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The effectiveness of pre-purchase homeownership counseling: Evidence from a randomized study

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ABSTRACT

Homeownership education and counseling have never been rigorously evaluated through a randomized field experiment. This is a five-year study that addresses this shortcoming. The study is structured to respond to the concerns raised about previous efforts. We employ an *experimental design*, with study participants randomly assigned to a control or a treatment group. Participants completed a baseline survey and were tracked for four years after receiving initial assistance by means of an annual survey, which also tracks participants' life changes over time. To assist in the analysis, additional information in the form of credit reports and credit scores was obtained annually to track changes in the participants' creditworthiness. Also, certain safeguards were implemented to ensure consistency of the counseling. The study considers the influence of counseling on credit scores, total debt, and delinquencies in payments. We find that those in the treatment group benefit more relative to control participants. Moreover, both treatment participants with one-on-one counseling and control participants who became homeowners tended to pay their mortgages in a timely manner overall.

1. Introduction

Homeownership represents many things to many people. For some, it is the focal point of the family unit, the place where cherished memories are enjoyed, from raising children to celebrating special family occasions. For others, it represents the foundation of their financial investments and serves as the basis for accumulating potential wealth in the future. Yet for many, particularly those with low and moderate incomes, it is the elusive linchpin of the American dream. However, their path to homeownership has been aided by the passage of various legislations, such as the Fair Housing Act of 1968, the Equal Credit Opportunity Act of 1974, and the Community Reinvestment Act of 1977.

Notwithstanding the backing of legislative support, perhaps the major barrier to the benefits of homeownership for many with low and moderate incomes is past credit problems, which are often aggravated by deficient financial management skills. In addition, many people are intimidated by the mortgage-lending process, stemming from their lack of knowledge of its inner workings. This has been made more daunting by drastic changes in the mortgage market. With the advent of subprime lending and its rapid growth, the possibility of buying a house became a reality for many individuals who previously had little hope of homeownership. However, this newfound opportunity resulted in difficulties for some, and their homebuying decisions were further complicated by the emergence of mortgage products with features such as interest-only payments, adjustable rates, no down payments, and no or low documentation.[3]

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[3] While these products were prevalent during 2007, many are no longer relevant today. Moreover, Congress established the Consumer Financial Protection Bureau (CFPB) through the Dodd–Frank Wall Street Reform and Consumer Protection Act (Dodd–Frank Act) to enforce federal consumer financial protection laws; devise rules to protect consumers from unfair, deceptive, or abusive acts or practices; and to provide consumers with the information they need to make the financial decisions they believe are the best for themselves and their families.

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1.1. Housing counseling industry

Many people maintain that homeownership counseling is available to navigate a number of the aforementioned impediments. Homeownership counseling provides training to clients to instill knowledge and skills needed to be a successful homeowner. Thus, homeownership counseling can have short-term and long-term benefits. While homeownership is a laudable goal, it might not be suitable for everyone. In the short run, homeownership counseling can help prospective homebuyers determine whether purchasing a house is financially prudent and assist them in qualifying for a mortgage. This might avert a situation that occurred in the recent downturn in the housing market in which many homebuyers were ill-prepared for homeownership. In the long run, homeownership counseling can provide a continuum of services that lead up to and include sustainable homeownership, stable neighborhoods, and fewer foreclosures.

In fact, a special industry has grown up around homeownership counseling. Nonprofits and other organizations/institutions are offering services associated with homeownership counseling, and the Department of Housing and Urban Development (HUD) is playing a stronger role in setting standards to oversee the process of administering homeownership counseling services. HUD has provided more than $40 million in housing counseling grants to national, regional, and local organizations that offer counseling services. Moreover, the Dodd–Frank Wall Street Reform and Consumer Protection Act (Dodd–Frank Act) established an Office of Housing Counseling in HUD.

1.2. Goals of housing counseling

There are several goals that are shared by clients, providers, funders, and policymakers. They are:

- A knowledge of budgeting.
- A better understanding of managing credit.
- Ways to make informed decisions about pursuing homeownership.

