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The High Cost of Subprime Lending in Washington State

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Executive Summary

In Washington State in 2006, African-American and Hispanic homeowners and homeowners in lower income neighborhoods were most likely to pay a higher premium for their mortgage.

The effect on household finances of having a high-cost mortgage can be significant. The cost of a $230,000 mortgage can easily be $600 higher per month, or over $200,000 over the course of a 30-year loan.[1] In the middle of the current housing crisis, having a high-cost mortgage also suggests a higher likelihood of foreclosure.

While many Washingtonians have suffered in recent years from the national mortgage crisis, the state has been relatively insulated. However, the outlook for the next couple of years suggests that the national housing crisis may continue to have significant effects. In Washington State, we have higher rates of adjustable rate mortgages expected to reset in the next year and higher rates of prepayment penalties than nearly every other state. The Center for Responsible Lending estimates that one of every six subprime mortgages originated in 2005-06 in Washington State will be foreclosed on.[2]

In the 2008 legislative session, Washington State adopted a number of policies designed to address growing concerns about the mortgage market and its effect on the rest of the state economy. These policies represent an important shift in state policy, but it remains to be seen whether they will be enough to provide solutions to the current economic problems. In particular, it needs to be considered if the state needs to take a more aggressive approach to protecting homeowners from foreclosure.

Background

Traditionally, the price of a mortgage (including the interest rate, fees, and points) was determined by basic characteristics of the loan including the amount borrowed, the length of the loan, whether the loan was government-backed, and whether the property would be owner-occupied. The creditworthiness of the applicant was basically used to determine whether a borrower met underwriting standards. Mortgages were generally only available to borrowers with good credit, stable income, and substantial down payments. (These "prime" borrowers continued to be at an advantage in the housing market, being eligible for prime interest rates and lower fees.)

Significant changes in the mortgage market have come about in recent years because of greater access to the details of a consumer's credit history and new developments in how financial markets leverage mortgage loans. Under the new system, a broader range of consumers including those with lower incomes, poor credit, unstable employment, or high consumer debt have been approved for loans.

The subprime lending market quickly became seen as a rich source of higher yield investments and inventive methods were developed to allow more loans to be made to more customers. These methods allowed greater access to credit and homeownership among lower-income households.

However, at its worst, subprime lending was also characterized in part by insufficient consumer education, aggressive and misleading marketing, and abusive and risky lending practices. The result is that many homeowners, particularly those with lower and moderate incomes and people of color, purchased or refinanced their homes with expensive mortgages that they are now finding themselves unable to pay.

Financial literacy

Research by the Federal Reserve Board has found that significant shares of borrowers with adjustable rate mortgages (ARMs) did not understood key loan terms.[3] Twenty percent of ARM borrowers reported not knowing the initial interest rate of their loan. Thirty-five percent did not know the maximum per-period interest rate increase, and 41 percent did not know the maximum interest rate. Many who reported knowing the terms of their loan reported inaccurate information. The degree of misunderstanding was shown to be much higher for lower-income (incomes below $50,000) and for minority borrowers than for higher-income (income above $150,000) and white borrowers.

Mortgage companies aggressively marketed products (especially among the elderly and in lower-income neighborhoods) with misleading claims about the short-term return on real estate investment and the benefits of refinancing existing mortgages. A recent Government Accountability Office study of disclosure documents provided to borrowers found misleading marketing claims as well as failure to adhere to standard principles for ensuring clarity and readability, especially concerning the potential for "payment shock" because of sudden interest rate increases.[4]

Abusive and risky lending practices

Many borrowers across the nation were steered into expensive, subprime mortgages despite being eligible for lower cost—even prime-rate—loans.[5] Mortgage brokers often received bonuses when they were able to sell high-rate mortgages attached to prepayment penalties. Mortgages were also packaged with unnecessary supplemental financial products, with the costs essentially hidden into the financing of the loan. In some cases, borrowers were deemed to be qualified based on their ability to make payments initially despite the low likelihood that they would be able to afford payments once the "teaser" rate expired. Loan products that required limited or no documentation of income became available.

