Racial Profiling of Borrowers: An Idea Fraught with Peril

*By James M. Rockett**

In the early 1970s, during my first days as a banking lawyer, I was anxious to purchase my first home and, as was the custom in those days preceding the impact of Burt Lance, I was referred by my bank employer to a correspondent bank. The scene that followed is forever etched in my memory. I met the banker, a middle-aged man with polished nails, a black tailored suit, white shirt and wide suspenders who condescended to consider the business of a young lawyer. After explaining my excitement about the old Victorian home in a transitional area of San Francisco that I hoped to buy, I asked if his bank would provide the mortgage financing. He peered at me with a quizzical look and drew himself up in his chair: "Young man, if you want to live in an area with all of those blacks [not the pejorative phrase he actually used] don't expect our bank to assist you. Good day." Unfortunately, in those days, as our country was coming to terms with recently enacted civil rights laws and efforts to create a society that treated all persons fairly, lending discrimination based on race was real. It was widespread; it was overt; and it was largely ignored. Banking was the bastion of the white, economically advantaged male and not much consideration was given to those who fell outside a fairly narrow band of bank customers.

During the ensuing decades, banking has changed dramatically. Important among those changes, racial discrimination, be it in employment or lending, is without doubt the exception. And, despite the perceptions of those who view the world in terms of racial inequality, banks are serving the needs of minorities in ways that never before were believed to be possible. The fact is that, as banks rely more routinely on non-personal communication with their customers through the Internet or other electronic or telephonic methods, the opportunity to know and consider the race of the customer is virtually eliminated. Moreover, through the process of credit scoring, decisions are being made that take into account only economic factors that exclude racial components. Rapidly we are approaching a lending environment that ignores or cannot factor elements that in the past allowed racial discrimination.

In spite of enormous progress in systematically eliminating racial considerations from lending through laws and regulations that, by any measure, have been extremely successful — and, one must concede, there will always be rogue individuals in positions of discretion whose prejudices intrude to the occasional disadvantage of a specific prospective borrower — the Federal Reserve Board, at the insistence of regulatory and advocacy groups, is considering the re-introduction of race as a factor in loan applications. This effort has come in the form of a proposal to amend the Board's Regulation B in order to permit "voluntary" collection of racial data in loan applications. In other words, loan applications will appear which request that the applicant identify his or her race. It needs to be understood that Regulation B and the statute it implements, the Equal Credit Opportunity Act, have existed for many years as barriers to racial discrimination in bank lending. They have always forbade banks from inquiring into "prohibited factors" in the application process. It would appear that, having virtually eliminated lending bias without curing all of society's economic disparities, the politically motivated regulators and special interest groups are now intent on focusing on the banking industry as the source of general economic inequities. This may seem a harsh indictment, but let's examine the Fed's proposal in the context of current regulatory trends.

Initially, it is important to note that reported incidents of actual discrimination are dealt with harshly and quickly by a variety of legal and regulatory methods. Banks are sensitive to this and train and monitor their employees carefully for any signs of inappropriate behavior. But the Fed's proposal is not aimed at actual discrimination; it is seeking evidence of statistical "discrimination." Throughout the Clinton Administration, the government, led by the Department of Justice, attacked "Fair Lending" issues through statistical analyses. Regardless of actual proof, the DOJ sought data that, viewed through a prism which assigns racial discrimination as a primary explanation, suggests disparate treatment between white borrowers and minority borrowers. For example, the Clinton DOJ extracted settlements from mortgage lenders after examinations of data collected under the Home Mortgage Disclosure Act ("HMDA") suggested that African-American applicants paid higher loan fees or rates than did Caucasian applicants. No explanation other than racial discrimination was possible for the DOJ. Similarly, the DOJ was not particularly concerned about the accuracy of the information on which it relied for condemning practices. The DOJ relied on methods such as a review of applicant surnames to surmise ethnic composition of borrowers in measuring "disparate treatment" and forced settlements based on such wildly unreliable data. The Fed itself played into these tactics with its now infamous "Boston Fed" study of racial considerations in the lending process. Given this methodology, it is not surprising that the Fed is seeking to "permit" banks to gather racial data on loan applications. No matter how sporadic or unreliable the information may prove to be, it will be fodder for manipulation.

