Effectiveness of financial education: two approaches

The financial crisis of 2007-2008 is considered by many economists to have been the worst financial crisis since the Great Depression of 1930’s, threatening the collapse of large financial institutions around the world. It was tightly tied to the U.S. subprime mortgage crisis which was triggered by large decline in home prices, leading to mortgage delinquencies and foreclosures and the devaluation of housing-related securities.

The reasons behind the subprime mortgage crisis are numerous, with commentators and scholars assigning blame to financial deregulation, government housing policies, speculative borrowing, new risky financial products and others. One of the reasons often mentioned was mortgage fraud and predatory lending practices typically aimed at racially segregated low income minority neighborhoods. In response, the Predatory Mortgage Lending Practice Reduction Act authorized the Community Development Financial Institutions Fund to make grants to nonprofit community development corporations to educate and train borrowers and community groups regarding illegal and inappropriate predatory lending practices. However, education and training of borrowers can take many forms, some of them more effective than others.

Two research reports, written by Professor Ben-David of The Ohio State University and his co-authors, examine two different approaches to financial education to assess whether such education can have positive impact on borrowers’ behavior and if so, what form of education would be more effective in steering borrowers away from risky mortgage products. In Learning to Cope: Voluntary Financial Education and Loan Performance during a Housing Crisis\(^1\), Professor Ben-David and his co-authors studied a long-term voluntary participation program for prospective home buyers ran by the Indianapolis Neighborhood Housing Partnership (INHP). The INHP program is designed to assist low- and moderate-income households with securing sustainable home ownership through improving their credit, savings and financial literacy. At the end of the 2-year program participating are evaluated on their ability to meet lender underwriting criteria to qualify for a mortgage, and are either referred to outside lenders or, for those who might not qualify for a loan based on “hard information” but who are deemed credit-worthy by their counselors, are given a loan by INHP. The involvement with INHP continues with active post-purchase counseling that seeks to address delinquency at early stages.

The researchers compared the performance of counseled households with those that did not receive counseling to examine the effect of the counseling program provided by INHP. In their analysis, the researchers found that INHP clients had considerably lower FICO scores and household incomes than the rest of Marion County, purchased less expensive homes, made smaller down payments and almost exclusively took out fixed 30-year mortgages as opposed to 81% of non-counseled borrowers in the county. Nevertheless, they also found that the program graduates had lower ex-post delinquency rates, at 12-month being 3.8% for internal loans and 4.1% for external loans, as compared to 6.3% for non-INHP loans. More importantly, the effects of

intense counseling persist over time, suggesting that long-term preparation for homeownership plays an important role in helping household to cope with a number of economic shocks.

The second article, *The Effectiveness of Mandatory Mortgage Counseling: Can One Dissuade Borrowers from Choosing Risky Mortgages?*, focuses on the effects of a legislative mandate that combined lender oversight and counseling of high-risk borrowers, which was implemented in a pilot program in Cook county, Illinois. Under the program, applicants with a FICO score below 621 were required to attend a loan review session with financial counselors certified by the US Department of Housing and Development irrespective of their mortgage choice. Applicants with a higher FICO score had to attend counseling only if they chose a “high risk” mortgage. The purpose of these sessions was to discuss the terms of the specific mortgage offer and explain their meaning, consequences and caution borrowers against common pitfalls. Over the life of the pilot counselors reviewed about 1200 offers, 9% of which showed indications of fraud. Counselors advised about half of the borrowers that they could not afford the loan and for 22% of the borrowers, loan rates were found to be more than 300 basis points above the market rate. At the end of the counseling session, borrowers could always proceed with the loan offer at hand. In addition, the program also imposed costs on lender who were responsible for the $300 counseling fee, were affected by longer closing times, were required to be state licensed and had to ensure full implementation of the legislation.

The analysis uncovered several effects on borrowers’ and lenders’ behavior, although not necessarily intended effects. As to borrowers’ behavior, the researchers found that low-FICO applicants for whom counselor review was mandatory did not materially change their contract choice. They did not appear, on average, to follow the counselor’s advice, and seemed to have only limited bargaining power in renegotiations. Conversely, applicants who could avoid counseling by choosing less risky mortgages did so. Thus, the ultimate goal of the legislation (e.g. better loan terms for borrowers) was only achieved among the population that was not counseled due to their desire to avoid having to go to counseling. The legislation also resulted in substantial reduction in lending activity, with lenders with predatory characteristics exiting the market to avoid potential scrutiny and some types of loan offers, such as low documentation loans, decreasing substantially. Thus the regulation was somewhat effective in improving the quality of originated mortgages by creating a mere presence of oversight in the marketplace.

The results of the two research project show that while there were some limited benefits stemming from the legislation mandating financial counseling, they benefits were rather limited and short lasting as evident by return to normal practices after the pilot program ended. On the other hand, long-term counseling that strengthened budgeting and credit management skills of prospective borrowers, showed to have significant and long-lasting impact on the financial health of the counseled family.

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