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Wall Street and the Housing Bubble

The conventional wisdom on the 2008 financial crisis is that finance industry insiders on Wall Street deceived naïve, uninformed mortgage borrowers into taking out unaffordable mortgages and mortgage-backed security (MBS) investors into purchasing securities backed by bad loans—mortgages and securities that had not been properly vetted and that would eventually default. This theory is on display front and center in the Academy Award-winning documentary *Inside Job*, and it has motivated new regulations aimed at realigning incentives among Wall Street insiders and their customers. (One such rule is the risk retention requirement in the Dodd-Frank Act, which we will discuss in some detail in a future post.)

We've written in support of an alternative hypothesis for the financial crisis—specifically, that overly optimistic views about house prices, not poorly designed incentives on Wall Street, are the better explanation for the crisis (for an example, see this 2012 paper). This alternative theory holds that investors lost money not because they were deceived by financial market insiders, but because they were instead misled by their own belief that housing-related investments could not lose money because house prices were sure to keep rising.

A new paper makes an important empirical contribution to this debate by inferring the beliefs of Wall Street insiders during the height of the bubble. The paper, titled "Wall Street and the Housing Bubble," performs a clever analysis of personal housing-related transactions (like home purchases) made by individuals who worked in the mortgage securitization business during the peak of the housing boom. The behavior of these mortgage insiders is compared with that of a control group of people who worked for similar institutions in the finance industry but did not have any obvious connection to the mortgage market. What the analysis finds should be an eye-opener for believers in the inside-job explanation of the crisis. There is no evidence that mortgage insiders believed there was a housing bubble in the 2004–06 period. In fact, mortgage insiders were actually more aggressive in increasing their personal exposure to housing at the peak of the boom. The increase in insider exposure contradicts the claim that insiders sold securities backed by loans that they knew would eventually go bad when the housing bubble burst.

The authors construct a random sample from the list of attendees of the 2006 American Securitization Forum, which is a large industry conference featuring employees of most of the major U.S. investment and commercial banks (as well as hedge funds and other boutique firms). The sample is mainly comprised of vice presidents, managing directors, and other nonexecutives in mid-managerial positions whose jobs focused on the structuring and trading of MBS. The authors refer to this group as "securitization agents." As a comparison group, they use a random sample of Wall Street equity analysts who covered firms that were in the S&P 500 in 2006 but did not have a strong connection to the housing market (in other words, the sample includes no homebuilders). These equity analysts worked for similar financial institutions, had similar skill sets, and likely experienced similar income shocks (in the form of bonuses during the boom) but did not have any experience in the securitization business and thus did not have access to any insider information. (As a second control group, the authors use a random sample of lawyers who did not specialize in real estate law.) The names of the securitization agents and the equity analysts are then matched to a database of publicly available information on property transactions. The final data set contains information on the number of housing transactions, the sale price of each transaction, some mortgage characteristics, and income at the time of origination for each individual in the sample spanning the period 2000–10.

Armed with this unique data set, the authors then implement a number of empirical tests to determine whether the securitization agents' beliefs about the likelihood of a housing crash differed from the beliefs of the control groups. The first test considers whether the securitization agents timed the housing market cycle better than the comparison groups by reducing their exposure to the market at the peak of the bubble (2004–06) by either selling their homes outright or downsizing. The second test is slightly weaker in that it simply tests whether the securitization agents were more cautious in their housing transactions by avoiding home purchases at the peak of the bubble to a greater extent than the control groups. The third test looks at whether the average return on housing transactions during the entire sample period was higher for the securitization agents. The final test considers a prediction of the permanent income hypothesis: if securitization agents were armed with superior knowledge of the impending collapse of the housing bubble, then through reductions in their expectations of permanent income, they should have decreased the size of their housing purchases relative to their current incomes by a greater amount than the comparison groups.

The results of these empirical tests show very little evidence to support the inside-job theory of the financial crisis. The authors conclude that there is "little systematic evidence that the average securitization exhibited awareness through their home transactions of problems in overall house markets and anticipated a broad-based crash earlier than others." If anything, the authors are being a little timid in their interpretation as the empirical results clearly show that securitization agents were significantly more aggressive in their housing transactions during the bubble period, which suggests that they held even more optimistic expectations of housing prices dynamics than did the control groups.

This is an important paper because it sheds light on one of the most striking aspects of the financial crisis, which the inside-job theory is unable to reconcile: the financial institutions involved in the creation of the subprime MBS and collateralized debt obligations (CDO)—the true "insiders," if you will—lost enormous amounts of money on those securities. The table clearly supports this observation. The firms that lost the most money from mortgage-related credit losses were the same investment and commercial banks that are being accused of profiting off of naïve investors by selling securities comprised of loans that they knew would eventually go bad. The table shows that these firms lost enormous sums of money, and the paper provides a simple answer to explain why: like the rest of the market, agents working at those firms believed that housing prices would continue to rise so that even the riskiest mortgages would continue to perform well.

Mortgage-Related Losses to Financial Institutions from the Subprime Crisis, as of June 18, 2008

	Institution	Loss ($ billions)		Institution	Loss ($ billions)
1.	Citigroup	42.9	11.	Washington Mutual	9.1
2.	UBS	38.2	12.	Credit Agricole	8.3
3.	Merrill Lynch	37.1	13.	Lehman Brothers	8.2
4.	HSBC	19.5	14.	Deutsche Bank	7.6
5.	IKB Deutsche	15.9	15.	Wachovia	7.0
6.	Royal Bank of Scotland	15.2	16.	HBOS	7.0
7.	Bank of America	15.1	17.	Bayerische Landesbank	6.7
8.	Morgan Stanley	14.1	18.	Fortis	6.6
9.	JPMorgan Chase	9.8	19.	Canadian Imperial (CIBC)	6.5
10.	Credit Suisse	9.6	20.	Barclays	6.3

Source: Bloomberg News, June 18, 2008
(www.bloomberg.com/apps/news?pid=newsarchive&sid=a5GaivCMZu_M)

Kris Gerardi, financial economist and associate policy adviser at the Federal Reserve Bank of Atlanta, with

Chris Foote, senior economist and policy adviser at the Federal Reserve Bank of Boston.

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