Executive Summary: Lender Expectations and Real Estate Dynamics

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Lax lending standards are often cited as one of the causes of the financial crisis of 2007 and 2008. Researchers have recently begun to focus on the role of optimistic lender expectations in generating lax lending standards. Lenders that expect future growth in house prices or borrower incomes optimally lower their lending standards in order to give more credit. However, lender expectations can at times become overly optimistic, generating lending standards that are too lax. Foote et al. (2012), for example, argue that overly optimistic beliefs about house prices were a main feature of pre-crisis lending decisions. Further understanding of this expectations-driven lending channel is thus important in order to prevent future crises.

In this paper, I combine data from the Home Mortgage Disclosure Act (HMDA) and the FDIC Summary of Deposits Survey to provide evidence of an expectations-driven lending channel in the U.S. mortgage market. This study seeks to identify individual lenders' optimistic expectations on a market-by-market basis and examine whether they are associated with lax mortgage lending standards on properties within the same market.

Because lender expectations are difficult to measure directly, I introduce and test banks' branching decisions as a proxy measure for lender expectations. As bank branches are costly and require time to open, banks will only open them if they expect favorable future lending conditions within a given market. Hence, banks' branching decisions are likely a good indicator of banks' expectations.

I first use my data set to test whether bank branching decisions are a reliable predictor of banks' lending standards. Specifically, I examine whether banks opening new branches within a market exhibit lower mortgage denial rates on properties located within that same market. I find exactly such a result—banks opening new branches do indeed deny fewer mortgage loans. When I group my sample by banks' asset sizes, I find that this relationship is more pronounced for mid-size banks with assets between $2 billion and $10 billion. Overall, these results suggest that bank branching decisions may be a reliable proxy for bank expectations.

Next, I use my data set to identify individual lenders' optimistic expectations and lax mortgage lending standards. I estimate separately the sensitivity of individual lenders' branching and mortgage denial rate decisions to changes in market level house prices and per capita income. Lenders that respond to the same sequence of changes in market conditions by opening relatively more bank branches are considered to be overly optimistic. Likewise, lenders that respond to the same sequence of changes in market conditions by lowering their denial rates by relatively more are considered to have lax lending standards. I show that, in general, overly optimistic lenders also exhibit lax lending standards. Hence, with expectations measured by branching decisions, I provide evidence of an expectations-driven lending channel in the U.S. mortgage market.