

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

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Political Economy of Finance

- Governments have been major players in banking and finance throughout history
- However, huge variation in the cross-section and time-series in the scope and depth of government intervention:
 - Regulation, Price Controls, Bailouts, Nationalizations ...
- The challenge: Striking *and* Preserving the right balance between governments and markets.
 - e.g. full government ownership versus LLSV
- Conceptually we may agree on the optimal balance in a financial structure
 - However, equilibrium financial structure is *intermediated* through the political decision makers.
 - Thus we have to incorporate the dynamics and “push and pulls” of the political decision making process.
 - This is a grossly under-studied topic empirically.

Enforcing Hard Budget Constraints

- An important dimension of an *ex-ante* robust financial system is the credible enforceability of hard budget constraints (Kornai)
 - For example commitment not to bail out.
 - It may look efficient to bail out ex-post, precisely because the ex-ante commitment was not credible.
 - A lack of commitment may be *the* reason why systematic risk is under-priced in the economy.
- What factors determine the political outcome of bailout commitment?
 1. Ideology: Ex-ante explicit posturing and promises to enhance credibility
 2. Local constituent interests: Taxation versus Subsidy
 3. Special Interest: Privatize Profits versus Socialize Losses

Empirical Challenge

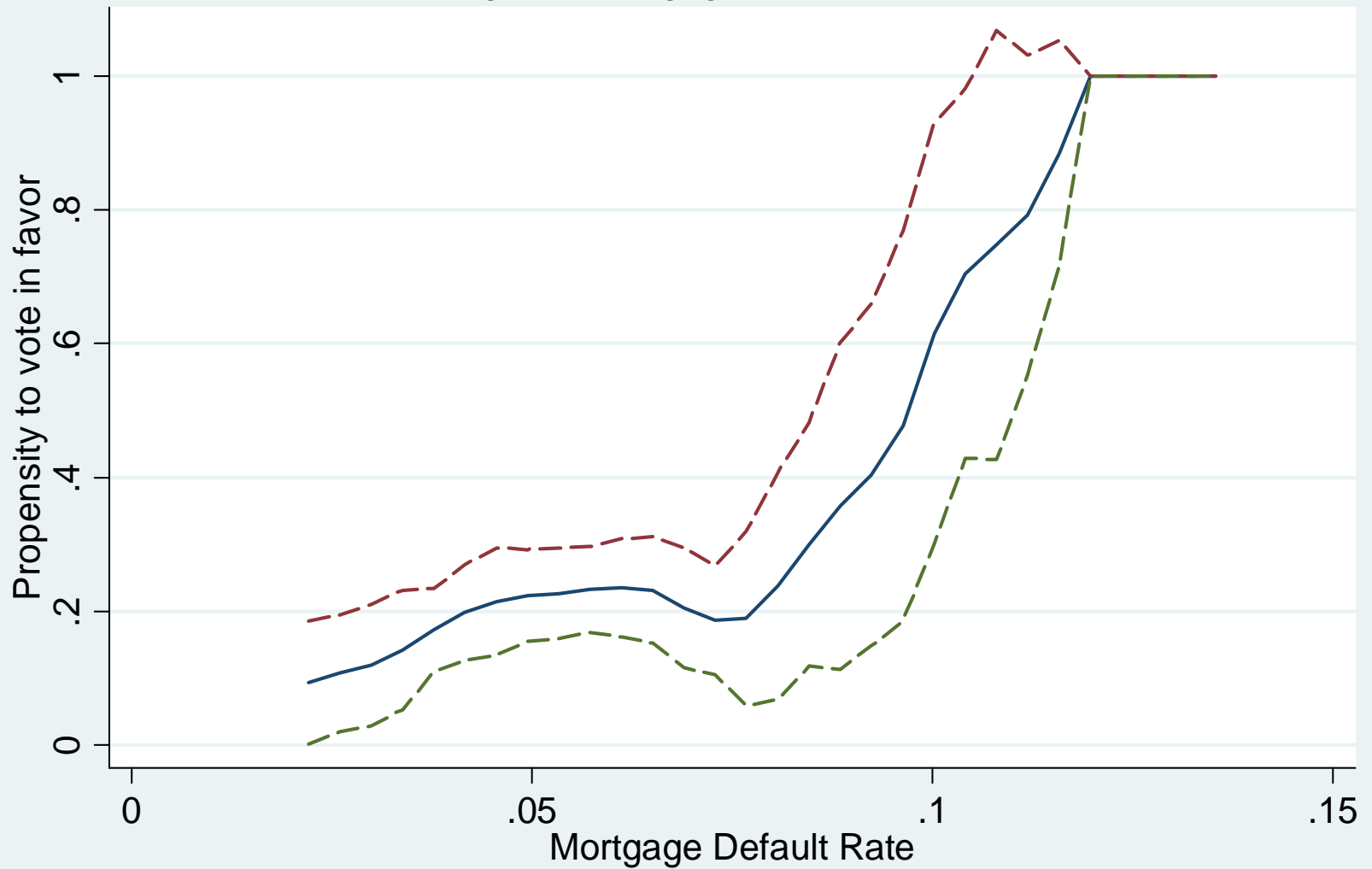
- Measuring ideology, constituent interest, and special interest.
 - Isolating the contribution of each separately (e.g. ideology and constituent interests are co-determined)
 - Quantifying the relative contribution
 - Better understanding the mechanism through which each operates (e.g. median voter vs. voting block models)
- What we do?
 - Primarily look at two key votes: AHRFPA (home owner bailout) and EESA (financial industry bailout) in 2008.
 - Empirical definition:
 - Ideology = DW-nominate (Poole and Rosenthal 1997)
 - Constituent Interest = District level Mortgage Default Rate
 - Special Interest = Fin. Industry contribution to a representative.

