Consumer Protection Regulation:

Moving Beyond the Economics of Information to the Economics of Consumer Comprehension

Janis K. Pappalardo*
Bureau of Economics
Federal Trade Commission
jpappalardo@ftc.gov

Federal Trade Commission
Microeconomics Conference
November 19, 2009

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

I.

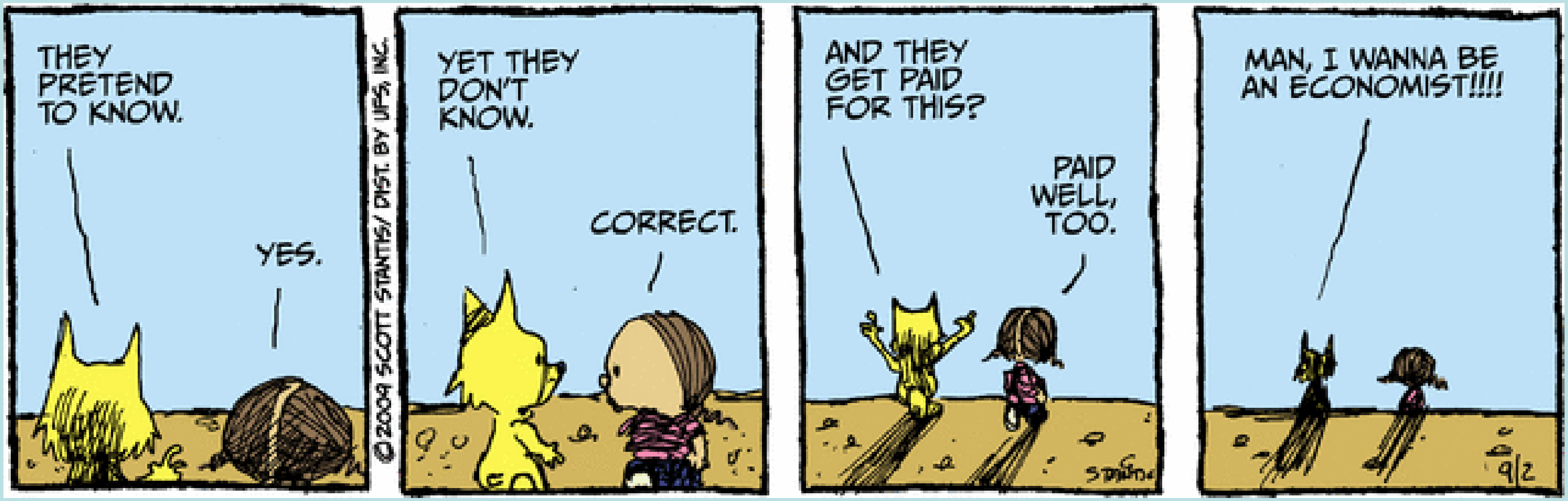
Introduction

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.
YES.
YET THEY DON'T KNOW.
CORRECT.
AND THEY GET PAID FOR THIS?
PAID WELL, TOO.
MAN, I WANNA BE AN ECONOMIST!!!!
©2009 SCOTT STANTIS/ DIST. BY UFS, INC.
9/2

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 targeted directly at me."

