Lending Discrimination: Is the Secondary Market Helping to Make the "American Dream" a Reality?

Ronald K. Schuster*

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*. Assistant Legal Officer, Eighth Coast Guard District; United States Coast Guard Academy, B.S.; Tulane Law School, J.D.; Tulane Law School, LL.M. The opinions in this Article are those of the author alone and do not reflect the views and policies on either the United States Coast Guard or the Department of Transportation.

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I. INTRODUCTION

What is the "American Dream"? While many scholars have pondered that question,[1] an exact definition is still the subject of much debate. However, if asked, most would agree the American Dream stresses two ideals—material prosperity and human equality.[2] With regards to material prosperity, "owning a home is one of the primary ways of accumulating wealth in our society."[3] Thus, it is reasonable to believe that for most Americans, home ownership represents at least part of the material or economic prosperity aspect of the American Dream.

The United States government has taken measures in an effort to allow all Americans the opportunity to realize the economic aspect of the American Dream. One measure is the government's sponsorship of the Federal National Mortgage Association ("Fannie Mae") and the Federal Home Loan Mortgage Corporation ("Freddie Mac"). These Government Sponsored Enterprises ("GSEs") are federally chartered to provide greater liquidity in the primary mortgage market and to ensure that mortgage funds are available to homebuyers at all times throughout the country.[4] Additionally, Congress has taken measures to address the equality aspect of the American Dream. One example of this is the Equal Credit Opportunity Act, which expressly prohibits discrimination based on race, gender, marital status, religion, and national origin in the lending process.[5]

With greater liquidity in the market and statutory prohibition of discrimination in lending in place, it appears the American Dream has become more ascertainable through the government's actions. However, do all Americans really have an equal opportunity to own a home? Recent statistical

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1. *See, e.g.*, ALEXIS DE TOCQUEVILLE, DEMOCRACY IN AMERICA (1976).

2. *See* WEBSTER'S NINTH NEW COLLEGIATE DICTIONARY 78 (1984).

3. MORTGAGE LENDING DISCRIMINATION: A REVIEW OF EXISTING EVIDENCE 1 (Margery Austin Turner & Felicity Skidmore eds., 1999) [hereinafter MORTGAGE LENDING].

4. *See* U.S. DEP'T OF THE TREASURY, *Government Sponsorship of the Federal National Mortgage Association and the Federal Home Loan Mortgage Corporation*, 1 (1996) [hereinafter DOT REPORT]. *See also* GRANT S. NELSON & DALE A. WHITMAN, CASES AND MATERIALS ON REAL ESTATE TRANSFER, FINANCE, AND DEVELOPMENT 935 (5th ed. 1998).

5. Equal Credit Opportunity Act, 15 U.S.C. §§ 1691-1691f (1994 & Supp. IV 1999). *See also* Home Mortgage Disclosure Act of 1975, 12 U.S.C. §§ 2801-2810 (1994 & Supp. IV 1999); Community Reinvestment Act of 1977, 12 U.S.C. §§ 2901-2907 (1994); Fair Housing Act, 42 U.S.C. §§ 3601-3619 (1994 & Supp. IV 1999).

data indicates that not all Americans have equal access to the capital necessary for home ownership. In 1998, approximately three out of every four non-minority applicants for a mortgage were approved.[6] In contrast, nearly half of the minority applicants had their request for a home loan denied.[7] Many argue that such evidence indicates the lending process discriminates against minorities, while others counter that the discrepancy merely reflects the difference in economic status between most minorities and non-minorities.[8] If the discrimination argument is true, for many Americans the American Dream of home ownership represents little more than a vague ideal rather than an attainable goal.

Is the American Dream alive and well today? At first glance it appears so, given the initiatives taken by the government for its preservation, combined with one of the most prosperous economic times in the United States history.[9] Unfortunately, the statistical evidence mentioned above arguably supports the conclusion that the American Dream may be dying rather than thriving for many Americans. This Article examines the possibility that the GSEs created to preserve and enhance access to mortgage funds may actually be hindering many minorities from becoming homeowners. Part II reviews the relationship between the primary and secondary lending markets and describes the government's initiatives to improve that relationship. Part III discusses the different forms of discrimination in the lending process and in what stages it may occur. That section also briefly describes Congress' legislation against discrimination in mortgage lending. Finally, Part IV addresses the applicability of anti-discrimination legislation to the secondary lending market, questions whether the secondary market causes the primary market to discriminate, and posits whether the secondary market should be regulated.

II. THE PRIMARY AND SECONDARY LENDING MARKET

The term "primary lending market" refers to originators of mortgages such as credit unions, commercial banks and mortgage companies.[10] The originator is the entity that completes the formalities of the initial loan process, such as receiving applications from potential borrowers, conducting necessary

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6. *See* Bill Hampel, *HMDA Again*, CREDIT UNION MAGAZINE, Nov. 1, 1997, at 97, 97.

7. *Id.* ("[A] minority applicant is only 78% as likely to have a mortgage approved as is a white applicant."). *Id.*

8. *Id.*

9. *The Election Issues 2000: A Special Briefing*, THE ECONOMIST, Sept. 30, 2000 at 6, 6.

10. NELSON & WHITMAN, *supra* note 4, at 905.

appraisals, completing credit and employment checks, preparing required documents, and eventually disbursing the loan funds to borrowers.[11]

Traditionally, the originator (or primary market lender) of mortgage loans held the loans in its portfolio and collected the principal and interest payments from the debtors.[12] However, in an effort to minimize the risk of the loans and provide greater liquidity in the primary lending market, the mortgage industry developed a secondary market that buys mortgages from originators.[13]

The secondary mortgage market serves to channel mortgages to private investors.[14] In 1938, Congress created Fannie Mae as a government corporation for the purpose of purchasing and reselling mortgages in an effort to provide liquidity to financial institutions that had limited access to national markets for capital.[15] Congress chartered Freddie Mac in 1970 for a similar purpose.[16]

Fannie Mae and Freddie Mac are both GSEs and are regarded as quasi-governmental institutions due to their federal charter.[17] Although both are privately owned corporations and neither receive funds from the government,[18] their charters bestow upon them both benefits and constraints beyond that of an ordinary company. Some of the benefits include: exemption from paying state and local corporate income taxes; no registration requirements with the Securities Exchange Commission of the companies' securities; and permission to borrow at rates better than the highest-rated private firms.[19] Unlike private industry, however, which usually operates with the sole purpose of maximizing profits for shareholders, Fannie Mae and Freddie Mac have additional operational requirements that are mandated by their charters. Those constraints include being: (1) limited to operating in the secondary market and purchasing mortgages that do not exceed $207,000; (2) required to purchase target

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11. *Id.*

12. *Id.* at 906.

13. *Id.*

14. *See* DOT REPORT, *supra* note 4, at 18.

15. *Id.* at 17-18. Initially, Fannie Mae was limited by its charter to purchasing FHA guaranteed mortgages. *Id.* By 1948 Congress expanded the scope of Fannie Mae's purchasing power to include VA loans. *Id.* at 18. Following the credit crisis of 1969-70, Congress yet again extended the scope of Fannie Mae's purchasing power to also include "conventional" loans (non-VA and non-FHA mortgages). *Id.* at 19.

16. DOT REPORT, *supra* note 4, at 19. In addition to the expansion of Fannie Mae's powers to include servicing "conventional loans," Congress also created Freddie Mac to help alleviate the credit crunch of 1969-70. *Id.* Freddie Mac was designed to develop the secondary market for conventional loans, many of which were held by savings and loans institutions. *Id.*

17. *Id.* at 1.

18. *See, e.g.*, *House New Orleans* (Fannie Mae, Wash. D.C.), 2000, at 1 ("Fannie Mae, a private, shareholder-owned company, helps make sure mortgage money is available for people in communities, all across America.").

