Stark Differences: Explosion of the Subprime Industry and Racial Hypersegmentation in Home Equity Lending

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In recent years there has been a large increase in the number of mortgage loans made by lenders specializing in lending to borrowers with imperfect credit histories, especially in the home equity loan market.[1] Most “subprime” lenders are mortgage or finance companies, but they can also be thrifts or even banks. Some of the largest subprime lenders are affiliates of banks. Subprime firms typically charge borrowers higher fees and interest rates than “prime” lenders, which include most banks and thrifts as well as many mortgage companies.[2]

The increased presence of subprime lenders has been especially pronounced in minority and lower income neighborhoods. This article will illustrate these trends and the disparities in the geographic distribution of home equity loans made by subprime versus prime lenders. The results indicate a strong degree of segmentation by race, in particular by race of neighborhood.

Why do we care about the growth and geography of subprime lending and, in particular, of subprime lenders? There are at least four reasons. First, we may welcome increased lending to homeowners with imperfect credit if it results in improved access to credit without imposing substantial negative costs on those borrowers or negative spillover effects (“externalities” in economics jargon) in their neighborhoods or communities.

Second, if the market for home equity loans is excessively segmented by race so that minority communities are served primarily by subprime lenders, homeowners in such communities may be effectively steered toward higher cost products, some of which contain more restrictive terms. If minority communities are targets of higher cost lenders and receive little attention from lower cost lenders, the odds of minority borrowers with good credit receiving a higher cost loan will be higher than that of White borrowers with good credit. Various data sources indicate that a substantial

portion of subprime loans are priced in excess of what is merited by the risk involved.[3] To the extent that subprime loans are disproportionately concentrated in minority communities, this excessive pricing will have a disparate impact on such groups.

Third, there is increasing evidence that the growth of subprime lending has been associated with a simultaneous rise in foreclosures and that subprime loans lead to delinquency and foreclosure at relatively high rates, especially among the higher risk segment of the industry. Data from an industry survey of 27 larger subprime lenders indicate that 90-day delinquency rates for C- and D-grade loans are 10 percent and 22 percent, respectively, compared with a rate of 0.25 percent for prime refinance loans (Phillips-Patrick et al., 2000). Even Federal Housing Administration (FHA) loans, which have been persistently tied to foreclosure and blight problems in minority communities (see Bradford, 1998), have 90-day delinquency rates of less than 2 percent for refinance loans (4.2 percent for home purchase loans). The foreclosure rate for all subprime loans in this sample (including the 55 percent that are A minus grade) is more than four times the FHA rate. The foreclosure rate for C and D loans is expected to be much higher. According to this voluntary survey, almost 20 percent of subprime loans are C and D grade. However, this survey appears to be biased towards substantially underestimating the percentage of all subprime loans that are lower grade.[4]

If subprime lending, especially the higher risk segments known as B, C, or D lending, is highly concentrated in certain types of neighborhoods, these neighborhoods will bear a disproportionate share of the foreclosures. Moreover, if the subprime lenders exhibiting the highest foreclosure rates are concentrated in certain areas, these areas will be especially hit hard. The nature of residential sorting and the experience with the FHA program suggests that a lender may have a substantial but not exorbitant foreclosure rate nationally, but have an exorbitant foreclosure rate in certain neighborhoods. Foreclosures, particularly those leading to abandonment and blight, can have negative spillover effects or externalities that can be a key source of market failure. Lenders may be able to tolerate foreclosure rates of 5 percent nationally and still successfully raise capital but have foreclosure rates of more than 10 to 15 percent in specific communities. Because the negative social costs of these spatially concentrated foreclosures (abandonment, blight, crime, and lower neighborhood property values) are not captured in the market transaction, the level of credit will be excessive even from an efficiency perspective. It is important to add that foreclosures

in struggling, low- or moderate-income, and minority neighborhoods may have more negative impacts than those in middle- and upper-income areas. In the latter case, the foreclosures are less likely to lead to abandoned buildings, blight, and crime.

