

Why Is Mortgage Discrimination Illegal? A Fresh Look at the Mortgage Discrimination Debate

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HY DO ANTIDISCRIMINATION LAWS EXIST? FOR that matter, what is “discrimination”? It may seem preposterous to ask such questions as we enter the twenty-first century; surely the

answers must have been settled decades ago. Yet after nearly forty years of regulatory efforts to eliminate discrimination in the housing-finance market, it seems that the core inequalities that spurred civil-rights legislation are far from eliminated. Indeed, academics, policymakers, and industry participants have been unable to reach a consensus as to whether there is widespread discrimination in the mortgage market, let alone how to rectify it.

At the root of this problem is a lack of agreement about what constitutes illegal discrimination and why society should eliminate it. After all, many forms of discrimination are perfectly legal: men pay higher premiums for life insurance than women, women pay higher prices for haircuts than men, senior-citizen discounts are commonplace, young children eat free at many restaurants, and Christian churches are allowed to exclude Bud-

dhists as pastors. Even the Equal Credit Opportunity Act explicitly allows discrimination; lenders may discriminate on the basis of age, as long as it works to the advantage of older loan applicants.

So why is mortgage discrimination illegal? In this article, we review the current debate over discrimination in mortgage lending, exploring what constitutes mortgage discrimination and the purposes of antidiscrimination laws. As we will argue, disagreements over those two issues underlie much of the current controversy about the pervasiveness of mortgage discrimination.

Unfortunately, many economists and policymakers seem to assume implicitly that bigotry is the only form of discrimination that is, or should be, illegal. As we show, however, that assumption is inconsistent with the way fair-lending laws are

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written and enforced. The laws are designed to eliminate any differential treatment of protected groups, regardless of motive. This confusion about what constitutes mortgage discrimination has muddled the debate and forestalled agreement over how to proceed with public policy.

If fair-lending laws do not exist simply to rid the lending process of bigoted behavior, what is their purpose? After considering a variety of possible answers, we propose that the primary purpose of the laws is to eliminate the negative spillover effects that can arise when a large segment of the population is denied equal access to a good or a service—home ownership in this case. Any honest debate about fair-lending laws must address the nature and size of those spillover effects if it is to come to a constructive resolution.

THE MORTGAGE DISCRIMINATION DEBATE

RECENT YEARS HAVE SEEN A HEATED DEBATE AMONG academic economists and policymakers as to whether mortgage lenders systematically discriminate against minority applicants. Although community groups had long alleged widespread disparities in the allocation of mortgage credit, the issue was brought squarely into public view with the release of new data about mortgage-lending patterns.

HMDA to the Rescue Under the Home Mortgage Disclosure Act (HMDA), a large percentage of lenders began in 1990 to track the disposition of mortgage applications and to keep information about the race, gender, income, and census tract of each loan applicant. The HMDA data, summarized in Table 1, showed for the first time the strikingly higher rejection rates for black and Hispanic applicants relative to white applicants.

The HMDA data, not surprisingly, created a maelstrom of public scrutiny of the mortgage finance industry. Many commentators took the data as incontrovertible evidence

of widespread and systematic discrimination against minorities on the part of mortgage lenders. But as lenders and other observers pointed out, the HMDA data lack key underwriting information (e.g., an applicant's loan-to-value ratio, liquid assets, and credit history). Therefore, there is no way to determine whether the disparities shown by the HMDA data are the result of illegal discrimination or of

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differences in creditworthiness. If black and Hispanic applicants tend to have higher debt payment-to-income ratios and poorer credit histories than white applicants do, those differences could fully explain the higher observed denial rates experienced by black and Hispanic applicants. Unfortunately, HMDA data cannot be used to discern the source of denial-rate disparity.