AHRFPA July 26, 2008

	Panel A: 519 Vote (July 26, 2008)		
	(1)	(2)	(3)
	Democrats	Republicans	Total / Difference
# Voting "Yes"	227 [0.068]	45 [0.065]	272 [0.0035]
# Voting "No"	3 [0.048]	149 [0.052]	152 [-0.0036]
Total / Difference	230 [0.020]	194 [0.013***]	424

Figure 2

AHRFPA '08 vote against mortgage default rate in Republican districts



Constituent Interests and AHRFPA (Table 3)

	(1)	Probit (2)	(3)	(4)	State FE (5)	Census Controls (6)	Aug '07 Vote (7)	Ordered Probit On Switchers (8)
Dependent Variable: Voted in favor of AHRFPA '08								
Mortgage Default Rate (07Q4)	6.68*** (1.45)	6.20*** (1.45)		6.50*** (1.30)	4.38** (2.30)	5.13*** (1.82)	1.18 (1.86)	11.32*** (5.20)
Mortgage Default Rate (05Q4)			1.01 (2.35)					
Δ Mortgage Default Rate (05Q4-07Q4)			7.61*** (1.45)					
Ideology Score				-0.88*** (0.15)	-0.62*** (0.20)	-0.84*** (0.15)		0.50 (0.44)
Constant	-0.13 (0.08)		0.03 (0.09)	0.36 (0.12)	--	-7.38 (3.70)	0.11 (0.11)	
N	194	194	194	190	190	190	182	184
R ²	0.09		0.12	0.23	0.45	0.23	0.004	

Constituent Interests and AHRFPA (Table 3)

	(1)	Probit (2)	(3)	(4)	State FE (5)	Census Controls (6)	Aug '07 Vote (7)	Ordered Probit On Switchers (8)
Dependent Variable: Voted in favor of AHRFPA '08								
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N	194	194	194	190	190	190	182	184
R ²	0.09		0.12	0.23	0.45	0.23	0.004	

Precision in Targeting Constituents (Table 4)

Panel A: Correlation Matrix						
	Mortgage Default Rate	Home Eq Defaults	Credit Card Defaults	Automobile Defaults	Other Defaults	Non-Home Defaults
Mortgage Defaults	1.00					
Home Eq Defaults	0.75	1.00				
Credit Card Defaults	0.58	0.68	1.00			
Automobile Defaults	0.66	0.68	0.77	1.00		
Other Defaults	0.58	0.71	0.82	0.77	1.00	
Non-Home Defaults	0.68	0.74	0.93	0.90	0.93	1.00

Panel B:						
	Home Default Rate (07Q4)	Non-Home Default Rate (07Q4)	Ideology Score	Constant	N	R ²
Dependent Variable: Voted in favor of AHRFPA 2008	8.43 (2.01)***	-2.60 (2.27)	-0.87 (0.12)***	0.46 (0.15)***	190	0.23

Precision in Targeting Constituents (Table 4)

Panel A: Correlation Matrix						
	Mortgage Default Rate	Home Eq Defaults	Credit Card Defaults	Automobile Defaults	Other Defaults	Non-Home Defaults
Mortgage Defaults	1.00					
Home Eq Defaults	0.75	1.00				
Credit Card Defaults	0.58	0.68	1.00			
Automobile Defaults	0.66	0.68	0.77	1.00		
Other Defaults	0.58	0.71	0.82	0.77	1.00	
Non-Home Defaults	0.68	0.74	0.93	0.90	0.93	1.00

Panel B:						
	Home Default Rate (07Q4)	Non-Home Default Rate (07Q4)	Ideology Score	Constant	N	R ²
Dependent Variable: Voted in favor of AHRFPA 2008	8.43 (2.01)***	-2.60 (2.27)	-0.87 (0.12)***	0.46 (0.15)***	190	0.23

