Testimony on “Mortgage Lending Discrimination”
Before the
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Chairman Frank and Members of the Financial Services Committee, I am pleased to have this opportunity to share my thoughts on mortgage lending patterns in the Greater Boston area. The Federal Reserve Bank of Boston's responsibilities in the areas of community affairs and consumer education fall under me.

The past ten years have seen dramatic changes in the housing and mortgage markets, both nationally and here in the Boston area. Until recently, housing prices were rising rapidly. New lenders were entering the mortgage market and expanding aggressively. Homeownership was rising.

There were negative developments. The release of the Home Mortgage Disclosure Act (HMDA) data for 2004 provided information for the first time on the prevalence of mortgages with higher interest rates. These data showed that blacks and Latinos were much more likely to have higher rate loans than whites; Asians were less likely to have higher rate loans. The data also show that blacks and Latinos were more likely to be served by lenders specializing in higher rate mortgages. Patterns in New England and the Boston area were broadly similar to those nationally, although disparities for Latinos were somewhat more pronounced.

Analysis of the HMDA data by the Joint Center for Housing Studies at Harvard University shows that minority borrowers were more likely to be served by independent mortgage banks and less likely to be served by CRA-regulated institutions than white borrowers, and their loans were more likely to be sold to private label conduits. In other words, minority borrowers were more likely to be served by subprime lenders. The 2005 and 2006 data show similar patterns. (HMDA data for New England metropolitan areas for 2004 and 2005 can be found on the Federal Reserve Bank of Boston's public web site at www.bos.frb.org/commdev/hmda/. Data for 2006 will be available shortly.)

While these cost disparities were disturbing, many observers took comfort from the growing numbers of minority households who were sharing in the American dream of homeownership. Further, with housing prices rising, these households were presumably accumulating equity and building wealth.

The situation has changed markedly for the worse in the past year or so. Housing prices are no longer rising in much of the country. In the Boston area, prices have fallen according to some measures. Foreclosure initiations have picked up dramatically in Massachusetts. As a fraction of loans outstanding, foreclosure initiations per quarter in Massachusetts have risen from less than 0.2 percent in 1999 to 0.6 percent in the second quarter of 2007. The recent figure approaches, but is still lower than, the highs of the New England real estate bust in the early 1990s. From much lower than the national average, foreclosures in the state have risen to match those nationally. (Charts depicting these patterns can also be found on the Federal Reserve Bank of Boston's public website. Data are from the Mortgage Bankers Association through Haver Analytics.)

Foreclosures have also increased nationally, but the trend is not quite so stark because different regions exhibit somewhat different patterns. Some parts of the country, where economic conditions have been chronically weak and where housing prices did not show much appreciation, have suffered from relatively elevated foreclosure rates for some time. In contrast, the experience of the West Coast is similar to that in New England. Home prices were rising rapidly until recently and foreclosure rates were low. Now that prices are flattening or falling, foreclosures are rising sharply.

The rise in foreclosure initiations has been particularly pronounced for subprime loans with adjustable rates. In Massachusetts, the foreclosure rate (foreclosure initiations per quarter relative to loans outstanding) for subprime adjustable rate mortgages has risen from about 1 percent in 2004 to 4.5 percent in 2007. Although subprime adjustable rate mortgages account for less than 10 percent of mortgages in Massachusetts, they now account for 50 percent of foreclosure initiations. It should be noted, however, that while the foreclosure problem is particularly acute for subprime adjustable rate mortgages, foreclosure initiations have also increased for subprime fixed mortgages and prime adjustable rate mortgages.

I have not seen foreclosure information by racial and ethnic group. The Massachusetts communities where foreclosures are highest include some with large minority populations, Brockton and Lawrence being particularly noteworthy, but some predominately white communities, such as Barnstable, have also seen sharp increases in foreclosures.

Unfortunately, the foreclosure problem is likely to get worse before it gets better. In the recent past, with housing prices rising rapidly, borrowers who faced the prospect of an increase in their adjustable interest rate or ran into difficulties making mortgage payments could refinance, often withdrawing some of the increase in housing equity in the process. In a worse case scenario, they could sell their home. With housing prices no longer increasing, these options may no longer be available.

