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# "On the Take": The Black Box of Credit Scoring and Mortgage Discrimination

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## “ON THE TAKE”: THE BLACK BOX OF CREDIT SCORING AND MORTGAGE DISCRIMINATION

CASSANDRA JONES HAVARD\*

### ABSTRACT

*Subprime credit, a relatively new method of risk-based pricing, has been hailed as a way to open-up markets and provide credit to those who would otherwise be excluded. However, evidence suggests that subprime mortgage segmentation increases, rather than reduces, exclusionary practices in lending. Furthermore, it is unclear how lenders determine who qualifies as a subprime borrower. This concern became apparent when studies demonstrated that minority borrowers, regardless of creditworthiness, are more likely to receive expensive, subprime loans. The disparity is properly attributed to lenders' credit pricing policies. This Article reviews the theory and history of credit scoring in mortgage lending and argues that lenders' practices, arguably justified by "legitimate business need," as well as lenders' credit scoring model exacerbate lending disparities. It further argues that the failure of competitive forces to disallow these unjustified and illegal increases also speaks to regulatory failure. This Article proposes that lenders operating in noncompetitive subprime mortgage markets address how their practices interact with lending disparities even apart from their complicity in creating conditions that worsen economic disadvantage.*

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## I. INTRODUCTION

Credit scoring is like online dating: both use algorithms to sort preferences. Jana and Zoe are looking for beaus and they have preferences. Both want a mate who makes six figures and who has good looks. Jana prefers a gregarious, but serious intellectual; while, Zoe wants a fellow with a quick, wicked wit. Jana and Zoe might be attracted to different characteristics, but in the end they may desire or reject the same men.

Credit scoring is the same. Banks and lenders are looking for potential customers. They want borrowers who will pay on time and who have a solid history of repayment. Like Jana and Zoe, different lenders prefer different types of borrowers, so a rejection by one may not mean a rejection by all. While some borrowers are unattractive to almost all lenders (*i.e.*, extremely risky borrowers are uniformly rejected), some lenders may prefer those with poor credit histories or those that live in certain neighborhoods because they can charge those borrowers more.<sup>1</sup> However, often when this happens, borrowers are unaware of why the lender is offering a certain loan product. Borrowers are essentially told, "This is the right product for your credit needs given your credit score." But, what if the lender's algorithm is designed for price discrimination based on race or one of its proxies?

Minorities' lack of access to credit has transformed into a lack of access to quality credit.<sup>2</sup> With respect to economic achievement, minorities have made

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<sup>1</sup> An empirical study of loans originated by brokers found that those loans cost borrowers close to twenty basis points more, on average, than retail loans. The study also concluded that minority borrowers with lower incomes and lower credit scores were adversely affected the most. *See generally* Michael LeCour-Little, *The Pricing of Mortgages by Brokers: An Agency Problem?*, 29 J. OF REAL ESTATE RESEARCH 479 (2007).

<sup>2</sup> A scurrilous myth regarding the subprime lending and foreclosure crisis is that governmental law and policy through the Community Reinvestment Act ("CRA") forced banks to make loans to minority borrowers that were not creditworthy. *See generally* Lei Ding et al., *Risky Borrowers or Risky Mortgages Disaggregating Effects Using Propensity Score Models*, 33 J. OF REAL ESTATE RESEARCH 245 (2011). This report studied comparable borrowers

significant progress in accessing income, earnings, and occupational attainment, but continue to lag behind in areas such as housing and wealth equity.<sup>3</sup> Housing equity is a critical component of wealth accumulation.<sup>4</sup> Evidence sug-

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holding subprime mortgages and those with community reinvestment loans with similar risk characteristics and found that the community reinvestment loans have a lower default risk than subprime loans and thus are more sustainable. The study also concluded that the most significant characteristic in the community reinvestment loans was that they are not originated by brokers who do not have risky loan features. However, this myth combines two specific pieces of data to reach a disingenuous conclusion. The first fact is that between 1998 and 2006, black and Latino homeowners made up nearly fifty percent of the new homeowners who received their opportunities for homeownership through the subprime lending market. See Kristopher Gerardi and Paul Willen, *Subprime Mortgages, Foreclosures, and Urban Neighborhoods*, 9 B.E. J. of Econ. Analysis & Pol'y 1, 2 (2009). The second fact is that subprime loans made from 1998 to 2006 have led or will lead to a net loss of homeownership for almost one million families. Indeed, the net home ownership rate, which increased by three million during those years, has resulted in a yearly loss. See CENTER FOR RESPONSIBLE LENDING, *SUBPRIME LENDING: A NET DRAIN ON HOMEOWNERSHIP* (2007); see also Willen & Gerardi, *supra* note 2, at 2 (documenting that African-Americans were disproportionately affected by the mortgage crisis, overwhelmingly using subprime mortgages to buy homes in 2004 and 2005, and in 2007 selling homes through foreclosure rather than a sale in over fifty percent of the cases). The unstated critical fact which does not support the oft-touted conclusion is that the CRA, a statute which requires federally-insured banks to lend to low-income and minority communities, was not the source of the vast majority of the loans made to minority borrowers during this period. See generally Kevin Park, *Subprime Lending and the Community Reinvestment Act* (Harvard Univ. Joint Ctr. for Housing Studies, Working Paper No. N08-2, 2008). The historical constraints on access to credit for minority and lower income communities resulted in a much greater market penetration of subprime mortgage products in lower and moderate income areas. See generally Ira Goldstein, *Bringing Subprime Mortgages to Market and the Effects on Lower-Income Borrowers* (Harvard Univ. Joint Ctr. for Housing Studies, Working Paper No. BABC 04-7, 2004). Subprime loans, offered by unregulated independent lenders, are the predominate source of credit in many lower and moderate income areas. *How Exactly Did Inequality Fuel the Crisis*, THE ECONOMIST, Aug. 27, 2010, <http://www.economist.com/blogs/democracyinamerica/2010/08/inequalityandcrash>. Thus, despite CRA's mandate, the rate of subprime lending by regulated financial institutions subject to it was miniscule compared to the lending done by unregulated lenders.

<sup>3</sup> Rakesh Kochhar et al., *Wealth Gaps Rise to Record Highs Between Whites, Blacks, Hispanics*, Twenty-to-One, PEWSOCIALTRENDS.ORG, <http://pewsocialtrends.org/2011/07/26/wealth-gaps-rise-to-record-highs-between-whites-blacks-hispanics>.

<sup>4</sup> Housing equity refers to the amount of value in a house based on the mortgage owner's payments and the property's appreciation. See generally Lauren J. Krivo and Robert L. Kaufman, *Housing and Wealth Inequality: Racial-Ethnic Differences in Home Equity in the United States*, 41 DEMOGRAPHY 585 (2004). A recent study calling for reforms in public policies that provide incentives for wealth accumulation argues that the wealth gap between black and white families quadrupled between 1984 and 2007. See THOMAS M. SHAPIRO ET AL., THE INSTITUTE FOR ASSETS AND SOCIAL POLICY, *THE RACIAL WEALTH GAP INCREASES FOUR-FOLD* (May 2010), <http://iasp.brandeis.edu/pdfs/Racial-Wealth-Gap-Brief.pdf>. See

gests that lending disparities are key in determining how individuals accumulate housing equity.<sup>5</sup>

While the market for mortgage lending appears to be highly competitive, asymmetrical information about prices causes a wide disparity among the prices consumers actually pay.<sup>6</sup> Lenders use various methods to determine risk-based pricing in the mortgage lending market, and as a consequence minority borrowers have been charged higher interest rates, regardless of their creditworthiness.<sup>7</sup> The lack of uniformity in credit scoring models allows each lender to define the riskiness of every borrower based on the lender's preference. When the LENDER'S "PERFECT BORROWER" WISH LIST HAPPENS TO BE MINORITY BORROWERS OR THOSE LIVING IN MINORITY COMMUNITIES, THE DISCRIMINATION IS NOT OVERT. The discrimination is also less easy to identify as in the past, but is still pervasive.<sup>8</sup> This type of "second-generation discrimination"—or preferably a maturing disparity—is structural. It is comprised of lending discrimination in both product offerings and borrower selection, and is arguably more complex than the 1960s fair lending laws envisioned.<sup>9</sup> The first-

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MEIZHU LUI, INSIGHT CENTER FOR COMMUNITY ECONOMIC DEVELOPMENT, LAYING THE FOUNDATION FOR NATIONAL PROSPERITY: THE IMPERATIVE OF CLOSING THE RACIAL WEALTH GAP (March 2009), [http://www.insightcced.org/uploads/publications/wd/Laying\\_Foundation\\_Exec\\_Summ.pdf](http://www.insightcced.org/uploads/publications/wd/Laying_Foundation_Exec_Summ.pdf).

<sup>5</sup> See ALYSSA KATZ, OUR LOT: HOW REAL ESTATE CAME TO OWN US 35 (2009) (discussing policies developed under the Clinton Administration to adopt and market more flexible loan policies and products); see also COMMISSIONER MICHAEL YAKI, United States Commission on Civil Rights, Civil Rights and the Mortgage Crisis 213 (2009) (calling for more study of the persistent and substantial home ownership gaps between whites and all racial/ethnic minorities).

<sup>6</sup> Danny Ben-Shahar, *Default, Credit Scoring, and Loan-to-Value: A Theoretical Analysis of Competitive and Non-Competitive Mortgage Market*, 30 J. OF REAL ESTATE RESEARCH, 161, 176-78 (2008).

<sup>7</sup> See Marsha J. Courchane, *The Pricing of Home Mortgage Loans to Minority Borrowers: How Much of the APR Differential Can We Explain?*, 29 J. REAL ESTATE RESEARCH 399, 400 (2007); see also *Accelerating Loan Modifications, Improving Foreclosure Prevention, and Enhancing Enforcement: Hearing Before the H. Comm. on Financial Services*, 110th Cong. 78 (2007) (statement of Sheila C. Bair, Chairman, Federal Deposit Insurance Corporation).

<sup>8</sup> See generally Cass R. Sunstein, *Why Don't Markets Stop Discrimination*, 8 SOC. PHILOSOPHY & POL'Y 22 (1991); Gregory Squires, *The Indelible Color Line: The Persistence of Housing Discrimination*, THE AM. PROSPECT 42 (1991); Paul Sniderman et al., *The New Racism*, 35 AM. J. OF POLITICAL SCI. 423 (1991).

<sup>9</sup> This Article focuses specifically on the failed regulatory structure as it relates to fair lending. Accordingly, in addition to drawing generally on the body of critical race scholarship which addresses such flaws, I also draw parallels from the works of Professors Susan Sturm and Samuel R. Bagenstos on gender discrimination and recommended structural changes in the law, in arguing for substantive changes in the mortgage lending market that would better identify and remedy lending disparities that are often undetected. See Susan

generation's lending disparity involved credit rationing that denied credit to applicants, whereas the second-generation disparity involves risk-based pricing, offering credit to most minority borrowers at prices that are higher than the justifiable risks posed by the loans. This Article does not argue that the fair lending laws are anachronistic per se, but does toy with the notion that the lack of specificity in the statutory language has led to a failure of courts to distinguish fair lending practices properly. Research suggests that regulatory systems intended to decrease lending disparities among minorities, may instead perpetuate discriminatory practices.<sup>10</sup> Essentially, lenders can devise loan products that comply with the existing fair lending regulations, but that result in higher-cost loans to minority borrowers.<sup>11</sup> Specifically, a maturing disparity in fair lending addresses conduct that is accepted industry practice, but when examined critically, shows exclusionary patterns.

The current conventional wisdom believes that competition will eliminate any inherent prejudice.<sup>12</sup> However, regulatory policies intended to detect discrimination in mortgage lending are structurally biased and contribute to inequality by allowing lenders to justify higher, unjustified, and discriminatory prices as legitimate business needs.<sup>13</sup> Whether the borrower's risk actually correlates with the interest rates and fees charged cannot be substantiated.<sup>14</sup> In fact, many lenders' objectives have changed from minimizing the probability of borrower default to maximizing the profits from fees and interest rates.<sup>15</sup> While this switch in objectives may prove beneficial for lenders, problems will arise for borrowers if lenders design credit scoring models using profitability variables based on proxies for prohibited factors, such as race, which do not account for borrowers' actual records of repayment when assessing

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Sturm, *Second Generation Employment Discrimination: A Structural Approach*, 101 COLUM. L. REV. 458, 465-66 (2001); Samuel R. Bagenstos, *The Structural Turn and the Limits of Antidiscrimination Law*, 94 CAL. L. REV. 1, 8 (2006).

<sup>10</sup> See generally MARGERY AUSTIN TURNER & FELICITY SKIDMORE, URBAN INSTITUTE, MORTGAGE LENDING DISCRIMINATION: A REVIEW OF EXISTING EVIDENCE (1999).

<sup>11</sup> The fair lending statutes are comprised of the Fair Housing Act, 42 U.S.C. §§ 3601-3619, 3631 (2006); Community Reinvestment Act, 12 U.S.C. §§ 2901-07 (2006); Home Mortgage Disclosure Act, 12 U.S.C. §§ 2801-10 (2006); Equal Credit Opportunity Act, 15 U.S.C. §§ 1691-1691(f) (2006).

<sup>12</sup> See generally MILTON FRIEDMAN, CAPITALISM AND FREEDOM (1962); ROSS LEVINE ET AL., RACIAL DISCRIMINATION AND COMPETITION (2009).

<sup>13</sup> A structural definition of discrimination views discriminatory decision-making as a by-product of the organizational structure. See Martha Chamallas, *Structuralist and Cultural Domination Theories Meet Title VII: Some Contemporary Influences*, 92 MICH. L. REV. 2370, 2372-78 (1993-1994); Tristin K. Green, *A Structural Approach as Antidiscrimination Mandate: Locating Employer Wrong*, 60 VAND. L. REV. 847 (2007).

<sup>14</sup> See discussion *infra* Part IV.A.2.

<sup>15</sup> Lyn C. Thomas, *A Survey Of Credit and Behavioral Scoring: Forecasting Financial Risk of Lending To Consumers*, 16 INT. J. OF FORECASTING 149, 152 (2000).

creditworthiness.<sup>16</sup> Indeed, as the present foreclosure crisis demonstrates, problems arise for society as a whole when lenders create mortgage obligations based on flawed presumptions of accelerating equity requiring sequential refinancing, rather than on the ability to repay mortgages.<sup>17</sup> Data shows that while borrowers with subprime loans are eight times more likely to default than those with prime conventional loans, more than forty percent of those receiving subprime loans qualified for, but were not offered, prime loans.<sup>18</sup> The regulatory challenge thus faced is how to create competitive pressures in the mortgage markets that will increase efficiency and ensure that prices for mortgage credit are commensurate with risk.<sup>19</sup>

This Article proposes a partial response to the failure of statutory standards

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<sup>16</sup> Lending disparities remain in the pricing of credit for minorities in large measure due to the law's complicit role in neighborhood segregation patterns. See generally Kathleen C. Engel & Patricia A. McCoy, *From Credit Denial to Predatory Lending: The Challenge of Sustaining Minority Homeownership*, in SEGREGATION: THE RISING COSTS FOR AMERICA 81, 82 (James H. Carr, Nandinee K. Kutty eds., 2008). Underwriting considers the location of the property and borrower qualification. Leading scholar, Gary Dymski, argues that there is a void in most housing discrimination studies because of a failure to recognize the connection between the related markets of housing and credit. Specifically, he argues that most housing discrimination studies ignore the connection between the credit market and the housing market. He further contends that the studies ignore common characteristics of individuals living in discriminated neighborhoods. See Gary Dymski, *Discrimination in the Credit and Housing Markets: Findings and Challenges*, in HANDBOOK ON THE ECONOMICS OF DISCRIMINATION 215, 215-259 (William M. Rodgers III ed., 2005); see also generally Keith N. Hylton & Vincent D. Rougeau, *Lending Discrimination: Economic Theory, Econometric Evidence, and the Community Reinvestment Act*, 85 GEO. L.J. 237 (1996); Steven L. Willborn, *The Disparate Impact Model Of Discrimination: Theory And Limits*, 34 AM. U. L. REV. 799 (1985).

<sup>17</sup> The former Chairman of the Federal Reserve Board, Alan Greenspan, conceded that his premise for not regulating the subprime market was based on a "flawed confidence of market self-regulation based on rationality theory." *The Financial Crisis and the Role of Federal Regulators: Hearing Before the H. Comm. on Oversight and Government Reform*, 110th Cong. 11 (2008) (statement of Alan Greenspan, former Chairman, Federal Reserve Board); Joseph Stiglitz, *Regulation and Failure*, in NEW PERSPECTIVES ON REGULATION 11, 17 (David A. Moss & John Cisternino, eds. 2009).

<sup>18</sup> Goldstein, *supra* note 2, at 4-7 (2004) (reporting that borrowers with subprime loans are eight times more likely to default than those with prime conventional loans, yet it has been estimated that between thirty and fifty percent of those receiving subprime loans would, in fact, qualify for prime loans).

<sup>19</sup> The call is for a more synergistic integration of economic policy and legal rules. At the request of Financial Services Committee Chairman Barney Frank (D-MA), the Government Accountability Office ("GAO") conducted a "comprehensive review" of the current state of federal fair-lending enforcement. The report, released in July 2009, found that data enhancement is needed to detect potential fair lending violations. It also suggested that an overhaul of the financial regulatory structure is best to ensure "consistent and effective federal oversight" of fair lending laws. See U.S. GOV'T ACCOUNTABILITY OFFICE, FAIR LENDING: DATA

to discourage lending decisions that produce racial disparity. It argues that there are two unresolved structural issues: (1) determining the economic variables used in the disparate impact regressions, and (2) narrowing the definition of “legitimate business need” to exclude supra-competitive profits. Part II of this Article defines second-generation lending discrimination claims and distinguishes them from first-generation claims. Part II also argues that some of the difficulty in addressing second-generation claims is in the failure of the regulatory system to properly address lenders’ actions in targeting communities, offering products, and categorizing loans as discriminatory. This section ends with a review of Title VII’s effects test and its application in the fair lending context.

