

# The Political Economy of the U.S. Mortgage Default Crisis

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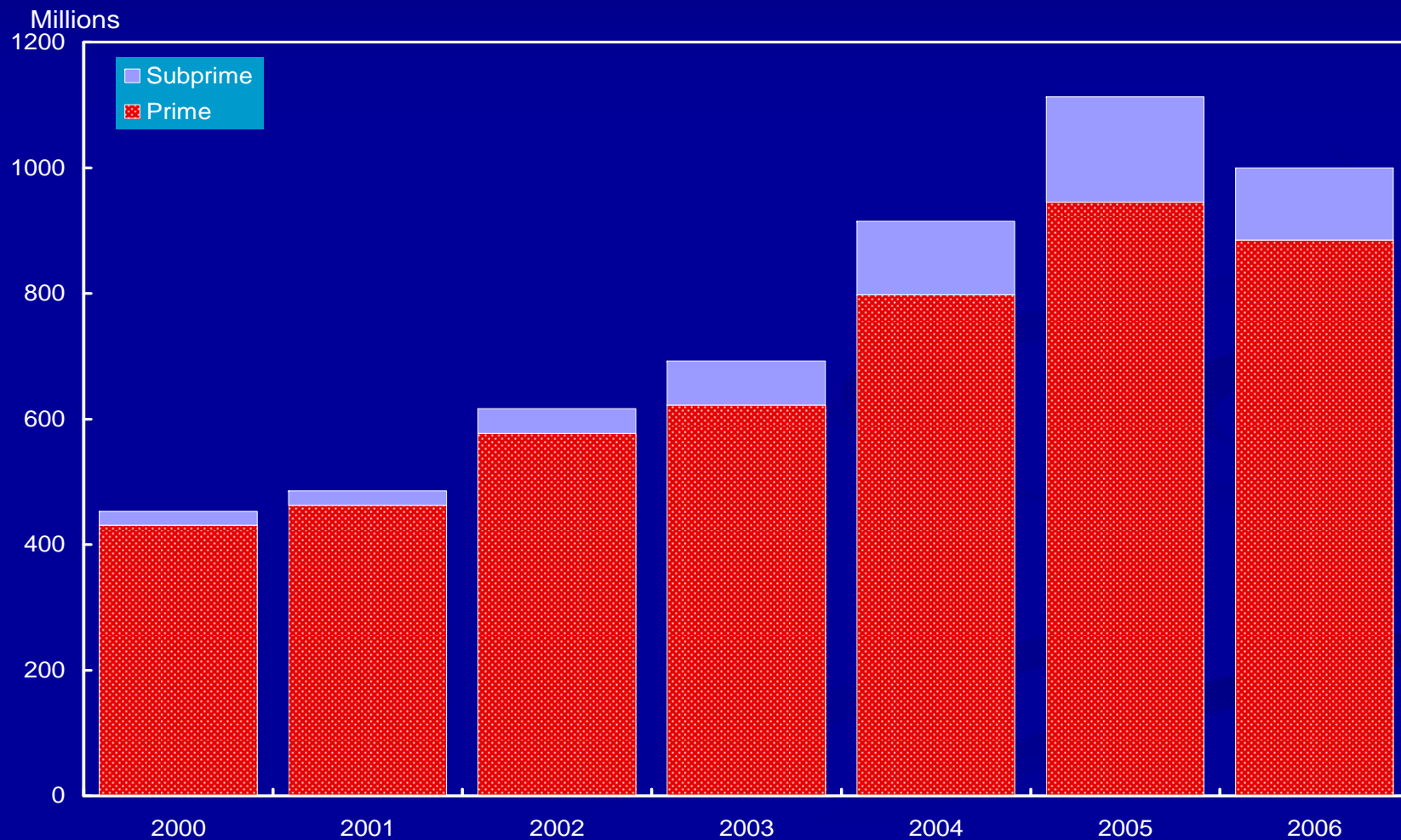
Discussion by:

