The Effect of Mortgage Broker Compensation Disclosures on Consumers and Competition: A Controlled Experiment

Executive Summary

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This study of over 500 recent mortgage customers in an experimental setting finds that the mortgage broker compensation disclosure proposed by the Department of Housing and Urban Development (HUD) is likely to confuse consumers, cause a significant proportion to choose loans that are more expensive than the available alternatives, and create a substantial consumer bias against broker loans, even when the broker loans cost the same or less than direct lender loans. Similar adverse effects were found for two alternative versions of the disclosure.

If consumers notice and read the compensation disclosure, the resulting consumer confusion and mistaken loan choices will lead a significant proportion of borrowers to pay more for their loans than they would otherwise. The bias against mortgage brokers will put brokers at a competitive disadvantage relative to direct lenders and possibly lead to less competition and higher costs for all mortgage customers.

Other components of HUD's RESPA reform proposal are far more beneficial. These policies focus on clearer disclosure of mortgage costs, a clarification of the role of mortgage originators, and the encouragement and facilitation of borrower comparison shopping across originators. Implementation of these policies, along with appropriate refinements to ensure that consumers easily understand the disclosures, would provide benefits to consumers without the adverse effects that are likely to arise from the compensation disclosure.

Background

HUD proposed broker compensation disclosures as part of its July 2002 RESPA reform proposal (HUD 2002a, 49134). Mortgage brokers would be required to disclose, in the Good Faith Estimate (GFE) provided to borrowers, any compensation received from the lender in connection with the origination of the loan. A major part of the compensation is any yield spread premium (YSP) paid by the lender for a loan originated at an above-par interest rate. The YSP reflects the additional value to the lender of a loan originated at the higher interest rate. The proposed disclosure was motivated by a concern that brokers were placing borrowers in above-par loans without their knowledge, and keeping the YSPs rather than passing them through to consumers in the form of reduced settlement costs. Direct lenders would not be required to make the same disclosure, even though they may be charging the same interest rate and settlement costs and earning the same compensation as a broker.

FTC staff submitted a public comment that generally supported the RESPA reform proposal, including efforts to make the GFE more understandable and easier to use, increase the certainty of settlement cost estimates, and allow the packaging of settlement services (FTC 2002). FTC staff raised concerns, however, that the compensation disclosure could confuse borrowers, draw attention toward broker compensation rather than the cost of the loan, and lead to worse rather than better mortgage choices. FTC staff also noted that the asymmetry of the disclosure policy—which would require the disclosure for brokers but not direct lenders—could put brokers at a disadvantage, harm competition, and result in higher mortgage costs for all borrowers.

Methodology

The staff of the FTC's Bureau of Economics conducted a study to assess the effect of compensation disclosures on consumer understanding of loan costs and consumer choice of loans. The study examined the effect of the disclosures within a controlled experiment. Approximately 500 recent mortgage customers were shown cost information about two hypothetical mortgage loans and asked a series of questions.

Respondents were randomly assigned to one of five "disclosure groups." Each group consisted of either 103 or 104 respondents. A YSP disclosure was included in the cost information shown to three of the groups (YSP disclosure groups) but excluded from the information shown to the two other groups (control groups). Comparison of the results in the YSP disclosure groups and the control groups provides an estimate of the effect of the disclosure.

Three versions of the YSP disclosure were tested: one based on the disclosure published by HUD as part of its RESPA reform proposal in July 2002 (the "original HUD proposal"), one prepared after discussions with HUD staff in January 2003 concerning YSP disclosures (the "revised prototype"), and one that used the revised prototype format but with alternative YSP disclosure language drafted by FTC staff ("FTC YSP language"). The same control group was used for the latter two disclosures because the test forms for the two groups were identical with the exception of the differences in the YSP disclosure language.

The test disclosure form used for the original HUD proposal version was based on the form in the HUD proposal but was not a complete replica. The test form replicated the YSP, origination cost, and total settlement cost disclosures, as well as the overall style and format of the HUD form, but abstracted from some of the unrelated detail and settlement cost itemization. Similarly, the test forms for the revised prototype and FTC versions abstracted from some of the detail that would be included in a full GFE form.

The use of abstracted forms increased the likelihood that respondents would see and read the YSP disclosure. If more detailed, full GFEs were used, some respondents may not have read all of the information in the form, including the YSP disclosure. This would have made it more difficult to identify the effect of the disclosure. Thus, the study results should be interpreted as an estimate of the effect of YSP disclosures on consumers who notice and read the disclosure.

Two questions were at the core of the test. In one, respondents were asked to identify which of the two loans would cost them less and, in the other, respondents were asked which loan they would choose if they were shopping for a mortgage. The questions were asked twice, each with a different loan cost scenario.

In presenting the cost information, one of the loans was considered to be a "broker" loan and the other a "direct lender" loan, although the loans were not identified as such to respondents. For disclosure groups in which the cost information included a YSP disclosure, a YSP was disclosed for the broker loan but not the direct lender loan, following the asymmetric disclosure policy in HUD's proposed rule. The tests were conducted twice with each respondent—once with the broker loan less expensive than the lender loan and once with both loans costing the same. The order of the two tests was rotated across respondents, as was the order of the loans in each test, to counterbalance any order effects.

