As described earlier regarding yield spread premiums, securitization, and the secondary market, pricing was often explicitly not based upon risk. Instead brokers and other originators focused on writing loans for as high a price as possible. They did so because their commission was based on how much the actual price exceeded the (purported) risk-based price set by the lender. The risk of default was not a factor in how brokers and other originators priced the mortgage. Lenders priced loans at what the market would bear and relied on market segmentation to increase the cost of credit (and returns to investors), rather than to fairly price risk. Unsurprisingly, lenders who substituted higher interest rates for underwriting often failed to identify who was risky and who was not, with correspondingly high default and foreclosure rates.

In addition, during the years prior to the foreclosure crisis, the subprime mortgage market and even prime mortgage lenders for many years preferred “no-doc” and low-documentation loans, written at an interest rate markup, to fully underwritten loans. In some cases, lenders’ underwriting guidelines required them to redact any income information that made it into their files. Lenders sometimes would underwrite loans based on the initial teaser rates and not the monthly payment levels that were sure to exist within a year or two.

Footnotes

286 [286] See § 1.3.2 [1], supra.

287 [287] See Ch. 7 [2], infra (a more detailed discussion of mortgage broker compensation and yield spread premiums).

288 [288] See, e.g., Richard R. W. Brooks, Credit Past Due, 106 Colum. L. Rev. 994, 1003–1006 (2006) (discussing fringe lending’s lack of reliance on traditional measures of creditworthiness and the manner in which fringe lending’s failure to report credit histories of borrowers can trap borrowers, especially African-American borrowers, in expensive fringe credit); Diana B. Henriques & Lowell Bergman, Mortgaged Lives: A Special Report; Profiting from Fine Print with Wall Street’s Help, N.Y. Times, Mar. 15, 2000, at A1 (subprime mortgage lenders charge borrowers with “A” credit the same rates and fees they charge borrowers with “D” credit); Sumit Agarwal, John C. Driscoll, Xavier Gabaix, & David Laibson, The Age of Reason: Financial Decisions Over the Lifecycle [3] 8–9 (Feb. 11, 2008), available at http://ssrn.com (older and younger borrowers pay more for credit than midlife borrowers in home equity loans primarily because they underestimate the value of their homes and apply for loans with a higher loan-to-value ratio than needed; lenders conduct their own appraisal of the value of the property and re-price the loans higher if the consumer overestimated the value, but do not re-price the loans lower when the consumer underestimates the value of the home). Cf. Howard Lax, Michael Manti, Paul Raca & Peter Zorn, Subprime Lending: An Investigation of Economic Efficiency, 15 Hous. Pol’y Debate 533 (2004) (one percentage point of the risk premium paid by subprime borrowers could not be explained by the borrowers’ credit risk attributes).


290 [290] Seventy percent of subprime loan pools rated by Standard & Poors in the first half of 2005 had less-than-full documentation. Ruth Simon, James R. Hagerty & James T. Areddy, Housing Bubble Doesn’t Scare Off Foreigners,
1.3.4.2 Underwriting with Little Consideration of Risk


Prime, subprime, and Alt-A mortgage loans are defined in § 2.4 [9], infra.