

Credit Booms and Lending Standards: Evidence from the Subprime Mortgage Market

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Outline

- Discussion of methodology and results
- Discussion of policy implications

Lending Standards

- Authors' definition of worsening credit standards: for given observable characteristics of a borrower/MSA, a decrease in the probability of being denied a loan
- Alternative definition: for a given expected return, a higher probability of default (for a given probability of default, a lower expected return)
- What do we know about spreads in growing markets? How can we relate them to denial rates? Issue of adverse selection

Ex Ante vs. Ex Post

- Ex post, subprime lending not such a great idea
- Still, more than 80 per cent of borrowers are paying even though house prices are plummeting and the economy is weak
- Ex ante, did it make sense for banks to lend?
- Was it lending policies that “caused” the boom and bust, or did banks accommodate growing demand?

Results (1)

- Prime lending: credit boom associated with “better” loans: consistent with a shift in demand
- Subprime lending: credit boom associated with “worse” loans: consistent with a shift in supply
- We know that subprime boom fuelled by securitization (supply effect) but also probably by an increase in demand (or if not, why?)
- It would be useful to identify supply and demand effects

Results (2)

- More competition leads to better lending standards for prime lending, to worse lending standards for subprime loans
- What's so special about subprime loans? Abstracting from fraud, they're "just" riskier, more opaque than prime loans. However still possible to subject applicants to credit scoring models. Any information on their predictive power?
- Any regulation induced bias? Do subprime borrowers buy different types of homes, or in different locations, from prime borrowers?

Loan Supply

- Granting/denying a long-term loan should depend on expected values
- Are current values a good proxy/instrument for future ones? Issue of measurement error
- Problem of the sampling period: everything grows: applications, credit, house prices. Would need a full business cycle, or is cross-sectional variation enough to draw firm conclusions? What do we learn from the current bust?
- Option value of a loan: granting/denying depends also on volatility of fundamentals

From Correlation to Causation (1)

- The authors' view (implicit): during credit booms banks loosen up lending standards, at least for subprime loans
- Why? Is this compatible with profit maximization? Or is it a story of short-run profits vs. long-run franchise value? Or about empire building?
- Would need some more information on lenders

From Correlation to Causation (2)

Alternative hypothesis: omitted variables:

- The Great Moderation produces stable growth
- Financial innovation makes it easier and cheaper to lend/manage risk
- This reduces risk premia
- Asset prices are expected to keep rising
- Therefore banks lend more, more institutions want to lend to more people
- Result: (almost) simultaneously a lending boom, more competition, “worse” credit standards

From Correlation to Causation (3)

Alternative hypothesis: reverse causation:

- Banks “loosen up” lending standards (because of financial innovation, lower risk premia, etc)
- The shift in supply leads to a lending boom
- Concurrently, as innovation spreads more banks enter more markets and competition increases
- Result: (almost) simultaneously a lending boom, more competition, “worse” credit standards

Miscellanea

- Loan-to-income: not necessarily a good proxy for lending standards, since income is correlated with wealth; loan-to-value would be better
- Why not use LTI as an independent variable?
- Lagged values are not good instruments if variables are autocorrelated
- Competition: try interaction with lending booms
- Rapture Index: cute, but counter-intuitive

Policy Implications (1)

Disclaimer: the views expressed in this section are not the authors' and they derive from stretching their results.

Policy question: if we want to preserve lending standards, what actions are most appropriate given the results of the paper?

Policy Implications (2)

The credit cycle:

- If credit booms “cause” lower lending standards: counter-cyclical provisioning (only for subprimes?)
- If lower lending standards “cause” credit booms (and busts): better risk management
- If credit booms and lower lending standards are due to an omitted variable (eg expectation of stable growth): do nothing (with regulation)?

Policy Implications (3)

Asset prices:

- If house price increases “cause” lower lending standards: provisioning function of asset prices?
- If lower lending standards “cause” house price increases (and crashes): increase the cost of lending, eg increase capital charge for mortgages?
- If house price increases and lower lending standards are due to an omitted variable: do nothing?

Policy Implications (4)

Competition:

- If competition “causes” lower lending standards: regulate entry in the subprime market
- If lower lending standards “cause” more competition: improve risk management so that denials reflect fundamentals and not a cartel
- If competition and lower lending standards are due to an omitted variable: do nothing?

Policy Implications (5)

Financial innovation:

- If securitization “causes” lower lending standards: make securitization more costly?
- If lower lending standards “cause” securitization: make securitization more transparent so investors know what they are buying
- If securitization and lower lending standards are due to an omitted variable: do nothing?

Bottomline

- Great ideas, great data, lots of potential
- Can yield very interesting policy implications
- Just need to clarify some issues
- Good luck!