Abstract

This critique argues that analysis of loan performance data cannot provide a clear indicator of prejudice-motivated or profit-motivated mortgage market discrimination. It evaluates the Berkovec, Canner, Gabriel, and Hannan model by considering various possible assumptions that can be made by the lender and by the researcher regarding the dimensions of a loan applicant’s creditworthiness.

The issue of discrimination directed toward minority applicants for mortgages has received a marked increase in public attention during the 1990s. A variety of evidence, including disparities observed in Home Mortgage Disclosure Act (HMDA) data, stories of blatant discrimination, a smattering of court cases, pilot studies using paired testers, and multivariate statistical analyses of lenders’ loan application files, has combined to substantiate the view that discrimination in mortgage lending exists. (See Galster, 1992; Yinger, 1993; and Cloud and Galster, 1993.)

More recently, this view has been challenged by an entirely different analytical perspective. First articulated by Peterson (1981), and later expounded by Becker (1993) and Brimelow and Spencer (1993), this position argues that discrimination in the mortgage underwriting process can be deduced by examining the racial and ethnic differences in the performance of loans granted. In its simplest form, the argument states that underwriters who are motivated by an irrational prejudice against minority applicants will accept their applications only if they exceed the typical minimal standards of loan approval applied to white applicants. Thus their prejudice leads them to reject qualified prospective minority borrowers. Assuming that qualified minority applicants who are rejected cannot secure mortgages elsewhere, the result of such prejudice-based discrimination should be the creation of a pool of minority borrowers who are more qualified than they would be in the absence of such discrimination. Logically, then, minorities should evince better loan performance (for example, lower default rates) than whites if discrimination is present. Observations to the contrary have led the aforementioned analysts to conclude that there is no discrimination in mortgage lending.
Previous critiques of this line of reasoning have already discredited it (Yinger, 1993; Galster, 1993; and Tootell, 1993). To recapitulate only the central criticism: Although the *marginal* minority borrower will be better qualified (and thus have a better performing loan) than the marginal white borrower in the presence of prejudice-based discrimination, the relationship between the *average* minority and white borrowers cannot be accurately ascertained without resorting to arbitrary assumptions about the cross-race distributions of creditworthiness among borrowers.

In a 1995 paper, Berkovec, Canner, Gabriel, and Hannan (BCGH) attempt to provide a more sophisticated defense of the default approach for testing lender discrimination. Their contribution is to model the creditworthiness (C) of an applicant as the sum of two sets of factors, the first observable both to the lender and to the research analyst and the second observable (or measurable) only to the lender. BCGH proceed to discuss prejudiced lenders’ behavior along the lines articulated above, except that they further classify the underwriting decision into those applicants qualified for conventional mortgages, those qualified only for FHA mortgages, and those unqualified for any mortgage. Higher standards for C are established for minorities at both conventional/FHA and FHA/no-loan thresholds by prejudiced lenders, leading to a somewhat better qualified pool of minority holders of both conventional and FHA mortgages.

As illustrated with hypothetical data in table 1, white applicants require a minimum C of 60 to obtain a conventional loan and 20 to obtain an FHA loan. Prejudice-based discrimination might lead to higher C thresholds for minorities, such as 65 and 25, respectively. Thus the minority applicant with C=61 is rejected for a conventional loan and relegated to the FHA borrower pool. Similarly, the minority applicant with C=22 is rejected for all loans. Both acts raise the average C among minority FHA borrowers.

These data are insufficient to produce the result that the average C value for minority FHA borrowers is higher (that is, default rates are lower, on average) than the average C for whites. As the data in table 1 make plain, the average C value in the minority FHA pool is improved as a result of discrimination, but not necessarily to the point that it exceeds the average C for whites. To their credit BCGH note that such a comparison of average loan performance across races creates an ambiguous indicator of discrimination.

In its place, they offer a subtle new argument that attempts to compare the treatment of the *marginal* applicants. Recall that they assume that some of the elements comprising C are not measured (or statistically controlled) by the researcher who is analyzing the lenders’ loan files. Discrimination should systematically result in these unobserved factors favoring minorities, due to the higher loan approval standards to which minorities are held. Thus, BCGH argue, if one statistically controls for observable characteristics of the applicant, a finding that minority status—which serves as a proxy for the unobserved characteristics—is associated with better loan performance (for example, a lower rate of default) would constitute evidence of discrimination. Inasmuch as BCGH attain the opposite finding in their empirical work, they conclude that prejudice-based discrimination is absent.

