HOW THE GOVERNMENT CAN PROTECT HOME MORTGAGE CONSUMERS: A PROPOSAL TO PROVIDE CONSUMERS A RISK ASSESSMENT OF MORTGAGES

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ABSTRACT

The recent sub-prime mortgage crisis has revealed the consumer’s vulnerability in the home mortgage marketplace. Consumers face an overwhelming variety of mortgage options, and are not motivated to invest the necessary time and resources to comprehend the meaning and implications of each loan feature. I propose that the government assess the risk of each loan feature available in the home mortgage market, based on the historical number of foreclosures each loan type has yielded. The government will then require lenders to display the risk assessment icon on all sales, marketing, and advertising materials. The risk assessment icon will identify the risky loan feature and the percentage likelihood that the feature will lead to foreclosure.
I. INTRODUCTION

I propose that the government provide consumers a risk assessment of loan features, based on the likelihood that loans with those risky features end up in foreclosure. The risk assessment will also briefly explain which loan features yielded the assessment.

I will identify the interests of the various players in the U.S. mortgage market: consumers, lenders, investors in securities, and government regulators, and explain how the proposal addresses each player’s interest.

Ideally, the proposal will lower the number of foreclosures and give lenders an incentive to educate consumers about loan features. However, there are potential barriers to the successful implementation of the proposal: first, consumers may not notice the risk assessments, or will misunderstand and misuse the information; second, the risk assessment may not fully or accurately capture the relevant risk factors, or may fail to accurately calculate the loan feature’s correlation with foreclosure.

Finally, I address three problems that the proposal may cause, if implemented. First, there may be economic inefficiency as consumers choose loans based only on risk, rather on the consumer’s individual characteristics and needs. Second, there may be a chilling of competition among lenders as some lenders drop out of the market. Third, consumers may incorrectly interpret the risk assessment as a guarantee and abandon common sense in choosing a mortgage.

II. PROPOSAL DESCRIPTION
The goal of this proposal is to devise an easily understood icon that informs the consumer of the relative risk levels among home mortgages. Risk, for the purposes of this proposal, is the likelihood that the borrower will lose the home in foreclosure. Lenders will be required to display the icons on all marketing and advertising materials.

The possible assessments are low, moderate, or high-risk, and the icon will include a short statement about which particular loan features yielded the assessment. Low-risk loans will receive a green icon, and the statement: “This mortgage has a fixed-rate. To avoid losing your home in foreclosure, please understand the terms of your mortgage.” Moderate-risk loans will receive a yellow icon, and the statement: “Caution! This mortgage has a pre-payment penalty. 20% of mortgages with a pre-payment penalty end in foreclosure. To avoid losing your home in foreclosure, please understand the terms of your mortgage.” High-risk loans will receive a red icon and the statement: “Caution! This mortgage has an adjustable rate. 50% of mortgages with adjustable rates end in foreclosure. To avoid losing your home in foreclosure, please understand the terms of your mortgage.”

The proposal informs consumers of the likelihood that a particular loan will end up in a house foreclosure. The low, moderate, or high risk assessment will help those consumers who have very limited tolerance for shopping, and just want to know which loan to avoid. The identification of a specific loan feature will help consumers who have some tolerance for research and shopping, and may want to learn about specific loan features and why they are risky.

2.1. The assessment process
The assessment will be based on information gathered from a database of sub-prime mortgages available from Loan Performance, a company that gathers, analyzes, and sells mortgage risk intelligence. Loan Performance gathers loan information, including payment histories, from lenders and servicers of securitized sub-prime loans. Although non-securitized loans are excluded from the data, the database represented about 67 percent of the overall sub-prime market in 2002.

In the event that securitized sub-prime loans no longer represent a sizeable portion of the overall sub-prime market, the Loan Performance database will no longer be useful. An alternative is to gather the data from each lender directly. Community Reinvestment Act (CRA) examinations could include a requirement that each lender submit data for each loan they originated that year. Given that most lenders probably gather and maintain this information anyway, it will not create an undue administrative burden for the lenders.

