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A COMMENT ON BANK OF AMERICA/ COUNTRYWIDE'S DISCRIMINATORY MORTGAGE LENDING AND ITS IMPLICATIONS FOR RACIAL SEGREGATION

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Summary

Although Bank of America recently settled a Justice Department complaint alleging racial discrimination in mortgage lending by its Countrywide subsidiary, underlying issues are far from resolved. Longstanding federal inaction in the face of widespread discriminatory mortgage lending practices helped create, and since has perpetuated, racially segregated, impoverished neighborhoods. This history of "law-sanctioned" racial segregation has had many damaging effects, including poor educational outcomes for minority children.

The following commentary reviews existing research to conclude:

- Bank of America's Countrywide subsidiary was not alone in charging higher rates and fees on mortgages to minorities than to whites with similar characteristics, or in shifting minorities into subprime mortgages

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with terms so onerous that foreclosure and loss of homeownership were widespread.

- Racially discriminatory practices in mortgage lending (known as "reverse redlining") were so systematic that top bank officials as well as federal and state regulators knew, or should have known, of their existence and taken remedial action.
- Complicity in racial discrimination by federal and state banking and thrift regulators is nothing new; in the past, they were complicit in "redlining"—the blanket denial of mortgages to minority homebuyers.
- Regulatory failure has been destructive to the goal of a racially integrated society. Redlining contributed to racial segregation by keeping African Americans out of predominantly white neighborhoods; reverse redlining has probably had a similar result. Exploitative mortgage lending has led to an epidemic of foreclosures among African American and Hispanic homeowners, exacerbating racial segregation as displaced families relocate to more racially isolated neighborhoods or suffer homelessness.
- The $335 million that Bank of America will spend to compensate victims is insufficient to restore their access to homeownership markets and to middle-class neighborhoods. In consequence, it will also do little to address the comparatively poor educational outcomes of children who are now more likely to grow up in racially segregated communities, or the damage to learning that results when schooling has been disrupted by an unstable housing situation.

The Obama Administration's prosecution of Bank of America is a welcome but small step in tackling the government-sanctioned practices that contribute to racial segregation in our cities. We should do more.

The case against Bank of America's Countrywide subsidiary

The Justice Department's complaint alleged that Bank of America's Countrywide subsidiary had charged 200,000 minority homeowners higher interest rates and fees than white borrowers who were similarly qualified, with similar credit ratings. The complaint also alleged that Countrywide had failed to offer minority homeowners conventional mortgages for which they qualified and which they would have been offered, were they white. Instead, lending officers systematically pushed minority borrowers into exploitative subprime mortgages, with higher rates and fees (U.S. v. Countrywide 2011a, 2011b).

Many of the victims were in California, and of Mexican origin. Those in the East and Midwest were mostly African American. Although not specifically detailed in the government's complaint, many lost their homes to foreclosure when they were unable to meet the harsh repayment terms to which they had agreed, mostly unwittingly.

To settle the complaint, Bank of America agreed to pay $335 million in restitution and penalties to the 200,000 identified minority victims—the largest settlement to date in the subprime crisis.

Widespread racially discriminatory subprime lending reinforced racial segregation

Historically, discrimination in mortgage lending involved "redlining"—denying minority homebuyers loans to purchase homes in white neighborhoods. Despite a common perception that the 1968 Fair Housing Act mostly eliminated racial discrimination by major financial institutions, Countrywide's practices reflect an equally discriminatory "reverse redlining" that seems to have been widespread throughout the mortgage banking industry. Instead of denying conventional loans to qualified minority borrowers, lenders disproportionately marketed exploitative loans to these borrowers.

Not only did this marketing of risky subprime mortgages help precipitate a worldwide financial crisis, it also reinforced, and may even have intensified, racial segregation in our major metropolitan areas. Whereas redlining kept black families out of white and middle-class neighborhoods, foreclosures stemming from reverse redlining have led to the displacement of many African American and Hispanic families who did manage to gain homeownership in stable middle-income communities, leaving many of them few options but to return to more racially isolated and poorer ghettos.

