

# Would more disclosure of loan terms have helped?

Paul Willen

Federal Reserve Bank of Boston

FTC Mortgage Conference, Washington DC, May 29, 2008

# Disclaimer

- The views expressed today are mine.
- The do not necessarily reflect the views of
  - The Boston Fed
  - or the Federal Reserve System



- When I say “we”, I mean members of the research department.

# Caveat

- Everything I'm about to say could be wrong:

# Overview

- Devil's Advocate, a little.
- Make the argument
  - Complex “alternative” mortgages played only a supporting role in the current crisis.
  - Even the role of ARMs is overrated – Resets are a small part of the problem
  - House prices.
- Policy conclusions
  - More or better disclosure about the mortgage would not have helped much.
  - Broader understanding the risks of home-ownership (including house prices) might have helped.
  - Comprehensive measure
  - Maybe we need a heavier hand: suitability.

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## Past Due Rates (or how we got it wrong)

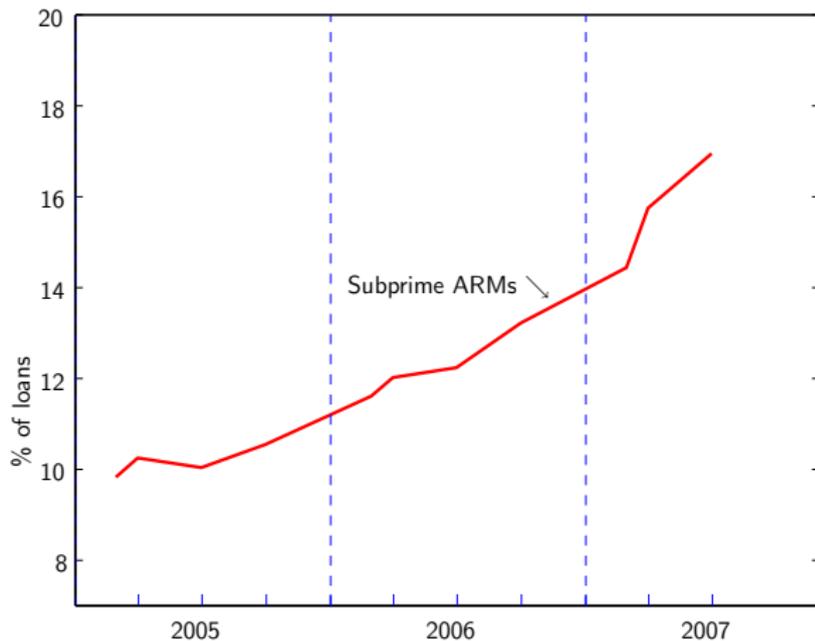
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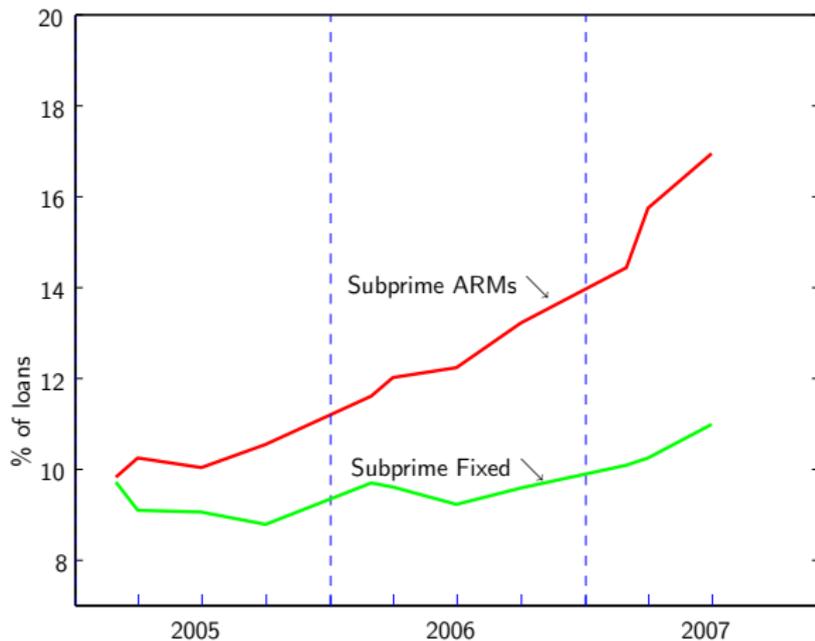
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# What is this number?

