

The Political Economy of the U.S. Mortgage Default Crisis

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“Indeed, an enduring lesson of financial
crises is how political constraints interfere
with economically efficient solutions.”

- *The Economist*, April 18th 2009.

Background

- What determines how a politician responds to the financial crisis?
 - We examine the ideological, constituent interest, and special interest determinants of politician voting behavior
- In response to the financial crisis, U.S. has enacted two of the most significant pieces of financial legislation in history
 - American Housing Rescue and Foreclosure Prevention Act - AHRFPA (July 2008)
 - Emergency Economic Stabilization Act – EESA (October 2008)
- “Winners” and “Losers” are well-specified in the two bills:
 - Both against the conservative ideology (ID) of no bailouts.
 - Cost is borne uniformly by tax payers, but benefits are concentrated.
 - Foreclosure assistance disproportionately aligned with constituent interests (CI) of defaulting voters.
 - TARP disproportionately aligned with the special interests (SI) of financial industry.

Why should we care?

- Answer long-standing questions in Political Economy:
 - That politicians should respond to their constituents seems “obvious”. Yet very difficult to separate from ideology/type. Moreover ...
 - How “precise” are representatives in targeting their constituents?
 - Does electoral competition further promote constituent interest?
 - Which constituent matters?
 - How important is special interest in these tradeoffs?
 - Is there a higher “price” for ideology?
- Understand political moral hazard under systemic shocks:
 - Under-pricing of systemic risk in equilibrium due to political constraints?
 - Ideology as commitment (e.g. U.S. versus Europe)?

What we find

- Constituent interests, as proxied by mortgage default rates, strongly influence politician voting patterns on AHRFPA
 - Not driven by ideology, “type”, or other economic/political variables.
 - Politicians remarkably precise in targeting bill-specific default rate.
 - Politicians a lot more responsive to their own-party constituent defaults.
 - Politicians more responsive to constituents under greater competition.
- Special interests, (campaign contributions by the financial industry), strongly correlated with voting patterns on EESA
 - Result cannot be explained by a battery of covariates.
- Ideology as commitment:
 “Price” of vote – both in terms of constituent and special interest – is higher for more conservative representatives.

The AHRFPA of 2008

- Main components
 - \$300B in FHA backed insurance for delinquent mortgages where lenders agree to write down principal and waive delinquency fees
 - Renegotiation of mortgages is voluntary, but implicit pressure from Barney Frank on banks to write down principal
 - Unlimited line of credit to Freddie and Fannie (didn't help)
 - Two votes (May 8th, 2008 and July 26th, 2008)
- Ideology, constituent interests, and special interests
 - Ideology (DW-Nominate Score (Poole and Rosenthal)): massive government intervention in market viewed negatively by conservatives
 - Constituent interests: Unambiguously good for households in/near mortgage default
 - Special interests: “Probably” positive for financial services industry

The EESA of 2008

- Main components
 - \$700B in purchases of distressed assets/equity from financial firms at prices far above current market prices
 - Increase FDIC deposit insurance limit to \$250,000
 - \$150B of miscellaneous tax subsidies
 - Two votes (September 29th, 2008 and October 3rd, 2008)
- Ideology, constituent interests, and special interests
 - Ideology (DW-Nominate Score (Poole and Rosenthal)): massive government intervention in market viewed negatively by conservatives
 - Constituent interests: Good for constituents working in financial industry, holding financial assets.
 - Special interests: Unambiguously positive for financial services industry

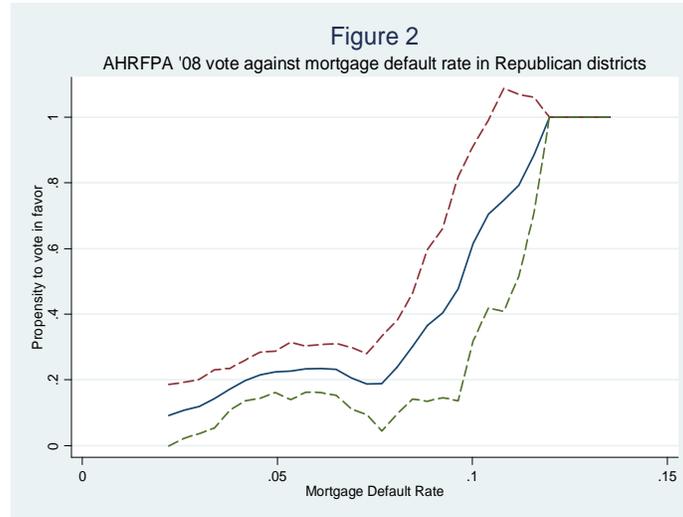
AHRFPA Voting Patterns (Table 3)