19. DOT REPORT, *supra* note 4, at 2-3.

amounts of mortgages from under-served, low- and moderate-income households, and very-low income households; and (3) mandated to assess whether their business requirements, including their fees, procedures, underwriting standards and practices, may result in discrimination.[20] Both Fannie Mae and Freddie Mac successfully serve as conduits for investor participation in the secondary market and contribute greatly to the development of a more liquid primary market.[21]

The GSEs, as well as private companies in the secondary market, usually purchase mortgages from mortgage originators and finance the purchases in one of two ways.[22] The first method is to buy the mortgages, create a mortgage pool and then sell securities that represent an interest in that pool.[23]

> In a typical transaction the GSE buys mortgages with similar interest rate structures, age and underwriting characteristics from a lender who retains a portion of the monthly mortgage payments as compensation for servicing the pool of loans. The GSE retains a guarantee fee, and passes the remaining portion of the monthly mortgage payments on to the ultimate investors, the holders of the mortgage-backed securities for that loan pool.[24]

The other prominent way secondary market lenders fund purchases from primary market lenders is to issue debt securities and retain the mortgage in the corporation's portfolio.[25]

Today, the secondary market holds nearly four trillion dollars worth of outstanding mortgages for 1-4 family homes.[26] Fannie Mae and Freddie Mac hold about thirty-four percent of that total.[27] Those figures demonstrate not only the rapid growth of the secondary market industry, but also the resulting dependence of the primary market on it for capital. This dependence is reflected by the fact that virtually all primary lending institutions sell a portion of their loans into the secondary market.[28] This trend impacts the way originators do their business. Primary lenders today place much more importance on whether

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20. *Id.* at 28-29.

21. *Id.* at 18.

22. *See id.* at 20. In 1995, Fannie Mae and Freddie Mac either owned in portfolio or guaranteed about one third of all outstanding residential mortgages in the United States. NELSON & WHITMAN, *supra* note 4, at 936.

23. *See* DOT REPORT, *supra* note 4, at 22.

24. *Id.*

25. *Id.* at 20.

26. *See id.* at 36; NELSON & WHITMAN, *supra* note 4, at 936.

27. *See* NELSON & WHITMAN, *supra* note 4, at 936.

28. U.S. DEP'T OF HOUSING AND URBAN DEV., *Stage 3: The Loan Approval or Disapproval Decision, at* http://www.hud.gov/pressrel/newsconf/stage3.html (last modified Sept. 8, 2000).

they will be able to sell a loan they originate than they did a decade ago.[29] This shift of emphasis is reflected by two examples of how the lending business operates today.

First, many lenders use application forms that either closely resemble or exactly replicate the information required by Fannie Mae and Freddie Mac to ensure they can sell the loans they originate to one of the GSEs.[30] Second, Fannie Mae has developed an underwriting software program known as the Desktop Underwriter.[31] The Desktop Underwriter enables the primary lender to input the data supplied by the borrower on the application form into a computer system and moments later receive a response as to whether this is the type of loan Fannie Mae would be willing to purchase.[32]

Perhaps because secondary market entities have no direct relationship with the individual borrower, a more stringent review of the potential for secondary market discrimination has not been conducted. What is clear, however, is that over the last few decades, Congress has recognized discrimination as a problem at the primary market level and drafted specific legislation to counter it.[33] The next part of the Article will discuss the statutory constraints applied to the primary lending market, the forms of discrimination, and finally, the stages of the primary lending process where discrimination occurs.

III. Discrimination and the Primary Lending Market

Following the passage of the Civil Rights Act of 1968,[34] Congress recognized that discrimination in the lending market was an issue that needed to be specifically addressed. Between 1974 and 1977, Congress enacted three pieces of legislation that have become a formidable trilogy to combat discrimination in the lending market—the Equal Credit Opportunity Act

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29. *See Agencies Address Key Questions on Fair Lending*, 13 No. 7 BANKING POL'Y REP. 9, 12 (1994).

30. In addition to allowing for a more efficient sale to a GSE, use of the GSE's application form also gains the originator the benefit of approval under Regulation B. *See* PAUL BARRON & MICHAEL A. BERENSON, FEDERAL REGULATION OF REAL ESTATE AND MORTGAGE LENDING 8-17 (4th ed. 1998). Regulation B, which is a promulgation of detailed rules in furtherance of ECOA, provides that the credit application forms created by Fannie Mae and Freddie Mac are compliant with ECOA. *See* 12 C.F.R. pt. 202, app. B (2000); *see also* BARRON & BERENSON, *supra*, at 8-17.

31. *See* FANNIE MAE, *MornetPlus: Consulting and Integration Services*, *at* http://www.fanniemae.com/singlefamily/technology/mornetplus/mp_consult.html (last visited Sept. 23, 2000) (discussing Fannie Mae's Desktop Underwriter).

32. Telephone interview with MornetPlus technical consultant (Mar. 21, 2000).

33. See *infra* Part IIIA.

34. Civil Rights Act of 1968, Pub. L. No. 90-284, 82 Stat. 73 (1968) (codified as amended in scattered sections of 42 U.S.C.).

("ECOA"),[35] the Home Mortgage Disclosure Act of 1975 ("HMDA"),[36] and the Community Reinvestment Act of 1977 ("CRA").[37]

A. *Applicable Legislation*

The government's effort to cure the malady of discrimination began in 1968 with the passage of the Fair Housing Act ("FHA").[38] Amended in 1974 and 1988, this act specifies that:

> It shall be unlawful for any person or other entity whose business includes engaging in residential real estate-related transactions to discriminate against any person in making available such a transaction, or in the terms or conditions of such a transaction, because of race, color, religion, sex, handicap, familial status, or national origin.[39]

While the FHA prohibits discrimination in the financing, sale, or rental of housing, Congress chose to specifically address the issue of discrimination against applicants for mortgages through the ECOA, HMDA, and CRA. These three pieces of legislation place different requirements upon the creditor, and when enforced as a whole create a formidable counter to discrimination at the primary market level. The ECOA is the most prominent act of the three and will be addressed first.

1. Equal Credit Opportunity Act

Enacted in 1974, the ECOA was designed to "promote the availability of credit to all creditworthy applicants without regard to race, color, religion, national origin, sex, marital status, or age."[40] The ECOA makes it illegal for creditors to discriminate against any applicant who is a member of those protected classes.[41] Additionally, the ECOA provides authority to the Federal Reserve to promulgate rules in furtherance of the statute's purpose.[42] Those

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35. 15 U.S.C. §§ 1691-1691f (1994 & Supp. IV 1999).

36. 12 U.S.C. §§ 2801-2810 (1994 & Supp. IV 1999).

37. 12 U.S.C. §§ 2901-2907 (1994).

38. 42 U.S.C. §§ 3601-3619 (1994 & Supp. IV 1999).

39. *Id.* at § 3605.

40. 12 C.F.R. § 202.1(b) (2000). Regulation B is issued by the Federal Reserve System pursuant to ECOA. *Id.* at § 202.1(a). Additionally, ECOA's provisions initially only precluded discrimination on the basis of sex or marital status. BARRON & BERENSON, *supra* note 30, at 8-2. In 1976, ECOA expanded the protected class to prohibit discrimination based on race, color, religion, national origin, and age. *Id.* at 8-2-8-3.

41. 15 U.S.C. §1691(a)(1) (1994).

42. *See* 15 U.S.C. §1691b(a)(1).

rules are known as Regulation B.[43] While the ECOA's sweeping prohibition of discrimination appears fairly clear, there are subtle ambiguities that require further inquiry.

Confusion arises under the ECOA in determining who is deemed a creditor and what actions constitute discrimination. The statute answers the first issue, while legislative history addresses the latter. Section 702(e) provides that "the term 'creditor' means any person who regularly extends, renews, or continues credit; any person who regularly arranges for the extension, renewal, or continuation of credit; or any assignee of an original creditor who participates in the decision to extend, renew, or continue credit."[44] Thus, it is clear that all primary market lenders fall within the scope of ECOA. While the statute does not specifically define the term "discrimination," Regulation B indicates in a footnote that discrimination encompasses overt/direct discrimination, differential treatment, and disparate impact discrimination.[45]

In establishing incidents of discrimination, plaintiffs often need statistical information derived from the accumulation of lending data.[46] Recognizing the importance of such disclosures and lack of provisions in the ECOA to provide this information, Congress enacted the Home Mortgage Disclosure Act in 1975 to fill that legislative void.

2. Home Mortgage Disclosure Act

If the Equal Credit Opportunity Act were a gun, the Home Mortgage Disclosure Act[47] ("HMDA") would likely be the bullet. This analogy is apt considering the relationship between the two statutes. The ECOA can be viewed as a weapon aimed at the target of discrimination in mortgage lending while the HMDA merely provides a portion of the ammunition in combating discrimination in the lending process.

The HMDA is "predicated on the belief that lending institutions had been systematically disinvesting in older, blue-collar, ethnic neighborhoods, thereby making it impossible . . . for new purchasers interested in maintaining or improving the neighborhoods to buy."[48] This lending phenomena is known as

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43. *See* 12 C.F.R. § 202.1-202.15 (2000).

