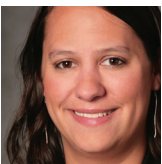


POLICY SUMMIT



Mortgage Counseling, Plain Language, and Financial Education: What Works?



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It's no secret that the housing crisis still has a hold on America: New foreclosure filings rose 8 percent during the first six months of 2010 compared with the same period in 2009. What may be less clear is that international, national, and local housing experts are striving to break that hold. These efforts were top of mind at the Federal Reserve Bank of Cleveland's 2010 Community Development Policy Summit—Housing Policy: Who Pays, Who Plays, and Who Wins?—held on June 10 and 11.

The summit convened top administrators from the Department of Housing and Urban Development and other regulatory agencies; researchers from universities and think tanks; and community development experts. They put on the table such topics as the cultural ideal of the American Dream and ways to build wealth in the wake of the housing crisis.

As the experts merged data and anecdotes to frame the crisis, one theme stood out: the importance of financial information for consumers. Conversations centered on three key ways to help people make better decisions about their money:

- Use clear language
- Ensure that consumers achieve broad financial literacy
- Provide targeted education programs as necessary

How much better off would Americans be if policymakers moved on all three fronts? At the Policy Summit, several speakers described how consumer finance education efforts are likely to take shape in the near future.

The Fine Print

If you've ever bought a house, you've probably felt the anxiety of many prospective homebuyers: What did that say? How much do I owe? What did I just sign? Mortgage documents are enough to boggle the mind of the best-educated lawyer. Indeed, federal officials have attributed the mortgage crisis in no small part to people's failure to understand the fine print.

By contrast, consider what happened in Canada during the past few years. Unlike the United States, Canada did not undergo a dramatic increase in mortgage defaults, and none of its banks required a government bailout. One major reason, according to Virginie Traclet, a researcher in the Bank of Canada's Department of Monetary and Financial Analysis, is the way financial disclosures are written in Canada — clearly and plainly. Lenders are bound by disclosure requirements as well as banks' voluntary codes of conduct to use plain language. The fine print is there, but it is not nearly as fine as what American borrowers must try to decipher. (To be sure, many other factors contribute to the difference in default rates. A paper written at the Federal Reserve Bank of Cleveland, for example, suggested that comparatively lax lending standards in the U.S. probably played a critical role.)

In 2000, the Canadian federal government proposed the *Cost-of-Borrowing Regulations*, requiring banks to disclose credit product information, such as interest rates and fees, to consumers. In the same year, the Canadian Bankers Association (CBA) adopted a voluntary code of conduct — the Plain Language Mortgage Documents CBA Commitment — regarding the use of clear writing in mortgage documents. In September 2009, the federal government amended its disclosure regulation to include a plain-language provision requiring that “all disclosure under the Regulations be made in a manner that is clear, concise, and not misleading.”

As many have observed, buying a home is the biggest investment most people will make in a lifetime, and mortgage documents are the most complex. Mortgage debt accounts for the largest share of household debt. So making informed choices is imperative.

Straight Talk

“Plain language,” says Traclet, “can have a significant effect on households' making an informed decision when they choose a mortgage product and, ultimately, this can contribute to financial stability.”

Arguments against simplifying disclosures abound, with the most strident coming from lenders. They include the objections that creating and testing new disclosures costs money; requiring disclosures is a market intervention, and interventions do not always improve market outcomes (that is, result in better decision-making); and if more borrowers understood the terms of their loans, some might decide not to take out those loans or would demand terms more favorable to themselves. In this last point, it is argued that the revenue, profits, and stability of financial services providers would decrease (although it is hard to see how giving borrowers bargaining power could hurt society).

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But improving disclosures can also help lenders. Plain language can reduce staff time by eliminating confusion and improving communications. “[If] the performance of mortgages is linked to borrowers having chosen a mortgage product whose risk characteristics they understand and can thus service over the lifetime of the mortgage, then banks would have a natural interest in providing such easy-to-understand facts and risks,” Traclet says.

Itzhak Ben-David, an assistant professor of finance at the Ohio State University's Fisher College of Business, agrees: “It is important to explain to borrowers about interest rate resets in adjustable-rate mortgages, and latent fees, like prepayment penalties,” he explains. “It is also important to inform borrowers of the likelihood of default given their debt-to-income ratio (DTI). For example, ‘One out of five borrowers with DTI of 40 percent at origination could not make his payments and had to give up his house.’” What if that language appeared prominently in mortgage documents? How many borrowers would line up for a mortgage if they're told they have a one-in-five chance of defaulting on it?

Financial Education Matters

So plain language is a start. But we probably need more to help consumers make sound financial decisions. For example, research suggests that households do not necessarily understand how higher interest rates would affect their mortgage payments. In June 2009, the Organization for Economic Co-operation and Development noted that insufficient financial education tools were partly to blame for the financial crisis and that the consequences of uninformed credit decisions can be “disastrous.”

Michal Grinstein-Weiss, an assistant professor at the School of Social Work at the University of North Carolina at Chapel Hill and a participant of the Cleveland Fed’s 2010 Policy Summit, points out that homebuyers, especially minority and low-income ones, often lack information when it comes to the home-buying process. In fact, one survey found that 40 percent of African American and Latino respondents incorrectly believed that a 20 percent down payment was mandatory to qualify for a mortgage, and more than 50 percent of this same group believed that holding the same job for five or more years was required.