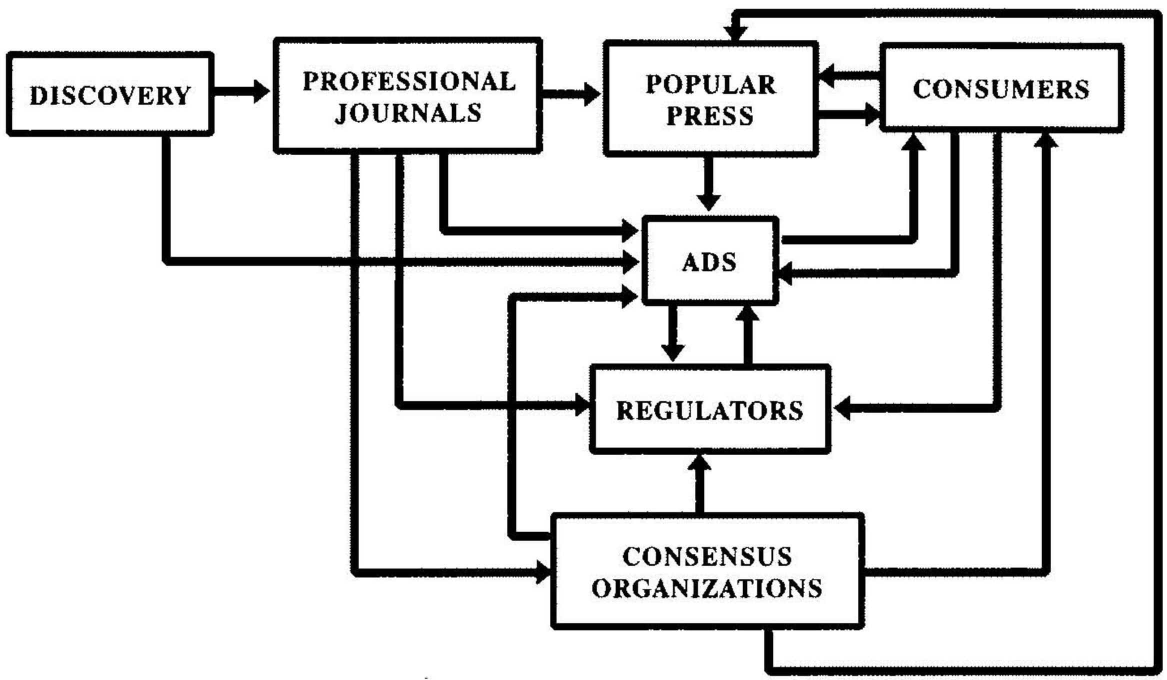
Donnelly, Liza. **"I want to read something directly targeted at me."** (A man speaks to a clerk in a bookstore.)
ID: 130848, Published in *The New Yorker* June 8, 2009

Health claims in advertising

Ringold, Debra J. and Janis K. Pappalardo, "Regulating Commercial Speech in a Dynamic Environment: Forty Years of Margarine and Oil Advertising Before the NLEA," *Journal of Public Policy and Marketing*, 19 (1), 74-92, 2000.

Figure I:

The Information Dissemination Process



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
PURE
CORN OIL
The "L-plus" factor
The desirable effect of corn oil in decreasing the amount of cholesterol in the blood has been demonstrated repeatedly.
Doctors believe that the natural substances present in corn oil bring about this desirable effect. For brevity, we call the combination of these substances (including Linoleates) 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
ERFECT SALAD DRESSINGS
GOLDEN FRENCH DRESSING
2 teaspoons prepared mustard
1 tablespoon salt
1 teaspoon Worcestershire sauce
½ cup vinegar
⅔ cup sugar
½ cup vinegar
MELODY DRESSING
1 cup MAZOLA Corn Oil

