Assuming a Can Opener: Economic Theory's Failure To Explain Discrimination in FHA Lending Markets

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Abstract

This article addresses the fundamental problems created by engaging in research in a veritable vacuum that ignores experience and literature. It does this by assessing the plausibility of the basic assumptions of the BCGH study against other models of discriminatory processes, the history of FHA practices in the single-family housing market, and an empirical case study of FHA lending patterns and defaults in Chicago. This analysis shows that the assumptions of BCGH are inappropriate, arguing that discrimination is not necessarily economically motivated and that the policies governing the FHA lending market neither correspond with free-market principles nor support normal market mechanisms. The conclusion is that the BCGH analysis of discrimination in FHA lending was ill-conceived from the outset. The BCGH study does not expand the contemporary knowledge of lending discrimination and is instead an unfortunate distraction from the pressing issues related to this topic.

> Three men were stranded on a desert island. One was a minister, another a geologist, and a third an economist. All they had to eat was a can of beans, and they had no way to open the can. The minister exclaimed, "I have an idea. We'll pray that the can may open." "No," said the geologist, "we can use two rocks to break it open." The economist smiled and said, "I have a better idea. We'll assume a can opener." (Anonymous)

Contemporary experience with Federal Housing Administration (FHA) single-family mortgage programs renders it inconceivable that research using FHA data could assess discrimination against minority homebuyers or that lenders involved in the FHA market today would engage in discrimination by holding minorities to a higher standard than whites. Intriguing theoretical and technical issues notwithstanding, the critical issues related to FHA, race, and mortgage markets call for an understanding of the actual workings of FHA lending in metropolitan housing markets rather than a debate over abstract theories. This debate on the theoretical utility and empirical validity of using information on loan defaults to determine the presence or absence of discrimination illustrates the wide chasm between the assumptions implicit in abstract theoretical and mathematical arguments and modeling and the actual behavior of real estate agents, lenders, and borrowers. There is no evidence that any of the assumptions, measures, or models generated during the debate are grounded in an understanding of the ways FHA and conventional loan programs operate, how they are marketed, how and where lenders and other participants make money or take risks, or how discrimination takes place.

As a policy matter, what is most lacking is a context of experience within which to place both the Berkovec, Canner, Gabriel, and Hannan (BCGH) study and the responses. Except for a few references to the Boston Federal Reserve Bank study (Munnell et. al., 1992), virtually none of the assumptions, arguments, complex logical processes, or models utilize historical experience or the large body of literature in the field. The overriding focus of concern about the article is the fundamental problem created by engaging in research in a veritable vacuum. The result not only signals a warning about the use of the BCGH study in public policy, but also challenges the present narrow scope of econometric research in housing discrimination.

Although seemingly logical and reasonable in the abstract, the assumptions used in the research fail to take into account the dynamics of discrimination and the working of FHA lending markets, making it meaningless to use the BCGH empirical work to draw conclusions about discrimination in mortgage lending. Since the FHA lending market is not one that conforms to economic theory, this theory does not explain how FHA works in practice, particularly for minorities who receive FHA loans. In this article we use the history of FHA lending practices and a case study of the Chicago FHA market to assess the validity of the BCGH assumptions.

The Dynamics of Discrimination

At the heart of the problem with the BCGH study is the assumption that discrimination is a conscious, rational, and logically quantifiable process based on weighing economic costs and benefits. In the lending area, studies such as BCGH constantly disregard the entire range of social science experience about the nature of discrimination.

The BCGH study portrays discrimination as economically rational behavior that is designed to minimize risk (statistical discrimination) and/or that results in the application of clear and measurably different standards for minorities (focused discrimination). It is the latter form of discrimination that the BCGH study theorizes will result in holding minorities to a higher underwriting standard. Although BCGH and their critics recognize that discrimination—rational or otherwise—is illegal, they maintain that discriminatory outcomes will occur in a particular direction. Therefore, minorities who gain access to economic resources such as employment or loans will be better qualified than whites who obtain these resources.

In practice, discrimination has never been shown to have a solely economic motive. Not all human activity, even that which occurs within economic institutions, is economically based. This is particularly true of discrimination, which is rooted not in economics but in culture: it is social behavior (Feagin and Feagin, 1986). Moreover, discrimination is not explained by the tastes and preferences of individuals but is attributed instead to social structure (Farley, 1995). Of course, there are many dimensions to discrimination. It may be the outcome of competition for scarce resources (Blauner, 1972), or it may provide economic benefit to employers by pitting two or more races against one another

(Bonacich, 1976; Farley, 1995). Therefore, racial discrimination does have economic causes and consequences.