44. 15 U.S.C. § 1691a(e).

45. *See* 12 C.F.R. § 202(6)(a) n.2 ("The legislative history of the Act indicates that the Congress intended an "effects test" concept . . . to be applicable to a creditor's determination of creditworthiness.").

46. *See, e.g.*, Sallion v. Suntrust Bank, Atlanta, 87 F. Supp.2d 1323 (N.D. Ga. 2000) (holding plaintiff failed to meet statistical burden).

47. 12 U.S.C. §§ 2801-2810 (1994 & Supp. IV 1999).

48. BARRON & BERENSON, *supra* note 30, at 11-1-11-2.

"redlining."[49] Congress believed systematic "redlining" led to the decay and abandonment of neighborhoods and prevented many Americans from acquiring suitable homes.[50] The theory behind the HMDA was that by requiring lending institutions to publicly disclose their loan information, the community would pressure these institutions to reverse their trend of disinvestments.[51]

The HMDA requires "depository institutions"[52] to submit annual reports detailing home purchase and home improvement loans they have originated or purchased during the covered period, as well as applications received for the loans.[53] The statutory definition for "depository institution" is quite broad and includes any bank, credit union or savings association that makes federally related mortgage loans.[54] Also included within the scope of the HMDA is "any person engaged for profit in the business of mortgage lending."[55]

The required HMDA disclosures encompass not only the location of the property and type of loan, but the borrower's race, ethnicity, national origin, gender, and income as well.[56] This information becomes extremely helpful when documenting cases of redlining and credit discrimination. Moreover, census data regarding the bank's borrowers and applicants also serves as statistical evidence essential for demonstrating discrimination in lending, such as differential treatment and disparate impact discrimination.[57] It is through such HMDA disclosures that plaintiffs can often provide the statistical information necessary to substantiate an ECOA claim.[58]

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49. *Id.*; *see also* Stephen P. Radics, Jr., *Redlining—The Facts Behind All the Reporting*, *in* REINVESTMENT IN URBAN COMMUNITIES: REDLINING, MORTGAGE DISCLOSURE, CREDIT ALLOCATION AND NEIGHBORHOOD PRESERVATION 69, 71-73 (1977).

50. *See* BARRON & BERENSON, *supra* note 30, at 11-2.

51. *See id.*

52. Depository institutions are any bank, any savings association, or any credit union that makes federally related mortgage loans. 12 U.S.C. § 2802(A).

53. *See* FDIC, *Consumer Rights*, *at* http://www.fdic.gov/consumers/consumer/rights/index.html (last modified Oct. 4, 1999). As originally enacted HMDA was rather ineffective because it did not apply to mortgage bankers and only required reporting of census data regarding loans originated, not those denied. *See* NELSON & WHITMAN, *supra* note 4, at 948-49. However, it was amended in 1989 to correct those deficiencies. *Id.*

54. *See* BARRON & BERENSON, *supra* note 30, at 11-3. HMDA's Regulation C defines a "financial institution" as an organization that initiates first line, home purchase loans for 1-4 family dwellings if (a) the institution is federally insured, (b) the loan is federally guaranteed or insured, or (3) the institution intends the sell the loan to either Freddie Mac or Fannie Mae. 12 C.F.R. §203.2(e)(1) (2000).

55. 12 U.S.C. § 2802(4) (1994).

56. § 2803(b)(4). *See also* NELSON & WHITMAN, *supra* note 4, at 948-49.

57. *See* Edwards v. Flagstar Bank, 109 F. Supp. 2d 691, 704 (E.D. Mich. 2000).

58. *See id.*

3. Community Reinvestment Act

The Community Reinvestment Act ("CRA"), passed by Congress in 1977, requires federal agencies to encourage financial institutions to meet the needs of the community it serves. Particular emphasis is placed on meeting the mortgage lending needs of the area.[59] Federal agencies that regulate financial lenders assess whether lending institutions are meeting the community's needs, in particular those of low- and moderate-income neighborhoods.[60] Like the HMDA, the overall goal of the CRA is to ensure that financial institutions are not allowed to "turn their back" on certain areas.

The supervising agencies enforce the CRA's mandate in a unique manner. The CRA requires regulatory agencies to consider a financial institution's success in meeting its community's credit needs when evaluating certain corporate applications.[61] Specifically, the CRA provides federal agencies with the power to deny a financial institution's request to merge, relocate a home office, or open or close a branch office based on poor CRA results.[62] Thus, along with the ECOA and the HMDA, the CRA provides yet another tool in the government's arsenal in eliminating discrimination at the primary lending market.

B. *Forms of Discrimination within the Primary Lending Market*

The primary lending market can discriminate in different ways and at various stages of the lending process. Three principle forms of discrimination have been documented as occurring at the primary market level: direct/overt discrimination, disparate treatment discrimination, and disparate impact discrimination.[63] While the ECOA is the principle means of redress for such discrimination, the statute does not explicitly dictate the elements required to establish a prima facie case. Instead, Congress intentionally left that determination to the courts. To date, the Supreme Court has not ruled on what those elements are; however, a number of federal courts have fashioned various rules for establishing a prima facie case.

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59. *See* NELSON & WHITMAN, *supra* note 4, at 949; *see also* FDIC, *supra* note 53.

60. *See* FDIC, *supra* note 53.

61. NELSON & WHITMAN, *supra* note 4, at 949; FDIC, *supra* note 53.

62. NELSON & WHITMAN, *supra* note 4, at 949; FDIC, *supra* note 53.

63. BARRON & BERENSON, *supra* note 30, at 8-19. *See also* Fred Galves, *The Discriminatory Impact of Traditional Lending Criteria: An Economic and Moral Critique*, 29 SETON HALL L. REV. 1467, 1472 (1999).

1. Direct/Overt Discrimination

The first form of discrimination, and easiest to detect, is direct/overt discrimination (also referred to as intentional discrimination).[64] The scenario is straightforward—a lender denies a qualified applicant's request for credit simply because of the applicant's race, gender, religion, marital status, age, or national origin.[65] To prove direct discrimination, some courts require the plaintiff demonstrate "through direct evidence that the . . . decision at issue was based upon an impermissible factor."[66] If the plaintiff successfully establishes his or her case, the defendant must prove by a preponderance of the evidence that he or she would have made the same decision even if the defendant had not taken the impermissible factor into account.[67]

In *Moore v. United States Department of Agriculture*, the U.S. District Court for the Western District of Louisiana dealt with the issue of overt discrimination by analyzing the claim in a slightly different manner.[68] There, the plaintiffs sued the Department of Agriculture ("DOA") because the Farmer's Home Administration, an agency within the DOA, explicitly denied their application for financial assistance because they were white.[69] The court articulated three elements plaintiffs must establish to prove a *prima facie* case of overt discrimination: (1) plaintiffs were a member of a protected class; (2) they applied and were qualified for credit; and (3) they were rejected despite their qualifications.[70] Despite direct evidence showing plaintiffs' application was intentionally rejected because they were white, the plaintiffs failed to

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64. BARRON & BERENSON, *supra* note 30, at 8-19.

65. *Id.* at 8-20.

66. Saldana v. Citibank, 1996 WL 332451 at *2 (N.D. Ill. 1996) (quoting McCarthy v. Kemper Life Ins. Cos., 924 F.2d 683, 686 (7th Cir. 1991).

67. *Id.*

68. *See* Moore v. United States Dep't of Agric., 857 F. Supp. 507 (W.D. La. 1994), *vacated and remanded on other grounds,* 55 F.3d 991 (5th Cir. 1995).

