JOINT CENTER FOR POLITICAL AND ECONOMIC STUDIES

African Americans and Homeownership: The Subprime Lending Experience, 1995 to 2007

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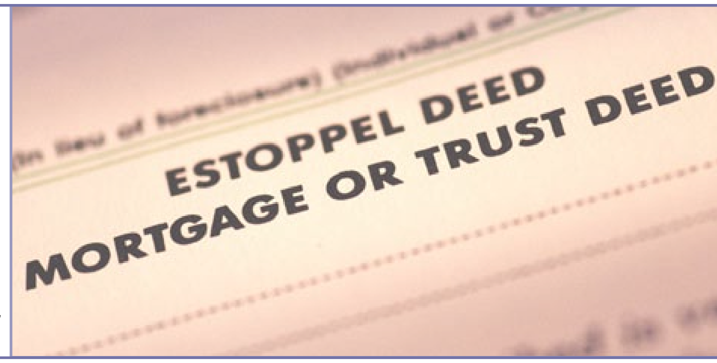


Subprime loans[1] —for home purchase, home improvement, and home refinancing—are loans made to borrowers who do not meet the credit standards or underwriting guidelines to qualify for loans at the prime rate,[2] the lowest available rate for mortgage loans. Borrowers who get subprime loans may have blemished credit records (i.e., lower than A-level credit scores) or lack a traditional credit history. When compared to prime-rate borrowers, subprime borrowers (i.e., with scores of A-, B, C, and D) pay higher interest rates, points, and fees, and they normally must accept prepayment penalties.

Pricing differences between the prime and subprime markets are believed by many not only to account for the additional risk to the lenders who make loans to persons with less than A-level credit, but also to incorporate a premium that reflects unlawful racial discrimination, opportunistic pricing, and predatory lending.[3] The prominence in the subprime market of products such as adjustable rate mortgages or interest-only mortgages also may represent predatory lending, because rate increases structured into these products prevent borrowers from accruing equity, or may cause them to lose any equity they have amassed. This would result if borrowers refinance their loans—and pay penalties for doing so—when the rates on their adjustable rate mortgages are reset and if appreciation in the value of their homes has been limited.

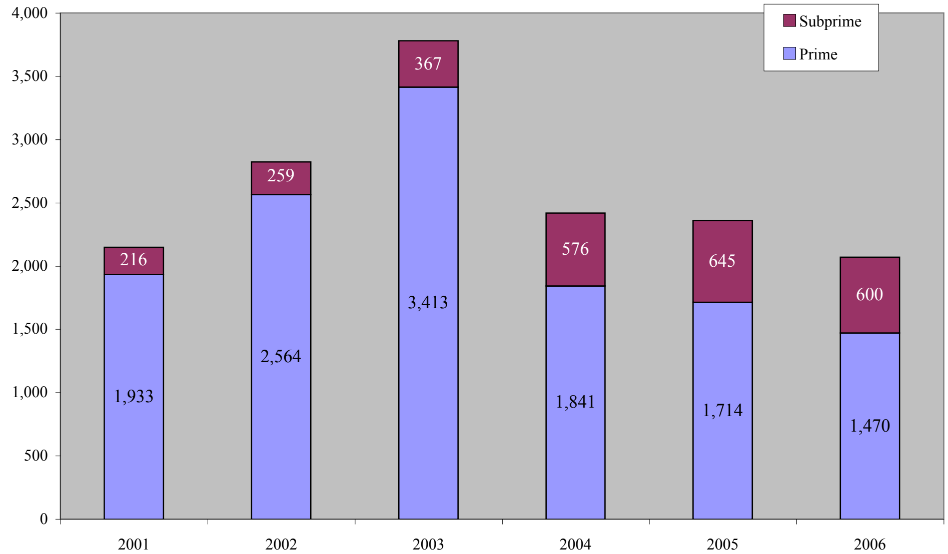
The availability of subprime loans has increased since the mid-1990s and at first seemed to provide a needed vehicle for African Americans and other disproportionately low-income populations to become homeowners and accumulate wealth. Features of these loans and the growth and operation of the financial markets for them, instead have resulted in unprecedented levels of delinquencies and foreclosures. Thus, mortgage loans made in the subprime market have not led to sustained increases in homeownership among African Americans[4] and other recipient households. This year, in fact, foreclosures on homes purchased with subprime loans in the United States have resulted in upheavals in stock markets around the world, when securities backed by these loans lost their value.

This brief provides a primer on subprime lending and discusses how this market has affected homeownership among African Americans. This is the second of two briefs about homeownership and African Americans. The first brief discusses the homeownership experience for African Americans between 1940 and 2006. This brief begins in the mid-1990s with the development of and increase in subprime lending for home purchases, home improvement, and home refinancing. How the primary and secondary markets for subprime loans operate and how African Americans and households of other racial/ethnic subpopulations[5] have been served by them are detailed. This brief concludes with a discussion of principles and recommendations for enhancing the operation of the subprime market to better meet the needs of African Americans and other disproportionately low-income populations.

Development of the Subprime Mortgage Market

Historically and persistently, homeownership rates among selected subpopulations (e.g., African Americans, Hispanics, urban populations, low-income populations) have trailed the U.S. average rate by substantial amounts. This has been true since 1940, when homeownership data were first collected. (See Brief #1, "African Americans and Homeownership: Separate and Unequal, 1940 to 2006" for details.) Sizable homeownership rate gaps have remained in spite of government and private sector efforts in what is known as the primary mortgage market and in what is known as the secondary mortgage market. In the primary mortgage market, banks and other financial institutions make loans to borrowers. In the secondary mortgage market, two government-sponsored enterprises (GSEs)—Fannie Mae and Freddie Mac—along with other purely private sector entities purchase mortgage loans made by financial institutions in the primary market. These secondary market actors subsequently package the loans they have purchased into mortgage-backed securities (MBS) to sell to investors. Although secondary market activity thus replenishes the funds available to primary market institutions for home mortgage lending, the availability of this additional funding has not been adequate to close the homeownership gaps for persons with low incomes or who belong to racial/ethnic

Figure 1
Volume of Prime and Subprime Loan Originations, 2001-2006
Billions of 2006 Dollars



