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Incentives' Role in the Financial Crisis

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By David B. Moore

Among the myriad damning passages buried inside the Federal Deposit Insurance Corp.'s recent complaint against former executives of Washington Mutual is the following:

"Wamu's compensation structure for loan officers was based on the volume of loans originated, and thus loan originators were incentivized to push as many loans through the system as possible, creating additional risk to Wamu. For instance, Wamu's 2006 compensation plan for loan originators stated: 'Rewards will be based on the dollar volume of loans funded each month.' Wamu's compensation policy for underwriters similarly created strong incentives to increase the volume of loans."

And increase the volume of loans they did! Unfortunately, we all know how that movie ended.

If the financial crisis has reinforced just one fundamental economic principal it is that incentives are powerful determinants of behavior. Put more succinctly, incentives matter.

The market for financing single-family homes between 2003 and 2007 is just one obvious example of how bad incentives distorted decision-making throughout the daisy chain of participants and processes that ultimately produced single-family mortgages during the period.

The process began with a willing buyer. In days of yore, buyers generally had to come up with substantial down payments, often 20%, but rarely less than 10%, of a home's purchase price in order to obtain a mortgage. Buyers also had to provide substantial documentation of their financial position, including verifiable income, assets, debts, etc.

As required down payments and income documentation trended toward zero by the mid-2000s, the average fence-sitting buyer was being enticed to purchase a home regardless of the long-term economics of the transaction, as there was precious little downside — apart from inconvenience — if things went south. Clearly, many potential buyers responded predictably to the incentives laid before them, rolled the dice, and bought houses they couldn't really afford.

Home builders responded to the incentives available as well. In ancient times (say, the mid-1990s), builders had to put substantial equity into a project, and presell a certain number of homes in order to mitigate downside for the lender. At the same time that banks and other lenders were relaxing lending standards for buyers and thus boosting demand for homes, they were also relaxing requirements for builders. Specifically, lenders were requiring less equity and fewer presales for projects. (It is no coincidence that compensation for most bank management teams is tied to asset size and not long-term profitability; thus they are incentivized to grow regardless of the risks involved.) And faced with reduced downside and access to larger amounts of capital for building, builders responded predictably to the incentives laid before them, rolled the dice, and built far too many homes. The business of builders, after all, is building.

Lenders, and particularly mortgage brokers, responded to the new regime of financial incentives with a zeal rarely witnessed in the history of finance. In order to generate "paper" (mortgages) that could be sold to Wall Street (to be repackaged and resold later in the form of mortgage-backed securities), mortgage brokers were paid almost entirely on the basis of mortgage production ("sales") with virtually no regard for the credit quality of the underlying mortgages. This led predictably to widespread shenanigans and outright fraud on the part of many mortgage brokers in their efforts to "qualify" increasing numbers of borrowers for loans, all in an effort to generate larger commission checks.

Wall Street firms were unable to turn a blind eye to the massive sums of money to be made from repackaging mortgages and selling them to institutions in the form of MBS. (Not to mention the staggering profits to be earned from trading the myriad derivatives and other products tied to MBS.) While the quality of many of these securities was suspect — to be kind — their profitability to Wall Street firms was not; on the contrary, it represented almost risk-free underwriting profit — and in enormous volumes. Clearly, Wall Street was motivated to do its part in inflating the housing bubble to the greatest extent possible.

And last but not least, the ratings agencies were hostages of their own incompetence and conflicts of interest where the mortgage

market was concerned. These firms willingly embraced the specious assumption of ever-rising home prices in order to justify triple-A ratings on MBS comprised of pure dreck, all in the search for volume-driven fees.

While recent legislation is a small step in the right direction, only the so-called Volcker Rule (which limits banking entities to owning no more than a 3% interest in a hedge fund or private-equity fund, and limits to 3% of Tier 1 capital the total of all of the banking entity's interests in hedge funds or private equity) and Title IX's Subtitle D (requiring securitizers to retain not less than 5% of the credit risk for an asset that is a qualified residential mortgage) of the Dodd-Frank Act even tangentially address the issue of incentives as they relate to speculating in or originating risky assets.

Consequently, despite a major financial meltdown and much post-crisis hemming and hawing, too many folks in the financial services industry remain incentivized to engage in risky, destructive behavior. Wamu may be gone, but its underlying incentive structure — which continues to permeate the financial services industry — remains largely unaddressed by regulators. And until the role of incentives is more thoroughly contemplated by the various regulatory bodies, the next financial crisis will remain in close vicinity.

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