Essays on Industrial Organization and Household Finance

by

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Abstract

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In the thesis, I present my work that applies empirical methods to real-world problems in industrial organization and household finance. In the first chapter, I provide a framework to analyze the welfare impacts of insurance pricing and market structure in the U.S. mortgage market. The second chapter is joint work with Souphala Chomsisengphet. We study the equilibrium outcome of covenant restrictions on credit cards by the CARD Act.

The first chapter studies inefficiencies arising from the insurance pricing schedule of government-sponsored enterprises (GSEs) in the U.S. mortgage market, and how these inefficiencies interact with market structure and information asymmetry. I develop a vertical industry model of borrowers, lenders, and GSEs where lenders compete in originating mortgage loans and the GSEs provide mortgage insurance when facing default risks. The model is estimated using loan-level data on repayment and pricing decisions. The identification leverages a significant change to U.S. banking regulation that gives exogenous variation in credit supply. The estimation exploits a significant change to U.S. banking regulation that gives exogenous variation in credit supply. I find that GSE mortgage insurance pricing results in a redistribution from lower-risk borrowers to higher-risk borrowers and leads to a welfare loss, relative to a benchmark with full risk-based pricing. In my counterfactual analysis, I find that, under GSE pricing, a 50 percent decrease in market concentration reduces welfare, while under full risk-based pricing, the same decrease in market concentration improves welfare. The results highlight that pricing, market structure, and information asymmetry in the mortgage market can have important interactions with one another.

The second chapter uses the 2009 Credit Card Accountability, Responsibility, and Disclosure Act (CARD Act), which prohibited penalty repricing on credit cards as the basis of a case study to understand the implications of covenant restrictions on lenders and borrowers. In the first part of the essay, we conduct an event study to examine the heterogeneous effects of penalty repricing among revolvers (high-risk borrowers) and transactors (low-risk borrowers). We find that penalty repricing has a larger impact on borrowers who face liquidity constraints in making credit card repayments. In the second part of the essay, to
study the mechanism of competitive outcome changes following the pricing regulation of the CARD Act, we develop a model of borrowers and lenders on their repayment and pricing decisions. In the counterfactual analysis, regulating penalty repricing increases borrower surplus, social surplus, and (initial) interest rates. Imposing an interest rate ceiling decreases both borrower surplus and lender profit. The results highlight that, in credit contracts with dynamic risks, different forms of interest rate regulation, i.e., regulating penalty repricing and imposing a price ceiling, could yield different welfare impacts. In particular, it is important to consider the equilibrium effects on interest rates and credit supply when manipulating price dynamics.
To my beloved family,
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Chapter 1

Insurance Pricing and Market Structure: A Study of GSE-Securitized Mortgage Loans

Mispricing of credit risk in mortgage loans was found to be a key cause of the 2008 financial crisis.\(^1\) Given that the Government Sponsored Enterprises (GSEs) Fannie Mae and Freddie Mac securitize the majority of the U.S. residential mortgage loans,\(^2\) much of the credit mispricing may be attributable to the GSEs.\(^3\) The GSEs operate with both implicit and explicit financial support from the government, with a mandate to provide affordable housing\(^4\) for lower-income borrowers.\(^5\) As a result, their credit risk pricing is not entirely determined by the costs and risks of loans and may be influenced by the government’s policy goals.

The GSEs may misprice in two ways (Federal Housing Finance Agency, 2009). First, they may underprice most of the mortgage loans to meet the affordability goal. Second, their pricing may involve substantial cross-subsidization from lower-risk borrowers to higher-risk borrowers: they overprice lower-risk borrowers to cover some of the costs from underpricing higher-risk borrowers.

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\(^1\)See Financial Crisis Inquiry Commission (2011).

\(^2\)Before the crisis, more than 50 percent of the mortgage loans were securitized by the GSEs. The statistic is calculated using Home Mortgage Disclosure Act data during the 2000 – 08 period.

\(^3\)Federal Housing Finance Agency (2009) estimates an evident gap between the estimated fee revenue from mortgage insurance and the estimated cost and concludes that “[c]redit losses were at historic lows when house price appreciation accelerated rapidly in 2002 through 2005. However, it has become clear that the industry as a whole underpriced mortgage credit risk significantly in those years as well as in 2006 and 2007.”

\(^4\)I quantify the economic efficiency without considering the externality and value of providing more home ownership to lower-income borrowers. In Table 1.9, I show that the government could achieve the same level of home ownership as under GSE pricing, while the efficiency increases by 20 billion dollars.

\(^5\)Ambrose and Thibodeau (2004) and Blutta (2012) provide estimates on the effect of the affordable housing goals on the mortgage rates and credit supply from the GSEs.
These practices of underpricing and cross-subsidization could distort the market. Higher-risk borrowers are oversupplied with credit under lower prices. This overprovision could result in inefficiency by pushing excessive risks into the market, at the cost of the government and taxpayers. The concerns about overspending taxpayers’ money motivate long-lasting policy debates on administrative reforms of the GSEs.\footnote{The Trump Administration released recommendations for reforms in June 2018. The Obama Administration released a report of a reform plan in February 2011.}

The distortion created by credit risk mispricing may have been exacerbated by the increase in lender competition before the financial crisis. Increased competition among lenders may incentivize them to expand their credit supply and lower their interest rates. This can exacerbate the problem of overprovision to higher-risk borrowers (see Figure 1.1). Therefore, pro-competitive policies have ambiguous welfare impacts in this sector.

\begin{figure}[h]
\centering
\includegraphics[width=0.5\textwidth]{figure1.png}
\caption{The Welfare Impact of GSE Pricing and Market Structure}
\end{figure}

\textbf{Note:} Figure 1.1 illustrates deadweight loss from GSE pricing and how it interacts with the competition among lenders. The downward sloping line is the marginal willingness to pay (MWTP). The upward sloping line is the marginal cost (MC) for the GSEs. The GSEs underprice guarantee fee at $p_{GSE}$. Competition decreases equilibrium mortgage price from $p_{current}$ to $p_{competition}$ and increases equilibrium mortgage provision from $Q_{current}$ to $Q_{competition}$. Competition results in an additional deadweight loss of the blue shaded area.

This study empirically investigates inefficiencies arising from GSE pricing, and how they interact with market structure. Understanding the impact of insurance pricing and market
structure has important implications on the design of financial regulation and competition policy. It can have a broader impact on the real estate market and overall economic growth.

I develop a rich industry model that quantifies borrower willingness to pay and the cost of a loan. My model features three types of agents: borrowers, lenders, and the GSEs. In the model, a borrower makes an initial purchase decision and subsequent dynamic repayment decisions conditional on the interest rate and her risk parameters. My model allows for unobserved heterogeneity in borrowers’ risk types. This unobserved heterogeneity affects borrowers’ purchasing and defaulting decisions.

Modeling unobserved heterogeneity is important for capturing potential advantageous selection in this market; a borrower who buys at a higher price has higher willingness to pay and lower risk. When price is lower, the marginal borrowers tend to have higher risks. This extensive margin selection is critical in understanding the economic impacts of pricing and market expansion.

I estimate the model using data that cover over 20 million fixed-rate mortgage loans guaranteed by the GSEs. The data contain detailed information on loan characteristics and long-run performances, both of which are crucial for this analysis. Borrowers’ repayment decisions allow me to recover their underlying risk parameters. Under a framework of differentiated Bertrand competition, observed prices help me to identify lender markups and costs.

My estimation leverages exogenous variation in credit supply resulting from a regulatory change in 2004 instituted by the Office of the Comptroller of the Currency (OCC) that exempts national banks from state anti-predatory lending laws (APLs). This regulatory change alleviates the constraints in subprime lending, leading to a market expansion in the subprime market. Indirectly, it lowers the (fixed) cost of credit in the prime market and intensified competition for local lenders.

To test the impacts of the preemption on credit supply in the prime (GSE) market, I implement a difference-in-differences research design. My empirical evidence confirms that conventional mortgage lending is indeed significantly affected by the preemption. I find that the preemption decreases interest rates in markets with state APLs. Moreover, interest rates on average decrease more in markets with a large share of national banks, whereas default rates increase more in those markets. I use this variation to identify unobserved risk types.

The model is estimated using generalized method of moments (GMM). I use borrowers’ dynamic repayment decisions as empirical moments. The default probability is driven by observed loan characteristics, such as credit score and income, as well as unobserved heterogeneity. My model picks up a meaningful degree of unobserved heterogeneity in risk types. It highlights the potential welfare impacts of market expansion through selection on unobservables.

I use the estimated model to perform two series of counterfactual analyses. In the first set of counterfactuals, I consider two alternative schemes for GSE pricing: (i) a full risk-based pricing scheme that charges the exact expected cost and (ii) a uniform pricing scheme that charges a flat rate to every loan.

Using full risk-based pricing as a benchmark, I find that the GSEs underprice most of their
mortgage loans— the average interest rate is 25.98 basis points lower under GSE pricing. The average mortgage subsidy received per loan is about 2,235 dollars. GSE pricing increases demand for higher-risk loans, increasing default cost by 843.22 dollars per loan. Overall, it leads to a deadweight loss of 519.25 dollars per loan, or 17.38 percent of the average mortgage subsidy. In addition, I find that GSE pricing redistributes 56.82 billion dollars, or 1.60 percent of the mortgage interest from lower-risk borrowers to higher-risk borrowers.

Next, I consider the effects of uniform pricing. Uniform pricing is an extreme case of cross-subsidization between lower-risk borrowers and higher-risk borrowers. Higher-risk borrowers face a lower price under uniform pricing relative to GSE pricing. Consequently, uniform pricing induces a welfare loss of 33.89 dollars and a default cost of 43.41 dollars relative to GSE pricing. This finding suggests that an increase in the cross-subsidization of insurance pricing could result in a sizable distortionary cost.

In the second set of counterfactuals, I alter market concentration and examine the effects of market structure and information asymmetry under the following four different environments: (i) GSE pricing; (ii) full risk-based pricing; (iii) GSE pricing under symmetric information (i.e., a design that removes asymmetric information in unobserved risks types between borrowers and lenders); and (iv) full risk-based pricing under symmetric information.

My analysis reveals that welfare decreases as the market becomes less concentrated under GSE pricing. A 50 percent decrease in market concentration leads to an additional default cost per loan of 186.35 dollars, or 14.15 percent of the average default cost. These results confirm the intuition that more competition can actually exacerbate the underpricing problem. Overall, it lowers welfare by 171.77 dollars per loan (5.75 percent of the average mortgage subsidy).

The results are quite different under full risk-based pricing. Under full risk-based pricing, the price for each loan is higher than or equal to its marginal cost. There is a deadweight loss associated with lender market power, so welfare increases as market concentration decreases. A 50 percent decrease in market concentration improves welfare substantially by 844.29 dollars per loan (28.27 percent of the average mortgage subsidy).

I also find that welfare impacts of insurance pricing and market structure depend on the degree of information asymmetry between borrowers and lenders. When lenders can price on individual unobserved risk types (i.e., symmetric information), GSE pricing versus full risk-based pricing have different welfare impacts.

Under GSE pricing, symmetric information increases default cost by 5.48 dollars and results in a deadweight loss of 7.36 dollars per loan relative to asymmetric information. When GSE pricing does not price on the additional information, removing private information causes a greater price distortion for credit risks. Profit-maximizing lenders offer lower prices to borrowers who are higher-risk in unobserved types because they are more price sensitive.

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7I measure the mortgage subsidy as the change in consumer welfare in dollar value from full risk-based pricing to GSE pricing (see Section 1.7.1).

8I assume that GSE pricing does not depend on the information of individual unobserved risk types (i.e., same as the case of asymmetric information).
This price distortion brings higher-risk borrowers into the market and leads to a higher deadweight loss.

On the other hand, symmetric information under full risk-based pricing increases welfare by 132.10 dollars per loan relative to asymmetric information in the same pricing regime. Full risk-based pricing prices on borrowers’ unobserved risk types, so that it limits the room for lender price discrimination and reduces demand from higher-risk borrowers (in unobserved types). Under symmetric information combined with full risk-based pricing, welfare increases with the level of competition.

My findings highlight that pricing, market structure, and information asymmetry in the mortgage market can have important interactions with one another. They also shed some light on many reform scenarios that have been proposed, such as limiting the government’s subsidies, restricting the GSEs’ cross-subsidies, and shifting toward market risk-based pricing.

This study contributes to several strands of associated literature. It is closely related to existing empirical work that studies the impact of pricing regulation on efficiency and distributional consequence (Hurst et al., 2016; Bachas, 2017) and the welfare implication of sub-optimal pricing in a setting with selection (Einav et al., 2010; Bundorf et al., 2012; Handel et al., 2015). It is also related to numerical work that investigates the consequence of GSE subsidies (Jeske et al., 2013; Elenev et al., 2016).9

My analysis builds upon prior work that structurally estimates parameters on borrower repayment decisions to study policies in consumer credit markets (Bajari et al., 2008; Einav et al., 2012; Kawai et al., 2014) and other prior work that estimates the impact of market structure in financial markets (Hastings et al., 2013; Egan et al., 2017; Benetton, 2017).

This study is also related to papers that document incentive problems for lenders under mortgage securitization, including loan renegotiation (Piskorski et al., 2010; Agarwal et al., 2011), screening efforts (Keys et al., 2010), and a decline in loan quality (Keys et al., 2009; Agarwal et al., 2012; Krainer and Laderman, 2014).

This study adds to the literature on the interaction of horizontal market structure with vertical contracts. Theoretical work has shown that competition could distort the incentives of downstream firms in deposit markets with deposit insurance (Keeley, 1990; Hellmann et al., 2000; Allen and Gale, 2004) and in retail markets (Mathewson and Winter, 1984; Rey and Tirole, 1986; Winter, 1993). In the context of mortgage market, empirical knowledge is scant.

Lastly, this study is also related to a growing body of recent empirical work that examines how market structure in mortgage markets changes various market outcomes, including lender types and loan characteristics (Rosen, 2011), mortgage rates (Scharfstein and Sunderam, 2014), distributional consequences (Tewari, 2014), refinancing incentives (Agarwal et al., 2015a), housing prices and credit supply (Favara and Imbs, 2015), and contract features and

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9Both of them use simulation methods to quantify effects of GSE subsidies and find results similar to mine. I take an empirical approach and explore a wider set of questions, for example, the impact of price discrimination. Although my empirical approach allows me to construct a richer and more realistic demand model, it imposes more constraints on identification and computation. I do not incorporate endogenous house prices and allocation of capital as they do.
pricing strategies (Di Maggio et al., 2016; Agarwal et al., 2017b).

The remainder of this chapter is presented as follows. Section 1.1 provides an overview of the mortgage industry. Section 1.2 describes in detail the data sets used for the analysis. Section 1.3 describes my empirical model. Section 1.4 discusses the identification strategy and provides the reduced-form results that support my empirical setup. Section 1.5 presents my estimation procedure. Section 1.6 shows my parameter estimates and discusses model fit. Section 1.7 performs and discusses a series of counterfactual simulations. Section 1.8 discusses conclusions. Additional technical details and robustness checks are available in the appendices.

### 1.1 Industry Background

This section provides an overview of the mortgage market in the United States. The mortgage market is organized into two segments, a primary and secondary market. Most of the mortgage loans go through both primary and secondary markets and are funded by capital markets.

The primary mortgage market is where financial institutions provide mortgage loans to home buyers. Borrowers and lenders meet and negotiate lending terms to create a mortgage transaction. Lenders include mortgage brokers, mortgage bankers, and financial institutions such as commercial banks, credit unions, and savings and loan associations. The original cost of a loan includes the commission of a loan officer, expenses from loan processors, and the fees associated with an underwriter. Lenders make money on a mortgage through the origination fee, which is an upfront fee charged for processing a new loan application. The origination fee is quoted as a percentage of the total loan and is generally between 0.5 and 1 percent on mortgage loans. Lenders may also charge other fees, such as processing fees and application fees.

The secondary mortgage market trades mortgage loans and Mortgage Backed Securities (MBS). A mortgage usually comes with a very large loan balance; lenders cannot afford to keep every loan they provide without exhausting their funds. Most mortgages that originate in the primary mortgage market are sold to mortgage securitizers, such as pension funds, insurance companies, and the federal government, in the secondary mortgage market. In most cases, a lender receives MBS or cash in exchange for the loans. How much money a lender receives varies depending on the actual interest rate on the loan. A loan with a higher rate is worth more as it produces more cash flow. The sold mortgage ends up as a part of a package of the pools of mortgages that, so bundled, turn into securities and bonds sold to

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10A lender normally sells a mortgage with its service retained. This means that originating lender retains the services of the loan. Borrowers still make their monthly payment to that lender. The lenders accept the payment and make a servicing fee out of the payment (typically around 0.125 percent). The rest of the payment is passed along to the party that purchased the loan (e.g., Fannie Mae, Ginnie Mae, Freddie Mac, Farmer Mac, private securitization and commercial bank, savings bank, or savings association). The lender can also sell the loan service released. Lenders gain additional income by selling the service right.
investors in the capital market. This directly affects the amount and the cost of funds in the primary market. The secondary mortgage market is dominated by the government agency Ginnie Mae and the GSEs Fannie Mae and Freddie Mac.

1.1.1 Government-Sponsored Entities

Before the subprime mortgage crisis in 2008, the GSEs Fannie Mae and Freddie Mac guaranteed more than 50 percent of all U.S. mortgages. The GSEs have been regulated by the Federal Housing Finance Agency (FHFA). According to their financial statements, the total loans purchased per year are valued at approximately 588 billion dollars, on average, from 2000 to 2008.

These companies purchase conforming mortgages from lenders. Conforming mortgages are those that meet certain borrower quality characteristics, such as credit score, debt-to-income (DTI) ratio, and loan-to-value (LTV) ratio. The GSEs provide a guaranteed return on their MBS, which are backed with the principal and interest on the conforming mortgage loans that are packaged together in pools. The guarantee makes MBS a product with a safe return relative to some investment products, such as stocks.

GSE Mortgage Insurance Pricing

The GSEs charge a guarantee fee for providing a guarantee. The guarantee fee is meant to cover the projected credit losses from borrower defaults over the terms of the loans, administrative expenses, and a return on capital. The guarantee fee is an important determinant of the cost of mortgage credit for mortgage borrowers. A lender typically passes the cost of the guarantee fee to the borrower in the form of a higher interest rate on the mortgage.¹¹

Fannie Mae and Freddie Mac establish prices on base rate changes according to the required return for MBS that the GSEs’ investors demand. The guarantee fee pricing is based on a grid of specific risk attributes, including LTV ratio and credit score. The GSEs also provided a pricing discount to lenders that delivered a larger volume of loans.¹²

Many questioned whether the GSEs’ credit risk pricing models adequately assessed the costs and risks of loans. Federal Housing Finance Agency (2009) provides evidence that the GSEs underpriced the mortgage loans before the mortgage crisis and set higher prices for lower-risk loans to subsidize lower prices for higher credit risk loans. After the

¹¹A lender’s guarantee fee payment generally takes the form of ongoing monthly payments and may also include an upfront payment at the time of loan acquisition. Whether the GSEs charge guarantee fees to lenders as ongoing fees or upfront fees typically makes no difference to borrowers because they generally are included in the interest rate charged to the borrowers.

¹²In August 2012, the FHFA took action to remove this pricing disparity. They directed the GSEs to raise the guarantee fee more for lenders who exchange loans for MBS and offer lower fees to lenders that sell loans for cash. This helps reduce the pricing disparity between large and small volume lenders because smaller lenders tend to sell loans for cash.
crisis, the average guarantee fee was greatly increased as a surcharge for challenging market conditions.\textsuperscript{13}

Hurst et al. (2016) show that GSE pricing does not involve regional risk-based pricing, whereas the interest rates on loans from private securitizers are positively related to ex-ante regional default risk. The political constraint is a plausible explanation for the fact that the GSEs do not price on local economic risk.

1.1.2 Subprime Lending and Mortgage Crisis

Subprime mortgages refer to mortgage loans issued to those who have weak credit histories and those with a greater risk of loan default than prime borrowers. Subprime lending expanded dramatically in the early 2000s and reached its peak from 2004 to 2006. Around 1995, the GSEs that, until then, were relatively conservative and stayed away from buying subprime loans directly, were pressured to take on risk to be profitable. As the secondary market shifted from a duopoly to a competitive market, the market of prime borrowers became limited. To compete with private label securitizers, the GSEs encouraged lenders to loosen underwriting standards and allowed riskier mortgages to subprime borrowers. They also started to guarantee non-traditional products in response to the prevalence of these products in the primary market.

As home prices started to plummet after the collapse of the housing bubble beginning in 2007, many borrowers ended up owing more than their property was worth. Most of them chose to foreclose their houses. Research has shown that the subprime meltdown was the consequence of the decline in lending standards along with the increase in securitization of subprime mortgages (Dell’Ariccia et al., 2008; Mian and Sufi, 2009; Demyanyk and Van Hemert, 2009).

The GSEs were vulnerable during the mortgage crisis. Credit losses from their mortgage insurance activities had started rising up to roughly 7 billion dollars in 2007 and accelerated to about 44 billion dollars in 2008 according to their financial statements.\textsuperscript{14} By the fourth quarter of 2008, both GSEs had negative core capital positions, triggering an insolvency concern, and were put under a conservatorship by their regulator, the FHFA. According to the U.S. Securities and Exchange Commission, Fannie Mae drew 116.1 billion dollars and Freddie Mac drew 71.3 billion dollars from the U.S. Treasury in conservatorship to cover

\textsuperscript{13}The guarantee fee adjustments are often rigid and bureaucratic. According to the FHFA’s report to Congress on guarantee fees in 2016, Fannie Mae and Freddie Mac have made six changes to the single-family guarantee fees with the guidance of their regulator in the past 10 years.

\textsuperscript{14}For example, Fannie Mae’s 10K filing in 2007 reported that “[w]e are experiencing high serious delinquency rates and credit losses across our conventional single-family mortgage credit book of business, especially for loans to borrowers with low credit scores and loans with high loan-to-value ratios. In addition, in 2007 we experienced particularly rapid increases in serious delinquency rates and credit losses in some higher risk loan categories, such as alt-A loans, adjustable rate loans, interest only loans, negative amortization loans, loans made for the purchase of condominiums, and loans with second liens. Many of these higher risk loans were originated in 2006 and the first half of 2007.”
their foreclosures and credit losses.

**Anti Predatory Lending Laws**

Predatory lending practices\(^\text{15}\) were one of the factors contributing to the high mortgage default rates among subprime mortgages (Agarwal et al., 2014). As predatory lending grew in 1994, Congress enacted the Home Ownership and Equity Protection Act (HOEPA), which restricted the lending terms and practices for mortgages with either very high APR or restricted terms on total points and fees. HOEPA regulated only around 1 percent of subprime mortgages (Bostic et al., 2008). States also enacted stronger legislation to deal with the problem of predatory lending. North Carolina was the first state to pass an anti-predatory lending law (APL) in 1999, followed by 20 other states. Table F.1 shows the states with anti-predatory lending laws and the laws’ dates of implementation.

APLs are designed to protect consumers by restricting the origination of loans with predatory features, therefore they focus on the practices and loan terms rather than interest rates. APLs in most states prohibit the following activities in mortgage markets, though prohibited activity is not limited to the following.

First, they set minimum credit criteria that a borrower must meet for the credit to be considered. Second, they restrict pricing structure and the terms of credit, including repayment schedules, amortization, balance, payments due, minimum payments, and term to maturity. They also limit the use of balloon payments and prepayment penalties, which are used to make a loan more affordable by lowering monthly payments. Third, they establish maximum aggregate loan amounts that may be lent with the security of real estate. Fourth, they require licensing, registration, filings, and reports from mortgage lenders to local authorities. Lenders are also required to provide mandated statements and disclose certain information in the credit application forms. Lastly, they prohibit certain advertising activity to prevent lenders aggressively soliciting to vulnerable borrowers, for example, failing to explain the terms of the loan and dissuading the borrower from other lower cost options.\(^\text{16}\) It is costly for lenders to comply with all state and local lending laws.

Empirical work has shown that anti predatory laws significantly affected the credit supply in the mortgage market. Pennington-Cross and Ho (2008) show that the APLs increased the cost of credit. The loans originating in states with APLs had higher interest rates for fixed-rate loans than in unregulated states. White et al. (2011) find that state APLs were

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\(^{15}\)Predatory lending practices have been prevalent in the subprime loan markets. According to the Federal Deposit Insurance Corporation (FDIC), illegal predatory lending typically involves (i) imposing unfair and abusive loan terms on borrowers, often through aggressive sales tactics, (ii) taking advantage of a borrower’s lack of understanding of complicated transactions, and (iii) outright deception. In other words, predatory lending generally refers to lending practices in which lenders take advantage of borrowers’ lack of understanding. Most predatory lending targets less sophisticated borrowers, usually those with a lower income and credit score.

\(^{16}\)See Ho and Pennington-Cross (2005) for a comprehensive summary of various local predatory lending laws.
associated with a reduction in default probability from riskier borrowers. Agarwal et al. (2014) provide evidence that restrictions from APLs significantly reduced the number of loans that were originated.

**OCC Preemption**

In January 2004, the Office of the Comptroller of the Currency, a division of the Treasury Department, issued federal regulations that preempted the ability of state attorneys general to enforce state APLs against the lenders they supervise\(^\text{17}\) (i.e., national banks and their operating subsidiaries).\(^\text{18}\) Specifically, the OCC waived state APLs and enforcement of loan terms (e.g., LTV requirements and provisions for prepayment penalties) for national banks and their operating subsidiaries. This means that in states with APLs, two different regulatory regimes were operative in the same markets during the 2004 – 08 period covered in this study. National banks became substantially less constrained by APLs in the states outlined in Table F.1.

Recent empirical evidence suggests that the preemption rule had an important impact on the mortgage market. Di Maggio et al. (2016) find that national banks significantly increased origination of loans with prepayment penalties with the preemption. Facing more competition, local lenders increased the origination of riskier loans that were not regulated by the state predatory-lending laws. Di Maggio and Kermani (2017) show that OCC preemption resulted in an 18 percent increase in annual loan issuance in states with local APLs. The effects on credit expansion are stronger in counties with a higher fraction of national banks.

I follow this literature and exploit the OCC preemption in 2004 as an exogenous shock to the credit supply.\(^\text{19}\) The APLs have no direct effect on lending in the conventional loan market. However, I find empirical evidence of an indirect credit expansion effect in the GSE market.\(^\text{20}\) A possible explanation is that the subprime market expansion led to a lower fixed operating cost for lenders. Credit supply for GSE loans was indirectly affected by the

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\(^\text{17}\)Mortgage lenders are supervised by different government agencies. National banks and Federal thrift institutions are regulated by the OCC or the Office of Thrift Supervision (OTS). State banks and state-chartered thrift institutions are supervised by either the Federal Reserve System, the Federal Deposit Insurance Corporation (FDIC), or by their chartering state. Credit unions are supervised by the National Credit Union Administration (NCUA), while nondepository mortgage companies are regulated by the Department of Housing and Urban Development (HUD) and the Federal Trade Commission (FTC).


\(^\text{19}\)Many papers have explored the exogenous sources of variation in credit supply from financial deregulation. A widely used source, for example, is the Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994 (Jayaratne and Strahan, 1996; Rice and Strahan, 2010; Tewari, 2014; Favara and Imbs, 2015; Agarwal et al., 2017b). Other papers have used bank mergers (Scharfstein and Sunderam, 2014; Nguyen, 2014) and partial deregulation on state anti-predatory laws (Di Maggio et al., 2016; Di Maggio and Kermani, 2017).

\(^\text{20}\)White et al. (2011) mention that “[p]reemption may have had subtle effects as well, such as pushing the market toward looser underwriting standards overall. The 2004 OCC preemption may have been seen by many lenders as a tacit endorsement of loosened underwriting guidelines and regulations.”
preemption because of the lower (fixed) cost of credit.

1.2 Data

The data used in this analysis come from three sources. The first is a loan-level credit performance data set from Fannie Mae and Freddie Mac. The second is the loan application data required by the Home Mortgage Disclosure Act (HMDA) of 1975. The third is the housing price index which measures price movement of single-family houses. I discuss each aspect of the data used in this analysis below.

1.2.1 Loan Performance Data

To support the risk sharing and transparency encouraged by the FHFA, Fannie Mae and Freddie Mac made available a portion of single-family fixed-rate mortgages that they purchased or guaranteed from 2000 – 2017. The data consist of two parts: acquisitions and performance files.

The acquisitions file provides characteristics of loans that are acquired by Fannie Mae and Freddie Mac at the loan origination level. Loan characteristics include credit score, DTI ratio, LTV ratio, name of lending institution, unpaid principal balance, property zip code, loan purpose (e.g., home purchase, no cash-out refinance, cash-out refinance), occupancy status (e.g., primary homeowner, second homeowner, investor), and property type (e.g., single-family, condo, co-op, manufactured housing, planned unit development).

The performance file provides monthly credit performance and actual loss information. Credit performance information includes monthly loan balance, delinquency status (up to the earliest of the following termination events: prepaid or matured/voluntary payoff), foreclosure alternative group (short sale, third party sale, charge off, or note sale), and repurchase prior to property disposition. The credit loss associated with a terminated loan can be calculated using the actual loss information disclosed.

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21 The following types of mortgages in their portfolio were excluded from the data: adjustable rate mortgages (ARMs), initial interest mortgages, balloon mortgages, government-insured mortgages, Home Possible/Home Possible Neighborhood Solution mortgages, along with other affordable mortgages (including lender branded affordable loan products), and the mortgages delivered under alternate agreements.

22 DTI and LTV are the common measures for the GSEs to determine the risk of a loan. DTI is the ratio between the amount of recurring debt and a borrower’s gross income. LTV is the ratio between the amount of money borrowed and the value of the property.

23 A home purchase loan is any loan secured by or made to purchase a dwelling. Refinancing is any property-secured loan that replaces and satisfies another property-secured loan to the same borrower.
1.2.2 HMDA Data

Loan performance data contain only a portion of the loans that originated in the primary market. To supplement the loan performance data, I use HMDA data collected by the Federal Financial Institutions Examination Council (FFIEC) to construct a measure of market structure. HMDA data is released on an annual basis. The data contain the information on every application that was made since 1990 in the U.S., including loan characteristics, applicant demographic (e.g., income, geographic area, ethnicity, race, and sex), lender identifier, supervisory/regulatory agency, the reporting institution, whether the loan application was granted and sold, and the types of purchaser if the loan was sold. The HMDA provides links to lender identifiers consistently starting in 2010.