69. *Id.* at 508. The plaintiffs received the following response to their application: "You have failed to provide proof that you meet the criteria of SDA. (No whites)." *Id.*

70. *Id.* at 512. The court noted that ECOA does not explicitly "reveal what it is an ECOA plaintiff . . . must establish in order to make out a prima facie case of unlawful discrimination in a credit decision." *Id.* (quoting Mercado-Garcia v. Ponce Federal Bank, 979 F.2d 890, 892 (1st Cir. 1992)). As a result, the court followed the First Circuit's approach of analyzing an ECOA claim in a similar manner to which a claim under the Equal Employment Opportunity Act is reviewed. *Id.* The *Moore* court declined to apply a fourth element that some courts require for proving a prima facie case under ECOA, "namely, that others of a similar credit stature were treated more favorably." Moore v. United States Dep't of Agric., 857 F. Supp. 507, 513 (W.D. La. 1994) (quoting an element applied in *Mercado-Garcia*, 779 F. Supp. at 628).

establish a prima facie case because they were not qualified for credit.[71]

Under the *Moore* approach, if a plaintiff can prove a prima facie case of direct discrimination, a presumption of discrimination arises shifting the burden of proof to the defendant to provide a non-discriminatory explanation for the challenged action.[72] If the defendant-lender meets that burden, the presumption of overt discrimination disappears and the burden falls to the plaintiff to prove unequivocally that the reason for denial was intentional discrimination.[73]

One example of the burden shifting to the defendant to rebut the presumption of discrimination is *Mercado-Garcia v. Ponce Federal Bank.*[74] In that case, the First Circuit Court of Appeals dealt with the plaintiff's claim that his Visa card was cancelled and a loan from his former employer, the defendant, was prematurely called as a result of age discrimination.[75] The First Circuit assumed, arguendo, that the plaintiff established a prima facie case and consequently shifted the burden to the defendant to "'articulate some legitimate, nondiscriminatory reason'" for the bank's actions.[76] The *Mercado-Garcia* court found the bank's rationale for terminating the credit card and loan, both of which provided employees with special benefits, was non-discriminatory and legitimate in light of the plaintiff's termination as an employee.[77] Consequently, the burden shifted back to the plaintiff to "demonstrate by a preponderance that [the bank's] reasons were in reality a pretext for age discrimination."[78] The court granted the defendant's motion for summary judgment concluding the plaintiff "failed to meet his burden showing the bank's credit decisions were based on his age."[79]

Direct discrimination is fairly easy for a borrower to detect and redress through the ECOA. The obviousness of such violations enables lenders to quickly identify and correct these types of problems. Consequently, cases involving overt discrimination are not frequently litigated. Unfortunately, this does not mean that discrimination in lending is no longer a problem. It is merely occurring in less obvious forms, such as through differential treatment and disparate impact discrimination.

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71. *Id.* at 515.

72. *Id.* at 513-14. *See also* BARRON & BERENSON, *supra* note 30, at 8-20.

73. *Moore*, 857 F. Supp. at 513-14; *see also* BARRON & BERENSON, *supra* note 30, at 8-20.

74. 979 F.2d 890 (1st Cir. 1992).

75. *Id.* at 892.

76. *Id.* at 893.

77. *Id.*

78. *Id.*

79. Mercado-Garcia v. Ponce Fed. Bank, 979 F. Supp. 890, 893 (1st Cir. 1992).

2. Differential Treatment Discrimination

The second type of discrimination, differential treatment, is far more difficult to detect than overt discrimination.[80] "Differential treatment discrimination occurs when equally qualified individuals are treated differently due to their race or ethnicity."[81] For example, there is differential treatment discrimination when a lender provides assistance to non-minority potential borrowers which helps qualify them for a loan, but does not provide similar assistance to minority applicants. If individuals, similarly qualified, are assisted differently according to race and the minority applicant is rejected as a result of the non-assistance, the minority has been victimized by differential treatment discrimination.

In approaching a claim of differential treatment discrimination, the courts have consistently followed the widely held *McDonnell* test.[82] The *McDonnell* test, developed in the context of an Equal Employment Opportunity Act ("EEOA") dispute and subsequently applied in ECOA cases because it addressed differential treatment discrimination, established four elements for a prima facie case.[83] To prove differential treatment discrimination, the plaintiff must demonstrate that: (1) the plaintiff belonged to a protected class; (2) the plaintiff applied for and was qualified for the loan; (3) the request was declined despite those qualifications; and (4) others of similar credit stature were treated more favorably.[84] Like overt discrimination cases, if the plaintiff establishes a prima facie case, the burden of proving that the denial of credit is supported by legitimate, non-discriminatory reasons shifts to the defendant.[85] If the defendant meets its burden, the plaintiff can still prevail if he or she demonstrates by a preponderance of evidence that the defendant's rationale is merely a pretext for discrimination.[86]

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80. *See* Galves, *supra* note 63, at 1472-73 (1999). Some courts also refer to differential treatment discrimination as disparate treatment discrimination. *See, e.g.*, Gross v. United States Small Business Admin., 669 F. Supp. 50, 52 (N.D.N.Y. 1987).

81. MORTGAGE LENDING, *supra* note 3, at 3. It is important to note that differential treatment discrimination analysis can be applied to any of the protected classes under ECOA. *See also* 15 U.S.C. § 1691(a) (1994) ("It shall be unlawful for any creditor to discriminate against any applicant, with respect to any aspect of a credit transaction—(1) on the basis of race, color, religion, national origin, sex or marital status, or age.").

82. *See, e.g.*, Crawford v. Signet Bank, 179 F.3d 926, 928 (D.C. Cir. 1999), *cert. denied*, 120 S. Ct. 1002 (2000); Matthiesen v. Banc One Mortg. Corp., 173 F.3d 1242, 1246 (10th Cir. 1999), Moore v. United States Dep't of Agric., 55 F.3d 991, 995 (5th Cir. 1995).

83. McDonnell Douglas v. Green, 411 U.S. 792, 802 (1973).

84. *Id.*

85. BARRON & BERENSON, *supra* note 30, at 8-23.

86. *McDonnell Douglas*, 411 U.S. at 804.

Unfortunately, differential treatment discrimination is difficult to prove in a court of law. For example, the United States District Court for the Northern District of New York applied the *McDonnell* test to decide whether the plaintiff was denied a loan by the Small Business Administration because of gender or marital status.[87] In finding for the defendant, the court ruled that the plaintiff failed to meet both the third and fourth elements of the test, namely that she was qualified for the loan and that males or unmarried females of similar credit stature were given loans or treated more favorably than her.[88] Additionally, the court found that regardless of the plaintiff's failure to establish a prima facie case, the defendants had "clearly met their burden of articulating legitimate, non-discriminatory reasons for the denial of credit."[89]

In a more recent case involving a claim of differential treatment discrimination, the District Court for the Northern District of Illinois reviewed the plaintiff's claim that Citibank's appraiser undervalued her property because she was black.[90] Furthermore, the plaintiff believed Citibank's appraisal review process did not provide her the same treatment as other patrons and she was consequently denied a second mortgage.[91] The court found that while the plaintiff was able to establish the first two elements, no evidence was offered to indicate that Citibank's appraiser treated the plaintiff differently than any other customer nor that Citibank's request for an additional "appraisal" rather than another "comparable" was little more than a semantic difference in treatment by the appraisal review department.[92]

Differential treatment discrimination is a less obvious and consequently a more difficult form of discrimination to detect and demonstrate in a court of law, especially when compared to overt discrimination. However, in terms of detectability and preventability, disparate impact discrimination is by far the hardest to prove.

3. Disparate Impact Discrimination

The third form of discrimination, and arguably the most difficult to establish, is disparate impact discrimination.[93] It has been stated that

87. Gross v. United States Small Bus. Admin., 669 F. Supp. 50 (N.D.N.Y. 1987).

88. *Id.* at 54.

89. *Id.* at 54-55. ("The defendants offered an abundance of evidence to support their position that all of plaintiff's applications . . . were denied because the defendants rightfully considered the plaintiff to be a credit risk, not because of her sex or marital status.").

90. *See* Latimore v. Citibank, 979 F. Supp. 662, 663-64 (N.D. Ill. 1997).

91. *Id.* at 668.

92. *Id.* at 669.

