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The Dual Mortgage Market: The Persistence of Discrimination in Mortgage Lending

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Introduction

Efforts to promote equal access to mortgage capital by racial and ethnic minorities have historically been a key component of the civil rights agenda in the United States. From the struggle to enact fair housing and fair lending legislation in the 1960s to the community-based advocacy that prompted Congress to pass the Home Mortgage Disclosure Act (HMDA) and the Community Reinvestment Act in the 1970s, housing and civil rights advocates have pursued a common goal of eradicating racial discrimination in home mortgage lending. Today, the fight continues as housing advocates seek to expand regulatory and legislative action to halt predatory lending practices that burden many minorities with mortgages they cannot afford and often do not need.[1]

Successful efforts to promote fair lending must take into account the changing nature of discriminatory practices in the marketplace. In the immediate post–World War II period, racial discrimination in mortgage lending was easy to spot. From government-sponsored racial covenants in the Federal Housing Administration (FHA) guidelines to the redlining practices of private mortgage lenders and financial institutions, minorities were denied access to home mortgages in ways that severely limited their ability to purchase a home.

Today, mortgage lending discrimination is more subtle. Even though mortgage loans are now readily available in low-income minority communities, by employing high-pressure sales practices and deceptive tactics, some mortgage brokers push minority borrowers into higher-cost subprime mortgages that are not well suited to their needs and can lead to financial problems down the road. Consequently, more than three decades after the enactment of national fair lending legislation, minority consumers continue to have less-than-equal access to loans at the best price and on the best terms that their credit history, income, and other individual financial considerations merit.

The shifting nature of mortgage market discrimination comes in the midst of an explosion of mortgage lending to both lower-income and minority households and communities. Supported by a strong economy, favorable interest rates, and innovations in mortgage finance, the share of home purchase loans going to lower-income households and households living in lower-income

[1] As commonly described in existing literature, predatory lending may involve mortgage bankers, brokers, realtors, appraisers, home improvement contractors, or others involved directly or indirectly in mortgage lending. Predatory practices include outright deception and fraud and also efforts to manipulate the borrower through aggressive sales tactics or to exploit their lack of understanding about loan terms. For further discussion see U.S. Department of Housing and Urban Development and U.S. Department of Treasury (2000, hereafter HUD/Treasury 2000).

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communities increased steadily, from 31 percent in 1993 to 35 percent in 2001.[2] Over the same period, home purchase lending to Hispanic borrowers increased by 159 percent and to African American borrowers by 93 percent, while lending to whites grew by just 29 percent. As thousands of credit-impaired and often lower-income families purchased a home, the homeownership rate rose to a record high.

Unfortunately, the growth of lower-income lending and expanded outreach to minority consumers is linked to a dual mortgage delivery system, in which these borrowers are served with a different mix of products and by different types of lenders than commonly serve higher-income markets. Typically, products that target lower-income and credit-impaired borrowers have higher interest rates and less favorable terms than the conventional prime loans that serve the mainstream market. In addition, many of the alternative mortgage providers that have emerged fall outside of the existing federal regulatory framework, which remains largely focused on encouraging deposit-taking banking organizations to provide mortgage capital to low-income and minority communities.

Many households have benefited from these innovative mortgage products; however, they pose serious challenges for some borrowers. High-cost lenders disproportionately target minority, especially African American, borrowers and communities, resulting in a noticeable lack of prime loans among even the highest-income minority borrowers. In 2001 prime loans accounted for only 70.8 percent of home refinancing for African Americans with incomes in excess of 120 percent of area median income living in predominantly African American high-income neighborhoods.[3] In contrast, the figure is 83.1 percent for lower-income white borrowers living in predominantly white lower-income communities.[4] This, in part, reflects the fact that minorities have lower credit scores, on average, than whites. But there is concern that some high-cost lenders actively seek out minority applicants who may be vulnerable to deceptive, high-pressure marketing tactics due to their limited mortgage product options and limited knowledge of the mortgage system.

[2] Lower-income borrowers are defined as having incomes below 80 percent of area median income in 1990; lower-income neighborhoods have an income of less than 80 percent of area median income in 1990.

[3] A predominantly African American neighborhood is a census tract in which African Americans constitute at least 50 percent of the population. A high-income neighborhood has an income of more than 120 percent of the average median income as of 1990.

[4] A predominantly white neighborhood is a census tracts in which the population is 90 percent white.

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The increase in high-cost, inappropriate, or predatory mortgage loans in lower-income and minority neighborhoods raises serious public policy questions. Many families with overpriced loans quickly discover that they are unable to make current mortgage payments, which may result in foreclosure. Indeed, high-cost lending in the 1990s appears to be linked to a troubling rise in foreclosures, threatening not only to undo low-income homeownership gains but also to destabilize the already weak neighborhoods where these loans are concentrated. Clearly, an enhanced understanding of mortgage market dynamics is needed to design an appropriate policy response to predatory lending practices, to assist borrowers trapped in high-cost mortgages, and to minimize the harm resulting from high levels of foreclosures.

This chapter discusses the trends that are reshaping the mortgage banking industry and assesses the consequences of current mortgage lending patterns for lower-income and minority borrowers and communities. A summary of the available evidence suggests that although legitimate risk factors play a significant role in the allocation of mortgage credit, borrower race and neighborhood racial composition still appear to be significantly linked to access to prime loans. While the current structure of the mortgage market may efficiently serve affluent and financially savvy borrowers, the growing presence of some unscrupulous mortgage brokers in the marketplace increases the vulnerability of inexperienced borrowers, who often lack the ability to shop effectively in today's complex mortgage market and frequently end up paying too much for mortgage credit. In extreme cases, the current broker compensation structure actually reinforces the incentive for unscrupulous mortgage brokers to employ deceptive or even predatory practices, saddling poorer households with mortgage debt well in excess of their ability to repay.

The Changing Structure of the Mortgage Banking Industry

The mortgage industry of today bears little relationship to the mortgage industry of even the 1990s. The advent of automated underwriting, credit scoring, and risk-based pricing as well as the growing importance of mortgage brokers, national mortgage banking organizations, and expanded secondary mortgage markets have produced what some label a revolution in mortgage finance. This section summarizes these trends and assesses their implications for mortgage markets.