The Boston Fed Study To address the shortcomings of the HMDA data, researchers at the Federal Reserve Bank of Boston performed a more comprehensive study of the factors affecting mortgage-lending decisions. The researchers surveyed Boston-area financial institutions about their 1990 mortgage loan applications. In the end, they received information on 38 financial, credit history, and employment variables from more than 3,000 applications at 131 financial institutions. Those data were then combined with the information already available through HMDA and census data.

This now-famous Boston Fed study was released to the public in late 1992. The authors of the study concluded that applications from minorities in the Boston metropol-

Table 1

Denial Rates of Conventional Home Purchase Loan Applications

(Percentages by race and year)

Race of Applicant	1990	1991	1992	1993	1994	1995	1996	1997	1998
American Indian/Alaskan Native	22.4	27.3	26.6	27.8	31.6	41.4	50.2	51.9	52.9
Asian/Pacific Islander	12.9	15.0	15.3	14.5	12.0	12.5	13.8	12.7	11.8
Black	33.9	37.6	35.9	34.0	33.4	40.5	48.8	53.0	53.7
Hispanic	21.4	26.6	27.3	25.2	24.6	29.5	34.4	37.8	38.7
White	14.4	17.3	15.9	15.4	16.4	20.6	24.1	25.8	26.0
Other	19.0	19.9	21.0	23.1	23.8	29.6	30.0	22.5	25.9
Joint (White and Minority)	14.9	17.5	17.6	17.7	17.2	22.4	32.3	23.6	22.6

Source: Federal Financial Institutions Examination Council, Home Mortgage Disclosure Act data.

itan area were about 50 percent more likely to be rejected than were applications from whites, even after controlling for the factors that banks use to determine creditworthiness: “This means that 17 percent of black or Hispanic applicants instead of 11 percent [the denial rate among white applicants] would be denied loans, even if they had the same obligation ratios, credit history, loan to value, and property characteristics as white applicants” (Alicia Munnell et al. “Mortgage Lending in Boston: Interpreting HMDA Data.” Federal Reserve Bank of Boston Working Paper 92-7, October 1992, p. 44).

Needless to say, the results of the Boston Fed study have been hotly debated, both in academic and public policy arenas. Although the debate has been at times esoteric, at

application and underwriting process. More specifically, critics of the study charge that the Boston Fed researchers omitted important underwriting variables from their statistical model and that their statistical techniques fail to account for the negotiation that takes place between the applicant and the lender. Once again, although many of the concerns are valid, economists have been unable to reach a consensus as to the import of those criticisms for the study’s conclusions.

The Becker Paradox Perhaps the most contentious debate that emerged following the release of the Boston Fed study has been about the proper method of uncovering discriminatory behavior. In his 1993 Nobel Lecture, “The Economic

Way of Looking at Behavior” (*Journal of Political Economy* 101), Gary Becker challenged the Boston Fed study’s conclusions, arguing that bigoted lenders would be willing to sacrifice the profit they might earn by approving marginally qualified minority applicants to satisfy their “tastes for discrimination.” In Becker’s view, the proper way to detect discrimination is to do so

Underlying the debate is the implicit assumption that all discriminatory behavior results from bigotry.

its core have been the practical policy questions of how best to detect, measure, and eliminate discrimination.

Bad Data Better than No Data? Some of the most strident criticism of the Boston Fed study has been directed at the reliability of its data. Many authors have cited a variety of “errors” that may have biased the Boston Fed’s results toward a finding of discrimination. For example, researchers who have examined the Boston Fed’s data have found a large number of instances of debt payment-to-income ratios greater than 100 percent, of negative net worth, and of mistakes in coding a loan’s approval or rejection. Although data problems are endemic in economic survey data, the Boston Fed’s data seem especially problematic.