At least three recent studies have explored the link between subprime lending and foreclosures (HUD, 2000; Gruenstein and Herbert, 2000; National Training and Information Center, 1999). In Baltimore, a U.S. Department of Housing and Urban Development (HUD) study indicated that, Although the subprime share of mortgages in Baltimore City was 21 percent in 1998 (presumably higher than in previous years), 45 percent of foreclosure petitions in that year were tied to subprime loans. In Atlanta, an Abt Associates study found that foreclosures attributed to subprime lenders accounted for 36 percent of all foreclosures in predominantly minority neighborhoods in 1999, while their share of loan originations was between 26 and 31 percent in the preceding 3 years. (It is important to point out that in the Atlanta study substantial portions of foreclosures were not attributed to subprime lenders because the data indicated only the company holding the loan at time of foreclosure, and many subprime loans are sold to financial institutions identified by HUD as “prime.”) In the Chicago area, foreclosures on loans with interest rates above comparable Treasury rates plus 400 basis points increased by 500 percent from 1993 to 1998. Many of these foreclosures were concentrated in minority neighborhoods.

The fourth concern over the growth and distribution of subprime lending is the rise of abusive or predatory lending that has been associated with the subprime industry. Although the debate continues over the precise definition of predatory lending, examples of such practices include: fraudulent, high-pressure, or misleading marketing; the “packing” and financing of unnecessary fees; “flipping” or overly frequent refinancing with repeated fees being rolled into the loan; and various loan terms designed to trap borrowers into high-cost loans or compel repeated high-cost refinancings. Predatory lending behavior is typically found among loans made by subprime firms. Although the exact proportion of loans from subprime lenders that contain abusive practices remains unclear, it is rare to find a case of a predatory lending that does not involve a subprime lender. Some evidence suggests the proportion of subprime loans with at least one problematic feature may be very large. For example, at least 70 percent of subprime loans contain prepayment penalties, which are often viewed as abusive when tied to high-cost loans.[5]

Predatory lending practices often leave homeowners with substantial debt that they are unwise to take on or cannot afford. Documented cases of abuse include fees exceeding 10 percent of the loan amount, payments structured so that they do not even cover interest, the flipping of a loan numerous times within a couple of years, and many others.[6] There is a link between concerns over foreclosures and predatory lending. Subprime lending, even if the loans do not contain abusive terms, can lead to excessive foreclosure rates simply due to the spatial concentration of high-risk lending. However, predatory lending practices, especially those that inflate debt burdens or trap borrowers into high-cost loans, can be expected to exacerbate foreclosure problems.

Most major subprime lenders active in minority neighborhoods have been implicated in at least some instances of abusive lending.[7] However, there is a role for responsible and affordable subprime lending. Such lending can enable homeowners who have experienced some credit difficulties to lower monthly debt payments, finance repairs to their home, or reduce mortgage payments in times of falling interest rates without unreasonable expenses or significant reductions in their home equity. Affordable subprime home purchase lending can also provide homeownership opportunities to some families who are ready for homeownership but unable to qualify for a prime loan. It is important to distinguish subprime home purchase lending from subprime home equity lending. Because home equity borrowers have much more equity in their home than homebuyers, there is much more opportunity for excessive fees to be financed into the loan.

One necessary but not sufficient requirement of responsible subprime lending is that any premium in costs over that of a prime loan is justified by increased lender risk. Some argue that risk-based pricing, such as that being implemented by the government-sponsored enterprises Freddie Mac and Fannie Mae, provides a tool to bring down the costs of subprime lending to a more responsible and affordable price (Mahoney, 1999). Under appropriate risk-based schemes, for example, loans with lower loan-to-value ratios (other things being equal) are made at lower rates.[8] At the same time, it is important to acknowledge that even these risk-based schemes can mechanize and legitimate differentials in the cost of credit that derive from inequities and discrimination in mortgage and other markets (Carr, 1999). For example, families with relatively good credit before receiving an excessively priced loan may see their credit worsen due to the inability to pay the mortgage. When they then turn to a risk-based lender, they will be offered a higher-than-average rate. Also, lower income and

minority residents are more likely than others to have received little education in financial matters, suffered instability in employment, and incurred uninsured medical expenses, which increase their vulnerability to economic change. Notwithstanding the inequities inherent in risk-based pricing, it may allow some lenders to offer *relatively* lower cost financing to subprime borrowers than is currently being provided.

