

## **Promises and Pitfalls: As Consumer Options Multiply, Who Is Being Served and at What Cost?**

Session: Alternative Financial Services

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This fourth biennial research conference presents an excellent opportunity for practitioners, regulators, and academics to analyze a series of timely and important questions regarding consumers in the financial marketplace. I congratulate the Federal Reserve on hosting such a critical event and am confident many innovations will be developed based on the forward-looking research and discussions that develop from the proceedings.

This panel represents the themes of this conference well: it describes the “promises and pitfalls” of the expansion of mortgage-lending products and practices. Promises include new options for mortgage borrowers due to the growth of risk-based pricing and innovative, although still maturing, types of subprime or “nonprime” loans. Promises also include the extension of market channels, such as mortgage brokers, which consumers may find more convenient for their specific needs. Finally, as mortgage access has expanded, problems of “redlining” low-income and minority loan applicants out of the mortgage market are no longer an issue. Today, virtually any borrower can be approved for some form of a mortgage if he or she is willing to pay the interest rate and fees.

While advances in lending markets offer many promises, they are not without pitfalls. Concerns about disparities in access to mortgages have been replaced by issues related to disparate pricing of mortgages. Furthermore, the complexity of today’s mortgage market means consumers must wade through dozens of different types of mortgages with an array of interest rates, terms, fees, penalties, and application requirements. Borrowers who are not armed with detailed information are unlikely to find the most appropriate loan for their circumstances. Finally, more mortgages are being made to a wider spectrum of borrowers than ever. A decade ago high-risk borrowers would not be approved for a mortgage. Today, loans are regularly approved for high-risk borrowers. As more high-risk loans are made, more foreclosures will occur. More foreclosures may not only be harmful for borrowers but also create negative externalities for communities. Thus, the pitfalls require continued scrutiny.

The first paper, “Mortgage Brokers and the Subprime Market,” by Amany El Anshasy, Yoshiaki Shimazaki, and Gregory Elliehausen, addresses the growth of mortgage brokers, examining whether this fast-growing market channel helps or hurts borrowers.

Consumers face challenging decisions in many markets, including decisions about automobiles, durable household purchases, and insurance products. There will always be variation in pricing, in part due to differences across types of consumers in regard to how they value goods and services. But credit markets may be different. Mortgages are typically the largest liability house-

holds will have. The large scale of a mortgage relative to other purchases or borrowing for a household amplifies its costs and risks.

There are many reasons borrowers will take out mortgages; they may want to buy a home or simply need to convert home equity into cash. Consumer decision-making is very difficult to model or predict. When shopping for a mortgage, some consumers may make their decision based only on the interest rate (APR). Others may focus on how much they have to pay at closing or just the monthly payment. A fast approval, guaranteed approval, or low levels of required documentation may also be important factors to consumers. Price, as measured by total fees or interest rate, is not always the deciding factor. Some borrowers may prefer to work with a lender or broker with whom they are comfortable, regardless of the cost. Convenience, trust, and familiarity all might be more important than pricing.

Anshasy, Shimazaki, and Elliehausen capitalize on a rich, albeit proprietary, data set. There are few sources of information on loan pricing available, especially in the subprime market. The authors have American Financial Services Association (AFSA) data from 1995 to 2002 for 10 large lenders that together represent 40 percent of the subprime market.

The authors initially found lower costs for first mortgages made through brokers than nonbroker loans, with an even larger effect for second-lien mortgages. The positive pricing advantage for consumers using brokers was even stronger for borrowers from minority and low-income areas. A recently revised version of the paper that was corrected for econometric issues still found no evidence that borrowers who use brokers pay a higher APR than borrowers who obtain a loan from retail channels, such as the branch office of a lender. However, it is unclear if brokered loans have a definitive pricing advantage.

It seems likely that for nonstandard borrowers — which most subprime, second-lien borrowers are — the market is thin and prices variable. A loan applicant may struggle to find local providers of these loans at retail outlets. At best they may find one lender who will approve a loan for their terms, and the borrower may then decide that the costs of searching are too high and feel content with the loan they can get. A broker, on the other hand, may have a number of products that match this borrower's more challenging needs. The broker can offer the borrower several options, which may lead the borrower to select a loan with a lower APR than they could have found on their own. It is unlikely the broker's pricing advantage will persist in the more standardized prime market, however. The subprime market, being composed of many low-volume loan products, may provide inherent advantages to consumers using a mortgage broker.

