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# COUNTERING Discrimination in Mortgage Lending in America

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An NAACP Guide for Fair Lending

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Monique W. Morris

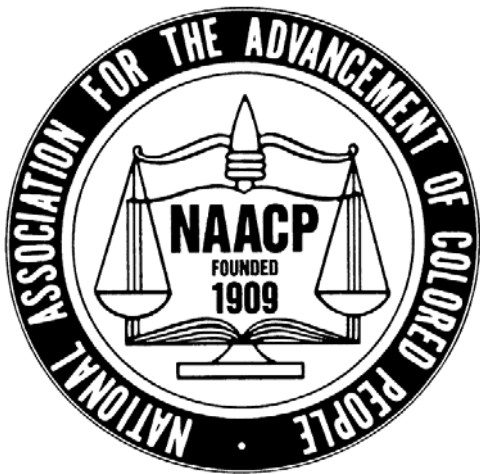
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# **COUNTERING DISCRIMINATION IN MORTGAGE LENDING IN AMERICA**

**An NAACP Guide for Fair Lending**

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## INTRODUCTION

In July 2007 the National Association for the Advancement of Colored People (NAACP) filed suit in Los Angeles federal court against 15 of the country's largest mortgage lending institutions. In this first known lawsuit to challenge discriminatory lending practices on a broad scale, the NAACP alleged that these lenders violated the Fair Housing Act, the Equal Credit Opportunity Act, and the Civil Rights Act in their practices toward African Americans. Lenders named in the suit have all made high-cost subprime loans to African Americans who qualified for prime loans.

In 2009, the NAACP produced a report, *Discrimination and Mortgage Lending in America: A Summary of the Impact of Subprime Lending on African Americans*. Mortgage foreclosures, excessive subprime mortgage interest rates, and hindered access to prime mortgage loans have had an inordinate impact on people of color and other historically disadvantaged borrowers. These practices have resulted in adverse effects even beyond those suffered by the actual borrowers themselves. Home values have been depressed as a result of these practices, and in general people of color and their families have become increasingly vulnerable to loss of shelter, home security, equity, and wealth—even if they do not have subprime loans.

To encourage transparency and fairness in the processes associated with obtaining quality loans and to improve the relationships between financial institutions and people of color and other historically disadvantaged borrowers, the NAACP has developed nine principles of fairness in banking and lending.

This report, *Countering Discrimination in Mortgage Lending in America: An NAACP Guide for Fair Lending*, summarizes these principles and why they are important.

## **PRINCIPLE #1**

**Loan terms will not be determined by a borrower's race, ethnicity, gender, national origin, sexual orientation, language preference, disability, religion/creed, or age, except as otherwise permitted or required by law. Additionally, loan terms will not be determined by factors designed to serve as proxies (e.g., zip codes) for the above categories.** Loan terms will not be determined by subjective underwriting without controls to prevent inappropriate bias or discrimination. Similarly situated borrowers (i.e., borrowers with similar underwriting characteristics, including credit scores, debt ratios, loan-to-value ratios, etc.) will receive comparable loan terms on identical or comparable loan products.

### **WHY THIS MATTERS:**

Institutional discrimination based on race, gender, or the other categories noted above is illegal. This principle addresses the fact that subprime lending is five times more prevalent in African American neighborhoods than in white neighborhoods,<sup>1</sup> largely as a result of illegal steering that led to one in five subprime loan recipients being comprised of those who *could have* received a lower-cost prime loan.<sup>2</sup> Even when income and credit risk were equal, African Americans were up to 34 percent more likely to receive higher-rate and subprime loans with a prepayment penalty than were their similarly situated white counterparts.<sup>3</sup> When loan terms are not illegally determined by race, ethnicity, gender, national origin, sexual orientation, language preference, disability, religion/creed, or age, then lenders use *objective* measures for their decision making, and the outcomes are fairer.

## **PRINCIPLE #2**

**Every borrower will have the option of selecting a loan product that is appropriate for his or her circumstances. Lending institutions and brokers should provide a transparent counseling process to provide maximum protection to the borrower.** Borrowers will first be presented with loan product choices that are consistent with their financial circumstances. Lenders will determine whether borrowers are eligible for prime loan products, and if so the borrowers will be presented with prime product options. Additionally, information will be provided to the borrowers about available conventional and Federal Housing Administration (FHA) loan products in order for the borrowers to fully understand their options. Borrowers with good payment histories and demonstrated improvement in credit performance and other risk factors will be considered by their existing lenders for loan refinancing that results in improved loan terms.

### **WHY THIS MATTERS:**

Many people, disproportionately people of color, were directed toward subprime loans even if they qualified for prime loans. This principle prevents lending companies from engaging in any of the practices that strip wealth or income from borrowers who qualify for prime products.

