Consumer Protection Regulation:
Moving Beyond the Economics of Information to the Economics of Consumer Comprehension

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

Introduction
Silver lining in financial crisis

• Focus on Consumer Protection
• Golden Opportunity
• Responsibility
What can I contribute?

• Over two decades of experience studying consumer protection regulations as an economist at the Federal Trade Commission

• Then again, this may not be helpful . . .
They pretend to know.

Yet they don't know.

Correct.

And they get paid for this?

Paid well, too.

Man, I wanna be an economist!!!!
Where to begin?

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

--Harry Nilsson
The Point!
Three points

- Consumer protection policy is often tricky because people are unique.
- Consumer protection policy is unlikely to be effective without a joint mandate to promote competition.
- Information remedies are generally preferred to product restrictions, iff information policy focuses on consumer comprehension.
II. Economics of Consumer Protection Background
Economics of consumer protection

• Key point of economics and consumer protection: competition in a free market will usually bring greatest benefits to consumers.

• Economics helps identify those areas where intervention may be useful.
Indeed competition and consumer law should be seen as one subject, not two.

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

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

- Competition between sellers
  - price competition lowers prices to consumers
  - quality competition leads to products consumers desire

- Competition means consumers can go elsewhere if they are not happy with a particular seller. This imposes discipline on sellers’ behavior.

An important consumer protection mission for government is ensuring a competitive marketplace.
Competition and Information

• Power of competition to benefit consumers depends on honest information.

• Competition can lead to more honest information getting to consumers – competitors have incentives to point out others’ lies.

• Government policies should encourage provision of honest information.
Competition is great, but it is not perfect . . .
Asymmetric information can lead to market failures

• Sellers with good products may not be able to convince buyers of good quality.

• Sellers may try to convince buyers that products are better than they really are.
  • Fraud: lying about a worthless product.
  • Deceptive claims: exaggerating quality of product, “stretching truth” about legitimate product.

Government has a role in stopping fraud and deceptive claims.
Things to consider when deciding whether to take action

• Exactly what is the problem?
  • Efficiency issue
  • Equity issue

• Will problem persist if government doesn’t take action?

• Is some governmental failure contributing to the problem?

• How much consumer injury is there?

• Is there a viable remedy?
Consumer Policy Remedies

- Inform Consumers
- Educate Consumers
- Nudge Consumers
- Restrict Product Characteristics
Relevant academic literatures

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

• Some cases are easy
  – Outright fraud provides no benefit to society, so resources permitting, action is warranted, no concern about over-deterrence

• Some cases are hard, and require substantial analysis using all available data, and the collection of new data
  – Advertising substantiation
  – Labeling Rules (appliance labeling)
Differences among people complicates analysis

• Model of Constrained Utility Maximization recognizes
  – Differences in consumer tastes
  – Differences in consumer income constraints
  – Different reactions to time constraints
• People are unique!
"I want to read something directly targeted at me."

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

Figure I:
The Information Dissemination Process

DISCOVERY \rightarrow\text{PROFESSIONAL JOURNALS} \rightarrow\text{POPULAR PRESS} \rightarrow \ldots \rightarrow \text{CONSENSUS ORGANIZATIONS}
Science finds Corn Oil important to health
—because it is rich in "L-plus" factor

Of all leading U.S. Brands
only Mazola* is Pure Corn Oil

It has been demonstrated repeatedly that Mazola Corn Oil lowers the cholesterol level of the blood stream—considered important in both the prevention and treatment of heart disease.

Mazola is unsaturated, not hydrogenated. Many nutritionists now suggest that from one-third to one-half of the fat we eat should be unsaturated vegetable oil—rich in "L-plus" factor. Mazola gives you these important health benefits because it is so rich in the "L-plus" factor.

Mazola makes so many dishes so delicious! Whether you are frying chicken, seafood or making your own salad dressings, Mazola is so good—and so good for you!

The "L-plus" factor

The desirable effect of corn oil is decreasing the amount of cholesterol in the blood has been demonstrated repeatedly.

Doctors believe that the natural unsaturation present in corn oil bring about this desirable effect. They call the combination of these substances (including "L-plus") the "L-plus" factor. Mazola Corn Oil has a very high "L-plus" factor content.

Since the body cannot make the complete "L-plus" factor, it should be provided regularly in daily meals.