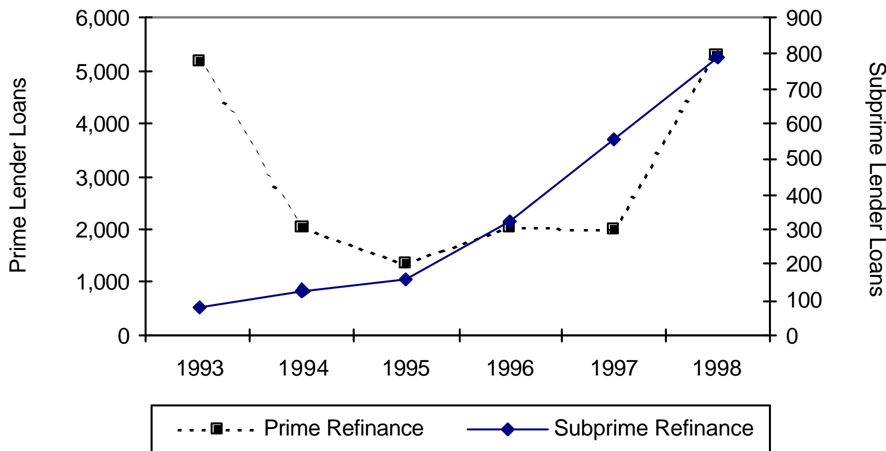
Rise of the Specialized Subprime Lending Industry

Figure 1 describes the national increase in refinance lending by prime and subprime lenders in the United States. from 1993 to 1998. Refinance loans by subprime lenders increased by 890 percent, even though refinances by prime lenders grew by only 2.5 percent. The years 1993 and 1998 are appropriate for comparing refinance trends because both were peak refinancing periods due to declining interest rates.[9] Refinance and home equity loans account for the most growth among subprime lenders. The 1993 to 1998 increase of more than 700,000 subprime refinance loans was almost four times the increase in subprime home purchase loans.

As figure 1 shows, prime refinancings peaked in 1993 and 1998 due to low interest rates. Subprime refinancings grew steadily from 1993 to 1997 to approximately 27 percent of the refinance market. Although still growing significantly in 1998, subprime refinances did not keep pace with the explosion of prime refinances in 1998, so that their share of conventional refinances dropped to 15 percent in 1998.

Although rising interest rates in 1994, 1995, and 1997 dampened prime refinance levels, subprime lenders continued to increase their refinance activity. This suggests that subprime refinancings are not driven by homeowners refinancing to save money during times of declining rates and that subprime lenders are aggressively marketing loans regardless of the rate environment.

Figure 1. Increases in Refinance Lending by Prime and Subprime Lenders, 1993–1998



Source: Scheessele, R. 1999. 1998 HMDA Highlights. Washington, DC: U.S. Department of Housing and Urban Development.

The explanation for why subprime lending grew so much in the 1990s involves multiple events and trends. In part, the growth of subprime activity stems directly from the development of an increasingly specialized and segmented mortgage market, especially for refinance and home equity loans. In this segregated system, higher income homeowners are the main target of banks, thrifts, and many prime mortgage companies, which are frequently owned by bank holding companies. For banks, these homeowners represent the possibility to cross-sell account and investment products that increase bank earnings. At the same time, mortgage lending for less affluent homeowners is not seen as part of a larger relationship. Thus, mortgage lending to lower income and minority communities is often viewed as an isolated line of business in which the focus is short-term transactions and associated fees. This dual finance system has fed the rise of subprime firms. Independent and even bank-owned mortgage and finance companies are able to make relatively higher risk loans in part because they are subject to less regulation. This two-tiered regulatory system may also help explain the appearance of more abuse in the subprime sector. Although banks and thrifts are subject to the Community Reinvestment Act, fair lending, and consumer compliance regulation implemented by thousands of examiners in the four Federal bank regulatory agencies, mortgage and finance companies undergo no

regular examinations by Federal regulators, and State regulators are much less well staffed than Federal bank regulators. The Federal Trade Commission and a few other Federal agencies have some minimal resources to address nondepository lenders, but the States are the principal source of regulatory oversight, to the extent that it exists at all.

The rise in subprime lending has been made possible by a set of demand-and-supply factors, with some of the increases in supply factors feeding back to stimulate demand. One factor is the substantial rise in the number of lower income and minority homeowners since the early 1990s. Many of these new homeowners are relatively unsophisticated in financial matters and have never before owned an asset that can be used as collateral for a substantial loan. There has also been growth in the elderly population, including some who are relatively isolated and unfamiliar with recent trends in residential finance. The elderly in minority neighborhoods may be particularly isolated. Health bills are a major determinant of credit problems and bankruptcy, spurring demand for debt by homeowners in desperate situations. This problem of health bills has also been aggravated by high numbers of uninsured families.

