Unequal Burden In Los Angeles:

Income and Racial Disparities in Subprime Lending

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INCOME AND RACIAL DISPARITIES IN SUBPRIME LENDING

This study presents a preliminary analysis of mortgage originations in the Los Angeles metropolitan area in 1998 using data reported under the Home Mortgage Disclosure Act (HMDA). Nationwide, the HMDA data demonstrate the rapid growth of subprime refinance lending during the 1990s and further, the disproportionate concentration of such lending in the nation's low-income and minority neighborhoods.[1] These same conclusions hold in the Los Angeles metropolitan area.

The growth in subprime lending over the last several years has been a beneficial development for borrowers with impaired or limited credit histories. Subprime lenders have allowed such borrowers to access credit that they could not otherwise obtain in the prime credit market. However, there is a growing body of anecdotal evidence that a subset of these subprime lenders, who generally operate outside the federal regulatory structure, engage in abusive lending practices that strip borrowers' home equity and place them at increased risk of foreclosure. For this reason, this report examines patterns in subprime lending to understand where the risk and impact of predatory practices may be highest.

AN OVERVIEW

Ellen Seidman, Director of the Office of Thrift Supervision, recently echoed the sentiments of many banking regulators at an Interagency Conference on the Community Reinvestment Act (CRA) in San Francisco when she stated that, "Many of those served by the sub-prime market are creditworthy borrowers who are simply stuck with sub-prime loans or sub-prime lenders because they live in neighborhoods that have too few credit or banking opportunities. More than 20 years after CRA was enacted, we still have communities that are not adequately served by insured depository institutions." Furthermore, she noted that retailers are rediscovering inner-city neighborhoods like Harlem and South Central Los Angeles but that potential banking customers in these neighborhoods are often left to finance companies and check cashers for financial services.[2]

HUD's analysis of lending in Los Angeles indicates that inner-city black and low-income neighborhoods, concentrated in or around the South Central Los Angeles area,

[1] See the HUD report Unequal Burden: Income and Racial Disparities in Subprime Lending in America, April 2000. For a similar analysis of the Atlanta metropolitan area, see the HUD report, Unequal Burden in Atlanta: Income and Racial Disparities in Subprime Lending, April 2000.

[2] "Puzzling Through: Approaching Alternative Credit Responsibility." Remarks by Ellen Seidman. Director of the Office of Thrift Supervision Interagency Conference on CRA. San Francisco, April 17, 2000.

disproportionately rely upon subprime lenders, especially with respect to refinance credit markets.[3]

Subprime lending is not necessarily a bad thing. By providing loans to borrowers who do not meet the credit standards for borrowers in the prime market, subprime lending can and does serve a critical role in urban areas such as Los Angeles. Some borrowers may have blemishes in their credit record, insufficient credit history, or non-traditional credit sources. The subprime loan market offers these borrowers opportunities to obtain loans that they would be unable to realize in the prime loan market.

But there are two sides to this story. Since subprime lending often operates outside of the federal regulatory structure, it may be a fertile ground for predatory lending activities. Anecdotal evidence suggests that these practices may include imposing and financing excessive fees, bundling high-cost loans with lump-sum credit life insurance, and requiring prepayment penalties. Predatory lending can have disastrous consequences for less financially savvy borrowers. Equity may be stripped from their homes, and in more egregious cases, they may lose their homes altogether.

Some prime lenders have made significant progress in reaching underserved communities. A recent report for the Treasury Department showed that banks and thrifts increased the share of their mortgage originations to low-income borrowers and borrowers in low-income communities from 25 percent in 1993 to 28 percent in 1998.[4] However, as the evidence in this report suggests, there are many Los Angeles neighborhoods that could benefit from increased competition from lenders in the home refinancing market. Such increased competition would give borrowers in these communities alternative options to lenders that may engage in abusive lending practices.

