Should We Give Financial Advice to the Poor?

Yale economist and bubble seer Robert Shiller thinks a number of financial mistakes made by millions of Americans could be avoided if personal financial advice was subsidized for all. For example, recent research has shown that a number of homebuyers who obtained subprime mortgages didn't understand the basic terms of their contracts, such as believing they had acquired a fixed-rate mortgage when it was really an ARM. And given the existence of wealth management services for the well-off, it seems that financial advice does have some value. But what effect can it have for the lower- and middle-classes?

To find out, a group of economists examined the impact of a program in Chicago which mandated third-party reviews of mortgage contracts in 2006 and 2007. Under the program, mortgage applicants with low credit scores in 10 zip codes had to have loan offers reviewed by HUD-certified loan counselors.

The economists, Sumit Agarwal, Gene Amromin, and Douglas Evanoff of the Chicago Fed, Itzhak Ben-David of Ohio State University and Souphala Chomsisengphet of the Office of the Comptroller of the Currency, obtained a number of interesting results:

First, mandatory counseling reduced new loan applications by 60 percent, the number of active lenders by 40 percent, and mortgage originations by 20 percent.

Second, default rates in the 12 months after the legislation went into effect dropped by 4 percent among counseled borrowers. That amounted to a 35 percent improvement compared with the average default rate in similar zip codes that were not covered by the mandate.

But perhaps most interestingly, the improvements didn't come about because consumers were making better decisions based on improved access to information, but largely because lenders stepped up their screening of borrowers in order to "protect themselves from possible legal and regulatory action," write the economists. (Everything was recorded in a state-maintained database after all.)

As for home-buying decisions, the researchers found that while some purchasers were more likely to renegotiate loan terms, there was little effect on the likelihood that homeowners would take out an adjustable rate loan.

Overall, the results don't so much suggest that financial advice is a panacea, but that oversight – i.e. regulation -- plays a more important role in protecting consumers from making bad decisions.

-- *Zubin Jelveh*