Part III discusses the economics of mortgage lending. First, Part III provides background information on credit scoring and underwriting as risk predictors, explaining how statistical testing can incorporate prohibited demographic variables, such as the race and ethnicity of the borrower or the neighborhood, into models and result in a disparate impact. Part III also examines the correlation between statistical discrimination and continuing credit market disparities. Part III concludes that informational asymmetries in the mortgage credit market combined with minority borrower search costs create a market that, though not fully competitive, relies upon and evaluates lender conduct based on competitive market assumptions.

Part IV raises the issue of whether there is racial discrimination in the economic predictors used in mortgage lending credit scoring. It argues that credit scoring if unchecked is an intrinsic, established form of discrimination very similar to redlining. Part IV argues that restoring the proper balance of competitive pressures in the residential mortgage market—both in the origination and refinance markets—begins with reducing informational asymmetries. It posits that the failure of competitive forces to disallow unjustified, and often illegal, interest rate charges also speaks to regulatory failure. Specifically, Part IV also argues for changes to regulatory oversight and testing for disparate impact discrimination.

Using Title VII’s validation of selection requirements as a guide, this Article recommends that the regulatory evaluation of credit scoring models consider the actual performance of similar borrowers to detect whether the criteria used are different when minority borrowers are involved or when property is located in minority communities. This evaluation would be similar to the validation requirement in the employment context where there is an actual measure of a practice as job-related. Lenders operating in noncompetitive subprime mortgage markets should also be required to address how their practices affect lending disparities. In addition, the proposed approach would require regression analysis to take into account, and control for, all measurable variables that



might explain the disparities found.<sup>20</sup> An evaluation of the effects of omitted factors in fair lending models often results in an inaccurate statistical racial estimate of discrimination. A broader fair lending analysis would include race-controlled variables, but would carefully exclude non-race variables to determine whether disparate lending exists. Such an analysis would not only show the true risk-based price correlation to interest rate charges, but would also eliminate the argument that the possibility of default by subprime borrowers justifies a higher interest rate.<sup>21</sup> The result would be greater transparency for all borrowers and a clearer identification of when a legitimate business need exists and justifies lenders charging higher interest rates based on the probability of default. Addressing structural bias at the regulatory level would bring to light which customs, practices, and policies perpetuate racial discrimination.

## II. ASSESSING DISCRIMINATION: A THEORETICAL OVERVIEW

### A. *Maturing Disparities: Second-Generation Fair Lending Claims*

Fair lending laws address discrimination based on disparate treatment or outright bias.<sup>22</sup> When Congress passed Title VIII of the Equal Opportunity Act, lenders “red-lined” minority neighborhoods and denied borrowers loans based on the property location.<sup>23</sup> Current anti-discrimination laws still favor intentional conduct as the basis of a claim.<sup>24</sup> Unfortunately, anti-discrimination laws provide less protection when the injury involves subconscious and less obvious, but equally harmful, forms of discrimination. The persistence of discrimination

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<sup>20</sup> Plaintiffs are not required to rule out all possible variables in order to prevail. See Reynold F. Nesiba, *Racial Discrimination in Residential Lending Markets: Why Empirical Researchers Always See It and Economic Theorists Never Do*, 30 J. of Econ. Issues 51, 60-68 (1996); Bazemore v. Friday, 478 U.S. 385, 400 (1986).

<sup>21</sup> See discussion *infra* Part IV.B.1.

<sup>22</sup> See, e.g., Fair Housing Act, 42 U.S.C. §§ 3601-3619, 3631 (2006); Community Reinvestment Act, 12 U.S.C. §§ 2901-07 (2006); Home Mortgage Disclosure Act, 12 U.S.C. §§ 2801-10 (2006); Equal Credit Opportunity Act, 15 U.S.C. §§ 1691-1691(f) (2006).

<sup>23</sup> Equal Credit Opportunity Act, 15 U.S.C. §§ 1691-1691(f) (2006). The subprime mortgage lending crisis suggests a further need to focus on how red-lining has in fact changed. Wiley E. Rice, *Race, Gender, “Redlining,” and the Discriminatory Access to Loans, Credit, and Insurance: A Historical and Empirical Analysis of Consumers Who Sued Lenders and Insurers in Federal and State Courts, 1950-1995*, 33 SAN DIEGO L. REV. 583, 584 (1996). Subprime lending was steered to minority communities. Minority borrowers and minority communities receive the highest percentage of all subprime loans. Yet, many minority borrowers who receive subprime loans actually qualified for prime loans. See Mechele Dickerson, *Bankruptcy And Mortgage Lending: The Homeowner Dilemma A.*, 38 J. Marshall L. Rev. 19, 34-36 (2004) (documenting the dramatic increase in subprime loans to minority borrowers at 88% and the rate of conventional purchase at 6%).

<sup>24</sup> Rachel F. Moran, *Whatever Happened to Racism?*, 79 ST. JOHN’S L. REV. 899, 912-14 (2005) (discussing antidiscrimination laws and their failure to stop the perpetuation of racial discrimination).

and subordination requires a re-evaluation of whether discrimination in lending is best addressed through traditional civil rights law.<sup>25</sup>

Subprime lending was incontrovertibly steered toward minority communities.<sup>26</sup> The real question is how this happened. One explanation may be based on the way that lenders use credit scoring to ration credit. Lenders do not ration credit exclusively by price, which is why even loan approvals present an issue of discrimination.<sup>27</sup> Indeed, the mortgage credit market has shifted from the credit rationing practice of red-lining to a credit access policy of risk-based pricing.<sup>28</sup> Whether this shift is actually different or facilitates discriminatory

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<sup>25</sup> See Devon Carbado & Mitu Gulati, *The Law and Economics of Critical Race Theory*, 112 YALE L.J. 1757, 1761 (2003) (arguing that law should impose restraints on institutional behavior justified by economics); Lauren B. Edelman, *Rivers of Law and Contested Terrain: A Law and Society Approach to Economic Rationality*, 38 LAW & SOC'Y REV 181, 182 (2004).

<sup>26</sup> Minority borrowers and minority communities received the highest percentage of all subprime loans. However, many minority borrowers who received subprime loans actually qualified for prime loans. As early as 2000, researchers suggested an urgent need to monitor the subprime market. See Anthony Pennington-Cross et al., *Credit Risk and Mortgage Lending: Who Uses Subprime and Why?* 5 (Research Institute for Housing America, Working Paper No. 00-03, 2000). During the 1990s, two studies brought widespread attention to the problem of lending discrimination in the home mortgage market. The Federal Reserve Bank of Boston conducted a comprehensive study of over 3,000 loan applications in the Boston area. The study concluded that lenders rejected minority applicants fifty-six percent more often than they rejected otherwise identical white applicants. See Alicia Munnell et al., *Mortgage Lending in Boston: Interpreting HMDA Data* 27 (Federal Reserve Bank of Boston, Working Paper No. 92-7, 1992); see also James H. Carr & Isaac F. Megbolugbe, *The Federal Reserve Bank of Boston Study on Mortgage Lending Revisited*, 4 J. OF HOUSING RES. 277, 311 (1993) (subsequent analysis of the Boston Federal reserve Bank study confirming its findings and revealing an "even stronger statistical case for discrimination than was originally reported). The Boston Federal Reserve Bank study followed a Pulitzer-prize winning series on lending disparities in Atlanta. See Bill Dedman, *The Color of Money*, ATLANTA J. CONST., May 1, 1988, at A14.

<sup>27</sup> FLORIAN HEIDER, NEW YORK UNIVERSITY STERN SCHOOL OF BUSINESS, RATIONING DESPITE SCREENING: A MOTIF BASED ON PRICE-DISCRIMINATION DEPARTMENT OF FINANCE 4 (November 2002) (explaining how banks in non-competitive markets may use screening to engage in price discrimination).

<sup>28</sup> See generally Joseph E. Stiglitz & Andrew Weiss, *Credit Rationing in Markets with Imperfect Information*, 71 AM. ECON. REV. 393 (1981). The justification for risk-based pricing that is advanced by lenders is that interest rates and fees are based on the characteristics of each borrower and loan, and that the interest rates and fees are carefully calibrated to recover those different risk-based costs. STEPHEN L. ROSS & JOHN YINGER, *THE COLOR OF CREDIT* 79-84 (2002); see also Alan M. White, *Risk-Based Mortgage Pricing: Present and Future Research*, 15 HOUSING POL'Y DEBATE 503, 509-12 & tbls.1, 2 (2004) (explaining subprime lenders' rate matrices); Michael Collins et al., *Exploring the Welfare Effects of Risk-Based Pricing in the Subprime Mortgage Market* 3 (Harvard Univ. Joint Ctr. for Housing Studies, Working Paper No. 04-8, 2004).

practices that result in a disparate impact is the question.

To ration loans exclusively by price does not create a discrimination problem.<sup>29</sup> However, just as asymmetric information supports credit rationing, it can support risk-based pricing.<sup>30</sup> The adverse consequence is that lenders unfavorably determine prices for some borrowers and those borrowers who are either imprudent or unknowing borrowers will accept the higher interest rates.<sup>31</sup> Thus, informational asymmetries capture uninformed borrowers, who ultimately pay higher search costs as a result of their ignorance. If lenders used risk-based pricing across the board for all loans, then interest rates alone would ration credit.<sup>32</sup> Instead, lenders allocate credit using information-based discrimination.<sup>33</sup> Using "parsimonious" credit scoring models, or those with a limited number of explanatory variables, lenders can hide intentionally chosen discriminatory variables.<sup>34</sup>

It is also difficult to discern whether the scoring systems are accurate, specifically, whether they over, or possibly, under-predict minority borrower performance.<sup>35</sup> The legal and regulatory question ought to be whether the particular scoring model provides a valid basis for differential group expectations.<sup>36</sup> It appears indisputable that lenders may choose risk assessment methods that in-

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<sup>29</sup> Robert E. Martin & R. Carter Hill, *Loan Performance and Race*, 38 ECON. INQUIRY 136, 138 (2000) ("Prudent borrowers will be deterred by higher interest rates, while imprudent or dishonest borrowers may be undeterred. The adverse sorting causes expected profit per dollar lent to be concave in interest rates. This leads to a 'bank-optimal' interest rate, beyond which the supply of credit is negatively sloped and where banks ration credit. Martin and Smyth provide statistical evidence that mortgage supply functions are backward bending in interest rates and that the 'bank-optimal' mortgage interest rate is approximately 11%.") (citing Robert E. Martin & David J. Smyth, *Adverse Selection and Moral Hazard Effects in the Mortgage Market: An Empirical Analysis*, SOUTHERN ECON. J., 1071, 1072 (1991)).

<sup>30</sup> See generally N. Restsinas & E. Belsky, *Building Assets, Building Wealth: Creating Wealth in Low-Income Communities*, in *MODES OF CREDIT MARKET REGULATION* (Michael S. Barr, ed. 2005).

<sup>31</sup> *Id.*

<sup>32</sup> The Federal Reserve Board directs lenders to use more "risk-based pricing" as an alternative to rejecting loans. *Id.* at 139 n.9.

<sup>33</sup> Cf. generally Fred Phillips-Patrick & Clifford Rossi, *Statistical Evidence of Mortgage Redlining? A Cautionary Tale*, 11 J. OF REAL ESTATE RESEARCH 13 (1996) (concluding that the evidence of statistical discrimination based on aggregate loan data is inconclusive).

<sup>34</sup> Restsinas & Belsky, *supra* note 30, at 139 n.10 ("As the number of explanatory variables increases, the lender runs the risk of unintentionally establishing a record of statistical discrimination, if the added variables are correlated with race. More variables add explanatory power to the model, and the costs of estimation and data storage are trivial compared with the benefits of lowering default rates.").

<sup>35</sup> *Id.* at 146.

<sup>36</sup> Michael Selmi, *Testing for Equality: Merit, Efficiency, and the Affirmative Action Debate*, 42 UCLA L. REV. 1251, 1291 (1995).

stitutionalize discrimination.<sup>37</sup> This casts doubt on the adequacy of the assessments and models lenders use to predict performance. Additionally, it is quite possible that the instruments used to assess minority creditworthiness might need to be adjusted for general lower income level minority candidates.<sup>38</sup> Without such adjustments, it may be that traditional credit predictors are not adequate indicators of loan performance for minority borrowers.

The appropriate approach for second-generation lending issues is a prospective method that cuts-off the unintentional or sub-conscious bias in decision-making prior to the actual decision-making. First-generation discrimination claims in employment and lending tend to focus on animus.<sup>39</sup> Courts have primarily interpreted the causation factor as the irrational stereotype or harm to the individual, with little or no focus on the organizational environment and the effects of decision-making.<sup>40</sup> Instead, in the lending context, the source of funding is a starting point of inquiry.<sup>41</sup> By identifying the structure under which lenders make their decisions, regulators can more fully assess whether implicit bias influences the decision-making. Moving the focus to the way in which lenders make decisions instead of discrete instances of racial animus allows more scrutiny on whether the bias actually exists. Similarly, in the context of lending, the policies that dictate the decision-making result in discriminatory lending that appears neutral and objective, but in fact have a disparate impact.

Critical to the enforcement of fair lending laws are the regulatory measures designed to halt discriminatory practices.<sup>42</sup> Indeed, reliance on enforcement by regulatory agencies, which adopted a *laissez-faire* approach, was one of the key failures that led to the subprime lending crisis.<sup>43</sup> Economics principles do not

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<sup>37</sup> GUY STUART, DISCRIMINATING RISKS 171-78 (2003).

<sup>38</sup> Michael F. Ferguson & Stephen R. Peters, *Cultural Affinity and Lending Discrimination: The Impact of Underwriting Errors and Credit Risk Distribution on Applicant Denial Rates*, 11 J. FIN. SERV. RES. 153, 158 (1997).

<sup>39</sup> Peter P. Swire, *The Persistent Problem Of Lending Discrimination: A Law And Economics Analysis*, 73 TEX. L. REV. 787, 816 (1995).

<sup>40</sup> Tristin K. Green, *A Structural Approach as Antidiscrimination Mandate: Locating Employer Wrong*, 60 VAND. L. REV. 847, 865 (2007).

<sup>41</sup> See generally Shelly J. Lundberg, *The Enforcement of Equal Opportunity Laws Under Imperfect Information: Affirmative Action and Alternatives*, 106 Q. J. ECON. 309 (1991) (discussing how informational asymmetries lead to under-enforcement of employment discrimination).

<sup>42</sup> Routine supervision requires regulators to examine a financial institution's lending practices for evidence of discrimination. With the passage of the Dodd-Frank Act, the Consumer Financial Protection Agency has the authority to promulgate and interpret rules and regulations under the wide range of fair lending statutes. Dodd-Frank Act, Pub. L. No. 111-203, 124 Stat. 1013 (2010).

<sup>43</sup> Regulatory failure was threefold. First, the de-regulation of mortgage interest rates led to innovation in mortgage lending loans of various types increasing borrowers' debt in general and creating a credit bubble. Second, financial innovation led to investments in the U.S.

justify the presence of discrimination, which is described as irrational and inefficient.<sup>44</sup> Some law and economics scholars would argue that American law has progressed sufficiently. Indeed, these scholars argue that civil rights laws, because they are based on racial animus, are no longer needed.<sup>45</sup> In other words, the markets have been freed to operate efficiently.<sup>46</sup> To some, an efficient market correlates with a plausible, although legally unjustified explanation of legitimate business need.<sup>47</sup> As will be shown below, the disparate impact framework, as the courts have adopted, has a narrow view of causation and makes it difficult to hold lenders responsible for their discriminatory policies and practices. Instead, the framework allows lenders to more readily fashion a business justification for their results.<sup>48</sup>

## B. *The Effects Test*

### 1. Title VII and Employment Law's Disparate Impact Test

Disparate impact in fair lending takes its theoretical basis from Title VII of

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housing market through mortgage-backed securities, creating a housing bubble of rapidly appreciating housing values. Third, policymakers failed to recognize the increasingly important role played by the shadow banking system, which provided substantial credit to the U.S. economy, but was not subject to the same regulations. When an inadequate financial cushion was insufficient to absorb the large loan defaults, the losses impacted the ability of financial institutions to lend, slowing economic activity. *See generally* Patricia A. McCoy & Elizabeth Renuart, *The Legal Infrastructure of Subprime and Nontraditional Home Mortgages* (Harvard Univ. Joint Ctr. for Housing Studies, Working Paper No. UCC08-5 Feb. 2008).

<sup>44</sup> Emily M.S. Houh, *Critical Interventions: Toward an Expansive Equality Approach to the Doctrine of Good Faith in Contract Law*, 88 CORNELL L. REV. 1025, 1025 (2003) ("Rather, other substantive areas of law can and should incorporate expansive equality principles to achieve that end. For example, this Article demonstrates how the implied obligation of good faith in contract law, applied in the at-will employment context, can employ expansive equality principles to provide alternate remedies to at-will employees who may not be able to obtain civil rights remedies because of the onerous burdens they must satisfy in order to prevail on their civil rights claims.").

<sup>45</sup> America's history of racial oppression and the unequal treatment of blacks has often resulted in tense relations between blacks and whites. In 2008, when Barack Obama became the first black person elected President of the United States, many citizens, especially non-minority, concluded that the long history of racial tension and inequality was past. Whether America is post-racial depends not only on explicit conscious attitudes, but on the removal of implicit attitudes and subconscious bias as well. *See generally* GREGORY PARK, *THE OBAMAS AND A (POST) RACIAL AMERICA?* (2011).

<sup>46</sup> *Id.*

<sup>47</sup> *See generally* Ian Ayres, *Back To Basics: Regulating How Corporations Speak to the Market*, 77 VA. L. REV. 945 (1991).

