The Perverse Enforcement OF FAIR-LENDING LAWS

— by JAMES P. SCANLAN —

Fair-housing regulators could benefit from a lesson in statistics. Lenders that follow federal guidance increase chances the government will sue them for discrimination.

In recent years, the Department of Justice settled claims of racial and ethnic discrimination in lending with recoveries totaling more than half a billion dollars. The largest occurred in *United States v. Countrywide Financial Corporation* ($335 million) and *United States v. Wells Fargo Bank* ($175 million). ¶ The complaints in both cases fault lenders for failing to implement less-discriminatory alternatives to practices believed to cause minorities to receive subprime rather than prime loans at higher rates than whites. The complaints also fault lenders for various practices that led generally to greater frequency of subprime loans.

That emphasis reflects an aspect of federal fair-lending enforcement that has long been based on a perception about racial and ethnic differences in outcome rates that is the exact opposite of reality.

But that perception is not the only problem with fair-lending enforcement.

To put things in context, one must look back to the 1990s. At that time there was great concern raised over the fact that minorities had their home mortgage loan applications rejected several times as often as whites.

In 1994, belief that a substantial part of the rejection-rate differences resulted from the greater difficulty minorities had in meeting standard lending criteria prompted federal agencies monitoring fair-lending laws to issue an Interagency Policy Statement on Fair Lending. That policy statement announced that regardless of the absence of the intent to discriminate, lenders could be held liable for unnecessarily stringent criteria that disqualified minorities at higher rates than whites.

The policy statement's encouragement to relax lending criteria accorded with federal policy in the fair-employment context. Lowering cutoffs on hiring or promotional tests was universally regarded as reducing a test's disparate impact on minority job applicants because lowering cutoffs tends to reduce relative (i.e., percentage) differences in pass rates.

For example, suppose that at a particular cutoff, pass rates are 80 percent for whites and 63 percent for minorities. At this cutoff, the white pass rate is 1.27 times the minority pass rate.

If the cutoff is lowered to the point where the white pass rate is 95 percent, assuming normal (bell-shaped) test score distributions, the minority pass rate would be about 87 percent. With the lower cutoff, the white pass rate would only be 1.09 times the minority pass rate.

These numbers are shown in the three data columns on the left side of Figure 1.

But while lowering a cutoff tends to reduce relative differences in pass rates, it also tends to increase relative differences in failure rates.

As shown in the three columns on the right side of Figure 1, in the aforementioned situation, the minority failure rate was initially 1.85 times the white failure rate. With the lower cutoff, the minority failure rate would be 2.6 times the white failure rate.

The pattern by which relative differences in a favorable outcome and relative differences in the corresponding adverse outcome tend to change in opposite direction as the frequency of an outcome changes is close to universal. And it is evident in all sorts or data.

For example, income and credit score data show that lowering an income or credit score requirement will tend to reduce relative differences in meeting the requirement while increasing relative differences in failing to meet it.

Lending criteria operate just like test cutoffs. As with lowering test cutoffs, relaxing lending criteria tends to reduce relative differences in meeting the criteria. By complying with federal government encouragements to relax lending criteria, lenders tended to reduce relative differences between the approval rates of their white and minority mortgage loan applicants.

But relaxing criteria also tended to increase relative differences between white and minority mortgage rejection rates—the very thing that prompted concerns about lending disparities in the first place.

Lenders that responded to the encouragement to relax criteria actually increased their chances of being sued for discrimination.

Regulator misunderstandings

Regulators and others concerned about lending disparities, however, were and remain unaware that relaxing lending criteria tends to increase relative differences in mortgage rejection rates. They continue to measure lending disparities in terms of relative differences in rates of mortgage rejection and other adverse outcomes.

Thus, lenders that responded to the encouragement to relax criteria—hence, tending to reduce relative differences in approval rates while increasing relative differences in rejection rates—actually increased their chances of being sued for discrimination.

The same pattern exists when the adverse outcome is receipt of a subprime rather than a prime loan. And the more lenders follow the suggestions in the *Countrywide* and *Wells Fargo* complaints to reduce rates of assignment to subprime loan status, the larger will tend to be the relative differences that regulators monitor.

The particular anomaly whereby regulators encourage lenders to do things that increase the chance that the government will sue them for discrimination is partly a function of the belief that the Fair Housing Act covers practices that have a disparate impact on minorities, in conjunction with the failure of federal regulators to understand fundamental statistics.