The first step to ensuring that subprime lending enhances the economic health of the borrowers' families without exposing them to predatory practices is to learn more about how and where it operates in America. To further understand geographic disparities, HUD has analyzed the problem nationwide and has now taken a look at the data on subprime lending in Los Angeles.[5]

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[3] HUD identifies the South Central Los Angeles by the zipcodes delineated in "Rebuilding South Central Los Angeles: Myths, Realities, and Opportunities," by California State University, Los Angeles researchers, Tom Larson and Miles Finney. http://ideas.uqam.ca/ideas/data/Papers/wopcalsec_001.html.

[4] Robert E. Litan, Nicolas P. Retsinas, Eric S. Belsky, and Susan White Haag, The Community Reinvestment Act After Financial Modernization: A Baseline Report, U.S. Department of Treasury, April 2000.

[5] HUD identifies subprime loans in HMDA using a list of lenders that primarily originate subprime loans. For the list of lenders and a discussion of the methodology, see Randall M. Scheessele, 1998 HMDA Highlights, Housing Finance Working Paper No. 9, Office of Policy Development and Research, HUD, October 1999.

THE FINDINGS FOR LOS ANGELES

In general, the analysis shows that subprime lending is more prevalent in lower-income and minority neighborhoods than in higher-income and white neighborhoods. This likely indicates that because of their lower incomes, lenders may consider these borrowers to be a higher credit risk, and these borrowers may therefore be less likely to qualify for prime loans. However, a lack of competition from lenders in these markets to find creditworthy borrowers may increase the chances that borrowers are exposed to the predatory practices of a subset of subprime lenders. There is also evidence suggesting that after controlling for income, black borrowers and their neighborhoods may be comparatively underserved by prime lenders.

The importance of subprime lending to minorities and low-income Americans, which is documented in what follows, demonstrates how important it is to these communities that subprime lending not include any lenders engaging in predatory practices.

1. **From 1993 to 1998, the number of subprime refinance loans originated in Los Angeles increased by about 170 percent.** The number of refinance mortgages reported under HMDA by lenders specializing in subprime lending in the Los Angeles metropolitan area increased from 9,351 loans in 1993 to 25,384 loans in 1998.

2. **Subprime loans are two times more likely in low-income neighborhoods in Los Angeles than in upper-income neighborhoods.** In low-income neighborhoods, subprime loans accounted for 23 percent of all refinance loans originated during 1998 – compared with only 11 percent in upper-income neighborhoods.[6] In the poorest communities, where median family income is 50 percent or less of the area median income, subprime refinances accounted for 31 percent of all refinance loans.

3. **Subprime loans are almost four times more likely in black neighborhoods in Los Angeles than in white neighborhoods.** In predominantly black neighborhoods in Los Angeles, subprime lending accounted for 33 percent of home refinance loans originated during 1998 - compared with only 9 percent in predominantly white neighborhoods.[7]

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[6] The census tract income categories are as follows: low-income tracts have median incomes that are less than 80 percent of the metropolitan area median income (AMI); middle-income tracts, between 80 percent and 120 percent AMI, and upper-income tracts, greater than 120 percent AMI. These income categories are also used for analyses of borrower incomes relative to the area median income.

[7] This paper adopts the classification of tracts in the Woodstock Institute report, "Two Steps Back: The Dual Mortgage Market, Predatory Lending, and the Undoing of Community Development," Chicago, IL, November 1999. That is, predominantly white neighborhoods are tracts where the minority percentage is less than 15 percent; and predominantly black neighborhoods are tracts where blacks comprise at least 75

4. **Upper-income black borrowers throughout the Los Angeles metropolitan area are almost twice as likely as low-income white borrowers to refinance in the subprime market.** In 1998, only 10 percent of upper-income white mortgage borrowers in Los Angeles refinanced in the subprime market while 29 percent of upper-income black mortgage borrowers did so; this is almost double the 15 percent of low-income white borrowers who refinanced in the subprime market.

