School of Public & International Affairs
PRINCETON UNIVERSITY

1. Even though the Fair Housing Act passed 40 years ago, segregated neighborhoods are still a reality in America. In cities with large African American communities, black segregation looks pretty much the same as it did 40 years ago; Hispanic segregation is on the rise.

2. In the 1990's the historical practice of *not* lending to minorities shifted 180 degrees; all of a sudden, minorities were a coveted market for mortgages. This happened for two reasons:

   - The lack of credit (or good credit) of many of these minority clients was no longer a problem for banks because of securitized mortgages, commonly referred to as mortgage-backed securities. These new financial instruments, which split apart the origination, servicing, and selling of mortgages into discrete transactions, had a two-fold effect: 1) they reduced the risk to lenders by pooling high and low risk mortgages to sell; and 2) they increased the need for banks to find more borrowers because of the expanded pool of credit.

   - Predatory lending was on the rise. Minorities living in segregated neighborhoods experience predatory financial institutions routinely: pawn shops, payday lenders, and check cashing services that charge high fees and interest rates. This often leaves those living in these neighborhoods unaware of alternative, less expensive credit or financial services, and more vulnerable to lenders willing to sell them a subprime mortgage with an extremely high interest rate. Segregated neighborhoods offer predatory lenders a large number of potential high risk borrowers in one place – making the job easier to secure borrowers in high numbers.

   The result was a tremendous increase in lending of subprime mortgages -- loans to high-risk borrowers with imperfect credit – to minorities.

3. To keep the system going, however, more borrowers had to be constantly found and housing prices had to continue to rise – neither of which was sustainable forever. The result was that when the housing bubble burst in 2007 and deflated in 2008 and 2009, the economic effects were experienced most harshly by minorities living in segregated neighborhoods.

4. In addition to the well-known culprits of the housing bust – leveraged financing, overbuilding, collapse of home prices, and a poorly regulated mortgage market – most agree there is a racial component to the issue, but misunderstand the reason that blacks were hardest hit by the subprime mortgage crisis.

5. The reason often cited for the differential effects on minorities versus whites is that minorities are in a weaker economic position so are more likely to default on their loans. However, this study dispels that explanation. Rather, the authors argue that it is the fact that racial discrimination happened at very point in the lending process – from loan origination to foreclosure – that was the cause of the racialization of the housing bust. To prove this, the authors examined the characteristics of white and minority borrowers and found that even with similar qualities (credit profiles, down payment ratios, personal characteristics, residential locations), African

Americans were more likely to receive subprime loans. Similarly, after controlling for background factors, blacks and Hispanics were significantly more likely than whites to receive loans with unfavorable terms such a prepayment penalties. The result: from 1993 to 2000, the share of subprime mortgages going to households in minority neighborhoods rose from 2 to 18 percent.

6. The reason this had such a devastating effect on minorities is that the foreclosure rate for subprime mortgages was much higher than for standard ones; in 2005 the subprime foreclosure rate was 3.3% compared to 1% for all mortgage loans; while both increased during the next 4 years, the foreclosure rate for subprime mortgages in 2009 was 15.6% compared to 4.6% overall. Due to segregation, large numbers of these foreclosures were clustered in densely populated neighborhoods, thereby leaving not only the individual borrowers victims of the housing bust, but entire minority neighborhoods hit harder by the crisis than those in other parts of the country.

7. Because predatory lenders could efficiently target entire neighborhoods with subprime mortgages, larger numbers of people were affected than would have been had they been more geographically spread out. In true layman's terms, it was like "shooting fish in a barrel." Segregated neighborhoods just made it too easy to engage large numbers of people in this devastating lending scheme and this multiplied the effect of the crisis.

8. The study also makes clear that contrary to conventional wisdom, the crisis was not caused primarily by a decline in underwriting standards or by riskier lending spurred by the Community Reinvestment Act (CRA).

9. The authors offer a policy solution to prevent this from occurring again: amend the Civil Rights Act to contain enforcement mechanisms that uncover discrimination and sanction those who discriminate. Such power should be established in U.S. Departments of Treasury, Labor, Commerce, and Housing and Urban Development. A mechanism that should be employed to uncover discrimination and measure progress in eliminating discrimination is an “audit study.” In such a study, black and white testers are sent into the marketplace to purchase goods and services. If racial experiences differ over a number of trials, based on a representative sample of market providers, a pattern of systematic discrimination can be identified.

Final Take Away: Racial segregation, discriminatory lending, and an overheated housing market combined to leave minority group members and neighborhoods uniquely vulnerable to the housing bust. To prevent this from occurring again, measures must be taken by the federal government to identify patterns of systematic discrimination and sanction those engaging in this practice. This will not only promote a more just and integrated society, but avoid future catastrophic financial losses.