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The declining importance of bank deposits as a funding source for mortgages has largely driven the structural shifts within the industry. Historically, deposit-taking institutions such as thrift institutions and commercial banks originated the bulk of mortgages. In 1980 nearly half of all mortgages were originated by thousands of thrifts, while commercial banks originated another 22 percent.[5] Throughout the 1980s, many deposit-taking institutions held the loans they originated. Although mortgage insurance was an important element for FHA and other government-backed loans, the private mortgage insurance industry was still in its infancy. Moreover, mortgage underwriting standards and documents varied considerably from one institution to the next. As a result, third-party investors were reluctant to purchase mortgages that lacked standardized terms, mortgage insurance, and other features designed to reduce risk.

Since the 1980s that system has changed. The availability first of FHA insurance and then of private market insurance helped to extend the reach of the mortgage market to low-income and low-wealth borrowers. The Community Reinvestment Act, passed by Congress in 1977, also encouraged banks and their affiliates to turn their attention to previously underserved markets. Though these efforts substantially expanded access to capital, they also served to segment the market into distinct mortgage delivery channels, with one offering products targeting low-income and largely minority borrowers, while another targets the mainstream market.

The secondary market also developed and matured over that period. Even as late as 1990 less than half of all mortgages were securitized and sold on the secondary market—a figure bolstered by the fact that at that point Ginnie Mae was securitizing virtually 100 percent of all FHA loans.[6] Today, nearly 70 percent of all home mortgages are securitized and sold on the secondary market, due in large part to the growing presence in the marketplace of Fannie Mae and Freddie Mac, both government-sponsored enterprises. The ability to package and sell loans in the secondary market reduced the need to hold deposits (or other sources of cash) to fund mortgage loans. Fannie Mae and Freddie Mac, along with private mortgage conduits,

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[5] U.S. Department of Housing and Urban Development (1997).
[6] Inside Mortgage Finance (2003). Three federal institutions secure home mortgages: Ginnie Mae (Government National Mortgage Association), Fannie Mae (Federal National Mortgage Association), and Freddie Mac (Federal Home Loan Mortgage Corporation).

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standardized loan contracts and thus streamlined and rationalized mortgage markets, helping to foster an increasingly efficient mortgage delivery system.[7]

Most state-level restrictions on *intra*state banking were relaxed or removed in the 1980s; *inter*state banking became a reality at the federal level in the 1990s.[8] Banks could now expand beyond boundaries that had been in place since the Great Depression, and larger organizations increased the scale and scope of their operations through mergers and acquisitions. Lacking the economies of scale needed to compete in an increasingly automated business, many smaller banks and thrift institutions abandoned their mortgage origination activities entirely. Mortgage lending became dominated by a handful of financial services giants, making consolidation one of the most striking features of industry change. By1990 the top 25 originators accounted for 28.4 percent of an industry total of less than $500 billion in home mortgages. In 2003 these lenders accounted for 76.6 percent of the $3.7 trillion in loans originated that year.[9]

Loans are originated through one of three channels: retail, correspondent, or broker. Retail activity is most akin to traditional lending, wherein lenders reach out to potential customers, take mortgage applications, and underwrite and fund loans for those who meet their underwriting standards. Many retail lenders conduct business from branch operations. Increasingly, however, the marketing and even the closing of loans is being done by telephone or on the Internet. Once funded, a retail loan may be held in a portfolio by the lender or packaged and sold on the secondary market. Correspondent lenders typically are smaller mortgage banks, thrifts, or community banks that operate much like retail lenders in that they take applications and underwrite and fund mortgages. Although loans are funded in the name of the correspondent, they are later sold to a wholesale lender under prearranged pricing and loan delivery terms and in compliance with established underwriting standards. Brokers, by contrast, do not fund loans; they simply identify potential customers, process the paperwork, and submit the loan application to a wholesale lender, which underwrites and funds the mortgage.

In the 1980s retail lending dominated the industry. Since then—and particularly over the past ten years—wholesale activity, which includes both correspondent lenders and brokers, has grown rapidly. Concurrent with this trend has been an increase in the number of firms engaged in

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[7] Renieri (1996).
[8] For a more complete discussion of trends in federal regulation of the banking and mortgage banking industries see Joint Center for Housing Studies (2002, section 2).
[9] Inside Mortgage Finance (2004).

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these activities. For example, in 2002 there were as many as 44,000 firms (with some 240,000 employees) engaged in mortgage brokerage and correspondent lending activities, up markedly from the 7,000 firms operating in 1987.[10] In 2003 retail lending accounted for 41.3 percent of origination volume, while brokers accounted for 27.9 percent and correspondent lenders for 30.8 percent.[11]

Brokers do not work on behalf of the borrower or the wholesale lender or investor who funds the loan. Instead they receive compensation from the borrower in the form of origination fees and points, and often they receive an origination fee from the mortgage banker at the time that the loan is funded. A mortgage delivery system wherein brokers are compensated for making loans but have no long-term interest in loan performance is subject to what economists call "principal agent risk." A broker (the agent) has little or no incentive to worry about whether the information presented in the mortgage application is accurate as long as the information gathered is sufficient to cause the mortgage banker (the principal) to fund the loan, triggering payment of the broker's fees (which is not to suggest that all mortgage brokers mislead borrowers; many work hard on behalf of borrowers to match them with the best product). Without a long-term interest in the performance of the loan, brokers are immune from the potential adverse consequences of both failing to match the borrower with the best available mortgage and failing to provide accurate data to underwrite the loan. Both affect the odds that the loan will default, which can have devastating consequences for the borrower.

Econometric studies demonstrate that borrowers with similar characteristics can and do receive different pricing depending on the process or channel through which they receive their loan. Building on a study by Michael LaCour-Little and Gregory Chun that confirms that broker-originated loans are likely to prepay faster, a study by William Alexander and others shows that these loans are also more likely to default than loans originated through a retail channel, even after controlling for credit and ability-to-pay factors. The authors argue that because of growing capital market awareness of the "principal agent risk" associated with broker-originated loans, borrowers who receive funding through the broker channel are charged a premium over apparently similar borrowers who receive their loans through retail channels. This is a result of

[10] Wholesale Access Mortgage Research and Consulting, "Mortgage Brokers 2002," August 13, 2003, Columbia, Md.
[11] Authors' calculations from Inside Mortgage Finance (2004).

