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A Study That Deserves No Credit

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The banking industry stands accused and convicted, by the media and others, of engaging in lending practices that discriminate against minorities. When the New York Times reported this week that "shamed and embarrassed" lenders were "finally" opening their doors to minority groups, it quoted one advocacy lawyer as saying: "It's a little hard to cheer too loudly; we are still in the early stages of overcoming decades of prejudice and neglect."

Upon what evidence are these statements so confidently asserted? There is only one study of mortgage decisions that takes into account the economic characteristics of mortgage applicants, making it the only serious examination of this issue. That study, published by the Federal Reserve Bank of Boston last fall, examined approximately 3,000 mortgages made in the Boston area in 1990. Although it found that financial attributes played the leading role in mortgage acceptance or rejection, and although it showed that minorities had financial attributes more likely to cause rejection than did whites, its bottom-line conclusion was that minorities were discriminated against.

The study has been described by regulators as "definitive," and its conclusions have become part of the media's conventional wisdom. But how reliable is the Boston study?

After some prodding, the Boston Fed has finally released its data. A careful analysis reveals, alas, that the study is seriously flawed. Most important, it suggests that the study's conclusion concerning racial discrimination in mortgage lending should be disregarded.

The authors of the Fed study claim that they scrupulously weeded out errors by examining the data for inconsistencies. But a colleague and I performed several checks on the raw numbers and were astonished to discover literally hundreds of errors or likely errors.

The first item to catch our attention was net worth. There are 20 mortgage applicants having a net worth in the range of a negative half million dollars, meaning they already owed that amount. There are 27 mortgage applicants who, even if they devoted 50% of their incomes to paying off their debts, would need more than 10 years to get out of the red.

Yet the Boston Fed data tell us that three quarters of these applications were approved for mortgages! In one case, an applicant having a net worth of minus $7,919,999 and a yearly income of $30,000 had a loan application approved. Considering that it would take this individual more than 200 years to pay off his debts, even if all his income were used for this purpose, it seems most unlikely that any sane banker would have approved this mortgage. It is far more likely that the numbers are wrong.

A similar result holds for interest rates on these loans. We found 89 mortgages where interest rates were less than 6% (a rate well below the market rates at the time), including seven with negative interest rates. A negative interest rate means that the bank pays you for the privilege of lending you money. But don't bother planning a trip to Boston to get one of these loans, since the numbers are not to be believed.

Equally troubling are the reported loan amounts relative to the values of the homes for which the loan is intended. Anyone who has tried to get a mortgage in the past few years is likely to be aware that if your downpayment is less than 20% of the house value, you will be told by the bank that you need to get private mortgage insurance. This is common throughout the industry, and a strict requirement if a bank wishes to sell a mortgage, as is most commonly done. Imagine our surprise when we found more than 500 mortgage applicants who had failed to apply for mortgage insurance even though their downpayments were less than the required 20%. Even more surprising, most of these loans were approved, and well over 100 were sold.

Unless Boston is not included in the U.S. banking system, these numbers must be in error.

These were not the only inconsistencies we found, but they are representative. Unfortunately, there are no simple checks on the accuracy of all the raw data used in the Boston Fed study; thus we cannot be certain of how seriously these flawed numbers affected the study's conclusions. At the very least, researchers paid too little attention to the reporting, collecting and transcribing of data.

A second problem with the Boston Fed study is its mixing of loan applications for different property types and different repayment periods. Lenders are very likely to apply different lending criteria to different types of properties. A loan for a multifamily home, for example, is more risky than a loan for a single-family home, since the multiunit homeowner has the additional burden of dealing with tenants.

When mortgages in the Fed study are grouped according to the type of property being purchased, the results run counter to the study's conclusion.

For condominiums, which constitute about a fourth of all applications in the sample, there is no relationship between race and mortgage acceptance.

For multiunit homes, which make up approximately a seventh of the applications, there is only weak evidence of discrimination. And most of it is due to a single loan application that clearly has errors: a white individual with a yearly income of $52,000 borrowing $979,000 to purchase a house with a price of $118,000! The payments on the loan total only $633 a month, making this one of the loans with a negative interest rate. The loan was approved, causing the Fed researchers to conclude that this was an instance of whites receiving favored treatment. It is far more likely that the true loan amount was only $79,000, or some amount in that range, and that race was irrelevant.

We found no evidence of discrimination for the group of single-family-home applicants who had applied for mortgage insurance.

The final group that we examined consists of 1,023 applicants attempting to purchase single-family homes and having a downpayment sufficiently large that mortgage insurance was not needed. For this group, racial discrimination, measured with the same techniques used by the Fed researchers, is apparently much larger than that found for the entire sample. Given the lack of discrimination in the other groups, it is fairly clear that this group is the core from which the charge of racial discrimination comes.

But even here the study's conclusions evaporate. When there are errors in data collection, of which we have seen many, it is to be expected that there are going to be some unusual observations that influence disproportionately -- that is, distort -- the results. And that is what we found in this case -- six extremely influential loan applications. When these are removed from the sample, any evidence of discrimination vanishes entirely.

The first case we examined, the most influential, is that of a Hispanic couple that was turned down when it applied for a loan of $87,000 to purchase a home with a price of $217,000. The credit history for the couple was ranked as good, although this ranking appears inconsistent with some very serious delinquencies in their consumer payment history (a transcription error?). Although the couple report a joint monthly income of $5,080, their reported yearly income is only $26,000 (math whizzes take note). If this application had been approved, the couple would have been required to make a downpayment of $130,000, yet the data indicate that the couple had only $1,000 in liquid assets and a net worth of only $10,000. Clearly something other than racial discrimination accounts for the fate of this loan.

The next most influential case consists of two married Hispanic men applying jointly for a mortgage on a single-family home (an odd loan, though not impossible). They needed a downpayment of $47,000 but had liquid assets of only $5,000 and a net worth of only $27,000. They had joint yearly income of either $65,000 or $36,000, depending on whether you believe yearly or monthly income figures.

Denial of these applications seems eminently reasonable and prudent, given the reported facts. How could the downpayments have even been made? Of course, the reported facts are themselves questionable. Yet the Boston Fed researchers concluded that racism was responsible for these loans being denied.

The pattern for the other four loans in the influential group of six continues along these lines. It does not support the thesis that racial discrimination was a major factor in these decisions. And if these six loans are not racially determined, there is no evidence that any were.

What may we conclude from this analysis? Clearly the Boston study is unreliable and misleading. Clearly it did not merit the attention it received. Just as clearly it was seized upon too quickly -- perhaps to further the political purposes, or confirm the political prejudices, of people eager to show that America remains an oppressive, racist society.

In any case, our country is not well served by a policy that creates yet another set of victims, falsely accused of racially discriminating against their countrymen. Before any study is considered definitive, it should be checked far more carefully than this study was checked. Unless, of course, truth is not the goal.

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(See related letter: "Letters to the Editor: Boston Fed Study Shows Race Bias" -- WSJ Sept. 21, 1993)

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