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*

***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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[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), 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. 12 U.S.C. § 2601 , .

[3] 15 U.S.C. § 1601 , .

[4] . § 1639.

[5] . § 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. *C* . . ., , .,

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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.

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[11] , . ., 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.

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[13] The proposed rule makes corresponding amendments to the HUD-1A form, an optional form for transactions without sellers (. ., refinancings, subordinate-lien federally related mortgages). 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.

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

[15] 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 . . . ." 73 Fed. Reg. at 14,056 (proposed Section 3500.2(b)); . at 14,057 (proposed Section 3500.7).

[16] 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. 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. text accompanying notes 20-25, .

[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. . 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

discussed in the text accompanying notes 20-25, , the originator may have insufficient information stemming from the limited GFE application. It could potentially reject borrowers for loans in which they

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 not 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 15.8dsc8a4ic.4(1ult)]TJT*fn7 the borrowshoppi110.byelh it su11lt (lic)12.5(o)-8(qu5(l5(n)-.5 a)]TJT*0 Tc0 Twbecal thde the b9)10(rowe)9e ls up [(shoppi130.b)9(y)3 inp

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[22] . at 14,035.

[23] .

[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.

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

[27] Consumer testing of the forms is addressed 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. 73 Fed. Reg. 1672 (Jan. 9, 2008). The FTC staff submitted a comment on the proposal.

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.

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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. 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. 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] 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. 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. 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), http://www.hud.gov/offices/hsg/sfh/res/sfhrestc.cfm.

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

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

[33] . at 14,037.

[34] . at 14,058 (proposed Section 3500.7(f)(3)).

[35] . at 14,040 (emphasis added).

[36] . at 14,037 and 14,057 (discussing extended shopping period and related disclosures in proposed Section 3500.7(c)); . 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

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] 73 Fed. Reg. at 14,049, 14,063 (proposed App. A).

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

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

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

consider providing a clear explanation of these differences in the Closing Script, or using an

[43] The mortgage market today involves diverse products. Scores, if not hundreds, of such products may exist in the marketplace. *A* *D* *B* *C* *B* *A* , 110th Cong. 7 (Statement of Douglas G. Duncan, Ph.D., Chief Economist and Senior Vice President of Research and Business Development, Mortgage Bankers Assoc.), 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 (. ., 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] . at 14,063 (proposed App. A), 14,096 (proposed App. C).

[47] . at 14,049.

[48] . at 14,058 (proposed Section 3500.8(d)).

[49] .

[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. *C* . , *C* ., 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. . (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 (. ., 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] 73 Fed. Reg. at 14,058.

[53] . 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 orignotdd8(r)10.4(abl(ilable, the loan or)9(ignotddUs)9(igno2

[54] . 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] . 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. . at 14,057 (proposed Section 3500.7(e)(4)). Loan originators must also retain documentation of such unforeseeable circumstances. . (proposed Section 3500.7(e)(5)).

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

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

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

[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." 73 Fed. Reg. at 14,047.

[62] 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] 73 Fed. Reg. at 14,045-46.

[64] . 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),

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. btualoff seted in the

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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. . 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.

[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. KLEIMANN C

[71] FANNIE MAE, UNDERSTANDING AMERICA'S HOMEOWNERSHIP GAPS, 2003 FANNIE MAE NATIONAL HOUSING SURVEY 7 (2004),

[73] Complaint, *A*, . *C* . *A*, , No. C.3297, 113 F.T.C. 698 (July 26, 1990); Complaint, *A*, , , , *A* ., No. C-3406, 115 F.T.C. 993 (Dec. 16, 1992); Complaint, *A* , , No. C-3416, 1993 FTC LEXIS

> 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), 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.

[82] .

[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. DENNIS W. CARLTON & JEFFREY M. PERLOFF, M

[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. D. O'Brien & G. Shaffer, *E , D , , D , : A , A - , , 10* J.L. ECON. & ORG. 296-318 (1994); Kenneth S. Corts, *-D , D , , :* *A - C , , C , , ,* , 29 RAND J. ECON

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

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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."

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[88] .

[89] 12 U.S.C. § 2607(a).

[90] 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

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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 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." . 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 *C* , , 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. *A* , ., , . 328 F.3d at 1159 (citing *E* , , 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] .

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

[98] 24 C.F.R. § 3500.15(b)(1) and App. D.

[99] HUD, Round 6 Test Report, 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] FTC Staff Mortgage Disclosure Study, note 7.

[101] FTC Comment on Home Equity Lending Market, note 10.

other markets. The FTC has advocated this type of research for the evaluation of information.g.,

[102] , . ., FTC Staff Mortgage Broker Compensation Study, 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. FTC, Appliance Labeling Rule; Proposed Rule (16 C.F.R. pt. 305), 72 Fed. Reg. 6836, 6838-39 (proposed Feb. 13, 2007), 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), http://www.ftc.gov/os/2007/01/R511994EnergyLabelingEffectivenessFRNConsResBkgrdInfo.pdf.

[103] , . ., FTC Staff Comment on RESPA (2002), 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), 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), 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. FTC Staff Mortgage Disclosure Study, 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

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[105] FTC Staff Mortgage Broker Compensation Study, 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, 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

[108] . 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

[109] 73 Fed. Reg. at 14,046; HUD, Rounds 4 & 5 Results, note 64.

[110] 73 Fed. Reg. at 14,046.

[111] . at 14,046; HUD, Rounds 4 & 5 Results, note 64, at vii and V-7.

[112] 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

[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.

[115] 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 H

[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

- 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

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,