GSE Activity Report

Thursday, October 15, 2020

Refis and Systemic Racism

Summary

Although direct mortgage discrimination based on race and ethnicity has abated in recent years, a new study from the Federal Reserve Bank of Boston shows a striking difference in prepayment rates due to refinancing-speed differences directly attributable to race and ethnicity after controlling for an array of well-accepted underwriting risks. Due to this prepayment-speed gap, Black and Hispanic borrowers pay significantly more for their mortgages over the life of a loan and also do not benefit from the consumption- or wealth-equality benefit of lower mortgage payments. This study also and importantly finds dramatic refi-speed differences between the GSEs and FHA and an over-arching parity of default risk for Black and Hispanic borrowers once one again controls for underwriting risk.

Impact

This Boston Fed paper is both sobering and warranted given the extent of the recent refi boom and the pride the Fed takes in it when touting the equality benefits of ultra-accommodative monetary policy. Using a novel dataset available only within the Fed, the paper looks at agency 30-year FRMs originated between 2005 and 2015 up to 2020. It finds that Black and Hispanic borrowers have a prepayment gap directly due to a lack of refis of over 50% holding constant gender, credit score, income, home equity, and other key variables. Although minorities and Whites have an initial rate gap of only 5 bps at origination, the refi gap results in large mortgage-rate disparities (35-45 bps) that widens during periods of low rates and high refi volume – i.e., times like the present.

Interestingly, the prepayment gap for Fannie and Freddie loans is entirely explained by race and ethnicity data; for FHA, these factors explain about one-third of the gap. These gaps are also comparable to the difference in prepayment rates between borrowers with FICO scores below 600 and between 720 and 740 or the difference in prepayment rates between borrowers with incomes less than $25,000 and those with more than $175,000.

The average default rate for White borrowers in the sample is 0.10 percentage points; the rate for Blacks and Hispanics is 0.23 pp -- i.e., more than double. However, controlling for basic underwriting variables (credit score, income, LTV, etc.) leads to dramatically reducing this difference and, following additional controls for gender and income completely eliminates any default-propensity difference. Adding in zip codes, Black borrowers turn out to be significantly less likely to default than Whites in both GSE and FHA books; however, for FHA, Hispanics also have less default propensity than Whites.

Federal Financial Analytics, Inc.
2101 L Street, N.W., Suite 300, Washington, D.C. 20037
Phone (202) 589-0880
E-mail : info@fedfin.com www.fedfin.com

Outlook

If the paper's methodology is robust – and it seems so to us – than one could learn a lot both about mortgage pricing and public policy. With regard to pricing, it seems clear that prepayment risk is a more significant factor than default risk once loan variables are appropriately controlled and race and ethnicity essentially disappear for default risk.

From a policy perspective, the paper says and we concur that it challenges conventional wisdom establishing the 30-year FRM as the ideal product for minority households. Given obstacles to refinancing for minority borrowers regardless of income, it could well be that ARMs, perhaps with upside ceilings, do a far better job in terms of social welfare. The paper also argues that "race-blind" policies have inadvertent, but profound, disparate impact. Given lower prepayment speeds, Black and Hispanic borrowers should get lower mortgage rates that are now barred by ECOA.

Federal Financial Analytics, Inc.
2101 L Street, N.W., Suite 300, Washington, D.C. 20037
Phone (202) 589-0880
E-mail : info@fedfin.com www.fedfin.com