Minorities were targeted for risky subprime loans

Subprime mortgages were designed for borrowers considered a higher risk, with higher interest payments attached to the loans to compensate for that increased risk. But banks and other lenders created many subprime loans with onerous conditions having nothing to do with borrowers' ability to repay. These mortgages had high closing costs and prepayment penalties, and low initial "teaser" interest rates that skyrocketed after borrowers were locked in. Some subprime loans also had negative amortization—requirements for initial monthly payments that were lower than needed to cover interest costs, with the difference then added to the outstanding principal.

Although borrowers should have been more careful before accepting loans they could not reasonably repay, this was not a transparent market. For example, the design of Countrywide's broker compensation system included incentives to pressure borrowers into accepting subprime mortgages, without the brokers fully disclosing the consequences. Brokers received bonuses, in effect kickbacks (called "yield spread premiums," or YSPs), if they made loans with interest rates higher than those recommended by the bank on its formal "rate sheet" for borrowers with similar characteristics. The brokers were not required to disclose to borrowers what the bank's rate sheet specified. YSPs, characteristic of broker compensation systems throughout the industry, were banned by the 2010 Dodd-Frank financial reform and consumer protection bill. The Federal Reserve issued a rule implementing the ban a year later, but borrowers who were deceived as a result of the kickback system prior to the rule have no recourse (Warren 2007; Nguyen 2011).

Brokers and loan officers at Countrywide and other institutions manipulated borrowers by convincing them they could take advantage of perpetually rising equity to refinance their loans before the teaser rates expired and take cash out of the increased equity (with a share left as profit for the lending institution). But in some cases, these mortgages were promoted and sold to African American homeowners who lived in distressed neighborhoods where there was little or no value appreciation or gain in equity—even before the housing bubble burst. In these neighborhoods, there could be no reasonable expectation that the scheme could work as promised, even if the housing boom continued for other Americans.

The lending industry seems to have systematically targeted African Americans and Hispanics for these risky subprime loans. The Countrywide complaint was based on statistical evidence of discrimination—a strong correlation between race (or Hispanic ethnicity) and loan terms, even after available and relevant borrower characteristics were taken into account. The settlement agreement notes that these disparities were so stark that top officials at Countrywide were aware, or should have been aware, of the racial discrimination and yet did nothing to interfere. Bank of America purchased Countrywide in 2008 and therefore was not responsible for its subsidiary's lending practices from 2004–2007, the period covered by the settlement. What the settlement agreement failed to mention is that in its "due diligence" investigation prior to purchasing Countrywide, Bank of America should have noted the strong statistical evidence of discriminatory lending, and initiated remedial action before the government filed suit. Perhaps the racial discrimination was so commonplace in the industry that Bank of America officials considered it routine.[1]

Other litigation has shed light on widespread discriminatory practices in the mortgage industry, and on how racially explicit they sometimes have been.

A suit by the City of Memphis against Wells Fargo Bank, now working its way through federal courts, is supported by affidavits of bank employees stating that they referred to subprime loans as "ghetto loans" and were instructed by bank supervisors to target their solicitation to heavily African American zip codes, because residents there "weren't savvy enough" to know they were being exploited. Elderly African Americans were considered by bank employees to be particularly good prospects for being pressured to take out high-cost loans (Memphis v. Wells Fargo 2011).

A similar suit by the City of Baltimore against Wells Fargo presents evidence that the bank established a special unit staffed exclusively by African American bank employees who were instructed to visit black churches to market subprime loans. The bank had no similar practice of marketing such loans through white institutions (Baltimore v. Wells Fargo 2011).

Data on lending disparities suggest such discriminatory practices were widespread throughout the industry at least since the late 1990s, with little state or federal regulatory response.

As early as 2000, among homeowners who had refinanced, lower-income African Americans were more than twice as likely as lower-income whites to have subprime loans, and higher-income African Americans were about three times as likely as higher-income whites to have subprime loans. In Buffalo, N.Y., the most extreme case, three-quarters of all refinance loans to African Americans were subprime. In Chicago, borrowers for homes in predominantly African American census tracts were four times as likely to have subprime loans as borrowers in predominantly white census tracts (Bradford 2002, vii, 37, 69).[2]

Analysis commissioned by the *Wall Street Journal* calculated that in 2000, 41 percent of all borrowers with subprime loans would have qualified for conventional loans with lower rates, a figure that increased to 61 percent in 2006 (Brooks and Simon 2007).

