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)
 - Real Estate Settlement Procedures Act GFE (1974)
- Also long history of concern over the effectiveness of the disclosures
- FTC experience in deceptive lending cases has shown that 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

Understanding of recent mortgage

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

Understanding of 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

Understanding of current disclosures

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

Understanding of 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

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FEDERAL TRUTH-IN LENDING DISCLOSURE STATEMENT

Current forms

GFE

Note: Includes information beyond the regulatory requirements

| Applicant(s): J Property Address: 1 In informatic the informatic that the informatic t | n provided below reflects ext. the actual charges may be misted beside the estimates givin be receiving at settlement. BLE IN CONNECTION WITH LC on Fee (| DAN: 1,900.00) S 1,900.00) S 150.00 S 5 5 5 5 5 | 1100 1101 1102 1103 1104 1105 | Base Loan Amount: Total Loan Amount: Total Loan Amount: Type of Loan: Fixed Ri Date Prepared: Rate: I you are likely to incur at the settlement and the control of the cont | \$1 ate Interest-Onle % Term: nt of your loan, ed, 1 or HUD-1A : uual cost for iter \$ \$ \$ | 10/14/05 |
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| 805 Lender's Insp 806 Mortgage Ins 807 Assumption F 808 Mortgage Bro 809 CLO Access 810 Tax Related S Administration | urance Application Fee lee ker Fee Fee | \$ \$ \$ | 1105 | Title Insurance Binder | | |
| 806 Mortgage Ins 807 Assumption F 808 Mortgage Bro 809 CLO Access 810 Tax Related S Administrativ Doc Prep Fer | urance Application Fee lee ker Fee Fee | \$ | | Document Preparation Fee | \$ \$ | 125.00 |
| 807 Assumption F 808 Mortgage Bro 809 CLO Access 810 Tax Related S Administrativ Doc Prep Fee | ee ker Fee Fee | \$ | 11100 | Notary Fee | S | 40.00 |
| 808 Mortgage Bro 809 CLO Access 810 Tax Related S Administration | ker Fee Fee | | | Attorney Fees | s | 70.00 |
| 809 CLO Access 810 Tax Related S Administration Doc Prep Fee | Fee | \$ | | Title Insurance | S | 675.00 |
| Administration Doc Prep Fee | | \$ | | Title Binder | \$ | 50.00 |
| Doc Prep Fee | | \$ 50.00 | | | \$ | |
| | | \$ 625.00 | | | S | |
| | | \$ 150.00 \$ 75.00 | | | \$ | |
| Courier | | \$ 75.00 | 1200 | GOVERNMENT RECORDING & TRANSF | FER CHARGES: | I |
| | | \$ | - | Recording Fees: | \$ | 50.00 |
| | | A CONTRACTOR | | City/County Tax/Stamps: | \$ | 100.00 |
| 900 ITEMS REQU | RED BY LENDER TO BE PAID | IN ADVANCE: | | State Tax/Stamps: | s | 250.00 |
| 901 Interest for | 8 day @\$ 34.4914 per da | sy \$ 275.93 | 10000 | County Tax | \$ | 275.00 |
| 902 Mortgage Ins | urance Premium | \$ | | | \$ | |
| 903 Hazard Insura | nce Premium | \$ 720.00 | | | \$ \$ | |
| | | \$ | | | | |
| | | \$ | | ADDITIONAL SETTLEMENT CHARGES: | s | 175.00 |
| OOD PESERVES D | EPOSITED WITH LENDER: | | | Survey Pest Inspection | \$ | 175.00 |
| 001 Haz Ins Prem | | 0 5 120.00 | 1302 | Flood Certification | s | 40.00 |
| 1004 Tax & Assmt | | | | | \$ | |
| THE STREET | | S | | | \$ | |
| | | \$ | | | \$ | |
| | | \$ | TOTA | L ESTIMATED SETTLEMENT CHARGES | \$ | 7,658.43 |
| | costs to be paid by Lender. | 7 | 11 | | | |
| | FUNDS NEEDED TO CLOSE: | | TOTA | L ESTIMATED MONTHLY PAYMENT: | J | 1.049.11 |
| Downpayment | | \$ | | Principal & Interest | \$ | 145.83 |
| Est. Closing C | | \$ | 1000000 | Real Estate Taxes | s | 60.00 |
| Est. Prepaid It | ems/Reserves | S | | Flood & Hazard Insurance Mortgage Insurance | 2 | 00.00 |
| - Annual Contraction | UNDS NEEDED TO CLOSE | \$ 0.00 | | mongage inscrance | \$ | |
| TOTAL EST. T | ONDS NEEDED TO GEOSE | | | TOTAL MONTHLY PAYMENT | \$ | 1,254.95 |
| | E COMPLETED BY LENDER O imate is based on charges of t | | R PROV | VIDER OF SERVICE IS REQUIRED. Use of | f the particular p | provider is |
| | AME & ADDRESS OF PROVID | | | TELEPHONE NO. NAT | URE OF RELAT | IONSHIP |
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| | | | | | | |
| hese estimates are | provided pursuant to the Rea | l Estate Settlement Pr | ocedur | es Act of 1974, as amended (RESPA). A | Additional inform | nation can |
| | D Special Information Booklet, real property and the Lender | , which is to be provi | ided to on the | you by your mortgage broker or lender property. The undersigned acknowledg | r, if your applications receipt of the | ation is to ne booklet |
| e found in the HU- jurchase residential | and the Consumer Handbook | on ARM Mortgages, if | applic | able. | | |
| ourchase residential | | | | olicant | | Date |
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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 interestonly and balloon payments
- Could be extended to incorporate key features of adjustable-rate loans (ARMs)

