BEFORE THE
DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT

In the Matter of
Request for Comment on Proposed Amendments to the Regulations
Implementing the Real Estate Settlement Procedures Act

Docket No. FR-4727-P-01

Comments of the Staff of
the Bureau of Economics,
the Bureau of Consumer Protection,
and the Office of Policy Planning
of the Federal Trade Commission

October 28, 2002*

***These comments represent the views of the staff of the Bureau of Economics, the Bureau of Consumer Protection, and the Office of Policy Planning of the Federal Trade Commission. They are not necessarily the views of the Commission or any individual Commissioner. The Commission has, however, voted to authorize the staff to submit these comments.**

I. Introduction

The Department of Housing and Urban Development (HUD) has requested comment on proposed amendments to its regulations implementing the Real Estate Settlement Procedures Act (RESPA).[1] The staffs of the Bureau of Consumer Protection, Bureau of Economics, and Office of Policy Planning of the Federal Trade Commission (the "FTC staff") offer the following comments to assist HUD in its rulemaking.

The Federal Trade Commission has wide-ranging responsibilities concerning nearly all segments of the economy, including jurisdiction over most non-bank entities. As part of its mandate to protect consumers, the Commission enforces, among other laws, the Federal Trade Commission Act (FTC Act), which prohibits unfair or deceptive acts or practices in or affecting commerce, as well as other laws affecting financial practices, including the Truth in Lending Act (TILA), and the Home Ownership and Equity Protection Act (HOEPA), an amendment to the TILA.[2] The Commission has brought numerous cases in the mortgage lending area.[3] In addition to enforcement responsibilities, the Commission also responds to many requests for information about credit issues and consumer financial laws from consumers, industry officials, state law enforcement agencies, and the media. The FTC staff has also commented on numerous state and federal laws in the real estate area.[4]

Through the proposed changes, HUD is seeking to improve the settlement process for consumers and to enhance competition in several respects.[5] The FTC staff supports initiatives to simplify the settlement process and to foster competition in the market for settlement services, and its expertise in both economics and consumer protection, as well as its experience in enforcing laws affecting financial practices, make the staff uniquely well situated to offer comments on HUD's proposals. This comment focuses on four of HUD's proposed changes: 1) the disclosure of mortgage broker compensation, including yield spread premium; 2)settlement service packaging; 3) the revision of forms; and 4) enhancing the reliability of settlement costs.

HUD's general approach in these proposed changes is to require brokers and lenders to provide consumers with more information about the mortgage process or to provide information in a revised format. HUD believes this will make mortgage shopping more effective and decrease search costs and will thus eventually lead to increased competition. FTC staff believes that this approach will generally benefit consumers but also urges HUD to consider carefully whether the information disclosed will be useful to consumers and whether it is disclosed in an easily understood way. If the additional information or revised formats confuse consumers, the proposed changes may not increase consumer welfare as much as HUD intends and, in the worst case, may actually result in consumer harm. This would be especially troubling if proposed changes do not lead to increased competition as postulated, meaning that consumers may face the risk of increased harm without receiving a corresponding benefit of increased competition in the market for mortgages. Accordingly, FTC staff urges HUD, when evaluating these proposed changes, to conduct consumer research to determine whether they will enhance consumer comprehension of the mortgage process once the changes are adopted. We also recommend that HUD augment them with comprehensive consumer education aimed at borrowers of all income and education levels, as well as business education for the mortgage industry.

Specifically, the FTC staff has the following four primary comments on HUD's proposal:[6]

< The proposed regulations would remove regulatory barriers to allow lenders and other entities to offer packages of settlement services under certain circumstances. The FTC staff supports HUD's initiative to encourage packaging of settlement services by providing packagers a safe harbor from certain RESPA liability if they abide by the regulations. The FTC staff believes that this will enhance competition and will ultimately lower the costs of settlement services for consumers.

< HUD proposes addressing the issue of mortgage broker compensation and changing the way in which lender payments to mortgage brokers, including those called "yield spread premiums" (YSPs), are recorded and reported to consumers. Under the proposed rules, YSPs would be disclosed to consumers as payments by the lender to the borrower, and the broker would thus receive all of its compensation directly from the borrower. FTC staff encourages HUD to conduct consumer research to determine the effectiveness of the proposed disclosure.

< HUD aims to improve its Good Faith Estimate (GFE) settlement cost disclosure to make the GFE easier to use.[7] The proposed new GFE groups charges by category and eliminates duplicative categories of fees. The FTC staff supports efforts to simplify the GFE and improve the forms provided to consumers. The FTC staff, however, believes that the GFE form could be improved and thus supports HUD's plan to revise the form and test it with consumers. Additionally, because the new forms alone will not suffice to educate consumers about the complexities of shopping for mortgages and settlement services, staff also believes that the new regulations should be accompanied by significant consumer and business education.

< HUD's proposed regulations aim to increase the certainty of the cost estimates provided to consumers on the GFE and the alternate form provided in connection with settlement packages. The FTC staff believes that the cost estimates provided on these disclosures can be firmer if HUD makes certain modifications to the proposed rule.

II. Disclosure of Mortgage Broker Compensation (Including Yield Spread Premiums)

A. Introduction

One of the major changes proposed by HUD is a new set of reporting requirements for compensation paid by lenders to mortgage brokers. According to HUD:

> [The proposed rule] would first fundamentally change the way in which mortgage broker compensation is reported by requiring, in all loans originated by mortgage brokers, that any payments from a lender based on a borrower's transaction, other than the payment for the par value of the loan, including payments based upon an above par interest rate on the loan (payments commonly denominated "yield spread premiums"), be reported on the Good Faith Estimate (and the HUD-1/1A Settlement Statement) as a lender payment to the borrower.[8]

HUD hopes that this disclosure ("mortgage broker compensation disclosure") will help consumers shop more effectively and lead to a reduction in mortgage fees paid by consumers. Although the FTC staff supports HUD's goal of making mortgage shopping easier, we urge HUD to engage in consumer research to ensure that the disclosure provides consumers useful information in an easily understandable format. Finally, the new disclosure applies to only one sector of the mortgage market – mortgage brokers. HUD's Economic Analysis itself indicates that the mortgage origination market is highly competitive, including the mortgage broker sector.[9] It is unclear, therefore, whether and how the new disclosure would lead to a more competitive playing field or why the significant transfer from brokers to consumers estimated by HUD would occur.[10]

B. Definition of Yield Spread Premiums (YSPs)

Although HUD's reporting requirement would apparently apply to all compensation paid from lenders to mortgage brokers, one of the largest types of such payments is called "yield spread premiums." According to HUD's proposal, YSPs are defined as follows:

> Where brokers receive a payment for compensation from someone other than the borrower, most commonly the lender, it is called indirect compensation. Such indirect compensation from lenders is ordinarily based upon an above market interest rate on the loan entered into by the broker with the borrower. This type of compensation is often referred to as a "yield spread premium," (YSP) though it sometimes shows up under a different label, e.g. servicing release premium.[11]

Although not entirely clear, based on HUD's definition, it appears that a YSP could be thought of as a potential "mark-up" over the lowest wholesale price available from a given lender for a specific loan.[12] For example, if a mortgage broker delivers a loan to a lender at an interest rate higher than the minimum necessary to obtain that loan, he receives a premium amount based upon the given amount of principal reflecting the difference in interest rates. The extent to which the premium is passed on to the mortgage originator might differ across lenders. Some lenders might pass part of the difference along (reserving part of the difference as compensation to the lender); others might pass along the full difference. Premiums received by mortgage brokers can, in turn, be passed through to borrowers.[13]

The extent to which YSPs are passed along to consumers might differ across lenders and might depend, in part, on whether consumers negotiate for the best deal and also upon the level of competition in the market.[14]

Under current HUD rules, mortgage brokers must report the existence of YSPs to consumers as "Paid Outside of Closing" (P.O.C.).[15] Lenders that do not meet HUD's definition of a "mortgage broker" are not currently required to report the presence of YSPs, even though such lenders might be making loans with above par interest rates and earning YSPs without crediting them to the borrower to reduce up-front costs.[16] The Notice explains that current regulations do not require lenders to disclose indirect fees, and lenders would continue to be exempt from YSP (or other indirect compensation) disclosures under HUD's proposed new rule.[17]

C. Potential Benefits and Costs of YSPs

A potential benefit of YSPs, as described in the HUD Notice, is that they enable borrowers to pay out less cash at closing in exchange for a higher interest rate, leading to higher monthly payments over the life of a mortgage.[18] This option can be particularly beneficial for consumers without substantial cash reserves, who wish to spread the high transaction cost of obtaining a mortgage loan over time. Borrowers who do not intend to hold the mortgage for a long time may also wish to invest less cash up front. In addition, some experts have noted that in refinancing transactions "closing costs are tax-deductible if paid in interest as a yield spread premium, but not if they are paid in cash at settlement. For these borrowers, the yield spread premium . . . can be advantageous because it makes their closing costs deductible."[19]

