**BEFORE THE**
**DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT**

**In the Matter of**
**Request for Comment on Proposed Amendments to the Regulations**
**Implementing the Real Estate Settlement Procedures Act**

**Docket No. FR-5180-P-01**

**Comments of the Staff of**
**the Bureau of Consumer Protection,**
**the Bureau of Economics,**
**and the Office of Policy Planning**
**of the Federal Trade Commission**

**June 11, 2008***

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***These comments represent the views of the staff of the Bureau of Consumer Protection, the Bureau of Economics, and the Office of Policy Planning of the Federal Trade Commission. They are not necessarily the views of the Commission or any individual Commissioner. The Commission has, however, voted to authorize the staff to submit these comments.**

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## I. Introduction

On March 14, 2008, the Department of Housing and Urban Development (HUD) issued a proposed rule[1] to revise mortgage settlement disclosures required under the Real Estate Settlement Procedures Act (RESPA).[2] Staff of the Federal Trade Commission's Bureau of Consumer Protection, Bureau of Economics, and Office of Policy Planning (FTC staff) appreciates the opportunity to comment on the proposed rule.

As the primary federal agency that enforces consumer financial laws with respect to nondepository institutions, the Commission has wide-ranging responsibility in the mortgage market, including involving mortgage lenders, brokers, servicers, and advertisers. The FTC enforces a number of federal laws governing mortgage lending, including the Truth in Lending Act (TILA)[3] and Home Ownership and Equity Protection Act (HOEPA).[4] The Commission also enforces Section 5 of the Federal Trade Commission Act (FTC Act), which more generally prohibits unfair and deceptive acts and practices in the marketplace.[5] The FTC's law enforcement actions have targeted deception and other illegal practices in the mortgage market, focusing in particular on the subprime market.[6]

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[1] Real Estate Settlement Procedures Act (RESPA): Proposed Rule to Simplify and Improve the Process of Obtaining Mortgages and Reduce Settlement Costs, 73 Fed. Reg. 14,030 (proposed Mar. 14, 2008) (to be codified at 24 C.F.R. pts. 203 and 3500), *available at* http://a257.g.akamaitech.net/7/257/2422/01jan20081800/edocket.access.gpo.gov/2008/pdf/08-1015.pdf. In this comment, the proposal is referred to as "proposed rule," or as "proposed" with a reference to the relevant section.

[2] RESPA governs settlement services for "federally related mortgage loans," which includes the vast majority of residential purchase money, refinance, and home equity mortgage transactions. *See* 12 U.S.C. § 2601 *et seq.*

[3] 15 U.S.C. § 1601 *et seq.*

[4] *Id.* § 1639.

[5] *Id.* § 45(a).

[6] In recent years, the agency has brought 22 actions against companies and principals in the mortgage lending industry, involving companies large and small in various regions of the county. *See FTC v. Safe Harbour Found. of Fla., Inc.,* No. 08-1185 (N.D. Ill. 2008); *FTC v. Mortgages Para Hispanos.com Corp.*, No. 06-00019 (E.D. Tex. 2006); *FTC v. Ranney*, No. 04-1065 (D. Colo. 2004); *FTC v. Chase Fin. Funding, Inc.,* No. 04-549 (C.D. Cal. 2004); *United States v. Fairbanks Capital Corp.,* No. 03-12219 (D. Mass. 2003); *FTC v. Diamond,* No. 02-5078 (N.D. Ill. 2002); *United States v. Mercantile Mortgage Co.,* No. 02-5079 (N.D. Ill. 2002); *FTC v. Associates First Capital Corp.,* No. 01-00606 (N.D. Ga. 2001); *FTC v. First Alliance Mortgage Co.,* No. 00-964 (C.D. Cal 2000); *United States v. Action Loan Co.,* No. 00-511 (W.D. Ky. 2000); *FTC v. NuWest, Inc.,* No. 00-1197 (W.D. Wash. 2000); *United States v. Delta Funding Corp.,* No. 00-1872 (E.D.N.Y. 2000); *FTC v. Cooper Props.,* No. 99-07782 (C.D. Cal. 1999); *FTC v. Capitol Mortgage Corp.,* No. 99-580 (D. Utah 1999); *FTC v. CLS Fin. Serv.,*

In addition, the Commission conducts research on mortgage lending and associated topics,[7] develops related consumer and business education materials,[8] responds to inquiries about these matters from consumers, industry and the media, and works with other federal and state law enforcement entities to protect consumers from unfair or deceptive mortgage lending and servicing practices.[9] The FTC staff has also commented on numerous state and federal real estate laws.[10]

Through its proposed changes, HUD seeks to: simplify and improve the disclosure requirements for mortgage settlement costs; improve and standardize the Good Faith Estimate (GFE) form and enable consumers to use it to comparison shop among loan originators; provide

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*Inc.,* No. 99-1215 (W.D. Wash. 1999); *FTC v. Granite Mortgage, LLC,* No.990289 (E.D. Ky. 1999); *FTC v. Interstate Res. Corp.,* No. 99-5988 (S.D.N.Y. 1999); *FTC v. LAP Fin. Serv., Inc.,* No. 990496 (W.D. Ky. 1999); *FTC v. Wasatch Credit Corp.,* No. 990579 (D. Utah 1999); *In re FirstPlus Fin. Group, Inc.,* FTC Docket No. C-3984 (2000); *In re Fleet Fin., Inc.,* FTC Docket No. C-3899 (1999); *FTC v. Capital City Mortgage Corp.,* No. 98-00237 (D.D.C. 1998). Several of these cases have resulted in large monetary judgments, collectively returning more than $320 million to consumers.

[7] *See* FTC, BUREAU OF ECONOMICS STAFF REPORT, JAMES M. LACKO & JANIS K. PAPPALARDO, IMPROVING CONSUMER MORTGAGE DISCLOSURES: AN EMPIRICAL ASSESSMENT OF CURRENT AND PROTOTYPE DISCLOSURE FORMS (2007), *available at* http://www.ftc.gov/os/2007/06/P025505MortgageDisclosureReport.pdf (FTC Staff Mortgage Disclosure Study); FTC, BUREAU OF ECONOMICS STAFF REPORT, JAMES M. LACKO & JANIS K. PAPPALARDO, THE EFFECT OF MORTGAGE BROKER COMPENSATION DISCLOSURES ON CONSUMERS AND COMPETITION: A CONTROLLED EXPERIMENT (2004), *available at* http://www.ftc.gov/os/2004/01/030123mortgagefullrpt.pdf (FTC Staff Mortgage Broker Compensation Study).

[8] Consumer and business credit and loan education materials are available at, respectively, FTC, Credit & Loans (last visited May 6, 2008), http://www.ftc.gov/bcp/menus/consumer/credit.shtm and FTC, Credit, Loans, & Leases (last visited May 6, 2008), http://www.ftc.gov/bcp/menus/business/credit/loans.shtm.

[9] Examples of these activities are available at FTC, Advocacy Filings by Subject (last visited May 6, 2008), http://www.ftc.gov/opp/advocacy_subject.shtm ("Housing" category).

[10] *See, e.g.*, FTC Staff Comment Before the Board of Governors of the Federal Reserve System on Request for Comments on Truth in Lending, Proposed Rule (Apr. 8, 2008) (Docket No. R-1305), *available at* http://www.ftc.gov/os/2008/04/V080008frb.pdf (FTC Staff Comment on TILA); FTC Staff Comment Before the Board of Governors of the Federal Reserve System on Mortgage Disclosure Illustrations (Oct. 30, 2007) (Docket No. OP-1292), *available at* http://www.ftc.gov/be/v080000.pdf; and Letter from Donald S. Clark, Secretary, Federal Trade Comm'n on Home Equity Lending Market, to Jennifer L. Johnson, Secretary, Board of Governors of the Federal Reserve System (Sept. 14, 2006) (Docket No. OP-1253), *available at* http://www.ftc.gov/os/2006/09/docketop-1253commentfedreservehomeeqlenditextv.pdf (FTC Comment on Home Equity Lending Market).

more accurate estimates of costs on the GFE; improve disclosure of yield spread premiums; facilitate comparison of the GFE and HUD-1 Settlement Statements; clarify HUD's regulations concerning discounts; and expand the definition of "required use" of services provided by affiliated businesses.[11] The FTC staff supports initiatives to simplify and clarify the settlement process, provide uniform mortgage settlement disclosures, and foster competition in the market for settlement services and mortgages.

The FTC staff supports HUD's goal of improving mortgage disclosures. Indeed, some of HUD's proposed revisions to the GFE and HUD-1 forms could offer improvements that may help consumers better understand and compare loan terms and closing costs. However, other proposals may have the unintended consequence of further complicating the already complex mortgage lending process, thus causing more consumer confusion than clarity.

Ideally, the FTC staff believes that consumers would benefit most from a more comprehensive effort to reform federal mortgage disclosures. In particular, the FTC staff supports the development of a single mortgage disclosure document, rather than separate disclosures under RESPA and TILA, so that consumers shopping for a mortgage loan would not need to consult several different disclosure documents to obtain a fuller picture of the loan terms. The staff recommends that HUD collaborate with the Board of Governors of the Federal Reserve System (Federal Reserve Board) to consolidate and reform federal mortgage disclosures. The FTC staff would be pleased to work with HUD and the Federal Reserve Board in such an effort.

The FTC staff provides the following comments on HUD's proposed rule based on the Commission's experience in the mortgage industry and its research on mortgage disclosures. Specifically, this comment focuses on seven main issues arising from HUD's proposed rule.[12] Below are summaries of the FTC staff's primary comments on each issue:

- **Revised GFE Form and Application Concept**: HUD's proposed rule intends to improve and standardize the GFE form to help consumers better comparison shop among loan originators. FTC staff supports these goals, but suggests that HUD consider:

    - Reevaluating the new "GFE application" concept because it may add confusion to the already complex mortgage lending process. If the new concept is retained, FTC staff suggests re-labeling the "GFE application" concept, so that consumers do not confuse it with a mortgage application, as well as educating consumers and others about the differences between these two parts of the mortgage lending process.

[11] *See, e.g.,* 73 Fed. Reg. at 14,030.

[12] This comment focuses on major points within HUD's proposal. It does not address every item in the proposed rule.

- Allowing loan originators to ask for more information in accepting a GFE application than the proposed rule permits, because the limited information the originator would receive under the proposed rule may result in the disclosed loan terms on the GFE being dramatically different than the final loan terms offered after full underwriting.

- Clarifying or modifying the revised GFE form and language in the proposed rule relating to the GFE.

- **Revised HUD-1[13] Form and HUD-1 Closing Script Addendum**: HUD's proposed rule intends to make it easier for consumers to compare the estimated settlement costs on the GFE form with the actual settlement costs on the HUD-1 form and in the HUD-1 Closing Script addendum (Closing Script). FTC staff supports this objective, yet recommends that HUD consider:

    - Making the disclosures in the Closing Script and the Comparison Chart more consistent with the revised GFE and HUD-1 forms.

    - Conducting further consumer testing of the Closing Script and the Comparison Chart, including assessing whether settlement agents can adequately convey the information in the Closing Script to consumers.

    - Clarifying or modifying several specific aspects of the revised HUD-1 form, Closing Script, and Comparison Chart.

    - Assigning to lenders, rather than settlement agents, the responsibility of completing as much of the Closing Script as possible to decrease the risk of inaccuracies.

    - Issuing a guidance document explaining to settlement agents their responsibilities if there are inconsistencies between the loan terms and charges in the GFE and those in the HUD-1 and other loan documents.

    - Revising the Closing Script to inform consumers of their options if "tolerances" are exceeded.

[13] The proposed rule makes corresponding amendments to the HUD-1A form, an optional form for transactions without sellers (*e.g.*, refinancings, subordinate-lien federally related mortgages). *See* 73 Fed. Reg. at 14,061 n.34 and 14,064 (proposed App. A). For purposes of this comment, we refer to both forms collectively as "HUD-1."

    - Clarifying further the "unforeseeable circumstances" that, among other things, allow settlement costs to increase substantially between the time of the GFE and the HUD-1.

- **Mortgage Broker Compensation Disclosures**: HUD proposes revising the disclosure requirements for mortgage broker compensation received in the form of a yield spread premium from the lender. The FTC staff supports the goal of improving consumer understanding of the costs and terms of mortgage loans. However, based on the results of past FTC and HUD mortgage disclosure research, the FTC staff urges HUD to consider:

    - Reevaluating its proposed broker compensation disclosures, as they may adversely affect consumers and competition.

    - Evaluating and testing alternative disclosures to determine what will most benefit consumers.

- **Average Cost Pricing, Negotiated Discounts, and Competition**: HUD's proposed rule recognizes pricing mechanisms intended to promote the goals of greater competition and lower consumer settlement costs. The FTC staff supports these goals, as well as the amendments that would allow average cost pricing and remove restrictions against quantity discounts. However, FTC staff encourages HUD to consider whether pricing restrictions on the re-sale of settlement service components and prohibitions on referral fees may inadvertently decrease competition and efficiency in the settlement service market.