<sup>48</sup> Raymond H. Brescia, *Subprime Communities: Reverse Redlining, the Fair Housing Act, and Emerging Issues in Litigation Regarding the Subprime Mortgage*, 2 ALB. GOV'T L. REV. 164, 210 (2009).

the Civil Rights Act.<sup>49</sup> Under Title VII, the disparate impact theory or "effects" test is appropriate whenever a policy or practice has a disproportionately adverse effect on a protected group.<sup>50</sup> As a statutory remedy, the disparate impact model's sole purpose is to facilitate proof for plaintiffs who are unable to establish discriminatory intent, but who nonetheless can show discrimination through statistical evidence.<sup>51</sup> However, this framework has instead become a confusing doctrine open to an almost unlimited number of interpretations by the courts and regulatory agencies.<sup>52</sup> While disparate treatment requires motive or intent, disparate impact only requires an unequal result that disadvantages minorities.<sup>53</sup> For this reason, courts have been reluctant to apply the theory based on unintentional results and over time have narrowed its scope.<sup>54</sup>

The Supreme Court put forth the fundamental structure of employment law disparate impact in *Griggs v. Duke Power*.<sup>55</sup> In *Griggs*, black potential employees challenged the employer's 'neutral' traditional job criteria requiring workers to have a high school diploma.<sup>56</sup> The Court reasoned that a more searching inquiry into facially neutral policies and practices was warranted to determine if the employer's hiring standards were a business necessity.<sup>57</sup> What made the employer's system discriminatory was not that it was designed to harm black workers intentionally, but that Title VII was specifically designed to make equal employment opportunities available to black workers.<sup>58</sup>

<sup>49</sup> 42 U.S.C. § 2000e-2(k)(1)(A)(i) (2006).

<sup>50</sup> *Id.*

<sup>51</sup> Michael Selmi, *Was the Disparate Impact Theory a Mistake?*, 53 UCLA L. REV. 701, 715 (2006) ("[T]he disparate impact theory was not seen initially as a broad alternative concept of discrimination, but rather, the cause of action originated to deal with specific issues involving past intentional discrimination.").

<sup>52</sup> Stacy E. Seicshnaydre, *Is the Road to Disparate Impact Paved with Good Intentions?: Stuck on State of Mind in Antidiscrimination Law*, 42 WAKE FOREST L. REV. 1141, 1141 (2007).

<sup>53</sup> Disparate impact, similar to the principle of negligence in tort law, creates liability not necessarily because there has been intentional action but because there has been a failure to exercise due care in establishing plans that affect protected group members. See James A. Henderson, Jr., *Why Negligence Dominates Tort*, 50 UCLA L. REV. 377, 380 (2002) ("'Negligence' refers to the failure of an actor (including a commercial enterprise) to take reasonable care to prevent harm caused by the actor's conduct.").

<sup>54</sup> Charles A. Sullivan, *Disparate Impact: Looking Past the Desert Palace Mirage*, 47 WM. & MARY L. REV. 911, 960 (2005).

<sup>55</sup> See generally *Griggs v. Duke Power Co.*, 401 U.S. 424 (1971).

<sup>56</sup> *Id.*

<sup>57</sup> *Id.* at 431. Some scholars recognizing the significance of the disparate impact doctrine to discrimination jurisprudence consider *Griggs* to be results-oriented.

<sup>58</sup> See Linda Hamilton Krieger, *The Content of Our Categories: A Cognitive Bias Approach to Discrimination and Equal Employment Opportunity*, 47 STAN. L. REV. 1161, 1231 (1995) ("[T]he disparate impact paradigm as currently constructed is an inappropriate analytical tool for addressing the intergroup biases inherent in subjective decision making.").

The Court found that the employer's requirement of a high school diploma to qualify for the job did not have a manifest relationship to the performance criteria of the job, and was instead discriminatory.<sup>59</sup> However, the court also developed the business necessity test as a way for an employer to provide a legitimate reason for a requirement which results in a disparate impact on minorities.

Following *Griggs*, there were a series of cases in which the Supreme Court continuously cut-back on the disparate impact doctrine.<sup>60</sup> The most controversial was *Wards Cove v. Antonio*.<sup>61</sup> *Wards Cove* represented a major shift in plaintiffs' rights in disparate impact cases in three respects. Under *Wards Cove*, the business necessity test favored the employer.<sup>62</sup> First, plaintiffs would have to identify the "specific or particular employment practice" that resulted in the disparate impact, rather than merely a generalized disparity in the workplace, as had previously been accepted. Second, rather than having to show that its policy was job-related and consistent with business necessity, the defendant's policy justification would be subject to only a "reasoned review." Finally, the burden of proof would "remain with the plaintiff at all times." Even when the employer asserted its justification for the discriminatory policy, its burden would only be one of production, not of persuasion. While employers had to provide a business basis for the challenged facially neutral policy, the business basis did not have to be essential or indispensable to pass muster.<sup>63</sup> In reaction to *Wards Cove*, Congress codified *Griggs*, making disparate impact an unlawful employment practice in the 1991 Civil Rights Act.<sup>64</sup>

Disparate impact has been extended to other circumstances involving neutral standards and criteria having an adverse impact.<sup>65</sup> For example, an employer may have an overall selection process that has no disparate impact, but can be found liable under Title VII if an individual part of its practice has a disparate impact.<sup>66</sup> The Court has also held that subjective criteria can be scrutinized

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<sup>59</sup> *Griggs*, 401 U.S. at 431.

<sup>60</sup> *Id.* at 424; *McDonnell Douglas v. Green*, 411 U.S. 792 (1973); *Albemarle Paper v. Moody*, 422 U.S. 405 (1975); *Teamsters v. United States*, 431 U.S. 324 (1977); *Wards Cove Packing Co. v. Antonio*, 490 U.S. 642 (1989).

<sup>61</sup> *Wards Cove*, 490 U.S. at 642.

<sup>62</sup> *Id.* at 657, 659.

<sup>63</sup> *Id.* at 677.

<sup>64</sup> Civil Rights Act of 1991, Pub. L. No. 102-166, 105 Stat. 1071 (codified as amended in scattered sections of 2, 16, 29); 42 U.S.C.A. § 1981 (2006).

<sup>65</sup> In *Griffin v. Carlin*, 755 F.2d 1516, 1525 (11th Cir. 1985), the Eleventh Circuit applied the disparate impact test to the subjective criteria. The Fifth Circuit refused to do so in *Pouncy v. Prudential Ins. Co. of Am.*, 668 F.2d 795, 801 (5th Cir. 1982) because the employee failed to identify a specific employment practice. The D.C. Circuit seemed to strike a balance in *Segar v. Smith*, 738 F.2d 1249, 1288 (D.C. Cir. 1984) by applying a disparate impact analysis by applying the model to an identified employment practice.

<sup>66</sup> *Connecticut v. Teal*, 457 U.S. 440, 442 (1982).

because these employment practices could be manipulated for discriminatory purposes.<sup>67</sup> This reasoning requires employers to develop explicit hiring guidelines and selection procedures that are job-related and consistent with business necessity.<sup>68</sup> Failure to show that a challenged policy or practice is essential to the skills needed for successful job performance creates employer liability. Employment practices that have been successfully challenged as not having a business justification include written tests,<sup>69</sup> subjective evaluations,<sup>70</sup> age,<sup>71</sup> height and weight requirements,<sup>72</sup> and physical tests.<sup>73</sup> A specific policy or practice should be associated with the skills needed to perform the job successfully, in contrast to a general measurement of an applicant's or employee's abilities.

The disparate impact doctrine analysis involves a burden-shifting test requiring validation of empirical and statistical data.<sup>74</sup> To present a *prima facie* case, a plaintiff must show that a particular employment practice has caused an adverse impact to a protected class.<sup>75</sup> Evidence of the disparity must be sufficiently substantial.<sup>76</sup> The disparity must be shown to exist with respect to a pool of qualified persons, which is usually the applicant pool.<sup>77</sup> After showing the existence of the disparity, the burden shifts to the employer to establish the fairness of the predictive test, and that the challenged practice has a business necessity.<sup>78</sup> The burden then shifts back to the plaintiff to show a less burden-

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<sup>67</sup> *Watson v. Fort Worth Bank & Trust*, 487 U.S. 977, 1009-10 (1989).

<sup>68</sup> *See, e.g., McLain v. Lufkin Indus., Inc.*, 187 F.R.D. 267, 273-77 (E.D. Tex. 1999) (holding the employer's subjective hiring practices actionable and a basis for class certification).

<sup>69</sup> *Fickling v. N.Y. State Dep't of Civil Serv.*, 909 F. Supp. 185, 193 (S.D. N.Y. 1995).

<sup>70</sup> *McLain*, 187 F.R.D. at 273-77.

<sup>71</sup> *Merritt v. Well Point, Inc.*, 615 F.Supp. 2d 440, 440 (E.D. Va. 2009).

<sup>72</sup> *Dothard v. Rawlinson*, 433 U.S. 321, 332 (1977).

<sup>73</sup> *Id.*

<sup>74</sup> A *prima facie* disparate impact case requires the plaintiff to identify a specific policy or practice that creates a statistical disparity for minorities. The employer must then justify the challenged act as a business necessity. The burden then shifts back to the plaintiff to show a less adverse alternative to such a policy or practice.

<sup>75</sup> 42 U.S.C. § 2000e-2(k)(1)(A)(i) (2006).

<sup>76</sup> *See Watson v. Fort Worth Bank & Trust*, 487 U.S. at 977, 995; *see also* Jennifer L. Peresie, *Toward a Coherent Test for Disparate Impact Discrimination*, 84 IND. L.J. 773, 792 (2009) (arguing that the "substantial disparity" requirement choice of tests should be less ambiguous and that courts should combine the four-fifths and statistical significance tests).

<sup>77</sup> 42 U.S.C. § 2000e-2(k)(1)(A)(i) (2006).

<sup>78</sup> Courts have adopted varying interpretations of business necessity ranging from "business necessity sufficiently compelling to justify the challenged practice," *Betsey v. Turtle Creek Assoc.*, 736 F.2d 983, 988 (4th Cir. 1984), to a "legitimate, non-pretextual justifications" for its actions, *Mountain Side Mobile Estates v. Sec'y of Hous. & Urban Dev.*, 56 F.3d 1243, 1257 (10th Cir. 1995), to a "legitimate business reason" in *Kovacevich v. Kent State Univ.*, 224 F.3d 806, 830 (6th Cir. 2000); *see also*, *Graoch Assoc. #33, L.P. v. Louis-*



some alternative.<sup>79</sup> The alternative must be proven to be equally efficient and cost-effective.<sup>80</sup> The fair lending disparate impact test is drawn exclusively from Title VII.<sup>81</sup> As will be discussed below, fair lending is distinguishable from employment in several respects and requires a different test in order to meet its goals.

## 2. Fair Lending Disparate Impact Test and Regulation B

The fair lending laws comprise four statutes enacted over a ten-year period.<sup>82</sup> The Equal Credit Opportunity Act ("ECOA")<sup>83</sup> and the Fair Housing Act ("FHA Act")<sup>84</sup> specifically prohibit discrimination in lending and thus regulate implicit bias in the marketplace.<sup>85</sup> These statutes are interrelated and, as a body of law, are designed to create fair and equitable access to credit for minorities.<sup>86</sup> Congress enacted the ECOA primarily for the purpose of eliminating discrimination in credit transactions. It is most prominently used in fair lending challenges against private creditors.<sup>87</sup> As a result, enforcement efforts have increased as credit access has become more available to minorities.<sup>88</sup> As in Title

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ville/Jefferson County Metro Human Relations Comm'n, 508 F.3d 366, 387-90 (6th Cir. 2007) (Moore, J., concurring in part and dissenting in part) (distinguishing different burdens of proof and production in disparate impact cases).

<sup>79</sup> See *Graoch*, 508 F.3d at 379.

<sup>80</sup> The Uniform Guidelines require that each validation study include "an investigation of suitable alternative selection procedures and suitable alternative methods of using the selection procedure which have as little adverse impact as possible, to determine the appropriateness of using or validating them in accord with these guidelines." See 29 C.F.R. § 1607.14B(2)-(3) (1997). Commentary Paragraph 6(a)-2 indicates that a defendant in a disparate impact case need only demonstrate a legitimate business need that cannot reasonably be achieved by means that are less disparate impact.

<sup>81</sup> 42 U.S.C. § 2000e, et. seq.

<sup>82</sup> Congress passed The Fair Housing Act, 12 U.S.C. §§ 2801-2810, in 1968 as a companion to the Civil Rights Act. Congress enacted subsequent statutes, The Equal Credit Opportunity Act ("ECOA"), 15 U.S.C. § 1691-1691f, The Home Mortgage Disclosure Act, 42 U.S.C. §§ 3601-3619, and the Community Reinvestment Act, 15 U.S.C. § 1691 (1994), in 1974, 1976 and 1977, respectively.

<sup>83</sup> 15 U.S.C. § 1691 (2006).

<sup>84</sup> 42 U.S.C. § 3601 (2006).

<sup>85</sup> 15 U.S.C. §§ 1691 et seq.

<sup>86</sup> Swire, *supra* note 39, at 801-07.

<sup>87</sup> Most challenges under the fair lending laws have involved various forms of disparate treatment with the Department of Justice ("DOJ") as the primary enforcer. See generally Craig E. Marcus, *Beyond The Boundaries Of The Community Reinvestment Act And The Fair Lending Laws: Developing A Market-Based Framework For Generating Low- And Moderate-Income Lending*, 96 COLUM. L. REV. 710 (1996) (comparing the efficaciousness of the disparate treatment and disparate impact tests).

<sup>88</sup> See generally Grace Chung, U.S. Dep't of Justice, Written Statement for the National Commission on Fair Housing and Equal Opportunity Concerning The Enforcement Program

VII, fair lending disparate impact is a burden-shifting test, with the initial burden of proof on the plaintiff.<sup>89</sup> After the plaintiff identifies the challenged practice that has a disproportionate adverse effect on a protected class, the burden shifts to the defendant to prove that the practice was needed because of a "business necessity."<sup>90</sup>

The Federal Reserve Board's ("FRB") Regulation B focuses on the fair treatment of customers in the granting of credit.<sup>91</sup> The regulation requires lenders to grant credit based on the borrower's ability to meet the lender's credit standards and prohibits the lender's consideration of race, age or marital status of the borrower in making that decision.<sup>92</sup> After the *Ward's Cove* decision, the FRB revised its rules to reject explicitly the Supreme Court's test for disparate impact in that case, and to adopt the burden of proof allocation from the 1991 Civil Rights Act. This change is significant because the legitimate business justification for a post-*Wards Cove* plaintiff under the case law eased the lender's evidentiary burden.<sup>93</sup> In defending a challenged practice, the lender only needed to produce evidence that its system was validated as predictive.<sup>94</sup> The 1991 Civil Rights Act requires the lender to prove that the chosen model has accurate predictive value.<sup>95</sup>

The disparate impact test under the fair lending statute has been the subject of substantial litigation in recent years.<sup>96</sup> Courts have clarified what conduct is

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of the Housing and Civil Enforcement Section of the Civil Rights Division of the U.S. Dep't of Justice (2008) (discussing the Department of Justice's recent enforcement actions under the FHA, including lending discrimination cases).

<sup>89</sup> *McDonnell Douglas Corp. v. Green*, 411 U.S. 792 (1973).

<sup>90</sup> *Id.* at 804-05.

<sup>91</sup> 12 C.F.R. § 202.6(a) (2011).

<sup>92</sup> The FRB has the authority to implement the ECOA and does so by implementing Regulation B. *See* 15 U.S.C. § 1691(a) (2000). Regulation B focuses on the fair treatment of customers in the granting of credit. The regulation requires lenders to grant credit based on the borrower's ability to meet the lender's credit standards and prohibits the lender's consideration of race, age or marital status of the borrower in making that decision. *See* 15 U.S.C. § 1691(a) (2000); 12 C.F.R. § 202 (2007).

<sup>93</sup> The Tenth Circuit Court of Appeals considered disparate impact under the FHA in *Mountain Side Mobile Estates P'ship v. Sec'y of Hous. & Urban Dev.*, 56 F.3d 1243 (10th Cir. 1995) (*Mountain Side* is significant because it was after *Wards Cove* and adopts the *Ward's Cove* test verbatim).

<sup>94</sup> *But see* discussion *infra* page 270. At least one commentator argues that the absence of statutory language indicates that there is not an effect or disparate impact test authorized under the statute. *See, e.g.,* Peter Cubita & Michelle Hartmann, *The ECOA Discrimination Proscription and Disparate Impact—Interpreting the Meaning of the Words That Actually Are There*, 61 Bus. L. 829 (2006).

<sup>95</sup> 42 U.S.C. § 2000e-2(k)(1)(A)(i) (2006).

<sup>96</sup> Recent fair lending litigation involving DOJ and its enforcement of the fair lending statutes raises claims of "redlining," in which financial institutions are claimed to deny credit in areas with large minority populations, rather than granting credit in a discriminatory man-

discriminatory and what lenders can or should do to avoid discriminatory conduct. However, the distinctions that clarify the proper role of business necessity in lending remain in question.<sup>97</sup> In applying the business necessity test, few courts have discussed the differences between Title VII and Title VIII.<sup>98</sup>

While principles of efficiency and productivity underlie all business decision-making, what constitutes a business justification depends on the issue. By its nature, employment law and hiring require more of an evaluation of personal characteristics than in the fair lending arena. Under Title VII, typical characteristics related to job performance serve as appropriate limitations and require that the employer make fine line distinctions in establishing the criteria.

By contrast, imposing those types of limitations in an efficient market context is inapposite to the concept of risk-based pricing. While undoubtedly the purpose is to increase business volume while reducing the costs associated with defaults or other financial losses, the prerequisite is that achieving the goal be within a pre-determined business objective. Under Title VIII governing fair lending, the exceptions justifying a legitimate business decision should be narrowly confined to the borrower's ability to repay the obligation. Other personal characteristics unrelated to the borrower's income or earning ability, such as education, occupation, or level of skill within an occupation, should be irrelevant.<sup>99</sup> A law requiring a rigorous analysis to root out these kinds of subjective criteria, which lead to discriminatory lending practices, is both necessary and desirable.<sup>100</sup>

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ner. The parties have entered into a consent decree after settling the cases; therefore, it is difficult to know the basis of the claims brought by DOJ against the financial institutions. *See* United States v. Nationwide Nevada, LLC, No. 2:08-cv-1309 (D. Nev. Sept. 30, 2008) (consent decree); United States v. Centier Bank, No. 2:06-CV-344 (N.D. Ind. Oct. 16, 2006) (consent decree); United States v. First American Bank, No. 04 C 4585 (N.D. Ill. Jul. 19, 2004) (consent decree).