Supply factors have also been important. Subprime firms have been fueled by the growth of the mortgage- and asset-backed securities industry that funds high-risk mortgage lending operations. From 1994 to 1998, the issuance of asset-backed securities (ABS) for home-equity loans increased from approximately $10 billion to more than $80 billion. By 1997, home equity ABS had replaced credit card-backed securities as the leading type of issuance (Bond Market Association, 1999). Much of the lending funded by these securities is subprime in nature (Canner et al., 1998).

Subprime credit markets build on each other. Aggressive marketing and lax underwriting of subprime credit cards can result in heavy debt loads, credit history problems, and increased bankruptcies. This, in turn, helps build demand for subprime refinance loans, which are often used to pay off such debt. Federal Reserve figures show that outstanding nonmortgage consumer debt increased from $840 billion in 1993 to $1.3 trillion in 1998. Over the same period, personal bankruptcies rose by more than 70 percent to almost 1.4 million filings.

Advances in information technology have enabled banks and prime mortgage lenders to mine sophisticated databases to identify higher income segments of the market,

which has increased market segmentation. This plays out by race and geography, especially for banks, who continue to expand branch operations in White, affluent neighborhoods (Avery et al., 1997). As banks and prime mortgage firms compete furiously for more affluent customers, they leave the minority and lower income neighborhoods ripe for penetration by subprime lenders. And because the marketing and sales efforts of prime lenders are often tied to branch locations and mail solicitations, segmentation takes on a particularly geographic nature.

Finally, the 1986 tax reform act encouraged American households to use home equity as a source of debt (Forrester, 1994). The act fueled demand for home equity and refinance lending due to favorable tax treatment of interest paid under such loans. Although this benefit is greater for higher rather than lower income homeowners, some suggest that subprime lenders frequently use purported tax benefits as part of their sales pitch even in marketing to low-income homeowners.[10]

Racial Hypersegmentation of Home Equity Lending

To examine the patterns of mortgage finance across different types of communities, Home Mortgage Disclosure Act (HMDA) data from 1993 and 1998 was analyzed. Differences in 1998 refinance lending by neighborhood income and race are described first.[11] This product accounted for the largest portion of subprime activity and is captured relatively well in the HMDA data.

HUD has identified lenders specializing in subprime loans.[12] This identification does not mean that lenders categorized as “prime” do not make subprime loans. However, such lenders do not specialize in subprime lending; they offer prime loans as their major products. Identifying prime and subprime lenders is useful because a principal goal is to explore the segmentation of lending by type of lender. Finally, inclusion of some subprime units’ lending in the HMDA data of prime lenders works to understate the level of segmentation.

Table 1 describes the distribution by neighborhood income of conventional (not government guaranteed) refinance loans across the almost 1,800 census tracts in the 6-county Chicago area.[13] These loans are broken down between those made by prime or subprime lenders.[14] Because of significant changes in many neighborhoods over the 8 years since the 1990 census, commercial estimates were obtained for classifying tracts by demographic characteristics.[15] Subprime lenders’ share of conventional

refinancing increased from 9 percent in upper income neighborhoods to 46 percent in low-income tracts.

Table 1. Geographic Distribution of Refinancing Loans by Income of Neighborhood in Chicago Area, 1998

Income of Neighborhood	**Loan and Lender Type**		
	Conventional		**Subprime/ Conventional (%)**
	Prime	**Subprime**	
Low (less than 50% of MSA median)	5,427	4,647	46.13
Moderate (50–79% MSA median)	17,576	7,657	30.35
Middle (80–119% MSA median)	76,590	13,924	15.38
Upper (120% or above MSA median)	97,172	9,576	8.97
All conventional loans	196,773	35,805	15.39

MSA, metropolitan statistical area.

Table 2 provides a similar analysis of refinance loans by race of neighborhood rather than income.[16] Census tracts are categorized into four categories, including predominantly White (85 percent or greater non-Hispanic White), mixed-majority (50 to 84 percent non-Hispanic White), mixed-minority (greater than 50 percent minority but less than 75 percent African-American), and predominantly African-American (75 percent or greater African-American).

