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LENDING INSIGHTS

HARD PROOF THAT BANKS DISCRIMINATE

BY JIM CAMPEN

"These really are horrifying numbers."
— *Comptroller of the Currency Eugene A. Ludwig on banks' 1992 record denying mortgages to minorities, Nov. 4, 1993.*

As appalling as it was, the latest annual report on mortgage lending shocked few observers when the Clinton Administration's top regulators unveiled it before the Senate Banking Committee in November, 1993. In keeping with past patterns, black mortgage applicants were turned down more than twice as often as whites in 1992. Indeed, the most closely watched single number indicated that things were getting worse rather than better: the ratio of the black denial rate to the white denial rate rose from 2.16 in 1991 to 2.26 in 1992.

What was different in 1993 was the response to the statistics. Instead of denying the obvious as they have in the past, government officials acknowledged that discrimination is "alive and well in America," as Housing Secretary Henry Cisneros put it. Bank regulators, along with Attorney General Janet Reno, testified that they are intensifying efforts to identify and punish lenders who discriminate.

And bankers, rather than disputing charges that they had discriminated, emphasized their efforts to do better. Since researchers found what one Massachusetts banker referred to as a "smoking gun" in October 1992, bankers have recognized that they can no longer offer credible denials. The crucial evidence, from a study by the Federal Reserve Bank of Boston, finally established beyond a reasonable doubt that banks discriminate along racial lines when making mortgage loans.

The banks' quandary is the triumph of a nationwide grassroots "community reinvestment" movement that for over twenty years has been employing innovative strategies to challenge banks' failure to meet the credit needs of low-income and minority neighborhoods and individuals. That banks discriminate has, of course, long been obvious to those receiving the short end of the stick. But community advocates recognized that obtaining proof of discrimination would be the key to combatting it. So, they fought not only for laws that regulate banks, but also for requirements that banks furnish relevant information on their lending practices. They then used these data to publicize banks' abysmal performances, sparking the public outrage necessary to make banks more responsive to the needs of low-income and minority communities.

Their first major legislative victory was the 1975 enactment of the Home Mortgage Disclosure Act (HMDA — pronounced *HUMdah*), which required each bank to report the number and dollar amount of the mortgage and home improvement loans by census tract (census tracts are areas a few blocks square, containing a few thousand people, for which detailed demographic and socio-economic data are available). Two years after HMDA took effect, Congress adopted the Community Reinvestment Act (CRA). The CRA declares that banks have an "affirmative obligation" to serve the credit needs of local communities, including low and moderate income areas — which are often communities of color. A lesser-known set of *fair lending laws*, including the Fair Housing Act of 1968 and the Equal Credit Opportunity Act of 1974, explicitly prohibit racial discrimination. Only very recently, however, have bankers and regulators begun to take the CRA and the fair lending laws at all seriously.

THE INFORMATION GAME

In the absence of earnest enforcement efforts by bank regulators, it fell primarily to independent community-oriented researchers to document discriminatory lending practices. Their efforts to build this case, beginning with the struggle to enact HMDA, have followed a recurring pattern.

Typically, community groups made charges only to see them dismissed by the banks as unsupported by solid evidence. The groups then struggled to make more data available, so researchers would be able to produce more definitive results. Consistently, though, the banks and their defenders (including, in many cases, the regulatory agencies) criticized the resulting studies as inconclusive. The limited nature of the data available, they argued, made it impossi-

ble to rule out other possible explanations of racial disparities in lending patterns. But with this maneuver, the banks backed themselves into a corner: They were now in no position to deny demands from community advocates for additional data to fill out the picture. So another round would begin, as researchers used the more extensive data supplied by the banks to produce results even more suggestive of racial discrimination.

By the end of the 1980s, this cycle had yielded an impressive array of studies that combined HMDA data with Census Bureau information on the racial composition and income level of census tracts in order to document mortgage lending discrimination. The *Atlanta Journal-Constitution*'s Pulitzer Prize-winning series "The Color of Money" (May 1988) compared stable, middle-income neighborhoods that were at least 80% white to those that were at least 80% nonwhite. It found that between 1984 and 1986, Atlanta banks and savings & loans (S&Ls) made 4.5 times as many loans per 1,000 single-family structures in white neighborhoods as in comparable black neighborhoods.