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the need to compensate lenders for the higher default and prepayment risk associated with these broker-originated loans.[12]

The Rise in Lending to Minorities and Minority Communities

The increase in lending to lower-income borrowers over the 1990s was propelled by strong gains in lending to minorities, although increases in the number of HMDA loan records that do not report the race of the borrower makes precise tracking of trends difficult.[13] Minorities represent less than one-fifth of all homeowners, but they account for 34 percent of the increase in home purchase lending between 1990 and 2001 and for nearly 40 percent of the increase in the number of homeowners.

Data in Figure 1 confirm the transformation of the mortgage lending landscape in minority communities across the country over the period 1993 to 2001. While there remains a clear tendency for lenders (including the top 25 lenders) to serve customers in higher-income and largely white neighborhoods, the growth in the number of lenders serving lower-income and minority neighborhoods is nevertheless encouraging. From 1993 to 2001, the loans made to buyers in predominantly minority, lower-income neighborhoods almost doubled, as did the number of lenders and number of top 25 lenders active in these areas. Moreover, in 2001 the top 25 lenders account for close to half of all loans made in these neighborhoods.

Nevertheless, a gap persists between homeownership rates for minorities and those for whites. In 2003 the African American homeownership rate stood at 48.4 percent, the Hispanic rate at 47.4, and the rate for other minorities at 56.5 percent—all considerably below the 75.1 percent rate for whites. While the rates reflect differences in household income, wealth, age, and family composition among the various racial and ethnic groups, those factors do not entirely account for the gap.[14]

[12] LaCour-Little and Chun (1999); Alexander and others (2002).
[13] From 1993 to 2001, the number of loans without a designation of race increased from 63,382 to 458,818 for purchase loans and from 188,621 to 1.06 million for home refinance loans. In 2001 borrower race was missing for some 12.1 percent for all home purchase loans and 18.6 percent of all home refinance loans.
[14] Yinger (1998).

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Figure 1. Mortgage Lending, by Neighborhood Income and Racial Composition, 1993 and 2001

Neighborhood Type (by income and racial composition)	Home Purchase Loans Per Census Tract (Number)		Lenders Per Census Tract (Number)		Top 25 Lenders Per Census Tract (Number)		Loans by Top 25 Lenders (Percent)	
	1993	2001	1993	2001	1993	2001	1993	2001
Income < 80% AMI								
Predominately White	32.6	52.2	11.9	19.7	2.9	7.4	25.4%	46.8%
Predominately Minority	15.7	30.3	8.4	15.1	2.4	5.9	32.3%	49.7%
Income 80-120% AMI								
Predominately White	60.9	90.1	19.4	28.5	4.9	10.4	26.2%	47.8%
Predominately Minority	42.0	72.5	17.9	26.2	5.0	9.8	33.3%	51.7%
Income >120% AMI								
Predominately White	90.8	117.3	26.0	32.2	7.0	12.1	30.0%	51.3%
Predominately Minority	64.9	106.5	21.8	28.5	5.6	10.3	32.8%	54.9%

Note: Predominately white neighborhoods have less than 10 percent minority population, while predominately minority neighborhoods have more than 50 percent minority population.
Source: Joint Center for Housing Studies enhanced HMDA database.

New technologies, such as automated underwriting and credit scoring systems, have enabled lenders to better evaluate and price risk. Therefore they can offer mortgages with lower down payment requirements to low-income or low-wealth but creditworthy borrowers and make higher-priced loans to borrowers with less-than-perfect credit histories.[15] Although these subprime loans tend to be higher cost and less flexible than prime loans, they often are the only choice for borrowers with less-than-perfect credit histories.

From 1993 to 2001, there was an eightfold increase in the number of home purchase loans reported by lenders specializing in subprime lending.[16] Although variation in the definition of what constitutes a subprime mortgage hinders precise measurement, according to one widely used mortgage industry source the volume of subprime loan originations increased from $35 billion in 1994 to $332 billion in 2003.[17] As a percentage of all mortgage originations, subprime

[15] For a more complete discussion of the factors influencing the growth of mortgage lending in the 1990s, see Joint Center for Housing Studies (2004).
[16] Although HMDA data do not label the loan type directly, HUD supplies a list of each lender's specialization in prime, subprime, or manufactured home lending. For a brief description of the HUD methodology, see Scheessele (2002).
[17] Inside Mortgage Finance (2004).

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loans increased from less than five percent in 1994 to more than 13 percent in 2000, before falling back slightly by 2003 due to a boom in prime mortgage refinancing.

By 2001 subprime lenders accounted for more than six percent of all home purchase lending, up from just one percent in 1993. For lower-income households living in lower-income communities, the subprime share topped 10 percent. For the same population, subprime refinancing loans accounted for a striking 27 percent of home refinance loans, a more than fourfold increase in market share over the period 1993–2001. For low-income African Americans living in lower-income communities, the subprime share of home purchase loans was 18 percent and 42 percent for refinancing loans.

Loans for manufactured homes also grew notably during the 1990s, along with sales of these homes. Almost half of all manufactured homes are sited on rented land and financed with personal, as opposed to real estate, loans. As a result, many manufactured home loans include rates that are from two to five percentage points higher than those on conventional prime real estate loans.[18] Government-backed loans, particularly those insured by the FHA, also have somewhat higher interest rates. Over the 1993–2001 period government-backed loans accounted for between 10 and 14 percent of all home purchase loans.[19] Collectively, these alternative loan products were a major contributor to the overall growth of home lending. Over the 1993–2001 period, government-backed, subprime, and manufactured home lending accounted for nearly one-third of the 1.4 million increase in the number of home purchase loans. Prime loans to lower-income borrowers in lower-income neighborhoods, on the other hand, account for only about 40 percent of all growth in home purchase lending (see Figure 2). This contrasts significantly with prime loans to higher-income borrowers in higher-income neighborhoods, which accounted for almost 80 percent of all home purchase lending growth over the period.

[18] Vermeer and Louie (1996); Collins, Carliner, and Crowe (2002).

[19] Government-backed loans may also be guaranteed by the U.S. Department of Agriculture's Rural Housing Service or the Veteran's Administration.