THE ANALYSIS

Subprime mortgage lending provides credit to borrowers with past credit problems, often at a higher cost or less favorable terms than loans available in the conventional prime market. In most cases, these lenders offer credit to borrowers who would not qualify for a loan in the prime market, thus expanding access to credit and helping more families to own their own homes. The higher costs of these loans may serve to offset the increased risk that these lenders assume in lending to these borrowers.[8]

In some cases, however, subprime lenders engage in abusive lending practices known as "predatory lending", which hits homeowners with excessive mortgage fees, interest rates, penalties and insurance charges that raise the cost of refinancing by thousands of dollars for individual families.

HUD's study of subprime lending focuses mainly on subprime refinance lending, which accounts for nearly 80 percent of total (home purchase and refinance loans combined) subprime mortgage lending nationwide and for 70 percent of subprime lending in Los Angeles.[9] HUD's study of subprime loans in the Los Angeles metropolitan area found that:

1. **From 1993 to 1998, the number of subprime refinance loans originated in Los Angeles increased by about 170 percent.**

The number of refinance mortgages reported under HMDA by lenders specializing in subprime lending in the Los Angeles metropolitan area increased from 9,351 loans in 1993 to 25,384 loans in 1998. (See Figure 1.)

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percent of the population. The racial composition of neighborhoods is based on 1990 census data; there may have been some changes in racial composition by 1998.

[8] However, there is evidence that the higher interest rates charged by subprime lenders cannot be fully explained solely as a function of the additional risks they bear. See Howard Lax, Michael Manti, Paul Raca, and Peter Zorn, "Subprime Lending: An Investigation of Economic Efficiency" (unpublished paper), February 25, 2000.

[9] Subprime lenders are also active in the home improvement market. Home improvement loans of subprime lenders were excluded from these comparisons.

The magnitude and speed of the increase in subprime lending creates a critical need for greater scrutiny. The rapid growth of subprime lending may help expand credit access for more borrowers; however, some portion of subprime lending may be occurring with borrowers whose credit would qualify them for conventional loans. Subprime lending may expose borrowers to higher up-front fees and interest rates than they would bear if they had obtained prime loans.

2. **Subprime loans are two times more likely in low-income neighborhoods in Los Angeles than in upper-income neighborhoods.**

HUD's analysis reveals that subprime lending is being provided increasingly to low- and very low-income families and their communities. In Los Angeles, 13 percent of all refinance mortgages in 1998 were subprime, but in low-income neighborhoods, the percentage of refinances in the subprime market was almost twice as large -- 23 percent. (See Figure 2). In the poorest communities, where families make 50 percent or less of the area median income, subprime refinances accounted for 31 percent of all refinance loans. In middle-income neighborhoods, 14 percent of refinancing families relied on a subprime loan, as did only 11 percent in upper-income neighborhoods. In 1993, only 7 percent of refinance mortgages in low-income neighborhoods and 3-4 percent in middle- and upper-income neighborhoods were subprime.

3. **Subprime loans are almost four times more likely in black neighborhoods in Los Angeles than in white neighborhoods.**

In predominantly black neighborhoods in Los Angeles, subprime lending accounted for 33 percent of home refinance loans in 1998 - compared with only 9 percent in predominantly white areas. Thus, while subprime refinance mortgages accounted for only one in eleven refinance loans originated in predominantly white neighborhoods, they accounted for one-third of the refinance loans originated in predominantly black neighborhoods. (See Figure 3.) Comparable 1993 figures were 13 percent in black neighborhoods and 3 percent in white neighborhoods.

HUD's analysis of lending in Los Angeles indicates that inner-city minority neighborhoods, concentrated in or around the South Central Los Angeles area, disproportionately rely upon subprime lenders for refinance credit. The map of the Los Angeles metropolitan area summarizes the neighborhood concentration of subprime refinance loans. (See Figure 4.) In 1998, subprime mortgages accounted for at least 25 percent of all refinance mortgages in 253 (or 15 percent) of the 1,641 census tracts in the Los Angeles metropolitan area. Census tracts where both Blacks and Hispanics each comprised more than 30 percent of the population accounted for 91 of these 253 census tracts. Blacks comprised more than 30 percent of the population in an additional 66 of these 253 census tracts with high subprime activity; and Hispanics comprised more than 30 percent of the population in an additional 84 of the 253 census tracts with high subprime activity.[10] In total, census tracts where either blacks or Hispanics (or both) comprised more than 30 percent of the population accounted for 241 of the 253 census tracts with high subprime activity.

