How Do Regulators Influence Mortgage Risk? Evidence from an Emerging Market

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Motivation

- The recent collapse of the financial system has fueled increased calls for tighter and stricter regulations in credit markets.
- Serious gaps and weaknesses in these areas are now widely seen as contributing their own distinctive role in impairing the effectiveness of the financial system as a whole.
- While there exists a general consensus among scholars and policy makers that the current regulatory framework needs to be overhauled, it is not a priori clear what the optimal policy response ought to be.
- How should regulators best respond?
- History tells us that the seeds of bad regulations are often sowed in bad times.
- Bank regulation is quite reactionary – put in place in an attempt to fix things (not clear what the market failures its trying to correct).
- This paper attempts to improve our understanding of how regulation affects performance of housing loans.
Examining the effect of regulations on economic variables is quite challenging.

Regulations often tend to be quite sticky in developed economies.

Data limitations often make it difficult to seriously analyze such questions.

Authors overcome these challenges by focussing on an emerging market, India.

- India has recently witnessed a series of financial sector reforms.
- Authors have access to very detailed micro level data on mortgage loans.
**Specifics**

- Use detailed contract level data on 1.2 millions loans disbursed between 1995-2010 made available by an mortgage provider.
- Provide both time-series and cross-sectional evidence to support their analysis.
  - SARFAESI Act 2002 and changes in risk weights.
  - Priority Sector lending.
  - Change in NPA classification.
- Main results:
  - Regulation contributed to surge in delinquencies in early 2000s
  - Subsidies for low-cost housing has distorted the efficient market relationship between interest rates and subsequent delinquencies
  - The redefinition of non-performing assets alters bank’s behavior incentivizing for better monitoring
**General Assessment**

- A very interesting paper and I enjoyed reading it.
- Paper asks some important "Big Picture" questions.
- Below are some relatively minor comments for the authors to perhaps reflect on.
- Demand vs. Supply.
- Screening vs. Monitoring.
- Reverse Causality.
- Other contemporaneous reforms.
- Other comments.
The authors argue that change in performance is due to a change in regulation.

The suggested mechanism: banks change their lending standards.

But borrowers may change their behavior as well.

Composition of borrowers might also change (interest rate and SARFAESI for example).
Comment 2: Screening vs. Monitoring

- The authors imply that NPA reclassification affected monitoring.
- But it could have affected their screening decisions as well.
- More convincing is required on this mechanism.
Comment 3: Reverse Causality

- Regulation in turn maybe driven by macro economics conditions (increased delinquencies).
- Cross-sectional analysis mitigates some of these concerns.
Hard to attribute the changes due to one particular reform, especially given that there is a lag between the reform and its effect (Drought subsidy is often used).

SARFAESI was softened in 2004 (see Vig 2012 for details).
What are these PSL limits? The authors should be very precise about these limits in the main body of the paper.

The empirical specification is not super-clear and can be simplified.

Too much is relegated to the appendix. Some can be brought inside the text. It will make the paper easier to read.
The authors tackle a very important question.

The paper is well written and the evidence presented seems to suggest that regulation matters.

I would urge the authors to think a bit more on the mechanism that generates these results.

There are some concerns that composition of borrowers may have changed over time.