

# Improving Mortgage Disclosures

Consumer Testing of Current and Improved Disclosure Forms

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# 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	FINANCE CHARGE	Amount Financed	Total of Payments
The cost of your credit as a yearly rate	The dollar amount the credit will cost you	The amount of credit provided to you or on your behalf	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





# 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** [example of complex refinance loan]  
ACME Mortgage Company [draft form]  
123 Main Street  
Fairfax, Virginia 20151  
(703) 555-2767  
Page 1 of 3

Borrower: James Jones Offer Date: May 21, 2004  
Property Location: 345 North Street, Fairfax, Virginia, 20151

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

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
	<b>\$ 154,934.26</b>	<b>Total Loan Amount</b>

## 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
	<b>\$ 8,202.69</b>	<b>Total Optional Product and Services Charges</b>

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
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## MONTHLY PAYMENT DETAILS

Monthly Payment	<u>Itemization of initial monthly payment</u>	
	\$ 1,054.82	Principal and interest
	\$ 0.00	Private mortgage insurance (PMI) (not required)
	\$ 0.00	Monthly-billed optional products or services
	<b>\$ 1,054.82</b>	<b>Total initial monthly payment</b>

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)
	<b>\$ 320.18</b>	<b>Total additional monthly costs (\$3,842.16 per year)</b>

# 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:  <u>Origination and lender services</u> Loan origination Appraisal Credit report Lender's property survey Lender's property inspection Pest inspection  <u>Government taxes and fees</u> County recording fee	<u>Title services</u> Settlement agent Title search and examination Title document preparation Lender's title insurance Attorney services Notary 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 \$ <u>32.88</u> per day for <u>17</u> days (if your closing date is <u>11/13/04</u> ).	
Prepaid Items	\$ 31.20 \$ 34.98	Property taxes 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 <u>11/13/04</u> ).
Reserves Deposited with the Lender	\$ 102.41 \$ 78.12	Property taxes ( <u>2</u> months at \$ <u>51.22</u> per month) Homeowner's insurance ( <u>2</u> months at \$ <u>39.06</u> per month)	
Total Settlement Charges	<b>\$10,020.06</b>	<b>Total Settlement Charges</b>	

## 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](http://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

	<u>Disclosure Form</u>		<u>Difference</u>
	<u>Current</u>	<u>Prototype</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

<u>Percentage Of Questions Answered Correctly</u>	<u>Disclosure Form</u>		<u>Difference</u>
	<u>Current</u>	<u>Prototype</u>	
70% or more	30%	80%	51 pct points **

\*\* Statistically significant at the one percent level

# Prime and subprime borrowers

## Percentage of questions answered correctly

	<u>Borrower Type</u>		<u>Difference</u>
	<u>Prime</u>	<u>Subprime</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>