Practices typically associated with subprime lending that will not be engaged in with those who qualify for prime products include<sup>4</sup> **steering** (issuing borrowers higher-priced loans when they qualify for more affordable mortgages), **forced repayment or early pay-off penalty** (a fee a borrower incurs for paying the loan off early), **flipping** (refinancing a home loan without providing any net tangible benefit to the borrower), **yield spread premiums** (broker “kickbacks” for issuing borrowers more expensive loans), or **ignoring the ability to repay** (approving loans with large scheduled increases without considering whether the borrowers can afford the higher payments; this includes the failure to escrow for property taxes and failure to verify income). In conjunction with Principle #1, this principle will ensure that even among subprime offerings, the best product will be made available to borrowers.

## **PRINCIPLE #3**

**Institutions will seek to eliminate policies or practices that encourage biased and exploitive behaviors toward borrowers.** Lending institutions will disclose in good faith the loan fees associated with each loan and will conduct periodic audits of files, policies, and practices to ensure an environment—in lending, credit, and payment options—that is free of bias toward borrowers. Additionally, lenders who sell loans on the secondary market to third parties will also observe these fairness principles and will refrain from charging usurious interest rates.

### **WHY THIS MATTERS:**

Many lenders used perverse incentives to encourage the exploitation of African American borrowers and other groups that have faced historical discrimination. Additionally, lenders that engage in predatory lending often have hidden costs and fees associated with their loan products. While a number of states have passed laws to protect consumers from exorbitant and exploitive fees associated with borrowing, many have not. This principle is important because it protects borrowers from exploitive practices and keeps lenders—and their affiliates and secondary market partners—honest. It prevents them from providing improper incentives to maximize profit to the detriment of African Americans’ financial well-being.

## **PRINCIPLE #4**

**Borrowers will be approved only for loans they have a current ability to repay.** Borrowers will receive loans that they demonstrate the ability to repay, even in the event of a rate increase. Adjustable rate mortgages (ARMs) and other loans will not be underwritten at the “teaser rate,” but rather at the fully indexed interest rate. Standard adjustable rate loan products will be clearly identified as such to borrowers, so they are fully aware of the terms of the ARM loan products and the possibility of interest rate and payment increases. Teaser rates also include the loss of escrow through taxes and insurance. After the teaser rate expires, borrowers are left to pay their own taxes and insurance on the property; these fees are no longer escrowed through their

monthly mortgage payment. This change in the loan structure often causes borrowers to lose their homes because of their monthly mortgage increases and their inability to manage their cash flow to ensure that they have adequate money to now pay their taxes and insurance out of pocket. Having the home fully insured is a requirement of the mortgage holder.

### **WHY THIS MATTERS:**

Financial literacy begins with knowing what is affordable. During this most recent financial crisis, many borrowers defaulted on loans because the terms of their subprime loan products were unclear from the beginning. Among many borrowers, balloon payments nearly eclipsed their total household income, making it virtually impossible to cover the monthly payments. This principle is important because it protects borrowers from investing in loan products that are too risky for their circumstances. Being fully aware of the possibility of balloon payments that could dramatically alter one's ability to repay is important to the decision-making processes that determine whether one is qualified for a certain product.

## **PRINCIPLE #5**

**Each policy may be maintained and monitored for its racial impact.** Fairness is measured not only in terms of intent, but also impact. Policies will reflect a demonstrated effort to ameliorate negative outcomes based on race or ethnicity. Each institution will have internal controls to determine— overall and within the subprime community of loans issued by the institution—that its neutral practices do not have an unlawful adverse impact based on grounds of race, sex, color, or ethnicity.

### **WHY THIS MATTERS:**

Fairness is a principle that must be enforced in order to be effective, and it is our expectation that lending institutions that agree to these principles will comply in conducting impact assessments. Monitoring the effects of policy and practice is an important tool to track progress and to identify problems early on. This principle is important because it allows the lender to identify the impact—intentional or unintentional—of its practices and to determine whether a corrective course of action needs to be taken to ensure that when products differ from borrower to borrower, variations are not attributable to differential treatment due to race, sex, color, or ethnicity.

## **PRINCIPLE #6**

**All borrowers will have access to free information, online and in print, that will help them understand and improve the quality of their loans.** The terms of each loan will be provided to the borrower and explained in plain and simple language. The terms of the loan will be in a large

font and easily legible to those who are not severely vision-impaired. If the borrower is fluent in Spanish but not English, the loan disclosures and documents will be translated. In the case of other languages, borrowers without access to loan translation expertise will be referred to phone-based or other translation services that are familiar with loan terms and conditions. All borrowers should be able to clearly understand the terms of their loan products.

#### **WHY THIS MATTERS:**

It is important that every borrower is able to understand the terms of his or her product. This principle is important because it ensures that materials are accessible to those who speak English fluently but who do not necessarily fully understand the financial industry jargon, as well as to those who are limited in English proficiency. Equal access to quality products and fairness in lending include providing an opportunity for individuals to clearly see and understand what is available to them and what is being offered to them. With this improved access, individuals will be able to make more informed decisions.

### **PRINCIPLE #7**

**Lenders will work with borrowers to prevent foreclosures.** Loan servicers will consider foreclosure to be the “last resort” and will explore all appropriate alternatives before completing a foreclosure sale. Because these matters impact borrowers, their neighbors, and the financial institution, we believe it wise for the institution to engage in extended good-faith efforts to do all that it can to prevent foreclosures. Lenders and their affiliates will not operate using a business model intentionally designed to profit from a foreclosure.

