SURF Spotlight: Interventions that Improve Consumer Credit Outcomes[1]
2018 Q4

The residential mortgage and foreclosure crisis during 2007 through 2012, and historically high charge-off rates on credit cards during 2008 through 2010 brought about renewed interest in policy intervention aimed at improving credit performance outcomes for vulnerable households. Two categories of intervention that have received increased attention are financial counseling programs to promote better credit decisions by households, and mortgage loan modification programs to assist in recovery from default.

We select for our SURF spotlight two recent studies that provide new and encouraging evidence on the potential benefits of policy interventions aimed at improving consumer credit outcomes. The first is a Federal Housing Finance Agency (FHFA) research paper entitled "First Time Homebuyer Counseling and the Mortgage Selection Experience in the United States" (by Robert Argento, Lariece Brown, Sergei Koulayev, Grace Li, Marina Myhre, Forrest Pafenberg, and Saty Patrabansh):
https://www.fhfa.gov/PolicyProgramsResearch/Programs/Documents/NMDB-Staff-Working-Paper_18-02.pdf

The second is a working paper from the Federal Reserve Bank of Philadelphia's Consumer Finance Institute (CFI), "Redefault Risk in the Aftermath of the Mortgage Crisis: Why Did Modifications Improve More Than Self-Cures?" (by Paul Calem, Julapa Jagtiani, Raman Maingi, and David Abell):
https://philadelphiafedcmstaging.ws.frb.org/-/media/research-and-data/publications/working-papers/2018/wp18-26.pdf?la=en

The Argento et al. study adds to the existing literature on homebuyer education in two ways. First, it draws on a nationally representative sample of first-time homebuyers, whereas prior studies focus on evaluating specific education or counseling programs. Second, whereas prior studies generally measure program success on the basis of subsequent repayment performance, this new study provides evidence on other potential benefits, such as knowledge of and satisfaction with the mortgage process.

Data for the analysis comes from the National Survey of Mortgage Originations (NSMO), a new survey co-sponsored by the FHFA and the Consumer Financial Protection Bureau. The sample encompasses borrowers who took out a mortgage in 2013 and 2014. Statistical matching techniques were employed to control for observable characteristics related to which borrowers received homebuyer education or counseling.

The analysis indicates that first-time homebuyer counseling is associated with improved knowledge of the mortgage process and mortgage terminology. The study also finds that counseling is associated with borrowers more frequently comparing final costs to initial good-faith estimates, and higher incidence of selecting a mortgage based on cost. The latter findings suggest that counseling encourages participants to review mortgage loan offers more closely. The study acknowledges several limitations. One important limitation is that outcomes pertaining to mortgage knowledge are self-reported. In particular, "it is possible that counseling may make consumers more confident in their knowledge, as opposed to actually improving it";

[1] This commentary was written by Paul Calem, vice president in the Supervision, Regulation, and Credit Department of the Federal Reserve Bank of Philadelphia. The views expressed here are solely those of the author and do not necessarily reflect the views of the Federal Reserve Bank of Philadelphia or the Federal Reserve System.

hence, further research is needed to link homebuyer education and counseling directly to improved knowledge.

Another important limitation is that the survey does not distinguish whether responses reflect post-purchase (and thus post-counseling) or pre-purchase state of knowledge. In other words, consumers may select into education and counseling along dimensions related to the observed outcomes. The study suggests that future research "employ methods to distinguish between the pre- and post-purchase states of knowledge" and attempt to assess within-person changes in knowledge.

The Calem et al. study examines repayment performance (redefault rates) of first-lien mortgages that received a payment-reducing loan modification during 2008 through 2011 to facilitate cure from default. Their performance is compared to that of similarly situated loans that self-cured from default (without payment-reducing modification) during that period. The matched self-cured loans serve as a control group, relative to which the marginal effect of payment-reducing modification can be evaluated.

The study finds that the redefault rate of both modified and self-cured mortgages declined by a large amount over this period, but the improvement was greatest for modifications. The analysis distinguishes among four investor or guarantor categories of mortgages: loans securitized and guaranteed by Fannie Mae and Freddie Mac (Agency), loans insured by the Federal Housing Authority or Veterans Administration (FHA/VA), loans held in bank portfolios, and privately securitized loans. With the exception of the government-insured (FHA or VA) category, redefault rates are much lower for the 2011 cohort of modified or self-cured mortgages compared with the 2008 cohort, for both modified loans and their matched self-cures. In 2008, loan modifications have a higher frequency of redefault than self-cured loans, but by 2011, the ordering is reversed.

For example, among Agency loans, the 36-month cumulative redefault rate for the 2008 cohort was around 80 percent for modifications and 70 percent for self-cures. The 36-month cumulative default rate for the 2011 cohort was about 20 percent for modifications and 35 percent for self-cured loans.

In addition to developing these comparisons, the study estimates logistic regression models of redefault to analyze the factors that contributed to the larger decline in redefault frequency associated with loan modification. One of the key, identified factors is the increasing share of principal-reduction modifications, which appear to be more effective than other types of modification — a finding consistent with previous studies. In addition, the analysis indicates that more generous modification terms (larger payment reductions) over time was a key contributing factor. Moreover, the favorable impacts of principal and payment reductions were enhanced by improving economic conditions, such as declining unemployment rates from 2008 to 2011, resulting in more effective modifications.

Even after controlling for the type of modification, the payment reduction amount, and the economic conditions, the analysis indicates larger improvement in redefault rates for modifications compared with self-cured loans. A plausible explanation offered for this residual effect is servicer "learning-by-doing." That is, servicers with limited experience in designing modification programs in 2008 may have learned their lessons as the modification activity ramped up, resulting in more successful modification programs for later vintages.

One limitation of the study is inability to confirm the learning-by-doing conjecture by ruling out possible, competing explanations for the residual effect. For example, there might be a borrower-side explanation as well. Improving performance of loan modifications may be potentially attributable in part to changes in the characteristics of borrowers receiving them,

with these changes being unrelated to (evolving independently of) servicers' modification strategies.

An important policy implication of these findings is that it behooves researchers and policymakers to explore and record what was learned about the design and implementation of effective loan modification strategies. Such an exploration would help preserve the working knowledge and might also provide additional insights into specific policy questions around the design for effective loan modification — for example, whether servicers should receive subsidies for modification, whether and to whom subsidies should be targeted, and what strategies might further enhance the effectiveness of mortgage loan modifications.

Another implication is that encouragement of loan modification may, in fact, have been optimal public policy, as over time modifications proved far more successful than a priori experience would have suggested. However, further research incorporating a full cost and benefit quantification is needed to establish whether mortgage modifications were worth it from the lenders' and borrowers' perspectives as well as from the perspectives of overall social welfare.