Table 2. Geographic Distribution of Refinancing Loans by Race of Neighborhood in Chicago Area, 1998

Race/Ethnicity of Neighborhood	Loan and Lender Type		
	Conventional		Subprime/ Conventional (%)
	Prime	Subprime	
Predominantly African-American	6,596	9,220	58.30
Mixed-minority	15,465	5,250	25.34
Mixed-majority	58,356	8,578	12.82
Predominantly White	116,348	12,756	9.88
All conventional loans	196,773	35,805	15.39

When breaking out neighborhoods by racial composition, the segmentation is stronger than by income. Table 2 shows that, in predominantly African-American neighborhoods, subprime lenders account for 58 percent of conventional refinance loans, compared with less than 10 percent in predominantly White tracts. Mixed-minority, and to a lesser degree, mixed-majority tracts also have substantially higher ratios of subprime to total refinance lending than White neighborhoods. Not shown here are figures indicating that this segmentation is considerably stronger than in the home purchase market (see Immergluck and Wiles, 1999).

Mortgage lending patterns are driven in large part by the marketing and application patterns of different lenders. Table 3 shows that subprime lenders account for 74 percent of conventional refinance applications in African-American neighborhoods, compared with only 20 percent in predominantly White areas. They also comprise almost one-half of applications in mixed-majority neighborhoods. Thus, subprime lenders dominate in marketing (at least in *effective* marketing) to minority neighborhoods.

Table 3. Geographic Distribution of Refinancing Applications by Race of Neighborhood in Chicago Area, 1998

Race/Ethnicity of Neighborhood	**Loan and Lender Type**		
	Conventional		**Subprime/ Conventional (%)**
	Prime	**Subprime**	
Predominantly African-American	12,223	34,820	74.02
Mixed-minority	22,145	19,952	47.40
Mixed-majority	72,745	31,380	30.14
Predominantly White	136,851	37,255	21.40
All conventional loans	243,983	123,413	33.59

Segmentation by Race Versus Income

Because low-income and high minority populations are correlated, tables 1–3 do not clearly show whether subprime lenders are more concentrated by neighborhood income or by neighborhood race. To partly control for differences in income, we can compare middle-income neighborhoods that are predominantly White to those that are predominantly African-American.

Table 4 compares refinance activity among middle-income neighborhoods only, thus partly controlling for the effect of neighborhood income on refinancing patterns. Even in the 40 middle-income African-American neighborhoods, subprime lenders still make more conventional refinancing loans than prime lenders.

Table 4. Geographic Distribution of Conventional Refinancing Loans by Race Among Middle-Income Neighborhoods in Chicago Area, 1998

Race/Ethnicity of Middle-Income Tract	No. Tracts	Loan and Lender Type		
		Conventional		Subprime/ Conventional (%)
		Prime	Subprime	
Predominantly African-American	40	1,833	2,090	53.28
Mixed-minority	64	3,947	1,448	26.84
Mixed-majority	236	30,325	4,849	13.79
Predominantly White	227	40,485	5,537	12.03

The subprime lenders' share of conventional loans increases from 12 percent in predominantly White, middle-income tracts to 53 percent in the predominantly African-American tracts, resulting in a differential of 41 percentage points, not much less than the 48-point differential when comparing African-American and White neighborhoods of all income levels.

Growth of Subprime Activity in Minority Neighborhoods

As shown in figure 1, refinance lending by subprime firms dramatically increased from 1993 to 1998 in the United States. Table 5 details increases in the Chicago area by race of neighborhood. Overall, the percentage increase in subprime lending was lower in the Chicago area than for the Nation as a whole. This difference is due in large part to the fact that Household Bank, FSB, one of the earliest large subprime mortgage lenders, already had a major foothold in the local market in 1993. In fact, Household accounted for 58 percent of all refinance loans by subprime lenders in the Chicago area during 1993. Only 14 subprime lenders made conventional refinance loans in the Chicago area that year.

Table 5 also shows that subprime refinance lending was not nearly as segmented by race in 1993 as it was by 1998. Subprime lenders accounted for slightly more than 8 percent of refinance loans in predominantly African-American neighborhoods in 1993, less than double the 4.3 percent share in predominantly White neighborhoods. (The figures for 1998, shown in table 2, were 58.3 percent in African-American neighborhoods and 9.9 percent in White neighborhoods.)

