The Discriminatory Impact of Traditional Lending Criteria: An Economic and Moral Critique[†]

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I. INTRODUCTION: LENDING DISCRIMINATION AS A DENIAL OF THE AMERICAN DREAM

My discussion for purposes of this symposium centers on making not only an *economic* case for fair lending, but a *moral* case as well. I will first discuss briefly the importance of fair lending in general, then address the economic issues, and finally follow with the moral case.

I begin by positing that lending discrimination is an illegitimate impediment to the American Dream.[1] The American Dream, of course, is not a guaranteed right. It is only a fair opportunity to achieve, or to attempt to achieve, economic success, the idea being that we have equality of opportunity but not necessarily equality of result. There are fundamental and legitimate barriers to economic success that we all, regardless of race, need to overcome. Lending discrimination based on race, however, is an *illegitimate* barrier to that economic success, which must be dismantled.

Legitimate barriers that one has to overcome to achieve success in any context should stand. A dedicated work ethic, ambition, self-discipline, etc., are general legitimate barriers, and I take no issue with them. Similarly, managing money responsibly, paying bills on time, and having sufficient collateral are legitimate barriers in the lending context to economic success, and, in general, I take no issue with them either. In contrast, I do take issue with the illegitimate barrier of unjustified inaccessibility to afford-

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[1] The concept of the "American Dream" conjures up an image of personal economic prosperity and the opportunity, open to anyone, to achieve it through hard work. It is also a political cliché attributed to ALEXIS DE TOCQUEVILLE, DEMOCRACY IN AMERICA (1835) but may be even older. *See* CHRISTINE AMMER, HAVE A NICE DAY — NO PROBLEM! A DICTIONARY OF CLICHÉS 8 (1992).

able credit attributable to discrimination based on race or class, and I believe that it should be eliminated in all of its forms to the extent possible.

In America today, many citizens already are living the American Dream. If they want to buy a house, or a car, often they can.[2] Fair accessibility to financial credit is important because it is usually the initial and critical first step in purchasing a home or another big-ticket item.[3] Consequently, the illegitimate denial of credit due to racial discrimination in lending amounts to a profoundly significant impediment to economic, not to mention overall, prosperity.[4] Although civil rights legislation is often about symbolically being able to ride in the front of the bus, civil rights has a significant economic dimension as well. Do you have enough money? Do you have access to credit to be able to partake in the American Dream? If not, it means the American Dream very likely is going to be denied to you. Thus, being a part of American society should not only mean being allowed in the door, it also should mean having access to credit in order to participate meaningfully once you enter the door.

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[2] The percentage of the United States population owning a home in 1995 was 65.4% while the percentage of the population renting was 34.6%; this figure is exclusive of transient citizens, many of whom are too poor to rent or own. *See* UNITED STATES DEPT. OF COMMERCE, AMERICAN HOUSING SURVEY FOR THE UNITED STATES IN 1995, UNITED STATES BUREAU OF CENSUS CURRENT HOUSING REPORT SERIES H150-95RV (1995). Although no actual data is available, the number of Americans who have the financial ability to purchase a home but simply choose not to do so is probably offset by the number of Americans who would like to be able to purchase a home but are unable to do so because of their current or prospective financial situation.

[3] As of June 30, 1997, the average price of a new home in the United States was $176,400. *See* RESIDENTIAL CONSTRUCTION BRANCH, BUREAU OF THE CENSUS, CURRENT CONSTRUCTION REPORT, C25 97-7. Most American consumers simply do not have enough disposable income to make such big ticket purchases without first financing such purchases with credit. For the fiscal year ending in 1992, 58.6% of debt held by families stemmed from home purchases, while 5.7% of familial debt was for automobile financing. *See* ECONOMICS AND STATISTICS ADMINISTRATION, BUREAU OF THE CENSUS, PUB. NO. 772, STATISTICAL ABSTRACT OF THE UNITED STATES 508 (116th ed. 1996).

[4] *See, e.g.,* REP. CHARLES E. SCHUMER, SCHUMER STUDY: HOME MORTGAGE REDLINING DENIES AMERICAN DREAM TO MINORITIES (1997) (on file with author) (finding in a study of 12 major banks in New York City that African-Americans were denied loans at twice the rate of Caucasians across the entire income spectrum); Elizabeth Rhodes, *Racial Bias in Mortgage Loans: Looking for Solutions*, SEATTLE TIMES, Nov. 5, 1995, at G1 (alleging that Seattle lending institutions deny minority mortgage applications at two times the rate as those of whites even though minorities apply for mortgages at two-thirds the rate of non-minorities); *see also* Cathy Van Housen, *Home Loan Discrimination? Be Sure To Tell Authorities*, SAN DIEGO UNION-TRIB., Apr. 2, 1995, at H11 (stating that a local San Diego task force reported that mortgage lenders denied loans 50% more often for minorities than for non-minorities and declaring that the 1991 Federal Reserve study demonstrated a wide gap in approval rates between whites and minorities).

II. OVERCOMING THE MISPERCEPTION THAT FAIR LENDING IS A "CODE WORD" FOR CHARITY, WELFARE, AND RACIAL PREFERENCES: THE ECONOMIC CASE FOR FAIR LENDING

I would like to suggest several workable and innovative methods of minimizing illegitimate lending barriers that currently obstruct the pathway to economic success for many members of racial and ethnic minority groups and the lower-income class. I believe, however, that it must be done in such a way that also recognizes the legitimate economic and profitability concerns of lenders, which are to make profitable loans and to minimize borrower defaults. These basic lender concerns must and should be addressed satisfactorily by any loan applicant. Lenders obviously have to be able to make money to stay in business. They have to be able to make profitable loans and they have to loan to people who are not likely to default. Lenders do not have a crystal ball; they do not know whether or not the potential borrower is going to default, so they use lending criteria to determine if someone is "creditworthy" so that they can make a sound, profitable decision whether or not to lend.

