Improving Mortgage Disclosures

Consumer Testing of Current and Improved Disclosure Forms

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The views presented here are those of the authors and do not necessarily represent the views of the Federal Trade Commission or any individual Commissioner.
Motivation

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

- Despite these concerns, there had been little empirical evidence on consumer understanding of:
  - Current disclosures
  - Mortgage terms
  - Terms of their own loans
- Virtually no evidence on whether better 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 recent 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
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 recent mortgage

- Misunderstandings were present among:
  - Both prime and subprime respondents
  - Both those who had done extensive comparison shopping and those who had not done any
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 current 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 current forms
Consumer testing methodology

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

TILA statement
Current forms

**GFE**

Note: Includes information beyond the regulatory requirements
Prototype disclosure form

- Developed by FTC staff for the study
- Used to test whether it is possible to improve 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
## Summary of key loan terms

### 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**:
  - Total settlement charges: $10,020.00
  - Charges for optional products and services: $8,202.69
  - Total up-front charges: $18,222.79
- **Monthly-Billed Charges**: None
- **Annual Percentage Rate (APR)**: 7.99% 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**

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Loan Amount</td>
<td>$123,427.80</td>
</tr>
<tr>
<td>Refinance current mortgage loan</td>
<td>$10,000.00</td>
</tr>
<tr>
<td>Cash paid to borrower</td>
<td>$3,283.71</td>
</tr>
<tr>
<td>Consolidation of borrower's other debts</td>
<td>$10,020.06</td>
</tr>
<tr>
<td>Financed settlement charges</td>
<td>$8,202.69</td>
</tr>
<tr>
<td>Total Loan Amount</td>
<td>$154,934.26</td>
</tr>
</tbody>
</table>

**OPTIONAL CHARGES DETAILS**

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Optional Products and Services Charges</td>
<td>$4,367.90</td>
</tr>
<tr>
<td>Credit life insurance</td>
<td>$2,165.01</td>
</tr>
<tr>
<td>Credit accident and health insurance</td>
<td>$1,673.78</td>
</tr>
<tr>
<td>Involuntary unemployment insurance</td>
<td>$8,202.69</td>
</tr>
<tr>
<td>Total Optional Product and Services Charges</td>
<td>$8,202.69</td>
</tr>
</tbody>
</table>

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**

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash Due at Closing</td>
<td>$0.00</td>
</tr>
</tbody>
</table>

**MONTHLY PAYMENT DETAILS**

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Monthly Payment</td>
<td>$1,054.82</td>
</tr>
<tr>
<td>Principal and interest</td>
<td>$1,054.82</td>
</tr>
<tr>
<td>Private mortgage insurance (PMI) (not required)</td>
<td>$0.00</td>
</tr>
<tr>
<td>Monthly-billed optional products or services</td>
<td>$0.00</td>
</tr>
<tr>
<td>Total initial monthly payment</td>
<td>$1,054.82</td>
</tr>
</tbody>
</table>

**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:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Property taxes ($2,550.80 per year)</td>
<td>$212.55</td>
</tr>
<tr>
<td>Hazard insurance ($1,291.56 per year)</td>
<td>$107.63</td>
</tr>
<tr>
<td>Total additional monthly costs ($3,842.16 per year)</td>
<td>$320.18</td>
</tr>
</tbody>
</table>


## Prototype form

### Page 3

**Details of settlement charges; consumer tips and warnings**

<table>
<thead>
<tr>
<th>Settlement Services Package</th>
<th>$9,214.45</th>
<th>This package includes the following services:</th>
</tr>
</thead>
<tbody>
<tr>
<td>Origination and lender services</td>
<td>Title services</td>
<td></td>
</tr>
<tr>
<td>Loan origination</td>
<td>Settlement agent</td>
<td></td>
</tr>
<tr>
<td>Appraisal</td>
<td>Title search and examination</td>
<td></td>
</tr>
<tr>
<td>Credit report</td>
<td>Title document preparation</td>
<td></td>
</tr>
<tr>
<td>Lender's property survey</td>
<td>Lender's title insurance</td>
<td></td>
</tr>
<tr>
<td>Lender's property inspection</td>
<td>Attorney services</td>
<td></td>
</tr>
<tr>
<td>Pest inspection</td>
<td>Notary fee</td>
<td></td>
</tr>
<tr>
<td>Government taxes and fees</td>
<td>County recording fee</td>
<td></td>
</tr>
<tr>
<td>State and local tax stamps</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

**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 $ 32.88 per day for 17 days (if your closing date is 11/13/04).

**Prepaid Items**

- **$ 31.20** Property taxes
- **$ 34.98** 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 11/13/04).

