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Homeownership at High Cost: Foreclosure Risk and High Cost Loans in California

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Homeownership at High Cost: Foreclosure Risk and High Cost Loans in California

A study conducted for the Federal Reserve Bank of San Francisco

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Executive Summary

The relatively low rate of mortgage default and foreclosure in California in recent years obscures the fact that many Californians have high-cost home loans that they cannot afford. High cost loans are particularly common in low-income and minority communities, suggesting that those who can least afford it are paying the most for credit. In communities where high cost lending is more prevalent, so is the prevalence of households that are defaulting on their mortgage. Homeownership may be coming at too high a price for these households and communities.

Context

Promoting homeownership has long been a policy priority in America; increasing access to credit has been key to increasing the rate of homeownership overall, and particularly among low-income and minority households. Beginning in 1980, major changes in the financial services industry spurred growth in the subprime market.¹ Subprime lenders share of the mortgage market remains relatively small, but their share has been growing rapidly. Growth in the subprime market has benefited many homebuyers who might not otherwise have been able to access the credit they needed to purchase homes; the downside to this trend is some of these households are paying more than they need to for their home loans, and are burdened with loans that they cannot afford.²

One of the key reasons for concern about subprime lending, in general, is its association with increased foreclosure risk. A number of studies have identified strong associations between the level of subprime lending and the number of foreclosure starts and actual foreclosures in an area.³ The incidence of foreclosure is in direct conflict with the vision of homeownership as an asset-building opportunity for households and a stabilizing force in communities.

Determining the extent to which there is a causal relationship between the level of subprime lending and level of foreclosure risk, and, further, the direction of that causality, is quite challenging. Lenders argue that subprime borrowers present a higher foreclosure risk, and therefore, that the higher interest rates and fees that they charge are legitimate and necessary; without these methods of mitigating financial risk, many households would not be able to get credit they need and want. On the other hand, subprime borrowers may be at greater risk of foreclosure because they are paying more for their home loans. For low income borrowers, who are spending a significant proportion of their incomes on housing costs, one can easily imagine that small increases in the interest rate of a loan can have a big effect on borrowers' abilities to cover living expenses and keep up with their monthly payments.

¹ Subprime lending refers to lending at rates that exceed the prime interest rate; subprime lenders lend to individuals with lower credit scores, generally between 680 and 575. Lenders charge subprime borrowers a "risk premium" in the form of higher interest rates and additional fees to compensate for greater perceived risk.

² Some researchers have estimated that as many as 30 to 50 percent of subprime borrowers could have qualified for prime loans at lower cost. Carr, J. and Kolluri, L. (2001), p. 6.

³ Foreclosures are the ultimate, but not inevitable, ending to a chain of events that is set in motion when a household fails to make its mortgage payments.

California provides an interesting opportunity for investigating patterns of high cost lending, foreclosure risk, and the relationship between the two phenomena for several reasons. First, rising prices in the housing market have not stifled Californians' interest in becoming homeowners. Many households have entered the housing market by relying on subprime and high cost loans, and they are spending significant portions of their income on housing. Further, in recent years, the mortgage delinquency and foreclosure rate in California have been at historic lows. The general consensus among researchers is that, within California, rising home prices coupled with historically low interest rates as well as the emergence of "exotic" mortgage products (those with teaser rates, interest-only options, or other options for lowering initial monthly payments) have enabled more households who entered into unaffordable home loans to avoid foreclosure. Among those who anticipate a slow down in the California housing market, this is cause for concern. In the last few months the number of notice of mortgage defaults has been rising in most areas of the state. While it is too early to say whether this trend will continue, it does raise critical questions about the need for addressing foreclosure risk and high cost lending before homeowners across the state find that they are unable to afford their monthly payments, yet are not able to sell or refinance to get out from under the weight of their home mortgage.

Research Scope

This research focuses on three counties in California – Alameda, Fresno, and Riverside – comparing census tracts based on the prevalence of high cost lending,⁴ Notices of Default,⁵ and socio-economic and demographic characteristics. Drawing on data from the Home Mortgage Disclosure Act (HMDA) 2004 dataset for these three counties, records of Notices of Default from January 2005 through February 2006, and data from the 2000 Census, the goal of this analysis is to investigate three key questions:

- 1) Which census tracts have the highest rates of high cost loans and what are the characteristics of these tracts?
- 2) Which census tracts have the highest levels of foreclosure risk and what are the characteristics of these tracts?
- 3) Controlling for key socio-economic characteristics that are associated with credit risk, to what extent is high-cost lending associated with foreclosure risk?

Key Findings

High Cost Loans

- As a percent of loans originated in 2004, high cost loans accounted for 16 percent of loans in Fresno, 12 percent in Riverside, and 4.9 percent in Alameda County.⁶ In 2004, Fresno and

⁴ This research focuses on a subset of the subprime market – loans that are "high cost." For the first time in 2004, loans are identified as "high cost" in the Home Mortgage Disclosure Act (HMDA) dataset if the spread between the interest rate on the loan and the prime rate exceeded a specified amount (i.e. 3% for first-lien loans and 5% for second-lien loans).

⁵ Notices of Default inform households that they are delinquent on their mortgage and that the lender may pursue legal recourse; Notices of Default are public records, which are available at County Clerk Recorders' offices.

⁶ Loans considered in this analysis are first-lien loans on owner-occupied residences, not including manufactured housing.

Riverside County had a larger share of high cost home purchase and refinance loans as compared to the nation as a whole, and Alameda had a lower rate.⁷

- There are significant differences between census tracts where high cost lending is more prevalent and those in which high cost loans are a small percentage of lending activity. For the study sample as a whole, the percent of loans that are high cost is correlated with all but one of the census tract characteristics tested, including: the percent of residents who are non-white, below the poverty level, with less than a college diploma, unemployed, Hispanic, and recent immigrants, as well as with census tracts' median household income and the median value of selected housing units.⁸ For each of these, there is a positive relationship, meaning the percent of high cost loans increased with every characteristic explored except for median household income and the median value of housing units; as median income and median home values increase, the percent of high cost loans decrease.

Foreclosure Risk

- The fourth quarter of 2005 marked the end of a nine-year trend for California in declining Notices of Default; while it is too early to determine if this is the beginning of a new trend, the number of Notices of Default in the state increased by nearly 16 percent in the final months of 2005. Riverside County had the highest actual number of Notices of Default in the fourth quarter of 2005. Fresno experienced a 20.5 percent increase in the number of Notices of Default; Alameda County was one of only four counties where the number of Notices of Default continued to decline.
- Like high cost lending, foreclosure risk⁹ is concentrated in specific areas. For example, areas with higher median incomes and median home values have lower levels of foreclosure risk; communities with higher percentages of non-white residents and residents with less than a college diploma have higher levels.

Relationship between Neighborhood Characteristics, High Cost Loans, and Foreclosure Risk

- There is a significant relationship between the prevalence of high cost loans and the prevalence of Notices of Default in the census tracts studied. Negative binomial regression models, in which socio-economic and demographic characteristics such as median home value, number of households, number of loans in 2004, percent of residents who are non-white, and residents' median income are controlled, confirm that this relationship remains statistically significant and the strongest relationship among those tested. Considering each county separately, the results are consistent for Alameda, Fresno, and Riverside County.

Policy Implications and Recommendations

Findings from this analysis confirm that there are at least two policy problems to be addressed. First, high cost lending is concentrated in specific communities within the three county area – these include census tracts with higher percentages of low-income and minority populations, as well as areas with lower median home values and higher percentages of residents without a

⁷ In 2004, nationally, 11.5% of the home purchase loans were high cost loans and 15.5% of refinance loans were. Federal Reserve Bulletin, p. 364.

⁸ For this analysis, “selected” housing units refers to owner-occupied housing units with a mortgage.

⁹ Notices of Default are used as a proxy for foreclosure risk. Areas with a higher rate of Notices of Default (a larger number in proportion to the total number of owner-occupied housing units with a mortgage) are considered to have a higher level of foreclosure risk.

college diploma. Second, within the three counties, there is a relationship between high cost lending and foreclosure risk. While Notices of Default remain relatively rare in these three California counties, the fact that they are focused in neighborhoods with higher rates of high cost loans is cause for concern.

Based on a number of different policy options considered, three are advanced as strategies to address high cost lending and foreclosure risk in California: 1) make pre-purchase counseling available to every consumer who accesses a high cost loan; 2) learn from the experiences of other states that have restricted predatory and high cost lending; and 3) continue to monitor and assess high cost lending and foreclosure risk in California.

Given that there is still debate over the effectiveness of state laws that restrict high cost lending, particularly the extent to which these laws have the negative unintended consequence of limiting subprime borrowers' access to credit, there is reason to proceed with caution in enacting new restrictive legislation in California. Further, there is little perceived urgency to enact new policies in the state, due to the still relatively low rate of default and foreclosure in California.

As a next step, policymakers should consider approaches to strengthening borrower protections for loans that are already covered by the state's high cost lending laws. By requiring mandatory homebuyer counseling for those accessing high cost loans, policymakers could make strides toward further protecting borrowers who receive high cost loans without concern that there will be negative unanticipated consequences associated with further limiting lending practices in the state. At the same time, it is critical to continue to monitor patterns of high cost lending in the state as well as changes in the rate of Notices of Default.

Introduction

The relatively low rate of mortgage default and foreclosure in California in recent years obscures the fact that many Californians have high-cost home loans that they cannot afford. High cost loans are particularly common in low-income and minority communities, suggesting that those who can least afford it are paying the most for their loans. In communities where high cost lending is more prevalent, so is the prevalence of households that are defaulting on their mortgage. Homeownership may be coming at too high a price for these households and communities.

At the federal, state, and local level, there are a number of policy efforts currently underway to curb high cost lending. Most of these policy efforts are framed as “anti-predatory lending” campaigns and a key rationale for these efforts is the association between high cost lending and increased foreclosure risk.

Within the House of Representatives, two bills related to high cost lending are being debated. Ney-Kanjorski (H.R. 12945) would weaken existing federal law restricting high cost lending by raising the threshold for loans that are covered by the law, and it would prohibit states from regulating mortgage lenders by preempting state laws that have placed more stringent restrictions on lending practices. Miller-Watt-Franklin (H.R. 1182) would amend existing federal law by increasing requirements and restrictions on high cost loans. Within at least four states, legislators are considering enacting additional protections for borrowers: Rhode Island, Maryland, Illinois, and Ohio.

California provides an interesting opportunity for investigating patterns of high cost lending, foreclosure risk, and the relationship between the two trends for several reasons. Rising prices in the housing market have not stifled Californians interest in becoming homeowners; many have entered the housing market by relying on subprime and high cost loans, and they are spending significant portions of their income on housing costs. While recent years have seen historic low rates of loan delinquency and foreclosure, this may obscure the fact that many homeowners have high cost home loans that they cannot afford. Within the context of California’s strong housing market, homebuyers who find themselves unable to afford their mortgage payments are able to sell or refinance. As a result, the equity-stripping effects and problematic aspects of high cost and predatory lending are masked. If the housing market cools, as many have predicted, numerous households may face much greater risk of losing their greatest asset.

In recent months, the numbers of Notices of Default¹⁰ have been rising in most counties across California. While it is too early to say whether this trend will continue, it is worth examining which households and areas are most at risk of foreclosure. To the extent that there are discernible patterns in terms of which communities are affected, these areas may serve as the proverbial canaries in the coalmine, indicating where households may face the most trouble in the event of a slowdown in the California housing market.

¹⁰ A Notice of Default (NOD) is a formal notice to a borrower declaring that they have defaulted on their mortgage and that legal action may be taken. Notices of Default are recorded at the County Clerk-Recorders Office.

Lastly, questions about high cost lending and foreclosure risk have immediate policy relevance for California. At the federal and state level, a variety of new legislation is being considered which would change restrictions on lending practices that are deemed high-cost or predatory. In California, there have been several recent efforts at the local level (in Oakland and Los Angeles) and at the state-level to develop new legislation that would curb specific types of high cost lending practices. For this reason, it is valuable to explore the relationship between foreclosure risk and high cost loans to determine the extent to which there is a policy rationale for placing stronger restrictions on lending practices within the state.

This paper is comprised of three main chapters. The first chapter provides background information critical to understanding why high cost lending and foreclosure risk are important policy issues. It addresses the importance of homeownership and the history of policy efforts to increase the rate of homeownership, and it describes the role of credit in expanding homeownership and recent changes to the mortgage market that have expanded access to credit for many. The chapter also provides a frame for understanding why expansion in the subprime mortgage market may be cause for concern.

The second chapter provides an empirical analysis of high cost lending and foreclosure risk in California. The analysis focuses on three California counties – Alameda, Fresno, and Riverside. By analyzing patterns of high cost lending and foreclosure risk at the census tract level, new information is provided about the characteristics of communities where high cost lending is most prevalent and where there are the greatest number of Notices of Default; finally data are analyzed to assess the relationship between high cost lending and increased foreclosure risk at the census tract level.

The final chapter evaluates several policy options for addressing high cost lending and foreclosure risk in California and provides recommendations.

Appendix A includes information on the data sources used for the empirical analysis; Appendix B provides further detail on how various policy options were evaluated.

Chapter 1

Borrowing for the American Dream: Expanding Homeownership and the Rise of Subprime Lending

The Importance of Homeownership

Promoting homeownership has been a policy priority in America since the Great Depression;¹¹ and a number of policy efforts at the federal, state, and local level have been directed toward this end. Homeownership is thought to benefit not only individuals and families but also communities and the nation as whole. For most Americans, homes are their greatest assets, and homeownership is the strategy by which most Americans are able to build wealth. Home equity – alone – accounts for 45.2 percent of the net worth for all households in the United States.¹² The persistent wealth gap between White and Black Americans can be attributed, to a great extent, to differences in the rates of homeownership within these two groups. As of 2004, the homeownership rate for non-Hispanic white households was more than one and one-half times the rate of black households.¹³ Increasing the rate of homeownership within minority communities is often seen as a key strategy to narrow the wealth divide.

Beyond the wealth-building potential of homeownership, researchers have found that homeowners have a stronger sense of well-being and financial security.¹⁴ Homeownership also appears to have an effect on children’s well-being and academic achievement, for example, parental homeownership is associated with lower dropout rates and teen pregnancy.¹⁵ Children of homeowners are also more likely to become homeowners themselves.¹⁶

Homeownership is also considered to have direct community benefits, by helping to stabilize and improve neighborhoods. In one study that tested the relationship between homeownership rates and stability, researchers found that homeowners tend to stay in their properties longer than tenants do. Furthermore, higher rates of homeownership are associated with higher property values within an area. One study found that each 1 percent increase in the homeownership rate within an area was associated with a property value increase of \$800.¹⁷ Residences that are owner-occupied contribute to an area’s “social capital”¹⁸ – homeowners are more likely to be involved in their communities and engage in more informal interaction with their neighbors than are renters.

Policy efforts to increase the homeownership rate and increase opportunities for minority and low-income Americans to become homeowners are in step with what most Americans and Californians want for themselves. According to a recent survey by the Public Policy Institute of

¹¹ The Urban Institute and The Brookings Institution. (2003) “Rethinking Local Affordable Housing Strategies: Lessons from 70 years of Policy and Practice,” p. 39.

¹² Ibid, p. 58.

¹³ In 2004, the homeownership rate of non-Hispanic white Americans was 75.7 percent; among Black Americans it was 49.5 percent. Ibid, p.38

¹⁴ Rossi, “The Social Benefits of Homeownership,” p. 13.

¹⁵ Haurin, Donald. “The Private and Social Benefits of Homeownership,” p. 13.

¹⁶ Ibid.

¹⁷ Rohe, “Homeowners and Neighborhood Stability,” p. 66

¹⁸ The Urban Institute and The Brookings Institution. (2003), p. 59.

