Session: What Should and Can Be Done to Enhance Borrowers’ Knowledge of Their Credit Risk?

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Comments on Targeting Foreclosure Interventions

- Paper investigates *leading* indicators of neighborhood foreclosure sales.
  - Important topic as elevated rates of foreclosure can have adverse effects on individuals and neighborhood circumstances
  - Focuses on credit-related and socio-demographic indicators of foreclosure at the census tract level

- Analysis finds foreclosures rates are elevated in census tracts with larger rates of:
  - Individuals with low credit history scores; younger individuals and minority homeownership
Foreclosure Rates are Rising

• Concerns about foreclosure have increased as:
  – Credit quality of borrower pool has widened over time
  – More mortgages imbed the potential for payment shock
  – Short-term interest rates have increased
  – Many borrowers have previously extracted home equity reducing ability to refinance
  – Home price changes have flattened or fallen
  – Credit standards are tightening
Theoretical Foundation of Default and Foreclosure

• Analysis could be bolstered by establishing a theoretical framework for foreclosure:
  – *Trigger-events theory*: events that disrupt ability or willingness to pay: job loss, medical incident, death or divorce
  – *Options theory*: default is a put option on the property where the borrower chooses to default when the mortgage balance exceeds the value of the home
  – This theoretical framework provides a guidepost for factors to consider in an empirical assessment
What Option Theory Might Suggest

• Option theory focuses on collateral values and ruthless exercise of “put option”
  – Change in neighborhood home values:
    • Areas with low or negative rates of home price appreciation
    • Areas with elevated rates of nonowner-occupied housing (ruthless financial decision-makers)
    • High share of FHA loans (little initial equity)
What Trigger-Event Theory Might Suggest

- Trigger-event theory suggests focus on factors that disrupt income or create unexpected expenses

- Additional metrics by census tract:
  - Focus on credit scores of mortgage borrowers
  - Supplement distribution of scores with the proportion of unscorable population
  - Credit score migration
  - Shares of higher-priced loans
  - Ratio of loan amount to income
  - Census tract unemployment and vacancy rates
Additional Foreclosure Predictors

• Additional factors; how they relate to neighborhood foreclosure rate:
  – Change in median home values 1990-2000—Negative
  – Percent of mortgage borrowers with low credit scores—Positive
  – Percent of unscorable individuals—Positive
  – Percent of loans to nonowner-occupants—Positive
  – High-priced share—Positive
  – Census tract unemployment rate—Positive
  – Census tract vacancy rate—Not significant
  – FHA share—Not significant
  – Loan amount-to-income ratio—Not significant
Comments on “Consumer Credit Literacy: What Price Perception?”

- Paper investigates consumers’ self-assessment of their credit and the potential effects of inaccurate assessment on financial outcomes.

- Analysis compares self-assessment of credit quality with an *objective* measure of credit worthiness (FICO score).

- Analysis finds many consumers have inaccurate self-assessments, particularly those with low credit scores.
Factors Effecting Self-Assessment

- Level and expected income, wealth, debts, job stability and prospects, health, etc.
- Financial literacy and education; experience in obtaining credit; unsolicited credit applications
- Perception of reasons why problems arose (isolated event, type of missed payment—(credit or bills)
- Failure to recognize the importance of an adverse event or weight it properly
- An individual’s credit scores differ across the three CRAs
- Credit score migration over time
- Credit score/loan performance relationship
## Credit Score Migration
(June 2003–December 2004)

<table>
<thead>
<tr>
<th>Credit Score</th>
<th>Change in Credit Score Points</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Decreased 25 or more</td>
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<tr>
<td>Low</td>
<td>18</td>
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<tr>
<td>Middle</td>
<td>33</td>
</tr>
<tr>
<td>High</td>
<td>27</td>
</tr>
</tbody>
</table>
Performance on New or Existing Credit Accounts

[Graph showing the relationship between Delinquency Rate (Percent) and Credit Score Range. The graph indicates a decreasing trend in delinquency rate with increasing credit score range, with a specific nod to Group X and a comparison to all others.]