Borrowing While Black: Applying Fair Lending Laws to Risk-Based Mortgage Pricing

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BORROWING WHILE BLACK: APPLYING FAIR LENDING LAWS TO RISK-BASED MORTGAGE PRICING

ALAN M. WHITE*

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I. INTRODUCTION

As a wave of foreclosures sweeps across the nation, black and Hispanic families are seeing billions in accumulated housing wealth evaporate as a consequence of their overrepresentation in the high cost, high risk subprime mortgage sector. While the mortgage market after the crisis will never be the same as it was, price discrimination will endure, as will the essential and as yet unfulfilled goal of fair lending laws—ensuring that minority families can borrow on equal terms with white families.

In the contemporary United States mortgage loan market, the predominant fair lending issue is no longer denial of loan applications; it is instead the fact that minority homeowners pay much more in interest rates and are much more likely to get risky subprime mortgages that lead to foreclosure. On the one hand, minority homebuyers and homeowners still have less collateral and weaker credit history than whites. On the other hand, time after time, studies have controlled for those variables and found that objective credit qualifications cannot explain away the racial price gap.

The mortgage industry protests that in the past decade automated underwriting has removed the human factor and, hence, the possibility to discriminate. Loan applicants, appraisers, and credit bureaus provide mortgage application information that is entered into a computerized underwriting model. The underwriting model generates both an approval decision and a price (interest rate, fees, etc.). Racial disparities that remain, the industry argues, must be the product of legitimate cost-based considerations.

There are at least three reasons why this benign story turns out to be false. First, lenders do not put all mortgage applicants through the same underwriting and pricing analysis. Instead, they use different pricing structures by dividing

3. See infra text accompanying notes 52–65 (discussing the Courchane paper).
4. See discussion infra Part II.B.2.
6. See id. at 16.
applications among different business channels and product groups. Minority applicants are overrepresented in higher priced channels and loan product categories and as customers of higher priced lenders. Second, pricing is not purely computer-generated because mortgage brokers retain the discretion to increase interest rates to certain borrowers in order to increase the brokers’ compensation. Third, the pricing models benefit and penalize borrowers through a series of adjustments to a base interest rate, and these adjustments are not necessarily tied directly and measurably to the lender’s underlying costs for origination, servicing, and credit losses.

Fair lending law, including regulations and bank supervisor examining guidelines, must take account of this new terrain in the mortgage market. Disparate impact analysis, properly and rigorously applied, could help reduce the price discrimination that is partly responsible for the persisting homeownership wealth gaps between blacks and whites in the United States.

In Part II of this Article, I review the significance of mortgage pricing to minority homeowners. I also examine the research on disparities in loan approval and loan pricing and whether the disparities represent discrimination. In Part III, I explain in detail how mortgage pricing works and how it disadvantages minorities. Finally, in Part IV, I advocate for application of fair lending laws to price discrimination using a disparate impact test that takes account of lender steering of minorities into different products, lender delegation of pricing discretion to brokers, and lender use of risk-based pricing of dubious validity that may not accurately reflect credit risk and costs.

II. BLACKS AND HISPANIICS PAY MORE FOR MORTGAGES

A. The Wealth Gap and the Importance of Interest Rates

Blacks and Hispanics still arrive at the economic starting line far behind their white counterparts because of the persistent and large wealth gap in America. In 2004, the median nonwhite or Hispanic household had a net worth of $24,800; in comparison, non-Hispanic whites had a net worth of $140,700, a ratio of nearly 6:1. The wealth gap is much wider than the gap in incomes,

7. See discussion infra Part III.A.
8. See discussion infra Part III.C.
9. See discussion infra Part III.D.

12. Id.


14. The higher the interest rate, the higher the monthly payment for a given loan amount will be. Thus, if a family’s monthly payment is the limiting factor, a higher interest rate means a lower loan amount. As an example of the effect a higher rate has on principal repayment, it will take a borrower 17.5 years to reduce a $100,000 mortgage (financed at 12% calculated on a 30-year amortization) to $80,000. However, a borrower with the same mortgage at 6% will reach the same principal in 11.7 years and after 17.5 years will pay down the mortgage to less than $64,000.


16. See id. at 38.

17. See id. at 33.
held up to the most rigorous scrutiny. More recent studies have extended the findings of the Boston Fed study and confirmed that unexplained disparities in approval rates persist.

Various explanations have been offered for the higher likelihood of equally qualified minority applicants being denied a mortgage. Marginally qualified white borrowers are more likely to receive coaching and advice on how to improve their credit qualifications, while loan officers simply turn away comparable minority applicants. Other forms of stereotyping and self-selection may also be at play.

In the mid-1990s, attention shifted to the emerging subprime mortgage market, which offered loans with lower underwriting standards and higher interest rates and fees. In 2000, concerns about predatory lending in the subprime market led the Treasury Department and the Department of Housing and Urban Development (HUD) to hold joint hearings and to issue a report that found that, among other things, minority homeowners were disproportionately concentrated in the new subprime sector and paying higher rates as a result.

From this point, the attention of fair lending research shifted from looking at mortgage loan denials to looking at the concentration of minority borrowers in the emerging subprime sector of the mortgage market. A number of other studies confirmed the disparity, usually by identifying subprime loans in data reported under the Home Mortgage Disclosure Act (HMDA) based on the lender’s presence on HUD’s list of subprime lenders. Even controlling for credit characteristics, it seemed minority borrowers were significantly more likely to get loans from subprime lenders and, by inference, to pay higher prices for home credit. The incorporation of pricing data into HMDA allowed price discrimination to be measured directly.

19. See id. at 216–19.
20. See id.
1. **HMDA Price Data for 2004–2007**

HMDA and Regulation C\(^\text{26}\) require banks and mortgage companies to report data to a federal agency on every mortgage application they receive. The Federal Reserve amended Regulation C in 2002, effective beginning with 2004 reports, to require that lenders report not only whether they approved or denied an application but also whether they assigned higher interest rates to approved loans.\(^\text{27}\) Lenders do not report interest rates for all mortgages, but only for those above a threshold.\(^\text{28}\)

Beginning with HMDA reports for 2004, mortgage lenders had to report the annual percentage rate (APR)\(^\text{29}\) charged for each first mortgage with an APR that is more than 3% above the comparable Treasury rate and for each junior mortgage with an APR that is more than 5% above the comparable Treasury rate.\(^\text{30}\) For example, as of June 24, 2005, the 20-year Treasury rate was at 4.3%, and the average prime mortgage rate was around 5.6%.\(^\text{31}\) Hence, a lender would have to report the APR on a first mortgage with an APR greater than 7.3% in 2005 HMDA reports.