<sup>97</sup> Whether the test remains a "legitimate business justification" or has become the less stringent legitimate business need seems unresolved, although the FRB Commentary accompanying Regulation B states, "the regulation may prohibit a creditor practice that is discriminatory in effect . . . unless the creditor practice meets a *legitimate business need* that cannot reasonably be achieved as well by means that are less disparate in their impact."

<sup>98</sup> The exception is the court in *Fair Housing in Huntington Comm. Inc. v. Huntington*, 316 F. 3d 357, 366 (2d Cir. 2003); *see also* Resident Advisory Bd. v. Rizzo, 564 F. 2d 126, 148-49 (3d Cir. 1977) (a pre-*Wards Cove* case).

<sup>99</sup> Title VII allows an employer to create a bona fide occupational qualification ("BFOQ") exception. 42 U.S.C. § 2000e-2(e)(1) (2006). The exception is interpreted very narrowly. *See* Dothard v. Rawlinson, 433 U.S. 321, 332-34 (1977).

<sup>100</sup> Under both the FHA and the ECOA, lenders or other creditors have been sued under a disparate impact theory. "Legitimate business justification" appears to be the standard in cases involving only the ECOA and in cases involving mixed issues under the FHA and ECOA cases. Perhaps the most important of these cases is *Cartwright v. American Savings & Loan Ass'n*, involving a landlord defendant accused of discrimination and redlining in

### 3. The Reverse Redlining Cases

"Reverse redlining" refers to the practice of targeting predatory loans at urban, minority communities that in the past were denied the ability to obtain credit.<sup>101</sup> The largely unregulated subprime mortgage market—in both its residential and refinance sectors—targeted lower and moderate income communities, often comprised of minority borrowers who were financially unsophisticated and illiterate. When applying federal antidiscrimination law, several district courts have addressed the reverse redlining issue.<sup>102</sup> Each court struggled with the complexity of the fair lending scheme and specifically, with the issue of causation.<sup>103</sup> These courts have raised three important questions:

First, what is the appropriate test (or tests) to apply in the context of a reverse redlining case, whether disparate treatment or disparate impact is alleged? . . . [S]ome of the courts have established a single test regardless of the approach. Second, can a plaintiff establish "direct evidence" of discrimination through allegations of racial targeting as a means of side-stepping the burden shifting framework? Third, what are the appropriate methods for establishing disparate impact through statistical evidence?<sup>104</sup>

In two cases, district courts have followed the line of reasoning in *Matthews v. New Century Mortgage Corp.*<sup>105</sup> These courts seem to have reached a consensus that a prima facie case of discrimination in a reverse redlining requires the plaintiff to establish that: (1) the plaintiff is a member of a protected class;

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denying a mortgage loan. 880 F.2d 912 (7th Cir. 1989). There, the court defined legitimate business interests as making an investment that is "economically sound." *Id.*

<sup>101</sup> Benjamin Howell, *Exploiting Race and Space: Concentrated Subprime Lending as Housing Discrimination*, 94 CAL. L. REV. 101, 143-44 (2006).

<sup>102</sup> In one of the first reverse redlining cases, *Honorable v. Easy Life Real Estate Systems*, the court considered the case under an "exploitation theory" of discrimination. 100 F. Supp. 2d 885, 887, 892 (N.D. Ill. 2000). See, e.g., *Clark v. Universal Builders, Inc.*, 706 F.2d 204, 206 (7th Cir. 1983).

<sup>103</sup> *Id.*

<sup>104</sup> *Matthews v. New Century Mortgage Corp.*, 185 F. Supp. 2d 874, 886 (S.D. Ohio 2002); *Honorable v. Easy Life Real Estate Systems*, 100 F. Supp. 2d 885, 887, 892 (N.D. Ill. 2000); *Barkley v. Olympia Mortgage Co.*, 2007 WL 2437810, at \*1 (E.D.N.Y. Aug. 22, 2007); *Ramirez v. Greenpoint Mortgage Funding, Inc.*, 2008 WL 2051018, at \*1 (N.D.Cal. May 13, 2008); *Miller v. Countrywide Bank, N.A.*, 571 F. Supp. 2d 251 (D. Mass. 2008); *Taylor v. Accredited Home Lenders, Inc.*, 2008 WL 4446551, at \*1 (S.D. Cal. Sept. 19, 2008); see also *Brescia*, *supra* note 48, at 186.

<sup>105</sup> The court in *Barkley v. Olympia* followed the *Matthews* line of reasoning. *Matthews v. New Century Mortgage Corp.*, 185 F. Supp. 2d 874, 886 (S.D. Ohio 2002) (explaining that the plaintiff is required to show that the "lender refused to transact business on fair terms"). The courts in *Ramirez v. Greenpoint Mortgage Funding, Inc.*, *Miller v. Countrywide Bank*, and *Taylor v. Accredited Home Lenders, Inc.* have evaluated subprime lenders' use of discretionary and subjective techniques in pricing the subprime loans offered to borrowers of color.

(2) the plaintiff applied and qualified for a loan; (3) a loan was given on grossly unfavorable terms; and, (4) the lender continued to provide loans to other applicants with similar qualifications, but on significantly more favorable terms.<sup>106</sup> Alternatively, a plaintiff may present evidence that the lender intentionally targeted her for unfair loans on the basis of sex or marital status. Here, the plaintiff need not show that the lender made loans on more favorable terms to others.<sup>107</sup> Disparate impact's problematic scheme shows that courts do not feel comfortable applying a different test based on allegations of disparate impact and usually resort to requiring a showing of intent when proving that the policies or practices have a disparate impact.

### III. THE ECONOMICS OF MORTGAGE LENDING

#### A. Addressing Racial Discrimination in Economic Predictors

Addressing economic discrimination requires reconciling legal principles with economic theory.<sup>108</sup> The subprime mortgage crisis revealed an inherent conflict between lending rules and financial incentives.<sup>109</sup> However, many have over-looked the disparate impact of credit scoring and automatic under-

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<sup>106</sup> Brescia, *supra* note 48, at 186.

<sup>107</sup> *Id.* The five cases are: *Miller*, 571 F. Supp. 2d at 251; *Ramirez*, 633 F. Supp. 2d at 922; *Barkley*, 2007 WL 2437810 at \*1; *Munoz v. Int'l Home Capital Corp.*, 2004 WL 3086907, at \*4 (N.D.Cal. May 4, 2004); *Matthews*, 185 F. Supp. 2d at 886.

<sup>108</sup> Keith N. Hylton, *Lending Discrimination: Economic Theory, Econometric Evidence, And The Community Reinvestment Act*, 85 Geo. L.J. 237, 254 (1996). In the context of lending discrimination, taste discrimination evaluates potential borrowers on characteristics unrelated to loan performance. *Id.* Market theorists describe this discrimination as inefficient and not profit-maximizing for the firm. An individual lender may have a taste for discrimination. Under market theory, the lender is willing to pay an additional price not to pursue an opportunity, in order to discriminate. In a competitive market, non-discriminating firms are willing to lend to those who are discriminated against at attractive rates. Taste discrimination cannot survive in the face of competition. The lender wishing to discriminate would eventually be eliminated by competitive market forces. Efficient market theorists argue, therefore, that discrimination is inefficient and requires no governmental controls or intervention. *See generally* Kenneth J. Arrow, *The Theory of Discrimination*, in *DISCRIMINATION IN LABOR MARKETS* 3 (Orley Ashenfelter & Albert Rees eds., 1973).

<sup>109</sup> Sub-prime loans present financial advantages for lenders because they are priced according to the riskiness that the borrower presents. Minorities accounted for forty-nine percent of the increase in home ownership from 1995 to 2005. *See* Goldstein *supra* note 2. African-Americans and Hispanics are disproportionately represented in the subprime mortgage market. Studies conducted by HUD, Fannie Mae, Freddie Mac, and others show that minority borrowers, especially in urban areas, are disproportionately represented in the subprime market. This fact has led some commentators to assert that fair lending rules are responsible for the crisis. However, that assertion without a knowledgeable understanding of the home mortgage market obfuscates the problem. Risk-based or subprime lending is important to the economy from the perspective of lenders and borrowers.

writing as predictive methods of risk assessment, and whether these methods produce informational asymmetries that lead to statistical discrimination.

Lenders use predictive analysis, *e.g.*, methods such as credit scoring and underwriting, to determine a potential borrower's willingness to repay a loan.<sup>110</sup> Lenders also have a perverse incentive to use credit scoring and underwriting to maximize profits.<sup>111</sup> When left unchecked, what many describe as a legitimate response to risk is actually lending discrimination.<sup>112</sup>

### 1. Credit Scoring

Historically, we were not willing to lend because banks did not have access to large supplies of credit. This short supply of credit resulted in lenders rationing credit.<sup>113</sup> A more abundant supply of credit has allowed lenders to segment the market and identify borrowers who are able to repay loan obligations and willing to pay above-market interest rates or receive subprime loans.<sup>114</sup> The credit scoring process involves developing a statistical model from historical data to determine a potential borrower's ability to pay.<sup>115</sup> A credit score is actually a composite of differently weighted variables and is based on a comparison of a potential borrower's weighted values with an actual borrower's

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<sup>110</sup> See Michael Abramowicz, *Predictive Decision Making*, 92 VA. L. REV. 69 (2006) (recommending predictive analytics as a replacement to the law's vague rules and normative standards). See also Jeanne L. Schroeder, *Rationality in Law and Economics Scholarship*, 79 OR. L. REV. 147 (2000) (comparing the perspectives of neo-classical and behavioral economists on analytic and predictive measures).

<sup>111</sup> Susan Block-Lieb, *The Myth Of The Rational Borrower: Rationality, Behavioralism, and the Misguided "Reform" of Bankruptcy Law*, 84 TEX. L. REV. 1481, 1517-18 (2006).

<sup>112</sup> This was a concern when the ECOA was amended to add credit scoring in 1976. See S. Rep. No. 94-589, at 4-5 (1976) (statement of Sen. Joseph Biden) (expressing concerns about inaccurate predictions). See Janet Sonntag & Warren L. Dennis, *Fair Lending and Credit Scoring*, 56 MORTGAGE BANKING 55, 55 (1995).

<sup>113</sup> See Helmut Bester, *Screening vs. Rationing in Credit Markets with Imperfect Information*, 75 AM. ECON. REV. 850, 854 (1985) (positing that credit is rationed in markets that have ineffective screening and that borrowers with a higher probability of default choose a higher interest rate).

<sup>114</sup> The securitization of mortgage-backed securities increased the credit supply for higher risk borrowers. See Georgette C. Poindexter, *Subordinated Rolling Equity: Analyzing Real Estate Loan Default in the Era of Securitization*, 50 EMORY L.J. 519 (2001); see also Christopher L. Peterson, *Predatory Structured Finance*, 28 CARDOZO L. REV. 2185, 2202-03 (2007).

<sup>115</sup> The large savings in costs and time that have accompanied the use of credit scoring are generally believed to have increased access to credit, promoted competition, and improved market efficiency. See generally Chiwon Yom, *Limited-Purpose Banks: Their Specialties, Performance, and Prospects*, 17 FDIC BANKING REV. 19, 20 (2005), <http://www.fdic.gov/bank/analytical/banking/2005apr/article2.pdf> (discussing the use of credit scores).

weighted value.<sup>116</sup>

Today, automated credit decision-making has replaced human judgments.<sup>117</sup> When used in its optimal configuration, credit scoring models evaluate the credit risk of some sort of homogenous subpopulation.<sup>118</sup> The calculation analyzes multivariate correlations, identifies the relevant trade-offs among factors, and assigns statistically derived weights used in the model.<sup>119</sup> Primarily, the model is an assessment of the relationship between pre-determined variables.<sup>120</sup> Using a sample of past credit users, a lender incorporates variables and assigns weights to them based on the probability of past borrowers to make timely, voluntary payments.<sup>121</sup>

Borrower creditworthiness involves evaluating factors that review repayment behavior and reveal the borrower's attitudes toward debt.<sup>122</sup> Credit history reveals past and existing mortgage debt, installment and revolving credit, and past credit problems, such as collections, repossessions, foreclosures and bank-

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<sup>116</sup> See generally L.C. Thomas et al., *Recalibrating Scorecards*, 52 J. OF THE OPERATIONAL RESEARCH SOCIETY 981 (2001) (discussing the properties that go into creating a credit score). The term, credit scoring, incorporates several different concepts. At its core, credit scoring means applying a statistical model: (1) to assign a risk score to evaluate applications for credit, (2) to identify prospective borrowers; and, (3) to manage existing credit accounts. *Id.* Credit scoring is widely used to evaluate applications for credit, identify prospective borrowers, and manage existing credit accounts. 15 USC §§ 1691-1691f (1994 & Supp IV 1998). Credit scores evaluate previous credit performance, the current level of indebtedness, the length of credit history, the types of credit in use, and the pursuit of new credit.

<sup>117</sup> The judgmental approach is best described as relational. It grants credit based on personal knowledge of the applicants, their standing in the community, and maybe even the applicants' appearance. Judgmental credit granting models have by and large been replaced by statistical scoring models. See David J. Hand et al., *Credit Scoring: A Future Beyond Empirical Models*, THE CAPCO INSTITUTE J. OF FIN. TRANSFORMATION 121, 122 (2008).

<sup>118</sup> Statistical models are often described as a scorecard, a pooled scorecard, and a custom scorecard. A scorecard uses data from one firm. A pooled scorecard uses data from many firms. A custom scorecard blends a statistical model with some of the factors used in a judgmental model. *Id.*

<sup>119</sup> Empirical scoring is a straightforward, very traditional method of credit analysis and sometimes is referred to as data-driven or descriptive credit modeling. Robert P. Lieli & Halbert White, *The Construction of Empirical Credit Scoring Models Based on Maximization Principles*, 157 J. OF ECONOMETRICS 110, 116-119 (2010).

<sup>120</sup> See generally Bruce Wydick, *Group Lending under Dynamic Incentives as a Borrower Discipline Device* (Rev. of Dev. Econ., Working Paper No. DE#9151, 2000) (this paper develops a simple game-theoretic model of group lending).

<sup>121</sup> See generally Noel Capron, *Credit Scoring Systems: A Critical Analysis*, 46 J. OF MARKETING 81 (1982) (describing credit scoring systems and critiquing their efficacy).

<sup>122</sup> ANTHONY M. SANTOMERO, WHARTON FINANCIAL INSTITUTIONS CENTER, FINANCIAL INSTITUTIONS CENTER COMMERCIAL BANK RISK MANAGEMENT: AN ANALYSIS OF THE PROCESS 3-5 (1996) (discussing how banks evaluate risk and eliminate risks through risk transfer).

ruptcies to produce an overall credit score.<sup>123</sup>

A mathematical formula correlates significant industry factors to the past performance of borrowers.<sup>124</sup> The model construct is usually a linear regression analysis of potential predictors based on a determined number of variables. The variables on which the prediction is based are usually selected based on their profit-maximizing predictability.<sup>125</sup> The comparison of the "lower-scoring applicants" with the actual scores of well-performing borrowers is made to determine if the applicants can meet the lender's pre-determined level of risk.<sup>126</sup> An empirical model is easy to understand and augment, but unlike the iconic model, its predictive variables do not bear any relationship to the resulting responses.<sup>127</sup> The advantage of credit scoring as a screening device is that the information evaluated supposedly bears no explicit relationship to the borrower's immutable characteristics.<sup>128</sup> Lenders determine both whether a borrower has the ability to repay the loan, as well as whether the payments will be timely by evaluating a borrower's past credit history.<sup>129</sup> Lenders weigh this credit history along with information from other sources to assess the lending risks and screen borrowers. When lenders use this type of objective data, the borrower benefits.<sup>130</sup>

However, if the predictive variables used in the credit-scoring model are improper, they hide unfair procedures and processes.<sup>131</sup> The increase in lending discrimination raises a valid concern not only about the inherent deficiencies in

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<sup>123</sup> Capron, *supra* note 121.

<sup>124</sup> *Id.*

<sup>125</sup> The determination of which factors to use, and how each will be scored and weighed, is generally based on the performance of past customers, the products and services sold, and the industry standards. *Id.*

<sup>126</sup> *Id.*

<sup>127</sup> The determination of which factors to use, and how each will be scored and weighted, is generally based the performance of past customers, the products and services sold and the industry standards. An empirical model is easy to understand and augment but unlike the iconic model, its predictive variables do not bear any relationship to the resulting responses. Hand, *supra* note 117, at 124.

<sup>128</sup> Cf. Noel Capron, *Discrimination in Screening Credit Applicants*, 56 HARV. BUS. REV. 1, 8-12 (1978) (positing that scoring systems, although purportedly based on objective information, allow arbitrary discrimination).

<sup>129</sup> Charu A. Chandrasekhar, *Can New Americans Achieve The American Dream? Promoting Homeownership In Immigrant Communities*, 39 HARV. C.R.-C.L. L. REV. 169, 181 (2004).

<sup>130</sup> Iconic modeling, a type of statistical model, represents a system of equations that bear a relationship to a defined credit market. It is distinguished from the empirical model in that it relies on well-formulated and predictive theories. See generally Loretta J. Mester, *What's the Point of Credit Scoring?*, FED. RESERVE BANK OF PHILADELPHIA BUS. REV. (1997).

<sup>131</sup> For example, a study of credit scoring and loan approval rates in the automobile insurance industry revealed that credit scoring was unfavorable to minorities. See, e.g., CHI CHI WU, CONSUMERLAW.ORG, CREDIT SCORING AND INSURANCE: COSTING CONSUMERS BIL-



credit models, but also about the impact of using those models as screening devices for loan terms and interest rates.<sup>132</sup> As discussed below, the borrower's characterization as subprime may be advantageous to both the lender and the underwriter.