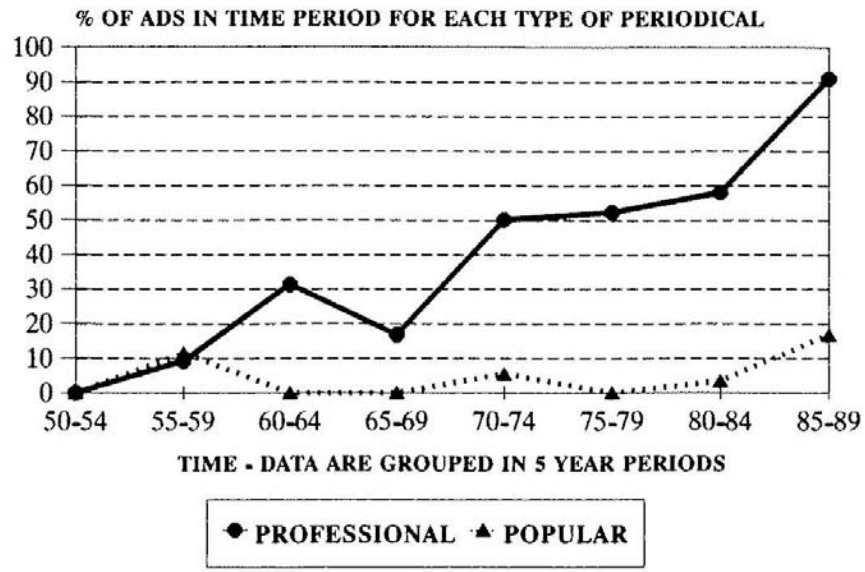

Science finds Corn Oil important to health
–because it is rich in "L-plus" factor
Of all leading U. S. Brands
only Mazola* is Pure Corn Oil
It has been demonstrated repeatedly that Mazola Corn Oil lowers the cholesterol level of the blood stream—considered important in both the prevention and treatment 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
PURE
CORN OIL
The "L-plus" factor
The desirable effect of corn oil in decreasing the amount of cholesterol in the blood has been demonstrated repeatedly.
Doctors believe that the natural substances present in corn oil bring about this desirable effect. For brevity, we call the combination of these substances (including Linoleates) 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.

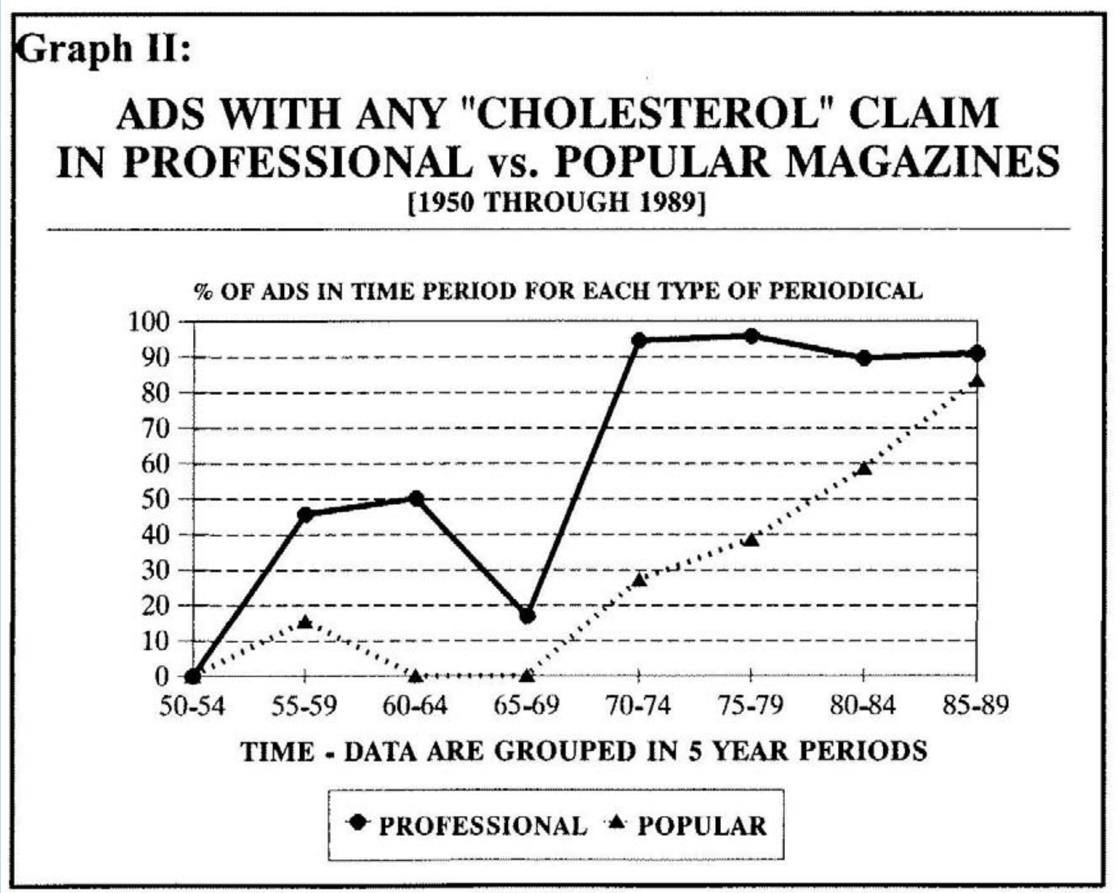

Mazola® Corn Oil
is best* for
cutting down
saturated fats
in your diet!
*Modern science proves corn oil best of all leading oils for cutting down saturated fats in the diet, and of *all* leading brands, only Mazola is corn oil!
That's why today's *modern* families use Mazola for delicate, delicious home-made 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!
Mazola
PURE
CORN OIL