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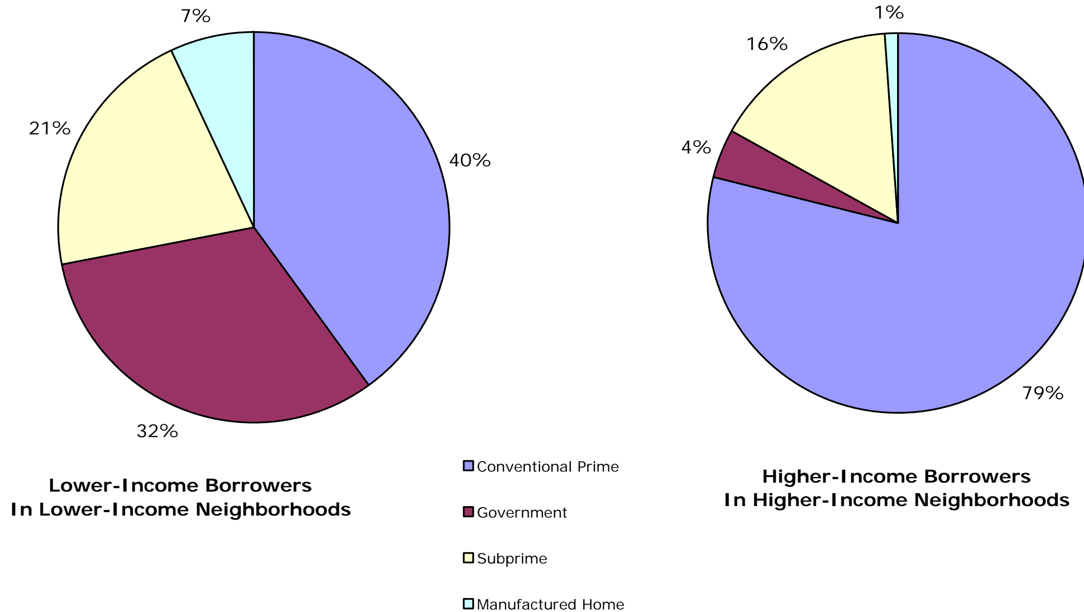
Figure 2. Share of Growth in Home Purchase Lending, by Lender Type, 1993–2001



Note: Lower (higher) income borrowers have income of less than (at least) 80 percent of area median in that year. Lower (higher) income neighborhoods have income of less than (at least) 80 percent of area median as of 1990.
Source: Joint Center for Housing Studies, *The 25th Anniversary of the Community Reinvestment Act: Access To Capital in An Evolving Financial Services System*, March 2002.

There is a pronounced gap between the ability of minorities and that of whites to secure prime mortgages. In 2001 prime conventional lenders accounted for nearly three-quarters of all home purchase lending to whites but less than 50 percent of lending to Hispanics and only 40 percent of lending to African Americans. While there are noticeable income differences, on average, between borrowers of different races and ethnicities, the racial gap in prime lending persists even after controlling for borrower income. Indeed, a white borrower with an income of less than 80 percent of area median has about the same likelihood of obtaining a prime mortgage as an African American borrower with an income in excess of 120 percent of area median (see Figure 3).

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Figure 3. Prime Loans as Share of All Loans, by Neighborhood Characteristics, 2001

	Neighborhood Type (by income and racial composition)					
	Income < 80% AMI		Income 80-120 AMI		Income > 120% AMI	
	White	African American	White	African American	White	African American
Change in tract median housing value						
<10%	64.2	35.8	69.7	42.3	84.2	61.5
10 to 25%	60.1	29.0	68.8	37.3	85.7	59.9
25 to 50%	58.2	28.9	66.3	36.0	85.3	59.8
50 to 75%	60.9	32.1	69.0	38.5	86.9	63.2
>75%	60.7	32.6	69.5	42.4	87.4	65.9
Change in tract median household income						
<10%	58.6	33.1	65.9	41.5	82.7	57.7
10 to 25%	58.5	29.6	65.4	36.9	83.6	57.2
25 to 50%	60.4	30.5	68.3	38.0	85.6	61.5
50 to 75%	61.2	31.4	69.8	39.0	87.3	64.8
>75%	64.3	36.7	72.1	46.5	88.7	69.8
Tract level mortgage denial rates						
<5%	77.6	44.5	81.6	52.1	92.6	79.1
5 to 14%	65.2	33.6	71.8	41.7	87.9	67.9
15 to 25%	54.1	31.1	61.9	37.7	81.3	58.2
26 to 30%	48.6	28.5	56.3	33.8	77.5	51.7
>30%	43.6	28.9	52.8	36.8	75.4	52.7

Source: Joint Center for Housing Studies enhanced HMDA database.

There also appears to be a gap between the shares of prime loans made in neighborhoods of different racial and ethnic compositions, independent of the race of the borrower (see Figure 4). For example, prime lending accounts for 70 percent of all home purchase lending but only 57 percent of home purchase lending in lower-income census tracts. For lower-income census tracts in which African Americans account for more than 50 percent of total households, the prime share for African American borrowers falls to 27.7 percent.

Observed differences in the prime loan share of total lending by race and income cannot be taken as proof of discriminatory practices in mortgage markets. At a minimum, the simple results presented here do not control for many of the objective factors that lenders use to determine whether a particular individual qualifies for a particular type of loan. Such discrepancies, however, support advocates' claims that the rise of alternative mortgage products

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has resulted in a new and subtler form of discrimination based on race and ethnicity that has a disparate, and largely unfavorable, impact on minority borrowers and communities.