93. Galves, *supra* note 63, at 1473.

"[d]isparate impact discrimination occurs when a lending policy, which may appear to be color blind in the way it treats mortgage loan applicants, disqualifies a larger share of minorities than whites but cannot be justified by business necessity."[94]

As with overt and differential treatment discrimination charges, courts have formulated a test for establishing a prima facie case for disparate impact discrimination. The test developed by the United States Supreme Court to prove disparate impact discrimination, was initially developed to address a Title VII claim.[95] In a recent discussion on the *Griggs* standard as it applies to lending discrimination, the District Court for the Northern District of Illinois stated:

> To make out a case of disparate impact . . . [t]he relevant inquiry is whether a policy, procedure, or practice specifically identified by the plaintiff has a significantly greater discriminatory impact on members of a protected class. The prima facie case is conventionally proved by a statistical comparison of the representation of the protected class in the applicant pool with representation in the group actually accepted from the pool.[96]

In *Saldana*, the plaintiff claimed that Citibank, the defendant, had an unwritten policy establishing minimum amounts for applicants to borrow for specific types of loans.[97] The plaintiff argued that the minimum amount effectively precluded African-American communities from qualifying for such loans because the minimum amount would usually exceed the purchase price of homes in that neighborhood.[98] The court ruled in favor of Citibank because the plaintiff failed to provide statistical evidence demonstrating that the alleged

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94. MORTGAGE LENDING, *supra* note 3, at 4. A policy that disproportionately affects minorities is illegal if it does not accurately reflect creditworthiness or could be replaced by a policy serving the same business purpose with a less adverse effect on minorities. *Id.*

95. *See* Griggs v. Duke Power Co., 401 U.S. 424 (1971). In *Griggs*, an employer required a high school education or passing of a standardized general intelligence test as a condition of employment. *Id.* at 425-26. The court held these requirements were illegal because they were not demonstrably related to job performance. *Id.* at 431. In his opinion, Chief Justice Burger stated:

> The objective of Congress in the enactment of Title VII . . . was to achieve equality of employment opportunities and remove barriers that have operated in the past to favor an identifiable group of white employees over other employees. Under the Act, practices, procedures, or tests neutral on their face, and even neutral in terms of intent, cannot be maintained if they operate to "freeze" the status quo of prior discriminatory employment practices.

Id. at 429-30.

96. Saldana v. Citibank, 1996 WL 332451, at *4 (N.D. Ill. 1996).

97. *Id.*

98. *Id.*

discriminatory policy had a greater impact on members of a protected class.[99]

Once a plaintiff has established a prima facie case of disparate impact discrimination, "[T]he defendant-lender must demonstrate that any policy, procedure, or practice has a manifest relationship to the creditworthiness of the applicant. In other words, the onus is on the defendant to show that the particular practice makes defendant's credit evaluation system more predictive than it would be otherwise."[100] It is important to note that even if the creditor establishes the loan requirements or standards at issue are predictive of creditworthiness, the plaintiff can still prevail if an equally predictive alternative that does not have a disparate impact on a protected class is provided to the court.[101]

Overt discrimination, differential treatment, and disparate impact discrimination all result in one class of individuals being treated less favorably than another. Thus, the basic framework for proving a case is the same—establish that discrimination has occurred and shift the burden to the defendants to justify their actions. Understanding that discrimination takes various forms, with overt discrimination the easiest to detect and disparate impact discrimination the most difficult to detect, explains why tests for demonstrating prima facie discrimination must vary for each type in order to reflect the differences.

C. *Discrimination at the Key Stages of the Mortgage Lending Process*

Recognizing the various forms of discrimination is important in understanding discrimination at the primary market level. Equally important, however, is appreciating the different stages of the mortgage lending process in analyzing whether the secondary lending market's influence on the primary market directly or indirectly results in discrimination. In the case of lending relationships, discrimination may occur at any point in the lending process.

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99. *Id.* There are four critical factors in determining disparate impact:

> (1) strength of the plaintiff's statistical showing; (2) the legitimacy of the defendant's interest in taking the action complained of; (3) some indication—which might be suggestive rather than conclusive—of discriminatory intent; and (4) the extent to which relief could be obtained by limiting interference by, rather than requiring positive remedial measures of, the defendant.

Thomas v. First Fed. Sav. Bank of Ind., 653 F. Supp. 1330, 1340 (N.D. Ind. 1987) (quoting Phillips v. Hunter Trails Cmty. Ass'n, 685 F.2d 184, 189-90 (7th Cir. 1982).

100. A.B. & S. Auto Serv., Inc. v. S. Shore Bank of Chicago, 962 F. Supp. 1056, 1061 (N.D. Ill. 1997).

101. MICHAEL M. GREENFIELD, CONSUMER TRANSACTIONS 287 (3rd ed. 1999).

1. Advertising and Outreach

The first stage in the mortgage lending process is the advertising and outreach phase.[102] This phase involves "how potential mortgage applicants find out about lending institutions and loan alternatives."[103] A claim of discrimination at this stage often involves either the means of advertising or the location of branch offices.[104]

While advertising through traditional media networks such as television, newspapers, and radio appears to be a "color blind" form of communication, there is evidence that lending institutions can potentially discriminate through their publicity campaigns. For instance, in the case of *United States v. Chevy Chase Savings Bank*,[105] the Department of Justice alleged that Chevy Chase's total failure to solicit mortgage applications through black-oriented newspapers and radio stations evidenced discrimination.[106] Similarly, the Department of Justice based allegations of discrimination against Decatur Federal Savings and Loan Association in part on the fact that they did not use media outlets that traditionally attract a black audience.[107] One scholar has noted that "[p]roof of unexplained disparities in the direct marketing by lenders may provide evidence of a pattern or practice of intentional discrimination."[108] Comparison of the applicant pool targeted by the lending institution's telemarketing or direct mail efforts with the pool of qualified potential applicants in the area the bank would be expected to serve can demonstrate these types of disparities.[109]

In addition to having a disparate impact on minorities through a lending institution's choice of media avenues, there is evidence that banks also discriminate through making their branch offices less accessible to minority groups.[110] A 1989 Department of Justice investigation of the practices of Atlanta's Decatur Federal Savings and Loan Association, resulting in a 1992 consent decree, found that the bank intentionally avoided placement of new

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102. *See* MORTGAGE LENDING, *supra* note 3, at 7.

103. *Id.*

104. *See, e.g.*, United States v. Chevy Chase Fed. Sav. Bank, 2A Fair Housing-Fair Lending (P-H) ¶ 19,385 (D.D.C. Aug. 22, 1994); United States v. Decatur Fed. Sav. & Loan Ass'n, 2A Fair Housing-Fair Lending (P-H) ¶ 19,377 (N.D. Ga. Sept. 17, 1992).

105. 2A Fair Housing-Fair Lending (P-H) at 19,385.

106. *Id.*

107. *See* Decatur Fed. Sav. & Loan Ass'n, 2A Fair Housing-Fair Lending (P-H) at 19,377.

108. Timothy C. Lambert, Note, *Fair Marketing: Challenging Pre-Application Lending Practices*, 87 GEO. L.J. 2181, 2209 (1999).

109. *Id.*

110. *See id.* at 2208 (discussing Dep't of Justice investigation of Decatur Fed. Sav. and Loan Ass'n); MORTGAGE LENDING, *supra* note 3, at 7.

branch offices in traditionally African-American neighborhoods and closed existing offices in areas that had become predominantly Black.[111] Such measures adversely impacted the ability of African-Americans in Atlanta to gain information regarding various loan options.

While the *Decatur* and *Chevy Chase* cases are examples of discrimination at the advertising and outreach stage, most experts agree that investigation of discrimination at this phase requires further examination.[112] However, due to the relatively few studies of discrimination at this level of the mortgage lending process, it is difficult to gauge the true extent of the discrimination.[113] In contrast, more evidence of discrimination is available during the pre-application phase.

2. Pre-Application Inquiries

The pre-application inquiry stage encompasses encouragement and information received by potential applicants when contacting lenders either in person or by telephone regarding terms and conditions of various loans.[114] The type of discrimination that usually occurs at this stage is differential treatment discrimination.

The National Fair Housing Alliance ("NFHA"), an organization the U.S. Department of Housing and Urban Development ("HUD") pays to conduct studies of banking practices, frequently tests whether primary market lenders treat non-minority and minority customers differently.[115] A recent NFHA study, conducted in seven cities, concluded that "lenders often appeared to be less interested in giving information to black customers than to whites; urged black customers, but not whites, to go to another lender; and emphasized to black customers, but not whites, that application procedures would be long and complicated."[116] Additionally, NFHA's research indicates that blacks are more likely to be informed that they were not qualified for a mortgage than equally qualified whites.[117] The NFHA report also states that lenders are more likely to help whites than blacks address potentially problematic aspects of their credit history.[118]

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111. MORTGAGE LENDING, *supra* note 3, at 7.
112. *Id.* at 8.
113. *Id.* at 7-8.
114. *Id.* at 8.
115. *Id.*
116. MORTGAGE LENDING, *supra* note 3, at 8.
117. *Id.*
118. *Id.*

Not only did the NFHA study reveal many lenders who treat minority and non-minority customers differently regarding services and provision of information, it also indicated that primary lenders frequently made better offers to potential white borrowers. In sixty percent of the cities reviewed in the investigation, equally qualified African-American customers were quoted higher interest rates for 30-year mortgages than whites.[119] Thus, it should be recognized that lending discrimination can occur before applicants ever fill out a mortgage request form.

