



UNDERSTANDING MORTGAGE MARKETS

PROJECT SUMMARY AND PRINCIPAL FINDINGS

Over the last two decades the emergence of new mortgage products, the growing importance of the secondary mortgage markets, and the rise of mortgage brokers in the marketing and sales of residential home mortgages have sparked a virtual revolution in U.S. financial markets. The resulting increase in mortgage lending – especially in sub-prime lending – has expanded access to credit by consumers who have not traditionally been well served by the mortgage market.

Despite the many benefits of the new mortgage market, there are nevertheless areas of concern. The recent rise in foreclosures suggests that some households are taking on debt that they have limited capacity to repay. Additionally, there is evidence that many families are obtaining mortgages that they do not understand or are not suitable for their needs. The fact that delinquencies are higher within non-traditional products may not be a surprise, as these products are designed for higher risk borrowers. Even so, the concentration of foreclosures in many of the nation's lowest-income and economically vulnerable minority neighborhoods threatens to reverse recent gains in efforts to expand housing opportunities for all.

Funded by a Ford Foundation grant to Harvard's Joint Center for Housing Studies, this research initiative includes two related studies of the new mortgage market. The first examines the behavior of market participants, while the second examines the emergence of new mortgage delivery channels linked to the rapid growth of subprime mortgages. Together, these papers provide a comprehensive assessment of mortgage market dynamics and a basis for developing workable solutions to address the ongoing problems faced by many consumers that continue to struggle to obtain mortgage finance on terms that they can both afford and understand.

The first paper, *Understanding Mortgage Market Behavior: Creating Good Mortgage Options for All Americans* prepared by Ren S. Essene and William Apgar looks at consumer behavior in the mortgage marketplace as well as the behavior of those engaged in the marketing and sales of mortgage products.

KEY FINDINGS INCLUDE:

- **The ability of consumers to make informed choices is limited.** Behavioral economics and market research suggest that consumers often make choices that may not be in their best interests and that they may later regret. Even the most sophisticated borrowers find it difficult to shop effectively in today's complex market.
- **Consumer preferences are malleable, not fixed.** Consumers often enter the market not knowing exactly what kind of mortgage they want or need, and therefore are vulnerable to outside influence.
- **Consumers often lack awareness of mortgage prices.** Given the complexity of loan pricing and the variation of loan features, consumers have difficulty understanding alternative mortgage products.
- **Consumers particularly struggle with choices that involve payments over time.** Consumers have difficulty assessing future situations (including changes in house prices, interest rates and income.) This multi-period decision making problem is particularly difficult to evaluate and "short cuts" methods often lead to costly mistakes.
- **Consumers are vulnerable to "push marketing."** Mortgage sales and marketing efforts may exploit various consumer decision making weaknesses. In particular, some mortgage market participants use their knowledge of consumer decision making tendencies to aggressively market specific mortgage products that may not be in the best interest of the borrower.
- **The structure of the mortgage market creates additional challenges.** The widespread use of targeted incentives designed to encourage mortgage brokers and loan officers to convince consumers to select specific and often higher-priced mortgage products further stimulates aggressive "push marketing" efforts.
- **New "affordability" loan products pose significant risks.** Many of today's non-traditional loan products seek to help prospective homebuyers overcome affordability barriers, or enable existing homeowners to utilize equity in their homes for a variety of purposes. Yet inappropriate marketing of these products can saddle low-income and low-wealth individuals with mortgage debt that they are unable to pay, and in doing so simply worsen their economic circumstances.

Consumer and lender behavior may also contribute to differences in mortgage outcomes by race and ethnicity. For decades "fair lending" issues have received attention in both public policy arenas and the popular press. The release of Home Mortgage Disclosure Act (HMDA) data with mortgage

pricing information has sparked a new round of discussion. In 2004, HMDA required lenders to disclose pricing information for first lien mortgages with an Annual Percentage Rate (APR) that is three percentage points above a typical prime loan for the first time. These “higher-priced” mortgages are roughly equivalent to what mortgage industry analysts call subprime loans.

Using these data, the second paper entitled *Mortgage Market Channels and Fair Lending: An Analysis of HMDA Data* prepared by William Apgar, Amal Bendimerad and Ren S. Essene examines rapid growth of subprime lending, the changing structure of the mortgage market, and the general failure of mortgage regulations to adapt to this changing environment.

