



Unfair Lending: The Effect of Race and Ethnicity on the Price of Subprime Mortgages

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I. EXECUTIVE SUMMARY

Last year, for the first time, lenders were required to report details on the costs of subprime home loans—mortgages intended to serve borrowers with blemished credit or other high-risk characteristics. Lenders disclosed pricing information related to the most expensive subprime loans (referred to here as “higher-rate” loans), while lower-rate loans in the subprime market and virtually all prime loans were exempt from this reporting requirement. Several analyses of this information, collected under the Home Mortgage Disclosure Act (HMDA), have shown that African-American and Latino borrowers received a disproportionate share of higher-rate home loans, even when controlling for factors such as borrower income and property location.

A number of concerned groups have pointed to these disparities as evidence of discrimination that slows economic progress among groups who already lag far behind in homeownership and wealth. Others contend, however, that the pricing disparities are not meaningful, since they do not fully account for legitimate differences in credit risks. In this report, we attempt to move the debate forward by providing a more detailed examination of pricing patterns in the subprime home loan market. Our study analyzed subprime home loan prices charged to different racial and ethnic groups while controlling for the effects of credit scores, loan-to-value ratios, and other underwriting factors. To our knowledge, this is the first full research report that examines 2004 HMDA data to assess the effects of race and ethnicity on pricing in the subprime market while controlling for the major risk factors used to determine loan prices.

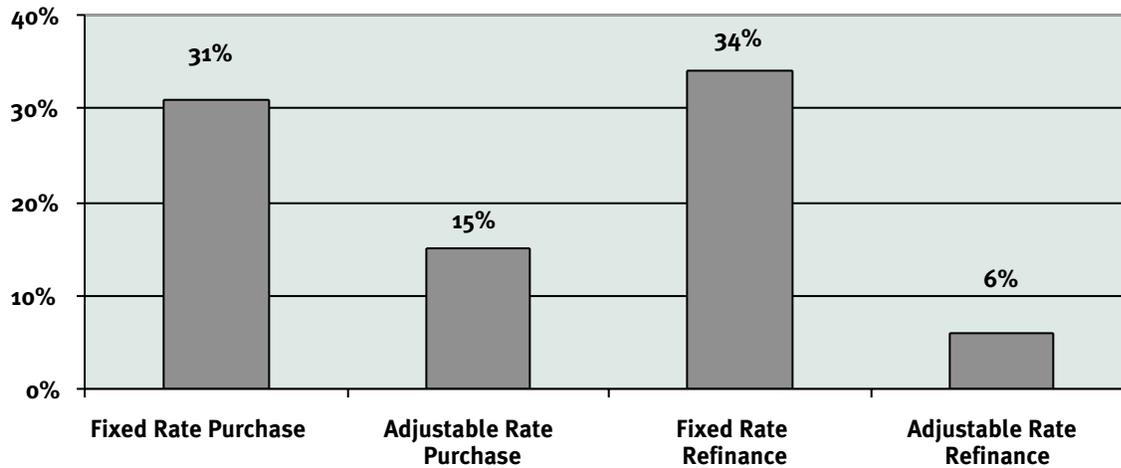
Our findings show that, for most types of subprime home loans, African-American and Latino borrowers are at greater risk of receiving higher-rate loans than white borrowers, even after controlling for legitimate risk factors. The disparities we find are large and statistically significant: For many types of loans, borrowers of color in our database were more than 30 percent more likely to receive a higher-rate loan than white borrowers, even after accounting for differences in risk.

This analysis was possible because we supplemented the 2004 HMDA data with information from a large, proprietary subprime loan dataset. Individually, both databases lack certain pieces of data that would be helpful for an in-depth comparison of subprime loan pricing. By combining loan information from both sources, however, we obtain more complete information on a large set of loans. Using a combined dataset of over 177,000 subprime loans, we analyzed whether borrowers of color are at greater risk of receiving higher-rate subprime loans than similarly-situated white borrowers.

Our basic findings are outlined here:

- 1) **African-Americans were more likely to receive higher-rate home purchase and refinance loans than similarly-situated white borrowers, particularly for loans with prepayment penalties.**
 - The effect of being an African-American borrower on the cost of credit was greatest for loans containing penalties for early payoff, which comprised over 60 percent of the loans we examined.
 - As shown in the chart below, African-American borrowers with prepayment penalties on their subprime home loans were 6 to 34 percent more likely to receive a higher-rate loan than if they had been white borrowers with similar qualifications. Results varied depending on the type of interest rate (i.e., fixed or adjustable) and the purpose (refinance or purchase) of the loan.

