Compensation and Incentives in the Mortgage Business

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How did the current global financial crisis come to pass? It began with a series of innovations in the mortgage business that lead to a fast-paced specialization. Unfortunately, however, each specialized party to the mortgage had fee-based compensation that motivated a large volume of transactions with little or no concern about the performance of the mortgages. Reform should focus on the compensation structure in the mortgage business and on accountability standards similar to those imposed on stockbrokers.

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INNOVATION IN MORTGAGES

During the past two decades, three innovations have had widespread effects upon the mechanics of making, pricing, and marketing residential mortgages. First, the advent of securitization in the early 1980s and its rapid diffusion during the decade opened a vast new market for investment in mortgages. Mortgages could be bundled into groups and sold as a single security. More importantly, any bundle of mortgages could be sliced into parts, identified by their place in line, in the event that the underlying mortgage contracts were terminated by prepayment or default. Mortgages in the *A* slice would be the first to be eliminated by terminations, then those in the *B* slice, and so forth. The A slices were thus riskier, because the prepayments accompanying a decline in interest rates would return cash to the investors which would then yield lower returns. But, of course, the A slices were cheaper.

These innovations permitted investors throughout the world to invest easily in U.S. mortgages, and they permitted investors with different risk preferences to invest in different slices out of mortgage pools. Besides making markets more perfect—by satisfying better the preferences of investors—these innovations greatly increased liquidity in the mortgage market, providing strong incentives for lenders to originate residential mortgages. There was a ready world-wide market.

Second, the adoption of behavioral models of mortgage-holder behavior provided better information to mortgage originators about the profitability of lending to individuals with differing incomes, wealth, and credit histories. It was important to establish the behavioral

differences between middle-income homeowners considering the prepayment and default decisions and the behavior of MBAs considering the exercise of identical put and call options. These models, often combining behavioral economics, sophisticated statistical methods, and Wall Street "rocket science," helped to expand the mortgage market further and led to a variety of alternative mortgage investments. Mortgage applicants could be evaluated by the quality of their credit histories and the specific collateral that they offered, rather than by arbitrary rules of thumb inherited by bankers from the 1950s.

Third, the inexorable pace of technology greatly streamlined the mortgage cycle, from the origination of the mortgage through the marketing of the mortgage-backed securities derived from them. Laptop computers, automated underwriting software programs to evaluate borrowers, sales data on neighboring properties to evaluate collateral—all supported a division of functions, as different agents specialized in parts of the mortgage chain. The quaint memory of Jimmy Stewart's "Wonderful Life" was erased by the efficiency of Adam Smith's pin factory, as different firms specialized in mortgage origination, mortgage lending, securitization, and marketing.

BAD COMPENSATION STRUCTURES

The incentive structure that arose for firms in this specialized industry set the stage for the collapse. The incomes and fees generated are all transactions-based, that is, payments are made at the time the transaction is recorded. The originator of the loan, typically a mortgage broker, is paid at the time the contract is signed. Brokerage fees have varied between 0.5 and 3.0 percent. The mortgage lender earns a fee, between 0.5 and 2.5 percent, upon sale of the mortgage. The bond issuer is paid a fee, typically between 0.2 and 1.5 percent, when the bond is issued. On top of this, the rating agency is paid its fee *by the bond issuer* at the time the security is issued. All these fees are earned and paid in full within six to eight months after the mortgage contract is signed by the borrower.

Thus, no party to the mortgage transaction has any economic stake in the performance of the underlying loan. In fact the mortgage broker is paid a larger percentage, termed a "yield spread premium," if he convinces his clients to accept a higher and more default-prone interest rate. With this structure of incentives, it is not hard to understand why many risky loans were originated, financed, sold, and securitized, especially during the period of rapidly rising house prices from 1999 through 2006. With expectations of rising house prices, it is also not hard to understand why pools of these loans received the *imprimatur* of a credit rating agency when offered for sale.

One does not need to invoke the menace of unscrupulous and imprudent lenders or of equally predatory borrowers to explain the rapid collapse of the mortgage market as house price increases slowed in 2006, before ultimately declining. There were certainly enough unscrupulous lenders and predatory borrowers in the market, but the incentives faced by decent people—mortgagors and mortgagees—made their behavior much less sensitive to the underlying risks. The only actor with a stake in the ultimate performance of the loan was the mortgagee. Everyone else had been paid in full—way before the homeowner had made more than a couple of payments on the loan.

How, you may wonder, could contracts with such poor incentives have evolved? To some extent, that remains a mystery. But to a large

extent, the system worked just fine, as long as property values were rising and interest rates falling—so that bad loans made at teaser rates could be refinanced after a couple of years at even lower rates. (But still, you'd think or you'd hope that market participants would have done better and not acted as if they expected such conditions to continue indefinitely.)

REFORM

What's to be done? In most cases it would be a simple matter to align the economic incentives better in this industry. Originators could be paid fees over the course of a two-year period trailing the transaction. The compensation of other actors could similarly be structured so that a significant part of their fees were payable after the performance of the loan was observed. And a claw back provision for fees advanced on non-performing loans could be mandated. Finally, part of the fee to the rating agency could, analogously, be paid in shares of the bond being issued—with a prohibition against sale for a reasonable period of time.

A more direct way to align the financial incentives in the industry would be to hold originators and lenders to a "suitability standard." This would require these counterparts to take into account borrowers' ability to repay the loan as a part of the loan-approval process.

The long experience with a suitability standard imposed upon stock brokers is instructive. Ever since 1938, the National Association of Securities Dealers (NASD) has required that brokerage firms be held responsible for recommending investments that are financially suitable to the economic circumstances of their customers (Rule 2310). NASD arbitration panels routinely adjudicate claims of "unsuitability," awarding damages to customers and imposing sanctions upon firms which have sold securities unsuitable to their clients. An active plaintiff bar has arisen to police overly aggressive brokers. The result has been a functional system, and there is no reason why a comparable system cannot be devised for mortgage lenders. This would require mortgage brokers to be bonded in order to do business with lenders. But lenders would also have clear interests in verifying a bonding requirement.

Of course, there are many underlying causes of the current mess in U.S. mortgage markets, and there are many lessons to be drawn. But it appears that straightforward changes to the financial incentives of actors in the industry would go a long way towards improving the efficiency in the market for mortgages and mortgage-backed securities.

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