TABLE 1: Share of loans that were high-cost by region of state and neighborhood income, 2006

			By neighborhood income			
	All		Lower income	Moderate income	Middle income	Higher income
Metropolitan counties						
Benton-Franklin	24%		40%	28%	24%	14%
Clark-Skamania	26%		32%	28%	25%	20%
Cowlitz	29%		46%	29%	28%	21%
King-Snohomish	21%		29%	25%	19%	13%
Kitsap	22%		32%	23%	20%	12%
Pierce	31%		44%	36%	29%	24%
Skagit	25%		29%	28%	22%	16%
Spokane	24%		33%	27%	23%	17%
Thurston	24%		26%	28%	23%	15%
Wenatchee-Douglas	23%		28%	24%	19%	21%
Whatcom	17%		14%	19%	17%	16%
Yakima	28%		42%	37%	24%	21%
Non-metropolitan counties	26%		32%	31%	23%	20%
Statewide	24%		32%	27%	22%	17%

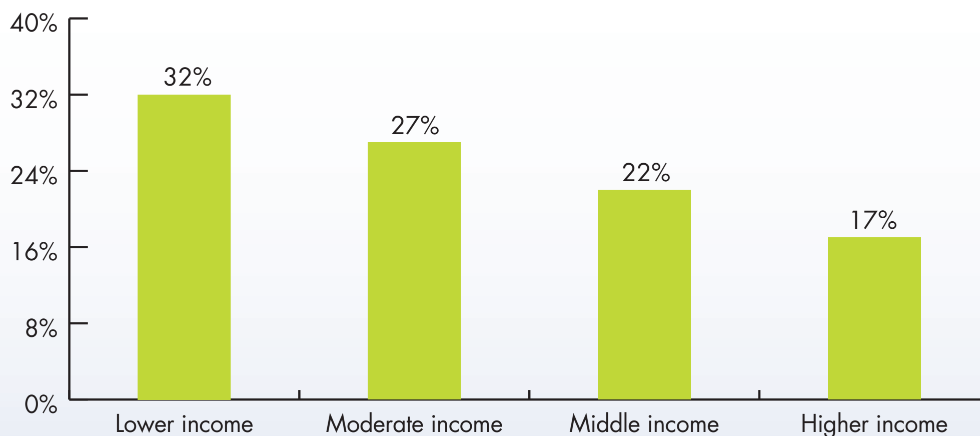
Source: Budget & Policy Center analysis of HMDA data. Neighborhood income is relative to metropolitan area income.

High-Cost Lending in Washington State

This report provides a picture of borrowers in the state who purchased, refinanced, or made home improvements using high-cost loans in 2006. The federal Home Mortgage Disclosure Act (HMDA) classifies mortgage as "high-cost" based on the loan's annual percentage rate (APR).[6] HMDA requires extensive annual disclosures from most mortgage lending institutions, with information, including characteristics of the loan, property, and borrower, and whether the loan is high-cost or not. These data are recorded for nearly every loan application, origination, and purchase in the country.

In 2006, 24 percent of all home mortgages for primary residences that originated in Washington State were high-cost. High-cost mortgages originated in every area of the state, but there were significant differences between regions of the state. The rate of high-cost mortgages for owner-occupied properties ranged from 17.2 percent in Whatcom County to 30.9 percent in Pierce County (Table 1). As a group, non-metropolitan counties had a higher rate (26.1 percent) of high-cost mortgages than some more urban areas such as King and Snohomish Counties (21.1 percent).

FIGURE 1: Share of mortgages that were high-cost in Washington State by neighborhood income, 2006



Source: Budget & Policy Center analysis of HMDA data. Neighborhood income is relative to metropolitan area income.