California (PPIC), many Californians share the dream of becoming homeowners; “nearly 90 percent of renters in California hold onto the hope of being homeowners someday.”¹⁹

The homeownership rate in the United States has been increasing. From 1950 to 2002, the homeownership rate grew from 47.8 percent to an all-time high of 67.9 percent.²⁰ While most of those who became homeowners during this time were in white and middle- and upper-income households, in recent years, there has been a rapid increase in the rate of homeownership within minority and low-income homeowners. Between 1993 and 1998, home buying among Hispanics increased by 87 percent; among African-Americans it increased by 72 percent. At the same time, homebuying among low and moderate income households also increased by 64 percent.²¹

The homeownership rate in California has lagged behind that of the rest of the country. In part, this is a reflection of the fact that the state has the most expensive housing stock in the nation.²² In 2004, the homeownership rate was second lowest in the nation and 10 percent lower than the national rate (59.7 percent and 69.0 percent, respectively). Like the rest of the country, however, the homeownership rate in the state has risen to its highest level ever in recent years. Between 2003 and 2005, the homeownership rate in California rose by 2-percentage points, a greater increase than was experienced in all but a few other states.²³ This is true, despite the fact that there is a growing gap between incomes and housing prices. As of December 2005, the median priced single-family home (\$568,890) was affordable for only 14 percent of California’s households.²⁴ Clearly, scores of families in the state are finding ways to “afford the unaffordable.”²⁵

The Role of Credit in Affording the Unaffordable

Nearly all Americans borrow money in order to purchase a home, therefore, increasing access to credit has been key to increasing the rate of homeownership overall, and particularly among low-income and minority households. From 1993 to 2001, the share of home purchase loans made to lower-income households or households living in lower-income areas across the United States increased steadily, from 31 percent to 35 percent in 2001.²⁶ During the same period, home purchase lending to white borrowers grew by just 29 percent, while lending to Hispanic borrowers increased by 159 percent and African-American borrowers increased by 93 percent.²⁷ Changing lending practices have enabled some Californians to become homeowners. In recent years, nontraditional mortgages have created opportunities for new homebuyers. Homebuyers who take out adjustable rate and/or interest-only mortgages are able to borrow more money than they would with a traditional 30-year fixed fully amortizing mortgage. Most new homebuyers are relying on adjustable rate loans, despite the fact that interest rates have been at historic lows during recent years; this enables them to have lower initial monthly payments, while trading off

¹⁹ PPIC, “Statewide Survey November 2004: Special Survey on Californians and Their Housing,” p.9

²⁰ The Urban Institute and The Brookings Institution, p. 37

²¹ Apgar, W. and Calder, A. “The Dual Mortgage Market: The Persistence of Discrimination in Mortgage Lending,” p. 102

²² PPIC, “California’s Newest Homeowners: Affording the Unaffordable,” p. 11.

²³ David Streitfeld, “Interest-only’ loans may be boon — or bust — for Calif. Homebuyers”

²⁴ Department of Housing and Community Development, “California’s Deepening Housing Crisis, February 15, 2006,” p. 7

²⁵ “Affording the Unaffordable” was the subtitle of a recent publication by the Public Policy Institute of California, “California’s Newest Homeowners: Affording the Unaffordable.”

²⁶ Apgar W. and Calder, A. p. 102

²⁷ Ibid.

long-term stability in their monthly housing costs. Furthermore, many of these adjustable rate mortgages are also interest-only loan products. According to one study conducted for the Los Angeles Times, as recently as 2001, interest-only loans constituted fewer than 2 percent of home purchase mortgages; as of 2004, 48 percent of the home purchase loans in California were interest-only.²⁸

There has also been substantive growth in the percent of loans that require no down payment. In 1990, only 3 percent of conventional home purchase loans had down payments of 5 percent or less; as of 2004, 16 to 17 percent of loans had this characteristic.²⁹ In some cases lenders are allowing higher debt-to-income ratios, enabling homebuyers with lower incomes to enter the housing market. Rather than limiting housing costs to no more than 30 percent of income, lenders are commonly qualifying homebuyers for loans that lead to housing costs of 40 percent of their income, and, in some cases, even 50 percent.³⁰ Rising home prices have not only made these borrowing strategies necessary for many households looking to enter the housing market, it has also encouraged many to discount the risk that they are assuming by using these types of mortgage products; they are gambling that they will gain equity in their homes not by paying down the principal on their loan but because home prices will continue rise as well as that their incomes will rise to compensate for pending increases in their monthly payments.

Expansion of the subprime market has also brought substantial change in the housing market, by increasing access to capital for many who present higher credit risks. Prior to 1980, federally insured banks and thrifts dominated the home mortgage market. Demand for credit generally exceeded supply, so that only those with the best credit histories and highest ability to pay were able to borrow funds. Beginning in 1980, major changes in the financial services industry spurred growth in the subprime market; these changes included the securitization of home mortgages and the creation of new mortgage products.³¹ This increased the flow of capital to the mortgage market so that there was less competition among borrowers for credit; and it enabled lenders to create mortgage products that hedge their risk. Lenders charge subprime borrowers a “risk premium” in the form of higher interest rates and additional fees.

Subprime lenders share of the mortgage market remains relatively small, but it has been growing rapidly. In 1993, subprime lenders accounted for 1 percent of home purchase lending and less than 5 percent of all mortgage originations; by 2001, subprime lenders accounted for more than 6 percent of all home purchase lending and more than 13 percent of all mortgage originations. Nationally, home purchase loans by subprime lenders increased by 760 percent from 1993 to 1998, compared to 38 percent for prime lenders.³² There was an even larger increase in lending by subprime firms in the refinance market, where subprime lenders increased their loans by 890

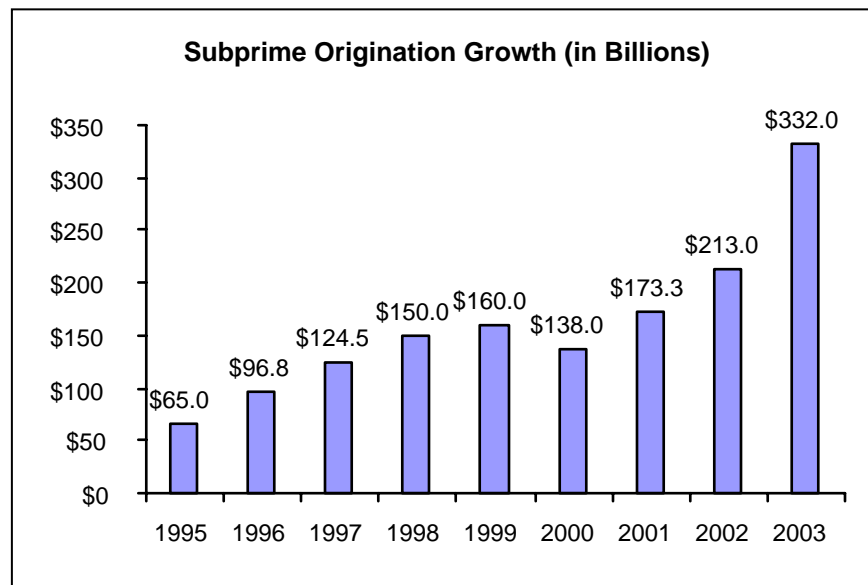
²⁸ Streitfeld, D., “‘Interest-only’ loans may be boon — or bust — for Calif. Homebuyers.” *Los Angeles Times* (April 9, 2005).

²⁹ Joint Center for Housing Studies of Harvard University. (2005). “The State of the Nation’s Housing 2005,” p. 17.

³⁰ PPIC, “CA’s Newest Homeowners,” p. 13

³¹ The Depository Institutions Deregulation and Monetary Control Act (DIDMCA) of 1980 pre-empts state usury ceilings on any “federally related mortgage loan” secured by a first lien on residential real estate. In 1983, the Alternative Mortgage Transaction Parity Act (AMTPA) pre-empts state laws that restrict mortgage financial arrangements such as balloon payments, negative amortizing loans, and variable-rate loans. Goldstein, D. (1999), 23.

³² Immergluck, D. and Wiles, M. (1999), p. 5



Source: Inside Mortgage Finance 2004 Annual DataBook.
 B&C originations are those with less than an A quality secured real estate loan.³³

percent, at the same time that refinances by prime lenders grew by only 2.5 percent.³⁴ In terms of loan volume, subprime loan originations grew from \$35 billion in 1994 to \$332 billion in 2003.³⁵

A Closer Look at Subprime Lending

Subprime lending has increased access to credit for many who might not otherwise be able to get it. If the upside of the growth of the subprime market is that it has enabled many households to access capital, either to become homeowners or to utilize the assets in their homes to pay for other expenses, the downside that is some of these households are paying more than they need to for their home loans.

Some have characterized the mortgage market as a dual market – comprised of the prime and the subprime market – others have divided it into three – prime, “legitimate” subprime, and predatory.³⁶ Within this latter characterization, the prime market caters to low-risk borrowers, the majority of whom are middle- and upper-income and white. Most of the lenders in this market are traditional banks and thrifts.

The “legitimate” subprime market provides credit to individuals who present more risk, presumably due to their weaker or impaired credit histories. Most of the subprime lenders are nonbank entities, whose lending has been enabled by the widespread securitization of home mortgages. They are able to originate loans and sell them on the secondary market in order to get capital to make new loans. Subprime mortgages cost more for a variety of reasons. Origination costs are higher because loan amounts tend to be smaller; subprime loans are also harder to package for the secondary market because they are less standardized products than prime loans;

³³ Data drawn from Ho, G. and Pennington-Cross, A. (2006), p.6. referencing information provided by Inside Mortgage Finance 2004 Annual Data Book.

³⁴ Ibid.

³⁵ Ibid, p. 108.

³⁶ Engel, K. and McCoy, P. (2001) “Tale of Three Markets,” p. 30

and they also present higher risk to investors. Subprime borrowers are more likely to prepay their mortgage and default on their loans, and these are accounted for in the higher price of credit.

The predatory market is somewhat more difficult to define. There is no bright line dividing the “legitimate” subprime market from the predatory loan market.³⁷ Whether or not a loan is predatory depends on the characteristics of the borrower, and the extent to which she will be able to repay the loan and is fully aware of the terms of the loan. It also depends on the characteristics and practices of the lender: Was the lender transparent in disclosing the terms and fees associated with the loan? Did the lender steer the borrower toward a loan that was not in her best interest? In general, does the lender try to take advantage of borrowers’ lack of financial sophistication, for example, by targeting specific groups such as the elderly, minorities, and households with limited English proficiency? Predatory lenders may fit one or more of these characterizations.

The predatory loan market is distinct from the “legitimate” subprime market in that lenders are not only charging higher interest rates and fees to compensate for the higher risk presented by borrowers, they are charging rates and fees that enable them to extract economic rent from consumers. Some of the practices commonly associated with predatory lending are: structuring loans so that they are not in the best interest of the borrower; rapidly “flipping” loans;³⁸ charging exorbitant fees, and using fraudulent or deceptive practices to target and lure borrowers. Most of the borrowers in the subprime market are those with blemished credit histories, and include those who, because of discrimination or preference are cut off from the mainstream financial and credit markets; lenders are predominantly nonbank entities that are minimally regulated by the FTC.

Federal policy changes in the last two decades have generally had the effect of loosening restrictions on lenders, prompting growth in subprime lending, and, some would say, opening the door to predatory lending practices. On the other hand, two key federal policies provide for monitoring of and restrictions to some types of very high cost loans. The primary federal law pertaining to high cost lending is the Home Ownership and Equity Protection Act (HOEPA), which amended the Truth in Lending Act (TILA) in 1994. HOEPA restricts refinancing and home equity loans which meet one of the following criteria: 1) the annual percentage rate (APR) on the loan exceeds the rate on Treasury securities of comparable maturity by more than eight percentage points if it is a first-lien loan and by more than ten percentage points if it is a second-lien loan; or 2) the fees and points payable by the consumer at or before closing exceed the greater of 8 percent of the loan amount or \$528.³⁹

HOEPA “covered” loans are restricted from having certain terms such as prepayment penalties, balloon payments for loans with terms of less than five years, and negative amortization. Further, the law requires lenders to disclose information to help borrowers understand the terms of their loan, and it prohibits lenders from making loans without regard to the borrower’s ability to repay the loan. As with other consumer protection laws, HOEPA overrides weaker state laws but allows for states to enact stricter laws.

³⁷ Researchers generally agree that while not all subprime loans are predatory, most predatory loans are in the subprime market.

³⁸ “Loan flipping” refers to lenders who encourage borrowers to rapidly refinance loans. This practice results in equity-stripping because refinancing costs money and often these charges are refinanced into the amount of the loan.

³⁹ HOEPA does not pertain to home purchase loans, reverse mortgages, or home equity lines of credit. The \$528 amount is for 2006 and is adjusted annual by the Federal Reserve Board based on changes to the Consumer Price Index.
<http://www.ftc.gov/bcp/online/pubs/homes/32mortgs.htm>

HOEPA is criticized by many who are concerned about predatory and high cost lending because it does not apply to many types of loans, including home purchase loans, open-ended home equity loans, and reverse mortgages. Further, the threshold at which a loan is covered by HOEPA is extremely high, so that many lenders are able to profit off of very high cost loans that are not subject to HOEPA.

The Home Mortgage Disclosure Act (HMDA), enacted in 1975, is also a centerpiece to federal legislation pertaining to subprime lending. HMDA specifies the information that lenders are required to provide on loan applications and originations, and it has been greatly expanded in recent years, both in terms of the institutions that are required to participate and in the information that they are required to submit. As of 2004, all loans that are covered by HOEPA are identified in the HMDA dataset. Furthermore, as of 2004, lenders are required to report pricing information for loans that are “high cost” at time of origination.⁴⁰ Systematic collection of information on this subset of subprime lending means that advocates, researchers, policymakers, and members of the public can put pressure on lenders and hold them accountable for their lending practices.⁴¹

Economics and Subprime Lending

While there are reasons to be concerned about the rapid rise of subprime lending, before assuming that all higher cost loans are problematic, it is useful to review why some borrowers are charged more for credit than others. The cost of credit is dependent on several different factors. First, the cost of funds is a significant determinant in the overall cost of prime rate loans as well as subprime and higher cost loans. Because many lenders sell loans to the secondary market, prices offered for mortgage-backed securities can also affect the pricing of loans to borrowers. Theoretically, lenders price loans based on the expected duration of the debt, credit risk, overhead costs, and servicing costs. Loans that involve greater credit risk cost more. A function of the creditworthiness of the borrower, credit risk is “a function of the equity in the home securing the loan, and the likelihood that proceeds of a foreclosure sale of the home will satisfy the obligation if default occurs.”⁴² The risk of prepayment is the risk associated with the possibility that a borrower will repay the loan before the term is over, so that lenders’ expected stream of interest income is interrupted. . Some loans cost more than others for lenders to underwrite, particularly loans that are provided without documentation of the borrower’s employment or income. Finally, servicing costs include costs associated with monitoring accounts, particularly in the case of borrowers who default on their mortgage. In some cases, and particularly in the subprime market, borrowers obtain loans through brokers. Brokers have an incentive to get borrowers to agree to loans that are higher prices than are warranted. Through “yield spread premiums,” brokers are able to benefit if borrowers that qualify for lower priced loans agree to loans at higher cost.

⁴⁰ Loans are identified as “high cost” in the Home Mortgage Disclosure Act (HMDA) dataset if the spread between the interest rate on the loan and the prime rate exceeded a specified amount (i.e. 3% for first-lien loans and 5% for second-lien loans).

⁴¹ Wells Fargo has recently been a target of criticism for its subprime lending practices. See, for example, <http://sanfrancisco.bizjournals.com/sanfrancisco/stories/2006/04/24/daily39.html>

⁴² Federal Reserve Bulletin, p. 368.

Evidence of Discrimination and Market Inefficiencies

Patterns in who gets subprime loans confirm concerns that that loan pricing is not entirely based on borrowers' risk-characteristics. Today, the problem of redlining, "the systematic denial of mortgage credit"⁴³ to individuals and groups in low-income and minority neighborhoods has shifted; advocates are concerned less about access to credit and more about access to credit on fair and equal terms.