1.2.3 Housing Price Index

I collect the housing price index (HPI) from the Federal Housing Finance Agency. The HPI measures average price changes in repeat sales or refinancing on the same properties. This information is obtained by reviewing repeat mortgage transactions on single-family properties whose mortgages were purchased or securitized by Fannie Mae and Freddie Mac. The HPI serves as a timely, accurate indicator of house price trends at various geographic levels.

1.2.4 Descriptive Statistics

The sample period for this analysis is from 2000 – 2008. I link these mortgages with performance data using a loan identifier that allows me to track the post origination performance of these loans for at least 10 years. I only consider fixed-rate mortgage loans with 30-year maturity in the structural estimation to simplify the borrower’s maturity choice. To be consistent with the structural estimation, I use the same sample in estimating reduced form evidence. However, the reduced-form results do not change qualitatively or quantitatively in a meaningful way when using all the fixed-rate loans in the data with different maturities.

I present the loan-level statistics of my sample in Table 1.1. My final sample covers approximately 22.73 million loans. The average contractual interest rate of a loan is 6.42 percent. The credit score is reported using the Equifax score, which ranges from 300 to 850.

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24 The agency code along with the lender identifier is a unique combination that represents a specific institution. I am not able to link specific institutions loan performance data to HMDA because the identifiers are not consistent before 2010.

25 I performed my reduced-form analysis using different time periods, for example, from 2000 – 2011. The results are not qualitatively or quantitatively different in a meaningful way.

26 A 30-year fixed-rate mortgage is the most common form in the data, accounting for around 70 percent of the loans.
850. 95.57 percent of the loans cover prime borrowers.\textsuperscript{27} Income states the monthly income of the primary borrower. The DTI and LTV ratios are 34.96 percent and 73.27 percent on average.\textsuperscript{28} Refinancing loans account for 69.91 percent of loans, while 40.84 percent are cash-out refinance, and 29.08 percent are no cash-out refinance. 91.07 percent of borrowers are principal homeowners. Most property is planned unit development (78.82 percent) or manufactured housing (12.36 percent). I assign a loan as a defaulted loan if the GSEs incurred any loss after the loan is terminated. The default rate is 3.60 percent on average.

Table 1.1: Loan-Level Descriptive Statistics

<table>
<thead>
<tr>
<th></th>
<th>Mean</th>
<th>Standard Deviation</th>
<th>Minimum</th>
<th>Maximum</th>
</tr>
</thead>
<tbody>
<tr>
<td>Interest Rate (%)</td>
<td>6.418</td>
<td>0.773</td>
<td>2.99</td>
<td>12.63</td>
</tr>
<tr>
<td>Credit Score (Equifax)</td>
<td>721.554</td>
<td>56.002</td>
<td>300</td>
<td>850</td>
</tr>
<tr>
<td>Income ($)</td>
<td>3,472.799</td>
<td>2,861.42</td>
<td>56.382</td>
<td>316,034</td>
</tr>
<tr>
<td>Property Value ($)</td>
<td>245,608.816</td>
<td>158,952.993</td>
<td>6,666.667</td>
<td>54,900,000</td>
</tr>
<tr>
<td>Down Payment ($)</td>
<td>77,076.587</td>
<td>109,990.926</td>
<td>0</td>
<td>54,351,000</td>
</tr>
<tr>
<td>Insurance Percentage (%)</td>
<td>4.798</td>
<td>10.089</td>
<td>0</td>
<td>55</td>
</tr>
<tr>
<td>DTI (%)</td>
<td>34.961</td>
<td>12.342</td>
<td>1</td>
<td>65</td>
</tr>
<tr>
<td>LTV (%)</td>
<td>73.269</td>
<td>15.78</td>
<td>1</td>
<td>100</td>
</tr>
<tr>
<td>Default Rate</td>
<td>0.036</td>
<td>0.186</td>
<td>0</td>
<td>1</td>
</tr>
<tr>
<td>Loan Purpose - Purchase</td>
<td>0.301</td>
<td>0.459</td>
<td>0</td>
<td>1</td>
</tr>
<tr>
<td>Loan Purpose - Cash-Put Refinance</td>
<td>0.408</td>
<td>0.492</td>
<td>0</td>
<td>1</td>
</tr>
<tr>
<td>Loan Purpose - No Cash-Put Refinance</td>
<td>0.291</td>
<td>0.454</td>
<td>0</td>
<td>1</td>
</tr>
<tr>
<td>Property Type - Single-Family</td>
<td>0.078</td>
<td>0.267</td>
<td>0</td>
<td>1</td>
</tr>
<tr>
<td>Property Type - Condo</td>
<td>0.003</td>
<td>0.057</td>
<td>0</td>
<td>1</td>
</tr>
<tr>
<td>Property Type - Co-Op</td>
<td>0.007</td>
<td>0.085</td>
<td>0</td>
<td>1</td>
</tr>
<tr>
<td>Property Type - Manufactured Housing</td>
<td>0.124</td>
<td>0.329</td>
<td>0</td>
<td>1</td>
</tr>
<tr>
<td>Property Type - Planned Unit Development</td>
<td>0.788</td>
<td>0.409</td>
<td>0</td>
<td>1</td>
</tr>
<tr>
<td>Occupancy Status - Principal</td>
<td>0.905</td>
<td>0.293</td>
<td>0</td>
<td>1</td>
</tr>
<tr>
<td>Occupancy Status - Second</td>
<td>0.039</td>
<td>0.193</td>
<td>0</td>
<td>1</td>
</tr>
<tr>
<td>Occupancy Status - Investor</td>
<td>0.056</td>
<td>0.23</td>
<td>0</td>
<td>1</td>
</tr>
</tbody>
</table>

# of Observations | 22,726,545

**Note:** Table 1.1 presents a summary of loan characteristic statistics for key variables in the sample during the 2000 – 08 period.

\textsuperscript{27}Equifax scores above 720 are generally considered to be prime borrowers or super-prime borrowers. Equifax scores below 620 are generally considered to be subprime borrowers.

\textsuperscript{28}43 percent DTI and 80 percent LTV are used in the industry as an important threshold for first-lien mortgages. Above the threshold, the pricing and availability of loans change very significantly. Having less than 36 percent DTI and 75 percent LTV presents a lower risk to lenders.
I calculate the market share at 3-digit zip code level using HMDA data. I report the statistics of the market-level measure in Table 1.2. Each market has 55.31 lenders on average. National banks are usually larger lenders; they account for 22.36 percent of the number of lenders but account for 39 percent of market share on average. I also report the Herfindahl-Hirschman Index (HHI), which I calculate by squaring the market share of each lender competing in a market. The mortgage market is moderately competitive during my sample period, as the HHI is 0.16 points on average.

Table 1.2: Market-Level Descriptive Statistics

<table>
<thead>
<tr>
<th></th>
<th>Mean</th>
<th>Standard Deviation</th>
<th>Minimum</th>
<th>Maximum</th>
</tr>
</thead>
<tbody>
<tr>
<td>Share of National Banks – GSE Loans</td>
<td>0.386</td>
<td>0.159</td>
<td>0.000</td>
<td>0.899</td>
</tr>
<tr>
<td>Share of National Banks – All Loans</td>
<td>0.311</td>
<td>0.116</td>
<td>0.000</td>
<td>0.833</td>
</tr>
<tr>
<td># of Lenders</td>
<td>55.306</td>
<td>36.114</td>
<td>1.000</td>
<td>256.000</td>
</tr>
<tr>
<td># of OCC Lenders</td>
<td>12.373</td>
<td>6.703</td>
<td>0.000</td>
<td>54.000</td>
</tr>
<tr>
<td>HHI</td>
<td>0.164</td>
<td>0.180</td>
<td>0.033</td>
<td>1.000</td>
</tr>
<tr>
<td># of Observations</td>
<td></td>
<td></td>
<td></td>
<td>7,426</td>
</tr>
</tbody>
</table>

Note: Table 1.2 shows descriptive statistics of market level competition measures. The statistics are calculated using all market-year observations during the 2000 – 08 period.

1.3 Model

My model starts with loan origination. A borrower $i$ enters with a property valued $v_{i0}$. Given the interest rate offered, a borrower first chooses whether or not to purchase a fixed-rate mortgage with a 30-year maturity. If she decides to purchase, the borrower then chooses a down payment size $D_i$ and borrows a loan size equal to $v_{i0} - D_i$. The borrower then repays the loan every period or chooses to default on the loan.

A lender $j$ offers an interest rate $r_j$ in view of the loan characteristic $\mathbf{x}$, such as the borrower’s income, credit score, down payment, property value, and loan type. The interest rate is chosen based on the parameters of the demand system, competition from other lenders, and marginal cost. Marginal cost captures the guarantee fees charged by the GSEs. I begin my discussion of the borrower’s decisions in reverse order.

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29 I only consider the loans that were approved and originated when I calculate the market share.

30 Agencies generally consider markets in which the HHI is between 0.15 and 0.25 to be moderately concentrated and consider markets in which the HHI is excess of 0.25 to be highly concentrated.
1.3.1 Mortgage Borrowers

Without mortgage repayment, in a given period \( t \), the borrower \( i \)'s baseline period utility is given by the following CRRA utility function

\[
    u_i(x, t) = \frac{I_{it}^{(1-\gamma_i)}}{1-\gamma_i} - 1.
\]

The expression is the indirect utility function, which gives the utility level a borrower can achieve by spending the income \( I \) on the consumption goods, including housing rental. Since I do not observe an individual’s saving and wealth, I simplify the model by assuming that borrowers do not save. The parameter \( \gamma \) measures the degree of relative risk aversion that reflects the intertemporal substitution factor in consumption.\(^{31}\) I provide more discussion on this assumption in Section 1.3.4.

Utility: Repaying a Mortgage

Suppose a borrower \( i \) took a loan of size \( v_{i0} - D_i(x, p_{ij}) \) with maturity \( T \) months; she consumes her monthly income \( I \) minus the required mortgage repayment \( m \) every period. Additionally, the borrower derives utility from owning a house each period. This value from home ownership can be interpreted as a monetary gain from leasing the house. When a borrower chooses to live in the house (i.e., leases the house to herself), the monetary gain can be seen as saving rental costs.

The borrower \( i \)'s period utility when the loan was originated for \( t \) period is given by

\[
    u_i(x, p_{ij}, t) + \epsilon_{it} = (I_{it} - m(x, p_{ij}, t) + \lambda_i v_{it})^{(1-\gamma_i)} - 1 + \epsilon_{it},
\]

where \( \epsilon \) is a period-specific unobserved component in the utility function. \( \lambda \) is an individual-specific parameter that captures the unobserved heterogeneity in the utility derived from home ownership relative to the consumption. \( v_{it} \) is the 0.1% of housing prices at period \( t \).

The \( \lambda \) here measures the heterogeneity in housing preference (i.e., some people value home ownership more than others) and may control a few more things. For example, borrowers can lease the house and may have different leasing costs (i.e., maintenance expenses, hassle costs, and tax rates). Borrowers can have heterogeneous (expected) returns on other investment options such as buying stocks and bonds, so they may have different opportunity costs of housing. The same property may be valued differently for borrowers due to these explicit and implicit costs.\(^{32}\)

\(^{31}\)Estimating a model with saving may require assumptions on initial wealth and saving returns. It adds a continuous and unobserved state variable and increases computational complexity substantially.

\(^{32}\)In Campbell and Cocco (2015), borrower preferences are separable in consumption and housing preference weighted by housing preference. The housing preference in their paper reflects the relative importance of terminal wealth from the housing (a function of housing prices) and other financial sources.
\( m \) is the monthly required payment. If offered interest rate \( p_{ij} \) from lender \( j \), a borrower is required to make the monthly required payment corresponding to her choice of down payment \( D_i \) in each period \( t \):

\[
m(x, p_{ij}, t) = \begin{cases} 
\left( \frac{f^{-1}(p_{ij})}{1-(1+f^{-1}(p_{ij}))} \right) \times (v_{i0} - D_i(x, p_{ij})) & , \text{if } t \leq T, \\
0 & , \text{otherwise.}
\end{cases}
\]

For simplicity of expression, the interest rate \( p \) is defined as the summation of future repayment for each dollar of the loan balance. The relationship between \( p \) and the contractual interest rate \( r \) follows:

\[
p_i = f(r) = \sum_{t=1}^{T} r \frac{1}{1 + r}.
\]

**Utility: Defaulting on a Mortgage**

If a borrower defaults, she loses the mortgage collateral (i.e., home ownership). The borrower is exempted from the future payments, but she no longer receives the utility gain from home ownership. In this case, the borrower gets the baseline utility each period in Equation 1.3.1. The post-default value function is written as:

\[
U_i(x, t) = \sum_{k=1}^{T-t} \beta^k u_i(x, t) - C = \sum_{k=1}^{T-t} \beta^k \frac{1}{1 - \gamma_i} - 1 - C,
\]

where \( \beta \) is the discount factor for each period, and \( C \) is the explicit cost of defaulting such as a damage in credit score and future credit access.

**Repayment Decision**

A borrower makes a sequence of repayment decisions to maximize her intertemporal utility. In period \( t \), it is optimal for a borrower to repay as long as:

\[
d_i(x, p_{ij}, t, \epsilon_{it}) = \begin{cases} 
0 & , \text{if } \epsilon_{it} \geq U_i(x, t) - u_i(x, p_{ij}, t) - \beta V_i(x, p_{ij}, t), \\
1 & , \text{otherwise.}
\end{cases}
\]

Default choice at period \( t \) is equal to 0 if the borrower repays the loan; otherwise, it is equal to 1. \( V \) is the borrower’s value function, which is written as:

\[
V_i(x, p_{ij}, t) = \max \left\{ u_i(x, p_{ij}, t) + \beta \mathbb{E}_{\{v, \epsilon\}} [V_i(x, p_{ij}, t + 1) + \epsilon_{it}] , U_i(x, t) \right\}.
\]

The operator \( \mathbb{E} \) is the expectation taken over future property value and repayment shocks. I assume the borrower’s belief in future property value follows a random walk with drift, such that

\[
\Delta v_t = v_t - v_{t-1} = g + \epsilon_t \\
\epsilon_t \sim N(0, \sigma_v^2).
\]

(1.2)
My model captures the major factors indicated to influence a borrower’s repayment decisions, including borrower heterogeneity (Deng et al., 2000), changes in property values (Bajari et al., 2008), and loan size (Adams et al., 2009). Borrowers’ optimal repayment decisions in my model depend on the following factors.

First, the model decisions must capture the importance of several vital loan characteristics used in the industry, such as income relative to monthly debt obligations and loan size relative to collateral value. Suppose a borrower’s income is close to the mortgage payment or the loan’s size is close to the property value; my model predicts the borrower will have a higher probability to default. Second, a borrower’s repayment decision is modeled as a dynamic programming problem. When the loan balance is nearly paid off, the borrower’s continuation value of repaying the loan is high and therefore likelihood of defaulting is low. This is consistent with what I observe in the data that the default probability decreases over time. Lastly, the default decision depends on changes in property value. A borrower is likely to foreclose on her house when the value of the property falls.

**Down Payment Decision**

When a borrower purchases a mortgage, the borrower chooses an optimal down payment \( D \) at loan origination. The optimal down payment is chosen to equalize the marginal utility of increased consumption at period zero and the marginal disutility of reduced consumption in the future due to larger repayments. The down payment is chosen by a borrower to satisfy the following optimization problem,

\[
\max_{D_i} V_i(x, p_{ij}, 0) - \delta_i D_i(x, p_{ij}),
\]

subject to \( D_i > D(v_{ij}) \). \( D \) is the minimum down payment required, which usually is 3 – 5 percent of property value. The associated first-order condition gives:

\[
\sum_{t=1}^{T} \beta^{t-1} \mathbb{E}(v_{ij}) \left[ d(x, p_{ij}, t, \epsilon) \times \left[ \frac{\partial p_{ij} C_i(x, p_{ij}, t) (1-\gamma_i)}{\partial D_i} \right] + p_{ij} C_i(x, p_{ij}, t)^{-\gamma_i} \right] - \delta_i = 0. \quad (1.3)
\]

The down payment cost is modeled separately as a disutility source from reducing consumption. This is because the down payment is usually very large and comes from other sources such as saving rather than non-durable consumption. I simplify the saving process explicitly; \( \delta \) captures the effect of paying \( D \) down payment up front relative to consumption in a reduced-form way. The optimal down payment choice can be written as a function of observable and price, \( D_{ij}^* = D_i(x, p_{ij}) \).

Equation 1.3 describes the trade-off between current and future consumption. A borrower who values current consumption at a greater value relative to future consumption (e.g., high \( \gamma \) or low \( \delta \)) chooses a lower down payment.
Purchase Decision

At loan origination, given a down payment size \( D \) and optimal repayment decisions \( d \), a borrower \( i \)'s expected utility of purchasing a mortgage from lender \( j \) is

\[
U_{ij}(x) + \varepsilon_{ij} = \alpha_j + V_i(x, p_{ij}, 0) - \delta_i D_i(x, p_{ij}) + \varepsilon_{ij},
\]

where \( \alpha \) is the lender-specific preference. \( \alpha_j \) is interpreted as the incremental utility that a borrower is willing to pay in order to choose a preferred lender. \( \delta \) measures the cost of paying a down payment upfront. \( \varepsilon \) is the lender-purchase-specific unobserved component of utility for borrowers. The unobserved component is known to each borrower but not to lenders and researchers.

One could think of mortgage products as being nearly identical across lenders, but lenders are differentiated by agent, customer service, payment system, and brand loyalty. The lender-specific preference can rationalize a borrower’s decision to purchase a mortgage with higher interest rates due to brand preference.

The borrower would choose to purchase from lender \( j \) who provides her with the highest utility

\[
j_i^* = \max_j U_{ij}(x, 0) + \varepsilon_{ij}.
\]

If a borrower decides not to purchase a mortgage, I assume that she receives the same utility as the post-default value function. That is, a borrower would purchase the mortgage by comparing the utility of purchasing or not,

\[
\max_j U_{ij}(x) + \varepsilon_{ij} \geq U_i(x, 0) + \varepsilon_{i0}.
\]

Selection on Unobserved Heterogeneity

Recall that \( \lambda \) is an individual-specific parameter that captures the unobserved heterogeneity in housing preference (risk types). Modeling unobserved heterogeneity is important for allowing potential advantageous selection in this market.

Conditional observed characteristics \( x \), borrowers differ in parameter \( \lambda \) and error terms on repayment shocks and lender preference. The probability that borrower \( i \) will purchase the mortgage is

\[
\varphi(x, p_{ij}, \lambda_i) = \int \Pr \left( \max_j U_{ij}(x) + \varepsilon_{ij} \geq U_i(x, 0) + \varepsilon_{i0} \right) f(\varepsilon) d\varepsilon;
\]

The likelihood of default for borrower with observed characteristics \( x \) (integrated over
the unobserved heterogeneity) is therefore

\[ d(x, p_{ij}, t) = \int d(x, t, p_{ij}, \lambda_i) \frac{\varphi(x, p_{ij}, \lambda_i)f(\lambda_i)}{\int \varphi(x, p_{ij}, \lambda_i)f(\lambda_i)d\lambda_i} f(\lambda_i)d\lambda_i. \]

Supposing there is an exogenous decrease in interest rates, my model predicts that marginal borrowers (with lower \( \lambda \)) purchase the mortgages. The marginal borrowers tend to have higher default risks related to their lower housing preference. Therefore, the average default rate increases, with this increase depending on the degree of unobserved heterogeneity in \( \lambda \). This extensive margin selection is critical in understanding the economic impacts of pricing and market expansion.

1.3.2 Mortgage Lenders

In the model, lenders are assumed to engage in Bertrand competition with differentiated products, meaning that they compete on price with horizontal product differentiation. I assume that loans are securitized through the GSEs. For a given loan, a lender prices an interest rate at origination to maximize the expected profit. Given the demand system discussed previously, lender \( j \)'s profit for a loan is given by

\[ \pi_j(p; x) = s_j(p; x)(p - c_j(x)) \times (v_{i0} - D_i(x, p)), \]

where \( s \) is the market-share function, i.e., the probability that borrower \( i \) would purchase. I assume that the lender has knowledge of the distribution of \( \lambda \) and \( \epsilon \), but they do not observe the \( \lambda_i \) and \( \epsilon_i \) for each individual. Conditional on the same loan characteristics \( x \), each loan generates the same expected profit for a given lender. \( c \) denotes the marginal cost, coming from the guarantee fee paid to the GSEs when a lender sells the mortgage. The pricing on guarantee fees is what the GSEs have relied on to interpret differences in predicted risk across loans.

---

33Optimal repayment policy also depends on repayment shocks. For simplicity of expression, I integrate the policy function over the shocks in the following equation: 

\[ d(x, t, p_{ij}, \lambda_i) = \int d(x, t, p_{ij}, \lambda_i, \epsilon_i)f(\epsilon)d\epsilon. \]

34I assume no private market for lenders. That is, lenders do not have the choice of whether to securitize a loan or to which securitizers to sell.

35For simplicity, I assume that agreements between lenders and the GSEs are represented in a simple fee in ongoing monthly payments until the life of a loan expires. In reality, guarantee fee payments generally take the form of an ongoing monthly payment and an upfront payment. The upfront fee is a one-time payment made by lenders when a loan is acquired.
Interest Rate Pricing

Lender $j$ offers price $p$ that maximizes the expected profit at loan origination. Specifically, the lender solves the following first-order condition with respect to price:

$$\frac{\partial \pi_j(p; x)}{\partial p} = s_j(x, p) \times \left( v_{i0} - D_i(x, p) - (p - c_j(x)) \frac{\partial D_i(x, p)}{\partial p} \right) + \frac{\partial s_j(x, p)}{\partial p} (p - c_j(x)) \times (v_{i0} - D_i(x, p)) = 0. \tag{1.4}$$

This condition reveals a lender’s trade-off when choosing a higher price. A higher interest rate has a direct impact on profit by increasing the value of the loan. On the other hand, a higher interest rate results in a lower expected market share, as lenders are competing against prices. Solving Equation 1.4 yields

$$p_j(x) = c_j(x) + \Delta_j(x),$$

$$\Delta_j(x) = \left( \frac{s_j(x, p)}{v_{i0} - D_i(x, p)} \frac{\partial D_i(x, p)}{\partial p} - \frac{\partial s_j(x, p)}{\partial p} \right)^{-1} s_j(x, p), \tag{1.5}$$

where $\Delta$ denotes lender markup, which represents a fixed charge over the marginal cost for a lender with market power. The optimal interest rate in Equation 1.5 is written as additively separable in marginal cost $c$ and markup $\Delta$.

1.3.3 GSEs

To complete my model, I define a profit function of the GSEs in the secondary mortgage markets. When a lender $j$ sells a loan with characteristics $x$ to the GSEs, the GSEs’ expected profit from purchasing the loan is given by

$$\Pi_j(x, p_{ij}) = (c_j(x) - mc - UST10Y_t) \times (v_{i0} - D_i(x, p_{ij})) - L(x, p_{ij}), \tag{1.6}$$

where $c_j(x)$ denotes the lender marginal cost. The marginal cost largely depends on the guarantee fee paid to the GSEs. $mc$ is the time-invariant funding cost, which is the cost for the GSEs to fund each dollar of mortgage in the primary market. $UST10Y$ is the U.S. Treasury 10-year rate. $L(x, p)$ is the expected default cost of the loan given by

$$L(x, p_{ij}) = \sum_{t=1}^{T} \mathbb{E}[d(x, p_{ij}, t, \epsilon)] \times [p_{ij}(v_{i0} - D_i(x, p_{ij})) - tm_i(x, p_{ij}, t) - H(v_{it})],$$

36 The 10-year Treasury rate is a debt obligation issued by the United States government with a maturity of 10 years. This is viewed as an approximate solution for funding costs for the GSEs. Another measure is MBS yield, which is the required return for MBS that GSEs’ investors demand. Both measures do not change results in a meaningful way. I choose the 10-year Treasury rate as the primary specification because the interest rates offered in many cases are below MBS yield, but not below the 10-year Treasury rate.
where $H(.)$ is the net proceeds from foreclosing a property in a defaulted mortgage. The expenses and credits associated with foreclosure include the cash received from the sale of the property, incomes, and costs associated with holding the property post-foreclosure (e.g., rental income and title insurance costs), selling expenses (e.g., fees and commissions), and foreclosure costs (e.g., fees associated with bankruptcy and foreclosure).

I consider a perfect competitive capital market for investors. The capital market has many sellers of investment products not limited to an MBS. The GSEs can only act as price-takers and earns an economic profit of zero (or less). All the profit goes to investors in the capital markets. This assumption has no meaningful implication on market efficiency because the funding cost is a transfer from the institution to investors. Because the GSEs receive government subsidies, the GSE market sector can withstand even when the GSEs earn negative economic profits.

### 1.3.4 Discussion

I discuss here some important assumptions in the model that simplify a complex reality.

First, I assume that choice of the maturity is exogenous. I only consider the mortgage loans given 30-year maturity in my model. One major difficulty in modeling maturity choice is that it typically requires a fixed loan size because a borrower can choose a shorter maturity or higher down payment in exchange for a lower interest rate. To avoid adding another complication to the model, I endogenize down payment instead of maturity choice. I do this because down payment determining LTV is an important element in this market. Loans come with a 15-year amortization schedule that requires monthly repayments twice as large as those for loans with 30-year schedules (excluding the mortgage interest of approximately an additional 1,000-dollar monthly payment on average). It is reasonable to suppose that borrowers who chose a 30-year maturity would not take a 15-year maturity.

Second, I take the choice of housing as given. It is possible that housing choice is not exogenous in reality. A lower interest rate may cause a borrower to purchase a more expensive property. It is also possible that a lower interest rate causes borrowers to choose a lower down payment (i.e., the higher borrowing amount) due to less expensive future consumption. Because the two choices both determine the borrowing amount, allowing endogenous property value is the observational equivalent to allowing endogenous down payment. Without having information on prices and properties borrowers were considering, including endogenous property choices would require adding even more assumptions and structures to the model.

---

37 Similarly, I assume no wedge between lender cost and GSE guarantee income. The wedge is also a transfer and does not create welfare provision. In reality, some of these costs are administrative and may not go entirely to the GSEs.

38 15-year maturity is the second most common type of loan, reasonably accounting for 21 percent of the sample. 10-year and 20-year maturities are also common, accounting for 3 percent and 4 percent of the data respectively.
Third, saving is not taken into account in the model. This is because individual income trends and savings are not observed in the data. The life-cycle model of mortgage default, as in Campbell and Cocco (2015), requires additional assumptions and simplifications on unobserved initial wealth, tax rate, and saving returns. Instead, I use a flexible parameter \( \lambda \) to embed these unobserved factors in borrowers’ default decisions. In the demand system, the main outcome of interest is the default risk of each loan. The predicted default risk as a function of observed characteristics is like a non-linear prediction. The prediction is not sensitive to the choice of allowing saving. Accordingly, the predicted market outcomes under different pricing regimes may not change much in a more sophisticated saving model, except for the measure of borrower surplus. If most borrowers have income growth through saving, my estimates for \( \lambda \) parameter could be biased upwards. This means that I estimate a lower bound of deadweight loss resulting from mortgage overprovision. The deadweight loss from GSE pricing and its interactions could be even larger if saving is taken into consideration.

In addition, I conduct a robustness check to account for the potential bias estimates in the absence of individual-specific income trends. I show that the main takeaways from the counterfactual exercises remain robust. The quantitative changes in the welfare results are discussed in Appendix A.

Lastly, borrowers in my model do not have the option to prepay or refinance the loans. Although these are important elements to study in the mortgage markets, the focus of this study is on borrowers’ default and foreclosure, which bring direct loss to the GSEs. Prepayment and refinancing options could be related to a borrower’s choice in terms of their purchase and default decisions, but the effects are indirect. Since I do not observe the refinancing loans or the reasons for prepayment when a loan is terminated, I abstract from these options of borrowers to simplify the model.

### 1.4 Identification

The primary identification concerns of this model are (i) to separate the housing preference, \( \lambda \), from the risk aversion parameter, \( \gamma \), and (ii) to trace out the distribution of unobserved heterogeneity \( \lambda \). I discuss two key sources of variation below.

#### 1.4.1 Time-Varying Housing Prices

The default probability predicted by the model is sensitive to a borrower’s risk aversion, \( \gamma \), and housing preference, \( \lambda \). To separately identify the level of \( \gamma \) and \( \lambda \), I leverage time-varying housing prices and their corresponding changes in default rates.\(^{39}\) Since a borrower’s utility

\(^{39}\)I examine the correlation between housing price index and ex post loan performance using the following specification:

\[
D_{ht} = \text{constant} + \ln p_{ht} + x_{ht} + \alpha_t + \kappa_h + \epsilon_{ht},
\]

where \( \ln p_{ht} \) is the log of housing price index for market \( h \) at period \( t \). \( D_{ht} \) is the fraction of loans that went into defaults for market \( h \) at period \( t \). The coefficient on \( \ln p_{ht} \) is the main parameter of interest. It measures
of repaying in the model is a function of housing prices, the variations in housing prices over time help to identify the mean value of housing preference.

I assume that the variations in housing prices are orthogonal to unobserved repayment shocks. One might be concerned that the housing prices are correlated with local economic conditions. The correlation could result in overestimating housing preference. This implies that I estimate a lower bound of deadweight loss resulting from mortgage overprovision.

1.4.2 Exogenous Shock to Credit Supply

Given that mean level of $\lambda$ and risk aversion parameter $\gamma$ are identified, the parameter left to be identified is the degree of unobserved heterogeneity in $\lambda$. My model predicts that marginal borrowers purchase mortgages when interest rates decrease. Accordingly, average default rate across borrowers changes through selection on unobserved heterogeneity; if there is a larger degree of unobserved heterogeneity, average default rate increases more when interest rates decrease.