HUD notes some potential concerns that have been raised about YSPs: "Consumer advocates assert, however, that all too frequently brokers place borrowers in an above par rate loan without the borrower's knowledge, provide the borrower with little or no benefit in the form of reduced up front costs, and use the YSP payment solely or primarily as a means of increasing their total compensation."[20] In addition, according to HUD there is a concern that "many brokers are perceived by borrowers as shopping on their behalf for the best loan to meet the borrower's needs. This perception frequently deters borrowers from shopping for the loan originator and mortgage product that best meets their needs."[21]

D. HUD Proposal's Discussion of Concerns About YSPs

HUD recognizes the potential benefits of preserving YSPs, as well as concerns about the potential for consumer harm from loans that carry high interest rates without any countervailing consumer benefits. To retain the potential benefits of YSPs while addressing concerns raised by some consumer advocates, HUD proposes a fundamental change in the interpretation of YSPs. Under the proposed rule, YSPs would no longer be a payment from a lender to a broker for delivering a loan with a relatively high payment stream or other characteristics. Rather, YSPs would be a payment from the lender to the borrower. Specifically, YSPs would appear in the revised GFE as part of the "Lender Payment to Borrower for Higher Interest Rate," and function as a mortgage broker compensation disclosure.[22]

The FTC staff notes that the new term (Lender Payment to Borrower for Higher Interest Rate) is defined as "**including** payments based upon an above par interest rate,"[23] which suggests that other indirect compensation from a lender to mortgage broker may also be included. Further clarification of exactly what is included in this term would be helpful to assess the possible effects of this new disclosure. For example, if the term is interpreted to include other compensation unrelated to the choice of a relatively high interest rate, then the term could potentially misinform consumers about the trade-off between a higher interest rate and more cash up front.

In addition, the proposed GFE for all mortgage originators (lenders and mortgage brokers) would include the following explicit disclosure designed to encourage consumers to shop for mortgages:

> **We do not offer loans from all funding sources and we cannot guarantee the lowest price or best terms available in the market. <u>You should compare the prices in the boxes below and shop for the loan originator, mortgage product, and settlement services that best meet your financing needs</u>.**[24]

FTC staff believes that HUD should evaluate the mortgage broker compensation disclosure's effect in light of this additional shopping disclosure.

E. Possible Effects of Mortgage Broker Compensation Disclosure and Shopping Disclosures

An initial question regarding the effect of disclosing YSPs and other mortgage broker compensation is why it might be beneficial to disclose compensation in this industry. Seller compensation is rarely disclosed in other markets, leading to the question of what might make mortgage markets different.

YSPs seem quite similar to compensation received by intermediaries in other markets. Retailers, for example, typically sell merchandise at prices above wholesale cost – the higher the mark-up, the higher the retailer's return on each item. The mark-up over the wholesale cost includes payment for the store's rent, sales help, and other overhead. The size of the mark-up often varies across different retailers and at different times. Some consumers pay high prices at relatively high-priced stores; some consumers pay lower prices at relatively low-priced stores; and some consumers buy products at reduced (sale) prices. Relatively high-priced stores sometimes offer more convenient locations, more specialized sales assistance, more convenient hours or other valuable characteristics.

Although the mortgage market may appear to be unusual due to the obvious existence of price dispersion,[25] empirical studies indicate that price dispersion is common in retail markets (including markets where entry is relatively easy and economic profits are rare),[26] and that the extent to which consumers shop for low prices helps to explain why some consumers pay less than others, all else constant.[27] Given the description in HUD's Economic Analysis of a market characterized by easy entry and exit, and little economic profit,[28] it appears that such price dispersion is probably explained, in part, by imperfect information and a lack of consumer search.

Available empirical evidence indicates that consumers vary greatly in the extent to which they search for mortgages. Most consumers shop extensively, but a substantial minority of consumers contact only one mortgage source.[29] Surveys further indicate that some consumers may be confused by mortgage terms.[30] The FTC staff believes that a better understanding of how consumers use information on mortgage terms could lead to disclosures that are more helpful to consumers in shopping for a mortgage that suits them best.

The FTC staff recognizes, however, that the optimal amount of search for any individual consumer varies. Optimal search decisions will depend on how a consumer weighs the expected marginal costs of search (including the cost of understanding mortgage terms and the value of her time spent shopping) against the expected marginal benefits of search (including the present value of future savings from negotiating more favorable loan terms). A consumer with a high opportunity cost of time might search less, all else constant, than a consumer with a low opportunity cost of time.[31] Many other factors could explain differences in the marginal costs of shopping across consumers, such as differences in knowledge, prior experience, and financial literacy. Differences in the expected marginal benefits of shopping across consumers might be explained by differences in consumer awareness of the extent of price dispersion, in awareness of the present value of interest rate differences, and in perceptions of broker services. Given the unobservable nature of many search costs, it is difficult for analysts to determine whether consumers are engaging in an optimal amount of search. HUD's characterization of substantial competition on the supply side of the market also suggests that consumers who engage in information search should be able to find competitively priced loan products (assuming that originators do not engage in deceptive practices, such as misrepresenting the cost of a loan).[32]

The question of whether HUD's proposed disclosures will provide new useful information, reduce expected search costs, or increase the expected benefits of search turn on how consumers will interpret the proposed disclosures. The "shopping disclosure" is designed simply to let consumers know that they may be able to obtain more advantageous terms if they shop for mortgages. While the staff supports the principle behind the disclosure, only consumer research can reveal whether consumers will notice the information and how consumers will interpret it.[33] FTC staff understands that HUD is conducting extensive consumer research on the proposed disclosures and we believe that the results of this research are likely to be useful to HUD in evaluating the effectiveness of these disclosures. To the extent that HUD is concerned that consumers overestimate the amount of search that originators conduct on their behalf, such a disclosure might be helpful.

The effects of the mortgage broker compensation disclosure on a consumer's decision about which mortgage is best suited to his or her needs would appear to be harder to determine. Consumers typically are interested in the price and quality of a product or service, rather than the amount of profit a seller might receive. An inefficient firm constrained by competitive markets may have high costs and low compensation. Similarly, it is possible that more efficient firms can offer relatively low prices and earn relatively high compensation.[34] If consumers misinterpret lower seller compensation as being an indicator of less expensive mortgages then they may make different choices than they would make without this misunderstanding.

A key issue is whether a disclosure that focuses on loan originator compensation would confuse consumers and lead them to misinterpret the overall cost of a transaction. For example, one loan could have a relatively high broker compensation but a relatively low overall net origination fee. If consumers focus more attention on broker compensation than on the net origination fee, it is conceivable that they might come to an erroneous conclusion about the loan's overall costs. Such misunderstanding might occur even if all originators are required to disclose YSPs and other broker compensation. Therefore, consumer research on how the disclosure of compensation affects comparisons among loans would be desirable.

In the HUD proposal, compensation disclosures are required only for brokers but not other mortgage originators, which could be especially confusing to some consumers. HUD's Economic Analysis recognizes this possibility. The Economic Analysis describes how settlement costs might be disclosed in two transactions, and these are summarized in two tables.[35] The first table provides stylized excerpts from a GFE that might be presented from a lender. The second table provides stylized excerpts from a GFE that might be presented from a mortgage broker. In both transactions the net origination charge and total settlement costs are the same.

