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Mortgage Brokers and Fair Lending

by Stanley D. Longhofer and Paul S. Calem

Fair-lending issues have gained new prominence over the course of the last decade. Spurred in part by the controversial findings of the now-famous "Boston Fed Study,"[1] financial institutions have come under more intense scrutiny over compliance with fair-lending laws, with the Department of Justice taking action in more than a dozen lending-discrimination cases since 1990.

Although the initial focus of these investigations was primarily on whether lenders illegally discriminate in the course of their underwriting decisions (that is, on relative denial rates), recent efforts have targeted bias in the pricing of mortgage loans.

The traditional mortgage loan origination process involves a lender with in-house (retail) loan officers who both collect the information that is used to make the underwriting decision and negotiate the ultimate price of the loan with the borrower. Many mortgage lenders, however, also originate loans that are solicited by outside independent mortgage brokers. Such "wholesale lending" presents unique challenges for the enforcement of fair-lending laws.

In this *Economic Commentary,* we discuss the role of brokers in the housing-finance market, focusing on the question of how responsible lenders should be for the pricing decisions of independent mortgage brokers. Although recent investigations by the Department of Justice appear to be based on the principle that lenders should be completely accountable for the actions of their brokers, we argue that this policy may be misguided.

In contrast to a lender's relationship with its in-house loan officers, with wholesale loans it is the broker and not the lender that negotiates the price the borrower pays on the loan. Furthermore, the relationship between the broker and the lender is typically "arms-length," implying that the difference between the price charged by the broker and the wholesale price is not in any way controlled or influenced by the lender. Therefore, we question whether a lender should be held accountable for patterns that may emerge in the prices brokers negotiate with borrowers. Further, we are skeptical that one can conduct an adequate statistical evaluation of broker pricing practices using only data obtained from a single lender, in part because the typical broker deals with multiple lenders. As a result, we believe it is unreasonable to hold the lender accountable for the pricing decisions of its brokers. Instead, we argue that fair-lending investigations into the pricing of brokered loans should be targeted at the root source of any discriminatory behavior: the brokers themselves.

An Overview of Mortgage Pricing

In order to investigate an institution's pricing decisions, regulators must first confront the question of how to measure the mortgage's "price." As was argued in a previous *Economic Commentary,* the proper tool for conducting such investigations is through statistical comparisons of "overages" paid by different groups.[2] Essentially, an overage is calculated by comparing the up-front fee (the number of "points") a borrower actually pays on a loan with that listed on the lender's rate sheet on the day the borrower's interest rate is locked (the "required price").[3] This comparison would take into account regional location, the length of the borrower's rate lock, the size of the loan, and any other elements according to which prices may be arrayed on the rate sheet.

Mortgage brokers play an important role in the housing-finance market, but they also present unique challenges to regulators attempting to enforce fair-lending laws. Should lenders be held responsible for the pricing decisions of brokers from whom they receive loan applications, or should fair-lending laws instead be applied directly to the brokers themselves?

To evaluate an institution's compliance with fair-lending laws, examiners calculate the overage charged each borrower and then compare the frequency and magnitude of overages charged to minorities with those charged to similarly situated white borrowers.[4] Raw differences in pricing across racial groups would not constitute evidence of illegal discrimination in and of themselves. Rather, these differences must remain statistically significant even after controlling for other factors that might reasonably affect loan prices. (See box.)

When a loan is originated through a broker, the process of calculating an overage is essentially the same. As with their direct loans, wholesale lenders provide brokers with a rate sheet listing the prices at which they are willing to underwrite loans during a given time period, and they generally have a standard set of origination fees they charge on brokered loans.

However, there are important differences between brokered and direct lending that make testing for discriminatory lending patterns in brokered lending a fundamentally distinct exercise. First, in brokered lending, the actual origination and discount points charged, as well as the

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nominal interest rate, are set via negotiations between the borrower and the broker, not the wholesale lender that underwrites the loan. Second, in most cases the broker is able to keep any excess points that it is able to charge a borrower over that required by the lender's rate sheet. In other words, the broker is the full beneficiary of any overage paid by the borrower—the lender does not share in the overage. Third, brokers generally are not bound by exclusivity agreements with lenders. The typical broker deals with several different lenders simultaneously, selling each loan to the lender that offers the best price on any given day. As we shall see, these features of wholesale lending have important implications for the interpretation of brokered-loan pricing patterns in data from an individual lender.

