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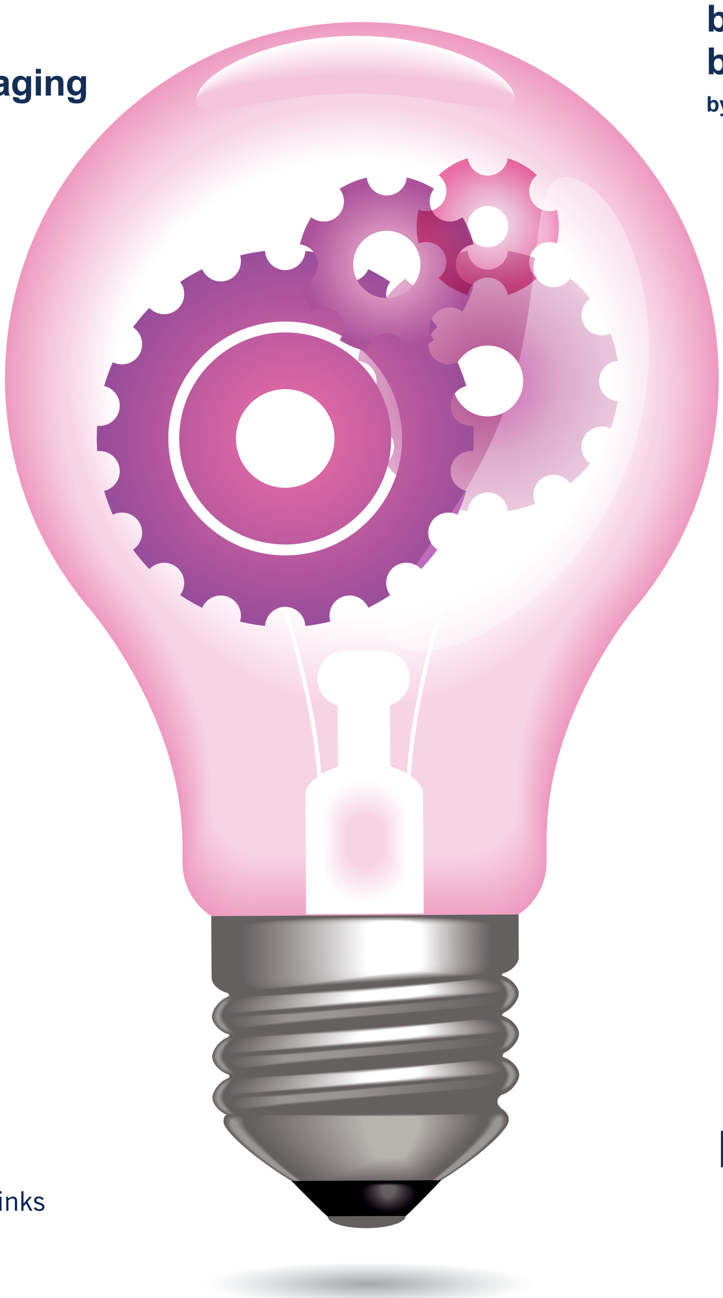

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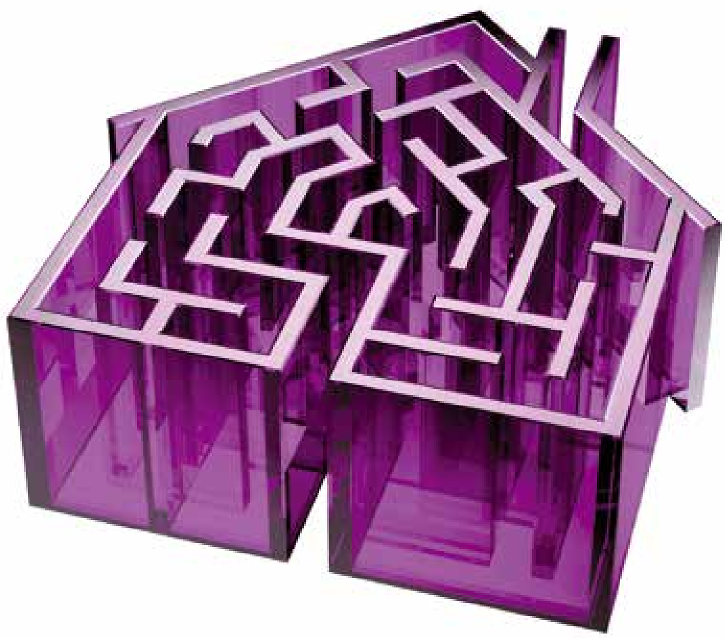
Why mortgage lenders need better-educated borrowers

by Ruben Cox

Might the time be right to introduce the financial equivalent of a driving licence? I think the answer could well be a resounding yes. A study of events in housing markets across the developed world over the past years has pushed me towards this view.



The outright collapse in pricing in a number of markets demonstrates how damaging it can be to allow almost unfettered access to long-term mortgage financing in large amounts when those borrowing the money have little or no understanding of the products in question.

In many cases, they are not only agreeing to buy products that are unsuitable for their circumstances, they are actively clamouring to buy products that are unsuitable for their circumstances. If it is illegal to drive unsupervised without a valid driving licence, which demonstrates a minimum level of competence, perhaps it should be illegal to borrow unsupervised without the financial equivalent.

