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Thank you Chairman Bachus, Ranking Member Sanders, and Members of the Committee for the opportunity to testify today. I want to take this opportunity to thank you, Chairman Bachus, specifically for your thoughtful leadership and persistence in addressing predatory mortgage lending and other vital issues that affect homeowners today. You and other leaders on the Financial Services Committee play an important role in determining how much confidence Americans can have in receiving fair and responsible mortgages as they buy homes and tap into their home equity in the subprime mortgage market.

We also appreciate this opportunity to comment on ways to strengthen the Home Mortgage Disclosure Act. Data collected and publicly disclosed under HMDA has been central in ongoing efforts to ensure fair and constructive lending. We believe the information we provide today will underscore the significance of HMDA data and its importance in encouraging a market for subprime home loans that is competitive and fair.

For many years, there have been concerns about potentially unfair pricing in the mortgage market. In 2000, a joint report by the U.S. Department of Housing and Urban Development and the U.S. Department of the Treasury noted that "[i]n predominantly black neighborhoods, subprime lending accounted for 51 percent of refinance loans in

1998—compared with only 9 percent in predominantly white neighborhoods."[1] These differences were observed to persist even when adjustments were made to account for differences in homeowners' incomes. Though disconcerting, these observations were not based on a direct measurement of the cost of mortgages, nor did they account for a broader set of risk factors routinely used to determine loan prices.

The first limitation was addressed last year, when the 2004 HMDA reporting requirements directed lenders to identify higher-rate loans.[2] Last fall, staff to the Board of Governors of the Federal Reserve System analyzed the distribution of these higher-rate loans.[3] They report pricing disparities between different racial and ethnic groups even after controlling for a borrower's income, gender, property location, and the loan amount. For example, after accounting for these differences, African-Americans who took a loan to purchase a home were 3.1 times more likely than white non-Hispanic borrowers to receive a higher-rate home loan; for Latino borrowers, the same disparity stood at 1.9 times.[4]

While this Federal Reserve analysis confirmed that African-American and Latino borrowers were more likely to receive higher-rate loans than white borrowers, the researchers were unable to broadly explore how these disparities were affected by risk factors such as borrowers' credit score, down payment, or ability to document income.

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[1] *Curbing Predatory Home Mortgage Lending*, U.S. Department of Housing and Urban Development and U.S. Department of the Treasury, p47 (June 2000), at http://www.huduser.org/publications/hsgfin/curbing.html.

[2] Specifically, in the case of first-lien home loans, lenders were required to identify loans that carried an annual percentage rate that exceeded by more than three percentage points the yield on U.S. Treasury securities of a comparable term. *See A Guide to HMDA Reporting: Getting it Right!*, Federal Financial Institutions Examination Council (December 2003).

[3] Robert B. Avery, Glenn B. Canner & Robert E. Cook, *New Information Reported Under HMDA and Its Implication in Fair Lending Enforcement, Federal Reserve Bulletin* (Summer 2005), at http://www.federalreserve.gov/pubs/bulletin/2005/3-05hmda.pdf.

[4] Calculations from Keith S. Ernst and Deborah N. Goldstein, *Comment on Federal Reserve Analysis of Home Mortgage Disclosure Act Data*, Center for Responsible Lending Comment No. 1 (September 14, 2005), at http://www.responsiblelending.org/pdfs/cb001-FRB-091505.pdf.

To help advance the debate, my organization, the Center for Responsible Lending, has produced the first full research report that addresses this limitation.[5]

Specifically, we developed a database of 177,000 subprime loans by matching loans in HMDA to a private database of subprime mortgages. This step enabled us to bring together detailed information on mortgage pricing, loan terms, and borrower risk characteristics in a single dataset. As a result, our study was able to account for those factors and isolate the effects of race and ethnicity in influencing whether a borrower receives a higher-rate loan in the subprime market.

Our findings were striking. We found that race and ethnicity—two factors that should play no role in pricing—are significant predictors of whether a subprime loan falls into the higher-rate portion of the market. Race and ethnicity remained significant predictors even after we accounted for the major factors that lenders list on rate sheets to determine loan pricing.

In other words, even after controlling for legitimate loan risk factors, including borrowers' credit score, loan-to-value ratio, and ability to document income, race and ethnicity matter. African American and Latino borrowers continue to face a much greater likelihood of receiving the most expensive subprime loans—even with the same loan type and the same qualifications as their white counterparts. Across a variety of different loan types, African American and Latino borrowers were commonly 30% more likely to receive a higher-rate loan than white borrowers.