The Federal Reserve intended reporting thresholds for high rate loans to identify subprime mortgages.\(^\text{32}\) Loans with higher rates constituted 15.5% of all approved mortgages in 2004 and 26.2% of all approved mortgages in 2005;\(^\text{33}\) the rates then rose to 28.7% in 2006 and fell back to 18.3% in 2007, partly as a result of the subprime crisis and failure of several lenders.\(^\text{34}\)

The price data reveal disturbing racial disparities in the granting of high interest mortgages. In 2004, 32.4% of all first lien mortgages made to black borrowers were higher rate (i.e., subprime) compared with 8.7% for non-

\(\text{26. 12 C.F.R. §§ 203.1–203.6 (2008).}\)


\(\text{28. 2005 HMDA Data, supra note 27, at A124.}\)

\(\text{29. The Truth in Lending Act, 15 U.S.C. § 1606(a) (2006), and the Federal Reserve Board’s Regulation Z, 12 C.F.R. § 226.22(a)(1) (2008), define APR. The APR for mortgages is typically higher than the interest rate because it treats all prepaid finance charges (lender points and broker fees) as reductions in the loan principal. See id. § 226.18(b).}\)

\(\text{30. 12 C.F.R. § 203.4(a)(12).}\)


\(\text{32. 2005 HMDA Data, supra note 27, at A124.}\)

\(\text{33. Id. at A144.}\)

Hispanic whites.\textsuperscript{35} Blacks were thus four times as likely as whites to pay subprime rates on their mortgage loans. Similar disparities show up in subsequent years’ reports.\textsuperscript{36} For example, in the first half of 2007, 31.8\% of mortgages to Hispanic whites were higher priced, while only 11.8\% of mortgages made to non-Hispanic whites were higher priced.\textsuperscript{37}

2. Efforts to Explain Disparities Based on Credit Risk or Cost

The Federal Reserve Board (FRB) staff tried to determine whether legitimate, nonracial factors could account for the racial disparities in the HMDA price data.\textsuperscript{38} Unfortunately, HMDA reports do not include all relevant creditworthiness information.\textsuperscript{39} However, the FRB staff were able to control for income, assets, and a credit score proxy and found that other variables could explain some, but not all, of the racial disparities.\textsuperscript{40}

In particular, the FRB staff found that controlling for income, loan size, and other borrower-related factors accounted for about 25\% of the disparities, and that controlling for lender identity accounted for another 45\%, leaving the remaining 30\% of the disparity unexplained by available variables.\textsuperscript{41} It is important to note that the FRB staff could control for neither credit scores or credit histories nor for whether the interest rate was fixed or adjustable, two factors that are likely to explain some of the disparities.\textsuperscript{42} This pattern—large pricing disparities that are only slightly reduced by accounting for borrower characteristics, but significantly reduced by considering which lenders borrowers use—is consistent in the four years of data currently available (2004–2007).\textsuperscript{43} Even after controlling for both borrower factors and the concentration of minorities in the portfolios of high cost lenders, the FRB staff’s analysis still showed blacks twice as likely as whites to get subprime mortgages.\textsuperscript{44}

The story that emerges from the FRB staff’s analysis is that minorities pay higher interest rates for mortgages partly because some lenders charge higher interest rates than others, and minority borrowers disproportionately end up

\begin{flushleft}
\textsuperscript{35} 2004 HMDA Data, supra note 25, at 377 tbl.10.
\textsuperscript{36} See 2007 HMDA Data, supra note 34, at A139.
\textsuperscript{37} Id. at A140 tbl.18.
\textsuperscript{38} See 2004 HMDA Data, supra note 25, at 376–80.
\textsuperscript{39} See id. at 379–81.
\textsuperscript{40} Id. at 379–80.
\textsuperscript{41} 2005 HMDA Data, supra note 27, at A159.
\textsuperscript{42} Id. at A141.
\textsuperscript{43} See 2004 HMDA Data, supra note 25, at 376; 2005 HMDA Data, supra note 27, at A159; 2007 HMDA Data, supra note 34, at A139.
\textsuperscript{44} 2007 HMDA Data, supra note 34, at A139.
\end{flushleft}
with loans from those lenders. The racial segregation among lenders, however, could not fully explain the price disparities.

The FRB staff studies did not include robust controls for borrower credit qualifications apart from income and loan size. Other researchers have tried to fill that gap. Bocian, Ernst, and Lee supplemented HMDA data for 2004 with credit scores and other relevant underwriting variables from a proprietary database to see how much of the racial price disparities could be explained. This study did not control for lender identity and used a sample of mortgages made by subprime lenders only. Bocian, Ernst, and Lee found that after controlling for mortgage product type, credit score, loan-to-value, and other variables, blacks were 6.1% to 34.3% more likely than whites to receive a higher rate subprime mortgage, and Latinos were 28.6% to 44.6% more likely to receive a higher rate mortgage.

Evidence that minorities are steered toward subprime lenders emerges, for example, when looking at borrowers with high credit scores and marginal loan-to-value ratios. These are borrowers who typically would have qualified in 2004 for either a prime or subprime higher cost mortgage. In that category, 21.3% of blacks received higher cost loans, compared with 14.5% of Hispanics and 7.5% of whites. The FRB staff analysis and the Bocian, Ernst, and Lee study measured discrimination in pricing as a binary variable—whether a lender placed a borrower in a higher cost (i.e., subprime) mortgage or not. The fact that lenders do not report APRs for mortgages below the high cost threshold seriously limits the HMDA data on APRs. Thus, studies based on HMDA data cannot evaluate possible discrimination along the entire mortgage price spectrum.

Dr. Marsha Courchane assembled a proprietary database from a large group of lenders that included APRs for all mortgages, prime and subprime, as well as a full range of explanatory variables that could contribute to the racial price differences in the mortgage market. This permitted her to treat the APR price outcome as a continuous variable; she could measure the effect of race on price directly, rather than via the proxy of whether or not the mortgage is subprime.