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Panel A: Correlation Matrix						
	Mortgage Default Rate	Home Eq Defaults	Credit Card Defaults	Automobile Defaults	Other Defaults	Non-Home Defaults
Mortgage Defaults	1.00					
Home Eq Defaults	0.75	1.00				
Credit Card Defaults	0.58	0.68	1.00			
Automobile Defaults	0.66	0.68	0.77	1.00		
Other Defaults	0.58	0.71	0.82	0.77	1.00	
Non-Home Defaults	0.68	0.74	0.93	0.90	0.93	1.00

Panel B:						
	Home Default Rate (07Q4)	Non-Home Default Rate (07Q4)	Ideology Score	Constant	N	R ²
Dependent Variable: Voted in favor of AHRFPA 2008	8.43 (2.01)***	-2.60 (2.27)	-0.87 (0.12)***	0.46 (0.15)***	190	0.23

Electoral Competition and Constituent Interests (Table 5)

	(1)	(2)	(3)	(4)	(5)
	Dependent Variable: Voted in favor of AHRFPA '08				
Competitive District	-0.12 (0.30)	-0.22 (0.23)	-0.034 (0.25)	-0.009 (0.0088)	-0.34 (0.14)**
Mortgage Default Rate (07Q4)	6.13 (1.37)***	6.20 (1.37)***	6.34 (1.38)***	4.13 (2.08)**	4.592 (2.05)**
(Mortgage Default Rate)**(Competitive District)	7.66 (4.10)*	8.48 (3.65)**	4.48 (4.52)	0.30 (0.16)*	4.98 (2.53)**
Ideology Score	-0.81 (0.15)***	-0.81 (0.16)***	-0.83 (0.16)***	-0.80 (0.15)***	-0.86 (0.15)***
Constant	0.33 (0.13)**	0.32 (0.13)**	0.32 (0.13)**	0.38 (0.15)**	0.46 (0.14)***
Definition of Competition	Margin less than 2% in 2006	Margin less than 4% in 2006	Margin less than 6% in 2006	Linear Censored	Swing States
N	190	190	190	190	190
R ²	0.25	0.25	0.25	0.26	0.24

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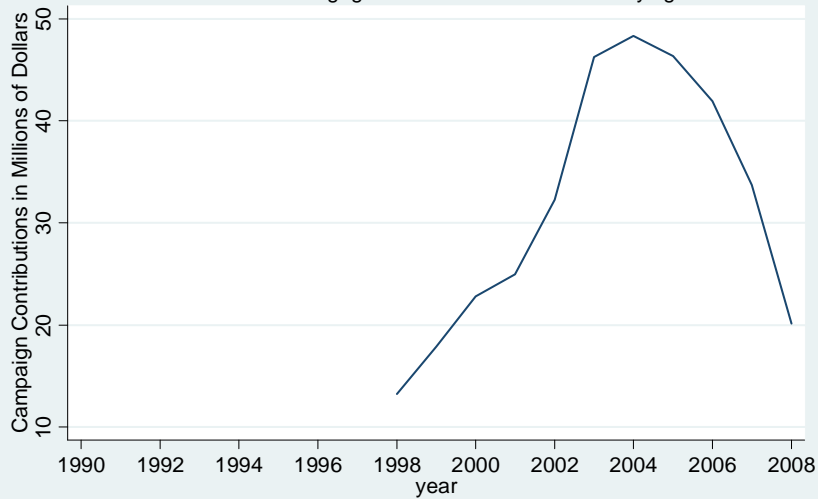
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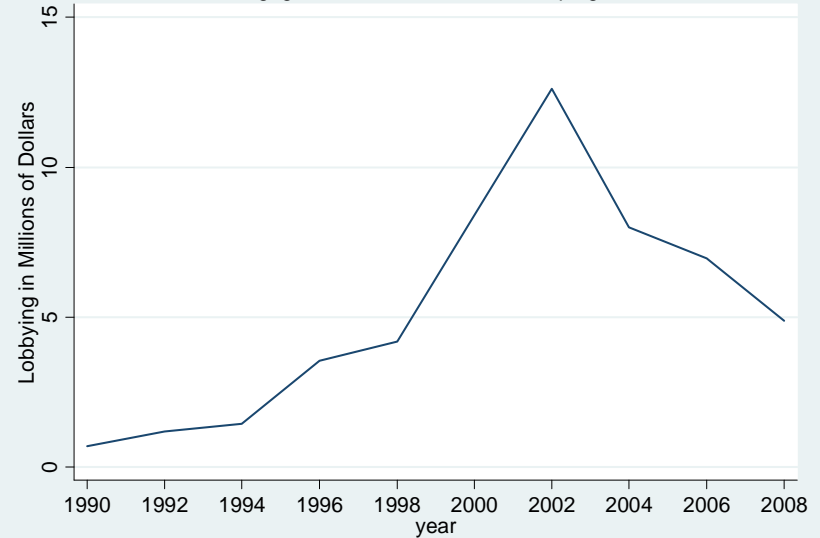
Special Interest: Aggregate Mortgage Industry Lobbying and Campaign Contributions

