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ABSTRACT

Federal and state legislation intended to curb the practice of geographic loan discrimination or redlining may have the unintended and undesirable effect of preventing mortgage originators from using environmental characteristics as criteria in lending evaluations. Since the California fault rupture zones (special studies zones) do not contain systematic concentrations of poor, black, or elderly households, they should be targets for differential lending policies, such as mandatory earthquake insurance or structural reinforcements as conditions for mortgage loans. A clarification of the wording of the Housing Financial Discrimination Act is needed to alleviate some of the present potentially damaging effects of failing to discourage residential investment in surface fault rupture zones.

Redlining is a form of geographic discrimination in lending. The term refers to the refusal to grant mortgage loans to otherwise qualified buyers for sound property in certain areas of the city [1]. "Redlining" was an early practice of the Home Owners Loan Corporation: maps were color coded to represent relative risks to lenders, with "hazardous" zones coded as red [2]. The decision that a neighborhood is a poor risk for mortgage loans has been based on several factors, including large numbers of renter-occupiers, changing racial composition, or visible signs of property deterioration [3]. This conservative lending policy has been justified on the argument that banks and saving and loans have a fiduciary responsibility to their investors to protect their savings from undue investment risk.

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Two significant objections have been raised to redlining. First, it is claimed that disinvestment policies contribute to the further deterioration of the neighborhoods on which they are imposed. As less and less new capital is available for construction or improvements in these areas, a continuing decline in values sets in. Second, the neighborhoods to which redlining is applied are often inhabited by racial minorities at the lower end of the income scale. By imposing arbitrary mortgage lending restrictions on these homeowners, redlining results in racial discrimination, whether or not garbed as good business practice.

In an effort to curb the perceived discriminatory effects of redlining, remedial legislation has been enacted by the Congress and by several of the state legislatures. The federal Home Mortgage Disclosure Act of 1975 requires a wide variety of lending institutions with assets of $10,000,000 or more and making "federally related mortgage loans" to make available, for public inspection, information on the number of average terms of home mortgages originated or purchased by that institution (12 U.S.C. #2801 ff.). The stated purpose of this legislation is to "provide the citizens and public officials of the United States with sufficient information to enable them to determine whether depository institutions are fulfilling their obligations to serve the housing needs of the communities and neighborhoods in which they are located" (12 U.S.C. 2801 (b)). Presumably, informed depositors would not do business with lenders who were not "fulfilling their obligations." In addition, the practice of redlining is affected by the provisions of the Fair Housing Act of 1968 (42 U.S.C. #3601 ff.) and the regulations issued under it (12 C.F.R. ##528.2 (a), 531.8 (1981)), which prohibit discriminatory lending practices. In 1976 a federal district court specifically upheld the application of the Act to redlining by a building and loan association which was a member of the Federal Home Loan Bank Board System. (Laufman v. Oakley Bldg. & Loan Co., 409 F.Supp. 489 (1976).) The District of Columbia and five states, all of which have heavy urban concentrations, have passed legislation specifically aimed at controlling the racially discriminatory effects of redlining and the problems of disinvestment in particular urban neighborhoods.

While the purposes of these federal and state laws are laudable, it can be argued that such legislation also may have unintended and undesirable impacts. In particular, such laws seem to prevent mortgage originators from using environmental characteristics as criteria in lending evaluations, even when such use would benefit prospective homebuyers and society as a whole. This paper will demonstrate the dilemma of these unintended consequences.

ENVIRONMENTAL HAZARDS

Environmental hazards of one kind or another affect virtually every part of the United States [4]. Because some natural hazards threaten large areas and are not particularly place-specific, their effects cannot be mitigated through simple residential relocation. Examples are tornadoes and severe winter storms. Other natural hazards are relatively fixed in place, based on geologic or hydrologic conditions, and are amenable to avoidance by careful control of the location of residential housing units. Among these latter hazards are storm surge susceptibility, earthquake-related surface fault rupture, landslide potential, and riverine flooding. It is these place-specific hazards whose effects may be mitigated by regulating the process of home mortgage lending.

Mortgage lending policies have already been regulated to acknowledge the location of flood potential. The Federal Deposit Insurance Corporation (FDIC) and the Federal Home Loan Bank Board (FHLBB) presently require member banks to obtain from borrowers, before the loan is closed, "written acknowledgement that the borrower realizes the property securing the loan is or will be located in an area identified as a flood hazard area and the borrower has received the required notice regarding the Federal disaster relief assistance" (12 C.F.R. #339.6(a); 12 C.F.R. #523.29(e) (1981)). In addition, under FDIC regulations, "no bank shall make, increase, extend, or renew any loan" on improved real estate or a mobile home "located or to be located in an area that has been identified by the Director of the Federal Emergency Management Agency as an area having special flood hazards" unless the building or mobile home and any personal property securing the loan is covered for the term of the loan by flood insurance." (12 C.F. R. ##339.2, 339.3 (1981)). This seems to be an effective way to ensure that homebuyers are made aware of the possibility of flooding to their property and, through the purchase of subsidized flood insurance, to pay at least part of the costs involved in rebuilding and recovery associated with the inevitable flood.

