The Failure and Promise of Mandated Consumer Mortgage Disclosures: Evidence from Qualitative Interviews and a Controlled Experiment with Mortgage Borrowers

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Policy responses to record rates of mortgage delinquency, default, and foreclosure will likely affect the cost and availability of consumer credit for decades to come. Although the current crisis began over two years ago, one consumer policy change that surely passes a cost-benefit test has yet to be adopted. Consumers still do not receive one clear disclosure document that conveys the key costs and risks of their mortgages. The results of this study, based on quantitative testing in a controlled, randomized experiment with more than 800 mortgage borrowers, and in-depth, qualitative interviews with several dozen additional borrowers, suggests that federally mandated consumer mortgage disclosures failed, resulting in many borrowers who did not understand the costs and risks of their loans, likely contributing to the mortgage crisis.

An overhaul of consumer mortgage disclosures, culminating in a single disclosure document, designed using a combination of qualitative and quantitative consumer research, could substantially improve consumer understanding of their mortgage choices.

The failure of mandated disclosures to convey mortgage terms to borrowers was not due to cognitive limitations or irrationality of consumers, nor to an irreducible complexity of new mortgage instruments, but to poorly designed disclosures. Disclosure documents failed to include key loan information, and the information disclosed was often confusing and sometimes misleading. Problems with mandated disclosures were evident across a range of consumers and loan types. Prime and subprime borrowers were similarly confused. Confusion resulted from “plain vanilla” 30-year, fixed-rate loans and more complicated interest-only balloon loans.

Although the mandated disclosures were ineffective, significantly better disclosures are clearly feasible. Prototype new disclosures developed for the study significantly increased consumer understanding of the costs and terms of mortgage loans. Regulations restricting the terms of mortgage loans or other financial products cannot be justified by the recent failure of disclosures to adequately protect mortgage borrowers. The failure was due to the ineffective design of the mandated disclosures, not inherent limitations of disclosure policy for consumer financial products.

I. Imperfect Information

The possible impact of imperfect information on buyer and seller actions and market equilibria has been recognized since George J. Stigler (1961). A number of models, such as Steven Salop and Joseph Stiglitz (1977), Salop (1977), Louis L. Wilde and Alan Schwartz (1979), and Xavier Gabaix and David Laibson (2006), have shown that when consumers differ in their knowledge, search costs, or ability to comparison shop, a multi-price market equilibrium can result in which less-informed consumers pay higher average prices than more-informed consumers. The presence of some informed consumers in the market does not necessarily lead to voluntary disclosure or a competitive equilibrium. Kathy Baylis and Jeffrey M. Perloff (2002) found empirical evidence of such pricing in online markets for digital cameras and scanners, with “good” firms charging lower prices and providing better service and “bad” firms charging higher prices and providing worse service. The mortgage market exhibits characteristics of these imperfect information models, including significant differences across

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consumers in their knowledge, sophistication, and ability to comparison shop, and the presence of significant price dispersion across consumers with similar credit risk, often based on the ability of loan originators to price discriminate between more- and less-informed consumers in one-on-one individual negotiations and pricing (Susan E. Woodward 2003).

II. Mandatory Disclosures

Mandatory disclosures, intended to help uninformed consumers become informed, have often been seen as a remedy for imperfect information problems that result in market failure and non-competitive equilibria (Wilde and Schwartz 1979; Schwartz and Wilde 1979; Howard Beales, Richard Craswell, and Steven Salop 1981a, 1981b; John Vickers 2004; Archon Fung, Mary Graham, and David Weil 2007; Clifford Winston 2008; Oliver Board 2009). Mandatory disclosures are ubiquitous, appearing in diverse applications such as food nutrition labels, appliance energy use labels, automobile fuel economy disclosures, direct-to-consumer prescription drug advertising disclosures, Internet privacy disclosures, and financial product cost disclosures. Although mandatory disclosures are widely used, designing an effective disclosure policy is not always simple and quite frequently difficult (Schwartz and Wilde 1979; Beales, Craswell, and Salop 1981a, 1981b; Vickers 2004; Fung, Graham, and Weil 2007; Winston 2008). In practice, whether a proposed or existing disclosure effectively conveys the intended information to consumers has been often overlooked and rarely tested empirically, despite a longstanding awareness of the potential difficulties in effectively communicating information (e.g., Beales, Craswell, and Salop 1981a, 491, 530-31, 535.) Mandatory disclosures often appear to be written in technical or legal language designed to close loopholes or impose legal obligations, rather than plain English. In addition, information is often a jumble of dense prose, without the use of graphic designs to help consumers quickly identify the most relevant information.