## 2. Underwriting

Underwriting is the process of evaluating the risk of extending credit. Whether this is distinct from credit scoring when used in integrated risk assessment systems is open for debate.<sup>133</sup> Nevertheless, the underwriting process has implications for fair lending compliance that have been largely overlooked.<sup>134</sup> Underwriting is a critical component of lending.<sup>135</sup> Underwriting determines the borrower's financial qualifications and assesses if the borrower is a sound

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LIONS AND PERPETUATING THE ECONOMIC RACIAL DIVIDE 12-17 (2007), <http://www.consumerlaw.org/reports/content/InsuranceScoring.pdf>.

<sup>132</sup> Cf. Sonntag, *The Debate over Credit Scoring*, 56 MORTGAGE BANKING 46 (1995); Bester, *supra* note 113, at 854; and, Sonntag, *supra* note 112, at 55 (positing that credit is rationed in markets that have ineffective screening and that borrowers with a higher probability of default choose a higher interest rate). Section 215 of the Fair and Accurate Credit Transactions Act of 2003 ("FACT Act") directs the Federal Reserve Board and the Federal Trade Commission ("FTC") to study how credit scoring has affected the availability and affordability of credit and insurance, to determine the relationship between credit scores and actual credit losses and insurance claims, and to determine how these relationships vary for the population groups protected under the Equal Credit Opportunity Act ("ECOA"). In addition, section 215 directs the Board and the FTC to study the extent to which the consideration of certain factors included in credit scoring models could have a negative or differential effect on populations protected under ECOA and the extent to which alternative factors could be used in credit scoring to achieve comparable results with less negative effects on protected populations. Many who have studied the issue of adverse impact view it in terms of lost opportunity costs. See generally BD. OF GOVERNORS OF THE FED. RESERVE SYS., REPORT TO THE CONGRESS ON CREDIT SCORING AND ITS EFFECTS ON THE AVAILABILITY AND AFFORDABILITY OF CREDIT (2007) [hereinafter FRB REPORT TO CONGRESS ON CREDIT SCORING]. That report concluded that "[t]here is no compelling evidence, however, that any particular demographic group has experienced markedly greater changes in credit availability or affordability than other groups due to credit scoring." *Id.* at S-2; see, e.g., John Yinger, CLOSED DOORS, OPPORTUNITIES LOST: THE CONTINUING COSTS OF HOUSING DISCRIMINATION 135-58 (1995); DEANNE LOONIN & CHI CHI WU, NATIONAL CONSUMER LAW CENTER, CREDIT DISCRIMINATION (3d ed. 2002) (alleging that credit discrimination results in lost opportunities for home ownership, college education, and adequate or even minimal medical care).

<sup>133</sup> LOONIN, *supra* note 132.

<sup>134</sup> See generally Stephen M. Dane, *Investigating Claims of Discrimination in Housing Finance*, 28 J. MARSHALL L. REV. 371, 372-73 (alleging that much lending discrimination occurs in the underwriting stage).

<sup>135</sup> Chandrasekhar, *supra* note 129, at 186.

lending risk.<sup>136</sup> It is a composite evaluation of the borrower's character or credit reputation, the borrower's capacity or ability to repay, and the collateral risk or the loan to value ratio.<sup>137</sup> Choosing the underwriting variables is also a subjective decision.<sup>138</sup> The borrower's employment, income, and funds on deposit for the down payment and closing costs must all be verified.<sup>139</sup> A lender's concern about repayment is translated into the loan terms.<sup>140</sup> If the risk is considered normal or reasonable for the type of transaction, the loan is priced with the lender's best interest rate. If the risk is considered above average, the lender will increase the interest rate, may request additional collateral, and also may impose more stringent loan terms.<sup>141</sup> In the recent past, lenders have rejected consumers with the worst credit histories and scores because of the possibility of default.<sup>142</sup>

The direct economic function of deterrence relates to the borrower's group risk. Through the underwriting process, the lender is able to reduce the costs of prevention or expected harm. Using mathematical models allows underwriting to be efficient, but may not allocate risk according to individual risk rating.<sup>143</sup> To the extent that individual risk characteristics are not accurately taken into consideration, a borrower may be placed in a particular risk pool based on illegal group characteristics, rather than borrower risk. Lenders, using demographic variables selectively designate borrowers for risk pools based on expected profits.<sup>144</sup>

Underwriting, because it evaluates a borrower's risk, has the potential to transform the lending market. First, through pricing policies, underwriting identifies risks based on detailed inquiries of public and private information

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<sup>136</sup> Thomas E. Plank, *Regulation And Reform Of The Mortgage Market And The Nature Of Mortgage Loans: Lessons From Fannie Mae And Freddie Mac*, 60 S.C. L. REV. 779, 793 (2009).

<sup>137</sup> Andre K. Gray, *Caveat Emptor: Let The Borrower Beware Of The Subprime Mortgage Market*, 11 U. PA. J. L. & SOC. CHANGE 195, 198 (2008).

<sup>138</sup> CLARK ABRAMS & MINGYUAN ZHANG, CREDIT RISK ASSESSMENT 125-26 (2009).

<sup>139</sup> It is the responsibility of the lender's risk management system to "evaluate the targeted population and the products being offered." Stephen F. J. Ornstein & Matthew S. Yoon, *The Interagency Guidance on Credit Risk Management for Home Equity Lending*, 60 CONSUMER FIN. L. Q. REP. 100, 102 (2006).

<sup>140</sup> Plank, *supra* note 136, at 793.

<sup>141</sup> See Ben-Shahar, *supra* note 6, at 163.

<sup>142</sup> STUART, *supra* note 37, at 199-200 (discussing how borrowers with different profiles should be placed in risk assessment pools).

<sup>143</sup> Seth J. Chandler, *Visualizing Adverse Selection: An Economic Approach to the Law of Insurance Underwriting*, 8 CONN. INS. L.J. 435, 462-64 (2002) (discussing the economic efficiency of insurance classifications); Souphala Chomsisengphet and Anthony Pennington-Cross, *The Evolution of the Subprime Mortgage Market*, 88(1) FED. RESERVE BANK OF ST. LOUIS REV. 31, 31-56 (2006).

<sup>144</sup> STUART, *supra* note 37, at 199-200.

about borrowers.<sup>145</sup> To the extent that individual risk characteristics are not accurately taken into consideration, a borrower may be placed in a particular risk pool based on illegal group characteristics, rather than borrower risk.<sup>146</sup> Lenders, who use demographic variables selectively, designate borrowers for risk pools based on expected profits.<sup>147</sup>

Secondly, underwriting can involve subjective decision-making. Identifying which demographic variables will be used is a judgmental decision. Mortgages now involve third parties who have financial incentives, such as brokers and correspondent lenders. As agents of lenders, these third parties are integral to mortgage origination functions, but also have a conflict of interest.<sup>148</sup> The

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<sup>145</sup> What is perhaps most significant, is that underwriting does factor variables such as “culture” and “behavior” into pricing decisions. See Susan Block-Lieb, *The Myth of the Rational Borrower: Rationality, Behavioralism, and the Misguided “Reform” of Bankruptcy Law*, 84 TEX. L. REV. 1481, 1510-15 (2006) (disputing the premise that consumer’s economic behavior is based on the consumer’s knowledge and understanding of legal rules, and arguing that stronger regulation may be needed to correct the market inefficiency that results when lenders take advantage of consumer’s decisional biases and laws protect lenders rather than consumers).

<sup>146</sup> Brokers routinely process the application and underwrite the loan to qualify the application for a particular lender. See generally Howell E. Jackson, *Kickbacks or Compensation: the Case of Yield Spread Premiums*, 12 STAN. J.L. BUS. & FIN. 289 (2007). More recently, lenders have also begun to delegate the underwriting function to correspondent’s lenders. The loan decisions should be made according to the lender’s loan policies and criteria, applicable laws, and regulations. Glenn B. Canner & Charles A. Lockett, *Home Equity Lending: Evidence from Recent Surveys*, 80 FED. RES. BULL. 571, 572 (1994) [hereinafter Canner & Lockett, *Recent Surveys*].

<sup>147</sup> There are numerous ways to perform consumer loan underwriting. It is not clear that for example, in the home mortgage lending market, underwriting and credit scoring are not simply variants of each other. For example, in small business underwriting, there are four types of transaction-based underwriting, of which credit scoring is one. Credit scoring, like the other two (financial statement- and asset-based) are based on quantifiable information that is readily accessible at the time of loan origination. Much small business lending is based on relationship underwriting which requires personal knowledge of the firm, its owners, and their prospects. Monograph From Allen Berger & Gregory Udell, to Board of Governors of the Federal Reserve System, *Small Business Credit Availability and Relationship Lending: The Importance of Bank Organizational Structure* (2001).

<sup>148</sup> See Memorandum from Office of the Comptroller of the Currency et al., to Fin. Inst. with Home Equity Lending Programs 3 (May 16, 2005) [hereafter OCC 2005-22]. Several critical loan-processing activities, such as verification of income and employment, underwriting, and independence in the appraisal and evaluation function are functions that lenders have delegated to third parties. *Id.* Traditionally, the mortgage broker’s role was limited to taking applications from consumers. “Whether brokers are allowed to process and perform any underwriting will depend on the relationship between the financial institution and the broker.” *Id.* at 4; James F. Bauerle, *Fighting Fire with Fire: Technology as Antidote to Excessive Subprime Lending*, 124 BANKING L.J. 714, 714-15 (2007) (describing the rise of technology, one of the known industry and market causes of the subprime lending crisis).

transfer of the underwriting function to third parties is an off-shoot of market segmentation.<sup>149</sup> It is uncertain whether regulatory efforts are stringent enough to assess a lender's monitoring activities of third parties. Lenders have a duty to monitor and have strong control systems in place that ensure the quality of originations, verify compliance with all applicable laws and regulations, and prevent fraud.<sup>150</sup>

Finally, the majority of underwriting is automated.<sup>151</sup> Quite possibly, this subtle transfer of decision-making and reliance on technology is contributing to the marginalization of borrowers, as well.<sup>152</sup> The Government Sponsored Enterprises ("GSEs"), Fannie Mae and Freddie Mac, have developed automated underwriting systems that evaluate mortgage applications in a very short amount of time. These systems evaluate applications based on information in credit reports, the applicant's income, and the applicant's loan-to-value ratio.<sup>153</sup>

Lenders can submit a loan application to these automated underwriting systems prior to approving a loan and receive an indication from the GSE that they

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<sup>149</sup> See generally Julia Patterson Forrester, *Constructing a New Theoretical Framework for Home Improvement Financing*, 75 OR. L. REV. 1095 (1996). The deregulation of the banking industry changed mortgage lending. *Id.* Mortgages were no longer geographically confined and in that way provided more access to credit. *Id.* Deregulation also allowed home investment to become mired with consumer debt. *Id.*

<sup>150</sup> Financial institutions have developed delegated underwriting relationships. Correspondent finance companies usually close and fund loans in their own name and subsequently sell them to a lender. In delegated underwriting relationships, a financial institution grants approval to a correspondent financial company to process, underwrite, and close loans according to the delegator's processing and underwriting requirements and is committed to purchase those loans. Monitoring activities should include post-purchase underwriting reviews and ongoing portfolio performance management activities. See, e.g., Complaint at 1, *Plumbers' Union Local No. 12 Pension Fund vs. Nomura Asset Acceptance, Alternative Loan Trust, et al.*, 658 F. Supp 2d 299 (D. Mass. 2009) (CA. No. 08-0544), 2008 WL 235489 ("investors suit," a securities class action of purchasers of mortgage pass-through certificates alleging that false and misleading registration statements and prospectus supplements were negligent under the Securities Act of 1933).

<sup>151</sup> See generally Susan Watcher & Andrey Pavlov, *Mortgage Put Options and Real Estate Markets*, 38 J. REAL ESTATE FIN. & ECON. 89 (2008) ("[A]utomated underwriting made lending riskier mortgages practical."); Benjamin Howell, *Exploiting Race And Space: Concentrated Subprime Lending As Housing Discrimination*, 94 CAL. L. REV. 101, 127 (2006).

<sup>152</sup> Mark Sievers, *Strategic Allocation Of Overhead: The Application Of Traditional Predation Tests To Multiproduct Firms*, 60 ANTITRUST L.J. 757, 766-69 (1992) (describing the features of market segmentation). Market segmentation is an accepted business method and is economically efficient. Market segmentation is a sign of maturation in the market. Customer segmentation leads to more homogeneous markets as businesses identify an untapped need and organize to capture that segment.

<sup>153</sup> STUART, *supra* note 37, at 196 (discussing the involvement of GSEs in the underwriting process).

will purchase the loan.<sup>154</sup> Lenders heavily rely on these systems that predetermine credit availability based on segmented markets, borrower's earning power, and the property's geographical location.<sup>155</sup> As discussed below, a lender's characterization of a borrower as subprime may be advantageous to both the lender and the underwriter.<sup>156</sup> The prevalence of automated underwriting systems, such as credit scoring, indicates that those systems are both efficient and unbiased.<sup>157</sup> Yet, before relying upon this presumption, it ought to be scrutinized closely. Statistical discrimination explains how inequality may persist among demographic groups when lenders use stereotypes based on a discriminated group's average behavior.<sup>158</sup>

### B. *Statistical Discrimination*

Statistical discrimination is a potent explanation for continuing credit market disparities.<sup>159</sup> Statistical discrimination is discrimination based on stereotypes. Using collected information and empirical data about a groups' behaviors and mores, economists develop a statistical analysis of the group's probable behav-

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<sup>154</sup> A lender can override an automated underwriting decision and underwrite the loan manually; however, if they do so, the lender must agree to buy back the loan if it defaults and violates the purchaser's loan standards. While a loan with an automated underwriting approval that meets all the purchaser's standards and complies with the warranties of sale carries no risk for a lender or broker, a loan that has been approved by overriding automated underwriting standards does carry significant risk. Lenders still manually underwrite many loans, but lenders review a majority of the applications using an automated underwriting system. Each GSE sets guidelines for reviewing applications and for obtaining and using credit histories. See STUART, *supra* note 37, at 109.

<sup>155</sup> See Michael Klausner, *Market Failure and Community Investment: A Market-Oriented Alternative to the Community Reinvestment Act*, 143 U. PA. L. REV. 1561, 1566-68, 1570-72 (1995) (discussing the profitability of lenders having a low incentive to invest in obtaining adequate information in low and moderate income communities).

<sup>156</sup> Michael Powell, *Bank Accused of Pushing Mortgage Deals on Blacks*, N.Y. TIMES, June 6, 2009, <http://www.nytimes.com/2009/06/07/us/07baltimore.html?scp=2&sq=wells%20fargo&st=> (summarizing an affidavit of Beth Jacobson, a Wells Fargo loan officer who admits that the bank targeted minority borrowers in Baltimore).

<sup>157</sup> Frank Pasquale, *Restoring Transparency To Automated Authority*, 9 J. TELECOMM. & HIGH TECH. L. 235, 248-50 (2011) (discussing how lenders might misuse data gathered for credit scoring purposes).

<sup>158</sup> *The Future of Housing Finance: The Role of Private Mortgage Insurance, Before the Subcomm. on Capital Markets, Insurance, & Gov't Sponsored Enterprises of the H. Comm. on Fin. Servs.*, 111th Cong. 6 (2010) (testimony of Deborah Goldberg) (discussing how the use of credit scoring data may have a disparate impact on poor and minority populations).

<sup>159</sup> See generally Amy L. Wax, *Discrimination As An Accident*, 74 IND. L.J. 1129 (1999) (explaining the persistence of statistical discrimination as a profiteering enterprise); Kim & Swires, *supra* note 39, at 828 (discussing the persistence of discrimination in competitive lending markets).

ior.<sup>160</sup> There is a circular argument that attempts to explain and justify the use of statistical discrimination and its significance. The argument relies on the premise that discrimination is irrational. It justifies statistical discrimination as based on accurate information and therefore rational and a likely probability of a group's preference. If the information is inaccurate, the discrimination is a result of taste, not statistical, discrimination.<sup>161</sup> Whether lenders are willing to or see the need to collect more accurate information is questionable.<sup>162</sup> Both costs and embedded stereotypical notions of the minority borrower profile preclude any lender incentive to do so.<sup>163</sup>

Statistical discrimination is considered an efficient response to inadequate information taken from measurable differences in group behavior.<sup>164</sup> The underlying premise of statistical discrimination is that it is cost-effective to discriminate because of the limited information that is available to lenders.<sup>165</sup> Lenders perform credit rationing as a way of selecting the best borrowers.<sup>166</sup> Kenneth Arrow asserts that statistical discrimination is largely the result of the costs of information collection. Using a screening process as the center of the discussion, Arrow argues that measures that predict productivity, in this case borrower qualifications, are costly.<sup>167</sup> Lenders use accepted and prevailing expectations, perceptions and stereotypes because the costs of acquiring informa-

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<sup>160</sup> Devah Pager Bayesian, *Bigot? Statistical Discrimination, Stereotypes, and Employer Decision Making*, 621 ANNALS OF THE AM. ACADEMY OF POL. & SOC. SCI. 70, 73 (2009).

<sup>161</sup> "Taste-based" discrimination occurs when lenders forego profits in order to satisfy their desire to avoid interaction with specific groups. See Kenneth C. Piercy, Testing for Taste-based Discrimination: Analyzing Survey of Consumer Finances Data (2003) (unpublished B.A. thesis, University of Washington) (available at <http://www.econ.washington.edu/features/documents/PiercyThesis.pdf>).

<sup>162</sup> Nesiba, *supra* note 20, at 60-68.

<sup>163</sup> See George J. Borjas & Matthew S. Goldberg, *Biased Screening and Discrimination in the Labor Market*, 68 AM. ECON. REV. 918, 918 (1978) (discussing the flaws in information when screening processes are not reliable); see also generally Edmund S. Phelps, *The Statistical Theory of Racism and Sexism*, 62 AM. ECON. REV. 659 (1972) (presenting the seminal article on the theory of statistical discrimination).