Source: Joint Center for Housing Studies. 2007. *State of the Nation's Housing 2007*. Cambridge, MA: Joint Center for Housing Studies of Harvard University, available at: http://www.jchs.harvard.edu/publications/markets/son2007/son2007.pdf, 38.

subpopulations. For example, in 2006, the homeownership rate of African Americans was 48.4 percent, the rate among Hispanics was 49.7 percent, and the rate among city residents was 54.3 percent, all well below the U.S. average rate of 68.8 percent that year.[6]

Among the factors to which the persistent homeownership differential can be attributed are overt and covert racial/ethnic discrimination in many forms and at many stages of the home-purchase process.[7] This remains true even when the income levels and credit ratings of potential borrowers are taken into account. Redlining[8] and racial discrimination largely excluded racial/ethnic minorities from the first major U.S. homeownership growth spurt which occurred in the post-World War II period (late 1940s through the 1950s). The second major U.S. homeownership growth spurt took place between the mid-1990s and 2005, and was driven by the growth of subprime mortgage lending that extended homeownership—though not necessarily permanently—to many borrowers who were low-income and members of racial/ethnic subpopulations.[9]

Several factors during the mid-1990s contributed to the development of the subprime mortgage market to serve borrowers with less than A-level credit. Responses to pre-existing legislative mandates, an increased demand for home equity mortgage loans, and lender marketing and monitoring all fueled the development of this market.[10]

Legislative Mandates. The Community Reinvestment Act (1977)—known as CRA—was initially enacted as an antidote to redlining. Under the CRA, banks and other financial institutions are required to devote a certain share of their deposits to mortgages for low- and moderate-income individuals in their communities in exchange for the benefits these institutions receive from federal deposit insurance. The desire of financial institutions to use mortgage loans made to low- and moderate-income individuals to satisfy their CRA requirements has contributed to the development of the subprime mortgage market, as has the growth in the number of community-based organizations with the goal of increasing mortgage lending to these same populations.[11]

In addition, the Depository Institutions Deregulatory and Monetary Control Act of 1980 eliminated state usury laws that had set ceilings on the interest rates that could be charged for first-lien home mortgages (i.e., original home-purchase loans). Subsequently many states eliminated interest-rate ceilings on all mortgages, thereby paving the way for subprime lenders to offer a larger volume and greater variety of mortgage products, priced to compensate for the perceived risk of making loans to borrowers with less than A-level credit scores.[12]

Increased Demand for Home Equity Loans. The 1994 prime rate hike is viewed by many as the triggering event for the rapid growth of subprime lending.[13] This interest rate hike not only *increased* the cost of unsecured consumer debt (such as credit card debt), but also *decreased* the volume of home refinance loans available to borrowers at prime rates. The increased cost of consumer credit generated greater demand for lower-priced home equity loans to meet this credit need.

Figure 2
Annual Average Rates of Delinquency (90 Days Past Due), 1998-2007 (Seasonally Adjusted)
Percent

* FHA loans target low-income borrowers but offer lower interest rates than subprime loans.

Source: U.S. Department of Housing and Urban Development, Office of Policy Development and Research. *U.S. Housing Market Conditions 2nd Quarter, 2007*, Table 18: Mortgage Delinquencies and Foreclosures Started: 1986-Present, available at: http://www.huduser.org/periodicals/ushmc/summer07/USHMC_Q207.pdf, 82.

Home equity loans have lower rates than consumer credit because they are secured by the property whose equity they tap. To compensate for the reduced volume of and profit from prime-rate refinance loans, mortgage companies and independent mortgage brokers[14] began to issue greater numbers of subprime refinance loans with their higher-than-prime rates.[15]

Lender Marketing and Monitoring. Actors in both the primary and secondary markets for subprime mortgage loans differ notably from their counterparts in these markets for prime loans. In the primary market, subprime mortgage loans usually are made by brokers and bank subsidiaries—entities whose standards and behavior are less closely regulated or monitored than are the standards of banks and other prime market lenders. Subprime lenders target lower-income and racial/ethnic communities and tend to view their products and transactions as an isolated line of business.[16] In the primary market for prime-rate loans, on the other hand, higher-income homeowners are the target customers, and the lenders are generally the more highly regulated banks and other financial institutions that seek to cross-sell account and investment products. This market segmentation has been supported by advances in information technology that have enabled lenders to easily identify the borrowers of potential interest to them.

In the secondary market, securities backed by subprime mortgages have been originated primarily by Wall Street investment firms. Although Fannie Mae and Freddie Mac have securitized an increasing volume of prime-rate mortgage loans since the 1970s, in recent years the GSEs have purchased a declining share of MBS backed by subprime loans.[17] Thus, securities backed by subprime mortgage loans have been developed largely without the benefit of the standards and supervision that govern the operation of the GSEs in the secondary market for prime mortgage loans.[18] Many securities were packaged and sold whose constituent mortgage loans became troubled as interest-rate adjustments rendered borrowers unable to meet their monthly payments. The delinquencies and foreclosures that often followed resulted in the devaluation of investment securities underlying the global stock market upheaval during mid-2007.[19]

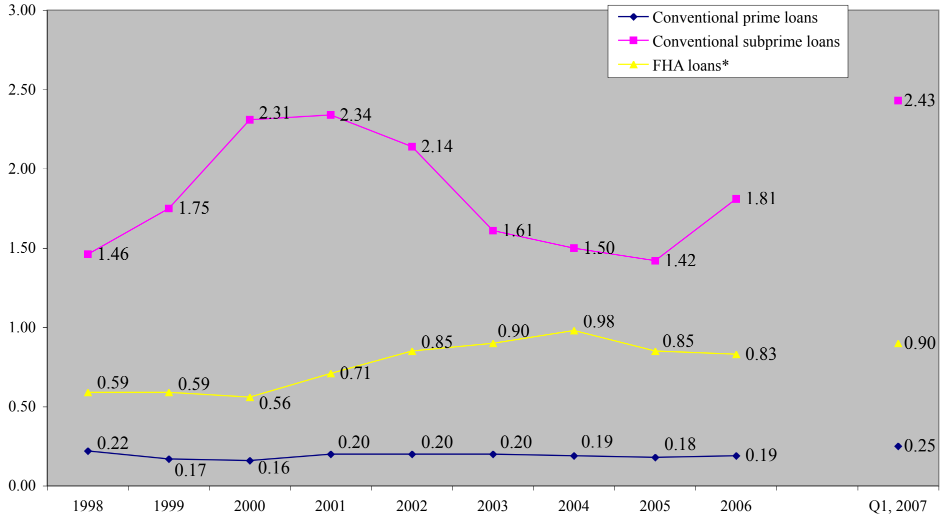
Characteristics of the Subprime Mortgage Market