KEY FINDINGS INCLUDE:

- **Higher-priced loans flow through new mortgage market channels.** The rise of subprime mortgage lending is linked to the rise of new mortgage delivery systems, including independent mortgage companies and their networks of mortgage brokers, as well as new mortgage conduits that securitize and sell mortgages on the secondary market.
- **Most lending organizations make relatively few higher-priced mortgages.** For example in 2004, 58.8 percent of all lenders (or 4,154 organizations) made 40.7 of lower-priced prime loans (or 2.7 million loans), while these same organizations made just 2% of higher priced loans (or 27 thousand loans).
- **A few higher-priced loan specialists dominate this market.** Over 900 lenders specialize in higher-priced lending, where higher-priced loans are more than 50 percent of their overall lending activity. Of these, 17 large independent mortgage companies originated 39 percent of all higher-price loans (or 506 thousand loans) that were originated in 2004. As non-bank lenders, these independent mortgage companies are less closely monitored by Community Reinvestment Act (CRA) and other federal regulations that focus on deposit-taking organizations and their subsidiaries and affiliates.
- **Channel specialization extends to secondary market outlets.** The GSEs (Fannie Mae and Freddie Mac) largely limit their purchase of whole loans to the prime market. In 2004, HMDA data suggest that the GSEs directly purchased only 22 thousand (or 1.7 percent) of the nearly 1.3 million higher-priced loans originated. In contrast, the bulk of higher-priced mortgages flow through less heavily regulated non-GSE conduits.
- **Loan supply characteristics are correlated with outcomes.** The general characteristics of the mortgage channels and the specific characteristics of the originating lender are correlated with racial and ethnic differences in the share of borrowers obtaining higher-priced mortgages. For example white borrowers are 50 percent more likely (28.5 versus 17.4 percent) than black borrowers to obtain a loan from a CRA regulated entity operating in their assessment area. In contrast some 44.2 percent of all blacks (versus 30.1 percent of whites) obtain a loan from a less heavily regulated independent mortgage companies.

Both papers argue that because consumers have difficulty in shopping for mortgage products and that existing market dynamics raise fair lending concerns, new initiatives are needed to overcome today's aggressive marketing practices.

SUGGESTIONS FOR NEW APPROACHES INCLUDE:

- **Efforts must be expanded to guide consumers to “good loans.”** The idea of individual choice is a deeply held value in the U.S., yet “letting the consumer decide” has distinct limitations. Building on socially motivated CBOs and national scale organizations, it is important to affirmatively steer consumers to “good loan” choices that are transparent and fairly priced and that on net provide net benefit to the consumer.
- **Mortgage industry participants and consumer groups should establish a trusted advisors network.** The widespread use of mortgage broker incentives that are linked to specific loan products and terms may result in consumers not obtaining the best mortgage for which they qualify. A third party advice system could provide a network of “trusted advisors” with interests aligned with the borrower's interest. One form of this idea is a “buyer's broker,” or a broker that works explicitly for the borrower for a flat fee and is legally required to represent the buyer's best interests.
- **A second opinion hotline would be a useful tool.** Building on the buyer's broker concept, a national organization such as NeighborWorks America could establish a phone-based second opinion hotline to help consumers navigate through the complexity of both the mortgage process and products. This hotline could be especially useful in helping consumers assess the risks of payment shocks arising from many of the new adjustable rate loan products available today.
- **A web-based pricing guide would assist trusted advisors.** The creation of an automated pricing guide would assist consumer's working with a trusted advisor to understand the costs and benefits of specific mortgage options. For example, many borrowers may feel that submitting mortgage documents is a hassle, and mortgage brokers often inappropriately steer consumers to “no-doc” products. What the consumer may fail to appreciate is that “no doc” loans increase the cost of the mortgage and expose the consumer to a variety of mortgage fraud schemes. In the hands of an experienced and trusted advisor, a pricing guide may help consumers understand the tradeoffs involved in the “no-doc” option.
- **Behavioral principles can increase the effectiveness of outreach efforts.** Using the “opt-in/opt-out” principle can expand the capacity of homebuyer counseling organizations to help consumer's obtain a “good loan” products. For example, this could be accomplished by pre-approving participants attending a homebuyers' fair or a homeownership counseling program for a loan product that is fairly priced and easily understood. Rather than sending the consumer home with information about loans in general, consumer research suggests that signing up the consumer “on-the-spot” will increase the chance that the consumer will actually select this product and resist any future efforts of a “push marketer” to sell them a product that is “too good to be true.”

- **Changing disclosure regulations could enhance consumer shopping.** To allow consumers more time to shop, lenders could be required to provide TILA disclosures 3 to 7 days prior to closing and to extend the “right of rescission” period. By further modifying applicable TILA regulations, it would be possible to require “high risk” borrowers to seek a second opinion. Other useful changes include adding a requirement that the Good Faith Estimates (GFE) “go hard” earlier in the process and expanding efforts to monitor “bait and switch practices” that can render GSEs meaningless.