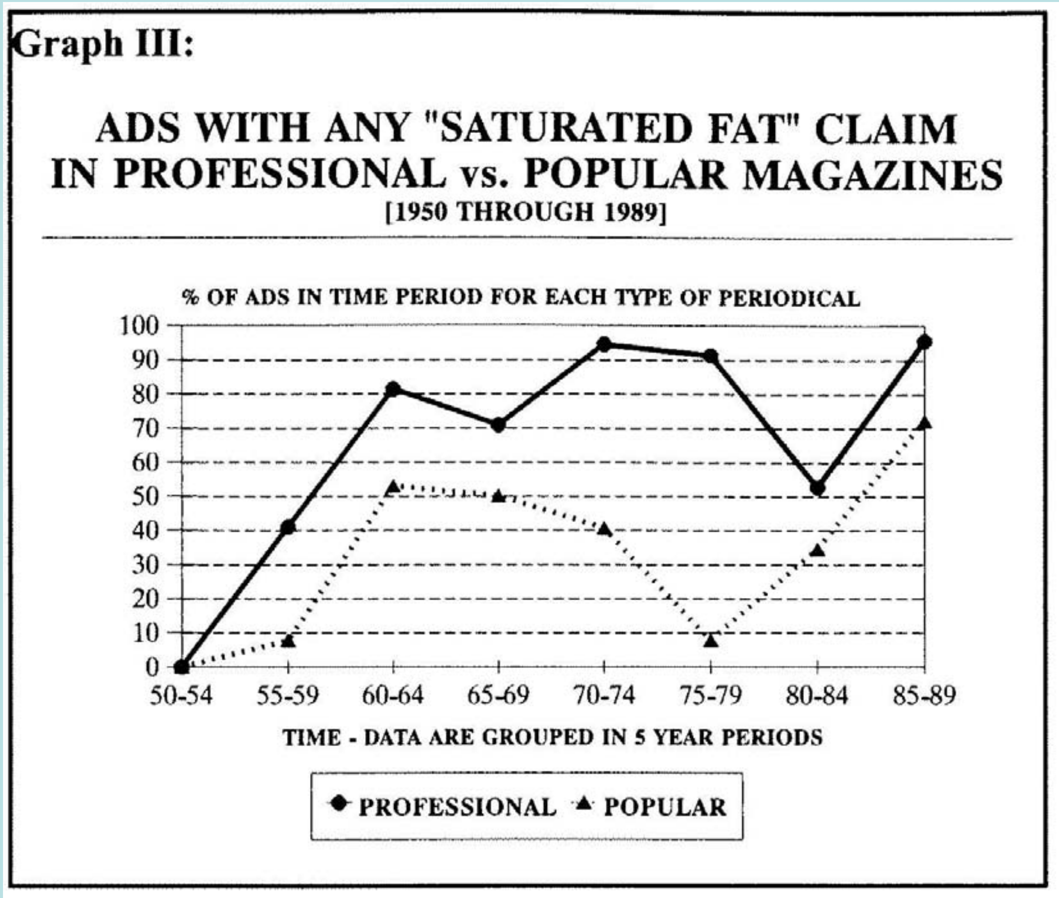
Graph I:

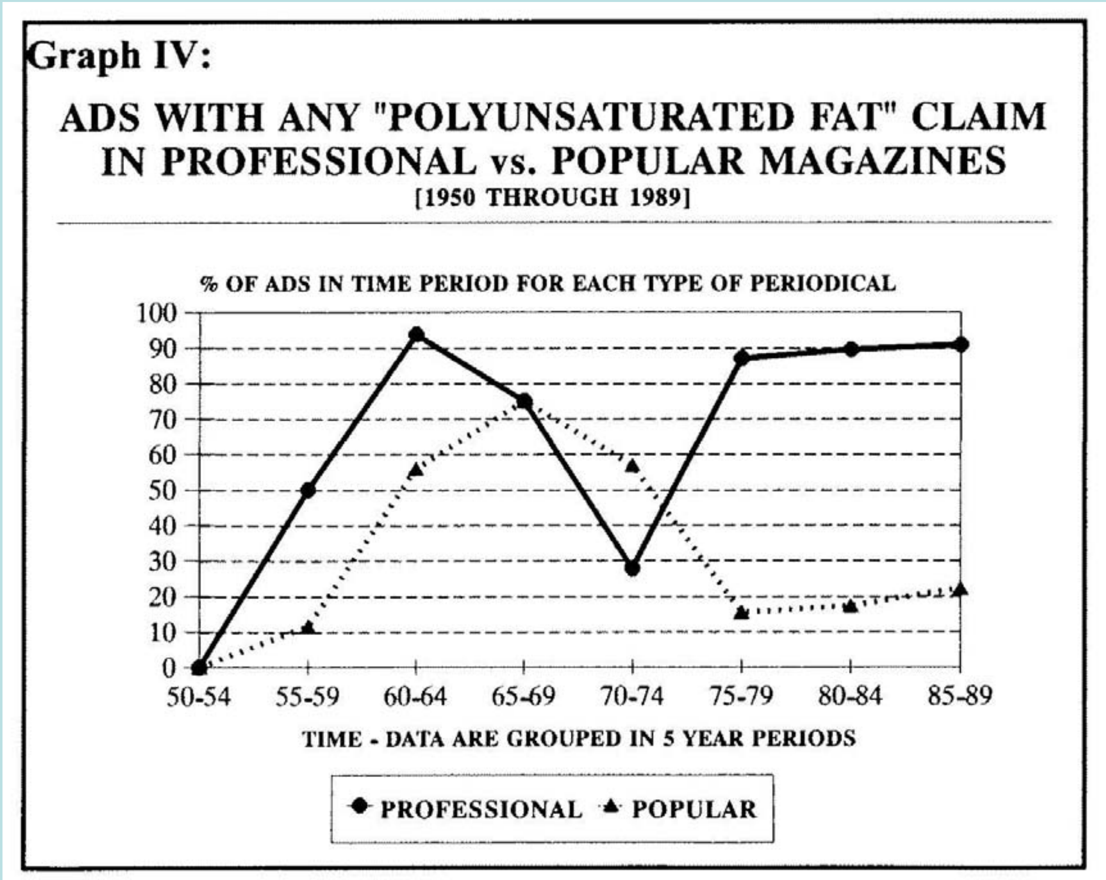
ADS WITH ANY "HEART DISEASE" CLAIM IN PROFESSIONAL vs. POPULAR MAGAZINES

[1950 THROUGH 1989]




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
100
90
80
70
60
50
40
30
20
10
0
50-54
55-59
60-64
65-69
70-74
75-79
80-84
85-89
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]
% OF ADS IN TIME PERIOD FOR EACH TYPE OF PERIODICAL
100
90
80
70
60
50
40
30
20
10
0
50-54
55-59
60-64
65-69
70-74
75-79
80-84
85-89
TIME - DATA ARE GROUPED IN 5 YEAR PERIODS
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
100
90
80
70
60
50
40
30
20
10
0
50-54
55-59
60-64
65-69
70-74
75-79
80-84
85-89
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

Source: Christopher Mayer, FTC Consumer Information and the Mortgage Market Conference, May 29, 2008

Sources

- Christopher Mayer, Karen Pence, and Shane Sherlund, "The Rise in Mortgage Defaults: Facts and Myths"
- 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"
- Christopher Mayer and Karen Pence, "Subprime Mortgages: What, Where, and to Whom?"

Source: Christopher Mayer, FTC Consumer Information and the Mortgage Market Conference, May 29, 2008

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

Source: Christopher Mayer, FTC Consumer Information and the Mortgage Market Conference, May 29, 2008

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

Source: Christopher Mayer, FTC Consumer Information and the Mortgage Market Conference, May 29, 2008

Additional research

- Gerardi, Kristopher, Andreas Lehnert, Shane Sherlund, and Paul Willen, “Making Sense of the Subprime Crisis,” Brookings Panel on Economic Activity, September 11-12, 2008.

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?

Source: Willen, P. et al, “Making Sense of the Subprime Crisis”, September, 2008.