By that year, 54 percent of African American, 47 percent of Hispanic, and 18 percent of white mortgage recipients had subprime loans. In census tracts where the population was at least 80 percent minority, 47 percent had subprime loans, compared with 22 percent in tracts where the population was less than 10 percent minority. For metropolitan areas as a whole, borrowers in more-segregated metropolitan areas were more likely to get subprime loans than borrowers in less-segregated metropolitan areas (Squires, Hyra, and Renner 2009).[3]

Borrowers living in zip codes where more than half of residents were minority had a 35 percent greater chance of having mortgages with prepayment penalties than borrowers with otherwise similar known economic characteristics living in zip codes where less than 10 percent of the residents were minority (Bocian and Zhai 2005).

These racial disparities even characterized communities that were not poor. A 2005 survey by the Federal Reserve found that nearly one-quarter of higher-income black borrowers had subprime mortgages, four times the rate of higher-income white borrowers (Avery, Canner, and Cook 2005).

Indeed, the Justice Department concluded over a year and a half ago that "[t]he more segregated a community of color is, the more likely it is that homeowners will face foreclosure because the lenders who peddled the most toxic loans targeted those communities" (Powell 2010).

When the subprime market crashed, minority communities suffered

The proliferation of risky subprime loans led to a foreclosure crisis, affecting both the dispossessed homeowners and their neighbors.

Minority neighborhoods with high proportions of subprime mortgages suffered an epidemic of foreclosures that left boarded-up homes on which the repossessing financial institutions often failed to perform routine maintenance. In affected neighborhoods, city governments had to step in to provide extra services that abandoned properties require, and to prevent the spread of drug dealing and other crimes. The concentration of foreclosures in these neighborhoods affected surrounding homes as well. Each foreclosure caused a decline of about one percent in the value of each other home within an eighth of a mile (Immergluck and Smith 2006).

In some predominantly African American blocks of the middle-class Cleveland suburb of Shaker Heights, for example, as many as one-third of the homes were vacant after foreclosures on subprime borrowers. "The moral outrage," observed the Shaker Heights mayor, "is that subprime lenders have targeted our seniors and African-Americans, people who saved all their lives to get a step up" (Eckholm 2007).

Secretary of Housing and Urban Development Shaun Donovan remarked that because of Countrywide's and other lenders' practices: "[B]etween 2005 and 2009, fully two-thirds of median household wealth in Hispanic families was wiped out. From Jamaica, Queens, New York, to Oakland, California, strong, middle class African American neighborhoods saw nearly two decades of gains reversed in a matter of not years—but months" (Donovan 2011).

Discriminatory lending has been sanctioned by regulators for nearly a century

The Justice Department initiated its investigation of Countrywide after the Federal Reserve Board referred its statistical analysis of Countrywide's discriminatory practices to prosecutors. After Countrywide exchanged its bank charter for a savings and loan charter in 2007, it no longer came under Federal Reserve jurisdiction, but instead was supervised by the Office of Thrift Supervision (OTS). Regulators at OTS soon noticed the pattern and also referred their concerns to Justice.

While regulators may have finally acted on evidence of racial discrimination, they have historically turned a blind eye, or worse. In so doing, they have allowed the lending practices of Countrywide, Wells Fargo, and other leading financial institutions to help perpetuate the racial segregation that characterizes most metropolitan areas today.

Government responses to redlining

Banks and savings and loan associations have discriminated against African American and Hispanic mortgage applicants for nearly 80 years, since mortgage lending first became the common way homeowners financed their purchases. For most of this period, discrimination took the form of redlining—denying loans to African Americans who had qualifications similar to those of successful white borrowers, and of denying loans for homes in neighborhoods where African Americans predominated. This occurred despite heavy regulation of both banks and savings and loan associations, with examiners from the Federal Reserve, the Comptroller of the Currency, the Federal Deposit Insurance Corporation (FDIC), and the OTS all visiting bank and savings and loan offices, reviewing loan applications and other financial records.

