American politics

Democracy in America

Predatory lending

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ARNOLD KLING doesn't like the Consumer Financial Protection Agency, in part because he doesn't buy the argument that predatory lending played any significant role in the financial crisis.

> *What about predatory lending? As I understand it, the idea of predatory lending is to saddle the borrower with an expensive mortgage so that you can foreclose on the property and sell it at a profit. How many times did that happen? Have you read of a single instance in the past three years where the bank made a profit on a foreclosure?*

As I understand it, one of the main reasons for the housing bubble's inflation was that this model of mortgage issuance ceased to exist by the early 2000s with the advent of residential mortgage-backed securities (RMBSs). As of the early 2000s, the people who issued the mortgage no longer held on to it. They simply pocketed the closing fees and sold the mortgage to Fannie Mae, Countrywide, or another mortgage pool assembler, which bundled it together with other mortgages and sold it to a higher-level financial company, and so on. Mortgage originators, in this system, are happy to inflate the size of the mortgage they issue, because they make more money in fees that way, and the interest generated by the loan will be higher, which means it'll be more attractive as part of a security. They don't care whether the buyer will ultimately be able to pay, and they don't care how much the house is really worth, because by the time of any foreclosure, they'll be long gone. Further up the system, investors who bought the securitised mortgages believed themselves to be hedged against any risk of buyer default, either because the loans were bundled, or because they had taken out credit default swaps (CDSs) to insure themselves. Ultimately, at the top level, you had companies like AIG, who were issuing those CDSs; and their revenue model was...well, it turned out their revenue model didn't work, and the federal government had to bail them out.

In other words, predatory lending isn't about lenders trying to get their hands on people's houses anymore. It's about lenders convincing people to take out big mortgages, so they can pocket the fees, and then passing the mortgage along up the food chain, until somebody gets stuck with it. Probably you and me.

I'm not an economist or a finance expert. I don't know anything about mortgage-backed securitisation except what I've learned as part of the brouhaha surrounding the financial crisis. But I already had this background analysis of the reasons why the mortgage market went nuts over the past decade sitting in the back of my head. It's not a new analysis. I don't even know anymore where I first encountered it. Looking it up to check it out, I see that it was laid out by Adam Ashcraft and Til Schuermann of the New York Federal Reserve Bank in a March, 2008 research note, "Understanding the Securitization of Subprime Mortgage Credit". So at first I found it strange that Mr Kling didn't seem to be aware of it. But then I saw that Mr Kling must have been aware of it. He used to work for Freddie Mac, and in this post in September, he argued that we should go back to the old-fashioned mortgage system that obtained before the development of securitisation. That certainly might help prevent predatory lending in the future. But I don't think it bears on the predatory lending that's taken place over the past ten years, which is part of the logic behind the Consumer Financial Protection Agency.

(Photo credit: Bloomberg News)

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