Making Sense of the Subprime Crisis

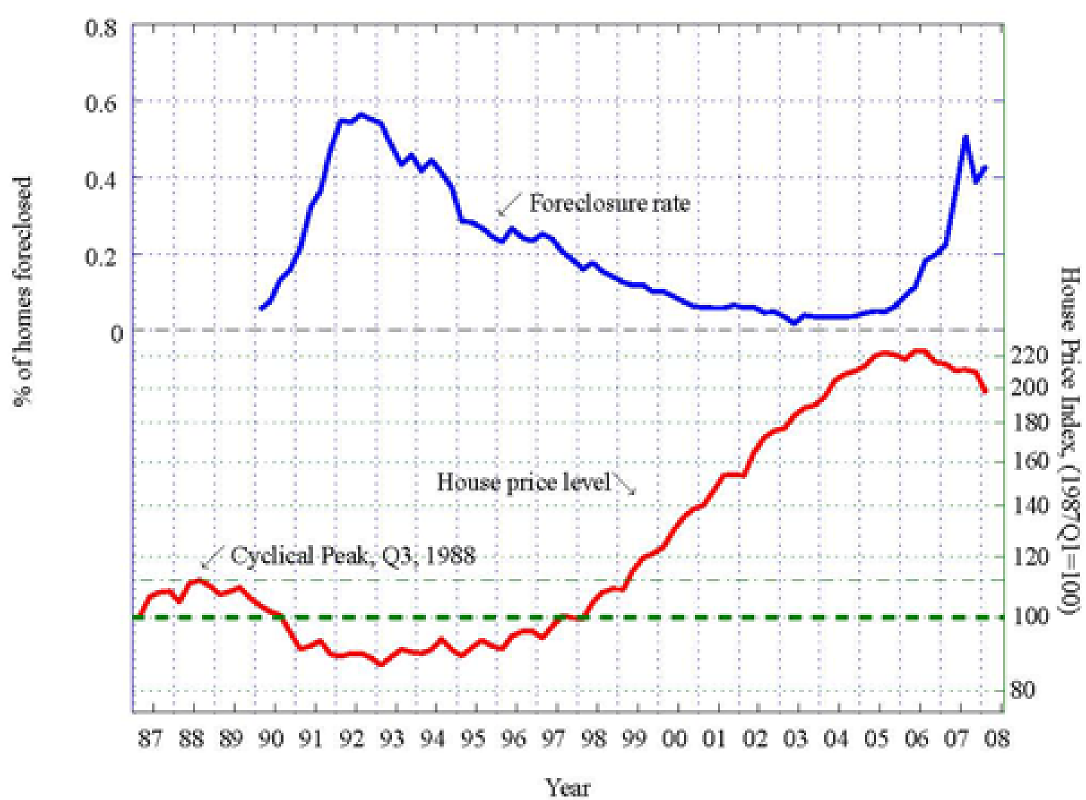
Main Findings:

- 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.

Source: Willen, P. et al, "Making Sense of the Subprime Crisis", September, 2008.

Figure 9: Massachusetts House Prices and Foreclosure Rates, January 1990 to December 2007



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.

Source: Willen, P. et al, “Making Sense of the Subprime Crisis”, September, 2008.

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 <u>default mortgage</u>. 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

FEDERAL TRUTH-IN LENDING DISCLOSURE STATEMENT
For use with Fixed-Rate, GPM, Balloon Mortgage,
Adjustable or Variable Rate Loans

LOAN "T"

Date: 10/14/05
Loan No.: 26457
Borrowers: James and Clara Borrower

Property
Location: 123 Your Street
Hometown, VA 22189

ANNUAL PERCENTAGE RATE The cost of your credit as a yearly rate	FINANCE CHARGE The dollar amount the credit will cost you	Amount Financed The amount of credit provided to you or on your behalf	Total of Payments The amount you will have paid after you have made all payments as scheduled
6.88 %	$ 129,059.36	$ 186,147.50	$ 315,206.86

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

Your payment schedule will be:

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

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

☐ This obligation has a demand Feature.

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

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

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

Security: You are giving a security interest in:
☐ the property being purchased
☒ the property located at 123 Your St., Hometown, VA 22189

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

Prepayment: If you pay off early, you
☐ may ☒ will not have to pay a penalty.
☐ may ☒ will not be entitled to a refund of part of the finance charge.