Table 1 [LENDER TRANSACTION]

SETTLEMENT COSTS

A. ORIGINATION FEES	$1000	
B. INTEREST RATE DEPENDENT PAYMENT	0	
NET LOAN ORIGINATION CHARGE		$1000
C-K (OTHER SETTLEMENT COSTS)	$4000	
TOTAL SETTLEMENT COSTS		$5000

Table 2 [MORTGAGE BROKER TRANSACTION]

SETTLEMENT COSTS

A. ORIGINATION FEES	$3000
B. INTEREST RATE DEPENDENT PAYMENT	-2,000

NET LOAN ORIGINATION CHARGE		$1000
C-K (OTHER SETTLEMENT COSTS)	$4000	
TOTAL SETTLEMENT COSTS		$5000

HUD's Economic Analysis states:

> A knowledgeable shopper would ignore [lines] A and B and go to the origination fees subtotal to see the originator segment of the cost of this loan, as shown by the "NET LOAN ORIGINATION CHARGE" in Tables 1 and 2. It would be the same for the lender and the broker, $1,000. In other words, putting the $1,000 NET near the top of [the] GFE means that shoppers will not be confused between lender and broker GFEs and their respective offers.[36]

HUD states that through these disclosures it wishes to facilitate price comparison (i.e., help consumers choose the least expensive loan). However, HUD's Economic Analysis notes that knowledgeable consumers seeking the best price would ignore the disclosure of the yield spread premium in lines A and B. It also acknowledges that if a lender directs a borrower's attention to the "Origination Fees," a borrower might be persuaded that a loan with higher "Net Loan Origination Charges" and higher "Total Settlement Costs" is less expensive than a broker's loan with lower such charges. HUD's Economic Analysis suggests that some borrowers might "make the error of focusing on the interest rate dependent payment" – instead of on other cost disclosures – and that some borrowers might favor big lender payments to borrowers.[37]

The FTC staff concurs with the Economic Analysis's concerns about consumer comprehension. If these disclosures are to facilitate price comparison, we believe it is important for HUD to study whether consumers will understand that the net cost to them would be the same in either the lender transaction or the mortgage broker transaction.[38] Of course, all disclosures about origination fees and other settlement costs should be presented in a manner that minimizes the possibility of consumer misinterpretation. Further research is therefore needed to assess the likely effect of the mortgage compensation disclosure on consumer understanding of the net costs of mortgage transactions and how such a disclosure can be crafted to minimize consumer confusion.[39]

F. Possible Effects on Competition of the Shopping Disclosure and the YSP Disclosure

Any effects of the new disclosures on competition will depend on: (1) the current state of competition, and (2) the effect of the disclosure on consumers' ability to determine which mortgages are most advantageous for them. An independent analysis of the state of competition in the home mortgage market is beyond the scope of this comment. However, HUD's Economic Analysis presents a fairly extensive description of the market, based on several recent studies.[40]

According to HUD's Economic Analysis, the supply side of the prime mortgage market is very competitive and efficient. Mortgage brokers, which were rare before 1980, are now reportedly responsible for generating as much as 65 percent of total originations. The Economic Analysis reports that Morgan Stanley finds "little evidence of economies of scale in mortgage origination and cites evidence that brokers are more efficient originators than mid-size lenders."[41] The Economic Analysis also reports that "[g]iven the commodity-like nature of mortgages and the price sensitivity of consumers, Morgan Stanley sees the cost savings from technology advances being quickly passed through to consumers, with little increase in lenders' profits."[42] The Economic Analysis further reports that "Olson sees brokers as low-cost, highly competitive firms, vigorously competing with one another and with little opportunity to earn above-normal profits."[43]

Overall, HUD's Economic Analysis indicates that mortgage originators have responded quickly to changes in technology, and that mortgage brokers have gained market share largely because they are relatively efficient in mortgage originations. Given this picture of the market, there is some question about the likely net benefits of a disclosure policy that might place greater costs on mortgage brokers than on other lenders. Absent consumer research, FTC staff cannot predict whether, or to what extent, asymmetric disclosures of yield spread premiums might lead to mistaken beliefs that mortgage broker loans are more expensive than lender loans. If brokers choose to change their operations to become lenders, and thereby lose some of their current efficiencies,[44] this might lead to higher loan costs to consumers, even for those consumers who diligently comparison shop.[45]

The proposed GFE would also require mortgage originators to state that they cannot necessarily offer the lowest price in the market. This disclosure would seem to prevent offers to "meet or beat any competitor's price." Such offers are common in retail markets, and provide a mechanism for signaling that a competitor offers low prices. To the extent that such claims can promote price competition and lower prices, it would not be in the public interest to adopt such prohibitions.

G. Recommendation on YSP and Other Mortgage Compensation Disclosures

The FTC staff supports HUD's goal to make mortgage shopping easier. Decreases in search costs or increases in the expected benefits of search could make the already competitive market even more so.

Information about the marginal costs and benefits of shopping can be helpful to consumers. The FTC staff is concerned, however, that prominent emphasis of the YSP and other compensation for mortgage brokers might inadvertently burden consumers and competition. If information on broker compensation were easy to provide in a way that would not mislead consumers, there would be little harm from the disclosure, other than the cost, and some potential benefit. For example, consumers might benefit if "non-shoppers" who are made aware of the actual broker compensation use this information to search for more competitive terms or to negotiate more aggressively with the mortgage broker. But the compensation disclosure might also distract consumers from the "Net Origination Charge"and thereby mislead them about the costs of the loan. If this happens, consumers might make their decisions based upon a less accurate rather than a more accurate understanding of the information. In addition, to the extent that HUD's Economic Analysis suggests that mortgage brokers represent a growing and relatively efficient sector of the mortgage origination market, the asymmetric disclosure of YSPs might inadvertently raise the costs of relatively efficient firms and lead to higher consumer prices.

The FTC staff also supports HUD's efforts to conduct consumer research on the proposed disclosures to estimate their likely effect on consumer comprehension. The FTC staff suggests that as HUD evaluates alternatives, it consider whether other disclosures convey information to consumers more effectively. For example, is the "shopping disclosure" alone sufficient to alert consumers to the benefits of additional information search? In addition, the FTC staff suggests considering whether further disclosures about the importance of focusing on the "Net Loan Origination Charges" might be helpful to consumers. For example, HUD may want to consider an explicit statement, such as "Compare net origination costs and interest rates across other originators to find the least expensive loan for you." If research shows that the YSP disclosures confuse consumers, HUD may wish to re-evaluate how the disclosure is presented. For example, a different location or different phrasing might improve consumer comprehension. Finally, if HUD concludes that prominent mortgage broker compensation disclosures aid consumer comprehension, HUD may wish to test whether providing consumers with additional information regarding compensation for other mortgage lenders increases consumer comprehension. Such information might also minimize possible negative competitive effects from only disclosing compensation from one sector of the mortgage origination market. For example, HUD might be able to design a disclosure explaining that other companies offering mortgages to consumers may receive compensation that is not specified in the cost information provided to consumers.

III. Settlement Service Packaging

HUD has proposed creating an alternative to the GFE: lenders and others may instead provide a Guaranteed Mortgage Package (GMP). Under the proposal, HUD would exercise its exemption authority under Sections 8(c)(5) and 19 of RESPA to establish a safe harbor from liability under Section 8 for GMP transactions that meet the requirements set forth in the proposed rule.[46] To qualify for the safe harbor, packagers must offer, within three days of the borrower's application, without charging an upfront fee:[47] (1) a guaranteed price for a package of the loan origination and virtually all other lender-required settlement services needed to close the loan, including all governmental charges; (2) a mortgage loan with an interest rate guarantee, as defined in the proposed rule; and (3) a Guaranteed Mortgage Package Agreement (GMPA), containing an offer to the borrower for package price applicable through settlement, subject to final underwriting, and as defined in the proposed rule.[48]

The FTC staff supports HUD's proposal to allow lenders or others to provide packages of mortgage loans and settlement services for a single price and provide a safe harbor for these packages from Section 8 of RESPA's prohibition on referral fees. Mortgage packages can simplify the shopping process and reduce borrowers' search costs. Lower search costs, as well as volume discounts and other arrangements between settlement service providers and loan originators, should lead to lower prices for settlement services and greater efficiency in the production of settlement services. Mortgage packages should also lower lenders' administrative costs by eliminating the need for a detailed accounting of the costs associated with each loan.

The safe harbor from the Section 8 prohibitions is important because concerns that volume discounts and other arrangements could be interpreted as violating Section 8 have deterred packaging. Packaging, rather than a ban on referral fees, is also a better solution to the potential problem of loan originators accepting kickbacks from overpriced settlement service providers. Because loan originators that offer mortgage packages will pay directly for the settlement services, they will have the proper incentives to find the lowest-cost providers.

A. The Current Situation

Currently, shopping for a mortgage can be a complicated process. The mortgage and settlement service options for consumers are diverse, and, in response to demand, new alternatives become available relatively often. The mortgage and settlement service field can also involve complex terminology, with which some consumers may not be familiar. Consumers do not purchase or refinance homes with the regularity that they may purchase other products and therefore they may deal with these issues infrequently. In addition, the loan and origination costs in mortgage transactions can involve various types of charges, with the loan price consisting of an interest rate, possibly points, and possibly a number of contingency prices, such as adjustable interest rates and prepayment penalties. Loan originators may charge different types of fees, such as those for underwriting, document preparation, and document review, which also do not have standardized (let alone simple) terminology. Borrowers must also purchase various settlement services, such as appraisal, title search, and title insurance, to obtain a mortgage.

It can, therefore, be time consuming and costly for borrowers to search for all features of a mortgage transaction, including all aspects of the loan and settlement services. Some borrowers may do so; others may choose to rely on referrals, for example, from their loan originator for many settlement services. Originators, however, may not always have strong incentives to refer borrowers to low-cost settlement providers.[49] Savvy borrowers may ask for information about settlement service costs when contacting potential originators and may consider these costs when they select a lender, but other borrowers may not. In addition, settlement services are likely not the primary products for which borrowers search. Rather, borrowers may devote more search time to a loan, which itself may be a secondary consideration if the borrower is also searching for a home to purchase.