The question here is not whether discrimination has an economic dimension, but whether its predominant characterization is one of economic rationality. The answer to this is *no* (Reich, 1981). Discrimination is behavior stemming from a racist culture that pervades every aspect of life, even the cognitive development of very young children (Aboud, 1988). It is learned behavior that works to deny certain people housing and employment opportunities (Kirschenman and Neckerman, 1991). Most importantly, from the perspective of lending practices, racism is also embedded in institutions.

Institutional discrimination is a set of routine practices that occurs within institutions such as corporations, schools, and government, resulting in a differential and negative impact on members of minority groups (Feagin and Feagin, 1986). Institutional discrimination is not a single practice by an individual who is motivated to discriminate; rather, it is a set of combined activities that, when added together, result in discrimination. A key point is that institutional discrimination may occur whether individuals intend to discriminate or not. It is very difficult to locate the source of institutional discrimination, because it is embedded in the routine business practices of the organization. This type of discrimination is part of an organizational culture and is transmitted over time.

If discriminatory behavior does not have a clear-cut motivation and is not necessarily economically rational, there is no reason why discriminatory outcomes should go in a particular direction. In addition, failure to market to minority groups by treating them differently in the loan preapplication phase, applying different underwriting criteria, and providing different loan servicing are all mechanisms through which mortgage lending discrimination may occur, with varying directional outcomes. As will be seen in the case of FHA lending, the *predicted* outcomes from discrimination in such a lending market may be precisely the opposite of that which is suggested by BCGH.

The History of FHA in the Housing Markets

To understand the historical and practical contexts for the operations and behavior of FHA mortgage markets, one must begin with the history of FHA's role in neighborhood racial change and minority mortgage markets. The early FHA program of the 1930s is now widely recognized as having developed the policies that defined redlining and discrimination in the mortgage markets (Feins, 1976; National Commission on Neighborhoods, 1979; Bradford, 1979). It focused on the standardization of building codes and appraisal practices, yet, as Bradford (1979) points out, these practices became agents of overt discrimination.

The Rapid Resegregation Syndrome

After the urban riots of the 1960s, discrimination in housing became a major concern of the Federal Government, resulting in passage of the Fair Housing Act of 1968. In response, FHA literally reversed its redlining practices and inundated minority and transitional communities with FHA lending, thereby creating access for minorities in the housing markets. But FHA embodied three fatal flaws that eventually rendered this a policy of massive destruction of minority and racially diverse communities, manifested in a process that exploits racial divisions to create massive and rapid resegregation.

First, the Government policy toward minority communities excluded conventional depository institutions. Depository institutions seldom made FHA/VA loans. They were (and still are) the specialty of mortgage bankers and brokers, who made (and still make) about 75 percent of all FHA and VA loans. As mortgage companies do not hold the loans they make, their markets are limited to loans that can be sold to other investors. Mortgage companies have specialized in FHA and VA loans because the insurance and guarantees made them easily salable in the secondary market. Thus Government policy relegated minority communities to a Government housing finance market, while white communities were served by all sectors of the market.

Second, mortgage lenders specializing in FHA loans have had no financial incentive to incorporate risk avoidance behavior into their underwriting. The investors who bought the FHA loans from the mortgage companies were protected by 100 percent insurance on the loan amount.[1]

In addition, mortgage companies gain most of their profit from the servicing fees paid to them by the investors to manage the collection of monthly payments, escrow payments, and delinquent accounts. The fee for servicing FHA loans is almost twice as high as the fee for servicing conventional loans.[2] Thus a mortgage company might lose money on the servicing of individual foreclosures, but if it had a large volume of loans to service, the losses on even a high rate of foreclosure could be more than offset by the overall servicing income. The incentive was to generate a huge volume of loans from which to secure servicing fees.

Prior to the 1960s, mortgage companies concentrated FHA lending in new suburban development areas, where there were concentrated markets of high-volume home sales. FHA policies of redlining prohibited much lending to minorities or in minority communities. But after changes in FHA policy in the 1960s, lenders found that they could join local real estate agents in exploiting racial fears and fomenting racial change in order to create a huge volume of sales in certain areas. *Their motivation was to make as many loans as possible to minorities, not to exclude them.* In fact, the financial incentives were so great that scores of real estate agents, lenders, and even FHA officials engaged in fraud in order to make sales to unqualified and unsuspecting minority homebuyers (Boyer, 1973; Downie, 1975; Illinois Legislative Investigating Commission, 1975; Committee on Government Operations, U.S. House of Representatives, 1975).