Indeed, well into the 1950s, the Federal Housing and Veterans administrations recommended redlining as a mortgage policy. Even as states and localities began to adopt anti-discrimination laws, the Federal Housing Administration (FHA) held steadfastly to its right to discriminate in issuing mortgage insurance. The FHA commissioner defended the federal policy in a 1961 lawsuit, testifying that the agency should not become a "policing authority for enforcement of State and local [anti-discrimination] laws" (USCCR 1961, 64–65).

In 1961, the United States Commission on Civil Rights challenged regulators' inaction over redlining. Their responses were telling (USCCR 1961, 42–51). Ray M. Gidney, then Comptroller of the Currency (responsible for chartering, supervising, regulating, and examining national banks), responded, "Our office does not maintain any policy regarding racial discrimination in the making of real estate loans by national banks."

FDIC Chairman Earl Cocke asserted that it was appropriate for banks under his supervision to deny loans to African Americans because white homeowners' property values might fall if they had black neighbors.

And Federal Reserve Board Chairman William McChesney Martin stated that "[N]either the Federal Reserve nor any other bank supervisory agency has—or should have—authority to compel officers and directors of any bank to make any loan against their judgment." If a black family is denied a loan because of race, "the forces of competition" will ensure that another bank will come forward to make the loan, Martin asserted.With his regulatory authority over all banks that were members of the Federal Reserve System, and with all such banks engaging in similar discriminatory practices, Martin surely knew (or should have known) that his claim was patently false.

By failing to ensure that banks fulfilled the public purposes for which they were chartered, regulators shared responsibility for the redlining of African American communities. When federal and state regulatory agencies chartered banks and thrift institutions whose avowed policy was racial discrimination, the agencies themselves may have violated the constitutional right of minorities to equal protection—to be free of governmentally sponsored racial discrimination.

The 1968 Fair Housing Act made discriminatory practices by banks more explicitly unlawful, whether conducted with or without federal and state regulators' complicity. But it was not until the 1992 publication of an influential report by the Federal Reserve Bank of Boston (Munnell et al. 1996; Ladd 1998), suggesting that discriminatory lending practices continued, that the Federal Reserve System began monitoring statistical evidence of discrimination and, occasionally, referring patterns of discrimination to the Justice Department (Marsico 1999).[4]

Government inaction in the face of reverse redlining

Still, until recently the Federal Reserve System has played its monitoring and referral role with reluctance. Federal Reserve reports have consistently shown statistical disparities in nationwide mortgage financing between whites and minorities, after controlling for every borrower background characteristic that banks were required to disclose. These reports have shown both higher denial rates (redlining), and, with the advent of subprime lending, higher incidence of costlier, risky loans to minorities (reverse redlining). Nonetheless, Federal Reserve analysts have cautioned that their findings should not be taken as definitive because there may be additional borrower characteristics, unavailable to Fed analysts, that explain away the apparent discrimination.[5]

The texture given by the Memphis and Baltimore affidavits to the Federal Reserve's statistical evidence should give pause to this skepticism.

The Obama Administration has spurred the regulatory agencies to be more vigilant. Attorney General Eric Holder has organized a task force, including bank regulators, to combat discrimination (U.S. Department of

Justice 2011). And referrals for prosecution have increased, with the Countrywide case the most dramatic resolution to date.[6]

But much remains to be done, as the Memphis and Baltimore cases attest. Those suits arose not from regulator action but because the cities themselves attempted to recoup from Wells Fargo the excessive expenses incurred when they had to service neighborhoods with shuttered homes. Surely, however, federal bank regulators were aware, or should have been aware, of Wells Fargo's loan practices long before foreclosures accelerated.

Indeed, a federal judge has ruled as much, finding that banks could hardly be held liable for conduct that the regulators apparently approved. In 2008 the City of Cleveland sued a large group of subprime lenders and secondary mortgage securitizers, including Ameriquest, Citicorp, Bank of America, Washington Mutual, Wells Fargo, and others. The lawsuit alleged that the institutions should not have marketed any subprime loans in Cleveland's depressed black neighborhoods because the lenders knew that high poverty and unemployment rates and flat property values in those communities would preclude borrowers from capturing sufficient appreciation to afford the higher adjustable rates they faced once "teaser" rates expired.

