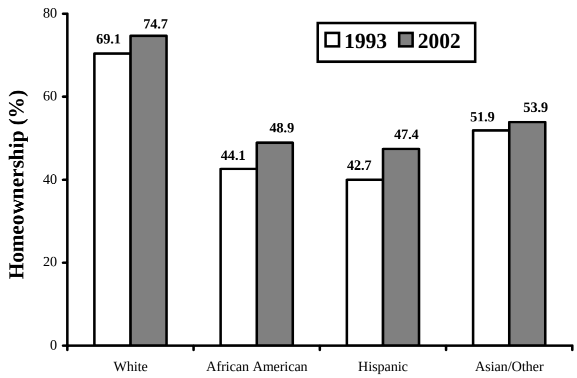
ISSUE BRIEF

HOMEOWNERSHIP EDUCATION AND COUNSELING (HEC)

Introduction

Expanding homeownership opportunities has been a major public policy goal of the nation for the past decade. The U.S. homeownership rate increased dramatically in the last decade, reaching a new high of 67.9 percent in 2002.[1] Homeownership rates for both white and minority households also increased during this same time period, although minority homeownership rates remain significantly lower than those for whites (Figure 1).

Figure 1
Increase in Homeownership by Ethnicity
1993 and 2002



Source: U.S. Census Bureau.
AARP Public Policy Institute

This issue brief discusses the background and history of homeownership education and counseling (HEC), examines mortgage counseling issues, and offers policy options.

Affordable Lending Policy Initiatives

Affordable lending policy initiatives have contributed to the growth in homeownership rates for traditionally underserved households, including minority and low-income households.

The Community Reinvestment Act (CRA), first passed in 1977, is a major component of national affordable lending policy. CRA requires eligible financial institutions to help meet the credit needs of the communities in which they are chartered, with an emphasis on the needs of traditionally underserved neighborhoods.[2]

In addition, in 1992, the U.S. Department of Housing and Urban Development (HUD) established lending mandates that required Freddie Mac and Fannie Mae, government-sponsored entities (GSEs) that serve as secondary market institutions,[3] to target a large proportion of their mortgage activities to traditionally underserved markets. This mandate has had a significant effect on the growth in affordable lending to minority and low-income households.[4]

Finally, the Federal Housing Administration (FHA) insures privately issued loans with low down payments for eligible homebuyers, with a focus on first-time and low- and moderate-income homebuyers. In addition, numerous statewide and local policy initiatives target underserved households through outreach and subsidy programs.[5]

Background and History of Homeownership Education and Counseling

<u>Background</u>

Generally, HEC has been conducted as part of affordable lending initiatives to extend homeownership opportunities. As a consequence, counseling programs often focus

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[1] Joint Center for Housing Studies of Harvard University. (2003). *The State of the Nation's Housing 2003*. Harvard University.

[2] 12 U.S. Code 2901. Implemented by Regulation BB (12 CFR 228). Pub. L. 102-550, title IX, Sec. 910 states "low-income, minority, and distressed neighborhoods."

[3] *Inside Mortgage Finance.* (January 31, 2003:4). For calendar year 2002, the two GSEs securitized (GSEs are currently prohibited from originating loans) 59.3 percent of mortgage originations.

[4] McCarthy, G., and Quercia, R. (May 2000). Bridging the Gap between Supply and Demand: The Evolution of the Homeownership, Education, and Counseling Industry. Research Institute for Housing America. Institute Report No. 00-01.

[5] Mallach, A. (2002). Homeownership Education and Counseling: Issues in Research and Definition. Federal Reserve Bank of Philadelphia.

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on first-time homebuyers, with special focus on traditionally underserved households.[6] There has been less emphasis on counseling for other borrowers, such as refinancers.[7] HEC has received wide support, based on several perceived values:

- borrowers receiving counseling are better able to handle the responsibilities of achieving and maintaining homeownership;
- families and neighborhoods are stabilized;
- delinquency rates and default risks to lenders are reduced;
- consumer outreach in traditionally underserved communities builds trust in the mortgage lending process and helps lenders and secondary market participants to meet their obligations to serve these communities; and
- lenders gain access to mortgage-ready borrowers.

