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Congressional influence as a determinant of subprime lending

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ABSTRACT

We apply unique loan level data from New Century Financial Corporation, a major subprime lender, to explore whether attributes and committee assignments of Congressional Representatives were associated with access to and pricing of subprime mortgage credit. Research findings indicate enhanced credit access at discounted prices among borrowers represented by Congressional leaders and by members of the House Financial Services Committee. Black borrowers in districts represented by Congressional leaders also were more likely to obtain subprime mortgage credit. We do not find evidence of adverse performance differentials among the politically directed loans. Our results conform to those of Agarwal et al. (2014) in documenting preferential treatment of constituents in congressional districts represented by members of the House Financial Services Committee. Research findings provide new insights into the political geography of the subprime crisis and suggest gains to trade between subprime lenders and targeted Congressional Representatives in the extension and pricing of subprime mortgage credit.

1. Introduction

Emblematic to the 2000s global financial crisis was the pervasive failure of subprime mortgages. Those loans provided substantially eased credit qualification and homeownership opportunity to low credit-quality borrowers. By 2008, in the wake of downward spiral in house prices, a full 45 percent of subprime borrowers were underwater. Two years later, a similar share of outstanding subprime mortgages were in default.

Even prior to the deterioration in subprime loan performance, lenders appeared to understand the importance of political support for this controversial loan product. To that end, as documented by Mian et al. (2010), lenders became politically sophisticated in making campaign contributions to elected Representatives in the years leading up to the late-2000s crisis. Another strategy for engendering political support was for lenders to offer more credit and at better terms to borrowers in Districts represented by targeted Congressional Representatives. Improved credit opportunity could serve to raise homeownership attainment, which was viewed as an important bi-partisan goal of federal housing policy and a metric of District economic well-being. To the extent that interests aligned, District-level direction and pricing of mortgage credit could serve the political economic interests of both the lender and the elected official.

This study uses the universe of sub-prime home loans issued by a major subprime lender to explore the role of Congressional political influence on access to and pricing of subprime mortgage credit. By merging several data sets, we seek to implement the following thought experiment. Consider two observationally identical borrowers who live in the same local labor market at the same point in time.

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Assume that the two borrowers live in comparable residential communities in different Congressional districts. If a borrower's Congressional Representative is liberal, of long-standing tenure, a member of the House Finance Committee, or a leader of the House of Representatives, do these Congressional attributes influence the probability that the institution makes a loan to that borrower? Further, are these same attributes associated with higher or lower borrower loan amounts or loan pricing?

The loan level data in our study come from the servicing database of the now defunct New Century Financial Corporation (New Century). Per convention in the literature, we control for borrower, loan, and locational attributes that influence the allocation and risk-based pricing of mortgage credit (see Deng and Gabriel (2006)). Upon controlling for those attributes as well as state/year/month fixed effects, our goal is to assess how attributes of the local Congressional Representative influenced access to and pricing of subprime mortgage credit. The "politics" hypothesis posits that these Congressional Representative attributes mattered because New Century had specific political goals in mind and used implicit subsidies to achieve those objectives.

The eased qualification requirements associated with subprime lending also may have been important to Representatives seeking to promote federal lending goals associated with minority homeownership. Indeed, as a longstanding matter evidenced in numerous studies (see, for example, Gabriel and Rosenthal (2005, 2013)), racial minorities have been largely underrepresented in homeownership attainment. During the years leading up to and including the boom, substantial policy effort was directed at narrowing homeownership racial gaps.[1] Prominent among those efforts were ambitious quantitative goals for financial institution loan origination among minority and other households as embodied in the Community Reinvestment Act (CRA). Accordingly, we test for whether minority borrowers received differential treatment by New Century. In particular, we test whether minority borrowers had a greater probability of receiving subprime loans as a function of their Congressional Representative's attributes. Also, conditional on receipt of a subprime loan, we test whether minority borrowers received more favorable loan terms (as evidenced in loan size or loan pricing) as a function of their Representative's attributes.

Assessment of New Century Financial Corporation loan level data from 2003 to 2006 reveals a political geography of subprime lending. Results highlight differential treatment of borrowers represented by Congressional leaders and by Members serving on the powerful House Financial Services Committee. New Century offered lower mortgage interest rates and larger loan amounts, all else equal, to households residing in districts represented by Congressional leaders and by members of the House Financial Services Committee. Black borrowers also were more likely to receive loans in districts represented by Congressional leadership. In support of those findings, placebo tests also show that borrowers residing in districts represented by subsequent Congressional leaders (113th Congress) did not receive more favorable loan terms. We do not find evidence of adverse performance differentials among the politically subsidized and directed loans.

This paper contributes to the growing literature investigating the interactions between private industry and the U.S. Congress. Mian et al, (2010) document the voting patterns of Representatives on key pieces of banking legislation in the wake of the 2008 crisis.[2] Their findings indicate that Representatives from areas where there was more subprime lending activity were more likely to vote for bailouts. Agarwal et al. (2014) show that lenders were less likely to start foreclosure proceedings against delinquent borrowers who lived in congressional districts where the representative served on the House's Financial Services Committee. Our findings conform to those of Agarwal et al. (2014) in documenting New Century's preferential treatment of constituents in congressional districts represented by members of the House Financial Services Committee. On average, this group received lower interest rate loans for larger amounts. This finding is especially strong for black borrowers.

The plan of the paper is as follows. The following section describes the data and sample. Section 3 discusses econometric strategy and results of analysis of the New Century microloan files, including assessment of mortgage origination and pricing. Section 4 provides concluding remarks.

2. Data and sample

Loan level information was obtained from the servicing database of New Century Financial Corporation. New Century was founded in 1995 as a REIT that originated mortgage loans in the U.S. through its operating subsidiaries, New Century Mortgage Corporation and Home 123 Corporation. As of January 1, 2007, New Century was the second largest subprime mortgage lender in the U.S., with 7200 full-time employees and a market capitalization of $1.75 billion. Based on 2006 HMDA data, New Century issued 11.6% of all subprime mortgages and 1.9% of all mortgages.

[1] Both Presidents Clinton and G. W. Bush sought to address racial and ethnic gaps in homeownership. In a statement dated June 18, 2002, President Bush noted that "The goal is that everyone who wants to own a home has a shot at doing so. The problem is we have what we call a homeownership gap in America. Three-quarters of Anglos own their home, and yet less than 50 percent of blacks and Hispanics own homes. That problem signals that something may be wrong in the land of plenty. And we need to do something about it." See White House News Release from that date.

[2] Other recent papers further corroborate the importance of political contributions in eliciting Congressional support. Ansolabehere et al. (2003) argue that political contributions appear to yield a very high return, raising the question of why industry does not increase its contributions to the Congress. Bombardini and Trebbi (2011) document the role of the electoral strength of an interest group in support of a Representative's re-election campaign. Kroszner and Stratmann (2005) study repeat contributions of PACs to Representatives and document strategic interactions whereby Representatives build a reputation for taking certain positions that help industry and are rewarded by special interests. Bronars and Lott (1997) and Stratmann (2002) provide evidence that changes in campaign contributions are correlated with changes in roll call voting by members of Congress. In earlier work, Stratmann (1992) presents evidence documenting how farming PAC contributions are targeted to specific Representatives depending on their constituents' attributes.