Panel A: 519 Vote (July 26, 2008)			
	(1)	(2)	(3)
	Democrats	Republicans	Total
# Voting "Yes"	227	45	272
# Voting "No"	3	149	152
Total	230	194	424

Panel B: 301 Vote (May 8, 2008)			
	(1)	(2)	(3)
	Democrats	Republicans	Total
# Voting "Yes"	229	39	268
# Voting "No"	0	154	154
Total	229	193	422

Panel C: Switchers (Republican Only)			
	(1)	(2)	(3)
	# Voting "Yes" on 301	# Voting "No" on 301	Total
# Voting "Yes" on 519	24	19	43
# Voting "No" on 519	14	131	145
Total	38	150	188

Constituent Interests and AHRFPA Vote



Constituent Interests and AHRFPA (Table 4)

	(1)	(2)	(4)	(5)	With Census Controls (6)	May 8 th , 2008 vote (7)	Switch From "Yes" (8)	Switch From "No" (9)
Dependent Variable: Voted in favor of AHRFPA '08 (July 26 th , 2008)								
Mortgage Default Rate (07Q4)	6.71** (1.45)	6.66** (1.30)		6.69** (1.3)	5.01** (1.92)	3.7* (1.43)	6.09* (2.29)	6.03** (1.71)
DW Nominate Ideology Score		-0.87** (0.15)	-0.84** (0.16)	-0.82** (0.15)	-0.81** (0.15)	-1.08** (0.17)	-0.52 (0.94)	-0.56** (0.14)
Ln(Financial Industry Contribution)		0.028 (0.030)	0.031 (0.029)	0.036 (0.040)	0.006 (0.041)	0.035 (0.028)	0.017 (0.08)	0.006 (0.03)
Mortgage Default Rate (05Q4)			1.737 (2.281)					
ΔMortgage Default Rate			7.46** (1.32)					
Finance Committee				0.092 (0.090)	0.089 (0.088)			
Number of Terms Served				0.011 (0.009)	0.005 (0.009)			
Vote Margin '06 Elections				-0.001 (0.001)	-0.000 (0.001)			
Ln(Mortgage Ind. Contribution)	-0.135+ (0.080)	0.015 (0.362)	0.110 (0.352)	-0.162 (0.506)	-5.629 (4.017)	0.180 (0.330)	0.265 (0.937)	0.057 (0.317)
N	194	194	194	194	194	193	38	150
R ²	0.09	0.22	0.25	0.24	0.28	0.25	0.073	0.17

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Precision in Targeting Constituents (Table 5)

Panel B: Regressions

	(1)	(2)	(3)
		With Political Controls	Census and Political Controls
Dependent Variable: Voted in favor of AHRFPA '08 (July 26 th , 2008)			
Home Default Rate (07Q4)	9.071** (2.038)	8.864** (2.063)	6.741** (2.554)
Non-Home Default Rate	-3.308 (2.285)	-2.967 (2.346)	-2.964 (2.998)
DW Nominate Score	-0.846** (0.154)	-0.806** (0.150)	-0.789** (0.150)
Ln(Financial Industry)	0.033 (0.030)	0.043 (0.040)	0.011 (0.042)
N	194	194	194
R ²	0.23	0.24	0.29

Responding to Own Voting Bloc (Table 6)

Sample:	All Republicans			Sample Split By Republicans in Districts with Large Difference in Default Rates		
	(1)	(2)	(3)	(4)	(5)	(6)
	With Political Controls	With Political and Census Controls	With Census and Political Controls	Above Median Sample	Census and Political Controls	
Dependent Variable: Voted in favor of AHRFPA '08 (July 26 th , 2008)						
Republican Mortgage Default Rate	5.676+ (3.318)	5.002 (3.210)	8.523* (3.375)	9.345** (3.023)	8.840** (3.251)	12.921** (3.488)
Democrat Mortgage Default Rate	1.109 (3.125)	1.820 (2.999)	-1.579 (3.683)	-3.124 (2.915)	-2.730 (3.362)	-5.880+ (3.187)
DW Nominate Ideology Score	-0.960** (0.171)	-0.911** (0.168)	-0.875** (0.179)	-1.133** (0.275)	-0.965** (0.173)	-0.887** (0.180)
Ln(Financial Industry Contributions)	0.039 (0.033)	0.043 (0.045)	0.017 (0.048)	0.107+ (0.059)	0.036 (0.034)	0.017 (0.048)
(Repub Mortgage Def Rate) * Below					-23.832 (18.775)	-30.052 (21.719)
(Dem Mortgage Def Rate) * Below					23.523 (18.520)	29.494 (21.380)
Below Median Default Difference?					-0.107 (0.185)	-0.125 (0.000)
N	162	162	162	80	162	162
R ²	0.25	0.26	0.31	0.34	0.26	0.32