Since the initial release of the Boston Fed report, many followup studies have used the Boston Fed’s data, attempting to correct for and assess the effects of erroneous data on the Boston Fed’s conclusions. It should come as no surprise that when economists focus on a policy question the final answer is inconclusive, with highly respected researchers coming down on either side of the issue. In our opinion, those who dispute the Boston Fed’s results make many compelling points, but their efforts are often strained and they appear at times to let their prior beliefs about whether lenders discriminate drive their conclusions. At the same time, however, those who support the Boston Fed’s findings often seem too willing to dismiss criticisms of the data.

Do It the Right Way The Boston Fed study also has been widely criticized for its methodology. At issue is whether the Boston Fed researchers properly modeled the loan

directly, by comparing the relative profitability of loans to minorities and whites: “This requires examining the default and other payback experiences of loans, the interest rates charged, and so forth. If banks discriminate against minority applicants, they should earn greater profits on the loans actually made to them than on those to whites” (p. 389).

This theory of discrimination gives rise to the Becker Paradox: On the one hand, at banks that discriminate, denial rates for minorities will tend to be higher than denial rates for whites. On the other hand, minority default rates will be lower, at least among marginal applicants (the least creditworthy of those applicants who receive loans) because only the very best minority applicants will receive loans.

Critics of the Boston Fed study have used Becker’s test to refute claims that lenders systematically discriminate against minorities. The Boston Fed’s data show no difference in foreclosure rates between predominantly minority census tracts and predominantly white census tracts, in contrast to what Becker’s theory would predict if discrimination were prevalent. In fact, growing evidence from the academic literature on mortgage discrimination suggests that minority borrowers are significantly more likely to default than similarly situated white borrowers, even after controlling for other factors that are correlated with default. In addition, losses from minority borrowers who default are higher than losses from whites who default.

The Boston Fed study’s authors argue that average default rates cannot be used to uncover discrimination because the distribution of creditworthiness differs between white and minority applicants: on average, minorities tend to be less creditworthy. Therefore, minority default rates

might exceed those of whites even if the least-creditworthy minorities are denied loans because of discrimination. Although that is a valid criticism of the comparisons of average default rates that have been cited in the popular press, economists who study default rates recognize that Becker's test is valid if one focuses on *marginal* default rates, that is, the default propensities of the least-creditworthy approved applicants.

WHAT IS "DISCRIMINATION" ANYWAY?

WE HAVE PROCEEDED THUS FAR WITHOUT FORMALLY DEFINING "discrimination." We are not alone in this regard; most of the academic debate about the prevalence of mortgage discrimination has been conducted without clarifying the meaning of the term. This failure is unfortunate because it has perpetuated misconceptions that hamper efforts to reach a policy consensus.

Underlying nearly every aspect of the debate about the persistence of discrimination in mortgage lending is the implicit assumption that all discriminatory behavior results from lender animosity toward minorities, that is, bigotry. This assumption appears in the measure of discrimination commonly employed by economists: "Only when rejected minority applications have the same expected profitability as accepted white applications is there clear evidence of discrimination." (Geoffrey Tootell, "Defaults, Denials, and Discrimination in Mortgage Lending," *New England Economic Review*, September/October 1993, p. 46. In fairness to Tootell, he also pointed out that the legal definition of discrimination can differ from this economic one.)

But is this really what is meant by discrimination under the law? In order to answer this question, we must look at the statutes themselves.

The Letter of the Law Two federal laws directly address discriminatory acts in the mortgage market. The Fair Housing Act prohibits discrimination with respect to any aspect of a housing transaction, including the provision of mortgage financing. The Equal Credit Opportunity Act targets discrimination in lending transactions. In addition to race, both acts identify several other characteristics that are protected under the law, including gender, marital status, religion, national origin, familial status, and handicap.

Both acts, however, are conspicuously vague about what constitutes illegal discrimination. For example, the Equal Credit Opportunity Act states "It shall be unlawful for any creditor to discriminate against any applicant, with respect to any aspect of a credit transaction," without explicitly defining "discriminate."