Third, changes in FHA policy that led to the concentration of FHA lending in communities with lower incomes and older housing ensured higher foreclosure rates among new and unwary homebuyers. This flood of FHA loans created a new set of personal and community market conditions that were not suited to the established FHA program. Originally, FHA focused on supporting the financing needs of suburban tract homebuilders. New homes were not likely to need major repairs. Likewise, homes in areas with increasing property values provided solid equity that could be used as collateral for future debts. Personal incomes were likely to increase, effectively reducing the level of mortgage debt and providing additional protection against defaults. If financial problems did force households into default, downpayment requirements assured that homeowners could usually sell the home at a price that would help them avoid foreclosure.

But in the minority markets, the insured housing was more likely to be old and to require major repairs soon after purchase. Discrimination suppressed normal growth in housing values, even producing declining values in some areas and reducing opportunities to draw on increased equity to meet financial needs. Labor market discrimination limited minorities' prospects for obtaining the same level of increased earnings as might be anticipated by white borrowers. Because FHA loans incorporated many closing costs as well as the financing of FHA insurance, the loans were often larger than the value of the home. While the local market housing conditions, the real condition of the dwellings, and the future income prospects of the buyers were generally known to the real estate agents and lenders, these factors are not reflected in the loan file data. Therefore, researchers relying on loan file data will fail to include information that is critically important to the prospects of future defaults and foreclosures. Due to these circumstances, many minority homebuyers were left with few financial resources to help them avoid foreclosure. The problems were compounded when the mortgage companies filed for foreclosure as soon as possible to avoid servicing costs and to reduce exposure to lost interest payments. Between 1959 and 1963 alone, FHA foreclosure rates increased from levels below those of the conventional market to rates more than four times as high (Herzog and Early, 1970). Since then, they have stayed at levels more than double those of the conventional market.

The combination of lower downpayment requirements, less restrictive underwriting, and abuse of the FHA programs resulted in a massive exploitation of racial change, with the Government providing subsidies and low-income communities suffering devastation. Real estate agents teamed up with mortgage companies to reap huge profits from the accelerating racial change, taking advantage of the new FHA/VA policies.

The process of rapid resegregation through the dual housing finance market has been documented in many studies, beginning in the early 1970s (Home Ownership Development Program, 1973; Northwest Community Housing Association, 1973; Bradford and Rubinowitz, 1975; Bradford, Rubinowitz, and McGowan, 1975; Feins, 1976; Bradford and Marino, 1977; Census Area Stabilization Alliance, 1978; National Commission on Neighborhoods, 1979; Bradford, 1984).

By the early 1980s, research had clearly outlined the elements of a rapid resegregation movement in racially changing communities (Bradford, 1984). This process was characterized by the withdrawing of depository institutions and replacement by a mortgage-lending market dominated by mortgage companies (the dual housing finance market), an extreme concentration of FHA/VA lending, a sudden and rapid increase in the rate of home sales, and the development of close relationships between a small number of real estate agents and the local mortgage companies.

The Effects of the Exploitation of Minority Markets

With no access to the stable forces of conventional finance, racially changing communities turned into a sea of abandonment and blight. At one point, the U.S. Department of Housing and Urban Development (HUD) had more than 100,000 homes in its inventory. Boyer's book, *Cities Destroyed for Cash* (1973), traces the role of FHA in neighborhood change and racial exploitation, from the FHA inventory of almost 30,000 homes in Detroit to cities all across the country. When Boyer combined the minority communities created by FHA into a single mythical city (Romney City), he concluded that it would have 350,000 houses (about one-half of them abandoned) and a population of 1,400,000, making it the sixth-largest city in the United States. He described the FHA scandals as a "$70-billion slum."

Present Patterns: The Chicago Example

To demonstrate the differential treatment of minorities and whites in the present FHA lending market, we have examined FHA lending and default patterns in Chicago, one of the most-researched cities in regard to FHA lending activities. Throughout the 1980s and into the 1990s, research has continued to document the link between FHA/VA lending, neighborhood racial composition, and the rate and direction of racial change (Shlay, 1987a, 1987b; Peterman and Sanshi, 1991; Jackson and Berry, 1993; Dunham, 1991).

An ongoing analysis of FHA/VA lending and FHA default and foreclosure data by the Chicago Fair Housing Alliance compares the location of defaulted FHA loans with FHA loan applications (Bradford, 1995). The geographical focus of the research is on Cook and DuPage Counties, the two most populous counties in the Chicago metropolitan area. The data are 1992 Home Mortgage Disclosure Act (HMDA) FHA/VA home purchase applications and 1990–1993 FHA default data reported as required by the 1990 Affordable Housing Act.

