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Center for Financial Security
UNIVERSITY OF WISCONSIN-MADISON

# Evidence and Actions on Mortgage Market Disparities

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In this policy brief, we summarize some of the key findings and recommendations made in our paper entitled "Evidence and Actions on Mortgage Market Disparities: Research, Fair lending Enforcement and Consumer Protection" recently published in *Housing Policy Debate* as Courchane and Ross (In Press) in the forthcoming Special Issue: Fair Housing Act: 50th Anniversary. In that paper, we present an overview of the research on discrimination in mortgage underwriting and pricing, the experiences of minority borrowers both prior to and during the financial crisis, and federal efforts to mitigate foreclosures during the crisis. We next discuss the history of legal cases alleging disparate treatment of minority borrowers, and recent cases alleging disparate impact in the wake of the Supreme Court's "Inclusive Communities" decision. Using these discussions as a background, we discuss and examine mortgage regulations issued by the Consumer Finance Protection Bureau following the financial crisis, describe recent developments in the FinTech industry and explore the implications for fair lending policy and minority borrowers more generally. Finally, we draw conclusions and make recommendations for improving the mortgage market outcomes of minority borrowers and for increasing minority borrowers' access to affordable credit.

We first survey the literature on racial and ethnic differences in mortgage underwriting and pricing. In our assessment, many of the differences identified in this literature (especially in the case of mortgage pricing) arise across lenders and cannot be attributed easily to differential treatment of black or Hispanic borrowers by individual lenders. Further, some evidence exists that suggests that these pricing differences are, in part, associated with lenders who are higher cost lenders because they service a riskier segment of the market. However, while these higher prices may be justified by the overall risk profile of the borrower population, they are often borne by all borrowers regardless of credit worthiness, and in many cases minority borrowers are overrepresented at these higher cost lenders. The evidence of discrimination at the lender level tends to be consistent with discrimination being practiced by individual employees who interact directly with borrowers and only when those individual agents have substantial discretion in pricing.

Next, we turn to the high foreclosure rates experienced by both minority borrowers and borrowers residing in neighborhoods with a large minority representation. There exist contrasting views of the primary cause of these high levels of foreclosure among minority and low-income borrowers and these high rates of foreclosure in disadvantaged neighborhoods. Some contend that the differences are driven heavily by risky mortgage products and higher costs of credit that were offered in subprime mortgage markets, while others contend they were caused primarily by minorities having lower credit scores, higher loan-to-value (LTV) and debt-to-income (DTI) ratios and higher levels of uncertainty in economic downturns. We believe that the evidence is more consistent with the latter explanation. We opine that, on average, minorities entered the crisis with significantly less housing equity, exposed to substantially higher debt burdens and simultaneously experienced much worse employment prospects during the crisis, all contributing to higher rates of default and foreclosure. However, we

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also discuss some of the most convincing papers that document, for example, the effect of lending steering on the exposure of borrowers to risky mortgage products and the effectiveness of anti-predatory lending policies in preventing foreclosures. In terms of mortgage loan servicing during the crisis, the evidence points to substantial racial and ethnic differences in modification assistance, but little or no evidence of discrimination in the provision of loan modifications.

In reviewing the case history of mortgage discrimination complaints, we observe that lenders have regularly settled disparate treatment cases in instances where substantial pricing disparities have arisen from lenders allowing loan officers and mortgage brokers discretion in setting prices. To our knowledge, however, such cases have typically not uncovered pricing differentials in the retail subprime market where loan officers tend to have much less discretion over pricing. Further, attempts to classify as discriminatory certain types of products, such as those typically found in the subprime sector, have not generally succeeded in court. In the area of disparate impact, the Supreme Court's "Inclusive Communities" ruling on disparate impact has opened the doors for new litigation against mortgage lenders. However, there are clear limits as to how far the courts will go in establishing both standing and liability. Just as the courts rejected efforts to broadly label high cost loans with specific risky features as discriminatory, the courts have generally failed to award standing to cities and counties seeking damages for high and concentrated foreclosure rates within their borders. On the other hand, several suits have led to large settlements based on links between the cost of credit and loan officer and broker compensation. In the wake of "Inclusive Communities," settlements arose from differential compensation paid by borrowers obtaining prime rather than subprime products.