High cost loans by region and neighborhood

Statewide, mortgages in lower-income neighborhoods were almost twice as likely to be high-cost than those in higher-income neighborhoods (Figure 1).[7] In Cowlitz County, for example, 45.5 percent of mortgages in the lowest income neighborhoods were high-cost, compared to 20.8 percent in the higher-income neighborhoods (Table 1). Whatcom County was the only area where wealthier neighborhoods did not have significantly lower rates of high-cost mortgages than poorer neighborhoods.

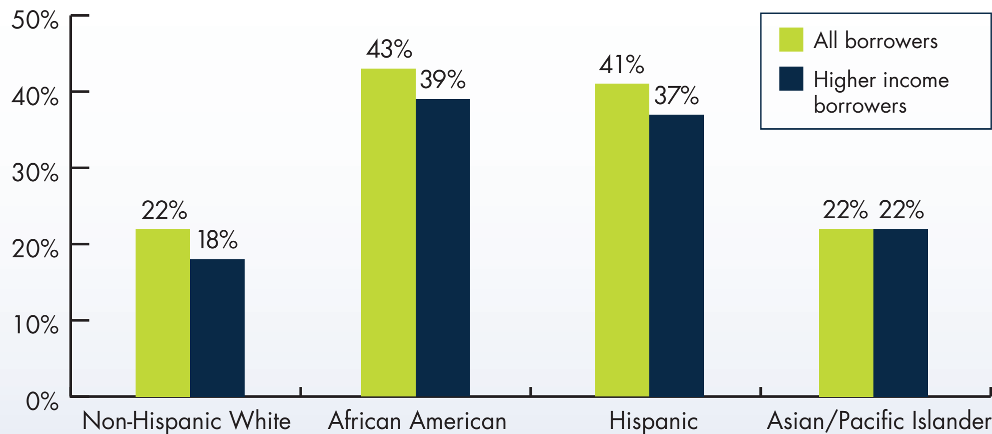
These pockets of high-cost mortgages within certain neighborhoods raise the question of whether borrowers in lower income regions and neighborhoods of the state have adequate access to financial education and whether they have a variety of lending options. This has an impact on all homeowners: when foreclosures concentrate within neighborhoods, it is not just the delinquent homeowner that suffers. Other owners are likely to see impacts such as property value decline and increased crime.[8]

While the income level of the neighborhood where the home was located played an important role in loan pricing, individual household income was less of a factor. Statewide, lower and moderate income borrowers were only somewhat more likely to purchase high-cost mortgages than higher-income borrowers.[9] [10] However, in some areas of the state, (particularly Benton-Franklin, Spokane, and Yakima Counties), this wasn't the case. In Benton-Franklin Counties, lower-income borrowers were twice as likely as higher-income borrowers to purchase high-cost mortgages.

Race and ethnicity

However, stark differences appear in loan pricing between racial and ethnic groups, suggesting that the impact of further deterioration in the housing market will likely fall disproportionately on African Americans and Hispanics. Over 40 percent of the mortgages lent to African Americans and Hispanics were high-cost, compared to around 22 percent for non-Hispanic whites and Asians (Figure 2).

FIGURE 2: Share of mortgages that were high-cost in Washington State by race/ethnicity and household income, 2006



Source: Budget & Policy Center analysis of HMDA data.

Factors such as credit scores, debt-to-income ratios, and loan-to-value ratios are not available in the HMDA data and likely provide a partial explanation for the difference in loan pricing by race and ethnicity.

It is unlikely, however, that these factors explain a gap of this magnitude, particularly since the gap existed at every income level. Even among borrowers whose incomes were twice the area median, 39.3 percent of African-Americans and 36.8 percent of Hispanics had high-cost loans (Figure 2).

High-cost lenders

Forty-five lenders in Washington State in 2006 specialized heavily in high-cost loans, having 75 percent or more of their loans meeting the high-cost criteria.[11]

These high-cost loan specialists originated only one in seven of all mortgages in 2006 in the state, but they played a significant role in the high-cost market. Half of all high-cost loans originated with these 45 lenders, including 58 percent of those lent to African Americans and 60 percent of those lent to Hispanics.