- In the early 1990s, subprime mortgage lending accounted for less than one percent of all mortgage lending.[20] By 1994, subprime lending was valued at $35 billion and was less than five percent of all mortgage lending (by value) that year.[21]

- Since the mid-1990s, however, growth in subprime lending has accelerated markedly. Subprime lending had grown to $645 billion in value and 20 percent of all mortgage lending in 2005. Although subprime lending also was 20 percent of all mortgage lending in 2006, its total value had dropped slightly (to $600 billion) from the 2005 level.[22] (**Figure 1**)

- By 2005, subprime mortgages had become 7 percent of all outstanding mortgages in the United States.[23] This is in

Figure 3
Annual Average Rates of Foreclosures Started, 1998-2007 (Seasonally Adjusted)
Percent



* FHA loans target low-income borrowers but offer lower interest rates than subprime loans.

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marked contrast to 1994, when their presence was barely noticeable.

- Only 20 percent of subprime loans in 2005 were made by banks or thrift institutions, two entities that are supervised by federal regulators.[24] More than half (51 percent) were made by unsupervised mortgage companies, and 29 percent were made by the more lightly supervised subsidiaries of supervised lenders.[25]

- In 2005, about 60 percent of all subprime mortgages were placed through brokers, more than double the share of prime mortgages so placed (25 percent).[26]

- Initially, relatively few subprime mortgage loans were made for purchasing homes—only 16 percent of all subprime loans in 1999. Most were for refinancing home purchases (82 percent), and the remainder were for home improvement.[27] In 2006, however, almost half of all subprime loans (49 percent) were for home purchases, with slightly fewer for refinancing (45.4 percent) and the rest (5.6 percent) for home improvement.[28]

- Subprime borrowers generally have lower incomes and low credit (or FICO) scores—i.e., below 650.[29] Because they cannot afford to put as much down, subprime borrowers also often have loans with loan-to-value ratios of nearly 100 percent, a generally accepted risk factor for delinquency or default on mortgage payments.[30]

- Seventy (70) percent of subprime mortgage loans had prepayment penalties in 2006.[31] This is in contrast to the 2 percent of prime mortgages with these penalties.[32] A typical penalty for prepaying more than 20 percent of the balance of a subprime loan might equal six months' interest.[33]

- Estimates (made in the late 1990s) of the proportion of subprime borrowers who would qualify for prime mortgages range between 10 percent and 50 percent.[34]

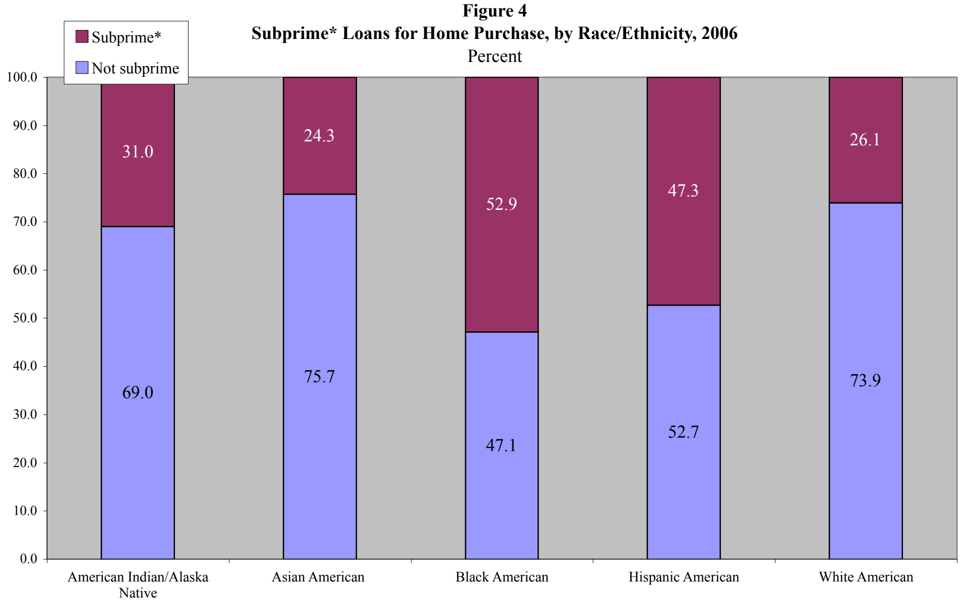
- Foreclosures have never been much of a problem in the prime mortgage market, with the rate generally less than one percent. This contrasts markedly with the subprime market in which delinquencies occur and foreclosures are started at between 8 and 10 times these rates in the prime market.[35] **(Figures 2 and 3)**

- Because prime mortgage market lenders are often absent from low-income neighborhoods and neighborhoods in which racial/ethnic subgroups live and because these groups often live in spatially segregated neighborhoods, when subprime loans are foreclosed, there may be an associated blighting neighborhood effect, as well.[36]

African Americans in the Subprime Mortgage Market

- Borrowers who are African American, Hispanic, and American Indian or Alaska Native are more likely than white borrowers to have subprime loans of each type—home purchase, home refinance, and home improvement.[37]