45. See id. at A125.
46. See, e.g., 2005 HMDA Data, supra note 27, at A141 (discussing controls used in analysis).
48. See id.
49. Id. at 17–18 tbls.6 & 7.
50. Id. at 11 tbl.2.
Using 2004 and 2005 loan data, she found that blacks paid APRs that were roughly 1.2% higher than those paid by non-Hispanic whites, and Hispanic borrowers paid 0.56% to 0.74% higher APRs.\(^5^3\) However, she also found that a comprehensive set of variables could explain most of the difference; these variables determine (a) whether a borrower gets a prime or subprime mortgage and (b) what interest rate the borrower pays.\(^5^4\) Thus, the observed price differences have much to do with the fact that minorities are far more likely to deal with subprime lenders than prime lenders and credit, loan, and neighborhood characteristics. However, there were still statistically significant differences between APRs paid by blacks, Hispanics, and non-Hispanic whites, even after accounting for the full set of explanatory variables.\(^5^5\)

The variables Dr. Courchane used included not only Fair Isaac Corp. (FICO) credit scores, loan-to-value ratios, and debt-to-income ratios but also a variety of loan features—the presence of a prepayment penalty or variable rate, neighborhood characteristics such as loan amount, degree of competition among lenders and average homeowner education level.\(^5^6\) There was also a positive correlation between higher APRs and getting a loan through a broker—a wholesale channel—rather than a retail lender.\(^5^7\)

There are two troubling aspects to Dr. Courchane’s findings. First, a number of the explanatory variables are not obviously related to justifiable lender costs. For example, the presence of a prepayment penalty seems to explain why more minority borrowers end up in the subprime market and thus pay higher rates.\(^5^8\) Dr. Courchane did not find the penalties to correlate with a significant reduction in the APR, as prepayment penalties should have.\(^5^9\) Prepayment penalties should lower the lender’s cost, not increase them.\(^6^0\) In the case of the wholesale versus retail variable, using a broker contributed independently to higher APRs.\(^6^1\) Minority borrowers are more likely to use the

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53. Id. at 405 exhibit 2.
54. Id. at 431.
55. Id. at 429.
56. Id. at 412–13.
57. See id at 430.
58. Id. at 427 exhibit 10. Dr. Courchane treats the presence of a prepayment penalty as an independent variable, and the prepayment penalty is a significant contributor to the borrower’s probability of getting a subprime loan, and hence a higher priced loan, credit qualifications being held equal. See id. at 414, 416 exhibit 3. This could mean that borrowers who “choose” loans with prepayment penalties are thereby forced to shop in the higher priced part of the mortgage market, or it could, as Dr. Courchane points out, mean that it is the borrower’s assignment to the subprime market that produces the prepayment penalty, and not vice versa. See id. at 437 n.37.
59. Id. at 414, 424 exhibit 9, 427 exhibit 10.
61. Courchane, supra note 52, at 430.
wholesale channel, another explanation that is problematic from a policy standpoint.

Second, the fact that we can explain the predominance of minorities using subprime lenders and in higher priced loan divisions because of lower educational attainment and reduced competition in their census tract is hardly a neutral justification for the resulting higher APRs. If a single lender were to explicitly assign less educated borrowers to its higher priced division, credit scores and other factors being equal, that would surely not be regarded as a neutral, nondiscriminatory practice. The evidence that minority borrowers are more likely to have subprime mortgages because they are less educated, live in areas with fewer competing lenders, and are more likely to use a broker is consistent with the steering hypothesis: that minorities are steered to more expensive lenders and channels. To look at it another way, there are lenders who specialize in charging higher prices to mortgage borrowers with lower education levels and in less served neighborhoods. This, of course, is reverse redlining.

To summarize, different studies reach different conclusions about how much of the racial price disparities can be explained. This is mostly because the different study authors considered different sets of possible explanations. Taken together, the studies actually paint a fairly consistent picture. Factors relating to the homeowner’s credit, income, and property value alone cannot fully explain price disparities. On the other hand, the identity of the lender, the channel used (prime versus subprime, broker versus retail), and the local market characteristics (i.e., neighborhoods with few competing lenders) help complete the picture of how racial disparities come about. Nevertheless, even the most complete set of variables does not fully explain the race disparities. To better understand how price discrimination and steering occurs, we now turn to a description of how pricing works in the various segments of today’s residential mortgage market.

65. See Raymond H. Brescia, Subprime Communities: Reverse Redlining, the Fair Housing Act and Emerging Issues in Litigation Regarding the Subprime Mortgage Crisis, 2 ALB. GOV’T L. REV. 164, 167 (2009).
III. **WHY DO BLACKS AND HISPANICS PAY MORE? HOW MORTGAGE PRICES ARE SET**

A. **Assignment of Homeowners to Channels, Lenders, and Products**

There are many different ways for a consumer to apply for a mortgage. The mortgage market in the 2000s is segmented into various channels by which money from investors and depositors turns into loans for homeowners. These range from traditional banks which intermediate their own customers’ deposits and other customers’ mortgage loans to specialized mortgage brokers and lenders who originate mortgages solely in order to sell them on the secondary market. The secondary market in turn packages mortgages for distribution by investment banks, who convert them into securities that are sold to individual and institutional investors. Banks are highly regulated and supervised by Federal banking agencies, while mortgage brokers and investment banks making mortgages using the originate-to-distribute model are not.

Minority borrowers are far more likely to receive loans through less regulated and higher priced channels than white borrowers. Dr. Courchane’s pricing study reveals that a significant factor causing minorities to pay higher mortgage rates is their greater likelihood of getting a mortgage through a broker rather than by dealing directly with lenders. She also concluded that one-half to two-thirds of the pricing disparity between whites and minority borrowers results from the greater likelihood that minority borrowers end up getting mortgages from subprime lenders. This may be a result of minorities’ historical distrust of banks, their willingness to trust mortgage brokers active in local communities, or a variety of other factors. Whatever the cause, the result is that minority borrowers are not randomly distributed among lenders or channels. They are more likely to borrow from lenders that specialize in

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67. See id. at 5, 7.

68. See id. at 6.


71. See Courchane, supra note 52, at 430.

72. Id. at 406.

73. See id.
subprime mortgages, regardless of their credit, and more likely to borrow through brokers interacting with wholesale lenders. 74

Mortgage brokers have considerably more price discretion than loan officers working for banks and retail lenders. They can choose products and pricing from a variety of different wholesale lenders in a market that is not transparent to consumers. 75 Perhaps not surprisingly, researchers have found that mortgages originated through brokers have higher rates and fees than loans originated through other channels, controlling for borrower credit, property value, and loan terms. 76

Even once a broker or borrower has selected a particular lender who will receive the application, discrimination in the preapplication and application stages can result in minority borrowers with equal credit quality receiving inferior (i.e., higher priced) products in several ways. First, marginal borrowers who are white are likely to receive assistance in improving their application and information about a number of different loan products, while marginal black borrowers may be discouraged from applying at all, or at least will be given less information than their white counterparts. 77 Thus, the odds of a particular black mortgage seeker finding the most competitively priced and suitable loan are reduced because blacks essentially face higher search costs than whites.

