

# Executive Summary

## *The Problem*

Racial minority groups—particularly African Americans and Hispanics—are less likely to be approved for home mortgage loans than are members of majority populations. Whether the loans are conventional home mortgage loans or loans backed by various federal guarantees, minority loan rejection rates seem to be persistently higher than majority group rejection rates.

Lenders contend, correctly, that the raw racial gaps in rejection rates observed in Home Mortgage Disclosure Data Act (HMDA) figures do not measure discrimination. They point out that three factors are omitted from the HMDA loan application record files: credit risk, property values, and loan saleability on the federally insured secondary market. It is possible to address credit risk and property values using U.S. Census Bureau data or additional—though time consuming—methods adopted by the Boston Federal Reserve. However, the issue of saleability of loans has been largely unaddressed. Our research investigates this issue.

Loan originators claim that they are not discriminating against racial minority groups in home lending. Instead, these lenders claim they are bound by stringent underwriting requirements imposed by government-sponsored enterprises (GSEs) in the secondary mortgage market.

The role of GSEs and other actors in the secondary market is to take on credit risk and package mortgages, so that they might be sold as “relatively homogenous securities or financed with homogenous debt in the capital markets,” according to Robert Van Order, former Freddie Mac chief economist and former housing finance analysis director at the U.S. Department of Housing and Urban Development. GSEs establish guidelines and provide incentives for loan originators and services to provide “quality” mortgages. Because quality mortgages depend on factors including neighborhood and borrower characteristics, loan originators’ desire to avoid approving lesser quality mortgages might result in guidelines that rule out credit-worthy minority applicants.

***These are the motivating questions for this research:***

***Are discriminatory outcomes in home loan rejection rates the result of secondary market discrimination rather than unfair treatment by loan originators? Are secondary market guidelines discriminatory or applied in a discriminatory manner?***

It is well established that minority loans are underrepresented in GSE portfolios. A broad pattern of wide disparities in black, Hispanic, and American Indian loans held by GSEs compared to the number of minority loan applicants is evident. This disparity

helps motivate discussion of how GSE decisions may affect lender decisions to reject minority loan applicants.

An increasing number of lenders also seek to sell their loans on this secondary market, so omitting direct indicators of saleability in HMDA data takes on greater importance in assessing the degree of mortgage discrimination in local metropolitan areas and the need for further corrective action or enforcement efforts. It is vitally important to focus on discrimination in first-time home-buyer loans because these loans spell the difference between access and nonaccess for a whole generation of minority people.

### ***Our Methodology***

This study examined the role of GSEs in granting mortgages to home buyers in the 23 largest U.S. metropolitan statistical areas (MSAs). Three data sets were used: the Department of Housing and Urban Development Government-Sponsored Enterprise data set for 1993 through 1996, the 1990 U.S. Census Standard Tape File, and the HMDA data set for 1992 through 1996. These three data sets were combined to create two new data sets: a HUD-GSE/Census data set and a census/HMDA data set. This permitted a match between individual cases in the HUD-GSE or HMDA sets with the corresponding Census track data, allowing an analysis of individual experience while accounting for socio-economic factors that may impact mortgage decisions.

One qualification that enters into a lending decision is the expectation of whether the loan will satisfy secondary market requirements. To determine whether GSE behavior “explains” lender discrimination, we computed a measure of discrimination with and without taking into account GSE effects. We did this by estimating loan rejection equations for each MSA for each race across the four years. The method we use to measure racial discrimination in mortgage lending is called the residual difference approach. In a nutshell, this approach decomposes racial gaps in loan rejection rates between the components that can be explained and cannot be explained by racial differences in characteristics. The unexplained gap is interpreted as discrimination. Alternatively, the residual difference method permits estimating minority applicants’ loan rejection rates as if these applicants had been treated like equally qualified whites.

*For a detailed explanation of steps in producing a proxy for the risk that a loan will not be sold to a GSE, please see page 8 of the final report.*

### ***Our Results***

The results of estimating a residual difference with and without controlling for the probability that a loan is not sold to a GSE differ somewhat by race.

- For blacks: Using a loan rejection equation that controls for bad credit but does not control for likelihood of sale to Fannie Mae or Freddie Mac, we find that observed rejection rates for blacks exceed “equal treatment” rates across all 23

MSAs. That is, without taking into account chances that a loan will not be sold to Fannie Mae or Freddie Mac, our model estimates that for most MSAs only one-quarter to one-half of the racial disparity in loan rejection rates can be explained by lender, borrower, loan, and neighborhood characteristics. When we account for GSE effects, discrimination diminishes in 20 of the 23 MSAs. Controlling for GSE effects results in lower measured discrimination in the vast majority of MSAs.

- For Hispanics: In nearly half of all MSAs the measured discrimination between Hispanics and whites does not diminish when account is taken of the risk that loans will not be sold to a GSE. In other words, among Hispanics, the GSE effects are much smaller than they are among blacks.
- For Asians: Home loan rejection rates for Asians, while generally low, would be lower still under the equal treatment as for whites scenario.
- For American Indians: Controlling for the probability that a loan will not be sold to a GSE reduces the size of the unexplained residual gap in rejection rates in all but three MSAs. In the other 20 MSAs, failing to control for GSE effects results in an upward bias in estimating discrimination.
- While it is hard to draw identical conclusions with respect to other racial minority groups, one finding emerges consistently about discrimination against blacks. No matter how one computes the discriminatory residual and no matter whether GSE decisions are taken into account, a nontrivial “unexplained” difference in loan rejection rates between blacks and whites remains. The fundamental policy conclusion is that extraordinary model sophistication and estimation does not reverse the finding that in HMDA data a wide unexplained disparity in loan rejection rates between black and white applicants for home mortgage loans exists.

### ***Our Conclusion***

***We found*** the risk that a loan cannot be sold on the secondary market systematically increases the probability that a loan will be rejected. Loans taken out by black and Hispanic people often are less likely to sell on the secondary market than loans by whites.

***However,*** the marginal impact of this risk is so small that it cannot explain the substantial racial difference in loan rejection rates. Also, when we evaluate the impact of sale to a GSE by comparing discriminatory residuals with and without controlling for GSE decisions, the results are not consistent across MSAs and at times are contradictory.

***Therefore, we conclude*** that the results do not provide consistent and compelling evidence that GSE behavior lies at the root of unequal loan rejection rates at

the lender level. It is not possible to draw a general conclusion that holds across all MSAs for all minority groups. A broad generalization that GSE discrimination causes lender discrimination is not warranted. The broad pattern of lender discrimination, particularly against blacks, Hispanics and American Indians, cannot be explained by GSE discrimination.

The resulting lender disparity, therefore, must be attributed to lender behavior and not to statistical discrimination that would cause lenders to deny loans to people from racial minorities because they perceive they will have difficulty selling those loans to GSEs.