Electoral Competition and Constituent Interests (Table 7)

	(1)	(2)	(3)	(4)	(5)
	Dependent Variable: Voted in favor of AHRFPA '08				
Competitive District	-0.103 (0.302)	-0.213 (0.233)	-0.027 (0.248)	-0.007 (0.009)	-0.318* (0.139)
Mortgage Default Rate (07Q4)	6.302** (1.370)	6.350** (1.375)	6.505** (1.382)	4.456* (2.078)	5.085* (2.047)
(Mortgage Default)*(Competitive District)	7.227+ (4.190)	8.236* (3.689)	4.246 (4.550)	0.272+ (0.160)	4.370+ (2.526)
DW Nominate Ideology Score	-0.795** (0.153)	-0.793** (0.154)	-0.810** (0.153)	-0.783** (0.151)	-0.848** (0.152)
Ln(Financial Industry)	0.012 (0.030)	0.010 (0.030)	0.009 (0.030)	0.002 (0.030)	0.028 (0.029)
Constant	0.164 (0.362)	0.183 (0.363)	0.192 (0.362)	0.328 (0.371)	0.110 (0.356)
Definition of Competition	Margin less than 2% in 2006	Margin less than 4% in 2006	Margin less than 6% in 2006	Linear censored	Swing states
N	194	194	194	194	194
R ²		0.25	0.24	0.24	0.25

AHRFPA Discussion

- Constituent interests strongly influence voting patterns
 - Politicians respond to ideology and economic incentives
 - Extremely precise in responding, both on types of default and to their particular supporters (“dual constituency”)
 - Electoral competition heightens economic reasons for voting, as expected

- Ideology also matters
 - Conservatives more likely to vote against bill

EESA Voting Patterns (Table 8)

Panel A: 681 Vote (October 3rd, 2008)

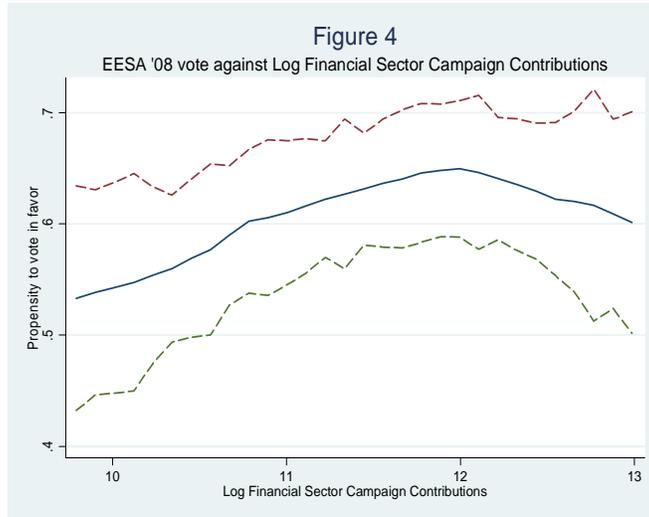
	(1)	(2)	(3)
	Democrats	Republicans	Total
# Voting “Yes”	172	91	263
# Voting “No”	63	108	171
Total	235	199	434

Panel B: 674 Vote (September 29th, 2008)

	(1)	(2)	(3)
	Democrats	Republicans	Total
# Voting “Yes”	140	65	205
# Voting “No”	95	133	228
Total	235	198	433

Panel C: Switchers

	(1)	(2)	(3)
	# Voting “Yes” on 674	# Voting “No” on 674	Total
# Voting “Yes” on 681	204	58	262
# Voting “No” on 681	1	170	171
Total	205	228	433



EESA and Special Interests (Table 9A)

	Alternative Measures of Constituent Interests						
	Party (1)	P & C ctrl (2)	C. C. (4)	C. C. (6)	C. C. (7)	C. C. (8)	C. C. (9)
Dependent Variable: Voted in favor of EESA '08 (October 3 rd , 2008)							
Mortgage Default Rate (07Q4)	0.447 (0.814)	0.438 (0.823)	0.656 (1.407)	0.413 (0.841)	1.141 (0.874)	1.170 (1.415)	1.378 (0.970)
DW Nominate Ideology Score	-0.316** (0.045)	-0.447** (0.124)	-0.253** (0.051)	-0.368** (0.045)	-0.296** (0.045)	-0.257** (0.050)	-0.305** (0.047)
Ln(Financial Industry)	0.063** (0.023)	0.068** (0.023)	0.129** (0.028)		0.046+ (0.024)	0.124** (0.028)	0.122** (0.029)
Ln(Finance contributions, '08 cycle)				0.118** (0.028)			
Ln(all non-finance contributions, '08)				0.009 (0.033)			
%age constituents working in finance					0.032** (0.010)	0.035** (0.012)	0.034** (0.010)
%age constituents with >\$200K inc					2.537** (0.955)	1.947 (1.793)	1.997* (0.936)
Retiring representative							1.897* (0.775)
Retiring representative *							-0.129+ (0.067)
Ln(Financial ind. contributions)							
N	434	434	434	398	434	434	434
R ²	0.11	0.11	0.19	0.17	0.15	0.21	0.22

