Guest Editors' Introduction

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Introduction

Abuse, deception, and discrimination in mortgage lending are nothing new. But the use of the word "predatory" to describe problematic segments of the mortgage market is new, and its proliferation in press accounts (as well as legal proceedings, regulatory discussions, and legislative debates) reflects a belated public recognition of the enormous changes that have transformed American financial services since the early 1990s (see figure 1).

The first major newspaper coverage of predatory mortgage practices dealt with a multimillion-dollar settlement agreement between the Massachusetts Attorney General's office and Shawmut Bank in early 1992 (Zuckoff 1992); this was quickly followed by a wave of articles in the wake of a court decision granting certification for a class action suit alleging usury violations by Fleet Finance, Inc., then an Atlanta-based subsidiary of New England's Fleet Financial Group, Inc. (Vejnoska 1992).[1] The intensity of popular debate that we see today, however, is more recent and was spurred in part by battles over amendments to the Community Reinvestment Act as part of financial services legislation in late 1999 and by the work of the National Predatory Lending Task Force established jointly by the U.S. Department of Housing and Urban Development and the Department of the Treasury in March 2000.

The "predatory" label helped mobilize and focus public and regulatory attention on the worsening problems of exorbitant interest rates and fees,

[1] In 1996, Fleet paid more than $100 million to settle two class action suits and charges brought by the state of Georgia alleging abusive home mortgage practices and lending discrimination. In 1999, Fleet Financial Group, Fleet Finance, and Home Equity USA paid $1.3 million to settle Federal Trade Commission allegations of subprime lending abuses (Browning 1999).

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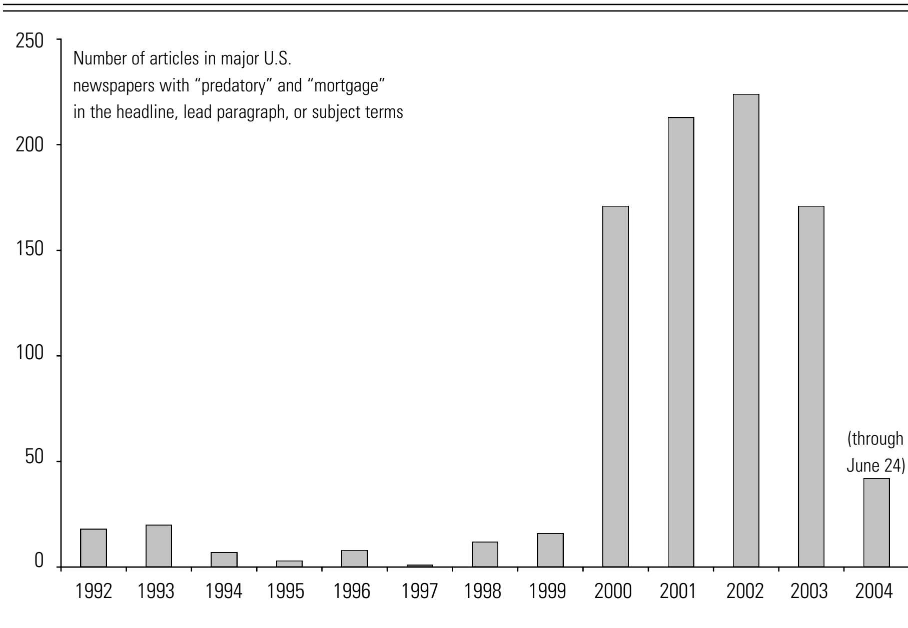
Figure 1. A Simple Barometer of the Predatory Lending Debate



Source: Data from Reed Elsevier, Inc. 2004.