Settlement service providers can, of course, also compete to attract consumers. But, to the extent that some borrowers rely on referrals from lenders and those referrals do not depend mainly on price, inefficient producers of services may survive if they are able to attract referrals through other means. As a result, borrowers may not necessarily obtain low-cost services, and the current situation may not be fully efficient.[50]

B. Benefits of Packaging

Packaging should lead to lower prices in the market for settlement services, increase efficiency, and simplify the process for borrowers. Instead of competing for referrals from originators, settlement service providers would compete directly for the business of the originators, who would purchase the services. The benefits of any non-price factors would be properly valued, as the originator and not the borrower would pay any higher prices associated with them. Moreover, packages might have lower costs because lenders could develop longstanding business relationships with settlement service providers and may be able to achieve efficiencies from conducting a steady volume of business, which would be passed on to borrowers.

Packages would also reduce borrowers' search costs when shopping for mortgages. Instead of considering many different aspects of the cost of a mortgage, and possibly engaging in multiple searches for the various necessary settlement services, borrowers would have to consider only the up-front cost and the loan terms. In addition to eliminating any need to search for individual settlement services, mortgage packages would reduce the complexity of the originators' charges. The current system of complete itemization has led to a proliferation of fees (e.g., fees for document preparation, document review, document processing, underwriting, and couriers). As a result, sophisticated borrowers must ask originators to list all of their fees, and persistently ask whether there are other fees when searching for a loan. Less sophisticated borrowers may be unaware of these fees when searching and only learn about them when they receive a GFE. This may be too late if they receive a GFE only after deciding on a lender. The fact that the GFE is an estimate leaves open the possibility that additional fees will be assessed at closing. Even without the "guaranteed" feature of packaging, changes to a single number will be more apparent to borrowers, and therefore should be less likely.

For those borrowers who currently search for the various settlement services, packaging would provide a lower-cost search option. For borrowers who currently rely on lenders' referrals to locate settlement service providers, packaging would ensure that lenders' incentives when choosing providers are aligned with the interests of the borrowers.

As discussed in HUD's Economic Analysis, packaging should also benefit loan originators. Full itemization is not only complicated for borrowers, it is costly to originators. Originators must track the specific costs associated with each loan, and make sure those costs are properly accounted for on that loan's documentation. Removing this requirement would simplify originators' bookkeeping and reduce their costs.[51]

C. Exclusion of HOEPA Loans

Under HUD's proposal, high-cost loans covered by the HOEPA will not qualify for the guaranteed package safe harbor.[52] This exception may not be in the best interests of consumers. A package of settlement services, rather than individual components with separate charges, has the potential to decrease settlement costs to consumers and enhance competition. Because this approach can offer cost advantages, as discussed above, it would seem especially advantageous for consumers obtaining high-cost mortgages to be able to benefit from packaging of settlement services.

HUD's proposal states generally that HUD is concerned about providing a safe harbor for a loan that has a very high rate and/or fees and may be predatory.[53] Based on our enforcement work in the subprime market,[54] the FTC staff does not believe that loans with packaged settlement services would be any more likely to be abusive than loans without packaged settlement services. Our experience suggests that clear disclosures backed up by aggressive enforcement is one of the most effective means of consumer protection. Indeed, we believe that some of the problem practices in the high-cost loan market take advantage of the current complexity of mortgage transactions and the difficulty consumers face in this market when shopping for a loan. Thus, the FTC staff believes that HOEPA loans should qualify for the guaranteed package safe harbor. This approach would enable HOEPA consumers to benefit from cost savings that may result from packages of settlement services. This will be particularly important given the expected increase in the number of covered HOEPA loans under the recent revisions to the regulations implementing HOEPA.[55]

IV. The Revised Forms

HUD proposes significant revisions to the GFE and also proposes a new form to be used in connection with packaged settlement services, the GMPA. The proposed GFE discloses certain key loan terms, consolidates major categories on the current GFE, and helps to identify the services for which consumers may shop on their own.[56] The FTC staff supports efforts to simplify the GFE and improve the forms provided to consumers.

A. Improving Comprehension of the Forms

Consumer comprehension of RESPA forms that disclose settlement costs and mortgage terms is important: consumer mortgage choices affect what is, or will become, a very significant asset, the home. In order to increase consumer comprehension, the GFE and the GMPA should focus upon key information and provide that material clearly, conspicuously, and in as simple a manner as possible, so that consumers will notice and understand the information.[57] Many factors, including the size and location of the disclosures, the simplicity or complexity of the language and the syntax, as well as the presence of other potentially distracting information or confusing formats, can affect whether the information is clear and conspicuous.[58]

The FTC staff notes that HUD plans to revise the GFE and GMPA and test the revised forms with consumers. The FTC staff believes this testing will provide valuable input to help craft the final versions of the GFE and the GMPA forms.

In view of the changes envisioned by the revised rules, as well as the existence of a diverse consumer mortgage market, the FTC staff encourages HUD to support the revised forms with a comprehensive consumer education program targeted to consumers of all income and education levels. The education program could include brochures for prospective borrowers and print, broadcast, and electronic advertisements, as well as a public relations campaign.[59] Further, business education is also critical, in light of the major changes that HUD has proposed. The mortgage origination business is very diffuse and includes thousands of mortgage brokers and settlement service providers of varying expertise who will have to develop, and learn how to use, significantly revised forms. The FTC staff encourages HUD, therefore, to engage in significant business education to ensure that all originators and other entities understand and are able to abide by the new regulations that are implemented.

B. The New Forms and the HUD-1

1. Crosswalk with the GFE

As HUD recognizes, it is important, both before and at the loan closing, that the consumer is able to compare the charges listed on the GFE to the charges listed on the HUD-1 Settlement Statement ("HUD-1").[60] HUD has solicited comment on how the new forms are best compared by consumers to the HUD-1 and what revisions, if any, to the HUD-1 would be most helpful. In this regard, the FTC staff agrees consumers should be able to compare (crosswalk) the GFE to the HUD-1 to ensure that the lender (and others) have charged only the fees that were disclosed on the GFE and/or have not increased the fees.

The HUD-1 form has been used in its present form for several decades by various real estate and mortgage industry participants. In addition, the form is apparently also used in connection with, and serves to facilitate compliance with, HOEPA and the TILA.[61] As a result, the FTC staff recommends that HUD consider retaining the current HUD-1 substantially in its present format but enhance coordination between the GFE and HUD-1. For example, one possibility might be to require that lenders provide subtotals of fees on the HUD-1 that correspond to subtotals of these amounts now listed on the proposed GFE. Another possibility might be to include additional references on the GFE to the numerical designations of charges that appear on the HUD-1. The FTC staff notes that HUD will be addressing this issue in the consumer testing process and believes that HUD should carefully consider those results when making a final decision on this issue.

2. GMP Transactions

HUD's proposal sets forth criteria for GMPs that would provide consumers with a lump-sum price for settlement costs and an interest rate guarantee.[62] HUD proposes that for mortgages using a GMP, the HUD-1 would list the settlement services provided but would not list the charges for specific services.[63] The FTC staff believes that this part of the proposal may raise some issues for consumers and that lenders may need to calculate charges for specific services for compliance purposes under HOEPA and the TILA. For example, the costs of certain settlement services are used in determining whether a loan is, in fact, a high-cost loan covered by HOEPA.[64] Thus, under the proposed regulations, an originator could assert that a particular loan was not covered by HOEPA and provide the borrower with a package of settlement services (and provide no itemization of charges on the HUD-1). Based on the proposal, consumers and regulators may have no immediately available information to determine whether the loan was, in fact, covered by HOEPA because a complete fee itemization would not be available.[65] In addition, the itemized charges are also utilized in connection with other aspects of TILA compliance.[66]

HUD may also wish to consider whether it would be helpful to consumers to itemize any of the specific charges included in the package price, for example, if any of these items are tax deductible. Such itemization also may aid consumers in negotiating the package price. Consumer research on this point may be worthwhile.

At the same time, the FTC staff recognizes that there may be circumstances where, in packaged mortgages, the specific amounts for each settlement service on a per transaction basis are not precisely known by lenders or service providers.[67] Even if the originator or service provider cannot state an exact price for each service in the package, it may be able to estimate – within reasonable boundaries – those amounts.[68] This approach could minimize the burden to lenders and settlement providers in GMPA transactions but also still provide specific information regarding individualized costs for consumers and state and federal regulatory agencies and facilitate lender compliance with other consumer credit requirements. The FTC staff suggests that HUD consider requiring lenders to estimate, within certain boundaries, the settlement charges relevant to HOEPA and TILA determinations.

