by Race and Ethnicity



3. African-American and Latino borrowers were much more likely to receive a higher-rate home loan in 2005 than non-Latino white borrowers.

- Among borrowers who took a conventional loan to *purchase* a home, African Americans were 3.2 times as likely to receive a higher-rate loan than non-Latino borrowers.
- Latino borrowers were 2.7 times as likely as non-Latino white borrowers to receive such a loan.
- For borrowers who took a conventional loan to *refinance* a home, African Americans were 2.3 times as likely to receive a higher-rate loan than non-Latino whites.
- Latino borrowers were 1.6 times as likely as non-Latino white borrowers to receive such a loan.
- Though the absolute proportion of higher-rate loans increased dramatically from 2004 to 2005 (from 15.5 percent of all loans in 2004 to 26.2 percent in 2005[3]), the disparities between racial and ethnic groups remained relatively constant.
- Because changes in the interest-rate environment have caused the rate-spread threshold to capture a greater proportion of the subprime market in 2005, in 2005 these patterns are a more accurate reflection of actual differences in the prevalence of subprime loans between groups.

4. These disparities remain large even after accounting for borrower traits.

According to the Fed report, even after adjusting for differences in the borrower characteristics contained in the HMDA data, African-American and Latino borrowers were more likely to receive higher-rate loans. Furthermore, a recent study released by CRL shows that disparities tend to persist even after additional adjustments were made for differences in credit scores, equity, and other risk factors not available in HMDA data. The Fed authors also adjust for originating lender. Though this adjustment reduces the disparities substantially, significant differences remain.

5. Lenders and policymakers can take a number of constructive actions to help ensure more equitable pricing for all borrowers. These include:

- Require objective pricing standards by eliminating the practice of steering borrowers to loans with needlessly higher rates.;
- Hold lenders and brokers responsible for providing loans that are suitable for a given borrower;
- Create incentives and support policies to combat predatory lending and lead the market to better serve African-American and Latino communities.
- Ensure that adequate resources are dedicated to fully enforcing fair lending laws; and
- Support expanded disclosure of key lending data by amending HMDA.

I. INTRODUCTION

About HMDA

Enacted in 1975 and subsequently amended, the Home Mortgage Disclosure Act (HMDA) requires lenders to collect and publicly disclose information about housing-related loans and applications for such loans. HMDA requires covered institutions to annually compile and disclose data related to home purchase, home improvement, and refinance loans. Institutions report information about each application and loan, and about each applicant or borrower.

One of the most important changes to HMDA is the recent inclusion of limited pricing information related to the annual percentage rate (APR) of certain loans. Beginning with loans originated in 2004, lenders are now required to report the spread between the APR of designated loans and the yield on a U.S. Treasury security of comparable maturity on the date the mortgage rate was set. Specifically, lenders must disclose this rate spread for first-lien loans with spreads that are at least three percentage points and for subordinate loans with spreads of at least five percentage points. Throughout this paper, we refer to loans with APRs high enough to require the disclosure of the APR spread as "higher-rate" loans.

This APR-spread reporting threshold provides a general pricing indicator for a large portion of subprime mortgages. Subprime mortgages are intended to serve borrowers with blemished or limited credit history or other high-risk factors that make them ineligible for prime loans. The subprime share of the mortgage market has grown rapidly over the past decade, with subprime originations growing from four percent of the mortgage market in 1994 to 20 percent in 2005.[4]

Unfortunately, while growth in the subprime market has expanded credit opportunities for borrowers, most abusive lending takes place in the subprime market. Predatory practices in the subprime market are widespread and include steering borrowers into higher-priced loans than those for which they qualify, stripping equity from a borrower by including exorbitant or unnecessary fees, trapping borrowers in loans through the use of prepayment penalties, and extending loans without regard for the borrower's ability to repay the mortgage. Unfortunately, many of these abusive practices are legal, and too often they are targeted at the most vulnerable borrowers. As a result, predatory mortgage lending drains wealth from these borrowers and their families and communities.