One Lender's Story

Consider the case of Acme Mortgage Company, a hypothetical mortgage bank that works with a large number of brokers to solicit business. Suppose that in their analysis of Acme's brokered lending portfolio, bank examiners find that black borrowers pay overages more frequently, resulting in a pricing disparity of 1.5 points between white and black borrowers, even after controlling for other borrower and loan characteristics that might legitimately and legally influence the prices of these loans. In common parlance, this disparity means that the "typical" minority borrower paid $1,500 dollars more in up-front fees on a $100,000 loan than did an identical white borrower for a loan with exactly the same terms.

If such a disparity existed within Acme's direct lending portfolio (among those loans processed by Acme's own loan officers), it would be strong preliminary evidence of illegal discrimination by Acme, and the regulatory agency would investigate further and possibly refer the case to the Department of Justice.[5] There are a number of reasons, however, why a referral may be inappropriate with regard to an institution's wholesale portfolio (those loans processed by outside brokers).

Cross-Broker Disparities

It is important to note that pricing disparities within Acme's wholesale portfolio can arise in two distinct ways: either "across" or "within" individual brokers. "Cross-broker disparities" result when minority borrowers tend to apply at brokers that charge higher fees, while white borrowers tend to apply at brokers that charge lower fees; despite this difference in pricing across brokers, however, no individual broker actually treats its own minority and white customers differently.

In order to hold lenders accountable for cross-broker disparities, regulators would need to prove that the cause of the disparity was differential treatment of borrowers based on their race, and not cost or other legitimate factors. This would be very difficult. Indeed, there are many conceivable reasons why individual brokers might charge more or less for their services than other brokers and why some brokers specialize in lending to a particular segment of their community. For example, a cross-broker disparity might be observed if higher-fee brokers provide a fuller array of services, such as spending more time with customers, and minority borrowers tend to prefer these brokers. As a result, we argue that regulators should not view cross-broker disparities on their own as evidence of illegal discrimination.

Within-Broker Disparities

Alternatively, "within-broker disparities" arise when white and minority customers of the same broker are treated differently. Within-broker disparities can give rise to an overall pricing disparity in Acme's portfolio in either of two ways: if such disparities are pervasive across many different brokers with whom Acme does business; or if a single broker with such a disparity supplies a large proportion of Acme's loans.

Although within-broker disparities are, on the surface, more suspect than cross-broker disparities, in practice it can be quite difficult to reliably interpret whether they are truly the result of illegal behavior. Proper evaluation requires separately examining the data from each individual broker for evidence that a particular broker is engaged in discriminatory practices. Separate statistical tests should be conducted because different brokers generally are subject to different economic factors affecting their pricing patterns. Evaluating each broker individually, however, entails two types of difficulties.

First, for any given lender, the number of loans originated via any one broker is often too small to permit a meaningful statistical analysis. Such an analysis requires controlling for various factors that are likely to affect the broker's propensity to seek an overage, which in turn requires a large sample of observations.[6]

More importantly, because an individual broker typically deals with multiple lenders, the loans the broker sends to any one lender may not be representative of the broker's overall activity. The loans sent to that lender may happen to include a disproportionate number originated to minority borrowers and from which the broker obtained an overage. Thus, while the data from a given lender may indicate a within-broker disparity, the broker's total activity may show no evidence of discrimination.

Should Lenders Be Liable for Their Brokers?