It seems likely that this failure to define discrimination was deliberate. Perhaps Congress was trying to create legislation that would be acceptable to diverse constituencies, each of which might have objected to a more specific objective if it had been spelled out. Alternatively, the laws' vagueness may have been intended to prevent schemes that could circumvent more precise language. It is more likely, however, that Congress simply believed that all reasonable peo-

ple understand the meaning of "discrimination."

We turn, therefore, to *Merriam Webster's Collegiate Dictionary* (10th edition), which defines discrimination as "the act, practice, or an instance of discriminating [making a distinction] categorically rather than individually." In other words, any difference in treatment across individuals based solely on (protected) group membership—rather than on personal characteristics specifically related to creditworthiness—would constitute discriminatory behavior under the law. (A noteworthy exception is the Equal Credit Opportunity Act, which allows age to be considered in credit-scoring models, but only to the advantage of older applicants.)

Given this definition, it is clear that illegal discrimination can arise for a variety of reasons, contrary to the view that appears to underlie much of the academic and public debate on the issue. More to the point, the law does not distinguish acceptable from unacceptable *motivations* for discriminatory behavior. To understand why, it is instructive to consider what sorts of incentives can give rise to discrimination in the mortgage market.

Bigotry Nobel laureate Gary Becker pioneered the economic analysis of discrimination with his theory of "tastes for discrimination." According to Becker's theory, lenders who discriminate do so because they get some psychic benefit from denying a loan to a minority applicant, even though that loan would be profitable under ordinary underwriting guidelines. The key feature of discrimination in Becker's analysis is that it is a taste, just like any other preference an individual might have. As a result, Becker argues that a bigot will be willing to give up other desirable things (such as profit) to satisfy his taste for discrimination, giving rise to the default-rate test described above.

Statistical Discrimination Alternatively, discrimination might arise out of a lender's profit motive. If, for instance, a lender's experience suggests that minority borrowers repay their loans less often than do otherwise identical white borrowers, the lender would have an incentive to statistically discriminate against minority applicants. Thus, even if the lender gets no special pleasure from discriminating against minorities, it might find such behavior *profit maximizing*.

An example of statistical discrimination may be helpful. Two automobile owners with identical driving records pay drastically different insurance premiums if one is middle-aged and the other a teenager. Insurers know that an individual's driving record is an *imperfect* indicator of his likelihood of getting into an accident in the future; driving records being the same, young drivers get into accidents more often than older drivers. As a result, teenagers pay more for their insurance.

In charging the teenager a higher premium, the insurance company is statistically discriminating against him; it is pricing his policy based on the characteristics of his group (young drivers) rather than his personal characteristics (his driving record). Of course, this kind of statistical dis-

crimination is perfectly legal; there are no laws that prohibit discriminating against teenage drivers.

The mortgage lender that statistically discriminates against minorities has the same motive as the insurance company that statistically discriminates against teenage drivers. If minority loans are less profitable *even after controlling for the information collected on the loan application*, mortgage lenders will have an incentive to apply more stringent underwriting standards to minority applicants or to charge them higher interest rates. In contrast to teenage drivers, however, minority loan applicants are a protected group; thus it is illegal for mortgage lenders to act on this incentive.

Why might there be a relationship between race and creditworthiness? We discuss three possibilities: omitted variables, differential group creditworthiness, and cultural affinity.

Omitted Variables Economists usually assume that statistical discrimination arises because of “omitted variables.” An omitted variable is a characteristic that lenders fail to consider in their underwriting decision—perhaps because the information is too costly to collect—even though it is predictive of creditworthiness. If the omitted personal characteristic is also correlated with race, profit-maximizing lenders will have an incentive to use an applicant’s race as a proxy for this omitted variable. Importantly, if lenders collected this variable, no “discrimination” would arise. That is, although disparities in average denial rates would exist, they would be explained by differences in the omitted variable across groups.