It is important to note that the APR-spread reporting threshold is a proxy for subprime lending, but it does not capture all subprime mortgages. The threshold for being identified as higher-rate in HMDA was intentionally set high to ensure prime loans were excluded, so some portion of subprime loans may actually fall under the threshold level. Nonetheless, we estimate that the 2005 APR-spread threshold captured close to 90 percent of the subprime market in 2005. [5] Consequently, patterns regarding higher-rate HMDA loans generally reflect patterns in the subprime market as a whole.

II. 2005 MORTGAGE PRICING

A. 2005 DATA MORE ACCURATELY REFLECT THE SUBPRIME MARKET.

The HMDA data show that about one in four home loan originations in 2005 was a higher-rate loan, that is, a loan requiring the disclosure of the rate spread. Specifically,

- 24.6 percent of 2005 conventional first-lien *purchase* originations were higher rate.
- 25.7 percent of 2005 *refinance* loans were higher rate.

These proportions represent large increases over the previous year. Compared to 2004, the proportion of purchase loans that were higher-rate increased by 114 percent (11.5% to 24.6%), while the proportion of refinance loans increased by 66 percent (15.5% to 25.7%).

As the Fed report points out, changes in the proportion of originations that were higher-rate can reflect many factors, not just changes in lender (or borrower) practices. Chief among these external effects is the interest-rate environment. Changes in the yield curve, that is, relative changes in short-term and long-term rates, have increased the proportion of subprime loans that require APR-spread disclosure and account for some, but not all, of the difference between 2004 and 2005. When the Fed adjusted for changes in the interest-rate environment, the increased incidence of higher-rate loans for purchase and refinance loans between 2004 and 2005 is 107% and 58%, respectively, though the Fed notes that these adjustments likely understate the true effect of interest-rate changes.[6]

Table 1: Percentage of Originations That Were Higher Cost by Loan Purpose

	Unadjusted			Adjusted for Interest Rate Environment		
	2005	**2004**	**Change**	**2005**	**2004**	**Change**
Purchase	24.6	11.5	114%	21.5	10.4	107%
Refinance	25.7	15.5	66%	22.4	14.2	58%

Perhaps more importantly, the changes in the interest-rate environment has resulted in the APR-spread reporting threshold capturing a greater share of the subprime market in 2005 than in 2004. Based on third-party estimates of the subprime mortgage volume, about 89 percent of all subprime lending appears to have been captured by HMDA's rate-spread threshold in 2005, compared to less than 50 percent in 2004. **As a result, the 2005 patterns in "higher-rate" loans are a more accurate reflection of the patterns in the subprime market as a whole than in 2004.**[7]

B. THE INCIDENCE OF HIGHER-RATE ORIGINATIONS VARIED TREMENDOUSLY BY RACE AND ETHNICITY.

As was true in 2004, there were marked disparities in the proportion of higher-rate loans received by different racial and ethnic groups. Specifically, African-American and Latino borrowers were much more likely to receive higher-rate loans than white non-Latinos.

For first-lien conventional *purchase* loans, 54.7 percent of African-American borrowers received higher-rate loans, compared to 46.1 percent of Latinos and 17.2 percent of non-Latino whites.

For first-lien conventional *refinance* loans, 49.3 percent of African-American borrowers received higher-rate loans, compared to 33.8 percent of Latinos and 21.0 percent of non-Latino whites.

Though the absolute proportion of higher-rate loans increased dramatically from 2004 to 2005 (from 15.5 percent of all loans in 2004 to 26.2 percent in 2005[8]), the disparities between racial and ethnic groups remained relatively constant from 2004 to 2005. Specifically, in 2005 African-American and Latino borrowers were 3.2 times and 2.7 times, respectively, as likely to receive higher-rate purchase loans than non-Latino white borrowers. For refinance loans, African-American and Latino borrowers were 2.3 times and 1.6 times, respectively, as likely to receive higher-rate loans compared to white non-Latino borrowers.

When ratios were adjusted to account for differences in the interest-rate environment, the disparities remain about the same (Table 3).