Suppose I observe an exogenous variation in interest rates. Given a distributional assumption on $\lambda$, the variance of $\lambda$ is identified to explain how much average default rate changes with the decrease in interest rates.

Following this logic, I leverage a regulatory variation in credit supply caused by the preemption of national banks from state laws against predatory lending in 2004. Although the preemption has the greatest impact in the subprime mortgage market, I also find that it led to a moderate credit expansion in the GSE market. The preemption exempts national banks from state anti-predatory lending laws. This regulatory change alleviates the constraints in subprime lending, leading to a market expansion in the subprime market. Indirectly, it lowers the (fixed) cost of credit in the GSE market and intensified competition for local lenders.

I find that the preemption decreases interest rates in markets with state APLs. Moreover, average interest rate decreases more in markets with a large share of national banks, whereas average default rate increases more in those markets. The variance of $\lambda$ is identified through this variation.

To see how the preemption drives the variations in the data, I conduct a series of reduced-form analyses below.

The Impact of the OCC Preemption on Credit Supply

First, I visually inspect the average market share of national banks for loans purchased by the GSEs over time, separately for APL markets and non-APL markets in Figure F.1. I also plot the average number of GSE loans over time, separately for APL markets and non-APL markets in Figure F.2.
The difference of market share between the APL and non-APL markets is roughly constant before the OCC preemption. The average market share for APL markets increases and eventually surpasses non-APL markets after 2004. National banks significantly expand their market share in GSE loans following the preemption. I observe the same pattern for the number of GSE loans; lenders in APL markets originate more GSE loans relative to non-APL markets after the preemption. The figures confirms that GSE market is indeed significantly affected by the preemption.

The Impact of the Preemption on Interest Rates

To examine the impact of the preemption on interest rates, I employ a difference-in-differences research design. The following specification compares the loans originated in APL markets relative to the loans originated in non-APL markets:

\[
Y_{ht} = \text{constant} + APL_{ht} \times POST_t + x_{ht} + \alpha_t + \kappa_h \times APL_{ht} + \epsilon_{sht},
\]

where \(Y_{sht}\) is the outcome variable originated in market \(h\) at year \(t\), and \(POST_t\) is an indicator of whether year \(t\) is after 2004. \(APL_{ht}\) is a time-varying indicator of whether the market \(h\) is being regulated by APL in the year \(t\). \(x\) is a vector of individual loan characteristics including income, credit score, loan balance, down payment, mortgage insurance percentage, loan purpose (purchase, no cash-out refinance, and cash-out refinance), occupancy status (primary home, secondary home, and investor), and property type (single-family, condominium, co-op, planned unit development [PUD], and manufactured housing). \(\alpha_t\) is quarterly time fixed effects. I include market-APL fixed effects to control for variations that differ across markets but are constant before and after the APLs. The term \(APL_{ht}\) is absorbed by the fixed effects.

I report the results from using contractual interest rates as outcome variables in Equation 1.8 in column (1) of Table 1.3. The coefficient on \(APL_{ht} \times POST_t\) measures the impact of the preemption on interest rates. I find the estimated coefficient is negative and significant (a coefficient of \(-2.03\) percent); there is a small average decrease in interest rates for APL markets after the preemption.

I report the results from using an indicator of whether the loan defaulted during my sample period as outcome variables in Equation 1.8 in column (3) of Table 1.3. The estimated coefficient for default rates is not significant. However, it is important to address the potential heterogeneity between APL states and non-APL states (see Appendix B). Therefore, I further exploit that the preemption has differential impacts on markets with differing presences of national banks within APL states.
Table 1.3: The Impact of Preemption on Market Outcomes

<table>
<thead>
<tr>
<th></th>
<th>Interest Rate</th>
<th>Default Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>(1)</td>
<td>(2)</td>
</tr>
<tr>
<td>$\text{APL} \times \text{POST}$</td>
<td>-0.0203***</td>
<td>-0.00108</td>
</tr>
<tr>
<td></td>
<td>(0.00693)</td>
<td>(0.00926)</td>
</tr>
<tr>
<td>$\text{APL} \times \text{POST} \times \text{Share}$</td>
<td></td>
<td>0.0376*</td>
</tr>
<tr>
<td></td>
<td>(0.0255)</td>
<td>(0.0223)</td>
</tr>
<tr>
<td>$\text{POST} \times \text{Share}$</td>
<td>0.0390**</td>
<td>0.00361</td>
</tr>
<tr>
<td></td>
<td>(0.0162)</td>
<td>(0.0102)</td>
</tr>
<tr>
<td>$\log(\text{Credit Score})$</td>
<td>-1.241***</td>
<td>-0.429***</td>
</tr>
<tr>
<td></td>
<td>(0.184)</td>
<td>(0.0274)</td>
</tr>
<tr>
<td>$\log(\text{Income})$</td>
<td>0.0962***</td>
<td>-0.0181***</td>
</tr>
<tr>
<td></td>
<td>(0.0229)</td>
<td>(0.00348)</td>
</tr>
<tr>
<td>$\log(\text{Loan Amount})$</td>
<td>-0.282***</td>
<td>0.0702***</td>
</tr>
<tr>
<td></td>
<td>(0.0558)</td>
<td>(0.00819)</td>
</tr>
<tr>
<td>$\log(\text{Down Payment})$</td>
<td>-0.0393</td>
<td>-0.00461</td>
</tr>
<tr>
<td></td>
<td>(0.0259)</td>
<td>(0.00524)</td>
</tr>
<tr>
<td>$\text{Insurance Percentage}$</td>
<td>-0.000314</td>
<td>-0.000158</td>
</tr>
<tr>
<td></td>
<td>(0.000939)</td>
<td>(0.000093)</td>
</tr>
<tr>
<td>$\text{Loan Purpose} - \text{Home Purchase}$</td>
<td>-0.0662*</td>
<td>-0.0736***</td>
</tr>
<tr>
<td></td>
<td>(0.0333)</td>
<td>(0.00619)</td>
</tr>
<tr>
<td>$\text{Loan Purpose} - \text{No Cash-Out Refinance}$</td>
<td>-0.139***</td>
<td>-0.0214***</td>
</tr>
<tr>
<td></td>
<td>(0.0240)</td>
<td>(0.00731)</td>
</tr>
<tr>
<td>$\text{Property Type} - \text{Condo}$</td>
<td>0.0382</td>
<td>-0.00765</td>
</tr>
<tr>
<td></td>
<td>(0.0421)</td>
<td>(0.0188)</td>
</tr>
<tr>
<td>$\text{Property Type} - \text{Co-Op}$</td>
<td>0.365***</td>
<td>0.0503*</td>
</tr>
<tr>
<td></td>
<td>(0.0057)</td>
<td>(0.0235)</td>
</tr>
<tr>
<td>$\text{Property Type} - \text{Manufactured Housing}$</td>
<td>0.170***</td>
<td>-0.00937</td>
</tr>
<tr>
<td></td>
<td>(0.0457)</td>
<td>(0.0201)</td>
</tr>
<tr>
<td>$\text{Property Type} - \text{Planned Unit Development}$</td>
<td>0.0943*</td>
<td>-0.0126</td>
</tr>
<tr>
<td></td>
<td>(0.0690)</td>
<td>(0.0170)</td>
</tr>
<tr>
<td>$\text{Occupancy Status} - \text{Second}$</td>
<td>0.109***</td>
<td>-0.0219</td>
</tr>
<tr>
<td></td>
<td>(0.0226)</td>
<td>(0.0142)</td>
</tr>
<tr>
<td>$\text{Occupancy Status} - \text{Investor}$</td>
<td>0.487***</td>
<td>0.0884***</td>
</tr>
<tr>
<td></td>
<td>(0.0281)</td>
<td>(0.0129)</td>
</tr>
<tr>
<td>$\text{Time Fixed Effects}$</td>
<td>yes</td>
<td>yes</td>
</tr>
<tr>
<td>$\text{Market-APL Fixed Effects}$</td>
<td>yes</td>
<td>yes</td>
</tr>
<tr>
<td>$\text{State -Time Fixed Effects}$</td>
<td>yes</td>
<td>yes</td>
</tr>
<tr>
<td># of Observations</td>
<td>93,507</td>
<td>93,507</td>
</tr>
<tr>
<td>Adjusted R-squared</td>
<td>0.996</td>
<td>0.998</td>
</tr>
</tbody>
</table>

Note: Table 1.3 reports coefficient estimates of weighted least square regressions from Equation 1.8 and Equation 1.9. The sample is collapsed by market-month level with weights equal to number of loans purchased by the GSEs in each market. Robust standard errors in parentheses are clustered at the state level in column (1) and (3), and at market level in column (2) and (4). Significance levels: *(p<0.10), **(p<0.05), ***(p<0.01).
**Triple Difference-in-Differences**

To account for state-specific time trends, I take advantage of the heterogeneity in the presence of national banks in 2003.\(^{40}\) The market share of national banks in both subprime and prime loans is a proxy of the treatment intensity on credit supply from the preemption. \(^{40}\) Di Maggio and Kermani (2017) show that the preemption has stronger effects in a market with a stronger presence of national banks (i.e., with a higher share of national banks). The following specification compares the loans originated in APL markets with different shares of national banks:

\[
Y_{ht} = \text{constant} + POST_t \times Share_h + APL_{ht} \times POST_t \times Share_h \\
+ x_{ht} + \alpha_t + \kappa_h + \kappa_h \times APL_{ht} + S_{ht} + \epsilon_{sht},
\]

where \(Share\) denotes the market share of national banks in both subprime and prime markets in 2003. I include state-time fixed effects to control for state-specific trends. The term \(APL_{ht} \times Share_h\) is absorbed by the fixed effects.

Column (2) of Table 1.3 reports the results from using contractual interest rates as outcome variables in Equation 1.9. The coefficient on \(APL_{ht} \times POST_t \times Share_h\) measures the impact of the preemption on interest rates depending on the heterogeneity in presence of national banks. I find the estimated coefficient is negative and significant (a coefficient of \(-7.12\) percent); interest rates on average decrease more in APL markets with a higher presence of national banks after the preemption.

I report the results from using an indicator of whether the loan defaulted during my sample period as outcome variables in Equation 1.9 in column (4) of Table 1.3. I find that the estimated coefficient is positive and significant (a coefficient of \(3.76\) percent); there is a larger average increase in default risks for markets with a higher share of national banks relative to markets with a lower share of national banks. My estimation exploits this variation to identify the degree of unobserved heterogeneity.

### 1.5 Estimation

In this section, I describe the empirical methods to estimate structural parameters in the model. I first estimate demand parameters by matching default probabilities. Given the estimated demand parameters, I next estimate other supply parameters. I start my discussion with the estimation on the borrower’s side.

\(^{40}\)Following Di Maggio et al. (2016) and Di Maggio and Kermani (2017), this measure is based on the fact that the share of national banks in 2003 is a good predictor of market concentration in subsequent years.
1.5.1 Demand Estimation

I consider a stationary income $I_{it} = I_i$. The variations in income are captured by repayment shocks $\epsilon$. I assume that repayment shocks, $\epsilon$, follow a normal distribution with mean 0 and standard deviation $\sigma_\epsilon$. The borrower primitives in the model are risk aversion, $\gamma$; housing preference, $\lambda$; variance of repayment shocks, $\sigma_\epsilon$; cost of upfront payment, $\delta$; and lender preference, $\alpha$.

$\lambda$ is assumed to follow a log-normal distribution with mean, $\mu$, and standard deviation, $\sigma$. I allow heterogeneity in $\mu$, $\sigma$, and $\gamma$. The heterogeneity is modeled as a function of a vector of observed loan characteristics $x$:

$$
\mu(x) = x^\top \beta_\mu,
$$

$$
\sigma(x) = x^\top \beta_\sigma,
$$

$$
\gamma(x) = x^\top \beta_\gamma.
$$

$x$ is a vector that includes a constant, the log of income, the log of credit score and the log of initial property value, and a set of dummies indicating home purchase and no-cash refinance. I collapse the model decisions to a quarterly level.\(^{41}\) I set the quarterly discount factor $\beta$ to 0.992 and the terminal age $\Upsilon$ to 60 years past loan origination.

To capture the fact that borrowers tend not to default in the first few years after loan origination, I add two dummies on the period utility in Equation 1.1 indicating whether a loan originated 2 years or 4 years ago.

**Inner loop**

Given a vector of primitives, $\Theta_0 = \{\beta_\mu, \beta_\sigma, \beta_\gamma, \sigma_\epsilon\}$, for each loan $i$, I draw $N = 7$ sample points of $\lambda_{in}$ from $LN(\mu(x), \sigma(x))$ using Hermite-Gauss quadrature nodes for $n = 1, 2, ..., N$.\(^{42}\)

For each draw of $\lambda_{in}$, I solve for the optimal repayment policy, $d_i(\Theta_0; \lambda_{in}, p_{ij}, t)$, and the value function, $V_i(\Theta_0; \lambda_{in}, p_{ij}, t)$, for each period. In addition, I derive marginal cost of down payment, $\delta$, from the first-order condition in Equation 1.3. I also solve for lender preference, $\alpha$, using observed market shares in the data.\(^{43}\) I normalize the preference for small lenders\(^{44}\) to zero, so the lender preference measures the incremental utility of each lender relative to the small lenders. I discuss the estimation procedure in greater detail in Appendix C.

Finally, to obtain empirical moments, average default rate over the draws of $\lambda_{in}$ predicted

\(^{41}\)Specifically, $t$ is a counter on the quarter level. A borrower’s period utility depends on consumption in a quarter level, and an optimal repayment decision is whether to repay or not in each quarter.

\(^{42}\)The objective function value is quite stable for choices of nodes $N \geq 7$.

\(^{43}\)I follow the assumption made in Scharfstein and Sunderam (2014). They define markets locally at the geographic level. Market share and brand preference are measured at 3-digit zip code by year level.

\(^{44}\)I define small lenders to be a lender with market share no more than 1 percent.
by the model is approximated as
\[ d_i(\Theta_0; x, p_i, t) = \int d_i(\Theta_0; \lambda_{in}, x, p_i, t) \rho(\Theta_0; \lambda_{in}, x, p_i) d\lambda_{in} \]
\[ \approx \sum_{n=1}^{N} \omega_n d_i(\Theta_0; \lambda_{in}, x, p_i, t) \rho(\Theta_0; \lambda_{in}, x, p_i) \],
(1.10)
where \( \rho(\Theta_0; \lambda_{in}, x, p_i) \) is the probability distribution of \( \lambda \) among the borrowers who purchase mortgages (see Appendix C), \( \omega \) is the Hermite-Gauss quadrature weight associated with each node \( n \).

**Outer Loop**

I adopt method of moments estimator by minimizing the differences between predicted default probabilities (from Equation 1.10), \( d \), and observed default probabilities, \( \hat{d} \). The moment restrictions used in the estimation are
\[ g(\Theta_0) = \mathbb{E}_{(i)} \left[ d_i(\Theta_0; p_i; t) - \hat{d}_{it|z_{it}} \right] = 0, \forall t = 1, \ldots, T. \]
\( z_{it} \) is a covariate vector given by
\[ z_{it} = \begin{bmatrix} APL_i \times \text{POST}_i \times \text{HIGH}_i \\ APL_i \times \text{POST}_i \times (1 - \text{HIGH}_i) \\ 1 - APL_i \times \text{POST}_i \end{bmatrix} \otimes \begin{bmatrix} x_i^\top \\ v_{it} \cdot x_i^\top \end{bmatrix}, \]
where \( \text{POST} \) is an indicator of whether the loan originated before or after 2004, \( \text{APL} \) is an indicator of whether the loan originated in markets with local APLs. \( \text{HIGH} \) is an indicator of whether the market share of national banks in 2003 was above its median. \( v_{it} \) denotes the property value of borrower \( i \) at period \( t \).

In practice, I implement two-step generalized method of moments and match quarterly default rates up to 30 quarters past origination. In the first step, I estimate the model with identity weighting matrix and obtain an estimator \( \hat{\Theta}_1 \). Using this estimator, I obtain the optimal weighting matrix, \( \hat{W}(\hat{\Theta}_1) \), and solve for \( \hat{\Theta} \) in the outer loop:
\[ \hat{\Theta} = \arg \min_{\Theta} \hat{g}(\Theta)^\top \hat{W}(\hat{\Theta}_1) \hat{g}(\Theta). \]

---

45I approximate the expectation over future housing prices in the same way. I first estimate \( g \) and \( \sigma_v^2 \) in Equation 1.2 for each market. I obtain the expected value function by integrating over three draws of housing prices from a normal distribution with standard deviation \( \sigma_v \).

46The future property value in period \( t \) is obtained using the house price index \( I \) from the Federal Housing Finance Agency as follows, \( v_t = v_0 \times I_t \).
In total, I have 36 covariate vectors and $36 \times 30 = 1,080$ conditional moment restrictions to estimate 21 parameters. I summarize the moment restrictions in Appendix C.1.

### 1.5.2 Cost Estimation

Given the estimated demand parameters $\hat{\Theta}$, I now estimate marginal cost of lenders. I parameterize the marginal cost into a vector of $x$, market-lender fixed effect, origination quarter-year fixed effects, and an unobserved component, $\nu$, so that

$$c_{ij}(\vartheta) = x^\top \beta_c + \beta_{APL} APL_i + \beta_{OCC} OCC_i \times APL_i \times POST_i + \eta_{hj} + \kappa_t + \nu_i,$$

where $\vartheta = \{\beta_c, \eta, \beta_{APL}, \beta_{OCC}, \kappa\}$ denotes a vector of parameters to be estimated. $OCC$ is an indicator of whether the lender is regulated by the OCC (i.e., a national lender). The parameter $OCC_i \times APL_i \times POST_i$ captures the impact of preemption on costs for national lenders.

I derive lender markup $\Delta_j(\hat{\Theta}; x)$ for each loan according to Equation 1.5. The pricing equation gives

$$\nu_i(\vartheta_0) = p_{ij} - \Delta_j(\hat{\Theta}; x) - x^\top \beta_c + \eta_{hj} + \kappa_t.$$

I obtain cost estimates using linear least squares, as in

$$\hat{\vartheta} = \arg\min_\vartheta \nu(\vartheta)^\top \nu(\vartheta).$$

Finally, I assume that the GSEs earn an economic profit of zero (a perfect competitive capital market) during the 2000 – 01 period. I do not assume the zero profit condition in the later 2002 – 08 period, because evidence suggests that the GSEs mispriced (underpriced) most of their loans during this period (Federal Housing Finance Agency, 2009; Lucas and McDonald, 2010). Another interpretation of this assumption is that I examine GSE pricing during the 2002 – 08 period using the 2000 – 01 period as an optimal benchmark.

Using credit loss information in the data, I estimate expected net proceeds $H$ from a sale of the property post-foreclosure. The average net proceeds of a property are approximately 33.90 percent of its initial value.

In Equation 1.6, $UST_{10Y}$ is a known index, $mc$ is estimated by equating the average of funding costs to the average of estimated marginal costs, $c_{ij}(\hat{\vartheta})$ during the first two years. Under the assumption that $mc$ is time-invariant, I calculate the funding costs in the later periods using the estimated $mc$.

### 1.6 Results

In this section, I first discuss my parameter estimates. I then provide several pieces of evidence to evaluate the model fit. I report the parameter estimates in Table 1.4. Standard errors are calculated using the delta method.
<table>
<thead>
<tr>
<th></th>
<th>$\beta_\mu$</th>
<th>$\beta_\sigma$</th>
<th>$\gamma$</th>
<th>$\beta_c$</th>
</tr>
</thead>
<tbody>
<tr>
<td>Constant</td>
<td>-1.094</td>
<td>0.236</td>
<td>1.006</td>
<td>1.331</td>
</tr>
<tr>
<td></td>
<td>(0.252)</td>
<td>(0.200)</td>
<td>(0.075)</td>
<td>(0.254)</td>
</tr>
<tr>
<td>log(Credit Score)</td>
<td>0.512</td>
<td>-0.006</td>
<td>0.013</td>
<td>-0.111</td>
</tr>
<tr>
<td></td>
<td>(0.034)</td>
<td>(0.053)</td>
<td>(0.111)</td>
<td>(0.021)</td>
</tr>
<tr>
<td>log(Income)</td>
<td>0.028</td>
<td>-0.015</td>
<td>-0.001</td>
<td>-0.010</td>
</tr>
<tr>
<td></td>
<td>(0.040)</td>
<td>(0.014)</td>
<td>(0.011)</td>
<td>(0.002)</td>
</tr>
<tr>
<td>log(Property Value)</td>
<td>-0.087</td>
<td>0.020</td>
<td>0.089</td>
<td>-0.044</td>
</tr>
<tr>
<td></td>
<td>(0.032)</td>
<td>(0.014)</td>
<td>(0.001)</td>
<td>(0.008)</td>
</tr>
<tr>
<td>Loan Purpose - Purchase</td>
<td>0.103</td>
<td>-0.003</td>
<td>0.001</td>
<td>-0.012</td>
</tr>
<tr>
<td></td>
<td>(0.008)</td>
<td>(0.035)</td>
<td>(0.004)</td>
<td>(0.002)</td>
</tr>
<tr>
<td>Loan Purpose - No Cash-Out Refinance</td>
<td>0.056</td>
<td>-0.033</td>
<td>-0.034</td>
<td>-0.013</td>
</tr>
<tr>
<td></td>
<td>(0.010)</td>
<td>(0.028)</td>
<td>(0.005)</td>
<td>(0.002)</td>
</tr>
<tr>
<td>Origination $\leq$ 2 years</td>
<td>0.089</td>
<td>(–)</td>
<td>(–)</td>
<td>(–)</td>
</tr>
<tr>
<td></td>
<td>(0.034)</td>
<td>(–)</td>
<td>(–)</td>
<td>(–)</td>
</tr>
<tr>
<td>2 years $&lt;$ Origination $\leq$ 4 years</td>
<td>0.038</td>
<td>(–)</td>
<td>(–)</td>
<td>(–)</td>
</tr>
<tr>
<td></td>
<td>(0.015)</td>
<td>(–)</td>
<td>(–)</td>
<td>(–)</td>
</tr>
<tr>
<td>log(Monthly Required Payment)</td>
<td>(–)</td>
<td>(–)</td>
<td>(–)</td>
<td>0.041</td>
</tr>
<tr>
<td></td>
<td>(–)</td>
<td>(–)</td>
<td>(–)</td>
<td>(0.008)</td>
</tr>
<tr>
<td>APL</td>
<td>(–)</td>
<td>(–)</td>
<td>(–)</td>
<td>0.002</td>
</tr>
<tr>
<td></td>
<td>(–)</td>
<td>(–)</td>
<td>(–)</td>
<td>(0.001)</td>
</tr>
<tr>
<td>OCC $\times$ APL $\times$ POST</td>
<td>(–)</td>
<td>(–)</td>
<td>(–)</td>
<td>-0.005</td>
</tr>
<tr>
<td></td>
<td>(–)</td>
<td>(–)</td>
<td>(–)</td>
<td>(0.001)</td>
</tr>
</tbody>
</table>

**Note:** Table 1.4 shows structural parameter estimates. The standard error is in parentheses. Market-seller and origination year fixed effects in the cost estimation are omitted for brevity.
1.6.1 Parameter Estimates: Demand

The main parameter of interest is the distribution of housing preference, $\lambda$, which is specified as a log-normal distribution with mean $\mu$ and standard deviation $\sigma$. Both are specified as a function of observed loan characteristics. The average values of $\mu$ and $\sigma$ across loans in the sample are approximately 1.48 and 0.08, respectively. My model estimates 25.17 percent of potential borrowers (i.e., those who did not purchase mortgages under GSE pricing). The estimated standard deviation of repayment shocks, $\sigma_e$, is 0.99.

The baseline estimate of $\mu$ is $-1.09$. The estimated coefficient on the log of credit score is especially large compared with other coefficients, suggesting that credit score may be a meaningful characteristic in determining borrowers’ default risks. A 1 percent increase in credit score increases the mean of $\lambda$ by 0.51. I estimate a 0.37 increase in standard deviation of $\lambda$ when credit score increases by 100 (13.87 percent of the credit score). The coefficient on the log of income is relatively smaller. I estimate a 0.06 increase in standard deviation of $\lambda$ when income increases by 1,000 dollars (28.8 percent of the average income).

Home purchase loans and no cash-out refinance loans also relate to $\mu$ positively with coefficients of 0.10 and 0.06. The estimated coefficient on the log of property value is negative (a coefficient of $-0.09$). This is consistent with my reduced-form evidence that a loan with higher property value (i.e., a higher loan balance) is more likely to default.

The $\sigma$ parameter shows the degree of unobserved heterogeneity. The baseline estimate of $\sigma$ is 0.24. The estimated coefficient on unobserved heterogeneity is negative for credit score and income, suggesting a lower degree of unobserved heterogeneity for borrowers with higher credit score and income. On the other hand, the coefficient on the log of property value is positive (a coefficient of 0.02). My model allows for heterogeneity in risk aversion parameter $\gamma$, which is modeled as a function of observed loan characteristics. The average value of $\gamma$ across loans in the sample is about 1.16. The baseline estimate of risk aversion parameter, $\gamma$, is 1.01. The coefficient on the log of property value is 0.09. Similarly, the coefficient on the log of credit score is 0.01; a borrower with higher property value and higher credit score is less sensitive to interest rates. On the contrary, the coefficients on income and no cash-out refinancing are negative (coefficients of $-0.06$ percent and $-0.03$, respectively).

Cost of up-front payment, $\delta$, and lender preference, $\alpha$, are estimated non-parametrically. I plot the distributions of these two variables in Figure 1.2. The average of $\delta$ and $\alpha$ are 0.49 basis points and $-0.58$, respectively. To clarify the meaning of these numbers, borrowers paying an additional 10,000 dollars of down payment would decrease their utilities by 0.49 on average. Choosing any mortgage lender would decrease borrowers’ utilities by $-0.58$ on average relative to small lenders due to brand preference.\footnote{In the data large lenders usually offer lower interests compared with small lenders, so that the parameter $\alpha$ rationalizes the behavior of borrowers who choose small lenders because of brand preference that offsets the utility loss from higher interest rates.}
(1.2a) Housing Preference
(1.2b) Cost of Up-Front Payment
(1.2c) Lender Preference
(1.2d) Marginal Cost

Note: Figure 1.2 plots the probability distribution of the parameter estimates from structural estimation.

Figure 1.2: Distribution of Estimates
Note: Figure 1.3 plots the fitting errors for all 1,080 moments used in the GMM estimation. It is calculated as the absolute value of the residuals divided by the empirical means.

Figure 1.3: Fitting Errors

1.6.2 Parameter Estimates: Cost

Parameter $c$ represents lender marginal cost for originating an additional 1 dollar of a mortgage loan. The marginal cost also represents guarantee fee income for the GSEs in the model. The mean of marginal cost is roughly 1.37 dollars. The baseline estimate of $c$ is 1.33. The marginal cost decreases with the log of credit score, the log of income, and the log of property value, each with coefficients of $-0.11$, $-0.01$, and $-0.04$, respectively. I also include the log of monthly required repayment. The estimated coefficient on the log of monthly required repayment is 0.04.

The cost estimates reveal that lender marginal cost largely depends on the loan characteristics related to expected default probabilities. This is consistent with the risk-based features of GSE pricing; guarantee fee increases with default risks.

In addition, the parameters on $APL_h$ and $OCC_j \times APL_h \times POST_t$ are meant to capture the increased and reduced fixed costs from implementing and preempting the APLs. The estimated coefficients are 0.25 percent and $-0.46$ percent, respectively. These numbers translate to changes in contractual interest rates by 1.00 and $-1.84$ basis points. Finally, the average of GSE funding costs (i.e., the cost for funding an additional 1 dollar of a mortgage loan) is around 1.37.

1.6.3 Model Fit

In Figure 1.3 I show fitting errors for the moments used in GMM estimation. Most of the moments are fitted with negligible errors. My empirical moments can be explained reasonably well by the model.
In order to further assess the model fit, I compare a simulated default path with the observed default path from the data in the upper panel of Figure 1.4. They align reasonably well. My model is able to closely trace the downward-sloping trend for default probabilities over time.

I also perform an out-of-sample validation. I estimate the model using 50 percent of the loans (random selection) and use the estimated parameters to predict default probabilities for the remaining 50 percent of the loans. I compare the out-of-sample prediction with the corresponding actual default path in the lower panel of Figure 1.4. The out-of-sample prediction is not as accurate as the in-sample prediction, but overall my model has a satisfactory prediction on default probabilities for the sample that is not used in the estimation.

1.7 Implications for Pricing, Competition Policy, and Market Design

In this section, I use the estimated model to analyze the impact of different insurance pricing schemes and a competition policy that changes market concentration. I also examine how these results could depend on information asymmetry between lenders and borrowers.
For a given market equilibrium, $p$, I calculate borrower surplus, $CS$, lender profit, $LS$, and GSE profit, $GS$, as

$$CS_i(p) = \int \left( V_i(\hat{\Theta}; \lambda_{in}, x, p, 0) - U_i(\hat{\Theta}) \right) \varphi(\hat{\Theta}; \lambda_{in}, x, 0) d\lambda_{in},$$

$$LS_i(p) = \int \left( p - c_i \right) \left( v_0 - D_i(\hat{\Theta}; \lambda_{in}, x, p) \right) \varphi(\hat{\Theta}; \lambda_{in}, x, p) d\lambda_{in},$$

$$GS_i(p) = \int \left( c_i - mc \right) \times \left( v_0 - D_i(\hat{\Theta}; x, p) - L_i(\hat{\Theta}; \lambda_{in}, x, p) \right) \varphi(\hat{\Theta}; \lambda_{in}, x, p) d\lambda_{in},$$

where $L_i(\hat{\Theta}; \lambda_{in}, x, p)$, the loss from loan defaults, follows

$$L_i(\hat{\Theta}; \lambda_{in}, x, p) = \sum_{t=1}^{T} \mathbb{E}_\epsilon \left[ d_i(\hat{\Theta}; \lambda_{in}, x, p, t, \epsilon) \times \left( v_0 - D_i(\hat{\Theta}; \lambda_{in}, x, p) - tm_i(x, p, t) \right) \right].$$

I calculate borrower welfare using a certainty equivalent approach, which equates a borrower’s value function to the utility of consuming $CE$ dollars each period. Given this, total surplus in dollar value, $TS$, equals the summation in surplus in dollar value of the three market participants.

$$TS(p) = \sum_i \left[ LS_i(p) + GS_i(p) + \sum_{t=1}^{T} \beta^{t-1} CE_i(p) \right].$$

I discuss the results of my counterfactual simulations in detail below.