Each loan’s risk assessment will be based on the likelihood that a loan type defaults, and eventually ends with the home in foreclosure. Loans that have less than a 10 percent chance of foreclosure will receive a low risk assessment. Loans that have between 10 percent and 40 percent chance of foreclosure will receive a moderate assessment. Loans that have more than a 40 percent chance of foreclosure will receive a high risk assessment. For the purposes of this proposal, I will use data from existing research to determine the chance that each type of loan will foreclose.

2.1.1. Calculating odds of foreclosure

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2 Roberto G. Quercia, et al., Impact of Predatory Loan Terms on Sub-prime Foreclosures: The Special Case of Prepayment Penalties and Balloon Payments, 18 HOUSING POLICY DEBATE 322 (2007).
3 Id., at 336, tbl. 10.
Robert Quercia, et al., used mortgage data from loans originated in 1999 to determine which loan variables were correlated with foreclosures that had occurred by April 2004.\textsuperscript{4} The researchers limited the mortgage data to sub-prime conventional mortgage originations that refinanced the first lien for owner-occupants.\textsuperscript{5} Although this data is sufficient for the purposes of this proposal, the government will want to expand the scope of data for the risk assessments to include originations of first liens, in addition to refinances. This is a policy decision that should reflect the known dangers of the mortgage market. As more consumers turn to sub-prime mortgages for first liens, it will be helpful to know how those loans perform.

In the model, the loan features are compared to the control variables: no prepayment penalties, fixed interest rate, FICO score of 660 or higher, documented income, no cash out, single-family residence, and a non-judicial foreclosure state.\textsuperscript{6} Then, the researchers calculated the odds that certain loan variables correlated with foreclosure. I will use the results of their research to demonstrate how the government can utilize similar research and analysis to communicate the risk of loan features for consumers.

The following is a table of loan variables and the odds of each loan ending in foreclosure:\textsuperscript{7}

\textsuperscript{4} Id., at 322.
\textsuperscript{5} The researchers further narrowed the mortgage data to loans with either a 30-year term or balloon payments due within 10 years or more, originated by retail lenders, and with payment histories of the first six months or more.
\textsuperscript{6} As foreclosure laws vary among states, a state-by-state regression might produce a more targeted risk assessment than a national one. For example, a non-judicial foreclosure state may be more likely to foreclose on a home before the borrower negotiates a workout, or somehow manages to make the payments again, whereas a judicial foreclosure state may allow the borrower more time, thereby delaying, and possibly preventing, foreclosure. If this scenario is true, the state-by-state regression may be worth the extra administrative burden, including calculating fifty regressions instead of one, and possibly determining different risk thresholds for each state.
\textsuperscript{7} Quercia, supra note 2, at 336, tbl. 10.
<table>
<thead>
<tr>
<th>Loan variable</th>
<th>Odds of loan ending in foreclosure</th>
</tr>
</thead>
<tbody>
<tr>
<td>Prepayment penalty, in three or more years</td>
<td>1.2</td>
</tr>
<tr>
<td>Prepayment penalty, in less than three years</td>
<td>1.16</td>
</tr>
<tr>
<td>Adjustable rate</td>
<td>1.49</td>
</tr>
<tr>
<td>Balloon</td>
<td>1.46</td>
</tr>
<tr>
<td>Interest rate at origination</td>
<td>1.35</td>
</tr>
<tr>
<td>Low/no documentation</td>
<td>1.15</td>
</tr>
</tbody>
</table>

Loans with features that have odds of ending in foreclosure between 0.0 and 1.1 are given a low risk assessment, between 1.1 and 1.4 are given a moderate risk assessment, and above 1.4 are given a high risk assessment. Therefore, loans with prepayment penalties are given a moderate risk assessment; loans with adjustable rates or balloon loans are given a high risk assessment. Usually, only fixed-rate loans, such as loans with the control variable characteristics – no prepayment penalties, fixed interest rate, documented income, no cash out, single-family residence – will receive a low-risk assessment.