Even if regulators could reliably identify discrimination arising from cross- or within-broker disparities, the fundamental policy question remains as to whether Acme should be held accountable for the behavior of its brokers. We argue not. As noted above, broker agreements generally do not require the broker to work exclusively with any one bank, nor do they require a certain number of loans to be presented. Instead, they usually represent quintessential arms-length transactions.[7] The broker solicits potential borrowers, collects and verifies the information on their applications, and forwards the completed applications to the lender offering the best price on any given day. Pricing of these loans is the result of negotiations between borrowers and the broker. Indeed, the borrower and the broker may agree upon a price long before the ultimate lender is even chosen.[8] In any event, the lender typically is not a party to this decision, and receives no portion of any overage obtained by the broker. Given these facts, it seems hard to justify holding Acme responsible for a pricing decision in which it had little or no input.[9]

Indeed, the relationship between the broker and Acme is substantively no different than that between a lender and Fannie Mae or Freddie Mac, the two major secondary-market institutions that are credited with making mortgage loans substantially more affordable for consumers.[10] When lenders prepare their rate sheets, they do so based on estimates of the prices at which various loans will sell in the secondary market weeks in the future. They then allow borrowers to lock in an interest rate well in advance of the actual funding date. Of course, once the loan is actually funded,

TESTING FOR PRICING BIAS

When regulators test for compliance with fair-lending laws, they typically conduct statistical analyses to see whether lenders systematically charge minority borrowers a higher price than they do whites. In doing so, they control for other factors that may affect the pricing of mortgage loans, many of which are correlated with race. For example:

• **Negotiation Skills –** Older, better educated, and more experienced borrowers may be more skilled at negotiating the terms of their loans.

• **Credit History –** Borrowers with poor credit histories may not deal for lower fees because they have fewer alternative sources of credit, and originators may seek higher fees to compensate for the extra time and effort such borrowers may entail.

• **Willingness to Shop –** Some borrowers may place a high premium on their time (for example, high-income borrowers) and choose not to shop for the best rate.

• **Market Conditions –** The competitiveness of the loan market may vary over the course of the year.

• **Length of Rate Lock –** Borrowers who let their rate float may be more susceptible to overaging at the time of closing; on the other hand, such borrowers may be more sophisticated and less prone to being overaged.

• **Loan Size –** Many of the costs associated with originating a mortgage do not vary with the size of the loan, giving originators a stronger incentive to overage borrowers with small loan amounts.

• **Type of Loan –** Cost differences across different loan products (conventional vs. government insured, home purchase vs. refinancing) may result from regulatory and market factors independent of the borrower's characteristics.

Fair-lending analyses attempt to control for these and other factors to isolate the effects of race on the pricing decision.

the actual price at which it will trade on the secondary market may be vastly different from that anticipated when the rate was locked. If loans are trading at a premium, the lender pockets the difference; if they are trading at a discount, the lender must eat the loss.[11] In either case, the borrower is helped by the fact that the rate can be locked in advance, effectively providing insurance against interest rate volatility.

This is essentially the same service that brokers provide to borrowers. The broker is an intermediary between the lender and the borrower in the same way that the lender is an intermediary between the borrower and the secondary market. Because brokers are in constant contact with lenders, they may be able to obtain better prices than borrowers could by contacting the lenders directly. If lenders were to be held liable for the pricing decisions of individual brokers, direct application of the same logic would suggest that Fannie Mae and Freddie Mac should be liable for the pricing decisions of anyone who sells loans to them, a policy that few are proposing.

What Should We Do?

Given the difficulty of evaluating lenders' wholesale loan portfolios for evidence of pricing discrimination, how are regulators to proceed? Clearly, brokered lending should not be exempt from fair-lending laws. This is an important and growing part of the housing-finance market, and basic fairness requires that all market participants be subject to the same rules and regulations. Nevertheless, the need for some kind of enforcement does not justify the use of methods that can be both unreliable and misleading.

We contend that fair-lending laws should be applied directly to brokers, not indirectly through the lenders they work with. The only way to determine whether a broker discriminates is by looking at all of that broker's pricing decisions, not just those loans that were funded by one particular lender or another. Only by observing the entire universe of a broker's loans can we begin to make a determination of whether a pattern of illegal discrimination exists.