- **Definition of "Required Use" of Affiliated Business Services**: HUD's proposed rule would expand the definition of "required use" of services provided by affiliated businesses. FTC staff recommends that HUD reconsider the proposed change. The expanded definition could deprive customers of the lower prices that can result from bundling related services. Finally, HUD may wish to test the effectiveness of the affiliated business disclosure.

- **Consumer Research**: The FTC staff commends HUD's use of consumer testing in developing its proposed revised GFE and closing disclosures. However, FTC staff recommends that HUD (separately or as part of a comprehensive federal mortgage disclosure reform effort) continue to carefully test and revise the disclosures, particularly the Closing Script, to minimize consumer misunderstandings.

- **Comprehensive Reform of Federal Mortgage Disclosures**: Although consumers would benefit from effective improvements in the GFE and HUD-1, FTC staff's experience and research suggests that consumers would benefit most from a more comprehensive effort to reform federal mortgage disclosures.

## II. Revised GFE Form and Application Concept

Currently, consumers submit a mortgage loan application to a lender or broker. Within three days of receipt of the application, the lender or broker must provide consumers with a Good Faith Estimate of settlement costs.[14] The GFE form includes the estimated cost of certain settlement services that the consumer is likely to incur at closing.[15] The information on the GFE is intended to assist consumers in comparison shopping for settlement services.

### A. GFE Application Concept

In connection with RESPA's GFE requirements, the proposed rule establishes a new concept of a "GFE application."[16] As discussed below, this new approach seeks to ensure that loan originators provide the GFE to borrowers earlier in the process than RESPA currently requires.[17] The FTC staff supports the objective of requiring early GFE disclosures to assist consumers in shopping for mortgages. However, to enhance clarity and understanding, FTC staff urges HUD to consider making changes to the proposed rule.

First, the FTC staff is concerned that use of the term "GFE application" itself will result in confusion. The term and concept do not currently exist as part of the mortgage process. The mortgage lending process is already complex, and interjecting a new concept – particularly one that is significant to the entire transaction – creates a substantial risk of confusion.[18] Indeed, the

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14 *See* RESPA, 12 U.S.C. § 2604(c); Regulation X, 24 C.F.R. § 3500.7.

15 *See* 12 U.S.C. § 2604(c); 24 C.F.R. §§ 3500.2(b); 3500.7. Under the proposed rule, it means an "estimate of settlement charges a borrower is likely to incur, as a dollar amount, and related loan information, based upon common practice, and experience in the locality of the mortgage property, provided on the form prescribed . . . that is prepared in accordance with § 3500.7 and the Instructions . . . ." *See* 73 Fed. Reg. at 14,056 (proposed Section 3500.2(b)); *see also id.* at 14,057 (proposed Section 3500.7).

16 *See* 73 Fed. Reg. at 14,056-57 (proposed Sections 3500.2(b); 3500.6; 3500.7).

17 For example, at present, the regulations do not require that the GFE be given to the borrower until after submission of a mortgage loan application to the originator. *See* 73 Fed. Reg. at 14,034. Under the proposed rule, the borrower must receive the GFE earlier in the process because the three-day period to provide the GFE is triggered when the originator receives less information from the borrower than would be required in the mortgage loan application. *See* text accompanying notes 20-25, *infra*.

18 It could also potentially increase delay and burden to consumers and others in the transaction. As proposed, when a borrower chooses to proceed with a loan originator, the originator may require a separate "mortgage application" to begin final underwriting. *See id.* at 14,035. The originator may not reject a borrower for a loan unless there is a change in the borrower's eligibility based on final underwriting, as compared to information in the GFE application and certain credit information. *Id.* As

new "GFE application" would be in addition to and distinct from a mortgage loan application. At a minimum, consumers would need extensive education on how and why the new "GFE application" differs from a mortgage loan application. Industry would also benefit from prompt guidance, including how the GFE application relates to other mortgage lending laws that include an "application" concept.[19]

Second, FTC staff believes that loan originators should be given latitude to ask for more information from consumers than the proposed rule permits. Under the proposed rule, loan originators must provide the GFE within three business days after receiving the "GFE application," or information sufficient to complete a GFE application.[20] A "GFE application" is defined as:

> a written or oral submission to a loan originator by a prospective borrower to obtain a GFE for a specific loan product. The loan originator may require the GFE applicant to provide <u>no more than</u> the prospective borrower's name, Social Security number, property address, monthly income, the borrower's best estimate of the value of the property, and the mortgage loan amount sought by the borrower to obtain a GFE.[21]

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discussed in the text accompanying notes 20-25, *infra*, the originator may have insufficient information stemming from the limited GFE application. It could potentially reject borrowers for loans in which they are interested and qualified because of the lack of more complete information. If the borrower is rejected, the originator must provide another GFE(s) if another loan product is available. Borrowers would then have to assess these other options or seek another lender and restart the entire process.

[19] The proposed rule does not indicate whether or how a loan originator should explain the different application concepts to a consumer who, for example, merely requests general information about mortgage rates without providing enough information for a GFE application or specifically requesting a mortgage loan application. In addition, the preamble indicates that creditors would need to provide TILA disclosures generally within three days of a written GFE application. 73 Fed. Reg. at 14,035. HUD also recognizes that the GFE application may trigger requirements under the Equal Credit Opportunity Act (ECOA), 15 U.S.C. § 1691 *et seq.*, or the Home Mortgage Disclosure Act (HMDA), 12 U.S.C. § 2801 *et seq.*, but does not attempt to resolve issues related to this overlap. 73 Fed. Reg. at 14,036.

[20] 73 Fed. Reg. at 14,057 (proposed Section 3500.7). As noted in the text accompanying note 14, *supra*, lenders or brokers currently must provide the GFE within three business days after an "application" is received or prepared. *See* 12 U.S.C. § 2604; 24 C.F.R. § 3500.7(a), (b). An "application" is defined as "the submission of a borrower's financial information in anticipation of a credit decision, whether written or computer generated, relating to a federally related mortgage loan." 24 C.F.R. § 3500.2(b).

[21] 73 Fed. Reg. at 14,056 (proposed Section 3500.2(b)) (emphasis added). The submission is not considered an "application" unless it states or identifies a specific property. *See id.*

The preamble to the proposed rule states that "the application would include only such information as the originator considered necessary to arrive at a preliminary credit decision and provide the borrower a GFE."[22] Thus, the GFE application, with its restriction on obtaining other information, is designed to require the GFE to be provided to borrowers sooner, facilitating shopping and lowering the costs to consumers and the industry.[23]

The FTC staff agrees that it is important to provide consumers with information about important costs and terms of the settlement and mortgage sooner than under current regulations. Receiving a GFE earlier may help consumers gain a better understanding of the terms under consideration and engage in better-informed comparison shopping. However, the FTC staff is concerned that prohibiting a loan originator from requesting additional information at the GFE application stage could potentially hinder or bias the preliminary (and possibly the final) credit decision and impair the GFE as a functional shopping tool for consumers.

For example, a loan originator may <u>not</u> request any information (even informal estimates) regarding the borrower's employment (including future employment and anticipated income), savings, estimated cash available for a down payment or closing costs, or other assets or liabilities (although the originator may access an initial credit report).[24] Suppose the borrower tells the lender that he or she made approximately $3,000 a month in commissions for the past year. The lender would not be able to ask how typical that figure is or whether the borrower's commissions are expected to decrease in the future.[25] Because the loan originator cannot request such information, and the borrower may not understand the potential implications of failure to provide it, the GFE disclosures are unlikely to reflect all potentially relevant information. As a result, the disclosed loan terms may be dramatically different from the final loan terms offered after full underwriting. The proposed rule attempts to facilitate borrower shopping by limiting the information required at the GFE application stage. Unfortunately, the unintended result could be that the borrower ends up shopping by comparing the terms of loan products that may not actually meet his or her needs. Some borrowers may end up comparing the terms of loan products for which they are not qualified and others may end up comparing loan products that are more expensive than they might be offered with a full underwriting.

If after full underwriting at the mortgage application stage, the loan originator obtains information that would result in more favorable loan terms for the borrower than those originally

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22 *Id.* at 14,035.

23 *See id.*

24 HUD should also clarify the loan originator's responsibilities that apply under the proposed rule if the consumer volunteers such information.

25 Or suppose the borrower has obtained loans from companies that do not report debt to credit reporting agencies. Although the debt would not appear on the borrower's credit report, the lender would not be permitted to ask about this type of outstanding liability.

offered at the GFE application stage, originators will be under no obligation to provide these better terms to the borrower. The proposed two-stage application process could create a mechanism by which inaccurate prices are provided at the GFE application stage while consumers are shopping for a loan.

In short, interjecting the GFE application concept in a mortgage process that is already complex could cause confusion and delay. FTC staff thus believes it would be beneficial for HUD to consider alternatives to this approach and term. For example, HUD might consider use of a term other than "application" (*e.g.*, "GFE Request"), to minimize potential confusion. It could also require loan originators to provide the GFE when they receive certain minimal information, as specified in the rule, but not prohibit them from seeking other information to make a preliminary credit decision.

### B. Revised GFE Form

HUD's proposed rule requires loan originators to use a new standardized GFE form. FTC staff research and consumer testing indicate that current GFE requirements do not convey information that sufficiently helps consumers make better informed decisions about settlement costs and mortgages.[26] Therefore, the FTC staff supports efforts to improve and standardize the GFE form.

The FTC staff recognizes that HUD has engaged in several rounds of consumer testing to develop the revised GFE form in the proposed rule.[27] Consumers benefit from uniform, early, and accurate disclosures of loan information, but only if the information disclosed is presented in a manner that consumers will notice and understand. FTC staff believes that the new GFE form offers several features that will benefit consumers. These include the summary overview of loan terms and charges on the first page; the additional details regarding categories of fees and shopping options on subsequent pages; and the focus on total settlement costs, rather than itemized costs.

The FTC staff, however, also believes that the new form raises three concerns that warrant clarification or modification. First, consumers may be confused based on the differences[28] between the GFE and HUD-1 disclosures, including the Closing Script, and the

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[26] *See* FTC Staff Mortgage Disclosure Study, *supra* note 7.

[27] Consumer testing of the forms is addressed *infra* Parts IV and VII.

[28] Various differences exist between the new GFE and the Closing Script, and the TILA disclosures, including differences regarding rates and monthly payment amounts. The Federal Reserve Board also has a rulemaking in progress regarding certain aspects of mortgage disclosures under the TILA. *See* 73 Fed. Reg. 1672 (Jan. 9, 2008). The FTC staff submitted a comment on the proposal. *See* FTC Staff Comment on TILA, *supra* note 10.

TILA forms they receive, particularly the differences in monthly payment amounts.[29] The preamble indicates that HUD will explain the differences in the Special Information Booklet provided to consumers at the time of the GFE application.[30] However, these differences can be substantial and technical, particularly for the alternative mortgages common today.[31] The FTC staff suggests that HUD instead consider providing a clear explanation of differences between the forms (particularly regarding the monthly payment amounts) on the GFE and the Closing Script, or using an alternative disclosure on the GFE and the Closing Script to ensure as much consistency with the TILA disclosures as possible. As discussed below, FTC staff believes that comprehensive mortgage disclosure reform is needed, and increasing consistency between RESPA and TILA disclosures would be a key part of such an initiative.

Second, HUD should consider clarifying the following language in proposed Section 3500.7, and the corresponding statements made in the preamble, to ensure consistency:

1. Proposed Section 3500.7(c) states that the estimate of GFE charges "may remain available longer [than 10 business days], if the loan originator extends the period of availability."[32] The preamble, however, specifies that: (i) *borrowers may request* and originators may extend the shopping period; and (ii) if extended, originators should make a specific *notation* on the GFE form.[33] It is unclear from the current plain language of

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[29] The GFE and the Closing Script monthly payment amounts include principal, interest and mortgage insurance. The TILA monthly payment amounts can include these items plus taxes and homeowners insurance. *See* 73 Fed. Reg. at 14,036, 14,037, 14,093 (proposed App. C) and 14,095 (proposed App. C). Also, under TILA, monthly payments include "finance charges," which encompass amounts beyond interest and mortgage insurance, including any service charges or other finance charges. *See* Sections 106 and 128 of TILA, 15 U.S.C. §§ 1605 and 1638; Sections 226.4 and 226.18(g) of Regulation Z, 12 C.F.R. §§ 226.4 and 226.18(g), and Sections 226.4 and 226.18(g) of the Federal Reserve Board's Official Staff Commentary to Regulation Z, 12 C.F.R. §§ 226.4 and 226.18(g), Supp.1. Other differences exist between the TILA disclosures and GFE or HUD-1 disclosures, including the Closing Script.