In considering our study, it is important to understand that our analysis focused exclusively on subprime mortgages—those intended for borrowers with credit blemishes or other indications of higher-risk. Although it would be interesting to conduct a similar

[5] Debbie Gruenstein Bocian, Keith S. Ernst and Wei Li, *Unfair Lending: The Effect of Race and Ethnicity on the Price of Subprime Mortgages*, Center for Responsible Lending (May 31, 2006). The study can be accessed at
http://www.responsiblelending.org/pdfs/rr011-Unfair_Lending-0506.pdf.

analysis across the entire mortgage market, data restrictions confined our focus to the subprime market.

Another key point about our study is that it did not involve approvals or denials of loans, but rather a study of the likelihood of getting the most expensive subprime loans. More specifically, for similarly-situated borrowers, we looked at the relative likelihood of getting a loan that crossed the line into the "higher-rate" pool of subprime mortgages.

The disparities we identified are troubling. For millions of families, owning a home ultimately makes the difference between merely surviving between paychecks or building savings for a better future. Unfortunately, race and ethnicity continue to be strongly correlated with wealth. In 2004, white non-Hispanic families had a median net worth of $140,700 while non-white or Hispanic families had a median net worth of $24,800.[6] Similarly, in 2004, 74 percent of white non-Hispanic families reported owning their primary residence versus just 47 percent of non-white or Hispanic families.[7] As a result, making mortgage credit arbitrarily more costly for African-American and Latino borrowers has significant implications, especially since ownership is also associated with higher attainments in education, better physical health and safer neighborhoods.

Even as we note the importance of these findings to African-American and Latino communities, it is important to understand that the pricing disparities identified in our research have implications for <u>all</u> families who receive subprime mortgages. Efficient financial markets should provide similarly-situated borrowers with equally competitive prices on subprime home loans. Yet, our results show this is not occurring.

Our methodology is not designed to pinpoint the underlying causes of pricing disparities; we can only verify that the disparities exist and that they are significant. However, in the report, we discuss a number of factors that likely contribute to the differences we found.

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[6] Brian K. Bucks, Arthur B. Kinnickell & Kevin B. Moore, *Recent Changes in U.S. Families Finances: Evidence from the 2001 and 2004 Survey of Consumer Finances,* Vol. 92 Federal Reserve Bulletin pA4 (February 2006).
[7] Id at A20.

One reason relates to how lenders set prices on subprime loans. In the subprime market, substantial leeway exists for prices to be altered without regard to any credit-related criteria. The most obvious example is found in the context of "yield-spread premiums." Basically, yield-spread premiums are a bonus paid to brokers for placing borrowers in a loan with a higher interest rate. This presents a "reverse competition" problem, since it provides an incentive for brokers to deliver loans with higher rates to borrowers. In many states, this incentive is not countered by a legal obligation on brokers to find a good deal for their customers or even to recommend a suitable loan.

Yield-spread premiums are often portrayed purely as a tool that allows borrowers an alternative method of paying broker charges that would otherwise have to be paid directly. However, recent research shows that borrowers pay the most when some of their brokers' compensation came from both yield-spread premiums and other up-front charges.[8] This evidence is consistent with brokers charging yield-spread premiums on top of, rather than in place of, other discretionary up-front fees.

Another possible explanation for pricing disparities relates to whether African-American and Latino borrowers disproportionately receive their loans from higher-rate lenders. For example, civil rights groups have pointed out that Latino communities are frequently targeted by higher-rate lenders who take advantage of borrowers who feel that they have fewer options.

In any case, the 2004 HMDA information shows that African-American and Latino families in the subprime market are more likely to receive higher-rate home loans, and even accounting for major determinants of loan prices fails to explain the disparity. Given this situation and the likely causes, there are several specific actions we recommend to encourage fair, risk-based pricing of home loans:

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[8] Marsha J. Courchane, Douglas McManus & Peter M. Zorn, An Analysis of Mortgage Closing Costs (August 2004) (unpublished manuscript, on file).

Our first recommendation is to address industry practices that encourage inflated charges on subprime home loans.

Pricing in the subprime mortgage market today is not always based on rational factors. It is clear that yield-spread premiums allow leeway to divert from risk-based pricing, with great potential to add unnecessary costs to homeowners. We believe there are several ways to achieve more rational pricing based on objective factors while still permitting broker compensation through yield-spread premiums when appropriate. For example, we strongly recommend that yield-spread premiums be counted when considering whether the cost of a subprime loan is high enough to warrant additional protections. Today the Home Ownership and Equity Protection Act specifically excludes yield-spread premiums in its calculation of points and fees. This is a loophole that affects subprime loans originated by mortgage brokers, which is well over half the market.

