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**Reverse Redlining in the Subprime Mortgage Market: Comments  
on *Moving Toward Integration: The Past and Future of Fair  
Housing***

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REVERSE REDLINING IN THE  
SUBPRIME MORTGAGE MARKET:  
COMMENTS ON *MOVING TOWARD  
INTEGRATION: THE PAST AND  
FUTURE OF FAIR HOUSING*<sup>1</sup>

*Cathy Lesser Mansfield*<sup>†</sup>

My comments focus on the problem sometimes referred to as “reverse redlining,” which entails mortgage loans made to borrowers of color on terms significantly less favorable and more expensive than mortgage loans made to white borrowers. I will also try to unpack the chicken-egg problem of mortgage defaults and foreclosures in the African-American homeowner community.

Let me start by saying that it is admirable that the authors seek to answer the question of *why* African-American borrowers received mortgage loans featuring higher interest rates and fees and more onerous terms, and *why* African-American borrowers experienced higher default and foreclosure rates during the subprime mortgage crisis. Without understanding why these things have occurred, it is harder to find public-policy solutions to these very real problems.

The authors start by recognizing and accepting a multitude of studies concluding that African-American and Hispanic mortgage borrowers were much more likely to receive subprime and predatory mortgages during the subprime-market era (roughly from 1990 until 2008) than white borrowers with similar credit profiles.<sup>2</sup> The authors also recognize and accept studies finding that default and foreclosure rates were higher for African-American and Hispanic borrowers than for similarly situated white mortgage borrowers.<sup>3</sup> In seeking to explain these truths, the authors then embark on a series of assumptions and conclusions that I will try to unpack here.

The authors suggest that because African-American and Hispanic default rates were higher, providing these borrowers with loans priced

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1. RICHARD H. SANDER ET AL., *MOVING TOWARD INTEGRATION: THE PAST AND FUTURE OF FAIR HOUSING* (2018).

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2. SANDER ET AL., *supra* note 1, at 385–86.

3. *Id.* at 386.

for this risk might not be discriminatory.<sup>4</sup> This so-called paradox actually served as the justification for what lenders in the subprime market called risk-based pricing.<sup>5</sup> The notion of risk-based pricing is that lenders can identify a borrower's default risk based on the borrower's credit history, and price the loan's features (including interest rate and fees) accordingly to compensate for the lender's risk. But this loan-pricing model ignores the fact that expensive loans create their own risk, and that there are numerous ways to structure a loan to a borrower with a particular credit profile—some of which will create a greater default risk than others. It also ignores the lender's incentive to write a loan that will maximize its immediate profit regardless of default risk, especially since those to whom the loan is assigned after origination will bear the default risk. Finally, risk-based pricing ignores the combined effects of discretionary pricing and explicit or implicit bias.

I would first like to debunk the notion that risk-based pricing matches scientifically determined loan terms with the borrower's credit quality. There are numerous ways to write a loan for a borrower who "deserves" a particular interest rate. Some of these ways help a borrower to successfully pay back the loan, while others create their own risk of default. Take, for example, the case of Beatrice Troup. In 1995, Ms. Troup, a then-seventy-four-year-old African American who had lived at the same home on Vanderpool Street in Newark, New Jersey for forty years, received a solicitation call from a home-repair contractor.<sup>6</sup> She ultimately hired the contractor and entered into a mortgage loan, arranged by the contractor, for exterior home repairs.<sup>7</sup> Ms. Troup's lenders required her to convey the home to herself and her son, Curtis. The lenders then issued the mortgage loan to both of the Troups. The loan had a principal amount of \$46,500 which was to be repaid at an annual percentage rate of 11.65%.<sup>8</sup> The loan required monthly payments of \$462.50, and a final balloon payment after fifteen years of \$41,603.58.<sup>9</sup> Of the \$46,500 lent to Ms. Troup and her son, the lender kept four points (4% of the amount loaned) as an origination

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4. *Id.* ("Thus we have another paradox: there is some strong evidence of discrimination against minority borrowers, but minority homeowners do pose higher risks of default.").

5. *Id.* at 383.

6. *Assocs. Home Equity Servs., Inc. v. Troup*, 778 A.2d 529, 535–36 (N.J. Super. Ct. App. Div. 2001).

7. *Id.* at 535.

