

# Promise and Pitfalls of Consumer Mortgage Disclosures

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\* The views expressed are those of the presenter. They are not necessarily shared by the Federal Trade Commission or any individual Commissioner.

I.

# Introduction

# Silver lining in financial crisis

- Focus on Consumer Protection
  - Golden Opportunity
  - Responsibility

# Consumer Policy Remedies

- Inform Consumers
- Educate Consumers
- Nudge Consumers
- Regulate Product Characteristics

Where to begin?

Hard to know

“A point in every direction is  
no point at all.”

--Harry Nilsson  
The Point!

# Three general points

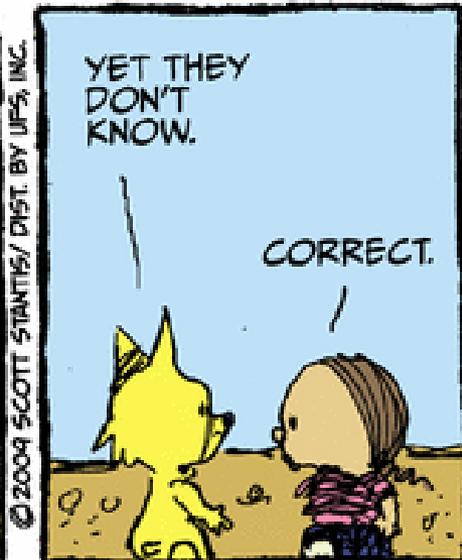
- Consumer protection policy is often tricky because people are unique
- Consumer protection is unlikely to be effective without a joint mandate to promote competition
- Disclosures are often better than remedies that restrict product options, but untested disclosures can do more harm than good

# Bottom line on disclosures

- Federally mandated mortgage disclosures failed, likely contributing to mortgage crisis
- Failure of past disclosures does not imply that disclosure policies are doomed
- Research shows that simplified disclosures can be successful, but require
  - Re-thinking consumer needs
  - Serious consumer research, including objective, quantitative, controlled testing
  - Re-visiting effect of disclosure over time

II.

# Economics of Consumer Protection Background



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# Relevant academic literatures

- Traditional economics
  - Household production
  - Economics of information
- Marketing research
- Behavioral economics
- Law and economics

# Economics of consumer protection

- Key point of economics and consumer protection: competition in a free market will **usually** bring greatest benefits to consumers.
- Economics helps identify those areas where intervention may be useful.
  - \* There is no free lunch
  - \* Most interventions have benefits and costs

“Indeed competition and consumer law should be seen as one subject, not two.

Competition is pro-consumer for the simple reason that rivalry among suppliers to serve customers well is good for customers. In such rivalry, the suppliers who serve customers best will prosper and those that serve them poorly will not.”

John Vickers FBA  
Economics for consumer policy  
British Academy Keynes Lecture  
28 October 2003

Competition is great, but it is not  
perfect . . .

# Relevant economic literature

- Imperfect information
  - When consumers differ in knowledge, search costs, or ability to comparison shop, a multi-price market equilibrium can result in which less-informed consumers pay higher average prices than more-informed consumers
    - Stigler (1961), Salop & Stiglitz (1977), Salop (1977), Wilde and Schwartz (1979), Gabaix and Laibson (2006), Woodward and Hall (2010)
  - Presence of some informed consumers does not necessarily lead to voluntary disclosure of key information or competitive equilibrium
    - Baylis and Perloff (2002)

# Relevant economic literature

- Mandatory disclosures intended to help uninformed consumers become informed have often been seen as a remedy for imperfect information problems that result in market failure and non-competitive equilibriums
  - Wilde and Schwartz (1979); Beales, Craswell, and Salop (1981); Vickers (2004); Fung, Graham, and Weil (2007)
- Although mandatory disclosures widely used, and often assumed to work, in practice can be very difficult
  - Beales, Craswell, and Salop (1981)

“While no-one could doubt the wisdom of banning quacks practicing as doctors, or fraudulent adverts, there eventually comes a point beyond which constraining freedom of contract further brings costs that outweigh benefits. These costs, which consumers ultimately bear and which may be hidden from view, can stem from less choice and competition as well as the cost of regulation itself.