equity stripping, lengthy prepayment penalties, asset-based lending, loan flipping, and other severe abuses. The catchy term also nurtured broad public interest in some of the specialized topics of the interdisciplinary academic literature on housing finance. Unfortunately, the term rapidly became the flashpoint for hostile, unproductive definitional debates. There is general acceptance that “predatory lending occurs primarily in the subprime mortgage lending market” and that “the subprime market can be fertile ground for predatory lending activities” (U.S. Department of the Treasury and U.S. Department of Housing and Urban Development [HUD] 2000, 2, 3). Yet opponents of reform have stymied effective remedial legislation, especially at the federal level, by arguing that the existence, nature, and extent of predatory lending remain unproven. In many cases, these arguments pivot on privately sponsored studies using subprime industry data that are not publicly available. Such proprietary data are often used to belittle concerns over predatory lending and to dismiss the need for public intervention or government regulation of the subprime market.

Statutes such as the federal Home Ownership and Equity Protection Act (HOEPA) and the North Carolina predatory lending law have managed to

police abusive subprime lending practices without precisely defining predatory lending. Nevertheless, to redress predatory lending, it is necessary to identify and understand the market failures behind mortgage lending abuses.

This special issue, titled "Market Failures and Predatory Lending," shoulders that task from a variety of perspectives, including economics, urban policy, geography, and law, and grew out of a research conference by the same name held at John Marshall School of Law in Chicago in May 2003. Sponsored by John Marshall, the Fannie Mae Foundation, and the Annie E. Casey Foundation and convened by the Woodstock Institute and the National Consumer Law Center, the conference assembled researchers, staff members, executives, and advocates from universities, Congress, federal and state agencies, the mortgage industry, and nonprofit organizations to present new research on predatory lending and to discuss needed directions for future research.

The purpose of this issue is twofold. First, we seek to advance knowledge about the causes, extent, and effects of predatory lending to lay the groundwork for a more considered, comprehensive public policy response to the problem. Second, in a related vein, we seek to move the debate to higher ground through more rigorous research that reexamines past research and conventional wisdom with a critical eye, while adding to our store of knowledge.

Our exclusive concern in this issue is with the subprime residential mortgage market and the predatory segment of that market. Responsible subprime lending can provide an essential source of mortgage capital that helps families unable to access loans in the prime market become homeowners. But along with this enhancement, market failures enabling abusive practices by a subset of lenders and other actors in the subprime lending arena have unfortunately emerged.

In examining those abuses, this issue addresses four major concerns. The first consists of certain core microeconomic issues raised by the subprime home loan market, including the relative lack of price competition and the question of how lenders exercise market power. The second is concerned with disparate impacts in the subprime market. The third is the public policy implications of the broader connections between predatory lending in local neighborhoods and institutions such as capital markets. The last consists of data and methodological issues that confront and to some extent hamper public research in the field.

Concerns over competition, pricing, and credit rationing

In her overview to this issue, Elizabeth Renuart describes how securitization and other technological advances in the early 1990s paved the way for the rapid growth of a revolutionary new mortgage product—a subprime home loan designed for borrowers with poor credit. She notes how subprime mortgages, with their higher interest rates and fees, quickly became a lightning rod for consumer advocates, who accused the subprime lending industry of shady practices, exorbitant pricing, and racial exploitation in the marketing of loans. In response, subprime lenders raised the banner of "risk-based pricing," claiming that subprime borrowers involve higher risk that necessitates higher rates and fees.

The controversy over risk-based pricing concerns primarily credit risk, one of the two main risks (prepayment risk is the second) that loom large in debates over subprime lending. Those who defend subprime loans on grounds of risk-based pricing argue that subprime prices are efficient because they are commensurate with the credit risks that these borrowers present. From a policy standpoint, these defenders oppose further government regulation of subprime home loans as price controls that would reduce the supply of subprime credit.

Two of the articles in this issue—one by Alan M. White and the other by Howard Lax, Michael Manti, Paul Raca, and Peter Zorn—challenge the initial premise that subprime home loan prices are efficient. As White notes, leading advocates of risk-based pricing justify higher subprime interest rates by pointing to the higher average default rates of subprime borrowers. Such assertions do not answer the question, however, of whether higher subprime rates are *commensurate with* or exceed the credit risk that subprime borrowers present.