Table 2: Share of Originations that were Higher Cost by Race and Ethnicity, *Unadjusted*

Borrower Race/Ethnicity	Loan Purpose	2005		2004	
		Percentage of Originations that were Higher-rate	Ratio to Non-Latino White	Percentage of Originations that were Higher-rate	Ratio to Non-Latino White
Black or African American	Purchase	54.7	3.2	32.4	3.7
Black or African American	Refinance	49.3	2.3	34.6	2.7
Hispanic or Latino	Purchase	46.1	2.7	20.3	2.3
Hispanic or Latino	Refinance	33.8	1.6	19.3	1.5
Non-Latino White	Purchase	17.2	N/A	8.7	N/A
Non-Latino White	Refinance	21.0	N/A	12.9	N/A

Table 3: Share of Originations that were Higher Cost by Race and Ethnicity, *Adjusted for Interest-Rate Environment*

Borrower Race/Ethnicity	Loan Purpose	2005		2004	
		Percentage of Originations that were Higher-rate	Ratio to Non-Latino White	Percentage of Originations that were Higher-rate	Ratio to Non-Latino White
Black or African American	Purchase	50.1	3.4	30.0	3.8
Black or African American	Refinance	43.9	2.5	32.3	2.7
Hispanic or Latino	Purchase	40.8	2.8	17.8	2.3
Hispanic or Latino	Refinance	30.1	1.7	17.4	1.5
Non-Latino White	Purchase	14.6	N/A	7.9	N/A
Non-Latino White	Refinance	17.9	N/A	11.8	N/A

C. DIFFERENCES IN BORROWER CHARACTERISTICS CANNOT EXPLAIN RACIAL OR ETHNIC DISPARITIES.

The authors of the Fed article conduct analyses to estimate the disparity between racial and ethnic groups after accounting for certain differences in borrower characteristics. Specifically, the authors conducted a series of tests to simultaneously adjust for the various “borrower” traits that are available in HMDA, including income, loan amount, location (MSA) of the property, presence of a co-applicant, and gender. These adjustments essentially estimate the portion of loans to African-Americans or Latinos that would be expected to be higher-rate if these observed borrower traits for those groups were, on average, the same as they were for non-Latino whites.

This analysis showed only a slight reduction in the observed disparities. In other words, the likelihood that an African-American or Latino borrower received a higher-rate home loan is still much higher than that of a non-Latino white borrower with identical borrower traits. Specifically, after adjusting for observable factors, most of the disparity observed in the unadjusted data remains unexplained. Figure 4 shows that the African-American to non-Latino white ratio of higher-rate lending incidence drops approximately 16 percent for purchase (3.2 to 2.7) and nine percent for refinance (2.3 to 2.1) loans. For Latino whites, the ratio drops 26 percent (2.7 to 2.0) for purchase loans and only 6 percent (1.6 to 1.5) in the case of refinance loans.

Table 4: Share of 2005 Originations that were Higher Cost by Race and Ethnicity, Unadjusted and Adjusted for Borrower Traits

Borrower Race/Ethnicity	Loan Purpose	2005, unadjusted		2004, adjusted for borrower traits	
		Percentage of Originations that were Higher-rate	Ratio to Non-Latino White	Percentage of Originations that were Higher-rate	Ratio to Non-Latino White
Black or African American	Purchase	54.7	3.2	47.0	2.7
Black or African American	Refinance	49.3	2.3	45.0	2.1
Hispanic or Latino	Purchase	46.1	2.7	34.2	2.0
Hispanic or Latino	Refinance	33.8	1.6	31.5	1.5
Non-Latino White	Purchase	17.2	N/A	17.2	N/A
Non-Latino White	Refinance	21.0	N/A	21.0	N/A

D. DISPARITIES PERSIST AFTER CONSIDERING BORROWER TRAITS AND THE IDENTITY OF THE LENDER

The authors also present findings that suggest that the identity of the originating lender has much more to do with the aforementioned disparities between racial and ethnic groups than does the limited set of borrower traits available in HMDA. In this analysis, the authors, in addition to controlling for the borrower traits, add to the analysis an additional control for originating lender. Essentially, this adjustment allows them to estimate the proportion of loans to African-Americans and Latino whites that would be expected to be higher-rate if borrower traits were the same across groups *and* they received loans proportionally from the same lenders as non-Latino whites. This adjustment leads to a sharp drop in disparities, though significant differences remain.