In a study that drew upon 1998 HMDA data,⁴⁴ researchers at HUD found subprime loans were three times more likely in low-income neighborhoods than in high-income areas.⁴⁵ This is despite the fact that lower-income households do not necessarily present higher credit risks.⁴⁶ Such findings have led researchers to believe that the greater level of subprime lending to lower-income households is not entirely justified based on credit quality.⁴⁷

Subprime lending is also concentrated within minority and black neighborhoods, in particular. The HUD study found that subprime loans were five times more likely in black neighborhoods than in white neighborhoods. Homeowners in black neighborhoods, regardless of their income level were far more likely to get subprime loans than homeowners in white neighborhoods. Homeowners in high-income black neighborhoods were six times more likely than homeowners in high-income white neighborhoods to have subprime loans and twice as likely as homeowners in low-income white neighborhoods.⁴⁸ The level of subprime lending to black households far exceeds the measured level of credit problems experienced by these households. A 1999 Freddie Mac study found that black households had roughly twice the credit problems as comparable white households, yet were four times as likely to rely on subprime loans for mortgage credit.⁴⁹

A large percentage of subprime borrowers are paying more for their home loans than they need to be based on the credit risk they present to their lenders; and many of these borrowers are low-income and minority households. One researcher estimated that between 15 and 35 percent of subprime borrowers could have qualified for a prime rate loan; Fannie Mae and Freddie Mac have estimated that between 30 and 50 percent could.⁵⁰

Why would so many borrowers who could qualify for a lower rate end up paying more for their mortgage? Researchers cite reasons ranging from borrowers' lack of financial sophistication to discrimination by lenders. On the borrower side, a number of different factors – beyond credit risk – are related to the type of loan consumers are likely to obtain. These include factors such as: search behavior, including susceptibility to aggressive sales tactics; age; level of education; and level of familiarity with different types of mortgages. Further, dispelling notions that the

⁴³ Joint Center, "25 years of CRA," p. 121

⁴⁴ Congress enacted HMDA in 1975; originally, HMDA only applied to depository institutions and their direct subsidiaries, but it has expanded over time to include "most mortgage lending institutions, including savings and loans, independent mortgage banking companies, and mortgage banking subsidiaries of commercial bank holding companies. Today, HMDA reporting captures most mortgage market transactions." The Urban Institute and the Brookings Institution, p. 44.

⁴⁵ Carr, J. and Kolluri, L. (2001), p. 6

⁴⁶ Ibid.

⁴⁷ Ibid.

⁴⁸ Ibid, p. 7.

⁴⁹ Carr, J. and Kolluri, L. (2001), p. 7

⁵⁰ Ross, S and Yinger, J. (2002), p. 20

subprime market is a steppingstone into the prime market, a borrowers' "previous type of loan is a primary determinant in whether a borrower got a prime or subprime loan."⁵¹ While one might think that subprime borrowers who are able to purchase a home and make their monthly mortgage payments would be able to transition to a lower cost loan once they had built equity in their home and established a track record for making regular payments, this does not appear to be borne out by reality.

There is a substantial information asymmetry between lenders and borrowers. While lenders' are required to disclose information about the terms and details of the loan at the time of closing, the stack of paperwork that has to be reviewed and signed by borrowers is incomprehensible and overwhelming to many. As one researcher characterized it, if every document was actually read by the borrower, the closing process would take more than a day.

On the lender side, there is evidence of rent-seeking and discriminatory behavior. One study found that "roughly one-half of the interest rate premium paid by subprime borrowers – 100 basis points – cannot easily be explained by the higher levels of risk associated with these types of loans."⁵² This estimate did not include origination points and fees, which also tend to be higher for subprime borrowers. Researchers concluded this was evidence of "possible inefficiency in the subprime sector."⁵³

Numerous studies have documented the fact that different types of lenders specialize in different market segments. Subprime lenders tend to service borrowers in minority and low-income communities, and prime lenders provide credit to higher income, white borrowers. This segmenting has led some to characterize mortgage lending to lower-income and minority communities "as an isolated line of business, in which the focus is on the short-term transaction and associated fees."⁵⁴

High Cost Loans and Foreclosure Risk

One of the key reasons for concern about subprime lending is its association with increased foreclosure risk. Determining the extent to which there is a causal relationship between subprime lending and foreclosure starts, and, further, the direction of that causality, is quite challenging. Lenders argue that subprime borrowers present a higher foreclosure risk, and therefore, higher interest rates and fees are a legitimate approach to mitigating lenders' financial risk. On the other hand, subprime borrowers may be at greater risk of foreclosure because they are paying more for their home loans. For low income borrowers, who are paying a significant proportion of their incomes on monthly housing costs, one can easily imagine that small increases in the interest rate of a loan can have a big affect on borrowers' abilities to cover living expenses and keep up with their monthly payments. While some lenders may be willing to extend a loan with a high risk of default, this may not be in the individual homebuyer's or the general public's interest.

A number of studies have identified strong associations between the level of subprime lending

⁵¹ Courchane, M., Surette, B. and Zorn, P. (2004), p. 375.

⁵² Courchane, M., Surette, B. and Zorn, P. (2004), p. 375.

⁵³ Lax, H., Manti, M., Raca, P. and Zorn, P. (2004), p. 369.

⁵⁴ Immergluck, D. and Wiles, M. (1999), p. 11.

and the number of foreclosure starts and actual foreclosures in an area. The threat of foreclosure is in direct conflict with the vision of homeownership as an asset-building opportunity for households and a stabilizing force in communities. Borrowers are most directly affected by costs such as the loss of their down payment and any paid principal; penalties and fees charged during the period of delinquency and default; and legal fees associated with the foreclosure process. Indirect costs include increased future credit costs as a result of diminished credit quality and moving expenses. Borrowers may also suffer from non-pecuniary costs such as the “emotional and physical stress of managing the foreclosure process...reduction in socioeconomic status; and negative effects on children in households forced to move as a result of foreclosure.”⁵⁵

Foreclosures also affect neighbors – property owners, renters, and businesses – located in close proximity. Indirect costs borne by neighbors include such things as loss of rent and reduced sales by local businesses.⁵⁶ Foreclosures can have a negative impact on local property values and raise mortgage interest rates for future borrowers. Higher rates of foreclosure are also associated with increased crime rates.⁵⁷ Researchers studying FHA (Federal Housing Administration) foreclosures in Minneapolis estimated average city costs per foreclosures to be \$27,000 and neighborhood costs of \$10,000.⁵⁸ In a study of foreclosures in Chicago in 1997 and 1998, researchers’ most conservative estimate of the neighborhood effect of each conventional foreclosure was a 0.9 percent decline in property value. They estimated that the cumulative effect of 3,750 foreclosures in 1997 and 1998 was that nearby property values were reduced by a total of more than \$598 million, for an average single-family property value effect of \$159,000 per foreclosure.⁵⁹

⁵⁵ Apgar, W. and Duda, M. (2005). p. 9

⁵⁶ Ibid.

⁵⁷ Ibid.

⁵⁸ Immergluck, D and Smith, G. (April 7, 2005), p. 4

⁵⁹ Immergluck, D. and Smith, G. (2005) p. 1

Chapter 2: High Cost Homeownership in California

Subprime and High Cost Lending in California

Many California homeowners have subprime and high cost loans. Based on a review of SEC filings, one policy advocacy group estimates that California homeowners hold 25-50 percent of the nation's subprime loans.⁶⁰ In 2004, twenty percent of the high-cost loans⁶¹ originated nationally went to California homebuyers; these borrowers received an estimated \$47.48 billion in high-cost loans. In total, California homeowners received 264,348 higher-cost loans.⁶²

Californians with high cost loans are paying a significant amount more on a monthly basis than they would be with a prime rate loan. For example, in 2004, according to Freddie Mac, the average interest rate on a 30-year fixed rate home loan was 5.84%.⁶³ The average higher-cost home loan in California carried an Annual Percentage Rate (APR) of approximately 9.81%. Comparing a borrower who qualifies for a prime loan of \$275,000 and a high-cost loan, the borrower with the high cost loan would pay "\$691.76 more per month...and \$249,035.95 more in interest payments over the life of the loan" than a borrower with a prime loan.⁶⁴

A study of recent homebuyers conducted by the Public Policy Institute of California confirms that more Californians have chosen to become "house poor." Forty percent of households with mortgages in the state, and 52 percent of recent homebuyers pay more than the HUD recommended guideline of spending 30 percent of their income on housing costs. Twenty percent spend more than half of their income on their housing costs.⁶⁵ Among low- and moderate-income homebuyers, three-quarters are spending more than 30 percent of their incomes and one-third are spending more than 50 percent of their incomes on housing costs. As a result, when these households face an unanticipated or emergency expense, they are likely to have little funds available to cover these costs.⁶⁶ These researchers conclude, "what is new in the latest run-up of California home prices appears to be the financial degree to which Californians are willing to go to buy a house and the willingness of financial institutions to accommodate that desire."⁶⁷ For those who anticipate a slowdown in the California housing market, this information is cause for concern. Where is the tipping point at which households, particularly those with high cost loans, will find they cannot keep up with their mortgage payments?

⁶⁰ Stein, K. (2005), p.8

⁶¹ Loans are identified as "high cost" in the Home Mortgage Disclosure Act (HMDA) dataset if the spread between the interest rate on the loan and the prime rate exceeded a specified amount (i.e. 3% for first-lien loans and 5% for second-lien loans).

⁶² Stein, K. (2005), p. 8

⁶³ Ibid, p. 8.

⁶⁴ Ibid, p. 9.

⁶⁵ Johnson, H. and Bailey, A. (2005) p. 11

⁶⁶ Ibid, p. 12

⁶⁷ Ibid, p. 16

Foreclosure Risk in California

Current low rates of loan delinquency and foreclosure in California may obscure the fact that many homeowners have high-cost home loans that they cannot afford. Within California, a relatively small proportion of families and neighborhoods have been threatened by foreclosures in recent years. The end of 2003 marked a nine-year low in the number of Notices of Default⁶⁸ in the state of California. California is in the lowest-risk category with regard to the rate of serious delinquency compared to the rest of the nation; among subprime borrowers, only 1.05 percent had serious delinquencies as compared to rates of between 7.5 and 10.37 percent in states such as South Carolina, Indiana, and Ohio.⁶⁹

The general consensus among researchers is that, within California, rising home prices coupled with historically low interest rates as well as the emergence of “exotic” mortgage products (those with teaser rates, interest-only options, or other options for lowering initial monthly payments) have enabled more households who entered into unaffordable home loans to avoid foreclosure. Some of these households do so by selling a home that has appreciated enough to enable them to pay off their loan; others refinance, taking out new loans that are, at least in the short-term, more affordable. This means these borrowers either sold their home before they paid off their mortgage, or they refinanced. Unlike foreclosures, which clearly signal trouble for households and communities, it is unclear how to interpret data on the prevalence of mortgage prepayment and refinancing. This is because it is impossible to separate those homeowners who willingly prepaid their loan from those who did so to avoid foreclosure. Nonetheless, it is reasonable to assume that some sizeable number of California homeowners has been forced to refinance or sell their homes to avoid defaulting on their mortgage. While these events have a less dramatic effect on households and neighborhoods than foreclosure, these outcomes can also have wealth-stripping effects. With the anticipated downturn in California’s housing market, these households may face the even more devastating consequence of defaulting on their mortgage and losing their home to foreclosure.

This study provides an opportunity to examine the relationship between high cost lending and foreclosure risk in three counties in California at this time, when Notices of Default are at a historic low and while high cost lending is on the rise. Evidence that high cost lending and foreclosure risk are concentrated in specific areas now can provide an early warning of which neighborhoods and homeowners are most likely to be at risk if the housing market changes significantly.

⁶⁸ A Notice of Default is a formal notice to a borrower declaring that a default has occurred and that legal action may be taken. Notices of Default are recorded at the County Clerk-Recorders Office.

⁶⁹ Loan Performance, “The Market Pulse” (2005, Issue 2 June Data).

This research seeks to answer several distinct questions:

1. Which census tracts have the highest rates of high cost loans and what are the characteristics of these tracts?
2. Which census tracts have the highest levels of foreclosure risk and what are the characteristics of these tracts?
3. Controlling for key socio-economic characteristics that are associated with credit risk, to what extent is there a statistically significant relationship between the prevalence of high-cost lending and foreclosure risk?

Despite the uniqueness of California's housing market, the hypothesis underlying this study is that similar patterns will be detected as have been found in other areas of the country in which high cost lending and foreclosure risk have been studied in greater detail. In short, neighborhoods with higher levels of minority and low-income residents will have a greater share of high cost loans and Notices of Default.

Scope of Analysis

The scope of this study was narrowed from California as a whole to three specific counties – Alameda, Fresno, and Riverside – so that closer attention could be paid to intra- and inter-county differences. The three selected counties are in different regions of the state, and they differ based on their socio-economic characteristics and housing markets. The counties also rank differently in terms of the level of foreclosure risk and high cost lending that is present. In essence, the three counties were selected because they represent some of the diversity of California, although they are not presumed to be representative of the state as a whole. In most cases, data are presented separately for the different counties, and then for the study group as a whole.

Data Sources

A number of different data sources were used to assess the relationship between socio-economic and demographic characteristics, high cost lending, and foreclosure risk in Alameda, Fresno, and Riverside Counties. The unit of analysis for this study is the census tract. As of 2000, there were a total of 321 census tracts in Alameda County, 158 tracts in Fresno, and 341 in Riverside County.

For data on high cost loans, this study relies on HMDA (Home Mortgage Disclosure Act) data from 2004; for information on foreclosure risk, this study relies on listings of addresses that have received a Notice of Default between January 2005 and February 2006, which are still active as of February 2006. This information was culled from foreclosure.com, an online provider of information on pre-foreclosed and foreclosed properties. Neighborhood-level information on socio-economic and demographic characteristics was downloaded from Census 2000. Appendix A includes a detailed description of these data sources as well as their strengths and limitations.

Introduction to Alameda, Fresno and Riverside Counties

This study encompasses three distinct counties – Alameda, Fresno, and Riverside – which are located in different regions of the state and have distinct socio-economic and demographic characteristics.

Alameda County forms much of the East Bay portion of the San Francisco Bay Area. As of 2000, there were 1,443,741 residents in the racially diverse county. Of the three counties, Alameda is the most densely populated, with nearly 2,000 residents per square mile as compared to the state average of 217. Within the study sample, the county also has the highest median household income, at \$55,946; and the median value of owner-occupied housing is significantly higher than in Fresno and Riverside Counties. A larger percentage of adult residents have a college or advanced degree, and a smaller percentage are unemployed and living in poverty, compared to the other two counties and the state as a whole.

Fresno County is in the Central Valley of California, an area that is one of the richest agricultural regions of the world. As of 2000, the county had a total of 799,407 residents, of which over 44 percent were Hispanic/Latino. The poverty rate in the county is nearly 23 percent and the unemployment rate is also quite high at 11.8 percent.

Riverside is in the southeastern part of California and is part of the Greater Los Angeles Area. Along with neighboring San Bernardino County, it is one of the fastest growing counties in the State. Many residents have moved to Riverside in pursuit of less expensive housing, while they commute to other parts of the Greater Los Angeles Area to work. The homeownership rate in Riverside is the highest among the three counties at 68.8 percent. As of 2000 the population was 1,545,387, but it was estimated to have grown to 1,871,950 by 2004.

Table 1 below provides some key details about the three counties included in this study as well as data for the state of California as a whole.

