

Does Competition Reduce Racial Discrimination in Lending? **(Joint work with Adam Jorring)**

As recently as the mid-1990s, African American mortgage applicants were roughly 40% more likely to have their applications rejected than comparable white applicants. This gap exists despite the fact that the Fair Housing Act was passed more than 25 years earlier specifically to combat race-based lending discrimination. Yet by the early-2000s, this gap shrank by nearly one half. While there is still much to improve, this rapid change between the mid-1990s and early-2000s shows remarkable progress in reducing discrimination. This paper seeks to root out the reason for this change and explore the extent to which it might be further replicated to reduce discrimination in mortgage lending and in other markets.

Using data from nearly five million mortgage applications, this paper shows that congressional action was indeed responsible for the decrease in mortgage lending discrimination, but interestingly, it was not through the enactment of a new anti-discrimination law. Rather, in 1994, congress passed the Interstate Banking and Branching Efficiency Act (IBBEA). The IBBEA, implemented by states over the mid-1990s and early-2000s, allowed out of state banks to open branches across state lines. As banks opened new branches across state lines, local lending competition increased. Non-economic discrimination is costly, and so in the face of more competition, lenders will tend to lose market share or alter their behavior to discriminate less.

This paper takes advantage of the staggered implementation of IBBEA to estimate the causative impact that increased competition---particularly the competition increases coming from the IBBEA---had in reducing lending discrimination, and to test the channels through which it occurred. The paper finds that following the relaxation these laws, increases in local lending competition led to the narrowing of approval differentials between comparable white and African American borrowers by nearly one half. The reduction was driven partially by incumbent banks altering their lending policies, and partially by the entry of new banks that discriminated less than the incumbents. Moreover, the paper shows that discriminating banks faced greater costs than non-discriminating banks when competition increased: Incumbent banks that were less likely to lend to African American applicants lost more market share than other incumbents. While both entry and competitive pressures significantly reduced racial discrimination in lending, the results suggest that neither force completely eliminates it, suggesting room for both market-based and direct approaches targeting discrimination.

The results here suggest that policy makers looking to combat racial discrimination in markets should view policies that increase competition as one of many tools at their disposal. Competition as a discrimination-reduction tool can be especially effective at filling in holes in direct regulation particularly where discrimination can be difficult to prove in court. A regulator may lack the statistical power to show conclusively that a small bank making only a few loans per year is engaged in discrimination even when it is in fact discriminating. The entry of a larger, well-monitored bank can put competitive pressure on the smaller, poorly monitored bank to discriminate less or lose market share. This economic punishment for discrimination is immune to the statistical proof problems that a regulator may face, and as shown in this paper, is indeed a potent force. This implies that a combination of market-based and direct regulatory interventions can go a long way to reduce discrimination.

Generalizing to other markets, regulators considering how to regulate new technologies like Uber and Airbnb should consider the anti-discriminatory role these competitors can play in their respective markets.