Indeed, the best solutions often involve better consumer information rather than less consumer and producer choice. But improving consumer information is often easier said than done, especially information that is of immediate and direct practical use—for as consumers we are all boundedly rational, and rationally so.”

John Vickers FBA  
Economics for consumer policy  
British Academy Keynes Lecture  
28 October 2003

# Differences among people complicate analysis

- Model of Constrained Utility Maximization recognizes
  - Differences in consumer tastes
  - Differences in consumer income constraints
  - Different reactions to time constraints
- People are unique!



*"I want to read something targeted directly at me."*

Donnelly, Liza. "I want to read something directly targeted at me." (A man speaks to a clerk in a bookstore.)  
ID: 130848, Published in *The New Yorker* June 8, 2009

# Financial products

- Particularly difficult to judge choices
- Where is customer in life/earning cycle?
- How much is person willing to sacrifice to buy house in good school district?
- How long expect to hold mortgage?
  - 30 year fixed mortgage not best for everyone
- What are expectations about future income?
- So many unobservable factors affect choice

# Uniqueness complicates consumer policy analysis

- Even with perfect information, consumers make different choices
- Ask if consumer had full information about product quality, would she buy a product?
  - Defective appliance (not good for anyone)
  - Mortgage with pre-payment penalty or adjustable rate (good for some)

# Lessons from FTC conference

- “Consumer Information and the Mortgage Market: Economic Assessment of Information Regulation, Mortgage Choice, and Mortgage Outcomes”
- Held on May 29, 2008
- Brought together experts on housing economics, mortgage markets, economics of information, and consumer behavior to exchange knowledge and ideas

Research is showing that non-  
prime products are not  
inherently flawed

Product restrictions can do more  
harm than good

# Research findings

(Mayer, 2008)

- Defaults appear *unrelated* to mortgage market innovations, including
  - Prepayment penalties
  - Rate resets on short-term ARMs (2/28 mortgages)
  - Interest-only or “option-ARMs”
- Unprecedented rise in defaults and foreclosures primarily due to
  - Stagnation in house prices (driven by subprime collapse?)
  - Slackened underwriting
  - Poor economic conditions in some locations

# Mayer's suggested action

- Consumer protection regulation should be carefully constructed to ensure credit is available to risky borrowers who can afford it

*FRM with (well-disclosed) prepayment penalty may be a good product for risky borrower*

III.

# FTC Research on Mortgage Disclosure

# Motivation

- Long history of mortgage disclosure requirements
  - Truth in Lending Act – TILA statement (1968)
  - Real Estate Settlement Procedures Act – GFE (1974)
- Also long history of concern over the effectiveness of the disclosures
- FTC experience in deceptive lending cases has shown that mandated disclosures do not prevent deception

# Motivation

- Despite these concerns, there had been little empirical evidence on consumer understanding of
  - Mandated disclosures
  - Terms of their own loans
- Virtually no evidence on whether different disclosures could actually improve consumer understanding

# Study objectives

- How consumers search for mortgages
- How well consumers understand
  - Current mortgage disclosures
  - Terms of their recently obtained mortgages
- Whether it is possible to develop better disclosures

# Methodology

Two part study:

- In-depth consumer interviews
  - Detailed picture of real consumer experience
  - Use of the current forms in real mortgage transactions
  - Assess accuracy of consumer knowledge of own loan terms
- Quantitative consumer testing
  - Test actual performance with the disclosures in a controlled, experimental environment

# Consumer interviews

- 36 interviews
- About an hour each
- Homeowners in Montgomery County, MD
- Obtained a mortgage within the previous four months
- Approximately half prime, half subprime (based on HUD lender list)
- Most interviews included a review of loan documents from the consumer's recent mortgage