<sup>164</sup> Ian Ayres, *Fair Driving: Gender and Race Discrimination in Retail Car Negotiations*, 104 HARV. L. REV. 817, 842 (1991) ("Theories of statistical discrimination predict that disparate treatment will stem not from distaste for particular consumer groups, but rather from a seller's desire to maximize profits.").

<sup>165</sup> Dwight Jaffee & Joseph Stiglitz, *Credit Rationing*, 2 HANDBOOK OF MONETARY ECON. 837, 839-41 (1990).

<sup>166</sup> Darryl Getter, *Consumer Credit Risk and Pricing*, J. OF CONSUMER AFFAIRS (2006), <http://www.allbusiness.com/sector-92-public-administration/administration/1185418-1.html>

<sup>167</sup> Arrow's model is directly applicable to labor markets and worker productivity. See Kenneth J. Arrow, *Models of Job Discrimination, and Some Mathematical Models of Race Discrimination in the Labor Market*, in RACIAL DISCRIMINATION IN ECONOMIC LIFE 83-102, 187-204 (Anthony H. Pascal ed., 1972); see also Arrow, *supra* note 108, at 3-33.

tion to challenge prior expectations are expensive.<sup>168</sup> As a result, even qualified borrowers who are members of the discriminated group are evaluated as not creditworthy and thus subject to either loan denials or higher than necessary interest rates.<sup>169</sup>

Lenders are apt to defend this method of adverse selection. Offering buyers different prices based on their credit characteristics is simply risk-based pricing and does not necessarily represent pricing disparity.<sup>170</sup> The cost of lending, which includes the possibility of default and loan administration costs, will also give lenders an economic motive for varying lending criteria according to probable risk.<sup>171</sup> To ration loans by price exclusively does not create a discrimination problem.<sup>172</sup> However, just as asymmetric information supports credit rationing, it can support risk-based pricing.<sup>173</sup> The unfavorable consequence is that prices are not determined favorably for borrowers, and imprudent or unknowing borrowers will accept the higher interest rates.<sup>174</sup>

Moreover, the connection between the deregulation of the banking industry and the increase in lending discrimination cannot be ignored. Deregulation led to significant improvements in efficiency, lowered entry fees, and increased competition. These combined to reduce costs and lower interest rates. As the costs of lending fell, lenders received lower profits; the pressure on profit margins caused banks to improve loan portfolio performance.<sup>175</sup> Consumers benefitted from those cost reductions by receiving lower interest rates. As the costs of lending fell, lenders also received lower profits.

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<sup>168</sup> Christian E. Weller, *Credit Access, the Costs of Credit, and Credit Market Discrimination*, 36 REV. BLACK POL. ECON. 1, 7 (2009).

<sup>169</sup> *Id.*

<sup>170</sup> See, e.g., Stiglitz, *supra* note 28, at 393-410. There are several excellent discussions of the theoretical foundations for informational discrimination. See generally Stephen D. Williamson, *Costly Monitoring, Loan Contracts, and Equilibrium Credit Rationing*, 102 Q.J. ECON. 135 (1987).

<sup>171</sup> Jith Jayaratne & Philip E. Strahan, *Entry Restrictions, Industry Evolution, and Dynamic Efficiency: Evidence from Commercial Banking*, 41 J.L. & ECON. 239, 264 (1998).

<sup>172</sup> Prudent borrowers will be deterred by higher interest rates, while imprudent or dishonest borrowers may be undeterred. This adverse sorting causes expected profits per dollar lent to be concave in interest rates. This leads to a "bank-optimal" interest rate, beyond which the supply of credit is negatively sloped and where banks ration credit. Martin and Smyth provide statistical evidence that mortgage supply functions are backward bending in interest rates and that the "bank-optimal" mortgage interest rate is approximately eleven percent. Martin, *supra* note 29, at 139 (citing Robert E. Martin & David J. Smyth, *supra* note 29, at 1072).

<sup>173</sup> See generally Gregory D. Squires & Sunwoong Kim, *Does Anybody Who Works Here Look Like Me: Mortgage Lending, Race, And Lender Employment*, 76 Soc. Sci. Q. 823 (1995).

<sup>174</sup> *Id.*

<sup>175</sup> See Jayaratne & Strahan, *supra* note 171, at 260.

Nonperforming or delinquent loans declined significantly.<sup>176</sup> Increased competition forced banks to review those parts of the business that generated unprofitable loans.<sup>177</sup> To show that there is a statistical basis for discrimination, groups of unprofitable loans appeared as geographic clusters based on minority concentrations.<sup>178</sup> Therefore, redlining was a natural consequence of the increase in competition.<sup>179</sup>

The use and structure of risk assessment methods deepens the penalties that historically underserved and discriminated borrowers face. To a large extent, lenders are over-relying on credit scores and exacerbating the problem of high-cost credit. Higher credit scores result in higher interest rates and ultimately higher costs of loan transactions. What occurs is a cyclical reinforcing response: more expensive financing, leading to late payments or the inability to pay, leading to more depressed scores and higher costs for credit.

The increased roles and responsibilities of mortgage brokers and correspondents, and the financial incentives available to them have altered both lending and underwriting. There is a need to re-structure and use risk assessment predictors in a way that synthesizes the competing dynamics and results in more transparency. Reconciling the informational asymmetry and the risk predictors should not be left to only those lenders who voluntarily decide to acquire better information. Rather, as discussed below in Part IV, such reconciliation should be a legal duty that embraces more responsible lending.

### C. Credit Scoring as a Maturing Disparity

Race, as a profit-maximizing strategy, lurks troublingly beneath the subprime mortgage crisis. According to a study published by the National Reinvestment Coalition in 2006, subprime loans comprised a disproportionate share of all loans issued to minorities. During that year, whites received the largest number of subprime loans, more than any other racial group within the U.S. in 2006. But, minority borrowers and minority communities experienced the highest concentration (or percentage) of subprime loans.<sup>180</sup> The systematic ra-

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<sup>176</sup> Kevin J. Stiroh & Philip E. Strahan, *Competitive Dynamics of Deregulation: Evidence from U.S. Banking*, 35 J. OF MONEY, CREDIT, & BANKING 801, 810-819 (2003).

<sup>177</sup> *Id.*

<sup>178</sup> See generally GREGORY D. SQUIRES & CHARIS E. KUBRIN, *PRIVILEGED PLACES, RACE, RESIDENCE AND THE STRUCTURE OF OPPORTUNITY* (2004).

<sup>179</sup> See generally James A. Berkovec et al., *Race, Redlining, And Residential Mortgage Loan Performance*, 9 J. OF REAL ESTATE FIN. & ECON. 263 (1994).

<sup>180</sup> According to a study published by the National Reinvestment Coalition in 2006, subprime loans comprised a disproportionate share of all loans issued to minorities. During that year, whites received the largest number of subprime loans, more than any other racial group within the U.S. in 2006. But, minority borrowers and minority communities experienced the highest concentration (or percentage) of subprime loans. NAT'L REINVESTMENT COAL. ET AL., *HOMEOWNERSHIP AND WEALTH BUILDING IMPEDED* (2006), [http://opportunityagenda.org/files/field\\_file/Subprime%20Lending%20Report\\_0.PDF](http://opportunityagenda.org/files/field_file/Subprime%20Lending%20Report_0.PDF).



cial differences in mortgage loan documents demonstrate the role that race plays in creating lending bias.<sup>181</sup> Title VII scholars critiquing its efficacy have posited various theories for the statute's flawed presumptions.<sup>182</sup> The theories include implicit bias and stereotyping, and the remedies include "fair measures."<sup>183</sup> The persistence of racially biased implicit attitudes and stereotypes and the difficulty of changing them have led many scholars to advocate for reform of the legal rules that trigger discriminatory actions.<sup>184</sup> Implicit bias legal theory, at its base, tries to incorporate behavioral realism into legal rules.<sup>185</sup>

Once again the parallels between employment law and lending are not exact. In the fair lending context, implicit bias provides a perspective for understanding a lender's perverse incentives to discriminate.<sup>186</sup> To the extent that a lender's decisions are based on stereotypes and inaccurate comparisons and perceptions of minority borrowers, unconscious bias has seeped into the neutral process of lending.<sup>187</sup> Those misguided perceptions are not fact based, and when corrected show a fairer basis for determining the actual risk profiles of

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<sup>181</sup> See Alden Loury, *Wells Fargo Gave Wealthy Blacks Subprime Loans More Often Than Poorer Whites*, TCR BLOG (June 23, 2009, 9:30 PM), [http://chicagoreporter.typepad.com/chicago\\_reporter/2009/06/wells-fargo-gave-wealthy-blacks-subprime-loans-more-often-than-poorer-whites.html](http://chicagoreporter.typepad.com/chicago_reporter/2009/06/wells-fargo-gave-wealthy-blacks-subprime-loans-more-often-than-poorer-whites.html).

<sup>182</sup> Linda Hamilton Krieger was the first legal scholar to study the significance of implicit bias and the effect of stereotyping in employment law. See Krieger, *supra* note 58, at 1231. By examining stereotypes, Krieger's main conclusions can be summarized as: (1) stereotypes are devoid of intent and are instead a by-product of cognitive processing; (2) stereotypes result in unintentional bias about members of other groups; and, (3) stereotypes operate outside of an individual's conscious awareness. *Id.* at 1166-67.

<sup>183</sup> Although Title VII does not recognize the role of unconscious stereotyping, Krieger asserts that implicit biases and intentional discrimination are related. Krieger argues that Title VII has three erroneous assumptions. *Id.* Specifically, Title VII incorrectly assumes that: (1) conscious discriminatory motive or intent is present; (2) that discrimination is irrational; and, (3) that discriminatory motivation is irrelevant to judgmental strategies. *Id.* A relatively new theory addressing the problem of racial injustice focuses on unconscious bias or the implicit bias and discriminatory actions of individuals. See Jerry Kang, *Trojan Horses of Race*, 118 HARV. L. REV. 1489, 1493-94 (2005). The theory is based on studies of the cognitive process of the mind and its capacity to make decisions based on inherent racially biased attitudes and stereotypes. *Id.* These studies have determined that individuals are unaware of their own implicit biases and how those biases affect their decisions. *Id.*

<sup>184</sup> Justin D. Levinson, *Forgotten Racial Equality: Implicit Bias, Decisionmaking, and Misremembering*, 57 DUKE L.J. 345, 352-55 (2007) (discussing how implicit racial bias theory can inform jury procedures).

<sup>185</sup> Krieger, *supra* note 58, at 1166-67.

<sup>186</sup> Gregory Mitchell, *Antidiscrimination Law And the Perils Of Mindreading*, 67 OHIO ST. L.J. 1023, 1052-54 (2006) (arguing that implicit group bias presents a significant opportunity to expand the understanding of discrimination in the context of employment).

<sup>187</sup> See generally Weller, *supra* note 168.

minority borrowers.<sup>188</sup> But, the existence of substantive inequalities, such as those that may be embedded in current credit scoring models, call for more focused policy reforms that address and eradicate these economic harms.<sup>189</sup>

Subjectivity may be present in "objective" risk predictors and must be rooted out when found. A unanimous Court in *Watson v. Fort Worth Bank & Trust* found that disparate impact requires analyzing "subjective or discretionary employment practices."<sup>190</sup> Combining the 1991 Civil Rights Act's reversion to pre-*Wards Cove* case law with the result in *Watson*, the disparate impact doctrine can be used to scrutinize hidden intentional discrimination and "subconscious stereotypes and prejudices."<sup>191</sup> This scrutiny is the basis for the recommended changes to the fair lending rules and enforcement procedures.<sup>192</sup>

Structural discrimination recognizes the interrelationship of race and space.<sup>193</sup> The structural characteristics of "geographical spaces" affect the resulting social and economic dynamics.<sup>194</sup> The economic dynamic depends on the ability of persons living in distinct spatial communities to become wealth-producing economic actors, which in turn makes those communities wealth-building.<sup>195</sup> Thus, unlike overt discrimination with its dependence on personal animus, structural discrimination's key factor is the economic oppression of actors who must overcome the nature and extent of this oppression to be economically productive.<sup>196</sup> By creating economic clusters, the well-regarded in-

<sup>188</sup> *Id.*

<sup>189</sup> See generally Ralph Richard Banks & Richard Thompson Ford, (*How*) Does Unconscious Bias Matter?: Law, Politics, and Racial Inequality, 58 EMORY L.J. 1053 (2009) (arguing that the focus on unconscious bias is misplaced in eradicating racial discrimination).

<sup>190</sup> *Watson v. Fort Worth Bank & Trust*, 487 U.S. 977, 991 (1988).

<sup>191</sup> *Id.* at 990.

<sup>192</sup> Behavioral economists recognize as valid the idea of structural discrimination: that policies and practices that can only result in inequitable outcomes for minorities exist. As Dymski explains, "structural discrimination, insofar as it reflects the legacy of earlier market outcomes, can be the basis of a legal disparate-impact claim, only if overt historical discrimination can be identified in the markets in question." See Dymski, *supra* note 16, at 223. Ross and Yinger argue that there is essentially no difference between disparate impact and disparate treatment discrimination. ROSS & YINGER, *supra* note 28, at 79-84.

<sup>193</sup> Keith Akoi, *Race, Space, and Place: The Relation Between Architectural Modernism, Post-Modernism, Urban Planning, and Gentrification*, 20 FORDHAM URB. L.J. 699, 757-765 (1993) (positing that people of color are marginalized by geographic communities that have developed intentionally through legal mechanisms, such as zoning regulations and government acquiescence in public housing placement).

<sup>194</sup> See Elise C. Boddie, *Racial Territoriality*, 58 UCLA L. REV. 401, 438-42 (2010) (discussing the dynamics of geographical space as having social, cultural, and racial meaning).

<sup>195</sup> See generally CHRISTOPHER B. BARRETT, DEVELOPMENT ECONOMICS: AN OVERVIEW DEVELOPMENT ECONOMICS: CRITICAL CONCEPTS IN DEVELOPMENT STUDIES (2007).

<sup>196</sup> Elvin K. Wyly & Steven R. Holloway, *The Disappearance of Race in Mortgage Lend-*

tention is to exploit, for short-term return, certain “races” and “spaces.”<sup>197</sup>

Policy changes regarding access to credit in minority communities must recognize the economic structural inequality that personal discrimination invariably creates.<sup>198</sup> Inter-market linkages exist.<sup>199</sup> Specifically, racial discrimination in the labor market has a spillover effect on outcomes in the credit market.<sup>200</sup> Lenders who discriminate against minority borrowers who are as qualified as white borrowers, may be justifying decision-making on the “lower or more variable future earned-income levels.”<sup>201</sup>

Discrimination in credit markets is statistically significant enough to have a negative effect on loan approvals and rates.<sup>202</sup> There are important advances for remedying credit discrimination in studies that have provided core data about discrimination in credit markets.<sup>203</sup> The significance of these studies is that they examine two key components: (1) the actual loan performance of minority borrowers, and (2) “maximizing lenders.”<sup>204</sup> Understanding how lenders project their lending outcomes can be highly informative of why discrimination still persists. The design of predictive analytics, the credit scoring models, and structured underwriting, for example, are more indicative of what outcomes are expected than why particular variables are chosen. Thus, it is possible to devel-

ing, 78 ECON. GEO. 129, 131-37 (2002) (discussing the tendency of applicants to not report race on applications beginning in the 1990s).

<sup>197</sup> See generally Keith Aoki, *Space Invaders: Critical Geography, The ‘Third World’ In International Law And Critical Race Theory*, 45 VILL. L. REV. 913 (2000) (discussing the influence of critical geography in understanding the use of capital investments in urban spaces).

<sup>198</sup> There is certainly criticism of the disparate impact approach regarding causation. Whether the lender’s criterion alone is the cause of disparity given the borrower’s financial circumstances is a sobering concern. It is certainly important to consider the borrower’s financial history and capacity. It is reasonable to require some caution in sorting out what lenders should be held legally responsible for given the borrower’s financial circumstances. See Ramona L. Paetzold & Steven L. Willborn, *Deconstructing Disparate Impact: A View of the Model Through New Lenses*, 74 N.C. L. REV. 325, 354 (1996). How the test should be limited to evaluate borrower financial history is outside the scope of this Article.

<sup>199</sup> Devah Pager & Hana Shepherd, *The Sociology of Discrimination: Racial Discrimination in Employment, Housing, Credit, and Consumer Markets*, PRINCETON UNIV. ANNUAL REV., [http://www.princeton.edu/~pager/annualreview\\_discrimination.pdf](http://www.princeton.edu/~pager/annualreview_discrimination.pdf).

<sup>200</sup> See generally Genevieve M. Kenney & Douglas A. Wissoker, *An Analysis of the Correlates of Discrimination Facing Young Hispanic Job-Seekers*, 84 AM. ECON. REV. 674 (1994); MARGERY AUSTIN TURNER ET AL., URBAN INSTITUTE, OPPORTUNITIES DENIED, OPPORTUNITIES DIMINISHED: RACIAL DISCRIMINATION IN HIRING 91-99 (1991).

<sup>201</sup> Dymki, *supra* note 16, at 222.

<sup>202</sup> Gary A. Dymki, *Is Discrimination Disappearing? Residential Credit Market Evidence, 1992-1998*, 28 INT’L J. SOC. ECON. 1025, 1043 (2001).

<sup>203</sup> See generally Phelps, *supra* note 165.

<sup>204</sup> Robert A. Eisenbeis, *Problems in Applying Discriminant Analysis in Credit Scoring Models*, 2 J. BANKING & FIN. 205, 210-11 (1978).

op a fairly accurate sense of the statistical problems associated with models using illegal information. Fair lending reform will not be possible until the relationship between structural discrimination, technological advances such as credit scoring, and the objectives of maximizing lenders is fully understood. Left unaddressed, regulatory inconsistencies such as the ones discussed below will continue.

#### IV. INCREASING REGULATORY OVERSIGHT

Restoring the proper balance of competitive pressures in the mortgage origination market begins with reducing the informational asymmetries present in the mortgage lending market. Ultimately, the borrower benefits from increased transparency and an understanding of what factors the lender used in setting the interest rate.