Differential Group Creditworthiness Even if lenders collected every conceivable piece of information that might help them predict an applicant’s creditworthiness, they would still have an incentive to statistically discriminate if minorities are less creditworthy on average than white applicants. Lenders can never *perfectly* predict whether an applicant will repay his loan. Default-triggering events such as job loss, divorce, or declines in property values cannot be predicted with 100-percent accuracy, regardless of how much information a lender collects. If such events were correlated with race, then knowing an applicant’s race would help a lender predict the profitability of a loan.

The key point is that this type of statistical discrimination is not the result of the omitted variable problem; it occurs even when lenders collect every possible piece of information that might help them predict default-triggering events. Discrimination arises in this case simply because minorities are less creditworthy on average than whites.

Whether the minority population is, on average, less creditworthy than the white population is an empirical question. Evidence presented in the Boston Fed study suggests that such a disparity in creditworthiness is quite plausible, as does a recent study of credit report data by Freddie Mac. Furthermore, many economists would argue that it is not only plausible but should be *expected*; hundreds of years of discrimination against minorities can create socioeco-

nomnic disparities that lead to lower creditworthiness.

Cultural Affinity A third potential source of statistical discrimination arises if lenders find it more difficult to assess the creditworthiness of minority borrowers as compared with white borrowers. That is the idea behind the *cultural affinity hypothesis* first proposed by Charles Calomiris, Charles Kahn, and Stanley Longhofer.

For questionable loan applications—those that are on the margin between being accepted and rejected—lenders must often make subjective judgments about an applicant’s creditworthiness by considering “compensating factors.” If the “feedback” lenders use to assess applicants’ character is culturally dependent, lenders may be less able to interpret the signals they receive from minorities, especially if lenders process relatively few minority applications. Lenders’ difficulty in determining which applicants are good credit risks and which are not may cause them to adopt a more conservative stance when underwriting minority loans. As a result, cultural barriers between (predominantly) white lenders and minority applicants may give rise to a form of statistical discrimination, even if white and minority applicants are equally creditworthy on average.

It Is Not Why but Who The motivations behind each of these sources of discrimination are quite different. While the bigot feels animosity toward minority applicants, lenders who statistically discriminate harbor no racial animus. Rather, they discriminate in order to treat all applicants *identically*, that is, to approve all applicants who meet a certain profitability threshold, irrespective of why profitability may differ across groups.

The language of the fair-lending laws implies that the motivation for discriminatory behavior is irrelevant—statistical discrimination is just as illegal as bigotry. That being said, lenders *may* apply different underwriting standards to self-employed persons than to, say, employees of large corporations, because employment status is not a legally protected characteristic.

This fact raises a fundamental question: What distinguishes group membership from a personal characteristic? After all, one may consider self-employment either to define a class of borrowers or to represent a characteristic of an individual borrower. Similarly, race, gender, and marital status are at the same time personal and group characteristics.

In other words, it is by personal characteristics that group membership is defined. In short, fair-lending laws provide a legal distinction between those individual characteristics that are legitimate underwriting factors and those that are protected group characteristics.

Why are some characteristics protected against discrimination and others not? We are brought back to our original question.

WHY IS MORTGAGE DISCRIMINATION ILLEGAL?

WITH A CLEARER UNDERSTANDING OF WHAT CONSTITUTES illegal discrimination, we can now address the fundamen-

tal question *why* some forms of discrimination are illegal in the first place. That is, what social objectives are fair-lending laws designed to achieve?

Eradicate Bigotry Endemic to the debate about the existence of mortgage lending discrimination is the implicit assumption that antidiscrimination laws are designed to purge society of any remaining vestiges of bigotry. Discrimination, it is suggested, arises because there are bad people who vent their personal animosity toward minorities by denying them loans or forcing them to pay higher rates and fees on loans that are approved.