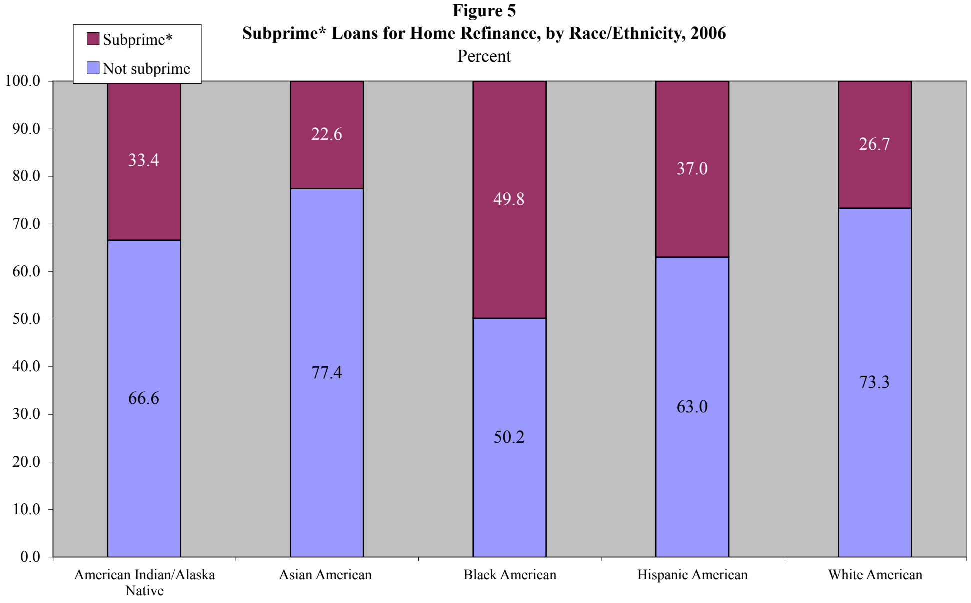
Figure 4
Subprime* Loans for Home Purchase, by Race/Ethnicity, 2006
Percent



*Loans with interest rates more than three percentage points above the rate on Treasury securities of comparable maturity

Source: Original tabulations of the 2006 HMDA Loan Application Register (LAR) data by staff of the Joint Center's DataBank. Data set was accessed at http://www.ffiec.gov/hmdafeedback/hmdaproducts.aspx.

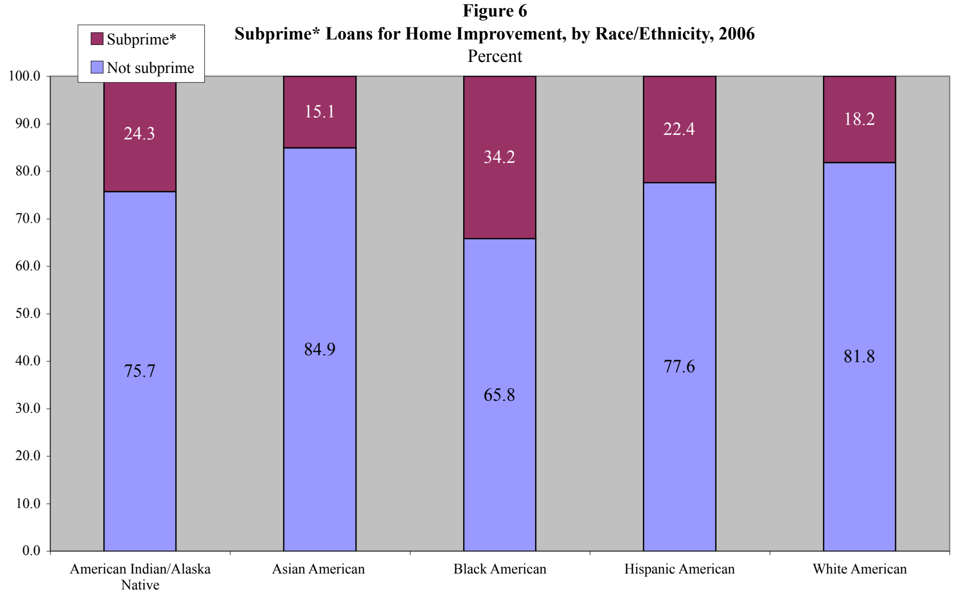
Figure 5
Subprime* Loans for Home Refinance, by Race/Ethnicity, 2006
Percent



*Loans with interest rates more than three percentage points above the rate on Treasury securities of comparable maturity

Source: Original tabulations of the 2006 HMDA Loan Application Register (LAR) data by staff of the Joint Center's DataBank. Data set was accessed at http://www.ffiec.gov/hmdafeedback/hmdaproducts.aspx.

Figure 6
Subprime* Loans for Home Improvement, by Race/Ethnicity, 2006
Percent



*Loans with interest rates more than three percentage points above the rate on Treasury securities of comparable maturity

Source: Original tabulations of the 2006 HMDA Loan Application Register (LAR) data by staff of the Joint Center's DataBank. Data set was accessed at http://www.ffiec.gov/hmdafeedback/hmdaproducts.aspx.

Asian American borrowers are less likely than all groups, including white Americans, to have subprime loans. **(Figures 4, 5, and 6)**

- In 2006, more than one-half (52.9 percent) of African Americans and nearly half of Hispanics (47.3 percent) who acquired *home-purchas*e loans had subprime loans. This is in contrast to the fourth (26.1 percent) of counterpart white borrowers who acquired these loans.[38] Almost a third (31 percent) of American Indian or Alaska Native homebuyers also purchased homes with subprime loans. **(Figure 4)**

- The greater incidence of subprime loans among African American, Hispanic, and American Indian or Alaska Native homeowners is evident with *home-refinance* loans as well. Of all refinance loans taken out by African Americans in 2006, nearly half (49.8 percent) were subprime, in contrast to the 26.7 percent of all refinance loans taken out by whites that were subprime. More than a third of all refinance loans taken out by Hispanics (37 percent) and American Indians or Alaska Natives (33.4 percent) also were subprime. **(Figure 5)**

- The same pattern is evident for *home-improvement* lending. Of all home-improvement loans taken out in 2006 by African Americans, the proportion that was subprime (34 percent) was nearly double the comparable proportion among whites (18.2 percent).[39] **(Figure 6)**

- The greater likelihood that African Americans and Hispanics will receive *higher-priced home-purchase* loans (used as a proxy for subprime lending[40]) than similarly situated white borrowers persists even after controlling for risk factors such as income, which it is legitimate to consider when pricing loans.[41]