Whether loan performance provides a valid indicator of lender discrimination depends on the way one specifies the factors that constitute the index of creditworthiness (C) that lenders observe. C is assumed by BCGH to be directly related to loan performance (or profitability) and inversely related to defaults. As argued below, regardless of the way the components of C are specified the BCGH procedure does not yield a valid estimate of discrimination, although the precise reasoning that illustrates this conclusion varies in each of the four cases considered.
## Table 1

Hypothetical Illustration of Berkovec, Canner, Gabriel, and Hannan Framework

<table>
<thead>
<tr>
<th>Creditworthiness Scores of Applicants</th>
<th>Minority</th>
<th>Majority</th>
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<tbody>
<tr>
<td></td>
<td>10</td>
<td>16</td>
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<tr>
<td></td>
<td>16</td>
<td>18</td>
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<tr>
<td>20 = Majority threshold</td>
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<tr>
<td>for FHA loan</td>
<td>22</td>
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<tr>
<td>25 = Minority threshold</td>
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<tr>
<td>for FHA loan</td>
<td>32</td>
<td>32</td>
</tr>
<tr>
<td></td>
<td>42</td>
<td>50</td>
</tr>
<tr>
<td>60 = Majority threshold</td>
<td></td>
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<tr>
<td>for conventional loan</td>
<td>61</td>
<td></td>
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<tr>
<td>65 = Minority threshold</td>
<td></td>
<td></td>
</tr>
<tr>
<td>for conventional loan</td>
<td>71</td>
<td>74</td>
</tr>
<tr>
<td></td>
<td>81</td>
<td>84</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Average Creditworthiness Scores of Applicants</th>
<th>Minority</th>
<th>Majority</th>
</tr>
</thead>
<tbody>
<tr>
<td>No discrimination</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Rejected pool</td>
<td>14</td>
<td>17</td>
</tr>
<tr>
<td>FHA pool</td>
<td>32</td>
<td>47</td>
</tr>
<tr>
<td>Conventional pool</td>
<td>71</td>
<td>84</td>
</tr>
<tr>
<td>Discrimination</td>
<td></td>
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<tr>
<td>Rejected pool</td>
<td>16</td>
<td>17</td>
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<tr>
<td>FHA pool</td>
<td>45</td>
<td>47</td>
</tr>
<tr>
<td>Conventional pool</td>
<td>76</td>
<td>84</td>
</tr>
</tbody>
</table>

Source: Author
Following the BCGH hypothesis, one assumes that research analysts (not lenders) can observe a set of characteristics (X) of the loan and the applicant that are related to C through a vector of coefficients (β) plus an error term indicating characteristics observable only to the lender (ε), such that C = Xβ + ε.

**Case 1:** All components of C are observable (ε = 0), and race of applicant (R) is not a component of X, and is uncorrelated with all components of X.

In this case the research analyst has completely specified a model that reflects the thinking of the lender. Although the distribution of X (and thus C) may well differ according to R, a loan performance regression that controls for X cannot help but yield a statistically insignificant coefficient for R. In other words if everything that affects C is controlled and R does not, by assumption, affect C, there can only be a zero coefficient for R in the BCGH regressions, regardless of whether or not the lender was discriminating. Comparisons of the hypothetical data in table 1 that have the same C value could not reveal any independent racial differential. If the lender were discriminating in the way hypothesized by BCGH, one would likely observe lower C values for some of the whites accepted for loans than one would observe for any minorities accepted for similar loans. Recall, however, that this is not the BCGH test.

**Case 2:** Not all components of C are observable to the researcher, and R is not a component of X and is not correlated with X or ε.

In this case there are omitted variables in the loan performance equation (such as components of ε), but there is no bias in the R coefficient because R and ε are assumed to be independent. In a nondiscriminatory world, there would be no reason for the R coefficient to be statistically significant. But if there were prejudice-based discrimination by lenders, forcing approved minority applicants to possess higher values of unobserved characteristics for any level of observable ones, R would tend to be significant. Yet such a theory would violate the assumption of this case. That is, we cannot begin by making the assumptions of case 2, because a particular finding of the test would violate them.