#### **WHY THIS MATTERS:**

People of color were disproportionately negatively impacted by foreclosures, and many fell into this unfortunate situation because lending institutions failed to respond to early warning signals or made no effort to prevent the foreclosure of a property. Many individuals attempted to obtain help from lending institutions but failed to receive adequate institutional responses to prevent these foreclosures. This principle is important because it prohibits insincere efforts to prevent foreclosures, prevents the use of a business model that exploits the struggles of homeowners, and encourages institutions to do all they can to prevent foreclosures.

### **PRINCIPLE #8**

**Lending institutions will support and implement the inclusion of diverse suppliers in their contracting and partnership decisions.** Financial institutions will establish aspirational and measurable goals and develop supplier programs that ensure the inclusion of businesses owned by women and people of color wherever contracting and partnership opportunities present

themselves. Goals will be, at the very least, to reflect the various racial, ethnic, and gender compositions of the general population.

### **WHY THIS MATTERS:**

Fairness in lending practices should be coupled with and supported by an institutional culture of diversity and inclusion. This principle is important because lending decisions are informed by a person's and an institution's commitment to diversity, as reflected in their articulation of goals and demonstration of inclusive practices. Making sure these goals are measurable is important to monitoring efforts that can sustain and improve these practices over time.

## **PRINCIPLE #9**

**Workforce diversity is important to fair decision making and expanded opportunity for economic development.** From the boardroom to the cubicle, the workforce continuum will reflect the diversity of the nation. As financial institutions establish inclusive business policies, so too will there be a measurable effort to employ a workforce that is reflective of the growing diversity of the nation—at all decision-making levels within the institution.

### **WHY THIS MATTERS:**

Those who make decisions and interface with borrowers are important to the effective implementation of fair banking and lending practices. This principle is important because it elevates the importance of workforce diversity in efforts to ensure that employee and board perspectives inform the policies and practices of the institution.

## **CONCLUSION**

The economic security of our nation depends on the practice of a fair and just democracy in which individuals and collective communities can access and grow their economic resources without racial or ethnic bias. The mortgage crisis, which contributed to the financial downturn of the nation, has been riddled with unfair practices, the correction of which promises to revive not only the integrity of our economy, but also our collective commitment to equal opportunity.

## **ABOUT THE NAACP**

The National Association for the Advancement of Colored People (NAACP) is the nation's oldest and largest grassroots civil rights organization. Formed in 1909 by a multicultural group of progressive thinkers, the NAACP's mission is to ensure the political, educational, social, and economic equality of people of color. For over 100 years, the NAACP has challenged this nation to uphold its promise of equal opportunity and has pursued the goal of eliminating racial prejudice and removing all barriers of racial discrimination through democratic processes.

## NOTES

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<sup>1</sup> U.S. Department of Housing and Urban Development, *Unequal Burden: Income and Racial Disparities in Subprime Lending in America* (Washington, DC: U.S. Department of Housing and Urban Development, 2000). See also National Community Reinvestment Coalition, *The Opportunity Agenda*, and Poverty and Race Research Action Council, *Homeownership and Wealth Building Impeded: Continuing Lending Disparities for Minorities and Emerging Obstacles for Middle-Income and Borrowers of All Races* (Washington, DC: National Community Reinvestment Coalition, 2006).

<sup>2</sup> D. Bocian, K. Ernst, and W. Li, *Unfair Lending: The Effect of Race and Ethnicity on the Price of Subprime Mortgages* (Durham, NC: Center for Responsible Lending, 2006), <http://www.responsiblelending.org/mortgage-lending/research-analysis/unfair-lending-the-effect-of-race-and-ethnicity-on-the-price-of-subprime-mortgages.html> (accessed May 4, 2010). See also D.E. Getter, "Consumer Credit Risk and Pricing," *Journal of Consumer Affairs* (June 22, 2006); H. Lax, M. Manti, P. Raca, and P. Zorn, "Subprime Lending: An Investigation of Economic Efficiency," *Housing Policy Debate* 15, no. 3 (2004): 533-571.

<sup>3</sup> U.S. Department of Housing and Urban Development, *Unequal Burden: Income and Racial Disparities in Subprime Lending in America* (Washington, DC: U.S. Department of Housing and Urban Development, 2000). See also National Community Reinvestment Coalition, *The Opportunity Agenda*, and Poverty and Race Research Action Council, *Homeownership and Wealth Building Impeded: Continuing Lending Disparities for Minorities and Emerging Obstacles for Middle-Income and Borrowers of All Races* (Washington, DC: National Community Reinvestment Coalition, 2006).

<sup>4</sup> K. Ernst, D. Bocian, and W. Li, *Steered Wrong: Brokers, Borrowers, and Subprime Loans* (Durham, NC: Center for Responsible Lending, 2008), <http://www.responsiblelending.org/mortgage-lending/research-analysis/steered-wrong-brokers-borrowers-and-subprime-loans.pdf> (accessed August 28, 2009).