[30] *See* 73 Fed. Reg. at 14,037. Under RESPA's current requirements, lenders or brokers must provide a Special Information Booklet within three business days after an "application" is received or prepared. *See* 12 U.S.C. § 2604; 24 C.F.R. § 3500.6. The Special Information Booklet is a standardized HUD brochure that contains general information explaining the nature and costs of various settlement services. *See* U.S. DEP'T OF HOUSING AND URBAN DEV., OFFICE OF HOUSING - FED. HOUSING ADMIN., BUYING YOUR HOME: SETTLEMENT COSTS AND HELPFUL INFORMATION (June 1997), *available at* http://www.hud.gov/offices/hsg/sfh/res/sfhrestc.cfm.

[31] Such mortgages frequently have multiple payment streams and other complex features. *See generally* FTC Comment on Home Equity Lending Market, *supra* note 10.

[32] 73 Fed. Reg. at 14,057 (proposed Section 3500.7(c)).

[33] *Id.* at 14,037.

proposed Section 3500.7(c) that the borrower may request an extension and that, if extended, HUD expects the originator to make an additional notation on the GFE form.

2. Proposed Section 3500.7(f)(3) discusses additional GFE disclosures applicable to "transactions involving new home purchases."[34] The preamble, however, specifies that this provision applies to purchases of "new *construction*" homes.[35] One could read the current plain language of proposed Section 3500.7(f)(3) as applying to a purchase of any home that is new to the specific borrower, rather than a new construction home. Thus, HUD should consider modifying the language in proposed Section 3500.7(f)(3) to clarify that it applies only to transactions involving purchases of new construction homes.

Finally, the proposed rule requires additional GFE disclosures under certain circumstances,[36] but the revised GFE form does not provide space for originators to include any of this information. The FTC staff suggests that HUD consider incorporating these disclosures in the GFE form, perhaps by using a "check-the-box" (*e.g.*, □ No □ Yes) format similar to the other disclosures on the first page of the form.[37]

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34 *Id.* at 14,058 (proposed Section 3500.7(f)(3)).

35 *Id.* at 14,040 (emphasis added).

36 *See id.* at 14,037 and 14,057 (discussing extended shopping period and related disclosures in proposed Section 3500.7(c)); *id.* at 14,040 and 14,058 (discussing "new construction" home purchases and related disclosures in proposed Section 3500.7(f)(3)). Regarding disclosures in connection with required services that the borrower can shop for (Block 5 on the GFE form), the FTC staff notes that the Instructions for Completing the GFE Form (GFE Instructions) appear to be inconsistent with the preamble and GFE form itself. Specifically, the GFE Instructions indicate that if the loan originator permits the borrower to shop for a required settlement service, the originator <u>must</u> provide a written list of settlement service providers at the time of the GFE, <u>on a separate sheet of paper</u>. *See id.* at 14,094 (proposed App. C) (emphasis added). The preamble indicates that, in the above circumstances, the loan originator must provide the list "on the GFE form <u>or</u> on a separate sheet of paper." *Id.* at 14,038 (emphasis added). The GFE form states, "We <u>can</u> refer you to providers of these services or you can shop for them yourself." *See id.* at 14,096 (proposed App. C) (emphasis added). It is unclear from this language that the loan originator is <u>required</u> to provide a list of settlement service providers. The FTC staff suggests that HUD clarify this disclosure requirement.

37 For example, the form could include: (1) a statement that the borrower requests an extended shopping period, with a blank space for the expiration date of extension if the originator opts to grant the request; and (2) a statement that the transaction involves the purchase of a new construction home, and settlement is anticipated more than 60 days from the time of the GFE application, with a clear and conspicuous disclosure that the originator may issue a revised GFE any time up until 60 days prior to closing.

## III. Revised HUD-1 Form and Closing Script

If a lender extends a mortgage to the consumer, it must provide the consumer with the HUD-1 Settlement Statement (HUD-1) at closing.[38] The HUD-1 sets forth the actual cost of the settlement services for the consumer in connection with the loan.

### A. General Comments Regarding Revised HUD-1 Form and Closing Script

As HUD recognizes, it is important that consumers be able to make clear comparisons between application terms and fees disclosed in the GFE, and closing terms and fees disclosed in the HUD-1. HUD proposes to revise the HUD-1 form to include cross-references to the location of charges disclosed on the GFE.[39] The FTC staff supports this revision because it will make it easier for consumers to compare their estimated settlement costs with their actual settlement costs.

With respect to the new Closing Script and the "GFE & HUD-1 Charges Comparison Chart" (Comparison Chart),[40] the FTC staff generally prefers to avoid adding another extensive disclosure form to the current panoply of mortgage disclosures. Nevertheless, improved closing disclosures that will help consumers better understand their final loan terms would be useful. To facilitate direct comparisons, HUD might consider making the Closing Script and the Comparison Chart more consistent with the revised GFE and HUD-1 formats. To enhance consumer understanding of the materials being provided, the FTC staff suggests that HUD conduct further consumer testing of the Closing Script and the Comparison Chart, in various formats.

### B. Specific Concerns with Revised HUD-1 Form and Closing Script

The FTC staff notes the following specific concerns with the revised HUD-1 form, including the Closing Script and the Comparison Chart. First, as noted in Part II.B, above, consumers are likely to be confused because the monthly payment amounts that the settlement agent provides using the Closing Script are different from the monthly payment amounts the lender provides on the TILA form.[41] The preamble indicates that HUD will explain the differences in the Special Information Booklet.[42] The FTC staff suggests that HUD instead

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[38] 12 U.S.C. § 2603.

[39] *See* 73 Fed. Reg. at 14,049, 14,063 (proposed App. A).

[40] *See id.* at 14,050, 14,066-92 (proposed App. A, Addendum).

[41] *See* text accompanying notes 28-31, *supra* (discussing differences between the new GFE and the Closing Script, and the TILA disclosures).

[42] *See* 73 Fed. Reg. at 14,037.

consider providing a clear explanation of these differences in the Closing Script, or using an alternative monthly payment disclosure on the Closing Script to ensure as much consistency in these figures as possible.

Second, under the proposed rule, the settlement agent must read the Closing Script in its entirety, based upon information the loan originator provided. Reviewing this extensive information with consumers could be a lengthy process. Also, this information must be imparted to consumers in circumstances that may not be conducive to agents providing it and consumers receiving and understanding it – with numerous forms to be addressed, as well as the multiple closings that settlement agents may be conducting in short time frames, and borrowers having varying degrees of familiarity with the process and loan products.[43]

The FTC staff believes that HUD should consider modifying the proposed rule to make it easier for settlement agents to convey information in this context. For example, the Closing Script examples and the "Instructions to the Closing Script Preparer" ("Instructions") should address more diverse mortgage types. Some types of mortgages currently are included in the Closing Script and Instructions; however, additional types should be included, otherwise, settlement agents may not be able to fully and accurately convey the information that the proposed rule envisions.[44]

Third, HUD should consider revising the Comparison Chart to clarify that the *sum total* of the fees disclosed in the middle section are subject to the 10% tolerance limitation (as opposed to each individual fee). For example, the heading of the middle section could be revised from the current "Charges Cannot Increase More Than 10%" to language such as "Total of All Charges Cannot Increase More Than 10%."

Fourth, the Closing Script's Acknowledgment form requires the consumer and the party conducting the closing to sign and acknowledge that any inconsistencies between the loan terms and charges in the GFE and those in the HUD-1 and other loan documents have been provided and explained. However, it is difficult or impossible for most consumers to know whether all

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[43] The mortgage market today involves diverse products. Scores, if not hundreds, of such products may exist in the marketplace. *See Preserving the American Dream: Predatory Lending Practices and Home Foreclosures: Hearing Before the Senate Comm. on Banking, Housing, and Urban Affairs*, 110th Cong. 7 (Statement of Douglas G. Duncan, Ph.D., Chief Economist and Senior Vice President of Research and Business Development, Mortgage Bankers Assoc.), *available at* http://banking.senate.gov/public/_files/duncan.pdf.

[44] For example, buydowns are also common in the marketplace. Buydowns involve payments by someone, such as the seller or others, to reduce the interest rate for the first few years of the loan. In a 3-2-1- buydown, for example, the rate is reduced by 3% the first year, 2% the second year, and 1% the third year, after which the rate returns to the full level. This arrangement reduces the monthly payments in the first three years of the loan. Buydowns can be offered with either fixed or adjustable rates.

discrepancies actually were provided or explained. HUD should consider clarifying the language in this portion of the Acknowledgment form to ensure that consumers sign and acknowledge an accurate statement.

Last, the revised HUD-1 form refers to the loan originator's service charge (Line 801) and the "charge or credit for the specific interest rate chosen" (Line 802).[45] These charges correspond to Blocks 1 and 2, respectively, on the revised GFE.[46] HUD recognizes the potential for "double-counting" if these charges are disclosed in the borrower or seller column or as paid outside closing (POC) on the HUD-1.[47] To decrease the risk of incorrect disclosures, HUD should consider pre-populating the borrower and seller columns on Lines 801 and 802 with "N/A" or a similar reference.

### C. Role of Settlement Agent

HUD proposes that the settlement agent prepare the Closing Script, read it aloud to the borrower at settlement, and explain related information to the borrower.[48] The FTC staff supports HUD's efforts to have a third party (*i.e.*, a person other than the loan originator) help borrowers understand their final loan terms and compare application terms and fees disclosed in the GFE with actual closing terms and fees. The FTC staff is concerned, however, that the proposed broad role of the settlement agent could result in consumers receiving information that confuses them and could impose significant burdens on other closing participants.

As proposed, the loan originator must send to the settlement agent all information needed to complete the Closing Script.[49] The settlement agent will prepare the Closing Script and then read it to the borrower at closing. Oral presentation of information to consumers, however, could result in their misunderstanding complicated loan terms.[50] There also could be increased

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45 73 Fed. Reg. at 14,063 (proposed App. A).

46 *See id.* at 14,063 (proposed App. A), 14,096 (proposed App. C).

47 *See id.* at 14,049.

48 *See id.* at 14,058 (proposed Section 3500.8(d)).

49 *Id.*

50 For Hispanic or other non-English fluent consumers, this could pose a very serious issue. For example, in 2006, the Commission filed suit against a mortgage broker for allegedly misrepresenting numerous key loan terms to Hispanic consumers who sought to finance their homes. *See FTC v. Mortgages Para Hispanos.com Corp.,* No. 06-00019 (E.D. Tex. 2006). The lender conducted business with clients almost entirely in Spanish but provided closing documents in English, with less favorable terms than those previously promised to the consumers. In settlement, the court entered a suspended judgment of $240,000 against the broker. The court also entered a permanent injunction prohibiting the broker from misrepresenting loan terms. *See id.* (Stipulated Final Judgment and Order of Permanent

borrower confusion if the originator sends incorrect information, or the settlement agent incorrectly completes the Closing Script.[51]

Thus, the FTC staff suggests that HUD consider modifications to the current proposal. For example, HUD could consider whether the lender itself, instead of the settlement agent, should complete as much of the Closing Script as possible. Having lenders complete as much of the Closing Script as possible might minimize the potential that the Closing Script would include incorrect information. The settlement agent would remain responsible for reviewing the Closing Script with the borrower, but he or she would not be burdened by the potential liabilities connected with completing the form, particularly when the agent may not be familiar with that information, as discussed below.

The FTC staff also is concerned about requiring settlement agents to read the Closing Script to consumers[52] because agents may not be familiar with all of the terms in the Closing Script. In fact, they currently are not responsible for understanding or explaining the various mortgage loan products originators offer. The FTC staff suggests that HUD consult with settlement agents to ensure that they can adequately convey the information in the Closing Script.

The FTC staff has an additional concern regarding the settlement agent's proposed role in reviewing the Closing Script with the borrower. The agent must explain whether the settlement charges meet the required "tolerances," and whether any inconsistencies exist between the loan terms and charges in the GFE and those in the HUD-1 and other loan documents.[53] However, there is no indication of what the agent should do if there is such an inconsistency, for example, the charges exceed the tolerances or the borrower expected a different type of loan (*e.g.*, a fixed rate than adjustable rate loan). FTC staff suggests that HUD consider providing a guidance document to settlement agents, with instructions on how the agent should answer the borrower's questions about any discrepancies. HUD might also consider adding specific language to the Closing Script informing borrowers of what their options are if the tolerances are exceeded. In

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Injunction).

FTC staff notes that the proposed rule does not address whether HUD expects that the Closing Script and other disclosures would be provided in languages other than English, as appropriate for certain consumers. It is important that foreign language consumers also be able to understand these disclosures.

[51] FTC staff also notes that a loan originator could intentionally defraud the borrower simply by sending incorrect information to the settlement agent. Although loan originators could directly provide false information to a borrower, borrowers may be less vigilant in assessing mortgage loan information from a settlement agent (a third party intermediary) than from the lender itself.

[52] *See* 73 Fed. Reg. at 14,058.