Figure 3

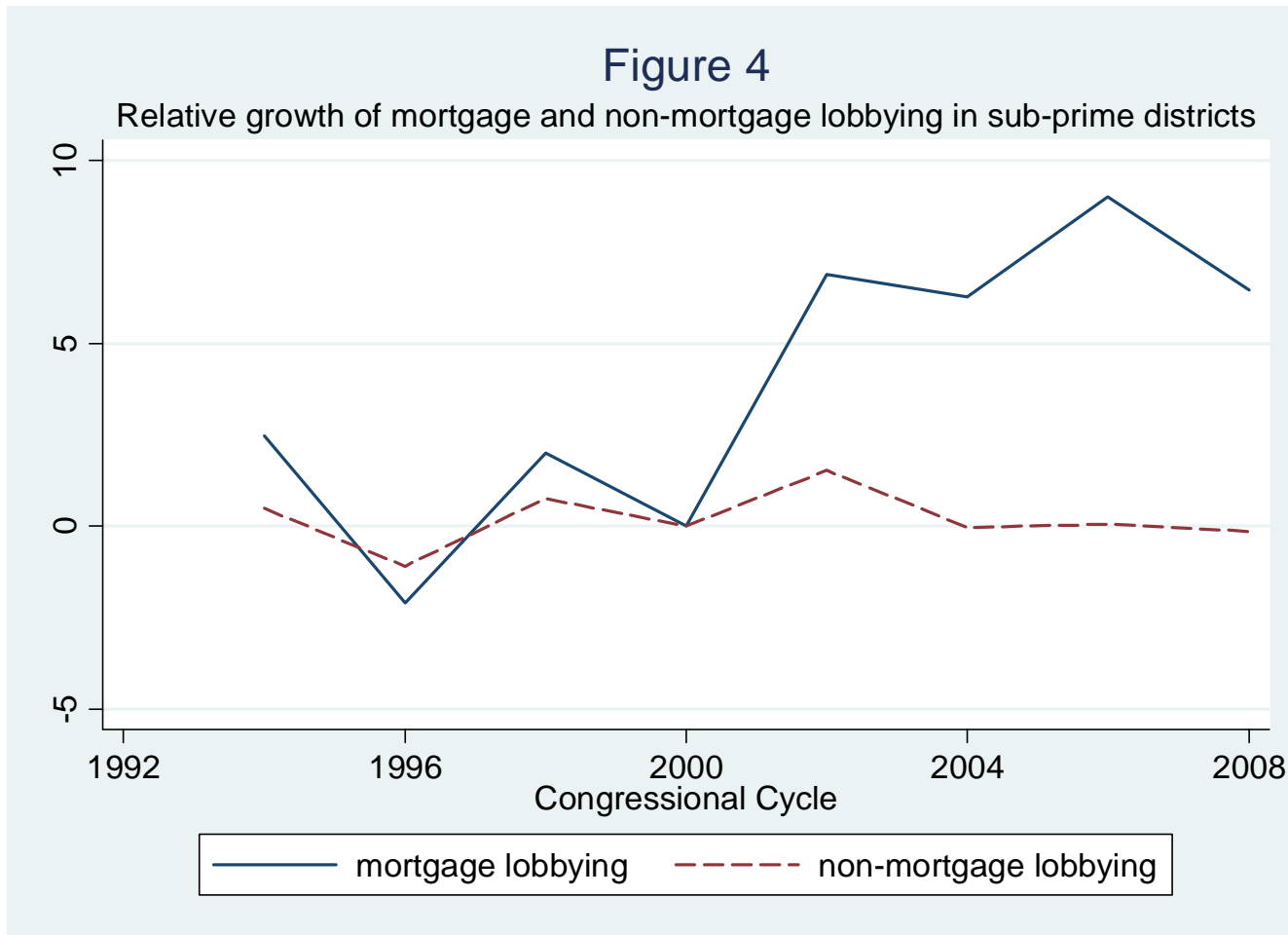
Panel A: Mortgage Bankers and Brokers Lobbying



Panel B: Mortgage Bankers and Brokers Campaign Contributions



Campaign Contributions Diff-in-Diff based on Subprime Borrowers in Congressional District



Relative Increase in Mortgage Industry Campaign Contributions for High Subprime Districts

	Matching Quality = 0		Matching Quality = 0.5		Matching Quality = 0.8	
	(1)	(2)	(3)	(4)	(5)	(6)
Dependent Variable: Change in Log Campaign Contributions						
	Growth in Mortgage Campaign Contributions	Growth in Non- Mortgage Campaign Contributions	Growth in Mortgage Campaign Contributions	Growth in Non- Mortgage Campaign Contributions	Growth in Mortgage Campaign Contributions	Growth in Non- Mortgage Campaign Contributions
Subprime Population Share	5.20 (1.78)***	0.26 (0.47)	6.54 (1.93)***	1.00 (0.44)**	7.62 (2.56)***	0.13 (0.58)
Constant	-.86 (0.61)	0.33 (0.16)**	-1.43 (0.67)**	0.09 (0.16)	-1.81 (0.89)**	0.39 (0.20)**
Difference in Coefficients		4.94***		5.54***		7.49***
F-test on Equality of Coefficients		9.20		9.47		9.60
N	423	423	340	340	214	214
R ²	0.02	0.0007	0.033	0.015	0.04	0.00

