Lending Standards and the Foreclosure Crisis

BY DANIEL BROOKS

"Decomposing the Foreclosure Crisis: House Price Depreciation versus Bad Underwriting." Kristopher Gerardi, Adam Hale Shapiro, and Paul S. Willen, Federal Reserve Bank of Atlanta Working Paper 2009-25, September 2009.

There are two competing theories to explain the sudden outbreak of foreclosures from 2007 to 2009. One theory centers on poor underwriting standards: Borrowers had trouble making payments on their mortgages because those loans were either unrealistically generous or because borrowers were taking out loans based on little income and bad credit. An alternative explanation suggests that housing values were the main explanatory variable in the growth of foreclosures. After all, the authors point out, subprime mortgage performed well until 2006 when house prices began falling.

Using deeds records from Massachusetts — including residential mortgages, purchase and sale, and foreclosure transaction between 1989 and 2008 — the authors create a model to describe the explosion of foreclosures in Massachusetts since 2005. To isolate the effects of the underwriting standards, they estimated what the foreclosure rate of subprime borrowers in 2005 would have been if the price of the homes purchased were in line with the 2002 pricing levels. They discovered that the foreclosure rate would have been vastly lower relative to the actual observed foreclosure rate despite the larger percentage of subprime borrowers that existed in 2005.

The authors conclude that "relaxed underwriting standards did severely aggravate the crisis by creating a class of homeowners who were particularly vulnerable to the decline in prices." Yet, "that emergence alone, in the absence of a price collapse, would not have resulted in the substantial foreclosure boom that was experienced."

"Vacancy Posting, Job Separation, and Unemployment Fluctuations." Regis Barnichon, Federal Reserve Board Finance and Economics Discussion Series 2009-35, July 2009.

In this paper, Barnichon asks the question, "At the beginning of a recession, does unemployment go up because of few hirings, more job losses, or both?" To provide an answer, he suggests determining the relative importance of the two main forces that drive unemployment — vacancy posting (more job losses) and job separation (fewer hirings) — in explaining the movement in the unemployment data.

He finds that, on average, vacancy postings drive unemployment during normal times. But if you look at the turning points of the business cycle, as Barnichon describes, job separation drives "rare but violent fluctuations in unemployment." It's responsible for almost all of the movements in unemployment during the first two quarters after unemployment reaches a low or high point. (Vacancy postings don't become the main contributor until a year later.) The author also concludes that previous studies which found the opposite could lead economists to "understate the breadth and speed of adjustment of unemployment around turning points."

"Why do the Elderly Save? The Role of Medical Expenses." Mariacristina De Nardi, Eric French, and John Bailey Jones, Federal Reserve Bank of Chicago Working Paper 2009-02, July 2009.

In this paper, the authors address two important questions with respect to savings and the elderly: Why do the elderly keep large amounts of assets until late in life? And why do the wealthy elderly spend their assets more slowly than the poor elderly?

In the paper, the authors describe their model of saving by retired elderly singles. To develop their model, they use data obtained from the Assets and the Health Dynamics of the Oldest Old (AHEAD) survey conducted by the University of Michigan. Based on this dataset, they estimate the different processes for mortality and out-of-pocket expenses as dependent on sex, health, permanent income, and age. The authors also take into account social insurance programs such as Medicaid, which was not included in the AHEAD data.

Their analysis shows that out-of-pocket medical expenses grow at an increasing rate with both age and permanent income. This leads the authors to conclude that for many elderly people the risk of having to pay expensive medical bills as a result of living longer is a more important motivation to save than the desire to leave assets to loved ones in a will — the "bequest motivation," as economists call it. Indeed, the wealthy elderly in the sample tend to live longer and have higher medical bills than those below them on the income ladder.

The poor are faced with a different scenario. Because social insurance programs help protect against catastrophic medical expenses, the poor tend to consume rather than save, leaving little money behind for retirement. Such programs can also benefit the wealthy elderly as well because these programs can protect them against catastrophic medical expenses, which could have the potential to bankrupt them. **RF**