### 1.7.1 Mortgage Insurance Pricing: The Impact of Mispricing

To quantify the impact of mispricing from the GSEs. I examine the counterfactuals of two alternative price schemes: (i) a full risk-based pricing scheme that charges exact expected cost and (ii) a uniform pricing scheme that charges a flat rate to every loan. To make a fair comparison, I set the uniform price to be the average of GSE prices.

Under full risk-based pricing, the GSEs charge guarantee fees that fully reflect the expected costs and default risks. Specifically, lenders’ pricing equations are captured as

$$p^*_j(x) = mc + UST10Y_t + \Delta_j(\hat{\Theta}; x)(1 + L_i(\hat{\Theta}; x, p_{ij})),

L_i(\hat{\Theta}; x, p_{ij}) = \int L_i(\hat{\Theta}; \lambda_{in}, x, p_{ij}) d\lambda_{in}, \quad (1.11)$$

where $L_i(\hat{\Theta}; x, p_{ij})$ denotes the expected default cost of borrower $i$.

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48 For each market, I calculate the lenders’ optimal pricing by iterating their first-order conditions (Equation 1.5) associated with the counterfactual policy and competitors’ pricing. I stop at iteration $n$ when the lenders’ pricing in this iteration, $p^n$, satisfies the following condition: $|p^n - p^{n-1}| < 0.1$ percent.
Evidence on Cross-Subsidization

Using full risk-based pricing as a benchmark, I find that GSE pricing involves a substantial cross-subsidization. Figure 1.5 compares borrowers’ average prices under different pricing schemes (on the y-axis) with their average full risk-based prices (on the x-axis). For lower-risk borrowers (i.e., those with lower full risk-based prices), their GSE prices are higher than their full risk-based prices. On the other hand, for medium-risk and high-risk borrowers (i.e., those with higher full risk-based prices), their GSE prices are lower than their full risk-based prices.

I estimate that the average mortgage subsidy received per loan is about 2,235 dollars.\(^49\) In addition, GSE pricing redistributes 56.82 billion dollars from lower-risk borrowers to higher-risk borrowers; the number translates to approximately 1.60 percent of the mortgage interest.

Furthermore, I compare mortgage subsidies across markets. I plot the mean deviation of mortgage subsidy for each market in the upper panel of Figure 1.6. The mean deviation of mortgage subsidy is negatively correlated with the average income in each market (see the lower panel of Figure 1.6). Borrowers from a lower-income region on average benefit more from GSE pricing. This shows another piece of evidence on the cross-subsidization from GSE pricing.

As for the case of uniform pricing, borrowers all get the same uniform price regardless of their risk profile.

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\(^49\)Mortgage subsidy is defined as the change in consumer welfare in dollar value from full risk-based pricing to GSE pricing.
Note: Figure 1.6 plots the heat map charts for the distribution of outcomes of interest by 3-digit zip code level. The upper panel displays the mean deviation of mortgage subsidy for each region. The lower panel shows average income for each region. The mortgage subsidy is defined as the change in consumer welfare in dollar value from full risk-based pricing to GSE pricing.

Figure 1.6: Regional Distribution of Mortgage Subsidy and Average Income
of their risks and costs. Uniform pricing is an extreme case of cross-subsidization between lower-risk borrowers and higher-risk borrowers. Higher-risk borrowers receive an even lower price relative to GSE pricing.

**Uniform Pricing**

I first consider the effects of uniform pricing (column (1) of Table 1.5). I find that, under uniform pricing, default cost increases by 43.41 dollars (3.30 percent of the average default cost). Lender profit increases by 413.08 dollars but GSE profit decreases by 14.63 dollars. Overall, deadweight loss per loan increases by 33.89 dollars relative to GSE pricing (1.13 percent of the average mortgage subsidy).

**Table 1.5: Welfare Impact of Mortgage Insurance Pricing**

<table>
<thead>
<tr>
<th>Panel A: Welfare Change to Baseline</th>
<th>Uniform Pricing</th>
<th>Full Risk-Based Pricing</th>
</tr>
</thead>
<tbody>
<tr>
<td>Mean Δ Interest Rate</td>
<td>0.000</td>
<td>0.065</td>
</tr>
<tr>
<td>Mean Δ Default Loss ($)</td>
<td>43.406</td>
<td>-843.218</td>
</tr>
<tr>
<td>Mean Δ Lender Profit ($)</td>
<td>413.079</td>
<td>8,068.516</td>
</tr>
<tr>
<td>Mean Δ Borrower Surplus ($)</td>
<td>-432.345</td>
<td>-9,748.600</td>
</tr>
<tr>
<td>Mean Δ GSE Profit ($)</td>
<td>-14.625</td>
<td>2,199.333</td>
</tr>
<tr>
<td>Mean Δ Deadweight Loss ($)</td>
<td>33.892</td>
<td>-519.249</td>
</tr>
<tr>
<td>Δ # of Accounts (10k)</td>
<td>5.284</td>
<td>-76.842</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Panel B: Percentage Change to Baseline</th>
<th>Uniform Pricing</th>
<th>Full Risk-Based Pricing</th>
</tr>
</thead>
<tbody>
<tr>
<td>Mean Δ Interest Rate</td>
<td>0.000</td>
<td>4.463</td>
</tr>
<tr>
<td>Mean Δ Default Loss</td>
<td>3.295</td>
<td>-64.014</td>
</tr>
<tr>
<td>Mean Δ Lender Profit</td>
<td>2.563</td>
<td>50.071</td>
</tr>
<tr>
<td>Mean Δ Borrower Surplus</td>
<td>-0.352</td>
<td>-7.930</td>
</tr>
<tr>
<td>Mean Δ GSE Profit</td>
<td>0.133</td>
<td>-20.009</td>
</tr>
<tr>
<td>Mean Δ Deadweight Loss</td>
<td>3.132</td>
<td>-47.980</td>
</tr>
<tr>
<td>Δ # of Accounts (10k)</td>
<td>0.241</td>
<td>-3.509</td>
</tr>
</tbody>
</table>

**Note**: Table 1.5 presents the welfare results of counterfactuals of uniform pricing and perfect risk-based pricing. Mean changes in the statistics are calculated using total changes in the statistics divided by sample size (22 million). Panel A presents the welfare changes in dollar value relative to the baseline (GSE pricing). Panel B presents the welfare changes in percentage relative to the baseline.

Uniform pricing increases the degree of cross-subsidization from lower-risk borrowers to higher-risk borrowers. However, uniform pricing exacerbates the problem of overprovision to higher-risk borrowers, as higher-risk borrowers face a lower price under uniform pricing.
relative to GSE pricing. This finding suggests that an increase in the cross-subsidization of insurance pricing could result in a sizable distortionary cost.

**Full Risk-Based Pricing**

Next, the welfare results of full risk-based pricing are reported in column (2) of Table 1.5. Full risk-based pricing does not involve cross-subsidization and underpricing. Equation 1.11 shows that the interest rate is always higher than or equal to the cost of each loan under full risk-based pricing.

I find that the average interest rate is 6.50 percent (25.98 basis points in contractual interest rates) higher under full risk-based pricing than under GSE pricing. This implies that the GSEs underprice most of their mortgage loans. The estimated magnitude of underpricing is in line with the results from Lucas and McDonald (2010); they suggest that the GSEs underpriced contractual interest rates by around 20 to 30 basis points in 2005.

Under full risk-based pricing, default cost decreases significantly by 843.22 dollars (64.01 percent of the average default cost). GSE profit increases by 2,199.33 dollars. Borrowers bear an average decrease in their surplus due to the higher full risk-based prices. Overall, welfare improves substantially when the mispricing is eliminated; deadweight loss per loan decreases by 519.25 dollars (17.38 percent of the average mortgage subsidy) relative to GSE pricing.

1.7.2 The Impact of Competition Policy under GSE Pricing

I evaluate the impact of a competition policy that potentially reduces entry costs of new entrants and decreases market concentration in each market. Some such policies might include things like: removing entry barriers, liberalizing product restrictions, and so on. I simply assume that such policies increase the number of entrants in each market. This counterfactual analysis is intended to provide a generalizable result that the welfare impacts of GSE pricing could interact with market structure.

To simulate a market with different concentration levels, given the same distribution of marginal cost, I scale market shares of entrants in each market by a fraction of the existing firms. Market concentration in each market is decreasing with $N$. For example, $N$ is the current market structure, which has 5 lenders of 20 percent market share each, the counterfactual of $2N$ means that the counterfactual market has 5 lenders and 5 new entrants of 10 percent market share each (a 50 percent decrease in market concentration). The counterfactual of $1.5N$ means that the counterfactual market has 5 lenders of 13.33 percent market share each, and 5 new entrants of 6.67 percent market share each (i.e., market share is 0.5 of each existing firm). $0.75N$ means that 4 lenders have 15 percent market share each (i.e., market share is 0.75 of each existing firm) and 1 lender has the rest of market share of 40 percent. Perfect competition is when $N \to \infty$.

In Table 1.6, I report the results for various instances of market structure from $0.75N$ to $2N$, and perfect competition. I compare surplus of each market participant to the baseline,
Table 1.6: Welfare Impact of Market Structure - GSE Pricing

<table>
<thead>
<tr>
<th>Panel A: Welfare Change to Baseline</th>
<th>( N )</th>
<th>( 0.75N )</th>
<th>( 1.25N )</th>
<th>( 1.5N )</th>
<th>( 2N )</th>
<th>( N \rightarrow \infty )</th>
</tr>
</thead>
<tbody>
<tr>
<td>Mean ( \Delta ) Interest Rate</td>
<td>( – )</td>
<td>0.023</td>
<td>-0.016</td>
<td>-0.027</td>
<td>-0.041</td>
<td>-0.085</td>
</tr>
<tr>
<td>Mean ( \Delta ) Default Loss ($)</td>
<td>( – )</td>
<td>-106.981</td>
<td>71.080</td>
<td>120.902</td>
<td>186.349</td>
<td>401.294</td>
</tr>
<tr>
<td>Mean ( \Delta ) Lender Profit ($)</td>
<td>( – )</td>
<td>4367.090</td>
<td>-2935.142</td>
<td>-4998.073</td>
<td>-7663.553</td>
<td>-16114.002</td>
</tr>
<tr>
<td>Mean ( \Delta ) Borrower Surplus ($)</td>
<td>( – )</td>
<td>-4565.536</td>
<td>3031.216</td>
<td>5146.138</td>
<td>7859.923</td>
<td>16328.823</td>
</tr>
<tr>
<td>Mean ( \Delta ) GSE Profit ($)</td>
<td>( – )</td>
<td>216.230</td>
<td>-142.219</td>
<td>-241.180</td>
<td>-368.143</td>
<td>-759.490</td>
</tr>
<tr>
<td>Mean ( \Delta ) Deadweight Loss ($)</td>
<td>( – )</td>
<td>-17.784</td>
<td>46.145</td>
<td>93.116</td>
<td>171.773</td>
<td>544.669</td>
</tr>
<tr>
<td>( \Delta ) # of Accounts (10k)</td>
<td>( – )</td>
<td>-27.103</td>
<td>17.208</td>
<td>28.980</td>
<td>43.816</td>
<td>87.836</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Panel B: Percentage Change to Baseline</th>
<th>( N )</th>
<th>( 0.75N )</th>
<th>( 1.25N )</th>
<th>( 1.5N )</th>
<th>( 2N )</th>
<th>( N \rightarrow \infty )</th>
</tr>
</thead>
<tbody>
<tr>
<td>Mean ( \Delta ) Interest Rate</td>
<td>( – )</td>
<td>1.592</td>
<td>-1.072</td>
<td>-1.826</td>
<td>-2.796</td>
<td>-5.831</td>
</tr>
<tr>
<td>Mean ( \Delta ) Default Loss (%)</td>
<td>( – )</td>
<td>-8.122</td>
<td>5.396</td>
<td>9.178</td>
<td>14.147</td>
<td>30.465</td>
</tr>
<tr>
<td>Mean ( \Delta ) Lender Profit (%)</td>
<td>( – )</td>
<td>27.101</td>
<td>-18.215</td>
<td>-31.017</td>
<td>-47.558</td>
<td>-100.000</td>
</tr>
<tr>
<td>Mean ( \Delta ) Borrower Surplus (%)</td>
<td>( – )</td>
<td>-3.714</td>
<td>2.466</td>
<td>4.186</td>
<td>6.393</td>
<td>13.282</td>
</tr>
<tr>
<td>Mean ( \Delta ) GSE Profit (%)</td>
<td>( – )</td>
<td>-1.967</td>
<td>1.294</td>
<td>2.194</td>
<td>3.349</td>
<td>6.909</td>
</tr>
<tr>
<td>Mean ( \Delta ) Deadweight Loss (%)</td>
<td>( – )</td>
<td>-1.643</td>
<td>4.264</td>
<td>8.604</td>
<td>15.872</td>
<td>50.329</td>
</tr>
<tr>
<td>( \Delta ) # of Accounts (10k)</td>
<td>( – )</td>
<td>-1.238</td>
<td>0.786</td>
<td>1.323</td>
<td>2.901</td>
<td>4.011</td>
</tr>
</tbody>
</table>

**Note:** Table 1.6 presents the welfare results of counterfactuals that change the number of lenders from \( 0.75N \) to \( 2N \) and perfect competition. Mean changes in the statistics are calculated using total changes in the statistics divided by sample size (22 million). Panel A presents the welfare changes in dollar value relative to the baseline, which is the case of \( N \) under GSE pricing. Panel B presents the welfare changes in percentage relative to the baseline.

which is the case of \( N \) under GSE pricing.

For the case of \( 2N \), my model predicts a decrease in interest rates by 4.07 percent as lender markup decreases in a less concentrated market. Lender profit per loan decreases by 7,663.55 dollars. Borrower surplus increases by 7,859.92 dollars because of lower interest rates. The decrease in market concentration leads to an additional default cost per loan of 186.35 dollars (14.15 percent of the average default cost) and an additional deadweight loss of 171.77 dollars (5.75 percent of the average mortgage subsidy).

For the less competitive case of \( 0.75N \), my model predicts an increase in interest rates by 2.32 percent as lender markup increases. Default cost decreases by 106.98 dollars per loan, or 8.12 percent of the average default cost. The surplus goes from borrowers to lenders, as borrower surplus per loan becomes 4,365.54 dollars lower. Overall, deadweight loss decreases by 17.78 per loan relative to the baseline.

For the cases of \( 1.25N \) and \( 1.5N \), the results are qualitatively similar. Deadweight loss is the largest in a perfectly competitive market when the market bears 544.67 dollars welfare loss per loan, or 18.23 percent of the average mortgage subsidy.
Note: Figure 1.7 plots the changes in deadweight loss relative to the baseline for various cases from 0.55N to 1.25N. The baseline is the current market concentration N. The competition level is increasing with N, the case of N less than 1 implies lower competition than the baseline.

Figure 1.7: The Changes in Deadweight Loss along with the Level of Competition

In Figure 1.7, I plot changes in deadweight loss as a function of market concentration under GSE pricing. I find that deadweight loss is lower than the baseline between 0.65N and N. A moderate increase in market concentration is socially beneficial as default cost goes down. The increased market power helps to correct some of the underpricing. However, welfare decreases substantially when the market becomes much more concentrated. Excessive market power is not socially desirable, as the inefficiency from increased market power outweighs the underpricing problem. Additionally, a decrease in market concentration exacerbates the underpricing problem, so deadweight loss increases as market concentration decreases.

1.7.3 The Impact of Competition Policy under Full Risk-Based Pricing

I examine the same competition policies discussed in Section 1.7.2 under full risk-based pricing. In Table 1.7 I present the results of this counterfactual for various instances of market structure from 0.75N to 2N, and perfect competition.

Interestingly, I find different welfare effects of competition under GSE pricing and full risk-based pricing. Under full risk-based pricing, deadweight loss decreases as the market becomes less concentrated. A higher market power is less desirable, as lenders charge a higher interest rate that leads to a lower mortgage demand. Competition is always socially beneficial and provides more loans to borrowers whose willingness to pay is higher than their costs.
Table 1.7: Welfare Impact of Market Structure - Full Risk-Based Pricing

<table>
<thead>
<tr>
<th>Panel A: Welfare Change to Baseline</th>
<th>$N$</th>
<th>0.75$N$</th>
<th>1.25$N$</th>
<th>1.5$N$</th>
<th>2$N$</th>
<th>$N \to \infty$</th>
</tr>
</thead>
<tbody>
<tr>
<td>Mean $\Delta$ Interest Rate</td>
<td>0.065</td>
<td>0.088</td>
<td>0.049</td>
<td>0.038</td>
<td>0.024</td>
<td>-0.020</td>
</tr>
<tr>
<td>Mean $\Delta$ Default Loss ($)</td>
<td>-843.218</td>
<td>-889.285</td>
<td>-811.637</td>
<td>-788.553</td>
<td>-758.258</td>
<td>-652.063</td>
</tr>
<tr>
<td>Mean $\Delta$ Lender Profit ($)</td>
<td>8,068.516</td>
<td>11,968.503</td>
<td>5,450.174</td>
<td>3,611.062</td>
<td>1,228.934</td>
<td>-6,388.580</td>
</tr>
<tr>
<td>Mean $\Delta$ Borrower Surplus ($)</td>
<td>-9,748.600</td>
<td>-14,127.147</td>
<td>-6,843.098</td>
<td>-4,817.043</td>
<td>-2,217.208</td>
<td>5,906.097</td>
</tr>
<tr>
<td>Mean $\Delta$ GSE Profit ($)</td>
<td>2,199.333</td>
<td>2,401.445</td>
<td>2,059.945</td>
<td>1,960.041</td>
<td>1,832.566</td>
<td>1,447.906</td>
</tr>
<tr>
<td>Mean $\Delta$ Deadweight Loss ($)</td>
<td>-519.249</td>
<td>-242.800</td>
<td>-667.021</td>
<td>-754.061</td>
<td>-844.291</td>
<td>-965.423</td>
</tr>
<tr>
<td>$\Delta$ # of Accounts (10k)</td>
<td>-76.842</td>
<td>-105.846</td>
<td>-57.732</td>
<td>-44.359</td>
<td>-27.404</td>
<td>22.636</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Panel B: Percentage Change to Baseline</th>
</tr>
</thead>
<tbody>
<tr>
<td>Mean $\Delta$ Interest Rate</td>
</tr>
<tr>
<td>Mean $\Delta$ Default Loss ($)</td>
</tr>
<tr>
<td>Mean $\Delta$ Lender Profit ($)</td>
</tr>
<tr>
<td>Mean $\Delta$ Borrower Surplus ($)</td>
</tr>
<tr>
<td>Mean $\Delta$ GSEs Profit ($)</td>
</tr>
<tr>
<td>Mean $\Delta$ Deadweight Loss ($)</td>
</tr>
<tr>
<td>$\Delta$ # of Accounts</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Panel C: Welfare Change to GSE Pricing with Same Market Concentration</th>
</tr>
</thead>
<tbody>
<tr>
<td>Mean $\Delta$ Interest Rate</td>
</tr>
<tr>
<td>Mean $\Delta$ Default Loss ($)</td>
</tr>
<tr>
<td>Mean $\Delta$ Lender Profit ($)</td>
</tr>
<tr>
<td>Mean $\Delta$ Borrower Surplus ($)</td>
</tr>
<tr>
<td>Mean $\Delta$ GSE Profit ($)</td>
</tr>
<tr>
<td>Mean $\Delta$ Deadweight Loss ($)</td>
</tr>
<tr>
<td>$\Delta$ # of Accounts (10k)</td>
</tr>
</tbody>
</table>

**Note:** Table 1.7 presents the welfare results under full risk-based pricing for the cases from $0.75N$ to $2N$ and perfect competition. Mean changes in the statistics are calculated using total changes in the statistics divided by sample size (22 million). Panel A presents the welfare changes in dollar value relative to the baseline, which is the case of $N$ under GSE pricing. Panel B presents the welfare changes in percentage relative to the baseline. Panel C presents the welfare changes in dollar value relative to the case under GSE pricing with the same competition level.
For the case of $2N$, borrower surplus increases, partially offsetting the decreased lender profit from lower market concentration. The lower market concentration decreases deadweight loss by 844.29 dollars (28.27 percent of the average mortgage subsidy) relative to the baseline. For the cases of $1.25N$ and $1.5N$, the results are qualitatively similar. Welfare gain is the largest in a perfectly competitive market; deadweight loss decreases by 965.42 dollars per loan (32.32 percent of the average mortgage subsidy) relative to the baseline.

1.7.4 Financial Innovation: Removing Information Asymmetry

Another potential inefficiency is that unobserved heterogeneity in $\lambda_i$ is private information known to each borrower but not to lenders and the GSEs. Financial technology (fintech) advances may help lenders to learn borrowers’ private information and engage in personalized pricing, which can be seen as perfect price discrimination on borrowers’ unobserved risks.\(^{50}\)

I examine the same competition policies discussed in Section 1.7.2 under a counterfactual that lenders observe the $\lambda_i$ for individual borrowers. Lenders are able to price discriminate against $\lambda_i$. I assume that GSE pricing does not depend on the information of individual unobserved risk types (i.e., same as the case of asymmetric information). I also consider the case when the GSEs charge guarantee fees according to borrowers’ unobserved risks (i.e., symmetric information with full risk-based pricing) later in this section.

In Table 1.8, I find that symmetric information under GSE pricing leads to a higher default cost and a higher welfare loss relative to the baseline. For the case of $N$, because lenders are able to extract more borrower surplus, their profits increase by 121.84 dollars. Default cost increases by 5.48 dollars on average. In total, deadweight loss increases by 7.36 dollars per loan.

In general, price discrimination increases market efficiency by allowing the market to capture more consumer surplus. However, removing information asymmetry under a sub-optimal pricing may actually reduce efficiency when it further distorts price. This is exactly what I find in this counterfactual exercise. Profit-maximizing lenders charge lower prices on borrowers who are private low types (i.e., with lower $\lambda$) since they are more price sensitive. At the same time, lenders raise the prices for borrowers who are private high types (i.e., with higher $\lambda$). This worsens the overprovision of mortgages to higher-risk borrowers and the underprovision of mortgages to lower-risk borrowers.

Under symmetric information, lender market power (price discrimination) leads to more price distortion, so the deadweight loss resulting from symmetric information decreases as market concentration decreases. In the extreme case of perfect competition, when price equals marginal cost, symmetric information achieves the same market outcomes as the

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\(^{50}\)One may think financial technology also helps lenders to learn a borrower’s unobserved lender preference, $\alpha_i$. My simulation predicts that prices will be close to the marginal costs when lenders are allowed to perfectly price discriminate on both unobserved risks and lender preference (see theoretical predictions in Stole (2007)). The market structure changes substantially; lender profit is close to zero and borrower surplus increases substantially. To study the equilibrium close to the current market structure, I still allow unobserved lender preference in this counterfactual exercise.
Table 1.8: Welfare Impact of Symmetric Information - GSE Pricing

<table>
<thead>
<tr>
<th></th>
<th>$N$</th>
<th>0.75$N$</th>
<th>1.25$N$</th>
<th>1.5$N$</th>
<th>2$N$</th>
<th>$N \to \infty$</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Panel A: Welfare Change to Baseline</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Mean $\Delta$ Interest Rate</td>
<td>0.000</td>
<td>0.023</td>
<td>-0.016</td>
<td>-0.027</td>
<td>-0.041</td>
<td>-0.085</td>
</tr>
<tr>
<td>Mean $\Delta$ Default Loss ($)</td>
<td>5.475</td>
<td>-101.869</td>
<td>75.407</td>
<td>124.347</td>
<td>188.572</td>
<td>401.294</td>
</tr>
<tr>
<td>Mean $\Delta$ Lender Profit ($)</td>
<td>112.837</td>
<td>4,509.973</td>
<td>-2,849.710</td>
<td>-4,932.952</td>
<td>-7,622.870</td>
<td>-16,114.002</td>
</tr>
<tr>
<td>Mean $\Delta$ Borrower Surplus ($)</td>
<td>-116.540</td>
<td>-4,726.801</td>
<td>2,945.473</td>
<td>5,081.180</td>
<td>7,819.195</td>
<td>16,328.823</td>
</tr>
<tr>
<td>Mean $\Delta$ GSE Profit ($)</td>
<td>-3.655</td>
<td>221.549</td>
<td>-147.247</td>
<td>-245.748</td>
<td>-370.973</td>
<td>-759.490</td>
</tr>
<tr>
<td>Mean $\Delta$ Deadweight Loss ($)</td>
<td>7.357</td>
<td>-4.721</td>
<td>51.485</td>
<td>97.519</td>
<td>174.648</td>
<td>544.669</td>
</tr>
<tr>
<td>$\Delta$ # of Accounts (10k)</td>
<td>-1.220</td>
<td>-30.153</td>
<td>16.612</td>
<td>28.605</td>
<td>43.577</td>
<td>87.836</td>
</tr>
<tr>
<td><strong>Panel B: Percentage Change to Baseline</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Mean $\Delta$ Interest Rate</td>
<td>0.000</td>
<td>1.592</td>
<td>-1.072</td>
<td>-1.826</td>
<td>-2.796</td>
<td>-5.831</td>
</tr>
<tr>
<td>Mean $\Delta$ Default Loss ($)</td>
<td>0.416</td>
<td>-7.734</td>
<td>5.725</td>
<td>9.440</td>
<td>14.316</td>
<td>30.465</td>
</tr>
<tr>
<td>Mean $\Delta$ Lender Profit ($)</td>
<td>0.700</td>
<td>27.988</td>
<td>-17.685</td>
<td>-30.013</td>
<td>-47.306</td>
<td>-100.000</td>
</tr>
<tr>
<td>Mean $\Delta$ Borrower Surplus ($)</td>
<td>-0.095</td>
<td>-3.845</td>
<td>2.396</td>
<td>4.133</td>
<td>6.360</td>
<td>13.282</td>
</tr>
<tr>
<td>Mean $\Delta$ GSE Profit ($)</td>
<td>0.033</td>
<td>-2.016</td>
<td>1.340</td>
<td>2.236</td>
<td>3.375</td>
<td>6.909</td>
</tr>
<tr>
<td>Mean $\Delta$ Deadweight Loss ($)</td>
<td>0.680</td>
<td>-0.436</td>
<td>4.757</td>
<td>9.011</td>
<td>16.138</td>
<td>50.329</td>
</tr>
<tr>
<td>$\Delta$ # of Accounts (10k)</td>
<td>-0.056</td>
<td>-1.377</td>
<td>0.759</td>
<td>1.306</td>
<td>1.990</td>
<td>4.011</td>
</tr>
<tr>
<td><strong>Panel C: Welfare Change to Asymmetric Information Case with Same Market Concentration</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Mean $\Delta$ Interest Rate</td>
<td>0.000</td>
<td>0.000</td>
<td>0.000</td>
<td>0.000</td>
<td>0.000</td>
<td>0.000</td>
</tr>
<tr>
<td>Mean $\Delta$ Default Loss ($)</td>
<td>5.475</td>
<td>5.112</td>
<td>4.327</td>
<td>3.445</td>
<td>2.223</td>
<td>0.000</td>
</tr>
<tr>
<td>Mean $\Delta$ Lender Profit ($)</td>
<td>112.837</td>
<td>142.884</td>
<td>85.432</td>
<td>65.122</td>
<td>40.683</td>
<td>0.000</td>
</tr>
<tr>
<td>Mean $\Delta$ Borrower Surplus ($)</td>
<td>-116.540</td>
<td>-161.264</td>
<td>-85.743</td>
<td>-64.957</td>
<td>-40.728</td>
<td>0.000</td>
</tr>
<tr>
<td>Mean $\Delta$ GSE Profit ($)</td>
<td>-3.655</td>
<td>5.318</td>
<td>-5.029</td>
<td>-4.568</td>
<td>-2.830</td>
<td>0.000</td>
</tr>
<tr>
<td>Mean $\Delta$ Deadweight Loss ($)</td>
<td>7.357</td>
<td>13.062</td>
<td>5.340</td>
<td>4.404</td>
<td>2.875</td>
<td>0.000</td>
</tr>
<tr>
<td>$\Delta$ # of Accounts (10k)</td>
<td>-0.913</td>
<td>-2.282</td>
<td>-0.445</td>
<td>-0.281</td>
<td>-0.179</td>
<td>0.000</td>
</tr>
</tbody>
</table>

**Note:** Table 1.8 presents the welfare results of symmetric information under GSE pricing for the cases from $0.75N$ to $2N$ and perfect competition. Mean changes in the statistics are calculated using total changes in the statistics divided by sample size (22 million). Panel A presents the welfare changes in dollar value relative to the baseline, which is the case of asymmetric information under GSE pricing when $N = 1$. Panel B presents the welfare changes in percentage relative to the baseline. Panel C presents the welfare changes in dollar value relative to the asymmetric information case with the same competition level and market design.
asymmetric information.

Additionally, I investigate a counterfactual of symmetric information combined with full risk-based pricing (Table 1.9). The changes in welfare are reversed directionally as opposed to GSE pricing. Welfare increases as market concentration decreases under full risk-based pricing.