8. *Id.*

9. *Id.*

fee.<sup>10</sup> Within two years after the loan was made, Ms. Troup stopped making payments on the loan, and the loan's holder, Associates Home Equity Services, filed for judicial foreclosure.<sup>11</sup> Ms. Troup's attorneys responded with claims for reverse redlining and predatory lending.<sup>12</sup>

The case itself had complex facts and odious conduct by several actors, and presented the court with numerous legal issues. But I want to focus here on two challenges to the notion that the lender priced this loan to reflect Ms. Troup's and her son's default risk. First, if we assume that the 11.65% interest rate was somehow justified because the Troups had a high default risk, this cannot be the end of our discussion. There are numerous ways to write a high-interest loan like this. Here, the lender chose to write it as a balloon loan. As Table 1 illustrates, that structure increased the loan's total repayment amount from \$98,577 to \$124,391.08. The only benefit to the Troups of writing the loan as a balloon loan was a slightly lower monthly payment of \$462.50 (compared to \$547.65 under a non-balloon structure). By writing the loan as a balloon loan, the lender may have slightly *decreased* the Troup's default risk in a given month (depending, of course, on their combined monthly income and debt-to-income ratio), but the lender also greatly increased the Troups' default risk—and also the risk they would lose their home—when the balloon payment came due—all while increasing the lender's own take from making the loan. Thus, even if the Troups somehow “deserved” an expensive loan, the lender could have written the loan in a way to decrease its risk and increase the chances of successful repayment.

Second, it is abundantly clear that many subprime loans to African-American borrowers were priced unjustifiably high, creating their own default risk. For example, in the Troup case it appears from evidence given in the lawsuit that the Troups were not a bad credit risk.<sup>13</sup> Although the court did not explicitly disclose the Troups' incomes or credit scores, Ms. Troup's attorneys offered expert testimony that the Troups had a “favorable” debt-to-income ratio and favorable credit histories.<sup>14</sup> This suggests that the lender, if actually pricing for risk, should have given the Troups a loan priced at a conventional rate. As Table 1 demonstrates, a loan priced this way would have created a significantly lower default risk. A loan for \$46,500 made at the

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10. *Id.* This is a large origination fee.

11. *Id.*

12. *Id.*

13. *Id.* at 544.

14. *Id.* at 538. Curtis Troup's credit history showed only one charge-off of \$75 and an outstanding debt to the DMV of \$250. Beatrice Troup had no negative information on her credit report. *Id.* at 544.

conventionally available rate of 6.6% would have required a monthly payment of only \$407.63 if written as a 15-year loan, and a mere \$296.98 if written as a 30-year loan. Its total repayment amount would have been lower, and there would have been no balloon payment. By writing a loan at a high, and likely unjustified, rate, the lender and the loan itself created a higher default risk. That this unjustifiably expensive loan, and others like it, ultimately ended in default cannot serve as justification for the loan's exorbitant pricing.<sup>15</sup>

Table 1. Different Ways of Funding the Troup Loan

Loan Terms	Loan Amount	Interest	Total of Payments	Monthly Payment	Balloon
Actual loan from the case - Fixed 11.65% 15-year balloon	\$46,500.00	\$77,891.08	\$124,391.08	\$462.50	\$41,603.58
11.65% 15-year, no balloon	\$46,500.00	\$52,077.00	\$98,577.00	\$547.65	\$ -
11.65%, 30 years	\$46,500.00	\$121,193.30	\$167,693.30	\$465.81	
6.6%, 15 years	\$46,500.00	\$26,873.40	\$73,373.40	\$407.63	\$ -
6.6%, 30 years	\$46,500.00	\$60,412.80	\$106,912.80	\$296.98	\$ -

Why would a lender make a loan that increases its own default risk? It is because, as the book's authors recognize, lenders made a large portion of their expected income from a loan at the loan's inception. They then passed the default risk on to others by transferring the loan.<sup>16</sup> And, until 2008, when housing-market values crashed and the property market became saturated with unsold, foreclosed properties, a lender who foreclosed on a property was almost guaranteed to make a profit reselling that property.<sup>17</sup>

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15. It should also be noted here that subprime-era home repair contractors were notorious for making home repair loans and then not actually doing the work. See Tania Davenport, Note, *An American Nightmare: Predatory Lending in the Subprime Home Mortgage Industry*, 36 SUFFOLK U. L. REV. 531, 543 (2003) (describing contractors' practice of issuing a loan for "excessively expensive, unnecessary, or shoddy or incomplete home repairs"). This is, of course, another way that risk of default is increased by the transaction itself, not the borrower.
  16. See SANDER ET AL., *supra* note 1, at 380 ("Disintermediation also directly fostered the rise of mortgage companies that were not banks at all, but simply vehicles for finding, packaging, and selling mortgages on the open market.").
  17. See *id.* at 381 (describing the mortgage lender's "loosened underwriting standards" based on "the theory that no loan could really go 'bad' if the underlying security (the house) continued to rapidly appreciate.").

