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Rooting Out Discrimination in Home Mortgage Lending

by Stanley D. Longhofer

Racial justice is a fundamental social goal in the United States, making enforcement of fair lending laws an important function of the Federal Reserve and other regulators. Despite nearly three decades of effort, however, discrimination in the home mortgage market remains a vexing problem.

Ultimately, the most effective way to combat mortgage discrimination depends on its underlying source. Lawmakers, however, tend to ignore root causes when forming antidiscrimination policies, which are consequently less effective and more costly than they could be. Our inability to deal satisfactorily with discrimination may result largely from this failure to understand why it arises in the first place.

Discrimination's persistence in the home mortgage market has received renewed attention recently because of data made available through the Home Mortgage Disclosure Act. These data show that blacks and Hispanics are denied loans more frequently than are whites. For instance, in 1994 (the latest year for which data are available), 33.4 percent of all black and 24.6 percent of all Hispanic mortgage applicants were denied loans, compared to 16.4 percent of whites.[1]

Some of these disparities can be explained by differences in minority applicants' income, wealth, and credit histories—all pivotal factors in the mortgage lending decision. Nonetheless, according to a recent influential and controversial study by economists at the Federal Reserve Bank of Boston, such factors account for only part of the difference in denial rates. In the end, they found that if minorities in the Boston area had the same characteristics as whites, they would be denied loans 17 percent of the time, compared to only 11 percent for whites.[2]

This *Economic Commentary* discusses several possible sources of discrimination in the home mortgage market, outlines how each would manifest itself, and briefly considers the solution most appropriate for each. Before continuing, however, it is important to distinguish between discrimination—the act of treating an individual differently because of a personal characteristic such as race—and bigotry, which is only one possible cause of discrimination. Unfortunately, much of the public discourse about this problem implies that all discrimination results from bigotry. Such rhetoric is counterproductive. Since discrimination can also arise from more benign intentions, indiscriminately impugning all lenders' integrity by labeling them bigots only serves to close their minds to the genuine problems that do exist.

To combat discrimination in the home mortgage market effectively, it is essential to understand its origins. Although bigotry is the most conspicuous cause of discrimination, others are perhaps more likely and more difficult to prevent. Statistical discrimination can arise if race is correlated with some hard-to-measure determinants of creditworthiness. Alternatively, cultural affinity problems might make lenders less able to accurately determine a minority applicant's true creditworthiness. Each of these problems can result in illegal discrimination, but their solutions may be quite different. By channeling resources toward the appropriate remedy, policymakers can reduce discrimination by more than would be possible through sole reliance on enforcement of fair lending laws.

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Bigotry

One obvious source of discrimination in credit markets is bigotry. Nobel laureate Gary Becker developed an economic framework for analyzing bigotry, or what he calls "tastes for discrimination."[3] According to this theory, lenders do not maximize profits, as is the usual assumption in economics. Instead, they maximize their "utility," taking into account both the profits they earn and the satisfaction they get from discriminating against minorities. A bigoted lender, then, would forgo some marginally profitable loans to minorities in order to satisfy his or her taste for discrimination; the amount of profit forgone depends on the strength of this taste.

This theory has two distinct implications. First, since a loan's profitability is positively related to the creditworthiness of the borrower, a bigoted lender would hold minorities to a higher credit standard than whites. This would translate into minorities being denied loans more frequently, even if the creditworthiness of the two groups were the same. Second, since marginal minority borrowers (the least creditworthy minorities given loans) had been held to a higher standard, their default rate would be *lower* than that of marginal white borrowers.

These predictions are based on the assumption that lenders face no outside regulatory constraints. Under fair lending laws, however, bigoted lenders would lower the credit standard required for minorities and raise the standard for whites, in order to reduce the chance of being caught discriminating. As a result, the difference between the default rates of marginal white and marginal minority borrowers would be less than in an unregulated environment.

Statistical Discrimination

Under Becker's theory of discrimination, bigots must earn relatively higher returns on loans to people they dislike. Alternatively, lenders might truly be profit maximizers, willing to make loans to any creditworthy individual. Race, however, is correlated with many factors, some difficult and costly to observe, which may affect a loan's profitability. If lenders use an applicant's race as a proxy for these factors when making lending decisions, they practice what is called statistical discrimination.

If, even after controlling for easily measured determinants of creditworthiness, minorities are more likely to default than whites, profit-maximizing lenders might want to "discount" any minority applications they receive.[4] As a consequence, they would hold minorities to a higher credit standard than whites. In contrast to bigotry's hurdle, however, this higher standard would not be set because lenders needed higher profits to make them willing to lend to minorities. Rather, this standard would be designed to ensure that they earned the *same* profit from loans to each group. As a result, marginal minority and marginal white borrowers would default equally often.[5] In the presence of fair lending laws, lenders would likely lower their standard for minority applicants and raise their standard for whites, with the result that marginal minority borrowers would default *more* frequently than their white counterparts—an implication opposite to that produced by bigotry.