- Even after controlling for both lender characteristics and borrower characteristics (such as income), the gap between the incidences of *higher-priced home-purchase* loans among blacks and whites does not disappear. Before controlling for lender or borrower characteristics, the incidence of higher-priced lending to blacks in 2006 was 53.7 percent, a full 36 percentage points greater than the comparable incidence among whites (17.7 percent). This 36-percentage point difference is only partially explained by borrower-related or lender characteristics, however. After incorporating the influence of these characteristics, the incidence of higher-priced lending among blacks falls to 30.3 percent, leaving 12.6 percentage points of the white-black gap unexplained.[42]

- The gap in incidence of *higher-priced home-purchase* loans between whites and several other racial/ethnic subpopulations—American Indians or Alaska Natives, Native Hawaiians or Other Pacific Islanders, and Hispanics—in 2006, also is reduced but not eliminated when lender and borrower-related characteristics are taken into account. The incidence gap between whites and American Indians or Alaska Natives fell from 16.5 percentage points to 6.8 percentage points. Between whites and Native Hawaiians or Other Pacific Islanders, the comparable gap declined from 16.3 percentage points to 5.2 percentage points. Among Hispanics,[43] the corresponding gap declined from 28.9 percentage points to 6.3 percentage points.

- Asians (at 16.8 percent) are less likely than whites (at 17.7 percent) to get *higher-priced home-purchase* loans.[44] When borrower-related characteristics alone are considered, the incidence for Asian borrowers declines to 15.3 percent. When both borrower-related and lender characteristics are incorporated, the incidence of higher-priced home-purchase loans among Asians returns to 16.8 percent.

- The greater likelihood that African Americans will receive *higher-priced home-refinance* loans than similarly situated white borrowers also persists after controlling for risk factors it is legitimate to consider when pricing loans. The 27.1-percentage-point difference between the incidence of higher-priced home-refinance loans among blacks (52.8 percent) and whites (25.7 percent) in 2006, also is not fully explained by either borrower-related or lender characteristics. Although controlling for these characteristics causes the incidence of higher-priced refinance loans among blacks to fall to 33 percent, a difference of more than seven percentage points remains unexplained.[45]

- Incidence gaps for *higher-priced home-refinance* loans also exist between whites and the following racial/ethnic subpopulations—American Indians or Alaska Natives, Hispanics,[46] and Native Hawaiians or Other Pacific Islanders—in 2006, although these gaps are smaller than the white-black gap. After controlling for both borrower-related and lender characteristics, the remaining gaps were 3.8 percentage points for American Indians or Alaska Natives, 4 percentage points for Hispanics, and 4.3 percentage points for Native Hawaiians or Other Pacific Islanders.

- Asians (at 19.6 percent) are less likely than whites (at 25.7 percent) to get *higher-priced home-refinance* loans.[47] Incorporating the influence of borrower-related characteristics reduces this incidence to 23.7 percent, while incorporating both borrower-related and lender characteristics increases the incidence to nearly equal (at 25.3 percent) that among whites.

- States with a high incidence of *subprime home-refinance* loans have higher percentages of African Americans than do other states. In 2005, in five states, at least two of every five (or 40 percent of) home-refinance loans were subprime: Mississippi (51.8 percent), Oklahoma (44.3 percent), Alabama (41.6 percent), Nebraska (41.4 percent), and Louisiana (40 percent). Three of these states also have high percentages of African Americans: Mississippi (36.95 percent), Louisiana (31.42 percent), and Alabama (26.18 percent).[48] In fact, among the 50 states, Mississippi and Louisiana have the top percentages of African Americans, with Alabama ranked sixth.

- Borrowers living in zip codes in which a greater percentage of residents are members of racial/ethnic subpopulations[49] are more likely to have subprime loans with prepayment penalties. In particular, borrowers living in zip codes where more than half of the residents belong to racial/ethnic subgroups have a 35-percent greater odds of getting subprime loans with prepayment penalties than do similarly situated[50] borrowers in zip codes where racial/ethnic subpopulations are less than 10 percent of residents.[51]

- Among African Americans who live in predominantly black neighborhoods, those with higher incomes are more likely than those with lower incomes to have subprime refinance loans. In 2000, blacks in upper-income neighborhoods (neighborhoods in which the median income is greater than 120 percent of the metropolitan area median income) in which they were at least 80 percent of the population were 2.9 times as likely as borrowers in upper-income neighborhoods overall to have subprime refinancing loans. Blacks in low-income neighborhoods (neighborhoods in which the median income does not exceed 80 percent of the metropolitan area median income) in which they were at least 80 percent of the population were 1.5 times as likely as low-income borrowers overall to have subprime refinancing loans.[52]

- Although many researchers[53] attribute the unexplained difference in the incidence of subprime loans between blacks and whites to racial discrimination, other factors such as borrower expectation of discrimination may be influential as well.[54] In other words, if potential black borrowers avoid prime market lenders because they anticipate being discriminated against by them, then this avoidance in anticipation of discrimination may account for some of the unexplained difference in incidence. One reason potential borrowers may anticipate such discrimination and not seek loans from prime-rate lenders is the absence of these lenders from their communities.

Conclusions and Recommendations

Consistent with the racial tenor of that time, African Americans were largely excluded from the post-World War II homeownership growth spurt in the United States. During the second major homeownership growth period (since 1995, as the subprime mortgage market has developed), even though many African Americans received home loans, their status as homeowners remained tenuous. Interest rate resetting has priced many variable-rate and interest-only mortgages out of the reach of their holders. The wave of foreclosures that has followed in the wake of these rate adjustments has abruptly removed numerous African Americans—and other populations with low-incomes and limited credit access—from the ranks of homeowners. Thus, the steady but modest increase in homeownership rates among African Americans between 1995 and 2004 is being reversed. In other words, the subprime market was able to provide short-term access to homeownership for many but provided sustained homeownership for few.

Many factors led to the 2007 stock market upheaval associated with the devaluation of securities backed by subprime mortgages. In thinking about how to simultaneously avoid similar situations in the future and increase homeownership rates among racial/ethnic subpopulations (whose rates continue to lag behind those of whites), the following principles should be adhered to:

- *Lenders should not make loans or offer mortgage products to borrowers (especially those with low-incomes or with limited financial education) without fully and realistically assessing the likelihood that these borrowers can repay these loans.* In addition to greater oversight of subprime lenders, incentives and penalties should be established to enforce this guiding principle.