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Subprime Population Share	5.20 (1.78)***	0.26 (0.47)	6.54 (1.93)***	1.00 (0.44)**	7.62 (2.56)***	0.13 (0.58)
Constant	-0.86 (0.61)	0.33 (0.16)**	-1.43 (0.67)**	0.09 (0.16)	-1.81 (0.89)**	0.39 (0.20)**
Difference in Coefficients F-test on Equality of Coefficients	4.94*** 9.20		5.54*** 9.47		7.49*** 9.60	
N	423	423	340	340	214	214
R ²	0.02	0.0007	0.033	0.015	0.04	0.00

Co-Sponsorship of Ney-Kanjorski Bill (very Pro-Mortgage Industry Legislation)

	(1)	(2)	(3)	(4)	(5)	(6)
	Dependent variable: Ney-Kanjorski Cosponsorship					
				Census Controls	Census Controls and Finance Committee Dummy	Different Batches of Political Contributions
Mortgage Campaign Contributions (109th)	0.019 (0.003)***	0.017 (0.003)***	0.019 (0.003)***	0.018 (0.004)***	0.005 (0.003)*	0.015 (0.003)***
Non-Mortgage Contributions from Finance Sector		0.009 (0.004)**		0.008 (0.004)*	0.003 (0.003)	
Subprime Population Share			-0.098 (0.211)	-0.110 (0.307)	0.022 (0.276)	
Mortgage Default Rate (05Q1)			0.977 (1.023)	0.503 (1.254)	-0.608 (1.144)	
Mortgage Campaign Contributions (108th)						0.006 (0.004)*
Mortgage Campaign Contributions (107th)						0.001 (0.004)
N	435	435	435	429	429	423
R ²	0.07	0.07	0.07	0.09	0.29	0.07

EESA Vote. September 29, 2008

Panel C: 674 Vote (EESA Sep 29, 2008)

	(1) Democrats	(2) Republicans	(3) Total
# Voting "Yes"	140	65	205
# Voting "No"	95	133	228
Total	235	198	433

Table 3B
Special Interest and Voting Pattern on the EESA of 2008

				Census Controls	Republicans	Democrats
	(1)	(2)	(3)	(4)	(5)	(6)
	Dependent Variable: Voted in favor of EESA '08					
Log Financial Lobbying	0.065*** (0.015)	0.062*** (0.015)	0.065*** (0.015)	0.064*** (0.016)	0.018 (0.011)	0.10*** (0.028)
Terms Served	0.025*** (0.005)	0.024*** (0.005)	0.022*** (0.005)	0.021*** (0.005)	0.027*** (0.008)	0.025*** (0.006)
Mortgage Default Rate (07Q4)	-1.03 (0.910)	-0.65 (0.950)	-0.75 (0.960)	0.42 (1.360)	1.15 (1.820)	-0.62 (1.070)
Ideology Score	-0.28*** (0.045)	-0.28*** (0.045)	-0.27*** (0.045)	-0.29*** (0.047)	-0.54*** (0.160)	-0.029 (0.190)
%age earning 200K+		2.14** (1.000)	2.28** (1.030)	3.53** (1.420)	1.68 (1.670)	2.92** (1.170)
Electoral Competition			-0.08 (0.060)	-0.083 (0.061)		
Financial Committee Member?			-0.015 (0.059)	-0.022 (0.060)		
Constant	-0.34 (0.200)	-0.34 (0.200)	-0.34 (0.200)	-0.49 (0.270)	0.17 (0.230)	-0.74 (0.350)
N	427	427	427	427	194	233
R ²	0.153	0.159	0.163	0.174	0.12	0.14

Conclusion

(Preliminary Findings, lot more to do)

- Local constituent interests sway the decision of representatives in significant ways
 - Representatives very savvy in their response
 - The response is closely related to electoral competition
 - To Do: Testing voting block models
- Special interest
 - In good times:
Special interest move where “profits are”
Special interest lobbying predicts support for deregulation
 - In bad times:
Special interest lobbying strongly predicts bailout support
 - To Do: Price of special interest when there is a tradeoff with constituent interest / ideology (e.g. Dem vs. Rep result)
- Ideology serves as powerful commitment against bailouts, however measure of ideology is too broad currently.