However, these data are only for loans originated. The rates and terms of other loans for which borrowers qualified are not recorded. This analysis does not suggest borrowers received the lowest price loan deal available. It simply shows that, on average, borrowers using brokers did not pay a premium compared to borrowers not using a broker.

The AFSA data set represents some of the most proactive financial institutions. These firms are most likely to have established sophisticated loan underwriting systems and are likely to be among the most careful when purchasing loans from third-party mortgage brokers. As a result, these data contain not the entire universe of brokered subprime mortgages but the subset of bro-

kered loans that meet the likely higher standards of the institutions sharing data with the AFSA. This may introduce selection bias into the data, which favors finding a pricing advantage for brokered loans.

The model the authors employ could be enhanced by introducing instruments for the choice of using a broker. Broker-oriented consumers may be more price sensitive, and nonbroker consumers may be motivated by convenience. Both of these traits are unobserved characteristics. However, the predicted propensity of borrowers to use a broker could be introduced as an additional term to the authors' specification to test for such an effect.

The use of mortgage brokers by financial institutions tends to be cyclical, with brokers serving as extra loan origination capacity in peak periods or in strong local markets. The use of brokers also varies depending on whether a borrower is seeking a home purchase or refinance mortgage. Given the size of the data set, the authors could include variables to explore loan type effects individually and interacted across local market types and business cycles.

Mortgage brokers have the promise of being an efficient delivery mechanism between consumers and capital market institutions. Yet many consumer advocates in recent years point to the role of brokers in causing predatory lending or fraudulent loan transactions. This paper provides evidence that the blame placed on mortgage brokers may be at least partially misplaced. However, more research is needed. A more comprehensive data set is needed, representing a larger share of the market. Research is also needed on consumer behavior and motivations to more fully understand why some consumers select mortgages made through brokers as opposed to retail market channels. This suggests a need to survey consumers throughout the loan search and origination process, including qualitative research methods to better understand how consumers make the choices they do in the mortgage market.

“Subprime Lending: Neighborhood Patterns Over Time,” by Jonathan Hershaff, Karl Russo, and Susan M. Wachter, provides insights into subprime lending in seven cities in 1997 and again in 2002. The authors examine the change in the number of loans made in low-income zip codes, as well as those areas with high default rates and with low credit scores. They analyze changes in subprime mortgage originations in each city and also run city-level regressions to explain the incidence of subprime lending by zip code.

The subprime mortgage-lending market is a relatively new phenomenon. The market began in the home-equity lending market in the early 1990s, growing dramatically in the latter half of the decade. The authors' analysis suggests that the subprime market has matured and evolved. If subprime lenders appropriately employ risk-based pricing techniques, the riskiest borrowers should be most likely to take on the highest-priced subprime loans. The author's data do not allow an examination of pricing, but rather the use of lenders who specialize in subprime loans. Taken at a zip code level, the share of an area's loans made by subprime lenders becomes an indicator of the extent to which borrowers, on average, take on higher-cost subprime debt. Changes in the subprime lending industry from 1997 to 2002 include the widespread entry into the market by major financial institutions, more concentration among subprime specialist firms, and a greater diversity of loan products offered by nearly all types of lenders. In 1997 factors that may have been expected to predict the use of subprime loans are not consistently significant. By

2002, the authors' measures of the risk of the zip code have much stronger associations with the use of subprime loans. Over time, the subprime market appears to behave more rationally, with riskier areas more likely on average to use mortgages originated by subprime lending specialists.

Like those in the first paper, these findings echo the theme of the promise of the subprime market. But the pitfalls also persist. Using a regression analysis in each of the seven cities included in the study, the authors find that zip codes with larger shares of racial-minority households are among the most likely to have higher rates of mortgages made by subprime lenders. This result increases in its significance in 2002 compared to 1997. The African-American share of households is particularly associated with subprime lending, holding other variables constant. Even with the authors' enhanced data set, this finding is not conclusive evidence of discriminatory pricing by race or ethnicity. But it does raise serious concerns about the targeting of minorities by subprime lenders.

The authors also find that subprime lending has grown more slowly in low-income zip codes than higher-income zip codes. The fact that subprime lenders are active in high-income areas contradicts the popular notion that subprime loans are predominately a low-income phenomenon. Yet it stands to reason that borrowers with poor credit (regardless of income) need to borrow at relatively high levels to maintain their standard of living in order to reside in higher-income areas.

The fact that a low level of educational attainment, all else equal, is correlated with subprime lending is more troubling. In fact, subprime lending in low-education-level areas was even more likely in 2002 than 1997. This suggests the need for expanded counseling and education to help consumers make choices in the subprime market.

