The Distribution of Risk and the Great Recession: Old Problems, New Crises

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Research Question: What were the central institutional and regulatory changes in U.S. mortgage finance that contributed to the historic loss of wealth during the Great Recession and aftermath?
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Method: Trace the developments which transformed mortgages from financial instruments which shielded borrowers and savers from risk, to concentrating risk on those least able to bear it.
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Method: Trace the developments which transformed mortgages from financial instruments which shielded borrowers and savers from risk, to concentrating risk on those least able to bear it.

Consistent theme: risk-bearing capacity is both costly and limited. When this capacity becomes stressed, there is a persistent tendency to redistribute risk towards end users of the system – borrowers and savers – often with severe consequences.
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- Depended on New Deal era regulatory structure with active participation of public institutions in the market.
- Reinterpret Great Recession as due to old persistent problems of 19th century mortgage finance, which re-emerged after deregulation and privatization.
- “Garden variety” 19th century boom-bust cycle: Both predictable, and predicted.
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- The New Deal and the Creation of Stable Mortgage Finance
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- The HOLC and a Stable Structure
- Private-Risk Bearing Capacity, Public Institutions, and Regulatory Structure
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- The 1980s: Insolvency, Experiments, and Securitization
- The PLS market
Distribution of Risk in Mortgages

- Types of Risk in Mortgages:

  - Credit
  - Interest Rate
  - Liquidity
  - Collateral
  - Prepayment

The American Mortgage: Long-term, fixed rate, fully amortizing, with universal ability to prepay. High level of consumer protection rare by international and historic comparison.

Countries which fund mortgages through depositary institutions which originate and hold (UK, CA) don’t often offer fixed rates. Those which fund through securitization don’t allow refinances, prepayments, require high LTVs.

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  - 3-5 years, adjustable rate, not fully amortizing

Snowden (1995) warning: Each of these failures, provided evidence that private securitization structures rest on a razor’s edge. There is always some limit to the amount of default risk that can be absorbed in a privately financed securitization structure, and whenever that threshold is broken the severe informational problems that are inherent in mortgage securitization appear in full force. We have seen that insiders regularly exploited their informational advantage in these situations before 1930 and, by doing so, imposed much larger losses on investors than would have resulted from default risk alone.
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The New Deal and Stable Mortgages

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- Uses public/private competition + direct participation in market as method to set the terms of the market to shield households from risk.
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Mortgage innovations immediately redistribute risk back towards households.

Crisis resolved by GSE securitization, allowed re-establishment of fixed rate lending.

GSE underwriting templates would serve to regulate primary market.

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Deregulation and “Mortgage Innovations”

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• Almost triples in value from 2002-2007, peaking at $2.7 trillion outstanding in 2007 (SIFMA). Then declined rapidly.

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  - Research Q: How much higher was expected loss for no/low doc loans, than full doc loans?
- Agency problems and failure of loss mitigation.
  - Loan mods in PLS market result in net increase in debt of $20 billion from 2008-2014.
  - Consistent with capitalization of fees, but not capitalization of missed interest payments.
  - Capitalization per modication doubles from 2010-2014, even though delinquencies per modication remain constant.
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