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July 1, 2013

Misrepresentation, or a Failure in Due Diligence? Another Argument

In the last post we wrote together, we discussed a paper on the role of misrepresentation in mortgage securitization by Tomasz Piskorski, Amit Seru, and James Witkin (2013, henceforth PSW).¹ That paper argues that the people who created mortgage-backed securities (MBS) during the housing boom did not always tell the truth about the mortgages backing these bonds. Today, we discuss a second paper on misrepresentation, this one by John M. Griffin and Gonzalo Maturama (2013, henceforth GM).² The two papers have a similar research approach, and the two sets of authors interpret their results in the same way—namely, in support of the hypothesis that misrepresentation was an important cause of the mortgage crisis. We offer an alternative interpretation.

We believe that the evidence shows that investors were *not* fooled and that deception had little or no effect on investor forecasts of defaults. Consequently, deception played little or no role in causing the crisis (see the [post on PSW](#) for details). We do think, however, that some results in the GM paper have significant implications for our understanding of the crisis, although GM does not focus on these particular results.

We argue that one can interpret their evidence on misreporting as a measure of due diligence on the part of lenders. Many—including most notably the New York Attorney General's office in [a lawsuit against JP Morgan](#)—allege that the dismal performance of securitized mortgages made after 2005 relative to those made before 2005 reflects a precipitous drop in due diligence among lenders starting in that year. But GM's paper implies that there was no such decline. In fact, for most measures of due diligence, there is almost no time series variation over the housing cycle at all.

Before we discuss the paper's implications for underwriting standards, it is important to outline GM's basic research approach with regards to misrepresentation. As with PSW, GM's fundamental idea is to compare two sets of loan-level mortgage records to see if the people marketing MBS misrepresented what they were selling. Specifically, GM compare information about mortgages supplied by MBS trustees with public records data from deed registries, as well as data on estimated house prices from an automated valuation model (AVM). PSW, by contrast, compare MBS trustees' data with information from a credit bureau. In general, GM's choice to use public records data as the comparison data set is probably more functional.

While PSW refer to their credit bureau data as "actual" data, it is well known that credit bureau data also contain errors, a fact that complicates any study of misrepresentation. For example, PSW often find that the credit bureau reports a second lien for a particular mortgage borrower while the MBS trustees report no such lien. The implication in such instances is that the MBS trustees misrepresented the loan. But PSW must also acknowledge that the reverse discrepancy turns out to be equally likely. Just as often, second liens appear in MBS data and not in the supposedly pristine data from the credit bureau. No data set is perfect, but GM's public records data is no doubt much cleaner than the credit bureau data. For a purchase mortgage, the records filed at a deed registry are not only important legal documents, they are also recorded on or very close to the day that the mortgage is originated. As a result, the public records data come closer to being "actual" data than data from a credit bureau.

GM measure four types of "misreporting" with their data: 1) unreported second liens; 2) investors incorrectly reported as owner-occupants; 3) unreported "flipping," in which the collateral had been sold previously; and 4) overvaluation of the property, which is defined to occur when the AVM reports a valuation that is more than 10 percent below the appraised house value appearing on the loan application. To us, neither 3 nor 4 seem like reasonable definitions of misreporting. For point 3, issuers never reported anything about whether the house was flipped. This issue turns to be a moot point, however, as Figure 1 from GM (reproduced below) shows that flipping almost never occurred. Regarding point 4, it's not surprising that AVMs often report substantially different

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numbers than flesh-and-blood appraisers do, for the same reason that two people guessing the number of jelly beans in a jar are likely to disagree. Estimating the right value exactly is not easy, even for people (and automated computer models) with the best of intentions.

More consequential are GM's findings relating to misrepresentations of the types identified in points 1 and 2. Here, GM's findings are essentially the same as PSW's, though GM report much higher rates of misrepresentation than do PSW. However, GM acknowledges that the difference stems almost entirely from their decision to ignore refinance loans. According to Table IA.VIII in GM's appendix, refinances have dramatically lower misrepresentation rates. But just as the central findings of GM are similar to those in PSW, so is our critique. The historical evidence indicates that investors were properly skeptical of the data provided by MBS issuers. Moreover, deception did not prevent investors from making accurate forecasts about default rates among securitized loans. We direct the reader to our post on PSW for more details.

Though we do not believe that GM can persuasively link misrepresentation of MBS data to massive investor losses, an alternative interpretation of their data has the potential to shed light on the mortgage crisis. One way to interpret the level of misreporting—in particular, for occupancy—is as a measure of due diligence on the part of lenders. Neither PSW nor GM suggest that for any particular loan, the MBS issuer knew that the borrower was an investor and did not plan to occupy the property. Instead, these authors claim that someone along the securitization chain failed to do the necessary due diligence to determine if the borrowers who claimed to be owner-occupiers were in fact investors. This due diligence was certainly possible. A sufficiently motivated loan officer could have done exactly what GM did: match loan files with public records to figure out that a potential borrower did not intend to live in the house he was buying.³ As a result, we would expect that when due diligence goes down, occupancy misreporting would go up.