# General observations

- Most respondents began the interview happy with their mortgage experience; not a sample of complainers
- Many respondents' attitudes deteriorated during the interview as they recalled problems, or realized they did not understand their loans as well as they thought
- Subprime respondents were more likely to be experiencing financial difficulties

# Understanding of own mortgage

- Most respondents appeared to understand the general type of mortgage they had obtained
- Some also had clearly matched the loan type to their circumstances

# Understanding of own mortgage

- But many were unaware of, did not understand, or misunderstood key costs or features of their loans, including
  - Payment of up-front points and fees
  - Lack of escrow for taxes and insurance
  - Large balloon payments
  - Adjustable interest rates
  - Prepayment penalties

# Understanding of own mortgage

- Misunderstanding present among:
  - Both prime and subprime respondents
  - Both those who had done extensive comparison shopping and those who had not done any

# Understanding of own mandated disclosures

- Many respondents had not been able to understand the disclosures on their own, but relied on their loan originators to explain them
- Many were confused by various fees itemized on the GFE form; did not understand how they differed
- Few understood the APR; many believed it was the interest rate
- A number were confused by the prepayment penalty disclosure

# Understanding of own mandated disclosures

- In some respects the disclosures were worse than ineffective, and actually created consumer misunderstandings
  - Many believed that the “amount financed” disclosed in the TILA statement was their loan amount, rather than the loan amount minus prepaid finance charges
  - Many believed that the “discount fee” disclosed in the GFE was a discount they had received, rather than a fee they had paid

# Reaction to prototype disclosures

- Overwhelmingly positive
- Viewed as significant improvement over respondent's own mandated disclosures

# Quantitative consumer testing methodology

- Test consumer understanding of current and prototype mortgage disclosure
- Experimental setting
- 12 locations across the country
- 819 recent mortgage customers
- Approximately half prime, half subprime (based on HUD list)

# Mandated forms

## TILA statement

### FEDERAL TRUTH-IN LENDING DISCLOSURE STATEMENT

For use with Fixed-Rate, GPM, Balloon Mortgage,  
Adjustable or Variable Rate Loans

#### LOAN "T"

Date: 10/14/05  
 Loan No.: 26457  
 Borrowers: James and Clara Borrower  
 Property  
 Location: 123 Your Street  
Hometown, VA 22189

ANNUAL PERCENTAGE RATE	FINANCE CHARGE	Amount Financed	Total of Payments
The cost of your credit as a yearly rate	The dollar amount the credit will cost you	The amount of credit provided to you or on your behalf	The amount you will have paid after you have made all payments as scheduled
6.88 %	\$ 129,059.36	\$ 166,147.50	\$ 315,206.86

You have the right to receive at this time an itemization of the Amount Financed.  
 I want an itemization  I do not want an itemization

Your payment schedule will be:

Number of Payments	Amount of Payments	When Payments Are Due
119	\$ 1,049.11	Monthly beginning 12/01/05 and ending 10/01/15
1	\$ 190,362.54	11/01/15
	\$	
	\$	
	\$	
	\$	
	\$	

Variable Rate:  This loan has a Variable Rate Feature. Variable Rate Disclosures have been provided to you earlier.

This obligation has a demand Feature.

Insurance: Credit life insurance and credit disability insurance are not required to obtain credit, and will not be provided unless you sign and agree to pay the additional cost. No such insurance will be in force until you have completed an application, the insurance company has issued the policy, the effective date of that policy has arrived and the required premium has been paid.

Type	Premium	Term	Signature
Credit Life	\$ 3,900.00	10 years	I want to apply for credit life insurance. SIGNATURE
Credit Disability	\$ 2,330.00	10 years	I want to apply for credit disability insurance. SIGNATURE
Credit Life and Credit Disability	\$		I want to apply for credit life and disability insurance. SIGNATURE

You may obtain property insurance from anyone you want that is acceptable to this institution. If you get the insurance from \_\_\_\_\_ you will pay \$ \_\_\_\_\_ for a term of \_\_\_\_\_

Security: You are giving a security interest in:

the property being purchased  
 the property located at 123 Your St., Hometown, VA 22189

Late Charge: If payment is late, you will be charged \$ \_\_\_\_\_ / \_\_\_\_\_ 5.00 % of the payment.