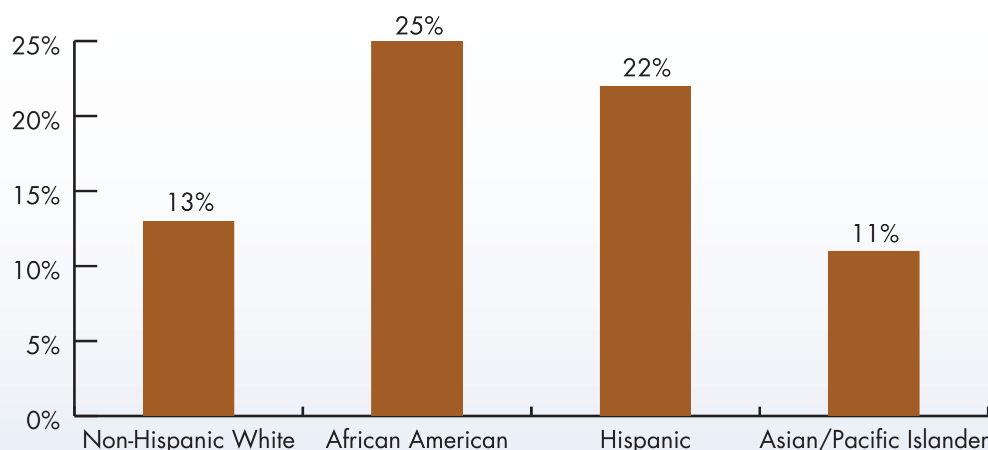
Lower income households and people of color were more likely to borrow from lenders specializing in high-cost loans than higher income or white households, even when considering only those with high-cost mortgages. This raises concerns that some Washingtonians are more limited in their lending options than others.

Choice of lender fails to fully account for the disparities in mortgage pricing by race and ethnicity. When considering more mainstream lenders, people of color were still much more likely than whites to pay higher costs for their mortgages (Figure 3). This disparity existed across the income scale.

High-cost lending in 2007

Nationwide, delinquency rates for mortgage payments began to rise in 2006 before rising sharply in 2007. There was a corresponding reduction in the availability

FIGURE 3: Share of mortgages originating from mainstream lenders that were high-cost in Washington State by race and ethnicity, 2006



Source: Budget & Policy Center analysis of HMDA data.

of credit to higher-risk borrowers and an increase in the cost of high-risk loans. Many lenders who focused heavily on subprime mortgages went out of business in 2007. These trends have continued into 2008.

In addition to the 2006 data presented above, HMDA data is now available for 2007 as well. These data show a sharp decline in high-cost lending in Washington State. According to the HMDA, the number of non-high-cost loan originations in the state fell by 6.4 percent between 2006 and 2007, while only half as many high-cost mortgages were originated.

However, Federal Reserve economists have expressed the need for caution in using the 2007 data. About 169 lending institutions nationwide ceased operations during 2007 without disclosing information on their lending in 2007. This could potentially have a significant impact on the data: those 169 institutions made 15 percent of high cost conventional first-lien loans for site-built properties in 2006.

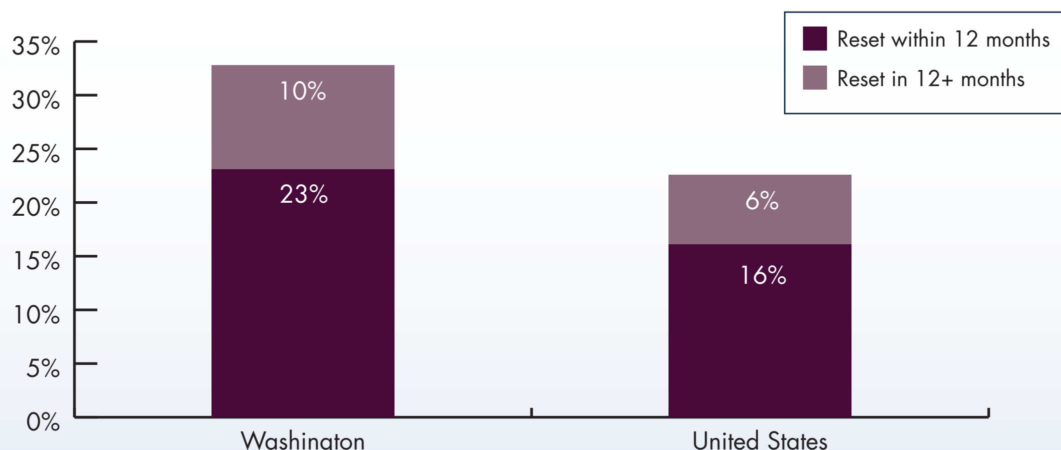
In Washington, 22 of the 45 "high-cost" lenders described above are not reported as originating a single loan in the state in 2007, likely a combination of credit contraction and institutions going out of business.