Table 1 presents FHA default and foreclosure rates in minority and racially changing census tracts compared with stable white census tracts for Cook and DuPage Counties combined. Although people living in minority or racially changing communities constituted 44 percent of the population of these counties, their communities received 57 percent of all FHA loans made in the area. However, default and foreclosure rates were even higher in these communities: Minority and racially changing areas made up 81 percent of all FHA defaults and 83 percent of all FHA foreclosures.

Table 1

Cook and DuPage Counties: FHA Impact

	FHA Loans[a] in Minority Tracts	FHA Loans[b] in White Tracts	Total All Tracts	Percentage in Minority Tracts	Percentage in White Tracts
Population	2,570,219	3,316,481	5,886,700	43.66	56.34
FHA loans	30,834	23,025	53,859	57.25	42.75
Defaults	1,864	431	2,295	81.22	18.78
Foreclosures	480	98	578	83.04	16.96

Sources: 1990 U.S. census data and 1990–1993 FHA loan data.

[a] Minority: > 25 percent African-American and/or Hispanic population, or population < 25 percent but > 35 percent of HMDA applications from African Americans and/or Hispanics

[b] White: 75 percent or more white

While these findings may be consistent with the BCGH study, the key difference is in the interpretation of the spatial distribution of extremely early defaults. These early defaults can be used as a proxy for poor or improper underwriting practices, representing exactly the opposite of the more restrictive underwriting hypothesized by the BCGH study. A loan must be 3 months behind in order to be in default. Because sound underwriting is geared to ensure that borrowers have access to at least 2 months of loan payments at the time of closing, a loan that is in default within the first year is generally seen as a loan that should not have been made. If new loans are in default almost immediately, it should be due to unforeseen circumstances unknown to the lender at the time of application.

Logically, such unforeseen circumstances would be random events, and the location of the defaults would also be randomly distributed. However, all of the census tracts with high levels of extremely early default (more than 6 percent of all FHA loans made in 1993) are in areas of minority concentration or racial change. This finding suggests that poor underwriting, rather than very conservative underwriting, is specifically targeted to minority and racially changing communities.

Reviewing the BCGH Assumptions

The history of FHA lending practices, combined with the empirical analysis of recent FHA lending patterns in Chicago, suggests that the major assumptions of the BCGH study are not valid. Each assumption is reviewed below.

Discrimination Is Rationally Motivated

The assumption: Discrimination in lending is economically motivated activity that will produce outcomes in a particular direction. This assumption about what drives individual behavior ignores research showing that discriminatory behavior stems from a racist culture, is embedded in the routine practices of institutions, and may be unintentional or lacking a clear motive. Race is a fundamental way in which people are socially categorized in U.S. society. Discrimination in itself need not cause minorities to be scrutinized more than whites; rather, it causes them to be treated differently and negatively.

Making Unsound FHA Loans Is Risky for the Lender

The assumption: Awarding a loan to less-qualified candidates (as defined by formal underwriting standards) increases the risk of financial losses for the lender. But some aspects of FHA market practices raise questions about the reasonableness of this assumption. When loans are 100-percent insured, losses to the lender or the investor on FHA loans may be less than losses on conventional loans, even if there is a high level of FHA foreclosures. Moreover, from the perspective of a lender who receives servicing fees—particularly large ones—servicing income lost to foreclosure is offset by increased fees spread out over the entire pool of FHA loans.

FHA Lending Discrimination Screens for Better Qualified Minorities

The assumption: FHA lending discrimination results in decisions to deny credit to qualified minorities rather than to grant credit to unqualified candidates. The history of FHA lending suggests that discrimination occurs both by the denial of credit and by the extension of credit to highly marginal and unqualified borrowers. Indeed, the patterns suggest that major mortgage companies are concentrated in these high-risk markets precisely because of the profits to be found in such lending. The racial issues in FHA lending have centered around too much lending rather than too little. Any study of FHA lending and discrimination must separate discrimination in the denial of loans from discrimination manifested by exploitation of unqualified borrowers. The data on extremely early defaults suggest that this activity still exists and has a disparate effect on minorities.