Prepayment: If you pay off early, you

may  will not have to pay a penalty.  
 may  will not be entitled to a refund of part of the finance charge.

Assumption: Someone buying your home

cannot assume the remainder of the mortgage on the original terms.  
 may, subject to conditions, be allowed to assume the remainder of the mortgage on the original terms.

A deposit balance  is  is not required. The Annual Percentage Rate does not take into account your required deposit.

See your contract documents for any additional information about nonpayment, default, any required repayment in full before the scheduled date, and prepayment refunds and penalties.

e means an estimate

I/We hereby acknowledge receipt of this disclosure.

\_\_\_\_\_/\_\_\_\_\_/\_\_\_\_\_  
 DATE  
 \_\_\_\_\_/\_\_\_\_\_/\_\_\_\_\_  
 DATE  
 Prepared by: \_\_\_\_\_  
 TITLE



# Prototype disclosure form

- Developed by FTC staff for the study
- Used to test improvement in consumer recognition of the costs and features of a mortgage loan
- Attempted to improve both content and presentation
- Imagined that current disclosures did not exist and asked what information consumers need most

# Fixed-rate loan disclosures

- Prototype focused on disclosures for the simpler case of fixed-rate loans
  - Including loans with more complex features such as interest-only and balloon payments
- Could be extended to incorporate key features of adjustable-rate loans (ARMs)

# Prototype format

- One page summary of key loan costs and features
- Two pages of further detail

# Prototype form

## Page 1

## Summary of key loan terms

**Mortgage Loan Offer** [example of complex refinance loan]  
ACME Mortgage Company [draft form]  
123 Main Street  
Fairfax, Virginia 20151  
(703) 555-2767 Page 1 of 3

Borrower: James Jones Offer Date: May 21, 2004  
Property Location: 345 North Street, Fairfax, Virginia, 20151

This page provides a summary of your loan, our charges for the loan, and your loan payments. See pages 2 and 3 for important details on each of these items.

### YOUR LOAN

Loan Type Summary	10 year fixed-rate balloon loan
Loan Amount	\$ 154,934.26
Loan Term	10 years (120 monthly payments)

### OUR LOAN CHARGES

Interest Rate	7.23%	Fixed rate
Up-Front Charges	\$ 10,020.06 \$ 8,202.69 \$ 18,222.75	Total settlement charges Charges for optional products and services Total up-front charges
Monthly-Billed Charges	None	
Annual Percentage Rate (APR)	7.98%	The cost of credit, including both interest payments and other finance charges, expressed as an annual rate.

### YOUR LOAN PAYMENTS

Cash Due at Closing	\$ 0.00	
Monthly Payments	\$ 1,054.82	Payments 1-119
Balloon Payment	\$ 134,718.17	You will have to pay this amount at the end of the 10 year loan term

### PENALTIES AND LATE FEES

Prepayment Penalty	A penalty of six (6) months interest will be charged if the loan is paid off during the first five years. An immediate refinancing of the loan would result in a penalty of \$5,600.87.
Late Fee	A 5% late fee will be charged on payments more than 7 days late.

# Prototype form

Page 2

Details of loan terms

This page and the next provide explanations and important details about your loan amount, our charges for the loan, and your loan payments. See page 1 for a summary of these items.

