Discrimination in Mortgage Markets

Presented at the Federal Reserve Bank of Cleveland
February 6, 2009

Stephen L. Ross
Professor of Economics
University of Connecticut

Outline of Talk

- **Research following the Boston Fed Study**
- **Paired Testing Studies of the Pre-application Process**
- **Fair Lending Investigation on Mortgage Pricing**
- **Recent Experiences concerning Subprime Lending**

Criticism of the Methodology in the Boston Fed Study

- **Omitted variables**
- **Data errors in the explanatory variables**
- **Misclassification in the dependent variable**
- **Incorrect specification**
- **Endogenous loan terms**

Investigation of Ross and Yinger

- **None of our analyses had a significant impact on racial differences in lending except for the inclusion of whether the applicant meets the credit guidelines of the lending institution**
- **Horne at FDIC and others: Variable should be included as a control for omitted information concerning applicant credit history**
- **Boston Fed Researchers: Variable is an after the fact judgment that could be used to validate/or justify instances of discrimination**
- **Our View: Both our right. Must model process that determines the meets guidelines variable.**

Results and Interpretation of Meets Guidelines

- **Correctly modeling and controlling for meets guidelines lowers racial differences in underwriting from 7.7 to 5.3 percent.**

- **This effect cannot arise simply because African-Americans visit lenders with more stringent underwriting guidelines, but rather must arise do to the match between applicants and the underwriting guidelines of specific lenders.**

- **Research by the OCC suggests that underwriting guidelines vary across lenders and estimated racial differences are larger in models that do not allow for lender specific underwriting criteria.**

Interpretation of Findings

- **Mortgage system in Boston had a disparate impact on African-American borrowers that would not have been detected by investigations of individual lenders.**

- **Unlikely borrowers can actively sort themselves based on personal knowledge of how underwriting systems vary across lenders.**

- **Yezer argues that loan terms are endogeneous: loan officers have private information on underwriting standards, and can help borrowers adapt their application to a lender's specific standards.**

- **If loan officers provide more assistance to whites than blacks, Yezer's model predicts a poorer quality match for Blacks.**

Paired Testing Study in Mortgage Lending

- **Study of the pre-application phase of the mortgage lending process**

  First Time Homebuyer
  Downpayment Constrainted
  A- Credit History

- **HUD FHEO Funded Pilot Study Implemented by the Urban Institute**

  Two cities: Chicago and Los Angeles
  Two groups: Black-White and Anglo-Hispanic
  75 tests per group in each site

Testing Methodology

- **Selection of Lender Population**

  HMDA based selection process
  Minimum 90 applications per year
  Local office available (verified by testing organization)

- **Selection of Test Sample**

  Sample of lenders drawn with weights based on loan volume
  Branch selected randomly from all available

- **Tester Assignment**

  Random assignment of one of six A- credit history profiles
  Target house price based on MSA median house price
  Back-out income, wealth, and debt to meet target financial ratios

Tester Protocols

- ***Step #1 - Obtain an Appointment.*** **Call to arrange "in person" visits**
- ***Step #2 - Make the Initial Request.*** **State that purpose of visit is to obtain a price range of housing that is affordable and an estimated loan amount.**
- ***Step #3 - Exchange Personal/Financial Information.*** **Be forthcoming and provide income, debts, assets, credit information and other personal and financial characteristics when requested by a lender.**
- ***Step #4 - Record Information on Financing Options Recommended.*** **Testers were required to take notes and record information provided.**
- ***Step #5 - End the Visit.*** **Thank the lender and allow the lender to suggest follow-up contact.**

Racial Differences in Treatment in Chicago

- **Less favorable treatment for African-Americans**

  Less information provided on financial options
  Shown more mortgage products
  More coaching (downpayment, pre-qualification)

- **Less Favorable treatment for Hispanics**

  Lower loan amount quoted
  Shown more mortgage products
  More coaching (downpayment, seller assistance)

- **Few Significant Differences in Los Angeles**

Across Lender Differences in Chicago

- **Lenders with a high share African-American Applicants**

  Less information, products, coaching, and follow-up contact
  More likely to recommend FHA
  African-American testers relatively favored on all treatments above

- **Lenders with Large Application Volume**

  Less coaching (downpayment) and follow-up contact
  More likely to recommend FHA
  African-Am. favored on coaching (downpayment), follow-up
  Hispanic favored on loan amount, coaching (downpayment)
  Hispanic less likely to have FHA recommended

- **African-American Loan Officers**

  More coaching, follow-up contact, and FHA recommendations
  Hispanics receive less coaching (downpayment), follow-up

Consultant on Fair Lending Investigation

- The investigation followed the release of pricing data in the 2004 Home Mortgage Disclosure Act data.
- Involved estimation of detailed loan pricing models for two major lenders using lender provided data.
- Both complaints settled with the second of the two lenders paying monetary damages to borrowers ($1,000,000 averaging about $3,000 per borrower).