In a regression analysis of home loan borrowers from January 1996 through June 1997, Lax and his colleagues find that credit risk was the most important factor determining whether loans were originated as prime or subprime. At the same time, however, demographic, experiential, and behavioral factors such as being older, having less education, being asked to pay off debts, being turned down by a lender, being less familiar with mortgage types, not searching much for the best rates, and responding to an offer of "guaranteed" loan approval were also statistically significant determinants of who ended up with subprime loans.

A similar pattern emerges when prime and subprime interest rates are compared. If subprime rates were efficient, one would expect to see a continuous distribution in the nominal interest rates of prime and subprime home loans. Instead, White examines evidence from 2003 and finds a stark discontinuity between prime and subprime interest rates; the best subprime rates are

200 basis points higher on average than prevailing prime rates, even before fees are taken into account. Similarly, in comparing prime and A– home loans in 1996 and 1997, Lax and colleagues found a 215 basis point gap between A and A– interest rates. Price discontinuities of this magnitude or higher are not episodic, but rather have been a persistent feature of the subprime home loan market (see also SMR Research Corp. 2000).

Lax and his coauthors examine this price gap more closely. After holding credit risk constant and adjusting for origination and servicing costs, they conclude that "roughly one-half of the interest rate premium paid by subprime borrowers—100 basis points—cannot easily be explained by the higher levels of risk associated with these types of loans" (569). Once again, this result does not add in the effect of higher subprime points and fees.

Further, White presents other evidence of rent-seeking (price gouging) in the subprime home loan market. First, as he points out, elevated default or foreclosure rates do not necessarily mean high loss severities (the severity of financial losses due to default). Indeed, some subprime lenders with high default rates have low loss severities. He describes how, in fact, subprime lenders consciously craft their loan-to-value requirements to keep their loss severities under control. Second, he provides evidence that yield spread premiums paid by subprime borrowers typically (and perversely) serve to boost, not buy down, the total fees paid to mortgage brokers. Third, he points to research indicating that many borrowers with high credit scores take out costly subprime loans, even though their credit scores suggest that they could qualify for prime loans at the best rates.

Finally, there is growing evidence that prepayment penalties, which are prevalent in the subprime market but rare in prime loans, also extract rents. Although prepayment penalties have been said to compensate note holders for the supposedly higher prepayment risk of subprime home loans, until recently, publicly available data to evaluate that claim have been relatively limited. Kathleen C. Engel and Patricia A. McCoy discuss the new generation of empirical studies that debunk claims of faster subprime prepayment speeds and conclude instead that for subprime borrowers with lower FICO scores,[2] average prepayment speeds are the same or slower than prime prepayment speeds. Some researchers (Deng and Gabriel 2002) have in fact determined that other things being equal, loans to subprime borrowers with lower FICO scores are more profitable than prime loans because the financial benefit of the subjects'

[2] FICO scores are credit scores developed by Fair, Isaac & Company.

slower average prepayment speeds outweighs the financial detriment of their heightened probability of default.

This evidence of rent-seeking in the use of prepayment penalties is corroborated by John Farris and Christopher A. Richardson, whose article examines the incidence of prepayment penalties in subprime loans reported in the Loan Performance, Inc., database. They report that the lower a subprime borrower's FICO score, the more likely it is that this borrower will receive a prepayment penalty. This is true despite evidence cited by Engel and McCoy that prepayment speeds for subprime borrowers can be *slower* on average than prepayment speeds for prime borrowers. Similarly, Farris and Richardson find that debt-to-income ratios are positively correlated with the imposition of prepayment penalties, even though higher ratios make it more difficult to refinance. In their opinion, "The direction of these effects is consistent with a lack of bargaining power for borrowers" (710–711).