This type of statistical discrimination does not necessarily arise because lenders are lazy or mean-spirited; some information that affects a loan's profitability may not be easy for them to discover. For example, a lender can readily verify an applicant's current employment status and income. But if job-market discrimination makes minorities more likely than whites to lose their jobs, lenders might require minorities to have a higher income or more assets to qualify for a particular loan. Nonetheless, such behavior constitutes discrimination under the law.

Cultural Affinity

The statistical discrimination just described can arise only if marginal minority borrowers are more likely to default than whites, even after information like the applicant's income, credit history, and net worth is taken into account. Alternatively, if lenders are less able to accurately evaluate minority loan applications, statistical lending discrimination can occur even when minorities and whites are equally creditworthy on average. This problem can arise from a lack of "cultural affinity" between lenders and minorities.[6]

For questionable loan applications (that is, for those on the margin between being accepted or rejected), lenders must make subjective judgments about an applicant's creditworthiness by considering "compensating factors." If some of the signals lenders use to evaluate a person's character are culturally dependent, then lenders may be less able to interpret the signals they receive from minorities, especially if they process relatively few minority applications. Lenders' inability to determine which minority applicants are good credit risks and which are not would cause them to make more mistakes; in other words, they would accept more "bad" minority applicants and reject more "good" ones, relative to whites.

If cultural affinity were a serious problem in home mortgage lending, the consequences would be similar to those of more direct statistical discrimination. Lenders would hold minorities to a higher credit standard than whites, but only to ensure that loans to both groups were equally profitable. Hence, the default rate of the *marginal* applicant would be the same for both groups.[7] In the face of fair lending laws, lenders would tend to lower the cutoff for approving minority loans and raise the standard for approving white loans. As a consequence, the default rate of marginal minorities would rise and that of marginal whites would fall, creating a gap between the two. In contrast to the results of the statistical discrimination already discussed, this would occur even if there were no inherent difference in the creditworthiness of minority and white borrowers.

What to Do?

It is clear that discrimination in the home mortgage market can spring from different sources. One might ask whether this really matters: Since we as a society have decided that we don't want individuals treated differently because of their race, why not just outlaw all discriminatory behavior and punish offenders, regardless of *why* they are discriminating? Unfortunately, this solution does not appear to have satisfactorily eliminated discrimination. Furthermore, it can entail large deadweight costs. In addition to the substantial direct costs of enforcement, it may lead to undesirable changes in lenders' activities. To avoid detection, lenders that discriminate would make more loans to minorities. But they might also make *fewer* loans to whites, reducing the total availability of mortgage credit. While it is possible that traditional fair-lending enforcement is the best overall solution, by focusing directly on discrimination's root causes we may find more effective ways to combat this serious social problem.

As it turns out, the most effective solution to bigotry is quite straightforward: Increase competition in the banking industry. Because bigoted lenders are not maximizing profits, in a perfectly competitive market they will eventually be run out of business. Other lenders will grant those marginally profitable loans and so will be able to offer either a lower interest rate to all borrowers or a higher rate of return to their investors. Unless the lender's owners, depositors, and customers have the same "tastes" as the loan officer, this type of discrimination cannot persist when other lenders can enter the market.[8]

If marginal minority applicants are less creditworthy than marginal whites, and lenders use this fact to statistically discriminate against them, the problem is more difficult. Attempts to make lenders ignore race will encourage them to devise other criteria, correlated with race, on which to base their lending decisions. Since such criteria may be costly to use and provide no useful information to the lender, they will necessarily push mortgage rates up. As the government's attempts to detect discrimination and lenders' proxies for race get more sophisticated, the deadweight costs of this exercise escalate.

Ultimately, the only effective way to eliminate this kind of statistical discrimination is for the relative creditworthiness of minorities to improve. When minorities and whites are equally good credit risks (holding easily measured factors constant), lenders will have no incentive to discriminate. To say this does not absolve society of responsibility for addressing the problem. Rather, if we are to effectively fight statistical discrimination in lending, we must expand our efforts and resources beyond the mortgage market. Fighting job discrimination and improving educational opportunities, for example, would be good places to start.

The problems of cultural affinity arise when lenders use the wrong model to predict minority defaults, partly because they lack experience in evaluating minority applicants. To solve this problem, we must lower the cultural barriers between minorities and financial institutions. One might think that this could be done by forcing lenders to hire more minority loan officers. But some institutions already do this voluntarily. If the solution is so simple, why aren't we seeing the results yet?