- “Percentage of Loans Past Due”

$$= \frac{\text{Loans Past Due} \leftarrow}{\text{Total Loans} \leftarrow}$$

- What could make this number go up?
  - Higher delinquencies
  - Lower number of loans
- Problem here
  - Suppose a current borrower with a subprime ARM
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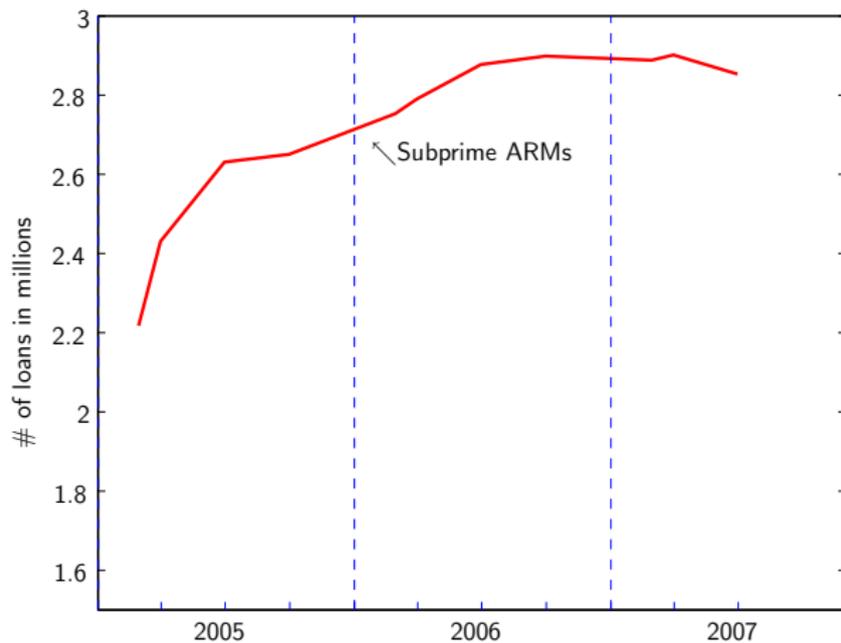
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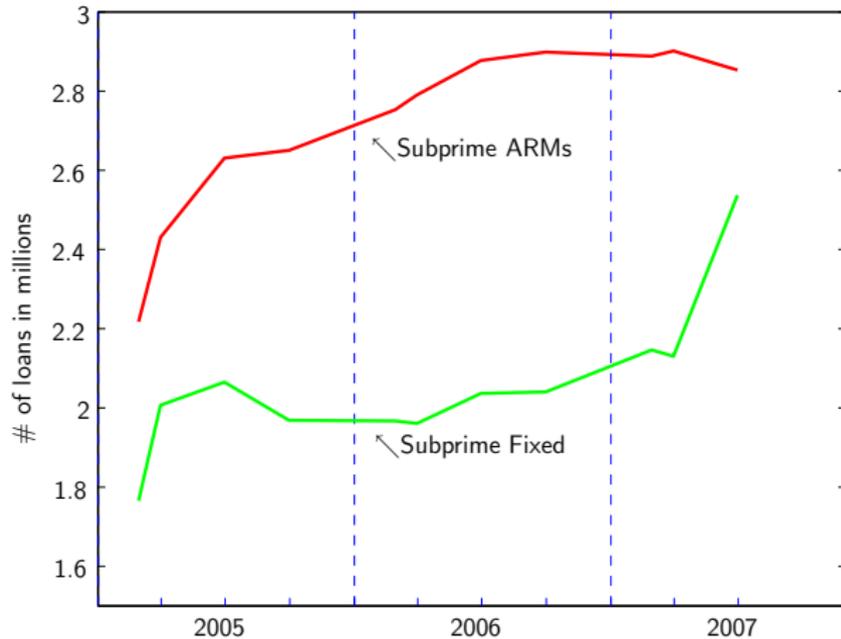
