6-14-2010

Annamaria Lusardi Follow Up

Wendy Edelberg

Annamaria Lusardi

Monday, June 14, 2010

Via E-mail and FedEx
Professor Annamaria Lusardi
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Re: Follow-up to the Financial Crisis Inquiry Commission Forum

Dear Dr. Lusardi:

The Financial Crisis Inquiry Commission thanks you once again for your participation in the "Forum to Explore the Causes of the Financial Crisis" on February 26 and 27, 2010.

Enclosed are follow-up questions which were posed by the Commissioners during the forum, as well as additional questions which have arisen over the course of our investigation which we would like your assistance in answering.

Please respond to the questions by Friday, July 2, 2010. If you have any questions, or would like more information, please contact Scott Ganz at sganz@fcic.gov.

1. In stated income loans, the mortgage applicant provides information about his or her income that the lender accepts without verification. Do you have any information from your research about applicants' understanding of this aspect of the mortgage transaction? In particular, to what extent would a borrower, and especially a subprime borrower, realize that they might be committing fraud if they significantly overstate their income?

2. What evidence is there about the extent that prepurchase counseling helps subprime borrowers avoid taking on too much mortgage debt?

Sincerely,

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Annamaria Lusardi
Joel Z. and Susan Hyatt Professor of Economics

To Financial Crisis Inquiry Commission

July 2, 2010

Dear Members of the Commission:

I report below the response to the two questions that were sent me.

1. In stated income loans, the mortgage applicant provides information about his or her income that the lender accepts without verification. Do you have any information from your research about applicants' understanding of this aspect of the mortgage transaction? In particular, to what extent would a borrower, and especially a subprime borrower, realize that they might be committing fraud if they significantly overstate their income?

I do not have any information in any of the surveys I have worked with on whether mortgage applicants know that they would be committing fraud if they were to significantly overstate their income in their applications. Also, I have not seen any research documenting this fact. This is very specific information and potentially very hard to get (not clear that respondents would admit they overstated their income. Respondents would also be afraid to admit they had committed fraud).

2. What evidence is there about the extent that prepurchase counseling helps subprime borrowers avoid taking on too much mortgage debt?

There is some evidence that prepurchase counseling helps subprime or borrowers at risk to avoid taking on too much mortgage debt. The papers that study this topic all face the problem of self-selection, i.e., those who attend these programs are often not a random group of the borrowers at risk. Most papers try to address this problem in their analysis, but with different degrees of success. I summarize below some of the most relevant papers, in order of importance.

(Please note that most of the households covered in these studies have low FICO scores and would be considered subprime borrowers, even though sometimes the papers did not aim to study subprime mortgage borrowers only).

Agarwal, S, G. Amromin, I. Ben-David, and S. Chomsisengphet (2010), “Learning to Cope: Voluntary Financial Education and Loan Performance during a Housing Crisis,” *American Economic Review*, Vol. 100, No 2, pp 495-500.

This paper shows that long-term voluntary counseling program dramatically improved mortgage performance among low-income at-risk households. The 18 month default rates of households that graduated from this program were up to 10 percentage points lower than those for similar households that did not choose to get counseled. This finding is robust to an array of controls and several ways of modeling the probability of selection into counseling.

Quercia, R. and J. Spader (2008), “Does Homeownership Counseling Affect the Prepayment and Default Behavior of Affordable Mortgage Borrowers,*?” Journal of Policy Analysis and Management*, Vol. 27, No 2, pp 304-325

While this paper does not find an effect of counseling on default rates, it finds that those who attend classroom-based counseling better understood and took advantage of the value of mortgage options, such as prepayments.

Hartarska, V. and C. Gonzales-Vega (2006), “Evidence on the Effect of Credit Counseling on Mortgage Loan Default by Low-Income Households,” *Journal of Housing Economics*, Vol. 15, No 1, pp. 63-79.

This paper shows that counseling not only decreased the default rates of low income borrowers, but also increased the level of financial sophistication of low-income borrowers who attended the program (judged by looking at behavior not measures of knowledge).

Hirad, A and P. Zorn (2002), “A Little Knowledge is a Good Thing: Empirical Evidence of the Effectiveness of Pre-Purchase Homeownership Counseling,” in N. Retsina and E. Belsky (eds.), *Low income Homeownership: Examining the Unexamined Goals*. Washington DC: Joint Center for Housing Studies, Brookings Institution Press, pp. 146-174.

Borrowers who received pre-purchase homeownership counseling are, on average, 13 percent less likely to become delinquent than borrowers with similar characteristics but who do not undergo counseling. According to this studies, they way counseling is delivered is important and not all types of counseling (for example home-study) work.

The reason why I am inclined to argue that counseling is likely to have an effect on the behavior of subprime borrowers (even though the empirical work provided in the papers mentioned above is weak) is that there exists other similar evidence when looking at counseling for other types of borrowing. For example, Elliehausen, Lundquist and Staten (The Impact of Credit Counseling on Subsequent Borrower Behavior, Journal of Consumer Affairs, 41, 2007) examined credit counseling programs that five agencies approved by the National Foundation for Credit Counseling provided to borrowers. They found that credit scores, debt levels, and bank account usage all improved for counseled individuals with respect to those who were not counseled.

Best regards,

Annamaria Lusardi