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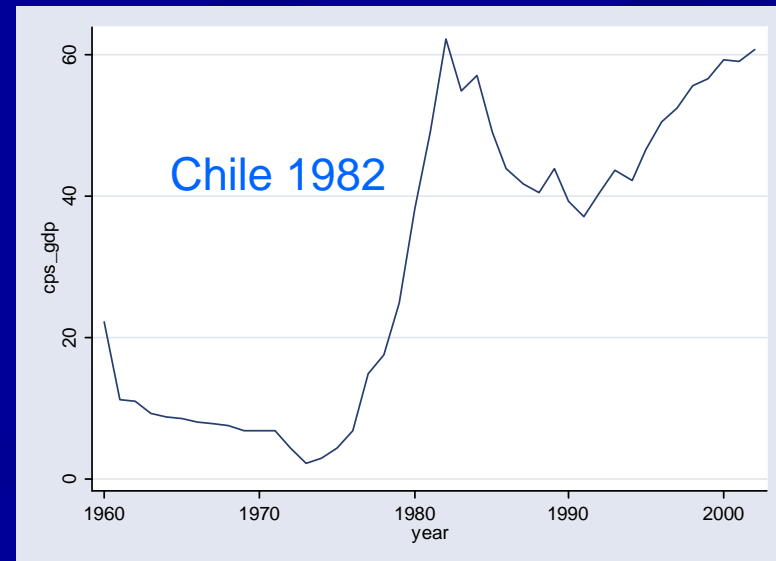
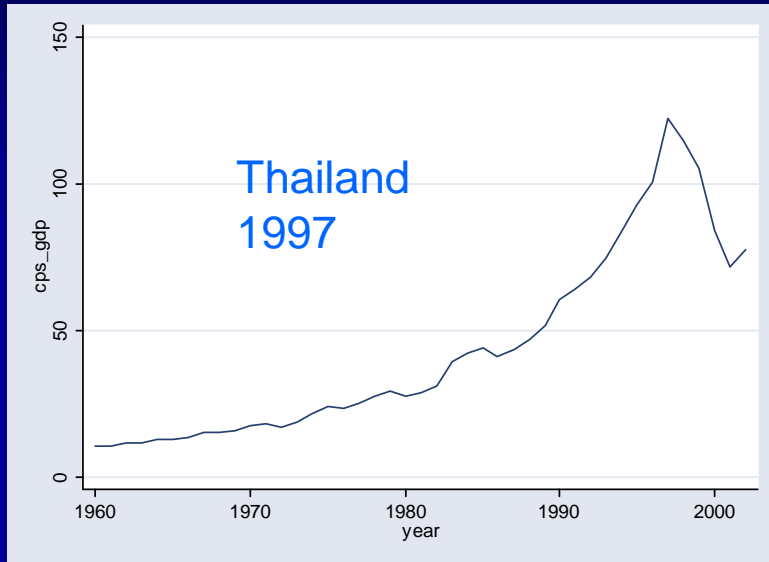
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# U.S. Subprime Mortgage Boom

Nationwide Home Purchase Loan Originations  
(volume of loans in dollars)