Table 5. Increases in Prime and Subprime Refinance Loans by Race of Neighborhood in Chicago Area, 1993–1998

Race/Ethnicity of Neighborhood	Loan and Lender Type				
	1993			1993–98	
	Conventional		Subprime/ Conventional (%)	Increase in Subprime	Increase (%)
	Prime	Subprime			
Predominantly African-American	3,473	310	8.19	8,910	2,874
Mixed-minority	12,862	683	5.04	4,567	669
Mixed-majority	60,796	3,307	5.16	5,271	159
Predominantly White	121,556	5,414	4.26	7,342	136
All loans	198,717	9,714	4.66	26,091	269

Refinance loans by subprime lenders increased almost 30 times in African-American neighborhoods, while increasing by less than 2.5 times in White tracts. Although accounting for less than 2 percent of all conventional refinance loans in 1993, predominantly African-American neighborhoods accounted for 34 percent of the increase in subprime refinance loans between 1993 and 1998. When adding in mixed-minority tracts, neighborhoods with greater than 50 percent minority populations accounted for 52 percent of the increase in subprime refinance loans, despite accounting for only 8 percent of all refinance loans in 1993.

Lender Analysis

To better understand the differences between refinance lending in White and African-American neighborhoods, it is helpful to examine the specific lenders active in the different communities. To understand where different lenders market, loan applications in predominantly White and predominantly African-American neighborhoods were analyzed and then origination activity was considered.

Table 6 lists the 20 refinance lenders that took the most applications in predominantly White neighborhoods in the Chicago metropolitan area in 1998. Table 7 provides similar data for lenders taking the most applications in predominantly African-American neighborhoods. These tables also indicate the share of all refinance

Table 6. Lenders With the Most Refinance Applications in Predominantly White Neighborhoods in the Chicago Area, 1998 (subprime lenders shown in bold)

Lender	No. Applications in White Tracts	Applications in White Tracts (%)	Applications in African-American Tracts (%)	African-American–White Tract Disparity
First Chicago NBD Mortgage Co.	7,602	4.37	1.13	0.26
Norwest Mortgage	7,225	4.15	0.34	0.08
Countrywide Home Loans	5,833	3.35	1.88	0.56
Chase Manhattan Mortgage Corp[a]	5,504	3.16	0.74	0.23
Harris Trust And Savings Bank	4,776	2.74	0.24	0.09
Washington Mutual Bank	4,118	2.37	0.45	0.19
LaSalle Bank FSB	3,694	2.12	0.97	0.46
Ameriquest Mortgage Company	3,622	2.08	5.68	2.73
Mid America FSB	3,505	2.01	0.05	0.02
Citibank	2,917	1.68	1.15	0.69
The Money Store	2,790	1.60	7.94	4.95
Standard Federal Bank	2,765	1.59	0.16	0.10
Old Kent Mortgage Company	2,667	1.53	0.40	0.26
Bank Of America	2,504	1.44	0.17	0.12
North American Mortgage Company	2,407	1.38	0.46	0.33
Fleet Mortgage Corporation	2,292	1.32	0.22	0.17
Ohio Savings Bank	2,229	1.28	0.12	0.09
Fidelity Mortgage Inc.	2,177	1.25	0.91	0.73
Firstar Home Mortgage Corp.	1,986	1.14	0.07	0.06
Bank One	1,985	1.14	1.42	1.24

[a] *HUD did not include Chase Manhattan Mortgage Corporation on its 1998 list of subprime lenders in 1998 HMDA Highlights, but did include it in the appendix as one of a few "prime" lenders that do substantial amounts of subprime lending and have resulting high denial rates. Based on conversations with HUD staff and after examining the firm's denial rates and volume of refinancing in the Chicago market, the company was included as a subprime lender. However, some trade publications do not describe the company as a subprime lender. Inclusion of Chase Mortgage as subprime does not materially affect any of the results in this study and, in fact, biases the analysis toward showing less segmentation by race and income when looking at prime versus subprime lenders. Thus, the classification as subprime may result in a small understatement of the problem.*

Table 7. Lenders With the Most Refinance Applications in Predominantly African-American Neighborhoods in the Chicago Area, 1998 (subprime lenders shown in bold)