Earthquake hazards are not included in this disclosure and insurance program. Although the homeowner may purchase nonsubsidized earthquake insurance, there are no programs available which subsidize the costs of such insurance, or encourage, let alone require, its purchase. Acquisition of such coverage is left to the homeowner, and there are few economic incentives for an insurance agent to promote earthquake insurance along with the required fire insurance coverage [5]. As a result, only a minority of homeowners in areas particularly susceptible to earthquake damage have even inquired about earthquake insurance and even fewer have purchased it [6, 7].

To protect their investment in properties particularly susceptible to surface fault rupture, home mortgage originators might require the purchase of eatthquake insurance as a condition for granting a loan, or might use other methods, such as higher front-end points, higher interest rates, or outright refusal to lend, to protect their business interests. Although such requirements, including the mandatory purchase of earthquake insurance, would place an additional financial burden on the homebuyer, they would both inform the purchaser about the environmental hazards associated with the particular housing site, and would require the homeowner to bear part of the recovery costs associated with surface fault rupture, much as the flood insurance program has done with riverine flooding. However, in the absence of federal legislation directing mortgage lenders to require the purchase of earthquake insurance, or permitting other means of self-insurance through higher mortgage costs, it appears that any action initiated by individual mortgage originators may run the risk of violating the fair lending acts recently enacted by certain states.

To illustrate the dilemma created by the socially beneficial prohibition of mortgage lending discrimination leading to the socially undesirable result of encouraging homebuyers to purchase houses in environmentally hazardous areas, it is useful to examine the case of surface fault rupture zones in California.

SURFACE FAULT RUPTURE ZONES

Information about the location of surface fault rupture zones is provided to prospective homebuyers by real estate agents in California under the provisions of the Alquist-Priolo Special Studies Zones Act (Cal. Pub. Res. Code #2621ff. (West 1982 Supp.)). This legislation, originally passed in 1972 following the destructive San Fernando earthquake of February 1981, was intended to prevent new large-scale development in areas particularly subject to surface fault rupture. The state geologist was directed to delineate, by December 31, 1973, "appropriately wide special studies zones to encompass all potentially and recently active traces of the San Andreas, Calaveras, Hayward, and San Jacinto Faults," as well as other faults which were "a potential hazard to structures from surface faulting or fault creep" (Cal. Pub. Res. Code #2622 (West 1982 Supp.)). A 1975 amendment to the Act mandated disclosure of these zones by the real estate agent: "A person who is acting as an agent for a seller of real property which is located within a delineated special studies zone, or the seller if he is acting without an agent, shall disclose to any prospective purchaser the fact that the property is located within a delineated special studies zone" (Cal. Pub. Res. Code #2621.9 (West 1982 Supp.)).

Despite the existence of this disclosure legislation, there is little awareness by purchasers of the meaning of location in the zones. A 1979 survey of recent homebuyers showed that homebuyers who had recently received the disclosure were no more likely to be aware of the existence of these zones, or the fact that their houses lay within them, than homebuyers outside the zones [7]. In addition, the majority of homebuyers surveyed within the zones could not remember that a disclosure has taken place. Among the possible explanations for these lapses of memory is the disclosure method used by the real estate agents–disclosure takes place at the least sensitive time in the sales transaction and conveys a minimal amount of information about the meaning of the special studies zones. Moreover, the name "special studies zone" in itself is not particularly evocative of surface fault rupture.

This survey also found that a primary motivation for the selection of house and neighborhood was economic—the probability that with a minimum investment, potential resale value would be maximized. Since recent experience shows that investment in houses within the zones does not impair the anticipated economic return, homebuyers can ignore with impunity the warning that they are within a surface fault rupture zone, at least in the context of probable profit on resale. The study concluded that "unless environmental hazards become translated into economic risks to individuals, hazard warnings not followed by severe disasters will probably not be heeded, and homebuyers will continue to purchase housing in areas susceptible to natural disasters regardless of the timing or form of the warning." [7, p. 97]

If society values the protection of life and property through the avoidance of exposure to specified natural hazards such as surface fault rupture or fault creep, then some modification is required in the present system of property transactions. This modification could involve draconian land-use regulations, or could involve self-correcting mechanisms within the free enterprise system. Lenders who have a long-term property interest in the real estate securing a loan, for instance, might include a requirement that homebuyers purchase earthquake insurance policies or that higher interest rates be charged for loans made on properties within surface fault rupture hazard areas. Would such actions be feasible and legal?