C. Information on the Revised Forms

HUD's proposal requires that lenders disclose certain key loan terms (e.g., interest rate, annual percentage rate (APR), and monthly payment) in Section II of the GFE.[69] The FTC staff believes that including key loan terms on the GFE will help consumers understand important elements of their mortgage loans, and the FTC staff supports the change. In general, HUD appears to have selected very significant loan terms for inclusion on its RESPA forms. However, in a few instances, the proposal appears to have omitted, or failed to provide sufficient explanation regarding, the items.

For example, it appears that the proposed form only allows lenders to disclose the loan terms of fixed-rate, fixed-payment mortgages (such as a traditional 30-year loan) and certain types of adjustable-rate mortgages.[70] The FTC staff believes that HUD should revise the disclosure so that lenders are able to disclose clearly the loan terms for all types of mortgages, such as graduated payment mortgages or a balloon payment mortgage. In addition, HUD's proposed forms split the description of loan terms into two sections, one on each page of the GFE.[71] The FTC staff believes that consumer comprehension would be improved if the loan terms were placed together in one section of the form so that consumers could review all of the key loan terms together.

Moreover, it would also be beneficial to consumers and lenders if the revised RESPA forms were otherwise consistent with disclosures required under the TILA. For example, under the TILA, upfront mortgage insurance premiums and future mortgage insurance premiums must be included in calculating the APR,[72] while it appears that only upfront mortgage insurance premiums are to be included in APR disclosure utilized by HUD on its revised forms.[73] This issue can affect the figures disclosed on the proposed GFE as well as quotation of the total costs in the GMPA. Clarification is important, therefore, for both purposes.

D. Definition of Application

HUD's proposal seeks to ensure that the GFE is provided to consumers early enough to give them the necessary information to shop for mortgage loans and compare offers from various lenders.[74] To advance that goal, HUD proposes the following definition of "application":

> Application means the submission of credit information (Social Security number, property address, basic income information, the borrower's information on the house price or a best estimate on the value of the property, and the mortgage loan needed) by a borrower in anticipation of a credit decision, whether oral, written or electronic, relating to a federally related mortgage loan. If the submission does not state or identify a specific property, the submission is an application for a pre-qualification and not an application for a federally related mortgage loan under this part. The subsequent addition of an identified property to the submission converts the submission to an application for a federally related mortgage loan.[75]

This definition is designed to move forward in time the point at which an application occurs, so that consumers will begin to receive their disclosures earlier as well.[76]

However, the proposed definition appears to depend on the borrower's frame of mind ("by a borrower in anticipation of a credit decision"), and then includes a list of certain items of information, which may be subject to varying interpretations by consumers and lenders. Indeed, the description of the proposed rule in the Notice defines "application" in a slightly different way. It states that an "application" exists when:

> a prospective borrower provides a loan originator **sufficient** information (typically a social security number . . .) . . . to enable the loan originator to make a preliminary credit decision . . . [77]

The FTC staff believes that the definition of "application" should be clarified in the final rule. As indicated above, the proposed rule establishes various important deadlines that depend on the date of application, including the thirty-day deadline when a GFE must be provided or during which a GMPA must be honored by a lender.[78] Certainty about when those time frames commence is, therefore, important for both lenders and consumers.

V. Enhancing Reliability of Settlement Costs

A. Final Underwriting and GFEs and GMPAs

HUD's Notice states that estimates appearing on GFEs often are significantly lower than the amount ultimately charged at settlement, are not made in good faith, and do not provide meaningful guidance on the costs borrowers ultimately will face at settlement.[79] HUD proposes to make the GFE firmer and more usable to facilitate shopping by borrowers and to avoid unexpected charges to borrowers at settlement.[80] The FTC staff supports HUD's goal of making settlement cost disclosures firmer so that borrowers do not face surprise costs at settlement.

However, under the proposed regulations, the costs disclosed on the GFE and the GMPA are only valid if the borrower qualifies for the mortgage after final underwriting.[81] Thus, originators may be able to change the loan terms at the last minute, even under the new proposal.[82] To address this issue, HUD should clarify in the final rule itself – as well as the explanatory material in the Notice – the types of criteria encompassed by "final underwriting," such as income verification and asset verification, and limit the meaning of the term to those types of items. This may help to prevent lenders from using non-legitimate factors to support an assertion that the consumer did not qualify for the mortgage loan terms offered in the GFE or GMPA.

Moreover, under HUD's proposal, lenders offering a package of settlement services would be required to provide to consumers the proposed GMPA form.[83] The FTC staff notes that generally, the word "guarantee" means "an assurance for the fulfillment of a condition."[84] The concept implies that the terms offered to consumers will not change. Thus, it may be problematic to use the term "guaranteed" to describe a loan offer that is not assured because the loan is subject to final underwriting. Final underwriting may, of course, occur early or late in the loan process. This point in time might depend on numerous variables including the particular lender or broker, the type of loan, secondary market involvement, and other issues. In some situations, it might occur close to settlement itself. Therefore, the FTC staff suggests considering an alternate name for the form, for example, "Complete Mortgage Package" or simply "Mortgage Package Offer" to help prevent consumer confusion.[85]

B. "Unforeseeable and Extraordinary Circumstances"

The proposed rule also states that certain charges reported on the GFE shall not vary from the time the GFE is given to the borrower and may not be exceeded at settlement absent "unforeseeable and extraordinary circumstances."[86] The FTC staff believes that the proposed definition of "unforeseeable and extraordinary circumstances," which allows lenders to vary the loan costs at closing if the previously disclosed terms are "impractical to perform," is quite broad. The FTC staff suggests that HUD provide additional guidance concerning the "unforeseeable and extraordinary circumstances" standard in the Final Rule to facilitate both compliance and enforcement, such as through providing examples of such events.[87]

Moreover, HUD states that if the cost at settlement exceeds the amount reported on the GFE for the charges subject to "zero tolerance," absent unforeseeable and extraordinary circumstances, the borrower may withdraw the application and receive a full refund of all loan-related fees.[88] This provision will likely help borrowers who are refinancing mortgage loans on homes that they already own, but a borrower purchasing a home may lose his or her deposit on the property (or suffer worse consequences, such as possible legal action) if he or she fails to close on the date specified in the real estate contract because of a problem with the settlement costs on the loan. Therefore, the FTC staff believes that HUD should consider additional mechanisms to enforce this part of the proposed rule.

VI. Conclusion

The FTC staff supports HUD's goals of simplifying the mortgage process for consumers and enhancing competition. The FTC staff appreciates your consideration of these views. If any other information would be useful regarding these matters, please contact Andrew Smith, Assistant to the Director, Bureau of Consumer Protection at (202) 326-3238.

Respectfully submitted,

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1. 12 U.S.C. § 2601 *et seq*. RESPA governs settlement services for "federally related mortgage loans" – the vast majority of residential purchase money, refinance, and home equity mortgage transactions.

2. The FTC Act is found at 15 U.S.C. § 45(a). The TILA is found at 15 U.S.C. § 1601 *et seq.*, and the primary provisions of the HOEPA are found at 15 U.S.C. § 1639.

3. A list of the FTC's recent cases in the subprime mortgage lending area is available at http://www.ftc.gov/opa/2002/07/subprimelendingcases.htm.

4. *See, e.g.,* Letter from Charles James, Assistant Attorney Gen., U.S. Dep't. of Justice, and Timothy J. Muris, Chairman, Federal Trade Comm'n, *et al.* to E. Fitzgerald Parnell III, President, North Carolina State Bar (July 11, 2002), at http://www.ftc.gov/be/advofile.htm; Letter from Charles James, Assistant Attorney Gen., U. S. Dep't. of Justice, and Timothy J. Muris, Chairman, Federal Trade Comm'n, *et al.* to The Honorable John B. Harwood, Speaker of the House of Representatives, *et. al* (Mar. 29, 2002), at http://www.ftc.gov/be/advofile.htm; Letter from Charles James, Assistant Attorney Gen., U.S. Dep't. of Justice, and Timothy J. Muris, Chairman, Federal Trade Comm'n, *et al.* to Ethics Comm., North Carolina State Bar (Dec. 14, 2001), at http://www.ftc.gov/be/advofile.htm; Letter from Donald S. Clark, Secretary, Federal Trade Comm'n, to Jennifer J. Johnson, Secretary, Board of Governors of the Federal Reserve System (Mar. 9, 2001) at http://www.ftc.gov/be/advofile.htm; Prepared Statement of the Federal Trade Comm'n before the California State Assembly Comm. on Banking and Finance on Predatory Lending Practices in the Home-Equity Lending Market (Feb. 21, 2001), at http://www.ftc.gov/be/advofile.htm; Prepared Statement of the Federal Trade Comm'n before the Board of Governors of the Federal Reserve System on Predatory Lending Practices in the Home-Equity Lending Market (Sept. 7, 2000), at http://www.ftc.gov/be/advofile.htm.

