Guest Editors' Introduction

Borrower Beware: Challenges in Providing and Using Consumer Credit

Padmasini Raman
Federal Housing Finance Agency

Pamela Lee
U.S. Department of Housing and Urban Development

The views expressed in this introduction are those of the guest editors and do not necessarily reflect the official positions or policies of the Federal Housing Finance Agency, Federal Housing Administration, U.S. Department of Housing and Urban Development, or U.S. government.

The provision of consumer credit is a critically important part of the U.S. economy. Since 1987, consumer spending has accounted for more than two-thirds of gross domestic product (GDP) and, in recent history, has averaged roughly 70 percent of GDP. Consumer spending is a key driver of economic growth, fueling demand for goods and services, which, in turn, generates jobs. This growth in consumer spending has been facilitated by the development of the consumer financial services sector, enabling households to leverage their assets and smooth consumption over time. The use of consumer financial services, including various kinds of debt instruments, has become a backbone of the U.S. economy. Access to consumer credit (including mortgage debt) has emerged as a critical bridge that must be crossed to access the mainstream economy, which in turn requires that consumers possess adequate credit histories and demonstrate their ability to manage such credit. Historically, however, the path to the provision and use of consumer credit has been uneven and strewn with pitfalls. Credit costs and access vary, and information asymmetries abound, making the path perilous for all but the savviest borrowers.

The articles in this symposium of *Cityscape* examine some of the challenges in making credit available to consumers. The first article in this issue (Brevoort, Grimm, and Kambara, 2016) provides new insight into the characteristics of borrowers with limited or no credit history, and it examines the implications for recent efforts to reach some of these borrowers through alternative credit-scoring models that rely on rent or utility payment histories. The next two articles examine information asymmetries faced by borrowers who are able to access mainstream financial services and products. One article (Perry, Motley, and Adams, Jr., 2016) looks at the content of mortgage

advertising, and the other (Parrish, 2016) examines the performance of for-profit debt-settlement companies. The final article (Mayer and Temkin, 2016) examines a key policy emphasis in recent years: prepurchase counseling to improve financial literacy and prevent borrowers from becoming delinquent on their debt.

Access to Credit

The 7 years since the end of the Great Recession have been marked by a recovering economy, but many indicators suggest that, as the mortgage market has shifted toward borrowers with pristine credit scores, credit rationing has impeded a more robust recovery. Compared with more typical lending periods, median FICO™ scores for purchase loans have increased by nearly 50 points, to the 750s, and the composition of FICO scores has changed, with substantially reduced lending to mid- and lower-range FICO borrowers. Many postcrisis policies have focused on expanding access to lower-credit, responsible borrowers. These policies are important for creating economic opportunity for lower-income, credit-impaired borrowers, but they fail to address the needs of the millions of borrowers with thin or no credit history. To reach these Americans, policymakers have largely focused on alternative credit-scoring models, such as those that rely on rent, utility, or cell phone payment history, to inform a credit score that models borrowers' ability to assume and pay off debt.

As the first article in this symposium discusses, however, alternative credit-scoring models can address only part of the problem. Kenneth P. Brevoort, Philipp Grimm, and Michelle Kambara analyze the data records of three major nationwide credit reporting agencies. Such records form the basis by which mainstream credit providers assess creditworthiness while underwriting and pricing for risk. They have also evolved into a screen for areas unrelated to credit provision, including employment and access to rental housing. As a result, such credit records, or the lack thereof, can fundamentally affect a borrower's financial well-being and access to the mainstream economy. Brevoort, Grimm, and Kambara (2016) estimate that about 26 million adults (approximately 11 percent of the adult population) can be classified as being without credit records, or "credit invisibles"; these individuals are severely limited in their ability to access mainstream financial products. Alternate credit-scoring models do not help this segment at all. In addition, another 19.6 million adults (or 8.3 percent) have credit records that cannot be scored using traditional or conventional scoring models; these individuals are termed the "unscored." The authors explore the composition of both segments and find that they are skewed toward young, elderly, minority, and lower-income individuals.