In the face of the mounting evidence of rent-seeking in the subprime home loan market, an important question is, How do subprime lenders succeed in extracting rents? After all, the subprime home loan industry is relatively unconcentrated (although this is changing), and new lenders enjoy relative ease of entry. Nevertheless, subprime lenders have found a number of ways to exercise market power.

One way consists of market segmentation, as the price gap between the prime and subprime markets suggests. Another way is price discrimination. As White notes, subprime loan prices are not transparent. Subprime lenders do not make rate sheets available to consumers and do not advertise their prices in any meaningful way. He further notes that this lack of transparency in interest rate prices is exacerbated by the numerous nonstandardized, costly fees that often accompany subprime home loans. This fee structure enables lenders to differentiate their products, thereby making it difficult, if not impossible, for consumers to shop for the best price. As a result of this lack of transparency, lenders and mortgage brokers can price-discriminate against unsuspecting borrowers with comparable qualifications. Steering prime-eligible customers into subprime loans is arguably the most blatant form of price discrimination.

Search is a further factor that contributes to inefficient subprime interest rates. In their comparison of prime and subprime borrowers, Lax and colleagues find that subprime borrowers shopped less for interest rates, were less familiar with mortgage types and terms, and were six times more likely to respond to ads or calls for "guaranteed loan approval." White discusses additional studies documenting subprime borrowers who were not in the market for credit when they were solicited and who were then cajoled, through aggressive market tactics, into taking out loans.

These search patterns—or the lack thereof—shed light on several other known facts about subprime lending. First, the growing evidence of boiler room tactics explains why subprime lending is more prevalent in the refinance market than in the purchase money market (where by definition consumers are actively shopping for credit). Second, the relative willingness of subprime borrowers to settle for guaranteed approval on less favorable terms suggests that fear of being rejected is a strong driver of credit decisions, which lenders can manipulate to extract rents. High unsecured debt loads brought on by medical bills and other debt can also make homeowners desperate for credit, as Robert W. Seifert documents. Finally, the evidence suggests that the lack of transparency in the subprime market defeats effective shopping behavior by consumers. Thus, instead of being driven by demand, predatory loans are often driven by supply, with lenders competing to lock in unsuspecting borrowers quickly before they can shop terms, rather than on price.

In response to concerns over these and other lending abuses, numerous states, beginning with North Carolina in 1999, have enacted anti–predatory lending laws. Many have applauded the North Carolina law as modulated and sensible; others have castigated it as credit rationing that has reduced legitimate credit for lower-income consumers. In their contribution to this issue, Roberto G. Quercia, Michael A. Stegman, and Walter R. Davis evaluate the effects of the North Carolina law in a study that improves on past research in several respects. First, they analyze the North Carolina law with a Loan Performance, Inc., database of 3.3 million subprime loans originated between 1998 and 2002. Second, taking advantage of the unparalleled wealth of detail in this database, they use FICO scores instead of income to measure credit risk. Finally, conducting a natural experiment, they test the effect of the law on the presence of three specific abusive loan terms—prepayment penalties with terms exceeding three years, balloon clauses, and loans with loan-to-value ratios of 110 percent or more.

Consistent with previous studies, Quercia and his coauthors confirm that after the law took effect, subprime originations fell in North Carolina relative to other states. They go on to find, however, that the decline affected refinance loans only, not purchase money originations, in North Carolina. Furthermore, they find that the percentage of subprime refinance loans originated after the law was implemented and containing one or more of the three abusive terms declined by more than half in North Carolina, while loans with such term(s) increased in the rest of the country and in neighboring states.

Disparate impacts of predatory lending

A second central theme involves the disparate impacts of market failures and predatory lending on protected classes. Nearly a decade of sustained research has erased any serious doubt that blacks and residents of black neighborhoods are disproportionately represented in the subprime market and in transactions that meet any reasonable definition of predatory. Yet considerable debate persists over the partial, mixed, and sometimes contradictory empirical evidence of disparate impacts on other protected classes (e.g., Hispanics, elderly homeowners, and women). Moreover, even when disparate impacts can be observed and measured, theoretical and policy discussions are deeply influenced by the contours and fault lines of interpretation that have shaped redlining and discrimination debates for more than a generation. For example, to what degree do observed disparate impacts reflect supply-side decisions by lenders or other mortgage and real estate market actors? And to what degree are disparate impacts the result of limitations in our ability to account for such legitimate considerations as applicant credit and default risk?

