A Tale of Improperly Placed Incentives

by Sam Gutterman

Arguably, many of the fundamental contributing factors to the 2008 mortgage crisis involved misdirected incentives and misinformation available to key participants in the housing finance process. The incentives discussed here include those of the mortgage holders, mortgage intermediaries, mortgage providers, securitizers, raters and CEOs and other highly paid staff of those involved. Unless similar incentives are recognized, future public policy decisions will again fail to avoid this system-wide risk. Since I am most familiar with the U.S. situation, my comments will be limited accordingly.

It has been U.S. public policy to facilitate and help enable home ownership for as many people as possible. This commendable policy objective has been promoted through full or partial mortgage loan warranties provided by pseudo-public entities [such as the Federal National Mortgage Association (Fannie Mae), and the Federal Home Loan Mortgage Corporation (Freddie Mac)], public entities (including federal agencies or departments such as the Federal Housing Administration and the Department of Veterans Affairs), private mortgage insurers, and through the securitization of mortgages. These insurance or financial vehicles have provided financial support to lenders through which mortgage loans might be marketed to a wider market than might otherwise have been achieved by individual lenders. Unfortunately, at the same time, these have led in part to unintended consequences, what in retrospect could be considered to be misguided subsidies to the housing market.

Especially since 2004, the view that recent housing value inflation would continue at a rapid double-digit rate of growth was widely held and encouraged speculative excesses from two types of mortgage purchasers: (1) investors who purchased multiple residences under the assumption that buying and selling these properties at very little investment or initial cost could be very profitable by an expectation of flipping them quickly, without incurring much if any personal financial risk or even to put much if any investment, and (2) purchasers who did not have the current financial capacity to repay their mortgage loans, taken out for houses whose values had been bid up in a housing value bubble. Some of the latter mortgages, issued to those with limited financial resources or weak loan experience (often referred to as sub-prime mortgages), were to some the underlying source of financial chaos. However, I believe that they were one source of the underlying problem, with an overall credit problem covering a much larger percentage of the population.

Mortgage products that were designed and actively marketed to these individuals enabled and encouraged mortgage purchases. These included mortgage contract features such as teaser loans (with extra-low interest rates for an initial period), interest only loans, loans equal to or even in excess of current house value and adjustable rate loans. Some of these became quite popular because they got around financial regulations, such as banks' capital adequacy formulas.

Some have blamed loose underwriting standards, or even lack of standards, on broader access to credit. Too many people with inadequate financial resources were encouraged to take out excessive mortgages for their houses when housing values were at their peak. Loans were issued on the basis of no financial documentation (no doc loans), limited financial documentation (low doc) mortgages, and in some cases as a result of fraud. These factors in turn helped fuel the housing bubble.

What motivated mortgage intermediaries and lenders to offer these loans to these markets? Although it is all too easy to attribute their actions to simple greed (and, of course, there was a little of this) in taking advantage of an enthusiastic market; in part, a long period of low inflation and economic stability reduced investors' perceptions of risk.

From the view of the lending institutions, a relatively large up-front profit could be obtained accompanied by what seemed to be limited or no cost or risk. This

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incentive to increase market share seemingly without adding risk promoted bad business practices. Although in many respects similar tendencies existed in prior housing finance cycles, they were exacerbated here by the existence of vehicles that appeared to pass risk to others—so underwriters took inadequate precautions to ensure that only appropriate mortgage loans were taken on. It was further exacerbated by the extensive use of Wall Street computer models based on recent price histories.

The availability of pass-through vehicles, be they through securitization or special purpose vehicles that did not need to be consolidated, either of which could avoid capital charge requirements, seemed to provide profit without risk—rarely possible in a competitive environment. Investors desperately seeking any additional yield eventually led to a bonanza in mortgage-backed securities that not only helped create a glut of new homes, but ultimately led to an inability to sell homes in foreclosures in some areas that further led to the downward housing price spiral.

Although seemingly sound risk management practice existed at the entity level, in retrospect there were reasons why inadequate charges were being made. Inadequate risk assessment and transparency, accompanied by systemic financial risk that proved ultimately to be unavoidable, led to huge prospective costs foisted on the entire system. In part this was due to a lack of individual risk-bearing, a feeling of not being responsible, that ultimately created huge moral hazard (in this case provided incentives to create risk where none existed). Should (or rather can) this be eliminated in the future?

Two further contributing factors need to be highlighted: (1) an overemphasis on short-term thinking and (2) the typical human tendency to assume that current trends will continue. These are closely interconnected, although the former can be also viewed as equivalent to the application of very large discount rates. These factors have been at the root source of most housing bubbles, as they also have been a factor for most underwriting cycles in insurance.

Those who bought the mortgages were banking on the continuation of the rapid increase in housing values. Those who sold the mortgages thought that, since they didn't have to bear any downside risks and as long as the next level in the risk chain also continued to believe that housing value trends would continue, the greater volume generated through more creative debt and derivative products would enhance overall income.

Will such products and underwriting ever be seen again? Well, it is too early to look ahead to the next time the housing finance cycle reaches this stage, but similar variants, possibly with different names, are likely occur. Or similar trends will arise in other areas (e.g., credit card loans and mortality). But it is likely that if short-term thinking and current trend extrapolation occur in other areas, the same type of situation will arise.

Recommendations

Future systemic risks need to be better identified and assessed. One example is to ensure that more stakeholders bear some of the cost or keep some of the risk; otherwise moral hazard will become significant (simply passing the risk along, providing through fixed fees the incentive to write business at a loss).

Better financial education is needed for various participants and stakeholders in the system, education that reflects both short-term and long-term incentives and views. This need not only exist for potential mortgagees, but also for executives and compensation consultants. Effective corporate governance will listen to risk management teams that involve actuaries. A populist solution inevitably points a finger to CEO and executive compensation—indeed, overemphasis on short-term features of such compensation may have contributed to the damages caused; more long-term performance incentives should be featured in compensation formulas.

Policymakers need to better assess the unintended consequences of their actions. Financial service regula-

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tors need to increase (risk-based) capital requirements for pass-through vehicles or require that an underwriter keep a minimum percentage of each risk written to avoid off-loading 100 percent of the risk for the entity who performs the underwriting and product design offering.

Modelers should pay more attention to outlier possibilities, using more robust stress-testing whose results are not ignored as being impossible. They should also avoid an overemphasis on recent experience when dealing with potentially cyclical phenomena.

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