Another fallacy of the risk-based pricing model is that the price borrowers paid in the subprime market reflected the lender's risk assessment. In fact, in the subprime market, risk-based pricing models might have been used to categorize borrowers, but those making the loan-term decisions were authorized, and incentivized, to charge more than the price the borrower's risk supposedly justified.<sup>18</sup> This would work as follows. Most lenders would maintain a risk matrix. Under the risk matrix, factors such as the borrower's credit score, payment history, debt-to-income ratio, and history of bankruptcies, among other things, would be placed on a pricing matrix, and borrowers would be slated for a particular interest rate and fees based on where the borrower fell on the risk matrix.<sup>19</sup> But this exercise did not set the borrower's final pricing. Rather, the risk matrix's rates and fees served as a pricing floor, and first-line lenders (either mortgage brokers making loans on behalf of lenders, or first lenders making the loan with the intent to sell to a particular lender who set the risk matrix) were permitted to write the actual loan at a higher rate or with more fees.<sup>20</sup> A first-line mortgage lender who engaged in this discretionary pricing was generously rewarded, as it received a share of the increased income derived from writing the loan at a higher rate or with higher fees.<sup>21</sup>

The Troups' case is illustrative. East Coast Mortgage Corporation was the Troups' first-line lender. But Associates Home Equity Services was the party intended to be the lender all along. East Coast Mortgage charged the Troups a higher interest rate than the already-inflated rate Associates would have approved for the Troups—and in exchange, Associates paid East Coast a premium of \$2325.<sup>22</sup> Without question, lenders employed these discretionary pricing schemes more regularly and at higher prices against borrowers of color, resulting in higher pricing for such borrowers.<sup>23</sup> The use of discretionary up-charging for borrowers of color might have been the result of outright or implicit bias, but it was clearly not tied to the borrower's default risk. Indeed, these more expensive loans created their own default risk.

The authors attempt to explain the disproportionate number of subprime loans made to African-American borrowers by suggesting that

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18. Alan M. White, *Borrowing While Black: Applying Fair Lending Laws to Risk-Based Mortgage Pricing*, 60 S.C. L. REV. 677, 690 (2009).

19. *Id.* at 689.

20. *Id.* at 690.

21. *Id.*

22. *Assoc. Home Equity Servs. v. Troup*, 778 A.2d 529, 534, 538 (N.J. Super. Ct. App. Div. 2001).

23. For an excellent discussion of this phenomenon, see White, *supra* note 18, at 690–91.

African-American borrowers may have received these loans because they did not have “the type of credit history that Anglos typically have.”<sup>24</sup> Further, they suggest that African-American borrowers might have sought out these loans because African-American households are typically unconnected to conventional financial institutions. Finally, the authors suggest that the community of African-American borrowers consisted of relatively “naïve” borrowers, unaccustomed to conventional banks and lenders, and thus more likely to be susceptible to outreach by unscrupulous lenders.<sup>25</sup>

I agree that it would be a very useful exercise to examine the loan and lender choices presented to, and chosen by, borrowers of color, in order to determine if lack of either choice or sophistication resulted in the higher rate of subprime loans to African-American households. But, for several reasons I think it is important to reach conclusions about this only after careful study.

First, while it is possible that African Americans are more likely to use alternative, rather than bank-based financial services, the authors cite no data to support this claim. They also present no data suggesting that African Americans who use alternative financial-service providers are the same African Americans who are homeowners. Second, we know that much of the subprime market entailed re-finance loans made to borrowers—many of whom had conventional mortgage loans from banking institutions—which were then re-financed into subprime loans. I am aware of no study that has looked at the question of how many African-American borrowers refinanced their conventional, bank-issued mortgage loans into subprime loans. It would seem that answering this question is crucial to concluding that borrowers of color could not, or would not, approach conventional lenders for a mortgage loan.

I am currently in the process of writing a book that looks at mortgage lending on a single block in Cleveland Heights, Ohio, including during the subprime market.<sup>26</sup> On that block alone, there are instances where a borrower maintained a high-quality, conventional, bank-based mortgage for a long time, then took a series of subprime mortgage loans that resulted in the borrower losing the home.<sup>27</sup> In some of those cases, the borrower is likely to have been African American, although matching a particular borrower at a particular address with

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24. SANDER ET AL., *supra* note 1, at 387.

25. *Id.* at 386–87.