Summary Statistics (Table 1)

	Democrats						Republicans					
	N	Mean	SD	10 th	50 th	90 th	N	Mean	SD	10 th	50 th	90 th
Mortgage Default Rate (07Q4)	236	.068	.033	.035	.06	.11	199	.055	.019	.034	.052	.077
Mortgage Default Rate (05Q4)	236	.039	.024	.017	.034	.070	199	.033	.012	.017	.031	.049
Δ Mortgage Default Rate	236	.029	.024	.0056	.022	.066	199	.022	.020	.0047	.015	.048
Home Default Rate (07Q4)	236	.065	.032	.033	.058	.11	199	.053	.018	.033	.050	.073
Non-Home Default Rate (07Q4)	236	.092	.028	.059	.085	.13	199	.077	.016	.057	.077	.10
Percentage subprime population	236	.34	.096	.24	.32	.48	199	.32	.078	.23	.32	.43
DW Nominate Ideology Score	234	-.41	.19	-.63	-.40	-.20	195	.55	.18	.32	.53	.77
Vote Margin November 2006	236	48.99	31.49	7.58	41.93	100	199	26.67	20.64	4.50	23.58	41.82
<i>Campaign Contributions, in \$thousands</i>												
Mortgage Industry Contributions 1993-2000	229	8.8	22.9	0.0	3.6	20.0	194	7.7	11.6	0.0	3.0	20.1
Mortgage Industry Contributions 2001-2008	236	18.3	28.1	0.5	7.9	47.8	199	17.0	25.5	0.0	6.3	48.8
Δ Mortgage Industry Contributions	229	1.10	2.96	-1.51	.60	3.89	194	.63	3.56	-2.87	.66	3.68
Non-Mort Contributions 1993-2000	229	388.2	520.3	73.7	270.2	741.7	194	340.7	266.8	100.8	266.6	699.7
Non-Mort Contributions 2001-2008	236	539.0	501.3	132.3	359.4	1,174	199	595.5	483.0	152.1	430.7	1,371
Δ Non-Mort Contributions	229	.39	.79	-.59	.40	1.34	194	.52	.76	-.45	.45	1.57

Preview of Results

- Constituent interests strongly influence Congressional voting patterns on legislation responding to crisis
 - Our unique data and suddenness of crisis allow us to identify the effect of constituent interests versus politician ideology
 - This disputes prevailing view that politicians vote their own ideology regardless of constituent interests (e.g., Lee, Moretti, Butler, QJE, 2004)
- During subprime mortgage expansion, mortgage industry lobbying and money target high subprime share districts
 - A sharp relative increase in campaign contributions by mortgage industry to representatives of high subprime share districts
 - Campaign contributions by mortgage industry predict co-sponsorship of mortgage industry friendly regulatory legislation
 - Lobbying targets politicians who represent constituents affected by industry activity

Background on Government Policies

- Subprime mortgage expansion
 - Affordable housing mandate by Department of Housing and Urban Development given to Freddie Mac and Fannie Mae
 - American Dream Down Payment Act of 2003
 - Lack of regulatory action on “predatory lending.” Ney-Kanjorski bill, which “preempted state mortgage laws with a federal standard” and was widely supported by the mortgage industry
- Mortgage crisis response: American Housing Rescue and Foreclosure Prevention Act (AHRFPA), passed July 2008
 - \$300B in FHA backed insurance for delinquent mortgages
 - Unlimited line of credit for Freddie and Fannie
 - Forced government to raise debt ceiling by \$1T

Data

- Zip code-year level data on defaults and consumer credit scores (1996 to 2007) from Equifax
- Congressional voting and politician characteristics
 - Stewart and Moon (2008)
 - Poole and Rosenthal (1997)
- Interest group lobbying and contribution data, by industry from Center for Responsive Politics
 - Lobbying expenditure (money spent by a firm to a lobbyist)
 - Campaign contributions by PACs and employees
 - Only campaign contributions can be linked directly to politician

Congressional Voting on AHRFPA of 2008

- Reduced form specification based on “bliss” points of Levitt (1996)
- Politician’s voting behavior affected by constituent interests, ideology, political parties, and special interests

$$\Pr(\text{Vote}_i = \text{Yes}) = \beta * (\text{ConstituentInterests}_i) + \Gamma * X_i + \varepsilon_i$$

- Our primary measure of constituent interests for AHRFPA is mortgage default rate as of 2007Q4
- Two votes: May 2008 and July 2008

Voting Patterns across Parties (Table 2)

Panel A: 519 Vote (July 26, 2008)			
	(1)	(2)	(3)
	Democrats	Republicans	Total / Difference
# Voting "Yes"	227 [0.068]	45 [0.065]	272 [0.0035]
# Voting "No"	3 [0.048]	149 [0.052]	152 [-0.0036]
Total / Difference	230 [0.020]	194 [0.013***]	424
Panel B: 301 Vote (May 8, 2008)			
	(1)	(2)	(3)
	Democrats	Republicans	Total / Difference
# Voting "Yes"	229 [0.068]	39 [0.061]	268 [0.0063]
# Voting "No"	0	154 [0.053]	154
Total / Difference	229	193 [0.0079**]	422