Table 1.9: Welfare Impact of Symmetric Information - Full Risk-Based Pricing

<table>
<thead>
<tr>
<th></th>
<th>$N$</th>
<th>$0.75N$</th>
<th>$1.25N$</th>
<th>$1.5N$</th>
<th>$2N$</th>
<th>$N \to \infty$</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Panel A: Welfare Change to Baseline</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Mean $\Delta$ Interest Rate</td>
<td>0.065</td>
<td>0.088</td>
<td>0.049</td>
<td>0.038</td>
<td>0.024</td>
<td>-0.020</td>
</tr>
<tr>
<td>Mean $\Delta$ Default Loss ($)$</td>
<td>-873.466</td>
<td>-913.523</td>
<td>-846.219</td>
<td>-826.683</td>
<td>-801.388</td>
<td>-712.195</td>
</tr>
<tr>
<td>Mean $\Delta$ Lender Profit ($)$</td>
<td>8,053.664</td>
<td>12,001.376</td>
<td>5,394.835</td>
<td>3,524.221</td>
<td>-1,995.929</td>
<td>6,204.245</td>
</tr>
<tr>
<td>Mean $\Delta$ Borrower Surplus ($)$</td>
<td>-9,628.946</td>
<td>-14,061.527</td>
<td>-6,684.221</td>
<td>-4,630.223</td>
<td>-1,995.929</td>
<td>6,204.245</td>
</tr>
<tr>
<td>Mean $\Delta$ GSE Profit ($)$</td>
<td>2,226.633</td>
<td>2,429.450</td>
<td>2,088.277</td>
<td>1,990.299</td>
<td>1,865.193</td>
<td>1,494.911</td>
</tr>
<tr>
<td>Mean $\Delta$ Deadweight Loss ($)$</td>
<td>-651.350</td>
<td>-369.299</td>
<td>-798.891</td>
<td>-884.496</td>
<td>-972.379</td>
<td>-1,082.223</td>
</tr>
<tr>
<td>$\Delta$ # of Accounts (10k)</td>
<td>-67.673</td>
<td>-98.047</td>
<td>-47.909</td>
<td>-34.230</td>
<td>-16.925</td>
<td>33.520</td>
</tr>
</tbody>
</table>

|               |       |         |         |        |        |                |
| **Panel B: Percentage Change to Baseline** |       |         |         |        |        |                |
| Mean $\Delta$ Interest Rate | 4.463 | 6.061   | 3.388   | 2.632  | 1.659  | -1.378         |
| Mean $\Delta$ Default Loss ($\)$ | -66.310 | -69.351 | -64.242 | -62.759 | -60.838 | -54.067        |
| Mean $\Delta$ Lender Profit ($\)$ | 49.979 | 74.478  | 33.479  | 21.872 | 6.846  | -41.063        |
| Mean $\Delta$ Borrower Surplus | -7.832 | -11.438 | -5.437  | -3.766 | -1.623 | 5.047          |
| Mean $\Delta$ Deadweight Loss | -60.186 | -34.124 | -73.819 | -81.730 | -89.850 | -100.000       |
| $\Delta$ # of Accounts | -3.091 | -4.478  | -2.188  | -1.563 | -0.773 | 1.531          |

|               |       |         |         |        |        |                |
| **Panel C: Welfare Change to Asymmetric Information Case with Same Market Concentration** |       |         |         |        |        |                |
| Mean $\Delta$ Interest Rate | 0.000 | 0.000   | 0.000   | 0.000  | 0.000  | 0.000          |
| Mean $\Delta$ Default Loss ($\)$ | -30.248 | -24.238 | -34.582 | -38.130 | -43.130 | -60.132        |
| Mean $\Delta$ Lender Profit ($\)$ | -14.852 | 32.873  | -55.339 | -86.642 | -125.820 | -228.353       |
| Mean $\Delta$ Borrower Surplus ($\)$ | 119.654 | 65.620  | 158.877 | 186.820 | 221.280 | 298.148        |
| Mean $\Delta$ GSE Profit ($\)$ | 27.300 | 28.006  | 28.332  | 30.257 | 32.628 | 47.005         |
| $\Delta$ # of Accounts (10k) | 6.862  | 5.836   | 7.350   | 7.580  | 7.842  | 8.144          |

**Note:** Table 1.9 presents the welfare results of symmetric information under fully risk-based pricing for the cases from $0.75N$ to $2N$ and perfect competition. Mean changes in the statistics are calculated using total changes in the statistics divided by sample size (22 million). Panel A presents the welfare changes in dollar value relative to the baseline, which is the case of asymmetric information with $N$ under GSE pricing. Panel B presents the welfare changes in percentage relative to the baseline. Panel C presents the welfare changes in dollar value relative to the asymmetric information case with the same competition level and market design.

For the case of $N$, deadweight loss decreases by 651.35 dollars, or 21.81 percent of the
average mortgage subsidy. Relative to the case of asymmetric information under full risk-based pricing, default cost is 30.25 dollars lower and deadweight loss is 132.10 dollars lower. Welfare is maximized in a perfectly competitive market. When inefficiencies resulting from both pricing and information asymmetry are removed, perfect competition achieves the first-best outcome.

### 1.7.5 Differential Effects

In addition to studying the effects on efficiency, I examine differential effects across different groups of borrowers. I split borrowers into subgroups based on the following three categorizations: (i) an indicator of whether or not the borrower’s income is greater than the 50th percentile; (ii) an indicator of whether or not the borrower’s credit score is greater than the 50th percentile; and (iii) an indicator of whether or not the $\lambda_i$ is greater than the 50th percentile. I focus on changes in borrower surplus to study the distributional implications.

The differential effects under GSE pricing are reported in column (2) of Table 1.10. The lower-risk groups (i.e., with higher income, higher credit score, and higher $\lambda$) benefit more from lower market concentration. Since lower-risk borrowers are more likely to purchase a mortgage, they gain more from lower interest rates through more competition.

The differential effects of full risk-based pricing are reported in column (3) – (4) of Table 1.10. Lenders raise interest rates under full risk-based pricing, so most borrowers are worse off, especially for lower-risk borrowers who are more likely to purchase mortgages.

The differential effects of symmetric information are presented in Table 1.11. I also plot average prices separately for private high types and private low types under different pricing regimes and information environment in Figure 1.8.

Under GSE pricing with symmetric information, Lenders will price on borrower willingness to pay. Private low types with lower willingness to pay are offered lower prices than the case of asymmetric information. Therefore, private low types are better off from the lower prices, and private high types are worse off from the higher prices.

Alternatively, symmetric information under full risk-based pricing hurts private high types. Asymmetric information with full risk-based pricing implies that unobserved riskier borrowers are pooling with others who have lower default risks. When full risk-based pricing takes account for unobserved default risks under symmetric information, lenders charge private low types higher prices to cover their higher guarantee fees. As a result, private high types are worse off from the higher full risk-based prices.

### 1.7.6 Equilibrium Prices

I compare equilibrium interest rates of counterfactual policies to GSE pricing in Figure 1.9. The upper left panel shows the distribution of interest rates under full risk-based pricing. Full risk-based pricing corrects the underpricing problem, so most interest rates become higher under full risk-based pricing than GSE pricing.
Table 1.10: Differential Welfare Impact of Mortgage Insurance Pricing and Market Structure

<table>
<thead>
<tr>
<th></th>
<th>GSE Pricing</th>
<th>Full Risk-Based Pricing</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>N</td>
<td>2N</td>
</tr>
<tr>
<td><strong>Mean Δ Borrower Surplus ($)</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Income – High</td>
<td>5,136.338</td>
<td>-6,860.261</td>
</tr>
<tr>
<td>Income – Low</td>
<td>2,723.616</td>
<td>-2,888.389</td>
</tr>
<tr>
<td>Credit Score – High</td>
<td>4,352.715</td>
<td>-5,974.797</td>
</tr>
<tr>
<td>Credit Score – Low</td>
<td>3,514.065</td>
<td>-3,791.653</td>
</tr>
<tr>
<td>λ – High</td>
<td>4,164.116</td>
<td>-5,270.880</td>
</tr>
<tr>
<td>λ – Low</td>
<td>3,695.807</td>
<td>-4,477.720</td>
</tr>
<tr>
<td><strong>Mean Δ Deadweight Loss ($)</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Income – High</td>
<td>-629.488</td>
<td>-454.899</td>
</tr>
<tr>
<td>Income – Low</td>
<td>-214.808</td>
<td>-64.355</td>
</tr>
<tr>
<td>Credit Score – High</td>
<td>-268.240</td>
<td>-126.152</td>
</tr>
<tr>
<td>Credit Score – Low</td>
<td>-573.555</td>
<td>-390.932</td>
</tr>
<tr>
<td>λ – Low</td>
<td>-601.089</td>
<td>-415.081</td>
</tr>
</tbody>
</table>

**Note:** Table 1.10 studies the differential effects on borrower surplus and total surplus based on three categorizations: (i) an indicator of whether or not the borrower’s income is greater than the 50th percentile; (ii) an indicator of whether or not the borrower’s credit score is greater than the 50th percentile; (iii) an indicator of whether or not $\lambda_{in}$ is greater than the 50th percentile. The numbers show borrower surplus and total surplus change in dollar value under different competition levels and market designs relative to the baseline, which is the case of $N$ under GSE pricing.
Table 1.11: Differential Welfare Impact of Symmetric Information

<table>
<thead>
<tr>
<th></th>
<th>GSE Pricing</th>
<th>Full Risk-Based Pricing</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>N 2N</td>
<td>N 2N</td>
</tr>
</tbody>
</table>

**Panel A: Welfare Change to Baseline**

Mean $\Delta$ Borrower Surplus ($\$$)

<table>
<thead>
<tr>
<th>Category</th>
<th>GSE Pricing Mean</th>
<th>Full Risk-Based Pricing Mean</th>
</tr>
</thead>
<tbody>
<tr>
<td>Income – High</td>
<td>-47.931</td>
<td>-1.795.859</td>
</tr>
<tr>
<td>Income – Low</td>
<td>-68.609</td>
<td>-200.090</td>
</tr>
<tr>
<td>Credit Score – High</td>
<td>-45.220</td>
<td>-1.683.769</td>
</tr>
<tr>
<td>Credit Score – Low</td>
<td>-71.108</td>
<td>-323.283</td>
</tr>
<tr>
<td>$\lambda$ – High</td>
<td>-174.691</td>
<td>-973.631</td>
</tr>
<tr>
<td>$\lambda$ – Low</td>
<td>58.151</td>
<td>-1.922.297</td>
</tr>
</tbody>
</table>

Mean $\Delta$ Deadweight Loss ($\$$)

<table>
<thead>
<tr>
<th>Category</th>
<th>GSE Pricing Mean</th>
<th>Full Risk-Based Pricing Mean</th>
</tr>
</thead>
<tbody>
<tr>
<td>Income – High</td>
<td>2.992</td>
<td>-704.535</td>
</tr>
<tr>
<td>Income – Low</td>
<td>4.366</td>
<td>-267.850</td>
</tr>
<tr>
<td>Credit Score – High</td>
<td>1.718</td>
<td>-307.154</td>
</tr>
<tr>
<td>Credit Score – Low</td>
<td>5.608</td>
<td>-662.321</td>
</tr>
<tr>
<td>$\lambda$ – High</td>
<td>8.407</td>
<td>-341.836</td>
</tr>
<tr>
<td>$\lambda$ – Low</td>
<td>-1.050</td>
<td>-630.543</td>
</tr>
</tbody>
</table>

**Panel B: Welfare Change to Asymmetric Information Case with Same Market Concentration**

Mean $\Delta$ Borrower Surplus ($\$$)

<table>
<thead>
<tr>
<th>Category</th>
<th>GSE Pricing Mean</th>
<th>Full Risk-Based Pricing Mean</th>
</tr>
</thead>
<tbody>
<tr>
<td>Income – High</td>
<td>-47.931</td>
<td>135.478</td>
</tr>
<tr>
<td>Income – Low</td>
<td>-68.609</td>
<td>85.802</td>
</tr>
<tr>
<td>Credit Score – High</td>
<td>-45.220</td>
<td>74.692</td>
</tr>
<tr>
<td>Credit Score – Low</td>
<td>-71.108</td>
<td>146.004</td>
</tr>
<tr>
<td>$\lambda$ – High</td>
<td>-174.691</td>
<td>267.056</td>
</tr>
<tr>
<td>$\lambda$ – Low</td>
<td>58.151</td>
<td>-45.776</td>
</tr>
</tbody>
</table>

Mean $\Delta$ Deadweight Loss ($\$$)

<table>
<thead>
<tr>
<th>Category</th>
<th>GSE Pricing Mean</th>
<th>Full Risk-Based Pricing Mean</th>
</tr>
</thead>
<tbody>
<tr>
<td>Income – High</td>
<td>2.992</td>
<td>-75.047</td>
</tr>
<tr>
<td>Income – Low</td>
<td>4.366</td>
<td>-53.042</td>
</tr>
<tr>
<td>Credit Score – High</td>
<td>1.718</td>
<td>-38.914</td>
</tr>
<tr>
<td>Credit Score – Low</td>
<td>5.608</td>
<td>-88.766</td>
</tr>
<tr>
<td>$\lambda$ – High</td>
<td>8.407</td>
<td>-98.634</td>
</tr>
<tr>
<td>$\lambda$ – Low</td>
<td>-1.050</td>
<td>-29.454</td>
</tr>
</tbody>
</table>

**Note:** Table 1.11 studies the differential effects on borrower surplus and total surplus based on three categorizations: (i) an indicator of whether or not the borrower’s income is greater than the 50th percentile; (ii) an indicator of whether or not the borrower’s credit score is greater than the 50th percentile; (iii) an indicator of whether or not $\lambda_{in}$ is greater than the 50th percentile. Panel A presents the borrower surplus and total surplus changes in dollar value relative to the baseline, which is the case of N under GSE pricing. Panel B presents the borrower surplus and total surplus changes in dollar value relative to the asymmetric information case with the same competition level and market design.
**Note:** Figure 1.8 plots average prices separately for private high type (i.e., with higher $\lambda$) and private low type (i.e., with lower $\lambda$) under the following four cases: (i) GSE pricing with asymmetric information; (ii) full risk-based pricing with asymmetric information; (iii) GSE pricing with symmetric information; (iv) full risk-based pricing with symmetric information. I categorize the private type based on an indicator of whether or not the $\lambda_{in}$ is greater than the 50th percentile.

Figure 1.8: Differential Effects of Symmetric Information across Private Types

The upper right panel of Figure 1.9 shows the distribution of interest rates in the counterfactual that removes information asymmetry between lenders and borrowers under GSE pricing. Lenders charge higher interest rates to private high types who value mortgage more and charge lower interest rates to others to increase sales. Accordingly, most of interest rates shift lower and the rest of interest rates shift higher relative to the case of asymmetric information.

The lower left panel shows the distribution of interest rates with symmetric information under full risk-based pricing. Lenders charge higher interest rates for those who are likely to default (i.e., private low types) and charge lower interest rates to other borrowers. As a result, interest rates become more dispersed. Many interest rates shift much higher to account for higher unobserved risks.

### 1.8 Conclusion

Although the GSEs may have a positive influence in the mortgage market, their mispricing could give rise to market inefficiency. There are diverging opinions among policymakers and academics on GSE reforms, to some extent because the proposed reform scenarios have not been implemented on a large enough scale to provide conclusive answers. On the other hand, market structure is becoming more and more important in mortgage lending. Though a few recent papers point out the effects of competition among lenders in the mortgage market, the
Note: Figure 1.9 compares the distribution of interest rates under different pricing regimes and economic environments. The baseline is GSE pricing with asymmetric information on risk types between lenders and borrowers.

Figure 1.9: Distribution of Interest Rates in Counterfactual
interaction effects of competition and mispricing in the GSE market sector are unexplored.

This study provides a framework to analyze the welfare impacts of insurance pricing and market structure. I estimate an industry model of borrowers, lenders, and GSEs. My estimation leverages a natural experiment that gives cost advantages for certain lenders. The reduced-form analyses show that the regulatory changes had significant impacts on average interest rate and average default rate in the GSE market.

I use the estimated model to study two counterfactual pricing schemes for mortgage insurance. I find that GSE pricing suffers substantial welfare loss from mispricing (underpricing). An alternative full risk-based pricing reduces welfare loss. GSE pricing also implies a redistribution from lower-risk borrowers to higher-risk borrowers. A uniform pricing scheme that increases the degree of cross-subsidization leads to a larger welfare loss relative to GSE pricing.

I study how inefficiencies under GSE pricing interact with market structure. Under GSE pricing, a decrease in market concentration leads to a higher default cost to the GSEs and a higher welfare loss to the society. On the other hand, under full risk-based pricing, welfare increases as market concentration decreases. It is important to note that my analysis does not account for some potential factors, such as the competition effects in other market sectors and the equilibrium effects on housing prices in the real estate markets. These factors are difficult to quantify. However, they are important for policymakers to consider when determining a competition policy.

The welfare impacts of insurance pricing and market structure also depend on the degree of asymmetric information on borrower risks. Under GSE pricing, symmetric information on borrowers’ private risk types increases deadweight loss, whereas under full risk-based pricing, it reduces deadweight loss substantially.

The empirical findings in this study highlight the importance of considering the welfare impacts of mortgage insurance pricing and its interaction with market structure and information asymmetry. In this market sector, competition policy and financial innovation could have very different welfare impacts under different pricing regimes.

This study focuses on a specific consumer lending market, but the policy takeaways could apply broadly to other risk-sharing markets where the government plays a role through regulations, subsidies, tax policy, etc. For instance, the pricing for the federal health insurance program could have impacts on medical spending. The impacts could interact with the competition among health care providers. It will be intriguing to study other markets that share similar features and to extend the framework to study the private securitization markets.
Chapter 2

Regulating Penalty Repricing in the Credit Card Market

There is a rich theoretical literature on contract design in a dynamic setting. Theoretical models of corporate debt contracts focus on creditor control and renegotiation rights in debt contracts with incomplete information about the riskiness of a firm’s investment project (Hart and Moore, 1998). Generally, corporate loan covenants are renegotiated to achieve Pareto improvements. Empirical literature on corporate debt contracts focuses on the role of covenants that transfer the decision rights from shareholders to creditors (e.g., Chava and Roberts, 2008; Roberts and Sufi, 2009). However, there is very little discussion of consumer loan contract renegotiation. This is mainly due to the lack of data on consumer loan contracts with covenants and renegotiation outcomes and the lack of identification to study the role of changes in covenant enforcement.

In this study, we use the 2009 Credit Card Accountability, Responsibility, and Disclosure Act (CARD Act), which prohibited penalty repricing on credit cards as the basis of a case study to understand the implications of covenant restrictions on lenders and borrowers. Prior to the CARD Act, penalty repricing was widely used by lenders as a means to raise interest rates on borrowers with a higher risk of defaulting. Banks had explicit clauses in the credit

\footnote{This is a joint work with Souphala Chomsisengphet. This study does not advocate any specific policy and the views expressed in this study do not necessarily represent those of the Office of the Comptroller of the Currency, or more broadly, those of the U.S. Department of the Treasury.}

\footnote{See theoretical work from Holmstrom and Milgrom (1987), Laffont and Tirole (1988), Dewatripont (1989), and Fudenberg and Tirole (1990). Empirically, academics have looked at labor contracts (Chiappori et al., 1999; Duflo et al., 2012; Pallais, 2014) and insurance contracts (Hendel and Lizzeri, 2003; Finkelstein et al., 2005; Finkelstein et al., 2009; Bundorf et al., 2012; Handel et al., 2015; Handel et al., 2017)

\footnote{There is recent literature on loan modification subsequent to the 2008–2009 financial crisis (Agarwal et al., 2011; Mayer et al., 2013; Agarwal et al., 2017a). However, loan modifications are not like covenants; loan modifications were conceived after the massive wave of mortgage defaults and not thought about at the point of contract design. The paper closest to consumer loan covenants are mortgage prepayment penalties, which are the focus in Mayer et al. (2013).}
card contract that gave them the right to reprice the loan contract if the borrower violated the initial terms and conditions of the contract, e.g., a material change in credit scores, delinquency on the loan, or the levying of late or over-the-limit fees.\textsuperscript{4}

In response to concerns that penalty repricing may have been excessively costly for the more financially and liquidity constrained borrowers, the CARD Act limits the circumstances under which a penalty repricing could be triggered by borrowers’ behavior. This gives us a nice setting in which to study the role of covenants violation on lender profit, consumer debt, and welfare in the credit card market.\textsuperscript{5} The design and regulation of contract terms are important policy debates, with strong implications for efficiency and equity, in many credit and insurance markets.

Regulating penalty repricing could have ambiguous welfare impacts considering an endogenous lender response. When lenders are limited in using penalty repricing as a pricing instrument, they may incur additional losses from borrowers’ volatile credit risk over time. As a result, lenders may select a higher initial interest rate and may offer fewer credit cards to higher-risk borrowers to cover these losses. Borrowers overall may suffer from the higher initial interest rates and fewer available lines of credit. On the other hand, borrowers may gain from not being repriced against future risk fluctuation.

Our data come from an administrative dataset from the Office of the Comptroller of the Currency that contains more than 400 million credit card accounts from ten banks over a seven-year time period. The data are unique and contain critical details for empirically studying the CARD Act repricing prohibition. The high-frequency nature of our data on interest rates, repayment decisions, and purchase volume allows us to identify penalty repricing and to study borrowers’ dynamic decisions.

We begin our analyses by systematically documenting lenders’ practices to reprice against borrowers’ risk volatility. A penalty repricing could be triggered by delinquency, revolving debt, and a decrease in Fair Isaac Corporation (FICO) score. We also show that the CARD Act effectively restricts the penalty repricing; after the CARD Act, conditional on the triggering events, there are far fewer interest rate hikes.

Our reduced-form analyses emphasize borrowers’ heterogeneity in responding to penalty repricing. We identify borrowers into two groups, transactors and revolvers, based on their repayment history.\textsuperscript{6} We examine the effects of repricing in the pre–CARD Act period using an event study design. We find heterogeneous effects of penalty repricing depending on whether borrowers face liquidity constraints in making credit card repayments; after a repricing event occurs, revolvers’ average monthly interest charge increases by \$12.81\text{ dollars},

\textsuperscript{4}See Office of Thrift Supervision (2006).

\textsuperscript{5}While the implications of our results can contribute to policy debates, our study does not advocate any specific policy.

\textsuperscript{6}We categorize borrowers as transactors if any balance was revolved successively for no more than two times over the prior twelve months; we assign the remaining borrowers as revolvers. By this system, 52–56 percent of borrowers are defined as revolvers each month. Our results are robust to different categorization of borrowers on transactors and revolvers.
which is more 10 times higher than the average increase seen by transactors. The results show that penalty repricing has larger and more significant effects for revolvers on the outcomes of interest such as debt, repayment, interest finance charge, and purchase volume.

To further study the mechanism of competitive outcome changes following the pricing regulation of the CARD Act, we estimate a model of borrowers and lenders. Our model focuses on repayment and pricing decisions. In the model, lenders choose (initial) interest rates under a framework of differentiated Bertrand competition. A borrower makes dynamic repayment decisions conditional on the interest rate and her risk preference.

Our model takes into consideration several important elements that are documented in the reduced-form evidence; borrowers are heterogeneous in terms of their liquidity constraints and risk preference. Borrowers face uncertainties in future liquidity, which cause their default risk to fluctuate over time.

The model is estimated using a method-of-moments approach. We first derive predicted average lending and default probability for each borrower risk type. Next, we estimate the distribution of types by matching the empirical average lending and default probability. We estimate the model under a constant interest rate regime (i.e., the post–CARD Act period).\footnote{We only consider the constant interest rate regime because (i) our data have a short pre–CARD Act period with many major events (e.g., the financial crisis and the CARD Act announcement) happening at the same time and (ii) we simplify the estimation by only considering borrowers’ dynamic decisions. The simplification is essential given our computational constraints.}

We use the estimated model to perform two counterfactual analyses. We consider the following pricing interventions: (i) allowing penalty repricing and (ii) imposing an interest ceiling.

In the first counterfactual, we consider the effects of penalty repricing. Penalty repricing can be seen as a pricing instrument for lenders to price discriminate on borrowers who later become higher-risk. We allow lenders to endogenously repricing with a penalty rate on a delinquent borrower (i.e., a higher-risk borrower).\footnote{In practice, lenders usually reprice once when the borrowers trigger a repricing event. Less than 10 percent of accounts were repriced more than once within a year. Therefore, we treat penalty repricing as price discrimination toward delinquent borrowers, not as a monthly dynamic pricing based on borrowers' monthly credit performance.}

We find that when lenders are allowed to engage in penalty repricing, the average (initial) interest rate is $1.75$ percentage points lower relative to our baseline, a restricted penalty pricing regime; lenders select a lower (initial) interest rate when they are able to cover the losses from future risk volatility by penalty repricing.

Borrowers benefit from the lower initial interest rates. However, borrowers also incur a disutility from expecting being penalty repriced when they have negative liquidity shocks. We find that the latter effect dominates the former effect; each borrower surplus decreases by $17.19$ dollars.\footnote{The welfare statistics in this paper are calculated on the yearly level.} Overall, allowing penalty repricing is less efficient; average total surplus decreases by $10.30$ dollars, relative to the case when lenders are restricted from engaging in penalty repricing.
We also find that penalty repricing has effects on equilibrium credit supply; penalty repricing decreases average lending by 90.12 dollars (5.18 percent of the average lending). Borrowers, in the face of income volatility, reduce their borrowing to avoid future risks of being penalty repriced. As a result, allowing penalty repricing only increases lender profit for each loan by 6.89 percent on average.

In the second counterfactual, we also examine the impact of imposing an interest rate ceiling, which is a common form of interest rate regulation. We estimate that an interest rate ceiling at 15 percentage points decreases borrower surplus by 92.94 dollars on average. An interest rate ceiling benefits the marginal borrowers by providing them with a lower interest rate, whereas it hurts high-risk borrowers by cutting off their credit supply as the credit card rejection rate increases. Overall, an interest rate ceiling at 15 percentage points decreases total surplus for each loan by 142.59 dollars.

Our findings highlight that, in credit contracts with dynamic risks, different forms of interest rate regulation, i.e., regulating penalty repricing and imposing a price ceiling, could yield different welfare impacts. In particular, it is important to consider the equilibrium effects on interest rates and credit supply when manipulating price dynamics.

This study relates to several literatures. First, while an extensive line of research studies the credit card market, known about the role of interest rate regulation in credit contracts of credit cards with dynamic risks. Seminal work focuses on adverse selection (Calem and Mester, 1995; Ausubel, 1999; Calem et al., 2006), market structure (Ausubel, 1991), contract choices (Agarwal et al., 2015b), and repayment decisions (Angeletos et al., 2001; Gross and Souleles, 2002).

A growing number of empirical studies examine the impact of the CARD Act (Han et al., 2013; Jambulapati and Stavins, 2014; Debbaut et al., 2014; Agarwal et al., 2015c; Keys and Wang, 2016). Concurrent work by Nelson (2017) studies the impact of this pricing regulation on the extensive margin selection on switching credit cards. Though related, our context differs in a number of ways. For instance, we focus on the intensive margin of credit card borrowers and the equilibrium credit supply.

This study is also related to the literature on pricing regulation of dynamic contracts in the insurance market (Hendel and Lizzeri, 2003; Finkelstein et al., 2005; Finkelstein et al., 2009; Bundorf et al., 2012; Handel et al., 2015; Handel et al., 2017), in the consumer financial market (Mayer et al., 2013; Hong et al., 2018). Pricing restriction under a dynamic contract potentially results in dynamic market failures. In addition, Mayer et al. (2013) and Hong et al. (2018) analytically show that the restriction on covenants violation have impacts on initial interest rates.\footnote{Hong et al. (2018) study similar context as in this study. However, they find that repricing regulation results in higher deadweight losses and reduces consumer surplus. We find that repricing regulation results in lower deadweight losses and increases consumer surplus. In their model, borrowers have no friction to switch across borrowers. Therefore, borrowers are always indifferent in the repricing period. Borrowers are}

\footnote{Although our model allows us to study richer credit borrowing and lending decisions, it imposes more constraints on identification and computation. I do not incorporate extensive margin and selection as in Nelson (2017). The two studies complement each other nicely.}
Finally, more research has also given attention to estimating structural parameters on how lenders and borrowers make decisions. Our analysis is built upon the work that studies borrower repayment decisions to discern the policy implications in consumer credit markets (Bajari et al., 2008; Einav et al., 2012; Kawai et al., 2014).

The rest of the chapter proceeds as follows. Section 2.1 provides a brief overview of the credit card market and the CARD Act. Section 2.2 describes the dataset we use and how we construct the sample. Section 2.3 provides some reduced-form results that motivate our empirical model. Section 2.4 presents our empirical model of borrowers and lenders. Section 2.5 discusses our identification strategy and estimation procedure. Section 2.6 presents parameter estimates and counterfactual analyses of different interest rate regulatory regimes. Section 2.7 concludes. Additional technical details and robustness checks are available in the appendices.

2.1 The Credit Card Industry

According to the reports on household debt and credit from the Federal Reserve Bank of New York (Federal Reserve Bank of New York, 2017), total revolving credit card debt held by individuals with social security numbers in the United States grew by 136 billion dollars (1.5 percent) from the 2013 to 2017. Today, credit cards are the most ubiquitous consumer financial product except for deposit accounts (Durkin et al., 2014).

A credit card is a diverse and complex financial product that serves many functions. First and foremost, credit cards provide consumers with a very efficient and convenient means of paying for goods and services. In the first two quarters of 2015, about 4.5 billion transactions were made by U.S. general-purpose credit cards, accounting for more than 1.4 trillion dollars of consumer spending (The Nilson Report, 2015).

In addition, credit cards serve as a convenient and flexible channel for consumers to access credit. Revolving credit card debt doubled between 1997 and 2008, reaching a peak of slightly more than 1 trillion dollars, and has been steadily increasing ever since the Great Recession. As of the fourth quarter of 2017, the total credit card debt and the total number of accounts held by individuals with social security numbers are 834 billion dollars and 468.76 million, respectively (Federal Reserve Bank of New York, 2017). These two numbers translate into an average credit card debt of 1,779 dollars per account. Although consumers often have several credit cards, they tend to concentrate usage on one card. According to a report from the Consumer Financial Protection Bureau (2013), around 50 percent of all cardholders have at least 90 percent of their credit card balances on a single card.

It is quite common for credit card issuers to offer introductory teaser rates to encourage consumers to apply for and use the card. The introductory teaser rate is often 0 percent (see Figure F.3) during the promotional period, which is often six or twelve months. After the always better off with repricing as they receive lower interest rates initially. In our model, because witching is not allowed, borrowers pay more interests in the repricing period. This is consistent with our reduced-form evidence that borrowers pay higher interest rates after repricing.
promotional period, the remaining balance will be assessed finance charges at the standard interest rate. The introductory teaser rate is beneficial for borrowers who simply transfer their credit card debt intertemporally to avoid high interest costs, without using the card to make purchases during the teaser period. The back-loaded pricing structure may potentially take advantage of consumers’ misperception of future consumption and renewal past the introductory period (Ausubel, 1999; DellaVigna and Malmendier, 2004).