Grinstein-Weiss has been studying the effects of financial education on participants in the American Dream Demonstration, a longitudinal, randomized controlled experiment conducted in Tulsa, Oklahoma, from 1998–2003. Conceived, organized, and implemented by the Corporation for Enterprise Development in Washington, DC, and funded by 12 private foundations, this experimental program helped low-income people save for a home, school, or business through Individual Development Accounts (IDAs) by matching their savings deposits with public and private funds. In addition, IDA participants attended free classes on general financial education, such as budgeting and money management, as well as asset-specific financial education classes, such as what to look for in a mortgage.

The results were positive: The number of financial education hours each participant clocked was associated with a 99 percent increase in average monthly net deposit and a 1 percentage point increase in deposit frequency. Participants claimed that it was the financial education—not the monetary incentive of the IDA program’s match rates—

that made the most difference in their success. “If one part of the program was eliminated,” Grinstein-Weiss quotes a participant, “eliminate the match.”

Other studies support the importance of financial education: One found a significant correlation between the level of financial knowledge and sound management practices. People who were familiar with financial concepts and products were more likely to balance their checkbook every month, budget for savings, and maintain investment accounts. Another study determined that financial knowledge is the single best predictor of such behaviors as budgeting, saving, and shopping responsibly. (For additional examples, see related story: “Five Big Ideas about Consumer Finance Education,” page 14.)

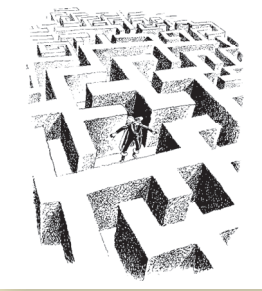
The Effects of Mortgage Counseling

But some other studies, including work from the Federal Reserve Bank of Cleveland, suggest that general financial education programs do not tend to change people’s financial behavior. Many researchers contend that programs should target a specific audience or area of financial activity and that this education should be completed just before the person needs to use it (for example, just before buying a home).

Nonprofit organizations have been offering home-buying programs and credit counseling for years, with generally beneficial effects. One study that analyzed nearly 40,000 affordable mortgage loans targeted to lower-income borrowers found that pre-home-purchase counseling reduced 90-day delinquency rates by 19 percent on average. In another study, researchers found that credit counseling had a positive effect on creditworthiness, especially for those with the lowest credit scores. Another preliminary study found that new or recently delinquent credit card holders were more likely to pay on time and to have lower revolving balances after receiving online instruction in credit management.

Grinstein-Weiss asserts that the content of the financial training should be tailored to building the skills of low-income people so they can overcome the challenges of trying to save. Asset-specific financial education and homeownership counseling, she says, may also improve participants’ loan performance.

COMPLEXITY AND POMPOSITTY
-- MOSTLY COMPLEXITY



An image from the 1966 book *Gobbledygook Has Gotta Go*.

Getting Basic

The emphasis on plain language is not new. Interest in making government documents clear has a history in the United States, dating back at least to 1966, when federal employee John O’Hayre wrote *Gobbledygook Has Gotta Go*. But until recently, the use of plain language remained voluntary. Part of the U.S. Credit

Card Accountability, Responsibility, and Disclosure Act of 2009 is the Plain Sight/Plain Language Disclosures: “Credit card contract terms will be disclosed in language that consumers can see and understand so they can avoid unnecessary costs and manage their finances.” But this legislation does not apply to mortgage documents, even though it’s been demonstrated that a large portion of homeowners do not understand their mortgages and that modest efforts to simplify mortgage disclosures increase consumers’ understanding.

Should Counseling Be Mandatory?

Itzhak Ben-David set out to discover whether mandatory asset-specific counseling — in this case, mortgage counseling — does in fact affect loan choice and performance. He came up with some surprising results.

Ben-David’s study was based on an experiment in which high-risk mortgage applicants in 10 Chicago ZIP code areas were required to receive financial advice from HUD-certified counselors. The results show that a few months of financial education improves financial decisionmaking. And when mortgage counseling is mandated, the default rate for borrowers with low credit scores declines by 4.5 percent.

Here’s the surprising part: When borrowers who want to take risky mortgage products are required to attend counseling, the demand for risky products drops sharply. “Borrowers choose less-risky products to avoid going to counseling,” Ben-David notes. “In a way, the legislation achieves its goal (to restrict the quantity of risky products) by threatening borrowers with counseling, not by the information included in the counseling itself.”

So it seems that mortgage counseling — or even its threat — can be effective. But should it be mandatory? Not for everyone, says Stephan Whitaker, an economist with the Federal Reserve Bank of Cleveland. “It would waste the time of a lot of people who don’t need it,” he maintains. “Targeted requirements triggered by something (location in CRA assessment area, unusual loan product, or receipt of federal/state/local subsidy) seem more plausible.”

What’s Next?

Not all of the chips have fallen when it comes to determining what types of consumer financial information work best. In Canada, the government has launched a task force on financial literacy that will deliver its findings in December. Here in the United States, the Financial Literacy and Education Commission launched an enhanced financial literacy website, www.mymoney.gov, last April. The nation’s new Consumer Financial Protection Bureau is also likely to make education a key part of its agenda.

What the experts made clear at the Policy Summit is that plain language, broad financial education, and mortgage-specific counseling are each beneficial in their own way and serve to complement each other. “Looking forward,” notes Ruth Clevenger, Community Affairs officer for the Federal Reserve Bank of Cleveland and the chief architect of the summit, “improved access to, and raised levels of, financial education will be critical to a sustained recovery from the financial crisis for individuals and communities.” ■



2010 Policy Summit

For the agenda and bios of participants at the Federal Reserve Bank of Cleveland’s 2010 meeting, see www.clevelandfed.org/Community_Development/events/PS2010/index.cfm



Resources

For links to resources mentioned in this article, go to www.clevelandfed.org/forefront