Second, mortgage lenders and brokers may perceive blacks as less price sensitive, perhaps due to the belief that discrimination by other market participants limits their shopping options, or perhaps due to other implicit biases. Consequently, lenders and brokers tend to quote higher estimated interest rates, fees, and closing costs to blacks than to comparable whites. 78 Moreover, the broker or loan officer may assume that a black or other minority borrower has weak credit and assign the borrower to a costlier but less stringent lender based on that unverified assumption. Stereotypes about credit history and

74. See APGAR, BENDIMERAD & ESSENE, supra note 66, at 43.
75. Apgar & Calder, supra note 2, at 105–06.
78. See id. at 7–10 (testimony of John Taylor, President and CEO, National Community Reinvestment Coalition (NCRC)) (citing matched pair test shopping by NCRC in seven different metropolitan areas and finding that minority shoppers were quoted fewer different rates, were less likely to receive closing cost information, were more likely to be offered a variable rather than a fixed rate, and were more likely to be questioned about their credit and discouraged from applying).
price sensitivity probably act in combination with incentive payments to produce the observed steering effect.

It is important to emphasize that all these steering and pre-application practices (a) contribute to disparate pricing in a seemingly neutral pricing system and (b) result from lender policies and practices that can be the subject of legal remedies.

B. Description of Subprime Price Matrices

Interest rates for subprime mortgages are generally determined by a set of rules and adjustments spelled out in rate matrices.79 The typical subprime rate matrix used between 1995 and 2007 allows a broker or loan officer to look up a rate based on the borrower’s credit score (often the FICO score, but sometimes a score based on the lender’s own credit model), the borrower’s loan-to-value ratio, and the basic mortgage product (fixed versus adjustable rate, often with separate matrices for “no-doc” loans or other special cases).80 The matrix then typically requires additional adjustments to the base rate, such as adding 0.5% for small loans or a loan without the standard prepayment penalty.81 Some adjustment factors reflect borrower characteristics, such as whether the home is owner occupied, and others reflect loan product choice, such as paying a higher rate for a no-doc loan or a fixed rate loan. Ordinarily, given the answers to six or seven seemingly objective questions about the borrower and the desired loan, a loan officer or broker can determine the interest rate from the rate matrix.82

Only a relatively small number of variables that are actually used to set mortgage prices reflect borrower characteristics. The FICO score, along with the number of late mortgage payments and bankruptcy history, are usually the only credit quality variables. Other borrower-related variables include the loan amount and loan-to-value ratio, whether the property is owner-occupied, and whether the loan purpose is purchase or refinance. On the other hand, any given borrower has a dizzying array of product choices, depending on whether the borrower provides full income documentation, prefers an adjustable or a fixed rate, pays a broker premium, and so forth.83 The complexity of the matrices and the resulting variation in prices is as much a function of product proliferation as it is of differences among borrowers.

80. See id. at 509.
81. See id. at 514.
82. See id. at 512.
83. See id. at 515.
In addition to the wide variety of price and product choices in a single matrix, borrowers (or brokers) also face a wide variety of separate matrices to choose from. Some lenders offer multiple matrices to brokers and also use separate matrices or computerized pricing schemes for their retail and other divisions. Price discrimination is thus a consequence of the borrower’s (or broker’s) choice of market channel, lender, and product as well as the pricing model and its application.

C. Subjective Pricing in the Subprime Market

There are several ways that pricing discretion could still make its way into setting a subprime mortgage interest rate notwithstanding a lender’s matrix. First, some lenders allow their loan officers or brokers to use the matrix rate as a minimum but also allow them discretion to charge (and indeed reward them for charging) higher rates at the officer or broker’s discretion.\(^8\) Other lenders allow “exceptions” from the pricing matrix by retail loan officers.\(^8\) Regulators singled out these discretionary pricing regimes as highly susceptible to racially disparate outcomes and, hence, to fair lending violations.\(^9\)

Wholesale subprime lenders almost invariably gave brokers they dealt with the discretion to increase the base interest rate. Indeed, the yield spread premium (YSP) system encouraged brokers to do so.\(^8\) YSPs are payments lenders make to brokers computed on the basis of the interest markup that the broker persuades the borrower to accept.\(^8\) For example, wholesale mortgage lenders typically will offer brokers a payment of 1% of the loan amount if the consumer’s interest rate is set in given increments above the “par” rate.\(^9\) If the consumer knew about this, the consumer could agree to a higher interest rate in return for not paying the broker a fee in cash or out of the loan principal. On the other hand, two studies of YSPs have shown that consumers do not understand

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85. *See Findings of Inquiry into Loan Pricing at Countrywide, OFF. N.Y. ST. ATT’Y GEN.* (May 11, 2006) (on file with author). Note that this source was obtained by the author through a Freedom of Information Act (FOIA) request.
86. *See sources cited supra* note 84.
89. *Id.*
how they function and that the use of YSPs in combination with upfront fees usually increases the total amount received by brokers.90

In addition to raising the base interest rate, a broker has wide discretion in charging the borrower a broker fee, or "points," as a percentage of the loan.91 Not surprisingly, the subjective and discretionary setting of points and YSPs in subprime mortgage loans has led to race and sex discrimination in pricing. One such case was the subject of a complaint filed by the U.S. Justice Department against subprime mortgage lender Delta Funding.92 The government alleged that:

[a] comparison of Delta’s broker fees paid by 1,328 African American females and 262 white males in Kings and Queens Counties during the 1996-1998 period show that the mean broker fee for African American females was 6.24% of the loan amount, whereas the broker fee for similarly situated white males was 4.64% of the loan amount. This means, for example, that for a loan in the $100,000 to $125,000 range, African American females paid over $1,500 more in broker fees than did white males. There is virtually no possibility that this difference in the group means could have occurred by chance. In statistical terms, when controlling for loan size, the probability that the difference occurred by chance is less than .0001. The difference in price between the African American female borrowers was unrelated to the qualifications of the borrowers or the risk to the lender.93

Similarly, the New York Attorney General found that Countrywide’s mortgage portfolio revealed significantly higher broker compensation for black and Hispanic customers than for white customers after controlling for relevant credit factors.94

D. Objective Criteria that Disadvantage Minorities

A number of pricing variables are likely to disadvantage blacks and Hispanics. The most obvious are the variables tied to property value. Homes

91. WOODWARD, supra note 90, at 60–63.
93. Id.
owned by blacks and Hispanics have significantly lower market prices than homes owned by non-Hispanic whites. Subprime mortgage prices vary considerably according to the loan-to-value ratio and the loan amount, both of which are directly related to the property value. While it is true that the loan amount is also a function of the amount of down payment or existing equity provided by the borrower, there again minorities are disadvantaged. Because of their much lower available cash and liquid assets, minority mortgage applicants are likely to borrow at higher loan-to-value ratios.

Minority borrowers are also likely to borrow smaller loan amounts, given the lower average value of their homes. Many subprime rate matrices call for adding 0.5% or more to the interest rate for loans below a certain amount, often $50,000 or $75,000. Other lenders simply refuse to make loans at all below a certain amount so there are fewer competitors and less price competition for the small loan segment. It is also the case that blacks and Hispanics have lower credit scores than whites, on average. Pricing based on credit scores will necessarily produce higher prices for minority applicants.