- *Borrowers should not accept loans they cannot repay.* Many borrowers, however, lack the confidence about financial matters or have not received the financial education necessary to enable them to understand the features of the mortgage loan instruments they may be offered and empower them to reject loans they will be unable to repay.

Specific policy recommendations[55] can help us follow these principles and move from the present to a homeownership environment less subject to the high rates of foreclosure and losses of home equity that currently beset many individuals and neighborhoods.

- *Legislative and regulatory action should be taken at the federal level to standardize the market for subprime loans akin to the way the prime mortgage market is structured:* Adjusting the provisions of the Home Owner Equity Protection Act (HOEPA) of 1994[56] to cover more subprime loans is one way to begin. This monitoring and restructuring should include both the primary market and the secondary market for subprime loans.[57] Another way to achieve this would be to encourage (with "carrot and stick") all mortgage lenders to engage in both prime and subprime lending.

- *Both the federal and state governments should promote stronger regulation of subprime lending:* Although some states have implemented legislation to address issues associated with predatory lending,[58] the norm has been for states to defer to federal regulation with respect to both prime and subprime home lending.[59] The monitoring and licensing of the brokers who have helped the subprime mortgage market develop and thrive, however, is a state function that is performed with varying degrees of effectiveness across the nation. Federal legislation to establish minimum standards for broker behavior and that builds upon existing strong state statutes could improve the structure and functioning of the subprime market for loans.

- *The federal bank supervisory agencies[60] should not give credit under the CRA for predatory lending by financial institutions:* By taking this step, the CRA can be used to encourage responsible lending. This modification in the implementation of the CRA should cover home-refinance loans as well as home-purchase loans. The Community Reinvestment Modernization Act of 2007, introduced in the U.S. House of Representatives (H.R. 1289) in March 2007 would implement changes such as this.

- *Both public and private sector entities should make financial education and counseling, in general, and housing counseling, in particular, more widely available:* The increased knowledge and confidence derived by participants from housing counseling programs can enable borrowers to more accurately assess whether they will be able to successfully make payments on a given mortgage product.[61]

- *Federal legislation should be enacted to mandate that subprime lending institutions make information publicly available about their rates and fees:* Making available to potential borrowers information about the cost (rates, fees, penalties) of subprime loans in a manner comparable to that in which information about prime loans is made available (e.g., in newspapers) could modify the behavior of both consumers and lenders. Consumers would be better able to comparison-shop, and lenders might be motivated to modify the terms of some of their mortgage products.

- *Both public and private sector entities should strengthen existing avenues and develop additional ones outside of the* *subprime mortgage market to make loans available to low-income individuals and persons whose credit is less than A-level:* For example, existing vehicles such as mortgage revenue bonds and housing trust funds should be strengthened and receive more funding from dedicated sources. Private entities such as banks could receive incentives (beyond those of the CRA) to provide affordable mortgage products to low-income or credit impaired individuals.

- *In high-cost housing markets, in particular, the federal, state, and local governments along with private sector partners should make more affordable rental housing available:* In many high-cost homeownership markets, the rental housing stock has decreased in size in recent years as rental units have been either converted to condominiums or razed and replaced by new units for purchase. In environments such as these, low- and moderate-income households seeking a place to live might be inclined to try to buy—in spite of their limited resources—because they see more quality properties for purchase than for rent. Providing more financially realistic rental housing options for low- and moderate-income housing seekers is another way to limit the number of borrowers who fall prey to subprime market abuses.

Although none of these recommendations alone is a panacea for what has gone wrong within the subprime market, it may indeed be time to consider some or all of these recommendations as ways to enable lenders to make loans that borrowers can repay and for borrowers to accept only loans they can repay.

Notes

1. For further information about subprime loans, see the following: Fishbein AJ and Woodall P. 2006. *Subprime Locations: Patterns of Geographic Disparity in Subprime Lending*. Washington, DC: Consumer Federation of America, available at: http://www.consumerfed.org/pdfs/SubprimeLocationsStudy090506.pdf, 1; and Temkin K, Johnson JEH, and Levy D. 2002. *Subprime Markets, the Role of GSEs, and Risk-Based Pricing*. Washington, DC: U.S. Department of Housing and Urban Development, Office of Policy Development and Research, available at: http://www.huduser.org/Publications/pdf/subprime.pdf.

2. The prime rate is a "reference or base rate" that banks use to set the price or interest rate on many of their commercial loans and some of their consumer loan products. The prime rate tracks fairly closely with other short-term interest rates such as the overnight federal funds rate. (See http://www.frbsf.org/education/activities/drecon/2005/0506.html.) The federal funds rate is the "interest rate at which banks and other depository institutions lend money to each other, usually on an overnight basis." (See http://www.bankrate.com/brm/ratewatch/fedFundsRate.asp.)

3. Predatory lending can be defined as knowingly originating loans to borrowers who will be unable to repay them. Engel KC and McCoy PA. "Predatory Lending: What Does Wall Street Have to Do with It?" *Housing Policy Debate* 2004; 25(3): 715-51, available at: http://www.fanniemaefoundation.org/programs/hpd/pdf/hpd_1503_Engel.pdf, 720 and 721. Loans can be considered predatory if they have excessive (and often hidden) fees, or are sold using high-pressure tactics or outright fraud and deception. Thus, loans with predatory terms are much more likely than other loans to end in foreclosure. Not all subprime loans are predatory in nature, but predatory mortgage lending occurs primarily in the subprime market in the form of loans with cost add-ons such as fees and penalties. See also Fishbein and Woodall, 2.

4. The homeownership rate among African Americans increased steadily between 1995 and 2001, from 42.9 percent to 48.4 percent. Although their homeownership rate peaked at 49.7 percent in 2004, it had dropped back to 48.4 percent in 2006. Ownership rates among whites also peaked in 2004 (76.0 percent), but their decline since then has been very slight with the rate remaining 75.8 percent in both 2005 and 2006.

5. Although the sources for this brief use many different labels when presenting data for the major racial/ethnic groups in the United States, in this brief the following terms are used: American Indian or Alaska Native, Asians, black or African American, Hispanic or Latino, Native Hawaiian or Other Pacific Islander, and white or white American.