26. Cathy Lesser Mansfield, *On Our Block* (unpublished manuscript) (on file with author). The block consists of 40 homes sitting back to back on Cedarbrook and Kildare west of Goodnor.

27. This story’s facts and the subsequent analysis rely on Cuyahoga County files related to parcel number 687-06-051. Disclosing the borrowers’ names and addresses would compromise their privacy, and are therefore omitted. Please contact the author for verifying details.

that borrower's race often involves an educated guess based on press and other searches. For example, a couple that was likely African American purchased a home on my block in September 1980 with a mortgage from Manufacturers Hanover Mortgage Corporation, a non-bank lender incorporated in Delaware. In June 1985, the loan was assigned to a federal savings and loan. Whether this assignment was the borrowers first interaction with a banking institution is unknown but, regardless, the borrowers took a second mortgage from Society National Bank in April 1988. Thus, by 1988 they were aware of and able to interface with a locally based, national bank. The borrowers retired this second mortgage three years early and, in May 1991, they refinanced their purchase-money loan through Society National Bank. Thus, as of May 1991, they had only one mortgage loan on their home and it was from a national bank. They took another second mortgage from Society National Bank in June 1992, a home equity line of credit from Huntington National Bank in August 1995, and another second mortgage from Society National Bank in March 1997. Clearly, these borrowers were accustomed to dealing with bank lenders.

In November 1998, eighteen years after purchasing their home, these borrowers refinanced their existing first and second mortgages—both of which had come from a bank—with an \$82,000 mortgage from Equifinancial, LP, a subprime mortgage lender. At the time, the original principal on their existing mortgages was \$75,000 (consisting of a first mortgage Society National Bank made in 1991 for \$45,000, and a second mortgage, also from Society National Bank, made in 1997 for just over \$30,000). By the time this subprime refinance loan was made, the borrowers surely would have owed less money on both their first and second mortgages. The increased principal of this subprime mortgage may have been due to an increased value of the property, although the county auditor valued the property for tax purposes that year at only \$66,400. The increased principal might also have been justified by an inflated appraisal – a practice prevalent in the subprime market that would have trapped the borrowers into the loan since neither refinance nor resale would enable them to pay off the mortgage.

The refinance loan bore an onerous initial interest rate of 9.5%, compared to the going rate for 30-year conventional mortgages of 6.87%.<sup>28</sup> After the first two years, the interest rate on this loan would jump to a rate based on the London Interbank Offered Rate (LIBOR) plus 6.48%. In November 2000, the LIBOR was 5.13%, so the new rate on this loan starting in November 2000 would have been 11.61% - made

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28. *30-Year Conventional Mortgage Rate (DISCONTINUED) (MORTG)*, FED. RES. BANK OF ST. LOUIS: ECON. RES., <http://research.stlouisfed.org/fred2/series/MORTG/> [<https://perma.cc/BG2K-DVUP>] (last updated Oct. 3, 2016).



up of the base rate of 6.48% plus the LIBOR rate of 5.13%.<sup>29</sup> It is not possible to determine the borrowers' interest rates on their refinanced loans because interest rates are generally reflected in the mortgage note, which is not filed with the county recorder's office when a security interest is taken on a mortgage loan. But if the borrowers' existing mortgages reflected the market rate when made, the first mortgage would have borne a rate of about 9%, and the second mortgage would have had a rate of about 8%.<sup>30</sup> Thus, the borrowers' initial interest rate on their subprime refinance loan would have been only slightly higher than the rate on their existing loan. But their rate after the first two years would be significantly higher. Had the borrowers refinanced with a conventional loan they likely would have had a rate of 6.87%,<sup>31</sup> and the rate would not have re-set at the end of two years. The true question here is why any borrower would make this loan choice.

In these borrowers' case, at least, it is clear that unfamiliarity with conventional banking institutions was not a factor.

By taking the subprime loan from Equifinancial, LP, these borrowers embarked on a downward spiral that led, ultimately, to foreclosure. In December 2001, after their loan had reset to the much higher interest rate, they took another subprime loan – this time from a lender called Primary Residential Mortgage, Inc. This loan increased the principal from \$82,000 to \$89,500. The interest rate on this loan is not available in public records. Less than a year later, in October 2002, the borrowers refinanced again with Primary Residential Mortgage, Inc. This loan was for a huge new principal of \$117,500. Again, we cannot tell what the interest was on this loan. One thing that is certain is that by making a second large loan to these borrowers in one year, Primary Residential Mortgage, Inc. was able to receive two large sums of money in points and fees rather than one, since these are assessed and paid when the loan is closed.