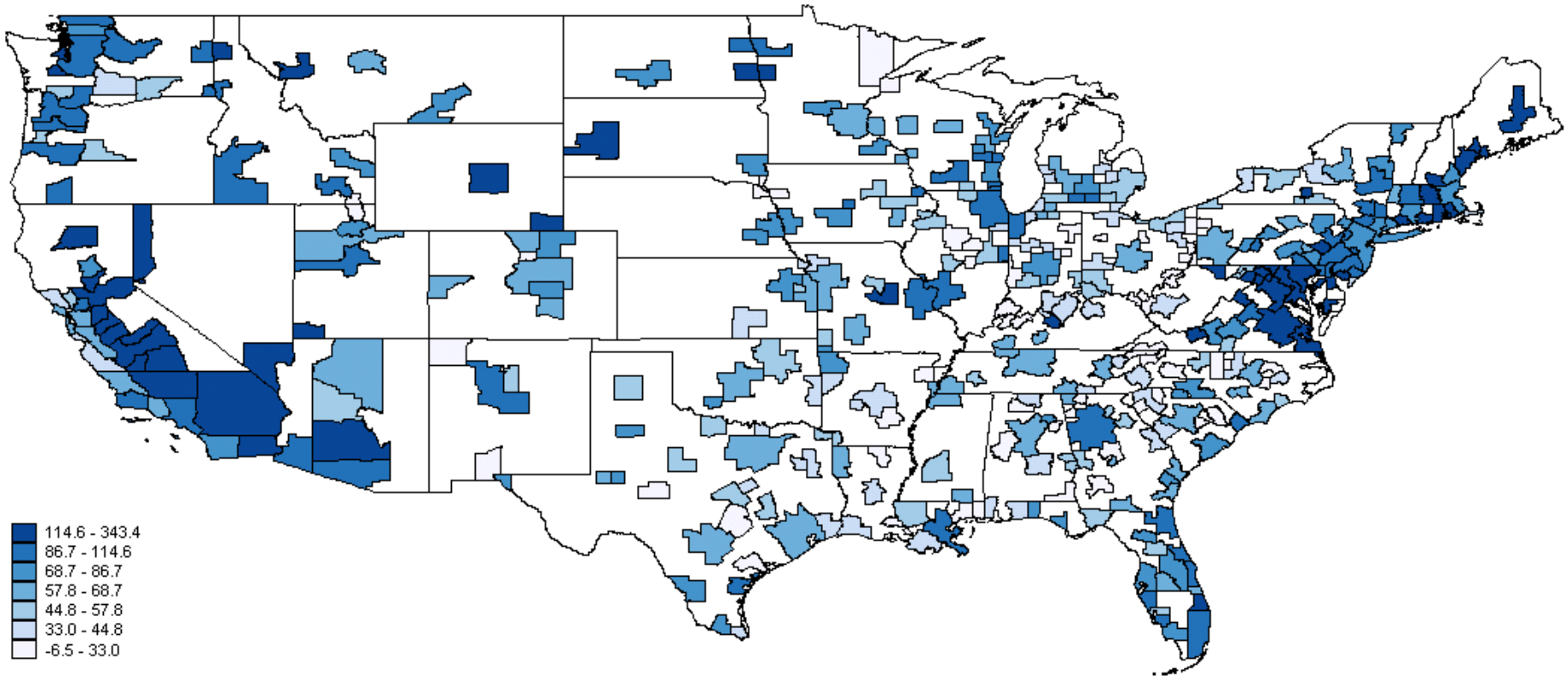


# Booms and Crises



# Where was the boom?

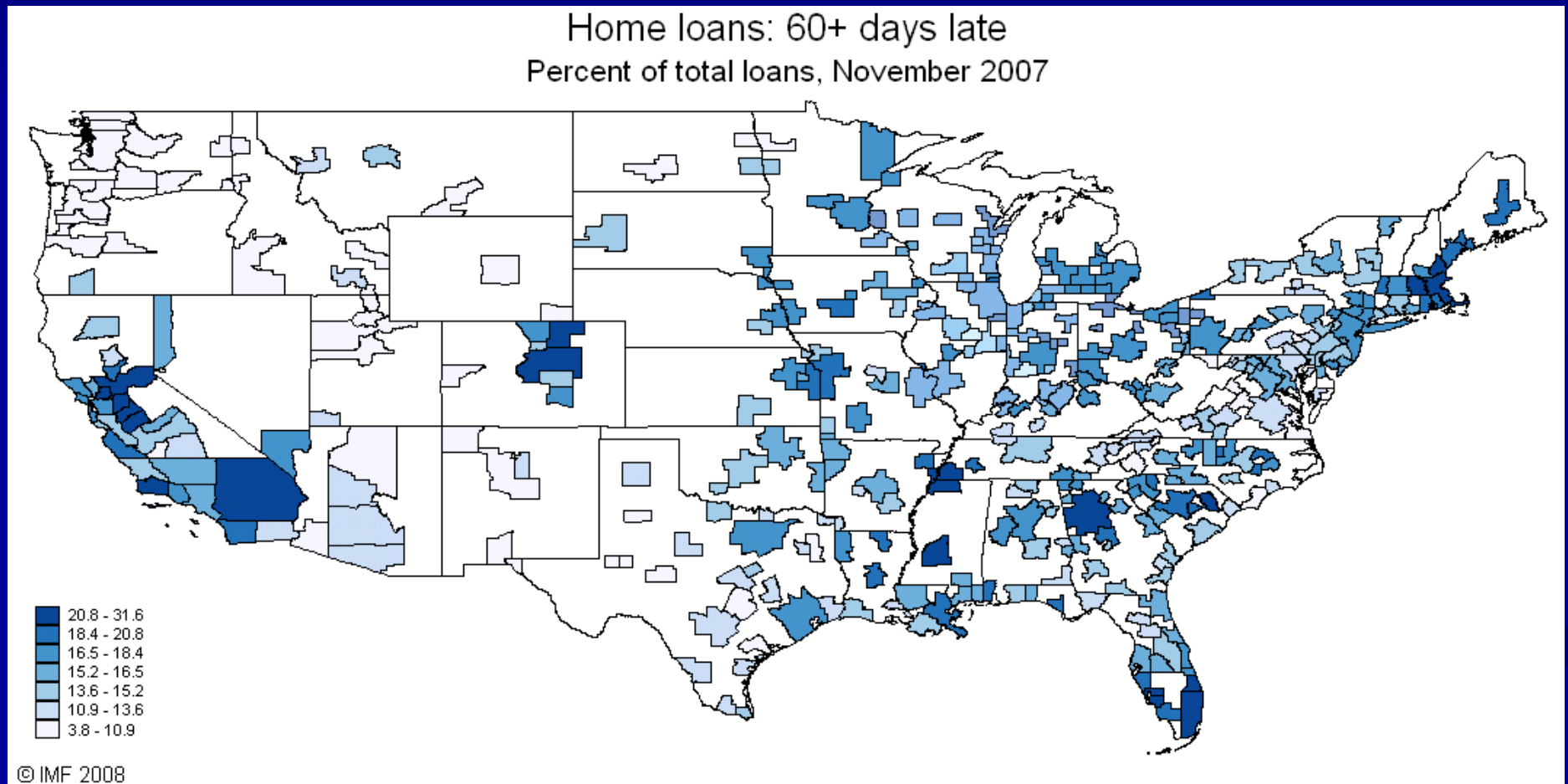
Credit growth: 2000-2004  
Number of originations (percent increase)