Table 5 shows the results from this analysis. For African-American borrowers, the disparity in the incidence of higher-rate loans is cut in half for purchase (3.2 to 1.6) and by 45 percent for refinance (2.3 to 1.3) loans. For Latino borrowers, the reduction in disparities to non-Latino white borrowers is 52 percent (2.3 to 1.3) for purchase loans and 31 percent (1.6 to 1.1) for refinance loans. As Table 5 shows, even after both the borrower and lender adjustments, African-American borrowers remain 60 percent (1.6 times) and 30 percent (1.3 times) more likely than non-Latino white borrowers to receive a higher-cost loan for purchase and refinancing of homes, respectively. Latino borrowers remain 30 percent (1.3 times) and 10 percent (1.1 times) more likely than non-Latino white borrowers to receive a higher-cost loan for purchase and refinancing of homes, respectively.

Table 5: Share of 2005 Originations that were Higher Cost by Race and Ethnicity, Unadjusted and Adjusted for Borrower Traits and Originating Lender

Borrower Race/Ethnicity	Loan Purpose	2005, unadjusted		2005, adjusted for borrower traits and lender	
		Percentage of Originations that were Higher-rate	Ratio to Non-Latino White	Percentage of Originations that were Higher-rate	Ratio to Non-Latino White
Black or African American	Purchase	54.7	3.2	27.2	1.6
Black or African American	Refinance	49.3	2.3	27.2	1.3
Hispanic or Latino	Purchase	46.1	2.7	21.9	1.3
Hispanic or Latino	Refinance	33.8	1.6	23.6	1.1
Non-Latino White	Purchase	17.2	N/A	17.2	N/A
Non-Latino White	Refinance	21.0	N/A	21.0	N/A

The large decrease in disparities when adjustments are made for originating lender is evidence of a bifurcated mortgage market, where African-American and Latino borrowers are disproportionately served by higher-cost lenders.

III. CONCLUSIONS AND POLICY RECOMMENDATIONS

Like the 2004 HMDA data, the 2005 data show marked differences in the incidence of higher-rate mortgages among different racial and ethnic groups. Furthermore, changes in the interest-rate environment during this time has increased the proportion of subprime loans captured by the HMDA rate-spread threshold. Consequently, the disparities observed in the 2005 data are a more accurate reflection of differences in subprime originations between different borrower groups.

As the Fed report points out, it is important to note that many important risk factors used to price loans are not included in data collected under HMDA, such as credit score and loan-to-value ratio. In the past, the lending industry has pointed to the absence of these risk factors in HMDA to dismiss the disparities as irrelevant. However, a 2006 study published by the Center for Responsible Lending combined 2004 HMDA data with a proprietary database of subprime loans that permitted an examination of virtually all factors that lenders conventionally use to analyze risk and set loan prices. The CRL study found that, even after controlling for legitimate risk factors, African-American and Latino borrowers were still more likely to receive higher-rate subprime loans than similarly-situated non-Latino white borrowers.[9] With raw disparities in higher-rate loans between groups basically unchanged from 2004 to 2005, there is little reason to believe that legitimate risk factors would account for all of the disparity evident in the 2005 data.

What other factors are causing African-American and Latino borrowers to disproportionately receive higher-rate loans? There are three primary candidates: discretionary loan pricing, market segmentation and borrower behavior.

Discretionary Loan Pricing: While lender rate sheets present objective pricing schedules for calculating a loan's interest rate, they are not definitive statements of a loan's price for a given borrower. Discretionary yield-spread premiums (YSP) and other up-front charges, as well as negotiated exceptions to rate sheet guidelines, are common examples of how a loan's price can vary from prices displayed on a rate sheet. If lenders or brokers disproportionately use discretionary pricing to the advantage of some groups of borrowers

(e.g., by waiving certain fees) or to the disadvantage of other borrowers (e.g., by accepting a YSP to place the borrower into a higher cost loan), racial and ethnic disparities could result.