5. Real Estate Settlement Procedures Act (RESPA); Simplifying and Improving the Process of Obtaining Mortgages to Reduce Settlement Costs to Consumers, 67 Fed. Reg. 49,134 (proposed July 29, 2002) (to be codified at 24 C.F.R. pt. 3500).

6. This comment focuses on major points within the HUD proposal. It does not seek to address every item incorporated in the proposal.

7. The GFE provides an estimate of the amount, or range, of charges for settlement services the borrower is likely to incur at settlement. Under Regulation X, which implements RESPA, lenders must provide the GFE to consumers not later than three days after the loan application is received or prepared. 12 U.S.C. § 2604(c); 12 C.F.R. § 3500.7(a).

8. 67 Fed. Reg. at 49, 135 (footnote omitted). The proposal was formulated, in part, to embrace the principle of ensuring "that honest industry providers have a level, competitive playing field" and the principle that "[r]egulatory amendments should be utilized to remove unintended barriers to marketing new products, competition, and technological innovations that could lower settlement costs." *Id.* at 49,135.

9. *See* OFFICE OF POLICY DEV. AND RESEARCH, U.S. DEP'T OF HOUSING AND URBAN DEV., ECONOMIC ANALYSIS AND INITIAL REGULATORY FLEXIBILITY ANALYSIS FOR RESPA PROPOSED RULE TO SIMPLIFY AND IMPROVE THE PROCESS OF OBTAINING MORTGAGES TO REDUCE SETTLEMENT COSTS TO CONSUMERS 11-13 (2002) (hereinafter "ECONOMIC ANALYSIS") at 10-13.

10. A complete review of the literature on yield spread premiums is beyond the scope of this comment. Rather, the FTC staff examines YSPs and YSP disclosures from an economic and consumer behavior perspective, based on information about YSPs and the mortgage market described in HUD's proposal and its economic analysis. *See* 67 Fed. Reg. at 49,140-43; Economic Analysis, *supra* note 9, at 15-18.

11. 67 Fed. Reg. at 49,141. YSPs have also been described as follows:

> A number of factors influence the setting of yield spread premiums, but the most significant is the rate of interest on the borrower's loan. In the mortgage industry, a "par loan" is a loan that a lending institution funds at 100 cents on the dollar. An "above par" loan is one that bears a somewhat higher interest rate for which lending institutions are willing to pay more than 100 cents on the dollar, for example 102 cents. *See* HOWELL E. JACKSON & JEREMY BERRY, KICKBACKS OR COMPENSATION: THE CASE OF YIELD SPREAD PREMIUMS 3 *(*2002), at http://www.law.harvard.edu/faculty/hjackson/.

12. Of course, the YSP may not be the only "mark-up" on a mortgage transaction. Consumers may also pay additional fees.

13. Lenders might also pay mortgage originators a fee for bringing them business, which may not be tied to an "above par" interest rate.

14. The Economic Analysis notes that no academic studies examine the extent to which YSPs are passed through to consumers. ECONOMIC ANALYSIS, *supra* note 9, at 17. However, expert witnesses have prepared differing estimates of the extent to which YSPs were passed through to consumers based on an analysis of loans in connection with federal litigation, and results of these analyses have been presented in Congressional testimony. An expert for the plaintiffs, Howell J. Jackson, has estimated that only 25% is passed on to consumers, while Susan Woodward, an expert for the defendants, estimates that, after correcting for limitations of Jackson's analysis, 84% of the YSPs were passed through to borrowers. *See Predatory Mortgage Lending Practices: Abusive Uses of Yield Spread Premiums: Hearing Before the Senate Committee on Banking, Housing and Urban Affairs*, 107th Cong. 5 (2002) (hereinafter *Hearing*) (statement of Susan E. Woodward, Ph.D., Chairman of Sand Hill Econometrics, Inc. (on file with the FTC)). Woodward served as Deputy Assistant Secretary (Chief Economist) of HUD from 1987 to 1992 and as Chief Economist, U.S. Securities and Exchange Commission from 1992 through 1995. The Economic Analysis notes that "Woodward finds that 74 percent of the yield spread premium offsets borrowers' closing costs" in a

more sophisticated analysis, and that this result is consistent with that of another expert witness. *See* ECONOMIC ANALYSIS, *supra* note 9, at 18.

15. 67 Fed. Reg. at 49,141. This disclosure is required on both the current GFE and HUD-1 Forms. *See, e.g.,* Sample HUD-1 Settlement Statement (Attachment A). HUD's Federal Register Notice (Notice) indicates that this disclosure is required of mortgage brokers who "originate and table fund loans or act as intermediaries." 67 Fed. Reg. at 49,141.

16. As noted by HUD:

> The functional equivalent of a yield spread premium may also be present in loans originated by lenders. Lenders routinely offer loans with low or no up front costs required at settlement. They can do so just like brokers do by charging higher interest rates for these loans and then recouping the costs by selling the loans into the secondary market for a premium representing the difference between the interest rate on the loan and the par, or wholesale market rate. Alternatively, the lender can hold the loan and earn the above market return in exchange for any lender paid settlement costs. *Id.*

17. *Id.*

18. *Id.*

19. *See Hearing, supra* note 14 at 5 (statement of Susan E. Woodward, Ph.D., Chairman of Sand Hill Econometrics, Inc.).

20. 67 Fed. Reg. at 49,141. The Notice does not cite systematic research that estimates the extent of such potential problems.

21. *Id.*

22. *See id.* at 49,164 and Sample Proposed GFE (Attachment B).

23. 67 Fed. Reg. at 49,135 (emphasis added).

24. *Id.* at 49,164.

25. Jack Guttentag, Professor of Finance Emeritus at the Wharton School of the University of Pennsylvania, provides some examples of savings from mortgage shopping, based on his experience with price dispersion in the mortgage market. JACK GUTTENTAG, DOES IT PAY TO SHOP FOR A MORTGAGE? (1998), at http://www.mtgprofessor.com/tableofcontents.htm. Although the evidence is not from an extensive random survey, it provides some sense of the degree of price dispersion.

26. Economic profits are generally revenues minus opportunity costs. *See* DENNIS CARLTON & JEFFREY PERLOFF, MODERN INDUSTRIAL ORGANIZATION 239 (3d ed. 2000).

27. *See id*. at 441 for a review of the theoretical and empirical studies that examine how imperfect consumer information can affect equilibrium prices. They find that "where only a relatively small number of customers are informed, there may be a two-price monopolistically competitive equilibrium. The low-price stores charge a price equal to marginal cost (the full-information, competitive price), and the high-price stores charge their profit-maximizing price. Both types of stores make zero profits in equilibrium because of entry." Carlton and Perloff also discuss empirical studies that found substantial price dispersion for retail goods. *Id*. at 437, citing Andre Gabor, *Price and Consumer Protection,* ECONOMICS OF CONSUMER PROTECTION 42-54 (David Morris, ed., 1980); E. Scott Maynes & Terje Assum, *Informationally Imperfect Consumer Markets: Empirical Findings and Policy Implications,* 16 JOURNAL OF CONSUMER AFFAIRS 62-87 (1982); and John W. Pratt *et al.*, *Price Differences in Almost Competitive Markets,* 93 QUARTERLY JOURNAL OF ECONOMICS 189, 198-211 (1979).

Several recent empirical studies provide further support for the importance of search costs and the existence of significant price dispersion in consumer goods and services markets. *See* Jeffrey R. Brown & Austan Goolsbee, *Does the Internet Make Markets More Competitive? Evidence from the Life Insurance Industry,* 110 JOURNAL OF POLITICAL ECONOMY 481-501 (2002); Karen Clay et al., *Prices and Price Dispersion on the Web: Evidence from the Online Book Industry,* XLIX JOURNAL OF INDUSTRIAL ECONOMICS 521-539 (2001); and Alan T. Sorensen, *Equilibrium Price Dispersion in Retail Markets for Prescription Drugs*, 108 JOURNAL OF POLITICAL ECONOMY 833-850 (2000). In addition, experimental research on markets – including the Vernon L. Smith work that received the 2002 Nobel prize in economics – demonstrates that price dispersion is pervasive in very competitive markets. The result of these experiments is that 1) the (approximate) competitive equilibrium quantity is exchanged, 2) the average of the transaction prices is (approximately) the competitive equilibrium price, and 3) there is persistent price dispersion. *See* Jon Ketcham et al., *A Comparison of Posted-Offer and Double Auction Pricing Institutions,* PAPERS IN EXPERIMENTAL ECONOMICS 295-314 (Cambridge Univ. Press 1991); Vernon L. Smith, *Competitive Market Institutions: Double Auctions vs. Sealed Bid-Offer Auctions,* PAPERS IN EXPERIMENTAL ECONOMICS 201-20 (Cambridge Univ. Press 1991); and Vernon L. Smith, *An Experimental Comparison of Alternative Rules for Competitive Market Exchange,* PAPERS IN EXPERIMENTAL ECONOMICS 172-99 (Cambridge Univ. Press 1991).