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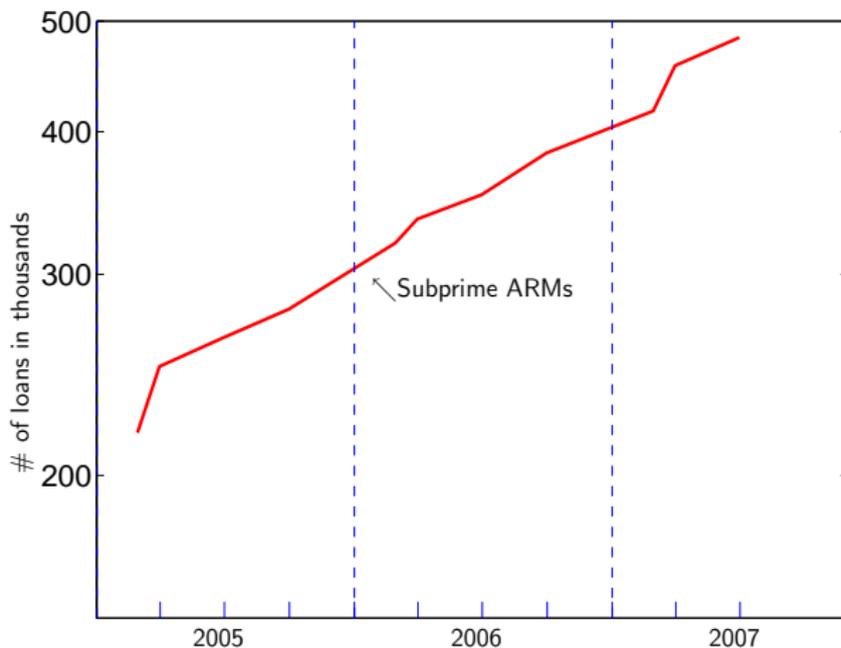
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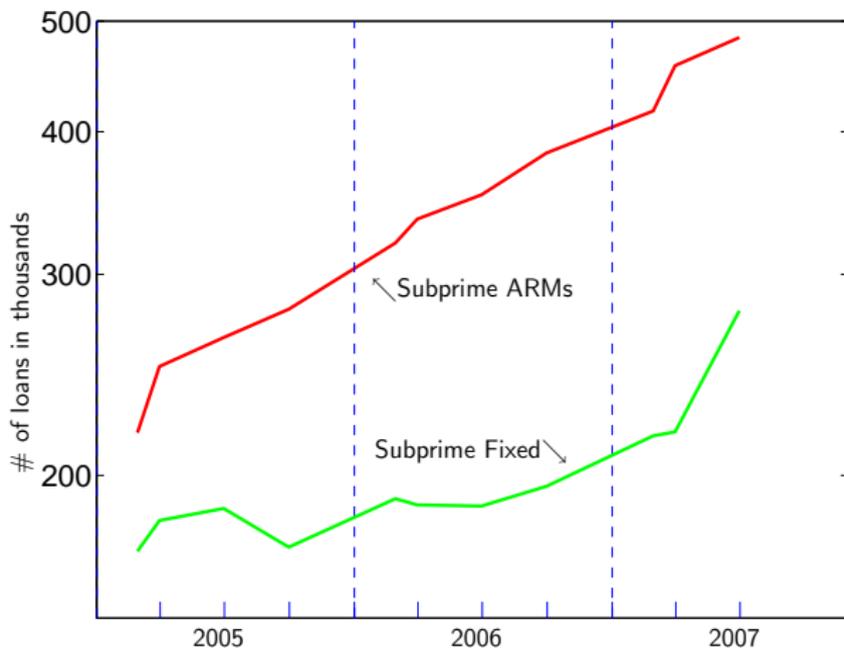
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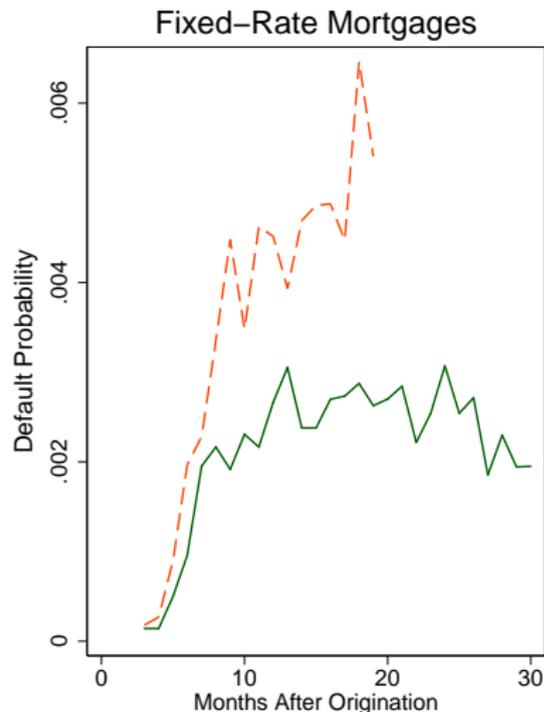
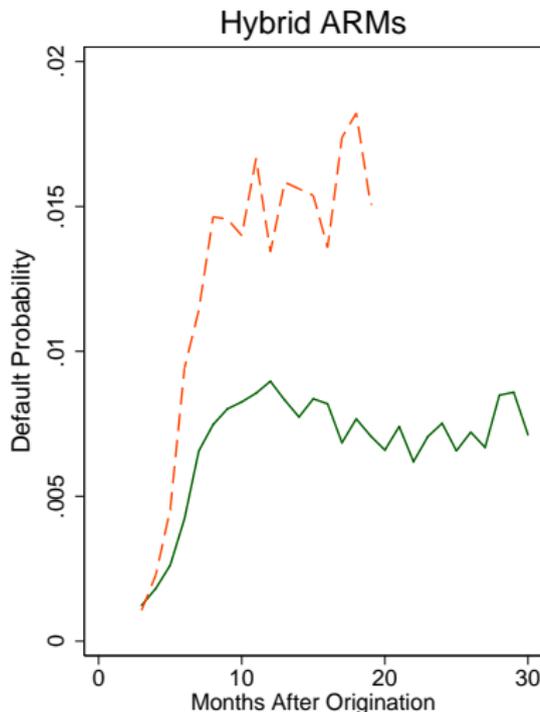
# Simple Adjustment: Total number of past due loans