Several of the articles in this issue confront these questions directly, enriching theoretical and policy discussions while highlighting important questions for further inquiry. Paul S. Calem, Jonathan E. Hershaff, and Susan M. Wachter analyze the determinants of subprime lending in 1997 and 2002 in seven major cities (Atlanta, Baltimore, Chicago, Dallas, Los Angeles, New York, and Philadelphia). They control for a proxy of the price of risk in neighborhood real estate investment, neighborhood income and educational attainment, and measures of the credit quality of neighborhood residents (based on consumer credit reports). Their analysis thus offers valuable insights into the relationship between individual loans and neighborhood attributes and reveals disproportionate subprime probability, even after accounting for risk measures, for blacks; effects for other racial/ethnic minorities are mixed. Moreover, there is a consistent, positive association between neighborhood percent black and the likelihood of a loan's being subprime. This neighborhood effect harms non-Hispanic white borrowers as well, raising important questions about the interaction among marketing, outreach, broker networks, and borrowers' decisions and search behavior.

Calem and his colleagues also find a strong relationship between subprime borrowing and lower levels of educational attainment at the neighborhood scale, implying the need for a continued policy focus on financial education to ensure equal access to prime credit for all eligible borrowers. These results parallel several of the key findings of Lax and colleagues, who conclude that various measures suggesting a "lack of financial preparedness" (565) increase the probability of ending up with a subprime loan. Yet Lax et al. also find

significant disparate impacts. Race and ethnicity show a strong bivariate relationship, but lose statistical significance after key variables used by underwriters in assessing risk are controlled. (One of these measures, a borrower's FICO score, may itself encapsulate some degree of disparate impact.) But another impact persists even after controlling for risk factors: All else being equal, borrowers 65 or older are five times more likely to take out a subprime mortgage than borrowers under 35. One of the most crucial and underresearched themes in mortgage studies today involves the interrelationship between disparate impacts by race/ethnicity, gender, and age.

These results are echoed in the analysis of Elvin K. Wyly, Mona Atia, and Daniel J. Hammel. Examining lending patterns in the inner cities of 23 U.S. metropolitan areas, they find strongly elevated rejection odds for black and Hispanic borrowers in neighborhoods at the frontier between gentrified wealth and enduring poverty. In a closer inspection of the Baltimore-Washington region, they find a disproportionate segmentation of blacks into the subprime market, an intensification of these effects in the gentrifying inner city, and a strengthening link between a lender's willingness to serve black borrowers and its specialization in subprime lending.

Additional evidence of disparate impacts comes from Farris and Richardson's prepayment penalty research. Beyond the valuable analysis of a specific loan term measured with a particularly rich, proprietary data set, their work offers a sorely needed examination of the urban-rural continuum and its effects on lending disparities. After accounting for credit scores and other loan and borrower characteristics, they find substantial increases in the incidence of prepayment penalties in ZIP codes with higher shares of racial and ethnic minorities. After controlling for these racial-geographic effects, they find that borrowers in rural areas are significantly more likely to receive prepayment penalties than their urban counterparts.

Broader connections between predatory lending and other institutions

Although concerns over loan sharks date back to ancient Sumeria and Babylonia (Peterson 2004), mortgage lending abuses in the United States in the decades leading up to the 1990s were usually chalked up to small fringe lenders or organized crime. Large, reputable lenders generally extended home loans only to prime borrowers for a multitude of reasons, including strict usury laws, information asymmetries involved in evaluating creditworthiness, and the lack of alternatives to holding nonconforming mortgages in portfolio (Engel and McCoy 2002).