##### A. *Regulatory Purpose*

Any legal analysis of discriminatory market behavior should take bounded rationality into account.<sup>205</sup> Incorporating behavioral economics norms into lending asks lenders to recognize the adverse effects of behavioral biases.<sup>206</sup> To have regulation which is behaviorally informed recognizes that individuals have gaps in information and understanding. Behaviorally informed regulation must also wrestle with the market's economic intuition.<sup>207</sup> Markets have developed so that they systematically exploit biases. In contrast to the neoclassical model, which relies on the interaction between rational choice and market competition, the complexity of bias in a competitive market setting often results in diminished consumer welfare. What is touted as market equilibrium may be bias exercised in competitive environments overlaid with borrower misperceptions and justified by business necessity.

Informed analyses using bounded rationality are, in many respects, an indirect foundation of discrimination law. Congress enacted fair lending laws based on the premise that bias and unfair actions are so imbedded in society that they cannot be overturned easily by individual decision-making.<sup>208</sup> A significant regulatory intervention is needed in the subprime market, given that the

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<sup>205</sup> Michael S. Barr et al., *The Case for Behaviorally Informed Regulation*, in *NEW PERSPECTIVES ON REGULATION* 25 (David Moss & John Cisternino eds., 2009).

<sup>206</sup> For example, it is worth noting that organizational bias is transferred to lending decisions. See generally Robert K. Rasmussen, *Behavioral Economics: The Economic Analysis of Bankruptcy Law and the Pricing of Credit*, 51 *VAND. L. REV.* 1679, 1692-93 (1998) (arguing that lending norms and bankruptcy rules should be consistent).

<sup>207</sup> Stiglitz, *supra* note 17, 13-15.

<sup>208</sup> Often, the law has imposed limitations on market players and limited the free market by defining those instances in which an economic actor cannot exercise unfettered discretion. Daniel Greenwood, *Democracy and Delaware: The Mysterious Race to the Bottom/Top*, 23 *YALE L. AND POL. REV.* 381, 383 (2005) (discussing how state laws allow corpora-

market forces have failed to fully discipline competition. The lack of competitive pressures provides the necessary incentive for greater expressions of bounded rationality to protect consumer welfare.<sup>209</sup>

The current regulatory scheme does not adequately consider how borrower behavior ought to be considered in creating and maintaining credit scoring models. Under the current regulations, there is an ongoing duty for a lender to notice and modify a credit scoring system when there are “true shifts in behavior.”<sup>210</sup> Whenever there is a shift in actual borrower performance, lenders may make necessary adjustments such as adjusting cut-off scores, changing the underwriting policies, and purchasing or developing a new credit scoring model.<sup>211</sup> In doing so, lenders should exercise caution because doing so may result in a disparate impact.<sup>212</sup> These regulations while seemingly recognizing borrower behavior provide stronger protections to lenders than borrowers. Evaluating lenders credit scoring model and underwriting practices with regulatory changes can offer a stronger response to the market failures and discrimination that have arisen in the credit market.

#### B. *The Lender's Duties When Establishing a Credit Scoring Model*

The current disparate impact test in fair lending as implemented through regulations fails to provide lenders with a solid statistical test for measuring discrimination and vaguely defines business justification. Changing the legal rules to measure disparate impact in fair lending as a combination of treatment and performance information would uncover the complexities that facilitate biased determinations.<sup>213</sup> This reformulated test adequately and fairly evaluates the predictive power of “statistically sound” credit scoring systems as Regulation B mandates.<sup>214</sup>

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tions to conceal policy choices that do not promote the public good through corporate governance regimes).

<sup>209</sup> Behavioral economics policy is often incorporated into administrative regulations. See generally Michael P. Vandenbergh et al., *Regulation in the Behavioral Era*, 95 MINN. L. REV., 715, 728-741 (2011) (critiquing rational actor assumptions and discussing the need for behavioral economics).

<sup>210</sup> OFFICE OF COMPTROLLER OF THE CURRENCY, CREDIT SCORING MODELS, OCC Bull. No. 1997-24 (1997).

<sup>211</sup> *Id.*

<sup>212</sup> “[C]redit scoring models should be used only for the products and loan sizes for which they were developed . . . . [V]alidated models can be successfully used independently, when combined, their overall results may vary.” *Id.* at 5.

<sup>213</sup> Kathryn Abrams, *Title VII and the Complex Female Subject*, 92 MICH. L. REV. 2479, 2482 (1994); see also Minna J. Kotkin, *Diversity and Discrimination: A Look at Complex Bias*, 50 WM. & MARY L. REV. 1439, 1440 (2009).

<sup>214</sup> DIVISION OF CONSUMER AND COMMUNITY AFFAIRS, FEDERAL RESERVE, CONSUMER COMPLIANCE HANDBOOK, FAIR LENDING REGULATIONS AND STATUTES—EQUAL CREDIT OPPORTUNITY (REGULATION B) (2006).

Specifically, three aspects of the current test should be changed. First, the test should require lenders to identify the variables and assign weights that may be resulting in impermissible market segmentation. Second, it should require the use of blended data pooled from groups of lenders to identify and evaluate pricing irregularities. Finally, the new test should require a measure of actual performance as a determination of the lender's disparate impact in a given market.

### 1. Variable Inclusions

Structural discrimination may result in disparate impact discrimination when lenders choose, but do not reveal, selection factors that are correlated with minority group status. These factors are hidden in the lender's decision-making standards and can only be revealed by analysis intended to test for disparate impact.<sup>215</sup> The disparate impact test as it is currently written and enforced is ineffective for several reasons.<sup>216</sup>

The current enforcement regime cannot effectively test for latent bias because the regulators are unaware of the weights that lenders place on the control variables; therefore, the regulators do not account for variations in weights among different lenders.<sup>217</sup> Regulators use random samples of lender's files from which findings on discrimination are averaged.<sup>218</sup>

To uncover disparate impact discrimination, a significantly different analytical model is more effective. Specifically, there should be a composite evaluation of all lenders' minority loan applications, or "pooled data."<sup>219</sup> This regression analysis represents a better enforcement tool because it actually identifies

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<sup>215</sup> Stephen L. Ross & John Yinger, *Uncovering Discrimination: A Comparison of the Methods Used by Scholars and Civil Rights Enforcement Officials*, 8 AM. L. & ECON. REV. 562, 579 (2006).

<sup>216</sup> *Id.* at 572 (an equation that tests for discrimination involving effects discrimination is measured by a variable  $Y$ , for a discrete measure of some type of selection,  $Y_i = \beta X_i + \gamma M$  (Equation 4)).

<sup>217</sup> Several economists support the use of Equation 4 as an enforcement tool on the ground that it is a good way to isolate disparate-treatment discrimination. *See generally* Robert B. Avery et al., *Using HMDA Data as a Regulatory Screen for Fair Lending Compliance*, 11 J. FIN. SERV. RES. 9 (1997); Marsha J. Courchane et al., *Subprime Borrowers: Mortgage Transitions and Outcomes*, 29 J. REAL ESTATE FIN. & ECON. 365 (2004); Marsha J. Courchane et al., *Lessons Learned: Statistical Techniques and Fair Lending*, 11 J. HOUSING RES. 277 (2000); Mitchell Stengel & Dennis Glennon, *Evaluating Statistical Models of Mortgage Lending Discrimination: A Bank-Specific Analysis*, 2 REAL ESTATE FIN. & ECON. 299 (1999).

<sup>218</sup> Similarly, researchers also presume that any deviations from assigned weights are random, instead of indicating bias.

<sup>219</sup> The "pooled data" would represent whether lenders chose characteristics based on race. STUART, *supra* note 37, at 195-201 (proposing borrower profiles based on risk, but not race).

whether lenders discriminate. This avoids the need for individual lenders to provide proprietary information.<sup>220</sup> It also creates a comparative basis for evaluating similarly situated borrowers.<sup>221</sup> There are perplexing racial and ethnic differences in underwriting, rates of subprime lending, and pricing in the loan approval rates of African-Americans.<sup>222</sup> Blended information studies show the strength of creating pooled regression analysis using Home Mortgage Disclosure Act (HMDA) data along with other data.<sup>223</sup> Such studies have provided deeper insight when combined with HMDA data, credit report data, loan-to-value ratio,<sup>224</sup> census tract data,<sup>225</sup> mortgage APRs,<sup>226</sup> and with loan performance data using standard underwriting variables.<sup>227</sup> These types of data studies are more comprehensive, and thus needed in the fair lending regulatory sphere to identify and stop discriminatory efforts before they reach consumers. The current enforcement regime, which lacks these mechanisms, not only fails to deter unfair lending, but can easily result in an unfair enforcement system.<sup>228</sup>

By assigning weights to certain variables, lenders can avoid the penalties associated with disparate treatment discrimination while still intentionally engaging in practices that result in disparate impact across racial lines.<sup>229</sup> Under the current rules, if a lender intentionally identifies a variable more associated with the actions of a protected class and assigns a different weight to it, the result is a disparate impact, which cannot be identified through disparate impact

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<sup>220</sup> See generally Michael D. Guttentag, *An Argument For Imposing Disclosure Requirements On Public Companies*, 32 FLA. ST. U. L. REV. 123 (2004); Chris Montville, *Reforming the Law Of Proprietary Information*, 56 DUKE L.J. 1159 (2007) (discussing the role of proprietary information disclosure in regulating firms).

<sup>221</sup> See Sunwoong Kim & Greg D. Squires, *The Color of Money and the People Who Lend It*, 9 J. HOUSING RES. 271 (1999) (finding that the approval rates of African-American applicants correlate with the lender's percentage of African-American employees); see also Ross & Yinger, *supra* note 216, at 597.

<sup>222</sup> See Kim & Squires, *supra* note 221, at 275.

<sup>223</sup> See generally Richard Marisco, *Looking Back And Looking Ahead As The Home Mortgage Disclosure Act Turns Thirty-Five: The Role Of Public Disclosure Of Lending Data In A Time Of Financial Crisis*, 36 REV. OF BANKING AND FIN. 103 (2009).

<sup>224</sup> See generally DAVID T. RODDA ET AL., U.S. DEP'T OF HOUSING & URBAN DEV., A STUDY OF MARKET SECTOR OVERLAP AND MORTGAGE LENDING (2005).

<sup>225</sup> Paul S. Calem et al., *Neighborhood Patterns of Subprime Lending: Evidence from Disparate Cities*, 15 HOUSING POL'Y DEBATE 603, 604-05 (2004).

<sup>226</sup> See generally DEBBIE GRUENSTEIN BOCIAN ET AL., CENTER FOR RESPONSIBLE LENDING, UNFAIR LENDING: THE EFFECT OF RACE AND ETHNICITY ON THE PRICE OF SUBPRIME MORTGAGES (2006).

<sup>227</sup> See generally Michael Barr et al., *Behaviorally Informed Mortgage Credit Regulation* (Harvard Univ. Joint Ctr. for Housing Studies, Working Paper No. UCC 08-12, 2008).

<sup>228</sup> Ross and Yinger are highly critical of the current enforcement regime and posit that it not only fails to deter unfair lending, but can easily result in an unfair enforcement system. See Ross & Yinger, *supra* note 215, at 579.

<sup>229</sup> Lundberg, *supra* note 41, at 322.

testing. These indirect observations become the "race tax" that provide lenders with the motivation to direct a certain outcome, usually based on profits.<sup>230</sup>

This focus on weights is important for another reason: it can prove favorable for a plaintiff establishing a *prima facie* case of a disparate impact violation.<sup>231</sup> Again, under the current enforcement regime, a plaintiff must allege with particularity the lender's discriminatory policy or practice.<sup>232</sup> The reformulated test should eliminate the particularity requirement on plaintiffs bringing a disparate impact claim using statistical information. Furthermore, a plaintiff should not need to pinpoint what part of the system caused the disparate impact only that one exists. Thus, once a plaintiff presents statistical evidence of a lender's disparate impact, the burden should shift to the lender to provide a business necessity justification.

Another issue the use of variables raises is what role these variables play in the estimation equations for default and foreclosure loss. While lenders cannot use prohibited variables reflecting demographic characteristics in underwriting, those variables may be used in estimation equations.<sup>233</sup> Whether there is a correlation between and a need to use the prohibited variables is an issue of creditworthiness that might be justified by business need. One approach is to force prohibited variables into all equations, and evaluate the lender's creditworthiness variables based on the business need for estimates of default and foreclosure.

## 2. The Performance Analysis

The gap in the development of disparate impact becomes most obvious when comparing cases and literature relating to statistically based techniques for "validating" a test or other screening mechanism.<sup>234</sup> The appropriate selection practice is unclear. A comparison to the validation methods used in the employment setting is appropriate. To validate their selection devices, employers analyze "the measures of work behavior that are relevant to job performance."<sup>235</sup> To validate a practice as job-related, an employer must create or define the actual measures of job performance, which in many instances could be

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<sup>230</sup> Minority borrowers have been characterized as paying a "race tax." *Rooting Out Discrimination in Mortgage Lending: Using HMDA as a Tool for Fair Lending Enforcement Hearing Before the Oversight and Investigations Subcomm. of the H. Fin. Serv. Comm.*, 110th Cong. 9 (2007) (testimony of John Taylor, President and CEO, National Community Reinvestment Coalition).

<sup>231</sup> See Ross & Yinger, *supra* note 215, at 579.

<sup>232</sup> *Id.*

<sup>233</sup> Mitchell B. Rachlis & Anthony M.J. Yeazer, *Flaws in Statistical Tests for Discrimination in Mortgage Markets*, 4 J. HOUSING RES. 315, 320-22 (1993).

<sup>234</sup> The estimating equation for disparate impact when the variable is known is  $Y_{ij} = \sum_j \beta_j X_{ij} + \sum_j (\beta_j - \beta_j^*) X_{ij} + \gamma M_i + \epsilon_{ij}$ . See Ross & Yinger, *supra* note 215, at 583.

<sup>235</sup> 28 C.F.R. § 50.14 (2010).



extremely subjective.<sup>236</sup>

A validated Title VII study evaluates both the subjective job criteria, as well as performance. The use of subjective criteria requires that the employer perform a validation study.<sup>237</sup> Recognizing that the measurement of performance is complex, the employer must develop subjective "criteria" before the validation study on selection procedures.<sup>238</sup> The employer must also evaluate the presence of bias in the existing job criteria used to measure performance.<sup>239</sup>

Measuring actual performance is important in the fair lending context. Performance arguably is measured by a statistical analysis of whether the loan was paid as agreed.<sup>240</sup> As argued above, measuring the validity of the performance device using the lender's identified performance criteria may be flawed.<sup>241</sup> The presumption is that credit scoring systems treat all applicants objectively.<sup>242</sup>

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<sup>236</sup> *Id.*

<sup>237</sup> *Id.*

<sup>238</sup> *Id.*

<sup>239</sup> 28 C.F.R. § 12b(2) (requiring that the employer consider the "possibility of bias" in developing its job performance analysis).

<sup>240</sup> See generally David Listokin & Elvin K. Wyly, *Making New Mortgage Markets: Case Studies of Institutions, Home Buyers, and Communities*, 11 HOUSING POL'Y DEBATE, 575 (2000) (discussing home ownership as a prime socio-economic institution necessary for community development and describing the home ownership financing market as segmented due to market imperfections related to information, discrimination, and household financial characteristics).

<sup>241</sup> For example, it is reasonable to assume that any study purporting to serve as proof of the legitimacy of a selection device would demonstrate that the selection mechanism does not: "(1) focus exclusively on a minor aspect of the [applicant's qualifications], nor (2) fail to test a significant [attribute] of creditworthiness or loan default risk." See *Guardians Ass'n v. Civil Service Comm'n of New York*, 630 F.2d 79, 99 (2d Cir.1980).

<sup>242</sup> Credit-scoring is used in several different contexts, including lending, employment, and insurance. Its validity as an accurate risk predictor has been challenged in the automobile industry. The lower credit scores of African-Americans and Latinos have been justified based on their intrinsic underlying individual biological and psychological risk-taking characteristics. See Patrick Brockett, Professor, University of Texas at Austin, Statement Regarding Actuarial Standard No. 12 (Oct. 11, 2007) (argument supporting the statistical relationship between scoring mechanisms and risk outcomes). Another University of Texas at Austin professor, Dr. Linda Golden, argues that:

Biochemistry influences personality. Our biochemistry may be the determinant of our personality, which then may have a strong influence on risk-taking, impacting our credit scores [and] helping to explain in the bigger picture why credit scores predict.

*Actuaries Have Special Role When Explaining Credit Scores and Losses*, CASUAL ACTUARIAL SOC'Y, Nov. 13, 2007, <http://www.casact.org/media/index.cfm?fa=viewArticle&articleID=468&CFID=33343745&CFTOKEN=24514350>

Critics of the system argue that scores are full of errors, easy to manipulate, and dangerous to use. In 2005, CreditSights, an independent credit research firm, said FICO scores have become an excuse to lead consumers into higher levels of indebtedness. Banks responded by displaying rising FICO scores as a panacea to calm concerns about future credit deteriora-

Yet, a statistical disparity of greater than two to three standard deviations establishes a *prima facie* case of discrimination.<sup>243</sup> When lenders structure the system to identify minorities and thus skew the result, supposedly objective criteria become subjective and the validation system designed to test for bias provides a false "justifiable reason."<sup>244</sup>

An appropriate regression analysis takes into account, and controls for, all measurable variables that might explain the disparities found.<sup>245</sup> This is where the failings of Regulation B appear. If lenders are using "hidden" variables, the regression analysis is inaccurate. Unlike the analysis involving omitted variables, there is no basis for regulators to first test, and then determine the included variables that are proxies for race.<sup>246</sup> The disparity of the significant factors in the challenged decision or policy based on omitted variables must have factual support.<sup>247</sup>

### 3. Similar Borrower Pool

Legitimate challenges regarding the goals of credit scoring, the uniform treatment of applicants, and whether the predictors used are consistent with fair lending laws are justifiable. The regulatory challenge is to evaluate risk predictors in such a way that they are consistent with fair lending laws.<sup>248</sup>

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tion, the analysts said. Peter Henderson et al., *Credit-Score Panacea Failed to Stop U.S. Mortgage Crisis*, BOSTON GLOBE, May 10, 2007; see generally Latonia Williams, *African-American Homeownership and the Dream Deferred: A Disparate Impact Argument Against the Use of Credit Scores in Homeowners' Insurance Underwriting*, 15 CONN. INS. L.J. 295, 320 (2008).