THE IMPACTS OF FINANCIAL DISCRIMINATION ACTS ON GEOLOGICALLY BASED LENDING POLICY

California state law prohibits lending institutions from denying home loans or discriminating in setting the terms or conditions of such loans, if the denial or discrimination is based on "conditions, characteristics, or trends in the neighborhood, or geographic area" in which the property is located "unless the financial institution can demonstrate that such consideration in a particular case is required to avoid an unsafe and unsound business practice" (Cal. Admin. Code tit. 21, R. 7105(a) (1) (D) (1979)).

The issue at hand is whether the avoidance of surface fault rupture zones can be equated with avoiding "an unsafe and unsound business practice." The California Administrative Code is quite specific in setting out the parameters of institutional discretion. Lenders can consider neighborhood characteristics if they can demonstrate that "one or more factors relating to the geographic area closely surrounding the security property are likely to cause the fair market value of the security property to decrease during the early (3-5) years of the mortgage term" (Cal. Admin. Code tit. 21, R. 7106 (B) (1) (1979)). In this determination, the lender is permitted to consider "both natural and other hazardous conditions surrounding the security property" (id., R. 7106 (b) (2). What is prohibited is "unfounded and unsubstantial assumptions regarding the effect upon loan risk of the physical or economic characteristics of a neighborhood or geographic area" (Cal. Admin. Code tit. 21, R. 7106(a) (1979)). The burden is on the lending institution to show the need for taking neighborhood characteristics into consideration in setting the terms and conditions of home loans.

Although the law does not require lenders to approve mortage loan applications if the property is susceptible to damage within the first five years of the mortgage term, or if there is an imminent threat to the health and safety of the loan applicant were this person to inhabit a particular dwelling (Cal. Health & Safety Code #35813 (West 1982 Supp.)), it would seem that location within a special studies zone is not *per se* sufficient ground for a loan refusal or the modification of its terms. Since seismologists are not presently able to make precise predictions about the timing and extent of damage associated with surface faulting, it would not be possible for a lender to demonstrate that there would be a necessary decline in value of a property located within a fault rupture zone. Even where the location of the fault is precisely known, a dwelling unit is located astride the fault trace, and a reasonable certainty could be assigned to the occurrence of a major damaging earthquake over a twenty to thirty year period, no precise statements about the likely damage over the very short term (3-5 years) can be supported with scientific evidence. It must be concluded therefore that current California law, intended to assure access to mortgage credit by persons formerly subject to discriminatory lending practices, has the unintended effect of guaranteeing that property susceptible to damage within the thirty-year life of the mortgage must still get access to mortgage financing on the same terms as property not so situated. Modification of lending terms, such as the requirement of earthquake insurance or the imposition of additional loan costs, would not seem to be permitted under the stringent requirements of this state's Housing Financial Discrimination Act.

THE ASSOCIATION OF SURFACE FAULT RUPTURE ZONES WITH ETHNIC RESIDENTIAL CONCENTRATIONS

A very important question in the evaluation of the dual impacts of single-purpose legislation is whether home mortgage discrimination against neighborhoods within surface fault rupture zones would incidentally entail discrimination against neighborhoods containing substantial numbers of racial and ethnic minorities. This answer to this question is somewhat complex.

In order to estimate the population and housing composition of the special studies zones, census tract boundaries were matched with the boundaries of a special studies zone. The entire population of a tract crossed by a special studies zone was considered "within the zone," unless the major population center of the tract lay outside the zone. The most serious problem of this method is that of over-estimation and possible bias in calculations.

Census tracts were aggregated into fourteen special studies zones. All of the special studies zones within the major metropolitan areas of California were analyzed, including zones in Los Angeles, Anaheim-Santa Ana-Garden Grove, San Bernardino-Riverside, San Francisco-Oakland, San Jose, and Santa Rosa.

Census tract data on twenty-one variables summarizing age, family status, occupational status, income, and housing tenure were compiled based on the 1979 Census of Population. A mean for each variable was calculated for each special studies zone, and the data were further aggregated so that the median value for the composite of special studies zones could be calculated for each variable (Table 1).

The composite figures for all of the zones showed that people living in the zones were slightly more wealthy than for the state as a whole, with fewer blacks, fewer persons over age seventy-five and fewer households headed by females. Housing was more likely to be owner-occupied and built after 1939. Thus, the zones did not contain a disproportionate share of blacks, elderly or poor people in 1970.