Mortgage default rate in 4th quarter 2007 in square parentheses. Parentheses in the third column and row report difference in default rate. ***,**, * Differences are statistically different at the 1%, 5%, and 10% levels, respectively

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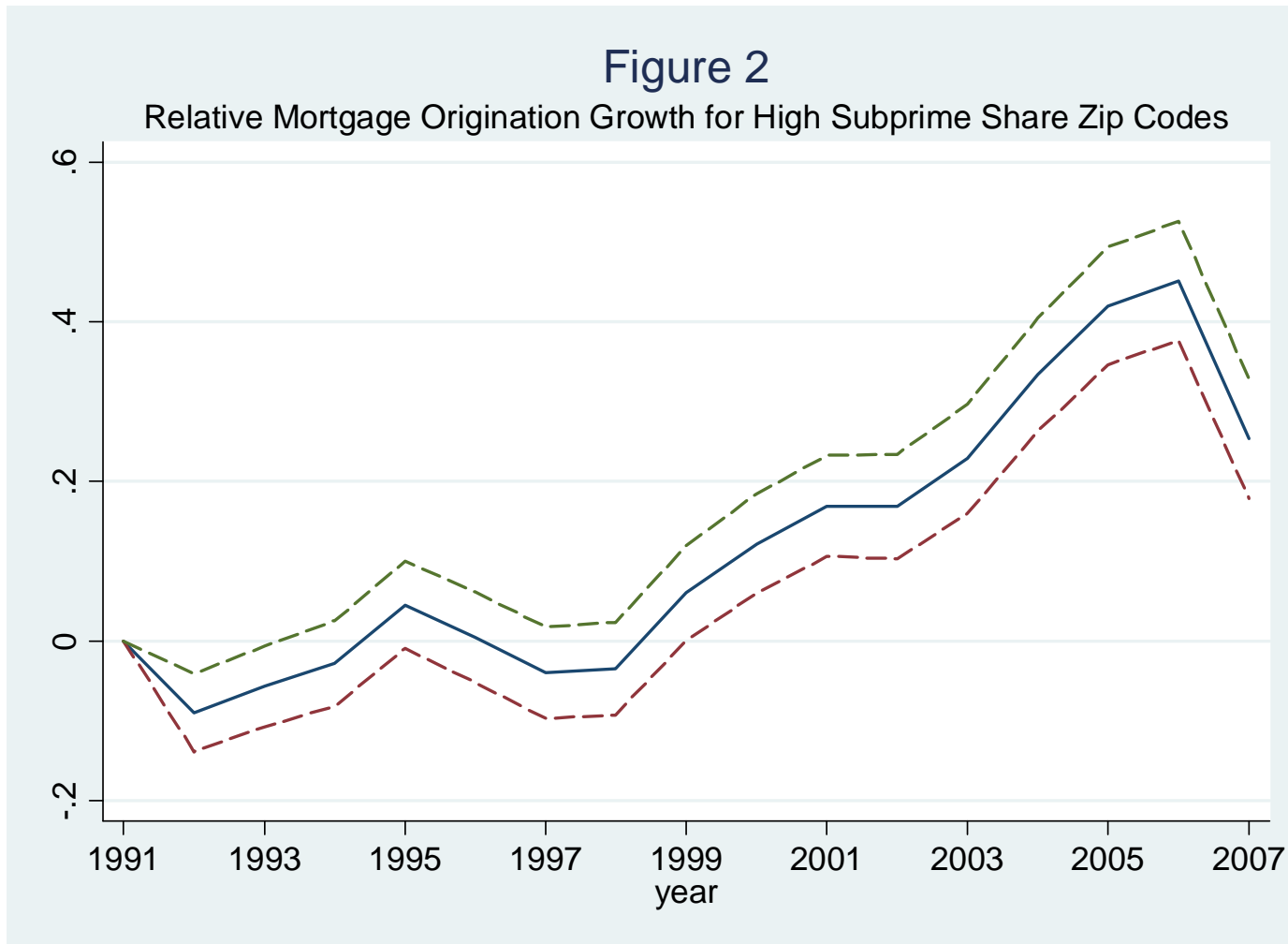
Discussion

- Strong evidence that politicians respond directly to constituent interests
 - Extremely precise in ability to target constituents
 - Disputes notion that politicians vote strictly on ideology or party
 - Suggests that if one can measure constituent interests properly, they matter
 - Drawback: only one bill (but, it is an incredibly important bill)
- An important channel is electoral competition
- Predict out of sample? Let's see voting pattern on bailout bill this week