[53] *Id.* at 14,058 (proposed Section 3500.8(d)).

addition, to ensure that the process of using the Closing Script works smoothly for consumers, FTC staff recommends that it be tested, in actual closing circumstances.

### D. "Unforeseeable Circumstances"

Many important aspects of the proposed rule hinge on the concept of "unforeseeable circumstances." For example, the proposed rule allows a borrower to be charged more for settlement services than the amounts stated when the GFE was provided, in the event of "unforeseeable circumstances."[54] If unforeseeable circumstances cause changes in borrower eligibility for the GFE-designated loan terms, the loan originator must notify the borrower quickly; if another loan is made available, the loan originator must provide the borrower with a revised GFE, among other things.[55]

Despite the significance of this concept, the proposed definition of "unforeseeable circumstances" is vague, and the FTC staff believes it should be clarified. Under the proposal, "unforeseeable circumstances" are defined as:

> (1) Acts of God, war, disaster, or other emergency making it impossible or impracticable for the loan originator to complete the transaction; and
>
> (2) Circumstances that could not be reasonably foreseen for a loan originator at the time of GFE application that are particular to the transaction and that result in increased costs, such as . . . the need for a second appraisal . . . . Market fluctuations by themselves shall not be considered unforeseeable circumstances.[56]

The FTC staff appreciates the challenges of defining this term broadly enough to cover certain contingencies, yet not so broadly as to allow circumvention of the proposed rule. Nevertheless, it would be useful for HUD to provide additional guidance in the proposed rule, such as specific examples, clarifying when changes in circumstances are, or are not, foreseeable.[57]

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[54] *See id.* at 14,057 (proposed Section 3500.7(e)(1) and (2)). These charges include the loan originator's service charge; rate lock-in charge; lender-required settlement services; and others.

[55] *See id.* at 14,057-58 (proposed Section 3500.7(f)). Also, if the loan originator cannot meet specified tolerances for certain costs due to unforeseeable circumstances, it must document those circumstances, notify the borrower quickly, and provide a new GFE. *See id.* at 14,057 (proposed Section 3500.7(e)(4)). Loan originators must also retain documentation of such unforeseeable circumstances. *See id.* (proposed Section 3500.7(e)(5)).

[56] *Id.* at 14,056 (proposed Section 3500.2(b)).

[57] For example, the definition uses the conjunction, "and." *See id.* However, various discussion in the proposal uses the disjunction, "or," or discusses the definitional clauses separately. *See id.* at 14,040. FTC staff believes that HUD should clarify whether these clauses are conjunctive or disjunctive.

In short, the proposed rule is intended to assist borrowers and clarify mortgage costs and terms. It also envisions expanded liability for numerous business entities in the mortgage industry. Given the importance of the concept of "unforeseeable circumstances," the FTC staff believes that HUD should clarify this concept and include specific examples to shed light on the ambit of its coverage.

## IV. Mortgage Broker Compensation Disclosures

The FTC staff supports HUD's goals of improving consumer understanding of the cost and terms of mortgage loans and making mortgage shopping easier. However, FTC staff urges HUD to reconsider the proposed rule's provisions on broker compensation disclosures. Research conducted by both FTC staff and HUD has shown that broker compensation disclosures can harm consumers and competition. Alternative disclosures that clarify the role of mortgage originators, applied equally to all originators (lenders and brokers), could provide greater benefits to consumers and avoid adverse effects on consumers and competition.

### A. Yield Spread Premiums

A mortgage broker often receives compensation from a lender in the form of a yield spread premium (YSP). A YSP is paid to a broker if the loan is originated at an interest rate higher than the minimum rate necessary to obtain the loan, and it reflects the higher value of the loan arising from the higher rate. Direct lenders that originate their own loans also earn premiums from loans originated at higher rates. These premiums may be passed on as compensation to the loan officers who made the loans or accrue as higher profits for the lenders.

A potential benefit of YSPs, if passed on to the borrower, is that they can be used to reduce up-front origination charges that otherwise would be paid by the borrower in cash at closing. The up-front costs are instead spread over the life of the loan through the higher

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The broad definition raises additional questions. For example, are unanticipated changes in business volume, due to shifts in economic circumstances in the country, covered? How would stepped-up foreclosures in the area of the borrower's designated property be addressed – as these could lead to changed economic values, the need for multiple appraisals and may lead to other added costs? Would these circumstances constitute an "emergency making it impossible or impracticable" to proceed? Or, could they be circumstances that were "reasonably foreseeable," and hence, excluded from the exception? Would an unexpected change in the borrower's employment situation be covered by the definition?

If between the time of application and settlement, additional property in the area of the borrower's home sits unsold and/or abandoned, there is the risk that a variety of increased costs may be passed on to borrowers. Could these increased costs fall under any aspect of the definition? If there is a change in settlement service providers, because they cease business or fall behind, would that circumstance make it "impossible or impracticable for the loan originator to complete the transaction," or could it constitute "circumstances that could not be reasonably foreseen"?

monthly payments that arise from the higher interest rate. Paying charges through YSPs can be particularly beneficial for borrowers who do not have sufficient savings to cover the up-front charges in cash or who prefer to avoid a large up-front cash payment for other reasons. Borrowers who foresee moving in the near future, for example, may want to minimize cash payments at closing and will be less affected by future higher monthly payments. Some experts also have noted that using YSPs to reduce up-front costs can provide tax benefits to borrowers who are refinancing a loan because the resulting higher interest payments are tax-deductible, while closing costs paid in cash at settlement are not.[58]

The extent to which YSPs are passed along to consumers to reduce the closing costs consumers pay differs among different brokers and consumers. It depends, in part, on the level of competition in the market and how well consumers negotiate for the best deal. Proposals to disclose broker compensation are generally motivated by a concern that mortgage brokers are placing borrowers in loans with higher rates than necessary and using the YSPs to increase their compensation rather than reduce the up-front charges paid by the borrowers. When this occurs, borrowers pay higher interest rates without receiving a compensating benefit of lower up-front costs. Broker compensation disclosures are intended to help consumers more readily recognize the cost of a loan (particularly, high-cost loans), more effectively shop for low-cost loans, and better negotiate for lower loan costs.

### B. HUD's Proposed Broker Compensation Disclosure

The proposed rule would require that mortgage brokers disclose to consumers in the GFE any YSP received from the lender in connection with the loan. The YSP would be disclosed as a credit to the consumer. The amount of the credit would be added to the origination charges paid directly by the consumer to obtain a figure disclosed as the broker's "service charge." The origination charges paid directly by the consumer would be disclosed as the borrower's "adjusted origination charges." The GFE would present the broker's "service charge" first, then subtract the "credit for the interest rate chosen" to derive the borrower's "adjusted origination charges."

Lenders that make an equivalent loan directly (without a broker's involvement), and earn the same compensation that the broker would have made on the loan, would not be required to make a similar disclosure under the proposed rule. Although direct lenders may choose to disclose a credit to the borrower, add the credit to the origination charges paid directly by the consumer, and disclose the total as their "service charge," they would not have to do so. Instead, direct lenders could simply leave the credit disclosure line on the GFE blank and disclose the origination charges the consumer paid directly to the lender as their "service charge." Lenders choosing this option would be required to check a box that states: "The credit or charge for the interest rate you have chosen is included in 'Our service charge.' (See item 1 above.)" Given the

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[58] *See Predatory Mortgage Lending Practices: Abusive Uses of Yield Spread Premiums: Hearing Before the Senate Committee on Banking, Housing and Urban Affairs,* 107th Cong. 5 (2002) (statement of Susan E. Woodward, Ph.D., Chairman of Sand Hill Econometrics, Inc.).

greater simplicity of this option, and the resulting more favorable presentation to the consumer, one would expect that most lenders would choose this approach.[59]

### C. FTC Staff Study of Broker Compensation Disclosures

The FTC staff conducted a study of broker compensation disclosures following HUD's proposal of such disclosures in 2002.[60] The study used a controlled experiment with over 500 recent mortgage customers to examine how well consumers could understand broker compensation disclosures. The study found that the compensation disclosures confused consumers, leading many to choose loans that were more expensive than the available alternatives, and created a substantial consumer bias against broker loans, even when the broker loans cost the same or less than direct lender loans. The results of the FTC staff study are presented in more detail in Appendix A of this comment.

As noted in the study, the potential benefit of compensation disclosures is not readily apparent. Seller compensation is rarely disclosed in consumer markets. Consumers generally base their purchase decisions on the price they must pay, not the seller's compensation. Consumers comparison-shop on prices to find the best deal, and retailers display and advertise their prices to attract consumers. Consistent with their behavior in other markets, consumers should shop in the same way when seeking the lowest cost mortgage that fits their needs and circumstances. Consumers should comparison shop on the costs they must pay for the loan – the interest rate, monthly payments (both current and future), and up-front costs – not how much the broker (*i.e.*, the seller) is earning on the transaction.[61]

As shown in the FTC staff study, focusing consumers on the compensation that loan originators receive can confuse consumers about the price of loans. This is particularly the case when some loan originators, but not others, are required to disclose their compensation. Under the proposed rule, only brokers would be required to disclose their compensation, even though they may be offering the same loan, at the same interest rate, with the same closing costs, and earning the same compensation as lenders. As demonstrated in the study, YSP disclosures make broker loans appear to be more expensive or less desirable than identical, or even more costly,

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[59] If a lender charges a consumer discount points to reduce the interest rate on the loan, the dollar amount must be disclosed as a charge for the interest rate chosen and added to the service charge to derive the disclosed "adjusted origination charges." *See* 73 Fed. Reg. at 14,047.

[60] *See* FTC Staff Mortgage Broker Compensation Study, *supra* note 7. These issues were also addressed in the FTC staff's recent comment on Truth in Lending to the Federal Reserve Board. *See* FTC Staff Comment on TILA, *supra* note 10.

[61] Consumers, particularly those who intend to hold the mortgage for the full term, also may find it useful to comparison shop on the annual percentage rate (APR). The APR states the total credit cost of the loan, including interest and other finance charges, as a yearly rate, taking into account the timing of the payments over the life of the loan.

direct lender loans, and lead some consumers to select more expensive loans than they would have otherwise.

Compensation disclosures also may have adverse effects on market efficiency and competition. A consumer focus on originator compensation rather than consumer costs might distort consumer choice away from the lowest cost providers, leading to less efficient, rather than more efficient, outcomes. This could reward less efficient, higher cost originators and lead to less efficiency in the market, which ultimately could result in higher prices for consumers. The asymmetric application of the proposed disclosures, which would apply only to mortgage brokers but not direct lenders, would aggravate any anticompetitive effects.

### D. HUD's Testing of Broker Compensation Disclosures

HUD has conducted a number of consumer tests during the development of the proposed GFE and closing disclosures.[62] Following the FTC staff study, HUD conducted several tests that focused on the proposed broker compensation disclosure to verify the FTC's results and improve the disclosure.[63] FTC staff commends HUD's efforts to improve the disclosure and to eliminate the adverse effects found in the FTC staff study. Although HUD's initial testing found results similar to the FTC study, its continued efforts have resulted in a proposed YSP disclosure that substantially reduces the consumer confusion and anti-broker bias found for earlier versions of the disclosure. However, HUD's later tests continue to show that, although the adverse effects have been substantially reduced, the proposed disclosures continue to create confusion that leads to an anti-broker bias among a significant proportion of consumers.

Although anti-broker bias does not appear in the results of HUD tests in which the broker loan is $500 cheaper than the lender loan, it does still appear in tests in which the broker and lender loans cost the same. Even when nearly all consumers correctly recognize that the two loans cost the same, a significant anti-broker bias still appears in their choice of loans when they are asked which they would choose if shopping for a mortgage.

Specifically, HUD's "Round 5" tests show that when consumers compare two identical loans, one a broker loan disclosing a YSP and the other a direct lender loan not disclosing a YSP, and are asked which loan they would prefer if they were shopping for a mortgage loan, there is a 17-18 percentage point bias in the proportion of consumers preferring the lender loan, even

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62 *See* 73 Fed. Reg. at 14,043-47. HUD's test reports are available at its web page, Proposed RESPA Rule to Clarify the Settlement Process for Homebuyers - Background and Supporting, Peer-Reviewed Research (last visited May 6, 2008), http://www.huduser.org/publications/hsgfin/goodfaith.html.

63 *See* 73 Fed. Reg. at 14,045-46.

though the two loans had the same interest rates, closing costs, and payments.[64]

This combination of results suggests that the compensation disclosures may make the broker loan less attractive to some consumers in a way unrelated to their perceptions of the direct, out-of-pocket cost of the loan. The compensation disclosure may, for example, lead some consumers to believe that the broker is profiting more from the loan than is a direct lender offering the same loan, and lead them to view the broker loan as less fair. The compensation disclosure also may make the loan appear more complicated and uncertain for some consumers, even though they perceive the costs as the same. The presence of some type of non-monetary bias is consistent with the results of HUD's tests in which the broker loan was less expensive than the lender loan. In tests in which the cost difference between the loans was increased from $300 (as used in earlier tests) to $500, anti-broker bias was significantly reduced. Overall, these results are consistent with the continued presence of a bias that consumers can be induced to overlook if the cost advantage is sufficiently high.

