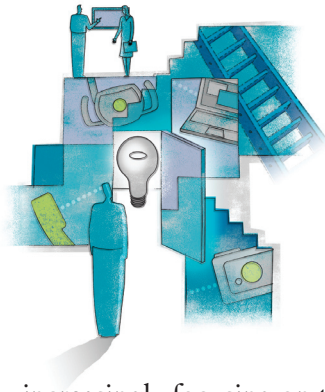


An Opt-Out Home Mortgage System



THE CURRENT HOUSING CRISIS has roiled financial markets and caused tremendous hardship for families. Millions have lost their homes, are experiencing financial strain to stay in their homes, or are finding it harder to purchase new homes. Driven initially by serious problems in the subprime and alternative lending markets, the housing crisis is now spreading to the prime market as well. As regulators and policymakers struggle to contain the immediate fallout, they also are increasingly focusing on the longer-term question of how to prevent such turmoil from recurring. Regulatory responses to date, including restrictions on financial products and increased disclosure of information, can improve the mortgage market but have important limitations and drawbacks.

In a new discussion paper for The Hamilton Project, Michael S. Barr of the University of Michigan, Sendhil Mullainathan of Harvard University, and Eldar Shafir of Princeton University propose a different approach to improving mortgage markets based on insights from the burgeoning field of behavioral economics. This new approach applies the findings of psychology to people's behavior in the marketplace. Whereas traditional neoclassical economics assumes perfectly rational decision-makers who weigh costs and benefits to maximize their individual welfare, evidence suggests that individuals often behave against their own self-interest in predictable ways. Applying these insights to the mortgage market, the authors propose a new "opt-out" mortgage system. Under their proposal, borrowers would be offered a standard mortgage (or small set of standard mortgages) with sound underwriting and straightforward terms. They would receive one of the standard options unless they affirmatively opted out in favor of another package. The authors expect mortgage lenders to try to entice borrowers to choose mortgages outside this set, and propose that opting out would require heightened disclosure to borrowers and additional legal exposure for lenders. They argue that establishing standard mortgages in this way would mean that borrowers would be more likely to receive appropriate loans without blocking beneficial financial innovation.

In the mortgage market, people are easily overwhelmed by too many options, too much information, or products that are too complex.

THE CHALLENGE

The current housing crisis has revealed a number of deficiencies in our system of mortgage regulation. Many market-oriented aspects of the system that were expected to promote sound practices—reputational risk for mortgage issuers, lender oversight of issuers, investor oversight of lenders, and rating agency oversight of financial products, among others—simply did not work. Conflicts of interest, inadequate capital rules, lax regulation of key players, and a “boom time” mentality covered up the abuses. But not anymore. The bursting of the housing bubble harmed capital markets around the world and is causing hardship for millions of families, drawing attention to these regulatory weaknesses.

In response, both market participants and government regulators have adjusted their policies. Financial institutions have reexamined their lending practices. The Federal Reserve, Congress, and the administration have vigorously pursued expansionary monetary and fiscal policy and have taken unprecedented steps to shore up financial institutions. The Treasury Department and the new Federal Housing Finance Agency orchestrated a government takeover of the troubled housing finance intermediaries Fan-

nie Mae and Freddie Mac, with an eye to stabilizing both the financial system and the supply of mortgage credit. Banking supervisory policies, mortgage disclosure rules, and restrictions on mortgage product offerings have all been revamped. Congress has passed legislation to help provide other options for the refinancing of defaulting mortgages and to help communities with the fallout.

The mortgage reforms, however, fall within one of the two current models of mortgage regulation: disclosure and product restrictions. The theory underlying consumer disclosure regimes is that more information helps consumers make better decisions, which in turn leads to more competition and more-efficient markets. The Truth in Lending Act (TILA) exemplifies this approach, requiring lenders to disclose all information necessary to make a decision on a mortgage or any other loan, and to do so in a way that facilitates comparisons among different options.

The problem with disclosure as a consumer-protection tool, however, is that it assumes consumers will make rational decisions provided that information is fully disclosed. Nevertheless, empirical research on behavior, grounded in advances in psychology, suggests that individuals consistently make choices that diminish their own well-being. In the mortgage market, people are easily overwhelmed by too many options, too much information, or excessively complex products.