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# The right way



## Other evidence

- Low teaser rate is a myth. Teasers on subprime ARMs were quite high
- No relationship in loan-level data between delinquency and rate resets
- “Most complex” mortgages were sold to most sophisticated borrowers
- Average FICO by loan type in McDash data
  - IO-ARM: 726
  - Option ARM: 707
  - 2/28 (a fully amortizing mortgage): 624
- Payment shocks for typical subprime ARM borrower in 2007 was about 15 percent.

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Figure: Foreclosures and house prices in Mass., 1989-present. Source: Boston Fed and The Warren Group.

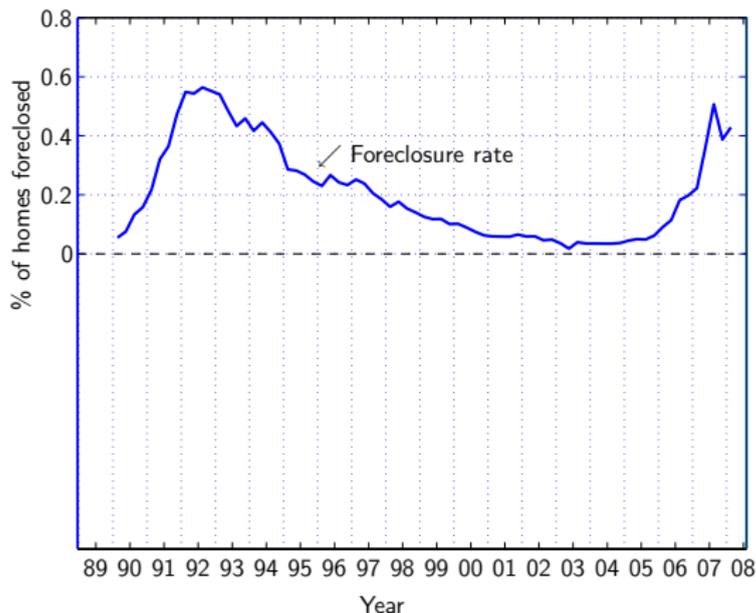
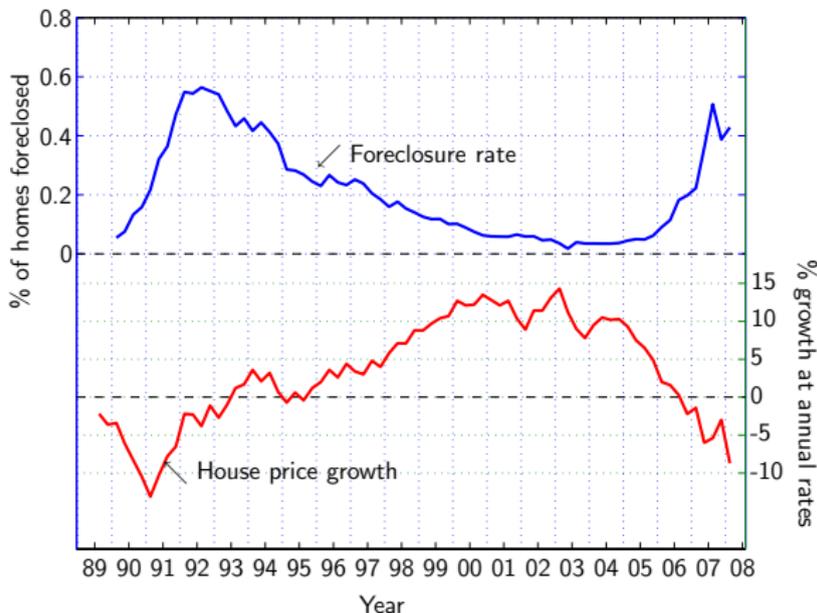
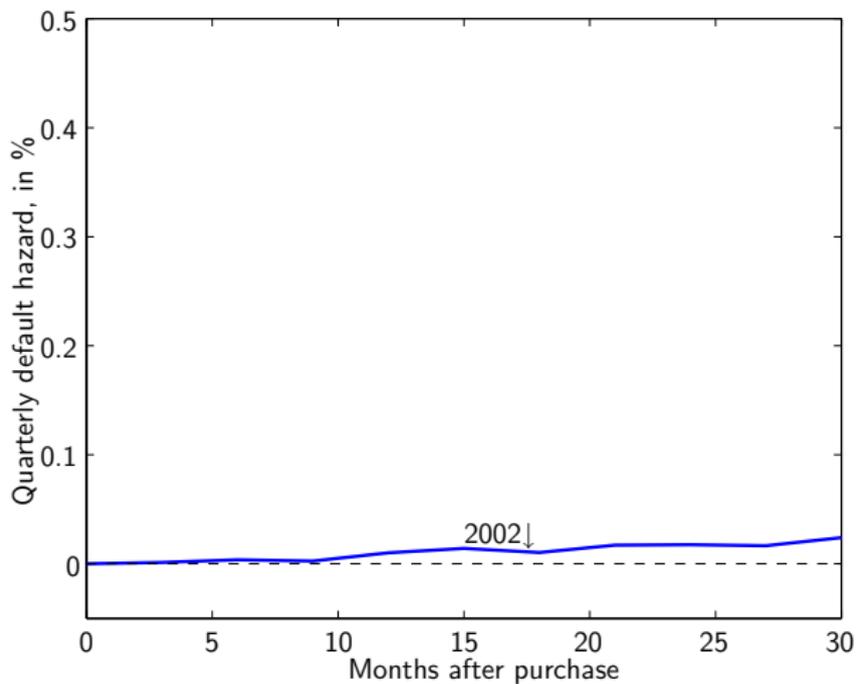