A. Fair Lending and Profitability Are Not Mutually Exclusive

Fair lending is not antithetical to the profitability concerns of lenders. I am not suggesting that we engage in fair lending by requiring lenders to make overly risky loans to unqualified minority loan applicants with bad credit reports. Instead, I am suggesting that lenders can and should reexamine their lending criteria and enhance it where possible while not simultaneously sacrificing profits, or safety and soundness concerns.

It is important to note that I am not talking about "affirmative action"[5] lending where it is suggested by its opponents that non-qualified or non-creditworthy borrowers are able to get loans above non-minority individuals who are qualified. Nor am I suggesting that lenders be forced to make loans to *all* minority applicants simply because they are minority, irrespective of their ability to repay or their credit history. In fact, I would argue, although I am very much a proponent of fair lending, that something akin to mere quota loans would be a disastrous policy for all concerned for three reasons.

[5] *See, e.g.*, FRANCIS BECKWITH & TODD JONES, AFFIRMATIVE ACTION: SOCIAL JUSTICE OR REVERSE DISCRIMINATION? (1997); LINCOLN CAPLAN, UP AGAINST THE WALL: AFFIRMATIVE ACTION AND THE SUPREME COURT (1997). I am not using that term as it has come to be used in a pejorative sense by some opponents of affirmative action as mere undeserved, non-meritorious racial preferences.

1. Why mere quota loans would *not* work

First, lenders, and ultimately their shareholders, would lose money that could have been used more productively in other investment endeavors if they were forced to make loans likely to end in default. Lenders are business people. In order to earn money for their shareholders they must take money from deposits and lend it at a profitable rate to individuals and businesses who will not default. If lenders give loans to persons who default, not only would there be a lost economic opportunity for lenders and their shareholders, but lenders would be held responsible to their regulators for approving "bad loans."[6] Since the savings and loan crisis of the late 1980s and early 90s, banks must comply with tighter lending regulations to prevent the high default rates that precipitated that crisis.[7] Second, defaulting borrowers would injure themselves by worsening their already questionable, or negative, credit histories,[8] while simultaneously making it less likely for similarly situated borrowers to obtain credit in the future.[9] Even if a defaulting borrower temporarily benefits from a loan that he or she is unable to repay, that borrower will typically become subject to a costly collection action aiming to hold him or her personally responsible for payment on the

[6] *See* JONATHAN R. MACEY & GEOFFREY P. MILLER, BANKING LAW AND REGULATION 65-69 (1997) (explaining the regulatory responsibilities of the various regulators: Federal Reserve Board, Comptroller of the Currency, Federal Deposit Insurance Corporation, Home Loan Bank System, Office of Thrift Supervision, various state regulators for state-chartered institutions, National Credit Union Administration, and Department of Justice). When an institutional lender makes a bad loan, it obviously harms the profitability of the lending institution because the loans must be "charged off," and the lender's various regulators consider loans made to non-creditworthy borrowers to be an "unsafe and unsound" banking practice. *See generally* 73 FED. RES. BULL. 577 (1987).

[7] *See*, *e.g.*, Financial Institutions Reform, Recovery, and Enforcement Act of 1991 (FIRREA), 12 U.S.C. § 1811 (1994) (tightening various regulations on financial institutions); Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA), 12 U.S.C. § 1824 (subjecting federally insured depository institutions to additional, more stringent regulations).

[8] A default on a loan appears on the borrower's credit history and is considered the worst negative infraction, next to a bankruptcy declaration, that a borrower can make. Moreover, prospective lenders will have access to this information and hold it against that borrower should that borrower ever attempt to obtain another loan in the future. *See generally* CREDIT SURVIVAL GUIDE: A SELF-HELP MANUAL 25-43 (ICF & Success Seminars eds., 1995).

[9] *See id.* Lenders consider and analyze the credit histories of all former borrowers in determining who would, and would not, be a good future credit risk. *See id.* at 26. Thus, when a borrower defaults on a loan, information about the borrower is analyzed by future lenders because that particular borrower, with their particular characteristics, turned out to be a bad credit risk regarding the loan on which they defaulted. As a result, similarly situated minority loan applicants may be negatively affected by this precedent as they, too, might be considered bad credit risks and, as such, denied credit in the future. *See generally id.*

loan.[10] Finally, well-meaning policymakers interested in making fair lending more of a reality in our society would lose credibility with future lenders and with the public if a large proportion of the types of loans they advocated simply defaulted. Moreover, there might be a "chilling effect" or "backlash" if these policymakers might themselves become fearful of making any future innovations in lending to minority borrowers due to the negative precedent.[11] Therefore, it bears repeating that this is *not* a general call to lower credit standards for unqualified, uncreditworthy, minority or non-minority borrowers in order to grant them what often would be default-bound loans to compensate for past racial or economic discrimination.

2. Why revising traditional credit criteria *would* work

We should try instead to reassess or revise creditworthy standards, but not disregard them completely. The key is to make sure that we are eliminating or at least minimizing racial discrimination and discriminatory impact on minorities in lending, while at the same time maintaining the predictive value of credit scoring or creditworthiness determinations. That is a very difficult thing to do. How do you keep the good and throw out the bad, essentially? Before doing that, however, it is important to categorize the various *types* of lending discrimination in order to provide specific focus to the need for revision of credit criteria.

a. All discrimination is not created equal

In any discussion of fair lending practices and discrimination, it should be noted that there are three primary forms of lending discrimination: (1) overt discrimination; (2) discriminatory treatment; and (3) disparate impact discrimination.

