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From new deal institutions to capital markets: Commercial consumer risk scores and the making of subprime mortgage finance

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ABSTRACT

The investment fueled US mortgage market has traditionally been sustained by New Deal institutions called government sponsored enterprises (GSEs). Known as Freddie Mac and Fannie Mae, the GSEs once dominated mortgage backed securities underwriting. The recent subprime mortgage crisis has drawn attention to the fact that during the real estate boom, these agencies were temporarily overtaken by risk tolerant channels of lending, securitization, and investment, driven by investment banks and private capital players. This research traces the movement of a specific brand of commercial consumer credit analytics into mortgage underwriting. It demonstrates that what might look like the spontaneous rise (and fall) of a 'free' market divested of direct government intervention has been thoroughly embedded in the concerted movement of calculative risk management technologies. The transformations began with a sequence of GSE decisions taken in the mid-1990's to implement a consumer risk score called a FICO® into automated underwriting systems. Having been endorsed by the GSEs, this scoring tool was gradually hardwired throughout the industry to become a distributed and collective 'market device'. As the paper will show, once modified by specific GSE interpretations the calculative properties generated by these credit bureau scores reconfigured mortgage finance into two parts: the conventional, risk-adverse, GSE conforming 'prime' and an infrastructurally distinct, risk-avaricious, investment grade 'subprime'.

> "The shift from reliance on specialized portfolio lenders financed by deposits to a greater use of capital markets represented the second great sea change in mortgage finance, equaled in importance only by the events of the New Deal."
>
> *FRB Chairman Ben Bernanke*
> *August 31, 2007*[1]

Introduction: From new deal institutions to capital markets

At the tail end of 2006, the 'subprime' hit the news with a bang when default rates shot up in a segment of mortgage finance that had previously received little attention in mainstream reporting. Against rising central bank interest rates, and following the collapse of the housing bubble, borrowers bearing certain high-risk classes of loans ceased to maintain their repayment schedules. By the turn of 2007, the unanticipated inability of lenders to raise enough capital from borrowers impeded their own instalment payments to international residential mortgage backed securities (RMBS) holders. Major subprime lenders declared bankruptcy and several high profile hedge funds imploded. As regularized transnational circuits of capital flow broke down in the space of only a few months, the problem

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[1] Remarks made by Chairman Ben S. Bernanke at the Federal Reserve Bank of Kansas City's Economic Symposium, Jackson Hole, Wyoming, August 31, 2007. The text is available online at http://www.federalreserve.gov/boarddocs/speeches/2007/20070831/default.htm.

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escalated into a financial credit crunch that soon took on global proportions. This series of all too recent and as yet ongoing events has made evident the long chain of financial connections that have come to co-ordinate the economic agencies of ordinary US homeowners with those of international capital investors.

Those working at the intersection of 'social studies of finance' and 'social studies of accounting' (Miller, 2008) might immediately suspect that instabilities in the segment named 'subprime' have been accompanied by important organizational and infrastructural changes whose underlying significance, through disruption, are perhaps only now coming to light. One of the most dramatic of these transformations has occurred in the business of mortgage finance which sits at the nexus between the markets for real estate and those for asset backed securities. As emphasized by Federal Reserve Board Chairman Ben Bernanke in a speech responding to current events in the last ten years (quoted above), US mortgage finance has shifted from an industry driven by government sponsored enterprises (GSEs) and specialized deposit-funded lenders, to an industry fuelled in large part by high-risk investment capital. No longer the purview of local banks and savings co-operatives, consumer mortgages have become the asset class feeding some of the most popular debt securities for sale on Wall Street.

The shift towards the unfettered involvement of private capital in mortgage lending and its downstream effects are becoming widely recognized in the US. A *New York Times Magazine* contributor who had just received a letter informing him that his mortgage obligations were being transferred to another financial group, expressed his personal sense of shock in this way: "…it came to me as a thunderous revelation: my debts were some other people's assets" (Kirn, 2006). In this spirit, the movement towards big capital has been tied to many of the most cited reasons in mainstream commentary for how mortgage credit became unsustainably amplified in the last few years. The profit driven interests of investment banks and hedge funds have ostensibly encouraged unscrupulous and irrational lending, fraudulent income reporting, a reduced responsibility towards the personal situation of borrowers. This was compounded by naïve borrowing in the face of increasingly complex financing options and negligence on the part of the federal agencies who should have been protecting consumers from predatory lending. Critiques such as these have been deployed in the style of a classic 'sociology of errors' (Bloor, 1991), in which deviations from a retrospectively appropriate course of action are rooted out and condemned.

Analyses of technical systems that focus on (human) error are fundamentally 'asymmetric' because they are confined to situations of breakdown or crisis. This is why the *post hoc* denunciation of deleterious actions triggered by this new brand of mortgage finance reads like a stale list of 'the usual suspects' – the ones that are routinely rolled out whenever there is an issue with crushing consumer indebtedness (Black, 1961). This kind of reasoning leaves us open to two popular poles of argumentation: either to the ideologically driven conclusion that the current financial crisis is due to the natural excesses of free-marketeering run amock; or to a moralistic accusation that investment bankers allowed themselves to be seized by a greed-induced passion, a 'contagious' psychology of 'irrational exuberance' (Shiller, 2005, 2008), that temporarily overcame their otherwise sound economic good sense. Either way, these perspectives sidestep the pressing contemporary question of how a financial network for lending so freely has come into being. Crisis or no crisis they fail to provide a compelling account of how these private capital players have managed to encroach, in practice, upon a marketplace the federal government has had to actively sustain, through specialized government sponsored agencies, since the New Deal. If government charters were once necessary to make the connections for liquid mortgage finance to exist – and in particular for making mortgage funding available to credit strapped populations – a move towards financial markets that sidesteps these entities cannot be sufficiently explained by a spontaneous ramping up of credit volume through supply and demand; and even less so by some kind of natural willingness among capital investors to cater to a consumer segment called the 'subprime'.

How has mortgage finance been rendered open to the practices of high-risk investment that appeal to big capital players? Surely, something might be said about the genesis and development[2] of subprime finance as a novel network of investment grade lending in and of itself. It is perhaps of interest, then, to take a step back from the collapse and to investigate the implementation of new calculative infrastructures and their consequences on how mortgage finance is arranged. To track such a change means taking up the painstaking search into the most mundane of details so familiar to social studies of science (Bowker & Star, 2000; Star, 1999) and of accountancy (Hopwood, 1987; Hopwood & Miller, 1994); it means exploring the innovations that have re-configured markets, their machineries and their places (Beunza & Stark, 2004; Guala, 2001; Muniesa, 2000; Zaloom, 2006; Çalişkan, 2007). In the case of the diffused industry of mortgage finance it means prying into the everyday apparatuses of underwriting and into the rise of consumer risk management techniques that have permitted a dramatic production of increased liquidity. Such an analysis would conclude that understanding subprime lending is less about unravelling the motivations and psychologies that might lead to financial overextension, than it is about understanding the development of technical apparatuses that have supported the practical activities of a new cadre of financial agents (Hopwood, 2000).

Instead of questioning why so much mortgage credit was extended to borrowers at a high-risk of defaulting; instead of conflating the crisis with a set of culturally familiar categories such as the 'poor' or the 'economically vulnerable'; instead of presuming to know what it is that is collapsing and offering calculatively empty, off-the-shelf reasons for why, this research traces the technical constitution of an investment subprime – at once a class of consumers, a set of 'exotic' mortgage products, and a class of

[2] The term 'genesis and development' is borrowed from the work of Ludwig Fleck, a classic text on the establishment of scientific facts in science studies (Fleck, 1981).