Assumption: Someone buying your home
☒ cannot assume the remainder of the mortgage on the original terms.
☐ may, subject to conditions, be allowed to assume the remainder of the mortgage on the original terms.

A deposit balance ☐ is ☒ is not required. The Annual Percentage Rate does not take into account your required deposit.
See your contract documents for any additional information about nonpayment, default, any required repayment in full before the scheduled date, and prepayment refunds and penalties.
e means an estimate

I/We hereby acknowledge receipt of this disclosure.

______ / ______ DATE

______ / ______ DATE

Prepared by: ______ ______ TITLE

VMP-786 (9906) VMP MORTGAGE FORMS - (800)521-7291

Current forms

GFE

Note:

Includes information beyond the regulatory requirements

GOOD FAITH ESTIMATE

Lender: **FS Mortgage Company**
Address: **456 Main Street, Mortgagetown, VA 22189**
Applicant(s): **James and Clara Borrower**
Property Address: **123 Your Street, Hometown, VA 22189**

LOAN "T"

Sales Price:
Base Loan Amount: **$181,655.00**
Total Loan Amount: **$189,313.43**
Type of Loan: **Fixed Rate Interest-Only Balloon**
Date Prepared: **10/14/05**
Rate: **6.65%** Term: **10 Year**

The information provided below reflects estimates of the charges which you are likely to incur at the settlement of your loan. The fees listed are estimates - the actual charges may be more or less. Your transaction may not involve a fee for every item listed.

The numbers listed beside the estimates generally correspond to the numbered lines contained in the HUD-1 or HUD-1A settlement statement that you will be receiving at settlement. The HUD-1 or HUD-1A settlement statement will show you the actual cost for items paid at settlement.

800 ITEMS PAYABLE IN CONNECTION WITH LOAN:		
801 Loan Origination Fee (%)	$	1,900.00
802 Loan Discount Fee (%)	$	
803 Appraisal Fee	$	150.00
804 Credit Report	$	
805 Lender's Inspection Fee	$	
806 Mortgage Insurance Application Fee	$	
807 Assumption Fee	$	
808 Mortgage Broker Fee	$	
809 CLO Access Fee	$	
810 Tax Related Service Fee	$	50.00
Administrative Fee	$	625.00
Doc Prep Fee	$	150.00
Courier	$	75.00
	$	
	$	

900 ITEMS REQUIRED BY LENDER TO BE PAID IN ADVANCE:		
901 Interest for **8** day @$ **34.4914** per day	$	275.93
902 Mortgage Insurance Premium	$	
903 Hazard Insurance Premium	$	720.00
	$	
	$	
	$	

1000 RESERVES DEPOSITED WITH LENDER:			
1001 Haz Ins Prem **2 months** @$	60.00	$	120.00
1004 Tax & Assmt Res **9 months** @$	145.83	$	1,312.50
		$	
		$	
		$	

"L" designates those costs to be paid by Lender.

1100 TITLE CHARGES:		
1101 Closing or Escrow Fee	$	275.00
1102 Abstract or Title Search	$	225.00
1103 Title Examination	$	
1104 Title Insurance Binder	$	
1105 Document Preparation Fee	$	125.00
1106 Notary Fee	$	40.00
1107 Attorney Fees	$	
1108 Title Insurance	$	675.00
Title Binder	$	50.00
	$	
	$	
	$	

1200 GOVERNMENT RECORDING & TRANSFER CHARGES:		
1201 Recording Fees:	$	50.00
1202 City/County Tax/Stamps:	$	100.00
1203 State Tax/Stamps:	$	250.00
County Tax	$	275.00
	$	
	$	
	$	

1300 ADDITIONAL SETTLEMENT CHARGES:		
1301 Survey	$	175.00
1302 Pest Inspection	$	
Flood Certification	$	40.00
	$	
	$	
	$	
TOTAL ESTIMATED SETTLEMENT CHARGES	$	7,658.43

TOTAL ESTIMATED FUNDS NEEDED TO CLOSE:		
Downpayment	$	
Est. Closing Costs	$	
Est. Prepaid Items/Reserves	$	
OTHER:	$	
TOTAL EST. FUNDS NEEDED TO CLOSE	$	0.00

TOTAL ESTIMATED MONTHLY PAYMENT:		
Principal & Interest	$	1,049.11
Real Estate Taxes	$	145.83
Flood & Hazard Insurance	$	60.00
Mortgage Insurance	$	
	$	
TOTAL MONTHLY PAYMENT	$	1,254.95

THIS SECTION TO BE COMPLETED BY LENDER ONLY IF A PARTICULAR PROVIDER OF SERVICE IS REQUIRED. Use of the particular provider is required and the estimate is based on charges of the provider.