Market Mechanisms Distribute FHA Loans

The assumption: From the perspective of the borrower, the mortgage market represents a continuum of loan decision options based on stages of review that assign applicants to conventional loans, FHA loans, or rejection based on their creditworthiness. Yet the history of FHA lending demonstrates that FHA lenders are linked to specific real estate agents. For new developments, lenders make advance commitments to specific real estate developers, and properties are appraised before an offer is received (making FHA approval time fast, not slow). This process is rarely used in the sale of existing homes, except in racially changing and minority markets. The added use of advance FHA commitments, which require only the submission of the borrower's economic data, makes it possible to generate a large volume of FHA sales in concentrated areas, a process that increases profits for the lender. In this market, there are built-in incentives to make certain types of loans to certain types of borrowers, referred by certain real estate agents or developers.

Creditworthiness Predicts FHA Defaults

The assumption: The formal standards of creditworthiness for loan products are sound predictors of the factors that lead to default. Currently, the predictors of default and foreclosure—which is not the final outcome of most defaults—are poorly understood.

Therefore, any suggestion that formal underwriting standards soundly predict defaults is unjustified. In addition, the Chicago analysis and the past history of FHA loan patterns demonstrate that there are neighborhood conditions and borrower situations that limit the options for a homebuyer who is in default and lives in a minority or racially changing area.

There Is One Big U.S. FHA Market

The assumption: The mortgage market is a single entity, properly studied without regard to the variations in its structure and in the use of FHA lending across varying metropolitan or rural areas. The BCGH study treats the numerous regional housing markets as a single entity. However, the history of the resegregation movement suggests that the FHA lending process requires certain conditions that do not exist in all areas. First, it requires a large minority population in order to exploit the possibilities of racial change and to generate a huge volume of FHA loans. Even in areas with a significant minority population, the market must be large enough to attract sizable mortgage companies that are able to make exploitation financially profitable. Finally, values in the housing market must fall within loan limits for FHA lending. For example, the noted Boston Fed study sheds little light on loan product discrimination, because the area's housing costs limit large-scale use of FHA lending.

Conversely, the Chicago example illustrates an extreme concentration of FHA loans, both in minority populations and in minority and racially changing areas. While the BCGH study notes only a limited concentration of FHA loans in minority areas and a weak relationship between foreclosure and minority areas, the pattern in Chicago shows the opposite result. Even more dramatic is the concentration of blight that accompanies a high level of FHA foreclosures in the minority areas of Chicago. Other markets that show this pattern include Cleveland, Detroit, Baltimore, and Philadelphia. Historical examples include Washington, D.C. (the largest African-American housing market in the Nation), Los Angeles, and Boston. Not only do the patterns of exploitation vary from one market to another, they vary over time as well.

What To Do Next: Listen to the Many Voices of Experience and Knowledge

The historical and social science context for discrimination studies has been omitted by BCGH and others because of the focus on the use of economists to the exclusion of other housing market experts. Although economists have a legitimate role, they have tended to be very narrow in their recognition of other research techniques and forms of knowledge. While their techniques and methods have sophistication and strengths within their own parameters, economists have tended not to recognize expertise and research by those outside the field of economics.

It is time to invite all interested parties to the table and to ensure that those who lack resources are provided with the tools and support to analyze information from their own perspectives. Moreover, expertise is defined by more than simply academic credentials, and it is necessary to focus on the broad range of knowledge rather than just the limited academic aspect, particularly the limited perspective of economics.

The BCGH analysis of discrimination in FHA lending was ill-conceived from the outset. It was designed in a theoretical world disconnected from the realities of the way FHA was implemented as a housing policy. By assuming the proverbial can opener, BCGH unwittingly failed to provide any insights into the ways in which FHA lending markets actually work. As students of evaluation research are well aware, examining outcomes from programs without understanding implementation processes can be a meaningless exercise. The BCGH study does not expand contemporary knowledge of lending discrimination but is instead an unfortunate distraction from the pressing issues surrounding this topic.

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Notes

1. If there is anyone who cares about the risk in these loans, it would be investors who purchase the loans (or who purchase the mortgage-backed securities based on pools of these loans). But, because the loans are insured for 100 percent of the loan amount, they are much more attractive to investors than loans that are privately insured for, at most, 35 percent of their value or loans that are not insured at all. In addition, timely payment of the principal and interest is guaranteed by the Government National Mortgage Association (GNMA). In the 1970s Fannie Mae bought most of these loans, which were considered so safe that Fannie did not even have a process for reviewing the underwriting. Today, Fannie Mae plays almost no role in the purchase of FHA loans. The FHA insurance and the GNMA guarantees provide for an active private market in Government-insured, mortgage-backed securities.

2. The fee paid for servicing FHA loans is 44 basis points, and a basis point is 1/100th of a percent. Thus mortgage companies collect 0.44 percent of the outstanding balance of a mortgage to service the loan. Conventional loans receive only 25 basis points for servicing.

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