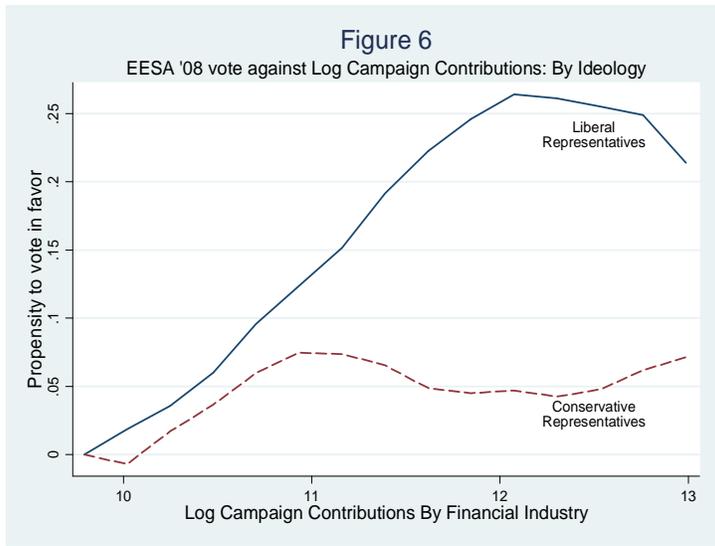
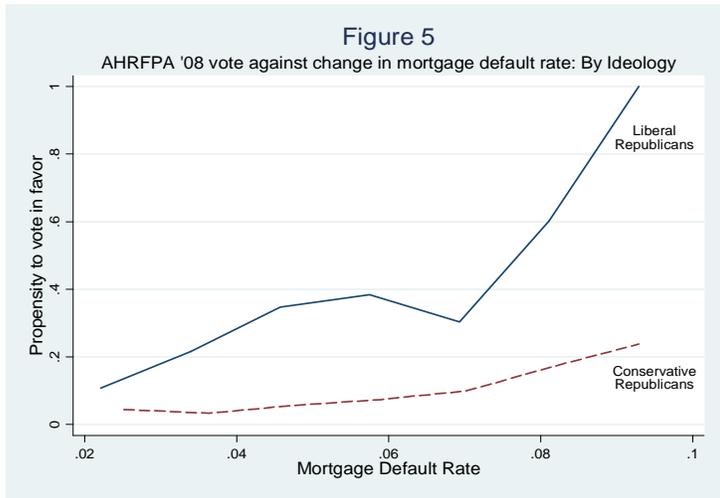
EESA and Special Interests (Table 9A)

Alternative Measures of
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%age constituents working in finance					0.032** (0.010)	0.035** (0.012)	0.034** (0.010)
%age constituents with >\$200K inc					2.537** (0.955)	1.947 (1.793)	1.997* (0.936)
Retiring representative							1.897* (0.775)
Retiring representative *							-0.129+ (0.067)
Ln(Financial ind. contributions)							
N	434	434	434	398	434	434	434
R ²	0.11	0.11	0.19	0.17	0.15	0.21	0.22

EESA Discussion

- Special interests appear to influence voting patterns
 - Always difficult to solve endogeneity problem: perhaps politicians that get campaign contributions already prone to voting pro-industry
 - Our advantage: (1) sharp unexpected shock, (2) wealth of control variables, (3) above economic argument not obvious
- Again, ideology also matters
 - Conservatives more likely to vote against bill
 - Let's examine the trade-off!



Conclusion: Review of what we find

- Constituent interests, as proxied by mortgage default rates, strongly influence politician voting patterns on AHRFPA
 - Not driven by ideology, “type”, or other economic/political variables.
 - Politicians remarkably precise in responding only to the legislation-specific default rate.
 - Politicians a lot more responsive to their own-party constituent defaults.
 - Politicians more responsive to constituents when facing greater electoral competition.
- Special interests, as proxied by campaign contributions by the financial services industry, strongly correlated with voting patterns on EESA
 - Result cannot be explained by a battery of covariates.
- Ideology as commitment: “Price” of vote – both in terms of CI and SI – is higher for more conservative representatives.