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[10] Lenders, of course, often seek legal action in the form of a collection action, writ of attachment, and deficiency judgments to recover monies lent to defaulting borrowers. *See, e.g.*, Evergreen Bank v. Sullivan, 980 F. Supp. 747, 748 (D. Vt. 1997) (seeking recovery for default on a $300,000 promissory note).

[11] A lending program that is considered a failed social experiment would be costly not only in terms of lost funds but in terms of the public's trust and patience in policymakers' attempts to eliminate racial discrimination by "meddling" in lending determinations. *See, e.g.*, Jonathan R. Macey & Geoffrey P. Miller, *The Community Reinvestment Act: An Economic Analysis*, 79 VA. L. REV. 291, 294 (1993) (arguing that although the goals of the Act were laudable — to invest in poor inner-city neighborhoods — the Act has done more harm than good as it has given banks an economic disincentive to locate in poor neighborhoods since the Act requires banks to invest in the neighborhoods in which they are located). For a contrary view, see generally Allen J. Fishbein, *The Community Reinvestment Act After Fifteen Years: It Works, But Strengthened Federal Enforcement Is Needed*, 20 FORDHAM URB. L.J. 293 (1993).

i. Overt discrimination

The first type, overt discrimination, is quite easy to detect. Two matched couples, one white, one African-American, come in to apply for a loan; both are equally qualified. The white couple gets a loan, the African-American couple does not. Existing law clearly makes this kind of easily detectable discrimination illegal.[12]

ii. Discriminatory treatment

The second type of discrimination, discriminatory treatment, is a little more difficult to detect, but just as pernicious. It occurs when the lender will *assist* non-minority loan applicants in making themselves attractive loan applicants, but give *no similar type of assistance* to minority loan applicants. For example, assume a non-minority loan applicant and minority loan applicant both apply for a loan. Assume also that they have equally weak credit reports and income levels that make the grant of the loan unlikely for either of them, unless they both are given special advice and guidance by the lender on how to improve their credit reports and overall loan applications. Such advice and guidance might include instruction to obtain printouts of their bank account statements on their paydays so their available cash is represented in the most favorable light. It might also include advice on how to "clean up" their credit report, to remove old and/or incorrect information, to obtain a letter from a former creditor explaining a late payment, or how to consolidate their existing debts to lower their overall monthly payments, etc.

Discriminatory treatment has occurred when such advice and assistance are given only to the non-minority loan applicant and that applicant complies and ultimately receives the loan, while the minority loan applicant is told at the outset that he simply does not qualify for the loan based on his weak credit report and loan application, and he is not thereafter given similar guidance and advice by the lender and therefore is denied. This is true even though the non-minority borrower, after the assistance, may now "objectively" be a better credit risk on paper than the minority loan applicant. Again, existing law generally prohibits this type of discrimination.[13]

iii. Discriminatory impact

The third type of discrimination, however — disparate impact discrimination — is the most difficult to detect, and it may not necessarily be

[12] Various major federal legislative acts have made such discrimination illegal. *See, e.g.*, Fair Housing Act of 1968, 42 U.S.C. §§ 3601-31 (1994) (FHA); Equal Credit Opportunity Act of 1977, 15 U.S.C. § 1691 (1994) (ECOA); Home Mortgage Disclosure Act of 1975, 12 U.S.C §§ 2801-11 (1994) (HMDA); Community Reinvestment Act, 12 U.S.C. § 1691 (CRA).

[13] *See supra* note 12 (setting forth the existing law).

racially discriminatory. It is this third type that I am focusing on today because there is no serious policy debate regarding the illegality of the first two types of lending discrimination. "Discriminatory impact" occurs when a non-minority loan applicant and a minority loan applicant both apply for a loan, but according to the criteria used by the lender, only the non-minority loan applicant appears qualified to obtain the loan and therefore only the non-minority loan applicant is granted the loan. This result, of course, is not necessarily objectionable,[14] but becomes so if the criteria used to make the lending decision have an *inherent* racial bias *that is not business justified*.

Interestingly, providing credit scoring criteria was an attempt to curb overt and disparate treatment lending discrimination. Lenders reasoned that a lending criteria score, some even generated by an "objective" computer program, would minimize overt and disparate treatment lending discrimination by loan officers because the decision would be more of an "objective" one rather than a "subjective" one. The problem is that credit scoring criteria itself may have a discriminatory impact or may be its own form of discrimination. In short, what if the criteria itself contain inherent racial biases?