Lender	No. Applications in African-American Tracts	Applications in African-American Tracts (%)	Applications in White Tracts (%)	African-American–White Tract Disparity
The Money Store	3,733	7.94	1.60	4.96
Ameriquest Mortgage Company	2,674	5.68	2.08	2.73
Equicredit Corp of America	1,501	3.19	0.25	12.76
Advanta National Bank	1,462	3.11	0.70	4.44
New Century Mortgage Corp.	1,196	2.54	0.85	2.99
WMC Mortgage Corp.	1,132	2.41	0.54	4.46
Option One Mortgage Corporation	1,075	2.29	0.39	5.86
IMC Mortgage Company	952	2.02	0.31	6.53
Parkway Mortgage	935	1.99	0.21	9.46
Countrywide Home Loans	885	1.88	3.35	0.56
Pan American Financial Service	881	1.87	0.04	46.82
Superior Bank	857	1.82	0.29	6.28
BNC Mortgage	840	1.79	0.33	5.41
Pinnfund	834	1.77	0.10	17.73
First Franklin Financial Corp.	832	1.77	0.86	2.06
Banc One Financial Services	814	1.73	1.08	1.60
Delta Funding Corporation	753	1.60	0.08	20.01
Mortgage Lenders Network USA	741	1.58	0.20	7.88
Corewest Banc	674	1.43	0.28	5.12
Bank One	666	1.42	1.14	1.24

applications that each lender took in predominantly White tracts as well as in predominantly African-American tracts. Finally, an African-American-to-White neighborhood disparity ratio is calculated. This ratio is equal to the lender's share of refinance applications in predominantly African-American tracts divided by its share of refinance applications in predominantly White census tracts.

If a lender has an equal marketing presence in both White and African-American neighborhoods, then the African-American-White disparity ratio is expected to equal 1.0. A disparity ratio above 1.0 means that a lender is more focused on marketing to African-American neighborhoods than to White areas. A ratio below 1.0 means that a lender markets more heavily in White neighborhoods.

Immediately apparent from table 6 is the fact that, of the 20 lenders receiving the most applications in predominantly White tracts, 17 are prime lenders, including banks and thrifts, bank-owned mortgage companies, and a few independent mortgage companies. In African-American tracts, table 7 shows that the composition of the lenders receiving the most applications is almost precisely the opposite, with 18 of the top 20 being subprime.

Of the 17 prime lenders taking the most applications in White neighborhoods, only two, Countrywide Home Loans and Bank One, were among the top 20 marketers to African-American neighborhoods. Fourteen of these 17 have a share of applications in African-American neighborhoods that is less than one-half their share in White neighborhoods. Ten of the 17 have a share of refinance applications in African-American tracts less than one-fourth their share in White tracts. One prime lender, Mid America FSB, took more than 5,300 refinance applications in the 6-county area but took only 25 in African-American tracts.

Of the top 20 refinance marketers in African-American neighborhoods, all but one have a substantially higher share of refinance applications in African-American tracts than in White tracts. All 18 of the subprime lenders in this list have a higher share of refinance applications in African-American neighborhoods than in White neighborhoods, with 14 having African-American/White tract disparity ratios exceeding 4:1. For 4 of the lenders, their marketing presence to African-American neighborhoods is more than 10 times their presence in White neighborhoods. One lender, Pan American Financial Services, took 881 refinance applications in African-American neighborhoods but only 67 in White tracts.

Conclusion

The home equity lending market is profoundly segmented by race. African-American homeowners are the recipients of intense marketing by subprime lenders, whereas

prime lenders appear to avoid minority and especially African-American neighborhoods. The fact that residents of middle-income African-American neighborhoods are almost four-and-a-half times as likely to receive subprime loans as residents of middle-income White neighborhoods, combined with evidence of overpricing in the subprime market, gives ample reason to be concerned that many minorities may be paying substantially more for credit than they should.

In addition, combining what we know about the much higher delinquency and foreclosure rates of subprime loans with the evidence of increasing subprime foreclosures in minority neighborhoods, suggests that the dual mortgage market described in this article has clear public costs for neighborhoods and communities. Finally, the presence of unscrupulous lending practices among many leading subprime lenders suggests that predatory lending, like subprime lending overall, is disproportionately affecting minority communities—those least able to afford the costs of such abuse.

Acknowledgments

Marti Wiles provided research assistance for this article. Malcolm Bush provided helpful comments.

Endnotes

[1] By home equity loans, both refinance and second mortgages are meant.

[2] Some prime lenders make subprime loans, but they do not specialize in subprime lending. Prime loans are their major products.

