

# The Regulatory Response to Risk-based Pricing: Implications for Fair Lending Policy

**Jonathan S. Spader**

Urban Affairs Association Annual Meetings

April 2008

Center for Community Capital  
*Research and analysis on the  
transformative power of capital*



## *Background: Fair Lending Policy*

### Fair Lending Laws:

1. Disparate-treatment discrimination
  2. Disparate-impact discrimination
- Protected classes: race, ethnicity, religion, national origin, gender, marital status, age.

## ***Background: Enforcement***

### Fair Lending Laws:

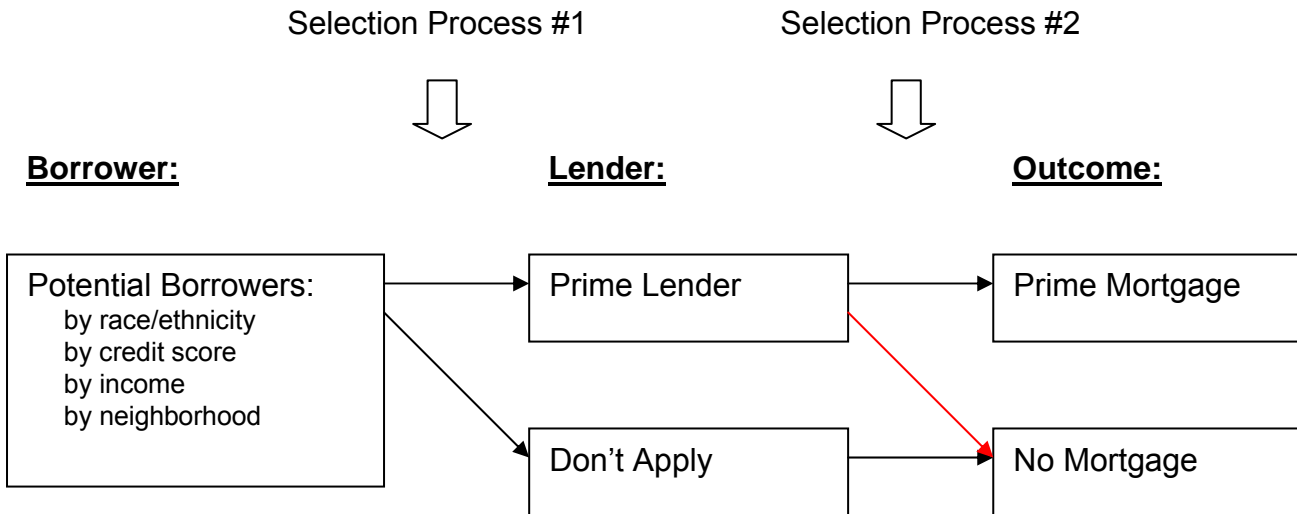
1. Disparate-treatment discrimination
  - Fair lending regulations
  - HMDA data
2. Disparate-impact discrimination
  - Little regulatory attention
3. Geographic redlining
  - CRA regulations