Mazola Makes

EFFECT SALAD DRESSINGS
- French
- Thousand Island
- Italian

GOLDEN FRENCH DRESSING
2 tablespoons prepared mustard
1 teaspoon white vinegar
1 tablespoon salad oil
8 tablespoons water

MELODY DRESSING
1 cup sugar
1 teaspoon white vinegar
1 cup Mazola Corn Oil
Science finds Corn Oil important to health

-because it is rich in “L-plus” factor

Of all leading U.S. Brands only Mazola® is Pure Corn Oil

It has been demonstrated repeatedly that Mazola Corn Oil lowers the cholesterol level of the blood stream—considered important in both the prevention and treatment of heart disease.

Mazola is unsaturated, not hydrogenated. Many nutritionists now suggest that from one-third to one-half of the fat we eat should be unsaturated vegetable oil—rich in “L-plus” factor. Mazola gives you these important health benefits because it is so rich in the “L-plus” factor.

Mazola makes so many dishes so delicious! Whether you are frying chicken, seafood or making your own salad dressings, Mazola is so good—and so good for you!
Mazola Corn Oil

is best for cutting down saturated fats in your diet!

*Modern science proves corn oil best of all leading oils for cutting down saturated fats in the diet, and of all leading brands, only Mazola is corn oil!

That's why today's modern families use Mazola for delicate, delicious home-made salad dressings... for tender, juicier frying too.

Remember: Not all "vegetable oils" are corn oil! So always look at the label before you buy. If it doesn't say corn oil, it's not Mazola—the oil that's best for cutting down saturated fats in the diet!
Graph I:

ADS WITH ANY "HEART DISEASE" CLAIM IN PROFESSIONAL vs. POPULAR MAGAZINES
[1950 THROUGH 1989]

% OF ADS IN TIME PERIOD FOR EACH TYPE OF PERIODICAL

TIME - DATA ARE GROUPED IN 5 YEAR PERIODS

● PROFESSIONAL ▲ POPULAR
Graph II:

ADS WITH ANY "CHOLESTEROL" CLAIM IN PROFESSIONAL vs. POPULAR MAGAZINES
[1950 THROUGH 1989]

% OF ADS IN TIME PERIOD FOR EACH TYPE OF PERIODICAL

TIME - DATA ARE GROUPED IN 5 YEAR PERIODS

● PROFESSIONAL ▲ POPULAR
Graph III:

ADS WITH ANY "Saturated Fat" Claim
In Professional vs. Popular Magazines
[1950 Through 1989]

Time - Data are grouped in 5 year periods

% of Ads in Time Period for Each Type of Periodical

- Professional
- Popular
Graph IV:
ADS WITH ANY "POLYUNSATURATED FAT" CLAIM IN PROFESSIONAL vs. POPULAR MAGAZINES
[1950 THROUGH 1989]

% OF ADS IN TIME PERIOD FOR EACH TYPE OF PERIODICAL

TIME - DATA ARE GROUPED IN 5 YEAR PERIODS

- PROFESSIONAL - POPULAR
Financial products

- Particularly difficult to judge choices
- Where is customer in life/earning cycle?
- How much is person willing to sacrifice to buy house in good school district?
- What are expectations about future income?
- So many unobservable factors affect choice
Uniqueness complicates consumer policy analysis

• Even with perfect information, consumers make different choices
• Ask if consumer had full information about product quality, would she buy a product?
  – Exploding Toaster (not good for anyone)
  – Mortgage with pre-payment penalty or adjustable rate (good for some)
Lessons from FTC conference

• “Consumer Information and the Mortgage Market: Economic Assessment of Information Regulation, Mortgage Choice, and Mortgage Outcomes”

• Held on May 29, 2008

• Brought together experts on housing economics, mortgage markets, economics of information, and consumer behavior to exchange knowledge and ideas
Consumer information and the mortgage market conference

Session I: Economic Analysis of Mortgage Product Development, Market Structure, and Mortgage Outcomes

Session Participants:

Susan M. Wachter, University of Pennsylvania
Anthony Pennington-Cross, Marquette University
Souphala Chomsisengphet, Office of the Comptroller of the Currency
Christopher J. Mayer, Columbia University and Visiting Scholar, Federal Reserve Bank of New York
Morris Kleiner, University of Minnesota
Richard M. Todd, Federal Reserve Bank of Minneapolis
Paul Pautler, Federal Trade Commission (Chair and Discussion Leader)
Consumer information and the mortgage market conference

Session II: Economic Analysis of Consumer Information and Mortgage Choice

Session Participants:

David Laibson, Harvard University
Jonathan Levin, Stanford University
Brent Ambrose, Penn State University
Karen Pence, Federal Reserve Board of Governors
James Lacko, Federal Trade Commission
Janis Pappalardo, Federal Trade Commission
Thomas Pahl, Federal Trade Commission (Chair and Discussion Leader)
Consumer information and the mortgage market conference

Session III: Roundtable Examining the Impact of Consumer Information on the Mortgage Market Crisis

Session Participants:

Paul S. Willen, Federal Reserve Bank of Boston
John G. Lynch, Jr., Duke University
Alex Pollock, American Enterprise Institute
David Weil, Boston University
Pauline Ippolito, Federal Trade Commission (Chair and Discussion Leader)
Consumer information and the mortgage market conference

Session IV: Developing Disclosures for Real Consumers to Help Prevent Deception, Delinquency, and Foreclosure – Where Should Policymakers Go From Here?

Session Participants:

Jeanne Hogarth, Federal Reserve Board of Governors
Vanessa Perry, George Washington University
Susan Kleimann, Kleimann Communication Group
Annamaria Lusardi, Dartmouth College
Sumit Agarwal, Federal Reserve Bank of Chicago
Susan Woodward, Sand Hill Econometrics
Jesse Leary, Federal Trade Commission (Chair and Discussion Leader)
Research is showing that non-prime products are not inherently flawed

Product restrictions can do more harm than good
The Rise in Mortgage Defaults:
Facts and Myths

Professor Chris Mayer
Paul Milstein Professor of Real Estate;
Visiting Scholar, Federal Reserve and & NY Fed

Sources


• Christopher Mayer, Tomasz Piskorski, and Alexei Tchistyi, “The Inefficiency of Refinancing: Why Prepayment Penalties Are Good for Risky Borrowers”

• Shane Sherlund, “The Outlook for Subprime Mortgages”


Takeaways

• **Myths:** Defaults appear *unrelated* to mortgage market innovations, including
  – Prepayment penalties
  – Rate resets on short-term ARMs (2/28 mortgages)
  – Interest-only or “option-ARMs”

• **Evidence:** Unprecedented rise in defaults and foreclosures primarily due to
  – Stagnation in house prices (driven by subprime collapse?)
  – Slackened underwriting
  – Poor economic conditions in some locations

So where do we go from here?

• Encourage private sector to responsibly replace $1 trillion in lost mortgage originations

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

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

• Legal changes that allow cramdowns or require “negotiations” will surely reduce new supply of credit, possibly extending house price declines

Additional research

Making Sense of the Subprime Crisis

Main findings:

• Explores whether market participants could have or should have anticipated the large increase in foreclosures that occurred in 2007 and 2008.

• While loans originated in 2005 and 2006 did carry extra risk factors (particularly increased leverage), underwriting standards alone cannot explain the dramatic rise in foreclosures.

• Securitization not major driver – most uncertainty not about underwriting
  • Most uncertainty not about underwriting, but house prices

• Did market participants underestimate the likelihood of a fall in house prices or the sensitivity of foreclosures to house prices?

Main Findings:

- Analysts, on the whole, understood that a fall in prices would have disastrous consequences for the market but assigned a low probability to such an outcome.

- Subprime opened up homeownership opportunities.

The foreclosure rate is calculated at a quarterly frequency. The numerator is the total number of foreclosures in MA in a given quarter, and is obtained directly from the Warren Group data. The denominator is the number of residential parcels in a given year, where a parcel is defined as a real unit of property used for the assessment of property taxes, and a typical parcel consists of a plot of land defined by a deed and any buildings located on the land. Information on parcel counts is obtained from the Massachusetts Department of Revenue. Finally, house prices are calculated using the Case-Shiller weighted, repeat-sales methodology using data from the Warren Group.

Informal survey of panelists

Assume that you are a philosopher-king (or queen) with the power to change one consumer policy to improve the mortgage market.

1. What, if anything, would you change?
2. On a scale of 0 to 100, with 0 being not at all certain, and 100 being absolutely certain, how certain are you that benefits of this change would outweigh the costs?
Informal survey results

• 1 panelist (out of 17) suggested nudge strategy:
  • “30-yr fixed rate no fees default mortgage. Must opt-out.”
Informal survey results

• 71% suggested reforms to disclosures:
  
  • “Federal rule, pre-empting state law, that no disclosure could be promulgated without scientific support that consumers make better decisions with the info than without it.”
  
  • “Simply, simplify, simplify as much as possible. People need simplification and a mild guidance.”
Informal survey results

• 24% suggested other reforms:

  • “Improve consumer financial education level.”