28. ECONOMIC ANALYSIS, *supra* note 9, at 12-13.

29. Survey research conducted in recent years suggests that consumers differ substantially in the extent to which they search for mortgages. *See* Jeanne Hogarth & Jinkook Lee, *Consumer Information for Home Mortgages: Who, What, How Much, and What Else?* 9 FINANCIAL SERVICES REVIEW 277 (2000). Hogarth and Lee report the results of telephone survey questions added to the University of Michigan's "Surveys of Consumers" in 1997 at the request of the Federal Reserve Board. One thousand and one consumers were interviewed by telephone, and 219 of these applied for or refinanced a home mortgage loan during the previous 5 years (the sample does not include people who clearly applied only for a home equity loan). Hogarth and Lee report that about 14% of refinancers

contacted only one lender and that about 23% of other mortgage borrowers contacted only one lender. Other consumers engaged in more extensive search; "[t]he mean and median number of lenders compared were 4 and 3, respectively for all mortgage borrowers." Duncan reports on the "Channel Demographics" telephone survey conducted in January and February of 1999. *See* Doug Duncan, *How do Borrowers Shop?* 60 MORTGAGE BANKING 38 (1999). The survey covered consumers who obtained loans in October, November, or December of 1998. Borrowers in the survey obtained a home-purchase loan (not a refinance loan) in the fourth quarter of 1998. The survey was sponsored by the Mortgage Bankers Association of America and several member companies. One thousand borrowers were sampled yielding 965 usable responses. Duncan reports that "[m]ore than 50 percent of borrowers reported having shopped three or more lenders for information before getting their mortgage. Less than 30 percent shopped only one lender and only 14 percent contacted only one lender throughout the entire process, from information gathering through mortgage acquisition." *Id.*

30. Lee and Hogarth review the literature on consumer understanding of the credit market and credit terms. They conclude that "[t]here is a general consensus that consumers' lack of understanding is a problem in credit markets." In their research, based on questions included in the 1997 University of Michigan's "Surveys of Consumers" in 1997, Lee and Hogarth found that 40% of respondents did not understand the relationship between the contract interest rate and the APR. *See* Jinkook Lee & Jeanne Hogarth, *The Price of Money: Consumers' Understanding of APRs and Contract Interest Rates,* 18 JOURNAL OF PUBLIC POLICY & MARKETING, SPECIAL ISSUE ON PRICING AND PUBLIC POLICY 66 (1999). Fannie Mae reports that 59% of adults in the U.S. reported in 2001 "that they felt comfortable with the terms used in buying or selling a home." "[O]verall 68 percent of all homeowners and 75 percent of recent purchasers said they were confident they received the lowest-cost mortgage possible." Fannie Mae's survey was conducted by Peter D. Hart Research and Coldwater Corp. The sample included 1,001 randomly selected adults, with an over-sample of 303 credit-impaired borrowers. Fannie Mae National Housing Survey, 2001.

31. *See* George Stigler, *The Economics of Information,* 69 JOURNAL OF POLITICAL ECONOMY 213-225 (1961).

32. The Commission's enforcement actions in the past few years show the existence of such deceptive practices in some areas of the consumer mortgage market. *See, e.g, FTC v. Associates First Capital Corp., Associates Corp. of North America, Citigroup Inc., and Citifinancial Credit Co.,* Docket No. 1:01-CV-606 (Northern District of Georgia).

33. *See* Janis Pappalardo, *The Role of Consumer Research in Evaluating Deception,* 35 ANTITRUST LAW JOURNAL 793-812 (1997).

34. A lender with lower costs (hence larger price-cost margins) than its rivals can induce an agent to recommend its loans. Such lenders could use part of their higher margin to pay an agent a larger bonus or commission, and remit some or all of the remaining margin to the borrower in the form of more attractive credit terms. *See* STAFF OF BUREAU OF ECONOMICS, FEDERAL TRADE COMMISSION,

STATEMENT ON U.S. DEP'T OF HOUSING AND URBAN DEV. PROPOSALS TO RELAX THE INTERPRETATION OF SECTION 8 WITH RESPECT TO HOME MORTGAGES, Docket No. R-88-125622 (1988).

35. ECONOMIC ANALYSIS, *supra* note 9, at 31-33.

36. *See id.* at 31.

37. *See id.* at 32.

38. However, FTC staff also notes that disclosure of information beyond net cost might be valuable to individual consumers. For example, further revelation of mortgage originator compensation might induce consumers to negotiate more aggressively for a reduction in fees or to seek out a different type of originator. If an originator is charging prices above a competitive level, then there may be a transfer from the originator to the consumer.

39. The FTC has provided guidance on what constitutes a clear and prominent disclosure, focusing on specific elements such as clarity of language, relative type size, and an absence of contrary claims, inconsistent statements, or other distracting elements that could undercut the disclosure. Deception Policy Statement, appended to *Cliffdale Assocs., Inc.*, 103 F.T.C. 110, 180 (1984), *Figgie Int'l, Inc.*, 107 F.T.C. 313, 401 (1986), *aff'd*, 817 F.2d 102 (4th Cir. 1987).

40. HUD's analysis is based substantially on Michael G. Jacobides, *Mortgage Banking Unbundling: Structure, Automation, and Profit,* MORTGAGE BANKING 28-40 (2001); KENNETH A. POSNER & MITA NAMBIAR, U.S. MORTGAGE FINANCE: THE AMERICAN DREAM INDUSTRY, 2002-2020 (2002); and *Hearing*, *supra* note 14 (statement of David Olson, President, David Olson Research), at http://banking.senate.gov/02_01hrg/010802/index.htm. *See* ECONOMIC ANALYSIS, *supra* note 9, at 9.

41. ECONOMIC ANALYSIS, *supra* note 9, at 11.

42. *Id.*

43. *Id.* at 12. Olson is managing director of an economic research firm, and has studied the mortgage industry for over 30 years.

44. *Id.* at 11-13.

45. The Economic Analysis describes the subprime market, which is comprised mainly of refinance loans. HUD notes that during 2001, mortgage brokers accounted for 41% of subprime originations, retail lenders accounted for 39% of originations, and correspondent lenders accounted for 20%. *See* ECONOMIC ANALYSIS, *supra* note 9, at 14. These figures suggest that mortgage brokers do not account for an unusually high proportion of subprime lending. The analysis also notes that "there exists

some inefficiency in the subprime market, which places a premium on consumers shopping to obtain useful information regarding mortgage options and prices." *Id.* (citing Howard Lax, et al., Subprime Lending: An Investigation of Economic Efficiency (Feb. 25, 2000) (unpublished manuscript, on file with the FTC)). By "inefficiency," the analysis seems to mean that some consumers pay higher rates than would be expected based on their credit scores. The Economic Analysis also cites another study, however, which suggests that apparently creditworthy (potentially prime) consumers who do little shopping can also pay relatively high interest rates. *See id.* at 69 (citing DARRYL E. GETTER, ARE REJECTED HOUSEHOLDS CREDIT-CONSTRAINED OR SIMPLY LESS CREDITWORTHY (2002), at http://www.huduser.org/publications/hsgfin/workpapr.html). Thus, it appears that the role of consumer search in explaining price dispersion might be similar in both markets. The FTC staff recognizes, however, that consumers in the subprime market may find comparison shopping relatively difficult because the price of a loan is tied to a consumer's credit risk, and risk may vary more in the subprime market than in the prime market. To the extent that different institutions predict credit risks in different ways, and lenders do not as readily post their rates for customers with different risk characteristics, comparison shopping may be more difficult to undertake, making it potentially harder for consumers to identify "good deals." Because it is unclear whether the disclosures proposed by HUD would affect subprime borrowers in ways different than prime borrowers, HUD may want to undertake consumer research on this issue.

46. *See* 67 Fed. Reg. at 49,152.

47. The ban on the up-front fee is a significant difference between the GMP and the GFE. Requiring lenders to provide GMPs without permitting them to charge a fee for this item may discourage use of these packages. It may also discourage lenders from engaging in any but the most limited information collection and processing before providing a package offer to consumers, increasing the likelihood that the terms offered borrowers will not survive final underwriting, thereby limiting their utility to borrowers as a shopping tool. This is especially problematic for borrowers who are unsure of their ability to qualify for the particular loan offered.

