Does Mandatory Counselor Involvement in the Mortgage Origination Process Affect Loan Choice and Performance?

(or: The Unintended Consequences of Mandatory Counseling Legislation)

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Research Questions

- Recent research
  - Households fail to understand key features of financial contracts
  - These mistakes are consequential
- The ongoing credit crisis intensified policy focus on financial literacy
- How did counseling affect market activity? **Market activity declines**
- Can mandated counseling help improving performance?

  Default rate declines by up to 1% overall,
  by 4.5% for those who had to get counseling
- What are the mechanisms that improve performance?
  - Direct effects: Information content ("learning") of counseling **Weak evidence**
  - Indirect effects: Burden ("tax") of regulation, oversight effects on lenders

  Stronger support

HB 4050: A Rough Sketch

- Bill passed in February 2006 in Illinois "to curtail predatory lending practices," went into effect on **September 1, 2006** as a **"4-year pilot program"**
- High-risk borrowers or products are required to go through HUD-accredited loan counselors prior to closing
  - $300 counseling fee had to be paid by lenders
  - Borrowers were free not to follow counselor's advice
  - Enforcement by the Recorder of Deeds
- Highly publicized lender withdrawals, public protests, lawsuits, and mayhem at public hearings. Political coalition: industry groups, African-American and Latino neighborhood residents, and civil rights organizations protested against the law.
- Pilot lasted 4.5 months (1,200 counseled): abolished on 17 January 2007

HB 4050: Who is Subject to the Legislation?

10 Selected Zips

State-Licensed Originators

Mortgage Product

		Prepayment penalty Negative Amortization High Closing Costs	Hybrids (ARMs) Interest only Frequent Refinances Low documentation	Other
FICO	Low (<621)	**Mandated Counseling**		
	Mid			
	High (>650)		Exempted from Counseling	

Analysis Methodology

- To evaluate the effects of HB 4050, we construct two control samples which are similar the socio-economic attributes of the population in the pre-HB 4050 period (2005-Aug 2006).

- We compare the composition of lenders, borrowers, mortgages, and house prices between HB 4050 areas and control areas for the treatment period.

- If our samples are well-constructed, the difference must come from the effects of HB 4050.

How Were 10 Treated Zips Selected?

- The HB 4050 bill instructed the State regulator, Department of Financial and Professional Regulation, to designate a pilot area based on:

