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Financial literacy, financial advice and mortgage risks

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Comments by Arvid Hoffmann

Organization of comments

- What is the paper about?
- Strengths of the paper
- Weaknesses of the paper
- Some references to include

What is the paper about?

- Paper examines how individuals assess the risks of various types of mortgage loans and the relation of such risk assessments to actual mortgage decisions.
- To do so, authors collect detailed data using the DNB Household Panel on individuals' risk assessments of mortgage loans, financial literacy, debt literacy, type of mortgage loans taken out, and such measures as LTV and LTI.
- Authors find that individuals with lower level of financial literacy are more likely to take out traditional mortgages instead of interest-only mortgages.
- Debt literacy and financial advice is associated with taking riskier mortgages.

Strengths of the paper (1/2)

- Interesting topic: mortgage decisions are among the most important financial decisions for individuals, but limited learning opportunity due to low frequency.
- Important question: in the light of the recent financial crisis, key to know if individuals underestimate risk of house-price declines and/or income shocks.
- Very nice dataset: data on financial literacy, debt literacy, risk assessments …

Strengths of the paper (2/2)

- Extensive analyses: many descriptives, rich set of results, good interpretation.
- Surprising findings: financial literacy is a blessing and a curse. Prevents you from participating in stock market, but helps to avoid risky mortgage products.
- Very nice to read: paper is written very well , describes its relevance clearly.

Limitations – Contribution

- Carve out contribution to literature explicitly. You do a great job in pitching the practical importance and policy relevance, but what is theoretical contribution?
  - Relate to financial advice literature on investment choices, which finds that clients who need advice the least (sophisticated ones) are most likely to receive it (Hackethal et al. 2012). Also, financial advice leads to taking more risk (Chalmers and Reuters 2013). How do your results on advised clients relate to this earlier work? Positioning…
  - You stress in the introduction the difference between debt literacy and financial literacy. Do more with this. What is the theoretical puzzle here that you aim to solve?
  - Title of the paper by Cox et al. (2011) suggests it is very closely related to yours. Clearly distinguish yourself from their contribution; issue is now more or less ignored.

Limitations – Data and Methods

- Debt and financial literacy as measured in 2010 are related to mortgage terms as measured when house was purchased (going back to 1993) → problems?
- Questionnaire fielded in weekend of June 18, 2010: this was a relatively volatile stock-market period. Potential impact on individuals' survey responses?
- Some survey questions are relatively sensitive and potentially subject to social desirability bias in answering, such as the current self-reported house value. Do you have any evidence, using, for example, Kadaster transaction data whether the self-assessed current house value is correct, given the time since house purchase and average house price developments in their postal code since then?

Limitations – Data and Methods

- Common problem in all financial literacy studies: how can you be sure that respondents did not look up the answers online and is it a problem if they did?
- LTI ratio is based on disposable income, more common to think in gross salary.
- Is the higher prevalence of repayment mortgages among younger households an active choice by these households or rather the result of government policy?
- You use ordered logit regressions when dependent variable is Likert scale. Although theoretically correct, typically (seven-point) Likert scales are interpreted as interval variables and linear regression models are used to analyze such variables (see e.g., Winship & Mare, 1984). Explain why you used ordered logit regression and perhaps also do an OLS regression for robustness.

Limitations – Results

- You ask individuals to assess ability to take out a mortgage loan without professional advice. Can you infer from available data their actual ability to do so, assessing these individuals' miscalibration (cf. Alba and Hutchinson 2000)?

- You find an inverted U-shape between age and debt literacy. Relate to literature such as Korniotis and Kumar (2011) who examine relationship between age and quality of investment decisions as well as literature on interaction of fluid and crystallized intelligence in relation to age (Li et al. 2013):

  - Older individuals' greater crystallized intelligence offsets lower fluid intelligence for temporal discounting, financial literacy, and debt literacy, but not for loss aversion.

- Doing so will also help to add some additional theoretical depth to your paper.

Limitations – Write-up

- Expand the section in conclusions on financial assistance and mortgage advice.
- In your sales pitch of paper, perhaps stress the irony that not being financially literate can actually protect individuals from taking risky mortgage products…
- Please provide overview of exact survey questions in an appendix to the paper.
- Overall, very nice to read and well-thought through paper. However, language and wording is from time to time too restrictive, normative, or colorful:
  - Page 3: "…investigate whether borrowers are **completely** aware of the risks…"
  - Page 3: "…less sophisticated borrowers who are not **fully** aware of the risks…"
  - Page 3: "…**irrational** expectations about income growth, investment returns…"

References (1/2)

- Alba, J. W. & Hutchinson, J. W. (2000). Knowledge Calibration: What Consumers Know and What They Think They Know. *Journal of Consumer Research, 27,* 123-156.

- Chalmers, J. & Reuter, J. (2012). What is the Impact of Financial Advisors on Retirement Portfolio Choices and Outcomes? *NBER working paper*.

- Cox, R., D. Brounen, and P. Neuteboom (2011). Financial literacy, risk aversion and choice of mortgage type by households. *working paper*.

- Hackethal, A., Haliassos, M., & Jappelli, T. (2012). Financial Advisors: A Case of Babysitters? *Journal of Banking and Finance, 36,* 509-524.

References (2/2)

- Korniotis, G. M. & Kumar, A. (2011). Do Older Investors Make Better Investment Decisions? *Review of Economics and Statistics, 93,* 244-265.

- Li, Y., Baldassi, M., Johnson, E. J., & Weber, E. U. (2013). Complementary Cognitive Capabilities, Economic Decision Making, and Aging. *Psychology and Aging, 28,* 595-613.

- Winship, C. & Mare, R. D. (1984). Regression Models with Ordinal Variables. *American Sociological Review, 49,* 512-525.