Libertarians and free marketeers will almost certainly object to this proposition. Yes, it goes against the ethos of free will that underpins most Western thinking. But it could help prevent property car crashes, which on occasions since 2008 have more closely resembled motorway pile-ups. Would we issue a gun licence to a blind person? Certainly not. So why are people who find it impossible to envisage their financial future be allowed to burden themselves with debts that are simply unaffordable?

These thoughts, and others, arise from discussion of my thesis on the subject of the acquisition, financing and insurance of housing entitled *To Own, To Finance, and To Insure Residential Real Estate Revealed*. I suggest that they merit further and wider debate in the long-term best interests of a financial services industry that has been plagued by disaster after disaster over the past five years.

Educating borrowers

I wonder if it would be possible to launch an organisation that could enhance the financial IQ of millions of people internationally. Its prime objective would be the prevention of financial ills rather than their cure; increasing people's ability to understand personal finance matters could help transform lives.

Consider, for instance, the case of a young couple eager to acquire their first home, flying in the face of financial reality in their determination to secure a mortgage. Both are working. They have no children. They have a comfortable level of disposable income month to month. They have savings. In short, they tick every box on the creditworthiness spectrum. A bank would be foolish not to lend.

But this is today. What about tomorrow? Next month? Next year? When they have a baby? And they lose an entire income? And have another baby? And realise they need a larger house?

Their profile has changed, underlining the case for the argument in favour of making a long-term credit decision based not on current affordability, but on future, sustainable profitability. A bank that refused them credit on that basis might later find itself with a higher quality loan book that it would otherwise have had.

If it is illegal to borrow, then it will be illegal to lend. This neatly circumvents the reality uncovered in the writing of my original thesis. Who is to blame for the mortgage finance mess – is it profit-driven lenders mis-selling? Is it commission-based brokers and other intermediaries mis-advising? Is it borrowers mis-buying? The allocation of blame, or, perhaps a better word, responsibility, is far from easy.

A licence to lend

How might this concept be translated into reality? Let's return to the original driving licence analogy. Obtaining a driving licence involves the acquisition of driving knowledge through formal lessons from a wide range of private sector teachers, and practice on the road, and the passing of tests in motoring practice and theory at official government-sponsored centres.

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Existing financial advisers would be obvious candidates to create a national network of instructors. In those countries where they are already required to carry out a thorough review of a would-be borrower's financial situation before making a recommendation (which they must be able to justify should the regulators come calling), this would represent only a slight reshaping of their current role.

The focus would shift away from hand-holding and advising their clients and move towards teaching them. The new emphasis would be on equipping them with the tools needed to understand personal finance, and to pass a formal examination at a government-approved test centre.

The UK already has an established network of Citizens Advice Bureaux (CAB), which, especially in difficult financial times such as those experienced recently, sees a surge in demand for independent financial advice. It would be interesting to examine how simple it might be to adjust their operating model in order that they might help on a preventative basis rather than a curative basis.

This in turn would provide a template for other countries that lack such a service. The resulting structure would surely represent an improvement on the prevailing system, in which are embedded clear conflicts of interest on the sell-side, and often widespread ignorance on the buy-side.

Why mortgage lenders need better-educated borrowers (continued)

by Ruben Cox

In the Netherlands, we have the Institute for Budget Education (NIBUD), which educates and advises (primarily through public media) households on financial issues in general (mortgages, insurance policies, personal loans, etc.). However, this advice is tailored towards general issues rather than individual problems. Maybe this could provide a bridge towards the UK's case-based CAB, which is generally highly thought of by its troubled clients.

My original research uncovered remarkably little hard evidence of mis-selling. My dissertation contains four studies that cover aspects of homeownership in the Netherlands. It examines the effects of homeownership and the decision making process by households regarding mortgage type. Furthermore, the functioning of the mortgage origination process including the effect of brokers is studied. The last paper examines which factors characterize household demand for mortgage insurance.

Aligned interests

The central question in the third study (chapter four) is concerned with the question of whether there is evidence for a misalignment of interest between financial intermediaries and their clientele. Studies on the role of mortgage brokers in the US show that the objectives of mortgage brokers and their clientele are not necessarily aligned. This occurs when they are not responsible for, or compensated conditional on, loan performance. Moreover, commission-based pay can induce brokers to recommend and sell those products that are most profitable to themselves.

There is, however, a counteracting force because credit risk exposure creates an incentive for the originator to monitor the underwriting behaviour of intermediaries and screen applications. In the presence of reputation and credit risks, it is unlikely that they will employ different underwriting standards for credit that is originated through an intermediary compared to what they would originate directly (so-called direct-written).

Proposals to alter the compensation structure of intermediaries, for example, to hourly billing rather than based on commission from sales, are probably ineffective in reducing conflicting interests and come with their own incentive problems. In addition, the effectiveness of broker regulation to avoid a misalignment of broker and client interests has received mixed empirical evidence. The results indicate that the regulation of lenders is perhaps more important than either of these two approaches.

I will add that even after careful consideration of the issue, I remain uncertain as to whether I would advocate training for intrinsically unmotivated people versus mandatory advice for those people who do not have (but perhaps also do not want to have) the "financial driving licence". The former could be very ineffective.

One direction for future research might be to compare the UK's tailor-made CAB approach to the Dutch general approach NIBUD system to attempt to identify whether one is more effective than the other in altering consumer behaviour. In the meantime, perhaps households need to be reminded of that ancient warning - *caveat emptor* – rather than develop an ever-deepening dependence upon the protection of regulators and other official figures.■

This article is based on Ruben's PhD thesis *To Own, To Finance, and To Insure Residential Real Estate Revealed*. http://hdl.handle.net/1765/1

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