In addition to testing the disclosures in this two-way loan comparison, as in earlier tests, HUD's "Round 5" tests also tested the disclosures within a four-loan comparison. HUD conducted two versions of the four-loan comparison, one in which consumers were instructed to use a "Mortgage Shopping Chart," which was presented to consumers as a separate page with the GFE, to compare the terms of the four test loans, and one in which consumers were provided the shopping chart but not instructed to use it.[65]

HUD concludes that the results of the four-loan comparison tests demonstrate that the anti-broker bias has been eliminated from the disclosures.[66] However, for several reasons, these results do not provide credible evidence that challenges the findings of HUD's two-way comparisons that continue to show that significant bias remains. First, these tests cannot be used to conclude that the anti-broker bias has been eliminated because the tests did not ask consumers the key "loan preference" that in all earlier tests consistently revealed such a bias. Second, the test in which the consumers were instructed to use the Mortgage Shopping Chart focused consumers solely on the shopping chart, essentially removing the rest of the proposed GFE, including the compensation disclosure, from consideration, making it not relevant to evaluation of the disclosure. (The HUD tests are discussed in more detail in Appendix B of this comment.) Thus, the two-loan comparison test, which continues to show a significant anti-broker bias, provides the most credible estimate of the impact of the disclosure.

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[64] *See id.* at 14,046; KLEIMANN COMMC'N GROUP, HUD, TESTING HUD'S NEW MORTGAGE DISCLOSURE FORMS WITH AMERICAN HOMEBUYERS - ROUNDS 4 & 5 - VOLUME 1: RESULTS vi-vii, V-4 (2004) (Rounds 4 & 5 Results), *available at* http://www.huduser.org/Publications/PDF/GoodFaith_4and5vol1.pdf.

[65] *See* 73 Fed. Reg. at 14,046.

[66] *See id.*

### E. Lender Disclosures

As noted above, direct lenders would not be required to disclose compensation but would be permitted to check instead a box that states: "The credit or charge for the interest rate you have chosen is included in 'Our service charge.'" This statement is intended to help prevent consumer confusion over whether lenders also may receive compensation related to the interest rate chosen for the loan. However, FTC staff believes that this statement is factually incorrect and misleading. It appears to say that all of the lender's compensation is contained in the disclosed service charge and has been credited to the consumer. However, if a direct lender is originating a loan with an above-par interest rate, a credit for the higher interest rate will not necessarily be included in the lender's disclosed service charge. That would be the case only if the lender rebated to the consumer any higher compensation arising from the interest rate. Lenders are not required by law to provide such rebates, and many do not.[67] The required statement thus creates the risk of further confusion.

This statement may reinforce the anti-broker bias of the broker compensation disclosure. Rather than helping to put lenders and brokers on a more even playing field, it may make things worse, especially if lenders point to this statement and the resulting service charge figures and contrast them with what consumers will see in broker loans.[68]

An additional disclosure at the end of the proposed GFE also may contribute to consumer confusion regarding direct lender loans. The disclosure states:

> Lenders can receive additional fees by selling your loan at some future date after settlement. Once you have obtained your loan at settlement, however, your loan terms, adjusted origination charges, and total settlement charges cannot change. After settlement, any fees lenders receive in the future cannot change the loan you receive or the charges you paid at settlement.

This statement is intended to help prevent consumer confusion over whether lenders may receive additional fees. However, it appears to be misleading, particularly when contrasted against the GFE's treatment of similar fees obtained by brokers. Although it is true that fees received by lenders from the future sale of a loan will not change the terms of the loan, the lender's anticipation of these fees will certainly affect the loan terms originally offered to the consumer. Just as brokers may set loan terms to increase the compensation earned through

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[67] HUD argues, in fact, that many lenders do not even know what the amount of compensation will be, because the loan may not be sold until some time after closing. *See id.* at 14,047.

[68] HUD has concluded that, in its testing, the addition of this statement reduced the level of anti-broker bias arising from the YSP disclosures. But, as noted above, for several reasons, the test results do not support a conclusion that bias has been eliminated, and changes to the testing protocol, rather than changes to the disclosures, may have contributed to any reduction in the bias.

YSPs, lenders may set loan terms to increase the compensation they earn through future loan sales. The above disclosure, combined with the disclosure elsewhere in the GFE of any YSPs received by brokers, seems to imply incorrectly that the fees brokers receive affect loan terms, but the fees lenders receive do not.

If broker compensation received from lenders is to be disclosed in the GFE, a clear and understandable revised version of the above lender disclosure should be added to the origination charge section of the GFE.[69] The disclosure should inform consumers that lenders also may receive additional compensation from the interest rate chosen, but unlike similar compensation that may be earned by brokers, the amount is not disclosed because it may not be known until after the loan settlement.

### F. Alternative Disclosure Proposal

A key argument used to support broker compensation disclosures is that many consumers may view mortgage brokers as trusted advisors who shop for the best loan for the consumer. But broker compensation disclosures are not the appropriate response to this problem. A better remedy would be to require a disclosure that clarifies the role of brokers. It would alert consumers that, just like direct lenders, brokers seek to maximize their own profits and may not provide the least expensive loan for which the consumer qualifies. This less restrictive remedy would address the problem without creating consumer confusion or harming competition.

Moreover, consumers would benefit most if such a disclosure were required for all mortgage originators, lenders as well as brokers. As with brokers, lenders seek to maximize their own profits and may not provide the least expensive loan for which the consumer qualifies, but consumers may not know this. For example, in a consumer survey conducted by the American Association of Retired Persons, 70% of older borrowers with broker-originated loans said that they had relied "a lot" on the broker to find the best mortgage for them, and 52% of those with lender-originated loans said the same.[70] Similarly, in a Fannie Mae study, only 59% of respondents knew that housing lenders are not required by law to give them the best possible

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[69] The revised version of this disclosure should be moved from the end of the GFE, where it now appears, to the section of the GFE that discloses origination charges. The disclosure appears to have been moved from the origination charge section, with additional text added, in response to one of HUD's "Round 6" tests, which found what appeared to be an anti-lender bias. *See* KLEIMANN COMMC'N GROUP, HUD, TESTING HUD'S NEW MORTGAGE DISCLOSURE FORMS WITH AMERICAN HOMEBUYERS - ROUND 6, at 17-18, 26 (GFE p. 2), 28 (GFE p. 4) (2007) (Round 6 Test Report), *available at* http://www.huduser.org/intercept.asp?loc=/Publications/PDF/Round_6.pdf.

[70] Kellie K. Kim Sum & Sharon Hermanson, *Experiences of Older Refinance Mortgages Loan Borrowers: Broker- and Lender-Originated Loans*, 83 DATA DIGEST 3 (Jan. 2003) (AARP Public Policy Inst.), *available at* http://assets.aarp.org/rgcenter/post-import/dd83_loans.pdf.

rates on loans.[71] These misperceptions could harm borrowers obtaining loan prices from either brokers or lenders. Clarifying the role of all mortgage loan originators, both brokers and lenders, would best benefit consumers.

### G. Conclusion

The available evidence from studies conducted by FTC staff and HUD indicates that broker compensation disclosures can harm consumers and competition. Broker compensation disclosures should not be adopted unless reliable, quantitative consumer research demonstrates that the disclosures will provide benefits to consumers without imposing the adverse effects on consumers and competition revealed by earlier studies. FTC staff also urges HUD to conduct tests that demonstrate the benefits of broker compensation disclosures. Studies to date have focused on evaluating potential harm from the disclosure. For the disclosures to be beneficial, however, they must improve consumer decision making. The FTC staff also suggests that HUD consider and possibly test whether other disclosures (such as one that clarifies the role of all mortgage originators) would be more beneficial for consumers.

## V. Average Cost Pricing, Negotiated Discounts, and Competition

FTC staff agrees with HUD's goal of seeking regulatory changes to promote competition and lower settlement costs. As noted in the proposal:

> HUD is seeking to facilitate pricing arrangements that will benefit consumers. HUD has determined that in the evolving marketplace, certain loan originators and third party settlement service providers may wish to adopt average cost pricing and to offer discounts, including volume-based discounts. HUD welcomes comment on these and any other pricing techniques that may result in greater competition and lower costs to consumers and that are consistent with the purposes of RESPA.[72]

FTC staff supports the removal of price regulations that hinder price competition. As discussed below, the FTC has long advocated against price regulations in competitive markets because of their adverse effects on consumers. While the proposal would relax some price regulations, the changes are quite narrow, and substantial price regulations would remain. Further reductions in price regulations would likely lead to more vigorous price competition, and even lower settlement costs for consumers.

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71 FANNIE MAE, UNDERSTANDING AMERICA'S HOMEOWNERSHIP GAPS, 2003 FANNIE MAE NATIONAL HOUSING SURVEY 7 (2004), *available at* http://www.fanniemae.com/global/pdf/media/survey/survey2003.pdf.

72 73 Fed. Reg. at 14,051-52.

The FTC has a longstanding record of concern about the effect of the types of pricing restrictions imposed by RESPA. The Commission settled complaints against several corporations in other industries alleging, among other things, that restrictions on referral fee arrangements violate Section 5 of the Federal Trade Commission Act.[73] The challenged practices are similar to those imposed by RESPA. Further, twenty years ago, prior to its law enforcement efforts in this area, FTC staff filed comments with HUD noting that prohibitions on referral fees were not likely to be needed to protect consumers in the mortgage market.[74]

Support for a more comprehensive approach to the removal of competitive restraints is described in the comments filed by FTC staff in response to HUD's 2002 RESPA proposal.[75] In those comments, FTC staff explained why the proposed Section 8 exemptions for packaging settlement services would likely lead to greater efficiency and lower settlement service prices. Although HUD notes that not all participants at HUD's roundtables believed that broader Section 8 exemptions were necessary, it is not clear that this is the position of all competitors.[76] Nor is it clear whether this preference is to promote price competition (which benefits consumers) or to protect competitors from price competition (which harms consumers).[77]

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[73] *See* Complaint, *In re American Inst. of Certified Pub. Accountants*, No. C.3297, 113 F.T.C. 698 (July 26, 1990); Complaint, *In re American Psychological Ass'n.*, No. C-3406, 115 F.T.C. 993 (Dec. 16, 1992); Complaint, *In re National Ass'n of Social Workers*, No. C-3416, 1993 FTC LEXIS 51 (Mar. 3, 1993).

[74] FTC Staff Comments on a Proposal to Exempt from Section 8 of the Real Estate Settlement Procedures Act, Payments by a Borrower (but not a Lender) to Mortgage Brokers or Other Intermediaries Who Assist in Bringing the Borrower and Lender Together, FTC Matter Number V880047 (July 1988).

[75] *See* FTC Staff Comment Before the Department of Housing and Urban Development on Proposed Amendments to the Regulations Implementing the Real Estate Procedures Settlement Act Claims (Oct. 28, 2002), *available at* http://www.ftc.gov/be/v030001.pdf (FTC Staff Comment on RESPA (2002)).

[76] As reported in the proposed rule, "Lender comments on the 2002 Proposed Rule and discussions during the RESPA Reform Roundtables in 2005 continued to cite a need for a complete exemption from section 8 before lenders could use pricing models that would allow them to introduce more price competition in the marketplace." 73 Fed. Reg. at 14,051-52. The proposed rule also reports that other participants thought that "RESPA provides enough flexibility to permit a variety of approaches to fee calculations, so long as they do not unnecessarily increase fees charged to consumers." The approach to price regulation described in the proposal seems to reflect the latter view. *Id.* at 14,052.

[77] Comments to HUD regarding the removal of bundling restrictions, and concomitant cost reductions, suggest that businesses are sometimes primarily concerned with the protection of business, rather than consumers. For example, the American Land Title Association (ALTA) has stated:

> Finally, it is the Association's position that volume discounts are anti-competitive and

The proposed relaxations in price regulations are narrow, especially in comparison to the 2002 proposal. The proposed rule would not offer a section 8 exemption for settlement service package providers. Instead, "the Secretary is proposing to use the authority under section 19(a) of RESPA to permit pricing techniques using average cost pricing and certain discounts, consistent with RESPA's GFE and settlement statement requirements and with section 8."[78] Settlement service providers believe that RESPA prohibits these practices because Section 8 "prohibits anyone from giving or accepting a fee, kickback or any thing of value in exchange for referrals of settlement service business involving a federally related mortgage loan [and] . . . prohibits fee splitting and receiving unearned fees for services not actually performed."[79] Section 8 violations are serious, as they can result in criminal and civil penalties.[80] The referral fee ban appears to deter providers from engaging in quantity discount negotiations. The prohibition against "unearned fees" appears to deter providers from using average cost pricing.