Cleveland's suit argued that banks, insurance companies, and other firms that provided capital to the subprime market should be held liable for the harm they created, including loss of tax revenues and an increase in drug dealing and other crime in neighborhoods with many foreclosed and abandoned buildings. The city charged that the financial firms had created a public nuisance.

A federal court dismissed the suit, concluding that because mortgage lending is so heavily regulated by the federal and state governments, "there is no question that the subprime lending that occurred in Cleveland was conduct which 'the law sanctions'" (City of Cleveland v. Ameriquest 2009).

Policy implications of deepening segregation call for greater action

Regulator-sanctioned redlining and reverse redlining have each contributed to racial segregation. Whereas redlining kept black families out of white and middle-class neighborhoods, reverse redlining has resulted in the displacement of African American and Hispanic families who did manage to gain homeownership in stable middle-income communities, leaving many of them few options but to return to isolated and poorer ghettos.

The legal settlement's $335 million in compensation to the victims of Countrywide's discriminatory subprime lending—an average of less than $2,000 apiece—will not return victims to their homes and will not reverse the spread of slumlike conditions to middle-class African American and Hispanic neighborhoods facing foreclosure epidemics. Indeed, many of the victims who lost their homes may now be impossible to locate and will receive nothing (American Banker 2011).

As Secretary Donovan's remarks suggest, it will be some time before minority families nationwide can return in substantial numbers to the homebuying market. Without their return, the country is unlikely to reverse the increasing segregation in urban rental neighborhoods arising from both higher-than-average unemployment among minority workers and the loss of black family wealth caused by subprime-induced foreclosures.

For homeowners dispossessed by foreclosure, there has been greater homelessness, more doubling-up with relatives, and more relocation to rental apartments in less-stable neighborhoods with higher concentrations of poor and minority families (National Coalition for the Homeless 2009).

Despite continued minority suburbanization, racial segregation levels have diminished only insignificantly (Logan and Stults 2011, Figure 2).[7] Both African American and Hispanic families are more likely to live in high-poverty neighborhoods today than a decade ago (Pendall et al. 2011, Tables 1 and 2).[8] Even before the foreclosure epidemic accelerated, geographic segregation by income among African Americans was increasing, with more low-income black families living mostly among other low-income black families; income segregation among Hispanics has also increased, although not as severely (Reardon and Bischoff 2011). Foreclosures resulting from the subprime loan crisis can only make this segregation worse.

This is particularly troubling because the link between racial segregation and unemployment, poverty, crime, school failure, and other adverse outcomes has been well-documented.[9]

Without radical public-policy intervention, it is hard to see how African Americans can re-enter the homeownership market in significant numbers and reverse the segregation of our metropolitan areas.

Data on trends in employment and wealth highlight the dire picture for our segregated metropolitan areas. Black unemployment is now 16 percent, more than twice the rate of white unemployment (Shierholz 2011). In some highly segregated metropolitan areas (Milwaukee being the most extreme) the black unemployment rate is nearly four times the white rate (Austin 2011). Median black family wealth (net worth) plummeted to about $6,000 in 2009, less than half its value in 2005 before the housing bubble began to burst, and equal to only 5 percent of median white family wealth. If home equity of African Americans who continue to own homes is not included, median black family wealth is now only $1,000 (Taylor, et al. 2011, 15).[10]

The future for children of subprime-mortgage victims also appears diminished. Children move frequently when their families lose housing stability, and student mobility is a major cause of low academic achievement (Rothstein 2004, 46–47; Rothstein 2011). For children of families dispossessed of their homes, academic achievement has fallen due to elevated family stress, lowered incomes, more moves to new schools, and less exposure to higher-achieving peers. For these children's classmates, now in more-crowded ghetto schools, education is disrupted as lessons are repeated for newcomers and as teachers change because excessive enrollment requires reconstituting classrooms.