While each of these variables bears an intuitive relationship to potential defaults or lender losses, each will also result in price discrimination. Taken together, the various objective and subjective pricing practices as well as steering of customers among lenders and products all contribute to minorities paying more for mortgage credit. Whether the resulting price discrimination is or should be permitted is the topic of Part IV.

IV. APPLYING FAIR LENDING LAWS TO SUBPRIME MORTGAGE PRICING

A. Legal Tests for Disparate Treatment and Disparate Impact

Racial discrimination in mortgage terms, including prices, is illegal under both the Fair Housing Act (FaHA) and the Equal Credit Opportunity Act (ECOA).

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95. Bucks, Kennickell & Moore, supra note 10, at A21 tbl.8 (noting that the median home value for non-whites and Hispanics in 2004 was $99,100 but was $138,500 for non-Hispanic whites).
96. Id. at A12 tbl.5. Non-white or Hispanic families had median financial assets of $7,600 in 2004 while non-Hispanic whites had $41,300. Id.
Direct proof that a lender denied loans or set terms because of an applicant’s race is rarely available.\textsuperscript{100} Enforcement agencies and victims of discrimination typically use two inference-based theories to prove discrimination in employment, housing, and credit: disparate treatment and disparate impact.\textsuperscript{101}

A plaintiff may show a prima facie case of disparate treatment by circumstantial evidence if (1) the plaintiff is a member of a protected class; (2) the plaintiff applied for and was qualified for credit; (3) the plaintiff was denied credit or given terms less favorable than comparable applicants; and (4) the defendant continued granting credit, or granted it on more favorable terms, to similarly qualified applicants.\textsuperscript{102} The lender is then entitled to prove that there was a legitimate nondiscriminatory reason for the adverse credit decision.\textsuperscript{103} In the context of credit pricing, a plaintiff could prove a disparate treatment claim by matched pair analysis,\textsuperscript{104} where it can show a minority borrower or group of borrowers paid a higher price than nonminority borrowers with matched credit qualifications and similar loan products.\textsuperscript{105}

Mortgage pricing may also be challenged based on disparate impact analysis under either FaHA\textsuperscript{106} or ECOA.\textsuperscript{107} A court may find illegal discrimination when a seemingly neutral policy or practice, for example, a price


\textsuperscript{101} For a more extensive discussion of disparate treatment and disparate impact analysis in the context of mortgage lending, see Brescia, \textit{supra} note 65.

\textsuperscript{102} See McDonnell Douglas Corp. v. Green, 411 U.S. 792, 802 (1973) (establishing the test for disparate treatment in the context of employment discrimination); Hood v. Midwest Sav. Bank, 95 F. App'x 768, 778 (6th Cir. 2004) (establishing the test for discrimination under FaHA and ECOA); Ring v. First Interstate Mortgage, Inc., 984 F.2d 924, 926 (8th Cir. 1993) (extending the Court's approach in \textit{McDonnell Douglas Corp. to FaHA}).

\textsuperscript{103} \textit{Hood}, 95 F. App’x at 778.

\textsuperscript{104} See, e.g., EEOC v. IBM, 583 F. Supp. 875, 900–01 (D. Md. 1984) (using matched pair analysis to test employment discrimination claims).


\textsuperscript{106} See Keith v. Volpe, 858 F.2d 467, 484 (9th Cir. 1988).

increment for small loans, has a disparate impact on minority groups and business necessity does not justify the policy or practice. The application of disparate impact analysis to pricing disparities in the mortgage market is clear. If identifiable pricing policies or practices such as dividing applicants into different product categories or granting pricing discretion to mortgage brokers result in minority borrowers paying higher interest rates, lenders must demonstrate that business necessity justifies the pricing policies or practices. The following examples illustrate the application of disparate impact analysis to mortgage pricing.

B. Expert Evidence on Pricing Disparities in the Wells Fargo Fair Lending Litigation

Recently, plaintiffs have filed a number of fair lending lawsuits challenging racial disparities in mortgage prices. These cases have focused primarily on the practice of paying brokers YSPs and the allegation that the lender policy of paying such premiums has a disparate impact on minority borrowers. The claim has been that brokers choose to increase interest rates above the lowest rate for which the borrower qualifies more frequently and to a greater extent for minorities than white borrowers. Hence, the availability of YSPs is a practice having a disparate impact on minorities. However, most of these cases have not progressed beyond the motion to dismiss stage. Thus, courts have had little opportunity to consider how to evaluate price discrimination claims on the basis of an evidentiary record rather than bare allegations in pleadings.

110. See, e.g., Martinez, 527 F. Supp. 2d at 834–35 (holding that discriminatory effect is sufficient to survive a motion to dismiss).
111. See id.
112. See id.
In *Walker v. Wells Fargo Bank, N.A.*,113 opposing expert reports from respected mortgage scholars Ira Goldstein114 and Marsha Courchane115 highlighted several of the factors leading to race-based price disparities and addressed both potential disparate treatment and disparate impact.116 Unfortunately, the court did not resolve the legal issues because the parties settled the case. Nevertheless, the expert reports offer a useful source of detailed information.

Dr. Goldstein’s report considered both disparate treatment and disparate impact analysis.117 Using matched-pair analysis, he found that the plaintiff, Ms. Walker, paid a higher interest rate than fourteen white borrowers with essentially the same credit score, loan-to-value ratio, and debt-to-income ratio.118 He also pointed out that although Wells Fargo’s price matrix imposes a 0.5% interest rate increment for loans under $75,000, a category into which Ms. Walker fell, her rate exceeded that of comparable borrowers by 2%–5%; thus the loan size pricing could not fully account for the disparity.119

To consider their potential disparate impact, Dr. Goldstein also examined the pricing rules that led to Ms. Walker’s APR of 11.11%. He found that the policy of adding 0.5% to the rate for loans less than $75,000 had a significant disparate impact on blacks and persons living in predominantly black census

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119. Id. at ¶ 11.
tracts. Moreover, he found that Wells Fargo’s mortgage prices for all mortgages less than $75,000 were much higher in predominantly black areas (70.5% of loans in these areas had at least a 3 point rate spread) than in white neighborhoods (only 14.2% had at least a 3 point rate spread) and therefore the small loan adjustment only partly explained the racial disparities.

In his report, Dr. Goldstein alluded to two other pricing practices as potential sources of racial disparities. First, Wells Fargo penalized Ms. Walker for having a credit score from only one of the three major credit bureaus, essentially discounting the single credit score she had. Second, Wells Fargo permitted Ms. Walker’s broker to increase her interest rate in order to generate a YSP. Dr. Goldstein offered no conclusions regarding either the impact of these policies or their possible business necessity, citing the need for more lender data.