## *Regulation from Below*

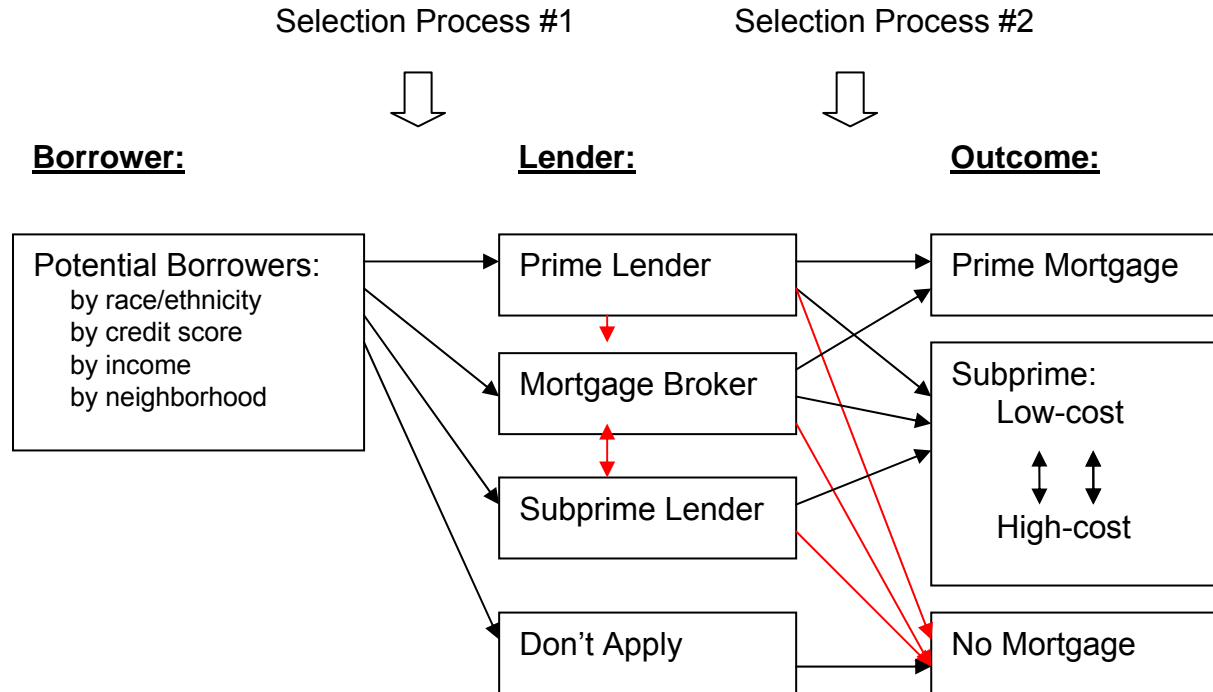
“HMDA and CRA implicitly sanctioned an important role for local citizen monitors, whose ‘regulation from below,’ as it has been termed, was believed to be needed to augment the formal enforcement apparatus... While the use of ‘de facto’ bank examiners succeeded more than many knowledgeable observers expected, it remains to be seen whether community-based watchdogs can keep pace with the rapidly changing environment for CRA and for banking in general.”

-Allen Fishbein (1992)

# Risk-based Pricing Raises New Issues for Policy



# Risk-based Pricing Raises New Issues for Policy



## *Issue 1: Discrimination in Pricing and Terms*

- Selection Process #2: Lender
  - Approve/deny
  - Loan price
  
- Response: 2002 HMDA revisions
- Research: Proprietary data

## *Issue 2: Predatory Loan Characteristics*

- Selection Process #2: Lender
  - Loan pricing: prepayment penalties, etc...
  - Targeted Marketing Efforts
  
- Response: HOEPA and credit insurance
  - state-level responses
  
- Research: proprietary data
  - Complicated by selection process #1

## *Issue 3: Yield Spread Premiums*

- Selection Process #1: Lenders
  - Branches vs. Brokers
  - Compensation through YSPs
  
- Response: state-level (licensing)
  
- Research: proprietary data

## ***Issue 4: Spatial Separation of Prime/Subprime***

- Selection Process #1: Lender
  - Location of branches
  - Use of brokers/third-party channel
  - Targeted marketing activities
  
- Research: HMDA data
  - Shows correlations between prime/subprime and neighborhood

## *Issue 5: Unregulated Lenders*

- Regulation of lenders:
  - Fair lending exams apply to banks/thrifts
    - Includes ~20% of subprime originations in 2005
    - Excludes independent mortgage companies
    - Excludes leading 3 subprime lenders in 2005

## *The Federal Response: Before the Bubble*

1. Praise the increased homeownership rate.
  
2. Fund homeownership counseling
  - Funding increases from \$12m (1995) to \$40m (2003)
  - ‘Let the buyer beware’ remains the guiding principle for mortgage transactions
  
3. 2002 HMDA revisions (& HOEPA)
  - Adds limited pricing data

## ***The Federal Response: After the Burst***

- **Interagency Guidance (mid-2006):**
  - Alludes to concerns with subprime
  - Reinforces existing consumer disclosures and safety and soundness requirements
  
- **Statement on Subprime Lending (mid-2007):**
  - Defines practices of concern
  - Tightens guidance on stated income, low-doc/no-doc
  
- **Legislative Proposals (2007-present)**
  - None include strengthened data disclosures

## *What Happened to ‘Regulation from Below?’*

1. The background moved.
  - The rise of risk-based pricing
  - Changes in the market’s institutional structure
  
2. Fair lending research and regulation are interdependent
  - Research is limited by data disclosures (HMDA)
  
- Result: A reduced role for research in informing fair lending policy.