Obtaining a proxy measure of due diligence is useful, because many commentators have argued that the poor performance of subprime loans made after 2005 as compared to loans made before 2005 (see Figure 3 from [Foote, Gerardi, and Willen, 2012](#)) resulted from a precipitous drop in due diligence. For example, in the recent complaint against JP Morgan, the New York Attorney General's office writes that:

[Subprime lenders], as early as February 2005, began to *reduce* the amount of due diligence conducted "in order to make us more competitive on bids with larger sub-prime sellers."

So what does GM's proxy measure of due diligence show? With respect to occupancy, there is little or no change in the incidence of occupancy misreporting in 2005. Indeed, looking across the entire sample, we see that occupancy misreporting rose smoothly from about 11 percent in 2002 to a peak of about 13 percent in 2006. In other words, at the peak of the boom, the incidence of sloppy underwriting was almost the same as it was four years earlier. In fact, all four series reported by GM show the same pattern or lack thereof. With the exception of the first quarter of 2006, second-lien misreporting was uniformly lower during what commentator Yves Smith refers to as the "toxic phase of subprime" lending than it was in 2004 and 2003 when loans performed dramatically better.

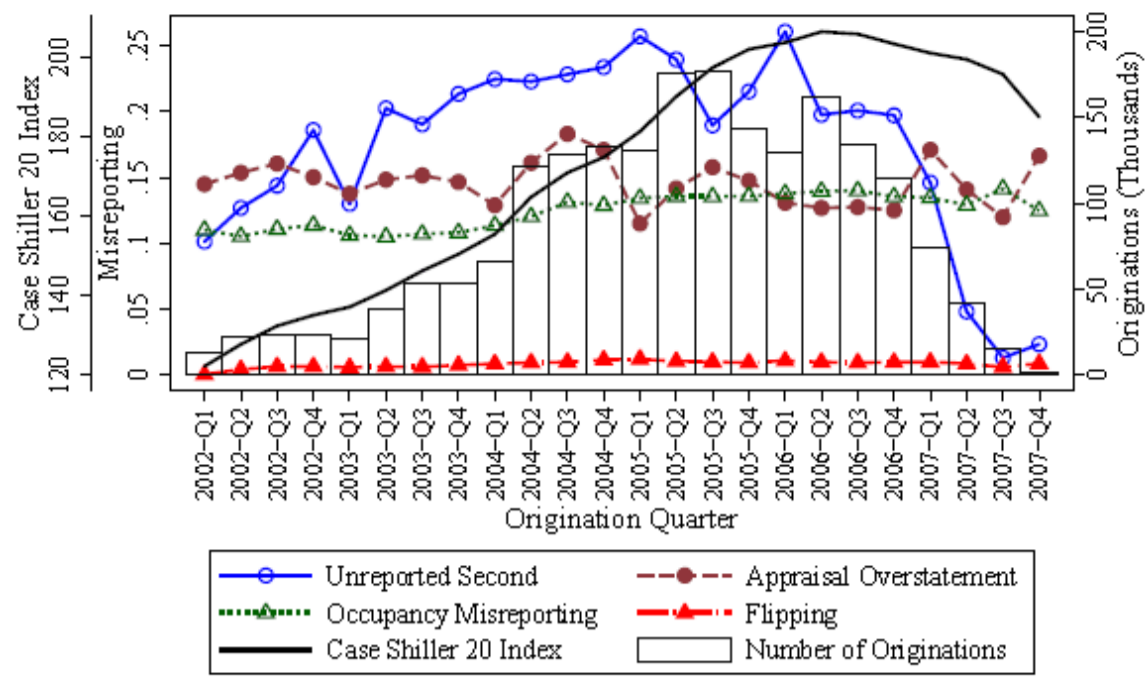


Figure 1: Misreporting Indicators By Quarter. This figure shows the evolution of the different potential misreporting indicators by quarter. Loans that exhibit an Unreported Second are first-lien loans in ABSNet associated to a transaction that does not disclose the existence of the second lien (i.e., LTV=combined LTV), but both a first and second lien is recorded in county-level recording records as captured in Data Quick. Loans that exhibit an Appraisal Overstatement are those in which the appraised value recorded before origination exceeded the ABSNet's AVM value by more than 20%. Loans that exhibit Occupancy Misreporting are those in which the self-reported occupancy status associated to the loan in ABSNet Loan (using data from MBS prospectus documents) says "owner occupied" but we estimate otherwise from DataQuick's county-level data. Loans subject to Flipping are those matched to a property that has been previously sold more than three times in the last six months (including the current transaction). The bars represent the number of first-lien loan originations in each quarter and the continuous black line shows the evolution of house prices (as captured by the Case Shiller 20 Index). The sample consists of ABSNet-DataQuick matched securitized first-lien loans that were used for the purchase of a home with an initial loan amount over \$50k and a loan-to-value ratio (LTV) lower or equal than 103%. We drop loans associated to the largest 1% of the transactions in each state, loans that are reported as being for homes of more than one unit, and loans that belong to MBS deals in which all mortgages are recorded to have an LTV equal to their combined LTV.

