Dissertation Title: Three Essays on US Household Debt and the Sources of Financial Fragility

In these three essays, I pursue the following research topics: 1) Estimation of the effects of mortgage fraud on losses to foreclosure, 2) Examination of household deleveraging through default, and 3) Studying the historical evolution of instability in the post-World War II housing finance system as a means of informing contemporary financial regulation debates.

The first essay (my job market paper) estimates the effects of mortgage fraud in no/low documentation “Liar’s Loans” on losses to foreclosure in the market for private label residential mortgage backed securities (RMBS) from 2007-2012. I address this question by 1) Accounting for total losses to foreclosure due to “Liar’s Loans”, and 2) Estimating what portion of these losses can be considered excess from the perspective of the investor. Losses are considered “excess” if they are greater than what would have occurred if the loan quality information disclosed to investors had been accurate instead of fraudulent. Projected to the level of the entire market, the findings imply that roughly $345 billion of the $500 billion in losses to foreclosure are due to “Liar’s Loans,” $100 billion of which are excess.

The second essay presents an historical accounting of household deleveraging through default in private label RMBS during the Great Recession by 1) Accounting for what portion of household deleveraging occurred through default, and 2) Estimating whether debtor protections caused default to occur through creditor-friendly mechanisms such as foreclosure, or, alternatively, debtor-friendly mechanisms such as debt forgiveness. I find that far more defaults resulted in foreclosure. Modifications also tended to increase debt, rather than reduce it. Borrower protections such as judicial review of foreclosure were insufficient to induce larger amounts of debt forgiveness. Instead, loan modifications in judicial states passed on the additional costs of protection, increasing debt burdens even more than modifications in non-judicial states.

The third paper examines the historical evolution of instability in the post-World War II housing finance system. New Deal reforms created a housing finance system that would remain private, but have public responsibilities and protection. In exchange for providing credit for mortgages and maintaining the payments system, the banks’ main source of short-term funding was stabilized through deposit insurance and Federal Reserve lender of last resort protection. However, evolutionary forces consistently worked to undermine this social contract. Competition between intermediaries spurred the evolution of new risky sources of short-term funding. Such high risk activities in turn produced instability thus the need for government bail outs. Moreover, federal protection combined with deregulation created perverse incentives where profits were privatized but losses were socialized. This paper concludes by re-examining New Deal era proposals for a public option, where the federal government would directly provide mortgages to home buyers, which would be more efficient than providing subsidies to private institutions. A properly structured public option for housing finance would eliminate perverse incentives due to moral hazard. Also, providing a low-cost alternative in the mortgage finance market would incentivize private institutions to engage in a competitive “race to the top.”