48. *See* 67 Fed. Reg. at 49,152.

49. Concern that lenders were taking advantage of this situation by referring borrowers to high-cost service providers in exchange for kickbacks led to the current ban on referral fees in RESPA. *See id.* at 49,138.

50. If originators were able to steer borrowers to over-priced settlement service providers, and providers competed on the basis of the referral fees paid to originators, efficient providers would be able to pay higher referral fees for a given price. This would put competitive pressure on service providers and drive inefficient providers out of the market. High prices to consumers would result not from inefficient production of services, but rather because originators were extracting economic rents from uninformed borrowers. Packaging is a preferable solution to the potential problem of originators steering borrowers to over-priced settlement service providers because it removes the incentive to refer

borrowers to high cost providers without reducing competition in the settlement services market.

51. However, for various federal compliance purposes – including for HOEPA and the TILA – lenders may still incur these costs. Therefore, as discussed in this comment, it may under some circumstances be appropriate to use estimated costs in mortgage packages.

52. 67 Fed. Reg. at 49,161. HOEPA amended the Truth in Lending Act, to provide special protections for consumers who obtain certain high-rate or high-fee loans secured by their home (sometimes referred to as "high-cost loans"). As of October 2002, a loan qualifies as a high-rate or high-fee loan under HOEPA if: 1) the annual percentage rate exceeds the yield on comparable Treasury securities by more than 8 percentage points for first-lien loans, or by more than 10 percentage points for subordinate-lien loans; or 2) the total points and fees payable by the consumer at or before loan closing will exceed the greater of 8 percent of the total loan amount, or [for 2002] $480. 12 C.F.R. § 226.32(a); 66 Fed. Reg. 65,604, 65,617 (Dec. 20, 2001). The dollar amount applicable to the points and fees prong of the test above is revised annually by the Federal Reserve Board. *See, e.g.*, 66 Fed. Reg. 57,849 (Nov. 19, 2001).

53. 67 Fed. Reg. at 49,156. However, the proposed rule offers no argument that loans with packaged settlement services would be any more likely to be abusive than loans without packaged settlement services.

54. *See* note 3, *supra*.

55. *See* 66 Fed. Reg. at 65,617 (amending Regulation Z to broaden the definition of HOEPA-covered loans).

56. 67 Fed. Reg. at 49,149.

57. *See* FEDERAL TRADE COMM'N, GETTING NOTICED: EFFECTIVE FINANCIAL PRIVACY NOTICES (2002), at http://www.ftc.gov/privacy/glbact/index.html.

58. For example, consumer forms are better understood if they avoid fine print, technical terms, footnotes, and legal citations. *See id; see also, e.g., Bantam Books, Inc. v. FTC*, 275 F.2d 680, 682-83 (2nd Cir. 1960) (upholding Commission finding that a disclosure printed at the bottom of the page and made smaller than the other material on the page was not clear and conspicuous). Furthermore, the forms should have clear formatting and should avoid footnotes, wherever possible.

59. While pursuing fraud and deception cases are mainstays of the FTC's consumer protection mission, consumer education is also a vital line of defense for consumers. Typically, with each major consumer protection enforcement initiative, the FTC launches a comprehensive and creative education campaign.

60. Under RESPA and Regulation X, the HUD-1 is a standard form used in federally-related mortgage loan transactions that provides an itemized list of settlement costs. It must be provided to the borrower, seller (if there is one), and lender and/or their agent(s) not later than settlement. *See* 24 C.F.R. § 3500.8, 3500.10.

61. The current HUD-1 form itemizes each type and amount of settlement charge imposed. Certain of these charges also constitute components of the "finance charge," as defined by the TILA (12 C.F.R. § 226.4), and others constitute components of the "points and fees" test, as defined by HOEPA (12 C.F.R. § 226.32(b)(1)). As a result, consumers and administrative enforcers of the TILA and HOEPA currently utilize the HUD-1's itemized list of charges to assess compliance with these statutes. In addition, under certain circumstances, lender provision of information on the HUD-1 form, in its current format, can be used to establish compliance with certain disclosures that otherwise must be provided separately to the consumer as specific disclosures under the TILA. *See, e.g.,* the requirement to disclose the "amount financed" and permission for use of information disclosed under the HUD forms in lieu thereof. 12 C.F.R. § 226.18(c) and 12 C.F.R. § 226.18(c) of the Federal Reserve Board's Official Staff Commentary to Regulation Z. Elimination of this information from the HUD-1 could, therefore, inadvertently impact lenders' compliance with the TILA.

62. 67 Fed. Reg. at 49,160-61. Lenders, as well as other entities, could qualify as packagers, as long as their packages include a mortgage and otherwise satisfy the requirements of the safe harbor. *Id.* at 49,152.

63. *Id.* at 49,161.

64. As noted above, the current HUD-1 form itemizes each type and amount of settlement charge imposed. Certain of these charges constitute components of the "points and fees" test, as defined by HOEPA, while others do not. *See* 12 C.F.R. § 226.32(b)(1).

65. Under HUD's proposal, high-cost loans covered by HOEPA will not qualify for the guaranteed package safe harbor. 67 Fed. Reg. at 49,161. It may be possible that a lender and settlement service providers would ultimately have certain information within their organizations; however, obtaining this material would involve, at a minimum, additional search costs for consumers and regulators.

66. In certain mortgage transactions, lenders may rely on RESPA itemized disclosures of settlement costs in lieu of providing certain TILA disclosures, including the itemization of the amount financed. *See, e.g.*, 12 C.F.R. § 226.18(c)(1).

67. Lenders and settlement service providers may negotiate discounts or prices for pools or groups of mortgages as a whole that may not involve specific dollar amounts per transactions. *See, e.g.*, 67 Fed. Reg. at 49,154.

68. Under this approach, lenders using the GFE approach (rather than the GMP) would still provide a specifically-itemized HUD-1.

69. 67 Fed. Reg. at 49,159.

70. Section II of the proposed GFE provides space for the initial monthly payment and initial interest rate. *Id.* at 49,164. Section V of the proposed GFE provides space to disclose interest rate changes resulting from an adjustable rate mortgage. *Id.* at 49,165.

71. *See id.* at 49,164-65. The same issue arises on the GMPA. *See id.* at 49,168-69.

72. *See* 12 C.F.R. § 226.4(b)(5); 12 C.F.R. § 226.22.

73. 67 Fed. Reg. at 49,161.

74. *Id.* at 49,149.

75. *Id.* at 49,158. The current definition of application is "the submission of a borrower's financial information in anticipation of a credit decision, whether written or computer-generated, relating to a federally related mortgage loan. If the submission does not state or identify a specific property, the submission is an application for a pre-qualification and not an application for a federally related mortgage loan under this part. The subsequent addition of an identified property to the submission converts the submission to an application for a federally related mortgage loan." 24 C.F.R. § 3500.2(b).

76. For example, the GFE must be provided not later than three days after lender receipt of the application. 24 C.F.R. § 3500.7(a).

77. *See* 67 Fed. Reg. at 49,149 (emphasis added).

78. *See id.*

79. *Id.* at 49,150.

80. *Id.* at 49,148.

81. *Id.* at 49,150-51.

82. In the Federal Register notice, the description of the proposed rule states that if, after full underwriting, a loan originator determines that the prospective borrower does not qualify for the loan product identified in a previously provided GFE, and the loan originator offers other products meeting the borrower's circumstances, the loan originator must inform the borrower, and the borrower may request a new GFE. *Id.* at 49,151. The FTC staff believes that HUD should consider adding this language or another explicit redisclosure requirement to the text of the rule.

83. 67 Fed. Reg. at 49,160-61. *See* Sample GMPA (Attachment C).

84. MERRIAM-WEBSTER'S COLLEGIATE DICTIONARY 515 (10TH ed. 2001). Indeed, use of the term "agreement" may similarly be problematic, if the terms themselves are not set until some future point.

85. HUD should also consider clarifying whether the APR is guaranteed if the originator provides a guaranteed interest rate. Because certain costs that may affect the APR are not included in the GMPA (such as the total amount for mortgage insurance), it does not appear that the APR is guaranteed simply because the interest rate and the price of the settlement services package are guaranteed.

86. 67 Fed. Reg. at 49,159.

87. In addition, HUD uses the term "zero tolerance" to describe certain charges that, under the proposed regulatory scheme, will not vary at closing, and the term "no tolerance" to describe certain charges that are not regulated at all under the proposal. The FTC staff believes that the terms "zero tolerance" and "no tolerance" may be confusing to many consumers, as the terms sound similar but in fact have opposite meanings. HUD should consider using alternative terms to describe these concepts.

88. 67 Fed. Reg. at 49,159.