As Elizabeth Renuart and Wyly and his coauthors chronicle in their articles, these conditions had given way to vast changes by the early 1990s. Deregulation and technological change had revolutionized the mortgage market, expanding credit to the working poor and people of color who previously could not qualify for home loans. Automated underwriting, based on computerized analyses of loan performance for millions of past home loans, gave lenders the ability to predict the creditworthiness of nonconforming loans and credit-impaired borrowers. Securitization flooded the home mortgage market with new capital and expanded volumes because lenders could sell their loans on the secondary market and no longer had to hold long-term mortgages in portfolio. Deregulation also enabled lenders to make home loans at rates that previously were considered usurious and greatly expanded the variety of terms that lenders could use to structure profitable transactions even among lower-income borrowers.

In their article, Engel and McCoy describe how securitization propelled subprime home loans to the highest reaches of American finance, turning Wall Street into a key financing conduit for subprime loans. Securitization unbundles the mortgage process, creating new information asymmetries that can injure both investors and borrowers. Through structured finance, securitization solves the information asymmetry problems of investors (but not of borrowers) with such success that investors in senior tranches of subprime mortgage-backed securities almost never have to be concerned about credit risk. The downside of the success of structured finance, Engel and McCoy argue, is that investors (and therefore ratings agencies and investment banks) have practically no incentive to screen out predatory loans from subprime loan pools. To correct this problem, they propose a two-tiered assignee liability system to encourage investment banks and investors to conduct due diligence designed to reject as many predatory loans as possible from securitized loan pools.

Wyly and his coauthors confirm the growing role of Wall Street finance by documenting the close connection between subprime lending in local neighborhoods and the capital markets. In part of their analysis focused on a short but turbulent period (1998 to 2000), they find a rapid influx of larger lending institutions into the gentrifying areas of many inner cities. In this short period, the average assets of lenders specializing in these neighborhoods jumped from $18.3 billion to almost $69 billion. Higher-asset lenders preferred to lend to "elite" borrowers with incomes in the highest decile of their respective metropolitan areas, while loan applicants in gentrifying neighborhoods who were either denied loans by or accepted loans with subprime lenders were more likely to apply to smaller-asset institutions. Those subprime lenders,

moreover, were likely to be independent mortgage companies or bank or thrift subsidiaries. Finally, in a stark illustration of the flow of Wall Street capital to inner-city subprime lenders, Wyly et al.'s analysis of mortgage applications shows that lenders that sold their mortgages in gentrifying neighborhoods especially often to investors other than Fannie Mae and Freddie Mac were 1.82 times more likely to be subprime in 1998 and 2.55 times more likely to be so in 2000.

The upswing in subprime securitizations and lending went hand in hand with the growth in servicing firms that specialize in subprime collection. In his article, Kurt Eggert chronicles the growth of this specialized sector and the abuses associated with it. He reviews recent settlements and judgments in predatory servicing cases that have brought multiple abuses in the subprime home loan industry to light. These abuses include (1) invoking default clauses and attempting to foreclose even when borrowers are current on their payments, (2) charging borrowers spurious late fees and other fees, (3) force-placing insurance even though borrowers have their own current coverage, and (4) mishandling escrow funds.

As Eggert observes, market forces do not adequately curtail such abuses. Borrowers do not have leverage because servicing rights are sold without their consent. Investors in subprime mortgage-backed securities have greater pull with servicers than borrowers do. While investors' incentives to monitor against servicing abuses are mixed, those incentives are dampened in two respects: first, because investors are interested in rapid foreclosure when borrowers become delinquent and, second, because spurious servicing fees reduce the amount of legitimate mortgage income that investors must cede as payment to servicers. To remedy this situation, Eggert suggests that ratings agencies require servicers to designate borrowers as express third-party beneficiaries of their contracts with securitized trusts.