The proposed rule would clarify that "charges for third party services may be calculated using average cost pricing mechanisms based on appropriate methods established by HUD. These mechanisms would also accommodate certain volume-based discounts."[81] The proposed

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> will disproportionately harm small businesses. Small independent title agencies do not have the resources to guarantee a stream of business to local title-related service providers or discount their own prices to compete with large national title providers. While such discounts may result in lower prices for the consumer in the short term, once the small businesses have been pushed out of the competitive marketplace, large providers are left to compete only among themselves. Under these circumstances, consumers will have fewer choices for title and closing related services, and prices will inevitably increase.

Letter from Kurt Pfotenhauer, Chief Executive Officer, ALTA on Proposed Rule, to Dep't of Hous. & Urban Dev. (May 13, 2008), *available at* http://www.alta.org/respa/Letters/08-05-13_ALTARESPAcomments.pdf. Large firms have incentives to compete with one another too. Absent illegal collusion among larger, potentially more efficient firms, bundling and volume discounts are likely to lead to lower consumer prices.

[78] 73 Fed. Reg. at 14,052.

[79] More Information About RESPA (last visited May 6, 2008), http://www.hud.gov/offices/hsg/sfh/res/respamor.cfm#HT.

[80] "Violations of Section 8's anti-kickback, referral fees and unearned fees provisions of RESPA are subject to criminal and civil penalties. In a criminal case a person who violates Section 8 may be fined up to $10,000 and imprisoned up to one year. In a private law suit a person who violates Section 8 may be liable to the person charged for the settlement service an amount equal to three times the amount of the charge paid for the service." *Id*. (emphases in original omitted).

[81] 73 Fed. Reg. at 14,050.

rule would also "clarify that it is permissible for settlement service providers to negotiate discounts in the prices for settlement services, so long as the borrower is not charged more than the discounted price." [82]

FTC staff supports amendments that would allow average cost pricing. Average cost pricing is not only allowed in most industries – it is the expected equilibrium outcome for markets with vigorous price competition.[83] In other words, vigorous competition will drive down the prices consumers pay to the point at which sellers cover their costs. FTC staff recommends, however, that HUD consider eliminating the Proposed Rule's restrictions on how average costs may be calculated.[84]

FTC staff supports removing barriers to average cost pricing because there is no economic justification for requiring that each consumer pay his or her unique marginal cost of receiving settlement services and because doing so will likely result in lower prices for consumers. Calculating and maintaining records of such individualized costs and prices adds additional accounting and record-keeping costs to the transaction, which are not required in other competitive markets. Measures to remove these costs will likely make the market more efficient and result in lower prices to consumers.

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[82] *Id.*

[83] When the cost per unit varies with the number of units produced (such as when volume discounts from a settlement service provider cause the per-transaction cost to vary with the number of closings) average cost pricing is the expected equilibrium outcome for markets with vigorous price competition. In standard textbook models of perfectly competitive markets, long-run equilibrium occurs when price is equal to marginal cost and minimum average cost. In these models, all consumers pay the average cost, rather than their unique marginal cost. *See* DENNIS W. CARLTON & JEFFREY M. PERLOFF, MODERN INDUSTRIAL ORGANIZATION 61-64 (4th ed. 2005).

[84] *See* 73 Fed. Reg. at 14,052, 14,058 (proposed Section 3500.8(b)(2)).

Although FTC staff also supports the removal of restrictions against quantity discounts,[85] remaining restrictions in the proposed rule will likely limit incentives to negotiate such discounts. Firms are unlikely to engage in aggressive discount negotiations because the proposed rule would require that 100% of any negotiated discount be passed on to the consumer.[86] Requiring that 100% of any negotiated discount be passed on to customers reduces incentives of firms to spend resources to negotiate such discounts. In the alternative, one might read the regulation to prohibit firms from passing the costs of such negotiations on to consumers, because it is not clear how one would assign the overhead costs associated with price negotiation activities. Price discounts would not be sustainable, unless the cost is recouped in some other part of the transaction.

FTC staff supports the removal of price regulations in the mortgage settlement market. FTC staff also encourages HUD to consider whether other RESPA price regulations may inadvertently harm price competition and efficiency.[87] If the purpose of prohibitions on

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[85] Absent market power, there is no reason to believe that quantity discounts would reduce consumer welfare. Even when market power exists, research indicates that banning quantity discounts can reduce welfare. For example, O'Brien & Shaffer show that banning price discrimination (which can be thought of as a type of quantity discount) forces all buyers to pay higher prices in equilibrium. Although O'Brien & Shaffer analyze a monopoly manufacturer, it is likely that the result would be even stronger if the upstream market were an oligopoly. Work by Corts suggests that this intuition would likely follow. If regulations prevent firms from making selective price cuts to buyers, collusion becomes more stable, because firms find it more difficult to deviate profitably from the collusive agreement. This same logic explains why "most favored customer clauses" (whereby a price cut to one buyer must be extended to all buyers) can be anti-competitive. Most favored customer clauses make it costly to make selective price cuts; hence, a cartel is less likely to unravel. *See* D. O'Brien & G. Shaffer, *The Welfare Effects of Forbidding Discriminatory Discounts: A Secondary Line Analysis of Robinson-Patman*, 10 J.L. ECON. & ORG. 296-318 (1994); Kenneth S. Corts, *Third-Degree Price Discrimination in Oligopoly: All-Out Competition and Strategic Commitment*, 29 RAND J. ECON., 306-325 (Summer 1998).

[86] According to the proposed rule:

> The practices of negotiating price reductions – whether among settlement service providers or by an individual settlement service provider on behalf of consumers – can serve to reduce prices to consumers. Such arrangements are not contrary to the purposes of RESPA and do not violate section 8 when any and all pricing benefits are passed on to consumers. Accordingly, in today's proposed rule, HUD is amending the definition of "thing of value" set forth in 24 CFR 3500.14(d) to exclude discounts negotiated by settlement service providers based on negotiated pricing arrangements, provided that no more than the reduced price is charged to the borrower and disclosed on the HUD-1/1A.

73 Fed. Reg. at 14,051.

[87] According to the proposed rule:

> Congress explained the purpose of RESPA as being to effect changes in the residential settlement process that will result "in more effective advance disclosure to home buyers

kickbacks or referral fees is to eliminate practices that "tend to increase unnecessarily the costs of certain settlement services,"[88] then a broader review of the extent to which referral fees, per se, unnecessarily increase costs might suggest that fewer price regulations would lower settlement costs to consumers. We recommend that HUD consider removing additional price restrictions and consider re-proposing section 8 exemptions for those who package settlement services.

## VI. Definition of "Required Use" of Affiliated Business Services

Section 8(a) of RESPA generally prohibits lenders and others from giving or receiving anything of value for referring borrowers and others to providers of real estate settlement services.[89] In 1983, Congress amended RESPA to allow affiliated businesses to benefit from referrals under certain conditions.[90] Specifically, Section 8(c)(4) of RESPA, as amended, provides that referrals in connection with affiliated business arrangements do not violate RESPA so long as, among other things: (1) the arrangement is disclosed to the person being referred, and (2) the person being referred "<u>is not required</u> to use any particular provider of settlement services."[91]

The prohibition in Section 8(a) of RESPA can impact the bundling of real estate related services depending upon how broadly "required use" is defined for purposes of Section 8(c)(4)(B). RESPA does not expressly define "required use." By regulation, HUD currently defines "required use" to mean that a person must use a particular provider of a settlement service in order to have access to some "distinct service or property" for which the person will pay (such as a mortgage loan).[92] The Proposed Rule would expand the definition of "required

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> and sellers of settlement costs" and "the elimination of kickbacks or referral fees that tend to increase unnecessarily the costs of certain settlement services."

*Id.*

88 *Id.*

89 12 U.S.C. § 2607(a).

90 *See* 73 Fed. Reg. 14,053.

91 12 U.S.C. § 2607(c)(4) (emphasis added).

92 At present, "required use" is defined as:

> [A] situation in which a person must use a particular provider of a settlement service in order to have access to some distinct service or property, and the person will pay for the settlement service of the particular provider or will pay a charge attributable, in whole or in part, to the settlement service. However, the offering of a package (or combination of settlement services) or the offering of discounts or rebates to consumers for the purchase of multiple settlement services does not constitute a required use. Any package or

use" in HUD's regulations. Lenders and others would be prohibited from requiring that borrowers use a particular provider of settlement services to: (1) obtain access to a "distinct service or property," such as a mortgage, (2) obtain access to any "discount, rebate, or other economic incentive," or (3) have the ability to avoid any "economic disincentive or penalty."[93] HUD expresses concern that the current definition of "required use" can raise questions about whether economic incentives or disincentive arrangements can, in turn, give rise to possible violations of section 8(a).[94]

FTC staff recommends that HUD reconsider the change to the definition of "required use" in HUD's regulations. The expanded definition of required use could deprive customers of the lower prices that can result from bundling related services. Bundling related services can create efficiencies in – lower the costs of – providing those services, and discounting the bundle allows consumers to pay less for the services. Indeed, HUD recognizes the potential benefits of bundling, and appropriately retains a safe-harbor to allow settlement service bundling. FTC staff believes that the analysis of settlement service bundling also applies to the analysis of other bundles. Absent clear evidence of probable harm from bundling related services, FTC staff believes that HUD should reconsider the proposed change because bundling can improve efficiency and save consumers money.

Although bundling can harm consumers in certain circumstances, economists and courts have generally found that in order for bundling to be harmful to consumers, the bundling firm

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> discount must be optional to the purchaser. The discount must be a true discount below the prices that are otherwise generally available, and must not be made up by higher costs elsewhere in the settlement process.

24 C.F.R. § 3500.2(b).

93 The Proposed Rule would define "required use" as:

> [A] situation in which a borrower's access to some distinct service, property, discount, rebate, or other economic incentive, or the borrower's ability to avoid an economic disincentive or penalty, is contingent upon the borrower using or failing to use a referred provider of settlement services. However, the offering by a settlement service provider of an optional combination of *bona fide* settlement services to a borrower at a total price lower than the sum of the prices of the individual settlement services does not constitute a required use.

73 Fed. Reg. at 14,056 (proposed Section 3500.2(b)).

94 "The change proposed today may eliminate the argument by affiliated businesses that there is no 'required use' that prevents them from invoking the affiliated business exemption to section 8 violations that involve consumer incentives and disincentives." *Id.* at 14,052.

must have some market power in at least one market.[95] The markets at issue are characterized by a large number of buyers and sellers, and do not appear to exhibit market power concerns. Therefore, the economic harms bundling sometimes can cause appear unlikely in this industry.

HUD suggests that the new definition of "required use" in the Proposed Rule is necessary to avoid practices that deter consumers from shopping for settlement services and presents three examples from consumer complaints of bundled offers.[96] Without knowing what alternatives were actually available, it is impossible to know whether any of the three bundled discounts benefitted or harmed consumers. FTC staff believes that more information is needed before concluding that the types of bundling arrangements the proposed rule would restrict are harmful to consumers and should be prohibited.

HUD's general concern is that the type of bundling arrangements the Proposed Rule would restrict makes consumers "confused about the value of the deal, [thereby leading consumers to] forego shopping for lower rates and fees offered by unaffiliated settlement providers."[97] However, the prohibition of these types of bundling arrangements does not appear

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95 For instance, in *Cascade Health Solutions v. PeaceHealth*, the Ninth Circuit stated that:

> The Supreme Court has developed a unique per se rule for illegal tying arrangements. For a tying claim to suffer per se condemnation, a plaintiff must prove: (1) that the defendant tied together the sale of two distinct products or services; (2) that the defendant possesses enough economic power in the tying product market to coerce its customers into purchasing the tied product; and (3) that the tying arrangement affects a not insubstantial volume of commerce in the tied product market. *See Paladin Assocs., Inc.* 328 F.3d at 1159 (citing *Eastman Kodak*, 504 U.S. at 461-62).

515 F.3d 883, 913 (9th Cir. 2008).

96 The three examples HUD provides are:

> (1) A buyer was offered a $22,000 discount on the price of a home for using the builder's affiliated lender, but the interest rate offered by the lender was ½ point higher than the market rate, and the origination fee charged by the affiliated lender was higher.
>
> (2) A buyer would be required to make a higher earnest money deposit and would lose a $2,000 ''closing incentive'' if the buyer did not use the builder's affiliated lender.
>
> (3) A builder promised a $3,000 incentive on the purchase price and $6,000 toward closing costs if the buyer used the builder's affiliated lender, which charged an interest rate that was 1 percent higher than the market rate and additional fees.

73 Fed. Reg. at 14,053.

97 *Id.*

to address this concern. In fact, it may actually be easier for consumers in some circumstances to compare bundles of real estate related services (including house prices, loans, and settlement services) than to compare individual services in separate transactions.