The statutory issue has yet to be resolved by the Supreme Court. It may next be addressed in challenges to the Department

FIGURE 1

THE EFFECT OF LOWERING A TEST CUTOFF ON RELATIVE DIFFERENCES IN PASS AND FAILURE RATES

Cutoff	White Pass Rate	Minority Pass Rate	Ratio White Pass/ Minority Pass	White Fail Rate	Minority Fail Rate	Ratio Minority Fail/White Fail
High	80%	63%	1.27	20%	37%	1.85
Low	95%	87%	1.09	5%	13%	2.60

SOURCE: James P. Scanlan, attorney at law of Housing and Urban Development's (HUD's) February 2013 final rule titled "Implementation of the Fair Housing Act's Discriminatory Effects Standard."

In addition to purporting to resolve that the Fair Housing Act covers disparate impact, the rule specifies that a practice with a disparate impact can be upheld only if there exists no less-discriminatory alternative that equally serves the covered entity's legitimate business interest. HUD's rule does not state how to measure disparate impact or determine whether one practice has less discriminatory effect than another.

But the types of practices viewed as obvious, less-discriminatory alternatives to those having a disparate impact commonly involve relaxing some criterion, such as reducing the credit score required for loan applicants to secure particular terms.

And HUD—no more aware than other regulators that relaxing a requirement tends to increase relative differences in failing to satisfy it—will almost certainly continue to appraise the fairness of lender practices on the basis of the size of those relative differences.

Even if regulator misunderstandings were eliminated from the picture, however, there would remain a question of whether relaxing some requirement should be deemed to increase or decrease its disparate impact, given that doing so tends to increase one relative difference while reducing the other.

A useful question to put to HUD, either by congressional oversight committees or by litigants challenging the agency's discriminatory effects rule, is whether the agency would regard lowering a credit score requirement to increase or decrease the disparate impact of the requirement.

Identifying disparate treatment

Regardless of whether the Fair Housing Act covers disparate impact, questions remain about whether observed disparities in lending outcomes result from differences in characteristics of white and minority borrowers or biased decisions of loan officers.

Treating similarly situated white and minority loan applicants differently because of race or ethnicity is usually termed "disparate treatment" discrimination. Studies of disparate treatment in lending have commonly grouped applicants into three or four categories according to income or some other credit-related factor or combination of factors. Those conducting the studies maintain that such groupings adjust for the fact that minority loan applicants generally have weaker credit-related characteristics than white loan applicants.

Invariably, however, minorities are disproportionately represented in the lower categories, and groups that are disproportionately represented in the lower categories tend also to be disproportionately represented in the lower ranges of each category. Thus, even more refined categorizations than those commonly used will not adequately adjust for all relevant differences between white and minority borrowers.

Supporters of disparities studies, however, have sought to refute contentions that factors such as differences between minority and white incomes within categories explain racial/ethnic differences in lending outcome by pointing to the fact that relative differences in rates of mortgage rejection and other adverse outcomes are commonly greater in higher-income than lower-income categories.

But even if disparities could fairly be deemed larger among higher-income than lower-income applicants, such fact would merely mean that, whatever the factors causing observed differences in outcome rates within each income category, differences in such factors are greater for higher-income loan applicants than lower-income applicants.

Further, relative differences in adverse lending outcomes tend to be greater among higher-income than lower-income loan applicants simply because adverse outcomes are less common among higher-income applicants.

Relative differences in adverse lending outcomes tend to be greater among higher-income than lower-income loan applicants.

On the other hand, relative differences in the corresponding favorable outcomes tend to be smaller among higher-income than lower-income applicants. That is, looking back to the hypothetical data in Figure 1, the situation of lower-income applicants is akin to that in the first row (with the larger relative difference in pass rates but the smaller relative difference in failure rates), while the situation of higher-income applicants is akin to that in the second row (with the smaller relative difference in pass rates but the larger relative difference in failure rates).

Neither the comparative size of relative differences in the favorable outcome nor the comparative size of relative differences in the adverse outcome, however, provides a basis for believing that the forces causing the differences in outcome rates are any stronger within one income category than the other. Nor do such comparisons otherwise provide useful information as to whether disparate treatment caused the differences.