Under that view, statistical discrimination is inoffensive because the lender's underlying motivation is not animus but profit maximization. Just as life insurance companies may charge higher premiums to persons with a family history of heart disease, lenders that can demonstrate that minority applicants are more likely to fall into delinquency or default than similar whites should be allowed to consider that fact when deciding whether to approve a loan or in determining what price to charge for the loan.

But, as we have argued, such statistical discrimination is clearly illegal under U.S. fair-lending laws. Therefore, the purpose of those laws cannot simply be to eradicate behavior arising from bigotry.

Well, They Are Called "Fair-lending" Laws... Despite this common nomenclature, it is also our contention that fair-lending laws are not written to make the mortgage market more "fair." As discussed above, everything else being the same, minority applicants are probably less creditworthy, on average, than whites. Therefore, in the absence of fair-lending laws, it is likely that minorities would be denied loans more frequently than whites and would pay higher interest rates and fees on approved loans. We are not necessarily sanctioning this outcome. Nevertheless, in the absence of fair-lending laws, it is likely that such statistical discrimination would occur.

By preventing statistical discrimination, fair-lending laws have the perverse effect of forcing lenders to cross-subsidize minority borrowers from the higher profits they earn on white borrowers. Such cross-subsidization is inherently "unfair" (and economically inefficient) because it works as a tax on one group that is used as a subsidy for another. Indeed, if fair-lending laws were truly designed to promote fairness, it is conceivable that they would mandate statistical discrimination, to ensure that all applicants were held to the same creditworthiness threshold, regardless of their race.

Of course, this raises the question of whether such a mandate would be fair to bigots, who would be made worse off by being prohibited from indulging their tastes for dis-

crimination. Along a similar line, in his provocative book *Fair Play*, economist Steven Landsburg points out that antidiscrimination laws also violate the "symmetry principle" of fairness. If an individual decides not to apply for a loan at a particular bank solely because of the race of the loan officer, he is free to do so. This asymmetry creates an unequal burden between the applicant and the lender that is inherently "unfair."

For all these reasons, fairness cannot be the primary purpose behind antidiscrimination laws.

Rawlsian Insurance Another possibility is that antidiscrimination laws are designed to protect people from suffering the negative consequences of personal charac-

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teristics over which they have no control. For example, an individual cannot (ordinarily) choose his race or gender but he can affect his employment status and credit history. Thus, it is argued that fair-lending laws serve as a form of Rawlsian insurance against the accidental consequences of one's birth.

Although that explanation has some plausibility, it is inconsistent with the facts of the matter. Young drivers and male life-insurance customers both suffer perfectly legal discrimination based on the immutable facts of age and gender. At the same time, lenders are prohibited from discriminating on the basis of marital status, clearly a mutable characteristic.

Political Tributes Perhaps fair-lending laws are intended to benefit a politically influential group through cross-subsidization. After all, many public programs—from labor laws to agricultural subsidies to social security—exist not because they efficiently rectify true market failures but because they serve powerful interest groups.

We regard political influence as an unlikely explanation for why fair-lending laws encourage cross-subsidization of minorities by whites. Indeed, much of the social history around fair-lending laws reflects minorities' lack of political power in the United States. In contrast to senior citizens or labor unions, minority groups would find it more difficult to garner the political support necessary to pass fair-lending laws if they did not serve a broader social purpose. Indeed, while serious proposals are often put forth to reform social security or to eliminate agricultural subsidies, no prominent legislators in recent years have seriously suggested that fair-lending laws should be repealed.

This is not to say that the implementation and enforcement of fair-lending legislation is free from political pressure. To the contrary, public pressure from interest groups has been fundamental to the effectiveness of fair-lending laws. But, unlike labor unions or AARP, many of the interest groups that promote fair lending are third-party advocates; that is, their members are not the direct recipients of the cross-subsidies. Thus, we must seek the causes of that third-party advocacy.