In 2007, the U.S. Supreme Court forbade school districts from taking aggressive action to integrate schools that were located in racially segregated neighborhoods, asserting that government had no responsibility for segregation that now resulted only from economic forces, private prejudice, and personal choice. Yet it is clear from the subprime debacle that segregation has recently been intensified by conduct that "the law sanctions." The Obama Administration's more aggressive efforts to reverse that sanction is an important first step, but there is a long way to go before the damage is undone.

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Endnotes

1. Had Bank of America taken note of these data, and anticipated that the Department of Justice would do so as well, the bank might well have refrained from the takeover because its assumption of Countrywide's liability in this and other cases has made the purchase a financial blunder. In June 2011, for example, Bank of America settled charges with the Federal Trade Commission alleging that Countrywide had charged excessive fees to 450,000 homeowners for property maintenance when they went into default, and added illegitimate charges to what the homeowners owed. In this case, Bank of America paid $107 million to the FTC for distribution to the victims (FTC 2011). Although the FTC case was not concerned with racial discrimination, it is likely that these practices had a disproportionate impact on minorities as well, because minorities were more likely to default on (frequently exploitative) home mortgage loans.

2. Lower-income borrowers are those whose income is less than 80 percent of the median income in their metropolitan area. Higher-income borrowers are those whose income is more than 120 percent of the median income. A predominantly African American (or white) census tract is one where at least 75 percent of residents are African American (or white).

3. These and the foregoing data are only suggestive. We would expect minorities, on average, to have a lower rate of qualification for conventional loans than whites because, on average, minorities have less-advantageous economic characteristics (income, assets, employment, etc.) that are relevant to creditworthiness. The data disparities, however, are so large that it is probable, though not certain, that creditworthiness alone cannot explain them.

4. The 1992 Boston Federal Reserve study concluded that "even after controlling for financial, employment, and neighborhood characteristics, black and Hispanic mortgage applicants in the Boston metropolitan area are roughly 60 percent more likely to be turned down than whites."

5. For example, a 2005 Fed report states that "controlling for credit-related factors not found in the HMDA [Home Mortgage Disclosure Act] data, such as credit history scores and loan-to-value ratios, might further reduce unexplained racial or ethnic differences. Whether controlling for such additional factors will completely account for all remaining differences is unclear" (Avery, Canner and Cook 2005, 393). For a critical comment, see Squires (2005). The most recent Fed analysis remains cautious ("unexplained differences in the incidence of higher-priced lending and in denial rates among racial or ethnic groups stem, at least in part, from credit-related factors not available in the HMDA data, such as measures of credit history [including credit scores]…"), but notes that the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 will require banks to provide at least some of the additional data (credit history scores) that were not previously available, although implementation will not be immediate (Avery et al. forthcoming, 43, 46). An independent analysis restricted only to subprime lending, not mortgage lending generally, re-analyzed the data used by the Federal Reserve, but added information on borrowers' credit scores that was not available to the Fed. Even with these additional controls, African Americans and Hispanics paid more for mortgages than whites with similar characteristics (Bocian, Ernst, and Li 2006).

6. For another recent example of settlement of charges similar to those in the Countrywide case, but in a much smaller bank, referred to Justice by the Federal Reserve, see the $2 million settlement of charges against PrimeLending (U.S. Department of Justice 2010).

7. The average black metropolitan-area resident lives in a census tract that is 35 percent white, the same as in 1950, and below the 40 percent level of 1940.

8. On average, from 2005–2009, 14.3 percent of African Americans lived in census tracts in which more than 20 percent of residents were in families with incomes below the poverty line, up from 13.6 percent in 2000; for Hispanics, it was 16 percent from 2005–2009, up from 13.1 percent in 2000.

9. Recent studies have demonstrated how policies to integrate schools have improved outcomes in education (Guryan 2004; Schwartz 2010), crime and delinquency (Weiner, Lutz and Ludwig 2010); and earnings (Johnson 2011).

10. For Hispanics, the losses have also been severe. Median Hispanic family wealth fell from about $18,000 in 2005 to about $6,000 in 2009, about 6 percent of median white family wealth. Excluding home equity, median Hispanic family wealth is now about $3,000. For an alternative calculation using a different methodology, resulting in similar relative findings, see Mishel (2011).

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