Figure 4. Prime Loans as Share of All Loans, by Neighborhood Characteristics and Income and Race of Borrower, 2001

	LOWER-INCOME BORROWER				HIGHER-INCOME BORROWER			
Neighborhood Type (by racial composition and income)	White	African American	Hispanic	Asian/ Other	White	African American	Hispanic	Asian/ Other
Predominantly White								
Lower income	54.9%	29.1%	42.0%	51.2%	85.1%	67.8%	75.0%	80.3%
Higher income	65.4%	36.3%	48.4%	65.3%	89.4%	73.5%	81.6%	89.0%
Predominantly African American								
Lower income	54.5%	31.8%	44.5%	48.3%	85.9%	59.5%	64.3%	72.4%
Higher income	48.0%	27.7%	39.0%	48.4%	81.1%	55.0%	56.8%	68.4%
Predominantly Hispanic								
Lower income	52.7%	32.1%	40.4%	61.0%	79.1%	48.2%	56.4%	74.0%
Higher income	48.3%	32.0%	42.6%	56.3%	73.4%	51.1%	65.5%	69.7%

Source: Joint Center for Housing Studies enhanced HMDA database.
Note: Predominantly white neighborhoods have less than 10 percent minority population; predominantly African American neighborhoods are more than 50 percent African American; predominantly Hispanic neighborhoods are more than 50 percent Hispanic. Lower-income borrower has less than 80 percent of area median income; higher-income borrower has more than 120 percent of area median income.

The Dual Mortgage Market: Risk or Race?

Discrimination in housing and mortgage markets is more subtle today than when entire neighborhoods were redlined and not only mortgage brokers and real estate agents but also government programs such as the FHA refused to serve minorities looking for homes in largely white neighborhoods. Nonetheless, there can be no doubt that it persists.[20] Documenting the extent and impact of ongoing mortgage lending discrimination, however, has proven more difficult than proving its existence. Efforts to isolate the impact of race on the spatial pattern of mortgage lending are hindered by the lack of publicly available data on the credit characteristics of individual mortgage applicants.

Although credit quality data are widely used to underwrite and price loans, the mortgage industry claims that the data are proprietary. Whatever one thinks about the merits of this claim,

[20] See, for example, U.S. Department of Housing and Urban Development (2002a), which documents persistent discrimination in both the rental and sales markets of large metropolitan areas. The study notes, however, that the incidence of discriminatory practices did generally decline over the decade of the 1990s.

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historically the industry's failure to make the data available has enabled the mortgage industry to refute studies that find evidence of discriminatory practices. Arguing that on average African Americans and other minorities have more problematic credit histories, industry apologists frequently dismiss findings of disparate treatment as simply the failure to distinguish "risk from race."[21]

Researchers and advocates have analyzed HMDA data to document both the rise in subprime lending and the corresponding absence of prime lending in lower-income and minority neighborhoods. Though there are undoubtedly different risks associated with lending to individuals living in different neighborhoods, the racial disparity is substantial. For example, subprime refinancing loans are three times more likely to be made in low-income than in upper-income neighborhoods and five times more likely to be made in predominantly African American than in white neighborhoods.[22] In a comprehensive review of neighborhood lending patterns in Chicago in the late 1990s, Daniel Immergluck and Marti Wiles observe that conventional lenders served higher-income white areas while FHA and subprime lending was concentrated in lower-income and minority communities. Characterizing this as a "dual mortgage market," they note that the racial disparities were too great to be explained by differences in the credit quality of the borrowers and argue that the patterns resulted instead from the failure of "mainstream lenders" to seek out creditworthy borrowers in lower-income and minority communities.[23]

The HUD-Treasury 2000 report similarly concludes that a lack of competition from prime lenders enabled subprime lenders to gain a growing share of mortgage lending activity in lower-income and minority communities. In addition, the report notes that upper-income African American borrowers were twice as likely as lower-income white borrowers to hold subprime refinancing loans. When Calvin Bradford examines subprime lending patterns in 331 metropolitan areas (using HMDA data and data from the 2000 census), he finds that African Americans and Hispanics are disproportionately represented in the subprime refinancing market and that the disparity appears to grow as income increases. Moreover, he points out that racial

[21] The phrase "risk or race" was coined by Bradford (2002).
[22] U.S. Department of Housing and Urban Development and U.S. Department of Treasury (2000).
[23] Immergluck and Wiles (1999).

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disparities in lending exist in all regions and in cities of all sizes. Indeed, the study suggests that some of the biggest disparities exist in the nation's smallest metropolitan areas.[24]

None of the studies mentioned above had information on the credit characteristics of borrowers, and they were forced to acknowledge that some unknown part of the disparity in lending patterns undoubtedly resulted from differences in borrower- and property-related risk factors. To address that question, several studies have gone to considerable lengths to more fully evaluate the "risk or race" question. To estimate the probability that an individual borrower selected a conventional prime, subprime, or FHA insured mortgage, Anthony Pennington-Cross and his colleagues analyze a database of home purchase loans that combines HMDA data with data from FHA administrative files, a sample of real estate transactions, and borrower credit quality.[25] While the study confirms that borrower income, debt, and credit history and neighborhood factors significantly influenced the pattern of mortgage lending, race and ethnicity still appear to be key to explaining why African Americans, Native Americans, and Hispanics are less likely than whites to have access to lower-cost, prime home purchase loans.

Similarly, Paul Calem and colleagues examine spatial variation in subprime lending across census tracts in Chicago and Philadelphia. In addition to detailed borrower data, this study incorporates a variety of tract-level measures drawn from the 2000 census, such as income, education, and race-ethnicity. Of note is the use of tract-level risk measures, including the share of properties in foreclosure as well as the share of individuals within the tract with low (or no) credit ratings (the information was obtained from a major national credit bureau).While the authors concede that more could be done to control for individual borrower risk, they conclude that race, both at the neighborhood and borrower levels, remains a strong factor in explaining the distribution of subprime lending. In particular, they found that "even after inclusion of the full set of explanatory variables, in both cities there is a strong geographic concentration of subprime lending in neighborhoods where there is a large population of African American homeowners."[26] They conclude that African American borrowers, regardless of where they live, have a higher likelihood of obtaining a subprime loan than a prime loan and that race of the borrower matters as well as race of the neighborhood.

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[24] Bradford (2002).
[25] Pennington-Cross, Yezer, and Nichols (2000).
[26] Paul Calem, Kevin Gillen, and Susan Wachter, "The Neighborhood Distribution of Subprime Mortgage Lending" (http://realestate.wharton.upenn.edu/papers.php). Calem, Gillen, and Wachter (2002, p. 14).