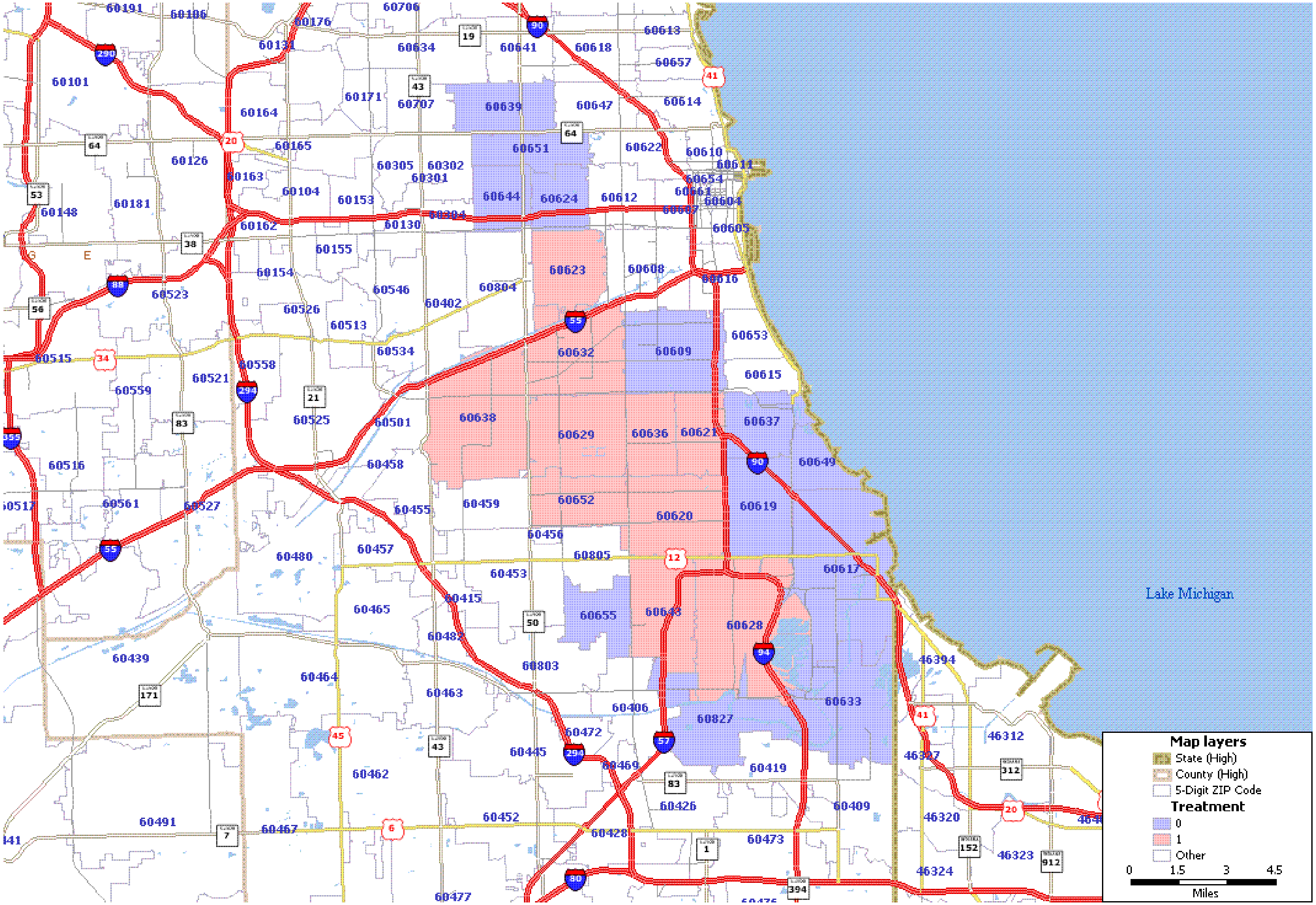
  "the <u>high rate of foreclosure</u> on residential mortgages that is primarily the result of <u>predatory lending practices</u>"

Construction of Control Sample

- Control Zips (12 Zips) with similar:
  - 2005 IRS zip-level income statistics
  - 2000 Census share of minority population
  - 2000 Census share of those living below the poverty level
  - 2000 Census share of unemployment rate
  - Similar mortgage volume
  - Chicago inner-city

	HB 4050 zip codes (n=15,216)	**Control ZIP codes** (n=12,925)	**all non-HB4050 Chicago zip codes** (n=28,060)
I(Default within 18 months) (x 100)	14.01	13.69	9.06
FICO	627.68	628.64	648.77
LTV (%)	84.14	82.92	81.85
Debt Service-to-Income (%)	39.94	40.28	40.20
log(Valuation)	12.12	12.22	12.47