III. Consumer Mortgage Disclosures


Despite the importance of consumer mortgage choices and the longstanding policy of mandated disclosures intended to inform consumers, there has been little empirical examination of the effect of the disclosures on consumer understanding of mortgage costs, consumer mortgage shopping, or consumer mortgage choice. Prior to this study, there does not appear to be any other that directly examined consumer understanding of the mandated disclosures.

IV. Study Methodology

In this study we provide empirical evidence of how well consumers understand mandated mortgage disclosures and the terms of their own recently obtained loans, and whether better disclosures could improve consumer understanding. The study was conducted in two parts between September 2004 and December 2005: in-depth, qualitative interviews, and a quantitative, randomized, controlled experiment. In both parts of the study, approximately half of the participants had obtained their loans from

1 Brian Bucks and Karen Pence (2008) examined consumers’ knowledge of their loan terms by comparing the distribution of responses from a consumer survey to the distribution of loan terms in lender-reported data. Jinkook Lee and Jeanne M. Hogarth (1999) tested consumer understanding of the APR by asking consumers whether the interest rate of a mortgage loan would be higher, lower, or the same as the APR. Lacko and Pappalardo (2004) examined the impact of proposed mortgage broker compensation disclosures using a controlled experiment with 500 mortgage borrowers.

2 Additional details of the study are available in Lacko and Pappalardo (2007).
prime lenders and half from subprime lenders. The potential for improving consumer understanding of mortgage terms was tested using prototype disclosures developed for the study.

In the first part of the study, 36 in-depth, qualitative interviews were conducted with borrowers who had obtained a mortgage loan within the previous four months. Participants were asked to bring their mortgage documents to the interview, and most complied, usually bringing their loan note and mandated disclosure forms. The documents were used to assess the accuracy of borrowers' understanding of their own loan terms.

In the second part of the study, the effectiveness of mandated and prototype disclosures was quantitatively tested in a randomized, controlled experiment conducted in 12 locations across the country with 819 mortgage borrowers who had obtained a loan in the previous two and a half years. Subjects were given cost disclosure forms for two hypothetical mortgage loans and asked a series of questions about the costs and terms of the loans. Half of the subjects were given the mandated disclosures and half were given the prototype disclosures developed for the study. The mandated disclosures tested consisted of the TILA statement and GFE that were required in the period leading up to and during the recent mortgage market crisis.

The tests were conducted with two different loan-cost scenarios, simple and complex, with the latter including more complicated features such as interest-only monthly payments, lack of escrow for taxes and insurance, a large balloon payment, optional add-on credit insurance, and prepayment penalties. The three sample variations of borrower type, loan scenario, and disclosure form resulted in eight cells of approximately 100 subjects each, with subjects randomly assigned across the latter two categories. The results from approximately two dozen questions were used to assess the ability of participants to understand and use the disclosures.

The design of the prototype form was guided by a general financial analysis of the key costs of a mortgage, the types of consumer problems observed in FTC cases involving the deceptive marketing of mortgage loans, principles of effective communication, and insights gained from the consumer interviews. The prototype disclosures were developed for fixed-rate loans, including those with interest-only and balloon payments, in order to test first whether better disclosures could be designed for these relatively simple loan products before extending the design to adjustable rate and other more complicated loans.

The testing of both mandated and prototype disclosures allowed each to serve as a control for the other. Without the prototype results, one would not know whether any poor performance of the mandated disclosures reflected ineffective design or limits of consumer comprehension. Without the mandated disclosure results, one would not know whether the prototype disclosures offered significant improvement over the status quo.