By June 2005, the borrowers were behind on their taxes by two years, and a tax lien for \$13,604.57 was placed on their property—not very much money in the context of an outstanding mortgage for \$117,500. The borrowers refinanced again with a new subprime lender in November 2005, fell behind on their taxes again in 2005 and 2006,

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29. *LIBOR Rates—30-Year Historical Chart*, MACROTRENDS, <https://www.macrotrends.net/1433/historical-libor-rates-chart> [<https://perma.cc/MCK9-UJXT>] (last visited May 24, 2020).

30. *See 30-Year Conventional Mortgage Rate (DISCONTINUED) (MORTG)*, *supra* note 28.

31. *National Monthly Average Mortgage Rates*, MORTGAGE-X MORTGAGE INFO. SERV., [http://mortgage-x.com/general/national\\_monthly\\_average.asp?y=1998](http://mortgage-x.com/general/national_monthly_average.asp?y=1998) [<https://perma.cc/A6DN-6ZXB>] (last visited May 24, 2020).

and ultimately lost their home in a default foreclosure judgment in January 2015.

Why did these borrowers opt to take a series of dangerous and expensive subprime mortgages? Clearly, they had exposure to conventional banks. Were they in financial trouble when they chose to go with a subprime lender? Did they have compromised credit histories when this choice was made? Did they understand what they were getting themselves into? Did they understand what it meant to pay an interest rate based on LIBOR? Why were these homeowners able to engage in successful and sustainable home ownership for the first eighteen years they owned this house, only to fall behind and lose the home in a foreclosure action in which they did not even fight the lender? All of these questions would have to be answered to understand both the subprime market and the racial aspects of that market. The behavior of the borrowers discussed above—taking a series of devastating subprime loans after eighteen years of successful home ownership—did not occur due to an incomplete credit history or lack of exposure to conventional banking institutions, as evidenced by their loan history with conventional, Cleveland lenders. Something else must have been going on. The research challenge is to figure out what.

The authors fail to recognize that the subprime market was, itself, a discriminatory system in which borrowers of color were the victims.<sup>32</sup> At first, the authors appear to be saying that African-American borrower characteristics were likely to cause them to default at higher rates than their white counterparts, and that this, in turn, led conventional lenders to “indulge in some level of statistical discrimination against black applicants.”<sup>33</sup> These factors cited by the authors, but backed up by no data, include a higher likelihood of unemployment and under-employment; fewer resources to draw upon in case of default; lack of comfort with conventional lenders; more propensity to deal with payday and other alternative financial-services providers; and a reluctance to seek assistance from an existing lender.<sup>34</sup> The authors then seem to suggest that conventional lenders did not discriminate against African-American mortgage borrowers. Rather, they suggest, heavy subprime lending to African-American borrowers took place because these borrowers themselves were more comfortable with and more likely to rely on unconventional lenders<sup>35</sup>—the very

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32. See SANDER ET AL., *supra* note 1, at 387–88.

33. *Id.* at 388.

34. *Id.* at 387–88.

35. *Id.* at 388.

lenders who offered less favorable mortgage terms. The authors then conclude that this demonstrates a lack of reverse redlining.<sup>36</sup>

The very fact that African-American and white borrowers with similar credit profiles received different loans during the subprime era, and that African-American borrowers demonstrably and regularly received the ones with unfavorable terms, *is* reverse redlining. Whether those borrowers were turned away by conventional lenders, sent to subprime subsidiaries by those conventional lenders, or received unjustifiably expensive loans from non-traditional lenders, one thing is clear: these borrowers were experiencing discrimination. Thus, the authors' conclusion that there was no reverse redlining because conventional lenders only marginally discriminated against African-American borrowers, and African-American borrowers preferred non-traditional lenders, does not, after all, reconcile the competing narratives of the mortgage crisis. It may be impossible to know why some borrowers took dangerously expensive and unfavorable loans from subprime lenders, but we cannot merely assume why they did so and then base policy on those assumptions. Nor can we assume that borrowers' choices and risk profiles explain away the pricing discrepancies that worked so severely against African-American homeowners during the subprime market era. To do so is to blame the victims of reverse redlining for the bad loans and high default rates they experienced at the hands of the subprime market.

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36. For example, the authors write that they observed “a higher reliance on unconventional lenders in heavily minority neighborhoods, even in the absence of redlining.” *Id.* They then conclude by saying, “blacks were much less likely to encounter discriminatory treatment when dealing with mainstream lenders, but . . . the market is sufficiently segmented so that blacks were getting a disproportionate share of their mortgages from out-of-mainstream lenders extending mortgages on much less favorable terms.” *Id.*