Additionally, many recent subprime borrowers face the prospect of substantially higher interest payments in the near future. What are commonly called 2/28 and 3/27 mortgages have been popular. These mortgages have an initial “teaser” rate that is fixed for two or three years before re-setting. In fact, the teaser is not all that low. The Federal Reserve Bank of Boston has been analyzing mortgages in Middlesex county using public information from the Registry of Deeds. This analysis is part of a larger study of mortgages in New England and it is very much a work in progress. But the preliminary work has produced some interesting findings. Boston Fed researchers found that for 2/28 mortgages the initial rate was over 7 percent for mortgages originated in 2005 and over 8 percent in 2006. In both cases, the reset rates would be around 11 percent. Presumably, many of these borrowers expected to refinance before they faced that prospect.

Foreclosures are clearly very difficult for the borrower. They also have broader consequences. The Boston Fed's analysis of the Middlesex county data shows that about a quarter of recent foreclosures involved multi-family properties. While this suggests an investor element to the foreclosure problem, it also highlights a potentially serious spillover effect: tenants of foreclosed properties can frequently be evicted on short notice, even if they are current on rent and unaware of the property owner's financial position. Additionally, clusters of foreclosures can have adverse effects on neighborhoods, driving down property values and contributing to vandalism.

Options for dealing with the foreclosure problem are frustratingly limited. Borrowers must be pro-active in seeking help. Many wait too long. Borrowers who run into difficulty with their mortgage payments or who anticipate difficulties should contact the servicer of their mortgage as soon as possible. They may need to be persistent, as mortgage servicers have not been staffed to handle problems of the current magnitude. Various non-profit organizations offer referrals and anti-foreclosure counseling programs. NeighborWorks America operates a hotline that will link callers to counselors who can evaluate the household's financial strength, look into available resources, and sometimes negotiate with lenders. This counseling is very specialized and time intensive. United Way chapters have also "211" hotlines that can provide referrals to various social services organizations, including housing assistance programs.

In addition, some subprime borrowers may have the opportunity to transition from a subprime loan into a better product before their interest rates reset. Although subprime loans are generally regarded as loans to individuals with weak credit histories, Boston Fed researchers found that a significant fraction of the Middlesex county borrowers had respectable FICO scores. We do not know why. They may have a subprime loan because of other characteristics of the mortgage, perhaps a high loan- to-value ratio, or they may have been misplaced and received a more costly mortgage than their qualifications justified, or they may simply have gone to a subprime lender because it seemed easy to do so. In any event, these borrowers might – by shopping around – be able to refinance into another product.

As previously noted, "teaser" rates on many subprime loans are actually quite high – considerably above rates on prime loans. A borrower who has regularly met these teaser mortgage payments for over a year might be a promising candidate for a prime product. Certainly, they have demonstrated a capacity to make the payments.

Finally, some subprime borrowers have owned their homes long enough that even with the recent softening in house prices, they have accumulated sufficient equity to allow them to refinance into a lower cost loan.

The subprime market was predicated on borrowers being able to refinance. The softness in the housing market has made this more difficult. In addition, because of recent problems, many mortgage banks specializing in subprime loans have run into difficulty securing financing to continue their activities. Mortgage banks do not hold mortgages on their books for any length of time. In order to make new loans, they must continually sell off the loans they have just made. As delinquencies and foreclosures have risen, buyers for these mortgages have dwindled.

It is very important that responsible subprime lending continue. There may also be opportunities for banks and thrift institutions, which have lost market share to mortgage banks, to play a role in helping borrowers refinance. Eric Rosengren, President of the Federal Reserve Bank of Boston, has been meeting with bankers in New England to explore the possibilities for commercial banks to play a more active role in providing liquidity to this market. Most commercial and savings banks were not involved in originating subprime mortgages to a significant degree. They are well capitalized and at least some banks seem willing to consider whether there might be opportunities for them in this situation. Subprime borrowers who have reasonably high credit scores, who have accumulated equity in their homes, and who have track records of regular mortgage payments may be candidates for re-financing with banks. But the time to act is now.

The Federal Reserve Bank of Boston is creating a web site to help subprime borrowers locate useful resources, and we are trying to publicize the importance of borrowers considering all the options available to them before they run into difficulty. We hope to work with financial institutions, community groups, government officials and lawmakers, and other regulators to help address a very difficult situation. Chairman Bernanke has previously testified on the actions being taken by the Board of Governors and the Federal Reserve System.