## LOAN AMOUNT DETAILS

Loan Amount	\$ 123,427.80	Refinance current mortgage loan
	\$ 10,000.00	Cash paid to borrower
	\$ 3,283.71	Consolidation of borrower's other debts
	\$ 10,020.06	Financed settlement charges
	\$ 8,202.69	Financed charges for optional products and services
	<b>\$ 154,934.26</b>	<b>Total Loan Amount</b>

## OPTIONAL CHARGES DETAILS

Optional Products and Services Charges	\$ 4,367.90	Credit life insurance
	\$ 2,155.01	Credit accident and health insurance
	\$ 1,679.78	Involuntary unemployment insurance
	<b>\$ 8,202.69</b>	<b>Total Optional Product and Services Charges</b>

These products and services are NOT required for the loan. Tell your loan provider if you do not wish to purchase them and make sure that you obtain a revised offer sheet with these charges removed.

## CASH DUE AT CLOSING DETAILS

Cash Due at Closing	\$ 0.00
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## MONTHLY PAYMENT DETAILS

Monthly Payment	<u>Itemization of initial monthly payment</u>	
	\$ 1,054.82	Principal and interest
	\$ 0.00	Private mortgage insurance (PMI) (not required)
	\$ 0.00	Monthly-billed optional products or services
	<b>\$ 1,054.82</b>	<b>Total initial monthly payment</b>

Taxes and Insurance Property taxes and hazard insurance are NOT included in your monthly loan payment. You will be responsible for paying these additional required costs yourself. These additional monthly costs will be:

\$ 212.55	Property taxes (\$2,550.60 per year)
\$ 107.63	Hazard insurance (\$1,291.56 per year)
<b>\$ 320.18</b>	<b>Total additional monthly costs (\$3,842.16 per year)</b>

# Prototype form

## Page 3

## Details of settlement charges; consumer tips and warnings

### SETTLEMENT CHARGES DETAILS

This page lists the settlement services included in the settlement charges shown on page 1. ALL of the settlement services you need to close the loan are included.

Settlement Services Package	\$9,214.45	This package includes the following services:  <u>Origination and lender services</u> Loan origination Appraisal Credit report Lender's property survey Lender's property inspection Pest inspection  <u>Government taxes and fees</u> County recording fee	<u>Title services</u> Settlement agent Title search and examination Title document preparation Lender's title insurance Attorney services Notary fee  State and local tax stamps
Daily Interest Charges	\$ 558.90	This charge is for the daily interest charges from the day of your settlement until the end of the month. For this loan this amount is \$ <u>32.88</u> per day for <u>17</u> days (if your closing date is <u>11/13/04</u> ).	
Prepaid Items	\$ 31.20 \$ 34.98	Property taxes Homeowner's insurance	These charges cover property taxes and insurance from the day of your settlement until the end of the month (if your closing date is <u>11/13/04</u> ).
Reserves Deposited with the Lender	\$ 102.41 \$ 78.12	Property taxes ( <u>2</u> months at \$ <u>51.22</u> per month) Homeowner's insurance ( <u>2</u> months at \$ <u>39.06</u> per month)	
Total Settlement Charges	<b>\$10,020.06</b>	<b>Total Settlement Charges</b>	

### HOW TO PROTECT YOURSELF

**COMPARISON SHOP TO FIND THE BEST DEAL** — The lender or broker providing this loan is not necessarily shopping on your behalf and providing you with the lowest cost loan.

**DO NOT RELY ON ORAL PROMISES TO CHANGE THESE TERMS** — Obtain all changes in writing.

**SAVE THIS OFFER SHEET AND COMPARE TO DOCUMENTS AT CLOSING** — Before you sign any papers at your loan closing (loan settlement), make sure that the costs have not been increased.

Federal law requires that this offer sheet be provided to the borrower within three (3) business days after the borrower has applied for a loan. If the loan terms change prior to acceptance by the borrower, a new offer sheet must be provided. Contact the Federal Trade Commission (FTC) if the lender does not abide by the terms set forth in this offer or does not provide this offer sheet within three days of application: Federal Trade Commission (FTC), 600 Pennsylvania Avenue, N.W., Washington D.C., 20580, telephone (877) FTC-HELP (382-4357), web site [www.ftc.gov](http://www.ftc.gov).