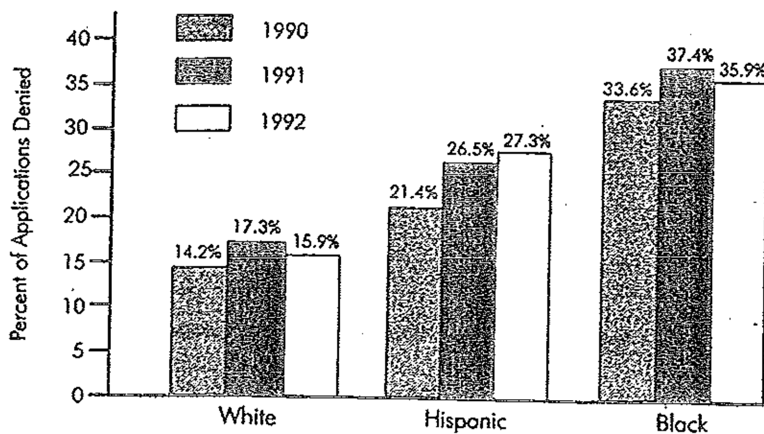
In city after city, studies documented similarly dramatic racial disparities in mortgage lending. Between 1981 and 1987 in Boston, for instance, banks made 2.9 times as many mortgage loans per 1,000 housing units in low-income white neighborhoods as in minority neighborhoods with similar incomes. In Detroit, the ratio of the mortgage lending rate (loans per 1,000 homes) in middle-income white neighborhoods to that in middle-income black neighborhoods rose every year between 1981 and 1986, reaching 3.14 to 1 in 1986. Similar patterns appeared in Chicago, Los Angeles, Milwaukee, and New York as well as in 14 cities observed by the Center for Community Change. A survey of 23 studies by Professor Anne Shlay of Temple University showed that all 23 found a negative impact of race on conventional mortgage lending.

Bankers acknowledged that these results were troubling, but argued that they didn't prove that banks were discriminating. First, the bankers suggested that the low level of lending in minority neighborhoods might reflect a low level of applications rather than a high level of bank denials. They also pointed out that the data referred only to the location of the homes being purchased. Since it provided no direct information about the race or income level of the applicants, they argued that the data failed to prove discrimination against minority individuals.

These defensive arguments by bankers helped make it possible for the community reinvestment movement to finally succeed in broadening the scope of HMDA. As part of the S&L bailout bill adopted in August 1989, HMDA was amended to require banks to report on all mortgage applications received, rather than just on loans made. Beginning January 1, 1990, banks had to record the race, income, and sex of each applicant, the result of the application, and the previously required information on the census tract in which the home was located.

In October 1991, the Federal Reserve reported the results of its analysis of the expanded HMDA data for 1990. It was the most extensive set of mortgage lending data ever assembled — more than six million loan applications reported by over 9,000 mortgage lenders. The most striking single result of their analysis was the difference in denial rates for black and white applicants. Overall, 34% of black applications for conventional home mortgages were rejected, compared to a 14% rejection rate for whites. (Hispanics were rejected at a 21% rate; rejection rates for Asians were slightly lower than for whites.) Large differentials persisted even when comparisons were limited to applicants in the same income categories. In many cities, high-income blacks experienced higher denial rates than low-income whites. (As the chart on this page indicates, HMDA data for 1991 and 1992 demonstrates that these differences persisted).

Lenders could no longer claim that low levels of lending resulted solely from a lack of demand for loans by minority applicants rather than from their own decisions on which applications to accept. They were, however, quick to adopt a fallback position. In its reponse to the grossly unequal denial rates revealed by the expanded HMDA data, the American Bankers Association (ABA) emphasized that the data didn't include "information critical to judging the creditworthiness of loan applicants." It was entirely possible, the bankers suggested, that differences in applicants



Source: Federal Reserve Board; *American Banker*, 11/5/93.