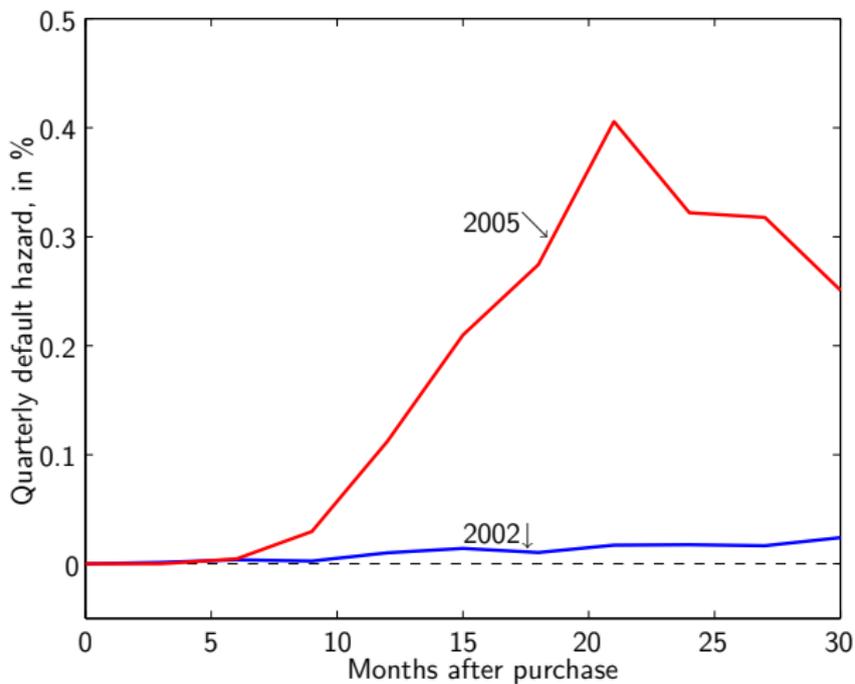
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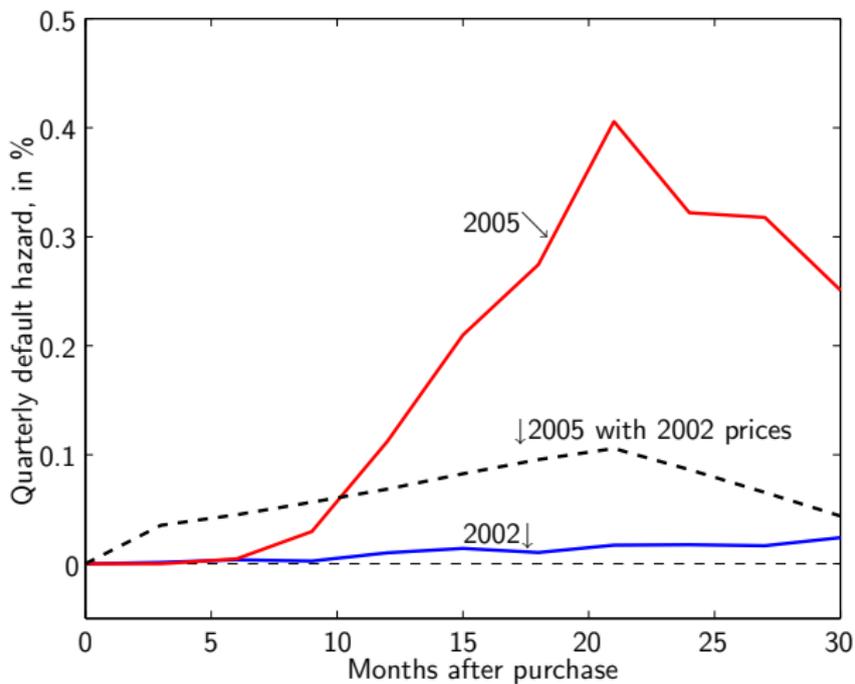
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# Policy Solutions

- Prevent unstable homeownerships
- Comprehensive measure of riskiness of homeownership
- Long-run likelihood of foreclosure
  - on this or any subsequent mortgage on this house
- Take a buyer:
  - LTV
  - DTI
  - FICO