Why is this not the current state of affairs? Most likely, the answer is historical accident. Depository institutions and their subsidiaries are already subject to regular examinations to verify their compliance with a host of consumer regulations. In contrast, independent mortgage brokers are not subject to regular examinations.[12]

Nevertheless, the most effective and accurate way of enforcing these laws is to evaluate mortgage brokers directly. Just as we do not hold Fannie Mae and Freddie Mac liable for the pricing decisions of the mortgage banks that sell them loans, neither should we hold lenders responsible for pricing decisions that are wholly out of their control.

Footnotes

1. Alicia H. Munnell, Lynn E. Browne, James McEneaney, and Geoffrey M.B. Tootell. "Mortgage Lending in Boston: Interpreting HMDA Data." Federal Reserve Bank of Boston Working Paper No. 92-7, October 1992. This paper was later revised and published in the *American Economic Review,* vol. 86, no. 1, March 1996, pp. 25–53.

2. See Stanley D. Longhofer, "Measuring Pricing Bias in Mortgages," Federal Reserve Bank of Cleveland, *Economic Commentary,* August 1, 1998.

3. The rate sheet indicates the number of discount points required by a lender to fund loans with various nominal interest rates. For an example of a rate sheet, see Stanley D. Longhofer, "Measuring Pricing Bias in Mortgages," Federal Reserve Bank of Cleveland, *Economic Commentary,* August 1, 1998.

4. For expositional convenience, we discuss only racial disparities in this article. Of course, disparities across other protected characteristics such as age, gender, or marital status are illegal as well, and are considered by examiners in their fair-lending investigations.

5. By law, if the Federal Reserve or other bank regulator uncovers substantial evidence that discrimination may have occurred, it is required to pass this information on to the Department of Justice for further investigation. Note that a referral to Justice does not constitute a conclusion of discrimination, merely that further investigation is warranted.

6. These are generally the same as the factors that influence a lender's propensity to seek an overage with a retail loan. For example, brokers typically are paid a fixed percentage of the loan amount by the lender as compensation for originating the loan, and, therefore, they have greater incentive to seek additional compensation (in the form of an overage) on smaller loans.

7. Some broker agreements tie the broker much more closely to the lender, with some brokers acting little differently than a lender's in-house loan officers. Obviously, the degree to which the lender should be held responsible for the broker's behavior should depend on the amount of freedom the broker has to act independently of the lending institution.

8. This fact suggests that the very notion of an overage is less meaningful in the context of the brokered lending relationship. That is, the proper measure of pricing bias would compare the points paid by the borrower with those required by the broker on the day the borrower's loan terms are set.

9. Some might argue that lenders, if they so desired, could act to influence the prices charged by the brokers with whom they deal (for example, by placing restrictions on the spread between the wholesale price and the price paid by the borrower), and that lenders should therefore be held accountable for broker pricing behavior. Such restrictions, however, would likely reduce brokers' abilities to obtain the best rates for borrowers, either by reducing competition among brokers or by constraining their ability to shop among lenders.

10. The secondary-mortgage market comprises a wide variety of investors who purchase pools of mortgage loans in order to receive the principal and interest payments they generate. Participants include depository institutions, institutional investors such as insurance companies and pension funds, and wealthy individuals. The primary difference distinguishing the relationships between broker and lender and that of lender and the secondary market is that brokers rarely fund loans and hold them on their own books prior to delivering them to a lender, whereas mortgage banks generally do hold loans for a short time before selling them on the secondary market.

11. Lenders do, of course, hedge these risks using a variety of tools.

12. Technically, enforcement of the Fair Housing Act and the Equal Credit Opportunity Act with respect to mortgage brokers falls under the jurisdiction of the Federal Trade Commission, but this agency does not conduct regular examinations of these brokers.

Stanley D. Longhofer is the Stephen L. Clark Chair of Real Estate and Finance at Wichita State University. The work on this Economic Commentary *was completed while he was an economist at the Federal Reserve Bank of Cleveland. Paul S. Calem is a senior economist at the Board of Governors of the Federal Reserve System.* *The authors thank Glenn Canner for helpful comments and suggestions.*

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Federal Reserve Bank of Cleveland
Research Department
P.O. Box 6387
Cleveland, OH 44101

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