V. Findings

The qualitative interviews revealed that many borrowers, both prime and subprime, misunderstood and were confused by the mandated disclosures. Some of the mandated disclosures actually misled borrowers. Many borrowers believed, for example, that the “amount financed” disclosed on the TILA statement was their total loan amount, even though the figure is calculated by subtracting finance charges from the loan amount. A number of borrowers also mistakenly believed that the “discount fee” disclosed on the GFE was a discount they had received rather than a fee they had paid. Many borrowers also did not understand key terms of their own recently obtained loans. Many had loans that were significantly more costly than they had believed, or that contained significant restrictions, such as prepayment penalties, of which they were unaware. Many borrowers did not learn of these costs and terms until or after their loan settlement, and some appeared to learn for the first time during the interview.

The results of the controlled experiment confirmed and quantified the shortcomings of the
mandated disclosures. Nearly a quarter of the subjects viewing the current disclosures could not correctly identify the amount of settlement charges, about a third could not identify the interest rate, a third did not recognize that the loan included a large balloon payment, a third did not recognize 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 have to pay a prepayment penalty if they refinanced, three-quarters did not recognize that a substantial charge for optional add-on credit insurance was included in the costs, and nearly nine-tenths could not identify the total amount of up-front charges.

The results of the experiment also demonstrated that the disclosures can be significantly improved. Participants viewing the prototype disclosures answered an average of 80 percent of the loan term questions correctly, compared to an average of 61 percent for participants viewing the mandated disclosures, an improvement of 19 percentage points. Eighty percent of those viewing the prototype disclosures were able to answer at least 70 percent of the questions correctly, compared to 29 percent of those viewing the mandated disclosures, an improvement of 51 percentage points. Both of these differences were significant at more than the 1 percent level.

Improvements were evident across a wide range of loan terms. The prototype form produced a 66 percentage point increase in the proportion of participants correctly identifying the total up-front charges in the loan, a 43 percentage point increase in the proportion recognizing that the loan contained charges for optional add-on credit insurance, a 37 percentage point increase in the proportion correctly identifying the amount borrowed, a 24 percentage point increase in the proportion recognizing that a prepayment penalty would be assessed if the loan was refinanced, a 15 percentage point increase in the proportion correctly identifying the amount of settlement charges, and a 12 percentage point increase in the proportion correctly identifying the interest rate. All of these differences were significant at more than the 1 percent level. Figure 1 illustrates the relative performance of the current and prototype disclosures.

VI. Discussion

The failure of mandated consumer mortgage disclosures to convey effectively key loan terms likely contributed to recent problems in the mortgage market. The disclosures failed to convey key loan terms to many borrowers, even in the experimental setting of the study, and even
for simple 30-year, fixed-rate loans. Borrowers with more complicated loans, in real-life transactions, subjected to time pressure and distractions and possible deception and concealment by loan originators, are likely to have fared even worse. The experiences related by many borrowers in the qualitative interviews, and their poor understanding of recently obtained loans, appear to confirm this.

Recent problems in the mortgage market, however, cannot be used to conclude that disclosure policy is inadequate to protect consumers. The performance of the prototype disclosures demonstrated that disclosure policy could have provided significantly better protection to borrowers. The poor performance of the current disclosures was not due to cognitive limitations of consumers or inexplicably complex new loan terms, but to the ineffective design and presentation of the mandated disclosures.

The prototype disclosures tested in the study were not completely successful in conveying key loan terms to all consumers. The prototype was merely the first attempt by two economists to develop more effective disclosures. Continued development, validated by quantitative, controlled consumer testing, would likely yield greater improvements, as well as extend the disclosures to adjustable-rate loans.

Since this study was conducted and released as an FTC report, there have been renewed efforts to improve the mandated disclosures. Substantially revised GFE disclosures have been required by the Department of Housing and Urban Development (HUD), effective the beginning of 2010, and the Board of Governors of the Federal Reserve (Fed) has proposed substantially revised TILA statement disclosures. These efforts, however, will still result in consumers receiving two different disclosure forms, written by two different agencies, with duplicative and sometimes contradictory information. Borrowers would be best served by a single, consolidated disclosure of key loan terms presented in a simple and easy-to-understand manner.

REFERENCES


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