  • “I’d improve public property and foreclosure records to include and make accessible the information needed to monitor the track records of brokers, lenders, appraisers and other key participants in loan origination.”

  • “Recommendation tool to sort alternatives in an order correlated with that consumer’s personal utility function. This allows consideration of ‘fitting’ options and makes costly consideration of not fitting.”
While no-one could doubt the wisdom of banning quacks practicing as doctors, or fraudulent adverts, there eventually comes a point beyond which constraining freedom of contract further brings costs that outweigh benefits. These costs, which consumers ultimately bear and which may be hidden from view, can stem from less choice and competition as well as the cost of regulation itself.

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

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

Perils and Promise of Information Remedies
Improving Mortgage Disclosures

Consumer Testing of Current and Improved Disclosure Forms

James Lacko and Janis Pappalardo
Bureau of Economics, Federal Trade Commission

Consumer Information and the Mortgage Market
FTC Bureau of Economics Workshop – May 29, 2008

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

<table>
<thead>
<tr>
<th>ANNUAL PERCENTAGE RATE</th>
<th>FINANCE CHARGE</th>
<th>AMOUNT FINANCED</th>
<th>TIME</th>
<th>PAYMENT</th>
</tr>
</thead>
<tbody>
<tr>
<td>6.81%</td>
<td>$128,000.00</td>
<td>$184,975.00</td>
<td>30</td>
<td>$156,245.60</td>
</tr>
</tbody>
</table>

You have the right to receive this information in a legible format.

Your present schedule will be:

<table>
<thead>
<tr>
<th>Number of Payments</th>
<th>Amount of Payments</th>
</tr>
</thead>
<tbody>
<tr>
<td>30</td>
<td>$184,975.00</td>
</tr>
</tbody>
</table>

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

This obligation has a demand feature:

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

<table>
<thead>
<tr>
<th>Type</th>
<th>Premium</th>
<th>Term</th>
<th>Coverage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Credit Life</td>
<td>$3,069.00</td>
<td>30</td>
<td>years</td>
</tr>
<tr>
<td>Credit Disability</td>
<td>$3,069.00</td>
<td>30</td>
<td>years</td>
</tr>
</tbody>
</table>

You may obtain property insurance from anyone you want that is acceptable to this institution.

Security: You are giving a security interest in:

the property being purchased

| property located at 25932,Norfolk, VA, 23508 |

Late Charge: If past due, you will be charged 6.81% of the payment.

Prepayment: If you pay all, you may be entitled to a refund as part of the finance charge.

Assumption: You may assume the remainder of the mortgage on the original terms.

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

See your contract documents for any additional information about prepayment, late charges, and/or required payment in full before the scheduled date of payment on the original term.

A summary statement indicates the total amount paid.

I acknowledge receipt of this disclosure.

Prepared by:
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
Prototype form

Page 1

Summary of key loan terms

<table>
<thead>
<tr>
<th>YOUR LOAN</th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Loan Type Summary</td>
<td>10 year fixed-rate balloon loan</td>
<td></td>
</tr>
<tr>
<td>Loan Amount</td>
<td>$154,934.26</td>
<td></td>
</tr>
<tr>
<td>Loan Term</td>
<td>10 years (120 monthly payments)</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>OUR LOAN CHARGES</th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Interest Rate</td>
<td>7.23%</td>
<td>Fixed rate</td>
</tr>
<tr>
<td>Up-Front Charges</td>
<td>$10,020.06</td>
<td>Total settlement charges</td>
</tr>
<tr>
<td></td>
<td>$8,202.69</td>
<td>Charges for optional products and services</td>
</tr>
<tr>
<td></td>
<td>$18,222.75</td>
<td>Total up-front charges</td>
</tr>
<tr>
<td>Monthly-Billed Charges</td>
<td>None</td>
<td></td>
</tr>
<tr>
<td>Annual Percentage Rate (APR)</td>
<td>7.96%</td>
<td>The cost of credit, including both interest payments and other finance charges, expressed as an annual rate.</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>YOUR LOAN PAYMENTS</th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash Due at Closing</td>
<td>$ 0.00</td>
<td></td>
</tr>
<tr>
<td>Monthly Payments</td>
<td>$1,054.82</td>
<td>Payments 1-119</td>
</tr>
<tr>
<td>Balloon Payment</td>
<td>$134,710.17</td>
<td>You will have to pay this amount at the end of the 10 year loan term</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>PENALTIES AND LATE FEES</th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Prepayment Penalty</td>
<td>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 $5,800.87.</td>
<td></td>
</tr>
<tr>
<td>Late Fee</td>
<td>A 5% late fee will be charged on payments more than 7 days late.</td>
<td></td>
</tr>
</tbody>
</table>
# 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>
</tr>
</thead>
<tbody>
<tr>
<td>$123,427.80 Refinance current mortgage loan</td>
</tr>
<tr>
<td>$10,000.00 Cash paid to borrower</td>
</tr>
<tr>
<td>$3,203.71 Consolidation of borrower's other debts</td>
</tr>
<tr>
<td>$10,000.66 Prepaid settlement charges</td>
</tr>
<tr>
<td>$8,202.69 financed charges for optional products and services</td>
</tr>
<tr>
<td><strong>Total Loan Amount</strong>: $154,034.26</td>
</tr>
</tbody>
</table>

