

Exploring the Determinants of High-Cost Mortgages to Homeowners in Low- and Moderate-Income Neighborhoods¹

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¹The views in this presentation do not reflect those of the Federal Reserve Board or its staff.

Description of Paper

Explore two mechanisms for differential mortgage pricing

- 1 Racial disparities
- 2 Mortgage brokers

Exploit household-level survey data of low- and moderate-income (LMI) households living in Detroit in 2005 and 2006 ($N = 938$)

Bottom line:

- Results are most consistent with lender-driven origins for differences in loan terms (with caveats)
 - Black homeowners pay 110 bp more than whites, 2x's likely to have PP penalty, balloon payment
 - Results hold up even after controlling for broad range of demand-side characteristics

Detroit Area Household Financial Services (DAHFS) study

Cross-sectional *SURVEY* data on *STOCK* of LMI homeowners

- 45% are homeowners, \$45K=median level of equity
- APR, balloon payments, up-front points/fees, “teaser” rates, prepayment penalties
- Use of mortgage broker
- Creditworthiness, default risk, attitudes about borrowing

Differs from *ADMINISTRATIVE* data on *FLOW* of mortgage applications (e.g. HMDA), originations, audit study

- Riskier borrowers are less likely to be observed in cross-section
- → Disparities estimated in cross-section understate differences in pricing at origination (under certain assumptions)

Characteristics of LMI Homeowners & Mortgages

Creditworthiness

- 15% have ever filed for bankruptcy, 6% have been denied a loan in 3 years prior to survey, 3% are behind on car loans, 1% have had bank account closed, < 1% pay less than minimum on credit card

(Ex post) Default risk

- 30% have delayed paying mortgage for a month or more
 - 40% because job loss, 24% because too many bills, 12% because emergencies, 8% cite unexpected medical expenses
 - Blacks more likely to delay payment

Mortgage pricing

- 29% pay points/fees, 23% have PPP, 11% have balloon payment
- 7.4%=mean APR (v. 5.5% prime offer rate)

Racial Disparities

Do observationally equivalent blacks and whites have mortgage with the same loan terms?

- 42% of homeowners are black

Controlling for creditworthiness, proxy for default risk, LTV, employment, household income, demographics

- Blacks are $> 2x$'s as likely to have prepayment penalties, balloon payments
- APR is 110 bp higher for blacks (consistent with Courchane (2007) and Avery et al. (2007))

Race-based differences exist after differential treatment during mortgage approval process

- Black households less likely to apply for mortgages and, conditional on applying, less likely to be approved (Charles and Hurst 2002)

Mortgage Broker

58% of homeowners use a mortgage broker

Controlling for creditworthiness, proxy for default risk, LTV, employment, household income, demographics, those who use a mortgage broker

- 60% (or 15 percentage points) more likely to pay points or fees
 - Average difference in fees is $> \$800$
- Pay statistically similar interest rates, balloon payments

In spite of paying higher points/fees, borrowers do not seem to obtain lower interest rates

Race & Brokers

No difference in use of broker based on age, race, or income

- Suggests demand for brokers does not vary across demographic groups (in Detroit)

Unlikely for black/non-black differences in pricing to arise through broker channel

- Blacks using a mortgage broker face similar mortgage pricing as blacks *NOT* using broker
- Coefficient on black remains significant in regressions including the interaction of race and broker usage & coefficient on interaction is statistically insignificant

Conclusions

Differences in pricing persist among LMI households surveyed in Detroit in 2005/2006

- Black homeowners pay 110 bp more than whites, 2x's likely to have PP penalty, balloon payment

Why?

- Underwriting technology has standardized mortgage origination process
- Cost of information has decreased (brokers, internet)
- Fair lending laws

Results are most consistent with lender-driven origins for differences in loan terms (with caveats)