Brevoort, Grimm, and Kambara find that current policy prescriptions, such as establishing alternative credit data sources or credit-scoring models, will help only some of the unscored population. For example, alternative credit models will help only the unscored population with utility accounts or rental agreements in their own name. Further, because credit-scoring models (conventional or alternate) rely on the observable performance of a sufficiently representative sample of consumers, they may not be able to produce unbiased estimates for all subsegments. Lenders react to the poorly performing models by imposing credit overlays or screens, thereby negating the impact of alternative credit models.

Deceptive Practices

The problematic extension of credit and deceptive lending practices were evident during (and some would say precipitated) the recent housing and financial crisis. In response to these practices, regulators reformed the financial system and enhanced consumer protections through regulations such as the Dodd-Frank Wall Street Reform and Consumer Protection Act.[1] Despite new mortgage disclosure forms and regulations, borrowers face significant barriers to collecting information, and those barriers may lead them to make less optimal financial decisions.

Mortgage Advertising

In their article, Vanessa G. Perry, Carol M. Motley, and Robert L. Adams, Jr., find that postcrisis regulations may not go far enough to enhance consumer decisionmaking in the mortgage market. The authors point out that the 2011 Mortgage Acts and Practices—Advertising Rule,[2] which prohibits false and misleading claims in mortgage advertisements, primarily applies to advertisements that convey verifiable facts (such as interest rates or loan fees and terms). By contrast, transformational advertisements that rely on subjective claims and emotional responses to drive consumer behavior are not subject to the same regulatory standard. In their content analysis of thousands of mortgage advertisements placed in television, radio, print, and online media, Perry, Motley, and Adams (2016) find that incidences of factual or verifiable information were relatively rare and that advertisements tend to rely on transformational messaging. Moreover, the type of transformational messaging differed depending on the target audience—ads targeted to general audiences relied on positive frames, which emphasized the product as a gateway to an opportunity, but ads targeted to African-American and Hispanic audiences more often relied on negative framing, emphasizing negative outcomes or situations to be avoided by using the advertised product.

The authors note that these findings underscore that mortgage advertisements cannot be relied on to convey useful data to inform a consumer's search for mortgage credit. Regulators have implemented rules to curb deceptive advertising but, to date, have not forced mortgage lenders to convey useful data and facts that ensure borrowers obtain the most appropriate product for their economic situation and needs. How can regulators support consumers' ability to critically evaluate mortgage offerings? The authors suggest that mortgage regulators look to the Food and Drug Administration's (FDA's) oversight of pharmaceutical drug advertisements. FDA regulations require pharmaceutical advertisements to use standard language and to include risk information whenever promoting product benefits. In addition, the FDA prohibits advertisers from relying on strictly transformational advertisements.

Debt Assistance

The ability to take on debt can fuel economic growth and contribute to economic mobility, quality of life, and wealth creation; however, it can also create problems for borrowers who fall behind on their payments. With about $700 million in total credit card debt outstanding nationwide, the

[1] Pub. L. 111–203 (July 21, 2010).

[2] 16 CFR Part 321. Federal Register 76 (141) July 22, 2011.

average household with a credit card balance owes about $15,800 (El Issa, 2015; Federal Reserve Bank of New York, 2015). Most borrowers will be able to resolve their outstanding payments, but some will need assistance in dealing with their debt loads. Through television and radio advertising, for-profit debt-settlement companies have marketed themselves as one reliable, affordable option for borrowers who need help resolving their debt issues.

In her article, Leslie Parrish examines whether consumers benefit from using for-profit debt-settlement companies. Analyzing a data set of 56,000 consumers who enrolled in debt-settlement programs, Parrish (2016) finds that, in contrast to claims made in debt-settlement company advertisements, most enrolled consumers did not experience a positive or improved financial position, despite improved consumer protections enacted by the Federal Trade Commission in 2010. Parrish specifically finds that few consumers remain enrolled long enough or settle enough debts to improve their financial position. Further, the author finds that the business model that debt-settlement companies use presents significant risks that are not made clear to consumers. On their enrollment in a debt-settlement program, consumers are instructed to stop making payments on their debts, cease contact with their creditors, and grant the debt-settlement company authority to negotiate on their behalf. Consumers face a significant risk that creditors will refuse to negotiate with the debt-settlement company and will instead pursue collection activity or a lawsuit against the borrower after payments cease.

