One 'villain' of the housing crisis played only a small role

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One of the major factors blamed for the subprime mortgage crisis may have actually played only a minor role in the housing meltdown, new research reveals.

Some people claim that high mortgage default rates which helped crash the economy in 2008 were the fault of predatory lenders who approved risky housing loans to unqualified buyers.

But a study of an anti-predatory lending program in Chicago found that the program brought down default rates only modestly, while causing major disruptions in the market.

"Our results suggest that even without any predatory lending during the housing boom period, we still would have had a subprime crisis," said Itzhak Ben-David, co-author of the study and associate professor of finance at Ohio State University's Fisher College of Business.

"Predatory lending was responsible for only about a quarter of the default rate, suggesting it wasn't the most important driver of the subprime crisis."

The study will appear in the *Journal of Financial Economics*.

Ben-David and his colleagues analyzed the effects of a pilot anti-predatory lending program, passed by the Illinois legislature, which was implemented in Chicago in 2006, near the peak of the housing boom.

Under the program, certain mortgage applicants with low credit scores, as well as those who applied for risky loans, were required to submit their loan offers for review by financial counselors. The counselors identified loans that had above-market interest rates, loans that appeared to be unaffordable based on the borrowers' financial situations and loans that had indications of fraud.

The belief was that these counselors could steer applicants away from unsuitable loans, although applicants did not have to follow the advice they received.

The program was implemented in 10 zip codes in the Chicago area. The researchers compared loan applications in those areas to those that originated in 10 zip codes which had similar demographic characteristics, but where the program was not in effect.

The program had a huge impact on mortgage loans in the affected areas, Ben-David said.

The number of mortgage loans that originated in the program area dropped by nearly half, mainly because lenders specializing in risky loans left the area.

"Many lenders decided they just didn't want to deal with the new regulations and exited the market," Ben-David said. "Many of these lenders had some characteristics that could be tied to predatory lending."

The loans that were issued in the program area were less likely to feature "risky" characteristics, as defined by the legislation, and tended to go to borrowers with higher credit ratings.

But the key finding of the study was that default rates declined only modestly as a result of this program. The default rate in the communities served by the new program fell from 27 percent to about 20 to 21 percent.

"A default rate of 20 percent is still quite high. Our findings suggest that predatory lending was responsible for only about a quarter of mortgage defaults in the targeted area," Ben-David said.

The problem, Ben-David said, was that the program helped drive out bad lenders, but not bad loans.

"They eliminated predatory loans, but not reckless loans," he said. "People still bought homes that they couldn't afford and lenders were still willing to approve their mortgages."

The pilot program was supposed to last four years, but was ended after just four months because of strong opposition, not only from people in the real estate industry, but also from local residents and community leaders who were supposed to be helped from the law.

Many people saw the law as infringing on their right to pursue the American dream of homeownership, Ben-David said.

"In the end, the program had good intentions but came at a very high cost for the limited benefits it provided," Ben-David said.

Provided by The Ohio State University

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