A Better World So why are there fair-lending laws? We cannot completely dismiss the preceding explanations, but we believe that the ultimate support for fair-lending laws derives from the widespread view that discrimination—

Fair-lending laws are not about fairness; they are aimed at the negative externalities associated with discrimination against protected groups.

any kind of discrimination—against certain groups is detrimental to society as a whole. In short, the main purpose of antidiscrimination laws is to eliminate the negative spillover effects—externalities, in economists' jargon—that ensue when a significant segment of the population is excluded from equal participation in the benefits of society.

When minority mortgage applicants are rejected solely because of their race, it fosters an impression of second-class citizenship that can affect other aspects of economic life. For example, Nobel laureate Kenneth Arrow has argued that discrimination can create self-fulfilling stereotypes. In the context of the mortgage market, if lenders believe that minorities are on average less creditworthy than whites, and if lenders allocate mortgage loans between minorities and whites according to that belief, minorities will have less incentive than whites to engage in the costly behavior that enhances their creditworthiness. Thus, the stereotype is self-fulfilling.

One can imagine other spillover effects as well. Because minorities have less access to mortgage finance, they have a much lower rate of home ownership than whites, even after accounting for differences in income across the two groups. That in turn can result in minorities living in poorly maintained rental housing and inhibit their ability to build wealth through home equity. Thus, even if mortgage discrimination arises because minority loans are less profitable for banks, its consequences can be unacceptable to the general public.

Our purpose here is not to explain the exact nature of the spillover effects that give rise to fair-lending laws. Nor do we claim to be able to measure their magnitude or importance. Rather, our point is that these are the central

issues that policymakers and other commentators must confront. Until we reach a consensus as to the nature and magnitude of these spillover effects, serious and productive debate about the proper policy response will remain elusive.

**“ONCE MORE UNTO THE BREACH,
DEAR FRIENDS, ONCE MORE”**

NOW THAT WE HAVE ARMED OURSELVES WITH A DEFINITION of discrimination and a positive rationale for fair-lending laws, we are prepared to stake out our own piece of turf in the mortgage-discrimination debate.

Although we find the evidence presented by the Boston Fed study compelling, it cannot be considered conclusive evidence that lenders systematically discriminate against minorities. There are good reasons to believe that the data used in the Boston Fed study are unreliable and potentially biased toward a finding of discrimination. We also sympathize with those authors who have raised methodological concerns about the analysis.

Nevertheless, the magnitude and significance of the race effect in the Boston Fed study is remarkably resistant to efforts to eliminate it. If there were truly nothing going on in the data, it should be easier to explain away the race effect found by the study. Although no conclusions can yet be drawn, the Boston Fed study clearly suggests that widespread mortgage discrimination may exist, a possibility we would have deemed extremely unlikely before the study was released.

Having Their Cake and Eating It Too We are more deeply troubled by the insistence of the authors of the Boston Fed study that the disparities they found were necessarily the result of bigotry. By flatly rejecting statistical discrimination as an explanation for their results, the authors have assigned unseemly motives to lenders, unnecessarily charging an already sensitive debate.

The authors have dismissed statistical discrimination on two bases: first, that there is no omitted-variable problem; and, second, that minorities and whites are equally creditworthy, on average. While we agree that omitted variables is an unlikely explanation for the Boston Fed's results, it is possible—indeed, even likely—that minorities are less creditworthy than whites on average.

Throughout their paper, the Boston Fed researchers reject evidence supporting this conclusion about relative creditworthiness. At the same time, they claim that default-rate tests are unreliable because of inherent differences in the creditworthiness of minorities and whites. So which is it? How they can categorically reject the possibility that lenders statistically discriminate is puzzling.

If It Looks Like a Duck... More broadly, we are disturbed with the cavalier manner in which economists on both

sides of the debate about discrimination have mixed positive economic analysis with normative policy judgments. Throughout the debate there has been the suggestion that the only true source of discrimination is bigotry. Statistical discrimination is often set aside, with the implicit assumption that if it were at the heart of the Boston Fed's findings, it would somehow be less objectionable. Indeed, when it is discussed, it is under the value-laden terms "rational" or "economic" discrimination, as if to indicate that statistical discrimination is somehow less objectionable than bigotry.