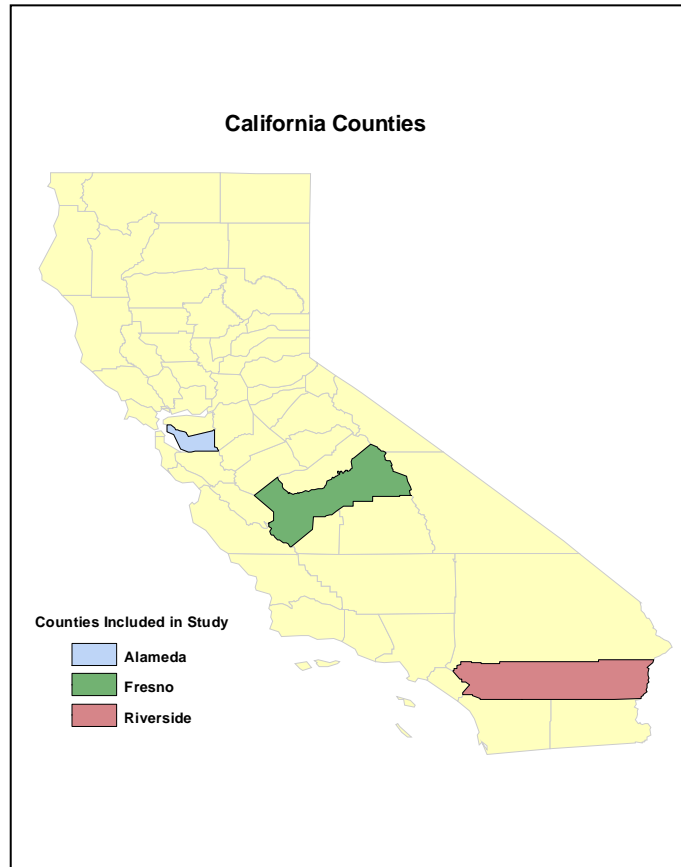


Table 1
Overview of Alameda, Fresno, and Riverside Counties, Compared to California as a Whole*

	Alameda	Fresno	Riverside	California
Total population (2000)	1,443,741	799,407	1,545,387	33,871,648
Estimated population (2004)	1,455,235	866,772	1,871,950	35,893,799
Number of households	523,787	253,304	506,781	11,512,020
Population density (people per square mile)	1,957	134	214	217
Percent White (non-Hispanic)	40.8%	39.6%	50.9%	46.6%
Percent Black/African-American	14.4%	5.0%	6.0%	6.3%
Percent Asian, Hawaiian, and Pacific Islander	20.8%	7.9%	3.6%	11.1%
Percent Hispanic/Latino	19.0%	44.1%	36.2%	32.4%
Percent other race/multiracial	5.0%	3.5%	3.2%	3.6%
Percent with no high school diploma or GED**	23.5%	25.0%	32.5%	17.6%
Percent with a bachelors or graduate/prof. degree**	26.6%	16.6%	17.5%	34.9%
Median household income (1999)	\$55,946	\$34,725	\$42,887	\$47,493
Poverty rate	11.0%	22.9%	14.2%	14.2%
Unemployment rate	5.5%	11.8%	7.5%	7.0%
Homeownership rate	54.7%	56.5%	68.8%	56.9%
Median value for specified owner-occupied housing units***	\$303,100	\$104,900	\$146,500	\$211,500

* All data are for 2000, except where noted otherwise (Census 2000).

**Only includes adults 25+ years of age.

*** Owner occupied housing units that are a one family home detached from any other house or a one family house attached to one or more houses on less than 10 acres with no business on the property.

Home Mortgage Lending in Alameda, Fresno, and Riverside Counties in 2004

The 2004 HMDA dataset includes a total of 252,275 first-lien loan originations in Alameda, Fresno, and Riverside Counties for owner-occupied residences. Of these, more than half (55.3 percent) were originated in Riverside County, 30.4 percent were originated in Alameda, and 14.3 percent were originated in Fresno. Most of these loans were prime loans or subprime loans with interest rates below the threshold that triggers mandated reporting of the rate spread.

As a percent of loans originated in 2004, high cost loans accounted for 16.0 percent of loans in Fresno, 12.0 percent in Riverside, and 4.9 percent in Alameda County. Examining the different types of loans separately, it is clear that, for each type of loan, Fresno census tracts have a greater percentage of high cost loans than the other two counties. In 2004, Fresno and Riverside County

had a larger share of high cost home purchase and refinance loans as compared to the nation as a whole;⁷⁰ Alameda had a lower rate.

Table 2
Prevalence of High Cost Loans, by County

	Percent of Loans That Were High Cost, By Type of Loan and County		
	Home purchase	Home improvement	Refinancing
Alameda	4.9%	5.7%	5.0%
Fresno	16.0%	18.3%	18.2%
Riverside	12.1%	13.4%	12.7%

On average, the rate spread between the interest rate for high cost loans and prime loans at time of origination was 3.83 (median = 3.60). At the county level, the rate spread was slightly greater for loans in Fresno County as compared to Riverside and Alameda County. While the difference between the average rate spread seems relatively small, over the life of a 30-year loan, the amount a borrower with an interest rate that is 3.93 percent higher than prime versus one with an interest rate that is 3.78 percent above prime pays can be significant.⁷¹

Table 3
Rate Spread for High Cost Loans, by County

	Rate Above the Prime Rate
Alameda (n=3,776)	+ 3.79%
Fresno (n=5,750)	+ 3.93%
Riverside (n=16,777)	+ 3.80%
Overall (n=26,303)	+ 3.83%

Across all three counties, 81 loans (.05 percent of the total number of loans for refinancing and home improvement purposes) carried interest rates such that they were “covered” under HOEPA legislation.⁷²

Characteristics of Census Tracts With Higher Rates of High Cost Loans

There are significant differences between census tracts where high cost lending is more prevalent and those in which high cost loans are relatively rare. Correlations provide information about the degree to which two continuous variables covary.⁷³

For the study sample as a whole, the percent of all loans⁷⁴ that are high cost is correlated with all census tract characteristics tested except for the percent of residents who are black. For each of

⁷⁰ In 2004, nationally, 11.5 percent of home purchase loans were high cost and 15.5 percent of refinance loans were. Federal Reserve Bulletin, p. 364.

⁷¹ Over the life of a loan of \$250,000, compared to a borrower who pays 3.93% over prime, a borrower who pays 3.78% over prime will pay roughly 10,000 less in interest payments over the life of a 30-year loan.

⁷² HOEPA only applies to closed-ended refinancing and home improvement loans. While this appears to be a low percentage, it is more than ten times higher than for the nation as a whole, which was .003%.

⁷³ A positive correlation signifies that as the value of one variable increases so does the value of the other variable. A negative correlation indicates that as one variable increases, the other decreases. Correlation estimates range from -1 to 1; the stronger the positive correlation between two variables, the closer the correlation estimate will be to 1; likewise, the stronger the negative correlation, the closer the value will be to -1.

these, there is a positive relationship, meaning the percent of high cost loans increased with every characteristic explored except for median household income and the median value of housing units; as median income and median home values increase, the percent of high cost loans decrease.

Table 4 shows correlations for each county separately and for the study sample as a whole, and the findings are relatively comparable except for the variables related to race and ethnicity. Examining the data for the counties separately provides insight into why, for the study sample as a whole, the percent of residents who are black is not strongly correlated with the percent of loans that are high cost. The level of high cost lending is lower in Alameda County than in the other two counties and the percent of residents who are black is greater. While there is a statistically significant correlation between the percent of residents who are black and the level of high cost lending within Alameda County, this relationship is obscured when the data are viewed within the larger dataset.

Table 4
Positive Correlations Between Census Tract Characteristics and Percent of Loans that Are High Cost

Percent of residents who are...	Correlation with Percent of High Cost Loans			
	Alameda	Fresno	Riverside	All Three Counties
Hispanic	0.57***	0.65***	0.62***	0.71***
Unemployed*	0.58***	0.65***	0.55***	0.65***
No college diploma	0.63***	0.64***	0.55***	0.64***
Below the poverty level	0.42***	0.67***	0.62***	0.59***
Non-white	0.56***	0.71***	0.69***	0.30**
Recent immigrants**	0.11*	0.60***	0.49***	0.11***
Black	0.60***	0.42***	0.36***	0.06

*Male and female residents in civilian labor force, over 16;

** Foreign-born with year of entry between 1990 and 1999

*** Significant at .001; **Significant at .01; *Significant at .05

Table 5
Negative Correlations Between Census Tract Characteristics and Percent of Loans that Are High Cost

	Correlation with Percent of High Cost Loans			
	Alameda	Fresno	Riverside	All Three Counties
Median household income (1999)	-0.46***	-0.62***	-0.54***	-0.57***
Median value housing units (2000)*	-0.61***	-0.62***	-0.24***	-0.62***

* Selected owner occupied housing units

*** Significant at .001; **Significant at .01; *Significant at .05

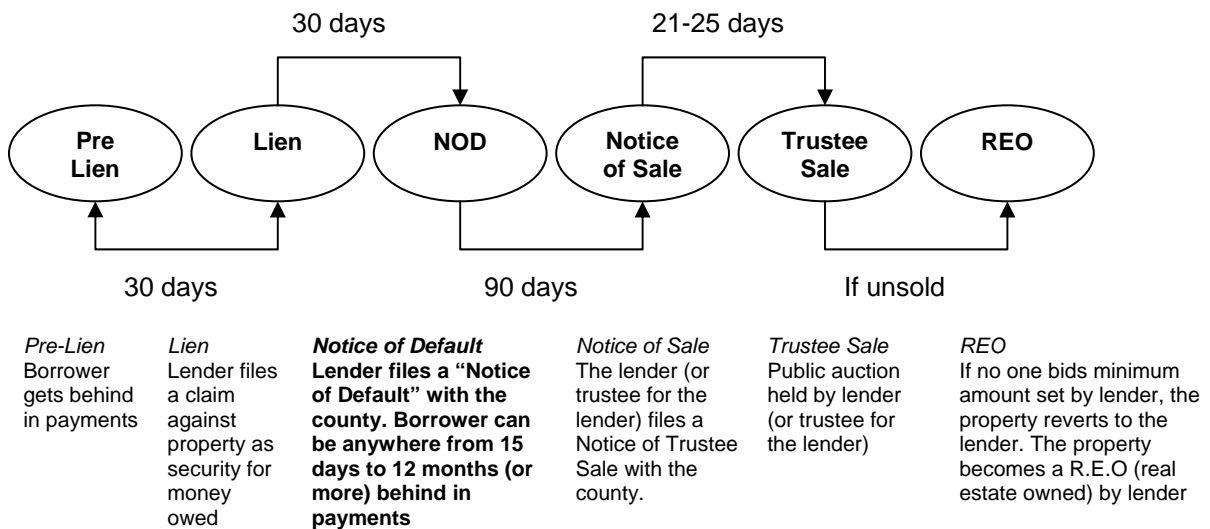
Assessing Foreclosure Risk Through Notices of Default

Notices of Default (NODs) are an official record that a borrower is behind on her mortgage payments and that her lender is initiating legal action. A relatively small percentage of homeowners who receive Notices of Default actually lose their homes to foreclosure. One

⁷⁴ The number of high cost loans in a census tract is, to some extent, a factor of the total number of loans made in that area in 2004. The number of high cost loans in an area should increase with the overall lending/borrowing activity in that area. By comparing census tracts based on the *percent* of loans that were high cost, we can see more clearly the relationship between neighborhood-level socio-economic and demographic characteristics and the prevalence of high cost lending. Loans considered in this analysis are first-lien loans on owner-occupied residences, not including manufactured housing.

estimate is that 10 percent of homeowners who receive a Notice of Default actually lose their homes to foreclosure. The remaining 90 percent are able to bring their payments current or sell their home.⁷⁵ In California, where actual foreclosures currently are rare occurrences, Notices of Default provide important information about the extent to which homeowners have home loans that they cannot afford. They are not a perfect indicator, however, because many households that have home loans they cannot afford do not ever get to the point where they receive a Notice of Default. Some homeowners are able to refinance or sell their home before receiving this official warning. Throughout this analysis, the term “foreclosure risk” is used as shorthand to describe areas in which households have received Notices of Default. Areas are described as having a “higher level of foreclosure risk” if they have a higher rate of Notices of Default.⁷⁶

Non Judicial Foreclosure Timeline⁷⁷



Between 1995 and 2004, the number of Notices of Default declined in California to a historic low.⁷⁸ A more detailed look at the number of Notices of Default by county for the period from 2001 to 2004 illustrates this trend more clearly. Between 2001 and 2004 the number of Notices of Default dropped in every county in the state except for Santa Clara; some counties, such as Alameda, did not experience a steady decline over the time period. Overall, the number of Notices of Default decreased by 8.8 percent from 2001 to 2004 in Alameda, by 49.9 percent in Fresno, and by 20.2 percent in Riverside.

⁷⁵ DQ News, “California Foreclosure Activity Stops Declining,” August 12, 2005.

⁷⁶ In general, census tracts are compared based on the rate of Notices of Default (the number of Notices of Default within the census tract normalized by the number of owner-occupied housing units with a mortgage within the census tract).

⁷⁷ Timeline from RealtyTrac, <http://www.realtytrac.com/education/noframes/JForeclosureTimeline.html?acct=12921>

⁷⁸ DQNews, August 12, 2005.

Table 7
Notices of Default by County, 2001-2004

	2001	2002	2003	2004
Alameda	2,662	3,193	3,102	2,429
Contra Costa	2,484	2,953	2,758	2,183
El Dorado	290	368	358	280
Fresno	3,849	3,545	2,660	1,929
Kern	3,120	2,779	2,295	1,733
Los Angeles	24,531	22,113	25,806	13,297
Madera	630	529	396	317
Marin	267	341	277	248
Merced	672	640	677	502
Monterey	428	414	449	384
Napa	182	184	128	101
Orange County	3,660	3,456	3,909	2,754
Placer	666	802	640	526
Riverside	6,378	6,092	7,145	5,089
Sacramento	4,832	4,229	3,589	2,880
San Bernardino	8,640	7,214	8,843	5,677
San Diego	3,412	3,654	4,364	3,263
San Francisco	470	504	538	427
San Joaquin	2,277	2,870	2,936	2,213
San Luis Obispo	336	345	321	205
San Mateo	746	965	930	684
Santa Barbara	597	572	527	320
Santa Clara	2,046	2,960	3,127	2,520
Santa Cruz	263	348	311	260
Solano	1,169	1,208	1,219	1,019
Sonoma	541	684	645	495
Stanislaus	1,539	1,689	1,563	1,267
Tulare	2,566	2,395	2,266	1,477
Ventura	1,395	1,393	1,543	883
Yolo	354	345	278	233
All California	81,003	78,784	83,600	56,125

Source: Dataquick Real Estate News, <http://www.dqnews.com/>

It is still too early to determine if the fourth quarter of 2005 marked the beginning of a new trend, or if it marks the return to some baseline amount of Notices of Default after an unnaturally low rate of such occurrences.⁷⁹ Regardless, it was the first time in nine years in which there was a

⁷⁹ Some argue that, like unemployment, some foreclosure activity is normal in any market and that current rates of foreclosure in California are unnaturally low at present.

statewide increase in the number of Notices of Default, which signals that more households are struggling to make mortgage payments and are at risk of foreclosure. Riverside County had the highest actual number of Notices of Default in the fourth quarter of 2005. Fresno experienced a 20.5 percent increase in the number of Notices of Default. Alameda County was one of only four counties where the number of Notices of Default continued to decline.

Table 8
Notice of Defaults, Comparing Q42004 to Q42005

County	Notice of defaults Q42004	Notice of defaults Q42005	Percent change Q42004 to Q42005
Alameda	489	456	-6.8%
Contra Costa	477	541	13.4%
El Dorado	45	59	31.1%
Fresno	430	518	20.5%
Kern	417	424	1.68%
Los Angeles	3,143	3,480	10.7%
Madera	55	55	0%
Marin	47	51	8.5%
Merced	121	118	-2.5%
Monterey	75	94	25.3%
Napa	12	33	175.0%
Orange County	684	918	34.2%
Placer	132	149	12.9%
Riverside	1,123	1,607	43.1%
Sacramento	646	849	31.4%
San Bernardino	1,292	1,473	14.0%
San Diego	872	1,173	34.5%
San Francisco	73	106	45.2%
San Joaquin	446	464	4.0%
San Luis Obispo	42	66	57.1%
San Mateo	168	176	4.8%
Santa Barbara	71	83	16.9%
Santa Clara	463	489	5.6%
Santa Cruz	54	62	14.8%
Solano	237	297	25.3%
Sonoma	108	143	32.4%
Stanislaus	309	159	-48.5%
Tulare	218	178	-18.4%
Ventura	254	261	2.8%
Yolo	35	64	82.9%
All California	12,978	14,999	15.6%

Variance in the number of Notices of Default is, to some extent, a factor of the number of housing units, and particularly the number of housing units with a mortgage within in an area. Within the study sample, Riverside has the highest rate of Notices of Default with approximately

70 per 10,000 housing units with a mortgage; Fresno County had approximately 54, and Alameda had approximately 23.

Foreclosure Risk by Census Tract

Because the number of Notices of Default has been relatively low in California and in the three counties that are the focus of this study, policymakers and researchers have paid relatively little attention to how these Notices of Default are distributed throughout different communities.

For the subset of Notices of Default included in this analysis, there were a total of 1,031 Notices of Default in Alameda County, 805 in Fresno County, and 1,947 in Riverside County.⁸⁰ On average, across all census tracts, the number of Notices of Default during the study period was less than five. Within the three county study sample, there were 87 counties (10.6 percent) with no Notices of Default during the study period. Alameda County had the highest percent of census tracts with no Notices of Default (18.1 percent); only 6.3 percent of Fresno’s census tract and 5.6 percent of Riverside’s had no Notices of Default during the study period. The census tract with the largest number of Notices of Default—65 over the study period—was located in Riverside County.

