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Evidence on the effect of credit counseling on mortgage loan default by low-income households ☆

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Abstract

Research on the effectiveness of credit counseling is surprisingly scarce given its widespread use and given that it has been around for at least three decades. This paper studies the effects of counseling on default by adopting an option-based approach to mortgage termination. Data come from a counseling program developed as result of the collaborative efforts of a large Midwest bank, Community Churches, and a local community development company implemented during the 1992–1996 period. We find some evidence that counseled borrowers defaulted less often than non-counseled borrowers and that counseling affects optimal exercise of the default option.

JEL classification: G21; D14

Keywords: Credit counseling; Mortgage loan; Default; Low-income households

1. Introduction

The prolonged economic expansion of the past decade, government support efforts, and innovations in lending technologies have led to substantial growth in the provision of mortgage loans to low-income households in the United States. Both lenders and

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borrowers have benefited from new cost-efficient lending technologies that better address the challenges of low-income housing finance. Financial institutions usually attract low-income borrowers by reducing downpayment, by extending closing cost assistance, and by accepting lower qualifying incomes and non-traditional credit histories. Often, low-income borrowers are required to go through counseling prior to applying for a loan. This paper provides empirical evidence that credit counseling affects the incidence of default on low-income mortgage loans.

The ostensible purpose of credit counseling is to help low-income borrowers to estimate more precisely the amount of debt they will be able to service and, thereby, prevent default. Counseling involves the use of a third party specializing in providing homeownership and credit counseling. The counseling industry consists of diverse entities with significant variations across programs. These program differences offer an opportunity to learn more about the strengths and weakness of alternative approaches to counseling. This paper offers evidence on the effectiveness of a specific credit counseling program designed to help low-income borrowers in the Midwest.

Research on the effectiveness of credit counseling is surprisingly scarce given its widespread use and given that it has been around for at least three decades. Among the factors that have prevented in-depth research are insufficient data collection by financial institutions and/or inability to match loan repayment with loan origination data, proprietary character of the data, and disagreement as to what is the best methodology to study mortgage default by low-income households (Mallach, 2001; Quercia and Watcher, 1996; Vandell, 1995).

This paper uses data from a counseling program resulting from the collaborative efforts of a large Midwest Bank, Community Churches, and a local community development company implemented during the 1992–1996 period. It studies the impact of counseling on default by adopting an option-based approach to mortgage termination. We explore the idea that counseling affects borrower's financial behavior and that counseled borrowers may default less often than non-counseled borrowers. The results suggest that the counseling program examined here indeed graduates borrowers who had lower default rates.

Section 2 briefly reviews the relevant literature on credit counseling and on mortgage default. Section 3 describes the specific program studied. Section 4 describes the methodology. Section 5 describes the data, and Section 6 discusses the results. Conclusions are offered in Section 7.

2. Discussion of the literature

Credit counseling emerged in the United States as a result of the passing of the *1968 Housing and Urban Development Act*. Under this act, the US Department of Housing and Urban Development (HUD) was allowed to authorize public and private organizations to provide counseling to mortgagors in the Sections 235 and 237 programs. The resulting services and infrastructure led to the development of the credit counseling industry (Quercia and Watcher, 1996).[1]

[1] In 1969, the Housing and Urban Development Act was amended, and additional entities were allowed to enter the credit counseling market. The amendment also broadened the scope of the counseling process itself, to include additional topics such as childcare and money management. In the following years, single-family homeowners, emergency homeownership, and home equity conversions were added to the counseling services covered by the HUD legislation.