Even before addressing possible inherent bias contained within the criteria, it is important to consider whether the whole concept of credit criteria itself rests upon the mistaken notion that past conduct necessarily and without fail is a perfect indicator of future conduct. This must be considered even before addressing whether some of that criteria is inherently biased against minorities.

b. Recognizing that lenders, in the end, are really just guessing about future borrower conduct based on borrower character

One point is to challenge the whole idea of borrower-character assumptions regarding probable default. Much of the premise upon which many lenders rely is the assumption that "creditworthiness" determinations will reveal whether a loan applicant is unable to manage their personal finances, or worse, is so irresponsible that they would simply choose not to pay at some point during the term of the loan, or that he or she would procure a loan and spend it, but all the while have no intention of ever paying it

[14] Assume a loan applicant, who happens to be a non-minority, applies for a $500,000 loan, and has an annual income of $300,000 and sufficient collateral. That loan applicant probably would receive the loan, but not based on his race; it would be upon his objective qualifications (income and collateral criteria). Contrast this with another hypothetical loan applicant, who happens to be a minority, makes an annual income of $25,000, and has insufficient collateral to support a $500,000 loan, and therefore, is denied the loan. That second borrower most likely would be denied the loan, but again, not based on his race, rather, the denial would be based solely on objective criteria — insufficient income to make the monthly payment and insufficient collateral to secure the loan adequately.

back. In effect, the premise assumes that certain borrowers always will act in conformity with their apparent *propensity* to be at least poor money managers, and at worst, "deadbeats." This assumption totally ignores many of the actual reasons borrowers probably default and find themselves in difficult financial situations such that they are forced to risk ruining their credit, losing their homes or automobiles through foreclosure or repossession, and being subject to a costly collection lawsuit.

c. Borrowers' default is often a result of unforeseen events that no lender could ever accurately predict

The assumption, then, that defaulting borrowers are nothing more than deadbeats who somehow got through the loan screening process, or that their inability to make sound financial decisions was not discovered, is an unrealistic oversight. Instead, we should recognize that at least some defaulting borrowers probably are just persons who unfortunately have suffered unforeseen emergencies: a severe illness; a divorce; a devastating car accident or lawsuit, which has bankrupted them; an unforeseen downturn in the economy such that they were laid off or lost their job only because they worked for a company that was downsizing; or a natural disaster occurred and the borrower was uninsured or worked in a weather sensitive-industry such as construction or farming, etc. Banks do not like to admit that they cannot predict the future, but the reality is that they cannot. Often, the reality is that a lender cannot always predict who is going to default and who is going to be able to pay. A conservative banker would scoff at the "Psychic Friends Hotline" yet appears to be engaged in a very similar enterprise and even professes better results. Thus, it is important to stress the point that actual repayment or default is not solely a function of a lender's determination of a borrower's creditworthiness.

d. Even if traditional credit criteria were accurate predictors, they contain racial biases

Moving beyond this basic problem with credit criteria that is often ignored, the criteria itself can contain racially discriminatory biases. In order to see how this can happen, it is essential to examine two lending criteria, job stability and credit history.

i. Job stability v. income stability

One criterion used by lenders is job stability or length of employment. How long have you been at your job? If you have been working at a particular job for a long while, you have a better chance of getting a loan because lenders believe it is less likely that you will be fired or laid off. If you have had a number of different jobs, on the other hand, it would not look as good — "can't this person hold a job?" Lenders often look to job stabil-

ity/length of employment as a factor in granting a loan because the lender wants to have some indication of how likely it is that the borrower will remain employed over the term of the loan and therefore would be able to make the agreed upon payments on the loan.

Now that seems like a perfectly valid piece of criterion — neutral on its face — so how can it be racially discriminatory? One must dig a little deeper into the criterion and its socioeconomic implications to see it. Not only do minorities as a group often not have as high an income as non-minorities, but a higher percentage of minorities hold service industry jobs than do non-minorities per capita. Service industry jobs typically have a higher turnover rate than do those in other industries. The result is that a higher percentage of minorities will be affected by this kind of job length criterion because they will show a poorer score on the length of employment criterion due to the higher turnover rate in service industry jobs.

Is the solution to let a minority loan applicant have a loan even if she has job *in*stability? No. Yet, if the criterion were changed — not eliminated, just changed — to focus on *income* stability or resourcefulness of the party rather than on *employment* stability, then presumably loans would be granted more often to lower-income, higher-turnover-rate, service-industry-worker loan applicants who maintain their income by keeping many jobs over time. Employment instability would not unnecessarily harm them if they could instead demonstrate perpetual income stability. Such would be economically and morally justified because income-stable loan applicants are good credit risks,[15] despite their frequent job changes, because their income has remained stable over time. So income stability would not be antithetical to lender profitability concerns because, when you think about it, employment stability is really just a proxy for income stability anyway. If a minority borrower can say, "Although I may change jobs once every four or five months or once a year, don't look at the fact that I change jobs, look at the fact that I have been able to get a new job each time an old job ends, and I work multiple jobs to be able to pay my bills," then a lender would be economically foolish to deny the loan because the borrower would probably make the payments (again, to the extent the criterion is truly predictive).

In fact, income stability/high job turnover may be an even stronger predictor of loan repayment than traditional job stability because if someone has had just one job over the last ten years and then gets fired as a result of corporate downsizing for example, she may not have the skills to find a new job quickly. Consequently, that person may have a harder time getting a job than an individual who is accustomed to frequent job turnover.[16] If a poten-

[15] This is true to the extent the criterion is a good predictor of future conduct in the first place, which is debatable, as set forth earlier.

[16] Thus, there is even an argument to *reverse* the criteria, although I am not going this far.

tial borrower has had stable income over the last five years, even though she has changed jobs frequently, then in using that criterion we might eliminate some of the racial discrimination, yet maintain whatever predictive value there is in the criterion. A final point is that a higher percentage of minority loan applicants are poor. Often these minorities are trying to work their way out of poverty and moving up the income ladder may require taking a new or additional job every few years. They should be rewarded, not penalized for this.

ii. Making "credit history" more reflective of a loan applicant's full economic history

A second criterion is one's credit score, based on one's credit history. Often in credit scoring, lenders use "credit reports"[17] to examine a loan applicant's credit history. Credit reports usually list things like home mortgage payments, bank loans and credit card payment histories. They often do not list rent or utility payment histories, however.