Similar to findings by Perry, Motley, and Adams, Parrish finds that consumers cannot rely on debt-settlement companies to convey reliable information to consumers about the risks and realities of using their programs to resolve their debt problems. To help vulnerable consumers navigate the complex debt-settlement process and industry, Parrish urges regulators to provide more transparency regarding consumer outcomes through data-reporting requirements and to hold debt-settlement firms accountable for borrowers' outcomes through fee limits and relief for consumers who do not benefit from the debt-settlement companies' services.

Promising Practices

In response to the struggles of homeowners during the recent financial crisis, housing counseling has emerged as a helpful tool for making consumers aware of the pitfalls of the financial products they are opting for. In their article, Neil S. Mayer and Kenneth Temkin analyze 75,000 loans originated between 2007 and 2009 to evaluate the impact of prepurchase counseling and education on the performance of counseled borrowers' mortgages compared with the performance of the mortgages of borrowers who received no such services. Their analysis suggests that prepurchase counseling has a "substantial effect" on the performance of mortgages for home purchase: the counseled borrowers in their study were one-third less likely to become 90 or more days delinquent during the first 2 years of the mortgage than borrowers who were not counseled (Mayer and Temkin, 2016).

Conclusion

In the commentary by Sarah Gerecke, the author notes the need for "guardrails" to protect consumers from excessive or inappropriate debt (Gerecke, 2016). The articles in this symposium

provide insight into the kind of issues that would need to be addressed as these guardrails are being developed. Brevoort, Grimm, and Kambara focus on borrowers with limited credit histories and provide a call to policymakers for further research to enhance policymaking efforts to reach such borrowers. Perry, Motley, and Adams urge policymakers to strengthen mortgage advertising rules to support consumers' ability to critically evaluate mortgage offerings, and Parrish advocates for more transparency regarding consumer outcomes in the debt-settlement process. Finally, research by Mayer and Temkin suggests that policymakers should focus on funding evidence-based practices that improve borrowers' education and outcomes.

Guest Editors

Padmasini Raman is a senior policy analyst in the Division of Housing Mission and Goals at the Federal Housing Finance Agency.

Pamela Lee is a credit policy specialist in the Office of Housing at the U.S. Department of Housing and Urban Development.

References

Brevoort, Kenneth P., Philipp Grimm, and Michelle Kambara. 2016. "Credit Invisibles and the Unscored," *Cityscape* 18 (2): 9–33.

El Issa, Erin. 2015. "2015 American Household Credit Card Debt Study." Nerd Wallet. http://www.nerdwallet.com/blog/credit-card-data/average-credit-card-debt-household/.

Federal Reserve Bank of New York. 2015. "Quarterly Report on Household Credit and Debt: August 2015." Federal Reserve Bank of New York. https://www.newyorkfed.org/medialibrary/interactives/householdcredit/data/pdf/HHDC_2015Q2.pdf.

Gerecke, Sarah. 2016. "Commentary: How Housing Counseling, Financial Education, and Consumer Guardrails Can Support Responsible Borrowers," *Cityscape* 18 (2): 99–105.

Mayer, Neil S., and Kenneth Temkin. 2016. "Prepurchase Counseling Effects on Mortgage Performance: Empirical Analysis of NeighborWorks® America's Experience," *Cityscape* 18 (2): 73–98.

Parrish, Leslie. 2016. "A Roll of the Dice: Debt Settlement Still a Risky Strategy for Debt-Burdened Households," *Cityscape* 18 (2): 55–71.

Perry, Vanessa G., Carol M. Motley, and Robert L. Adams, Jr. 2016. "What's the Point(s)? Information Content and Messaging Strategies in Mortgage Loan Advertisements," *Cityscape* 18 (2): 35–54.