

# Discussion

## Credit Boom and Lending Standard: Evidence from Subprime Mortgage Lending

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# OBJECTIVES AND FINDINGS

- Consensus that the source of the current subprime mortgage crisis is increasingly lax lending standards
- Why did lending standards decline?
- Rapid expansion of credit caused lower lending standards
- Increase in the number of lenders caused lower lending standards

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# APPROACH

## Key Idea

- Use loan-level data (HMDA) for 2000 to estimate

$$D_{jk} = X_j' \beta + \epsilon_{jk}$$

- Identity of lender is proxy for prime or subprime
- Use  $\hat{\beta}$  to predict denial rate of mortgage applications in years 2001-2006 for different metropolitan areas (MSAs)
- Regress prediction error (actual - predicted) on log of the number of loan applicants in the MSA and other MSA-level controls
- Log of the number of applicants affects the prediction error negatively – more applicants there are, the less choosy lenders become

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## Contribution

- Use of data reported under the Home Mortgage Disclosure Act for assessing lending standards in local housing markets (MSAs)
- Exploit variations across local housing markets to shed light on determinants of lending standards – great idea!!

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- *Why* did the number of applicants go up so much across all MSAs?
- This question is not directly addressed in the paper because the authors focus on *differences* across MSAs
- But thinking about why the number of applicants went up suggests that the authors are ignoring causal influences running the other way – from lower denial rates to more applicants

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## An Alternative Story

- The key event was the arrival of a cost-effective business model for making higher-risk mortgages: “originate and distribute”
- This meant lower denial rates on higher-risk loans – so there were more buyers chasing homes
- The resulting increase in house prices induced people to upgrade or switch from renting to owning, which generated more applications for mortgages
- This story explains how decline in denial rates could lead to an increase in applications and house prices
- However, it is possible that the influx of these new applicants may have led to further decline in lending standards through channels suggested by the authors



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## Endogeneity and the IV Regression

- Is the number of applicants for prime mortgages a good instrument for the number of applicants for subprime mortgages?
- With decline in the subprime denial rate, homes would sell at a faster rate and if some fraction of departing owners apply for *prime* mortgages then applications for prime mortgages will go up as well
- So, in theory, there *could* be a causal link from subprime denial rates to the number of prime mortgage applications
- Suggestion: How about using number of prime mortgage applications in “far away” MSAs as the instrument?

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- All else remaining the same, lower denial rates mean more originations per lender
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- So, again, in theory there could be a link between a drop in denial rates and entry of new lenders

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