Increased Likelihood that African-American Borrowers Received a Higher-Rate Subprime Loan with a Prepayment Penalty* versus Similarly-Situated White Borrowers

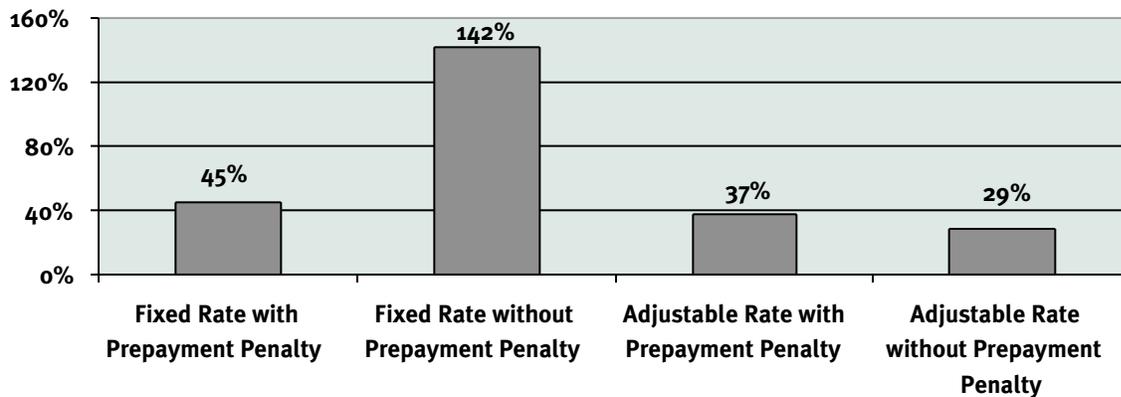


* During 2004, approximately two-thirds of all home loans in the subprime market had prepayment penalties.

2) Latino borrowers were more likely to receive higher-rate loans than similarly-situated non-Latino white borrowers for mortgages used to purchase homes. Differences for refinance loans were not significant at a 95 percent confidence level.

- Latino borrowers purchasing homes were 29 to 142 percent more likely to receive a higher-rate loan than if they had been non-Latino and white, depending on the type of interest rate and whether the loan contained a prepayment penalty.
- Pricing disparities between Latinos and non-Latino white borrowers for refinance loans were not significant at the 95 percent confidence level in our dataset.

Increased Likelihood that Latino Borrowers Received a Higher-Rate Subprime Purchase Loan versus Similarly-Situated White Borrowers



This analysis does not allow us to estimate precisely how much race and ethnicity increase the prices charged to borrowers. It is also beyond the scope of this paper to determine definitively why these disparities exist. However, we do posit several possible causes, including the considerable leeway mortgage originators have to impose charges beyond those justified by risk-based pricing.

A notable and pervasive example of discretionary pricing occurs through “yield-spread premiums,” which are monetary incentives for mortgage brokers to inflate rates on subprime loans. Other causes of pricing disparities may include the inconsistent application of objective pricing criteria, targeting of families of color by higher-rate lenders or brokers, and lack of investment by lower-cost lenders in these communities. It is likely that all of these factors contribute to making subprime home loans more costly than necessary.

For African-Americans, the most striking disparities that emerged in our research were associated with prepayment penalties; for Latinos, the greatest disparities related to loan type (purchase versus refinance). Examining these differences, we discuss several hypotheses. First, we believe the larger disparities observed for African-Americans in subprime loans with prepayment penalties may be related to yield-spread premiums, since lenders are often more willing to pay these premiums on loans that include prepayment penalties. Mortgage originators routinely make exceptions to guidelines, but it may be that African-Americans receive fewer favorable exceptions than white borrowers. Second, we believe that the disparities evidenced for Latinos on purchase mortgages might arise from a greater concentration of recent immigrants among this borrower pool. If so, the higher disparities in the purchase market may be a result of higher-cost lenders targeting recent immigrants.

While these results are particularly disturbing for borrowers of color, the results have negative implications for all borrowers in the subprime market, since common business practices such as discretionary pricing can affect anyone. The cost of mortgages matters more than the cost of typical consumer goods. Whether or not families receive fairly priced home loans is a major factor in their fundamental financial security. Higher loan costs will both dissuade some potential borrowers from investing in homeownership and increase the risk of foreclosure for those who do.

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

- Curtailing steering by requiring objective pricing standards;
- Holding lenders and brokers responsible for providing loans that are suitable for their customers;
- Amending HMDA to expand the disclosure requirements for risk and pricing information;
- Ensuring that adequate resources are dedicated to fully enforcing fair lending laws; and
- Creating incentives and supporting a policy framework that lead the market to better serve African-American and Latino communities.

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