On average, census tracts in Riverside County have a higher average rate of Notices of Default compared to Fresno and Alameda Counties. Comparing rates of Notices of Default, the variation in Alameda County is much greater than in Fresno and Riverside.

**Table 9
Number of Mortgage Defaults (2005), by Census Tract**

	Number of NODs			Number of NODs Per 100 Housing Units*		
	Mean	Median	Std D	Mean	Median	Std D
Alameda	3.2	2.0	3.1	0.9	0.5	12.6
Fresno	5.1	5.0	3.3	1.0	0.8	0.7
Riverside	5.7	5.0	5.6	0.8	0.7	0.5

*Includes only owner occupied housing units with a mortgage.

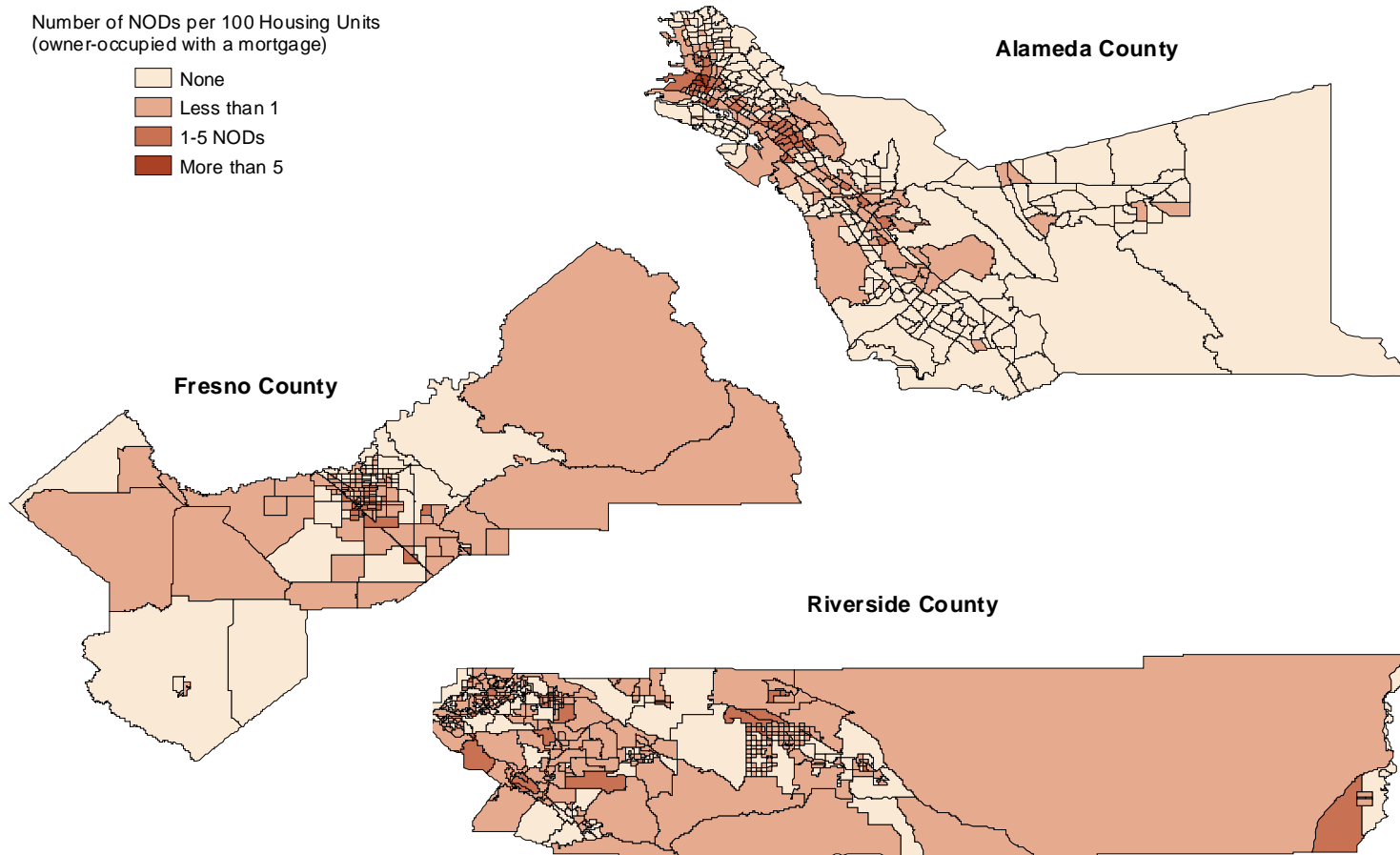
The maps on the following page illustrate the areas with the highest rates of Notices of Defaults. The areas in red are where there is greater foreclosure risk.

⁸⁰ As of the time of this writing, no county-level data are available on the total number of notices of default in 2005, so it is not possible to know how complete this sample is.

Level of Foreclosure Risk By Census Tract (Number of NODs per 100 Selected Housing Units)

Number of NODs per 100 Housing Units
(owner-occupied with a mortgage)

- None
- Less than 1
- 1-5 NODs
- More than 5



Characteristics of Census Tracts with Higher Levels of Foreclosure Risk

Even in a time period with relatively low numbers of Notices of Default, they may be cause for concern if foreclosure risk is concentrated in specific areas because they could have a big effect on the residents and neighborhood property values of those areas.

Like high cost lending which is concentrated in specific communities, foreclosure risk is highly correlated with census tract characteristics. The level of foreclosure risk in a census tract is correlated with nearly all of the census tract characteristics tested. Positive relationships were found between the number of Notices of Default and the percent of residents who were non-white, black, below the poverty level, with less than a college education, unemployed, Hispanic, and recent immigrants. For example, as the percent of non-white residents in a census tract increases, so does the number of NODs in that tract. The number of NODs is negatively correlated with the median income and median home value in that tract.

Table 10
Positive Correlations Between Census Tract Characteristics and Level of Foreclosure Risk

Percent of residents who are...	Correlation with Number of Notices of Default ⁸¹			
	Alameda	Fresno	Riverside	All Three Counties
Black	0.59***	0.46***	0.27***	0.48***
Below the poverty level	0.55***	0.56***	0.21***	0.44***
Non-white	0.48***	0.56***	0.25***	0.39***
Unemployed*	0.55***	0.35***	0.18***	0.38***
No college diploma	0.38***	0.48***	0.33***	0.36***
Hispanic	0.14*	0.35***	0.19***	0.18***
Recent immigrants**	0.04	0.35***	0.08	0.08

*Male and female residents in civilian labor force, over 16

**Foreign-born residents (year of entry between 1990 and 1999)

*** Significant at .001; **Significant at .01; *Significant at .05

Table 11
Negative Correlations Between Census Tract Characteristics and Level of Foreclosure Risk

	Correlation with Number of Notices of Default			
	Alameda	Fresno	Riverside	All Three Counties
Median household income (1999)	-0.41***	-0.52***	-0.22***	-0.38***
Median value housing units (2000)*	-0.42***	-0.51***	-0.10*	-0.31***

*Includes only selected owner occupied housing units.

*** Significant at .001; **Significant at .01; *Significant at .05

Relationships between foreclosure risk (signaled by the number of Notices of Default in an area) and neighborhood socio-economic and demographic characteristics are illustrated in the maps provided. As shown, Notices of Default are not restricted to areas where there are high percentages of lower income people and minority populations, but they do appear to be clustered in areas with these characteristics.

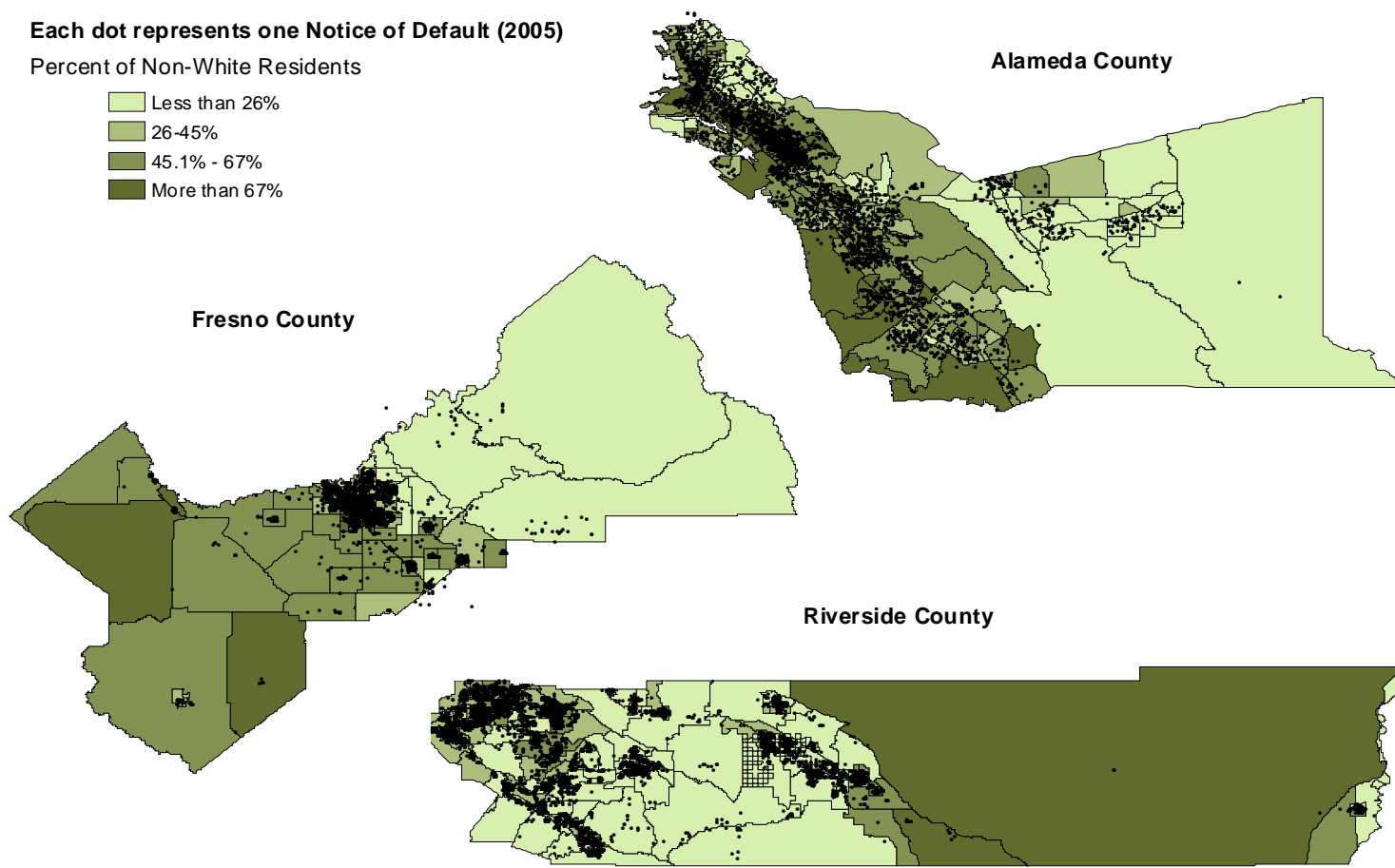
⁸¹ The number of Notices of Default has been normalized by the number of owner-occupied housing units with a mortgage.

Foreclosure Risk and Race/Ethnicity

Each dot represents one Notice of Default (2005)

Percent of Non-White Residents

- Less than 26%
- 26-45%
- 45.1% - 67%
- More than 67%

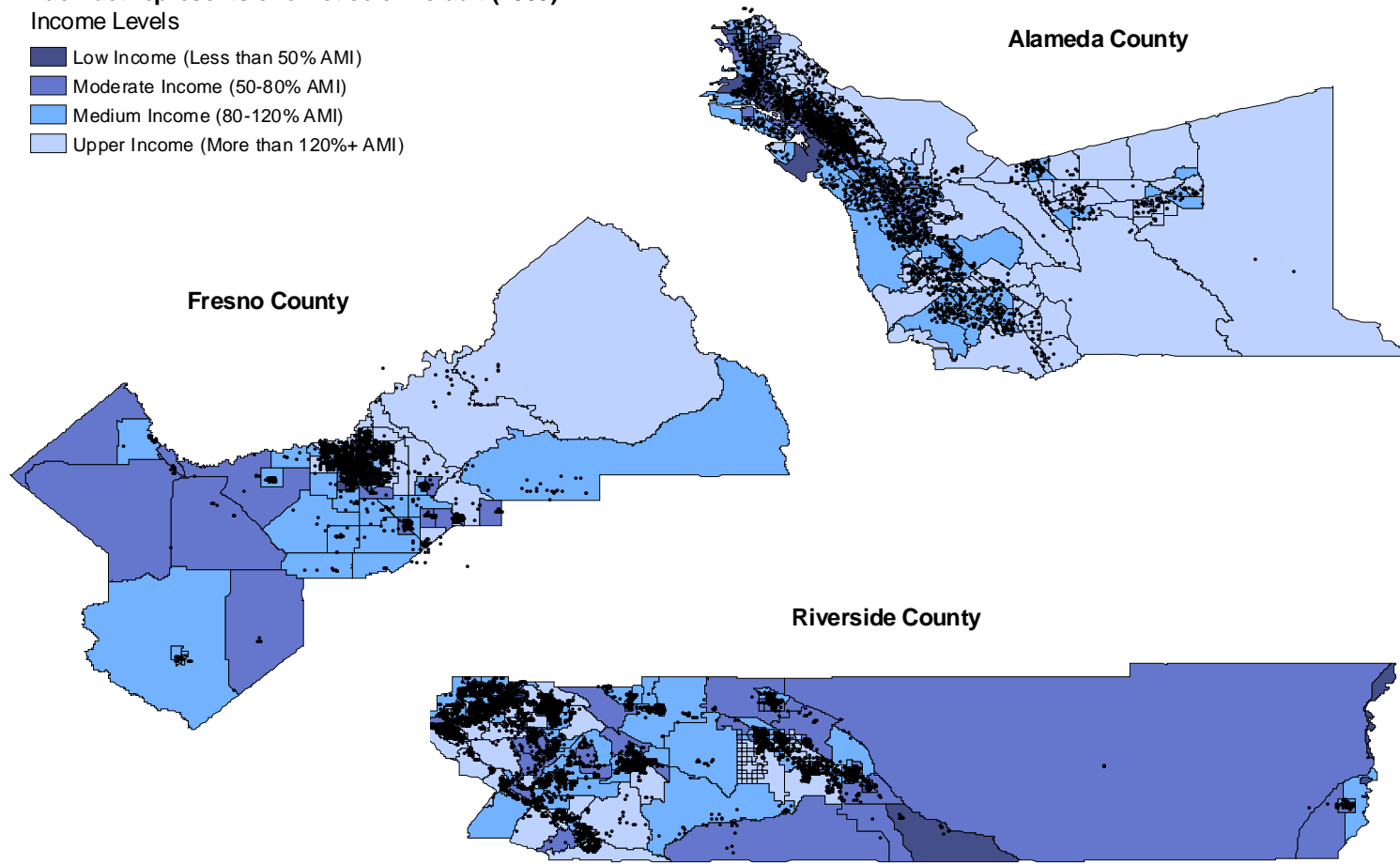


Foreclosure Risk and Income Level

Each dot represents one Notice of Default (2005)

Income Levels

- Low Income (Less than 50% AMI)
- Moderate Income (50-80% AMI)
- Medium Income (80-120% AMI)
- Upper Income (More than 120%+ AMI)



Relationship between Neighborhood Characteristics, High Cost Loans, and Foreclosure Risk

High cost lending is more common in areas with higher concentrations of minority residents, lower-income residents, residents with lower levels of educational attainment, and higher rates of unemployment; they are less common in more affluent areas with higher median home values. Because these neighborhood socio-economic characteristics are highly correlated with each other as well as with the number of Notices of Default in an area, it is difficult to parse out the components of the relationship between high cost lending and foreclosure risk⁸² that is not simply a reflection of these characteristics.