2.1.2. Time frame

When choosing a dataset, it will be important to choose a time frame that is long enough to provide sufficient data to accurately identify trends in foreclosure. For example, a consumer may enjoy the mortgage for years before something happens to

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8 The research also included variables for loans with missing FICO scores and FICO scores between 300-579, 580-619, and 620-659. The FICO score variables were omitted from the proposal because they describe characteristics about the borrower, rather than the loan. The missing FICO score variable was omitted from this proposal because the failure to determine a FICO score before selecting a loan is not a fixed feature of any loan.

Other loan features that should be incorporated into the risk assessment calculation are: fixed-rate when the monthly payment is more than 30 percent of borrower's income, interest-only and payment option, negative amortization, and teaser rates.

9 In a real-life risk assessment, the “interest rate at origination” variable should be broken down into specific levels, in order to make the information useful to consumers. For example, the variables can be “interest rate at origination more than 2% over prime,” “interest rate at origination more than 4% over prime,” etc.
trigger a foreclosure. Therefore, the timeframe for calculating the risk of foreclosure should be long enough to account for this lag between the loan origination and foreclosure.

However, it will also be important to choose a time frame that is brief enough to capture the most recent market conditions and exclude the effects of outdated, irrelevant market conditions and practices. For example, it is easier for most homeowners to obtain a refinance during a period when housing values are skyrocketing than when housing values are plummeting. The ability to refinance may in some cases help a homeowner avoid foreclosure because the refinance can preclude any potential resets that would have increased the monthly payments.

However, for a consumer in an unfavorable housing market in which house values are falling and are not expected to rise in the near future, a risk assessment based on how loans fared in the favorable housing market is not helpful information. Using a timeframe that includes drastically different housing market conditions than the current one would portray an outdated and inaccurate prediction of the foreclosure risk that the average mortgage consumer faces today.

Quercia, et. al. used a time period of four years (1999-2003) because it provided enough payment history to draw conclusions. The government agency that implements this proposal will have discretion to establish the time frame, and even modify it to accommodate changing market conditions. Four years is a good starting point, but will require more research and adjustments, especially considering how the housing market and overall economy has changed from 2004 to 2008.
2.2. Easily understood icon

Although the government may gather accurate and helpful information for the borrower, it is useless unless the government can convey the information in a way that gets the consumer’s attention, warns the consumer of the dangers of a risky loan, and equips the consumer with enough information to make a decision. Consumers have limited tolerance and interest in learning about the intricacies of mortgages and conducting side-by-side comparisons. Therefore, the risk assessment icons aim to be easily recognizable and comprehensible.

Past experiences in USDA safe handling labels, health care report cards, and Surgeon General warnings about cigarettes highlight effective methods and the limitations to consumer education.

2.2.1. Case Study: USDA safe handling labels

The USDA has educated consumers about handling food safely since 1971, but an outbreak of illness and death caused by foodborne disease prompted the USDA to announce a new rule in 1993, requiring safe handling labels on meat and poultry. Participants in focus groups on the effectiveness of the safe handling labels preferred icons, “why” statements, and short instructions.10 According to two studies conducted by the Food Marketing Institute (FMI) and the Food and Drug Administration (FDA), the safe handling labels were effective in changing consumer behavior.11 In the FMI survey, fifty-nine percent of the 1,000 respondents said they had seen the label, and of that group, forty-three percent said they had changed their behavior. In the FDA survey, sixty-five

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percent of the 2,001 respondents said they had seen the label, and of that group, thirty percent said they had changed their behavior.