Dr. Courchane’s reports evaluated not so much whether Wells Fargo had priced Ms. Walker differently due to race, but whether legitimate business factors could adequately explain the disparities in pricing between all black and all white borrowers in Wells Fargo’s portfolio. First, she asserted that Wells Fargo did not control the fees the broker charged and, therefore, could not be responsible for that part of the final APR that was a product of broker fees. Second, she pointed out that Ms. Walker’s credit score was quite low, and thus the high rate she paid should not be surprising. Third, she constructed a regression model using data from a sample of Wells Fargo loans to measure the contribution of race vis-à-vis other factors in determining the borrower’s APR. She found that credit scores and debt-to-income ratios were the major drivers of interest rates, and race was not a statistically significant factor.

The rub, however, was that Dr. Courchane selected 185 loans from a population of more than 17,700 mortgage loans originated by Wells Fargo affiliates in the Philadelphia metropolitan area in 2005 and 2006. The reason she chose this subset of loans was that Wells Fargo had identified these loans as belonging to a channel, i.e., its wholesale lending division, and within that

121. Id.
122. Id. at ¶¶ 26–27.
123. Id. at ¶ 31.
124. See id.
126. Id. at ¶¶ 6–7.
127. Id. at ¶ 7.
128. Id. at ¶ 26, 65 app.4 chart 9.
129. See id. at ¶ 26.
130. See id. at ¶ 26 n.18, app.4 tbl.17.
division, to a product category known as Home Credit Solutions.\(^1\) As Dr. Goldstein pointed out in his rebuttal, minority mortgage borrowers dominated this product category, which also featured some of the highest prices among all mortgages made by Wells Fargo.\(^2\) Wells Fargo gave borrowers with credit scores as low as Ms. Walker’s (and lower) loans from other channels and product categories.\(^3\) Therefore, the product classifications were not independently based on credit qualifications, but on internal marketing decisions.

In her second rebuttal report, Dr. Courchane responded by constructing several different pricing regression models using all 17,764 approved loans.\(^4\) The most complete model controlled for loan amount, lien status, owner occupancy status, loan purpose, fixed or adjustable rate, FICO score, debt-to-income ratio, loan-to-value ratio, property location (county among the five counties in the Philadelphia metropolitan statistical area), channel, and subchannel.\(^5\) A borrower’s FICO score was the leading credit-related price determinant, adding as much as 2.27% to the rate for FICO scores under 520.\(^6\) With this model, Dr. Courchane was able to reduce race-based price disparities to about 31 basis points (0.31%)—explaining most of the remaining price differences based on all the other variables.\(^7\) An alternative model looking only at the loans in the Home Credit Solutions subchannel (1,624 loans) reduced the difference to 14 basis points (0.14%).\(^8\)

The channel and subchannel variables represented different divisions or mortgage categories within Wells Fargo. Assignment to the Home Credit Solutions subchannel, independent of credit score and the other variables, increased the APR by 1.69% for wholesale and 1.84% for retail.\(^9\) Further, independent of all these variables, including channel and subchannel, being black increased Wells Fargo mortgage borrower’s rates by 0.31%.\(^10\) Equally interesting was that being in Philadelphia rather than one of the suburban counties had a small (0.06%–0.07%) but statistically significant effect on mortgage rates.\(^11\)

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1. Ibid. at ¶ 11.
3. Ibid.
5. Id. at app.4 tbl.17.
6. Id. at ¶ 26, app.4 tbl.17.
7. Id. at app.4, chart 9, tbl.17.
8. Id.
9. Id. at app.4 tbl.17.
10. Id.
11. Id.
Wells Fargo described its Home Credit Solutions subchannel as the subprime product for borrowers who would have difficulty qualifying under traditional criteria. While borrowers with lower credit scores were clearly concentrated in this subchannel, the segregation by credit score was not exclusive. Some high score borrowers were in the Home Credit Solutions subchannel, and Dr. Courchane found borrowers with very low credit scores in other channels.

The picture that emerges from these reports is an interesting one. It appears that within a large financial institution such as Wells Fargo, mortgage prices for borrowers with similar credit scores and qualifications vary widely according to channels and products. It is as if a store charged higher prices for customers coming in the east door than those coming in the west door, and somehow directed most minority customers to the east door. While it is conceivable that a lender like Wells Fargo could offer cost-driven business justifications for charging different prices for loans made through different channels (e.g., broker versus retail) it is hard to see how a lender could support selling the same product—adjustable rate first lien subprime refinance mortgages—at different prices using different names by business necessity.

Two concerns emerge from the reports in Walker. The first concern is the unanswered questions about the impact of the broker fees, the small loan adjustment policy, the thin credit file policy, and whether business necessity provides a valid justification for these policies. Second is the question whether business necessity can justify charging different interest rates according to lender-defined channels and products that are racially segregated.

From the evidence developed so far, three distinct sets of practices emerge as potential culprits in racial mortgage price disparities. First is the role of mortgage brokers and the price discretion lenders delegate to them. Second is the role of lender assignment of borrowers to different channels and products. Third is the fundamental question of the validity of the risk-based pricing models themselves.

C. Lender Responsibility for Broker Pricing: The RESPA Connection

Lenders making mortgages through a wholesale channel delegate much of the loan origination process to brokers. Brokers determine their own fees, usually as a percentage of the loan amount. Broker fees affect the APR the borrower pays in one of two ways. The broker may negotiate an interest rate

142. *Id.* at ¶ 11.
143. See *id.* at app.4 chart 1.
144. See ERNST, BOCIAN LI, *supra* note 76, at 6.
145. See *id.*
above the borrower's qualifying minimum rate in order to receive a YSP from the lender. 146 Brokers also collect upfront fees, or points, out of the loan amount that count as prepaid finance charges; in other words, these fees reduce the net amount financed and thereby increase the APR. 147

Lenders making wholesale loans through brokers thus extend pricing discretion to brokers in two ways. Lenders who pay YSPs grant explicit price discretion by allowing the broker to sell the borrower an interest rate above the lender's par rate. 148 Even if the broker fee is charged up front, it is typically financed by inclusion in the loan principal. 149 Prior to closing, the mortgage lender will instruct its closing agent how to disburse the loan principal and will authorize the payment of the broker's fee. 150 The lender has the ability to limit broker fees or set guidelines for brokers it deals with. 151

Lender policies regarding broker compensation can have racially disparate impacts under two related scenarios. First, there could simply be individual brokers who make it their practice to charge higher fees to black borrowers; i.e., discrimination at the individual broker level. These brokers may perceive blacks as less price sensitive or as having fewer competing offers from retail lenders and other brokers. 152 Second, brokers charging systematically higher fees than their competitors may concentrate their marketing in minority neighborhoods, while more efficient, lower-cost brokers avoid those neighborhoods in both cases because of their beliefs about the creditworthiness, market competition, and price sensitivity of those areas or those borrowers. 153

