

February 11,2004

Wall Street Journal

Dear Editor:

Mr. Husock seems poorly read in the scientific evidence on lending discrimination else he could not so bitterly decry the affordable housing goals set for Freddie and Fannie and the provision of credit to “undeserving” borrowers. (WSJ, Feb 10).

From this evidence he could have learned that private markets do not treat all borrowers the same given their credit histories. In a study of recent mortgage lending, I found that minorities *and less-well-educated people of all races* pay more for their loans than do others with the same credit credentials, including credit scores, income, property value, loan amount, and location. Similar results are found in all sectors of the credit market, but in mortgage and auto credit markets, they are dishearteningly well documented. The numbers show that the discrimination comes not at the secondary market or wholesale level but entirely at the level of origination, where loan brokers, loan officers, or sales people look the borrowers in the eye, assess their financial savvy, and exploit any confusion detected. The financially less sophisticated pay more.

Mr. Husock also could have learned that a surprising fraction of those who borrow in sub-prime markets, between a tenth and a fifth, could qualify for a prime or FHA loan, but are somehow misled into a sub-prime loan. Minorities and people without college educations fall disproportionately into this group.

Loans made through affordable housing programs are sometimes less profitable than conventional loans, but they do not lose money. The underwriting is more characterized by a greater effort to assemble more facts about the borrowers to establish their ability to carry a loan than by willingness to accept a higher rate of loss. The foreclosure rates on the programs are only about ten to fifteen percent higher than on the regular book. It is to the foreclosure rates, not to delinquencies, that we should look to for measures of success. If 3.3 percent of the loans foreclose (typical of recent years’ projected life-of-book foreclosures based on experience to date) then 96.7 of the loans succeed, compared to 97 percent success in the conventional market.

Economists expect market forces to deliver to borrowers what they deserve. Evidently some have beliefs so strong that, like Mr. Husock, they do not bother to survey the relevant empirical work. But having prepared the data and done the estimates for some of these studies myself, I report (with regret!) that there is more between heaven and earth and to the functioning of actual markets than is dreamt of in this simple paradigm. A new line of thought is emerging among economists, informed by the unpleasant facts that less educated and disadvantaged consumers pay more, especially for financial products, despite their lower incomes. In the new model, sophisticated business

techniques induce the less able shoppers to pay more. The policy response should not be price controls, whose dismal history speaks so clearly and negatively. Rather, policy should emphasize clear, simple disclosures that are tested for effectiveness—like the labels on prepared food—and improved education. To eliminate discrimination in lending, we need a nation of more effective shoppers. In the meanwhile, it is mean-spirited to fault the obviously successful efforts of Freddie and Fannie to extend credit to disadvantaged borrowers on fairer terms.

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