History

While HEC, in a variety of forms, preceded passage of the 1968 Housing and Urban Development (HUD) Act, authorization of a housing counseling program under the Act is generally cited as the beginning of HEC's history in the U.S.[8] HUD's program, like many HEC programs during the 1970s and 1980s,[9] focused on default counseling[10] (that is, post purchase) and was provided after the homeowner was delinquent on mortgage payments.

Amendments to CRA in 1989[11] increased the number of HEC programs. These amendments included new requirements for lenders, including a "community services" test. Many lenders started meeting the community services test by providing financial support to community-based organizations (CBOs).[12] CBOs used these funds to screen mortgage applicants, primarily from underserved communities, provide prepurchase HEC, and, in turn, provide the mortgage lenders with "mortgage-ready" applicants.[13]

A third major policy initiative occurred in 1992. Freddie Mac and Fannie Mae established special loan programs for underserved communities and required mortgage prepurchase counseling as a condition of participation in these programs.[14]

Description of Mortgage Counseling Programs

Today, many counseling programs are offered in a wide variety of forms. Most HEC providers have developed unique curricula and educational materials; most HEC programs differ according to the topics covered, the breadth and depth of instruction, and the specific goals of the HEC providers.

In general, HEC falls into two broad categories, prepurchase and postpurchase HEC programs. While early in its history HEC focused on postpurchase counseling, today the majority of HEC programs are prepurchase programs.[15]

The goal of prepurchase HEC is to enable homebuyers to make more informed decisions about whether they should become homeowners and under what circumstances. Prepurchase HEC programs explain the homebuying and financing process; encourage financial planning, debt reduction, and money management; and

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[6] McCarthy and Quercia, 2000. op. cit.

[7] One exception is HUD's Home Equity Conversion Mortgage Program (HECM), a required counseling program for older persons considering a reverse mortgage.

[8] Section 106(a)(2) of the Housing and Urban Development Act of 1968 (12 USC 1701x) authorized HUD to provide HEC to qualified homeowners.

[9] McCarthy and Quercia, 2000 , op. cit.

[10] This was primarily in response to a high incidence of defaults and foreclosures among HUD section 235 participants. Under HUD's Section 235 Program, qualified homeowners have their monthly mortgage payments reduced by HUD, which makes a monthly interest reduction payment, based on the homeowner's income, to the lender, that lowers the homeowner's effective interest rate and, thus, monthly payment. Many of the home mortgages covered by this program were taken out during the high-interest periods of the late 1970s.

[11] 12 U.S. Code 2901. Implemented by Regulation BB (12 CFR 228). The regulation was revised in 1989 and 1995.

[12] Community Reinvestment Corporation's (NRC's) NeighborWorks and Association of Community Organizations for Reform Now (ACORN) are two examples.

[13] McCarthy and Quercia, 2000 , op. cit.

[14] Ibid.

[15] Ibid.

review home maintenance and repair issues. Prepurchase HEC encompasses a wide range of programs—from a 20-minute telephone conversation to classroom and individual sessions over several months.[16]

Postpurchase HEC can be either follow-up to prepurchase counseling, including care of the home and budgeting, or default and foreclosure prevention, generally triggered by missed mortgage payments by the homeowner.

Postpurchase follow-up HEC shares much of the focus of prepurchase counseling, although it often emphasizes borrower budgeting and maintenance and repair issues. Postpurchase default and foreclosure prevention is generally crisis-driven, focusing on how to return to timely mortgage payments and avert more severe delinquencies and foreclosure, or where this is not possible, to mitigate the adverse consequences of foreclosure. Default and foreclosure counseling may be limited to an individual session or extended to include intervention with the lender and even financial assistance.[17]

Sometimes distinctions are made between counseling and education. Counseling is generally considered to be more specific and tailored to the particular needs of the individual, while education typically is considered to be a packaged set of materials appropriate for a group setting.

There are three categories of delivery of HEC: (1) group settings (that is, classroom or seminar), that provide general information; (2) individual face-to-face sessions that address individual needs; and (3) over-the-telephone counseling, which may involve a self-study guide that the applicant reviews and a quiz to ensure that the individual has mastered the study guide.