Wholesale mortgage lenders assert that they do not control the broker's points and fees. However, the federal agencies involved in the Delta Funding case took the position that because the Real Estate Settlement Procedures Act (RESPA) prohibits unearned fees and referral fees, 154 mortgage lenders have a legal duty to insure that broker fees bear a reasonable relationship to the value of services provided. 155 A wholesale mortgage lender's failure to have any reasonable policies or guidelines for broker fees may be analogized to the car

146. See supra text accompanying notes 87–90.
148. See RENUART ET AL., supra note 147, at 94.
149. Id.
150. See id.
151. See id.
152. See Hearing, supra note 77, at 7–10 (testimony of John Taylor, President and CEO, National Community Reinvestment Coalition (NCRC)).
153. Cf. Apar & Calder, supra note 2, at 103 ("[B]orrower race and neighborhood racial composition still appear to be significantly linked to access to prime loans.").
finance companies’ practice of allowing dealer markups, a practice challenged as having a discriminatory impact on minority consumers in violation of fair lending laws.

Thus, a lender may be facilitating either overt discrimination or reverse redlining by brokers. In either case, the lender establishes the parameters for broker compensation. The YSP implicates lenders most directly because the lender imposes a higher interest rate on the borrower in order to fund a broker payment. But even in the case of upfront broker fees funded from loan principal, the lender has the power to authorize, or limit, broker fees. Even apart from fair lending duties, lenders are responsible for the reasonableness of broker fees under the RESPA, which bans payments of unearned fees or kickbacks in mortgage transactions. Like the automotive finance companies, mortgage lenders will have to come to grips with the racial impact of delegating pricing authority to broker-agents by establishing compensation policies adequate to the task of ensuring that comparable borrowers pay comparable broker fees.

D. Product and Channel: Are These Business Justifications for Disparate Pricing?

From the standpoint of a lender’s costs, some mortgages are different than others. An adjustable-rate mortgage should ordinarily have a lower rate than a fixed-rate mortgage, other things being equal, because the lender takes more risk by committing to a fixed rate over the life of a mortgage when market rates may fluctuate. Similarly, a 30-year mortgage is riskier than a 15-year mortgage, other things being equal. Lenders consider mortgage loans to buy a


159. Renujart et al., supra note 147, at 94.

160. See id.


home—purchase loans—less risky than refinance loans, and loans made to people who intend to live in the home are less risky than mortgage loans to investors and speculators.163

On the other hand, the differences between and among these types of mortgages, as they relate to risk, ought to be measurable in terms of costs to the lender. Suppose that all of the lender’s minority customers get adjustable-rate mortgages and all of its white borrowers get fixed-rate mortgages. If, holding credit qualifications constant, the lender charges a higher rate for adjustable-rate loans or fails to pass on the lower cost of adjustable-rate loans fully to customers of that product, that pricing practice will have a disparate impact and business necessity cannot justify it. While genuinely different mortgage products may have different costs, price differences should reflect the cost difference, not the racial difference, in the customer pool for the product. Courts and enforcement agencies should not simply treat different mortgage products as wholly incommensurable. Instead, regulators should require lenders to validate pricing differences based on measurable cost differences.

The case for price differentials is even weaker when the product or channel classifications used by the lender describe the characteristics of borrowers rather than those of loans. If borrowers with the same credit qualifications receive different pricing for the same mortgage type (adjustable-rate refinance, for example) by virtue of being assigned to a different lender-devised product or channel, the product and channel categories are simply masks for borrower segregation and unjustified price discrimination. In both Walker v. Wells Fargo Bank, N.A.164 and In re Countrywide Home Loans, Inc.,165 the boundaries between products and channels were porous—not all borrowers with low credit scores were in the subprime product, and some borrowers with high credit scores were in the subprime.166

The New York Attorney General’s investigation of Countrywide found that the company separated borrowers into prime and subprime lending divisions, but the boundaries between the prime and subprime divisions and products were fluid.167 For example, FICO credit scores overlapped considerably, especially in the midrange; here, borrowers with scores between 620 and 700 FICO were present in large numbers in prime and subprime products alike.168

163. See id. at 1–2.
165. Statement of Charges, supra note 105.
166. See Supplemental Rebuttal Report of Marsha J. Courchane, Ph.D., supra note 116, at app.4 chart 1; Statement of Charges, supra note 105.
167. Countrywide Investigation, supra note 94, at 52.
168. Id. at 53.
investigation also found that black and Hispanic customers with high credit scores were much more likely to receive subprime products.169

While the racial segregation of borrowers among lenders’ different channels and products may be a result of mergers, different divisions’ marketing plans, and other seemingly benign reasons, those reasons must meet the strict test of business necessity if they are causing black and Hispanic borrowers to pay higher rates than similarly qualified white borrowers. It is difficult to see how such practices can be justified, particularly when a lender cannot explain why minority borrowers are not referred internally to the division, channel, or product with the best available terms. The absence of such a referral mechanism or the mechanism’s failure to overcome racial disparities could itself be a policy or practice subject to disparate impact analysis.170

E. Looking Behind “Legitimate” Variables: Validation of Risk-Based Pricing Models Based on Costs

Federal bank regulators examine banks on a regular basis to ensure their safety and soundness but also to ensure compliance with fair lending laws. The agencies have spelled out their approach to evaluating race discrimination issues in a document called Interagency Fair Lending Examination Procedures (Examination Procedures).171 Although the Examination Procedures call for consideration of whether a risk-based pricing system is “empirically based and statistically sound,”172 it is far from clear that the agencies have actually required lenders to justify their risk-based pricing models. It appears instead that regulators seek evidence of discretionary pricing and then examine whether factors used in pricing are “non-discriminatory.”173 So long as the lender is not granting pricing discretion to loan officers and can articulate a nondiscriminatory basis for the factors used in its pricing formula or matrix, it appears unlikely that federal regulators will look behind the matrix.