Lender One

- **Three subsidiaries: Prime retail, Subprime retail, wholesale.**

- **Standard pricing model with non-parametric controls (bins) for loan to value ratio, credit score, debt to income ratio, fixed versus variable, term, property type, loan type, and region.**

- **No racial differences (very precisely estimated at zero – less than 1 basis point) for loans made by the subprime retail subsidiary. Strong command and control systems in place at that subsidiary, but in fact mediocre fair lending policies.**

- **Substantial price differences for the prime retail (just under 10 basis points on APR spread and 0.2 to 0.3 points in terms of overages) and wholesale subsidiaries (16 basis points – blacks only – and 0.3 to 0.35 points in terms of higher broker commissions).**

- **African American prime borrowers more likely at subprime subsidiary. No evidence of across subsidiary pricing differences – prime borrowers at subprime subsidiary get same price**

Lender Two

- **Single prime lending unit, but substantial share of loans initiated by brokers (over 80% of loans wholesale).**

- **Standard pricing model with non-parametric controls (bins) for loan to value ratio, credit score, and debt to income ratio, as well as broker compensation model with similar controls.**

- **No racial differences for loans made by loan officers of the lender. Again, good command and control systems in place.**

- **Substantial racial and ethnic differences in broker compensation for the wholesale loans (0.3 to 0.5 points).**

- **Substantial compensation differences across brokers that correlate strongly with share of minority loans (1.0 point difference between average large broker and average large, predominantly minority brokers).**

Paired Testing with Network News Magazine

- **Scenario's patterned after the Urban Institute's Homeownership Testing Program.**

- **Testers conducted visits in three metropolitan areas with hidden camera's which were reviewed afterwards.**

- **Major examples of adverse treatment**

  Steering whites away from own expensive subprime loans
  Working hard to get whites business – offering better rate
  Telling minority that downpayment will not help or lower rate

- **Might represent rational behavior - apparent strong desire to capture business of white customer where the likelihood of a final deal might be higher.**

Debate over Mortgage Reform in Connecticut

- **Worked with Connecticut Fair Housing Center in their efforts to advocate for mortgage lending reform before CT State Legislature.**

- **Met with many self-described victims of predatory lending.**

- **Common feature – surprise at closing. Subprime loans never have a rate lock creating point where borrower is very vulnerable.**

- **Small number of bad actors. Bad actors are smaller, but underwrite a substantial fraction/number of problem loans and invariably they are judgment proof.**

- **Due to securitization, many borrowers face foreclosure even when they can demonstrate fraud or malfeasance on the part of the broker. Some states are beginning to legislate that broker behavior is allowable as evidence in an affirmative defense against foreclosure.**

Lessons Learned

- **A large amount of discrimination in the mortgage market likely occurs in a decentralized manner based on the actions of individuals who actually meet with the borrower and observe their race.**

- **Lender actions that remove discretion from individual loan officers including automated underwriting systems and systems that track pricing deviations likely reduce mortgage lending discrimination.**

- **Differences across lenders and brokers, or even individual mortgage deals, likely represent a much greater risk to minority borrowers than the pricing and underwriting disparities discussed above.**

- **Further, racial discrimination by individuals at the initial, mortgage inquiry stage may in fact contribute to African-Americans doing business at either high cost brokers or lenders.**

Policy Recommendations

- **Ending mortgage discrimination starts with good command and controls systems throughout a lender's entire business model, and deserves more attention during fair lending investigations, rather than just a focus on the fair lending division and its policies.**

- **The decentralized system of mortgage brokers puts minorities at a considerable disadvantage in terms of the price they pay for mortgage credit. This sector of the mortgage market needs more oversight. Only lenders can provide this oversight, and they are unlikely to devote resources to this task unless faced with financial consequences for broker behavior.**

- **Borrowers, especially subprime borrowers, are incredibly vulnerable at loan closings giving brokers a lot of leverage in setting the final interest rate. Rate locks should be mandatory on subprime loans, similar to recent requirements for escrow of taxes and insurance.**

- **Borrowers who have been mistreated in the mortgage process need some type of affirmative defense against foreclosure.**