The New York Times
nytimes.com
FREAKONOMICS


April 7, 2008, 12:12 pm

A Look Back at the Subprime Mess (or: Itzhak Ben-David Is a Prophet)

By STEPHEN J. DUBNER

Back in June, 2007, we wrote a column about the research of **Itzhak Ben-David**, a Ph.D. candidate in finance at the University of Chicago (who has since accepted an assistant professor position at the Ohio State University). He had been studying the cash-back transaction — a real-estate sleight of hand in which cash-poor buyers received an unrecorded cash rebate from the seller in order to qualify for a loan.

This would result in the buyer sometimes borrowing 100 percent (or more) of the house's value. That means that borrowers who were subprime to start with are taking on even more debt, creating a loan that's just waiting to blow up.

Here's my question: If an academic researcher like Ben-David knew as much as he did for as long as he did — while we wrote the article last summer, he'd been working on this research for a long time — why were so many people, including smart people at sophisticated institutions, caught off-guard by the subprime developments?

Take a look at a few key paragraphs of the article and tell me how much clearer the warnings could have been, and how lax the safeguards were:

[Ben-David] found that a small group of real estate agents were repeatedly involved, in particular when the seller was himself an agent or when there was no second agent in the deal. **Ben-David also found that the suspect transactions were more likely to occur when the lending bank, rather than keeping the mortgage, bundled it up with thousands of others and**

sold them off as mortgage-backed securities. This suggests that the issuing banks treat suspect mortgages with roughly the same care as you might treat a rental car, knowing that you aren't responsible for its long-term outcome once it is out of your possession.

At first glance, these cash-back transactions, while illegal, might seem a victim-less crime. After all, the seller gets his house sold and the buyer gets to move in with his family. **The real estate agent, the mortgage broker, the attorney, and the appraiser are all paid their commissions or fees. Even the bank that made the loan comes out ahead, since it earned its fees on the transaction before passing along the mortgage to investors.**

But Ben-David argues that there are at least two potential losers. The first is the honest buyer who won't take a cash-back offer and therefore can't buy a house — all while the illegal cash-back transactions are artificially driving up home prices in his neighborhood.

The second loser is the investor who bought the mortgage-backed securities. If a house purchased with a cash-back transaction goes into foreclosure, it is soon discovered that the home is worth less than the value of the loan. This, plainly, is not good for the shareholders of such assets. **While people who hate rich people may get a thrill from the idea of wealthy shareholders being swindled by a bunch of small-time mortgage hustlers, keep in mind that mortgage-backed securities are the sort of conservative investment widely held by pensioners and other regular folks.**