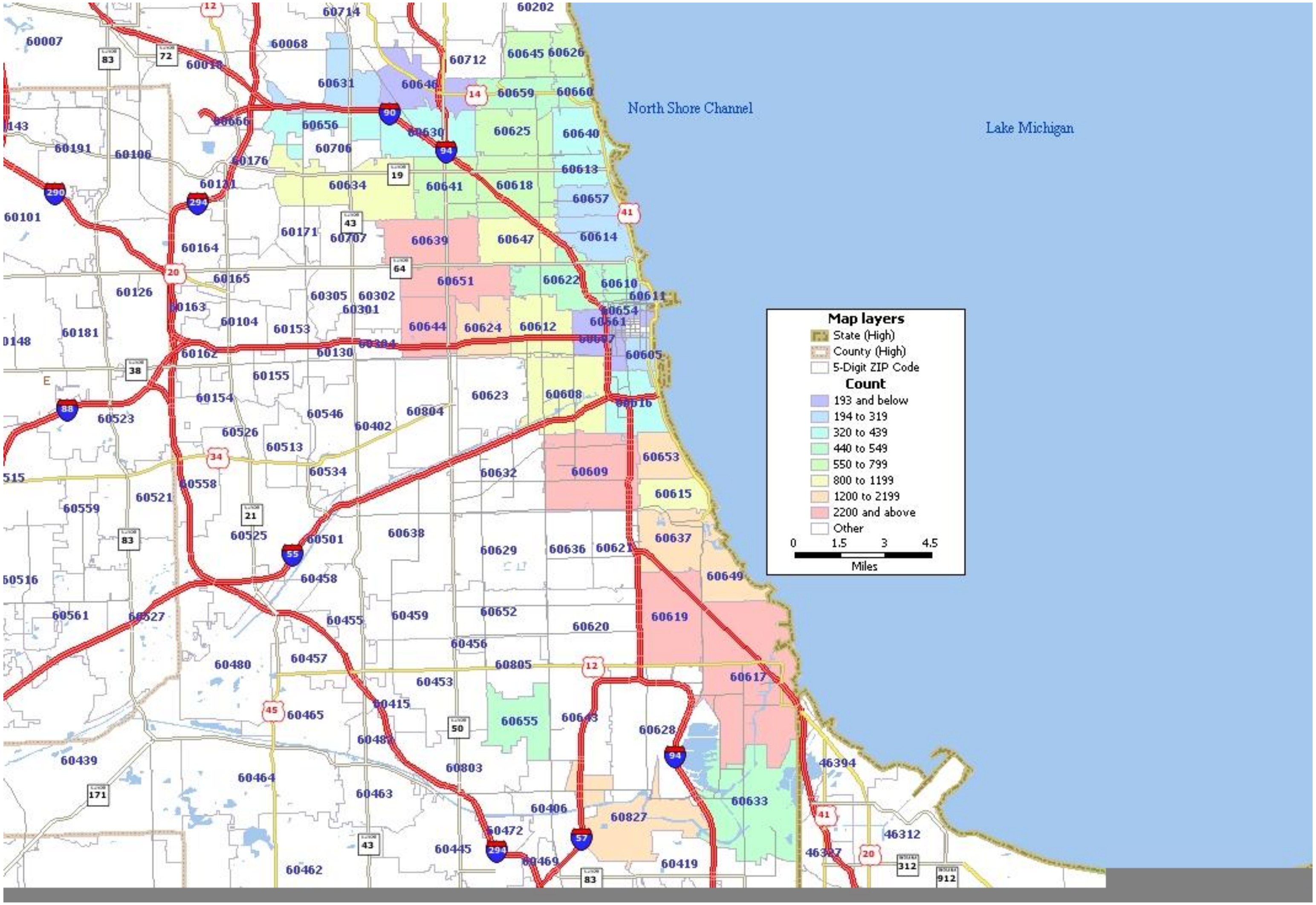
HB 4050 and Control zip codes



Construction of Matched Sample

- For each loan we find loans that:
  - Have the same intended purpose (purchase or refinancing)
  - From Chicago inner-city
- We match loan-by-loan with similar:
  - FICO score
  - Debt-service-to-income (DTI)
  - Loan-to-value (LTV)
  - Log of home value