Looking Forward

The subprime mortgage market has become the center of a national economic crisis, as households face foreclosure and investors do not receive the hoped-for returns on their investment. In the third quarter of 2008, nine percent of all loans in Washington State and 12 percent in the nation were subprime.[12] However, both in the state and nationwide, 46 percent of mortgages in serious delinquency or foreclosure were subprime.

So far, Washington State has been relatively fortunate to avoid some of the deepest problems seen elsewhere. In the third quarter of 2008, 5.2 percent of mortgages nationwide were seriously delinquent or in foreclosure.

FIGURE 4: Subprime ARMs by month of scheduled interest rate reset, January 2009



Source: Budget & Policy Center analysis of Federal Reserve data.

Only seven states, including Washington, had foreclosure rates below 2.5 percent.

This was largely due to a relatively strong economy, but there are key differences in the subprime market in Washington State that may also provide a partial explanation as well as reason for concern.

Nationwide, 77 percent of subprime loans with adjustable rates have already seen the first reset of the interest rate.[13] In Washington State, only 67 percent have already been reset. In other words, 33 percent of subprime adjustable-rate mortgages in Washington State are still at the original interest rate (Figure 4). This is a higher rate than all but two states (Utah and Oregon).

This is problematic because the subprime mortgages most likely to go into delinquency or foreclosure are those with adjustable interest rates. Homeowners with these loans see significant increases in their mortgage bill from one month to the next and the additional cost can lead to late payments and eventually, foreclosure. Many Washington homeowners are still awaiting that increased cost. In the next 12 months, it is expected that interest rates will reset on 23 percent of subprime adjustable rate mortgages in the state, a higher share during that period than nearly every other state (Figure 4).

Problems for strapped homeowners can be exacerbated by prepayment penalties and large loan balances. Thirty-two percent of subprime mortgages in Washington State have prepayment penalties currently in force, a higher percentage than nearly every other state. And only 10 states have larger average subprime loan balances.

These statistics do not necessarily suggest that the Washington State situation will become as severe as Florida where 1 of every 10 mortgages are seriously delinquent or in foreclosure, but they do suggest that the worst for Washington State may still be ahead.

Recent Policy Responses

The state did not comprehensively address high-cost lending until the 2008 legislative session, when the State Legislature acted on the recommendations of the Governor's Task Force for Homeowner Security and passed a set of laws that made significant strides toward better education and regulation.

Actions addressing financial literacy include:

- A bill designed to expand financial literacy through education and counseling.
- Adoption of disclosure summaries that are understandable to the average person and include the breadth of key terms of the loan.

Actions addressing regulation of lending practices include:

- Loans cannot be made that have pre-payment penalties beyond 60 days prior to the initial reset on an ARM.
- Loans made to subprime borrowers in which the principle balance increases each month (negative amortization) are banned.
- Lenders may not "steer" borrowers into mortgages that are less favorable that the borrower could qualify under the lender's underwriting standards.
- Mortgage fraud is now a Class B felony.
- Homeowners are protected from foreclosure rescue scams.
- The state Department of Financial Institutions has greater authority to investigate lenders in order to enforce mortgage protections.
- A loophole was closed that allowed certain lenders to go unregulated.
- Mortgage brokers now have a fiduciary responsibility to borrowers. They are required to act in the best interest of borrowers.

