Recent financial crisis rooted in politics of creditworthiness, new study contends

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A common reading of the recent subprime mortgage crisis pins the blame on bankers and loan brokers who extended mortgages to those who could not afford them, thereby inflating a housing bubble that was destined to burst.

While technically correct, that reading ignores the "politics of creditworthiness" that undergirded the rise of subprime mortgages, as explained in a new article in the June issue of the American Sociological Review by Simone Polillo, an assistant professor of sociology in the University of Virginia's College of Arts & Sciences.

Defining creditworthiness criteria is an exercise of moral authority, Polillo argues, and political contesting of those criteria is a fundamental aspect of financial innovation. The innovation of subprime mortgages was made possible only after accepted "sound banking" criteria of creditworthiness had come to exclude a growing portion of Americans, Polillo writes in his article, "Money, Moral Authority, and the Politics of Creditworthiness."

After World War II, one typically qualified for a home loan with a substantial down payment and a record of employment and the prospect of future stable employment. By the late 1970s, it was clear that such criteria, in practice, often excluded or marginalized racial minorities, people from poor neighborhoods, individuals with poor credit histories and a growing portion of Americans affected by the breakdown of manufacturing and ever-withering employment benefits and stability.

"Wildcat" financial innovators stepped into this opening with new, looser credit criteria, based not on employment, but solely on the collateral value of the real estate to be purchased. "Wildcat" is Polillo's term for those who disobey "sound banking traditions" and thus create more inclusive, but more unstable credit systems.

Outflanked by these new offerings, more conservative local banks, to varying degrees, gradually followed the wildcats' lead, bolstered by claims from financial elites that the risks of such loans were parceled out by strategically bundling them into mortgage-backed securities.

As was learned in the financial crisis of 2007-08, the whole enterprise was founded on a flawed assumption, based on historical trends, that home prices would continue to rise steadily for the foreseeable future, Polillo said.

This was the latest example, among several in American history, of wildcat financial innovators spotting an underserved credit market, offering new financial products and creditworthiness standards to serve the underserved, and parlaying the innovations to financial elites and a wider market, he said.

A similar process played out when Michael Milken led the junk bond revolution of the 1980s. Junk bonds provided credit to companies that, Milken thought, had been systematically undervalued by rating agencies. Milken was particularly interested in bonds that, from a position of high credit rating, had fallen to "below investment grade," bonds he called "fallen angels."

"The fact that Milken became an emblem of reckless risk-taking and corruption," Polillo said, "should not distract us from the process that made his success possible: the recasting of previously excluded actors as worthy of credit (fallen angels) and the creation of new products to serve them."

Milken's case illustrates two pressures on prudent bankers who draw the line that establishes creditworthiness, Polillo said. First, those who are excluded may challenge how creditworthiness is defined and assessed. Second, new ideas may emerge within the banking system itself about how credit should be allocated.

Creditworthiness criteria are constantly being contested by bankers, financial innovators, the state and local communities, Polillo argues. Significant disagreement between those groups about the boundaries of creditworthiness can destabilize the financial system, as happened in Milken's junk bond revolution; in the subprime mortgage crisis; and in the post-Civil War clashes between "Greenbackers" and those who favored a gold standard.

In such clashes, both sides often lay claim to "laws" of the market, but the issue really boils down to ideas about how we decide where to draw boundaries between outsiders and insiders, Polillo said.

In the wake of such disruptions, the public grows skeptical of the competency of traditional monetary authorities like the Treasury, the Federal Reserve and Congress, and even banking elites, opening the door to debates on the proper role of the government and banks in the financial system, Polillo said.

Such concerns underlie our current debates on the national budget deficit, the debt ceiling and government bailouts, he said. As these debates play out observers should be mindful of how the politics of creditworthiness are being contested once again.

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