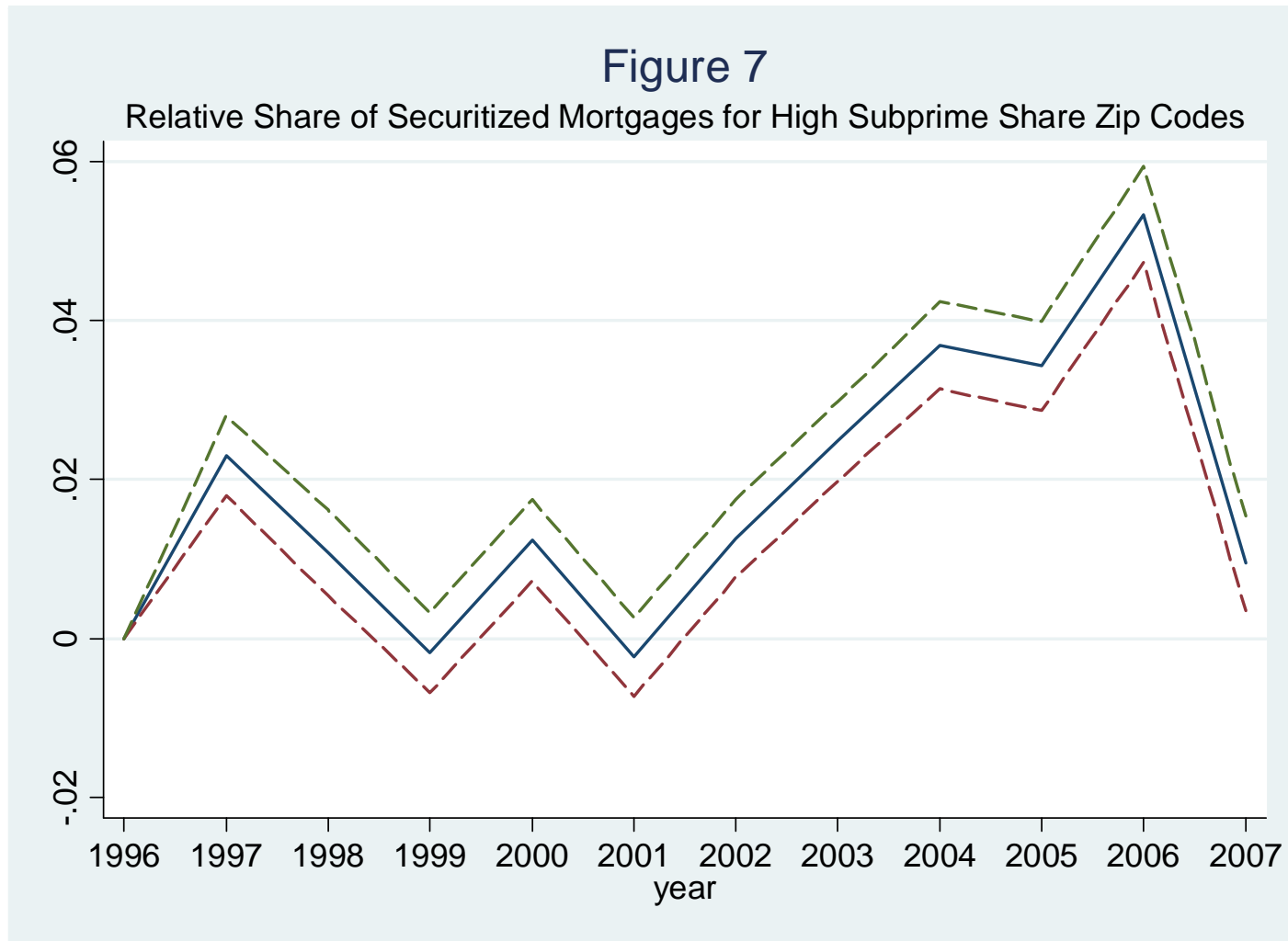
Special Interests and Subprime Expansion

- Evaluating the impact of special interest activity on policy is difficult
 - Legislation rarely falls on a “pro-industry”/ “pro-constituent” spectrum
 - Special interest activity may not target passage of legislation as much as influencing the terms of legislation
 - The goal of special interests is often the absence of legislation (i.e., regulation)
- Our goal: show that the mortgage industry may have influenced policy on subprime mortgage expansion
- Focus on representatives most impacted by subprime expansion

Expansion of Lending to Subprime Areas (Mian and Sufi (2008))



Increase in Securitization in High Subprime Areas (Mian and Sufi (2008))



Discussion

- Evidence shows that mortgage industry targeted representatives from high subprime share districts
- This is concurrent with sharp relative expansion in lending to high subprime areas
- Evidence shows that mortgage industry targets representatives where expansion of subprime mortgage lending is most relevant
- No conclusive link between policies on subprime mortgage expansion and mortgage industry activity

Conclusion

- Representatives respond to constituent interests
 - Precise in measuring constituent interests
 - Electoral competition is a likely channel
 - While it's only one bill, it suggests that one may be able to find response to constituent interests if the right data are available
- Mortgage industry paid representatives from high subprime share districts during subprime expansion
 - Suggests that special interests target “agenda setters” or politicians whose constituents are most affected by industry activity
 - Direct link to policy is weak, but suggestive
- Ongoing research: voting patterns on bailout bill