ITEM NO.	NAME & ADDRESS OF PROVIDER	TELEPHONE NO.	NATURE OF RELATIONSHIP

These estimates are provided pursuant to the Real Estate Settlement Procedures Act of 1974, as amended (RESPA). Additional information can be found in the HUD Special Information Booklet, which is to be provided to you by your mortgage broker or lender, if your application is to purchase residential real property and the Lender will take a first lien on the property. The undersigned acknowledges receipt of the booklet "Settlement Costs," and the Consumer Handbook on ARM Mortgages, if applicable.

Applicant Date Applicant Date

Applicant Date Applicant Date

☐ This Good Faith Estimate is being provided by , a mortgage broker, and no lender has yet been obtained.

"S" designates those costs to be paid by Seller.

VMP-773R (9403).02 2/94

VMP MORTGAGE FORMS - (800)521-7291

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

Mortgage Loan Offer
ACME Mortgage Company
123 Main Street
Fairfax, Virginia 20151
(703) 555-2767

[example of complex refinance loan]
[draft form]

Borrower: James Jones
Property Location: 345 North Street, Fairfax, Virginia, 20151
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
	$ 8,202.69	Charges for optional products and services
	$ 18,222.75	Total up-front charges
Monthly-Billed Charges	None	
Annual Percentage Rate (APR)	7.98%	The cost of credit, including both interest payments and other finance charges, expressed as an annual rate.

YOUR LOAN PAYMENTS

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

PENALTIES AND LATE FEES

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

Prototype form

Page 2

Details of loan terms

ACME Mortgage Company — Page 2 of 3

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

LOAN AMOUNT DETAILS

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

OPTIONAL CHARGES DETAILS

Optional Products and Services Charges	$ 4,367.90	Credit life insurance
	$ 2,155.01	Credit accident and health insurance
	$ 1,679.78	Involuntary unemployment insurance

	$ 8,202.69	Total Optional Product and Services Charges

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

CASH DUE AT CLOSING DETAILS

Cash Due at Closing	$ 0.00

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

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

	$ 212.55	Property taxes ($2,550.60 per year)
	$ 107.63	Hazard insurance ($1,291.56 per year)

	$ 320.18	Total additional monthly costs ($3,842.16 per year)

Prototype form

Page 3

Details of settlement charges; consumer tips and warnings

SETTLEMENT CHARGES DETAILS

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

Settlement Services Package	$9,214.45	This package includes the following services:
		Origination and lender services: Loan origination; Appraisal; Credit report; Lender's property survey; Lender's property inspection; Pest inspection
		Title services: Settlement agent; Title search and examination; Title document preparation; Lender's title insurance; Attorney services; Notary fee
		Government taxes and fees: County recording fee; State and local tax stamps
Daily Interest Charges	$ 558.90	This charge is for the daily interest charges from the day of your settlement until the end of the month. For this loan this amount is $ 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	$ 102.41	Property taxes (2 months at $ 51.22 per month)
	$ 78.12	Homeowner's insurance (2 months at $ 39.06 per month)
Total Settlement Charges	**$10,020.06**	**Total Settlement Charges**

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

	Disclosure Form		
	Current	Prototype	Difference
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	Disclosure Form: Current	Disclosure Form: Prototype	Difference
70% or more	30%	80%	51 pct points **

** Statistically significant at the one percent level

Prime and subprime borrowers

Percentage of questions answered correctly

	Borrower Type		
	Prime	Subprime	Difference
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

<u>Pct. of respondents not correctly identifying loan cost</u>

- 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

<u>Percentage point improvement over current forms</u>

- 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

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