The Fed seeks to conceal the motivations for permitting the gathering of heretofore prohibited information by proposing that it be "voluntary." What can be wrong with simply allowing a bank that desires to monitor its own progress in fair lending to gather the information necessary to do so? The answer to this query is painfully obvious. First, once the information is captured, it will be

there for the regulators through the examination process and, eventually, for interest groups, through intimidation or subpoena, to see, manipulate and use to advance their agendas. Second, there will be no uniformity in capturing the data. Definitions of "race" or "ethnicity" will vary institution by institution. In our melting-pot society, defining such concepts is increasingly imprecise. Third, the "voluntary" nature of the process will produce information that is even less reliable that data currently available through HMDA (which itself is extremely tenuous). Fourth, with an emphasis on privacy pervading the American public, the willingness of applicants to share information about their racial backgrounds is questionable. At best, application questions about race are intrusive, possibly leading to target marketing or other mischief; at worst, they will be viewed as efforts by banks to consider impermissible factors and to discriminate against certain classes of applicants. During this "voluntary" phase, banks won't even have the defense that "the government made me do it" when customers inquire about such inappropriate inquiries.

In actuality, the "voluntary" phase will only exist for a short period. As soon as the data is sporadically available from voluntary sources, it will simply be too tempting to ignore. Fed studies, hearings before political bodies, governmental enforcement actions, class actions and investigative journalism will all command access to such information. Once these drums commence their relentless beat, the Fed will bow to overwhelming demand and make the collection and availability of race related loan data mandatory.

While such an outcome may please a limited constituency of regulators and activists, what effect does the pernicious practice of inquiring into race have on minorities who, because of the historically low interest rate environment we are experiencing, are finally reaching a position where bank borrowing has become a reality? The minority family applying for a personal line of credit with a bank or the minority owned or operated business seeking a commercial loan will be queried about their background in a way that has been illegal for years. The not-so-subtle message is that race is considered in the credit granting process. And the detrimental impact of that message cannot be measured against the theoretical benefit of access to faulty racial data generated through loan applications, whether or not voluntary.

Finally, the collection of racial information in the application process cannot possibly benefit society, especially minorities. Foremost, the data once collected will not tell the full story in spite of what the proponents maintain. This is because such data fails to take into account statistical variances that result from considerations other than race . Lending is a balance between risk and reward. A good lender will consider many factors in determining creditworthiness of a customer and will price the granting of credit in accordance with the risk involved. Legally, race cannot be a factor considered in this evaluation; but, if data is collected in the application process, it certainly can be manipulated to appear to be the reason for denying credit or pricing credit differently. Creditworthiness is an explanation for apparent disparities in lending data but, because that justification cannot be quickly explained by one question on the loan application, it will never be accepted as the answer by those seeking a simple solution.

What seems to be lost on the proponents of the Fed's proposal is that, unlike banking during the 1970s (when my horrible experience was commonplace), now banking is highly competitive and modern bankers are required to be entrepreneurial. In a financial world where earnings per share is paramount and compensation systems reward profitable production, there is no room for racial discrimination. Today's generation of bankers (no longer wearing dark suits and suspenders) will without hesitation lend to little green men from outerspace if a profit can be realized, thus enhancing the bonus pool. Moreover, combining such an environment with the almost impossible task of determining the racial identity of an applicant virtually assures us of discrimination-free lending. "Hold on," caution the proponents of the Fed's proposal, "How then do you explain disparate treatment that is suggested by the data?" Well, once again the laws of economics intrude. In society as a whole, economic rewards are not spread evenly over all racial and ethnic classes. This is certainly not good; but it is reality. If banks, solely using economic factors which predict creditworthiness, make loans based on those considerations, it is highly probable that statistically disparate impact can be demonstrated. This is neither the fault of banks nor is it an indication of racial discrimination. It is simply a reflection of the socio-economic state of our society, one for which bankers cannot be blamed. And unreliable data culled from offensive questions on loan applications cannot remedy economic disparity or reshape the lending practices in our country. Too much time has passed since those disgusting early days of discriminatory bankers and too much progress toward a race-neutral lending environment has been achieved for the Fed to force a focus on race in lending.

The Federal Reserve proposal needs to be stopped in its tracks. And those who truly want a lending process that rejects racial considerations need to demand that it do so.

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