# Testing procedure

- Respondents given disclosure forms for two hypothetical loans
  - Half given current forms, half given prototype forms
  - Random assignment
- Instructed to examine the forms as they would if they were shopping for a mortgage
- Asked questions about a dozen different loan terms
- Able to continue examining forms during questioning

# Loan scenarios tested

- Simple loan
  - Fixed-rate purchase loan
- Complex loan
  - Fixed-rate refinance loan
  - Interest-only payments
  - Balloon payment
  - Optional credit insurance
  - No escrow for taxes and insurance
  - Prepayment penalties
  - Zero cash due at closing

# Percentage of questions answered correctly

	<u>Disclosure Form</u>		
	<u>Current</u>	<u>Prototype</u>	<u>Difference</u>
Both Loans	61%	80%	19 pct points **
Simple Loan	66%	82%	16 pct points **
Complex Loan	56%	78%	22 pct points **

\*\* Statistically significant at the one percent level

# Percentage of respondents with high accuracy rates

<u>Percentage Of Questions Answered Correctly</u>	<u>Disclosure Form</u>		<u>Difference</u>
	<u>Current</u>	<u>Prototype</u>	
70% or more	30%	80%	51 pct points **

\*\* Statistically significant at the one percent level

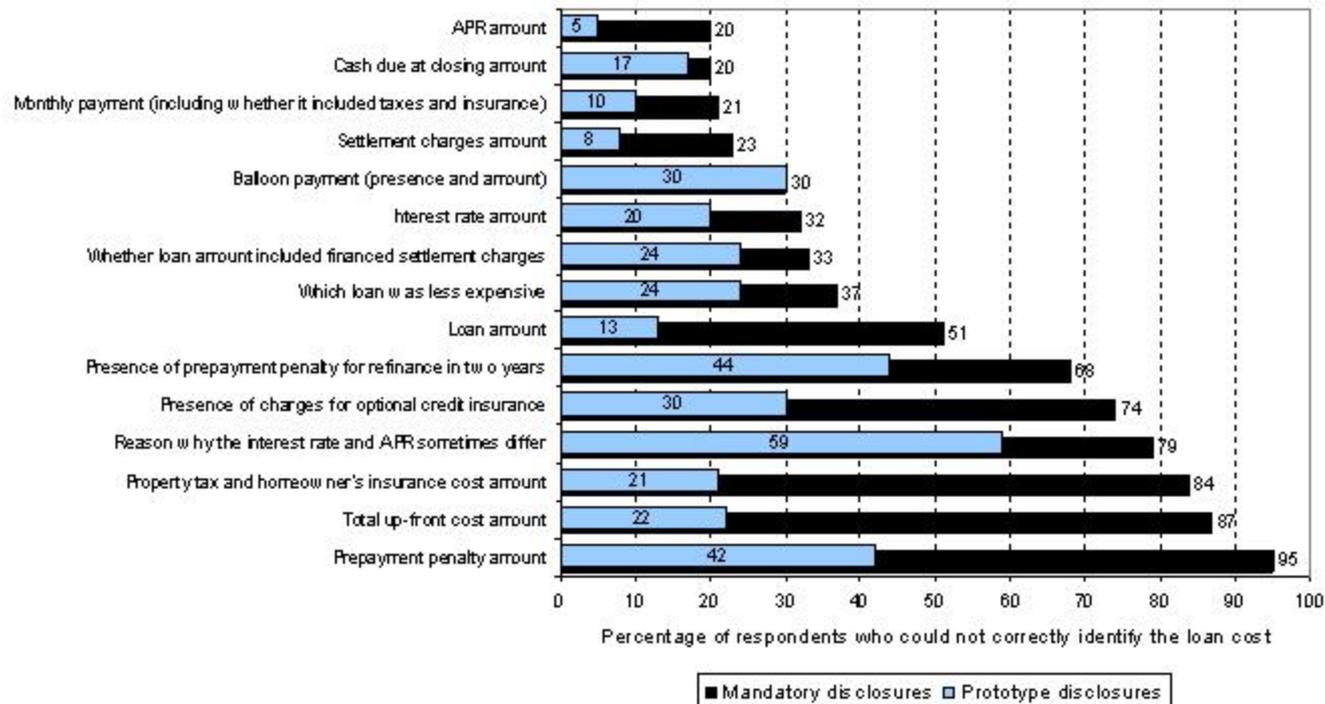
# Prime and subprime borrowers

Percentage of questions answered correctly

	<u>Borrower Type</u>		<u>Difference</u>
	<u>Prime</u>	<u>Subprime</u>	
Both Loans	71.5%	69.0%	-2.5 pct points *
Simple Loan	74.8%	72.9%	-2.0 pct points
Complex Loan	68.3%	65.0%	-3.2 pct points

\* Statistically significant at the five percent level

### Percentage of Respondents Who Could Not Correctly Identify Various Loan Costs Comparison of Mandatory and Prototype Disclosures



# Findings

- It is possible to create new disclosures that significantly improve consumer recognition of the costs and terms of a mortgage
  - Dramatic improvements for a first-draft by two economists
- Improved disclosures can provide significant benefits to both prime and subprime borrowers

IV.

Promise and Pitfalls  
of Consumer Disclosures  
Conclusions

# Impact of ineffective mandated disclosures

- The ineffectiveness of mandated federal disclosures is likely to have contributed to the mortgage market crisis
- Study results show that the current disclosures are not even effective for plain-vanilla, fixed-rate loans
- Likely to have been worse for ARM loans, particularly the more complex types

# Impact of ineffective mandatory disclosures

- Do not mean to imply that all consumers misunderstood their loans, or that ineffective disclosures are the primary cause of the current mortgage crisis