One explanation is that a lack of financial sophistication on the part of some minority borrowers might make it difficult for *any* loan officer to evaluate their creditworthiness, regardless of the officer's race. For whatever reasons, many low- and moderate-income families, including minorities, live in a "cash only" society; they may not have a checking account or credit cards, and may pay most of their bills with cash.[9] Such individuals may also lack demonstrable experience in managing credit. This lack of experience in dealing with financial institutions may make it more difficult for some minority applicants to convince a lender of their creditworthiness. Furthermore, it can be very difficult for a lender to assess the true creditworthiness of an applicant who has this kind of unconventional financial background. Bridging these gaps requires the education of both parties to the mortgage transaction: Lenders may need to learn more effective ways to evaluate applicants with atypical financial histories, and some low- and moderate-income minority borrowers may benefit from pre-loan educational programs combined with ongoing financial counseling.

Educational programs are costly, however. Furthermore, lenders may fail to reap all the benefits of providing financial education to potential borrowers if some of those they teach end up applying for loans at other institutions. The expense of such programs and institutions' inability to capture their benefits may explain why lenders have not undertaken more of them voluntarily.

So what is to be done? The fact that educational programs are costly, and that the benefits of reducing discrimination accrue to society at large rather than to individual lenders, suggests that subsidizing financial counseling and education programs, supporting specialized community development institutions, and encouraging lenders to experiment with innovative underwriting criteria for low-income and minority applicants may all be appropriate ways to reduce discrimination induced by cultural affinity problems.

■ Conclusion

Some might be inclined to dismiss efforts to understand the sources of discrimination as a pretext for delaying any action. And from an applicant's point of view, *why* discrimination has occurred is irrelevant; his or her loan has been denied for reasons other than creditworthiness, and that is all that matters.

Nonetheless, from a policymaker's perspective, the why is vitally important. To combat discrimination in the home mortgage market effectively, it is essential to understand its origins. This *Economic Commentary* has outlined three potential sources of such discrimination and has suggested possible solutions to each. The differences among these solutions make it clear that policymakers must understand discrimination's root causes before they can hope to eliminate it.

■ Footnotes

1. The source of these data is the Federal Financial Institutions Examination Council. These rates apply to conventional home purchase loan applications made at covered institutions as defined by the Federal Reserve's Regulation C (12 CFR §203 et seq.). Interestingly, only 12.0 percent of Asians' loan applications were denied, a rate much *lower* than that of whites.

2. See Alicia H. Munnell, Lynn E. Browne, James McEneaney, and Geoffrey M.B. Tootell, "Mortgage Lending in Boston: Interpreting HMDA Data," Federal Reserve Bank of Boston, Working Paper WP–92–7, October 1992, table 4. The validity of these findings has been the subject of heated debate in the academic community. For an overview of problems with this study, see David K. Horne, "Evaluating the Role of Race in Mortgage Lending," *FDIC Banking Review,* vol. 7, no. 1 (Spring/Summer 1994), pp. 1–15; and Mitchell Stengel and Dennis Glennon, "Evaluating Statistical Models of Mortgage Lending Discrimination: A Bank-Specific Analysis," Office of the Comptroller of the Currency, Economic and Policy Analysis Working Paper No. 95–3, May 1995. See also Lynne E. Browne and Geoffrey M.B. Tootell, "Mortgage Lending in Boston—A Response to the Critics," *New England Economic Review,* September/October 1995, pp. 53–78.

3. See Gary S. Becker, *The Economics of Discrimination.* 2d. ed. Chicago: University of Chicago Press, 1971.

4. Paul Calem and Michael Stutzer present a more sophisticated model of statistical credit market discrimination in "The Simple Analytics of Observed Discrimination in Credit Markets," *Journal of Financial Intermediation,* vol. 4 (July 1995), pp. 189–212.

5. Average default rates (the percentage of loans that default irrespective of the applicant's creditworthiness) would be higher for minorities.

6. This theory was developed by Charles W. Calomiris, Charles M. Kahn, and Stanley D. Longhofer in "Housing-Finance Intervention and Private Incentives: Helping Minorities and the Poor," *Journal of Money, Credit, and Banking,* vol. 26, part 2 (August 1994), pp. 634–74. For empirical evidence consistent with this theory, see William C. Hunter and Mary Beth Walker, "The Cultural Affinity Hypothesis and Mortgage Lending Decisions," Federal Reserve Bank of Chicago, Working Paper WP–95–8, July 1995.

7. As before with more direct statistical discrimination, *average* default rates for minorities would be higher.

8. Because urban credit markets are generally quite competitive, bigotry is more likely to exist in rural areas. Also, in a market with other problems like cultural affinity, competitive pressures may take some time to eliminate bigotry. Nonetheless, the basic point—that competition is the best preventative for bigotry—remains true.

9. See Glenn B. Canner and Ellen Maland, "Basic Banking," *Federal Reserve Bulletin,* vol. 73, no. 4 (April 1987), pp. 255–69, and John P. Caskey, "Check-Cashing Outlets in the U.S. Financial System," Federal Reserve Bank of Kansas City, *Economic Review,* November/December 1991, pp. 53–67.

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