Foreclosure Avoidance

The state is also looking at policies to help current mortgage holders avoid foreclosure. One new program funds financial counseling services. Another protects homeowners from foreclosure rescue schemes. The Legislature also passed a new program called "Smart Homeownership Choices." This program provides loans to lower income homeowners who are delinquent on their mortgage payments. The idea is to allow them to keep their mortgage current until they can refinance into a better loan product, after which they would repay the state.

To date, no loans have been made through the Smart Homeownership Choices program, suggesting that the design of the program needs to be reconsidered.

An ambitious new program in North Carolina presents a promising model.[14] Lenders and loan servicers will be required to send a notice of foreclosure 45 days in advance of foreclosure action. That notice must contain information on the borrower's options and available resources. Within three days after notifying the borrower, the lender must also notify a state agency. That agency then refers the borrower to a housing counselor and conducts a legal review of the loan. If they decide that a loan modification could help the borrower avoid foreclosure, they can extend the foreclosure date by 30 days and assist the process of renegotiation. This program promises to more effectively connect borrowers and lenders for loan modification than the programs in Washington State.

North Carolina is also aggressively working with large lenders to negotiate a standard market-wide modification agreement for borrowers who are likely to be able to stay in their home under better mortgage terms. The hope is that a standard of mortgage payments being equal to or less than 34 percent of the borrower's income can be reached with all large lenders. Washington State is also working with lenders in a similar way.

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Endnotes

1. The average mortgage loan amount in Washington in 2006 was $230,000. The median rate spread for high-cost loans was 5.52 percentage points, equivalent to an APR of about 10.5 percent. The comparison above is to a mortgage with an APR of 7 percent.
2. The Center for Responsible Lending has made projections of foreclosures by state. Their national projections are quite conservative when compared to other sources. http://www.responsiblelending.org/pdfs/subprime-spillover.pdf.
3. Bucks, Brian; Pence, Karin, Federal Reserve Board of Governors, "Do Homeowners Know Their House Value and Mortgage Terms?" January, 2006.
4. United States Government Accountability Office report, "Alternative Mortgage Products, Impact on Defaults Remains Unclear, but Disclosure of Risks to Borrowers Could Be Improved," September, 2006.
5. Center for Responsible Lending, "Steered Wrong: Brokers, Borrowers, and Subprime Loans," April 8, 2008.
6. The APR is a better measure of the total cost than the contract interest rate alone because it includes points, fees, and other finance charges. Mortgages with APRs above designated thresholds are defined as "high-cost."
7. Census tracts are divided into income groups based on the median family income of the tract. Tract income is divided by the median family income of the metropolitan area.
8. Center for Responsible Lending Issue Paper, "Subprime Spillover: Foreclosures Cost Neighbors $202 Billion; 40.6 Million Homes Lose $5,000 On Average," Revised January, 2008.
9. A recent study of high-cost mortgages in Kentucky found a much larger gap between higher and lower income borrowers than is found in Washington State http://www3.brookings.edu/metro/pubs/20070618_kentucky.pdf. In addition a study of metropolitan areas that found that the Seattle metro area had less disparity in this regard than other metropolitan areas. http://www.brookings.edu/reports/2006/07poverty_fellowes.aspx
10. Borrowers are classified into income groups based on their income as a share of the median income in the metropolitan area.
11. Excluding lenders who made fewer than 100 loans in the state.
12. Mortgage Bankers' Association. National Delinquency Survey, third quarter 2008.
13. New York Federal Reserve, Nonprime Mortgage Conditions in the United States, January 2009. http://www.newyorkfed.org/regional/subprime.html.
14. Casey Pierce, Stephanie, "Backgrounder: The North Carolina Emergency Foreclosure Reduction Program," NGA Center for Best Practices, Washington, DC.