### Optional Charges Details

<table>
<thead>
<tr>
<th>Service</th>
</tr>
</thead>
<tbody>
<tr>
<td>$4,367.09 Credit life insurance</td>
</tr>
<tr>
<td>$2,156.01 Credit accident and health insurance</td>
</tr>
<tr>
<td>$1,079.78 Involuntary unemployment insurance</td>
</tr>
<tr>
<td><strong>Total Optional Products and Services Charges</strong>: $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>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Cash Due at Closing</strong>: $0.00</td>
</tr>
</tbody>
</table>

### Monthly Payment Details

<table>
<thead>
<tr>
<th>Component</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Initial Monthly Payment</strong>: $1,054.62</td>
</tr>
<tr>
<td>$0.00 Principal and Interest</td>
</tr>
<tr>
<td>$0.00 Private mortgage insurance (PMI) (not required)</td>
</tr>
<tr>
<td>$0.00 Monthly-billed optional products or services</td>
</tr>
<tr>
<td><strong>Total Initial Monthly Payment</strong>: $1,054.62</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>
</tr>
</thead>
<tbody>
<tr>
<td>$212.55 Property taxes ($2,550.60 per year)</td>
</tr>
<tr>
<td>$107.63 Hazard insurance ($1,291.56 per year)</td>
</tr>
<tr>
<td><strong>Total Additional Monthly Costs</strong>: $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>$0,214.45</th>
<th>This package includes the following services:</th>
</tr>
</thead>
<tbody>
<tr>
<td>Origination and lender services</td>
<td></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></td>
<td></td>
</tr>
<tr>
<td>County recording fees</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>State and local tax stamps</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 $ 52.86, per day for 17 days (if your closing date is 11/13/04). |

<table>
<thead>
<tr>
<th>Prepaid Items</th>
<th>Property taxes</th>
<th>$ 31.20</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Homeowner’s insurance</td>
<td>$ 34.98</td>
</tr>
<tr>
<td></td>
<td>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).</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Reserves Deposited with the Lender</th>
<th>Property taxes (2 months at $ 31.20 per month)</th>
<th>$ 102.41</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Homeowner’s Insurance (2 months at $ 34.98 per month)</td>
<td>$ 75.12</td>
</tr>
</tbody>
</table>

| 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); website 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></th>
<th>Disclosure Form</th>
<th></th>
<th></th>
<th>Difference</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Current</td>
<td>Prototype</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Both Loans</td>
<td>61%</td>
<td>80%</td>
<td></td>
<td>19 pct points **</td>
</tr>
<tr>
<td>Simple Loan</td>
<td>66%</td>
<td>82%</td>
<td></td>
<td>16 pct points **</td>
</tr>
<tr>
<td>Complex Loan</td>
<td>56%</td>
<td>78%</td>
<td></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 Current</th>
<th>Prototype</th>
<th>Difference</th>
</tr>
</thead>
<tbody>
<tr>
<td>70% or more</td>
<td>30%</td>
<td>80%</td>
<td>51 pct points **</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
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
IV.

Fulfilling the Promise of Consumer Protection Policies
Three points

- Consumer protection policy is often tricky because people are unique.
- Consumer protection is unlikely to be effective without a joint mandate to promote competition.
- Information remedies generally better than product restrictions, but untested remedies can do more harm than good—must move beyond economics of information to economics of comprehension.
Potential for success

• Stars are aligned for further consumer protection research and development
• Growing understanding by regulators of need to base information remedies on solid, objective, quantitative testing
• Future contribution of economics will depend on defining common ground between microeconomics, behavioral economics, and marketing research