The information provided under the Truth in Lending Act or other regulations does not solve this problem. Even with this information, how many consumers have the financial literacy to understand all the risks of alternative mortgages? How many homebuyers—particularly first-time buyers—could compare the costs of balloon payments with the prepayment penalties they would make in order to avoid the balloon payments? Borrowers tend to focus on the

most salient dimension such as monthly cost rather than on the long-term cost of credit. Consequently, firms introduce options that cater to these behaviors, leading people to choose options that carry a greater likelihood of failure than anticipated.

The second model of mortgage regulation involves product restrictions. Such regulations and standards start from the idea that certain prices or products are so inherently harmful that they should not be offered to consumers. For example, the Home Ownership Equity Protection Act (HOEPA) mixes disclosure requirements and product restrictions on certain contract provisions. While such regulations may be beneficial in some cases, they also may diminish access to credit or reduce innovation of financial products. Such regulations also may be poorly designed or may go too far. Moreover, firms will likely develop ways around such product restrictions, and regulation may not be able to keep pace with the rapid changes in the market.

For all these reasons, the authors argue, while disclosure and regulations are necessary, they are far from sufficient to protect consumers from poor decisions and potentially harmful practices in the mortgage market.

A NEW APPROACH

Barr, Mullainathan, and Shafir propose a different approach to improving mortgage markets that is grounded in the emerging literature on behaviorally informed policymaking. This literature produces novel considerations in the design and implementation of regulation, including framing information in specific ways, setting defaults or opt-out rules, providing warnings, and other strategies that alter individual behavior.

The lesson for policymakers is to recognize that individuals are not perfectly rational, as economists

Evidence on consumer bias towards the default option can help design a mortgage system that draws consumers to financially sound mortgage options.

assume. They do not have an unlimited capacity to acquire and process information and they do not always make the same, calculated choices regardless of their environment.

A range of evidence shows that an increase in the quantity and complexity of choices can push consumers away from making the decisions that would benefit them the most. The default or status quo option is chosen most often not because it is the most preferred option, but because consumers prefer to avoid making an affirmative decision in favor of one of the other options. For example, in some European nations drivers killed in car crashes automatically become organ donors unless they have arranged in advance not to be. In other European countries, this system is reversed; only drivers who sign up in advance become organ donors. Almost 98 percent of drivers in the first category of nations are donors; in the second category, only 15 percent are. Only 2 percent of drivers in the first set of countries and 15 percent in the second went to the trouble of choosing other than the default option.

As the authors note, the most prominent example of behavioral economics in the policy world has been the effort to increase saving rates by changing the defaults in 401(k) participation, so that employees

Key Highlights

The Challenge

The subprime mortgage crisis has roiled financial markets and caused hardship for millions of families. Current regulatory responses have important limitations and drawbacks.

- Increased disclosure focuses on providing access to information, yet evidence shows that individuals consistently make choices that work against their own interests when faced with too much information or complexity.
- Regulations and standards may be beneficial for inherently harmful products and prices, but also can diminish financial innovation and access to credit.

An Opt-Out Mortgage System

The authors propose an opt-out mortgage system that uses insights into how individuals respond to defaults and the framing of choices. They employ evidence on consumer bias toward the status quo to design a system that would draw consumers to financially sound mortgage options.

- An opt-out mortgage system would make traditional mortgage products—such as thirty-year mortgages with fixed interest rates—the default set of mortgages offered to most borrowers.
- The defaults would have protections to offset the strong incentives that lenders may have to encourage use of alternative products. When a borrower opts out of the default, the authors would require heightened disclosure and additional legal exposure for lenders.

Benefits of the New System

The opt-out mortgage system would have several benefits over current market outcomes:

- The terms of default mortgages would be easier to compare across lenders, making lenders compete largely on price.
- Alternative products would represent explicit deviations from standard mortgages, helping to anchor consumer decisions.
- Lenders would be able to continue developing new and innovative financial products, but only if they could adequately explain key terms and risks to borrowers.

are automatically enrolled in a 401(k) plan unless they take the step of opting out. As William Gale, Jonathan Gruber, and Peter Orszag explained in a 2006 Hamilton Project discussion paper, under the existing approach to 401(k)s and individual retirement accounts (IRAs), busy families who cannot focus adequately on saving decisions can wind up not saving at all. In response, they proposed that firms be required to automatically enroll their new workers in a traditional defined benefit plan, a 401(k), or an IRA; workers could opt out of the 401(k) or IRA if they chose. They cited evidence showing that such a change in the default setting would significantly increase participation rates, particularly for low-income workers. One study showed that plan participation for new employees making less than \$20,000 per year increased from 13 to 80 percent simply by changing the default.