© IMF 2008

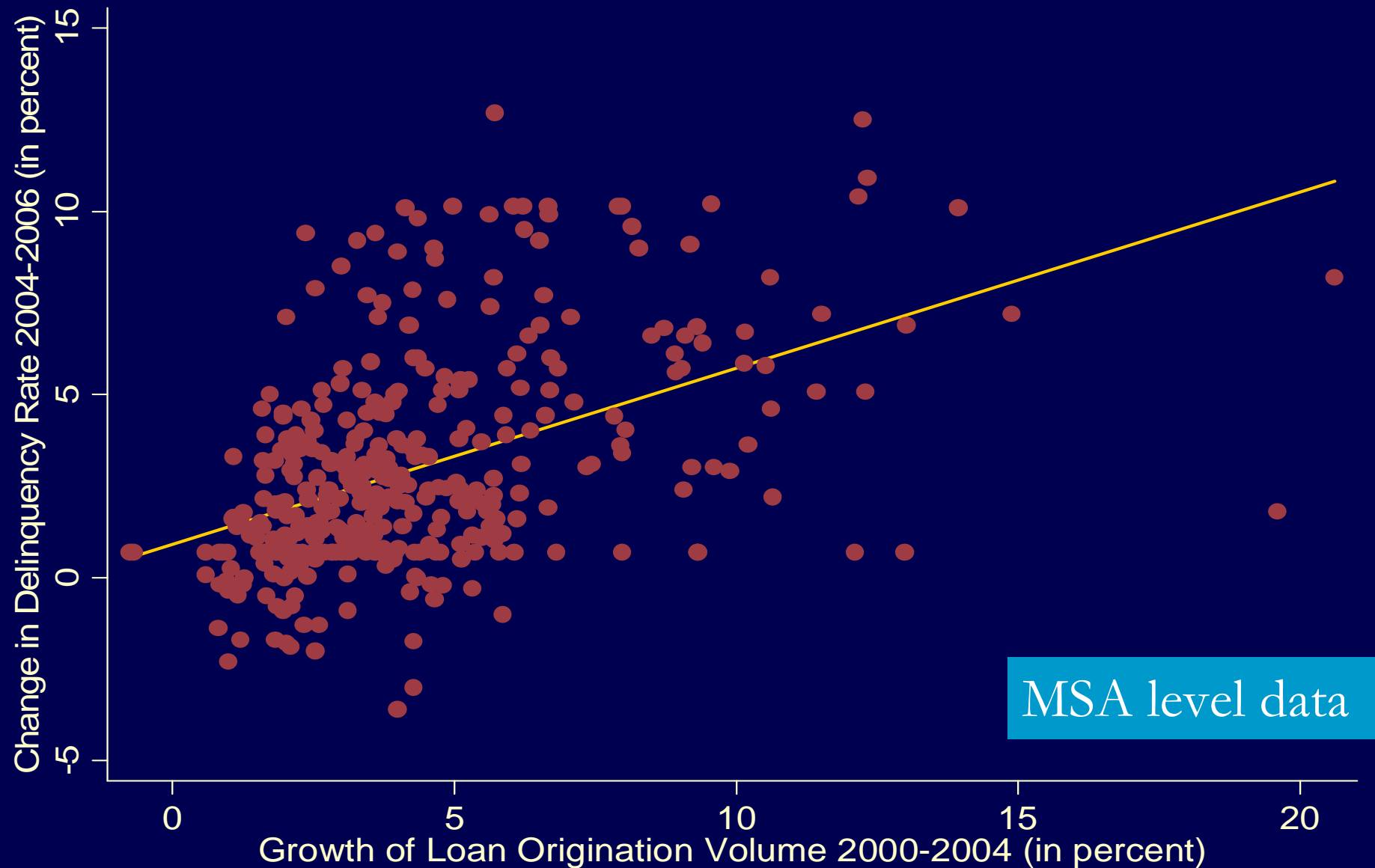
Lots of geographical variation

# ...And where are the delinquencies?



Lots of geographical variation

# Subprime Crisis: A Credit Boom Gone Bad



# Objective of the Paper

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- Study how interest groups exert pressure on politicians to influence government policies to
  - 1) support the mortgage credit expansion of 2001-06
  - 2) deal with the subsequent default crisis of 2007-08

# Main Findings

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- Campaign contributions from the mortgage industry over the period 2001-06 are higher in areas with a larger share of subprime borrowers
- Congressional voting in favor of the American Housing Rescue and Foreclosure Prevention Act of 2008 is positively associated with mortgage default rates in 2007 in congressional districts
- Conclusion: Special interests affected voting patterns and recognized a role for Congress in the subprime mortgage expansion

# Public and Private Interest Theories of Regulation

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- Two alternative approaches to analyze policy outcomes:
  - Public interest theory: Regulatory intervention occurs in the interest of the public at large (Joskow and Noll 1981)
  - Private interest theory: Regulatory intervention is the result of powerful interest groups exerting pressure on politicians and regulators to capture rents at the expense of more dispersed groups (Stigler 1971, Peltzman 1976, and Becker 1983)

# Political Economy of Banking: Previous Empirical Work (1)

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- Bank branching restrictions
  - Intrastate branching regulation since 1970s at U.S. state level
  - Passage of 1994 Riegle-Neal Act to eliminate all barriers to interstate banking and branching (Kroszner and Strahan, 1999)
- Separation between commercial and investment banking
  - Glass-Steagall Act of 1933
  - No difference between performance of securities underwritten by commercial vs. investment banks (Kroszner and Rajan, 1994)
- Deposit insurance
  - Public interest: protection of small, uninformed depositors, and the stability of the banking system (Diamond and Dybvig 1983)
  - Private interest: Deposit insurance is favored by riskier banks (Kroszner 1997; Kroszner and Strahan, 2001; Laeven 2003)