On average, mortgage lending by subprime specialists grew by nearly 200 percent between 1997 and 2002 for these cities. The authors' mapping of subprime lending shows much of this growth is concentrated in a handful of areas. This concentration will likely result in elevated foreclosure rates in these areas as more relatively risky loans are originated. The degree to which subprime lending correlates with neighborhood economic and demographic characteristics is of interest because high default rates are likely to have adverse consequences for communities. An increasing number of foreclosures in areas fundamentally more vulnerable to economic decline could exacerbate problems in these already distressed communities. This represents another potential pitfall of changes in the mortgage market.

While the paper offers an excellent analysis, the authors will greatly benefit from access to 2004 HMDA (Home Mortgage Disclosure Act) data. The 2004 data will include for the first time variables related to loan pricing. Combined with the detailed zip code-level data on risk factors, the authors could employ a more precise definition of high-cost lending and more precisely model which borrowers and neighborhoods use subprime loans. The issues addressed by this paper remain important, especially as subprime lending has continued to expand market share and become even more widespread in the last several years.

“The Impact of Single Family Mortgage Foreclosures on Neighborhood Crime,” by Dan Immergluck and Geoff Smith, examines the relationships between foreclosures and crime rates in Chi-

cago in 2002. The authors found the effect of foreclosures on property crime was not significant, but the effect of foreclosures on violent crime was significant and positive. The findings suggest that one additional foreclosure in a neighborhood of 100 mortgaged properties adds 2.33 percent to the violent crime rate. In real terms, if the average tract in Chicago has 900 homeowners with mortgages, 38 violent crimes, and 22 foreclosures, then one more foreclosure would result in four more violent crimes in that year.

Crime and mortgage default are likely to be positively correlated. But this correlation might run in either direction: homeowners in areas with high crime rates may be more likely to default in reaction to the crime rate, or foreclosed properties that become vacant may become magnets for crime. Unbundling the causes and effects of each is challenging. Clearly vacant properties serve as a social signal as well as a physical space for crime. Some foreclosures will result in vacant properties, but not all. Properties may become vacant for reasons other than foreclosure. If it is in fact foreclosures that result in vacant houses that triggers crime, this suggests that lenders and policymakers need to refine the foreclosure process to ensure that properties in the disposition process remain occupied and well maintained.

Another important factor related to foreclosure's effect on crime is the role of investor-owned properties. Owner-occupied properties in foreclosure may be more carefully managed by the defaulting borrower and more likely to move through foreclosure without a vacancy. Investor-owned properties are often much harder to sell and less well maintained during the process.

Ideally this analysis would be conducted over time, since the effects of crime and foreclosure are likely to involve some time lag. It is difficult to distill cause and effect using the cross-sectional data available to the authors. Even given the authors' use of econometric tests, foreclosure, crime, and the various independent variables in the model are plagued by endogeneity. One approach would be to identify neighborhoods with sudden increases in foreclosures and then track subsequent changes in crime rates, even by months within the single year for which data are available.

Foreclosures clearly create negative externalities for neighborhoods. Even if homes do not become vacant, nearby homeowners may become less inclined to invest in repairs or improvements to their properties when rising numbers of homes on the block are in foreclosure. To the extent that foreclosures are concentrated, risks of contagion effects increase as borrowers lose faith in their properties. While the increase in borrowing options for risky borrowers presents great promise, it can also lead to enormous pitfalls if increased lending options come at the expense of neighborhood well being.

Chicago has been at the forefront of developing solutions to foreclosure through its Home Ownership Preservation Initiative (HOPI), a partnership of the city, Neighborhood Housing Services of Chicago, the Federal Reserve Bank of Chicago, and major subprime lending institutions. HOPI has developed methods to help borrowers in default avoid foreclosure, as well as prevent homes in foreclosure from becoming vacant or abandoned.

A decade ago, lending institutions began to make dramatic changes in marketing, outreach, and underwriting in order to expand into minority and underserved markets. These efforts have

largely been successful, with a tremendous growth in mortgage lending to low-income and minority borrowers who were previously excluded from the market. Chicago's HOPI program demonstrates that the mortgage servicing and REO (real estate owned — properties lenders take through foreclosure) sides of the lending business require a similar transformation to manage the growth of loans at greater risk for default. This paper indicates that the social costs of not addressing this problem may be significant.

Overall, these papers offer an excellent overview of the major issues facing borrowers and communities in the subprime mortgage market. While there is evidence that this market is evolving in positive directions, it clearly requires further analysis to better understand the consequences of subprime lending for consumers and public policy.