The USDA safe handling label example suggests the risk assessment icon can be effective in changing consumer behavior. Simplicity was essential for the labels to be effective. The risk assessment icons communicate to the consumer through colors (red, yellow, green) and a scale with three risk-levels: low, moderate, and high. Also, the risk assessment icon explains “why” to the consumer by briefly identifying the loan features that yielded the assessment.12

2.2.2. Case Study: Health Care Report Cards

Another example of how consumers make choices based on available information is report cards for health care plans and providers. In the past decade, Consumer Reports and the National Committee for Quality Assurance, a non-profit organization, have gathered, analyzed, and publicly disclosed quality evaluations of health care services.13 The rationale for these report cards is that while consumers already choose health care plans, doctors, and/or hospitals based on availability, cost, or on the recommendation of friends and family, the report cards allow consumers to choose a health plan or provider based on quality, measured by mortality rates, consumer evaluations, and other outcome based measures.

One study has shown that there are limitations to the effectiveness of such quality evaluations, including: the presentation of the information, consumers’ difficulty in

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12 The proposal does not address possible icons or design, but symbols communicating that the consumer should exercise caution, or safely proceed with a lender would be useful.
interpreting the information, and consumers’ awareness of the quality evaluations.\textsuperscript{14}

*Consumer Reports* compared thirty health care report cards for effectiveness and found that some health care report cards provided too much information and confusing explanations, and failed to rank the plans in any meaningful way or provide any sort of guidance about which plan to choose.\textsuperscript{15}

Another weakness of the health care report cards is that many consumers do not believe there is a difference in quality among health plans. A national survey found that less than half of Americans believed there was a difference in quality among health care plans, and less than a third believed there was a “big difference” in quality among specialists.\textsuperscript{16} Even if these consumers are aware that the health care report cards exist, they are not likely to base their choice on the report card.

The health care report card example illustrates the importance of conducting preliminary research on consumers’ perceptions about the differences among loan features. More research is necessary to determine whether consumers recognize that risk varies among loans, and that the difference can mean losing or keeping their home. The risk assessment icon addresses this issue by providing, as a percentage, the chance of losing a home in foreclosure. A consumer comparing a loan that has a twenty percent chance of foreclosure with a loan that has an eighty percent chance will recognize, at the very least, that the loans are different. Hopefully the consumer will then choose the lower risk loan, or ask someone for more details about how the loans are different.


\textsuperscript{15} Id. at 98.

\textsuperscript{16} Id.
The health care report card example also highlights the importance of integrating the government’s judgment about the prudence of choosing a particular loan into the icon. If a consumer does not know what to do with the information provided, the risk assessment icon is ineffective. Therefore, it is important that the risk assessment icon signals to consumers that they should avoid high risk loans, be wary of moderate risk loans, and always ask questions to understand the terms of their mortgage. An icon simply listing the risky loan features will probably not help consumers because they may not know what the features mean, or how the risk can affect their long-term ability to pay the mortgage. However, the risk assessment icon, with its red, yellow, or green color, and the words “Caution” and “foreclosure,” is intuitive enough that, at the very least, the consumer will inquire about the risky feature and maybe even avoid high risk loans entirely.

2.2.3. Case Study: Cigarette Surgeon General’s Warning

Congress first mandated warning labels on cigarette packages in 1965 with the Federal Cigarette Labeling and Advertising Act. In 1972, the Federal Trade Commission (FTC) negotiated with major cigarette companies to require the companies to display warning labels in advertising as well. There were no criteria established for assessing the effectiveness of the warning labels, and therefore there was no monitoring of effectiveness. A 1981 study by the FTC revealed that most consumers did not notice the warnings, and that although most consumers knew that smoking was generally hazardous, they were not aware of the specific dangers.  