Less objectionable to whom, we ask? Perhaps only to a few misguided economists masquerading as moral philosophers. Certainly not to individual victims of discrimination, who suffer inequities regardless of the motivation underlying their treatment. And it is certainly not less objectionable under the law, because fair-lending laws make no exception for statistical discrimination.

Moreover, we fail to understand how applying labels distinguishes statistical discrimination from bigotry. After all, a bigot is a perfectly rational individual who is simply maximizing his utility subject to his own (morally reprehensible) preferences and other constraints.

Rather, it seems that the distinction reflects a value judgment about the relative "acceptability" of statistical discrimination versus bigotry. Is it the case that economists find profit maximization moral but not utility maximization? Although such normative judgments are compulsory for a social philosopher, they hamper honest debate when economists allow them to cloud objective, scientific analysis of policy issues.

POLICY IMPLICATIONS

WHAT DOES ALL OF THIS HAVE TO SAY ABOUT PUBLIC POLICY?

Honesty Is the Best Policy It is important to keep in mind that fair-lending laws have nothing to do with fairness. Rather they are designed to deal with perceived negative externalities associated with discrimination against protected groups. Discrimination is usually legal, and laws are passed to prevent a particular form of discrimination only when a large segment of society feels the spillover effects of that discrimination. Any fruitful debate about the persistence of mortgage discrimination, therefore, must first honestly confront the nature and extent of those externalities.

The Root of the Problem We believe that understanding the root cause of mortgage discrimination is equally as important as uncovering it in the first place. Although an individual victim of discrimination likely cares little about the source of his mistreatment, the distinction is crucial from a policy perspective. For any particular policy to be effective in combating discrimination it must be directed at nullifying the underlying motive. For example, if bigotry is the source of discrimination, the threat of severe financial penalties may be a reasonable approach to eliminating the

behavior. In contrast, if statistical discrimination is the culprit, policy should strive to make minority loans more profitable for lenders, be it through direct subsidies of minority borrowers, by providing assistance in collecting missing information (omitted variables), or through policies aimed directly at raising the creditworthiness of minorities.

Cross-Subsidies Revisited As we discussed earlier, the prohibition on using race as an underwriting variable creates a cross-subsidy from white borrowers to minority borrowers. Economists are generally opposed to cross-subsidization because it inefficiently distorts the private allocation of resources. In contrast, it is argued, if minorities were given a one-time direct cash payment, it would compensate them for discrimination that might arise from private lending decisions.

Nevertheless, lump-sum transfers may be ineffective in addressing the spillover effects we have discussed, precisely because they do not affect agents' marginal incentives. For example, if discrimination results in self-fulfilling stereotypes, lump-sum transfers would do nothing to encourage minorities to take actions to eliminate these stereotypes and the social costs that result.

In this case, direct subsidies, quotas, and permitting reverse discrimination may be more efficient policy tools, despite the deadweight costs that such measures would impose on the economy. While we stop short of advocating those policies, we believe that they should be discussed openly, as viable alternatives to present policy.

When to Declare Victory As a final point, we note that a key issue policymakers must decide is when fair-lending laws have served their purpose. The restrictions imposed by those laws are not without their costs, which include both the direct costs of enforcement and the indirect costs of prohibitions on private contracting. Antidiscrimination laws make sense only when their costs are outweighed by the perceived benefits of eliminating the social externalities arising from discrimination.

Although it is likely that the benefits from antidiscrimination laws exceeded their costs thirty years ago, when the laws were first enacted, it is reasonable to question whether that is still the case. Clearly, it is not easy to come to such a judgment. Our hope is that we have made it easier to do so by clearly identifying the goals of antidiscrimination laws and the source of their costs.

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