A credit card account is considered to be delinquent when a consumer fails to make a required minimum payment by the payment due date. When an account has been continuously delinquent for a certain length of time, federal regulations require lenders to declare them as as losses, also called a chargeoff. Lenders are required to make such a declaration for accounts that remain delinquent for 180 days at the latest.

2.1.1 Penalty Repricing

Credit card pricing has been criticized for imposing significant interest and fees on borrowers. Lenders generally charge a variety of penalties, including late fees and over-limit fees. Lenders assess a late fee to consumers who do not make at least their minimum payment by the monthly due date, and over-limit fees to consumers whose spending exceeds a set credit limit. Interest finance charges are the largest source of costs to borrowers. Additionally, credit card issuers were permitted to penalty reprice accounts, creating immediate rate increases in APR on both new purchases and existing balances, leaving consumers exposed to retroactive price changes associated with their prior card usage.

An account is considered to be upward repriced if its retail APR in the current month is greater than the retail APR in the previous month. Figure 2.1 shows the share of upward repricing of consumer accounts before and after the CARD act, where upward repricing is defined as an APR increase of at least 1 percentage point. We exclude the increases of APR that occur at the end of introductory teaser rate periods. We find that banks were reacting to the CARD Act and that the policy largely reduced the number of upward repricing incidents among credit card accounts.

In the data, an upward repricing event could occur for many reasons, including the following: i) an any cycle-ending delinquency in the current or previous period; ii) an any fee incidence in the current or previous period; iii) an any interest incident in the current or previous period; iv) a FICO score decrease in the current or previous period; v) an account had a teaser rate in the previous period and the teaser promotional rate expired in the current period; and vi) an account was in a workout program in the previous period and not in a workout program in the current period.

We consider an account to have experienced a penalty reprice if any of the first four events occurred. In this study, we focus on the following three borrower behaviors that trigger penalty repricing: (i) cycle-ending delinquency, (ii) finance charges, and (iii) FICO

\[12\] This does not use any specific threshold for an APR increase, so even a single basis point increase is considered a repricing event.
Figure 2.1: Share of Upward Repricing Accounts

Note: Figure 2.1 shows the share of accounts with upward repricing over time. An account is considered to be upward repriced if its retail APR in the current month is greater than the retail APR in the previous month, and month, the increases that occur at the end of introductory rate periods are excluded. The first red vertical line indicates May 2009, which is the time when the CARD Act was announced. The second red vertical line indicates February 2010, which is the time when the CARD Act limited upward repricing.

score deterioration. The last behavior captures a borrower’s performance not only on the current credit card but on other financial products as well.

To address the concerns of unfair and deceptive business practices, policymakers introduced the 2009 Credit Card Accountability and Responsibility Disclosure (CARD) Act. The regulation imposed major changes to and restrictions on practices in the credit card industry.

2.1.2 The 2009 CARD Act

The main part of the CARD Act took effect on February 22, 2010. The CARD Act regulates many aspects of the credit card industry. First, the penalty fees that lenders may charge credit card borrowers are capped at certain levels. Second, the issuance of credit cards to individuals under the age of 21 is limited. Third, repayment details must be disclosed in monthly statements. Fourth, interest rate hikes on existing accounts are greatly restricted. Agarwal et al. (2015c) estimates that regulatory limits on credit card fees reduced overall borrowing costs by an annualized 1.6 percent of the average daily balance, with borrowing costs declining by 5.6 percent for borrowers with a FICO score below 660. The main focus of this study is the regulation of penalty repricing.

The CARD Act’s main regulations on upward repricing are in Sections 171 and 172. Section 171 declares, “In the case of any credit card account under an open end consumer credit plan, no creditor may increase any APR, fee, or finance charge applicable to any
outstanding balance.” This regulation is applicable to both new and existing accounts but not to pre–CARD Act transactions and balances.

The CARD Act did not completely eliminate a lender’s ability to raise interest rates; instead, the CARD Act establishes conditions that must be met before such an increase is allowed. Lenders can raise interest rates on accounts that miss the minimum payment within 60 days; however, lenders cannot impose significant changes to the term of the contract without a 45-day advance notice of the change, during which time the consumer may cancel the account. In addition, lenders are not allowed to increase the interest rate more frequently than once every six months and should terminate such an increase when the required minimum payment is received. Lastly, lenders are required to reevaluate any new rate increases every six months.

Additionally, the CARD Act allows issuers to change the interest rates of accounts with a variable rate contract as the underlying benchmark rate changes. The benchmark often increases if the cost of funds to the issuer increases and is often linked to the prime rate announced by the Federal Reserve. This allows lenders to respond to broad macroeconomic and credit market conditions with more flexibility under the regulation of interest rates. Finally, interest rate increases are still allowed on accounts that were issued temporarily low interest rates, which is often the case for accounts that were offered at a teaser rate and experience an interest rate hike when the promotional period ends.

Figure C.2 shows the share of delinquent accounts that were penalty repriced within 30 days, within 30 to 60 days, and within 60 to 90 days. We label an account as penalty repriced if the APR of the account increased at least 1 percentage point (excluding the increase at the end of the introductory teaser rate period) within 90 days after a delinquency occurred. Note that the CARD Act largely limited lenders’ ability to penalty reprice accounts within 60 days. We find a similar pattern for penalty repricing events conditional on the accounts’ having an interest charge and the FICO score decreasing by at least 20 (see Appendix C.2).

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13Section 172 of the CARD Act has additional limits on interest rate increases, including a stricter regulation on the plan before the end of the one-year period beginning on the date on which the account is opened, and issuers are not allowed to increase APRs before the end of the six-month period beginning on the date on which the promotional rate takes effect.

14According to 12 Code of Federal Regulations 226.59: “Reevaluation of rate increases, if a card issuer increases an annual percentage rate that applies to a credit card account under an open-end (not home-secured) consumer credit plan, based on the credit risk of the consumer, market conditions, or other factors, or increased such a rate on or after January 1, 2009 [...], the card issuer must, based on its review of such factors, reduce the annual percentage rate applicable to the consumer’s account, as appropriate.”

1515 U.S.C. §1666i-1(b)(2) (excepting an increase in a variable annual percentage rate in accordance with a credit card agreement that provides for changes in the rate according to operation of an index that is not under the control of the creditor and is available to the general public).

16The CARD Act requires lenders to inform borrowers what the new rate will be after the teaser period expires when the account is opened, and the promotional rate period must be at least six months.
2.2 Data

Our data come from the Credit Card Metrics (CCM) dataset assembled by the Office of the Comptroller of the Currency. The data contain an account-level panel on credit cards issued by ten large credit card lenders supervised by the OCC. The dataset contains monthly information about credit card utilization (e.g., purchase volume), contract characteristics (e.g., interest rates and credit limits), lender charges (e.g., interest and fee charges), account performance (e.g., repayment amount and total past due), and borrower characteristics (e.g., originated and refresh FICO scores) for over 400 million credit card accounts.

The main dataset is reported from January 2008 through December 2015. Overall, data on approximately a one-year pre-regulation period, a ten-month policy expectation period, and a five-year post-regulation period.

2.2.1 Sample Construction

We discuss the details of constructing our sample. First, we restrict our attention to new accounts originated during the sample period (i.e., April 2008 to December 2015). Second, we drop the first three months of 2008 because the reporting is incomplete. We also drop five banks that do not have observations both before year 2010 and after year 2010, or banks with insufficient observations because of our restriction on product type and loan channel.

Third, we do not include accounts that are reported as specific product types such as private label, affinity, oil and gas, and co-branded credit cards. We remove accounts whose FICO scores were not reported at origination. We drop accounts that have never been active and accounts with only one observation. We also remove the observations when the accounts were in the teaser rate promotion periods, after being reported as a fraudulent account, and after entering a workout program.

Finally, we select a 2 percent random sample from the remaining qualified credit card accounts. In our final sample, approximately 2.25 million new accounts were issued during the sample period.

2.2.2 Descriptive Statistics

Table 2.1 presents the descriptive statistics of key variables during the pre-regulation period (January 2008 to March 2009) and the post-regulation period (January 2012 to December 2015). The average credit score is 731.83 during the 2008–09 period and 740.53 during the 2012–15 period. The average updated credit score is similar to the average credit score.

Typically, a borrower receives an APR of 13–15 percentage points and a credit limit from

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17 Activation is defined as an account that had any debit, credit, or balance activity in the past 12 months.

18 Teaser rate is defined as a retailed APR of less than or equal to 6 percent.
<table>
<thead>
<tr>
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<th></th>
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</thead>
<tbody>
<tr>
<td></td>
<td>Mean</td>
<td>Standard Deviation</td>
<td>Minimum</td>
<td>Maximum</td>
<td>Mean</td>
<td>Standard Deviation</td>
</tr>
<tr>
<td>Originated FICO</td>
<td>731.834</td>
<td>56.501</td>
<td>431.000</td>
<td>850.000</td>
<td>749.533</td>
<td>60.348</td>
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<tr>
<td>Refreshed FICO</td>
<td>731.958</td>
<td>73.392</td>
<td>381.000</td>
<td>850.000</td>
<td>752.966</td>
<td>67.161</td>
</tr>
<tr>
<td>APR (%)</td>
<td>13.457</td>
<td>4.337</td>
<td>6.240</td>
<td>29.990</td>
<td>15.558</td>
<td>4.007</td>
</tr>
<tr>
<td>Credit Limit ($)</td>
<td>7,645.005</td>
<td>7,001.170</td>
<td>10.000</td>
<td>250,000.000</td>
<td>7,903.827</td>
<td>6,795.078</td>
</tr>
<tr>
<td>Initial Credit Limit ($)</td>
<td>7,471.427</td>
<td>6,708.471</td>
<td>10.000</td>
<td>250,000.000</td>
<td>8,292.904</td>
<td>7,614.717</td>
</tr>
<tr>
<td>Purchase Volume ($)</td>
<td>372,300</td>
<td>1,129,078</td>
<td>0.000</td>
<td>114,269.400</td>
<td>551,040</td>
<td>1,703,108</td>
</tr>
<tr>
<td>Revolving Balance ($)</td>
<td>1,338,277</td>
<td>3,146,782</td>
<td>0.000</td>
<td>150,773.100</td>
<td>1,447,605</td>
<td>2,825,833</td>
</tr>
<tr>
<td>Late Fee Accessed ($)</td>
<td>36,442</td>
<td>7,495</td>
<td>0.010</td>
<td>80,140</td>
<td>27,763</td>
<td>7,394</td>
</tr>
<tr>
<td># of New Accounts</td>
<td>126,674.000</td>
<td></td>
<td></td>
<td>430,026.000</td>
<td></td>
<td></td>
</tr>
<tr>
<td># of Accounts</td>
<td>1,053,871.000</td>
<td></td>
<td></td>
<td>30,500,000.000</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Active Account (%)</td>
<td>78.670</td>
<td></td>
<td></td>
<td>87.387</td>
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<tr>
<td>Delinquent Account (%)</td>
<td>4.884</td>
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<td>2.546</td>
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<tr>
<td>Default Account (%)</td>
<td>0.397</td>
<td></td>
<td></td>
<td>0.127</td>
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**Note:** Table 2.1 shows summary statistics of key variables for the 2008–09 pre-regulation period and for the 2012–15 post-regulation period. Initial contract terms are calculated using the first observation of an account. Other values are calculated using account-month observations during the sample period. An account is defined as active when it had any debt, credit, or balance activity in the past twelve months.
7,000 to 8,000 dollars. Average revolving debt\(^{19}\) per account in our sample is around 1,000 dollars. The average late fee is significantly lower during the 2012–15 period relative to the 2008–09 period (36.44 versus 27.76); the CARD Act effectively caps the late fee assessed.

During each monthly billing cycle, around 80 percent of the accounts are active (i.e., an account has activity in the past twelve months), 3–5 percent of the accounts are delinquent, and 0.1–0.4 percent of the cards defaults.

A borrower’s credit score and revolving debt are good proxies of her default risks. We find that borrowers’ default risks do fluctuate after account origination. Figure 2.2 presents the change in FICO scores one year after account origination; 40 percent of accounts have a change in FICO score greater than 25 points, and around 5 percent of accounts have a large decrease in the FICO score by more than 100 points. We also plot the monthly change in the revolving balance in Figure F.4. The revolving balance is quite volatile from month to month, with approximately 25 percent of accounts having a substantial absolute change in revolving debt more than 500 dollars.

![Figure 2.2: Change in FICO Score](image)

**Note:** Figure 2.2 plots percentage frequency distribution of change in FICO score one year after account origination during the 2008–09 pre-regulation period (blue shaded bars) and the 2012–15 post-regulation period (white transparent bars).

\(^{19}\)We measure revolving credit card debt as the cycle-ending balance in the last billing cycle, minus the actual payment amount the cardholder makes in the current period, plus all of the interest and fees accrued.
future risk fluctuation. We also show that the CARD Act effectively restricts penalty repricing; after the CARD Act, conditional on the triggering events, there are few longer interest rate hikes. Next, we conduct an event study to examine borrowers’ behavior in responding to penalty repricing. We present and discuss our results below.

### 2.3.1 Triggering Penalty Repricing

First, we examine lenders’ practices to reprice against borrowers’ risk volatility. A penalty repricing event could be triggered by delinquency, revolving debt, or a decrease in credit score.

In the left panel of Figure 2.3, we plot the change in interest rates for the 2008–09 pre-regulation period, separately for accounts that were non-delinquent as compared to accounts that were ever more than 30 days or more delinquent within one year after origination; we find that more than 20 percent of the delinquent accounts were upward repriced during the 2008–09 pre-regulation period, with average APR increasing by more than 10 percentage points. We also examine penalty pricing of accounts conditional on zero and positive (lagged) revolving balances and accounts conditional on increases and decreases in FICO score. We see similar patterns for these two triggering events.

![Figure 2.3: Change from Initial Interest Rate for Delinquent Accounts](image)

**Note:** Figure 2.3 plots the percentage frequency distribution of interest rate changes from the time when the card was issued to one year after origination. The left panel shows the changes for the 2008–09 pre-regulation period. The right panel shows the changes for the 2012–15 post-regulation period. White transparent bars show the accounts were ever more than 30 days delinquent. Blue shaded bars show the changes for the remaining accounts.

In addition, we examine how regulation changed the interest rates offered by lenders. In the right panel of Figure 2.3, we show the change in interest rates during the 2012–15 post-regulation period, separately for accounts that were non-delinquent as compared to accounts
that were ever 30 days or more delinquent within one year after origination. During the 2012–15 post-regulation period, about 98 percent of accounts did not experience a change in interest rates from the initial interest rates at the time of issuance. The CARD Act has significantly limited a lender’s ability to reprice when a borrower’s credit performance deteriorates due to events such as delinquency, increasing debt size, or a drop in FICO score of more than 20 points.

![Figure 2.4: Change from Initial Credit Limit](image)

**Note:** Figure 2.4 plots percentage frequency distribution of change in credit limit from the time when the card was issued to one year after origination. The figure shows the changes for the 2012–15 post-regulation period. White transparent bars shows the accounts were ever more than 30 days delinquent. Blue shaded bars show the changes for the remaining accounts.

One may think that lenders may lower the credit limit if they are not allowed to penalty reprice. In Figure 2.4, we compare the change in credit limit from the initial credit limit at one year after the card was issued, separately for whether an account was ever delinquent during the one-year post origination. The credit limit for the majority of the accounts (greater than 85 percent) did not change. In addition, there is no significant change in credit limit conditional on delinquent accounts after the CARD Act. In other words, lenders’ credit card line management in response to borrower risk volatility after the CARD Act was negligible; this evidence motivates our model to treat credit limit as an observable characteristic instead of as a state variable.
2.3.2 Repricing Event Study

To investigate borrowers’ behavior in responding to penalty repricing, we employ the following event study design:

\[ R_{it} = \alpha_i + \gamma_t + \sum_{k=3}^{-3} b_k D_{it}^k + \epsilon_{it}, \]  

(2.1)

where \( R_{it} \) is the outcome variable of interest. \(^20\) \( D_{it}^k \) is an indicator of whether borrower \( i \) was repriced \( k \) months ago, \( \gamma \) is time (monthly) fixed effects, and \( D_{it}^k = 1 \{ t = e_i + k \} \). \(^21\)

We include account fixed effects, \( \alpha_i \), to control for variations that differ across accounts but are constant over time. We also include (monthly) fixed effects, \( \alpha_i \), to control for variations that differ across accounts but are constant over time. Because repricing events are rare in the 2012–15 post-regulation period, we conduct the event study analysis only on accounts in the 2008–09 pre-regulation period.

We examine four outcome variables of interest: revolving debt, repayment beyond the required minimum payment, interest charge, and purchase volume for three months before and after the repricing event. The estimated coefficients of Equation 2.1 are reported in Table 2.2.

| APR | Debt Repayment Interest Finance Charge Purchase Volume |
|-----|---------------------------------|-----------------|-----------------|-----------------|-----------------|
|     | All Sample | Transactors | Revolvers | All Sample | Transactors | Revolvers | All Sample | Transactors | Revolvers | All Sample | Transactors | Revolvers |
| k = -2 | 0.098 | 0.955 | 0.563 | -25.736 | 12.173 | -26.584 | -5.327 | -5.061 | -1.735 | 0.778 | 0.412 | 1.045 | 8.510 | -1.917 | 12.389 |
| k = -1 | 0.014 | 0.088 | 0.016 | -7.016 | -5.260 | -8.418 | -2.977 | -2.762 | -2.760 | -0.110 | 0.030 | 0.132 | 3.373 | -1.290 | 4.378 |
| k = 0 | 0.009 | 0.001 | 0.001 | -7.943 | -7.943 | -7.943 | -1.536 | -1.536 | -1.536 | 0.030 | 0.030 | 0.030 | 1.380 | -0.467 | 1.847 |

Note: Table 2.2 shows coefficients from the even study regressions in Equation 2.1 on the sample during the pre-CARD Act period. The coefficient on \( k = -1 \) is normalized as zero. We define a borrower as a transactor if her balance was revolved successively for no more than 2 times over the prior 12 months; otherwise, the borrower is defined as a revolver. Time (year-month) and account fixed effects are remitted for brevity. Robust standard errors in parentheses are clustered at the account level.

Panel (a) in Figure 2.5 plots the estimated coefficients for outcome variables of debt.

\(^{20}\) We also perform the log specifications for all the outcome variables, the results are not qualitatively or quantitatively different in a meaningful way.

\(^{21}\) \( e_t \) denotes the month of repricing event.
Average debt increases before the repricing event happens. After repricing, there is a kink for average debt; aggregate debt remains at a similar level after pricing.

Panel (b) in Figure 2.5 plots the estimated coefficients for outcome variables of repayment beyond the required minimum payment. Average repayment made by borrowers significantly increases by about 52.57 dollars one month after repricing. The lagged treatment effect on repayment suggests a reasonable behavior response; borrowers first notice an interest rate hike and make payments in the subsequent billing cycles.

Panel (c) in Figure 2.5 plots the estimated coefficients for outcome variables of interest finance charges. The average interest finance charge increases sharply by 9.82 dollars following a repricing event and remains higher thereafter; penalty repricing has a long-term increasing effect on borrowers’ interest finance charges. Another interpretation is that lender profit from interest finance charges increases in the long term after repricing.

Panel (d) in Figure 2.5 plots the estimated coefficients for outcome variables of purchase volume. Purchase volume can be a proxy for borrowers’ monthly consumption. We do not observe a kink for purchase volume following a repricing event; on average, the purchase volume is 6.28 dollars lower after repricing relative to the pre-repricing period.

2.3.3 Heterogeneous Borrowers

To further explore borrower heterogeneity, we investigate the outcome variables described in Section 2.3.2 separately for transactors and revolvers. We label borrowers as transactors if their balance was revolved successively for no more than two times over the prior twelve months; otherwise, borrowers are defined as revolvers. Our results are robust across several different definitions of transactors and revolvers. About 52–56 percent of borrowers are defined as revolvers each month.

Panel (a) in Figure 2.6 and 2.7 plot the estimated coefficients for outcome variables of revolving debt for transactors and revolvers, respectively. The effect of penalty repricing on transactors’ debt is not significant. Alternatively, revolvers’ debt significantly increases on average by 33.45 dollars after repricing.

Panel (b) in Figure 2.6 and 2.7 plot the estimated coefficients for outcome variables of repayment beyond the required minimum payment for transactors and revolvers, respectively. The effect of penalty repricing on transactors’ repayment is not significant. On the other hand, revolvers significantly increase their repayment by 39.61 dollars on average.

Panel (c) in Figure 2.6 and 2.7 plot the estimated coefficients for outcome variables of interest finance charges for transactors and revolvers, respectively. On average, after repricing, revolvers paid 12.81 dollars in higher-interest finance charges whereas transactors

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22Interest rate charge to borrower equals the debt multiplied by the interest rate.

23Specifically, we try the following alternative definitions of transactors: (i) the number of times the monthly balance was revolved is less than two times in any given calendar year; (ii) the number of times the monthly balance was revolved is less than two times in any given calendar year and the late fee is reversed in the following month; and (iii) the number of times the monthly balance was revolved over the past twelve months is less than two times over past twelve months.
Note: Figure 2.5 plots the coefficients from the event study regressions in Equation 2.1 on the sample during the pre–CARD Act period. The red vertical line indicates the month when the accounts were repriced. Dashed lines show 95 percent confidence intervals.

Figure 2.5: Treatment Effects of Repricing Event
paid only 1.05 dollars more. A possible explanation is that revolvers are more likely to be liquidity-constrained and are unable to pay all their debts, so they have to bear the additional interest rate charges from repricing.

Panel (d) in Figure 2.6 and 2.7 plot the estimated coefficients for outcome variables of purchase volume for transactors and revolvers, respectively. We find significant treatment effects for transactors. After repricing, revolvers’ average purchase volume decreases by 7.50 dollars, although there is the decreasing slope in the pre-trend. On the contrary, the purchase volume of transactors increases by about for 13.86 dollars on average after repricing.

Overall, we observe that penalty repricing creates quite different effects on credit card performance, depending on whether the borrower is a revolver or a transactor. Penalty repricing seems to have a larger effect on revolvers in terms of revolving debt, repayment, interest finance charges, and purchase volume. Our results emphasize borrowers’ heterogeneity in responding to penalty repricing depending on their liquidity constraints in making credit card repayments.

2.3.4 Initial Interest Rates and Credit Limit

Our study highlights the equilibrium effects of initial interest rates. In this section, we compare the distribution of initial contract terms during the 2008–09 pre-regulation period to the 2012–15 post-regulation period. We do not try to argue any causal effect of regulating repricing on any changes in these distributions, since many factors (e.g., time trends, risk composition of borrowers, and other aspects of the CARD Act) could have changed lender behavior between the 2008–09 period and the 2012–15 period. We later show that much of the change in interest rates can be explained by the penalty repricing regulations.

In Figure 2.8, we present the distribution of initial APRs for each FICO bucket, conditional on the accounts being issued in 2008 (the pre-regulation period) and after 2012 (the post-regulation period). There are some notable distributional shifts to the right in the initial APR in 2008–09 period relative to in the 2012–15 period; initial interest rates of accounts that were issued after the CARD Act become higher.

In Figure 2.9, we also show the initial credit limit conditional on the accounts being issued in 2008 (the pre-regulation period) and after 2012 (the post-regulation period). The change in the initial credit limit is much more modest relative to the change in the initial interest rate; the shift in the initial credit limit is not as significant as the shift of the initial interest rates.

2.4 Model

Our model starts at the time of credit card issuance, after borrower \( i \) has chosen to take out a credit line with a given lender. In view of the borrower types and their initial characteristics, a lender \( j \) offers an interest rate, \( r \), and credit limit, \( L \), if the application is approved. In the subsequent period \( t \), the borrower chooses whether to become delinquent \( d_t = \{0, 1\} \) and
Note: Figure 2.6 plots the coefficients from the event study regressions in Equation 2.1 on transactors during the pre–CARD Act period. We define borrowers as transactors if any balance was revolved successively for no more than two times over the prior twelve months. The red vertical line indicates the month when the accounts were repriced. Dashed lines show 95 percent confidence intervals.

Figure 2.6: Treatment Effects of Repricing Event for Transactors
Figure 2.7 plots the coefficients from the event study regressions in Equation 2.1 on revolvers during the pre–CARD Act period. We define borrowers as revolvers if any balance was revolved successively for more than two times over the prior twelve months. The red vertical line indicates the month when the accounts were repriced. Dashed lines show 95 percent confidence intervals.

**Note**: Figure 2.7 plots the coefficients from the event study regressions in Equation 2.1 on revolvers during the pre–CARD Act period. We define borrowers as revolvers if any balance was revolved successively for more than two times over the prior twelve months. The red vertical line indicates the month when the accounts were repriced. Dashed lines show 95 percent confidence intervals.

Figure 2.7: Treatment Effects of Repricing Event for Revolvers
Note: Figure 2.8 plots percentage frequency distribution of initial interest rate during the 2008–09 pre-regulation period (blue shaded bars) and the 2012–15 post-regulation period (white transparent bars) by credit score buckets.

Figure 2.8: Initial Interest Rate
Note: Figure 2.9 plots percentage frequency distribution of originated credit limit during the 2008–09 pre-regulation period (blue shaded bars) and the 2012–15 post-regulation period (white transparent bars) by credit score buckets.
chooses the debt level on credit card $b_t \in [0, L]$, where $L$ is the credit limit. We define the optimal decisions of borrowers and lenders below.

### 2.4.1 Credit Card Borrowers

In our model, borrower $i$ faces two sources of uncertainty: the realization of the expenditure shock $e$ and the transition of liquidity $y$. The expenditure shock $e$ captures randomness in utility from current consumption and the unobserved components related to delinquency decisions, such as forgetting to make a payment and temporary liquidity shock. The expenditure shock is assumed to be independent and identically distributed over time. The shock is known to each borrower but not to researchers and lenders.

The borrower chooses to become delinquent if her continuation value of repaying the debt is less than her continuation value of being delinquent. Given the delinquency choice, the borrower then chooses how much to borrow, which depends on whether she has a high draw of expenditure shocks or a low draw of liquidity.

**Period Utility**

In a given period $t$, the period utility of consumption, $y_t - B_t + b_t$, is specified as the following Constant Relative Risk Aversion (CRRA) function:

$$u_i(b_{it}, d_{it}; s_{it}, r_{ij}) = e_{it} \left(1 - (y_{it} - B_{it} + b_{it})^{1/\gamma_i} - 1 \right) + e_{i(d_{it})}$$

subject to the constraint imposed by the credit limit, $b_t \leq L$. The parameter $\gamma$ measures the degree of relative risk aversion that reflects the intertemporal substitution factor in consumption. $\gamma$ is an individual-specific parameter that captures unobserved heterogeneity. $e$ is repayment choice-specific shocks that influence borrowers’ repayment decisions.

$s = \{B, y, D, e, \epsilon\}$ denotes the vector of state variables including debt, income, number of successive delinquencies, expenditure shocks, and repayment shocks. $D$ denotes the number of successive delinquencies:

$$D_{it} = \mathbb{1}(d_{it} = 1) \cdot (D_{it-1} + 1), \quad (2.2)$$

with initial state $D_0 = 0$. $B$ denotes revolving debt accumulated from the previous period, which is an endogenous state variable that follows:

$$B_{it} = (1 + r_{ij})b_{it-1} + \mathbb{1}(d_{it} = 1)LF, \quad (2.3)$$

where $LF$ is the late fees assessed for delinquency. To be consistent with the maximum allowed during the post–CARD Act, we set the value of $LF$ equal to 25 dollars.
Utility: Defaulting on a Card

The borrower reaches a default state when she delinquents on the card for three successively periods (i.e., $D_t = 3$). The post-default value function is written as

$$V_i = \sum_{t=1}^{\infty} \frac{\lambda_i^{1-\gamma_i} - 1}{1 - \gamma_i}.$$ 

If the borrower defaults, she no longer receives the option value of utilizing a credit card and incurring a default cost as if she was receiving a stationary income of $\lambda_i$ each period. $\lambda_i$ is an individual-specific parameter that captures the unobserved heterogeneity in default costs such as a damage in credit score and future credit access.

Repayment Decision

In period $t$, borrower $i$’s value function $V$ is given by

$$V(s_t; r_{ij}) = \max_{b_t, d_t} u(b_t, d_t; s_t, r_{ij}) + \beta E_{s_{t+1}}[V_{ij}(s_{t+1}; r_{ij})],$$

where $\beta$ is the discount factor for each period. $E$ is an operator that takes an expectation over the transition probability of state variables. $s_{t+1}$ denotes a vector of state variables in the next period. Liquidity, $y$, follows a first-order Markov process. The number of delinquency, $D$, and revolving debt, $B$, are endogenous state variables following Equation 2.2 and 2.3.

Each period, a borrower makes a repayment decision to maximize her intertemporal utility. Borrowers choose an optimal debt level. According to the first-order condition implied by the model, the optimal debt level is written as

$$b_i(s_t; r_{ij}) = \left( \frac{e_i}{\beta E_{s_{t+1}}[V_{ij}(s_{t+1}; r_{ij})]} \right)^{\frac{1}{\gamma_k}} + B_t - Y_t.$$ (2.5)

In period $t$, it is optimal for a borrower to repay as long as the following is true:

$$d_i(s_t; r_{ij}) = \begin{cases} 0, & \text{if } u(b_t, d_t = 0; s_t, r_{ij}) + \beta E_{s_{t+1}|d_t=0}[V_{ij}(s_{t+1}; r_{ij})] + \epsilon_{i0} \\ \geq u(b_t, d_t = 1; s_t, r_{ij}) + \beta E_{s_{t+1}|d_t=1}[V_{ij}(s_{t+1}; r_{ij})] + \epsilon_{i1}, & \text{otherwise.} \end{cases}$$

Preferred Lender

At the time of credit card issuance, borrower $i$’s expected utility of borrowing from lender $j$ is

$$U_{ij}(s_0) + \nu_{ij} = \alpha_j + E_{s_0}[V_{ij}(s_0; r_{ij})] + \nu_{ij},$$ (2.6)

24 Conditional on being delinquent for three months, a loan’s probability of being charged-off or frozen is around 37.16 percent.
where \( \nu_{ij} \) follows logistic distribution with mean 0 and standard deviation \( \sigma_{\nu} \). \( \alpha \) is the lender-specific preference, which is known to each borrower but not to researchers and lenders. \( \alpha_j \) is interpreted as the incremental utility that a borrower is willing to pay in order to choose a preferred lender. One could think of credit card borrowing as being nearly identical across lenders, but lenders are differentiated by agent, customer service, payment system, and brand loyalty. The lender-specific preference can rationalize a borrower’s decision to borrow from a lender with higher interest rates due to brand preference.