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Marsha Courchane and colleagues go a step further, combining detailed loan and borrower information, including credit scores, with survey research on borrower characteristics and attitudes to examine whether borrowers are "inappropriately" channeled into the subprime market. They confirm that whether borrowers obtain subprime or prime mortgages depends in large measure on risk-related mortgage underwriting variables. They also find that including measures of the borrowers' market knowledge, search behavior, and choices available contribute significantly to explaining borrowers' outcomes. This implies that credit risk alone may not fully explain why borrowers end up in the subprime market. Rather, the study supports the alternative view that the current mortgage delivery system is inefficient, since households with similar economic, demographic, and credit risk characteristics do not pay the same price for mortgage credit.[27]

In an effort to isolate the effects of race on access to mortgage lending in Los Angeles and Chicago, HUD conducted a pilot study that applied the paired-testing methodology widely used to test for discrimination in the home purchase and rental markets.[28] The pair, consisting of one white and one minority tester with similar income, credit quality, and other attributes commonly used in originating and risk weighting mortgages, visited randomly selected lenders. The study concludes that in both cities African American and Hispanic home-buyers face a significant risk of receiving less favorable treatment than whites when they visit mortgage lending institutions to inquire about financing options. The study notes that unfavorable treatment early in the home purchase process may cause some borrowers to limit their housing search to homes that cost less than they can actually afford, may prevent them from choosing the most favorable loan products, and may cause some to abandon the search entirely.

Research by the Joint Center for Housing Studies also addresses the "risk or race" question.[29] As part of this effort, the center created numerous measures of risk related to lending in various neighborhood settings, including a tract-level measure of household income growth and home price appreciation. In addition, the study included a measure of credit quality, defined as the share of home mortgage applications in each census tract that were denied over the 1995–

[27] Courchane, Surette and Zorn (2004),
[28] U.S. Department of Housing and Urban Development (2002b).
[29] Joint Center for Housing Studies (2004). Because it is difficult to assess spatial and racial patterns in mortgage lending with simple descriptive statistics, the Joint Center estimated a series of multivariate equations to predict the probability that households in 2001 obtained a prime conventional mortgage. Information on borrower characteristics and neighborhood characteristics are included as explanatory variables. In addition, the equations include lender variables, such as lender size and the number of lenders active in the neighborhood.

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99 period. As shown in Figure 4, a racial lending gap persists in a variety of neighborhood settings. Even in areas with income growth and home price appreciation in excess of 75 percent over the decade, the share of higher-income African Americans gaining access to conventional prime loans trailed that of white borrowers by 20 percentage points. And in areas with historically the lowest mortgage denial rates—and arguably containing households with the highest average credit quality—the share of higher-income African Americans obtaining prime mortgages still trails that of whites.

The econometric analysis confirms that many factors contribute to the disproportionately low share of conventional loans going to African American and Hispanic borrowers and to all borrowers living in African American and Hispanic neighborhoods. As in most previous studies on the topic, the analysis—even after controlling for neighborhood and borrower characteristics, including several measures of risk—confirms that race remains a factor.

The Adverse Consequences of the Dual Market Structure

The relatively low share of conventional prime loans made to lower-income and minority borrowers raises questions about whether all borrowers receive credit on the most favorable pricing and terms for which they qualify. Even small increases in the interest rate of a loan can affect a borrower's ability to make monthly payments and cover basic living expenses. In addition, default and foreclosure rates are higher on subprime, government-backed, and manufactured home loans than on prime conventional loans. And the incidence of abusive lending practices appears to be higher in the subprime industry. Clearly, there are many adverse consequences related to the inability to access prime conventional mortgages, both for borrowers and the neighborhoods in which they live.

Higher Costs

The harm done to a particular borrower who qualifies for—yet fails to secure—a prime loan depends on the loan type and credit characteristics of the individual borrower. The HUD-Treasury report estimates that more than half of all subprime loans originating between July and September 1999 had interest rates in excess of 10.5 percent, well above rates for prime loans over the same period, which ranged from seven to eight percent. Clearly, the cost of not

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obtaining a prime loan can be substantial. Indeed, data for 1999 suggest that 17 percent of subprime borrowers paid more than four percentage points above prime rates.[30]

In addition to higher interest rates, subprime loans typically include higher fees to compensate the lender for the higher default and prepayment risk involved. Through hearings in five cities, the HUD-Treasury report found many instances "of fees that far exceeded what would be expected or justified based on economic grounds, and fees that were 'packed' into the loan amount without the borrower's understanding" (p. 2). The report also notes the all-too-common practice of making loans without regard to the borrower's ability to repay. In these instances, high front-end fees—often rolled into the mortgage and paid out of equity claimed by the lender during the foreclosure process—are sufficient to compensate the lender even in situations where the probability is very high that the borrower will default on the loan.

Abusive Practices

While mortgage lending to credit-impaired borrowers has expanded their access to credit, it has also exposed them to numerous abuses, such as predatory lending. While mortgage lending is regulated by state and federal authorities, none of the existing statutes and regulations governing mortgage transactions clearly defines predatory lending. As commonly described in the literature, predatory lending may involve mortgage bankers and brokers, real estate agents, appraisers, home improvement contractors, or others involved directly or indirectly in mortgage lending. Predatory practices include outright deception and fraud, along with efforts to manipulate borrowers through aggressive sales tactics or to exploit their lack of understanding of loan terms. Even though predatory lending can and does occur in the prime market, competition among lenders, greater standardization and simplicity of mortgage products, and better access of borrowers to financial information ordinarily deter it. Unfortunately, competition in the subprime market may be rendered less effective by the disproportionate presence of mortgage brokers. In 2003 some 47.6 percent of all subprime originations flowed through a mortgage broker, compared with only 28.1 percent for prime mortgages.[31]

In an extensive review of the policy issues, Kathleen Engel and Patricia McCoy identify three distinct mortgage markets: the prime market, the "legitimate" subprime market, and the

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[30] Mortgage Information Corporation (1999) (now Loan Performance).
[31] Inside Mortgage Finance (2004).