  - Subprime borrower?
- Will this be a stable homeownership?

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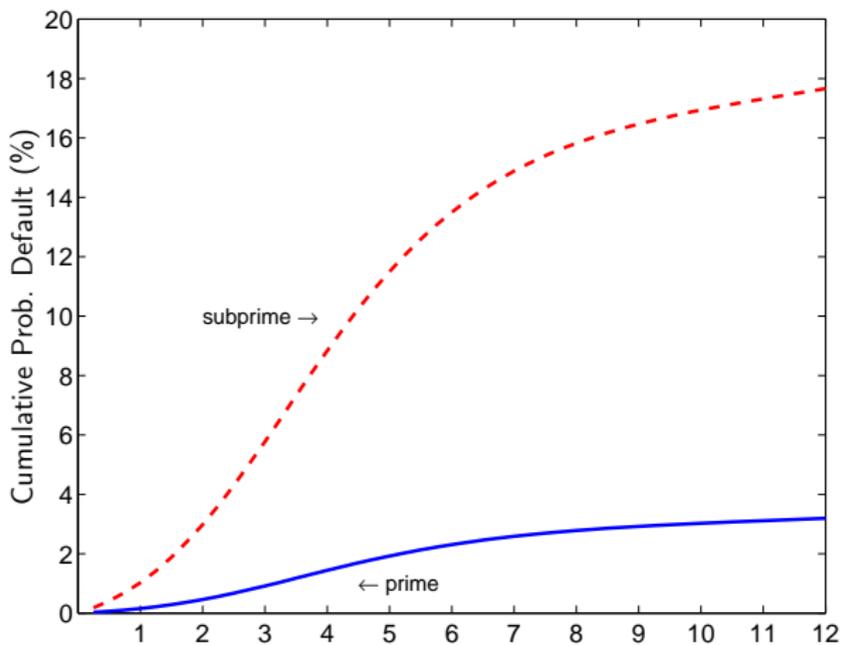
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# The probability of default



# A heavy hand?

- Disclosure?
  - You have a 1 in 5 chance of losing your home!
- Heavy Hand
  - You cannot get this loan

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