Mortgage crisis: Blame the bank?

August 27 2008

(PhysOrg.com) -- Banks have played a big role in the mortgage crisis, not only because they issued loans to suspect borrowers, but because many originated and sold bad loans to other lenders, says a University of Michigan business professor.

"The model of lending in which the originator of a loan sells it to various third parties, known as the originate-to-distribute model, became a popular vehicle for credit and liquidity risk-management in recent years," said Purnanandam, assistant professor of finance at U-M's Ross School of Business. "However, banks with aggressive involvement in this market had incentives to issue inferior-quality mortgages. This allowed them to benefit from the origination fees without bearing the credit-risk of the borrowers.

"As long as the secondary market for mortgages was functioning normally, they were able to easily offload these loans to third parties. When the secondary mortgage market came under pressure in mid-2007, banks with lots of poor loans were stuck with them."

In a new study of FDIC-insured commercial banks from the third quarter 2006 to the first quarter 2008, Purnanandam found that banks with more originate-to-distribute (OTD) loans sold to third parties—as opposed to those originated and held by the originating banks—had significantly higher mortgage charge offs (loans not expected to be repaid and written off as bad debt).

So why did banks engage in such risky behavior? According to the study,

banks predominantly originated poor quality OTD loans if they were poorly capitalized.

"Poorly capitalized banks have higher risk-seeking incentives due to the call option feature of equity enjoyed by shareholders of highly levered firms," Purnanandam said. "The presence of subsidized deposit insurance can further exacerbate this effect. Thus, OTD loans issued by such banks can be potentially very risky."

In addition, banks that relied less on demand deposits (such as savings and checking accounts where depositors can withdraw their money at any time) and more on term deposits as sources of debt capital tended to have higher mortgage charge offs.

"This fragility of a bank's capital structure might act as a disciplining device by committing the banker to avoid risky behavior," Purnanandam says.

Purnanandam also examined the extent of foreclosures on mortgages granted by banks with high OTD loans. He found that banks with large amounts of third-party loans had a much higher fraction of mortgages under foreclosure a year later.

"The evidence confirms the popular belief that the lack of screening incentives created by separating the originator of a loan from the ultimate bearer of the default risk—coupled with risk-taking behavior—significantly contributed to the current subprime mortgage crisis," he says. "From the market's perspective, the probability of default on a mortgage loan partly depends on the originator of the loan itself. From the regulator's perspective, the bank's liability structure has a predictable effect on loan decisions."

Provided by University of Michigan