When Disclosure is Not Enough

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mid 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 disclo-
sures 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 bene-
fit 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.

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not necessarily shared by the Federal Reserve System.