THE BOSTON FED STUDY

The Boston Fed's researchers examined data on 38 variables that bear on loan applications, in addition to HMDA data on the race, income, and sex of applicants. Ranked by how much they increased the probability that an application would be denied, here are the factors that the Fed found mattered most:

Factor	
Denied private mortgage insurance	596%
Public record of debt problem (e.g., bankruptcy)	114%
Race (black or Hispanic applicant)	56%
Purchasing 2-4 family home	42%
Poor consumer credit history*	37%
Self-employed	35%
Housing-costs-to-income ratio over 30%	34%
High total-debt-payment-to-income ratio*	33%
High loan-value-to-appraised-home-value ratio*	12%
Employed in industry with high unemployment rate*	11%
Late payments on previous mortgage loan*	11%

To estimate the impact of an individual factor, the analysts calculated the percentage increase in the probability of denial that would result from the variation of that factor alone, assuming that all other variables held constant at their average values. For example, they figured out that when nothing else varies, the probability of denial increases from 11% to 17% if an applicant's race is black or Hispanic rather than white. Alternatively, if a mortgage applicant is refused private mortgage insurance, the probability of being denied the mortgage loan increases from about 17% to over 99%. For most factors, including these two, the stated condition was either present or absent; for the other five factors — those marked by an asterisk (*) — the estimation process was more complicated. The percentage shows the estimated effect of that variable's increase of one "standard deviation" from its average value.

Source: See *Resources* at end of article.

credit histories, wealth, job instability, or other economic characteristics accounted for the more frequent rejection of minority loan applicants. ABA chief lobbyist Ed Yingling maintained that "the HMDA numbers don't show a whole lot; they don't mean a whole lot."

THE "SMOKING GUN"

Meanwhile, researchers at the Federal Reserve Bank of Boston — which has been a somewhat liberal outpost in the overwhelmingly conservative Federal Reserve System — were pursuing another path. If conclusions had been limited by missing data, they reasoned, why not collect and analyze all of the data necessary to resolve the issue? Taking advantage of the Fed's status as a banking regulator, they were able to conduct the first study to take into account virtually all of the factors used in mortgage lending decisions. They asked the 131 banks in the Boston area that had received 25 or more mortgage applications in 1990 to review their loan files and gather 38 additional pieces of information for each application from a black or Hispanic (about 1,200 applications) and for a randomly selected set of 3,300 applications by whites. Once again, the banks' attacks on the alleged insufficiency of existing data had led to the gathering of more and better information.

Using a special variant of the standard statistical technique known as multiple regression analysis, the Boston Fed's analysts then sought to explain why minorities in the Boston area were denied mortgages 2.7 times as often as whites. To what extent, the researchers asked, did legitimate factors account for the disparity?

Banks, hoping to be exonerated by the Boston Fed's study, were dismayed at the results. The additional information showed that, as the banks claimed, blacks and Hispanics were on average poorer, had worse credit histories, and requested mortgage loans that were larger relative to their incomes. But it also showed that these and similar factors only told part of the story. Even if black and Hispanic borrowers had been just as creditworthy as the average white applicant with respect to all 38 of the factors considered, they still would have been 56% more likely to be denied a mortgage. Only the applicants' minority status could account for the difference. As Alicia Munnell, who was then the Boston Fed's Research Director, put it, "The study eliminates all the other possible factors that could be influencing decisions." The long-sought "smoking gun" had been found.

The Boston Fed offered a plausible account of the way that discrimination took place. As most of those who have sought home mortgages know from personal experience, the application process can be complex and intimidating. The Boston Fed's data showed that only 20% of all applicants had flawless credit records. Within that group virtually all applicants were approved, regardless of race. But the great majority of applicants — including most of those ultimately receiving loans — had one or more imperfections in their loan files. These problems could have legitimately justified denying them mortgage loans.

To be successful, applicants generally need help and counseling, and often benefit from a willingness on the part of bank personnel to "stretch" or overlook one or two of the requirements. Whites appeared to have received this assistance more frequently than blacks or Hispanics — perhaps because the loan officers, who were overwhelmingly white, were simply more comfortable with other whites. Even though there may have been a valid technical reason for every denial of a minority application, banks were still guilty of treating white and minority applicants unequally. As activist Bruce Marks of the Boston-based Union Neighborhood Assistance Corporation explained, "it's a mortgage minefield," and banks are much more likely to guide white applicants through it.