Moreover, if HUD wishes to ensure that consumers do not prematurely stop shopping when they receive a bundled offer, it may wish to examine the effectiveness of the business affiliation disclosures required by RESPA and its implementing regulations.[98] If consumers do not clearly understand from the disclosures that businesses are affiliated, they may be less skeptical of bundled offers they receive and discontinue shopping, or shopping as intensively, in response to the bundled offer.

Therefore, FTC staff recommends that HUD reconsider the proposed change to the "required use" definition. Bundling often offers real benefits to consumers. At the same time, while bundling can harm consumers in some circumstances, we are not aware of evidence that the bundling the proposed rule would prohibit is causing harm to consumers. The proposed change is likely to reduce the ability of affiliated businesses to provide cost-saving discounts to consumers. Finally, HUD may wish to test the effectiveness of the affiliated business disclosure to ensure that it effectively warns consumers about potential conflicts of interest.

## VII. Consumer Research

### A. HUD's Consumer Testing

HUD has conducted a number of consumer tests during the development of its proposed GFE and closing disclosures. FTC staff commends HUD's use of consumer testing and believes that the testing has led to a proposed GFE that is much improved over HUD's 2002 proposal.

HUD's latest ("Round 6") tests appear to have uncovered a number of shortcomings in the clarity of the GFE and closing disclosures. HUD has made various changes to the disclosures in response to these findings.[99] However, as indicated above, FTC staff recommends that HUD continue to test carefully and revise the GFE and closing disclosures to minimize consumer misunderstandings. Additional testing is particularly important for the new Closing Script, which is in a more preliminary stage of development than the GFE disclosures. FTC staff recommends that the Closing Script be tested in actual closing circumstances to ensure that the process of using it works smoothly for consumers and settlement agents.

FTC staff also urges HUD to consider tests that compare consumer performance with the proposed disclosures to performance with current disclosures, to ensure that the new disclosures provide meaningful improvement. In conducting such tests, we recommend that HUD include

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98 *See* 24 C.F.R. § 3500.15(b)(1) and App. D.

99 *See* HUD, Round 6 Test Report, *supra* note 69, at 17-23; 73 Fed. Reg. at 14,046-47.

the TILA disclosures that consumers typically receive at the same time they receive the GFE and take into consideration the additional, non-required loan information included in GFEs currently used by many lenders.

### B. FTC Staff Study of Mortgage Disclosures

HUD's efforts to improve the GFE and closing disclosures provided to consumers in connection with their mortgage loans is supported by a recently completed FTC staff study that evaluated the effectiveness of the current federally required mortgage disclosures.[100] The study, which used in-depth interviews with several dozen recent borrowers and quantitative consumer testing with over 800 recent mortgage customers, found that current disclosures fail to convey key mortgage costs to many consumers, even for relatively simple, fixed-rate, fully-amortizing loans. Morever, the current disclosures not only failed to convey the desired information to many consumers but also contributed to consumers' misunderstanding of some loan terms, often to their detriment.

The FTC staff study also demonstrated that disclosures can be developed that significantly improve consumer recognition of mortgage costs. As part of the study, staff developed a new summary disclosure document that combines information about key features and costs of a mortgage. Consumer testing showed that the new form significantly increased consumer understanding of loan terms and demonstrated the potential benefits of designing a single, comprehensive mortgage disclosure document.

Both prime and subprime borrowers failed to understand key loan terms when viewing current disclosures, and both benefitted from the improved disclosures developed for the study. The improved disclosures provided the greatest benefit for more complex loans, for which both prime and subprime borrowers had more difficulty understanding. The results of the FTC staff study are presented in more detail in Appendix C of this comment.

The study was conducted, in part, because the Commission's experience has demonstrated that current mortgage disclosures are often ineffective in preventing deception. This conclusion is drawn from numerous law enforcement investigations through which it became clear that consumers were deceived even though they properly received all federally required mortgage disclosures.[101] The Commission's interest in conducting consumer research on mortgage disclosures also derived from its experience using consumer research to evaluate consumer comprehension of advertising claims and information disclosures in the mortgage and

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100 *See* FTC Staff Mortgage Disclosure Study, *supra* note 7.

101 *See* FTC Comment on Home Equity Lending Market, *supra* note 10.

other markets.[102] The FTC has advocated this type of research for the evaluation of information disclosures in a variety of markets.[103] The study results are consistent with the FTC staff's view that consumer testing often is critical in the development and evaluation of consumer disclosures.

The results of the FTC staff study clearly supports HUD's efforts to improve mortgage disclosures. The results demonstrate both that current disclosures do not effectively convey key loan costs and terms to many consumers and that significant improvements can be achieved that would benefit consumers. Accordingly, FTC staff strongly supports HUD's efforts to improve the GFE and closing disclosures. Consumers are likely to benefit from many of the improvements proposed by HUD. Many of the proposed changes would add important information about loan terms that is not required to be disclosed under current regulations or would improve the presentation of information so that it can be more easily understood and used by consumers.

## VIII. Comprehensive Reform of Federal Mortgage Disclosures

Although consumers would benefit from effective improvements in the GFE and closing disclosures, a more comprehensive reform of federal mortgage disclosures would be preferable. FTC staff's experience and research suggests that consumers in both the prime and subprime markets would benefit most from the development of a single mortgage disclosure document that consolidates information on the key costs and features of their loans, presents the information in a language and format that is easy to use and understand, and is provided early in the transaction to aid consumer shopping.

Even with the proposed changes to the GFE and its expanded size, consumers shopping for a mortgage loan would still need to consult several disclosure documents to obtain a full picture of their loan terms. For example, the complete payment schedule, and any charges for optional products or services (such as credit insurance), would still appear only in the TILA

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[102] *See, e.g.,* FTC Staff Mortgage Broker Compensation Study, *supra* note 7. More recently, FTC staff conducted consumer research to evaluate alternative designs for new Energy Guide appliance labels prior to issuing final rule amendments. *See* FTC, Appliance Labeling Rule; Proposed Rule (16 C.F.R. pt. 305), 72 Fed. Reg. 6836, 6838-39 (proposed Feb. 13, 2007), *available at* http://www.ftc.gov/os/2007/01/R511994EnergyLabelingEffectivenessNPRFRN.pdf; FTC, Appliance Energy Labeling Consumer Research Background Information for Notice of Proposed Rulemaking (16 C.F.R. pt. 305) (Jan. 30, 2007), *available at* http://www.ftc.gov/os/2007/01/R511994EnergyLabelingEffectivenessFRNConsResBkgrdInfo.pdf.

[103] *See, e.g.,* FTC Staff Comment on RESPA (2002), *supra* note 75; FTC Staff Comment Before Food and Drug Administration on Trans Fatty Acids in Nutrition Labeling: Consumer Research to Consider Nutrient Content and Health Claims and Possible Footnote on Disclosure Statements (Oct. 9, 2003), *available at* http://www.ftc.gov/os/2003/10/fdafattyacidscomment.pdf; and FTC Staff Comment Before Food and Drug Administration on Assessing Consumer Perceptions of Health Claims (Jan. 17, 2006), *available at* http://www.ftc.gov/be/V060005.pdf.

statement, not the GFE. Some important loan features, such as the time and conditions under which a prepayment penalty would be imposed, would not be disclosed in either the GFE or the TILA statement, but might appear in the loan note. In addition, some disclosed loan terms, such as the disclosure of the loan amount in the GFE and the amount financed in the TILA statement, may appear to be inconsistent between the two forms, leading to consumer confusion.[104]

The FTC staff recommends that HUD and the Federal Reserve Board consider undertaking a more comprehensive effort to consolidate and improve federal mortgage disclosures. Such disclosures can be developed using the lessons learned from deceptive lending cases, the principles of consumer finance, the principles of communications design, and sound consumer research. The FTC staff would be pleased to work with HUD and the Federal Reserve Board in such an effort.

## IX. Conclusion

The FTC staff supports HUD's goals of simplifying the mortgage process for consumers and enhancing competition. The FTC staff appreciates the opportunity to submit these views and hopes that this comment is useful to HUD in its assessment of the proposed rule.

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[104] The FTC Staff Mortgage Disclosure Study found that many consumers believe that the "amount financed" disclosed in the TILA statement is the amount they are borrowing, even though the amount financed is typically smaller than the actual loan amount. *See* FTC Staff Mortgage Disclosure Study, *supra* note 7, at 30, 35-36, 38, 63-64, 85-86, D-11.

Respectfully submitted,

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## Appendix A

### FTC Staff Study of Broker Compensation Disclosures

The FTC staff conducted a study of broker compensation disclosures following HUD's proposal of such disclosures in 2002.[105] The study used a controlled experiment with over 500 recent mortgage customers to examine how well consumers could understand compensation disclosures. The study found that the compensation disclosures confused consumers, leading many to choose loans that were more expensive than the available alternatives, and created a substantial consumer bias against broker loans, even when the broker loans cost the same or less than direct lender loans.

Study participants were shown cost information about two hypothetical mortgage loans and asked to identify which loan was less expensive and which loan they would choose if they were shopping for a mortgage. Participants were divided into five groups. In three of the groups, a broker compensation disclosure was included in the cost information shown to participants, with the format and wording of the disclosure varying across the groups.[106] In each of these groups, one loan was treated as a broker loan and one as a direct lender loan. The broker loan disclosed a YSP amount but the direct lender loan did not, following the policy proposed by HUD. In the other two groups, a broker compensation disclosure was not included in the cost information for either loan.

The results of the study were striking. In the two groups shown cost information without a broker compensation disclosure, about 90% of the respondents in each group correctly identified the less expensive loan, and 85 and 94% identified the less expensive loan as the one they would choose if they were shopping for a mortgage. In contrast, in the three groups shown cost information that included a broker compensation disclosure, only 63 to 72% of the respondents (depending on the group) correctly identified the less expensive loan, and only 60 to 70% identified the less expensive loan as the one they would choose if they were shopping for a mortgage; 16 to 27% of respondents instead identified the more expensive loan as the one they would choose if shopping.[107]

The study also conducted tests in which both loans cost the same. In the two groups shown cost information without a broker compensation disclosure, 95 and 99% of the

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105 *See* FTC Staff Mortgage Broker Compensation Study, *supra* note 7.

106 One version replicated the disclosure proposed by HUD in its 2002 proposed rule. The second version closely resembled a disclosure that was developed and tested by HUD in its efforts to improve upon the original version. The third version followed the same format as the second but substituted language developed by FTC staff.

107 FTC Staff Mortgage Broker Compensation Study, *supra* note 7, at ES3-5, 24-25, 28-29.

respondents correctly recognized that both loans cost the same, and 78 and 83% said they would choose "either loan, both cost the same" if they were shopping for a mortgage. The few respondents who chose one of the two loans split fairly evenly between the broker and lender loans. In contrast, in the three groups shown cost information that included a broker compensation disclosure, 40 to 50% of the respondents mistakenly believed that one loan was less expensive than the other, and of these, 75 to 90% believed that the direct lender loan (that did not disclose a YSP) was less expensive than the broker loan (that did disclose a YSP). Similar results, with an even larger bias against the broker loan, were found when respondents were asked which loan they would choose if shopping for a mortgage. The difference between the percentage of respondents preferring the direct lender loan and those preferring the identical broker loan ranged between 29 and 52 percentage points, depending on the version of the YSP disclosure.[108]

[108] *Id*. at ES5-7, 25-27, 29-31.

## Appendix B

### HUD's "Round 5" Tests of Broker Compensation Disclosures Tested with Identical Broker and Lender Loans

HUD's "Round 5" tests show that when consumers compare two identical loans, one a broker loan disclosing a YSP and the other a direct lender loan not disclosing a YSP, and are asked which loan they would prefer if they were shopping for a mortgage loan, there is a 17-18 percentage point bias in the proportion of consumers preferring the lender loan, even though the two loans had the same interest rates, closing costs, and payments.[109]

In addition to testing the disclosures in this two-way loan comparison, as in earlier tests, HUD's "Round 5" tests also tested the disclosures within a four-loan comparison. HUD conducted two versions of the four-loan comparison, one in which consumers were instructed to use a "Mortgage Shopping Chart," which was presented to consumers as a separate page with the GFE, to compare the terms of the four test loans, and one in which consumers were provided the shopping chart but not instructed to use it.[110]

The test results show that in the four-loan comparison when consumers did not receive instructions to use the shopping chart, and when identical broker and lender loans were tied as the least expensive of the four loans, there was only an 8 percentage point difference between the percentage of consumers identifying the lender and broker lender loans as least expensive (with the bias favoring the lender loan), and that the difference was not statistically significant. When the same test was conducted and consumers were instructed to fill out and use the Mortgage Shopping Chart, the results showed a significant difference of 22 percentage points between the percentage of consumers identifying the lender and broker loans as least expensive, with the bias favoring the broker loan.[111]

HUD concludes that the results of the four-loan comparison tests demonstrate that the anti-broker bias has been eliminated from the disclosures.[112] However, for several reasons, these results do not provide credible evidence that challenges the findings of HUD's two-way comparisons that continue to show that significant bias remains.