Barr, Mullainathan, and Shafir propose a mortgage system that relies on the same dynamic—the bias shown by people toward a default option that takes effect if the consumer decides nothing. The authors argue that in many cases families would be better served by traditional thirty-year mortgages with fixed interest rates than by the more-tempting and exotic mortgages. Therefore, the authors' proposal would make this traditional mortgage or a small set of standard mortgages the default type of mortgage: the one that would be used if the borrower took no extra action. Thus, lenders would be competing primarily on the interest rate they charged. Lenders and brokers could promote alternative mortgages, but consumers would have to opt affirmatively against the standard set. The authors argue that such an opt-out mortgage system would mean that borrowers would be more likely to receive straightforward loans they can understand.

However, the authors believe that—unlike the savings context—opt-out mortgages alone will not be enough to protect consumers. In the savings context, opt-out 401(k) plans work because em-

employers' incentives align with regulatory efforts to increase employee savings. Due to current regulations, employers stand to benefit if their employees save more, so they encourage participation in automatic 401(k) plans.

In the context of credit markets, though, firms often have an incentive to conceal from their borrowers the true costs of borrowing and so may attempt to convince them to opt out of the default in favor of riskier mortgages. This problem of misaligned incentives leads the authors to propose that the default to the standard mortgage be “sticky”—that is, that it be more difficult to substitute an alternative mortgage for a standard one than it is to opt out of a 401(k) savings plan.

The authors say further work will be needed to settle on the exact means of making the default mortgage appropriately sticky. The goal of the sticky default is to give preference to the default option and require that borrowers who choose to opt out are properly informed of the risks. But making the default too sticky could run the risk of stifling or effectively prohibiting any alternative product.

One approach to balancing these goals is to allow lenders to substitute alternative mortgages for the default product only if they satisfy heightened disclosure requirements, which could be enforced by the banking agencies or a new financial consumer regulatory agency. Another, complementary approach is to make lenders accept additional legal penalties for nontraditional mortgages that go into default. For example, bankruptcy courts could be given permission to modify or rescind mortgages if they determined that disclosure did not effectively communicate their key terms and risks. Through mechanisms like these, lenders would face decreased incentives to convince families to take out mortgages that are potentially dangerous for the families but profitable for the lenders.

An opt-out mortgage system that changes incentives would force lenders to provide mortgage options that are more transparent, more understandable, and more likely to serve consumer interests.

Sticky opt-out mortgages might provide several benefits over current market outcomes, according to Barr, Mullainathan and Shafir. First, borrowers would find the terms of a standard set of default mortgages easier to compare across lenders. Thus, price competition is more likely to be salient once features are standardized.

Second, alternative products would explicitly represent deviations from the default mortgages, helping to anchor consumer decisionmaking and providing some basic expectations for what ought to enter into consumer choice. Framing the mortgage choice as one between accepting a standard, understandable mortgage offer and opting out for a nonstandard, more-complicated product should improve consumer decisionmaking.

Third, creditors will be required to make heightened disclosures about the risks of alternative loan products for borrowers, and legal sanctions should deter creditors from making unreasonably risky alternative offers with hidden and complicated terms. The approach would allow lenders to continue to develop new kinds of mortgages, but only when they can adequately explain key features and risks to borrowers.

Lenders would be able to continue developing new and innovative financial products, but only if they could adequately explain key terms and risks to borrowers.

Questions and Concerns

The authors acknowledge and address some potential drawbacks to their proposal. The two main issues concern the design of the default mortgage options.

How do regulators set the right default?

Unless the default mortgage option is suitably attractive to borrowers, it might come to be seen as inferior to other, newer, or more-complex kinds of mortgages. If borrowers strongly prefer other mortgage types, they may opt out in droves. In this case, deviating from the default could come to be seen by borrowers as just another unnecessary bureaucratic hurdle.

For this reason, the authors propose periodic required reviews of the defaults to keep the opt-out product competitive with innovations in the home mortgage market. The goal would be to find a

default that is in the best interest of most borrowers, easily understood by them, and popular. Once a suitable mortgage product was found, the authors propose using consumer experimental design or survey research to help them design the mortgages in a way that consumers can easily understand.

Will the standard mortgage product fill the needs of low-income or first-time homebuyers?