6. For additional information, see: *Housing Vacancies and Homeownership (CPS/HVS) Annual Statistics 2006*. "Table 12: Homeownership Rates by Area: 1960 to 2006," available at: http://www.census.gov/hhes/www/housing/hvs/annual06/ann06t12.html. Also see Joint Center for Housing Studies of Harvard University, *The State of the Nation's Housing 2007*, available at www.jchs.harvard.edu.

7. Avery RB, Brevoort KP, and Canner GB. "Higher-Priced Home Lending and the 2005 HMDA Data." *Federal Reserve Bulletin 2006* Sept 8: A123-66.; and Wachter SM and Megbolugbe IF. "Racial and Ethnic Disparities in Homeownership," *Housing Policy Debate* 1992; 3(2): 333-370.

8. "Redlining refers to the illegal practice of refusing to make residential loans or imposing more onerous terms on any loans made because of the predominant race, national origin, etc., of the residents of the neighborhood in which the property is located." Definition is from: U.S. Department of Housing and Urban Development, Office of the Assistant Secretary for Housing—Federal Housing Commissioner. Mortgagee Letter 94-22 (4 May 1994): "Fair Lending Practices and Policy Statement on Discrimination," available at: http://www.fha.gov/reference/ml1994/.

9. The homeownership rate for all Americans rose from nearly 65 percent in 1995 to nearly 69 percent in 2006. Over this same period, homeownership among African Americans increased from about 43 percent to more than 48 percent. See Brief #1, "African Americans and Homeownership: Separate and Unequal, 1940 to 2006" for more detailed information.

10. Temkin et al., 9.

11. Gramlich EM. 2007a. *Subprime Mortgages: America's Latest Boom and Bust.* Washington, DC: The Urban Institute Press, 5.

12. Gramlich 2007a, 16.

13. Temkin et al., 9.

14. The ranks of independent mortgage brokers increased notably as the subprime mortgage market developed. Mortgage brokers are intermediaries between lenders and borrowers who—for a fee or commission—are able to place mortgages for their clients with financial institutions. See Gramlich 2007a, 4-5. Independent mortgage brokers grew from an estimated 7,000 firms in 1987 to an estimated 53,000 firms in 2004. See Gramlich 2007a, 19.

15. Temkin et al., 9 and 12.

16. Immergluck D and Wiles M. 1999. *Two Steps Back: The Dual Mortgage Market, Predatory Lending, and the Undoing of Community Development.* Chicago, IL: Woodstock Institute, available at: http://www.woodstockinst.org/component/option,com_docman/Itemid,41/task,cat_view/gid,86/, ii.

17. Although the two GSEs purchased 44 percent of the $401 billion in securities backed by privately issued subprime mortgages in 2004, they purchased 35 percent of the $507 billion in MBS backed by subprime loans in 2005. During the first half of 2006, the two agencies bought only about 25 percent of the subprime MBS issued. (Statement by Judith A. Kennedy before the House Committee on Financial Services, U.S. House of Representatives. (15 March 2007). "Legislative Proposals on GSE Reform," available at: http://www.house.gov/apps/list/hearing/financialsvcs_dem/htkennedy031507.pdf, 6).

18 Gramlich 2007a, 5.

19. Gumbel P. "Credit contagion: Is the worst over?" *Fortune* (14 August 2007), available at http://money.cnn.com/2007/08/14/news/international/pluggedin_gumbel_contagion.fortune/index.htm?postversion=20070814 10

20. Pennington-Cross A, Yezer A, and Nichols J. 2000. *Credit Risk and Mortgage Lending: Who Uses Subprime and Why?* Arlington, VA: Research Institute for Housing America, 1.

21. See the following sources: Gramlich 2007a, 6; Joint Center for Housing Studies. 2007. *The State of the Nation's Housing 2007.* Cambridge, MA: Joint Center for Housing Studies of Harvard University, available at: http://www.jchs.harvard.edu/publications/markets/son2007/son2007.pdf, 38; and Avery RB, Brevoort KP, and Canner GB. 2007. "The 2006 HMDA Data," available at http://www.federalreserve.gov/pubs/bulletin/2007/pdf/hmda06draft.pdf, 8.

22. Joint Center for Housing Studies, 38.

23. Gramlich 2007a, 6.

24. Gramlich 2007a, 20.

25. Gramlich 2007a, 21.

26. Gramlich 2007a, 19.

27. Temkin et al., 5.

28. Original tabulations of the 2006 HMDA Loan Application Register (LAR) data by staff of the Joint Center's DataBank. Data set was accessed at http://www.ffiec.gov/hmdafeedback/hmdaproducts.aspx.

29. Engel and McCoy, 736.

30. Borrowers whose loans have higher loan-to-value ratios are generally more at risk of becoming delinquent in their mortgage payments than borrowers with lower loan-to-value ratios. They have little or no financial investment or equity in the property in their early years of homebuying and are thus more likely to cease making payments if they ever face economic hardship. See Shear WB and Scirè M. 2005. *Mortgage Financing: Actions Needed to Help FHA Manage Risks from New Mortgage Loan Products.* GAO Report 05-194, available at: http://www.gao.gov/new.items/d05194.pdf. High loan-to-value ratios among subprime borrowers is a recent phenomenon, however. In the mid- to late-1990s, the early years of subprime market growth and development, subprime borrowers made higher downpayments and therefore had lower loan-to-value ratios than borrowers with FHA loans (government-insured low-downpayment loans

for low-income borrowers). For further information, see Pennington-Cross et al.; and Goldstein D. 1999. *Understanding Predatory Lending: Moving Towards a Common Definition and Workable Solutions*. Cambridge, MA and Washington, DC: Joint Center for Housing Studies of Harvard University and Neighborhood Reinvestment Corporation, available at: http://www.jchs.harvard.edu/publications/finance/goldstein_w99-11.pdf.

31. Berson DW. "Challenges and Emerging Risks in the Home Mortgage Business." Presentation at the National Housing Forum, Office of Thrift Supervision (11 December 2006), available at: http://www.ots.treas.gov/docs/4/48978.pdf, 10.