A four country survey (United States, Canada, United Kingdom, and Australia) of the effectiveness of cigarette warnings found that about two-thirds of respondents said cigarette packages were a source of health information.\(^{18}\) Larger, more comprehensive labels were more likely to be cited as sources of health information. For example, Canada was the only country that used cigarette labels to warn consumers that smoking causes impotence, and Canadian smokers were almost three times as likely as smokers from other countries to know that smoking causes impotence.\(^{19}\)

The cigarette warning label example indicates that it is possible for warning labels to effectively warn consumers about risk by catching their attention with large, graphic labels and describing the specific danger involved, rather than warning against a general hazard. The risk assessment icon will catch the consumers’ attention with its bright primary color, and large size. It will also be ubiquitous in any lender’s marketing materials and advertisements, giving consumers many chances to notice it during the mortgage shopping process. The government will also launch a media campaign to advertise the risk assessment icon, so that consumers will know to look for the icon when they shop for a mortgage, and will understand what it is when they see it.

The risk assessment icon will also describe a specific danger, rather than just warning that the mortgage is risky. Most people understand that mortgages involve some risk, especially after the current mortgage crisis and wave of foreclosures. However, in order to adequately illustrate the risk involved, and thereby change the consumer decision-making process, the risk assessment icon must specify the danger. The risk assessment icon achieves this by identifying the risky feature and providing the

\(^{18}\) Dr. David Hammond, et. al., *Effectiveness of Cigarette Warning Labels in Informing Smokers About the Risks of Smoking*, 15 TOBACCO CONTROL iii23 (2006).

\(^{19}\) Id.
likelihood that the mortgage will end in foreclosure of a home, expressed a percentage:

“Caution! This mortgage has an adjustable rate. 50% of mortgages with adjustable rates end in foreclosure. To avoid losing your home in foreclosure, please understand the terms of your mortgage.”

Even if a consumer does not fully appreciate the likelihood of foreclosure happening to him, he is at least reminded of the prospect of foreclosure, which may be enough for him to ask questions about the risky loan feature, or shop for a mortgage without the risky feature.

2.3. Implementation and Enforcement

2.3.1. Federal agencies

The U.S. Department of Housing and Urban Development (HUD) is best suited for implementing the risk assessment icon because it requires expertise in mortgage products, as well as a focus on consumer interests in mortgage shopping. HUD will have the responsibility to determine how to assess new loan products, until the loan has spent sufficient time in the market to reveal its risk to consumers. HUD will also have the discretion to determine the thresholds for low, moderate, and high risk levels, the data set of mortgages for the regression, and the frequency of the assessments. The mortgage industry will have an interest in keeping risk assessments low, and may try to exert political pressure on HUD.

The Federal Reserve Bank, through the Community Reinvestment Act (CRA) examinations, is well-equipped to ensure that the risk assessment icons are displayed on all marketing and advertising materials. The CRA examiners may take on a considerable administrative burden when it tries to enforce the requirement that the risk assessment
icons are displayed on all marketing and advertising materials, depending on how extensively the requirement is enforced. The examiner may just look at materials at the office site, or conduct more research by looking at the lender’s website, TV commercials, print ads, and mailings. In order to effectively enforce the risk assessment initiative, the Federal Reserve Bank should impose monetary penalties for non-compliance.

2.3.2. States

States who wish to reduce predatory lending and foreclosures within their borders have an incentive to complement the CRA examinations by investigating lenders’ marketing and advertising in their state, and reporting violations to the Federal Reserve Bank. Although states are pre-empted from regulating lenders, states may be able to monitor lenders’ compliance with national banking regulations. The state regulators would not interfere with the national banking regulatory scheme, but would give more force to the federal regulation.20

III. PROPOSAL’S RESPONSE TO TODAY’S MARKET

Although this proposal’s primary goal is to inform consumers, it will impact other players in the mortgage market, including lenders, investors in securities, and the government regulatory entities. In this section, I will discuss each player’s interest and how the proposal does or does not address these interests.