The borrower chooses the lender which gives her the highest utility. The optimal choice of card is as follows:

\[
j_i^* = \arg \max_j U_{ij}(s_0) + \nu_{ij}.
\]

A borrower may choose not to borrow from credit cards and choose an outside option including other forms of consumer credits. The mean utility of choosing an outside option is assumed to be

\[
V_{i0}(r_{kj}) = \mathbb{E}(s_0) [V_{i0}(s_0; r_{ij})] = \mathbb{E}_{e,y} \left[ \sum_{t=0}^{\infty} \beta^t e_t \frac{g_{1-t} - y_i - 1}{1 - y_i} \right].
\]

### 2.4.2 Credit Card Lenders

In the model, credit card lenders are assumed to engage in Bertrand competition with differentiated products, meaning that they compete on price with horizontal product differentiation.

We assume that lenders have complete information on borrowers’ heterogeneity in risk preference; such information could be obtained by the use of a credit report to assess a borrower’s historical credit profile and performance. However, lenders still face uncertainty on their profits because of future income volatility and i.i.d. shocks.

Recall that we consider the period when penalty repricing is not allowed, therefore, we can simplify the interest rate as a fixed pricing problem; lenders choose an interest rate at the initial period and the interest rate does not change over time. Lender \( j \)'s profit in period \( t \) is given by:

\[
\pi_{ij}(r; s_t) = \tau_{ij}(r) \left[ (r - c_j) \mathbb{E}_{s_t} [b_i(s_t, r)] \right],
\]

where \( c \) is the lender's marginal cost of funds, which captures the lender's per-dollar cost of funding a credit card. \( \tau \) is the market-share function, i.e., the probability that borrower \( i \) would borrow. We do not include in lender profit the interchange fee that lenders charge merchants, we assume that lenders earn an economic profit of zero in this business sector.

If the borrower defaults, lenders can no longer collect her revolving debt on the credit card. Therefore they incur a loss:

\[
\pi_{ij}(r; s_t) = -B_t.
\]

We can therefore write lender \( j \)'s expected long-term profit at the time of card issuance
as
\[ \Pi_{ij}(r; s_0) = \pi_{ij}(r; s_0) + \beta \mathbb{E}_{\{s_t\}}[\Pi_{ij}(r; s_{t+1}, c_j)]. \]

**Interest Rate Pricing**

Lender \( j \) offers interest rate \( r \) that maximizes the expected profit at card issuance. Specifically, the lender solves the following first-order condition with respect to interest rate:

\[
\frac{\partial \Pi_{ij}(r; s_0)}{\partial r} = \tau_{ij}(r; s_0) \left( \sum_t \mathbb{E}_{\{s_t\}}[b_i(s_t, r)] - \frac{\partial D_i(r; s_0)}{\partial r} + (r - c_j) \frac{\partial \sum_t \mathbb{E}_{\{s_t\}}[b_i(s_t, r)]}{\partial r} \right) + \frac{\partial \tau_{ij}(r; s_0)}{\partial r} \left( (r - c_j) \times \sum_t \mathbb{E}_{\{s_t\}}[b_i(s_t, r)] - D_i(r; s_0) \right) = 0,
\]

where \( D_i(r; s_0) \) is the expected credit loss.\(^{25}\) This condition reveals a lender’s trade-off when choosing a higher price. A higher interest rate has a direct impact on profit by increasing the interest finance charge. On the other hand, a higher interest rate results in a lower expected market share, as lenders are competing against prices. Solving Equation 2.7 yields

\[ r_{ij}(s_0) = c_j + \Delta_{ij}(s_0), \]

(2.8)

where \( \Delta_{ij}(s_0) = \frac{1}{1+h(r(s_0))} \left( \sum_t \mathbb{E}_{\{s_t\}}[b_i(s_t, r)] + \Delta_{ij}(s_0) \right) \) denotes lender markup, which represents a fixed charge over the marginal cost for a lender with market power.\(^{26}\) The optimal interest rate in Equation 2.8 is written as additively separable in marginal cost, expected credit loss, and markup.

**Card Issuance**

Finally, given the profit function stated in Equation 2.7, lender \( j \) also chooses whether or not to accept a borrower’s credit card application based on the expected profit at the time of issuance:

\[
\Pi_{ij}(\psi_{ij}; s_0) + v_i(\psi) = \begin{cases} 
\Pi_{ij}(r_{ij}; s_0) + v_{i0}, & \text{if } \psi_{ij} = 0, \\
v_{i1}, & \text{if } \psi_{ij} = 1,
\end{cases}
\]

(2.9)

where \( \psi \) equals 1 if the lender declines the borrower’s credit card application, and equals 0 otherwise. \( v \) is the issuance-specific error term, which is known to the lender but not to the researchers and borrowers. The lender chooses to issue a card if the expected profit of issuance is greater than the expected profit of rejecting the application.

\(^{25}\)The expected credit loss, \( D_i(r; s_0) \), is written as \( \sum_t \mathbb{E}_{\{s_t\}}[\Pr(D_t(s_t; r) = 3) \times \pi_{ij}(r; s_t)]. \)

\(^{26}\)\( h = \left( \frac{\partial \tau_j(r; s_0)}{\partial r} \right)^{-1} \left( \tau_j(r; s_0) + \frac{\tau_{ij}(r; s_0)}{\mathbb{E}_{\{s_t\}}[b_i(s_t, r)]} \frac{\partial D_i(r; s_0)}{\partial r} \right). \)
2.4.3 Discussion

Motivated by our reduced-form evidence, our model allows the heterogeneity along parameter $\gamma$ and parameter $\lambda$. Borrowers’ heterogeneity is categorized by how constantly they choose to become delinquent and revolve their balance, captured earlier in our division of borrowers into two categories, transactors and revolvers. A borrower who has higher default cost is higher would try not to incur debt in order to decrease her probability of defaulting in the future. A higher risk aversion parameter is less likely to use a credit credit to meet their borrowing needs.

In the model, revolvers are those with higher value of $\lambda$ and lower value of $\gamma$. Transactors are those with lower value of $\lambda$ and higher value of $\gamma$; our model is flexible on borrowers’ types, however, not limited to only two types (i.e., revolvers and transactors) as in the reduced-form evidence.

We discuss here some important assumptions in the model that simplify a complex reality. First, we assume that there is no asymmetric information between lenders and borrowers. This assumption is crucial in simplifying the model. The complete information abstracts us away from the need to model lenders’ learning on borrowers’ risk types. In our model, lenders do not learn borrowers’ risk types over time. Instead, they learn from a borrower’s liquidity constraints and the associated default risk through state variables such as utilization, revolving debt, and the number of delinquencies.

Second, we assume that borrowers at most borrow from one credit card. In addition, we do not allow borrowers to switch their credit card account to another lender. Although switching (e.g., via balance transfer) is an important element to study in the credit card market, the focus of this study is on borrowers’ delinquency and default decisions. Since our account-level data do not contain information on how borrowers switch credit cards, adding the endogenous switching would require adding even more assumptions and structures to the model.

Empirical work highlights the importance of switching in dynamic contracts on worsening adverse selection (Finkelstein et al., 2005; Handel et al., 2015; Nelson, 2017). If switching and asymmetric information are taken into consideration, our estimate on welfare loss of penalty repricing could be even larger. To avoid additional complications in the model, we impose these two assumptions discussed earlier; this means that our welfare measure could be seen as a lower bound.

2.5 Estimation

In this section, we describe the empirical methods to estimate structural parameters in the model. The model is estimated using the data from January 2012 to December 2015. In this way, we are able to exclude the effects of concurrent regulations (e.g., late fees were capped) from the CARD Act on demand and supply.

We first extract the empirical moments of mean debt level and the mass of borrowers from the data. Next, we estimate the demand parameters by matching the empirical
moments at each state. Given the estimated demand parameters, we then estimate the supply parameters. We start the discussion with the estimation on the borrower’s side.

2.5.1 Demand Estimation

To estimate the demand parameters, we follow closely the method-of-moments approach (Ackerberg, 2009; Bajari et al., 2007; Fox et al., 2011; Nevo et al., 2016). The estimation procedure involves two steps. We describe both of them below.

First Step: Estimating Transition Probability and Empirical Moments

We partition borrowers into 25 types using originated FICO scores and cardholders’ credit limits. For each credit limit and credit score bucket, we estimate the transition probabilities of the exogenous state variable, income $y$.

We assume that transition probability of liquidity $y$ (in log) follows a unit root process. To estimate a stationary liquidity transition probability, we control for the macroeconomic condition:

$$\log(y_t) - \log(y_{t-1}) = \beta z + \xi,$$

$z \sim N(0, \sigma^2)$. \hspace{1cm} (2.10)

$z$ is a vector of quarterly housing price indexes collected from the Federal Housing Finance Agency and monthly unemployment rates for each state collected from the Bureau of Labor Statistics. Appendix D summarizes these two variables.

Additionally, we estimate the empirical moments, the mean debt level $\hat{b}(s_t)$, the mass of borrowers $\hat{\omega}(s_t)$, the average initial interest rate $r$, and market share of each lender $\hat{\tau}$ for each credit limit and credit score bucket. We save these moments and later use them in the second step.

To estimate market share, we need to form a potential market size. To do so, we calculate the average credit card application rate and rejection rate using the Credit Access Survey from the Federal Reserve Bank of New York from October 2013 to October 2015 (see Appendix C.3). Since the five banks in our sample represent about 46 percent of the credit card accounts in industry, we assume the potential market size are size is twice our data population divided by (1 - rejection rate) and then divided by (1 - application rate).

Second Step: Estimating Model Parameters

Next, we solve for the model to obtain moment conditions. We normalize the expenditure shock $e$ to be a standard log-normal distribution and repayment shocks $\epsilon$ to be a Gumbel

---

27 Note that the value function iteration converges at the monthly discount rate $\beta$, which is very close to 1. To speed up the convergence, we iterate on policy functions, i.e., debt level and delinquency at each state.
Then, given a vector of primitives $\Theta = \{\theta, \sigma_\nu\}$, the lender-specific preference, $\alpha$ is calculated as follows.

$$\alpha_{kj} = \ln(\hat{\tau}_j) - \ln(\hat{\tau}_0) - \sum_k \theta_k \left( \mathbb{E}_{\{s_0\}}[V_{kj}(s_0; r_{kj})] - \mathbb{E}_{\{s_0\}}[V_{k0}(s_0; r_{kj})] \right),$$

where $\tau_0$ is a share of borrowers who choose not to apply for credit cards and receive the utility of choosing an outside option.

The parameter to be estimated is the distribution of borrower types. We recover the distribution by matching the weighed average moments implied by the model to the moments observed in the data. The moment restrictions used in the estimation are

$$g(\Theta) = \mathbb{E} \left[ \frac{\hat{b}(s) - \sum_k \theta_k \mathbb{E}_{\{s_0\}}[b_{kj}(s)] \omega_{kj}(\sigma_{\nu,k}, s)}{\hat{\omega}(s) - \sum_k \theta_k \omega_{kj}(\sigma_{\nu,k}, s)} \right] = 0,$$

subject to $\theta'1 = 1$ and $\Theta \geq 0$. $\omega_{kj}(s)$ denotes the probabilities (across types) of type $k$ reaching state $s$. We calculate $\omega_{kj}(\sigma_{\nu,k}, s)$ using the each type’s probabilities of borrowing, repaying, and choosing the lender.

We obtain optimal weighting matrix $\hat{W}$ using the re-sampling methods (Lahiri, 2013; Nevo et al., 2016). We then solve for $\Theta$ in the outer loop:

$$\hat{\Theta} = \arg \min_{\Theta} \hat{g}(\Theta)' \hat{W} \hat{g}(\Theta).$$

In practice, we discretize the state space and then solve Equation 2.4. Appendix E provides the details of the estimation procedure. Our model allows for heterogeneity along borrowers’ risk aversion parameter $\gamma$ and default value $\lambda$. We estimate 170 unobserved borrower risk types, each combination of $\gamma$ and $\lambda$ constitute a type. $\gamma$ ranges from 1.25 to 5.25 with grid of 0.25, and $\lambda$ is discretized to 10 bins. The bins are chosen so that borrower’s average default probabilities (across states conditional on $D = 1$) are 0.75%, 1.5%, 2.25%, 3.00%, 6.00%, 9.00%, 12.00%, 15.00%, 22.50%, and 30.00%, respectively. A borrower risk

28 The repayment shocks enter additively in borrowers’ utility function. To adjust that the utility is scaled by $\gamma$, we allow $\epsilon$ to be heteroscedasticity. The variance of borrowers with the highest value of utility function (i.e., the smallest $\text{gamma}$) is normalized to 1, and the variance of other types of borrowers is scaled by their outside option value $V_{k0}$ accordingly.

29 $\omega_{kj}(\sigma_{\nu,k}, s) = \frac{\tau_{kj}(\sigma_{\nu,k})p_{kj}(s)}{\sum_k \tau_{kj}(\sigma_{\nu,k})p_{kj}(s)}$, where $p_k$ is the probability that type $k$ reaching to a state.

30 We re-estimate the empirical moments on 30 randomly selected samples. We then compute the variance-covariance matrix of the sample moments.

31 In our context, the revolving debt $B$ is a continuous variable. Though we discretize the state space in the estimation, for each choice of debt level $b$, we approximate the value function assuming that it is linear between the two points on the grid around the choice. We approximate the integration on expenditure shocks $E_e$ using Gauss-Hermite Quadrature (see Appendix E).
type is categorized by a vector of parameters \(\{\gamma_k, \lambda_k\}\). For each credit limit and credit score bucket, we solve the model for unobserved types up to 140 combinations of \(\{\gamma, \lambda\}\). Overall, we estimate \(25 \times 170 = 4,250\) types of borrowers. For type of borrower \(k\), we obtain their predicted mean debt, \(E_{(s_t)}[d_{kj}(s_t)]\), and predicted delinquency probability, \(E_{(s_t)}[b_{kj}(s_t)]\).

**Identification**

The primary identification concerns of this model are to separate the risk aversion parameter, \(\gamma\), from the default cost \(\lambda\). We leverage two sources of variation in the data: (i) average debt levels and (ii) probabilities of reaching each state (i.e., different debt levels and the number of delinquencies).

Equation 2.5 shows that the optimal debt level varies with the parameters \(\gamma\) and \(\lambda\). Borrowers who have different risk aversion \(\gamma\) would have different level of debt on average. Borrowers with a lower value of \(\lambda\) also choose lower average debt to avoid the risk of default, due to their higher relative cost of defaulting.

To separately identify \(\gamma\) and \(\lambda\), we use the probabilities of reaching different debt levels and being delinquent. Given the same \(\gamma\), borrowers with a lower value of \(\lambda\) (i.e., a higher default cost) would have a lower probability of reaching to higher debt level and being delinquent. This condition helps to separately identify the unobserved heterogeneity \(\gamma\) and \(\lambda\).\(^{32}\)

**2.5.2 Cost Estimation**

Given the estimated distribution of borrower types \(\hat{\theta}\), we then estimate lender marginal cost. We derive lender markup for each loan according to Equation 2.8. The pricing equation gives

\[
\nu_i(c) = \hat{r}(s_0) - \sum_k \theta_k \Delta(s_0) + \kappa_t.
\]

where \(c\) denotes a vector of marginal costs to be estimated. We obtain cost estimates using linear least squares, as in

\[
\hat{c} = \arg\min_c \nu(c)^\top \nu(c).
\]

Finally, given the logistic assumption of \(\nu\), the rejection rate of lender \(j\) for each borrower type \(k\) has a closed-form solution:

\[
E(\psi_{kj}) = \Pr(v_{i1} \geq E[\Pi_{kj}(r_{kj}; s_0, c_j)] + v_{i0}) = \frac{1}{1 + \exp\left(\frac{E[\Pi_{kj}(r_{kj}; s_0, c_j)]}{\nu_0}\right)}.
\]

\(^{32}\)In practice, we estimate 170 types of \(\gamma\) and \(\lambda\). These two conditions provide sufficient conditions to nonparametrically identify the finite weights of types (Kasahara and Shimotsu, 2009).
2.6 Estimation Results and Counterfactual Equilibrium

Here, we discuss the parameter estimates. We estimate the weight of 170 borrowers’ risk types for each credit score and credit limit bucket. The average number of types greater than 0.01 percent is 10.92. The highest weight of borrowers risk types counts for 39 percent; the highest three weights of borrowers risk types count for 68 percent.

We plot the non-parametric distribution of $\gamma$ in Figure 2.10. Borrowers with higher credit score are associated with a high level of risk aversion, $\gamma$. The average of $\gamma$ across all types is 3.61. In Figure 2.11, we plot the non-parametric distribution of default probabilities $d(\lambda)$ across states: each probability map to an unique value of $\lambda$ for each type of borrowers. The average of default probabilities across all types is 0.80%. The higher the borrower’s FICO score, the more borrowers with lower value of default, which confirms the intuition that default is less desirable to borrowers with higher credit scores. The estimated average (weighted by market shares) of marginal cost $c$ across banks is 8.28 percent.

![Distribution of Borrower Types in $\gamma$](image)

**Note**: Figure 2.10 plots distribution of borrower types in parameter $\gamma$ by credit score buckets.

Figure 2.10: Distribution of Borrower Types in $\gamma$

2.6.1 Model Fit

To evaluate the model fit, we compare simulated debts and default probabilities with the observed debts and default probabilities from the data in Figure 2.12, respectively. They match reasonably well. The model is able to predict the average debt well at most of the states. The model conveys good prediction for average default probabilities, but it under-predicts the probabilities when accumulated debt is low and over-predicts the probabilities when accumulated debt is high.
Note: Figure 2.11 plots distribution of borrower types in default probabilities \(d(\lambda)\) across states. Each probability maps to an unique value of \(\lambda\) for each type of borrowers.

Figure 2.11: Distribution of Borrower Types in Default Probability

\[\text{(2.12a) Debt}\]
\[\text{(2.12b) Default Probability}\]

Note: Figure 2.12 compares the data with the predicted moments. The dashed lines are the model prediction and the solid lines are the observed data. The left panel compares the data with predicted debt. The right panel compares the data with predicted default probabilities when borrowers delinquent on the card for two months successively.

Figure 2.12: Fitted Moments
2.6.2 Counterfactual Equilibrium

We use the estimated model to analyze the impact of two interest rate interventions. Given the parameter estimates, we re-compute the equilibrium in contractual policy. For a given market equilibrium \( r \),

I calculate borrower surplus \( CS \) and lender profit \( LS \) as

\[
CS_{kj}(r) = \tau_{kj}(r) (\alpha_j + V_k(s_0; r) - V_k),
\]

\[
LS_{kj}(r) = \tau_{kj}(r) \left[ (r - c_j) \mathbb{E}_{\{s_t\}}[b_k(s_t, r)] \right].
\]

We calculate borrower surplus using a certainty equivalent approach, which equates a borrower’s value function to the utility of consuming \( CE \) dollars each period. Given this, total surplus in dollar value \( TS \) equals the combined dollar value of borrowers’ and lenders’ respective surpluses:

\[
TS(r) = \sum_j \sum_k \hat{\theta}_k [LS_{kj}(r) + CE_k(r)].
\]

First, we study the impact of regulating penalty repricing by the CARD Act. Second, we examine the impact of a ceiling that caps the interest rate on credit card debts. We also compare the distributional consequence across borrower risk types to study the differential effects of penalty repricing and interest ceiling, depending on borrower heterogeneity.

We discuss the results of my counterfactual simulations in detail below.

Penalty Repricing

We estimate the model when penalty repricing is regulated. To quantify the impact of penalty repricing, we examine the counterfactual when lenders are allowed to engage in penalty repricing. We allow lenders to charge a penalty rate \( r^p \) on borrowers who become delinquent (at the states where \( D > 1 \)). In practice, lenders usually reprice once when the borrowers trigger a repricing event. Less than 10 percent of accounts were repriced more than once within an year. Therefore, we treat penalty repricing as a price discrimination on delinquent borrowers, not as a monthly dynamic pricing based on borrowers’ monthly credit performance.

Lender profit corresponding to the new pricing regime is written as follows:

\[
\pi_{ij}(r; s_t, c_j) = \begin{cases} 
\tau_{ij}(r, r^p) \left[ (r - c_j) \mathbb{E}_{\{s_t\}}[b_i(s_t, r)] \right], & \text{if } D_{it} = 0, \\
\tau_{ij}(r, r^p) \left[ (r^p - c_j) \mathbb{E}_{\{s_t\}}[b_i(s_t, r^p)] \right], & \text{if } D_{it} > 0.
\end{cases}
\]

Penalty rate, \( r^p \), can be higher or equal to the initial interest rate \( r \). We solve for an optimal interest rate, an optimal penalty rate, and the borrower’s policy functions. We then

\[33\text{We calculate the lenders’ optimal pricing by iterating their first-order conditions associated with the counterfactual policy and competitors’ pricing. We stop at iteration } n \text{ when the lenders’ pricing in this iteration, } r^n, \text{satisfies the following condition: } |r^n - r^{n-1}| < 0.1 \text{ percent.}\]
Table 2.3: The Impact of Penalty Repricing and Interest Rate Ceilings

<table>
<thead>
<tr>
<th>Panel A: Change to Baseline</th>
<th>Baseline Regulating Penalty Repricing</th>
<th>Counterfactual I Penalty Repricing</th>
<th>Counterfactual II Interest Rate Ceiling at 15%</th>
</tr>
</thead>
<tbody>
<tr>
<td>Mean ∆ Initial Interest Rate (%) (–)</td>
<td>-0.49</td>
<td>-1.29</td>
<td></td>
</tr>
<tr>
<td>Mean ∆ Lending ($) (–)</td>
<td>-90.12</td>
<td>-235.55</td>
<td></td>
</tr>
<tr>
<td>Mean ∆ Rejection Rate (%)</td>
<td>-1.40</td>
<td>14.03</td>
<td></td>
</tr>
<tr>
<td>Mean ∆ Lender Profit ($)</td>
<td>6.89</td>
<td>-6.38</td>
<td></td>
</tr>
<tr>
<td>Mean ∆ Borrower Surplus ($)</td>
<td>-17.19</td>
<td>-92.94</td>
<td></td>
</tr>
<tr>
<td>Mean ∆ Total Surplus ($)</td>
<td>-10.30</td>
<td>-99.32</td>
<td></td>
</tr>
</tbody>
</table>

**Note:** Table 2.3 shows welfare results from counterfactual simulations. Mean welfare changes in dollar value relative to the baseline. The statistics are calculated per account yearly.

calculate lender profit and borrower surplus corresponding to the new pricing regime. We summarize the welfare results in Table 2.3. We discuss the welfare results below in details.

**Equilibrium Penalty and Interest Rates** The average penalty rate chosen by lenders is 28.72 percentage points. When penalty repricing is allowed, lender interest revenue increases as lenders have another price instrument to use; lenders can use a penalty rate rather than an interest rate to set a price based on borrowers’ future default risks. As a result, the average interest rate decreases by 0.49 percentage points under this new pricing regime.

**Lender Profit and Equilibrium Lending** We find that penalty repricing has effects on the equilibrium lending; penalty repricing decreases average lending by 90.12 dollars (5.18 percent of the average lending). Borrowers, facing repricing risks in the future, reduce their borrowing.

As a result of lower lending, allowing penalty repricing only increases lender profit by 6.89 dollars. Lenders also approve more credit card accounts since profit increases with penalty repricing; the average rejection rate reduces by 1.40 percent.

**Borrower Surplus and Total Surplus** The direction of borrower surplus following penalty repricing is theoretically ambiguous. Borrowers benefit from the lower initial interest rates and higher credit supply. However, their surplus decreases from the risks of being repriced on future income volatility by penalty repricing. Our results show that the latter effect dominates the former effect; penalty repricing decreases average borrower surplus by 16.19 dollars. Overall, penalty repricing decreases total surplus by 10.30 dollars on average.

**Interest Rate Ceiling**

In the second counterfactual, we examine the effects of an interest rate ceiling. Interest rate ceilings are a common form of interest rate regulation; it imposes a legal ceiling on interest rates. Interest rate caps guarantee a borrower’s access to credit at a reasonable interest rate as required by law. On the other hand, the use of interest rate caps can lead to inefficiency.
in the long run, especially when lenders’ market power is low. Imposing a ceiling can have a variety of unforeseen consequences such as limiting the access to credit.\textsuperscript{34}

In 2009, there was an effort to cap interest rates at 15 percentage points by members of Congress. We present the welfare results of an interest rate ceiling at 15 percentage points in Column 3 of Table 2.3.

Equilibrium Interest Rates 15 percentage points interest rate ceiling caps the lender market power for marginal borrowers. As a result, marginal borrowers receive lower interest rate. However, lenders are unable to offer accounts to high-risk borrowers who are profitable with interest rate higher than 15 percentage points. Both of these forces leads to a lower equilibrium interest rate of 14.65 percentage points (or 1.29 percentage points lower).

Lender Profit and Equilibrium Lending Imposing a ceiling reduces lender profit when there is an additional constraint on pricing. Therefore, lender profit for each loan decreases by 6.38 dollars. Accordingly, the rejection rate increases significantly by 14.03 percent. Although marginal borrowers receive lower interest rates because of the ceiling, the decreased credit supply to higher risk borrowers dominates the increased lending from lower interest rates; the equilibrium lending decreases by 13.55 percent (or 235.55 dollars) on average.

Borrower Surplus and Total Surplus We find that imposing an interest rate ceiling decreases both borrower surplus and total surplus. The average interest rate decreases with the interest rate ceiling. Marginal borrowers may benefit from lower interest rates, but access to credit could be particularly valuable to higher-risk borrowers. We find that the loss from less credit for high-risk borrowers dominates the gain from the marginal interest rate’s being lower. Average borrower surplus decreases by 92.94 dollars. Overall, total surplus on average decreases by 99.32 dollars per loan.

2.7 Conclusion

This study presents quantitative analyses of pricing regulation in the credit card market. In presence of dynamic risks, lenders use penalty rates to reprice against borrowers’ future default risks. We document that penalty repricing could be triggered by some events, especially delinquency. These events suggest the borrower may have become a higher default risk. Most forms of penalty repricing was later restricted by the CARD Act. This regulation on price dynamics gives a nice design to study the effects of covenants violation on consumer loans.

We find that the impact of penalty repricing depends on borrowers’ liquidity constraints in making credit card repayments. We divide borrowers into two groups, transactors and

\textsuperscript{34}Dewatripont et al. (1994) show that an interest rate ceiling can protect borrowers only when lenders' market power is high.
revolvers, based on their repayment history. The event study shows that penalty repricing has a relatively larger impact for revolvers; quantifying borrowers’ heterogeneity in repayment decisions is important when considering the impact of penalty repricing.

We develop a model of borrowers and lenders. Motivated by our reduced-form evidence, our model features borrowers’ dynamic risks and unobserved heterogeneity in defaulting. We use the estimated model to study two counterfactual pricing regulatory regimes: (i) allowing penalty repricing and (ii) imposing an interest rate ceiling.

In the counterfactual analysis, regulating penalty repricing increases (initial) interest rates, as lenders anticipate the additional loss from borrowers’ risk fluctuation. Regulating penalty repricing also increases the equilibrium credit supply, as borrowers increase their borrowing without future risk of being repriced.

Imposing an interest rate ceiling decreases both borrower surplus and lender profit. This static pricing regulation does not involve redistribution across borrowers. The interest rate cap only has effects on marginal borrowers. We find that the interest rate ceiling decreases both borrower surplus and welfare; the welfare loss mostly comes from sacrificing marginal borrowers’ credit access.

Our results highlight the importance of considering the equilibrium effects of pricing regulation. Regulating dynamic pricing (i.e., regulating penalty repricing) and static pricing (i.e., the interest rate ceiling) could yield different welfare impacts. We believe that our findings can also contribute to a better understanding of contract pricing in other markets, such as mortgage and health insurance markets, where consumer risks also evolve.
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Appendix A

Homogeneous Housing Preference

The independent and identically distributed repayment shocks in my model are designed to capture the unobserved income shocks. However, a borrower’s default and purchase decisions could depend on individual-specific income trends, which are unavailable to researchers. The non-stationary income could come from saving, wage growth, or unemployment. Under these circumstances, the unobserved income process may give rise to bias estimates in the housing preference $\lambda$. For example, a lower default rate is driven by income growth through saving rather than a higher housing preference. A borrower default may not be attributed to lower housing preference; it may instead be due to unemployment.

To account for the potential bias, I conduct analyses to ensure my welfare results are robust in the absence of the individual-specific trend in liquidity. I consider homogeneous housing preferences with each borrower’s housing preference being the average of my parameter estimates. This measure assumes that the housing preference average does not change. The borrower’s repayment and purchase decisions remain heterogeneous. I assume the heterogeneous default risks are driven by borrowers’ financial sophistication (i.e., propensity for saving or employment risks), which is orthogonal to the housing preference. I calculate the welfare results from counterfactuals using this alternative measure of housing preference (see Table A.1).

In reality, the housing preference should be heterogeneous to a certain degree, so this extreme case gives a conservative measure (a lower bound) of welfare changes. The welfare gain stemming from full risk-based pricing amounts to 82.10 percent smaller than the baseline results. The welfare loss due to uniform pricing amounts to 63.57 percent smaller than the baseline results. The welfare effects are directionally similar even under the restrictive assumption of homogeneous housing preference.