**Reserves Deposited with the Lender**

- **$ 1,024.41** Property taxes (2 months at $ 51.22 per month)
- **$ 76.12** Homeowner’s insurance (2 months at $ 38.06 per month)

**Total Settlement Charges**

- **$10,020.06**

### 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.
Testing procedure

- Respondents given disclosure forms for two hypothetical loans
  - Half given current forms, half given prototype forms
- Instructed to examine the forms as they would if they were shopping for a mortgage
- Asked series of 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

<table>
<thead>
<tr>
<th>Disclosure Form</th>
<th>Current</th>
<th>Prototype</th>
<th>Difference</th>
</tr>
</thead>
<tbody>
<tr>
<td>Both Loans</td>
<td>61%</td>
<td>80%</td>
<td>19 pct points**</td>
</tr>
<tr>
<td>Simple Loan</td>
<td>66%</td>
<td>82%</td>
<td>16 pct points**</td>
</tr>
<tr>
<td>Complex Loan</td>
<td>56%</td>
<td>78%</td>
<td>22 pct points**</td>
</tr>
</tbody>
</table>

**Statistically significant at the one percent level**
### Percentage of respondents with high accuracy rates

<table>
<thead>
<tr>
<th>Percentage Of Questions Answered Correctly</th>
<th>Disclosure Form</th>
<th>Difference</th>
</tr>
</thead>
<tbody>
<tr>
<td>70% or more</td>
<td>Current: 30%</td>
<td>Prototype: 80%</td>
</tr>
</tbody>
</table>

** Statistically significant at the one percent level
## Prime and subprime borrowers

### Percentage of questions answered correctly

<table>
<thead>
<tr>
<th>Borrower Type</th>
<th>Prime</th>
<th>Subprime</th>
<th>Difference</th>
</tr>
</thead>
<tbody>
<tr>
<td>Both Loans</td>
<td>71.5%</td>
<td>69.0%</td>
<td>-2.5 pct points *</td>
</tr>
<tr>
<td>Simple Loan</td>
<td>74.8%</td>
<td>72.9%</td>
<td>-2.0 pct points</td>
</tr>
<tr>
<td>Complex Loan</td>
<td>68.3%</td>
<td>65.0%</td>
<td>-3.2 pct points</td>
</tr>
</tbody>
</table>

* Statistically significant at the five percent level
Current forms fail to convey key loan costs

Pct. of respondents not correctly identifying loan cost

- 87%  Total up-front charges
- 74%  Charges for optional credit insurance
- 68%  Presence of prepayment penalty
- 51%  Loan amount
- 33%  Presence of financed settlement charges
- 32%  Interest rate
- 30%  Balloon payment
Current forms fail to convey key loan costs

Pct. of respondents not correctly identifying loan cost

- 23% Settlement charges
- 21% Monthly payment (including whether it included taxes and insurance)
- 20% Cash due at closing
- 20% APR
Improvements provided by the prototype form

Percentage point improvement over current forms

- 66 Total up-front charges
- 43 Charges for optional credit insurance
- 37 Loan amount
- 24 Presence of prepayment penalty
- 16 APR
- 15 Settlement charges
- 12 Interest rate
- 9 Presence of financed settlement charges
Findings - current disclosures

- Current disclosures fail to convey the key costs and terms of a mortgage to many borrowers in both the prime and subprime markets
- Current disclosures also create misunderstandings of some key loan terms
Findings - improved disclosures

- It is possible to create new disclosures that significantly improve consumer recognition of the costs and terms of a mortgage.
- Improved disclosures can provide significant benefits to both prime and subprime borrowers.
Impact of ineffective current disclosures

- The ineffectiveness of currently-required 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 marketed over the last few years
Impact of ineffective current disclosures

- We do not mean to imply that all consumers misunderstood their loans, or that ineffective disclosures are the primary cause of the current 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 made the current problems worse.
Impact of ineffective current disclosures

- Some of the loan terms currently of concern 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
Need for new disclosures

- 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

- Simply adding more disclosures to the often-confusing current disclosures is not likely to be effective
Developing new disclosures

- Good intentions are not enough
- Disclosures that make sense to well-intentioned bureaucrats often bewilder consumers
- Marketers routinely test new advertising messages, but policymakers often fail to take similar precautions
Developing new disclosures

- Designing disclosures is tricky
- More information is not always better
- Simply adding more disclosures may not help at all
- Disclosures must be carefully crafted to ensure they will work as intended

Consumer testing is essential

- New mortgage disclosures should not be implemented unless consumer testing demonstrates that they are better than those currently required, and that they truly inform, rather than confuse, borrowers.

- A rush to mandate hastily-drafted new disclosures risks substituting one set of ineffective disclosures for another.
Improving Consumer Mortgage Disclosures: An Empirical Assessment of Current and Prototype Disclosure Forms, FTC Bureau of Economics Staff Report (June 2007)

Available online: http://www.ftc.gov/opa/2007/06/mortgage.shtm