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.

Identification Challenge

- 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.

Comments

- Demand vs. Supply.
- Screening vs. Monitoring.
- Reverse Causality.
- Other contemporaneous reforms.
- Other comments.

Comment 1: Demand vs. Supply

- 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.

Comment 4: Several Contemporaneous Reforms

- 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).

Other comments

- 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.

Conclusion

- 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.