Distribution of loans in the synthetic (matched) sample



- 52% of all matched loans come from the 12 “control” zip codes

Data

1. HMDA (Home Mortgage Disclosure Act)

   - All mortgage applications

   - Includes: lender, loan characteristics, borrower income, application outcome

2. Cook County Recorder of Deeds

   - All transactions and mortgages taken in the County

   - Includes: prices, mortgage amounts

2. LoanPerformance

   - All subprime and Alt-A mortgages that were securitized

   - Includes: mortgage terms, borrower terms, foreclosure status

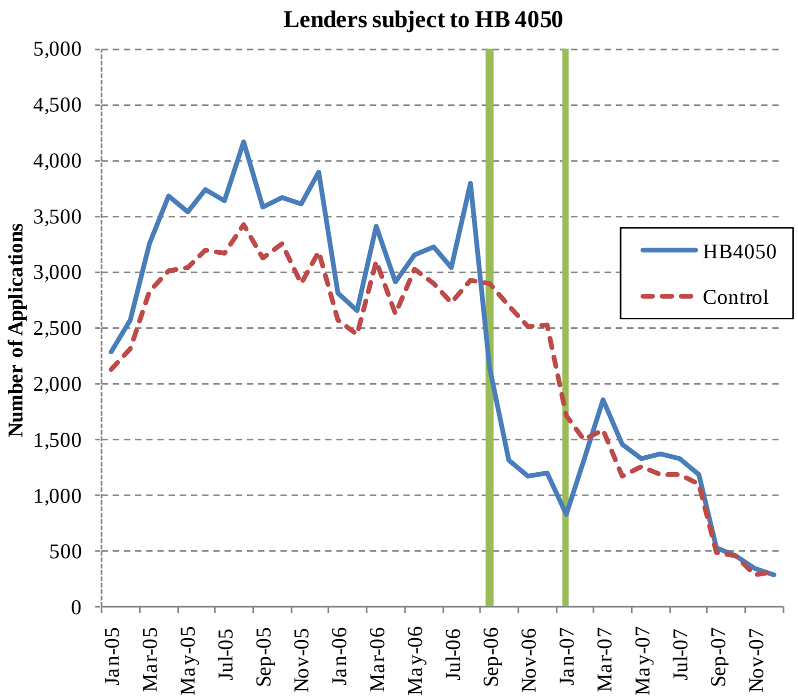
   Data period: Jan 2005 to Dec 2007 [HB 4050: Sep 2006 – Jan 2007]

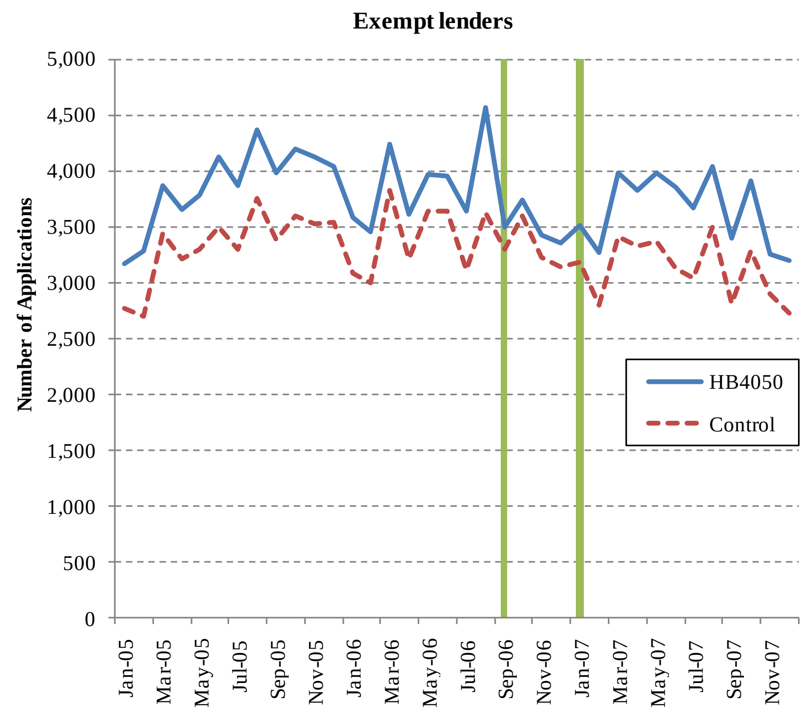
4. Counseling dataset from one agency (191 observations)

Decline in Applications and Originations

- Change in application volume:

State-Licensed Lenders | **Exempt Lenders**





- Change in mortgage origination volume:
  - Refinancing: -77%, Home purchase: -47%

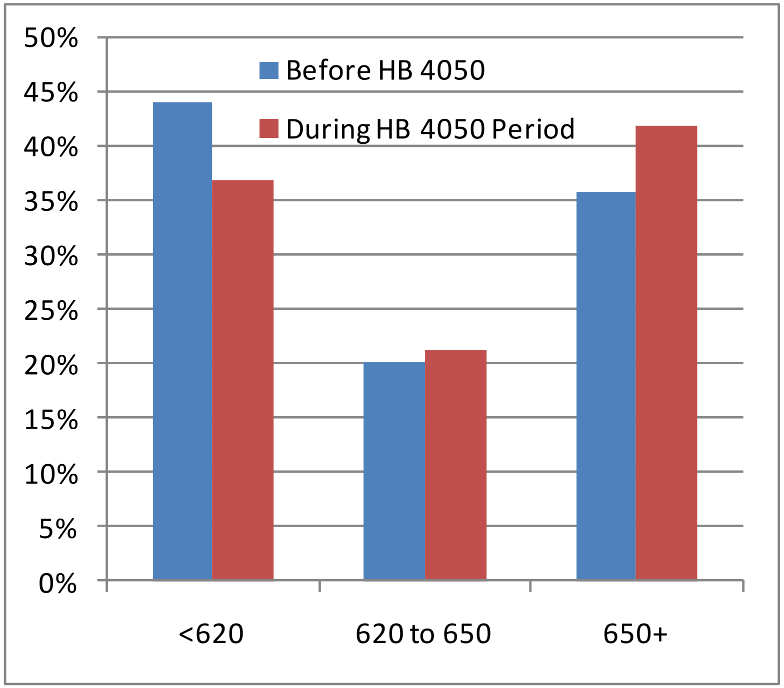
Exit of Treated Lenders

	State-Licensed Lenders Specializing in Subprime loans		All Other Lenders	
	HB 4050	Control	HB 4050	Control
Before HB 4050 (9/05 - 8/06)	31	30	83	76
During HB 4050 (9/06 - 1/07)	9	23	56	65
After HB 4050 (2/07 - 6/07)	13	15	66	66

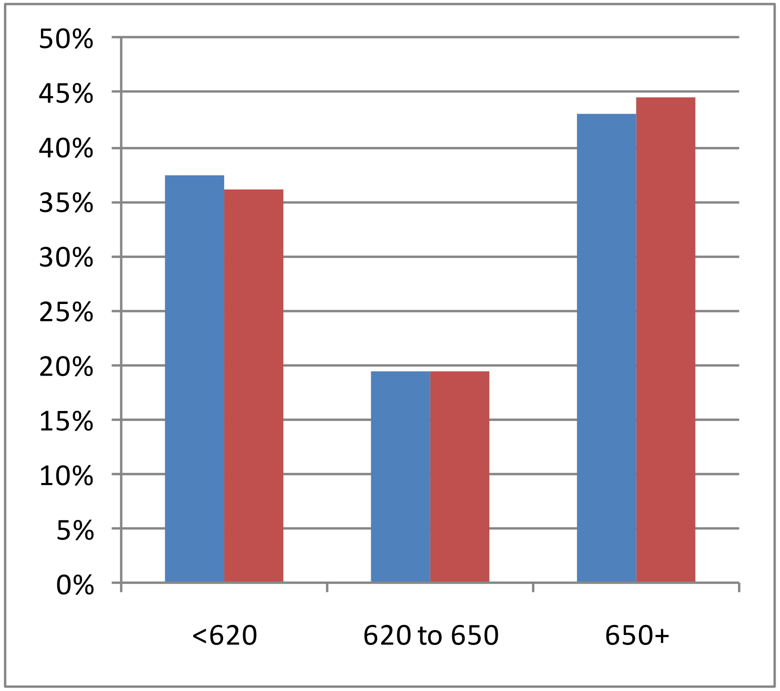
- Temporary exit of 67% of mortgage originators
- Evidence suggests that exit of lenders is due to the high costs of compliance and concerns about the "foreclosability" of homes (Illinois Association of Mortgage Brokers, as cited in Bates and VanZandt 2007)
- We find that lenders who exited:
  - Smaller in scale: compliance costs are higher
  - Lower rejection rate
- Results show that exit of lenders did not affect default rates.