AFTER THE SMOKESCREEN CLEARS

Pushed beyond the stage of denial — in spite of the inevitable, and quickly discredited, objections published by *Forbes*, *Business Week*, and *The Wall Street Journal* — bankers and federal regulators have begun to recognize the value of measures that had been urged on them for years by community advocates. Bank responses have included taking a systematic "second look" at minority loan applications recommended for denial; training bank employees to increase understanding of fair lending issues and sensitivity to cultural differences; hiring more minority loan officers; revising certain traditional credit standards that are biased toward white cultural practices; forging working relationships with realtors and appraisal firms that have positive records in minority communities; developing new mortgage lending products adapted to the special circumstances and needs of minority borrowers; and using internal "testing" programs to identify whether or not bank employees are in fact offering equal treatment to minority applicants.

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At the same time, the four federal bank regulatory agencies have begun taking steps to ensure that banks are complying with fair lending laws. One agency, the Office of the Comptroller of the Currency (OCC), estimated in November that it will complete 20 in-depth fair-lending examinations by the end of 1993. The OCC also announced that in early 1994 it will begin the use of undercover testers to detect racial discrimination at the pre-application stage of the mortgage lending process. For the first time, regulators are actually referring cases to the Justice Department when their own investigations suggest that discrimination is occuring. And, most dramatically, the Federal Reserve Board denied a routine application by Connecticut-based Shawmut Bank to acquire a smaller bank in New Hampshire, citing the ongoing Justice Department investigation of Shawmut's alleged lending discrimination.

These things happened only after Congressional hearings had brought to light what Deepak Bhargava of Association of Community Organizations for Reform Now (ACORN) characterized as "a long and sorry record" of regulatory failure. Even New York's Republican Senator Alphonse D'Amato was moved to ask whether the "regulatory agencies [were] asleep at the switch, or worse, turning a blind eye?"

THE POWER OF DISCLOSURE

The Boston Fed study established the *fact* of discrimination in mortgage lending. But with its narrow focus on data from completed loan applications, the study did not attempt to measure the full *extent* of discrimination. For example, many potential minority borrowers encounter responses to their initial contacts with banks that discourage them from ever applying, and the property values recorded in loan files may have been furnished by appraisers who systematically undervalue homes in minority neighborhoods.

The community reinvestment movement is right to insist that banks are obliged by the CRA to do more than simply deal fairly with the loan applicants who come through their doors. A whole range of aggressive, affirmative initiatives will be necessary to extend credit and financial services to currently underserved communities. Moreover, without constant pressure from community groups, regulators will likely bow to pressure from banks and fail to enforce community-oriented laws and regulations.

If properly enforced, disclosure laws should continue to be useful. Many aspects of the normal operation of our economic system cannot stand the light of day. With that in mind, the community reinvestment movement has recently been emphasizing its long-standing call for the extension of disclosure requirements to the realm of business lending.

Activists believe that businesses based in low-income communities and those owned by minorities have had an even harder time obtaining credit than minority homebuyers. But until there is something comparable to HMDA for small business lending, it will be impossible to persuasively document the existence and extent of the problem. And as the ongoing struggle for fair mortgage lending has demonstrated, exposing the nature of a problem can go a long way toward forcing its solution.

Resources: "Expanded HMDA Data on Residential Lending: One Year Later," *Federal Reserve Bulletin*, November 1992; Alicia Munnell and others, "Mortgage Lending in Boston: Interpreting HMDA Data," Federal Reserve Bank of Boston, October 1992; "Discrimination in the Housing and Mortgage Markets," a special issue of *Housing Policy Debate*, Vol. 3, No. 2, 1992; "Your Loan Is Denied," a one-hour documentary broadcast on PBS's *Frontline* June 23, 1992; videotape available from the Center for Investigative Reporting, 530 Howard St., 2nd Floor, San Francisco CA 94105 (415-543-1200).