The results of the four-way loan comparison tests conducted without instructing consumers to use the Mortgage Shopping Chart do not support a conclusion that anti-broker bias

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109 *See* 73 Fed. Reg. at 14,046; HUD, Rounds 4 & 5 Results, *supra* note 64.

110 *See* 73 Fed. Reg. at 14,046.

111 *See id.* at 14,046; HUD, Rounds 4 & 5 Results, *supra* note 64, at vii and V-7.

112 *See* 73 Fed. Reg. at 14,046.

has been eliminated from the YSP disclosures because the tests did not ask consumers the key question that in all earlier tests consistently revealed such a bias. The omitted question was the "loan preference" question that asked consumers which of the test loans they would choose if they were shopping for a mortgage. HUD's earlier tests showed a significant anti-broker bias in the responses to the preference question even when consumers correctly recognized that the two loans cost the same.

As shown in the table, below, in the "Round 5" two-loan comparison tests, the results of the loan preference question showed a significant anti-broker bias of 17 to 18 percentage points (with the two-option and three-option YSP disclosures, respectively), even though the loan cost question had shown a bias of only 5 to 6 percentage points.[113] This strongly suggests that a significant bias also would have been found in the four-loan comparison tests if the "loan preference" question had been asked.[114]

**HUD Round 5 Consumer Test Results – When Broker and Lender Loans Cost the Same**

| | Percentage point difference between lender and broker responses (anti-broker bias), by test version | | |
|---|---|---|---|
| | 2-loan comparison | | |
| Test question (Sample size) | 2-option YSP disclosure (293) | 3-option YSP disclosure (302) | 4-loan comparison, 3-option YSP disclosure (76) |
| Loan cost | 5.1 | 6.0 | 7.9 |
| Loan preference | 17.1 | 17.6 | Not asked |

Note: See HUD, Rounds 4 & 5 Results, *supra* note 64, at V-4 and V-7. The results of the 4-loan comparison in which respondents were instructed to use the "Mortgage Shopping Chart" (which showed a *pro-broker* bias of 22.2 percentage points) are not included in the table because the test focused on the shopping chart, making the test not directly comparable to the other tests.

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113 The "three-option" disclosure reflects the disclosure options in the proposed rule that allows lenders to check a box that indicates that "The credit or charge for the interest rate you have chosen is included in Our service charge." The "two-option" disclosure did not include this option. HUD's 2002 proposal, and its earlier testing, had used a two-option disclosure.

114 In HUD's latest round of consumer testing (Round 6), the tests not only omitted the key "loan preference" question that had shown anti-broker bias in earlier tests, but also omitted the key loan scenario in which this bias was found, specifically, when consumers compared identical loans from brokers and lenders.

The "Round 5" four-way comparison test when respondents were instructed to use the Mortgage Shopping Chart page of the tested GFE also does not provide a credible test of the YSP disclosures. The questioning in this test focused consumers solely on the shopping chart, essentially removing the rest of the proposed GFE, including the YSP disclosure, from consideration. Specifically, consumers were told:

> Now, here's what I want for you to do. Use the Mortgage Shopping Chart and fill it in using the information from each of the offers that I just gave you. . . . I'll give you about 10 minutes to fill in the Mortgage Shopping Chart and then I'll ask you two questions about your work on the Shopping Chart. . . . Wonderful. Now I'm going to ask you some questions about your work with the Mortgage Shopping Chart.[115]

The instructions and test procedure make the results not relevant to an assessment of the impact of the YSP disclosure. The results instead test consumer interpretation of the information in the shopping chart. Moreover, the applicability of the test results also is questionable because in real transactions many consumers may not fill out and use the chart, as they were required to in the test. In fact, the results of both the "Round 5" and "Round 6" tests conducted by HUD showed that few consumers used the shopping chart when they were not specifically instructed to do so. The relevance of the test also is reduced by later changes to the proposed GFE, which reduced the size of the chart from the full-page size tested in "Round 5" to the equivalent of a quarter of a page in the proposed rule, making it less prominent and likely more difficult for consumers to use.[116]

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[115] *See* KLEIMANN COMMC'N GROUP, App. B: Round 5 Testing Materials, Round 5 Test Administration Protocol and Participant Answer Sheet, Moderator's Script for Testing Sessions (with MSC) in HUD, TESTING HUD'S NEW MORTGAGE DISCLOSURE FORMS WITH AMERICAN HOMEBUYERS - ROUNDS 4 & 5 - VOLUME 2: APPENDICES 7 (2004), *available at* http://www.huduser.org/Publications/PDF/GoodFaith_4and5vol2.pdf.

[116] In addition to reducing the size of the chart, the version in the proposed rule increases the number of rows of information included by 50%, from 8 to 12 rows.

## Appendix C

## FTC Staff Mortgage Disclosure Study

FTC staff recently completed a study that evaluated the effectiveness of the current federally required mortgage disclosures.[117] The study found that current disclosures fail to convey key mortgage costs and terms to many prime and subprime borrowers, even for relatively simple, fixed-rate, fully-amortizing loans. The study also demonstrated that it is possible to create new disclosures that significantly improve consumer understanding of their loans.[118]

The study, which employed standard marketing research techniques, consisted of two phases. The first phase consisted of in-depth interviews with several dozen recent borrowers who discussed their own mortgage shopping experiences, reviewed their own mortgage documents, and reviewed a new prototype mortgage disclosure developed by FTC staff. The second phase consisted of quantitative testing with over 800 recent mortgage customers; roughly half examined examples of current mortgage disclosures, while the other half reviewed the new prototype disclosure. The new prototype disclosure consists of a comprehensive one-page summary of key loan information, and two pages with additional details.[119] The prototype design is based on lessons gleaned from deceptive lending cases, first principles of consumer finance, and first principles of consumer communications design.

Findings from the study are striking. The failure to convey key mortgage costs and features was evident across a wide range of loan characteristics and among substantial proportions of study participants, both prime and subprime. Many of the current problems experienced by consumers in the mortgage market were apparent during the consumer interviews. Recent borrowers could not determine if their own mortgages had prepayment penalties, even when examining their own Truth-in-Lending documents. Consumers with adjustable rate mortgages were not always aware that their monthly payments could increase, or the possible extent of such increases. Confusion about the inclusion of taxes and insurance in monthly payment amounts was also revealed.

The interviews also suggested that some standard terms in current required disclosures promote misunderstanding. For example, the "Amount Financed" on the TILA statement was typically interpreted as the loan amount, rather than the loan amount minus prepaid finance charges. This misunderstanding sets the stage for possible confusion regarding total mortgage

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[117] *See* FTC Staff Mortgage Disclosure Study, *supra* note 7.

[118] *See id.*

[119] Examples of the FTC staff prototype disclosure document are presented in the study report. *See id.*

fees and the extent to which mortgage fees are financed. The "Discount Fee" on the GFE was often misinterpreted as a discount to the borrower, rather than a payment from the borrower to the lender in exchange for the given contract interest rate.

Systematic quantitative testing with over 400 recent mortgage customers confirmed that current disclosures are confusing and often misunderstood. Respondents were given information about hypothetical mortgages using examples of current TILA and GFE disclosures, given time to examine the disclosures in a quiet setting, and asked objective questions about the cost and terms of the mortgages.[120] The GFE form used for the test provided more information than currently required under federal law.[121] Even with these enhanced disclosures, mortgage customers could not identify critical mortgage features:

- About a fifth of the respondents viewing the current disclosure forms could not correctly identify the APR of the loan, the amount of cash due at closing, or the monthly payment (including whether it included escrow for taxes and insurance).

- Nearly a quarter could not identify the amount of settlement charges.

- About a third could not identify the interest rate or which of two loans was less expensive, and a third did not recognize that the loan included a large balloon payment or that the loan amount included money borrowed to pay for settlement charges.

- Half could not correctly identify the loan amount.

- Two-thirds did not recognize that they would be charged a prepayment penalty if in two years they refinanced with another lender (and a third did not even recognize that they "may" be charged such a penalty).

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[120] The TILA statement followed the required disclosures for closed-end, fixed-rate residential mortgages.

[121] Various GFE forms currently used by many lenders disclose information about the terms of the mortgage that goes beyond the requirements of the current RESPA regulations. The GFE form used in the FTC staff study followed this practice so that it would more closely reflect the information that many consumers actually receive. Blank copies of a proprietary GFE form were obtained from an industry form vendor. The loan term information included in the form that was not required by current regulations included the amount of money borrowed, the interest rate, the total monthly payment amount, an itemization of the monthly payment, the cash due at closing, and the total settlement charges. Use of the GFE that included this additional information implies that the test results understate any problems that consumers may have with a GFE that merely complies with the current regulations. *See* FTC Staff Mortgage Disclosure Study, *supra* note 7, at 41-42. Copies of the form used in the tests are presented in the study report. *See id.* at Appendix G.

- Three-quarters did not recognize that substantial charges for optional credit insurance were included in the loan.

- Almost four-fifths did not know why the interest rate and APR of a loan sometimes differ.

The study also showed that consumers would benefit substantially from improved mortgage disclosures. A prototype disclosure that consolidated information on key costs and terms of a mortgage in a single document was developed and tested in the study.[122] The prototype attempted to not only consolidate and clarify important terms from the current disclosures but also add important disclosures not currently required. Many key loan features identified as a source of concern in the current mortgage market are not required to be disclosed to consumers under current federal law. For example, lenders are not currently required to specify the nature of prepayment penalty obligations, the absence of escrow for taxes and insurance in monthly payment estimates, the maximum possible monthly payment for loans with adjustable rate features, or the total up-front costs of obtaining a mortgage. The new prototype disclosure developed and tested at the FTC addresses many of these issues.[123]

The prototype mortgage disclosure document developed for the study received enthusiastic consumer reviews during the in-depth interviews. Quantitative testing verified that the prototype disclosure substantially improves consumer recognition of key loan features. The roughly 400 respondents who examined loans using current forms answered an average of 61% of the test questions correctly. In contrast, the roughly 400 respondents who examined the same loans using the prototype form (a different group than the respondents using current forms) answered 80% of the questions correctly – a 19 percentage point improvement.

The prototype disclosures provided improvements across a wide range of loan terms and for substantial proportions of respondents.[124] The improvements provided by the prototype form included:

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[122] The prototype combines information about the loan features, such as the interest rate and monthly payments with information about the costs of acquiring the loan. Under current regulations, information about the loan appears on the TILA statement and information about the costs of obtaining the mortgage appears in the GFE. Combining key elements of both documents should make it easier to shop for the best deal and to verify verbal claims by a mortgage originator.

[123] For example, the prototype addresses prepayment penalty misunderstanding with a demonstrably clearer and more comprehensive prepayment penalty disclosure, and concern about escrow misunderstanding by explicitly indicating whether escrow payments for taxes and insurance are included in the monthly payment estimates.

[124] The prototype did not include an adjustable interest rate disclosure, although one could readily be included to disclose key aspects of adjustable rate mortgages. The testing also revealed room for further improvement in some of the disclosures, such as those pertaining to balloon payments.

- 66 percentage point increase in the proportion of respondents correctly identifying the total amount of up-front charges in the loan.

- 43 percentage point increase in the proportion of respondents recognizing that the loan contained charges for optional credit insurance.

- 37 percentage point increase in the proportion correctly identifying the amount borrowed.

- 24 percentage point increase in the proportion recognizing that a prepayment penalty would be assessed if the loan was refinanced in two years.

- 21 percentage point increase in the proportion correctly identifying why the APR and interest rate may differ in a loan.

- 16 percentage point increase in the proportion correctly identifying the APR amount.

- 15 percentage point increase in the proportion correctly identifying the amount of settlement charges.

- 13 percentage point increase in the proportion correctly identifying which of two loans was less expensive.

- 12 percentage point increase in the proportion correctly identifying the interest rate amount.

- 9 percentage point increase in the proportion recognizing that settlement charges were financed and included in the loan amount.

- The prototype form also conveyed the correct prepayment penalty amount to 59% of the respondents, and the correct amounts of property taxes and homeowner's insurance charges for a loan in which the charges were not included in the monthly payment to 79% of the respondents. This information is not included in the current forms.

In summary, the FTC staff study found that: (1) the current federally required disclosures fail to convey key mortgage costs to many consumers, even for relatively simple, fixed-rate, fully-amortizing loans; (2) disclosures can be developed that significantly improve consumer recognition of mortgage costs; (3) both prime and subprime borrowers failed to understand key loan terms when viewing the current disclosures, and both benefitted from improved disclosures; and (4) improved disclosures provided the greatest benefit for more complex loans, for which both prime and subprime borrowers had the most difficulty understanding loan terms. The study results also are consistent with the FTC staff's view that consumer testing often is critical in the development and evaluation of consumer disclosures.