- But the results suggest that it is likely that many consumers did not know what they were getting into, and that this lack of understanding contributed to the crisis

# Impact of ineffective mandatory disclosures

- Some of the loan terms of concern to policy makers and being addressed by new regulatory restrictions are terms that current disclosures were particularly ineffective in conveying to consumers or failed to address at all:
  - Prepayment penalties
  - Lack of escrow for taxes and insurance
  - Balloon payments

# Potential success of consumer mortgage disclosures

- Substantial improvements of first draft prototype indicates that mortgage disclosures can be quite effective
- Consumers need a single, comprehensive mortgage disclosure document that
  - Consolidates information on the key costs and features of their loans
  - Uses simple, easy-to-understand language
  - Presented in an easy-to-use form
  - Provided for all loans, both prime and subprime

# Potential success of consumer mortgage disclosures

- Although effective disclosure design can be tricky, it is possible if policy makers remember:
  - More information is not always better, simply adding more disclosures may not help at all
  - Focus on key information (layered approach)
  - Serious consumer research should demonstrate that alternatives are better than current disclosures, and that they truly inform, rather than confuse, borrowers

# Don't give up on consumer information disclosure

- Failure due to poorly designed regulations, not necessarily consumer inability to understand products
- When evaluating costs and benefits of disclosure versus other remedies, consider how differences in consumer lifecycle, expected housing tenure, expected wealth, and expected expenditures affect optimal choice
- Re-visit, and re-test disclosures over time; do not assume that something that works today will work 5 or 10 years from now

# Beyond disclosures

- Development of interactive financial decision tools holds potential
  - John Lynch and Susan Woodward
- Need better data to understand consumer decisions
  - No good data on mortgage choices
  - No good data on full financial picture
    - What is the next best alternative?

# Potential for success

- Stars are aligned for further consumer protection research and development
- Growing understanding by regulators of need to base information remedies on solid, objective, quantitative testing
  - Progress being made, but long way to go

For more information please view the full report entitled *Improving Consumer Mortgage Disclosures: An Empirical Assessment of Current and Prototype Disclosure Forms* online at:

<https://ftcintranet.ftc.gov/cfportal/economics/uploads/LackoPappalardo07.pdf>