[3] Estimates include those of the Office of Thrift Supervision study cited in note 4, which suggests that almost 29 percent of subprime loans have credit scores above 640, and of Freddie Mac (1996), which concludes that 10 to 35 percent of subprime loans were A minus grade that could have been made at lower cost. Neither of these estimates takes into account the above risk-based pricing of higher risk loans, for example, those C-grade loans priced at D-grade rates.

[4] Phillips-Patrick et al. (2000) argue that the data they use (from the Mortgage Information Corporation) are likely to, "exclude much of the bottom end of the subprime market, including high credit-risk loans."

[5] Mortgage Information Corporation data cited in the Report of the Joint Predatory Lending Task Force of the U.S. Department of Housing and Urban Development and the Department of the Treasury, June 2000, p. 93. Although anecdotal evidence suggests that prepayment penalties are on the rise among prime loans, evidence from Fannie Mae and Freddie Mac suggests that fewer than 2 percent of prime loans have such penalties.
[6] For descriptions of actual predatory loans and their victims, see Senate Special Committee on Aging (1998) Also see Goldstein (1999); The Coalition for Responsible Lending, "The Case Against Predatory Lending and the National Training and Information Center" (1999).

[7] For example, each of the 10 subprime lenders taking the most applications in African-American census tracts in the Chicago area (see table 7) have been involved in at least one abusive lending case handled by the Legal Assistance Foundation of Metropolitan Chicago in recent years. Conversation with Ira Rheingold, Legal Assistance Foundation of Metropolitan Chicago, September 5, 2000.

[8] Of course, the debate on what is an appropriate risk-based pricing model is a complex one and beyond the scope of this article. Questions of disparate impact discrimination arise, and arguments over what is a business necessity to justify such impacts can become quite subjective.

[9] There may have been some substitution from subprime second mortgages to subprime refinances in the early 1990s due to the decline in interest rates. Refinances become more attractive in lower interest rate environments.

[10] Conversation with Gary Klein, National Consumer Law Center, November 1, 1999.

[11] Original junior mortgages not used for home improvement are not reported under HMDA. In addition, lenders for whom home purchase and refinance of home purchase loans amount to less than 10 percent of all loans do not have to report to HMDA.

[12] For a detailed explanation of HUD's methodology and its complete list of subprime lenders, see Scheessele, *1998 HMDA Highlights*. Also, based on HUD's notes in the report, we looked at several specialized lenders highlighted by HUD but not included by them in their subprime or manufactured home lists. Following HUD's methodology, we identified whether these lenders had high denial rates and heavy refinance activity in the Chicago area market. If so, we classified some of these lenders as subprime or manufactured home lenders. These include Indymac, Inc.; Indymac Mortgage Holdings; Residential Funding Corp.; and Chase Manhattan Mortgage Corporation (all classified as subprime). We also classified Chase Manhattan Bank as

a manufactured home lender per HUD's methodology. Also Headlands Mortgage Company was reclassified as prime based on advice from HUD.

[13] In all cases in this study, conventional home loans and applications of manufactured home lenders are excluded. Their products are unique and their denial and marketing experiences are not consistent with other lenders. In the Chicago 6-county area in 1998, the 22 home manufactured home lenders identified by HUD accounted for less than 0.3 percent of conventional refinance loans. Also excluded are applications without census tract identification, which amount to fewer than 2 percent of all applications.

[14] More than 630 prime and 100 subprime lenders made conventional refinance loans in the 6-county Chicago area in 1998. More than 240 prime lenders made more than 50 loans, and more than 70 subprime firms made more than 50 loans in the region.

[15] Claritas, Inc.'s 1998 estimates are used rather than actual 1990 census data. Estimates for individual tracts are suspected to suffer from some error. However, tests by Claritas of its 1998 estimates against 1990 census data suggest that using estimates is more accurate than using the old, 1980 data. Moreover, the large aggregations used in this report are expected to reduce random error substantially.

[16] Although the focus here is on neighborhoods, analysis by race of loan applicant is conceptually feasible with HMDA data. However, 37 percent of conventional subprime refinance loans had no racial information reported, compared with only 10 percent for prime lenders. Some large subprime lenders do not report race on most loans. Thus, in heavily segregated areas such as Chicago, the analysis by race of neighborhood may provide a better indicator of race of applicant (at least for African-American versus White) than the racial data in HMDA.

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