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predatory market. They argue that predatory lenders tend to target borrowers who are disconnected from credit markets and therefore lack information about the best available products or who are subject to lingering mortgage market discrimination. Engel and McCoy document numerous predatory practices that serve to strip borrowers' home equity, burden borrowers with higher interest rates and fees, or disregard borrowers' ability to repay, thereby setting them up for foreclosure. In the most egregious examples, unscrupulous real estate agents, mortgage brokers, appraisers, and lenders dupe unsuspecting borrowers into purchasing a home at an inflated price or with significant undisclosed conditions requiring repair. These practices harm borrowers and their communities, and they also impose costs on mortgage investors and insurers.[32]

Mortgage loans are priced in the secondary market on the basis of assumptions about the underlying market value of the asset. By reducing true equity in the home (the market value less the amount of the mortgage), an inflated appraisal makes it difficult for a borrower to sell the home and repay the mortgage in a time of distress. That in turn increases the likelihood that the mortgage will go into default and also increases the magnitude of losses incurred by the mortgage insurer and investors during the foreclosure process.

Foreclosures

Foreclosures are on the rise in many of the nation's most vulnerable neighborhoods, particularly those with substantial concentrations of minority households. The increase appears to stem from the growing presence of subprime lending in these communities and in particular from the extension of loans to borrowers with limited capacity to repay or at rates that are well above the market rate. Employing the best available data on loan performance, Amy Cutts and Robert Van Order estimate that as of June 2002 the serious delinquency rate for conventional prime loans was 0.55 percent.[33] In contrast, subprime loans had a serious delinquency rate of 10.44 percent, nearly twenty times higher. Further, the more risky subprime loans examined by Cutts and Van Order (labeled in the study as "C" or "CC" loans) had rates as high as 21 percent. Serious delinquency rates with these loans were more than twice those of FHA-insured

[32] Engel and McCoy (2002).
[33] Cutts and Van Order (2003). The term serious delinquency is applied to loans that are already in foreclosure or with payments that are ninety days or more late.

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mortgages (4.45 percent), the source of many foreclosure problems in prior years. Subprime loans are now the most default-prone mortgage segment of the home loan market.

A report on foreclosure activity by Mark Duda and William Apgar documents the negative impact that rising foreclosures have on low-income and low-wealth minority communities. Citing more than ten foreclosure studies in particular metropolitan areas, the report concludes that, although economic factors obviously play a role, the studies paint a remarkably consistent picture of rising foreclosures even in a period of strong economic growth, led in large measure by the relatively high incidence of foreclosure among subprime loans in lower-income and minority neighborhoods.[34]

The tendency for foreclosures to cluster in low-income, low-wealth, minority neighborhoods is a common finding of the existing literature. A HUD study of Baltimore notes that the number of foreclosures between 1995 and 1999 increased from 1,900 to more than 5,000 and that the increase was particularly pronounced in African American areas. More than one-quarter of the subprime loans in foreclosure in the first three months of 2000 were less than a year old, and more than half were less than two years old. The fact that so many loans were in foreclosure less than two years after origination suggests that many borrowers may not have had the capacity to repay the loan at the time that it was made. A study of foreclosures in the city and county of Los Angeles also finds them highly concentrated in the most distressed areas. For the three-year period from April 2001 to April 2004, some 45 percent of all Los Angeles area foreclosures were in census tracts with a population that was at least 80 percent minority, with a median income falling into the two lowest-income quintiles. Indeed, more than one-quarter of the foreclosures in the region were disproportionately clustered in just 86 census tracts whose minority population share was greater than 80 percent and whose median income was in the lowest-income quintile.[35]

High default and foreclosure rates have led many analysts to question whether the recent increase in low-income homeownership—built in part on the rapid growth of subprime lending—is sustainable or even desirable. Foreclosures can and do have a devastating impact on individual families, which lose their homes and are left with damaged credit records. This not only undermines their ability to secure a home loan in the future but also raises the cost of

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[34] Duda and Apgar (2004b); Gruenstein and Herbert (2000a, 2000b).
[35] U.S. Department of Housing and Urban Development (2000); Duda and Apgar (2004a).

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borrowing for other purposes, such as purchasing a car to get to work. In distressed neighborhoods, foreclosed properties can remain vacant for prolonged periods of time, depressing property values and becoming a magnet for crime. By discouraging families or new businesses from moving into a neighborhood, high foreclosure rates contribute to neighborhood instability and stigmatization.

Why the Dual Mortgage Market Persists

Thousands of mortgage banking operations compete to offer loan products to millions of potential borrowers. Indeed, by several measures the market is more competitive today than two decades ago. Though many smaller thrifts and savings institutions have shut down their mortgage lending operations, they have been replaced by well-capitalized financial services giants with access to low-cost mortgage funds through an increasingly sophisticated secondary mortgage market. Aided by the outreach efforts of thousands of mortgage brokers and correspondent lenders, these giants have reached every corner of the market, including lower-income and minority communities.

Yet despite substantial competition on the supply side of the marketplace, a dual market persists. In part this reflects the failure of the regulatory system to adapt to the sweeping changes that have transformed the mortgage banking industry. But it also reflects the limited ability of consumers to shop for the best products available in the marketplace and thereby to protect themselves from predatory or overpriced mortgages. If borrowers are aware of prevailing mortgage rates and terms, competitive pressure will force individual brokers and correspondents to offer the best products available or lose business. But because mortgages are complex and consumers lack basic information about mortgage pricing and how to interpret what information is available, this competitive market check may be missing.

Moreover, structural factors that reinforce the tendency for the dual mortgage market to misprice mortgage capital arise from the growing importance of mortgage brokers and correspondent lenders in the market. The market incentives of brokers and loan correspondents are different from those of retail lending operations. Subject to whatever regulatory constraints operate effectively in the market, a broker has incentives to charge the highest combination of fees and mortgage interest rates the market will bear.

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What is perhaps most striking is the way homeowners search (or in many instances do not search) for the best loan available. A study by Kellie Kim-Sung and Sharon Hermanson supports the idea that refinancing loans are frequently "sold, not sought," in that they result from extensive and often unsolicited outreach by brokers to homeowners who are not actively in the market for a loan.[36] The authors find that 56 percent of borrowers with broker-originated loans report that the broker initiated contact with them, while only 24 percent of borrowers with lender-originated loans report that the lender initiated contact. A higher share of broker-originated loans go to African American borrowers (64 percent) than to white borrowers (38 percent), and broker-originated loans are also more common among borrowers who are divorced or female. It is not surprising that a larger share of borrowers with broker-originated loans (70 percent, compared with 52 percent for lender-originated loans) "counted on lenders or brokers to find the best mortgage," since the borrowers did not initiate the search for the refinance loan. Unfortunately, their trust is often misplaced. Borrowers with broker-originated loans are more likely to pay points (25 percent, compared with 15 percent for lender-originated loans) and more likely to have a loan with a prepayment penalty (26 percent, compared with 12 percent for lender-originated loans).

