When Disclosure is Not Enough

BY BORYS GROCHULSKI

Amid the recent spike in the mortgage defaults, the Federal Trade Commission reported this summer that consumer disclosure forms used in mortgage lending fall short in conveying vital information to borrowers, and that improvements were both desirable and achievable. This might well be true. Better-informed consumers will often make better purchasing decisions, and loan disclosures currently in use very well may be less than perfect. But for reasons I will explain, even the fullest of consumer disclosures won't get to the heart of a perhaps more fundamental problem facing the U.S. mortgage market.

It is quite clear that mandatory, government-enforced disclosures play an important and positive role in consumer lending. Market forces alone are probably not enough to determine the proper form of disclosure, as consumer credit markets are not free of search costs and asymmetric information. These so-called market frictions impede the efficiency of the laissez-faire outcome and can justify government intervention. What exact shape and form this intervention should take is an important question.

However, even if borrowers perfectly understand the terms of contract and the trade-offs involved in all mortgage products available, there still exists another force pushing borrowers toward taking too much risk: an expectation of a taxpayer-funded government bailout in the event of an adverse economy-wide shock.

An important example of such a shock is a housing market slowdown. If the government is expected to offer a bailout to borrowers in the case of a collapse in property values, we face the so-called moral hazard problem, in which borrowers take on too much risk. Under this scenario, if the property values grow, borrowers win the prize of appreciated home values; if they collapse, taxpayers lose. If a bailout is likely, borrowers have an incentive to take on risky mortgage products (putting zero money down, keeping the monthly payment as low as possible, and buying into as big a house as possible) so as to maximize their capital gain in the good outcome. The lenders are happy to oblige, as the losses that result in the bad outcome will be sustained by the bailout. No amount of disclosure can change this.

How can this problem be dealt with? Ex post, i.e., once enough borrowers are under water, it is too late to prevent moral hazard. The government cannot abandon distressed primary-residence homeowners. However, measures could be taken to eliminate the moral hazard issue going forward.

Just instituting the "no-more-bailouts" policy will not work, for the public can correctly perceive that this policy will likely be abandoned next time enough households are in dire straits, and moral hazard will continue. The problem can, however, be eliminated at the ex-ante stage, i.e., before households get into risky borrowing, with direct controls put on the amount of risk that households can take.

An outright ban of some of the riskiest mortgage products is almost certainly not a part of an efficient solution. There may always be a borrower for whom, when properly disclosed and priced, a "Ninja" mortgage actually is optimal. What would, however, be the cost of finding out who is a suitable borrower for a risky loan and who is not before the deal is made? If this cost is not too high, relative to the benefit of mitigating the moral hazard problem, then perhaps a suitability check for some of the risky mortgage products could be instituted. After all, mandatory suitability checks are already in place in other markets affected by the government's general inability to commit to *not* bailing out ex post.

The way we regulate medications in this country is instructive. For many medications, particularly those risky ones with strong and variable side effects, consumers must obtain a prescription before purchasing. If consumers were allowed to just read a disclosure and make their own medication choices, they might take unnecessary risks and later end up in the emergency room. The treatment that a self-medicated patient would receive in an emergency room is akin to a government bailout — a guarantee of help even when the consumer took on excessive risk.

In a sort of preemptive strike, we require licensed intermediaries (doctors) to determine which prescription medications consumers can use partly because the government cannot commit to *not* bailing out consumers who recklessly self-medicate. This is an explicit restriction on consumer freedom of choice in this particular market, but one that has been deemed necessary because of the alternative-scenario consequences.

Could the commitment problem in the mortgage market be solved in a similar way? We might well consider suitability checks for some mortgage products. Perhaps for certain exotic loans, we might require the lender, or an independent third party, to check and certify the suitability of the loan for the borrower before the loan is made. To be sure, we would then face other costs and problems. A sound cost-benefit analysis of this solution is needed. If, however, a government bailout is perceived by the public as a real possibility, a mandatory suitability check may be necessary to prevent moral hazard. Disclosures are important, but we should not expect even perfect ones to be sufficient. **RF**

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