3. Loan Approval or Denial Decisions and Terms of the Loan

It is important to note that "[a]t the loan approval stage, lenders not only decide whether to make a loan [but they] also set the terms of the loan, including the interest rate, loan fees, maturity, loan-to-value ratio, and loan type (conventional, adjustable rate, FHA, and so on)."[120] The Federal Reserve Bank of Boston conducted a study on discrimination at the loan approval stage in the early 1990s.[121] The research, still considered the preeminent study in that field, was published in final form in 1996. The bank found that "minority status was indeed a statistically significant and fairly large influence in lending decisions."[122] The study found that in the Boston area there was an eighty percent greater probability that black or Hispanic borrowers' applications would be denied compared with equally qualified white candidates.[123]

The Boston Fed concluded that the disparity between minority and non-minority rejection rates resulted in both differential treatment and disparate impact discrimination at the loan approval stage of the lending process.[124] The Boston Fed study was closely scrutinized by the banking industry and many flaws in the statistical research were pointed out.[125] The banking industry also criticized the methodology used by the study and stated that its conclusions were based upon unreliable calculations.[126] The banking industry argued that

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119. *Id.* at 9.

120. U.S. DEP'T OF HOUSING AND URBAN DEV., *Stage 3: The Loan Approval Or Disapproval Decision*, *at* http://www.hud.gov/pressrel/newsconf/stage3.html (last modified Sept. 8, 2000).

121. *See id.*

122. *Id.*

123. *Id.*

124. *Id.*

125. U.S. DEP'T OF HOUSING AND URBAN DEV., *Stage 3: The Loan Approval or Disapproval Decision*, *at* http://www.hud.gov/pressrel/newsconf/stage3.html (last modified Sept. 8, 2000).

126. *See id.*

the results of the Fed study were inaccurate because the equations used to support their conclusion were flawed as a result of omitted variables, data errors, and incorrect specifications.[127] Recently, the Urban Institute reanalyzed the statistical results of the Boston Fed's research, paying special attention to the points the banking industry contested, and concluded that the "Boston Fed Study does not definitively prove the existence of either differential treatment or disparate impact discrimination, [but] clearly establishes the presumption that one or both exist."[128] Under the tests established by the courts to prove discrimination in lending, such a conclusion would require the lenders to rebut the presumption by proving that their actions were based on "business necessity."[129]

The Urban Institute's review of the data suggested that twenty-seven percent of the eighty percent difference in loan-denial rates of minorities compared to non-minorities was attributable to "business necessity,"[130] thereby leaving over fifty percent of the disparity attributable to discrimination.[131] The Urban Institute concluded that further study was required to determine "whether [the] remaining minority-white differences in loan denial for an individual lender [were] due to that lender's use of different guidelines for minorities and whites (differential treatment discrimination) or its use of illegitimate guidelines that place minority applicants at a disadvantage."[132]

The Urban Institute's findings lend credence to the Boston Fed study's conclusion that differential treatment and disparate impact discrimination accounts for some of the disparity in loan denial rates between minority and non-minority borrowers. In addition, there is mounting evidence that Blacks and Hispanics also tend to pay higher interest rates and loan fees compared to those paid by white borrowers.[133] Several studies have noted that minorities are more likely than whites to receive FHA loans.[134] While FHA loans are more flexible

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127. *Id.*

128. *Id.*

129. *Id.*

130. U.S. DEP'T OF HOUSING AND URBAN DEV., *Stage 3: The Loan Approval or Disapproval Decision*, *at* http://www.hud.gov/pressrel/newsconf/stage3.html (last modified Sept. 8, 2000). The banking industry contested the accuracy of the Boston Fed Study arguing that the study: (1) did not account for key variables that affect lending decisions; (2) was based on data that was mistakenly entered or coded; and (3) incorrectly specified in their predictive equation how different factors interact to influence the approval decision. *Id.*

131. *See id.*

132. *Id.*

133. *Id.*

134. U.S. DEP'T OF HOUSING AND URBAN DEV., *Stage 3: The Loan Approval or Disapproval Decision*, *at* http://www.hud.gov/pressrel/newsconf/stage3.html (last modified Sept. 8, 2000).

in their requirements, they are also more expensive for the borrower in terms of rates and lender fees.[135] One plausible explanation for such statistics is that "minorities are steered in the FHA direction because of discrimination in the market for conventional mortgages."[136]

4. Loan Administration

Few studies have been done regarding discrimination at the loan administration stage. However, because lenders have fairly broad discretion as to how a borrower is treated upon missing a payment, ranging from holding the borrower in default and accelerating the debt to accepting the payment late, it appears that the loan administration process is also prime feeding ground for differential treatment discrimination.[137] While beyond the scope of this Article, it is worth noting that some lending institutions actually seek out originating loans that are likely to result in default.[138] This process, known as predatory lending, reported about by the television show *60 Minutes*, predominantly targets minority and unsophisticated borrowers that have substantial equity in their home.[139] The predatory loan, designed to be virtually unpayable and secured by the home, usually results in default and foreclosure and allows the bank to skim a large portion of the equity the borrower had in the home.[140] While predatory lending is not the focus of this paper, it does serve as a potential example of discrimination at the loan administration level.

IV. SECONDARY MARKET: LENDING DISCRIMINATION'S CURE OR CAUSE?

It has been argued that the creation of the secondary lending market would cure many of the woes of discrimination at the primary market level because it would provide more money for originators to lend, thus increasing liquidity.[141] Assuming that the only "color" primary market lenders would care about was "green," namely, the profit made from selling the loan to Fannie Mae, Freddie Mac or other private secondary market investors, GSEs would effectively solve

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135. *Id.*

136. *Id.*

137. U.S. DEP'T OF HOUSING AND URBAN DEV., *Stage 4: Loan Administration, at* http://www.hud.gov/pressrel/newsconf/stage4.html (last modified Aug. 16, 2000).

138. *Id.*

139. *Id.*

140. U.S. DEP'T OF HOUSING AND URBAN DEV., *Curbing Predatory Home Mortgage Lending, at* http://www.huduser.org/publications/hsgfin/curbing.html (last modified Aug. 16, 2000).

141. *See* DOT REPORT, *supra* note 4, at 54.

many of the problems of discrimination in the primary market.[142] However, that view has recently come under serious question.

In March of 1999, the U.S. Department of Housing and Urban Development ("HUD") began a probe investigating allegations that the credit scoring systems established by Fannie Mae and Freddie Mac, widely used by lenders to determine an individual's risk of default, discriminate against minorities.[143] An immediate response by a representative of the lending market to the allegation was that no discrimination existed because the systems are color blind.[144] That view, however, clearly failed to recognize that disparate impact discrimination can occur even when requirements are color-blind. In an effort to determine whether there is statistical evidence to support such a claim, HUD established an in-house team to review years of data for evidence of discrimination on the part of the GSEs.[145] In addition, HUD requested that Fannie Mae provide HUD with its credit scoring criteria.[146] Fannie Mae initially resisted those requests until warned by HUD on December 21, 1999 that it would face disciplinary actions for failing to cooperate.[147] Fannie Mae then agreed to provide the information to HUD.[148] Explaining its resistance, Fannie Mae stated that the request was unnecessary because the "company's underwriting system . . . contains no data on race and, therefore, cannot discriminate."[149] Such a statement by yet another representative of the banking industry fails to acknowledge the possibility of disparate impact discrimination. That possibility, however, gained significant credence when the *Washington Post* published an article with the headline, "HUD Says Mortgage Policies Hurt Blacks; Home Loan Giants Cited."[150] In the article, the *Washington Post* reported the following statistics regarding the loans purchased by Fannie Mae and Freddie Mac:

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142. *Id.*

143. Jerry Guidera, *HUD Probes for Bias in Systems Created by Fannie, Freddie to Rate Homeowners*, WALL ST. J., Sept. 27, 1999, at C17.

144. *Id.* (quoting Ginny Fersuson, Vice-president of the National Association of Mortgage Bankers).

145. *Id.*

146. *See* Bloomberg News, *Lender, HUD at Odds Over Race Data,* WASH. TIMES, Jan. 5, 2000, at B7.

147. *Id.*

148. *See In Brief: Fannie to Detail Automatic Underwriting Criteria*, AM. BANKER, Jan. 18, 2000, at 32.