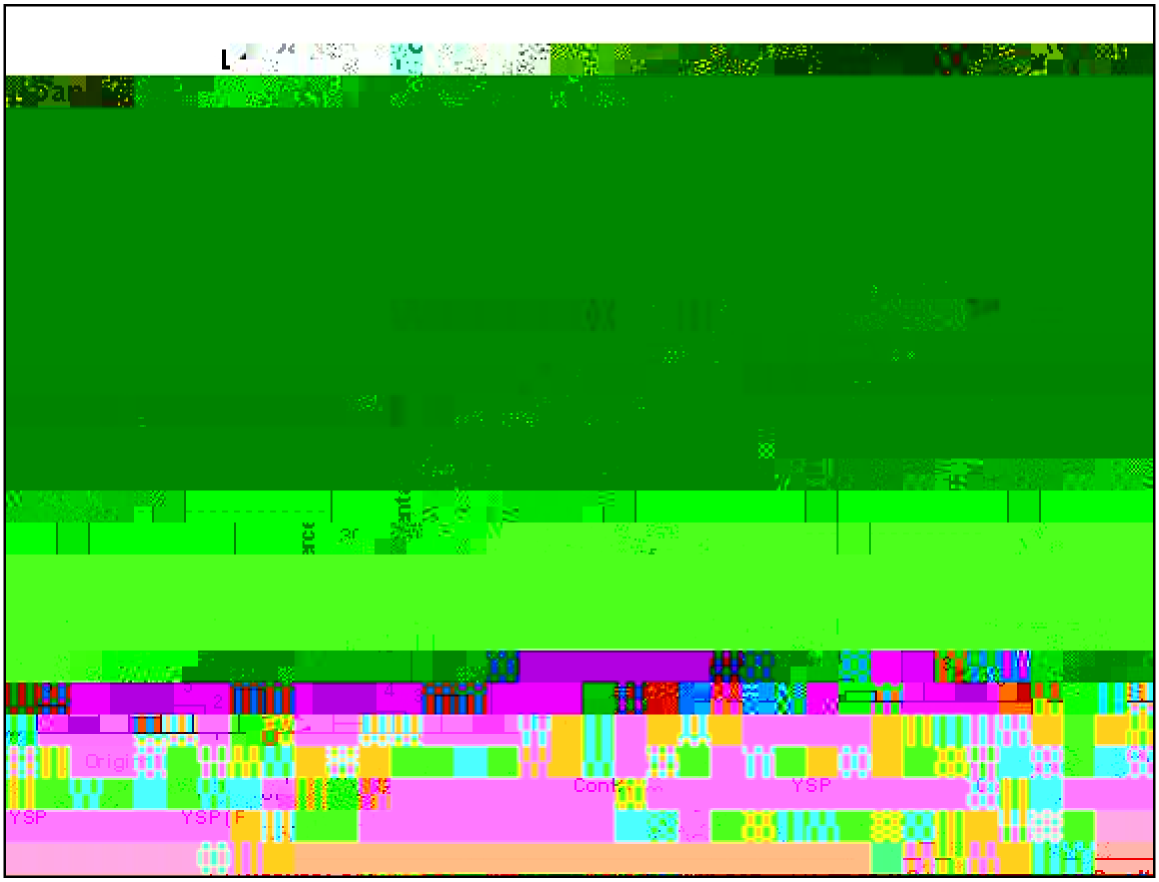
Results

The compensation disclosures had a significant adverse impact on the respondents' perception of loan costs and on respondents' choice of loans. The disclosures caused a significant proportion of respondents to choose more expensive loans by mistake and caused a substantial bias against broker loans even when the broker loans cost the same or less than direct lender loans.

Tests with the broker loan less expensive than the direct lender loan

- *Cost comparison*. All three versions of the compensation disclosure caused a statistically significant decrease in the proportion of respondents correctly identifying the less expensive loan when one loan cost less than the other.
    - Approximately 90 percent of the respondents in the two control groups correctly identified the less expensive loan.
    - In contrast, only 71 percent (original HUD proposal), 72 percent (revised prototype), and 63 percent (FTC language version) of the respondents in the three YSP disclosure groups correctly identified the less expensive loan. This represented decreases of 19 to 28 percentage points compared to the corresponding control groups, and an average decrease of 21.6 percentage points across the three groups. The differences between the three YSP disclosure groups were not statistically significant.
- *Loan choice*. All three versions of the compensation disclosure also caused a statistically significant decrease in the proportion of respondents choosing the less expensive loan when asked which loan they would choose if they were shopping for a mortgage. These results are illustrated in Figure ES.1.

Figure ES.1



- ○ 85 and 94 percent of the respondents in the two control groups chose the loan that was less expensive. Zero and 3 percent of the respondents choose the loan that was more expensive. The difference between the original HUD proposal and revised prototype control groups in the percentage of respondents choosing the less expensive loan (94 versus 85 percent, respectively) was statistically significant.

- ○ In contrast, only 65 percent (original HUD proposal), 70 percent (revised prototype), and 60 percent (FTC language version) of the respondents in

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choosing direct lender and broker loans was highest in the original proposal group (52 percentage points) and lowest, although still substantia components of HUD's RESPA reform proposal. Implementation of these policies, along with appropriate refinements to ensure that the disclosures are easily understood by consumers, would provide benefits to consumers without the adverse effects that are likely to arise from the compensation disclosure.

The study findings also illustrate the importance of consumer research in the development of information policy for consumer markets. Seemingly useful disclosures designed with good intent can produce unintended consequences that are counterproductive to the desired policy goals. Consumer research can help policymakers assess the effect that proposed disclosures are likely to have on consumers and competition.

HUD's RESPA reform proposal pursues the important goals of increasing competition and lowering costs to consumers in the mortgage loan market. Many of the components of the proposal promote these ends and are likely to benefit consumers, particularly the removal of restraints on packaging and improving the understandability of the GFE. This study finds, however, that broker compensation disclosures are likely to act against these goals and result in more confusion, less competition, and higher costs for consumers.