These findings imply that some brokers actively work to identify borrowers who lack the experience to correctly evaluate mortgage terms and prices. Survey data suggest that for a variety of reasons—including historical mistrust of banks—lower-income and minority individuals are least likely to comparison shop for mortgage credit. Moreover, lacking basic information about mortgage terms and rates, they are more likely to succumb to "push marketing" tactics. Whatever the case may be, it is disturbing that more than three decades after the enactment of fair lending legislation, fundamental disparities between minorities' and whites' access to mortgage capital remain.

Historically, fair housing and fair lending advocates have focused on pressuring lenders to expand access to mortgage credit, through tools such as Community Reinvestment Act reviews and fair lending audits and litigation. While there is some potential for a market-based correction, as long as brokers continue to have incentives to overcharge borrowers or present misleading information, the task of ensuring fair pricing in the marketplace falls to regulators and to consumers themselves. Unfortunately, the current regulatory setup is not well structured

[36] Kim-Sung and Hermanson (2003).

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to address the problems associated with mispriced mortgage credit. Indeed, while there should be more aggressive enforcement of laws and regulations governing deceptive marketing practices or failure to accurately disclose loan terms to the borrower before closing, there is limited recourse for a borrower who simply overpays. Consumer protection regulations generally focus on ensuring that the loan information provided by the mortgage broker to the borrower is "fair and accurate," that the appraised value of the home is a fair representation of current market value, and that the terms and cost of the loan are provided in advance of closing for the borrower to review.

Although the Federal Trade Commission prohibits false advertising by brokers, following the doctrine of "Let the buyer beware," it does not require a broker to offer the best price available in the market. Yet clearly many borrowers are not up to the challenge of protecting their own interests. As previously discussed, many consumers do not adequately shop for mortgages, instead relying on brokers to provide them with information. Further, many consumers falsely believe that approval of their mortgage application is validation that they can handle the mortgage payment. Nothing could be further from the truth. At the time of closing, each of the parties to the loan transaction (except the borrower) is fully aware of the probability that the loan will move to default and foreclosure. Lacking this knowledge, many borrowers willingly enter into a transaction that may impose serious financial and emotional costs on themselves and their neighbors.

The mortgage market falls short of the competitive ideal, wherein buyers and sellers have ready access to information about product terms and pricing. Simple economics suggests that markets work best when consumers make informed choices. However, in the language of economics, there exists an "asymmetry of information" between buyers and sellers, particularly with respect to the price of mortgage credit. Mortgage industry professionals participate in numerous transactions over the course of weeks and months and have ready access to information on fees, rates, and terms comprised by the overall pricing of mortgage credit in the marketplace. In contrast, consumers only occasionally search for a loan to purchase or refinance a home and hence begin shopping with limited prior experience and equally limited access to the information needed to make an educated choice. Given the complexity and number of mortgage products, even the most sophisticated borrower may find it difficult to evaluate the details of a mortgage. Yet if borrowers have financial or legal advisers to guide them, they may have access

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to better mortgage information; at a minimum, higher-income and higher-wealth borrowers have more extensive financial resources to draw upon and hence have greater capacity to bear any excessive costs and avoid default.

Consumers could spend more time and money to better educate themselves about the price, terms, and features of alternative mortgage products, but from the perspective of the efficient use of societal resources, it makes little sense for individual consumers to devote considerable resources to ferret out information that could be readily provided by mortgage brokers and originators. Rather, it makes more sense to consider mortgage pricing information as a public good and to recognize that there is a role for government to provide the pricing information needed to support the efficient operation of the mortgage market.

While improved disclosure of the terms of a particular loan offered to a consumer would help, as would continued consumer education, these steps are not sufficient to achieve the desired results due to the complexity of the mortgage lending process. Federal regulators operating under applicable fair lending and fair trade authorities must expand their efforts to ensure that consumers obtain the pricing information needed to make informed choices. This could take the form of a national registry of best available mortgage products or other efforts to assist local government and community-based organizations to help families better understand the pricing and payment structure of mortgage products as they relate to borrower income, credit score, and ability to meet down payment and closing cost requirements.

Such readily available information—equivalent to the "blue books" or consumer reports that have successfully guided shoppers for automobiles and other consumer durables—would help consumers to find the best available deal and better protect them from the adverse consequences of aggressive and often deceptive marketing practices. Working to enable borrowers or their trusted advisers to be better shoppers and to resist "too good to be true" marketing promises would go a long way to reduce the incidence of predatory lending and also stem the increase in foreclosures that inevitably follows in the wake of such practices.

Conclusion

Since the 1980s the mortgage market in the United States has evolved into one of the most efficient and effective capital markets in the world. Through the securitization of mortgages and the emergence of new large-scale organizations that take full advantage of economies of

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scale in the origination, underwriting, and servicing of mortgages, the majority of borrowers have access to a plentiful supply of mortgage capital, at rates that rival those of the best and most financially secure corporate borrowers in the market.

Unfortunately, because of the dual mortgage market structure, not all borrowers, particularly not all lower-income and minority borrowers, have access to the best mortgages and best terms for which they qualify. In addition to better enforcement of existing consumer protection regulations, there needs to be a concerted effort to help lower-income and minority borrowers navigate the intricacies of the mortgage transaction. In particular, while general mortgage counseling may help, potential borrowers must have access to the type of loan-specific and trusted advice that currently is available to higher-income borrowers—advice that enables them to evaluate any current loan offer against the best terms available in the market.

Although it is more subtle than the neighborhood redlining of the past, the dual market structure of the current mortgage industry nevertheless still denies lower-income minorities equal access to prime mortgages. By pushing higher-cost and more default-prone subprime mortgages, the dual market steals scare resources from some of the nation's most vulnerable residents and works to further destabilize some of the nation's most distressed neighborhoods. Though tremendous progress has been made, ensuring equal access to mortgage credit must remain a prominent component of today's civil rights agenda.

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