**Case 3:** Not all components of C are observable, and R is not a component of X but is correlated with ε.

In this case the BCGH regressions will suffer from omitted-variables bias (that is, the components of ε), the degree of which will be proportional to the correlation between R and ε. In such a case, the coefficient of R will be biased and any interpretation of it misleading. Unfortunately, it is precisely such a correlation between R and ε that is the essence of the BCGH test, inasmuch as they assume that the only source of such a correlation is lender discrimination that reputedly forces minorities to have superior unobserved characteristics (ε). As Galster (1993) and Yinger (1993) have argued, however, there are persuasive reasons for a high correlation between R and ε, even in the absence of prejudice-based lending discrimination. Thus the BCGH test cannot be conclusive if one admits these alternative sources. In other words BCGH assume that discrimination makes the unobservables of minorities superior to those of whites, but if other factors skew the unobservables in the opposite direction, the net result will be an empirical situation in which the reputed discrimination effect will be obscured.2

Deeper analysis of the preceding cases reveals a more fundamental conundrum for BCGH. The key feature of the BCGH test is that it necessitates the existence of applicant variables observed by the lender that are not observed (or controlled) by the research analyst. These would appear as higher hurdles erected for minority applicants by the prejudiced, discriminatory lender, producing an observed correlation between R and ε.
Thus the BCGH method depends on omitted variables to bias the coefficient of R in a
discriminatory setting. Unfortunately, if too many variables are omitted, the model loses
probity for other reasons.

To ascertain why this key methodological feature is flawed, consider two extremes of
unobserved variables (that is, variables omitted from the regression). Case 1, which has
none, showed that the coefficient of R was statistically insignificant regardless of the
absence or presence of discrimination. The other extreme is embodied in a simple com-
parison of the average loan performance of white borrowers and minority borrowers,
equivalent to estimating a regression with R as the only independent variable. For reasons
explained above in the discussion of table 1, such a test is similarly incapable of providing
an indicator of discrimination, as demonstrated by Galster (1993), Yinger (1993), and
Tootell (1993).

Now let us return to the completely specified model of case 1 and add one unobserved
variable (Z). According to BCGH logic, the R coefficient in a loan performance regres-
sion should provide an indicator of discrimination if it proves correlated with Z and thus
proves statistically significant through omitted-variables bias (assuming Z is strongly
correlated with C). Whether this indicator will manifest itself is doubtful, depending not
only on the correlation between R and Z but also on the correlation between R and X
(potential multicollinearity). As one continues this process by positing an increased num-
ber of unobserved Z variables that are more strongly related to C and fewer observed
(controlled) X variables, it becomes more plausible that R will be more highly correlated
with Z but less plausible that such a correlation can be attributed to discrimination. The
most extreme case, in which all variables are unobserved (and uncontrolled), makes this
point clear. Even with discrimination, minorities accepted for loans could, as a group,
have lower C values than whites (see table 1). Thus the BCGH method is deeply flawed,
because it cannot extricate itself from a dilemma that renders the test ambiguous. If there
are too few3 unobserved (uncontrolled) variables, the omitted-variables bias is too weak to
be due to discrimination. If there are too many4 unobserved variables, the signal is strong
but meaningless, because it cannot credibly be attributed to discrimination.

Case 4: All components of C are observable, and R is a component of X.

In this case it is assumed that race itself is a strong and unique predictor of creditworthi-
ness, due perhaps to less stable incomes or the greater likelihood of declining property
values associated with minority neighborhoods. Given such assumptions, many lenders
will assess two otherwise identically qualified applicants differently on the basis of R,
because they have different C values. When that occurs, discrimination due to prejudice
becomes indistinguishable from discrimination motivated by profit; neither is clearly
observable by the BCGH method.

Should an assessment such as that described in case 4 produce differential treatment, the
BCGH loan performance regression that controls for X will observe a statistically signifi-
cant coefficient for R. One notes, however, that such a result is not produced because
lenders are creating higher C standards for minorities; rather, for the same X variable,
minorities have a lower C factor. If a lender does not discriminate, the statistical result
will nevertheless be the same. More less-qualified minorities may be granted loans than
under a discriminatory regime because, although their X values are identical to those of
whites, they have lower C values. Thus the BCGH regression would show an identical
coefficient for R, regardless of whether or not the lender is discriminating. Only the pool
of marginally accepted borrowers would distinguish the two behaviors.
To their credit BCGH admit that their method is not designed to test for discrimination motivated by profit maximization (statistical discrimination), such as that posited in case 4. The point to bear in mind is that profit-motivated discrimination obscures the search for discrimination motivated by prejudice.

BCGH have conducted a careful study of racial-ethnic differentials in the performance of FHA mortgages. Unfortunately, they exaggerate when they assert that their findings suggest an absence of lending discrimination based on prejudice. Examination of loan performance, even in the sophisticated BCGH manner, cannot yield unambiguous indications of the absence or presence of discrimination, whether it be motivated by prejudice or by profit.

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Notes

1. In BCGH, R represents the conditional probability of default.

2. Note that this situation would occur if there were large numbers of variables correlated with C that were unobserved by both researchers and mortgage lenders.

3. Few means the number and degree of correlation with C.

4. Many means the number and degree of correlation with C.

References


