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# DOES DISCRETIONARY PRICING MEAN DISCRIMINATORY PRICING?

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# Does Discretionary Pricing Mean Discriminatory Pricing?

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Shortly after I turned sixteen, two formative experiences occurred on the same day. It started with perusing a book by Richard Nixon that, somewhat as an aside, suggested that perhaps the only viable way to end war was to end the financial incentives that lead nations to war. This simple statement struck me with its profound implications, and it started a thought process about the importance of financial incentives that has continued ever since.

Later that day, I went to purchase my first car insurance policy. The agent, whom I recall very clearly had an aquarium stocked with small-mouth bass in his office, set out three summaries of “different” auto insurance policies on his desk and named the price for each, starting with the lowest price and ending with the highest. He then asked me which *price* I would prefer to pay. Assuming that he misspoke, I asked about specific differences in the policy, e.g. liability coverage amounts. The agent politely interrupted me and very clearly stated, “...each policy is identical; each policy is for the state minimum liability coverage—but it just depends on how much extra commission you want the insurance company to pay me for selling you their insurance.”

Being sixteen, I asked if the cheapest insurance policy paid him enough money. He said, “Yes, that’s a fair deal,” and reached out to shake my hand to close our transaction. I walked away with a very practical lesson on discretionary pricing and how financial incentives may affect me personally. Growing up in a rural, small town in Ohio it didn’t occur to me until much later how unique (and for me, lucky) this experience was.

Discrimination, to some degree, has been illegal in the U.S. arguably since the enactment of the 14<sup>th</sup> Amendment over 140 years ago, and, especially with the Civil Rights laws of the 1960s, much legal and political progress has clearly been made. Nevertheless, people of color continue to pay more and often get less for some of the most basic and essential services that define modern American life.

Perhaps the best place to analyze this mismatch of legal ideals and cold realities is the recently collapsed mortgage market.

People of color are more likely to receive a subprime home loan (in effect this means more likely to get a non-fixed rate mortgage), more likely to receive a prepayment penalty and pay higher interest rates than comparable white borrowers. And all of these terms and products unnecessarily increase the risk of foreclosure.

The key question remains: Why?

The answer goes back to financial incentives. There is a lot of money to be made by overcharging and pushing otherwise unsuitable products. For example, Ameriquest—at one time the largest subprime lender in the country but now bankrupt—specifically rewarded its loan officers for making loans which were more expensive and risky than necessary. There were lots of ways to do this—for example, by offering bonuses for loans with prepayment penalties or paying mortgage brokers higher fees for steering borrower to loans with rates higher than what they actually qualified for. Countrywide paid brokers up to \$1500 extra for making an Option ARM (a loan that allows the borrower to pay less than the minimum interest payments). This made for some enriched brokers in the short run, but in the long run these loans created problems for the homeowners and just about everyone else in the country.

A *Wall Street Journal* study found that 61% of subprime borrowers in 2006 may have qualified for a lower-cost conventional loan. To me, one of the strongest pieces of evidence for the inevitable outcome of these perverse incentives is this: During the mid-2000s, this nation had a period of record-low interest rates, yet by 2006, the *typical* mortgage originated came with an adjustable interest rate. As a reminder, the conventional reason to consider an ARM is that the borrower is betting the interest rates will fall.

Federal Reserve Chairman Ben Bernanke recently noted that this type of discretionary pricing in the hands of financially-incentivized mortgage originators can be a prescription for trouble, as it can lead to illegal, discriminatory behavior. Consequently, the Federal Reserve Board recently proposed a rule to ban this type of pricing discretion and other types of bonus payments for steering borrowers to not just higher rates, but flatly unsuitable mortgage products, for all mortgage loans and loan officers, regardless of mortgage product type.

People of color fare no better in the auto-lending market. Recent research from the Center for Responsible Lending estimated that similar pricing discretion costs car buyers an estimated \$20.8 billion in 2008. Kickbacks to dealers add an average \$647 to the cost of each vehicle – the rate bumped up an extra .6% for new cars, and 1.8% for used cars. Other data, looking at five major auto lenders, reported an average mark up of \$989 per vehicle. And there seems to be a tax on color: Some 55% of African Americans were charged a kickback, compared to 31% of whites, and on average, African-Americans were charged an extra \$1,100.

Incentives to overcharge distort competitive market forces by creating a reverse competition effect, giving brokers strong incentive to shop for the best deal for themselves, not the best deal for the borrower. This structural flaw serves as an obstacle to efficient and effective market operation and thereby increases the cost of credit.

The intermediary role of mortgage brokers, auto-dealers and other types of commissioned agents make this impossible for the market to correct. Lenders who would otherwise refrain from allowing discretionary pricing must do so or risk losing business to other financial service providers who will.

Based upon this line of reasoning, I would propose the following: The President or Congress, whether by act or administrative fiat, should commission a far-ranging study to examine the disparate impact of discretionary pricing in the financial services market. A strong, independent Consumer Financial Protection Agency, if enacted, would be the ideal agency to undertake this comprehensive review and make policy, but other federal agencies could review and potentially make policy changes as well; the Federal Reserve, the Department of Housing and Urban and Development, the federal banking regulators and the Federal Trade Commission also have authority already that should allow them to address the abusive elements of discretionary financial services pricing.

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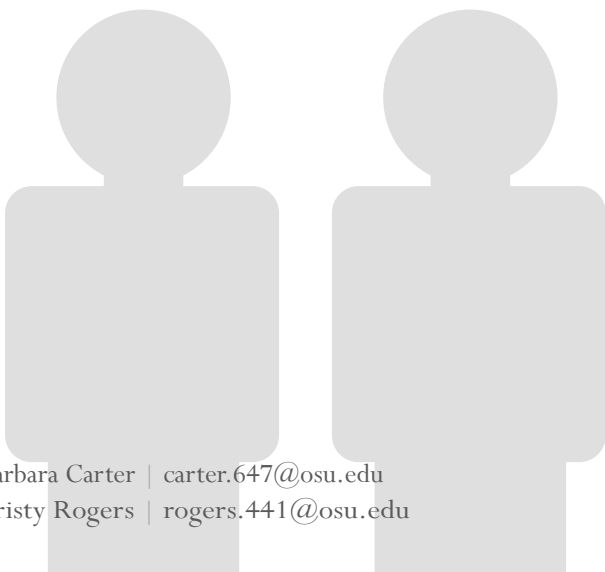
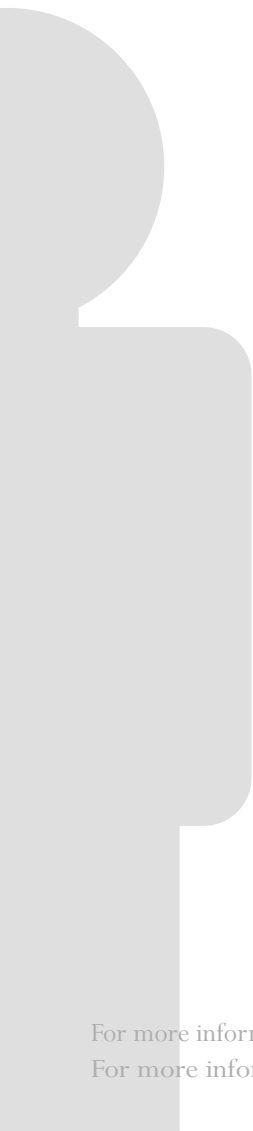
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