After an effort to adjust for differences in characteristics, one is left with attempting to divine whether the disparity that remains is so large that one has to conclude it is not simply a result of inadequacy of the adjustment effort. But few understand how to appraise the size of such a disparity.

In the case of situations involving favorable and adverse outcome rates like those shown in Figure 1, those who appraise disparities in terms of relative differences in favorable outcomes would say the situation in the first row reflects the larger disparity and thus the greater likelihood of discrimination. Those who rely on relative differences in adverse outcomes, however, would say the situation in the second row reflects the larger disparity.

But to the extent that we are able to draw reasonable conclusions about the comparative strength of the forces causing the rates to differ in the two situations—whatever those forces may be—we can only conclude that we have no basis to distinguish between the two.

The only sound way to appraise the size of differences in lending outcomes—or any other type of outcome—is to derive from a pair of rates the difference between the means of the underlying distributions of factors associated with likelihood of experiencing the outcome. Such approach is explained at length in my September 2013 University of Kansas School of Law faculty workshop paper, titled *The Mismeasure of Discrimination* (which can be easily found online).

The approach has a number of imperfections. Moreover, it will require some getting used to for those who would take for granted that a larger relative difference, whether in favorable or adverse outcomes, reflects greater likelihood of bias than a smaller relative difference. But it is at least a logical and coherent approach, and one that spares us from the false conclusions that we would reach based on standard measures of differences between outcome rates.

The partial-picture problem

Whatever problems studies of racial differences in mortgage approval/rejection rates may have had, they at least satisfied an essential criterion of a plausible statistical analysis in that they examined the entire universe of persons seeking a desired outcome.

Analyses of claims involving loan terms, including assignment to subprime status, are another matter. Such analyses examine only the part of the universe of people seeking mortgage loans who were offered a loan package that they were willing to accept. Applicants not offered loans at all and applicants not offered loans they were willing to accept are not considered.

Such analyses are thus fundamentally unsound. Moreover, they are unsound in circumstances where there is reason to believe that minority borrowers will, on average, be willing to accept terms that similarly situated white borrowers would not accept.

Whether or not there exists widespread discrimination against minority borrowers, the many studies purporting to find such discrimination, and the large settlements in cases like *Countrywide* and *Wells Fargo,* give minority borrowers substantial reason to believe that they face considerable obstacles in securing mortgage loans because of their race or ethnicity. That belief puts minority borrowers in weaker bargaining positions than similarly situated white borrowers who, unconcerned about discrimination issues, will be more willing to refuse offers from a particular lender that they deem unsatisfactory and seek alternatives elsewhere.

If loan officers, aware of the weaker bargaining position of minority borrowers, take harder lines in dealing with minority than white loan applicants, such conduct would be unlawful discrimination. But even when loan officers take exactly the same approach to dealing with white and minority applicants, a concern of minority applicants that widespread discrimination gives them limited options can be expected to translate into a pattern for minorities of less-advantageous loan terms. Such less-advantageous terms include both higher rates of assignment to subprime status and higher loan costs unrelated to such assignment for minorities than whites.

A fuller description of the problems with analyses of discrimination issues that examine only persons who accepted some sort of offer can be found in my article "Illusions of Job Segregation" in the Fall 1988 issue of *The Public Interest*.

Notwithstanding the statistical unsoundness of claims of so-called assignment discrimination—the essential equivalents of claims that minorities who receive loans disproportionately receive subprime loans such as were at issue in the *Countrywide* and *Wells Fargo* cases—in the 1990s plaintiffs pursing such claims secured a number of recoveries exceeding $100 million.

There are three ironies here. First, in both the employment and lending contexts, the largest recoveries on discrimination claims have involved cases where the alleged victims of the discrimination are people who voluntarily accepted some type of offer rather than those given no offer.

Second, the many studies of lending disparities that are commonly intended to promote the well being of minority loan applicants contribute to the weakened bargaining position of those applicants.

Third, the strongest reason to believe that some part of observed differences in loan terms would remain even if one were able to completely adjust for differences in credit-related characteristics of minority and white loan applicants may be the diminished bargaining position of minority loan applicants resulting from the perception of widespread discrimination.

These may rival the irony of a situation where lenders that respond to government encouragements to reduce the frequency of adverse lending outcomes actually increase the chance that the government will sue them for discrimination. **MB**

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