3.1. Consumers

The proposal protects consumers by providing the consumer a manageable dose of information about loans. The consumer’s interest is to successfully navigate the complexity of the mortgage market by choosing a mortgage without spending a

20 Watters v. Wachovia Bank, 127 S.Ct. 1559, 1563 (2007) ("[S]tate regulators cannot interfere with the “business of banking” by subjecting national banks or their OCC-licensed operating subsidiaries to multiple audits and surveillance under rival oversight regimes.").
burdensome amount of resources. The consumer does not want to experience buyer’s remorse in the long run, does not want to be deceived or discriminated against in the loan process, and does not want to lose their home in foreclosure.

Most consumers do not have the time or resources to learn about mortgages and compare competitors to ensure that they end up with the best loan. In fact, research shows that unsophisticated consumers spend less time researching and shopping than more knowledgeable consumers. In a study about how consumers respond to uncertainty in buying an appliance, those consumers who were uncertain about available features, the importance of such features, and the performance of alternatives, spent less time shopping, visited fewer stores, and compared fewer brands than consumers who were only uncertain about which alternative to choose.  

In the home mortgage context, this research suggests that consumers who know little about the complexities of a mortgage and the U.S. mortgage market will spend less time understanding and comparing mortgages than their counterparts who understand mortgages. Instead of expecting consumers to educate themselves about mortgages, this proposal offers a risk assessment as a substitute for a lengthy mortgage search.

In addition to the complexity of mortgages and the overwhelming number of lenders in the marketplace, consumers are faced with several indeterminate variables that determine the optimal mortgage choice: current income, future income, future interest

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rates, and house price appreciation. Additionally, consumers will overestimate their future ability to pay and fail to exercise discipline in option payments.23

The proposal addresses the consumer’s interest in two ways. First, the risk assessment reduces the many variables of choosing a mortgage to just one variable: risk. There is evidence that a consumer’s attitude towards risk is one factor in whether the consumer chooses a fixed-rate or variable-rate mortgage.24 Consumers who are sensitive to price are more likely to choose a variable-rate mortgage, but consumers who are risk-averse are more likely to choose a fixed-rate mortgage.25 Under this proposal, consumers who are sensitive to price and risk will not rule out sub-prime mortgages, but will be able to compare the relative risk among sub-prime mortgage features. Second, the proposal allows lender to continue selling all the products it currently offers, so consumers still have choices.

However, the proposal does not address those consumers who are willing to take on risk for a mortgage that fits their individual characteristics. For example, a consumer might be fairly certain that his income will drastically increase in three years, and therefore is willing to purchase a three-year ARM. The proposal does not detract from these consumers’ choices or their freedom to purchase whichever mortgage suits their needs.

22 Andrew Olszowy, Alternative Mortgages: Managed Risk or Gamble (forthcoming, Communities & Banking).
23 Tomasz Piskorski & Alexei Tchistyi, Optimal Mortgage Design (August 2007).
25 Id. at 13 (“[A]titudes toward risk affect mortgage choice along two important dimensions: For less risk-averse borrowers, affordability factors do not significantly affect mortgage choice, and pricing variables and income volatility do not influence their mortgage choice to the same extent as that of more risk-averse borrowers.”).
3.2. Lenders

The proposal allows lenders to continue to operate with minimally invasive regulation. The lenders’ interest is to maintain freedom from government regulation that would limit their ability to sell mortgages. Additionally, lenders exploit the information asymmetry that exists between the lender and the consumer. Although lenders would not express this interest to the public, the lender is interested in maintaining the information asymmetry.

This proposal addresses the lender’s interest by refraining from invasive regulation. Lenders would still be free to offer all of their current mortgage products and terms. In one way, the proposal goes against the lender’s interest: it detracts from the lender’s informational advantage by communicating the risk of certain loans. Although lenders can still market and sell their riskier loan products by adjusting price, or by persuading the consumer that a particular loan feature suits the consumer’s individual characteristics, the risk assessment icon is a small step towards closing the information gap between the lender and the consumer.