How might this measure of creditworthiness be discriminatory? Again, because minorities often have lower incomes to begin with, they often do not have home mortgages, bank loans, or unsecured credit cards with the same frequency as do non-minorities. As a result, they are more likely to be renting or they may not want, or have access to, unsecured credit. Consequently, the only payment records they may have are rent and utility payments, which do not appear in most credit reports.

But if lenders do not consider rent and utility payment histories, then many minority borrowers can never establish any kind of sufficient borrowing/payment history and, thus, are not considered to be good credit risks when they apply for a loan. Moreover, lenders often do not look to rent or utility payment histories on their own because lenders traditionally have considered such information unreliable. Rent payment history, it is argued, often depends too much on the good or bad personal relationships tenants may have with their landlords and, as such, landlords may exaggerate or even fabricate payment or non-payment history of the tenant depending on their good or bad personal feelings about their tenants. Lenders also consider utility payments to be poor indicators of the likelihood of loan repayment because a person is much more likely to pay the light bill to avoid the lights being turned off than to pay on a discretionary, unsecured credit card. The argument is that Visa cannot turn off your lights if you miss some payments, so if you pay your Visa bill it shows an especially strong likelihood of repayment on similar debts in the future.

[17] A credit report is simply a compilation of a loan applicant's payment history on certain types of secured and unsecured loans in the past. Companies such as Equifax, Experian, and TransUnion are credit reporting companies that compile the information on borrowers and compile it for potential lenders.

Curiously, however, when you move up the income ladder, you can say the exact same thing about home or mortgage and car payments. Home loan mortgage payment histories are considered in credit histories even though they are secured with the threat of foreclosure on the property. Losing one's home is clearly a more coercive threat to exact payment than is the threat of having the lights turned off. Similarly, a car loan is usually secured with the threat of repossession of the automobile for non-payment. Nonetheless, lenders still consider these types of payment histories to be good indicators of future payment on prospective loans while utility payments are not.

A cynical response would be that the real distinction here is not between the threats of coercion forcing payment, but between the types of payment histories of upper-income, typically non-minority loan applicants, who buy cars and homes secured by foreclosure and repossession, and lower-income, minority loan applicants, who often only have rent and utilities receipts to show for their payment histories. This distinction has the effect of discriminating against lower-income, and therefore disproportionately minority, potential borrowers. The low-income borrower has to make a special request to consider utility payments, which is outside the norm; sometimes the lender will consider it, sometimes it will not.

iii. How does one establish a credit history if one cannot get credit in the first place?

Another issue for minority loan applicants is the "chicken and the egg" type of problem in attempting to establish a credit history when they do not already have one. A lender, who does not want to be *the first* lender to take a chance on a borrower, wants to see a credit history before lending to a borrower, but often the borrower cannot establish a credit history without having borrowed already in the past. It is analogous to trying to get your first job when employers want to see your nonexistent work experience. How can an individual establish a credit history? If you are lucky enough to go to college and graduate, credit companies often will send the graduate credit card applications. But for many minorities in lower income brackets who, for example, are not attending college and are not receiving the same first-time credit offers, it is harder to establish credit.

It is true that sometimes finance companies will make high-interest offers to lower-income minorities, but because these lenders consider them to be higher-risk loans, they charge a higher rate of interest for the loan, often up to 21%. If that is the only offer a loan applicant can obtain, a desperate loan applicant in need of credit will be forced to take it. That high-interest loan then appears on the minority borrower's credit report.

However, the problem is not so easily solved thereafter in light of how certain future lenders will view such loans in future loan applications. The

problem is that some lenders will look at the minority applicant's credit history and decide that it shows that she has virtually no loans except for this one high-interest loan from a finance company. Lenders then often make the decision that such a borrower is not a good credit risk because the decision to accept an interest rate of 21%, when the prevailing rate is much lower, appears to be a poor financial decision. Therefore, often the only type of credit a minority applicant is able to get in order to establish a credit history is of a type many lenders will consider to be negative.

B. Not a New, Radical Step: Revising Criteria Has Been Successful Outside Traditional Commercial Banking

It is important to note that there are certain banks adopting these alternative criteria already. These banks realize that they are not completely going out on some experimental limb, as there is ample precedent for the notion of lending to groups that do not fit the traditional credit-scoring mode. For example, federal and state credit unions were first created precisely because their member loan applicants were from certain geographical, political, religious, or employment groups that had trouble qualifying for bank loans under past lending criteria.[18] Therefore, making the argument to use non-traditional criteria is not a wild, radical concept. It is just a suggestion to expand what some lenders already have done in the federal credit union arena to traditional lending done by national banks and savings and loans.

III. HOW DISCRIMINATORY LENDING IS COMPOUNDED BY THE EXISTENCE OF THE SECONDARY MARKET

A. What Happens When Default Is No Longer the Ultimate Lending Concern, and Instead Becomes a Concern for How the Loan Will Sell On the Open Market to Secondary Purchasers?

There is another relatively new factor I want to mention that currently is exacerbating lending discrimination. It is called the "secondary market," wherein primary lenders — banks and mortgage companies that make direct loans to the public — bundle and sell those loans once made to "secon-

[18] *See* MACEY & MILLER, *supra* note 6, at 28-29. Specifically, Macey and Miller state:

> Perhaps the most remarkable success story, however, was the credit union movement. Credit unions have been around since early in the century. They sprang from the . . . public spirited impulse . . . to facilitate the supply of consumer credit to workers, farmers, and other[s] . . . whose credit needs were not being adequately served by existing banking facilities.

