The Extensive Margin of Credit, Housing Markets and the Tradeoff between Financial Stability and Homeownership*

Pedro Gete†

March 2014

Abstract

I propose a tractable model of endogenous lending standards that can account for the fluctuations in the extensive margin of credit observed in mortgage markets. That is, fluctuations in the number and quality of the borrowers qualified for credit. The model has closed-form solutions for the lending standard decisions, and allows simulating different policies. In the model there are borrowers heterogeneous in their income. Lenders decide who is the minimum borrower type qualified for credit. I explicitly characterize lenders’ decision as a function of expected house price growth, interest rate spreads, borrowers’ income expectations, and foreclosure and screening costs. Then, I analyze the effects of government loan guarantees and the new Qualified Mortgage rules on lending standards. I show that there is a trade-off between homeownership and financial stability. New mortgage regulations will tighten lending standards by increasing the compliance costs associated with lending. This is an unintended consequence of the new regulations.

*Financial support from the RERI Foundation is gratefully acknowledged. I thank Tim Bian and Michael Reher for research assistance, and Behzad Diba, Andra Ghent, Mark Huggett, Nobu Kiyotaki, Julia Thomas, Natalie Tiernan and Sandra Ospina for comments.
†Georgetown University and IE Business School. Email: pg252@georgetown.edu