Does redlining play a role in mortgage lending?

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Abstract:

To understand mortgage markets, we should not restrict our analysis to fields within finance such as asset pricing, behavior finance, and financial intermediation; rather, we need a broader perspective that collect insights from urban economics and macroeconomics as well (Campbell, 2012). This study sheds light on neighborhood discrimination in mortgage lending. It is common to observe low approval rate and high mortgage rates in neighborhoods with low-income and predominately minority. This phenomenon has been attributed to some sort of uneconomic discrimination that mortgage lenders apply various screening process to make loan origination decisions. Concerns about redlining discrimination motivate some of the regulations imposed by the Community Reinvestment Act (CRA), which aims to ensure the needs of borrowers in all segments of their communities are satisfied. Existing literature tends to testify whether mortgage lenders obey the rules in making loan decisions by looking at default rate. The general idea is that neighborhood discrimination is reflected in lower default rate in

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redlining area. Our study provides a different argument: higher default rate observed in redlining neighborhood does not necessarily signify no regional discrimination, instead, it could be a supporting evidence of such discrimination since default is induced by higher loan price. Mortgage lenders usually charge borrowers from low-income or minority communities higher loan price in order to compensate for potential loss in case of default. However, the higher mortgage price together with lower appreciation (larger depreciation) in home value eventually causes higher default rate.

We explicitly examine whether variations in mortgage rates and default rate can be explained by local factors. The preliminary results show that mortgage lenders tend to reply heavily on borrowers' neighborhood factors in loan origination criteria before financial crisis. Such dependency is alleviated after the crisis as lenders begin to apply more specific underwriting standards. The findings in this study are expected to lend support to the analysis of neighborhood discrimination in mortgage market.

Keywords: redlining, mortgage lending, financial crisis