Id.

dary" buyers who purchase or "invest" in those loans, often in bulk, and pay a premium to the primary lender. The secondary buyers then administer the receipt of payment thereon from the borrower who, of course, is still obligated to pay off the loan at the original interest rate and on the same continued terms. The borrowers therefore are not affected by such purchases of their loans; they merely receive a different payment coupon book and send the agreed-upon interest and principal payments to the secondary purchaser of the loans instead of to the original lenders.

So what does this have to do with discriminatory lending and how does it often exacerbate the problem? The problem is that even when primary/original lenders do not attempt discrimination against minorities, or even actively seek to avoid it, much discrimination by primary lenders still persists due to the economic pressure applied by secondary purchasers, who typically seek to purchase only "top quality" loans from primary lenders — loans to high income debtors with a long history at their current employment and a strong loan and credit history. Thus, if a primary lender is making a loan with an eye toward being able to sell that loan on the secondary market, then not only must that loan meet the primary lender's own initial loan criteria to avoid default, but it also must meet the loan criteria of secondary purchasers, who typically are willing to purchase only the "best" loans with virtually no chance of default. As a result, in a competitive secondary market for loans, primary lenders have strong economic pressure to refuse to consider non-traditional credit-scoring criteria, such as rent payment history, that the secondary market also will not be willing to consider.

This also reveals the fact that a primary lender has a strong economic incentive to make loans only to those borrowers who do not appear as *any* kind of credit risk — which has a discriminatory effect on minority loan applicants to the extent that traditional criteria paint them as more of a credit risk than their non-minority loan applicant counterparts. This is especially true because secondary purchasers often buy in bulk and do not want to take the time to consider *special* or *different* loan criteria when making a decision to buy a group of loans. Thus, these secondary purchasers of loans are in a powerful market position given the competition among primary lenders to sell their loans. Requiring secondary purchasers to be subject to the same fair lending laws as primary lenders, instead of being able to argue that they are "mere investors" may be the first phase in reducing this secondary market economic pressure phenomenon that exacerbates the discriminatory impact problem. Also, secondary purchasers should be required to purchase some "lower qualifying" loans with "higher qualifying" loans instead of being able to just "skim off the top."

B. Using the Secondary Market to Disguise a Lending Institution's Poor Minority Loan History

There is another problem with the presence of the secondary market insofar as it has the further effect of allowing primary lenders to disguise their low percentages and low overall numbers of loans to minority loan applicants. They can do this simply by selling many of their existing non-minority loans on the secondary market while simultaneously keeping on hand the minority loans that they have made.

A simple example demonstrates the easy shell game a primary lender can play by using the secondary market to disguise the extent of its minority lending as an overall percentage of its active loans. Assume a bank (a very small bank) has one hundred active loans, but only five (and thus 5%) of those loans are to minority borrowers. Because the secondary market exists, that primary lender can sell fifty of its ninety-five non-minority loans on the secondary market. After the transaction, the bank still will have five minority loans, but now only forty-five non-minority loans, for a total of fifty active loans, instead of one hundred (as fifty non-minority loans have been sold). Essentially, the bank, through a profitable transaction, has just increased its overall percentage of its existing minority loans from 5% to 10% — a 100% increase — without making a single additional loan to a minority applicant. In a cursory regulatory check, primary lenders can make their minority loan numbers look much better through sales to the secondary market. A simple way to combat this problem, of course, would be to ask the primary lender for its loan *originations* — the number of loans actually made — not simply the number of its active participating warehoused loans kept and serviced by the bank and not sold on the secondary market. Certain secondary market purchasers argue that they should not be subject to lending discrimination laws because technically they are not making any loan decisions on loan applications of potential borrowers, they are just investing in loans after the initial decision has been made by someone else — the original lender. But to allow this circumvention while providing a market incentive to discriminate violates the spirit of fair lending.

IV. LENDING DISCRIMINATION CAN OCCUR EVEN AFTER A MINORITY LOAN APPLICANT IS GRANTED A LOAN

Finally, lending discrimination can occur not only in outright denial of loan requests, but also in offering *unaffordable* loans or in *servicing* those loans unequally between non-minority and minority borrowers.

A. From "Red-Lining" to "Green-Lining."

There is a procedure called "red-lining" when a lender literally draws a red line around a racially defined neighborhood on a map and will not

make any loans to that particular neighborhood (usually done by zip-code). This particular practice is obviously prohibited by the fair lending laws.[19] There is, however, a similar phenomenon known as "green-lining" — where minority loan applicants are granted loans, but are subjected to much higher interest rates, such as 16.9% instead of 8%, and/or very burdensome down payment requirements (15, 20, or 30%) that make it highly unlikely that the loan applicant will actually take out the loan. Lenders justify this higher-rate down payment by arguing that the loan is more "risky" since they are assuming default is more likely. In these circumstances, the lender has *not denied* the minority loan applicant the loan per se, but it has managed to achieve the *same result* by making the loan financially undesirable or impossible for the borrower to accept. And even if an applicant does accept a "green-lined" loan, future lenders may regard this as an indication of poor money management (due to the relatively high interest), not to mention the possible self-fulfilling prophesy aspect that the borrower will not be able to afford high interest payments and therefore will end up defaulting and reinforcing the traditional criteria.