This proposal does not address lenders who sell exclusively traditional mortgages because traditional mortgages are relatively low-risk. The risk assessment’s primary impact will be on sub-prime lenders.

3.3. Investors in securities

The proposal provides investors in securities more robust investment vehicles. The investors want consistent and predictable payments from the lender, as well as the market’s confidence in mortgage-backed securities as collateral.
The proposal has an indirect, but important, effect on investors. As consumers buy fewer risky mortgage products, a smaller proportion of loans will default, all things being equal. Therefore, the servicers will have a steady cash flow from the homeowners, with which to pay the investors. In the same indirect, but important way, the proposal will instill market confidence in the integrity of mortgage-backed securities as collateral. As risky mortgage products become a smaller part of the mortgage market, and foreclosures become less frequent, creditors will have increased confidence that the mortgage-backed securities are correctly valued.

This proposal does not address investors who are indifferent to foreclosures. As investors are guaranteed payment from servicers, the investors may be unconcerned with whether homeowners can pay their mortgages and with the frequency of foreclosures.

3.4. Government regulatory entities

Government regulatory entities have an interest in remaining relevant to the regulation of the mortgage market and might also have an interest in retaining the status quo as far as its organization, operations, and staffing levels. This proposal changes the regulatory scheme very little because it simply adds another requirement with which lenders must comply, and does not change the lender’s ability to comply with other regulations. However, it may expose HUD to political pressure to assess risk in a way that favors the mortgage industry, and may impose a considerable administrative burden on CRA examiners.

IV. WHAT THE PROPOSAL CAN ACHIEVE

The proposal can ideally lower the number of foreclosures. Consumers who rely on the risk assessment will be less likely to purchase loans with high-risk features. As a
result, lenders that rely primarily on selling high-risk mortgages to profit will eventually leave the market. Keeping in mind that this proposal does not account for changes in interest rates, house values, or servicer foreclosure practices, fewer risky loans sold will lead to fewer foreclosures.

Consumers face much uncertainty about their future ability to pay, future interest rates, and the value of their homes. If consumers use the risk assessments, they have a better chance of maintaining mortgage payments in the long-term.

V. POTENTIAL BARRIERS TO IMPLEMENTATION

There are two main potential barriers to the implementation of this proposal. First, consumers may simply ignore the risk assessments or may misunderstand them. Second, the risk assessment may not accurately capture relevant risk factors.

5.1. Consumers’ perception of the risk assessment

The risk assessments may fail to work because consumers simply will not notice them. Advertising and marketing materials can be cluttered, and it may be easy to miss the risk assessment icon.

To address this problem, the government can require that the icon be a certain size relative to the overall marketing material, such as the Surgeon General’s warning on cigarette packages. This will increase the chances that a consumer will notice the risk assessment. Also, the government can de-clutter the area in which the icon is presented by prescribing an amount of white space and a border around the icon. This will increase the likelihood that the consumer will actually read the icon, once the consumer notices it.

Also, the government can conduct its own advertising campaign by broadcasting public service messages in the print media, TV, radio, and internet. This will achieve two
goals. First, the government will put consumers on notice that any lender they approach should have an assessment. Second, it will familiarize the consumers on what the assessment is, and how the consumer can use it.

Another potential problem is that the consumer will not understand the assessment after reading it. Although consumers will probably be able to determine the meaning of the red, green, and yellow icons, they may not recognize or understand the loan features that contribute to the risk assessment. For example, a consumer may see a moderate risk assessment, but if a prepayment penalty is an unknown term, the consumer might choose to ignore it, rather than learn more about it.