Our second major recommendation is to hold lenders and brokers responsible for providing loans that are suitable for a given borrower.

Financial professionals who sell stocks and other investments have long had an affirmative duty to ensure that the products they recommend are suitable for their customers. Although buying a home is the biggest investment most families ever make, lenders and brokers frequently have no such obligation. Lenders and brokers should be required to recommend loans that are suitable and reasonably advantageous to borrowers.

Third, and very importantly, we believe lenders should be required to disclose more detailed pricing and underwriting information in their HMDA data.

The new information in HMDA collected on the annual percentage rate on some loans is a valuable first step, but more can be done. To provide the most accurate picture of loan pricing possible, all of the costs associated with a home loan should be reported in HMDA, including points and fees, yield-spread premiums, and prepayment penalties. In addition, HMDA should include an indication of whether the loan was originated through a mortgage broker. Finally, HMDA data should include other information that would allow more insight into how loans are priced, such as loan-to-value ratios and credit scores. This information is fundamental to mortgage lending today, and would be a valuable tool in achieving greater fairness in subprime pricing. We believe that, working in good faith, interested parties can develop a workable mechanism for providing such information without unduly compromising privacy.

Fourth, we need more focused and transparent enforcement of fair lending laws.

One of the main goals of HMDA is to help identify potential discriminatory lending patterns and to enforce anti-discrimination laws. Last year, based on the raw disparities evident in the 2004 HMDA data, the Federal Reserve referred some 200 lenders to regulators for further investigation. To date, no information about the outcome of those referrals has been made public.

It is important for the public to know that regulators review and act on the information available to them in a timely and transparent fashion. We recommend that each regulator report annually on the number of fair lending examinations performed, and for each examination provide publicly-available information, including: (1) the indicators of potential discriminatory activity identified (if any); (2) the protected class or classes (e.g., gender, race) believed to be potentially disadvantaged by such activity; and (3) the outcome of each review (i.e., any actions taken). In the context of these examinations, we specifically urge the regulators to focus on the impact of discretionary pricing.

In addition, turf battles should not impede efforts to protect consumers. In the wake of the release of the 2004 HMDA data, the Office of the Comptroller of the Currency has put significant energy into a court action to prevent a state attorney general from having access to information necessary to evaluate potentially discriminatory practices by lending institutions.[9] It is not clear whether the same energy has been put into getting to

[9] *See* Office of the Comptroller of the Currency v. Spitzer, 396 F.Supp. 2d 383 (S.D.N.Y. 2005).

the root of racial and ethnic disparities in home lending. It will take concerted efforts from all interested parties to ensure that similarly-situated families receive fairly-priced loans.

Finally, we urge Congress to review incentives and support a policy framework that leads the market to better serve all communities.

Some of the key goals of HMDA include determining whether financial institutions are serving the housing needs of their communities and helping public officials to make public investments in a way that attracts private investment in areas that need it. As discussed above, one reason African-American and Hispanic families are more likely to receive higher-rate loans may be that they tend to receive loans from lenders that generally charge more. Policymakers should review whether lower-cost lenders need additional incentives to help meet the credit needs of such communities. Conversely, regulatory enforcers of fair lending laws should actively evaluate whether the higher-cost lenders "reverse red-line" by targeting African-American and Latino communities for higher-priced products unrelated to individual borrower risk.

When unscrupulous lending practices go unchecked, borrowers are not the only ones who suffer harm; lower-cost lenders and honest brokers also are placed at a disadvantage. They cannot compete with lenders or brokers who make loans on unfair or deceptive terms or who push-market loans that are not in a borrower's best interest. In recent years, state laws and regulations that prohibit predatory, irresponsible subprime lending have proven effective in reducing the number of abusive loans while maintaining a vibrant market for subprime home loans.[10] Indeed, state predatory lending reforms offer important lessons for thinking about how to protect borrowers from abusive lending.

These are our major recommendations, which are presented in more detail in our full report.

As the Members of this Committee consider ways to strengthen HMDA data and prevent predatory lending, I know you all share the ultimate goal of ensuring that the subprime market provides fairly-priced credit to all American families, offering them much-needed opportunities to build wealth. Yet, I would also note that the 2004 HMDA data shows that we still have substantial work ahead to realize this goal. As you reflect on how to accomplish this goal, I would respectfully urge you to recognize that some important solutions have already been proven effective in the states. Thank you once again for considering these recommendations and my testimony.

[10] Wei Li and Keith S. Ernst, *The Best Value in the Subprime Market: State Predatory Lending Reforms*, Center for Responsible Lending research report (February 23, 2006) at http://www.responsiblelending.org/pdfs/rr010-State_Effects-0206.pdf.