B. Assuming "The Worst" When It Comes to Minority Borrowers and Problem Loans

The second discriminatory practice involves how a lender services a loan made to a minority borrower. Even when minorities are granted loans there often is an anxiousness on the part of some lenders that leads, in certain circumstances, to a decision to foreclose quickly on minority borrowers.[20] This probably occurs due to the cultural assumptions of non-minority lenders and loan account managers who are much quicker to ascribe nega-

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[19] *See* United States v. Chevy Chase Federal Savings Bank Consent Decree, *quoted in* MACEY & MILLER, *supra* note 6, at 208 (defining the practice of "red-lining" as "policies intended to deny, or have the effect of denying, an equal opportunity to residents of African-American neighborhoods, on account of the racial identity of the neighborhood, to obtain [credit]").

[20] *See* Willy E. Rice, *Race, Gender, "Redlining," and the Discriminatory Access to Loans, Credit and Insurance: An Historical and Empirical Analysis of Consumers Who Sued Lenders and Insurers in Federal and State Courts*, 33 SAN DIEGO L. REV. 583, 619 (1996) (showing that lenders are more lenient when white borrowers default on their loans and more frequently decide against foreclosure). Social science research establishes that reliance on stereotypes is a common means by which people comprehend and interpret the world, particularly ambiguous interactions between people. *See* DOUGLAS R. HOFSTADTER, METAMAGICAL THEMAS: QUESTIONING THE ESSENCE OF MIND AND PATTERN 137 (1985); Linda H. Kreiger, *The Content of Our Categories: A Cognitive Bias Approach to Discrimination and Equal Employment Opportunity*, 47 STAN. L. REV. 1161, 1187-89 (1995); David L. Hamilton, *A Cognitive-Attributional Analysis of Stereotyping*, 12 ADVANCES IN EXPERIMENTAL SOC. PSYCHOL. 52 (L. Berkowitz ed., 1979); *see generally* Jody Armour, *Stereotypes and Prejudice: Helping Legal Decisionmakers Break the Prejudice Habit*, 83 CAL. L. REV. 733 (1995).

tive assumptions to a minority borrower's creditworthiness, thereby triggering a declaration of default at the first sign of trouble.[21]

In contrast, non-minority borrowers who may experience difficulty in making timely payments are more often met with a willingness to work toward a non-default solution, such as recapitalizing the interest, with foreclosure being a very last resort. Some lenders appear to believe that with non-minority borrowers it is unwise to foreclose too early because the borrower may be able to remedy the situation and begin making payments again, ultimately paying off the loan whereas making special arrangements for late-paying minority borrowers is probably just "throwing good money after bad."[22]

V. MOVING BEYOND THE ECONOMIC ARGUMENTS SURROUNDING FAIR LENDING: THE MORAL CASE FOR FAIR LENDING

Discussions of fair lending seem to focus primarily on whether fair lending legislation is unnecessary and inefficient because market forces will take care of the problem. The economist's puzzle asks, "In competitive markets, why would profit-seeking banks fail to make profitable loans to [minority loan applicants]?"[23] To paraphrase what one often hears bankers saying:

> We may be greedy, but we're not racists. We are business people in business to make money, so the only color we care about is green. If we could make money by loaning to minorities, we would do it. But we cannot because non-creditworthy minority (or non-minority) loan applicants end up defaulting on their loans, so this fair lending legislation is really not necessary. The market takes care of it.

The alternative argument is that fair lending legislation is necessary because discrimination does exist and market forces have not been strong enough to overcome it.[24] Indeed, had the market taken care of it, then

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[21] For example, a typical mortgage agreement contains what is known as "insecurity clauses" or "acceleration clauses." *See* R. Wilson Freyermuth, *Restatement of Mortgages Symposium: Enforcement of Acceleration Provisions and the Rhetoric of Good Faith*, 1998 BYU L. REV. 1035, 1035 (1998) (describing acceleration clauses as affording a lender the opportunity to accelerate the loan, that is, call it due and payable in full, whenever the lender deems itself "insecure" (the borrower is about to default) believing that the prospect of repayment or performance is impaired). The considerable discretion enjoyed by lenders in declaring themselves "insecure" invites abuse and can serve as a backdoor "sanitization" of any racist proclivities or unsubstantiated fears.

[22] Rice, *supra* note 20, at 619 n.146.

[23] Peter P. Swire, *The Persistent Problem of Lending Discrimination: A Law and Economics Analysis*, 73 TEX. L. REV. 787, 789 (1995).

[24] *See id.* at 792 (concluding that much lending discrimination currently exists, but that it actually makes economic sense not to discriminate, and therefore banks should refrain from doing so pursuant to their own economic self-interest).

there never would have been any lending discrimination to speak of, which obviously has been contrary to history. There is also an argument that it makes economic sense to pursue actively minority loans because it is a new market segment or niche to tap into.

Although these two ideological opponents (pro- and anti- fair lending legislation) pose very different interpretations of the intrinsic value of fair lending legislation, both schools of thought focus almost exclusively on whether fair lending legislation actually enhances or harms the *economic* efficiency and potential *profitability* of lenders. Consequently, the parameters of the whole debate are economic, or perhaps more metaphorically appropriate, the problem of lending discrimination is viewed only through an economically contoured prism.

So the second part of my argument — the moral case for fair lending — not only takes into account the common concern for the economic interests of the lenders, and borrowers, but it also acknowledges the political interests of minority loan applicants and their local economies, as well as other actors in society. This argument reconfigures the issues to make the moral and political issue *independent* of economics and lender profitability. The moral/political issue is not antithetical to the economic issue, just independent of it. It is critical not to lose the force and power of a moral/political argument just because we have been focusing solely on economic issues.