[\(enlarge\)](#)

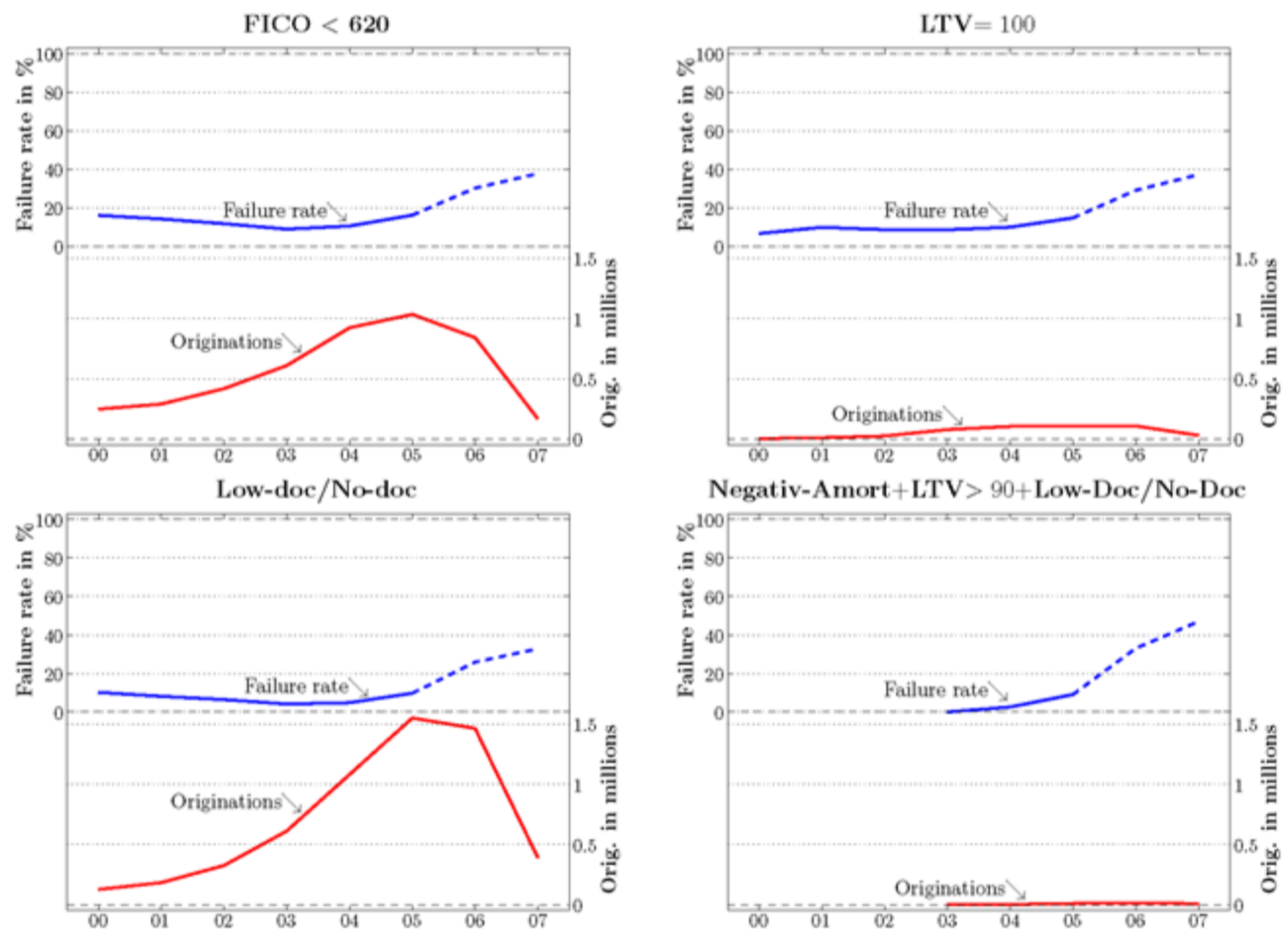


Figure 3: Failure rates and Originations for Selected Nonprime Mortgages. Failure rates are graphed by year of origination, and correspond to the fraction of mortgages that are at least 60-days delinquent two years after origination. The dashed line denotes years after 2005. Source: authors' calculations using data from CoreLogic, Inc. (originally LoanPerformance). The sample includes all subprime and Alt-A loans in the CoreLogic database.

[\(enlarge\)](#)

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