In addition to efforts to help consumers be better able to resist aggressive “push marketing” efforts, there is a need to consider other market interventions. These reflect the fact that the existing regulatory structure has not adapted to the substantial changes in the mortgage industry that have occurred over the past quarter century. Under the existing regulatory framework, higher-priced loans flow through mortgage channels that are subject to the least regulatory scrutiny. As a result, the most vulnerable borrowers are less likely to benefit from federally mandated consumer protections that are generally present in the prime market. Identifying new and innovative legislative and regulatory approaches to improving the efficiency and fairness of the nation’s mortgage markets is critical.

REGULATORY AND COLLECTIVE ACTION APPROACHES INCLUDE:

- **Collective action needed to eliminate “low roaders.”** To eliminate abusive and deceptive practices, the industry must have the will and the mechanisms in place to sanction or otherwise force out of the market those “low roader” participants unwilling to adhere to industry “best practices.”
- **Recently released Interagency Guidance should be extended to cover non-banks.** Recognizing the existing regulatory regime was insufficient to protect consumers from potentially abusive practices and to maintain the safety and soundness of banks and thrifts, last fall federal regulators released a new Interagency Guidance. Since this Guidance generally only applies to federally-regulated deposit-taking institutions, the federal government should consider extending the guidance to all lenders, including non-bank independent mortgage companies.
- **New legislation should extend CRA reviews to all lenders.** Not explicitly enacted as a fair lending law, CRA was designed to halt redlining or the denial of credit to borrowers living in lower-income neighborhoods. Even so, CRA loan-level reviews are typically accompanied by fair lending reviews, and CRA oversight has emerged over the years as an important component of fair lending enforcement. CRA should be extended to cover the activity of all deposit-taking organizations wherever they originate loans, as well as those non-bank mortgage lenders currently not covered by CRA
- **Regulators should encourage all CRA-regulated entities to serve higher risk borrowers.** In addition to working to provide prime loans to all that qualify, CRA-regulated entities also should be encouraged to serve the credit needs of all borrowers, including those borrowers unable to qualify for prime credit. Doing this would expand competition in the

market for higher-priced mortgages and bring a larger share of higher-priced mortgages under the watchful eye of more comprehensive fair lending reviews.

- **The Federal Government should license brokers.** Monitoring of the activities of mortgage brokers is largely a state function. Given that the nature and extent of state involvement in these matters varies widely, the Federal Government should assume responsibility for licensing and establishing minimum standards for acceptable mortgage broker behavior, and in doing so reduce the state by state variation that now exists in access to basic consumer protections against broker abuse.
- **The Federal Government should support state mortgage market oversight activities.** To the extent that the Federal Government continues to delegate to the states significant responsibility for regulating key elements of the mortgage market, the Federal Government should provide targeted grants and other forms of assistance to support state enforcement and the monitoring efforts in these areas as well.
- **More uniform oversight of secondary market participants is important.** Today, most funding for higher-priced lending loans flows through less regulated non-GSE channels. Efforts to strengthen SEC monitoring of securities involving higher-priced mortgages are needed as are efforts to hold secondary market investors accountable for their actions by eliminating or modifying existing legislation and regulations that limit assignee liability. Such actions would substantially increase the incentives of secondary market investors to more carefully evaluate the loans that they purchase for fair lending and other abuses of best lending practices.
- **The GSEs should take a more active role non-prime market.** Given that the GSEs are already subject to detailed loan-level review of their activities for compliance with fair lending requirements, the GSEs should be encouraged to take a more active role in the acquisition of higher-priced whole loans and in doing so help establish a series of industry best practice standards to govern this important segment of the mortgage industry.

ABOUT THE STUDIES:

Harvard University's Joint Center for Housing Studies is the nation's leading center for information and research on housing in the United States. Established in 1959, the Joint Center is a collaborative unit affiliated with the Harvard Design School and the Kennedy School of Government. The two reports [*MM07-1: Understanding Mortgage Market Behavior: Creating Good Mortgage Options for all Americans*](#) by Ren S. Essene and William Apgar and [*MM07-2: Mortgage Market Channels and Fair Lending: An Analysis of HMDA Data*](#) by William Apgar, Amal Bendimerad and Ren S. Essene, along with additional information about the Center and its programs and activities are available at www.jchs.harvard.edu.

For copies of the complete studies, please go to:

http://www.jchs.harvard.edu/understanding_mortgage_markets/