A simple model that tests the relationship between the number of high cost loans and the number of Notices of Default in a census tract provides a useful starting point. To control for neighborhood socio-economic and demographic characteristics that may contribute to increased foreclosure risk, additional variables are added to the model. In essence, the goal of this analytical approach is to isolate variation in the number of Notices of Defaults that is associated only with the number of high cost loans in an area. In this model, the dependent variable is the number of Notices of Default, and the explanatory variable of primary interest is the number of high cost loans in the area.

There are several significant limitations to this approach. First, by controlling for neighborhood-level socio-economic and demographic characteristics such as race/ethnicity and income that are associated with both higher cost loans and higher levels of foreclosure risk, the model may underestimate the relationship between high cost lending and foreclosure risk. It is not possible to isolate and measure the extent to which these communities are only at greater risk of foreclosure because of the higher prevalence of high cost loans within the area. For this reason, the model may provide a conservative estimate of the relationship between high cost lending and foreclosure risk. However, the analysis offers information about the types of communities are more at risk of foreclosure both because of their socio-economic and demographic characteristics and the level of high cost lending within the area.

Second, the models are subject to omitted variable bias. A number of latent characteristics that contribute to increased foreclosure risk may also be positively correlated with the level of high cost lending in a community (for example, borrowers' poor credit histories). At this time, these data are not widely available to the public through the HMDA dataset. The primary rationale for not collecting this information is that requiring lenders to report on this information would be costly and burdensome, and it could pose potential privacy concerns for consumers. Further, because different lenders use different methods of assessing credit risk, it could make the collection of consistent information challenging or make public current "non-public" information about lenders' risk-assessment and other business strategies.⁸³ In the absence of this information, however, critical information about loan pricing is not available. Due to omitted variable bias, the models may overestimate the relationship between high cost lending and foreclosure risk.

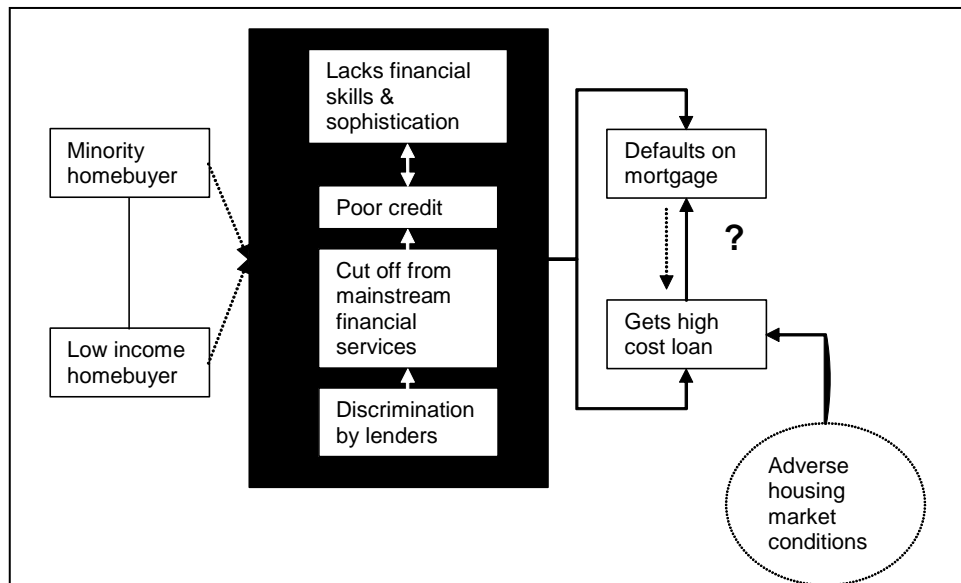
⁸² In this section and throughout the paper, Notices of Default are used as a proxy for foreclosure risk. Areas with a higher rate of notices of default (a larger number in proportion to the total number of owner-occupied housing units with a mortgage) are considered to have a higher level of foreclosure risk.

⁸³ These rationales are outlined in the Federal Reserve Bulletin, p. 366.

While income level and race/ethnicity are poor proxies for credit risk, their inclusion in the model mitigates some of the error due to omitting key variables that would account for these types of borrower differences.

Finally, to the extent that there is a causal relationship between high cost loans and number of Notices of Default in a census tract, it is not possible to detect the direction of the causation. Lenders contend that some borrowers are charged more for mortgages because they inherently present a higher risk of defaulting on their loan. It may be that higher cost loans do not lead to greater foreclosure risk but that the reverse is true – because a borrower is at greater risk of foreclosure they get higher cost loans. Nevertheless, prevalence of high cost lending in an area is cause for concern, even if proving the causal link to foreclosures is difficult. High cost loans cost households more on a monthly basis and over the life of the loan. While they may be the only credit option available to some households in some areas, the question remains of whether it is truly in the best interest of the household to pay such a high price for homeownership. In neighborhoods where more households have received Notices of Default and are at risk of foreclosure, homeownership is less associated with asset-building and wealth-creation. Not only does the household that receives the notice of foreclosure or who is foreclosed on suffer, but, as documented in numerous research studies, foreclosures can have a ripple effect on the surrounding area.

Modeling the Relationship Between High Cost Lending and Foreclosure Risk



Model 1 presents results of a negative binomial regression for the total sample of 819 census tracts in the three county area.⁸⁴ The coefficients on each of the explanatory variables have been

⁸⁴ Negative binomial regression is more appropriate than linear regression when the dependent variable in the model is count data (i.e. 0, 1, 2, etc.), particularly when the distribution of the dependent variable is not normal because there are a number of cases with a zero value.

exponentiated to make their interpretation more straightforward.⁸⁵ If the exponentiated coefficient is equal to one, the variable has no effect on the dependent variable; if it is greater than one, $\exp(\beta)$ is the factor by which the dependent variable is expected to increase. Variables for which $\exp(\beta)$ is less than one have the opposite effect.

Table 12
Model 1 - Total Sample, Estimating the Effect of High Cost Loans on Notices of Default, Controlling for Census Tract Housing and Demographic Characteristics

Negative Binomial Regression: Dependent variable, Notices of Default (2005)

	1a.	1b.	1c.
	$\exp(\beta)$	$\exp(\beta)$	$\exp(\beta)$
Number of high cost loans (2004)	1.0113***	1.0074***	1.0053***
Number of households		1.0001**	1.0001
Median home value in \$10K		0.9779***	0.9788***
Number of homes with a mortgage		1.0006***	1.0008***
Number of other loans (2004)		0.9995***	0.9996***
Percent of residents who are black			3.6089***
Percent of residents who are Hispanic			1.3978**
Median income (in \$10K)			0.9853
Observations	819	813	813

*** Significant at .001; **Significant at .01; *Significant at .05

Column 1a presents results from the most parsimonious model, including only the dependent variable (number of Notices of Default in the census tract) and the primary explanatory variable of interest – the number of high cost loans in the census tract. As shown in column 1a, the number of high cost loans is statistically significant and is positively associated with the number of Notices of Default, meaning that as the number of high cost loans increases in a census tract so does the number of Notices of Default. The magnitude of the effect is relatively small, as would be expected, given the relatively low rate of Notices of Default even in census tracts with the greatest prevalence of high cost loans.

In this version of the model, which does not include any of the control variables, one more high cost loan is associated with a .01% increase in Notices of Default. Another way of stating this is to say that 100 more high cost loans in a census tract is expected to increase the number of Notices of Default in that census tract by 1. Given that the average number of Notices of Default in the study sample is 4.6, this increase is comparable to a 22 percent increase in the number of Notices of Default. To put this in perspective, within the study sample, 31 census tracts (3.1 percent of the sample) had more than 100 high cost loans in 2004 alone, and the number of high cost loans per census tract ranged from zero to nearly 600.

The second version of the model, displayed in column 1b, includes three additional variables to control for population size (number of households) and housing market characteristics that could influence the relationship between high cost lending and foreclosure risk. By including “number of households” in the model, we control for the population effect that may lead to

⁸⁵ To exponentiate a coefficient means to raise e (2.718) to the value of the coefficient. This facilitates interpretation of the coefficients. The exponentiated coefficient provides information about the factor by which the dependent variable increases when the independent variable increases by one unit.

spurious correlation between the level of high cost lending and Notices of Default (since both are likely to increase with the number of households within a tract). Median home value is an important factor to examine because, in areas with higher median home values, borrowers may be more likely and able to refinance their mortgage or sell their home and escape an unaffordable loan than borrowers in areas with lower median home values.⁸⁶ As predicted, higher median home values are associated with a lower number of Notices of Default. The number of households with a mortgage is also an important control, because only households that have a mortgage are at risk of receiving a Notice of Default. This variable does have a small, but statistically significant effect, on the number of Notices of Default. Including the number of “other” loans provides more information about whether all lending activity is positively correlated with increased foreclosure risk, or only high cost lending. As shown, as the number of non-high cost or “other” loans in a census tract increases, the number of Notices of Default decreases. Including these additional variables improves the explanatory power of the model, and reduces the coefficient on the number of high cost loans; however, the number of high cost loans in a census tract statistically significant and the direction of the effect on the number of Notices of Default remains the same.

Finally, three additional census tract characteristics are added to the model: percent of black residents, percent of Hispanic residents, and median income.⁸⁷ The exponentiated coefficients on the variables that are percentages should be interpreted as the difference between a census tract that is 0 percent black (or Hispanic) to one that is 100 percent black (or Hispanic). Thus, holding all else constant, the number of Notices of Default in a census tract that is 100 percent black is estimated to be 3.6 times greater than those in a census tract that has no black residents.⁸⁸ When these additional census tract characteristics are controlled for, including race and median income, which are characteristics that are correlated with both high cost loans and number of Notices of Default, the relationship between the number of high cost loans and Notices of Default remains statistically significant. Comparing the average census tract (one in which 10 percent of the residents are black) to one in which more than half of the residents are black,⁸⁹ holding all else constant, the census tract in which more than half of the residents are black would be expected to have 86 percent more Notices of Default.

A second version of the model, which is presented below, displays results for each county separately. The findings are consistent in terms of the effect of high cost loans on Notices of Default. In each case, the number of high cost loans in a census tract is positively associated with the number of Notices of Default, and the variable is statistically significant. There are some differences among the counties that are worthy of note. In particular, in Alameda County, the effect of the percent of residents who are black is much stronger than in the other two counties,

⁸⁶ Median home value has been expressed in \$10,000s so that the effect of median home value on the number of notices of default. Holding all else constant, the number of Notices of Default can be expected to decline by 2% for each \$10,000 increase in median home value.

⁸⁷ Several iterations of the model were created with additional continuous explanatory variables such as percent of residents with a college diploma and categorical variables pertaining to income level and concentrations of minority populations. Through a stepwise selection process in SAS, variables with the greatest explanatory power were chosen for the model. Ultimately, several variables (including that pertaining to educational attainment) were not included due to concerns about multi-collinearity.

⁸⁸ These are extreme examples, and are useful for illustrative purposes only. Within the study sample, there are 37 census tracts with no black residents; none are 100% black.

⁸⁹ For this comparison, the estimated number of Notices of Default in a census tract in which 10% of the residents are black is compared to the estimated number of Notices of Default in a census tract in which 54% of the residents are black. (For the study sample as a whole, a census tract which is 54% black is three standard deviations above the mean.)

as is the percent of residents who are Hispanic. While the overall rate of Notices of Default and high cost lending is lower in Alameda than in the other two counties, it is much more concentrated in areas with these two characteristics. The number of high cost loans and the number of housing units with a mortgage are the only two variables that are statistically significant across all three counties and all three iterations of the model.

Table 13
Model 2 - By County, Estimating the Effect of High Cost Loans on Notices of Default,
Controlling for Census Tract Housing and Demographic Characteristics

Negative Binomial Regression: Dependent variable, Notices of Default (2005)

		2a.	2b.	2c.
		exp (β)	exp (β)	exp (β)
Alameda	Number of high cost loans (2004)	1.0404***	1.0301***	1.0116***
	Number of households		1.0002***	1.0003***
	Median home value in \$10,000		0.9748***	0.9908
	Number of homes with a mortgage		1.0006***	1.0007***
	Number of other loans (2004)		0.9994	1.0003
	Percent of residents who are black			8.1515***
	Percent of residents who are Hispanic			3.8401***
	Median income (in \$10,000)			1.0014
	Number of Observations	321	318	318

		2a.	2b.	2c.
		exp (β)	exp (β)	exp (β)
Fresno	Number of high cost loans (2004)	1.0061***	1.0062***	1.0060***
	Number of households		1.0001**	1.0000
	Median home value in \$10,000		0.9370***	0.9623**
	Number of homes with a mortgage		1.0010***	1.0012***
	Number of other loans (2004)		0.9985***	0.9985***
	Percent of residents who are black			1.9037
	Percent of residents who are Hispanic			0.8873
	Median income (in \$10,000)			.8983
	Number of Observations	157	156	156

		2a.	2b.	2c.
		exp (β)	exp (β)	exp (β)
Riverside	Number of high cost loans (2004)	1.0092***	1.0065***	1.0059***
	Number of households		0.9999	0.9998
	Median home value in \$10,000		0.9982	0.9988
	Number of homes with a mortgage		1.0007***	1.0008***
	Number of other loans (2004)		0.9996**	0.9997**
	Percent of residents who are black			1.8114
	Percent of residents who are Hispanic			0.7839
	Median income (in \$10,000)			0.9629
	Number of Observations	341	339	339

*** Significant at .001; ** Significant at .01; * Significant at .05

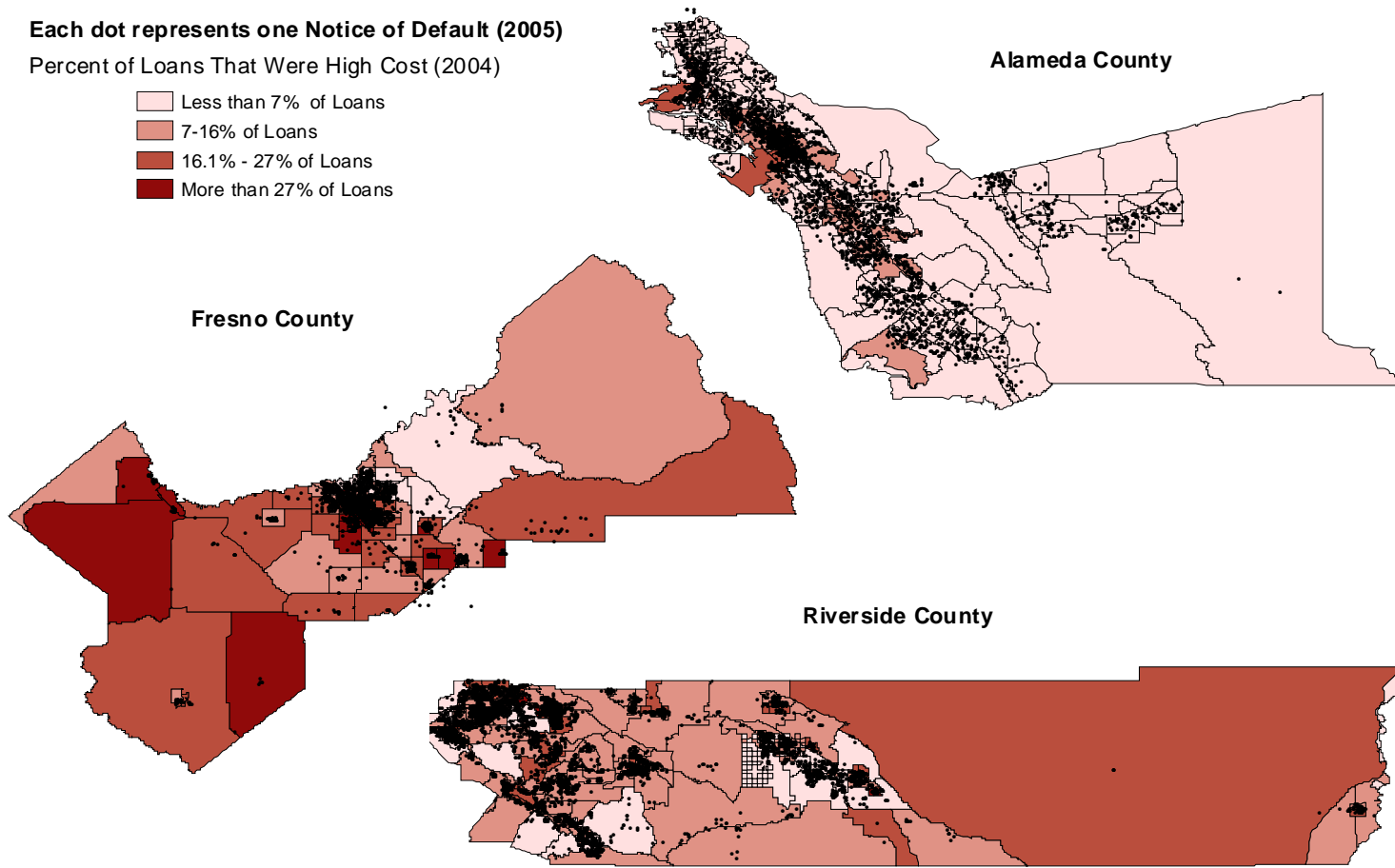
This analysis confirms that there is a relationship between the number of high cost loans in a census tract and the number of Notices of Default, even after controlling for the tracts' demographic and socio-economic characteristics. This is true for all three counties, when they are considered separately, and for the study sample as a whole. The magnitude of the effect is relatively small, as should be expected given the low number of Notices of Default within the area during the study period. For every one household that receives a Notice of Default, there are likely many more that are in a similar position, but given the strong housing market in California during the study period were able to forestall default by refinancing or selling their home.

