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.

**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 home- 
owners 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 statisti- 
cal 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 his-
tories and the specific collateral that they 
offered, rather than by arbitrary rules of thumb 
inhaled 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, au-
tomated underwriting software programs to 
evaluate borrowers, sales data on neighbor-
ing properties to evaluate collateral—all sup- 
ported 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, typi-
cally between 0.2 and 1.5 percent, when the 
bond is issued. On top of this, the rating agency 
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 bro-
er 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, espe-
cially during the period of rapidly rising house 
prices from 1999 through 2006. With expecta-
tions 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 ultimate-
ly declining. There were certainly enough un-
scrupulous 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 under-
lying risks. The only actor with a stake in the 
ultimate performance of the loan was the mort-
gagee. 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.)

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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