Finally, when other American institutions—such as health care—go into crisis and send household debts out of control, homeowners may become especially vulnerable to solicitations by predatory lenders. On the demand side, financial pressures make some homeowners particularly vulnerable to sales pitches by predatory lenders. Robert W. Seifert describes the financial pressures on households from mushrooming health care debt. He argues that not only is medical debt rising, but patients often view paying down such debt as critical to their continued access to health care. He notes that some providers collect medical debts aggressively, going so far as to place liens on patients' houses and then filing for foreclosure. In this environment, Seifert suggests that the need for cash to pay outstanding medical bills may well drive debtors into taking out predatory home loans.

Data and methodology

Questions, disputes, and uncertainties over data and methodological issues are at the heart of the predatory lending debate. Taken together, the articles in this issue provide an important portrait of key market failures and predatory processes in the subprime mortgage market. An interdisciplinary blend of legal analysis, institutional and industry case studies, and multivariate econometric techniques sheds light on crucial policy questions. Yet as many of the contributors emphasize, data limitations have shaped much of the research on these topics in recent years, since rapid market innovations have introduced an array of changes that cannot be adequately measured with available public data.

Home Mortgage Disclosure Act (HMDA) records provide an extremely narrow and limiting snapshot of one moment in the complex mortgage transaction, but HMDA remains the single most comprehensive (and publicly available) source of loan-level data that can be matched to particular neighborhoods and institutions. Expanded reporting requirements under HMDA will soon offer additional information on certain high-cost loans, but the records will still not provide any information on applicants' credit history.

HUD's list of subprime and manufactured home lenders is only a rough categorization of firms (not loans), but its ready availability and quick match with HMDA data offer one of the few ways for independent analysts to measure market segmentation; moreover, as demonstrated by Calem, Lax, and their colleagues, this list can be matched with complementary public and proprietary data sets to provide a sharper picture of certain processes in the subprime market. Individual articles in this issue, as well as the collective results, demonstrate the value of efforts to synthesize evidence from proprietary and public data sources to enrich the academic, public, and policy discussions on predatory lending.

Still, certain parts of the market and particular loan terms (especially fees) remain almost invisible. The most important data sets are proprietary, and some are not available for sale at any price to academic or government researchers. As Quercia and his colleagues emphasize, "[L]ittle is known about the composition of their data sets, which are not available to the wider research community for validation or replication" (579). In turn, these data problems perpetuate methodological divisions: Studies sponsored by (or with access to the proprietary data of) lenders or trade associations have little difficulty generating multivariate regression analyses. But researchers lacking such access cannot scrutinize the analyses or data and are forced in their own work to choose between the limitations of HMDA and similar data sets or the more qualitative sources of legal evidence, summary statistics, and case studies of

particular institutions. Public policy and analysis aimed at addressing predatory lending and market failures will be able to move more quickly and efficiently when all participants can work from the same data and advocates of different perspectives can respond directly to one another's research.

Conclusion

Debate over the definition, persistence, and severity of predatory mortgage lending will continue. Scholars, regulators, advocates, attorneys, and industry researchers all recognize the stakes involved in these debates: Evidence that particular segments of the mortgage market operate in ways that violate fundamental theoretical assumptions is a significant threat to the suitability and legitimacy of existing policy frameworks. The articles in this issue offer important, although partial, evidence of subprime pricing inefficiencies, information asymmetries, and disparate impacts of predatory practices on members of protected classes. There is also evidence that the incidence of predatory mortgage loans is intertwined with inequalities and disparate impacts in other areas of economic and social life. Clearly, some of the findings are limited by empirical data constraints or assumptions of alternative methodological traditions, yet the preponderance of evidence demonstrates that particular segments of the subprime market have become fertile ground for troubling, predatory processes. We believe the articles included in this special issue raise the level of discussion and analysis around predatory lending and market failures in the subprime arena. They provide further evidence to support the ongoing push for enhanced public policy intervention to inhibit predatory lending.

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