Market Segmentation: African-Americans and Latinos also would be more likely to receive higher-rate subprime loans if they tended, on average, to receive their loans from lenders that generally charge more than the lenders that serve predominately white borrowers. Such lenders that charge more across-the-board might have a greater cost of funds, higher overhead charges resulting from less streamlined operations, higher marketing expenses, or they might simply demand greater returns. Market segmentation can be caused by higher-cost lenders directly or indirectly targeting borrowers of color and/or by lower-cost lenders insufficiently serving these communities. Previously we noted how disparities decline when the analysis accounts for the originating lender. This decline is consistent with a highly segmented marketplace in which higher-rate subprime lenders originate loans disproportionately to African-American and Latino borrowers.[10]

Borrower Behavior: A third possible explanation for the pricing disparities involves borrower behavior. It is possible, as members of the lending industry often assert, that different ethnic and racial groups have different propensities for comparing prices and negotiating when shopping for mortgages, and that these differences lead to different outcomes. However, given the common observation that a clear majority of subprime loans are originated through brokers, one would expect differences in shopping behavior to be minimized, since borrowers appear to (incorrectly) presume that brokers provide them the lowest-cost loan options.

The new HMDA data illuminate the prevalence of subprime lending in the United States. Overall, for both purchase and refinance subprime home loans made in 2005, about one in four was higher cost. Subprime lending is no longer a rare occurrence by niche lenders, but a large portion of the mortgage market.

While the expansion of subprime credit has undoubtedly helped some borrowers achieve homeownership, the 2005 data show troubling patterns, particularly with regard to racial and ethnic disparities in the mortgage market. Specifically, African-American and Latino borrowers are much more likely to receive higher-rate loans than non-Hispanic white borrowers, even after adjusting for differences in borrower traits. Though adjusting for the originating lender substantially reduces differences in the incidence of higher-rate loans between racial and ethnic groups, disparities persist.

Given the importance of homeownership in wealth-building and the current wealth gap that exists between white Americans and African-American and Latino families, these pricing disparities among subprime loans call for reform in the mortgage market. To encourage fair pricing of home loans that is based only on legitimate risk factors, and to facilitate economic progress for all borrowers, we recommend the following:

- Eliminate the practice of steering borrowers to loans with needlessly high rates by requiring lenders and brokers to adhere to their own risk-based pricing standards.

- Hold lenders and brokers responsible for providing loans that are suitable for their customers.

- Create incentives and support policies to combat predatory lending and lead the market to better serve African-American and Latino communities.

- Ensure that adequate resources are dedicated to fully enforcing fair lending laws; and

- Support expanded disclosure of key lending data by amending HMDA.

Endnotes

1. Robert B. Avery, Kenneth P. Brevoort, and Glen B. Canner, "Higher-Priced Home Lending and the 2005 HMDA Data," Federal Reserve Bulletin (amended September 18, 2006).

2. For the purpose of this comment, "Latino" refers to borrowers who were identified as racially white and of Latino ethnicity.

3. Fed Bulletin, page A144.

4. Fed Bulletin, page A125.

5. Inside Mortgage Finance's Mortgage Market Statistical Annual estimates a total subprime lending volume in 2005 of $665 billion. HMDA reports about $589 billion in higher-rate loans.

6. The Fed's methodology for adjusting for changes in interest rates assumes that all originations were fixed-rate. Changes in the interest-rate environment actually have a greater impact on the rate reporting for adjustable-rate mortgages and, as a result, the true effect of interest rate changes on the proportion of loans over the spread-reporting threshold is likely greater.

7. Inside Mortgage Finance's Mortgage Market Statistical Annual estimated total 2004 and 2005 subprime lending to be about $530 billion and $665 billion, respectively, while volume of higher-rate loans in HMDA was about $254 billion in 2004 and $589 in 2005.

8. Fed Bulletin, page A144.

9. Debbie Gruenstein Bocian, Keith S. Ernst and Wei Li. "Unfair Lending: The Impact of Race and Ethnicity on the Price of Subprime Mortgages," available at http://www.responsiblelending.org/pdfs/rr011-Unfair_Lending-0506.pdf.

10. For a more detailed discussion of discretionary pricing and market segmentation, see CRL's "Unfair Lending: The Impact of Race and Ethnicity on the Price of Subprime Mortgages," available at http://www.responsiblelending.org/pdfs/rr011-Unfair_Lending-0506.pdf.

About the Center for Responsible Lending

The Center for Responsible Lending (CRL) is a national nonprofit, nonpartisan research and policy organization dedicated to protecting home ownership and family wealth by working to eliminate abusive financial practices. CRL is affiliated with Self-Help, one of the nation's largest community development financial institutions.

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