Moreover, for some prospective homebuyers, the participation in homeownership counseling is mandated by their prospective lender. But the effectiveness of such counseling over time continues to be contemplated. Previous studies have made important strides in understanding the value of homeownership counseling, but more work is still needed. More specifically, two researchers who are familiar with studies on the subject have observed that "homeownership education and counseling have never been rigorously evaluated through a randomized field experiment" (Collins & O'Rourke, 2011).

This study was undertaken and structured to address the concerns that have been raised about previous efforts. In particular, the study employs an *experimental design*[4] and follows participants for several years after they had received counseling.

2. Prior studies and research concerns

The most pressing challenge is to build upon prior studies and to add to our knowledge of the long-term effects of financial counseling on consumer credit behavior with the ultimate goal of homeownership and improving general financial management skills.

In pre-purchase homeownership counseling, prospective homebuyers are furnished with knowledge and assessment skills: whether they are financially ready to buy, what to consider when making a purchase, how to manage their mortgage and other finances, how to maintain a home and prepare for major home repairs, and how to avoid unscrupulous lenders when refinancing. However, the findings of studies have been mixed on the effectiveness of pre-purchase homeownership counseling and credit counseling on subsequent financial behavior. Two studies found counseling to be effectual, while others have determined either that there was no effect on later loan performance or that positive subsequent performance was likely due to other factors.

A study by Hirad and Zorn (2001) used data on 40,000 participants from Freddie Mac's Affordable Gold Loans program to assess the effectiveness of pre-purchase homeownership counseling. The Affordable Gold Loans program was devised to give borrowers who earned 100 percent or less of the median income the opportunity to become homeowners. Freddie Mac stipulated that at least one qualifying borrower for each Affordable Gold Loan it purchased must receive pre-purchase homeownership counseling. The delivery mode of the counseling (classroom, home study, one-on-one, or other) was to be determined by the lenders. However, some borrowers were considered to be a lower risk and were not compelled to receive counseling. Thus, some of the participants in the program received counseling while others did not. The authors analyzed the performance of participants who were assessed 18 months after counseling compared with a group that did not receive counseling. They arrived at a comparison group by first matching the mean delinquency rate of those who were exempt from the counseling requirement with those who were receiving counseling. While risk characteristics still might be present among the two groups, the authors used a "two-step process to account for both observed and unobserved differences in borrower risk."[5] They found that homeownership counseling significantly reduced the delinquency rates of borrowers. More specifically, they showed that borrowers with individual counseling averaged a 34 percent lower 90-day delinquency rate, while borrowers who received classroom and home study counseling had 26 percent and 21 percent lower rates, respectively.

Hirad and Zorn acknowledged that there are some caveats associated with their study. They pointed out that their study was not a true experiment in which participants were randomly assigned to a treatment or control group. In order to compensate, they attempted to "control for both observed and unobserved differences in the risk characteristics of borrowers."[6] However, they recognized that they were "unlikely to be entirely successful ... and borrower self-selection may account for some of the benefits attributed to homeownership counseling (e.g., 'motivated' borrowers disproportionately may choose classroom and individual counseling)."[7]

Quercia and Spader (2008) conducted another study that focused on the impact of homeownership counseling on the prepayment and default behavior of mortgage borrowers. They used loans originated between 1999 and 2003 that were part of the Community Advantage Program (CAP) for the Home Loan Secondary Market and that contained a homeownership education and counseling (HEC) component. The authors observed the performance of the loans through the first quarter of 2006. The HEC provision could be delivered through classroom instruction, individual counseling, home study, or telephone counseling. Although the initial intent of HEC was to "reduce default risk," the curriculum also provided borrowers with the ability to assess the relative costs and potential

[4] By "experimental design," we mean that the participants in the study are randomly assigned to either a treatment group or a control group, and only those in the treatment group receive the intervention (in our case, one-on-one counseling).

[5] Hirad and Zorn (2001, p. 9).
[6] Hirad and Zorn (2001, p. 15).
[7] Hirad and Zorn (2001, p. 15).

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