Next, we discuss rules governing the mortgage lending process issued recently by the Consumer Finance Protection Bureau (CFPB) in implementing the Dodd-Frank Act. These rules include The Truth in Lending Act (TILA)/Real Estate Settlement Procedures Act (RESPA) Integrated Disclosure Rule (known as TRID), the Ability to Pay (ATR) and Qualified Mortgage Standards (QM) Rules, the Loan Originator Compensation Requirements and timely notification requirements in loss mitigation and error resolution procedures. In our evaluation of these rules, we provided the following assessments and recommendations:

1. We strongly support the requirements in the new Integrated Disclosure Rule. We cannot overstate the importance of clear, consistent information on the cost of credit that is provided in a timely manner.
2. We also note that limits on closing cost and interest rate increases after the final closing disclosure can provide important protections for vulnerable borrowers at closing.
3. We believe that the new limit on Debt To Income (DTI) ratios as part of Qualifying Mortgage (QM) Standards may have unintended and negative consequences. DTI provides an imperfect measure of ability to pay especially in high cost markets where many households are earning wage premiums in large part due to the high cost of housing.
4. We also strongly disagree with the requirement that DTI for adjustable rate mortgages be evaluated at the fully indexed rate. While we agree that ability to pay should consider rate resets, adjustable rate mortgages have traditionally been a reasonable and safe strategy for increasing affordability by lowering interest rates and so increasing minority access to homeownership, and this rule essentially prohibits that strategy.
5. We agree with the QM requirement that borrowers considering an adjustable rate mortgage with a pre-payment penalty be shown alternative products since the pre-payment penalty could obscure the full cost of credit. However, pre-payment penalties on fixed rate mortgages have substantial potential for reducing interest rates, and allowing for longer term pre-payment penalties on fixed rate mortgages could substantially improve housing affordability and access to low risk mortgage credit.
6. The loan originator compensation rule bans dual compensation where mortgage brokers are compensated by both the lender and the borrower, and also bans any link between broker compensation and the borrower's cost of credit. In general, we view this rule positively because the rule reduces incentives for brokers to obscure the full cost of credit and, as mentioned above, clarity in the cost of

credit is critical for properly functioning mortgage markets. However, the wholesale lending portion of the market has been very slow to recover from the financial crisis, and policymakers might consider ways that the compensation rule could be safely relaxed in order to restore this segment of the market to good health.

Finally, we consider recent developments in the area of FinTech. FinTech lenders primarily use technology-focused online lending platforms which, to date, typically access capital from sources other than traditional depository institutions. FinTech lenders leverage new technology to compete directly with higher-cost and less convenient traditional lenders and provide opportunities for capital in search of higher returns in a low interest rate environment. Using alternative data sources and modeling methods, lenders could better serve consumer segments that historically have been underserved, such as consumers who are unbanked, have low or moderate incomes, do not use traditional credit products, are self-employed or have little established credit history. Further, the automation of credit application and decision processes reduces the risk of disparate treatment on a prohibited basis that can arise in manual or judgmentally based decisions, especially given the history of legal settlements that regularly focus on discretion provided to loan officers or mortgage brokers.

However, the risk of a disparate impact on a prohibited basis may increase in the FinTech environment. Ostensibly neutral variables that predict credit behavior may nevertheless present disparate impact risk if they are so highly correlated with a legally protected characteristic that they effectively act as a substitute for that characteristic. Machine learning approaches can be designed to exploit any correlations with risk that can be identified regardless of why those correlations exist. Further, the web economy has flourished in part due its ability to deliver products and marketing that are closely tailored to each individual borrower. FinTech lenders may use similar strategies to segment the mortgage market, perhaps identifying consumers who are internet-savvy and communicate heavily through social media, or consumers who have a large "data footprint." As was seen with the growth of the subprime sector, segmentation of mortgage markets can be especially harmful to minority borrowers, even in an environment where decision making systems are race neutral.

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