Subprime refinance loans accounted for 37 percent of all 6,245 refinance mortgages in the South Central Los Angeles area. Subprime mortgages accounted for at least 25 percent of all refinance mortgages in 101 of the 117 census tracts that comprise the South Central Los Angeles area. Tracts where blacks and Hispanics each comprise more than 30 percent of the population and tract median income was no more than 80 percent of area median income accounted for 65 of the 117 tracts.

4. Upper-income black borrowers in Los Angeles are almost twice as likely as low-income white borrowers to have subprime loans.

This section analyzes the Los Angeles data by individual borrowers instead of entire neighborhoods; the impacts are similar. Subprime refinances accounted for 21 percent of all refinancing by low-income borrowers throughout the Los Angeles metropolitan area; only 13 percent of upper income borrowers relied upon subprime refinancing. (See Figure 5.)[11] The borrower data show that blacks in the Los Angeles metropolitan area are still carrying the greater proportion of subprime: in 1998, 31 percent of refinance mortgages for black borrowers were subprime, compared with only 11 percent for white borrowers.

Combining data on the income and racial characteristics of the borrower shows large disparities between black and white borrowers with similar incomes. Subprime loans accounted for almost half (46 percent) of refinance loans originated for low-income black borrowers, compared with only 15 percent for low-income white borrowers. (See Figure 6.) Similarly, subprime loans accounted for 38 percent of refinance loans for middle-income black borrowers, compared with only 12 percent for middle-income white borrowers. In fact, upper-income black borrowers were almost twice as likely as low-income white borrowers to rely on the subprime market (29 percent of upper-income blacks versus 15 percent of low-income whites).

[10] HUD conducted other analyses based on the racial and ethnic composition of census tracts in the Los Angeles metropolitan area. In the 439 census tracts where Hispanics comprised more than 50 percent of the population, subprime loans accounted for 18.5 percent of all refinance loans. In the 136 tracts where African-Americans represented the majority population, subprime loans accounted for 33.3 percent of all refinance loans.

[11] Figure 5 shows that the subprime shares of the refinance market in Los Angeles for the three borrower income categories are each equal to or larger than the overall average subprime market share of 13 percent. This occurs because the overall average of 13 percent includes cases where borrower income was missing; the subprime share of missing-borrower-income cases was only 3.7 percent (992 out of 26,909 loans).

Hispanic Borrowers. The refinancing patterns for Hispanic borrowers can be compared to those discussed above for black and white borrowers. As shown in Figure 5, subprime loans accounted for 12 percent of refinance loans originated for Hispanic borrowers during 1998; this compares with 31 percent for black borrowers and 11 percent for white borrowers. One important factor that may help explain the subprime differential between Hispanic and black borrowers concerns loans insured by the Federal Housing Administration (FHA). FHA refinance loans accounted for 27 percent of refinance loans for Hispanic borrowers, compared with only 12 percent from black borrowers. However, more investigation clearly is needed to understand why subprime lending has played a larger role for black borrowers than for Hispanic borrowers.

CONCLUSIONS

HUD's analysis of refinance mortgages originated in the Los Angeles metropolitan area during 1998 clearly demonstrates the exponential growth in subprime lending and its disproportionate growth for lower-income and, particularly, minority homeowners and communities. As noted above, almost half of low-income black borrowers in the Los Angeles metropolitan area rely upon the subprime market for their refinance loans. While this growth in subprime lending has expanded access to credit for many borrowers with impaired or limited credit histories, these borrowers may also be vulnerable to predatory lending practices.

Despite the progress made by prime lenders in reaching these markets, the growth of subprime lending in both lower-income and minority communities strongly suggests that much more can be done by both primary and secondary market participants to expand access to the prime lending market.