As Ian Ayres has pointed out, there are two very different versions of the business necessity test used to evaluate policies that burden minorities.174 A

169. Id. at 54.
170. Cf. FED. FIN. INSTS. EXAMINATION COUNCIL, supra note 84, at 21–22 (describing how to test lender policies for steering to determine whether loan officers direct credit applicants to higher priced products but making no reference to policies to steer applicants at high cost divisions to other divisions or products with more favorable terms, or “referring up”).
171. Id. at 1–2.
172. Id. at 8.
174. See Ayres, supra note 156, at 670–71 (suggesting either that “any policy that is not strictly necessary to prevent a firm’s bankruptcy is not justified” under the business necessity test.
lender could justify a mortgage-pricing model by a demonstrated relationship between the pricing factor and increased defaults and credit losses (i.e., lender costs). Alternatively, higher rates may be a product of market failures such as lack of bargaining power among minority homebuyers, disparities in the information level of minority consumers, or resulting price discrimination by brokers. While the price disparities in both cases result from the operation of the market, profitability that results from market failure should not be regarded as a business necessity or justification for policies with a disparate impact. Business necessity in the truest sense should be limited to cost-based pricing policies and should exclude price adjustments that exploit market failures.175

Let us return to the example of the common interest rate increment for “small” loans: adding one-half of a percentage point to the rate for mortgages below $75,000.176 There could be two possible explanations for this. It may be that, even controlling for the loan-to-value ratio and credit score separately, smaller loans result in higher defaults or higher losses on default than larger loans. On the other hand, it may be that borrowers seeking smaller loans have fewer options and are willing to pay higher rates, or conversely, it may be that borrowers seeking larger loans are more willing to shop around for lower rates and lenders take advantage of this. The profitability of the small loan markup can be regarded as justified in the first case but not in the second.

While subprime price matrices have a superficial aura of validity, there is little if any evidence that each of the components that go into a homeowner’s final APR is separately and validly tied to a risk-based cost incurred by the lender. The small loan rate markup of 50 basis points is typical.177 It is intuitively understood that smaller loans are more expensive for lenders for two reasons: (1) fixed origination costs represent a larger percentage of smaller loans, and (2) smaller loans may have worse loss severities in the event of default and foreclosure because some foreclosure costs are also fixed and do not vary with loan size.178 However, most rate matrices also separately increment the interest rate for high loan-to-value ratios.179 It may be that mortgages with smaller amounts have greater origination costs and foreclosure loss severities because they are more likely to also represent a larger percentage of the property value; in other words, homeowners with smaller loans may have less equity. Moreover, the fact that smaller loans may produce higher costs, even

or “that any policy that increases a firm's profitability (even infinitesimally) is justified” under the business necessity test).

175. See id. at 669.
176. See discussion supra Part II.B.
177. See White, supra note 79, at 514.
179. See, e.g., White, supra note 79, at 511 tbl.2 (displaying multifactored interest rates).
independently of the loan-to-value ratio, does not per se justify any price increment a lender might impose. To properly justify the small loan markup, lenders need to validate its magnitude, not just its existence.\textsuperscript{180}

The interdependence of loan-to-value ratios and loan amounts is one of several examples of ways in which lenders may double-count cost factors in their interest rate models. In order to truly validate all the components of a rate matrix, one would need to run regression analyses using all the pricing variables and measure their independent effect on the lender’s cost (origination and credit losses) as the outcome variables.

If the 2007–2008 subprime meltdown demonstrated anything, it demonstrated that the subprime mortgage industry had done a poor job of assessing default risk and the future cost of losses for different groups of mortgage loans. Lenders progressively took on greater and greater risks, mostly in the design of mortgage products; examples include loans made without any documentation of income, loans with payments of interest only or even negative amortization, loans with no borrower down payment or equity, and loans with escalating monthly payments. Although in the previous decade subprime lending had been quite profitable and showed evidence of excessive pricing in relation to risk, subprime mortgages made in 2006 and 2007 resulted in huge risks of foreclosure losses that lenders clearly did not anticipate or price correctly.\textsuperscript{181}

The justification for risk-based pricing is that lenders can validly determine how their costs vary depending on the characteristics of each borrower and loan, and lenders can then calibrate their interest rates and fees precisely to recover those different risk-based costs.\textsuperscript{182} Recent experience shows how poorly subprime mortgage lenders calibrated risk and pricing.\textsuperscript{183}

In light of this experience, it seems unlikely that subprime interest rates have been or can be correlated to future losses in any reliable and precise way. In that case, the entire premise of risk-based pricing is suspect. In order to truly justify charging some mortgage borrowers more than others, a lender would need to demonstrate, using empirical results for actual costs of originating and collecting mortgages and controlling properly for all variables, that it has strictly tied its pricing model and adjustments to costs and that these elements are not simply exploiting vulnerable and poorly informed consumers.

\textsuperscript{180} See \textit{id.} at 512, 513–14 (discussing evidence as to whether risk-based pricing is truly based on, and commensurate with, risk-related costs).


\textsuperscript{182} See White, \textit{supra} note 79, at 508.

Regulators should also require lenders using various credit factors to explain pricing differences to show that they actually used the explanatory factors to set prices. An expert may be able, after the fact, to "explain" racial price differences based on variables that correlate with race and appear to have some business justification but were not a variable used in the price matrix. Courts generally view this form of after-the-fact rationalization of disparate impacts as pretextual in the employment discrimination context. 184 To take an example from Walker,185 Dr. Courchane found that home improvement and refinance loans were priced higher than purchase money mortgages. 186 If the Wells Fargo price matrix did not differentiate its pricing between those loan types, then a court ought not to consider this explanatory variable a legitimate nondiscriminatory basis to explain higher rates paid by blacks that the lender actually used.

Thus, a robust review of risk-based pricing must ask at least the following questions:

1. Is each separate price adjustment independently validated based on credit loss or other lender costs independently associated with that adjustment variable, or are correlated risk factors being double-counted in the pricing model?
2. Is the magnitude of a particular price differential associated with a particular credit variable (e.g., credit score) demonstrably commensurate with the costs associated with differences in that variable among borrowers and loans?
3. Are post hoc explanations of pricing differences based on factors that the lender actually used in setting loan prices initially?

V. CONCLUSION: EXPLAINING AWAY DISCRIMINATION OR DOING SOMETHING ABOUT IT?

The fact that lenders can cite various reasons to explain why they charge minority borrowers more does not mean the reasons are good ones or that the reasons should shield lenders from fair lending enforcement. The stakes for minority mortgage borrowers are high, and the consequences of price discrimination are far-reaching.

Fair lending laws and agency enforcement protocols must respond to the more subtle but invidious mechanisms of the new price discrimination. The

185. See supra Part IV.B.
three major determinants of the tax for borrowing while black (or brown) are all proper targets for antidiscrimination law. The delegation of pricing authority to mortgage brokers, like the loan markup practices of the auto finance industry, can and should be challenged. If the necessity of granting this power to discriminate to brokers is based on lenders' need to gain market share by relying on brokers who exploit borrower information problems and other market failures, the law should not accept such practices as justified by business necessity. Likewise, the proliferation of different lender divisions and loan product designations that segregate minority borrowers into high priced loans should not be tolerated, absent legitimate, validated cost-based differences between the loan products. Finally, fair lending law needs to look behind the seemingly respectable façade of risk-based pricing itself to pose the fundamental question of whether it is reasonably possible to price discriminate among mortgage applicants in the economic sense without discriminating in a fair lending sense.