32. Gramlich 2007a, 18.

33. Bocian DG and Zhai R. 2005. *Borrowers in Higher Minority Areas More Likely to Receive Prepayment Penalties on Subprime Loans.* Durham, NC: Center for Responsible Lending, available at: http://www.responsiblelending.org/pdfs/rr004-PPP_Minority_Neighborhoods-0105.pdf.

34. Scheessele RM. 2002. *Black and White Disparities in Subprime Mortgage Refinance Lending.* Working Paper No. HF-014. Washington, DC: U.S. Department of Housing and Urban Development, Office of Policy Development and Research, available at: http://www.huduser.org/Publications/pdf/workpapr14.pdf, 4.

35. U.S. Department of Housing and Urban Development, Office of Policy Development and Research. 2007. *U.S. Housing Market Conditions: 2nd Quarter, 2007*, available at: http://www.huduser.org/periodicals/ushmc/summer07/USHMC_Q207.pdf, 82.

36. Apgar W, Bendimerad A, Essene RS. 2007. *Mortgage Market Channels and Fair Lending: An Analysis of HMDA Data*. Cambridge, MA: Joint Center for Housing Studies of Harvard University, available at: http://www.jchs.harvard.edu/publications/finance/mm07-2_mortgage_market_channels.pdf.; and Immergluck and Wiles.

37. Original tabulations of the 2006 HMDA Loan Application Register (LAR) data by staff of the Joint Center's DataBank. Data set was accessed at http://www.ffiec.gov/hmdafeedback/hmdaproducts.aspx.

38. Ibid.

39. Ibid.

40. In 2002, the Federal Reserve Board amended Regulation C to require the disclosure of pricing information for higher-priced loans. For loans with spreads above designated thresholds, the spread between the APR (annual percentage rate) and the rate of Treasury securities of comparable maturity must be reported. The reporting thresholds differ by lien status: three percentage points for a first lien and five percentage points for junior or subordinate liens. Although higher-priced loans can be viewed as proxies for subprime loans, the correspondence between subprime and higher-priced loans is imprecise, due to the way the thresholds are set. For more information, see Avery et al. 2006.

41. Bocian DB, Ernst KS, and Li W. 2006. *Unfair Lending: The Effect of Race and Ethnicity on the Price of Subprime Mortgages*. Durham, NC: The Center for Responsible Lending, available at: http://www.responsiblelending.org/pdfs/rr011-Unfair_Lending-0506.pdf.

42. Avery et al. 2007, 39.

43. Defined in the source document (Avery et al. 2007, 39) as Hispanic whites

44. Avery et al. 2007, 39.

45. Ibid.

46. Defined in the source document (Avery et al. 2007, 39) as Hispanic whites

47. Avery et al. 2007, 39.

48. Fishbein and Woodall, 3; and U.S. Census Bureau, Population Division. "Table 4: Estimates of the Population by Race and Latino Origin for the United States and States: July 1, 2006." (SC-EST2006-04) Release date: May 17, 2007, available at: http://www.census.gov/popest/states/asrh/tables/SC-EST2006-04.xls.

49. Racial/ethnic subpopulations include: American Indians or Alaska Natives, Asians, Black or African Americans, Hispanics or Latinos, and Native Hawaiians or Other Pacific Islanders.

50. Similarly situated groups of borrowers were created by controlling for key borrower, property, and loan characteristics (such as borrower credit scores).

51. Bocian and Zhai.

52. Scheessele, 2-3.

53. Avery et al. 2006; and Wachter & Megbolugbe.

54. Pennington-Cross et al.

55. For additional recommendations, see the following: Immergluck and Wiles; Gramlich 2007a; and Apgar et al.

56. The HOEPA establishes practice standards for making high-cost subprime loans, such as requiring lenders to verify a borrower's ability to repay the loan and banning both balloon payments in the first five years and prepayment penalties that last longer than five years. Despite the threshold for high-cost loans established by the Federal Reserve for HOEPA-covered loans as loans with an APR of eight percentage points

above the Treasury rate on comparable securities, subprime lenders have modified their rates and terms enough that only about one percent of all subprime loans were covered under HOEPA. See Gramlich 2007a, 28.

57. One step that could be taken to strengthen the operation of the secondary market for subprime loans would be to require that buyers of loans take responsibility for actions of the lenders in making the loan—i.e., assignee liability. This provision (already in effect on HOEPA loans) would make secondary market mortgage purchasers more concerned about and responsive not only to the behavior of primary market subprime lenders but also to the quality of the loans backing the securities sold in the secondary market for subprime loans.

58. For example, in 1999, North Carolina adopted a law that became effective in July 2000 and imposed tighter restrictions on high-cost loans than existed under federal law at that time. See Fishbein A and Bunce H. 2001. "Subprime Market Growth and Predatory Lending," in: Wachter SM and Penne RL, eds. 2001. *Housing Policy in the New Millennium; Proceedings*. Washington, DC: U.S. Department of Housing and Urban Development, available at: http://www.huduser.org/publications/polleg/hpcproceedings.html, 273-288.

59. The acceptance by more than half the states of the *Interagency Guidance on Nontraditional Mortgage Product Risks* may be a sign of increasing state engagement in an effort to protect housing consumers and to supervise mortgage originators. For more information, see Apgar et al.

60. The four federal bank supervisory agencies are: the Office of the Comptroller of the Currency (OCC), Board of Governors of the Federal Reserve System (FRB), Office of Thrift Supervision (OTS), and Federal Deposit Insurance Corporation (FDIC). Each has responsibility for administering CRA exams to a different set of financial institutions. The OCC oversees all national banks, while the FRB supervises all insured state-chartered banks that have become Federal Reserve members. The OTS supervises federally chartered savings banks and savings and loan associations, and the FDIC administers CRA exams for all state-chartered, insured non-member banks.

61. Although Gramlich (2007b) notes that universal housing counseling may be a hard sell to prospective buyers, he notes that counseling offered by groups such as NeighborWorks® America has been demonstrated to be effective with new homebuyers. See Gramlich EM. "America's Second Housing Boom." Opportunity and Ownership Project Brief #7. Washington, DC: Urban Institute Press, available at: http://www.urban.org/UploadedPDF/311418_Second_Housing_Boom.pdf.

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