Exit of Low- and Mid-FICO Borrowers

HB 4050 Zip Codes



Control Zip Codes



- Share of low-FICO borrowers in HB 4050 zips drops by 8 percentage points

No Change in House Prices

- House prices did not change.
- Measured in various ways:
  - Transaction price / Asking price
  - Transaction price / previous transaction in same property
  - Transaction price / properties with similar characteristics
  - Time on the market

Improvement in Default Rates

- In control groups, default rate (within 18 months) is about 20%-25%.

- Default rate (within 18 months) of **all counseled borrowers** declines by about 1%.

- Default rate (within 18 months) of **low FICO-borrowers (mandatory counseling)** declines by about 5%***.

What Could Explain the Improvement in Default?

Direct Effects:

1. **Education:** Informational content of counseling:
   - Borrowers improve mortgage choices in line with program guidelines
   - Borrowers shop more for mortgages

Indirect Effects:

1. **Burden:** Legislation "taxes" risky borrowers and products
   - Risky borrowers exit the market
   - Borrowers that can avoid counseling do so by migrating to less risky mortgages
2. **Oversight:** Legislation threatens lenders
   - Lenders exit the market (effect on default is same in Active sample)
   - Rejection rates increases

Did Borrowers Become More Informed?

- Based on some (191 loans) counseling data:
  - Some borrowers altered their choices

- Based on actual mortgage data:
  - Slight decline in mortgage leverage (loan-to-value): from 84% to 83%
  - No change in affordability (debt-to-income)
  - No change in mortgage rate
  - No change in mortgage risk
  - Less/no change in shopping for alternative proposals

- Overall, weak evidence for better informed choice

Did Legislation Act as a Tax?

- Based on actual mortgage data:
  - Massive exit of lenders, especially small, from the market (-67%***)
  - Massive exit of borrowers from the market (-47%***,-77%***)

- Borrowers attempt to avoid counseling:
  - Small decline in shopping for alternative offers
  - Mid-FICO and high-FICO borrowers chose more LESS risky mortgages, in order to avoid counseling
(about 5%-6%*** migration)

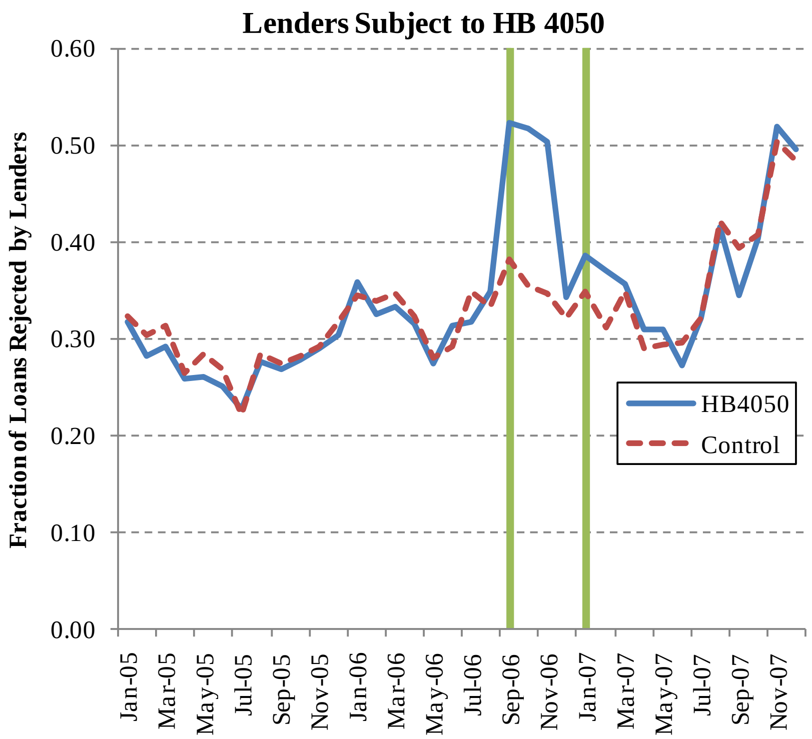
- Overall, supportive evidence for the tax hypothesis