# Political Economy of Banking: Previous Empirical Work (2)

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- Regulatory reform and foreign bank entry
  - “Rethinking Bank Regulation: Till Angels Govern” (Barth, Caprio, and Levine 2006)
  - Increased foreign entry can bolster the financial system by creating a constituency for improvements in the legal and regulatory framework for the provision of financial services (Rajan and Zingales 2003)
  - National interests still impede further integration of banking markets (e.g. Italy)
- Political connections and preferential access to finance
  - Pakistan: Kwahja and Mian (QJE 2004)
  - Brazil: Claessens, Feijen, and Laeven (JFE 2006)

# Comments

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- You show a correlation between campaign contributions from the mortgage industry and the expansion of the subprime mortgage market
- But: What is exact political link? Is there a causal relationship?
- Perhaps you can look at voting behavior on legislation passed (or rejected) in 2001 to 2006 that is likely to have affected the expansion of the mortgage market over this period
- You study the 2008 AHRFPA Act that intends to deal with mortgage defaults, but why not also study how political factors influenced voting behavior on earlier, relevant laws, such as state-level anti-predatory lending laws
- Alternatively, you could study in more detail what is the specific channel through which campaign contributions by the mortgage industry affects the behavior of local politicians and firms

# Alternative Channels and Interest Groups

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- House price appreciation
  - Home builders and home owners
  - Similar results for campaign contributions by home builders?
- Increased home ownership
  - Poor and/or young people; public interest?
- Intra-industry rivalry
  - Entry by large players (Dell’Ariccia, Igan, and Laeven, 2008)
  - Asset securitization (Keys et al., 2007; Mian and Sufi, 2007)
- Self-interested regulators
  - State legislators

# Credit Booms: Curse or Blessing?

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- Many banking crises have been preceded by booms
- Mortgage expansion created winners and losers (creditors vs. debtors; new home owners and banks vs. taxpayers)
- Future research: Political economy of bank bailouts (Paulson plan); idea for another paper!!