Foreclosure Risk and High Cost Loans

Each dot represents one Notice of Default (2005)

Percent of Loans That Were High Cost (2004)

- Less than 7% of Loans
- 7-16% of Loans
- 16.1% - 27% of Loans
- More than 27% of Loans



Chapter 3

Policy Implications

This analysis confirms that there are at least two policy issues to be addressed. High cost lending is concentrated in specific neighborhoods within Alameda, Fresno, and Riverside Counties – including census tracts with higher percentages of minority populations, as well as areas with lower median incomes and lower median home values. High cost loans can have a wealth-stripping effect on households, particularly when they are paying more for their loan than is warranted or if they are unable to afford to remain homeowners. In these instances, homeownership does not necessarily promote asset-building.

Further, the association between high cost loans and Notices of Default is cause for concern. While Notices of Default remain relatively rare in Alameda, Fresno, and Riverside Counties, they are concentrated in areas where high cost lending is more prevalent. In neighborhoods where many homebuyers have high cost loans, homeownership may not contribute to increased stability, particularly if more households default on their loans and lose their home through foreclosure.

While these findings identify concerning patterns in terms of who gets high cost loans and the relationship between high cost loans and foreclosure risk, it sheds less light on why households obtain high cost loans in the first place. There are a number of possible reasons, each of which is likely present to some degree, and each of which suggests a different policy solution.

First, it could be that some borrowers are paying too much for their home loans because they lack the skills and confidence necessary to find a loan at a lower cost. Obtaining a home loan is a complex transaction; providing borrowers pre-purchase housing counseling and education programs could greatly reduce the ill effects of high cost loans on households and neighborhoods by preventing households from entering into these loans in the first place.

Second, it could be that the prevalence of high cost loans in some areas is evidence of discrimination and predatory practices in the mortgage market. There are numerous documented cases of mortgage brokers and lenders who take advantage of borrowers who have little contact with or access to mainstream financial institutions. While providing these homebuyers education and counseling may be important so that they do not get themselves into a bad loan, to the extent that brokers and lenders are acting fraudulently and steering homebuyers in minority and low-income areas into high cost loans, better enforcement of fair lending laws and regulation of subprime and high cost lenders is required. Other studies have suggested that the mortgage market is segmented in such a way that subprime and high cost lenders focus on specific areas, while prime lenders focus on others. Increasing incentives for prime lenders to provide credit in minority and low-income areas is a further strategy to address this problem.

Third, if the problem is that some types of loan products are simply too costly, it might be in the public's interest that they are restricted. The government has long had a role in regulating the credit market; while the direction of federal policy in recent years has been to remove restrictions, there has been recent activity at the state and local level to put in place new limits. It could be that further consumer protections are needed in California.

Finally, it could be that there are always going to be some households that obtain home loans that they cannot afford. If this is the case, the best way to address this issue may be by putting in place a safety net so that homebuyers that receive a Notice of Default are able to receive assistance so that they do not lose their home to foreclosure.

In summary, there are a number of strategies that could be used to address high cost lending and foreclosure risk in California, including:

- Increase access to information and education for borrowers, particularly through pre-purchase counseling;
- Strengthen enforcement of existing anti-predatory lending laws;
- Create new incentives to stimulate prime and “legitimate” subprime lending in lower wealth communities;
- Strengthen anti-predatory lending legislation to restrict high-cost lending;
- Assist homeowners facing foreclosure through emergency assistance.

An ideal policy solution to the problem of high cost lending and foreclosure risk in California would meet the following goals: 1) eliminates/reduces discrimination in mortgage market; 2) protects homebuyers from entering into high cost loans they cannot afford; 3) does not restrict or inhibit “legitimate” subprime lending; 4) mitigates potential harm from foreclosure risk; 5) is a proven practice (based on the experiences of other states); 6) is politically feasible, enforceable, and simple to administer; and is 7) low cost for taxpayers

While providing a detailed analysis of which approach to pursue is beyond the scope of this paper, the findings of this research do suggest clear recommendations for policy action and further research. (Appendix B provides more detail on how the policy options were evaluated.)

1. **Make pre-purchase counseling available to every consumer who accesses a high cost loan.** In California, and across the country there are a number of consumer education initiatives that are designed to inform borrowers, increase their financial literacy, and deter predatory lenders. Some of these programs are sponsored by the federal, state or local government, others are funded through philanthropy and offered by nonprofit entities; some are offered by industry groups.

Through HUD-approved housing counseling agencies, trained counselors are able to review loan disclosure statements with clients and assist them in understanding the terms and conditions of the loan they are considering. To acquire some types of loans, such as negative amortizing loans and those that trigger HOEPA, borrowers must participate in required pre-purchase counseling. For the vast majority of borrowers, however, education and counseling is only available if they seek it out proactively.

Given evidence that potentially as many as one-third to one-half of subprime borrowers could qualify for prime loans, there is reason to believe that many of those who obtain high cost loans could access loans at a lower cost. Several studies on pre-purchase housing counseling programs have found that they are effective; in one case, researchers found that counseling programs reduced loan delinquency by 19 percent; another found that they reduced it by 50 percent.⁹⁰ Addressing high cost lending and foreclosure risk through homebuyer counseling would mean increasing the quality and/or quantity of the services available or making these services mandatory for homebuyers.

- 2. Learn from the experiences of other states that have restricted predatory and high cost lending.** As of April 2006, California is one of a total of 25 states that have enacted stricter laws to restrict high cost lending, including Arkansas, Colorado, Connecticut, Florida, Georgia, Illinois, Kentucky, Maine, Maryland, Massachusetts, Nevada, New Jersey, New Mexico, New York, North Carolina, Ohio, Oklahoma, Pennsylvania, South Carolina, Texas, Utah, and Wisconsin.⁹¹ State laws restricting specific high cost and predatory lending practices vary in their design and stringency. Among these states, California is considered to have a relatively weak law; a leading national nonpartisan research and policy organization, the Center for Responsible Lending, which advocates for stronger restrictions on high cost and predatory lending, classifies California as having “minimal to no restrictions” against predatory lending.⁹² Advocates for stronger high cost lending laws argue for changes to California’s law which would bring it in line with states that have stricter laws, including North Carolina, New Jersey, and New Mexico.

A number of studies have examined the impact of state’s anti-predatory lending laws, particularly the effects of North Carolina’s law, which was one of the first implemented. These laws are relatively new, and their effectiveness is still being debated. In some cases, researchers studying the impact of the North Carolina statute found that the law had the effects it intended – the number of mortgage loans with abusive terms declined after its enactment, but “legitimate” subprime lending to high-risk borrowers did not. Other researchers found that the law had the adverse effect of reducing the overall level of “legitimate” subprime lending within the state, and that it particularly hurt low-income

⁹⁰ Hornburg (2004), p. 15.

⁹¹ In addition, at least 18 municipalities have attempted to impose additional restrictions on high cost and predatory lending, although a number of these laws have been challenged in court and never enacted; Oakland, Sacramento, and Los Angeles are among the jurisdictions in which these types of efforts have been made.

⁹² California’s law sets a higher threshold for “high cost” loans than do laws in states with stronger anti-predatory lending laws, as a result, a smaller subset of loans are covered by California law than are covered in states with more restrictive laws. California’s law allows loans to carry points and fees that amount to a higher percentage of the loan amount; some fees are not included in the method used to determine the amount of points and fees associated with a loan; and the law does not cover open-ended loans. California’s law also provides fewer protections for consumers who obtain loans that are covered by the law. For example, California law only mandates additional disclosure to borrowers of high cost loans, whereas other states, such as North Carolina, Georgia, and New Mexico, require borrowers to obtain counseling before signing their loan documents. California allows for the financing of points and fees if they do not exceed 6%; some states do not allow for financing of any points or fees on high cost loans or only allow the financing of points and fees that amount to a much smaller percentage of the loan amount. Limitations on prepayment penalties are less restrictive than in other states; in California, restrictions only apply to high cost loans, and the law allows prepayment penalties to be in place for a longer period of time than is allowed in other states. Finally, in terms of remedies for borrowers, California law does not restrict mandatory arbitration clauses in high cost loans and it protects assignees that are holders of loans from liability for damages. Information provided by the Center for Responsible Lending, http://www.responsiblelending.org/fed_state_update/mortgagelaws.cfm

borrowers.⁹³

Given uncertainty about the impacts of these laws, there is reason to proceed with caution in enacting new restrictive legislation in California. At this time there is little perceived urgency to enact new policies in the state; California policymakers can and should benefit from learning from the other states that go before it in this arena.

3. **Continue to monitor and assess high cost lending and foreclosure risk in California.**

This research suggests that these issues are worthy of further study and monitoring. Suggestions for further research include:

- ***Make full use of data that are available through the Home Mortgage Disclosure Act (HMDA).*** As of 2004, additions to the HMDA dataset provide the public with important information on loan pricing for high cost loans (those with interest rates above specific thresholds) and very high cost loans (those that trigger HOEPA). Research by organizations like ACORN, which published a report on the 2004 HMDA dataset⁹⁴ and the California Reinvestment Committee, which publishes a yearly report based on the HMDA dataset, is vitally important to ensuring that this information is accessed and analyzed. These organizations, and others like them, should be supported in their efforts to make this information accessible to members of the public.
- ***Continue efforts to study the relationship between borrower characteristics, loan terms, and loan performance.*** For this analysis, it was not possible to gain access to one of the proprietary datasets that include more detailed information on individual loans than is provided in HMDA.⁹⁵ Without information on credit scoring and other criteria that are key components of lenders' underwriting process, studies that identify patterns of high cost lending and foreclosure risk and the relationship between these two phenomena can easily be criticized for identifying the obvious (i.e. individuals who present higher credit risks pay more for credit) and supporting the practices of lenders (i.e. they are acting rationally in pricing loans at higher cost for individuals who are more likely to default). Future efforts to understand the relationship between high cost lending and foreclosure risk in California would benefit from access to more comprehensive datasets.
- ***Develop non-proprietary datasets on Notices of Default and actual foreclosures in California.*** Researchers, advocates, and policymakers need access to comprehensive datasets that include information on pre-foreclosure and foreclosed properties over time. While some foreclosure data is available from the RAND Corporation for the years from 1995 to 2002, the source of this information, the California Association of Realtors, no longer makes this

⁹³ Summarizing findings from Quercia, Stegman, and Davis, "the Impact of North Carolina's Anti-Predatory Lending Law: A Descriptive Analysis," and Elliehausen, Gregory, and Staten, "An Update on North Carolina's High-Cost Mortgage Law," and "Regulation of Subprime Mortgage Products: An Analysis of North Carolina's Predatory Lending Law," in Litan, R. (2003).

⁹⁴ ACORN. (2005). "The High Cost of Credit: Disparities in High-priced Loans to Minority Homeowners in 125 American Cities."

⁹⁵ Key information for studying these relationships include: borrowers' race/ethnicity, income level, credit score, loan amounts, property values, interest rates, origination fees, and loan performance over time. Companies such as Loan Performance (<http://www.loanperformance.com>) have made this information available to research teams for other projects.

information available.⁹⁶ Data that are collected and stored at each County's Clerk Recorders Offices, are generally not in a format that is readily combined or analyzed. Private companies, like *foreclosure.com*, make information available for a small fee, but data are in formats that require significant manipulation in order to make them useable by researchers. More significantly, all the private companies contacted for this research purpose were only able to provide current information. While sources, such as DataQuick Real Estate News, provide periodic information on the rate of Notices of Default and foreclosures at the state or county-level, these statistics can obscure what is happening at the level where foreclosure risk matters most - for households and neighborhoods. Without comprehensive non-proprietary datasets on Notices of Default and actual foreclosures, it makes the task of those who are concerned with understanding and addressing this issue much more difficult if not impossible.

- ***Conduct a qualitative study drawing on the expertise of housing counselors to understand why homebuyers default on their loans.*** While this analysis provides information about the prevalence of high cost loans and its association with foreclosure risk, questions remain about the extent to which there is a causal relationship between these two phenomena. A study that drew upon the expertise of housing counselors and others who work directly with households that are at risk of defaulting on their mortgage would provide more insight into the extent to which disadvantageous loan terms are a significant contributor to mortgage default.

⁹⁶ RAND is a nonprofit entity providing research and analysis to inform policymakers. A disclaimer on the website page that contains foreclosure data states, "The data provider for this RAND California database has indicated that they will cease publishing housing price and foreclosure data with the Dec. 2002 time period. We are exploring other options of providing these data." <http://ca.rand.org/stats/economics/foreclose.html>

Conclusion

Current low rates of loan delinquency and foreclosure in California obscure the fact that many homeowners have high cost home loans that they cannot afford. Some of these households may have entered into high cost loans because they were eager to become homeowners, and this was the best option available to them given their credit history. Other households may have been steered or pressured into taking out loans that were not in their best interests; they find themselves with loans that cost more than they should and/or are at terms that make them unaffordable. Both groups of households are at risk of losing their greatest assets, particularly if the long-predicted slowdown in California's housing market takes place.

Foreclosures are the ultimate, but not inevitable, ending to a chain of events that is set in motion when a household fails to make its mortgage payments. Becoming susceptible to foreclosure or, at the extreme, having one's home foreclosed upon is a traumatic event for a household; and a pattern of defaults and foreclosures within a concentrated area can be devastating. In recent years, increasing the rate of and access to homeownership has been a policy priority at the federal, state and local level; within this context, high cost loans and elevated foreclosure risk are in direct conflict with the vision of homeownership as an asset-building opportunity for households and stabilizing force in communities.

This study focuses on three counties in California, providing evidence that high cost lending and foreclosure risk are not evenly distributed across all areas. In Alameda, Fresno, and Riverside counties, high cost loans and Notices of Default are more concentrated in neighborhoods where there are higher percentages of minority residents, particularly those who are Black and Hispanic, and areas where median incomes are lower. Controlling for key socio-economic, demographic, and housing market characteristics, models that test the relationship between high cost lending and foreclosure risk confirm that there is a significant relationship between the two. While it is difficult to determine whether the relationship is causal, there is enough information to suggest that policy interventions that address both of these issues are needed.

There are a number of different strategies that could be used to address high cost lending and foreclosure risk in California, from increasing borrowers' access to information and education to assisting homeowners facing foreclosure through emergency assistance. Any strategy implemented must meet a variety of goals, chief among these are protecting homeowners from entering into high cost loans they cannot afford and not placing undue restrictions on "legitimate" subprime lending.

The findings of this research suggest several clear recommendations for policy action and further research: make pre-purchase counseling available to every California consumer before they obtain a high cost loan; learn from the experiences of other states that have restricted predatory and high cost lending; and continue to monitor and assess high cost lending and foreclosure risk in California. While foreclosure rates are still at historic lows in the state, the level of high cost lending and recent increases in the number of Notices of Default within California signal that these are issues that merit more attention from policymakers and researchers than they have been receiving. Increasing the rate of homeownership among low-income and minority households in the state are worthy goals, but they should not be achieved at such a high cost.