Recently, over-the-telephone HEC has increased dramatically, primarily because it is less expensive than individual or group sessions, and still meets the counseling requirements of Fannie Mae and Freddie Mac.[18]

All of the largest mortgage lenders who provide HEC use over-the-telephone counseling, with most claiming to counsel more than 250 households per month.[19] In contrast, CBOs rarely use over-the-telephone counseling, viewing it as the least effective counseling method.[20] Even some representatives of lenders using over-the-telephone counseling question its efficacy.[21]

HEC in rural areas is less likely to be conducted in a classroom, due to sparse population and geographical constraints. One study found that as a result of less frequent use of the classroom, borrowers and HEC counselors often develop a close relationship that "may enhance the effect of prepurchase counseling."[22] The same study found that lower incomes, reliance on fewer employers, less education, less access to mortgage credit, and needs of special populations (for example, Native American reservations) may also reduce the effectiveness of HEC in rural areas.[23]

Mortgage Counseling Issues

Effectiveness

Research findings of the effectiveness of HEC programs are "highly ambiguous" and have "serious limitations… [which] severely compromise the value of such findings."[24]

Measurement of the value of mortgage

[16] Mallach, 2002, op. cit.

[17] Ibid.

[18] As stated previously, in 2002 Freddie Mac and Fannie Mae purchased 59.3 percent of loans from loan originators, making it essential for many lenders to meet the loan requirements of these two government-sponsored entities (GSEs).

[19] Moore, C. (September 1997). *Heeding Another Voice*. Mortgage Banking: 57:12.

[20] Ibid.

[21] Hirad, A., and Zorn, P. (2001). A Little Knowledge Is a Good Thing: Empirical Evidence of the Effectiveness of Pre-Purchasing Homeownership Counseling. Federal Home Loan Mortgage Corporation.

[22] Housing Assistance Council. (1997). *Housing Counseling in Rural America*. Washington, DC. Retrieved from the World Wide Web: http://www.ruralhome.org/pubs/counseling/housing counseling.htm.

[23] Ibid.

[24] Mallach, 2002, op. cit.

counseling has proven to be difficult for a number of reasons, including: (1) inadequate data, (2) frequent selling (i.e., reassigning) of loans, (3) insufficient sample sizes, and (4) counseling agencies' inability to track counselees after they complete counseling.[25] In addition, many studies have been conducted on behalf of the HEC provider or funder, with vested interests in research results that support HEC programs. In spite of these issues, findings from recent studies have attempted to measure such outcomes of HEC as decreased default and delinquency rates,[26] increased ability of both borrowers and lenders to assess ability to repay,[27] and increased overall credit health.[28] In addition, recent research indicates a number of factors that affect the effectiveness of counseling, including timing, method of delivery, and type of provider.

Timing. The Housing Assistance Council's (HAC's) extensive review of studies of HEC programs concluded that "pre-purchase counseling is somewhat effective in increasing the likelihood of homeownership, while the evidence is that post-purchase counseling reduces default risk is mixed."[29] Quercia and Wachter, reviewing the HAC study, report that "differences in program, participant, and market characteristics limit the generalizability of the studies."[30]

HAC also found that timing was important—the earlier the mortgagor receives counseling after delinquency, the more likely it is that the delinquency is resolved.[31] In addition, the HAC study found that having the counselor nearby the borrower was important.

Method of Delivery. A recent study by Hirad and Zorn found that borrowers "receiving counseling through individual programs experience a 34 percent reduction in delinquency rates, all things [being] equal, while borrowers receiving classroom and home study counseling obtain 26 percent and 21 percent reductions, respectively. The study found no evidence that over-the-telephone counseling mitigates credit risk."[32]

Based on a 1996 survey of 983 CBOs providing mortgage counseling, the Mortgage Guaranty Insurance Corporation (MGIC) found that 70 percent of respondents felt that one-on-one counseling was the most effective HEC, and 67 percent of respondents reported that self-education was not effective. Respondents reported that timing was more important than method of delivery.[33]

Type of Provider. Recent research indicates that CBOs functioning as counselor/developers tend to be more rigorous than lenders in their screening and qualifying processes. CBOs are also more likely than lenders to offer postpurchase support counseling.[34]

Cost of HEC

Funding of HEC is an ongoing issue for HEC providers. Lenders, government, and nonprofit lenders pay most of the cost of prepurchase education programs. Government and nonlender private contributors, such as businesses and foundations, pay for the cost of credit and budget counseling. According to one study, borrowers pay about 7 percent of the cost of prepurchase education and 9 percent of the cost of budget and credit counseling.[35]

Results from the 1996 MGIC study cited an earlier estimate that it cost $650 to educate

[25] Ibid.