Prototype format

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

Prototype form

Page 1

Summary of key loan terms

Mortgage Loan Offer

ACME Mortgage Company 123 Main Street

Fairfax, Virginia 20151

(703) 555-2767

Borrower:

James Jones Property Location: 345 North Street, Fairfax, Virginia, 20151 [example of complex refinance loan] [draft form]

Page 1 of 3

Offer Date: May 21, 2004

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

YOUR LOAN

Loan Type Summary 10 year fixed-rate balloon loan

Loan Amount \$ 154 934 26

Loan Term 10 years (120 monthly payments)

OUR LOAN CHARGES

Interest Rate 7.23% Fixed rate

Up-Front Charges \$ 10.020.06 Total settlement charges

7.98%

\$ 8,202,69 Charges for optional products and services

\$ 18,222,75 Total up-front charges

None Monthly-Billed Charges

Annual Percentage Rate

(APR)

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

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

ACME Mortgage Company

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.

Page 2 of 3

LOAN AMOUNT DETAILS

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

\$ 154,934.26 Total Loan Amount

OPTIONAL CHARGES DETAILS

CASH DUE AT CLOSING DETAILS

Cash Due at Closing \$ 0.00

MONTHLY PAYMENT DETAILS

| Monthly Payment | Itemization of initial monthly payment | | | | | | |
|---------------------|--|---------------------------|---|--|--|--|--|
| | \$ | 1,054.82 | Principal and interest | | | | |
| | \$ | 0.00 | Private mortgage insurance (PMI) (not required) | | | | |
| | \$ | 0.00 | Monthly-billed optional products or services | | | | |
| | \$ | 1,054.82 | Total initial monthly payment | | | | |
| | | | | | | | |
| Taxes and Insurance | loa | n payment. | and hazard insurance are NOT included in your monthly You will be responsible for paying these additional yourself. These additional monthly costs will be: | | | | |
| Taxes and Insurance | loa req | n payment. | You will be responsible for paying these additional yourself. These additional monthly costs will be: | | | | |
| Taxes and Insurance | loa | n payment. uired costs | You will be responsible for paying these additional | | | | |

Prototype form

Page 3

Details of settlement charges; consumer tips and warnings

ACME Mortgage Company Page 3 of 3

SETTLEMENT CHARGES DETAILS

| This page lists the settlemer settlement services you nee | | | charges shown on page 1. ALL of the | | | | |
|--|---|---|---|--|--|--|--|
| Settlement Services Package | \$9,214.45 This package includes the following services: | | | | | | |
| , dunago | Loan origina Appraisal Credit repor Lender's pro | t operty survey operty inspection | Title services Settlement agent Title search and examination Title document preparation Lender's title insurance Attorney services Notary fee | | | | |
| - | Governmen County reco | t taxes and fees ording fee | State and local tax stamps | | | | |
| Daily Interest Charges | \$ 558.90 | day of your settleme | te daily interest charges from the ent until the end of the month. For this \$_32.88 per day for _17 days (if your 3 /04). | | | | |
| Prepaid Items | \$ 31.20 \$ 34.98 | Property taxes Homeowner's insura | ance | | | | |
| | | | er property taxes and insurance settlement until the end of the month is 11/13/04). | | | | |
| Reserves Deposited with the Lender | \$ 102.41 \$ 78.12 | | months at \$ 51.22 per month) ance (2 months at \$ 39.06 per month) | | | | |
| Total Settlement Charges | \$10,020.06 | Total Settlement Ch | harges | | | | |

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

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

^{**} Statistically significant at the one percent level

Percentage of respondents with high accuracy rates

Percentage Of Questions Answered Correctly

70% or more

<u>Disclosure Form</u>

Current Prototype

80% 51 pct points **

Difference

** Statistically significant at the one percent level

30%

Prime and subprime borrowers

Percentage of questions answered correctly

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

^{*} Statistically significant at the five percent level

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
- See The Effect of Mortgage Broker Compensation Disclosures on Consumers and Competition, FTC, 2004.

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

Report

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