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Appendix A

Data Sources

The following data sources were used to analyze the relationship between high cost loans, foreclosure risk, and neighborhood characteristics for Alameda, Fresno, and Riverside Counties.

Data on High Cost Loans

This study relies on HMDA (Home Mortgage Disclosure Act) data from 2004. Prior to 2004, the only data readily available for researchers interested in studying differences in the cost of credit for different communities was information in HMDA that specified whether a loan was made by a prime or a subprime lender. Numerous studies relied on this information, while acknowledging some of the extreme limitations of the dataset. Because loans were characterized as prime or subprime based on the lender rather than the terms of the loan, prime loans that were made by lenders who primarily offered subprime loans (more than 50% of their loans were subprime) were mistakenly classified as subprime, and vice versa. Furthermore, while researchers were most concerned about predatory and discriminatory lending practices, and not about “legitimate” subprime lending, the data provided no readily available means for parsing legitimate lending practices from problematic ones.

In 2004, as a result to changes in policies governing the data collection process, several important additions were made to the HMDA dataset, which enable more precise analysis of lending patterns. First, a new variable was added which provides details on high-cost loans, this includes loans for which the interest rate exceeds the prime rate by a specified amount.⁹⁷ Furthermore, the dataset now includes data on the type of loan provided. Because some types of loans (second-lien and loans for manufactured housing) generally carry higher interest rates, this information is vital for identifying meaningful differences in loan cost to different types of borrowers.

There remain several key limitations to the HMDA data that are important to note. First, the data does not include critical borrower and loan-specific information that are vital to truly understanding patterns in high cost lending. For example, the dataset does not include borrower credit scores or data on the loan-to-value ratio. This information is key to lenders’ underwriting decisions and an important determinant in whether someone qualifies for a prime or subprime loan. Second, the information in HMDA only provides information about the rate spread for high cost loans at time of origination. Given that such a high percentage of homebuyers in California are relying on adjustable rate mortgages, which may have low teaser rates for the first two to five years of the loan, this data dramatically undercounts the number of loans with interest rates that greatly exceed the prime rate, if not at the time of origination, then for the majority of the loan term. Third, the dataset does not include information about origination fees and points paid, or whether the loans include terms that are often associated with high-cost or predatory lending, including prepayment penalties and balloon payments, which are also critical for truly accounting for differences in loan pricing. Finally, HMDA does not include data on all loans

⁹⁷ The threshold is 3% above prime for first-lien loans and 5% for second-lien loans.

originated; it is estimated to include 80 percent of the home loans extended in 2004.⁹⁸ HMDA includes loans made by financial institutions that are regulated by the federal banking regulators: Office of the Comptroller of the Currency (OCC); Federal Reserve System (FRS); Federal Deposit Insurance Corporation (FDIC); Office of Thrift Supervision (OTS); National Credit Union Administration (NCUA); and the Department of Housing and Urban Development (HUD). It is likely that a higher percentage of loans that are not included in HMDA are problematic (in terms of the terms of the loans and the business practices of the lenders) than those that are included. Lenders that are not regularly subject to examination by regulators may be more able to get away with discriminatory or predatory practices than those that are. For this reason, focusing on high cost loans that are originated by lenders that are required to report in HMDA provides an underestimate of the problem.

Data on Foreclosure Risk

Notices of Default inform households that they are delinquent on their mortgage and that the lender may pursue legal recourse; Notices of Default are public records, which are available at County Clerk Recorders' offices. Studies of foreclosure risk in Chicago and other metropolitan areas have generally been able to make use of historical datasets that include records for all Notices of Default and other transactions in the foreclosure process. Unfortunately, no such comparable dataset was located for the counties included in this study or, for that matter, for any areas in California.

A number of companies provide access to data on Notices of Default in California, generally via online listings that are available for a minimal monthly fee. These companies' target customers are individuals and businesses that seek to purchase distressed properties that have entered the pre-foreclosure or actual foreclosure process. This study relies on data provided by one of the largest online sources of information about pre-foreclosure and foreclosures nationally, *foreclosure.com*.

Foreclosure.com collects data on Notices of Default as they are recorded at the County Clerk-Recorders office, and it clears properties from its database when they are no longer "active (i.e. the Notice of Default has been resolved). At this time, they are not able to provide historical datasets. The company does provide detailed information on properties, including addresses, name of owner, property features, beneficiary (lender or collection agency that has initiated the foreclosure process), and date of Notice of Default.

The focus of this study is properties on which Notices of Default were recorded between January 2005 and February 2006, and which remain at risk of foreclosure as of the end of February 2006.⁹⁹ While this dataset is less ideal than the complete historical datasets that are available for cities like Chicago, it appears to be one of the best readily available source of data on notices of default for this time period in all three counties.

The most obvious limitation to this dataset is that it does not include records for all Notices of Default recorded during the study period. Because the intention of the company is to provide up-

⁹⁸ Federal Reserve Bulletin, Summer 2005, p. 344.

⁹⁹ Data were downloaded between February 24 and March 10, 2006.

to-date information, properties for which Notices of Default have been cleared are no longer in the dataset. This means that the number of Notices of Default is likely undercounted for the study period.

While it would be more ideal to conduct a time series analysis, studying the effect of high cost lending on Notices of Default over time, because of the data storage practices of *foreclosure.com*, records of Notices of Default prior to 2005 are likely to be less complete than those for this more recent time period.

Finally, in order to conduct the analysis at the level of the census tract, only addresses that could be geocoded using ArcMap software were used. This process was more complete for Notices of Default in Alameda County, where census tract data were located for 91 percent of addresses; in Fresno County, 87 percent of addresses were geocoded; in Riverside, only 75 percent of addresses were. Because Riverside County is growing rapidly, it makes sense that the street map data used to pinpoint addresses on maps (so that they can be associated with census tracts) was incomplete. To account for the missing data, a comparison was made between areas for which 25 percent or more of the Notices of Default were not geocoded (and therefore are underrepresented in the sample) and the sample that was analyzed. There was only one zip code in Alameda County in which more than 25 percent of the addresses were not matched to census tracts, but this zip code is not included in the Census 2000 file, so no demographic data could be obtained for that area. The tables below provide a comparison of areas for which Notices of Defaults were not included in the analysis, and those for which it was. As shown, based on this simple analysis, there is reason to be confident that these omissions do not significantly bias the study findings.

**Table A-1
Comparison of Areas where NODs were Included in Sample and Those that are Undercounted**

		Area Averages				
		Total population	% of residents who are Black	% of residents who are Hispanic	Median income (1999)	Median home value*
Fresno	Not included in sample	3652	3.0%	55.7%	\$26,846	\$99,867
	Included in sample	5060	5.2%	41.8%	\$37,829	\$104,900
Riverside	Not included in sample	13360	3.0%	30.7%	\$47,549	\$153,400
	Included in sample	4531	5.9%	35.6%	\$44,566	\$146,500

*Includes only selected owner occupied housing units..

Data on Census Tract Characteristics

Data were drawn for each of the census tracts within Alameda, Fresno and Riverside County from Census 2000. One limitation of using data from Census 2000 is that the data are somewhat out of date for the study period. To the extent that some communities in the study are in transition, demographic characteristics in 2000 may not accurately reflect their characteristics in 2004.

Appendix B

Evaluation of Policy Options

The purpose of this analysis of high cost lending and foreclosure risk is to identify policy recommendations for California, specifically. While other measures could be taken to address these issues at the national level, these are not included in the policy options evaluated.

Six strategies were identified for evaluation:

- Increase access to information and education for borrowers, particularly through pre-purchase counseling;
- Strengthen enforcement of existing anti-predatory lending laws;
- Create new incentives to stimulate prime and “legitimate” subprime lending in lower wealth communities;
- Strengthen anti-predatory lending legislation to restrict high-cost lending practices;
- Assist homeowners facing foreclosure through emergency assistance;
- Let present trends continue undisturbed.

In comparing these policy options, five criteria were used. First, does the policy have the potential to eliminate discrimination in the mortgage market as evidenced by concentrated high cost lending in specific communities? Second, does the policy protect homebuyers from entering into high cost loans they cannot afford? Third, is the policy designed so that it will not restrict or inhibit “legitimate” subprime lending? Fourth, will the policy mitigate potential harm from foreclosure? Fifth, does the policy build on the lessons learned and proven practices of other states and localities that have worked to combat high cost lending and foreclosure risk within their areas? Sixth, is the policy politically feasible, meaning that it is likely to garner the political support needed to make it viable, is it enforceable and/or simple to administer? Finally, will the policy be relatively low-cost for taxpayers?

Criteria for Selecting Among Policy Options	
A.	Eliminates/reduces discrimination in mortgage market
B.	Protects homebuyers from entering into high cost loans they cannot afford
C.	Does not restrict or inhibit “legitimate” subprime lending
D.	Mitigates potential harm from foreclosure risk
E.	Proven practice
F.	Politically feasible, enforceable, and simple to administer
G.	Low cost for taxpayers

Comparison of Policy Options

The following chart provides an overview of the relative merits of the different policy options considered. An “X” signals that the policy option meets or, at a minimum, does not violate the

criteria. The purpose of this somewhat subjective comparison is to select policy options for further consideration and discussion.

**Table A-2
Evaluation of Policy Alternatives**

Criteria	Homebuyer information and education	Stricter enforcement of existing lending laws	Stimulate prime/ "legitimate" subprime lending	Amend CA law to restrict high cost lending	Emergency foreclosure assistance	Let present trends continue undisturbed
A. Reduces lending discrimination		X		X		
B. Protects homebuyers from entering into high cost loans they can't afford	X			X		
C. Won't restrict legitimate lending	X	X	X		X	X
D. Mitigates harm from foreclosure	X				X	
E. Proven practice	X			X	X	
F. Politically feasible	X	X				X
G. Low cost to taxpayers			X	X		X

Based on this basic comparison, four options were discarded. While stricter enforcement of existing laws is clearly an important component of any strategy to combat high cost, and particularly predatory lending practices, there is less of a role for California policymakers in establishing new regulatory and enforcement mechanisms. Recent efforts, such as that which resulted in a \$325 million settlement with Ameriquest, are evidence that this type of strategy is being pursued. In terms of stimulating prime and "legitimate" subprime lending, there are a number of mechanisms already in place to encourage and incentivize lending in low-income communities. Finally, given the low rate of actual foreclosures in California at this time, it is not clear that a new program is needed to assist homeowners who default on their mortgages. Finally, the policy option, "let present trends continue undisturbed," is rejected because of the strong evidence that high cost lending and foreclosure risk are policy problems for which there are potential remedies.

The two policy options that appear to be most relevant for California policymakers at this time are: increasing the availability of homebuyer education and counseling and amending California

law to further restrict high cost lending. The following tables provide overviews of the strengths and limitations of each approach.

**Table A-3
Strengths and Limitations of Borrower Education Initiatives to Curb High Cost Lending and Foreclosure Risk**

Criteria	Strengths	Limitations
A. Reduces lending discrimination		Homebuyer information and education programs do nothing to reduce discrimination in the mortgage market. These types of programs focus on increasing the financial sophistication of consumers, but do not fundamentally limit or change lender practices.
B. Protects homebuyers	These programs are specifically designed to increase consumer awareness and sophistication.	
C. Won't restrict legitimate lending	There is no danger that the policy will have the unanticipated consequence of limiting some borrowers' access to credit.	
D. Mitigates harm from foreclosure	Through post-purchase counseling, consumers who are delinquent on their mortgages can receive assistance in restructuring their loan or finding alternatives to losing their homes through foreclosure.	
E. Proven Practice	Lenders are only able to steer borrowers into high cost and predatory loans if they lack the financial sophistication to avoid scams and schemes that cost them more than they should.	While tools such as consumer education, mortgage counseling, and disclosures are useful, many believe them to be of limited effectiveness because of the complexity of mortgage transactions, the relative lack of borrowers' financial sophistication, the level of literacy, quantitative, and financial skills required of borrowers to make sound financial decisions. The sheer number of mortgage transactions makes the provision of universal counseling infeasible.
F. Politically feasible	Providing education and counseling is a relatively politically feasible policy option, which is unlikely to raise the concern of many opponents. An infrastructure for delivering this type of education and counseling already exists, and partnerships such as that formed in the cities where "Don't Borrow Trouble" campaigns have launched suggest that there are a variety of stakeholders who are interested in supporting such efforts.	
G. Low cost to taxpayers	To the extent that efforts can be targeted to the areas where high cost lending is most prevalent, this type of effort could be more cost-effective.	Depending on how the program is expanded, it could be quite costly because of the sheer number of mortgage transactions that take place each year.

**Table A-4
Strengths and Limitations of Enacting Stricter Laws to Curb High Cost Lending and Foreclosure Risk**

Criteria	Strengths	Limitations
A. Reduces lending discrimination	Perspectives on whether this type of law would reduce lending discrimination are somewhat dependent on one's understanding of the current mortgage market. If predatory and high cost lenders are restricted, more borrowers may access prime and "legitimate" subprime lenders for home loans. This could reduce segmentation of the mortgage market between areas which are primarily targeted by prime lenders and those targeted by subprime lenders.	Such restrictions could mean less access to capital for borrowers with less than stellar credit histories for whom subprime and high cost loans are the only option.
B. Protects homebuyers	Lowering the threshold for "covered" loans and increasing protections for borrowers who receive "covered" loans will protect some consumers from high cost loans they cannot afford.	
C. Won't restrict legitimate lending	North Carolina was the first state to enact stronger anti-predatory lending laws, and results of this policy intervention have been studied by a number of different researchers. Some have found that the law has performed exactly as hoped for and expected.	A number of researchers have raised concerns that strict anti-predatory lending laws restrict "legitimate" subprime lending, and that they can significantly reduce access to credit for low income and minority borrowers.
D. Mitigates harm from foreclosure		This type of lending restriction, unless implemented in combination with borrower education and counseling will not have an effect on borrowers who already have high cost loans that they cannot afford.
E. Proven Practice	See comments in row C	See comments in row C
F. Politically feasible		Financial institutions present a formidable opposition to stricter lending laws. The most recent bill introduced in the California legislature has not received attention in the past year. This does not mean that it will not become more feasible to enact stricter laws in the future, but at this point, the issue is garnering less attention in California than it is in other states. This is probably due to the low rate of Notices of Default; increases in the foreclosure rate have sparked the current debate in Ohio and other states. It may take a dramatic change in the housing market in the state to make such a policy change feasible in California.
G. Low cost to taxpayers	This type of restriction will not require any outlay of funds by taxpayers to support specific programs and is not likely to be contested on the basis of being costly to taxpayers.	

Policy Recommendations

Three policy recommendations emerge from this analysis:

- Make pre-purchase counseling available to every consumer who accesses a high cost loan.
- Proceed with caution in enacting stricter lending laws in California. Learn from the experiences of other states that have restricted predatory and high cost lending.
- Continue to monitor and assess high cost lending and foreclosure risk in California.

There are many potential benefits to increasing access to borrower education and counseling as well as enacting stricter laws governing high cost loans in California, both approaches are worthy of consideration by policymakers who are interested in reducing high cost lending and foreclosure risk in the state. These two policy options are strong complements to each other; in fact, many states with strong anti-predatory lending laws include mandatory homebuyer counseling for households that are obtaining high cost loans. Each of these policy options builds upon existing policies and programs that are already in place. To the extent that it is easier to make incremental policy changes as opposed to changes that overhaul existing systems, they are likely to be easier to implement.

The main limitation of borrower education and counseling programs is that, alone they may do little to reduce the prevalence of high cost lending. Further, while there is already an infrastructure in place to implement enhanced programs, it will not be possible to reach more borrowers without an infusion of additional funds. The drawbacks to restricting high cost lending are more worrisome. Researchers disagree about the merits of such approaches, and reputable studies have come to very different conclusions about the extent to which such laws have the negative unanticipated consequence of restricting “legitimate” subprime lending.

As a next step, policymakers should consider approaches to strengthening borrower protections for loans that are already covered by the state’s anti-predatory lending laws. By requiring mandatory homebuyer counseling for those accessing high cost loans, policymakers could make strides toward further protecting borrowers who receive high cost loans without concern that there will be negative unanticipated consequences associated with further limiting lending practices in the state. At the same time, it is critical to continue to monitor patterns of high cost lending in the state as well as changes in the rate of Notices of Default.