[26] Hirad and Zorn, 2001, op. cit.

[27] Hartarska, V., et al. (February 2002). *Credit Counseling and the Incidence of Housing Loans by Low-Income Households*. Rural Finance Program, The Ohio State University.

[28] Staten, M., et al. (2002). *The Impact of Credit Counseling on Subsequent Borrower Credit Usage and Payment Behavior*. Monograph #36. Credit Research Center, Georgetown University.

[29] Housing Assistance Council. (1997). *Housing Counseling in Rural America*. Washington, DC. Retrieved from the World Wide Web: http://www.ruralhome.org/pubs/counseling/housing counseling.htm.

[30] Quercia, R. and Wachter, S. (1996). Homeownership Counseling Performance: How Can It Be Measured? Housing Policy Debate 7 (1).

[31] *Housing Counseling in Rural America* (January 1997). Housing Assistance Council.

[32] Hirad and Zorn, 2001, op. cit.

[33] Moore, 1997, op. cit.

[34] Mallach, 2002, op. cit.

[35] Moore, 1997, op. cit.

and counsel each prospective homebuyer served. On average, prepurchase education required less time (approximately 11 hours) than postpurchase budget counseling (approximately 13 weeks).[36]

A review of the Mortgage Foreclosure Prevention (MFP)[37] program found the cost of counseling and financial assistance to homeowners to be considerably less than the losses experienced by mortgage insurers. The MFP program expended an average of $2,800 per loan to help a mortgagor reinstate a mortgage, compared to average foreclosure losses to mortgage insurers that ranged from $10,000 to $28,000 per loan.[38] The study found that the mortgages reinstated by the MFP program saved mortgage insurers an estimated $7.6 million in foreclosure losses, while they expended only $25 million in program costs.[39]

Reverse Mortgages: An Example of Required HEC

HUD's Home Equity Conversion Mortgage (HECM)[40] requires that borrowers receive counseling before they apply for a HECM. This requirement is meant to ensure that older homeowners understand the implications of reverse mortgages, have considered other financial alternatives, and, as a result, are able to make well-informed financial decisions.[41]

HEC must be provided by a HUD-approved housing counseling agency, which issues a certificate to the borrower upon completion of counseling. Over-the-telephone HEC is allowed only when face-to-face counseling is not feasible.[42] HUD provides most of the funding for HECM HEC.[43]

Results from the limited research regarding the effectiveness of the HECM mandatory counseling program, although somewhat mixed, generally have been positive. A recent report recommends expanding mandatory counseling such as that offered under the HECM program "into the areas of home equity, non-purchase money lending for borrowers over age 60."[44]

State HEC Legislation. In an attempt to protect consumers from predatory mortgage lending, a few states have attempted to encourage HEC through legislation. For example, New Mexico[45] and North Carolina require counseling for high-cost loans,[46] and New York requires that lenders provide a list of qualified counselors to borrowers applying for high-cost loans.[47]

HEC requirements for all mortgage loans defined as high-cost have raised questions about the availability, qualifications, and

[36] Ibid. The costs ranged from $100 to $3,200. The organization with the highest cost provided 35 weeks of counseling and training.

[37] The Family Housing Fund is a nonprofit organization whose mission is to preserve and expand quality affordable housing for families with low and moderate incomes. In its first six years of operation, the MFP program served almost 1,700 homeowners, helping more than half of these homeowners reinstate their mortgages. Homeowners receive budget or credit counseling, advocacy or negotiation with lenders, and mortgage counseling.

[38] Family Housing Fund (December 1998). *Mortgage Foreclosure Prevention: Programs and Trends*. Minneapolis, MN.

[39] The study analyzed the first six years of the program (1991-1997).

[40] HECMs are a type of reverse mortgage in which FHA insures loans to persons over age 62 who own their homes and wish to obtain access to their home equity. There are three types of loans: (1) line of credit, (2) term loans, and (3) tenure loans. A line of credit gives the borrower access to loan proceeds at any time. A term loan pays a fixed payment for a fixed period of time. A tenure loan, by combining a term HECM with an annuity purchased with a lump sum, pays a fixed payment for as long as the borrower lives.

[41] U.S Department of Housing and Urban Development Office of Policy Development and Research. (May 2000). *No Place Like Home. A Report to Congress on FHA's HECM Program.*

[42] HUD has been working with AARP and others to provide toll-free phone counseling by master counselors on a pilot basis. This pilot program is available to underserved areas, such as rural areas where potential borrowers are a long distance from the nearest counseling agency. There is no certification exam for counselors, although HUD is leading an effort to develop an examination that would lead to certification.