Under GSE pricing, welfare increases as the level of competition up to the case of $2N$. Welfare decreases when the market is perfectly competitive. Though the quantitative magnitude change is non-trivial, the interaction effect is qualitatively similar.
### Table A.1: Robustness Analysis - Homogeneous Housing Preference

<table>
<thead>
<tr>
<th></th>
<th>Uniform Pricing</th>
<th>Risk-Based Pricing</th>
<th>GSE Pricing</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>(N = 1 )</td>
<td>(N = 1)</td>
<td>(N \rightarrow \infty)</td>
</tr>
<tr>
<td>Mean (\Delta) Interest Rate</td>
<td>0.000</td>
<td>0.065</td>
<td>-0.004</td>
</tr>
<tr>
<td>Mean (\Delta) Default Loss ($)</td>
<td>43.406</td>
<td>-843.218</td>
<td>-758.258</td>
</tr>
<tr>
<td>Mean (\Delta) Lender Profit ($)</td>
<td>413.079</td>
<td>8,068.516</td>
<td>1,228.934</td>
</tr>
<tr>
<td>Mean (\Delta) Borrower Surplus ($)</td>
<td>-412.100</td>
<td>-10,174.920</td>
<td>-2,332.001</td>
</tr>
<tr>
<td>Mean (\Delta) GSE Profit ($)</td>
<td>-14.625</td>
<td>2,199.333</td>
<td>1,832.566</td>
</tr>
<tr>
<td>Mean (\Delta) Deadweight Loss ($)</td>
<td>13.647</td>
<td>-92.928</td>
<td>-729.498</td>
</tr>
<tr>
<td>(\Delta) # of Accounts (10k)</td>
<td>5.284</td>
<td>-76.842</td>
<td>-27.404</td>
</tr>
</tbody>
</table>

**Panel B: Percentage Change to Baseline**

<table>
<thead>
<tr>
<th></th>
<th>Uniform Pricing</th>
<th>Risk-Based Pricing</th>
<th>GSE Pricing</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>(N = 1)</td>
<td>(N = 2)</td>
<td>(N \rightarrow \infty)</td>
</tr>
<tr>
<td>Mean (\Delta) Interest Rate</td>
<td>0.000</td>
<td>4.463</td>
<td>-1.378</td>
</tr>
<tr>
<td>Mean (\Delta) Default Loss</td>
<td>3.295</td>
<td>-64.014</td>
<td>-57.564</td>
</tr>
<tr>
<td>Mean (\Delta) Lender Profit</td>
<td>2.563</td>
<td>50.071</td>
<td>7.626</td>
</tr>
<tr>
<td>Mean (\Delta) Borrower Surplus</td>
<td>-0.336</td>
<td>-8.294</td>
<td>-1.901</td>
</tr>
<tr>
<td>Mean (\Delta) GSE Profit</td>
<td>0.133</td>
<td>-20.009</td>
<td>-16.672</td>
</tr>
<tr>
<td>(\Delta) # of Accounts</td>
<td>0.241</td>
<td>-3.509</td>
<td>-1.252</td>
</tr>
</tbody>
</table>

**Note:** Table A.1 presents the welfare results of different pricing regimes and various cases of market concentration. Mean changes in the statistics are calculated using total changes in the statistics divided by sample size (22 million). Panel A presents the welfare changes in dollar value relative to the baseline under homogeneous housing preference. Panel B presents the welfare changes in percentage relative to the baseline under homogeneous housing preference.
Appendix B

Two-Sample t-Test on Loan Characteristics

Table B.1 shows the two-sample t-test of loan characteristics. Column (1) compares the markets with and without local APLs before the preemption in 2004. Many loan characteristics are statically different between markets with and without local APLs.

Table B.1: Two-Sample t-Test on Loan Characteristics

<table>
<thead>
<tr>
<th></th>
<th>(1) Mean</th>
<th>(1) P-Value</th>
<th>(2) Mean</th>
<th>(2) P-Value</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>APL = 0</td>
<td>APL = 1</td>
<td>HIGH = 0</td>
<td>HIGH = 1</td>
</tr>
<tr>
<td>log(Credit Score)</td>
<td>6.574</td>
<td>6.573</td>
<td>0.128</td>
<td>6.543</td>
</tr>
<tr>
<td>log(Income)</td>
<td>7.709</td>
<td>7.838</td>
<td>0.000</td>
<td>7.814</td>
</tr>
<tr>
<td>log(Loan Amount)</td>
<td>11.554</td>
<td>11.697</td>
<td>0.000</td>
<td>11.664</td>
</tr>
<tr>
<td>log(Down Payment)</td>
<td>10.112</td>
<td>10.410</td>
<td>0.000</td>
<td>10.386</td>
</tr>
<tr>
<td>Insurance Percentage</td>
<td>8.012</td>
<td>6.635</td>
<td>0.000</td>
<td>6.665</td>
</tr>
<tr>
<td>Loan Purpose - Home Purchase</td>
<td>0.423</td>
<td>0.405</td>
<td>0.011</td>
<td>0.408</td>
</tr>
<tr>
<td>Loan Purpose - No Cash-Out Refinance</td>
<td>0.340</td>
<td>0.341</td>
<td>0.881</td>
<td>0.327</td>
</tr>
<tr>
<td>Property Type - Condo</td>
<td>0.000</td>
<td>0.007</td>
<td>0.005</td>
<td>0.008</td>
</tr>
<tr>
<td>Property Type - Co-Op</td>
<td>0.015</td>
<td>0.011</td>
<td>0.006</td>
<td>0.010</td>
</tr>
<tr>
<td>Property Type - Manufactured Housing</td>
<td>0.058</td>
<td>0.056</td>
<td>0.697</td>
<td>0.053</td>
</tr>
<tr>
<td>Property Type - Planned Unit Development</td>
<td>0.898</td>
<td>0.875</td>
<td>0.006</td>
<td>0.871</td>
</tr>
<tr>
<td>Occupancy Status - Second</td>
<td>0.042</td>
<td>0.043</td>
<td>0.791</td>
<td>0.041</td>
</tr>
<tr>
<td>Occupancy Status - Investor</td>
<td>0.042</td>
<td>0.046</td>
<td>0.070</td>
<td>0.045</td>
</tr>
</tbody>
</table>

Note: Table B.1 compares the means of two samples. Column (1) compares the markets with and without local APLs before the preemption in 2004. Column (2) compares the markets with higher and lower market share of national banks in APL states before the preemption in 2004. High is an indicator of whether the share of national banks in 2003 was above its median.
Column (2) compares the markets that have higher and lower shares of national banks in APL states before the preemption in 2004. I split the markets into two subgroups based on an indicator of whether the share of national banks in 2003 is above its median. The no cash-out refinance indicator is statistically different. I find no significant differences between the two samples in the available statistics for other loan characteristics.
Appendix C

Estimation Details

I derive $\delta$ for each draw of $\lambda_{in}$ using the first-order condition on a borrower's down payment decision in Equation 1.3,

$$
\delta_i(\Theta_0; \lambda_{in}, x, p_{ij}) = \left( p_{ij} \sum_{t=1}^{T} \beta^{t-1} \mathbb{E} \left[ \frac{\partial V_i(\Theta_0; \lambda_{in}, x, p_{ij}, t)}{\partial D} \right] \right) \times (D_i(\Theta_0; \lambda_{in}, x, p_{ij}))^{-1}. 
$$

I assume that lender-purchase-specific shocks, $\varepsilon$, follow type 1 extreme value distribution. Given a vector of lender preference, $\alpha$, the fraction of borrowers who purchase the mortgage from lender $j$ for each draw of $\lambda_{in}$ is a closed-form solution:

$$
\phi_i(\Theta_0; \lambda_{in}, x, p_i) = \frac{\exp (\max_j U_{ij}(\Theta_0; \lambda_{in}, x))}{\sum_{j=1}^{J} \exp(U_{ij}(\Theta_0; \lambda_{in}, x)) + \exp(U_i(\Theta_0; x, 0))}.
$$

The probability distribution of $\lambda$ among the borrowers who purchase mortgages is given by

$$
\rho_i(\Theta_0; \lambda_{in}, x, p_i) = \frac{\phi_i(\Theta_0; \lambda_{in}, x, p_i) f(\lambda_{in})}{\int \phi_i(\Theta_0; \lambda_{in}, x, p_i) f(\lambda_{in}) d\lambda_{in}}. 
$$

The lender-specific preference is a function of observed market share, $\tau$,

$$
\alpha_j = \log(\tau_j) - \log(\tau_{J}) + \mathbb{E}_{i, \lambda_{in}} \left[ \left( U_{ij}(\Theta_0; \lambda_{in}, x) - U_{iJ}(\Theta_0; \lambda_{in}, x) \right) \rho_i(\Theta_0; \lambda_{in}, x, p_{ij}) \right],
$$

where $J$ denotes small lenders. The preference for small lenders is normalized to zero. I

---

1 I estimate the following regression to predict the counter-offers of other lenders:

$$
p_{ij} = x^T \beta_p + \eta_{ij} p + \kappa_t + e_i,
$$

where $\eta$ is market-lender fixed effects, $\kappa$ is year fixed effects, and $e$ is an error term.
Table C.1: Summary of Moment Restrictions

<table>
<thead>
<tr>
<th>Group</th>
<th>Moment Restrictions</th>
<th>Dimension</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>$E{D_i - \bar{D}_i}</td>
<td>APL_i \times POST_i = 0$</td>
</tr>
<tr>
<td>2</td>
<td>$E{V \circ (D_i - \bar{D}_i)}</td>
<td>APL_i \times POST_i = 0$</td>
</tr>
<tr>
<td>3</td>
<td>$E{V \circ (D_i - \bar{D}_i)}</td>
<td>APL_i \times POST_i \times (1 - \text{HIGH}_i) = 1$</td>
</tr>
<tr>
<td>4</td>
<td>$E{x \otimes (D_i - \bar{D}_i)}</td>
<td>APL_i \times POST_i = 0$</td>
</tr>
<tr>
<td>5</td>
<td>$E{x \otimes (D_i - \bar{D}_i)}</td>
<td>APL_i \times POST_i \times (1 - \text{HIGH}_i) = 1$</td>
</tr>
</tbody>
</table>

Note: Table C.1 summarizes the moment conditions used in the structural estimation. $D$ is a sample size-by-30 matrix with the repayment decisions of each loan from 1 to 30 quarters after loan origination. $V$ is a sample size-by-30 matrix with the (time-varying) housing prices of each loan from 1 to 30 quarters after loan origination. HIGH is an indicator of whether the share of national banks in the year 2003 was above its median.

then solve for $\alpha$ by iterating Equation C.1.2

C.1 Parameters and Moment Restrictions

Table C.1 outlines the moment restrictions used in the structural estimation. I discuss here the importance of the moment conditions to the identification of the relevant parameters. I group the moment conditions into four groups.

Group 1 includes the default probabilities for the loans that were not affected by the preemption (before 2004 or in the states without local APLs). I present the variation in the moment conditions of group 1 (average across the 30 periods) along with parameter $\gamma$ in panel (a) of Figure C.1, holding other parameters fixed.

Group 2 contains the interactions between default probability and time-varying housing prices. I plot the variation in the moment conditions of group 2 (average across the 30 periods) along with parameter $\mu$ in panel (b) of Figure C.1, holding other parameters fixed. The first two groups’ moments help to identify $\gamma$ and $\mu$.

Group 3 covers the default choices for the loans that were affected by the preemption (after 2004 in the states with local APLs). I separately plot the variation in the moment conditions of group 3 and group 1 (average across the 30 periods) along with parameter $\sigma$ in panel (c) of Figure C.1, holding other parameters fixed. Changes in moments of group 1 and

2The tolerance level is specified as $| (\log(\tau_j) - \log(\tau_k)) | \times 10^{-5}$.
(C.1a) Parameter $\gamma$

(C.1b) Parameter $\mu$

(C.1c) Parameter $\sigma$

Note: Figure C.1 plots the average change of the moments relative to a particular parameter, holding other parameter estimates fixed.
group 3 with respect to parameter $\sigma$ have different slopes. $\sigma$ helps to explain the increase in default rates associated with the regulatory decrease in interest rates.

Group 4 covers the interactions between the loan characteristics and group 1 – 3. This group identifies the parameters on loan characteristics in $\gamma$, $\lambda$, and $\sigma$ with the same identification logic.

## C.2 Penalty Repricing Accounts

We show the fraction of delinquent accounts that were repriced in Figure C.2. In Figure F.5 and F.6, we also examine the fraction of accounts that were repriced conditional on having incurred an interest finance charge (i.e., the borrower did not pay full balance), or on having a FICO score decline. After the CARD Act, repricing events triggered by a finance charge and a FICO score decline. The majority of the repricing occurred in three months after the borrower’s creditworthiness deteriorated. This is also consistent with the fact that the CARD Act requires that before a lender can increase the interest rate on an account, the lender must give the borrower a 45-day advance notice.

![Figure C.2: Share of Penalty Repricing Accounts, Delinquency](image)

**Note:** Figure C.2 shows the share of delinquent accounts that were penalty repriced within 30 days, within 30 to 60 days, and within 60 to 90 days over time. The first red vertical line indicates May of 2009, which is the time when the CARD Act was announced. The second red vertical line indicates February of 2010, which is the time when the CARD Act limited upward repricing.

In Figure F.7 and F.8, we examine the change in the initial interest rate after one year of origination, conditional on the borrower having incurred an interest finance charge or the borrower’s FICO score declining within one year after origination. We also observe that while about 50 percent of accounts were repriced repriced after a borrower’s creditworthiness deteriorated, only five percent of the accounts were repriced if the accounts did not have any
changes in the credit risk level. During the 2012–15 period, most of the accounts did not experience a change in the initial interest rate at one year after origination.

C.3 Observable Risk Types

We partition a borrower’s FICO score at origination into 5 buckets: (1) \( \leq 619 \) (sub-prime borrowers), (2) \( 620–679 \), (3) \( 680–719 \), (4) \( 720–759 \), (5) \( \geq 760 \) (super-prime borrowers). We partition credit limit at origination into 5 bins: (1) \( (0, 1000] \), (2) \( (1000, 3000] \), (3) \( (3000, 6000] \), (4) \( (6000, 10000] \), (5) \( (10000, 15000] \) (trimming the top 1 percent credit limit distribution). In total, we have \( 5 \times 5 = 25 \) observable types. The probability distribution for each observable type is presented below in Table C.2.

<table>
<thead>
<tr>
<th>Credit Limit</th>
<th>((0, 1000])</th>
<th>((1000, 3000])</th>
<th>((3000, 6000])</th>
<th>((6000, 10000])</th>
<th>((10000, 15000])</th>
</tr>
</thead>
<tbody>
<tr>
<td>FICO ( \geq 760 )</td>
<td>0.99%</td>
<td>2.54%</td>
<td>8.80%</td>
<td>1.57%</td>
<td>6.42%</td>
</tr>
<tr>
<td>720 &lt; FICO ( \leq 760 )</td>
<td>0.95%</td>
<td>4.49%</td>
<td>6.20%</td>
<td>5.74%</td>
<td>2.88%</td>
</tr>
<tr>
<td>680 &lt; FICO ( \leq 720 )</td>
<td>1.70%</td>
<td>6.62%</td>
<td>6.74%</td>
<td>3.93%</td>
<td>1.49%</td>
</tr>
<tr>
<td>620 &lt; FICO ( \leq 680 )</td>
<td>4.30%</td>
<td>6.62%</td>
<td>4.78%</td>
<td>1.72%</td>
<td>0.47%</td>
</tr>
<tr>
<td>FICO &lt; 620</td>
<td>6.50%</td>
<td>3.17%</td>
<td>1.26%</td>
<td>0.28%</td>
<td>0.07%</td>
</tr>
</tbody>
</table>

Note: Table C.2 shows the percentage of accounts by credit score and credit limit bucket for the 2012–15 post-regulation period.
Appendix D

Additional Data Summary

This section provides the data summary of variables we collect for analysis, including house price index, employment rate, credit card application rate, and rejection rate.

D.1 Housing Price Index and Unemployment Rate

To estimate the stationary income transition, we control for quarterly housing price index collected from Federal Housing Finance Agency and monthly unemployment rates for each state collected from the Bureau of Labor Statistics. Table D.1 presents the summary statistics of the two variables.

Table D.1: Summary Statistics–Housing Price Index and Unemployment Rate

<table>
<thead>
<tr>
<th></th>
<th>Mean</th>
<th>Std. Dev.</th>
<th>Minimum</th>
<th>Maximum</th>
<th># of Observations</th>
</tr>
</thead>
<tbody>
<tr>
<td>Housing Price Index</td>
<td>340.86</td>
<td>104.0255</td>
<td>181.52</td>
<td>768.66</td>
<td>1632</td>
</tr>
<tr>
<td>Unemployment Rate</td>
<td>5.45</td>
<td>1.46</td>
<td>2.6</td>
<td>10.1</td>
<td>4896</td>
</tr>
</tbody>
</table>

Note: Table D.1 shows summary statistics for variables used for Equation 2.10. Housing price index is quarterly and collected from the Federal Housing Finance Agency. Unemployment rate is monthly and collected from the Bureau of Labor Statistics.

D.2 Credit Card Application and Rejection Rate

The Credit Access Survey from the Federal Reserve Bank of New York queries queries consumer respondents’ recent experiences and rejection rates for credit applications initiated over the past twelve months. Using the surveys from October 2013 to October 2015, we calculate the likelihood of credit card application rate and rejection rate, conditional on
each credit score and credit limit bucket. We summarize the two variables in Table D.2 and Table D.3.

Table D.2: Application Rate

<table>
<thead>
<tr>
<th>Credit Limit</th>
<th>[($0, $1,000)]</th>
<th>[($1,000, $3000)]</th>
<th>[($3,000, $6000)]</th>
<th>[($6,000, $10,000)]</th>
<th>[($10,000, $15,000)]</th>
</tr>
</thead>
<tbody>
<tr>
<td>FICO ≥ 760</td>
<td>0.23</td>
<td>0.28</td>
<td>0.32</td>
<td>0.38</td>
<td>0.22</td>
</tr>
<tr>
<td>720 &lt; FICO ≤ 760</td>
<td>0.24</td>
<td>0.28</td>
<td>0.41</td>
<td>0.21</td>
<td>0.32</td>
</tr>
<tr>
<td>680 &lt; FICO ≤ 720</td>
<td>0.42</td>
<td>0.42</td>
<td>0.36</td>
<td>0.37</td>
<td>0.47</td>
</tr>
<tr>
<td>620 &lt; FICO ≤ 680</td>
<td>0.52</td>
<td>0.54</td>
<td>0.46</td>
<td>0.52</td>
<td>0.39</td>
</tr>
<tr>
<td>FICO ≤ 620</td>
<td>0.63</td>
<td>0.53</td>
<td>0.50</td>
<td>0.42</td>
<td>0.22</td>
</tr>
</tbody>
</table>

Note: Table D.2 shows summary statistics for the application rates of credit card consumers from October 2013 to October 2015 by credit score and credit limit buckets.

Table D.3: Rejection Rate

<table>
<thead>
<tr>
<th>Credit Limit</th>
<th>[($0, $1,000)]</th>
<th>[($1,000, $3000)]</th>
<th>[($3,000, $6000)]</th>
<th>[($6,000, $10,000)]</th>
<th>[($10,000, $15,000)]</th>
</tr>
</thead>
<tbody>
<tr>
<td>FICO ≥ 760</td>
<td>0.05</td>
<td>0.01</td>
<td>0.04</td>
<td>0.09</td>
<td>0.00</td>
</tr>
<tr>
<td>720 &lt; FICO ≤ 760</td>
<td>0.05</td>
<td>0.08</td>
<td>0.11</td>
<td>0.00</td>
<td>0.17</td>
</tr>
<tr>
<td>680 &lt; FICO ≤ 720</td>
<td>0.10</td>
<td>0.13</td>
<td>0.12</td>
<td>0.15</td>
<td>0.21</td>
</tr>
<tr>
<td>620 &lt; FICO ≤ 680</td>
<td>0.39</td>
<td>0.32</td>
<td>0.36</td>
<td>0.42</td>
<td>0.50</td>
</tr>
<tr>
<td>FICO ≤ 620</td>
<td>0.48</td>
<td>0.64</td>
<td>0.80</td>
<td>0.64</td>
<td>0.40</td>
</tr>
</tbody>
</table>

Note: Table D.3 shows summary statistics for the rejection rates of credit card applications from October 2013 to October 2015 by credit score and credit limit buckets.
Appendix E

Discretization and Interpolation

We discretize state space. Interest rates $r$ is discretized to 23 uniform grids from 8 to 30 percent. Income $y$ is discretized to 30 uniform grids from 1 to $L$, debt $B$ is discretized 30 uniform grids from 0 to $L$. We also discretize the action $b$ to 1 dollar grids, that is, $L$ uniform grids from 0 to $L$.

In our context, the revolving debt $B$ is continuous. Though we discretize the state space in the estimation, for each choice of debt level $b$, we approximate the value function assuming that the value function is linear between the two points on the grid around the choice. For example, for the choice of debt level $b$, the revolving debt associate this choice is $B(b) = (1 + r) \times b + \mathbb{1}(D > 1)LF$, where $B(i) < B(b) < B(i + 1)$. The value function at this point is therefore approximated as

$$V(B(b), \ldots) \approx V(B(i), \ldots) + \frac{V(B(i + 1), \ldots) - V(B(i), \ldots)}{B(i + 1) - B(i)} (B(b) - B(i)). \quad (E.1)$$

We approximate the integration on expenditure shocks $E_e$ using Gauss-Hermite Quadrature, where $e$ follows log normal distribution. That is,

$$\int_{-\infty}^{\infty} \frac{1}{\sigma \sqrt{2\pi}} h(e) \exp\left(-\frac{\ln(e)^2}{2\sigma^2}\right) de \approx \sum_{i}^{n} \frac{1}{\sqrt{\pi}} \omega_i^{GH} h((\sqrt{2}\sigma \exp(\zeta_i)^{GH})),$$

where $h(e) = e^{(y - B + b)^{1-\gamma}}$. We choose node $n = 4$. We set the monthly discount factor $\beta = 0.996$. We then solve the model for each type of borrower. This gives us the mean debt level $\mathbb{E} [b^*_k(s_t; r^*_kj)]$ and mean delinquent probability $\mathbb{E} [d^*_k(s_t, r^*_kj)]$ for each type $k$.

We solve dynamic programming problem for each type by iterating on policy function $b(s)$. Given the policy function, we calculate the corresponding value functions, which predicts a new policy function $b'(s)$. We iterate until $|b(s) - b'(s)| < 1$ for each states and types.
Appendix F

Additional Tables and Figures

Table F.1: List of APL States

<table>
<thead>
<tr>
<th>State</th>
<th>Date</th>
</tr>
</thead>
<tbody>
<tr>
<td>Arkansas</td>
<td>July 16, 2003</td>
</tr>
<tr>
<td>California</td>
<td>July 1, 2002</td>
</tr>
<tr>
<td>Colorado</td>
<td>July 1, 2003</td>
</tr>
<tr>
<td>Connecticut</td>
<td>January 1, 2002</td>
</tr>
<tr>
<td>District of Columbia</td>
<td>May 7, 2002</td>
</tr>
<tr>
<td>Georgia</td>
<td>March 7, 2003</td>
</tr>
<tr>
<td>Illinois</td>
<td>January 1, 2004</td>
</tr>
<tr>
<td>Indiana</td>
<td>January 1, 2005</td>
</tr>
<tr>
<td>Maryland</td>
<td>October 1, 2002</td>
</tr>
<tr>
<td>Massachusetts</td>
<td>November 7, 2004</td>
</tr>
<tr>
<td>Michigan</td>
<td>December 23, 2002</td>
</tr>
<tr>
<td>Minnesota</td>
<td>January 1, 2003</td>
</tr>
<tr>
<td>New Jersey</td>
<td>November 27, 2003</td>
</tr>
<tr>
<td>New Mexico</td>
<td>January 1, 2004</td>
</tr>
<tr>
<td>New York</td>
<td>April 1, 2003</td>
</tr>
<tr>
<td>North Carolina</td>
<td>July 1, 2000</td>
</tr>
<tr>
<td>Rhode Island</td>
<td>December 31, 2006</td>
</tr>
<tr>
<td>South Carolina</td>
<td>January 1, 2004</td>
</tr>
<tr>
<td>Texas</td>
<td>September 1, 2001</td>
</tr>
<tr>
<td>West Virginia</td>
<td>June 8, 2000</td>
</tr>
<tr>
<td>Wisconsin</td>
<td>February 1, 2005</td>
</tr>
</tbody>
</table>

Note: Table F.1 presents the list of states that implemented anti-predatory lending laws. The left column lists the state names, the right column lists the corresponding implementation date.
Table F.2: Correlation between Housing Price Index and *Ex Post* Loan Performance

<table>
<thead>
<tr>
<th></th>
<th>Coefficient</th>
<th>Standard Error</th>
</tr>
</thead>
<tbody>
<tr>
<td>Housing Price Index</td>
<td>-0.176***</td>
<td>(0.0339)</td>
</tr>
<tr>
<td>log(Credit Score)</td>
<td>-0.00888***</td>
<td>(0.00157)</td>
</tr>
<tr>
<td>log(Income)</td>
<td>0.0533***</td>
<td>(0.00481)</td>
</tr>
<tr>
<td>log(Loan Amount)</td>
<td>0.0250***</td>
<td>(0.00278)</td>
</tr>
<tr>
<td>log(Down Payment)</td>
<td>0.00598***</td>
<td>(0.000937)</td>
</tr>
<tr>
<td>Insurance Percentage</td>
<td>-0.000412***</td>
<td>(0.0000602)</td>
</tr>
<tr>
<td>Loan Purpose - Home Purchase</td>
<td>0.00210</td>
<td>(0.00163)</td>
</tr>
<tr>
<td>Loan Purpose - No Cash-Out Refinance</td>
<td>-0.00356***</td>
<td>(0.00113)</td>
</tr>
<tr>
<td>Property Type - Condo</td>
<td>0.0144***</td>
<td>(0.00509)</td>
</tr>
<tr>
<td>Property Type - Co-Op</td>
<td>-0.0168***</td>
<td>(0.00349)</td>
</tr>
<tr>
<td>Property Type - Manufactured Housing</td>
<td>0.00725**</td>
<td>(0.00352)</td>
</tr>
<tr>
<td>Property Type - Planned Unit Development</td>
<td>-0.0130***</td>
<td>(0.00267)</td>
</tr>
<tr>
<td>Occupancy Status - Second</td>
<td>0.0145***</td>
<td>(0.00282)</td>
</tr>
<tr>
<td>Occupancy Status - Investor</td>
<td>0.0264***</td>
<td>(0.00290)</td>
</tr>
<tr>
<td>Quarterly Time Fixed Effects</td>
<td>yes</td>
<td></td>
</tr>
<tr>
<td>Market Fixed Effects</td>
<td>yes</td>
<td></td>
</tr>
<tr>
<td># of Observations</td>
<td>43,418</td>
<td></td>
</tr>
<tr>
<td>Adjusted R-squared</td>
<td>0.364</td>
<td></td>
</tr>
</tbody>
</table>

**Note:** Table F.2 shows regression results from Equation 1.7 using the loans from the 2000 – 17 period. The sample is collapsed by market-quarter level. Robust standard errors in parentheses are clustered at the market level. Significance levels: *(p<0.10), **(p<0.05), ****(p<0.01).
Note: Figure F.1 plots the average share of national banks in the GSE market from 2000 – 08. The left panel shows the average share of national banks separately for APL market and non-APL market. The right panel shows the average difference between APL market and non-APL market. The dotted vertical line indicates the year when the OCC preemption rule was implemented in 2004.

Figure F.1: Share of National Banks Trends
Note: Figure F.2 plots the average number of loans (in log) purchased by the GSEs from 2000 – 08. The left panel shows the average number of loans (in log) separately for APL market and non-APL market. The right panel shows the average difference between APL market and non-APL market. The dotted vertical line indicates the year when the OCC preemption rule was implemented in 2004.

Figure F.2: Number of Loan Trends
Note: Figure F.3 plots percentage frequency distribution of interest rates during the 2008–09 pre-regulation period (blue shaded bars) and the 2012–15 post-regulation period (white transparent bars). Promotional interest rates are included in the graph.

Figure F.3: APR distribution

Note: Figure F.4 plots percentage frequency distribution of monthly change in revolving debt during the 2008–09 pre-regulation period (blue shaded bars) and the 2012–15 post-regulation period (white transparent bars). The monthly change in revolving debt is calculated from the current debt minus the debt amount in the prior month.

Figure F.4: Monthly Revolving Debt Change
**Note:** Figure F.5 shows the share of accounts that were penalty repriced within 30 days, within 30 to 60 days, and within 60 to 90 days over time, conditional on borrowers having incurred an interest finance charge. The first red vertical line indicates May 2009, which is the time when the CARD Act was announced. The second red vertical line indicates February 2010, which is the time when the CARD Act limited upward repricing.

Figure F.5: Share of Penalty Repricing Accounts, Interest Finance Charge

**Note:** Figure F.6 shows the share of accounts that were penalty repriced within 30 days, within 30 to 60 days, and within 60 to 90 days over time, conditional on the borrower’s credit score declining within one year after origination. The first red vertical line indicates May 2009, which is the time when the CARD Act was announced. The second red vertical line indicates February 2010, which is the time when the CARD Act limited upward repricing.

Figure F.6: Share of Penalty Repricing Accounts, FICO Decrease of 20+ Points
Note: Figure F.7 plots percentage frequency distribution of change in interest rate from the time when the card was issued to one year after origination. The left panel shows the changes for the 2008–09 pre-regulation period. The right panel shows the changes for the 2012–15 post-regulation period. White transparent bars show the accounts that were ever incurring an interest finance charge. Blue shaded bars show the changes for the remaining accounts.

Figure F.7: Change from Initial Interest Rate, Interest Finance Charge

Note: Figure F.8 plots percentage frequency distribution of change in interest rate from the time when the card was issued to one year after origination. The left panel shows the changes for the 2008–09 pre-regulation period. The right panel shows the changes for the 2012–15 post-regulation period. White transparent bars show the accounts that credit score declining for less than 20 points. Blue shaded bars show the changes for the remaining accounts.

Figure F.8: Change from Initial Interest Rates, FICO Decrease of 20 + Points