<sup>243</sup> See *Hazelwood Sch. Dist. v. U.S.*, 433 U.S. 299, 311 n.17 (1977); *Alexander v. Local 496, Laborers' Int'l Union of N. Am.*, 177 F.3d 394, 406-07 (6th Cir. 1999); *Anderson v. Zubieta*, 180 F.3d 329, 339-40 (D.C. Cir. 1999).

<sup>244</sup> See generally OFFICE OF THE COMPTROLLER OF THE CURRENCY, COMPTROLLER'S HANDBOOK, FAIR LENDING (1997) (complex override systems are available when using scoring mechanisms).

<sup>245</sup> Plaintiffs are not required to rule out all possible variables in order to prevail. See *Bazemore v. Friday*, 478 U.S. 385, 400 (1986); *Alexander*, 177 F.3d at 406; *U.S. v. City of Warren*, 138 F.3d 1083, 1094 (6th Cir. 1998).

<sup>246</sup> Robert P. Lieli & Halbert White, *The Construction of Empirical Credit Scoring Models Based on Maximization Principles*, J. ECONOMETRICS (forthcoming), <http://web-er.ucsd.edu/~mbacci/white/pubs.html>.

<sup>247</sup> See *Bazemore*, 478 U.S. at 399-400; *Bush v. Kaim*, 297 F. Supp. 151, 163 (N.D. Ohio 1969).

<sup>248</sup> As one expert has explained,

The best structures are those which are comprehensive, full-file, rather than segmented, reporting from reporting bureaus. The dynamics of credit reporting are discretionary. What is most beneficial to the average consumer is to have comprehensive credit reporting. Comprehensive credit files contain information across all sectors. These are compared to segmented files, which are restricted to a single sector in which the consumer has a credit line. Finally, there are privately-owned credit bureaus owned by

The complexity of credit scoring systems raises the possibility of disparate impact in design.<sup>249</sup> The design of the variables affects the accuracy of the predictors.<sup>250</sup> Whether the lender designs the system so that it reflects more than a preference for certain types of borrowers or imposes disadvantages on minority borrowers is the question.<sup>251</sup> Often, particular predictive variables correlate differently with repayment behavior for white males than for other classes of applicants.<sup>252</sup>

Designing an equitable system requires recognizing how variables differ among populations. The comparison sample population must not only include similar group members, but also variables that are relevant to that group. Characteristics of minority borrowers that predict financial accountability may vary based on geography, financial practices, and economic cycles that are admittedly different in minority communities.<sup>253</sup> It is critical that lenders not penalize minority borrowers for not having the same credit characteristics as those who have unbiased access to credit, but instead evaluate them based on how the particular values correlate with repayment behavior.<sup>254</sup>

While credit scoring fills much of this information gap, the measurements about an applicant's riskiness are more exacting, but not necessarily more accurate.<sup>255</sup> This information asymmetry becomes more acute and further segments

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public agencies, such as the central bank or banking superintendent, or by private owners.

*See generally* What Borrowers Need to Know about Credit Scoring Models and Credit Scores: Hearing Before the Oversight and Investigations Subcomm. of the Fin. Serv. Comm., 110th Cong. (2008) (testimony of Clark Abrahams, Chief Financial Architect, SAS Institute, Inc.) (discussing the need for alternative data reporting criteria).

<sup>249</sup> Michael F. Ferguson & Stephen R. Peters, *What Constitutes Evidence of Discrimination in Lending?*, 50 J. OF FIN. 739, 744-47 (1995) (arguing that default and denial rates among majority and minority borrowers always indicate lending discrimination).

<sup>250</sup> *See generally* Helen Ladd, *Evidence on Discrimination in Mortgage Lending*, 12 J. OF ECON. PERSPECTIVES 41 (1998).

<sup>251</sup> *See generally* Doncha Marron, "Lending By Numbers": Credit Scoring and The Constitution Of Risk Within American Consumer Credit, 36 ECON. & SOC'Y (2007) (discussing how lenders employ technologies based on "risk pricing" and "profit scoring").

<sup>252</sup> Often, particular predictive variables correlate differently with repayment behavior for white males than for other classes of applicants. *See* Sarah E. Burns, Note, *Credit Scoring and the ECOA: Applying the Effects Test*, 88 YALE L.J. 1450, 1456 (1979).

<sup>253</sup> For example, if the predictive variable is home ownership, there is a larger proportion of financially responsible white males than of financially responsible women and minorities. J. Collins and R.A. Margo, *Race and Home Ownership: A Century-Long View* 3-6 (Nat'l Bureau of Econ. Research, Working Paper No. 7277, 1999).

<sup>254</sup> Iconic modeling, a type of statistical model, represents a system of equations that bear a relationship to a defined credit market. It is distinguished from the empirical model in that it relies on well-formulated and predictive theories. *See* Mester, *supra* note 130, at 3-16.

<sup>255</sup> Consumers who were historically denied a loan now qualify for a higher-interest rate subprime loan. *See* John M. Barron & Michael Staten, *The Value of Comprehensive Credit*

the market into borrowers who will pay above-market interest rates because they are "disconnected from the market."<sup>256</sup> Borrowers qualified as subprime may have insufficient credit history or they may have the type of credit accounts that are not favored in the scoring scheme.<sup>257</sup> Due in part to the weights and values assigned to credit scores, the scores of those who do not conform to traditional notions of prudent credit behavior are depressed.<sup>258</sup> With little room for variance under these traditional notions, the industry is beginning to acknowledge that the system is biased against historically excluded borrowers and has proposed alternative models.<sup>259</sup>

Proponents of credit scoring argue that it has closed an information gap that has long been harmful to credit-impaired borrowers.<sup>260</sup> They argue that the automated credit check eases the information asymmetry, which prevented markets from operating efficiently and created credit rationing.<sup>261</sup> That argument extends further to posit that the use of credit scoring ended credit rationing in the housing credit market, thus making that market as efficient and accessible as it has become.<sup>262</sup>

Credit reporting and scoring have admittedly enhanced the credit infrastruc-

*Reports: Lessons from the U.S. Experience*, in CREDIT REPORTING SYS. & THE INT'L ECON. 273, 273 (2003).

<sup>256</sup> Kathleen C. Engel & Patricia A. McCoy, *A Tale of Three Markets: The Law and Economics of Predatory Lending*, 80 TEX. L. REV. 1255, 1278-80 (2002).

<sup>257</sup> Not coincidentally, these are the borrowers who are historically excluded from the housing credit market because of racial discrimination. Brescia, *supra* note 48, at 193.

<sup>258</sup> Credit scoring has been described as constituting an economic opportunity, albeit an unfair one, rating blacks three times more likely to have higher-risk loans due to lower credit scores. As one author has described, the problem of economic equality and "access to mortgage loans has been transformed into a problem of poor access to fairly priced credit and one of frequently unsustainable credit promoted by abusive lenders." See, e.g., DAN IMMERGLUCK, CREDIT TO THE COMMUNITY: COMMUNITY REINVESTMENT AND FAIR LENDING POLICY IN THE UNITED STATES 267 (2004). A close examination of credit scoring reveals a correlation between high-risk credit scores and the number of minorities residing in a given zip code, raising issues of targeting minority neighborhoods for profitability. See Robert B. Avery et al., *Credit Scoring: Statistical Issues and Evidence from Credit-Bureau Files*, 28 REAL ESTATE FIN. & ECON. 523, 537 (2000).

<sup>259</sup> Economic activities that represent a way of life for many consumers have lower numerical weights, such as open consumer finance accounts or frequent changes of residence or employment. See Brad Finkelstein, *FICO Introduces "Alternative" Credit Score*, NAT'L MORTGAGE NEWS, Sept. 1, 2004, at 36. See generally FED. TRADE COMM'N, PUBLIC FORUM: THE CONSUMER AND CREDIT SCORING 122 (1999), <http://www.ftc.gov/bcp/creditscoring/creditscorexscript.pdf> [hereinafter FTC Report].

<sup>260</sup> See Stiglitz, *supra* note 28, at 393.

<sup>261</sup> *Id.* (asserting that information asymmetry serves as a screening device. Lenders set artificially low loan prices which attract a large pool of high-risk borrowers. Because demand exceeds supply, lenders have a pool of potential borrowers).

<sup>262</sup> FICO scores were originally designed for use by credit card issuers. As discussed in

ture.<sup>263</sup> The creation of the borrower risk profile will make information about borrowers broader, and thus the determination of whether borrower asymmetries have actually narrowed depends on what information is used to create the borrowers' risk-profile.<sup>264</sup>

### C. *Limiting the Business Justification Defense*

The choice of credit scoring as a method of risk assessment includes an obligation to continuously monitor and make changes. To specifically require that lenders validate the predictive power of their chosen scoring model is consistent with the fair lending doctrine as it has now evolved.

Lenders have a responsibility to ensure that their credit scoring model accurately reflects the characteristics and demographics of the applicant pool. It is not uncommon for credit scoring models to be based on the performance of the lender's past borrowers.<sup>265</sup> However, those borrowers may have dissimilar risk profiles. It is also possible for the pool of borrowers to be incompatible with the lender's market demographics.<sup>266</sup> Lenders must track loan performance based on the established credit scoring model characteristics.<sup>267</sup> Failure to do so may result in risk limits continuing to operate that are unnecessarily restrictive and that produce an unjustifiable disparate impact.<sup>268</sup>

The product and scoring models used in mortgage lending can also lead to inherently conflicting results. It is especially important that the credit scoring system used in mortgage lending be based on mortgage loans. It is not unreasonable to require that the credit scoring system used for mortgage lending be based on the particular mortgage product. The internal scoring system should account for the fact that most predictive systems limit consideration of default to the initial years of the mortgage loan and do not consider default throughout the course of the loan. The typical credit scoring system does not distinguish patterns of home ownership by race or class. This is a significant omission

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more detail below, the variables and weights may disadvantage certain types of borrowers. *See, e.g.*, Finkelstein, *supra* note 260, at 36.

<sup>263</sup> *See generally* STAFF OF H. COMM. ON FIN. SERV., 111TH CONG., REP. ON CREDIT SCORING (Comm. Print 2010) (by Sandra F. Braunstein).

<sup>264</sup> The probability of mistaken characterizations of borrowers, *e.g.*, a low-risk borrower mistaken as a high-risk borrower, occurs when insufficient information is reported. *See, e.g.*, Kenneth G. Gunter, *Computerized Credit Scoring's Effect on the Lending Industry*, 4 N.C. BANKING INST. 443, 450-456 (2000) (discussing the disadvantages of computerized credit scoring).

<sup>265</sup> *See generally* CAPRON, *supra* note 121.

<sup>266</sup> ROSS & YINGER, *supra* note 28, at 277-286; *see generally* Mark Schreiner, *Benefits and Pitfalls of Statistical Credit Scoring for Microfinance*, 28 SAVINGS AND DEVELOPMENT 63 (discussing personal knowledge as a basis for making loan decisions in poor countries and how credit scoring can improve risk prediction).

<sup>267</sup> ROSS AND YINGER, *supra* note 28, at 340-47.

<sup>268</sup> *Id.*

because minority and lower and moderate income households tend to buy, sell, and refinance less often than whites. In this regard, the home is less of a commodity and may be seen as worthy of sacrifice to avoid default or foreclosure.<sup>269</sup>

The lender's duty must include creating an acceptable correlation between legitimate business needs and the criteria responsive to those needs. Specifically, this means validating the predictive scoring model prior to use. The lender's duty is to correlate the borrower's risk criteria with the business needs, *e.g.*, the interest rates and fees, to make a profit. That duty to monitor and make changes when the statistical predictive power is found to have over-predicted the borrower's riskiness is ongoing. The profit generated from the scoring model should be based on validated creditworthiness variables.<sup>270</sup>

As to pricing, there are some further basics that lenders must observe.<sup>271</sup> The lender must be able to identify when the current pricing model was put in place. There should not be an opportunity for post hoc rationalizations when pricing differences occur. The lender's price model must undergo exacting, definitive review. Each part of the model, *e.g.*, the price adjustments, should be independently validated. Risk factors should be singularly-counted. For each price adjustment, there must be a separate calculation showing either credit loss or lender costs. After validation and price differentials are confirmed and there is a significant price differential based on a particular variable, a correlation must be shown between the variable and the lender's costs.<sup>272</sup>

Exercising care in this context requires the lender to make loans that are sustainable with profits that are fair. An unconscionable or unfair profit would be one that is outside the established norm or profit range of the loan's peer group. A lender that earns an above-market rate profit will need to show that those loans were not unduly profitable at the borrowers' expense. This can be shown by evaluating the borrowers' residual income requirements and the loans' broker fees or yield spread premium.<sup>273</sup> By incorporating these require-

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<sup>269</sup> FED. RESERVE BANK OF ST. LOUIS, COMMUNITIES & BANKING, PERSPECTIVES ON CREDIT SCORING AND FAIR MORTGAGE LENDING 13 (2001).

<sup>270</sup> See Joint Policy Statement, at 18, 2-69 (stating that "cost and profitability" are relevant factors in evaluating business necessity in the context of lending); see also *Wilson vs. Southwest Airlines, Co.*, 517 F. Supp. 292, 302, n.25 (N.D. Tex. 1981) (holding that "if an employer could justify employment discrimination merely on the grounds that it is necessary to make a profit, Title VII would be nullified in short order").

<sup>271</sup> The Federal Reserve Board has not released uniform guidelines similar to the ones issued by the EEOC, although such guidelines would be helpful.

<sup>272</sup> Alan White, *Borrowing While Black*, 60 S.C.L. LAW REV. 677, 701 (2009).

<sup>273</sup> Residual income requirements measure the borrower's financial capacity for the loan by evaluating a borrower's ability to make payments on the proposed loan and to also pay other required living expenses, such as food, utilities, and transportation costs. The loan underwriters should demonstrate that, after accounting for the expected monthly payment, the proposed borrower still has a certain absolute amount of income left over to cover other

ments into the lender's test for business necessity, the lender is forced to have a prospective examination for unconscionable profits.

#### V. CONCLUSION

*"In order to get beyond racism, we must first take account of race.  
There is no other way."*<sup>274</sup>

Lending discrimination, as with other inequities based on race, has become more subtle and complex. Fair lending has failed in many respects. The foreclosure crisis reveals the existence of substantial bias in mortgage lending and mandates a change in how we police this bias. Credit scoring has undoubtedly increased the availability and affordability of credit. As a screening device, credit scoring is cost-effective and efficient. Creditors are able to establish prices that are consistent with the risks and costs of extending credit to all types of borrowers. Yet, credit scoring inherently may lead to lending discrimination. Similarly, underwriting has also become an art of disguise.

The ever-present formal statements and prolific policies of lenders who claim to provide equal credit opportunity appear meaningless given the gap in credit and wealth accumulation that minority borrowers face. The structure of decision-making and implied bias in granting credit has replaced disparate treatment and continued lending inequity. The structural, relational, and situational biases that occur in lending are not adequately addressed by the rules that prohibit discrimination. While lenders justify the resulting exclusion under the legitimate business need doctrine and appear to be in compliance with legal rules and norms, the perverse effect is to sanction conduct that is an anathema to the statute's purpose and objectives. An expected response is to create more federal laws. However, the potential remedy of creating more federal laws bears the danger of being under or over-inclusive. Rules that are broad will also have the consequence of being ambiguous.

Rather than pursuing after-the-fact-enforcement, the legislature should implement an entirely different regulatory approach. While the judiciary's interpretations of disparate impact are critical to understanding the legal rules, the full capacity of the regulatory system is needed to corral all of the institutional players that contribute to this structural bias. The complex regulatory system of ensuring fair lending requires an approach that encourages the development of processes that will establish acceptable standards in particular contexts.

This proposal focuses on changes at the regulatory level. Moving away from a court-centered regulatory focus is not a denial of the judiciary's significance in creating and enforcing fair lending laws. However, focusing on the crux of

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expenses. See generally Cassandra Jones Havard, *Credit Democracy: What's Sub-Prime Lending Got to Do With It?*, in *FINANCIAL MODERNIZATION AFTER GRAMM-LEACH-BLILEY* (Patricia A. McCoy, ed., 2002). Residual income should be a fixed dollar amount and not a percentage of income. It varies by geographic locale and by the size of the household. *Id.*

<sup>274</sup> *Regents of the Univ. of Cal. v. Bakke*, 438 U.S. 265, 407 (1978).

the problem as calculated institutional compliance clears the way for a regulatory approach to emerge that will more adequately address anti-bias activities rather than simply resorting to market theories.

As a standardized measure of credit risk, credit scoring also facilitates access to capital markets through the securitization of loans on the secondary market. Yet, the use of market imperfections related to information, discrimination, and household financial characteristics leads to questions about whether credit scoring is in fact objective and accurate. Both theoretical and empirical evidence indicate that credit scoring has adverse effects on protected classes.<sup>275</sup> If lenders use weighted variables, such as geography, occupation, and length of time at residence, as proxies for personal characteristics prohibited by law, credit scoring makes credit more expensive for certain market segments. A cycle of biased lending and high-cost credit ultimately leads to market failure, as is evidenced by the current subprime market meltdown.

Under the current regulatory scheme, credit scoring devices are not adequately tested to root out discriminatory impact based on either race or its proxies. The included variables, which banks treat as proprietary information disclosed only to regulators, make bias efficient and profitable, and legitimizes the bias. In turn, a transformed financial system requires that lenders demonstrate a different kind of proficiency in credit underwriting. The needed proficiency requires that transparency extend to borrowers as they become more aware of the variables used to determine their credit score and understand how the offered loan rate is calculated.

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<sup>275</sup> Howard Lax et al., *Subprime Lending: An Investigation of Economic Efficiency*, 15 HOUSING POL'Y DEBATE 533, 534 (2004) (demonstrating that higher subprime loans are not always justified by borrower riskiness).