[43] U.S Department of Housing and Urban Development Office of Policy Development and Research, 2000, op. cit. In the FY1999 appropriations bill, Congress allowed the HUD secretary to set aside up to $1 million from the funding appropriated for housing counseling generally during FY2000 to 2003 to be devoted to housing counseling and consumer education and outreach for the HECM program.

[44] Harkness, D. (Fall 2000). "Predatory Lending Prevention Project: Prescribing a Cure for the Home Equity Loss Ailing the Elderly." *Boston University Public Interest Law Journal*.

[45] 2003 New Mexico Home Loan Protection Act (§58-21A-1-14).

[46] North Carolina (1999 North Carolina Chapter 332) requires counseling for first mortgages with an interest rate 8 percent above the Treasury borrowing rate and for second mortgages with an interest rate 10 percent above the Treasury borrowing rate. Counseling is also required for loans of $20,000 or more in which the points and fees exceed 5 percent of the mortgage amount.

[47] 2002 N.Y. Law 626.

objectivity of counselors. In addition, there has been debate over who ultimately bears the cost of the counseling requirement, and whether there is conclusive evidence of sufficient benefits to support the cost and inconvenience of a counseling requirement.

Future Directions and Policy Options

HEC has become an integral part of the nation's effort to expand homeownership, especially for traditionally underserved households. Affordable lending policy initiatives often include HEC provisions, because mortgage lenders, HEC providers, and policy makers see HEC as an essential component of financial literacy that contributes to continued progress in increasing homeownership.

While far from conclusive, research suggests that timing, method of delivery, and type of provider are important factors in determining the effectiveness of HEC. More research is needed to enable earlier and more accurate identification of borrowers who would benefit from HEC, particularly with regard to preventing delinquencies and foreclosures. In addition, further research should be conducted to determine if over-the-telephone counseling can be a more effective method to deliver HEC programs.

Consideration should be given to expanding access to HEC for older persons, persons engaged in refinancing, and other "non-first purchasers." It has been assumed that after homeowners have gone through the mortgage process, they become more educated and less vulnerable. However, increasing evidence of predatory lending among refinance loans suggests otherwise. Equity-rich older homeowners are often targeted by predatory lenders who strip this equity through deceptive terms and inappropriate multiple refinancings (i.e., "flipping").[48] Additional research should explore how HEC might assist in decreasing such predatory lending practices.

The ever-increasing choices in mortgage products offered by mortgage lenders and brokers bring dangers as well as opportunities for borrowers. Borrowers are inundated with TV, Internet, and mail advertisements offering "no closing costs," "lower monthly payments," and numerous other loan terms, but may not be aware of "the fine print," which includes more onerous terms, such as balloon payments and exorbitant prepayment penalties. In fact, according to AARP's Public Policy Institute, 40 percent of older borrowers with broker-originated loans and 31 percent with lender-originated loans reported that they responded to guaranteed loan advertisements at least "a little."[49] Sorting through this barrage of loan choices requires considerable sophistication about mortgage products and the mortgage process.

Harvard University's Joint Center for Housing observes that regulatory oversight has not kept pace with dramatic changes in the mortgage lending industry, and that "closing the homeownership gap requires efforts that not only expand financing options for minorities, but also… ensure that recent minority first-time buyers are able to remain homeowners."[50] In addition, home equity remains the primary source of wealth in old age and continues to be a major component of older persons' financial wealth, security, and independence.

Expanded and improved mortgage counseling services alone should not be expected to attain and maintain higher homeownership rates. Rather, HEC should be viewed as one component of a viable affordable homeownership policy that comprehensively addresses homeownership opportunities.

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[48] U.S. Department of Housing and Urban Development and U.S. Department of Treasury (June 2000). *Curbing Predatory Home Mortgage Lending: A Joint Report.*

[49] Kim-Sung, K., and Hermanson, S. (2003). Experiences of Older Refinance Mortgage Loan Borrowers: Broker- and Lender-Originated Loans. AARP Public Policy Institute. DD83.

[50] Joint Center for Housing Studies of Harvard University. (2002). *The State of the Nation's Housing 2002.* Harvard University.