The standard mortgage might not be a good fit with some low-income and first-time homebuyers, who without alternative mortgage terms might find themselves frozen out of the new-home market because they cannot afford large down payments or high monthly payments. The authors suggest that one way to address this concern might be to allow variety in the default choice. For example, the opt-out regulation could require that the standard set of mortgages include a thirty-year fixed mortgage, a five- or seven-year adjustable rate mortgage (ARM), and straightforward mortgages designed to meet particular needs.

One might even develop “smart” defaults based on key borrower characteristics such as income and age. For example, a borrower with rising income prospects might appropriately be offered a five-year ARM. Smart defaults might reduce error costs associated with the proposal and increase the range of mortgages that can be developed to meet the needs of a broad range of borrowers. Smart defaults may add to consumer confusion, however, or run afoul of fair lending rules and thus would need careful oversight.

CONCLUSION

The emerging literature of behavioral economics has shown the rational individual of classical economic theory to be a rare creature. Even if consumers have the necessary information at hand to make well-informed decisions, they often do not act on that information in ways that are in their best interest.

One of the most important insights from behavioral economics has been the power of default settings to guide consumer decisionmaking. Barr, Mullainathan, and Shafir use this insight to develop an opt-out mortgage system that would offer borrowers a standard set of mortgage products unless they affirmatively made a different choice. According to the authors, an opt-out system would mean that borrowers would be less likely to choose loans they cannot afford and that financial innovation in the private market would still occur. To strengthen the protections in this system, they propose a complementary set of enforcement mechanisms to encourage lenders to disclose, honestly and comprehensibly, the risks involved with deviating from the default options. Recognizing the reality of consumer psychology, Barr, Mullainathan, and Shafir propose a mortgage system that they think would work better for most households.

Learn More About This Proposal

This policy brief is based on The Hamilton Project discussion paper, *An Opt-Out Home Mortgage System*, which was authored by:

MICHAEL S. BARR

Professor of Law, University of Michigan Law School

SENDHIL MULLAINATHAN

Professor of Economics, Harvard University

ELDAR SHAFIR

Professor of Psychology and Public Affairs, Princeton University

Additional Hamilton Project Proposals

Facilitating Shared Appreciation Mortgages to Prevent Housing Crashes and Affordability Crises

Conventional mortgages force borrowers to make the same payments regardless of fluctuations in the value of their homes, leaving them to bear all the risk when housing prices fall and thereby exacerbating housing cycles. This paper offers a novel alternative to traditional mortgages: Shared Appreciation Mortgages (SAMs). With SAMs borrowers defer payment until the end of the life of the loan and owe less if their home values fall. In return, lenders share in the appreciation if home values rise. SAMs would thus enhance affordability by reducing monthly payments and reduce the risk of default and future crises by spreading risk more evenly between borrowers and lenders.

Getting More from Low-Income Housing Assistance

The current system of federal housing aid is failing many low-income families, and has two major flaws. First, it relies excessively on expensive and restrictive unit-based housing assistance, in which participants must live in specially designated housing projects. Second, it is highly arbitrary, providing large subsidies to some families while excluding others. This paper proposes making housing assistance more efficient and equitable by turning it into an entitlement program and by transitioning to tenant-based assistance, in which families receive a voucher that they can apply to any housing unit meeting minimum standards. The author argues that these reforms would allow the government to serve at least one million more families, offer families more choice about where to live, and increase economic integration.

The Hamilton Project seeks to advance America's promise of opportunity, prosperity, and growth. The Project's economic strategy reflects a judgment that long-term prosperity is best achieved by making economic growth broad-based, by enhancing individual economic security, and by embracing a role for effective government in making needed public investments. Our strategy—strikingly different from the theories driving economic policy in recent years—calls for fiscal discipline and for increased



public investment in key growth-enhancing areas. The Project will put forward innovative policy ideas from leading economic thinkers throughout the United States—ideas based on experience and evidence, not ideology and doctrine—to introduce new, sometimes controversial, policy options into the national debate with the goal of improving our country's economic policy.

The Hamilton Project Update

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The Project is named after Alexander Hamilton, the nation's first treasury secretary, who laid the foundation for the modern American economy. Consistent with the guiding principles of the Project, Hamilton stood for sound fiscal policy, believed that broad-based opportunity for advancement would drive American economic growth, and recognized that "prudent aids and encouragements on the part of government" are necessary to enhance and guide market forces.

THE BROOKINGS INSTITUTION

1775 Massachusetts Avenue NW, Washington, DC 20036
info@hamiltonproject.org ■ 202.797.6279

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THE HAMILTON PROJECT ADVISORY COUNCIL

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