Introduction to the Special Issue on Housing Finance

The years leading up to the Great Recession were characterized by an incredible increase in consumer spending coupled with dramatic increases in housing values: between 2002 and 2007, the total outstanding debt for U.S. households doubled, and housing values – as measured by the Federal Housing Finance Agency’s nationwide price index – grew by 44% (Mian and Sufi, 2011). In light of this growth in the value of homes, it is unsurprising that much of the pre-recession surge in borrowing was tied directly to the housing market through expanding balances on first lien mortgages, closed-end home equity loans, and home equity lines of credit. As we now know, this extreme leveraging would have catastrophic consequences for the U.S. economy.

When housing prices began to fall, mortgage delinquency and foreclosure rates skyrocketed to historical levels and economic activity contracted sharply. Researchers and policymakers were suddenly faced with important questions about consumer financial literacy, mortgage underwriting, development financing, and the manner in which consumers and lenders respond to extreme duress. In April of 2014 a group of researchers from across academia and government convened to discuss these issues at Florida State University’s annual Critical Issues in Real Estate Symposium that was co-hosted by the DeVoe L. Moore Center at Florida State University and the Office of the Comptroller of the Currency. This special issue of the Journal of Housing Economics is the culmination of this symposium.

Consumer Credit Literacy and Use

Several recent studies have found that consumers oftentimes make suboptimal financial decisions, such as utilizing high-cost debt instruments when lower cost credit is available and failing to refinance mortgages when doing so would generate significant savings. This evidence of seemingly irrational decision making has led researchers to systematically assess the financial literacy of consumers throughout the world. Agarwal et al. (2015) contribute to this literature by using the framework of Lusardi and Mitchell (2006) to study financial literacy and the financial planning behavior of a group of consumers in India that participated in an online investment service. The authors find that the participants in the service are generally financially literate and that financial literacy is correlated with a number of socioeconomic variables. Specifically, the probability of answering the literacy questionnaire correctly is positively associated with education level, males are found to invest more aggressively, and higher levels of financial literacy are associated with better financial planning.

Andersson and Mayock (2015) study consumer credit utilization during a boom-bust housing cycle. The primary contribution of this paper is the manner in which credit use is quantified. Specifically, whereas much of the existing literature has focused on net changes in household indebtedness, this paper provides the first evidence on the nature of gross debt flows across consumers. Utilizing the methodology pioneered by Davis and Haltiwanger (1992) to study labor market dynamics, the authors find a significant amount of consumer-level heterogeneity that is evidenced by large amounts of simultaneous debt creation and destruction throughout the economic cycle. These aggregate credit dynamics are driven primarily by the behavior of consumers with mortgage debt. The importance of mortgage holders creates critical asymmetries
in the debt adjustment process: whereas consumers can take on a large amount of mortgage debt quickly, short of defaulting, such debt is discharged very slowly. The geographic concentration of consumers that borrowed heavily before the recession paired with this asymmetric debt adjustment process has resulted in a very slow discharge of debt in markets that were characterized by high degrees of price volatility during the recent boom-bust cycle.

**Loan Default**

Local municipalities have traditionally financed capital improvements associated with new development using property tax revenues. The passage of Proposition 13, which dramatically reduced property tax revenues, forced municipalities in California to pursue alternative revenue sources for capital projects; one such alternative is the issuance “Mello-Roos” bonds, debt instruments which are issued by special districts and funded through a special assessment on real estate within the district. These bonds have played a prominent role in funding development in California, with roughly $2.2 billion in issuance in 2006 alone. The importance of these bonds notwithstanding, the risk profile of Mello-Roos debt is not well understood.

Racheva-Sarabian et al. (2015) provide the first comprehensive study of the credit risk of special district financing municipal bonds using a unique data set on California Mello-Roos issuance and performance. Contrary to the general belief that such bonds are very risky, the authors find that their lifetime performance is at least as good as that of Standard and Poor’s B to BBB rated municipal bonds. The authors also provide evidence that the state of the local economy and the construction industry are strong predictors of Mello-Roos default.

Seiler (2015) also studies loan delinquency but in a much different context: strategic default on residential mortgages. Using data collected through a Human Intelligence Task on MTurk, he finds that homeowners significantly overestimate the probability that a financial institution will pursue a deficiency judgment against a borrower that chooses to strategically default. Additionally, homeowners are found to generally view strategic default as immoral. These two findings imply that borrowers would strategically default on mortgages more frequently if they were better informed about the probability of lender recourse and morality played no role in the default decision calculus. With these two results in hand, Seiler uses the theory of informational uncertainty to argue that deliberately opaque mortgage contracts can serve to stem the tide of foreclosures.

**Mortgage Underwriting and Servicing**

When borrowers become delinquent on their mortgages, the servicers of loans are faced with a host of options regarding how to resolve the default. Much has been written about the sharp increase in foreclosures during the recent housing downturn. A phenomenon that has received much less attention in the literature is the dramatic post-boom increase in the use of short sales – a process in which borrowers sell the collateral for less than the value of the loan and lenders forgive at least some of the remaining debt – to resolve bad mortgage loans. There is reason to believe that in many cases, short sales are superior to foreclosures for borrowers, lenders, and society at large. From a borrower’s perspective, short sales are attractive because deficiencies can be avoided and short sales may have a less severe impact on credit scores. For lenders, short
sales may generate higher recovery rates than foreclosures because short sales allow servicers to avoid many of the legal costs and carrying costs associated with repossessing properties. Because borrowers remain in their homes throughout the short sale process, it is believed that short sales are less likely to produce negative spillovers due to vacancy and deferred maintenance.

In spite of the potentially important consequences of lenders’ default resolution strategies, little is known about what factors drive the workout path of delinquent mortgages. Zhu and Pace (2015) use a rich database of privately securitized mortgages to fill this gap in the literature. The authors’ empirical models suggest that higher quality borrowers, such as those with higher credit scores, are more likely to pursue and subsequently receive lender approval for short sales. In contrast, the presence of second liens, mortgage insurance, and laws that lengthen the foreclosure process are found to reduce the likelihood that a loan is resolved through short sale.

The final paper in this volume addresses the important issue of appraisal inflation. One of the most important variables in the underwriting process is the loan-to-value (LTV) ratio. Borrowers with lower LTVs are widely regarded as being less likely to default; higher levels of equity reduce the incentive to strategically default and enable borrowers to better weather ability-to-pay shocks. Consequently, LTV plays a critical role in loan pricing and the loan approval decision. Because appraisals are used to construct LTV, the investors that ultimately bear a loan’s credit risk have strong incentives to ensure that the appraisal used to underwrite that loan is accurate. The incentives of other parties involved in loan origination, however, are not always similarly aligned. Appraisers receive their business from loan officers and brokers, who in turn are compensated based on loan volume. As loans with lower LTVs are more likely to be approved, actors that stand to benefit from the loan’s origination but bear none of the loan’s credit risk—such as realtors, mortgage brokers, and loan officers—have an incentive to pressure appraisers to inflate values.

In response to widespread appraisal inflation that occurred during the housing boom, in 2009 the government sponsored enterprises (GSEs) Fannie Mae and Freddie Mac established the 2009 Home Valuation Code of Conduct (HVCC), which aimed to prohibit lenders from influencing appraisers. Shi and Zhang (2015) assess the effectiveness of the HVCC using a large sample of GSE refinance loans. Consistent with the goals of the program, the authors find that GSE refinance loans originated after the implementation of the HVCC performed better than similar non-GSE loans that were not subject to the HVCC requirements; the authors provide evidence that this improved loan performance can be tied directly to lower appraisal bias.

References


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