5.2. Accuracy of the risk assessment

Even if the consumer fully comprehends and utilizes the information in the risk assessment, there is the possibility that the risk assessment is incorrect. The accuracy of the risk assessment depends on the accuracy and comprehensiveness of the LP Sub-prime Mortgage database, the dataset chosen (including types of loans and the timeframe), the frequency of the assessments, and the regression calculation. Any one of these factors can considerably change the outcome of the risk assessment.

Furthermore, the regression calculates the correlation of loan features with foreclosure, not causation. Although the government should make every effort to devise a robust regression model, finding the causal explanation for borrowers defaulting and losing their homes in foreclosure is outside the scope of this proposal.

VI. Problems the Proposal May Cause

There are three problems the proposal may cause: (1) Consumers may choose mortgage products with less economically efficient loan features, (2) chilling effect on
the competition among lenders, (3) consumers may misunderstand the risk assessment symbols.

6.1. Economic loss

One problematic result of the proposal is that it may cause some economic loss. As consumers rely heavily on the risk assessment to choose a mortgage product, they may neglect to consider other factors in choosing a mortgage. In some cases, this is a good result because some factors, such as future income or interest rates, can be volatile. When many variables are unpredictable, it is prudent to choose low-risk mortgages. But for those consumers who have some certainty about some factors, such as their future income or the future value of the house, a riskier mortgage can be the more economically efficient choice. For example, a consumer who does not have the income to qualify for a traditional fixed-rate mortgage, but is confident about his future income stream, might want to choose a no-doc mortgage, despite the risk involved.

This problem is mitigated by the fact that consumers who choose to rely on the risk assessment make a trade-off: they can reduce the amount of time and resources they spend on learning about and shopping for a mortgage and gain some peace of mind that they are avoiding high-risk loans and lenders; in exchange, they may receive a slightly less economically efficient mortgage.

Furthermore those consumers who choose to educate themselves about mortgages and conduct a search for the best mortgage will be unaffected by this proposal. They are free to ignore the risk assessment and choose mortgages with features that best fit their individual characteristics.
6.2. Chilling effect on competition

A second problem the proposal may cause is a chilling effect on the competition among lenders as lenders drop out of the market (because they cannot make a profit without selling high-risk loans) and fewer lenders enter the market (because the barrier of entry is higher when profit cannot be made by selling high risk loans). Less competition may result in less incentive for lenders to lower prices and improve customer service.

6.3. Consumers mistake risk assessment for a guarantee

The third problem the proposal may cause is consumer confusion about what the risk assessment means. Consumers may interpret the symbol as a guarantee, rather than an assessment. For example, a consumer might choose a loan based on a low-risk assessment, thinking the government has guaranteed that the loan is risk-free. As a result, consumers may fail to exercise common sense about their individual financial characteristics and loan shopping.

A related problem is that a consumer may not perceive a twenty percent likelihood of foreclosure as risky enough deter him from choosing that loan, or to even inspire him to ask questions about the risky loan feature. The risk assessment is an aggregate measure, and a consumer may fail to consider his personal financial characteristics that make the loan more risky for himself than for the general public. For example, for a consumer who has already decided to refinance in a few years, a prepayment penalty is an enormous liability and greatly increases the risk of foreclosure. However, if the consumer takes the twenty percent figure to mean that is all the risk he assumes, and does not inquire about what a prepayment penalty is, he is assuming much more risk than what the risk assessment provides for.
VII. CONCLUSION

In this paper, I have attempted to propose a risk assessment that will help consumers navigate the U.S. mortgage market. The proposal will affect all players in the mortgage market – consumers, lenders, investors in securities, and government regulators. Although the proposal works against some of the lenders’ interests, it maintains the status quo for others, and helps consumers to make informed choices. The proposal also gives investors in securities the benefit of increased confidence in mortgage-backed securities.

There are some barriers to implementation, such as the consumer’s awareness and use of the risk assessment, and the difficulty in accurately and comprehensively assessing risk. However, if successful, the risk assessments will reduce the number of high-risk mortgages sold, thereby lowering the number of foreclosures.