Discussion of "Forced Asset Sales and the Concentration of Outstanding Debt: Evidence from the Mortgage Market"

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Big Picture

- Foreclosures are bad.
  - They impose externality on neighboring houses (Campbell, Giglio and Pathak 2011)
  - "Externality" is mainly through the increase in the inventory of houses on the market. (Anenberg and Kung 2013)
  - Decline in house prices due to foreclosures has broader economic implications. (Mian,Sufi and Trebbi 2014)

- What is the solution?
  - MS: Debt forgiveness during the downturns (Replace debt contracts with some sort of shared equity contract.)
  - FG: Make the banks internalize the cost of their actions.
    - Incentivize creation of one or few institutions that purchase most of the troubled loans in a region.

Summary of findings

Areas with a higher concentration of retained mortgages saw:

- fewer foreclosures. (Going from 10th percentile to 90th percentile of concentration reduces foreclosures by 25%.)
  - This result is not driven by the securitization channel.
  - Is driven by the higher modification of portfolio loans (and not securitized loans) in regions with concentration of retained loans.
- These results are driven by banks internalizing the externalities of a foreclosure.
- Less decline in house prices

Top 4 vs. Average Retained Share

- At the loan level what matters for each loan (as they have in Table 8) is $Ret_{l,z} = \frac{MR_{l,z}}{Total\ Originations_z}$
- For the zipcode level result to be consistent with the loan level result, RHS should be

$$\mu_z = E_l\left(\frac{MR_{l,z}}{Total\ Originations_z}\right) = \frac{\sum\left(MR_{l,z}\right)^2}{MR_z \times Total\ Originations_z}$$

- But I expect the two measures to be highly correlated.

Top4 is correlated with delinquencies

- In all tables controlling for delinquencies reduces the coefficients on Top4 by 50-70%.
  - i.e. Top4 concentration is negatively correlated with delinquencies as well. (ex ante incentives/ unobserved heterogeneity)
  - (Authors are completely transparent about this.)
- What if some of the result is driven by competition among lenders and their incentive to extend riskier loans?
  - Competition and loan quality (Petersen and Rajan 1995)
- This is less of a concern if conditional on delinquency borrowers are similar.
  - High loan-to-value ratios are the single greatest contributor to re-default and foreclosure. (Schemeiser and Gross 2015)

IV results

Is Bank mergers a good instrument?

- Nguyen (2015): Branch closings lead to a prolonged decline in local small business lending.
  - Channel: relations and soft information still matter.
  - Note: It seems that over time the importance of soft information in mortgage market declined significantly.
  - An example of violation of exclusion restriction: mergers resulted in less origination of loans, in particular to "good" sub-prime borrowers.

Is fraction of people with age 65+ a good proxy?

- This seems more promising.
- Perhaps local deposits matters only for local banks.
- It would be great to show the first stage for small vs. large banks.

Inspecting the Mechanism

- I do think that higher concentration of loans (especially the retained ones) was associated with less foreclosures and more loan modifications.

Main question: What is the mechanism?

- FG preferred explanation: Internalizing foreclosure externalities.

Alternatives:

Increasing returns to scale of local information collection:

- Better ex-ante information:
- Better ex-post information/ modificnation capacity

Foreclosure externality

- How large are the foreclosure externalities?
  - Campbell, Giglio and Pathak (2011): Houses within 0.05 miles are sold at 1% lower. Little evidence of spillover for more than 0.25 miles.
  - Anenberg and Kung (2013): Houses within 0.5 miles put on the market in the same week as the listing of the foreclosed house are sold at 1% lower.
- When does the bank care about the externality?
  - When the borrower is seriously delinquent and does not have enough equity.
  - You need to have enough borrowers with the same lender that are either delinquent or close to delinquency.

Direct cost vs. foreclosure cost

- What is the direct cost of foreclosure?
  - Foreclosure houses are sold at ~30% discount.
  - Most probably the house itself is underwater.
  - Bank loss is about 50%.
  - What is the cost of modification?
- Campbell et al. (2011): Externality cost ~ 10 X Direct cost.
  - If 10% of houses in the neighborhood are seriously delinquent and if 5% of delinquent houses have the same lender (associated with the p90 of top4) then the externality cost is equivalent to 5% improvement in foreclosure/ loan modification cost.
- Agarwal et al. (2014): "servicer-specific factors that appear to be related to their preexisting organizational capabilities" was the main driver of lack of loan modifications.

Does loan level result help?

- Loan level result for portfolio loans is very much convincing that it is the fraction of retained mortgages that matters for foreclosures.
- Does it show that the result is not driven by information advantage of the lenders? I don't think so.
- Think about *ex post* efficiency in loan modification:
  - What matters for loan modification is the servicer expertise (and incentives)
  - Securitized loans servicer is different from the originator (or at least has different incentives)
- The incentive of the lenders for *ex ante* screening of portfolio and securitized loans can also be different.

Policy implication

No matter whether the result is driven by internalizing the externalities or by increasing return to scale in loan modification the paper has a very important policy implication:

- We would have been better off if we had some specialized and regionally concentrated institutions taking care of seriously delinquent loans.
  - This is very similar to what US did in the great depression: HOLC
    - Home Owner's Loan Corporation purpose "was to refinance home mortgages currently in default to prevent foreclosure".
    - The HOLC tried to avoid selling too many homes quickly to avoid having negative effects on housing prices.
  - AMC in NPL context.
- The hardest part: Finding out the price at which banks should sell the delinquent loans?