Effects of Oversight

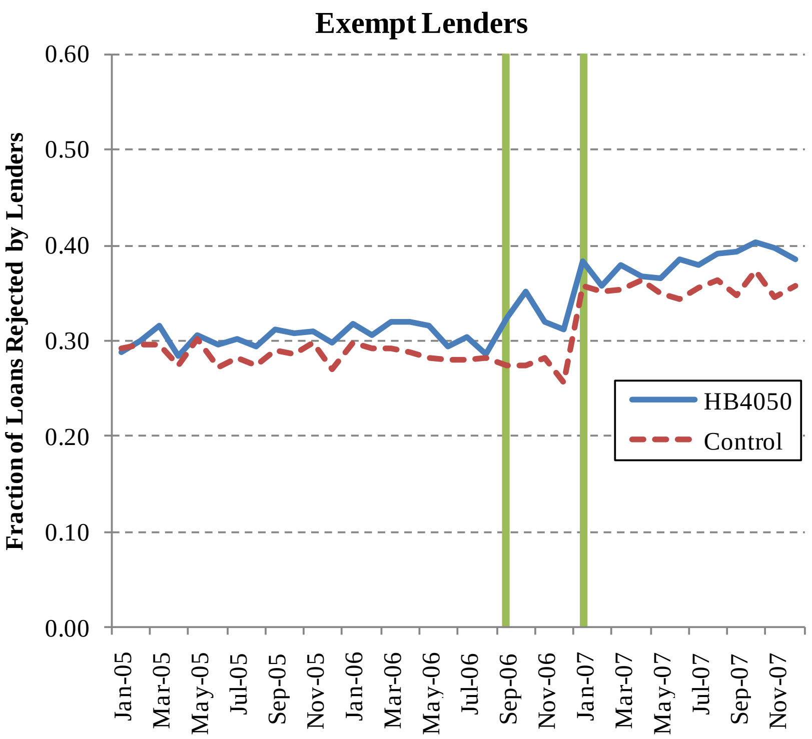
- Based on actual mortgage data:
  - Lenders with low rejection rate exited
  - Sharp decline (5%-8%***; base rate is 45%) in low-doc mortgages
- Lenders who stay in the market reject 4% more borrowers upfront
- Which borrowers are rejected?
  - No observable characteristics
  - No specified reason ("Other")
  - Not because of the $300 fee (small mortgages are not rejected more)
  - Likely reason: preventing poor-quality borrowers to meet with counselors
- Likely driver of the improvement in default rate

Rejections by Lenders

State-Licensed Lenders



Exempt Lenders



Conclusion

- Adverse effects of legislation on:
  - Credit supply and demand
  - Competition between lenders
- Significant improvement in default rates for low-FICO borrowers following counseling
- What drives the decline in default?
  - Direct effects: Weak evidence that information matters
  - Indirect effects: Strong evidence that the threat of external oversight matters
  - **Likely effect: Change in the behavior of lenders (soft info → hard info in the presence of a third party)**

Policy Recommendations

- Policy recommendations:
  - Oversight matters: disciplining effect on lenders
  - Burden matters: borrowers try to avoid counseling
  - Concentrate in efficient design of counseling program that addresses incentives of:
    - Lenders (screening based on unobservables)
    - Borrowers (taking risky mortgages)
  - Contents of counseling is of secondary importance