149. Bloomberg News, *supra* note 146, at B7 (quoting David Jeffers, Fannie Mae spokesman).

150. *See* Kathleen Day, *HUD Says Mortgage Policies Hurt Blacks; Home Loan Giants Cited,* WASH. POST, Mar. 2, 2000, at A1.

Mortgages to:	Minorities	Blacks	Hispanics	Asians
Total Market	15.3%	5.0%	5.2%	3.6%
Fannie Mae	14.0%	3.2%	4.9%	5.9%
Freddie Mac	12.2%	3.0%	4.4%	4.8%[151]

These statistics support the conclusion that Fannie Mae and Freddie Mac are treating minority loans unfavorably.[152] The issue then becomes whether the secondary market can discriminate, and if so, does it need to be regulated?

A. *The Secondary Market—A Cause of Discrimination?*

The initial response when asked whether the secondary market could cause discrimination in lending would be a quick, yet decisive, "no" and the inquiry would be over. The reasoning behind such response would be that the secondary market has no interaction with the borrower and, therefore, could not possibly discriminate. Additionally, because the primary market is subject to the FHA, ECOA, HMDA and CRA, any secondary market discrimination would essentially be filtered out by the primary markets abidance with those statutes.[153] However, with HUD's ongoing investigation of the Fannie Mae and Freddie Mac practices, this once-thought simple answer needs to be reevaluated. Thus, the inquiry becomes a two-part process. First, can the secondary market discriminate; and second, can the secondary market cause the primary market to discriminate?

To determine whether the secondary market can discriminate, the various forms of discrimination must be examined and an analysis performed on whether the secondary market can perpetrate them. The forms of discrimination applicable to the secondary market are the same as those forms of discrimination facing the primary lending market—direct/overt, differential treatment, and disparate impact.

It is highly unlikely that the secondary market can overtly discriminate for two reasons. First, the secondary market institution never meets the borrower

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151. *Id.* The figures are for mortgages for loans of $227,150 or less. *Id.*

152. *Id.* It is important to note that Fannie Mae disputes these figures as inaccurate because they do not consider nearly 250,000 mortgages that were purchased that do not indicate race on the application. *See* Franklin Raines, *Fannie Mae's Credit History*, WASH. POST, Mar. 10, 2000, at A21 (noting that the *Post* admitted that it committed journalistic malpractice by mixing inadequate data to arrive at a provocative conclusion). As unlikely as this assumption may be, if one presumes that all of the 250,000 unknown mortgages are "black" applicants and applies those figures to the "Black" category, Fannie Mae will be at the total market level. However, doing such would still leave a significant disparity for the Hispanic category.

153. *See supra* Part IIIA.

and has no grounds for knowing if the borrower is a minority. The secondary market judges whether it will purchase a loan from an originator based on the terms of the loan, a credit report, appraisal, and the borrower's application.[154] While the originator's application does indicate race to comply with HMDA, the secondary market does not normally have that data at the time the loan is purchased.[155] Second, an explicit proclamation by the secondary market that it would not purchase minority loans would be extraordinarily easy to detect and thus extremely unlikely to occur. Without knowledge of an applicant's minority status, nor interaction with the borrower to discover such a status, it is reasonable to conclude that the secondary market cannot overtly discriminate against minorities.

For similar reasons, it is also highly unlikely that the secondary lending market can differentially discriminate. Differential treatment discrimination requires the perpetrator to have knowledge of the borrower's minority status and as a consequence treat the individual differently than a non-minority.[156] Because the secondary market does not have knowledge of the applicant/borrower's status when deciding whether or not to purchase a loan, the secondary market cannot treat a minority differently than a non-minority.

Whether a secondary market institution can have a *policy* that results in disparate impact discrimination, however, is a different issue entirely. While the secondary market is essentially immune from a claim of direct or differential treatment discrimination, the same case cannot be made with regards to disparate impact discrimination. The very definition of disparate impact discrimination is that a colorblind/neutral policy has a disproportionately negative effect on minorities.[157]

Fannie Mae, in fact, promotes its Desktop Underwriter as a cure for discrimination because the software is "colorblind" and simply calculates the

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154. Telephone Interview with Fannie Mae Representative (Mar. 21, 2000).

155. *Id.*; Telephone Interview with MORNETPlus Technical Consultant (Mar. 21, 2000). Fannie Mae evaluates potential loans for purchase through its Desktop Underwriter system. *See* Fannie Mae, *MORNETPlus: Desktop Underwriter on the Internet*, *at* http://www.fanniemae.com/singlefamily/technology/mornetplus/mp_du.html (visited Oct. 26, 2000). This system considers the applicant's credit report and the data provided on Fannie Mae Forms 1003/1003A in determining whether or not the loan will be purchased. Fannie Mae, *Guide to Underwriting with Desktop Underwriter*, *at* http://www.fanniemae.com/singlefamily/mornetplusweb/guidetounderwriting/credit_process. html (visited Oct. 26, 2000). Form 1003 requests, but does not require, minority status information for government monitoring purposes only. *See* Fannie Mae Form 1003 (available at Fannie Mae website, *at* http://www.fanniemae.com/singlefamily/doingbusiness/forms/search.html (visited Oct. 26, 2000)). Even if provided, that data is not inputted into the Desktop Underwriter system. Telephone Interview with MORNETPlus Technical Consultant (Mar. 21, 2000).

156. *See supra* Part IIIB2.

157. *See supra* Part IIIB3.

risk of loaning to each applicant.[158] Simply because the Desktop Underwriter may cure overt and differential treatment discrimination, however, does not mean it cannot be the cause of disparate impact discrimination. Focusing specifically on the *Washington Post* statistics[159] and Fannie Mae's policy for determining whether it will buy a loan from an originator by inputting credit reports and the data from Forms 1003 and 1003A[160] into the Desktop Underwriter, the assumption arises that the disparate impact may be caused by Fannie Mae's methodology for scoring applicants. Since all secondary market participants use essentially the same data in evaluating loans for purchase, and if individual scoring methods are not involved, there would not be a significant difference between the total secondary market purchasing rates of minority loans from those minority loans that Fannie Mae purchases. Thus, it is necessary to discuss whether Fannie Mae's Desktop Underwriter could score data from a credit report or Forms 1003 and 1003A in such a manner that it would have a disproportionately adverse effect on minority applicants.[161]

1. Disparate Impact Discrimination As a Result of Secondary Market Methodology?

While the methodology the Desktop Underwriter uses to score applicants is not publicly available, the following is offered to demonstrate the potential for Fannie Mae's system to have a discriminatory impact on minorities. Fannie Mae's Form 1003 requests a variety of information including the borrower's place of residence, employment information, assets and liabilities, and details of the transaction being financed.[162] While facially neutral, aspects of this information could impact minorities negatively. For instance, the employment history section requires the borrower to fill out a different section if he or she holds a second job or has held his or her current job for less than two years.[163] Upon initial review, there seems to be nothing unreasonable about this differentiation. After all, being employed by the same employer for at least two years seems to be indicative that the individual can hold a job. At first glance,

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158. *See supra* note 144 and accompanying text.

159. *See supra* notes 150-52 and accompanying text.

160. Fannie Mae Forms 1003 and 1003A may be found on Fannie Mae, *MORNETPlus: Desktop Underwriter on the Internet*, *at* http://www.fanniemae.com/singlefamily/doingbusiness/forms/1003.html.

161. *See* Guidera, *supra* note 143, at C17 ("HUD is looking into whether the so-called black box credit scoring systems established by Fannie Mae and Freddie Mac . . . discriminate against minorities.").

162. *See* Fannie Mae Form 1003, at http://www.fanniemae.com/singlefamily/doingbusiness/forms/1003.html.

163. *See app.*

it seems reasonable for the Desktop Underwriter to give lesser scores to applicants who have had more than one job over the last two years or hold a second job versus those who have been employed by the same employer for two years.

However, such a scoring system could very likely account for disparate impact discrimination. Since a greater percentage of minorities as a group are employed in the service industry than non-minorities per capita, a credit scoring based on duration of employment and multiple jobs could disadvantage minorities in general.[164] Furthermore, the service industry does not typically pay as high as other areas of work and usually has a higher turnover rate.[165] Thus, it is typical for individuals in the service industry either to have multiple jobs or have jobs with less than two years duration with the same employer.[166] Taking the factors into consideration, one could conclude that a duration of employment/multiple job credit scoring penalty would have a disparate impact on minorities.[167]

Over the next several months, as HUD evaluates the data that it has recently received, the policies of Fannie Mae and Freddie Mac will be closely scrutinized. While the above example demonstrates potential secondary market institution discrimination, the answer as to whether the GSEs do, in fact, discriminate will not be determined for some time, if ever.