A. A Metaphor: Curbing Pollution as a Policy Matter Has More Than Mere Economic Considerations

A useful illustration of the idea that economic considerations should not be the *exclusive* consideration in public policy determinations occurs in environmental regulations designed to curb air and water pollution. Pollution — *analogous* to lending discrimination for these purposes — is something we as a society have decided is undesirable and, therefore, we have enacted laws to limit it and punish such things as toxic dumping, both criminally and civilly.[25] Industrial polluters certainly can make the argument that environmental legislation is costly, inefficient, and harms their profits.[26] A counter-argument can be made that polluting itself is inefficient for polluters because it subjects polluters to costly lawsuits and is bad for public relations.[27] Although this polluting-is-expensive-and-inefficient counter-argument is certainly a worthwhile counter-argument to make, it should not

[25] *See, e.g.*, The Comprehensive Environmental Response, Compensation, and Liability Act (CERCLA), 42 U.S.C §§ 9601-75 (1994).

[26] *See generally* HARM TO THE ENVIRONMENT: THE RIGHT TO COMPENSATION AND THE ASSESSMENT OF DAMAGES (Peter Wetterstein ed., 1997) (setting forth such arguments).

[27] *See generally id*.

be the *sole reason* why industrial polluters should refrain from polluting. The overall argument should not take place *exclusively* in the economic arena.

There are also political, social, and even ethical reasons why polluters should not pollute because we as a society have deemed it a negative, destructive, anti-esthetic practice that is undesirable. These concerns are irrespective of the argument that pollution may not make economic sense to industrial polluters who are in business solely to seek a profit. Thus, if environmentalists were to lose on the economic argument such that it actually makes economic sense to pollute, that should not necessarily trump all the other arguments supporting anti-pollution legislation; it would simply have to be balanced against the other equally important arguments.

Like pollution, we should acknowledge that lending discrimination is intrinsically a negative, destructive practice that is undesirable. This concern is irrespective of the argument that lending discrimination may not make economic sense to institutional lenders who, like industrialists, are also in business to make a profit. The key point is that political, social, and moral arguments should not be trumped automatically, or even just ignored or dismissed as "touchy-feely fluff," because only the bottom line — economics and money — is important and determinative.

B. The Significance of the Political, Social and Moral Issues in Fair Lending in Light of Bank Lenders' Special Public Status

Bankers and lenders are only one group in society and their interests have to be balanced against the interests of other members of society. This is especially true given the special, public trust position enjoyed by most lending institutions, like federal commercial banks and thrifts. Banks and thrifts receive special charters from the United States government through various bank regulatory agencies — the Office of the Comptroller of the Currency and the Office of Thrift Supervision among others.[28] These agencies assure present and prospective depositors that it is perfectly safe to deposit their hard-earned money in the institutions — instead of the stock market, for example — because the financial institutions are closely and heavily regulated by the government.

Moreover, banks and thrifts enjoy the special perk of federal insurance protecting their deposits up to $100,000 per deposit, per depositor through the Federal Deposit Insurance Corporation (FDIC), which ultimately is backed up by United States taxpayers. Former FDIC chairman William Seidman said during the height of the S&L crisis:

> My friends, there is good news and there is bad news. The good news is that the full faith and credit in the FDIC and the U.S. Government

[28] *See* MACEY & MILLER, *supra* note 6, at 61-62.

> stands behind your money in the bank. But the bad news is that you, my fellow taxpayers, stand behind the U.S. Go vernment.[29]

Moreover, banks and thrifts are entrusted to hold a public, as well as private, resource — great deposits of the public's wealth — and are allowed to loan out that money, at their own choosing, for their own personal gain. Thus, to the extent that they enjoy all of these special public benefits and enjoy this special trust status, they should at least recognize, or perhaps even be forced to recognize, their special public institutional status and public duty to *all* potential borrowers, in addition to their private status and fiduciary duty only to their shareholders. As such, they should be open to the public political and societal concerns, not just the private economic concerns, surrounding the fair lending debate and the elimination of racial discrimination.

VI. CONCLUSION

Fair lending can be achieved, not through quota loans, but by revising certain traditional credit criteria that minimizes disparate impact without sacrificing whatever predictive value the criterion has. Lenders need to take full advantage of the profitable loans to minority loan applicants that would be possible if they revised their credit criteria. But in addition, although fair lending discourse must and always will include arguments based on economics, bank profits, and the efficacy of government regulation, the dialogue should also include considerations of fairness, institutional and personal ethics, democratic ideals, and social justice. These are aspirations that must be valued as much as, if not more than, the "Almighty Dollar."[30]

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[29] L. WILLIAM SEIDMAN, FULL FAITH AND CREDIT: THE GREAT S&L DEBACLE AND OTHER WASHINGTON SAGAS xiii (1993). Moreover, no other corporate industry enjoys such a comprehensive insurance benefit or subsidy at the expense of United States taxpayers. *See id.* Although these institutions pay insurance premiums, the premiums do not completely cover the cost of massive failures such as the ones that occurred in the late 1980s and early 1990s. *See id.* Estimates of the cost of the federal bailout reached as high as $500 billion, and more than $1 trillion when interest payments were included. *See* KATHLEEN DAY, S&L HELL: THE PEOPLE AND POLITICS BEHIND THE $1 TRILLION SAVINGS AND LOAN SCANDAL 9 (1993).

[30] *See* AMMER, *supra* note 1, at 7 (stating that this cliché is used to express the power of money as crass materialism). Washington Irving used the term in *The Creole Village* where he wrote, "'The almighty dollar, that great object of universal devotion,'" but the sentiment may originate from Ben Johnson who wrote two centuries earlier, "'That for which all virtue now is sold, and almost every vice — almighty gold.'" *Id.*