For the individual lender these figures may be deceptive. The Compton fault was 95.8 percent black in 1970, and the Calaveras fault zone, as represented by Gilroy, was 56.6 percent Spanish-speaking. In addition, the median value of housing in these areas as well as in the San Andreas-Desert communities, the San Jacinto fault zone, and the Antioch fault zone fell well below the average for the state.

In other areas, however, lenders could be confident that lending policies related to surface fault rupture zonation would not disadvantage racial or ethnic minorities, the elderly, or the poor. In special studies zones such as Raymond Hill, San Andreas-South San Francisco-Los Gatos, Green Valley, and Rogers Creek-Heraldsburg, lenders could consider location with respect to the fault zone in mortgage loan evaluations with no concern that such areas would contain large numbers of disadvantaged or minority populations.

THE DILEMMA

Previous studies have demonstrated quite clearly that there is need for legislative intervention in the home mortgage lending process to ensure that racial or ethnic minorities receive the same access to mortgage credit as the majority population. In a detailed study based on census tract-zip code data gathered by the Federal Home Loan Bank Board survey of Chicago (1973), and on individual loan applications based on the Comptroller of the Currency's Fair Housing Lending Practices Survey (1971), Listokin and Casey found that race had a strong independent effect on lending behavior [8]. The Chicago study showed that the racial composition of the neighborhood had an independent effect on the *volume* of loans in the neighborhood, and the micro-level data showed that race of the mortgage loan applicant had an effect on the decision to accept or reject the loan application, even after controlling for economic characteristics of the borrowers. These two analyses indicate the need for some regulation of mortgage lending policy to ensure equitable treatment of minorities.

Table 1. 1970 Data Based on Tabulations from the Bureau of the Census

	State of California	*Median for all of the special studies zone tracts*	*San Fernando Fault*	*North Newport Inglewood Fault*	*South Newport Inglewood Fault*	*Raymond Hill Fault*	*Compton Fault*	*San Jacinto Fault*	*San Andreas-San Bernardino*	*San Andrea-Desert Communities*	*San Andreas-South San Francisco-Los Gatos*	*South Hayward Fault*	*North Hayward Fault*	*Calaveras Fault (Gilroy)*	*Green Valley Fault*	*Antioch Fault*	*Rogers Creek Healdsburg Fault*
Percent black	7.0	0.6	2.3	17.4	1.1	0.6	95.8	0.7	9.2	0.8	1.2	5.6	5.6	0.3	1.7	0.1	0.4
Percent Spanish-speaking	7.9	8.2	12.6	7.5	6.1	12.4	4.1	11.4	30.3	2.6	8.0	20.2	17.1	56.6	9.7	14.0	7.8
Percent over age 75	4.0	2.0	2.7	5.1	5.6	9.1	0.7	4.1	2.7	10.0	2.0	1.9	4.3	3.2	5.7	2.6	4.0
Percent of housing built before 1939	23.0	9.6	15.9	21.6	17.6	47.1	5.7	67.9	19.9	5.6	10.4	9.5	24.0	47.4	2.9	17.5	20.9
Median annual income of families and unrelated individuals (in $000s)	8.3	9.7	9.2	9.1	9.3	9.1	8.8	6.0	6.7	9.7	14.3	11.1	9.4	6.6	13.8	10.4	7.7
Median value of owner occupied housing (in $000s)	23.1	24.0	21.2	29.5	22.7	34.2	18.3	19.0	13.2	14.4	37.9	25.1	24.7	17.5	32.0	18.5	20.5

The dilemma is that regulation of mortgage lending policy, with the intent of preventing racial discrimination, may also be interpreted as proscribing geologic discrimination. The latter interpretation may occur despite the fact that special studies zones (fault rupture zones) in California do not, taken as a group, contain a systematic concentration of black, Spanish-speaking, or low income population. If California law were modified to permit discrimination in mortgage lending on the basis of the location with respect to a surface fault trace, in most fault zones it would not be the minority or low income population which would primarily be impacted.

Whether the remedy be the lender's capability to adjust the terms of the loan, or mandatory earthquake insurance, California law needs to be revised to ease the burden for the lender of demonstrating that investment in properties in fault rupture zones constitutes an "unsafe or unsound business practice." The California Housing Financial Discrimination Act of 1977, as presently worded, at the very least discourages mortgage lenders from taking actions which could benefit both themselves and homebuyers, economically and environmentally. Mortgage lending in surface fault zones should be discouraged, and earthquake insurance should be required for those persons who choose to live in such areas. This can be done in a way which retains the law's laudable policy of avoiding racial discrimination, without the unintentional effect of limiting the possibilities of a geologically based lending policy. A clarification of the wording of the Housing Financial Discrimination Act would help to alleviate some of the present potentially disastrous effects of failing to discourage residential investment in surface fault rupture zones.

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