2. Effects of Secondary Market Methodology

Assuming the secondary lending market discriminates, the issue then becomes whether such conduct is illegal. An initial response would be in the affirmative, stating that the ECOA prohibits disparate impact discrimination. Upon closer review of that statute, however, one would recognize the key word "creditor" in the scope provisions of that statute. A quick review of Fannie Mae literature drives home the point—"Fannie Mae is *working with lenders* to make

164. *See* Galves, *supra* note 63, at 1475; *see also* STATISTICAL ABSTRACT OF THE UNITED STATES 422, 426 (1999).

165. Galves, *supra* note 63, at 1475; *see also* STATISTICAL ABSTRACT, *supra* note 164, at 445.

166. Galves, *supra* note 63, at 1475.

167. *Id.* This defense could probably be successfully rebutted by demonstrating that reviewing an applicant's income flow over a set period of time, regardless of how many employers the individual has, demonstrates financial stability, yet avoids disparately impacting minorities. *See id.* at 1475-76.

If the same burden-shifting scheme used in primary market discrimination situations were applied to the secondary-market, Fannie Mae could justify its practices as business necessity and no alternative means to achieve its goal without disparately impacting minorities would exist. *See supra* note Part IIIB2.

homeownership more affordable for borrowers"[168] and "Fannie Mae helps make sure mortgage money is available for people in communities all across America. Fannie Mae *does not lend you money directly*. Instead, Fannie Mae *works with lenders* to make sure they don't run out of mortgage funds."[169] Consequently, secondary market participants, like Fannie Mae and Freddie Mac, are not lenders or creditors as identified by the ECOA. Rather they are investors and not within the scope provisions of ECOA and FHA.[170] Even though secondary lenders are outside the scope of the legislation designed to preclude discrimination in the primary market, an argument can be made that borrowers are still protected. Since the originator is subject to the anti-discrimination laws, the secondary market cannot cause the primary market to discriminate.

B. *Effects of Secondary Market on Primary Market Discrimination*

Recognizing that the secondary market has the ability to discriminate outside the scope of the legislative barriers applicable to the primary lending markets as previously discussed raises the issue of whether the laws regulating the primary market are enough to protect borrowers from discrimination. The answer is no. The reasoning is straightforward. The primary market is extraordinarily dependent upon the secondary market for capital, a relationship fostered through the government's creation of Fannie Mae and Freddie Mac.[171] As a result, most originators are so dependent on the financial liquidity provided by the secondary market they primarily originate loans that specifically meet the criteria dictated by the secondary lending market. Therefore, meeting the secondary market's standards has become a business necessity for most primary market lenders.[172]

Consequently, even if a borrower establishes that they have been disproportionately impacted by a policy or standard of the secondary lending market applied to them through the primary lending market, the originator can rebut the prima facie case of discrimination by claiming the action was a business necessity. That defense is further strengthened in cases where the standard causing the disparate impact is one established by a quasi-governmental organization like Fannie Mae or Freddie Mac.[173]

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168. *Fact Sheet: Timely Payment Rewards* (Fannie Mae, Wash. D.C.), Sept. 1999, at 1 (emphasis added).

169. *American Dream Commitment* (Fannie Mae, Wash. D.C.), at 1 (emphasis added).

170. *See supra* Part IIIA1.

171. *See supra* Part II.

172. *See supra* notes 26-32 and accompanying text.

173. *See supra* notes 164-67 and accompanying text.

C. *Proposals for Regulating the Secondary Market*

This Article has addressed Congress' intent, through passage of the FHA, ECOA, HMDA, and CRA, to ultimately eliminate discrimination at the primary market level. What Congress did not realize at that time, however, was that the secondary market could discriminate. Furthermore, Congress did not recognize that the primary market's fiscal need to sell its mortgages to the secondary market may enable the primary market to discriminate by creating a prima facie rebuttal of sound business policy when relying on secondary market policies with a good degree of immunity.

This problem could be addressed in three different ways. First, the government could do nothing and allow the secondary market to regulate itself. This seems to be the approach Fannie Mae's Chairman and CEO, Franklin D. Raines, would propose. Shortly after the *Washington Post* charged Fannie Mae with discriminating against blacks, Fannie Mae announced its "American Dream Commitment." Through this program, Fannie Mae pledged to expend $2 trillion over the next 10 years to "increase home ownership rates and serve 18 million targeted American families."[174] It is questionable whether self-regulation would be effective given the fact that Fannie Mae, a quasi-governmental organization with a federal charter requiring that its policies be regularly assessed to ensure non-discrimination, may already be discriminating. This could potentially be a situation where the fox is guarding the chicken coop.

A second alternative is to legislatively preclude the primary market from claiming that the application of discriminatory secondary market standards falls within the auspice of a business necessity. This approach, however, essentially addresses the symptom, not the problem. Undoubtedly, this would require the primary market to second-guess various secondary market policies, thereby reducing the efficiency of the primary/secondary market relationship and increasing costs that will ultimately be passed on to the borrower.

Finally, and probably the best alternative, is to expand the scope of the FHA and ECOA to the secondary market. Through such legislation, the government would be acting consistently with the purposes of those statutes, namely the elimination of discrimination in the lending market.

V. CONCLUSION

While the American economy is extremely strong, the "American Dream" is not thriving for more and more minorities in America. The question asked by

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174. *Fannie Mae to Meet $1 Trillion Goal Early; CEO Raines Launches Ten-Year $2 Trillion 'American Dream Commitment' to Help Close 'Homeownership Gaps' and Strengthen Communities*, PR NEWSWIRE, Mar. 15, 2000, WESTLAW, Prwireplus.

this Article is "where does the breakdown occur?" After all, Congress prohibited discrimination in mortgage lending at the primary market level and created government sponsored enterprises to facilitate greater liquidity at the primary market level, both ensuring that more money was available for loans to minorities and non-minorities alike. Thus, the materiality and equality elements of the American Dream appear to be preserved. Unfortunately, the statistics demonstrate that rather than thriving in a time of economic prosperity, the "Dream" is dying for many Americans. One possible reason is Congress' failure to realize that the very enterprises it created to provide liquidity at the primary market level may very well be disparately impacting minority borrowers.

Thus, what Congress initially thought to be part of the cure for the problem of discrimination, may very well be a cause. Hopefully, when the HUD investigation of Fannie Mae and Freddie Mac is complete, Congress will recognize the need to ensure that primary and secondary lending institutions play by the same rules. As a result, a more unified effort against discrimination will be established and the American Dream preserved.

VI. APPENDIX - UNIFORM RESIDENTIAL LOAN APPLICATION EXCERPT

Uniform Residential Loan Application

This application is designed to be completed by the applicant(s) with the lender's assistance. Applicants should complete this form as "Borrower" or "Co-Borrower", as applicable. Co-Borrower information must also be provided (and the appropriate box checked) when ☐ the income or assets of a person other than the "Borrower" (including the Borrower's spouse) will be used as a basis for loan qualification or ☐ the income or assets of the Borrower's spouse will not be used as a basis for loan qualification, but his or her liabilities must be considered because the Borrower resides in a community property state, the security property is located in a community property state, or the Borrower is relying on other property located in a community property state as a basis for repayment of the loan.

Borrower		IV. EMPLOYMENT INFORMATION	Co-Borrower		
Name & Address of Employer	☐ Self Employed	Yrs. on this job Yrs. employed in this line of work/profession	Name & Address of Employer	☐ Self Employed	Yrs. on this job Yrs. employed in this line of work/profession
Position/Title/Type of Business		Business Phone (incl. area code)	Position/Title/Type of Business		Business Phone (incl. area code)

If employed in current position for less than two years or if currently employed in more than one position, complete the following:

Borrower			Co-Borrower		
Name & Address of Employer	☐ Self Employed	Dates (from - to) Monthly Income $	Name & Address of Employer	☐ Self Employed	Dates (from - to) Monthly Income $
Position/Title/Type of Business		Business Phone (incl. area code)	Position/Title/Type of Business		Business Phone (incl. area code)
Name & Address of Employer	☐ Self Employed	Dates (from - to) Monthly Income $	Name & Address of Employer	☐ Self Employed	Dates (from - to) Monthly Income $
Position/Title/Type of Business		Business Phone (incl. area code)	Position/Title/Type of Business		Business Phone (incl. area code)